BANKS AND THE STATE IN GERMANY:

THE CRITICAL ROLE OF SUBNATIONAL INSTITUTIONS IN ECONOMIC GOVERNANCE.

by

RICHARD EDWARD DEEG

Submitted to the Department of Political Science in Partial Fulfillment of the Requirements for the Degree of

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ABSTRACT

It is argued in this dissertation that the capacity of the German banks to influence the decisions of non-financial firms and coordinate the activities of industry is significantly more circumscribed than is widely assumed in the comparative political economy literature. The weakening influence of the banks over industry is the result of several factors: The growing competition since the late 1960s between commercial, cooperative and public savings banks; the growing financial independence of large non-financial firms; the increasing importance of small and medium-sized firms as a customer group for the banks which has favored savings and cooperative banks as sources of industrial finance; and the growth of state economic intervention, especially by the federal states. The institutional role of the banking system in the German political economy is increasingly better characterized as one of information mediation. In this role banks supply firms, especially small and medium-sized firms, with an ever-wider range of non-financial information and services. The banks and the state must be understood as increasingly complimentary, not alternative, institutions for industrial policymaking.

The dissertation consists of two parts. The first part presents a historical overview of the emergence and preservation of a three-sector banking system. It is argued that the state played a crucial role in promoting the competitiveness of local and regional savings and cooperative banks partly in order to limit the economic power of the large commercial banks. Strong competition among the three banking groups inhibits bank influence over industry and fosters the growth of their information mediation role. The second part of the dissertation presents case studies that illustrate the changing role of the banks in the economy and the growing importance of subnational institutions, including governments, in promoting the economic adaptation of small- and medium-sized firms. Studies of North Rhine-Westphalia and Baden-Württemberg are presented, as well as two local case studies of Solingen and Heilbronn.

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CHAPTER ONE:

Banks, the State, and Economic Governance.

A. Introduction.

In 1989 the Daimler-Benz corporation, known worldwide for its production of Mercedes-Benz automobiles, acquired a substantial share in the ailing German armaments firm Messerschmidt-Bölkow-Blohm (MBB). It was a widely followed and passionately debated merger in the Federal Republic, for with this move Daimler became the nation's largest industrial concern with nearly 400,000 employees. Perhaps more importantly, the MBB takeover capped a string of acquisitions that also made Daimler the largest German aerospace and armaments producer and one of the largest in Europe. Guiding Daimler along its strategic expansion path - many would say orchestrating it - was Germany's largest bank. With just over 28% of Daimler's stock, the Deutsche Bank is its largest single shareholder.¹ The Federal Government, desperate to rationalize the troubled German aerospace industry and end massive subsidies to the European Airbus consortium via MBB, overrode the veto

¹ By German law a holding over 25% gives the shareholder(s) a 'blocking minority'. In practice this means that the shareholder can veto any major firm decision which does not meet its approval. Thus in the case of Daimler it means all major decisions - including acquisitions of other firms - must be made in consensus with the Deutsche Bank. Attaining such consensus is facilitated by the presence of three Deutsche Bank representatives on Daimler's supervisory board. The chair of Daimler's supervisory board until his death in December of 1989 was Alfred Herrhausen, who also just happened to be the head of the Deutsche Bank and a friend and economic advisor to Chancellor Kohl. The head of Daimler, Edzard Reuter, was "selected" by Herrhausen in 1987. According to public accounts Herrhausen himself was actively involved in engineering the Daimler-MBB merger. See Karl-Heinz Büchemann and Klaus-Peter Schmid. "Unter schlechem Stern," Die Zeit, 18 November 1988; and "Herrhausen und Reuter beraten über Fusion Daimler/MBB," Frankfurter Allgemeine Zeitung, 28 October 1989.
of the Federal Cartel Office and ignored intense public skepticism to enable the merger to proceed.

On the surface this brief story seems to tell a classic example of West German capitalism, namely, that large firms under the tutelage of the major commercial banks dominate and determine the course of West German industrial development. It also indicates that the state confers substantial authority for the formation and implementation of national industrial policy to the private sector. Accordingly, traditional scholarship on West Germany has long focused on the role of central actors - the large firms, major banks, and centralized trade, business, and labor associations - in "organizing" the economy. Standard accounts depict the big commercial banks as the linchpin of this 'organized capitalism.' It is a widely held view that the exercise of "industrial policy" by the banks largely alleviates the state of this critical economic function. This system was long hailed for its ability to successfully adapt industry to economic changes through a process governed by the negotiated agreements of large private sector organizations.

But over the past two decades the pattern of economic adjustment in West Germany has become harder and harder to explain using this model alone. On the surface, the Germany of today seems much the same as the West Germany of the 1970s despite the tremendous structural economic changes occurring in the intervening years. Formally, the major institutions of the polity and economy are largely the same. But in fact, centralized economic institutions and processes of industrial change have yielded much ground to decentralized institutions and processes.

The upheavals of the 1970s and 1980s generated some peculiar paradoxes: First, the federal government sought to reduce its intervention while the governments of the West German federal states - the Länder - were eagerly expanding theirs. Second, where many
large firms were scaling back and decentralizing production, smaller firms picked up the slack, expanding their exports and employment. Third, smaller, non-commercial banks took a significant share of the market for industrial finance away from the major commercial banks. Most importantly, these three paradoxical trends are closely interrelated - the growing and dynamic role of subnational governments, smaller banks, and smaller firms in the economy are mutually reinforcing processes. The basic goal of this thesis is to unravel these three paradoxes and explain how the expanding economic roles of subnational governments, regional and local banks, and small- and medium-sized firms (the *Mittelstand*) are interrelated.

In short, since the late 1970s West Germany is increasingly characterized by a more decentralized pattern of economic adjustment. The new prominence of decentralized actors is so strong that Peter Katzenstein claims the "era of centralized private industrial policy" to be over. While this does not mean that the large banks or federal government will never be involved in sectoral crises, it does mean "...the threshold for *centralized* public or private crisis management has risen substantially."² The task of managing economic crisis, and economic adaptation in general, is falling increasingly to non-central, or subnational, political and economic actors and institutions.

Thus when viewed against these broader changes, the Daimler-MBB merger stands out as an increasingly isolated case of bank-dominated organized capitalism. Moreover, if one scratches away the patina of this case, even here the critical role of subnational actors in the German economy are revealed: First, the controlling share of MBB was held by several Länder governments and Länder-owned banks that played a critical role in the

shaping the final outcome of the merger. Together they retained enough shares in MBB to ensure that it continued to serve their political goals. Second, Daimler-Benz faced widespread admonition from smaller firms within its vast supplier network and was forced to expend considerable public relations efforts to assuage their fears of excessive concentration. ¹ Finally, more than five years after starting its diversification strategy - a strategy very controversial among the firm’s top leadership - Daimler-Benz’s acquisitions continue to produce losses. Changed domestic and international conditions may have rendered obsolete a strategy based primarily on concentration and scale economies. Far more successful has been Daimler’s strategy of internally decentralizing production. The medium-term failure of Daimler’s diversification strategy also helped prompt the Deutsche Bank to rethink its approach and readiness for industrial intervention.

The primary contention of this thesis is that the standard view of the German political economy requires significant revision. The main subject of this thesis is the German banking system because it is ascribed a central position in the political economy by scholars, yet has received little careful scrutiny in recent years that would reveal pivotal changes within the banking sector and thus its broader economic role. I argue that the actual influence of the banks over industry is less extensive than generally assumed. Direct control of firms by the banks was, and still is, largely limited to certain sectors and certain regions. Other sectors and regions are characterized by greater firm autonomy and/or alternative (non-hierarchical)
bank-industry relations. Several institutional changes, including increased competition in the banking industry, are working to further reduce bank influence in firms.

Moreover, the spread of post-Fordist production principles since the late 1970s increasingly favors production in smaller economic units where non-hierarchical relations between banks and firms predominate. This, in turn, has favored those banks which can best capture the advantages of organizational flexibility and decentralization, and thus helps explain the postwar success of the non-commercial banks in expanding their share of industrial finance markets. The traditional 'tutelary' role of the banks vis-à-vis non-financial firms - understood as direct bank influence in the decision-making processes of other firms - is declining relative to what I call the 'mediator' role. In this role the banks' primary function is to provide not only capital but increasingly information resources to firms, not to play a dominant role in firm decision-making.

I will also argue that the state - especially at subnational levels - has carved out for itself a greater role in the management of the economy. Banks and the state are more than ever complimentary, rather than alternative, institutions for governing the economy. The growing interdependence between state and bank industrial policies is most evident - though not limited to - in the growing utilization of state-owned banks for economic intervention. The German banking sector itself has been extensively reshaped by the state in accordance with the state's industrial policy goals. This, in turn, has important ramifications for the changing nature of bank-industry relations, including the encouragement of the shift from bank tutelage to mediation.

In sum, the growing economic intervention of subnational governments, the expanding market share of small and medium-sized financial institutions, and the unexpected resilience of regional economics and sectors where smaller firms are dominant, all defy the logic of the
hegemonic view of the German economy, as well as the popular notion that global economic integration can only be successfully countered through political and economic centralization. The first step toward unravelling these paradoxes is a reexamination of the organized capitalism model.

B. The ‘Organized Capitalism’ Paradigm.

The roots of the organized capitalism paradigm reach back to the very beginning of this century when scholars chronicled and sought to explain the rapid industrial expansion of the German economy. From unification in 1870 to the eve of World War I in 1914, the exploding economic might of Germany propelled it into a new, powerful position among the European states. In contrast to other European nations, Britain in particular, the hallmark of German industrialization was the degree of economic concentration in large industrial concerns and large banks. The apparent dominance of large firms was increased by their growing linkages to each other within cartels, which in turn were linked to the banks.

For the Austro-Marxist theorist Rudolf Hilferding this concentration of capital in large firms and the growing interlock between bank capital and industrial capital was an essential stage in the process of capitalist development. While Hilferding applied his theory to all states, Germany and Austria represented the supreme examples of the high degree of bank capital invested in industry - what he called 'finance capital'. His functionalist argument begins with the emergence of joint-stock corporations. The resulting possibility to profit

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from share trading stimulated the centralization of capital and the growth of large corporations. The banks invested capital in industrial corporations and a mutually-reinforcing process of industrial and financial concentration sets in, resulting in the formation of cartels closely associated with the banks. Because of their heavy investment in industry the banks themselves became industrial capitalists. Even more importantly, the dependence of firms on the banks for capital enabled the banks to assume a hierarchically dominant position vis-à-vis firms. The pervasive market presence and power of the cartels and banks introduced planning and overall control into an otherwise anarchic market, eventually yielding a system of ‘organized capitalism.’

Probably the most widely accepted non-Marxist theory of German industrialization and bank dominance is that of Alexander Gerschenkron. Briefly and simply stated, Gerschenkron argued that Germany, like other late industrializing countries, had to industrialize on a large scale in order to overcome its "backwardness." Industrialization had to be large both in terms of the average size of an investment and in terms of the number of sectors which must simultaneously begin to industrialize. The German solution to this need to mobilize large sums of capital for investment at a time when there was a general shortage was the ‘universal bank’: a bank able to both extend credits to firms and own shares in them.

Like Hilferding, Gerschenkron attributed a "tutelary" role to the German banks vis-à-vis industrial firms. The heavy credit dependence of firms on the banks enabled the banks

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to dominant and often dictate the most important decisions of the firms. The banks used this control to organize industry into cartels in order to limit competition among firms in the industry and thereby raise bank profits. Thus both scholars shared the same basic argument - credit dependence led to bank dominance, which in turn led to greater concentration. The key difference between the two was that Gerschenkron saw the credit dependence of industry as the result of Germany's relative economic backwardness, whereas Hilferding saw it as rooted in the logic of capitalist development in general, and the dynamics of profit-seeking behavior in particular. Gerschenkron also acknowledged the eventual "emancipation" of the large firms from the tutelage or domination of the banks, though in his view the banks retained considerable, though not clearly specified, power in industry.

Both Hilferding and Gerschenkron were challenged by their contemporaries as well as more recent observers for their assertion of bank dominance over industry during nineteenth century industrialization. Riesser and Jeidels acknowledged the economic strength of the big Berlin banks and their close relations to firms, but argued against any treatise of bank 'dominance' over industry.\(^7\) Jeidels and Whale also argued against Hilferding's contention that competition among the banks was largely eliminated. They maintained that strong competition among the banks in the pre-WWI era limited bank influence.\(^8\) More recently, Jürgen Kocka and others argued against the notion of bank


dominance over industry before 1900. In general, these historians argue that the power balance between banks and large firms varied considerably, even in heavy industry where bank power was supposedly strongest. In numerous cases large, financially strong industrial firms could dictate the terms of financial investment to the banks. Though Kocka also acknowledged that the banks had a central role in the financing of industry and often had considerable "influence" over firms they financed.

Gerschenkron himself was challenged more directly for his assertion of a general capital shortage in mid-nineteenth century Germany. His late industrialization thesis, which implied that the banks came to such preeminence because they represented an efficient solution to the problem of development, has also been criticized. Critics charge that the preference of the banks for investment in heavy industry disadvantaged other sectors, thereby preventing an optimal allocation of resources in the economy and thereby kept the German economy from reaching its growth potential.

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In spite of this large list of critical studies, the basic analyses and theoretical concepts of Hilferding and Gerschenkron remain the corner-stones for subsequent writing on Germany. Virtually all contemporary writers, for example, are indebted to Hilferding’s evaluation of firm supervisory boards and interlocking directorates between banks and firms as the critical institutional bases of bank influence. More importantly, it has become the widely accepted historiography that the banks and the capital they mobilized greatly facilitated the large-scale industrialization Germany needed. The increasing amalgamation of the large German banks at the turn of the century gave them considerable influence, if not dominance, over industry. Whether one argued that the banks were responsible for increasing concentration in industry, or the converse, the outcome was the same: Germany was characterized by a high degree of economic concentration and a high degree of interlock between bank and industrial capital. In this ‘finance capitalism’ the coordinated actions of the large firms and banks dictated the path of industrial-ization in Germany. The Imperial German state is generally viewed as an important facilitator of industrialization through its benevolent attitude and policies toward industrial concentration, as well as through provision of the necessary economic and social infrastructure.\(^\text{13}\)

While there is now little debate that most of the large industrial concerns of Germany eventually achieved a significant degree of autonomy from the banks, nearly all scholars writing on the postwar German political economy continue to argue in support of, or simply assume, substantial bank influence over industry. And while the dominant position of the banks in organizing the economy has eroded, nearly all observers explicitly or implicitly continue to give banks the top rung in the hierarchy of private corporate power. In the post-WWII period one of the standard interpretations of the West German economic model, and the one on which so many studies in the Anglo-American social science literature have been based, is that of Andrew Shonfield.\(^{14}\)

Shonfield adopts the central tenets of the finance and organized capitalism model in arguing that key industrial adjustments in West Germany occur most importantly not via market mechanisms, but via negotiated or bargained agreements among private economic actors. Thus cartel-like arrangements in industry are often an integral part of sectoral "rationalization" programs. The political counterparts of the cartels are centralized, hierarchically ordered trade associations with semi-public status. The associations act as intermediaries in negotiations and bargaining between firms, as well as between government and industry. The final and critical linchpin of this institutional framework for "private collective economic management" is the banking system. While the major commercial banks no longer have quite the power over industry which they once did, their large holdings in industry still place them in a unique position to participate in, if not direct, the negotiated changes of industry. For Shonfield, it is the combination of these four elements - the high degree of economic concentration, cartel-like arrangements, the trade associations, and a

tutelary banking system - which continued to make the West German political economy distinct from others. Although more than twenty-five years old, Shonfield’s work remains one of the standard interpretations of the postwar German political economy.

In the course of the postwar years, the trade unions were gradually included into economic decision-making and industry negotiations via co-determination rights in firms and through national tripartite consultations in the 1970s. But this did not alter the basic tenets of organized capitalism. German labor unions generally pursued goals beyond individual worker benefits to include macroeconomic stability and continued industrial competitiveness through firm and sectoral rationalization programs. Thus rather than continually challenge the authority of business leaders to organize the economy, the unions participate as subordinates in the endeavor.\(^\text{15}\)

As in other European industrial economies, centralized economic intervention reached its peak in the 1970s in West Germany following the establishment of Keynesian and neocorporatist practices. But unlike many other states, the West Germans generally avoided direct government intervention in favor of providing investment incentives to industry. Even in times of tremendous sectoral crisis the West German state presumably plays a subsidiary role to the private sector, supporting the sectoral rationalization plans worked out by private industry and the major commercial banks.\(^\text{16}\) It consults with, and occasionally pressures


these private sector institutions in the settlement of their affairs, but intervenes directly only on an irregular basis. Government’s role is therefore generally considered "arms-length" or market-conforming. As Dyson argues, "...compared with Britain, [the West German] government is better insulated by a de-politicized system of self-organization of capital from the difficult process of managing industrial crises...".¹⁷

Dyson probably best states the widely hypothesized consequences of this "large role for the banks in industry and the emergence of an industrial-banking oligarchy." First, the banks provide an ‘early warning’ system to identify weaknesses in industry and occasionally mount rescue operations. Second, the strong banks assure industry ready access to funds. Third, the banks exert financial discipline in industry. Fourth, the banks as initiators or organizers of industrial activity help screen industrial policy from the general arena of politics. Fifth, the detailed long-term and inter- and intrasectoral studies done by the banks indicates their readiness to assume a long-term perspective regarding the firms in which they invest. The banks therefore focus on securing market share and improving the long-term cost structure of firms through the mobilization of financial, technical, and managerial resources. And sixth, the banks influence corporate policies through their ability to influence the appointment of top personnel.¹⁸ To this Bayliss and Philip add that banks pool information

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about firms in each sector and supplement this with their own research to provide their firm clients with useful, specialized information.\textsuperscript{19}

In sum, the essential principles of the German system of organized capitalism as outlined first by Hilferding, and later by Shonfield, are widely seen as still intact.\textsuperscript{20} But in a piecemeal fashion, the scholarly work supporting the basic organized capitalism model has been increasingly undermined in the last few years. Several scholars have begun to argue that the institutional basis for economic control by a relatively small number of large, centralized firms, banks, and other organizations has undergone critical changes. But the unresolved question - and one of the major issues of ongoing debate among scholars of German banking - is over exactly how much influence the banks have in industry and under what circumstances they exercise this influence. In the next section I explore some of these arguments and extend an initial outline of an argument that revises our understanding of the state-finance-industry nexus in Germany.


C. Problems of the Organized Capitalism Model.

Over the postwar years, and especially since the early 1970s, there has been a recurrent debate in Germany over the power of the banks. The intensity of the debate has waxed and waned according to particular incidents of bank industrial intervention. This debate has occurred in three overlapping, yet distinct arenas - in the public press, in government policymaking bodies, and in the academic literature. Numerous academics, politicians, and interest groups (especially the trade unions) have argued the banks have too much power. Others, including the banking sector itself, have argued that the power of the banks is greatly overestimated.\(^{21}\)

Regardless of where this debate has been carried forth and the position held by the participants, the common focus on both sides is on the actual, or potential, power of the banks that stems from the confluence of three institutional sources: First, the major banks have extensive shareholdings that they use, or at least potentially could, to influence firms. The potential influence of bank ownership of firms is multiplied through the system of proxy-voting in Germany that enables the banks to frequently vote far more shares than they actually own. Second, that through control of corporate supervisory board seats the banks directly intervene in corporate decision-making. And third, there is a high concentration of capital in the financial sector and that firms are highly dependent on the major commercial banks for capital.

Debates in Germany over the power of the banks, especially in political and popular circles, have focused around the meaning of these formal institutional sources of bank influence over nonfinancial firms. Those who argue the banks have excessive power assume

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\(^{21}\) This debate will be more closely analyzed in chapter 4.
positions more or less consistent with bank control theories of intercorporate relations. According to bank control theories, the compulsion for corporate managers to maximize profits creates dependence on external capital resources, in turn creating a dependency of nonfinancial firms, even large ones, on financial firms. Through lending and stock ownership of firms, banks are able to exercise direct control over the decisionmaking of the firms. Because the interests of financial firms do not coincide completely with those of industrial firms, long-term control is required for the financial institutions to maximize their interests. "This logic leads bank control theorists to argue that each important financial institution tends to direct the activities of a group of nonfinancial firms. This control is used to maximize the profits of the group as a whole - a policy that maximizes return to the dominant bank." From this capacity the conclusion follows - if the dominant banks establish a common goal and act collectively to pursue it, they can potentially coordinate an entire national economy, or worse, exploit their position of strength in order to appropriate an undue share of national wealth.

But without any mutually agreed measure or measures of bank influence, as well as systematic access to closely held corporate information, the debate has been driven as much or more by ideological positions than by a dialectic of empirical investigations. And ironically, the debate in these arenas may be largely misplaced. As Eglau points out, the power of the banks among nonfinancial firm may stem not so much from shareholding, proxy votes and board seats, but from the value placed by firms on the financial expertise of the

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banks and the network of contacts that the banks can use to assist, or interfere with, firms. Thus the importance of these formal mechanisms of bank control may well be overestimated.

But again, regardless of the source of bank power, nearly all observers would agree that the banks have at least the potential for considerable influence in industry - the question that still remains, of course, is exactly how much, how and when do they use it, and with which consequences.

In this thesis I argue that the capacity of the major German banks to influence industry and coordinate its activities is generally more circumscribed than most of the literature suggests. More recent writings on the role of the German banks have tended toward greater skepticism regarding the influence of the banks in industry, but most provide little supporting empirical evidence or do so only for one particular economic sector. Of the empirical studies that exist, nearly all are fixated on the three institutional bases of bank influence noted above and attempt to make arguments regarding bank influence based on trends in the shares or board seats held by the banks.

Yet to date, no truly comprehensive study of bank intervention in German industry has appeared. Given the complexity and immensity of such a project, in this thesis I also do not attempt such a detailed historical study. Instead, by focusing on changes in key structural and institutional factors that tend to reduce bank influence, I believe a broader argument can be made that the qualitative dimensions of the relationships between banks and firms in

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25. For example, Edwards and Fischer, 1991, op. cit.
Germany has significantly changed since the late 1960s. While incidents of direct bank intervention in firms clearly continue, institutional and structural economic changes are making direct bank intervention and coordination of a broad range of firms increasingly difficult. More and more the definitive relationship between banks and firms is not one of traditional tutelage, but one of cooperation based on bank provision of multiple resources, not just capital. For reasons discussed below, in this growing mediator role banks generally have less power vis-à-vis firms. Thus, unlike other studies, I argue not only that the traditional institutional role of the banks in the economy has been weakened, but also that this role has been at least partly supplanted by an alternative institutional role embodying different bank-industry and state-bank relations.

In this thesis I also go beyond typical bank studies by focusing on overall changes in the structure of the bank industry itself, in particular the growing role of the public sector savings banks and private cooperative banks. Three primary structural changes are the basis of the changing institutional role of the banks in the German political economy: First, a substantial increase in the degree of competition among banks has decreased the dependence of any one firm on a given financial institution. Understanding these changes within the financial sector requires first and foremost an examination of state action's to promote market competition in banking and the struggles among financial firms themselves to recast market-shaping state policies in their favor. Second, changes in the organization of industry in particular sectors and regions, as well as overall structural changes in the economy, are favoring the growth of smaller firms and decentralized production. This, in turn, is enhancing the market power of smaller, non-commercial banks that generally do not intervene directly into firm decisionmaking. Finally, the state itself, particularly at subnational levels, has become increasingly involved in the affairs of industry, thereby
dislodging the banks from their position of influence to a significant, albeit limited, extent. Rather than representing alternative mechanisms for economic coordination, the state and banks are increasingly acting in consort, especially at subnational levels.

*Bank Competition.*

Competition within the banking industry is a key variable determining the ability of banks to influence nonfinancial firms. Central to bank control arguments is the assumption that a high degree of capital concentration in a relatively small number of financial institutions (among which competition is limited) translates into considerable leverage over nonfinancial firms. Following Stearns, I assume firm financial dependence on financial institutions to be primarily a function of a) the availability of capital which is determined both by demand for it and its supply, and b) the degree of concentration and coordination among financial institutions.26

The German banking system is dominated by three major banking groups or sectors - the private commercial banks, a public savings bank sector, and a private cooperative banking sector. Beginning in the 1960s long-term structural economic changes, combined with critical state policy decisions to foster competition, encouraged the savings and cooperative banks to expand beyond their traditional markets and compete more and more directly with the private commercial banks. In this period the big three commercial banks lost a substantial portion of their share of industrial finance markets to the other two banking groups. The rapid growth in state subsidies and lending to firms in this same period has also raised the supply of capital and, perhaps more importantly, has usurped for the state some

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of the power of the banks to set the conditions of capital procurement. Both of these trends are relatively permanent institutional changes and thus represent qualitative changes in background conditions determining the capacity of banks to influence industry. Thus, on the supply side, the growing number of banks competing in the commercial lending market for large and smaller firms since the late 1960s has greatly enhanced the general availability and sources of capital for firms.

While increasing competition in the banking sector and the presence of a large number of local and regional banks are widely documented and acknowledged, few studies have actually theorized about the political and economic roles of these banks.27 Examinations of the West German economy, and theories on the role of the financial system, continue to be fixated on the power of the three major commercial banks. It is perhaps this fixation, or fascination, with the commercial banks which has led scholars to not only ignore local and regional banks, but to not bother with a careful examination of the consequences of tremendous changes within the banking sector.28

Some exceptions to this have focused either on the introduction of new financial services, or on the impact of technology and competition on the organization of work in the banking sector. Baethge and Oberbeck provide one of the more insightful analyses of the internal reorganization of West German banks and some structural changes in the banking


28. The recent popular literature on German banks continues to play up the power of the major commercial banks. For example, see Pfeiffer, Hermannus. 1987. Das Imperium der Deutschen Bank. Frankfurt: Campus; Eglau, 1989, op. cit.
They voice skepticism regarding the power of the major banks to influence industry, and argue instead that the most important source of bank power over the German economy (and society) stems from bank control over a high fraction of the population's financial transactions. In other words, consumer banking rather than industrial finance now defines the primary social function and power base of the banking sector.

While I share Baethge and Oberbeck's skepticism of the power of the major banks over industry, as well as the importance they assign to consumer banking for changes in the industry, their study on the modernization of the financial sector does not examine the external political forces impacting on change within the sector. Neither do they adequately explore the role of local and regional banks in contributing to changes within the banking sector, and in shaping the role of the state and the process of industrial adjustment - especially at the local and regional levels of the economy.

The policies of the central bank, the Bundesbank, are perhaps most important in determining changes in the availability of capital in the economy. But the role of the central bank can be subordinated in my analysis to these structural changes because the effects of monetary policy and banking regulations on capital supply are largely independent of these conditions.

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31. The authors argue further that the monetarization of all social exchange relations has empowered the banks to redistribute national wealth from the poor to the wealthy. Baethge and Oberbeck, op.cit., p. 299.
structural changes. Generally, tight monetary policies will enhance the relative power of financial institutions, but the long-term growth of competition partly offsets this effect by undermining coordination among financial institutions and thus their ability to exploit conditions of tight money.

On the demand side, there has occurred a long-term shift in the structure of demand by firms for external capital. Since the early 1970s the degree of self-finance among nonfinancial firms has significantly increased. This increase is greatest among the largest firms in Germany. Like the provision of loan capital, the rate of self-finance by firms is subject to cyclical changes in the economy. But the self-finance trend is largely the result of permanent institutional changes that enable firms to retain more of their earnings, and can therefore be expected to continue. Large firms have also increasingly availed themselves of capital sources less subject to control by the major commercial banks such as international capital markets, insurance companies, and loans from other nonfinancial firms.

Traditional bank lending is increasingly restricted to small and medium-sized firms. While demand among these firms for bank loans remains relatively high, intense competition and a significant amount of state lending have generally increased the bargaining power of these firms vis-à-vis banks. In addition, the continuing reluctance of smaller German firms to go public denies financial institutions the possibility to dominate such firms through ownership.

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32. Though banking regulations vary among the major categories of financial institutions, existing studies suggest that the effects of monetary policy do not, by and large, discriminate among them in terms of their ability to supply capital to firms. See Beber, Heike. 1988. *Wirkungen des bankaufsichtsrechtlichen Instrumentariums auf den Wettbewerb im Kreditgewerbe*. Göttingen: Vandenhoeck & Ruprecht.
Bank control theorists tend to see the financial industry as an economic sector sui generis - outside the traditional market model - because of its control over a unique and universally required resource.\textsuperscript{33} Without denying some of the unique qualities of capital and financial institutions, the evidence to be presented in later chapters suggests that market competition among banks can significantly alter the power relations between financial and nonfinancial firms. Competition enhances the supply of capital that, in turn, can reduce the degree of coordination and concentration among financial institutions. Stock ownership by banks remains an important potential source of influence, but for reasons to be explored later, this too appears to be weakening.

Under such conditions of lower firm dependence, formal mechanisms of bank control, such as bank representation on corporate boards, are more likely to serve an information function, rather than a control function.\textsuperscript{34} Thus to a certain extent we may be able to speak of a resurgence of managerialism (autonomy of corporate managers) in Germany. Summarily, I argue that understanding how the German banking system influences the decisions of governments and firms in the process of industrial adjustment, as well as understanding how the banking sector itself has adapted to change, requires a far more differentiated understanding of the banking sector than is usually adopted.

\textit{Banks and Variance in Patterns of Industrial Organization.}

The control or influence of the major commercial banks has always varied substantially across economic sectors and regions within Germany. And perhaps surprisingly, some of the most prosperous sectors and regions in Germany at the present are


\textsuperscript{34} See also Stearns, 1990, op. cit., p. 197.
those where bank influence is more circumscribed. This suggests both that the role of the banks is more limited than usually assumed, and second, that the 'leadership' of the major banks is not necessarily a prerequisite to industrial success. There appears to be more than one institutional path to competitiveness in Germany. Recent scholarship shows that there have been at least two distinct models or patterns of industrialization and industrial organization in Germany. Distinct regional agglomerations of industry in the Federal Republic can be distinguished by the predominance of one of these patterns. Herrigel argues further that both patterns of industrial organization, or 'order,' are economically viable as attested by the continued existence of both in the Federal Republic.35

The first pattern is that depicted in the traditional organized capitalism view. In regions characterized by this pattern of production, large, vertically-integrated firms dominated the region's economy. Firms in these regions became large in part because of the nature of the industry, but also because "the lack of surrounding infrastructure forced them to incorporate most of the stages of manufacture under their control."36 The high capital requirements of these industries also meant that they developed close relationships to the major commercial banks.


The prime example of this autarkic industrial order is the Ruhr area of the Land of North Rhine-Westphalia - the traditional stronghold of German heavy industry - coal, steel, chemicals, and heavy machinery. True to the organized capitalism model, the major commercial banks with their historical focus on large-scale heavy industry have a disproportionately large percentage of their business in the region. While the major commercial banks have long been deeply involved in numerous industries here, their capacity to direct industrial change in these sectors and the regions where they dominate seems to be faltering. The example of crisis in the steel industry, discussed in greater detail in chapter 6, is a case in point.

The second pattern of industrial organization is characterized by decentralized industrial production in small firms clustered within a geographically specific region. Spatial proximity among these small firms facilitates their direct cooperation as well as their indirect cooperation via local organizations that provide these firms with private and collective goods essential to their success. Because firms in many such regions typically produced specialized but complementary goods, the region as a whole may be analyzed as a loosely-connected unit of production.37 The state, especially the local and Land governments in such regions, provide essential support services to local firms.

Baden-Württemberg is the prime, though not the only, example of a region which industrialized to a large extent according to the decentralized pattern. In contrast to the Ruhr, the banking sector of Baden-Württemberg is dominated by small- and medium-sized private cooperative and public savings banks. These banks have historically been oriented

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toward the needs of small firms in close proximity. The major commercial banks are under-
represented in the region, with the exception of the export finance business since local banks
have little experience in international business.

While different economic sectors and firms within sectors face distinctive exogenous
changes and challenges, there are arguably broader economic changes which affect nearly all
firms and industries - technological change, especially regarding microelectronics, and
globalization of markets - that elicit some common responses. These responses can be
summarized as the spread of what has come to be known as post-Fordist systems of
production. Among other things, post-Fordism provides a more favorable environment for
production in smaller firms. This, when combined with growing competition among banks,
produces powerful imperatives for the financial sector.

Small and medium-sized firms are increasingly demanding more from their banks than
capital. Firms are demanding that their banks aid in the provision of non-financial resources
such as technical and managerial information. Banks are thus being driven through the
demands of firms and competition amongst themselves to either provide these resources or
act as mediators between their firm clients and third organizations that can provide them.
Banks, as part of this growing "mediator" role, are thus increasingly embedded within local
and regional organizational networks that provide both private and collective goods or
resources to firms. Fulfilling such a function is best accomplished by banks operating
autonomously at the local and regional levels of the economy. Thus the savings and
cooperative banks have been favored by these changes in the organization of production - and
in turn are reinforcing the viability of smaller firms and decentralized production. Through
internal decentrali-zation the major commercial banks have sought to capture these same
advantages of local autonomy and flexibility. With this strategy they have achieved notable
success, but in the process they have also contributed to a shifting emphasis from ‘tutelage’
to ‘mediation’ in their relations to firms.

Thus, in addition to sectoral and regional variations in bank-industry relations, recent
changes in the organization of industrial production are quite favorable to the type of non-
hierarchical bank-industry relationship long practiced by the savings and cooperative banking
sectors. Thus rather than declining because of their relatively small size, these non-
commercial banks are increasingly important in the German political economy.

*The State and Industry.*

The organized capitalism model also fails to adequately capture the role of the state
in the economy, particularly the role of the German federal states - the Länder.38 In
economic policy the Länder have always had significant powers, and in the course of the past
two decades have exercised these powers to a perhaps unprecedented degree. Even during
West Germany's brief flirtation with centralized corporatist policymaking in the 1970s the
power of the Länder in regional and national affairs was hardly circumscribed, and perhaps
even enlarged.

In response to the economic crises of the 1970s the Länder vastly expanded the scope
of their own economic policies and support for firms. At the most basic and obvious level
this expanded intervention is measured by the growth in subsidies to firms. But this was
hardly the extent of Länder interventionism. Many Länder governments became increasingly
involved in a broad range of economic activities from sectoral modernization programs to

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38. Though some recent work has begun to theorize about the impact of the increased
economic policy role of the Länder, few in-depth studies of Länder intervention exist.
Economic Policies in the Federal Republic of Germany: The ‘Meso’ Politics of Industrial
Adjustment," in *Publius* 19:4, pp. 147-164.
firm buy-outs and mergers. Even the least interventionist Land government in the early 1970s - Baden-Württemberg, which presided over one of the most successful regional economies in the Federal Republic - became heavily involved in economic promotion. Thus in the Federal Republic state policies at both the Federal and Länder level are increasingly microeconomic oriented - supporting firms with capital and producer services - in the attempt to promote structural adaptation in the economy. As will be discussed later, such structural policies are generally favorable, if not necessary, for the success of post-Fordist production in the economy.

Zysman, comparing the economic adjustment process of several industrial nations, argued that the structure of an economy’s financial system delimits the possibilities for government economic intervention. Zysman, like most scholars, sees the West German system of industrial finance as largely free of government direction. In his view it is a bank-, not government-, dominated system. In this thesis I focus in particular on the relationship between banks and governments in part because I believe, following Zysman, that for governments to continuously influence firms’ decisions, and thereby steer economic developments, they must be able to control or at least influence industrial finance. But Zysman’s analysis overlooks the fact that many large banks engaged extensively in industrial finance in Germany are under the control of the state and thus serve as instruments of state intervention. The role of the state in industrial finance is often far greater than depicted in the secondary literature.


40. In fact, in the late 1980s, fourteen of the largest twenty banks in the Federal Republic were state-owned or controlled.
Moreover, as Cox rightly points out, Zysman takes the financial system as an immutable constraint, ignoring the political struggles which defined, and redefine, its own structure as well as relations between the financial and industrial sectors. Moreover, it is not a priori clear whether the structure of the financial system is a determinant or outcome of the nature of state economic intervention.\footnote{Cox, Andrew. 1986. "State, Finance and Industry in Comparative Perspective." In \textit{The State, Finance and Industry}, ed. Andrew Cox. New York: St. Martin's.} What both Zysman and Cox overlook, however, are the struggles of actors in the industry itself to redefine their own organizations and thus the system. In this thesis I will examine both the struggles within the industry and the struggles between the state and the industry which are redefining the governance regime of the banking sector itself, and thus its broader economic role.

The more active pursuit of economic policy goals by the Länder has altered the bank-industry relationship in two important ways. First, the Länder governments have been instrumental actors in promoting competition within the banking industry because of their efforts to promote the capacity of the savings banks to provide industrial finance. Secondly, over the last two decades they have used savings banks increasingly as instruments of economic intervention. Without the support of decentralized societal institutions such as banks, the capacity of subnational governments to influence economic adaptation would be much more limited.\footnote{As Lehmburch writes, "regional policy networks were kept together by the mutual exchange of organizational resources between 'state' and 'society'." Lehmburch, Gerhard. 1989. "Institutional Linkages and Policy Networks." \textit{Publius} 19(4): pp. 221-235.} Thus, Länder governments have been able to extend direct and indirect state influence over industry via the public sector savings banks.

While the contemporary literature typically portrays the West German state as essentially neo-liberal in its economic policies, the interventionist activities of the Länder
suggest that a more differentiated examination of the state and its role in the economy is necessary. Contrary to the organized capitalism model, the banks and state should be viewed not so much as alternative or even competing mechanisms for economic coordination, but as increasingly interdependent or complimentary mechanisms. In sum, West Germany's 'organized private enterprise,' as Zysman calls it, has a much stronger element of public influence than the literature ascribes to it.\footnote{See Zysman, 1983, op. cit., pp. 251-265.}

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D. Comparative Theories of State-Society Relations and Industrial Change.

The 1970s represented the peak of centralism in the governance of advanced industrial economies. Keynesian ideas regarding macroeconomic management and state planning reached their zenith. Neo-corporatist institutional arrangements in which the central government, central business associations, and central union organizations bargained over the course of their economies were widespread. Consequently, in the 1970s and 1980s a wide variety of comparative studies in political economy also focused their attention on the nature of the relationships among the central union organizations, business, and governments.44

More generally, in this period the enterprise of comparative studies returned to the study of institutions as objects of political analysis. In this renewed approach, institutions - defined as formal organizations and as informal but regularized operating practices and procedures - are seen once again as a formative factor of political processes.45 The enduring characteristics of institutions shape or constrain preferences and thus action. And the state itself became once again an important independent variable, both for its institutional impact on shaping political interaction, as well as for its capacity to impose its own autonomously determined preferences on society. But establishing the ability of states to act

44. For many authors who contributed to the literature on neo-corporatism, this new variant of central economic control appeared to be superior to other political economic systems - for example the liberal market system of the United States - and the wave of the future. Probably the seminal work in this literature is Schmitter, Philippe C., and Gerhard Lehmbuch. 1979. Trends Toward Corporatist Intermediation. New York: Sage Publications. See also Berger, Suzanne E. ed. 1981. Organizing Interests in Western Europe: Pluralism, Corporatism, and the Transformation of Politics. Cambridge: Cambridge University Press.

autonomously of society has proven itself difficult. Consequently, several comparative studies adopted what some call a ‘relational approach’ to the study of state-society relations.

Relational approaches within the institutional political economy paradigm attempt to explain the nature and extent of state economic intervention by focusing on the interaction or relation among multiple variables: Variables such as the organization of the state (especially the degree of centralization); market structure; openness, or the position of the nation in the international political economy; the organization of labor; the organization of financial system; the organization of interests; the organization of political systems (party systems); and ideas or ideology. By analyzing the relationships between such state and societal factors, they generated theories to explain state economic policy choices, economic performance, the style or process of structural adjustment, and the capacity of the state to intervene in the economy.46

Which variables have been included in each scholar’s model varies, but all share some common presuppositions. First, relational analyses generally stress the explanatory significance of several variables in an attempt to avoid the limits of monocausal explanation. For example, state intervention is a function of multiple variables operating in a complimentary fashion. The relative importance of any single variable in a given model can change over time, but all matter. The task is thus to show how different variables relate, and in particular how institutional factors influence the organization, preference formation, and

thus actions and conflicts of individuals and groups in the state and private sector. Outcomes are not predetermined and thus a matter of historical conjuncture. But neither are outcomes completely open. By their very definition institutions have enduring, though not immutable, characters which make some outcomes more likely than others.

This thesis follows this by adopting a similar relational and institutionalist model. But a problem with much of the comparative political economy literature is its nearly exclusive focus on national level institutions and politics - other levels of the economy are assumed to be of secondary importance. But focusing analysis on this level has been called increasingly into question for three reasons: First, the breakdown of neo-corporatist arrangements at the national level in most industrial nations diminished the role of central business and labor associations. National economic policies generally moved away from Keynesianism to ostensibly less interventionistic neo-liberal positions, monetarism, and microeconomic policy. Second, political decentralization of various sorts became widespread in the late 1970s and especially the 1980s. Third, collective efforts at local and regional industrial reorganization and management also became widespread in the 1980s. The paradigmatic


cases of strong, centralized, interventionist states are Japan and France. But in the Federal Republic of Germany of the 1980s the most intrusive state interventions into the economy emanated primarily from subnational units of the state, namely the Länder. These efforts reflected in part the major structural economic transformations that occurred in nearly all industrial nations since the early 1970s.

In response to these changes a number of scholars have taken this institutional approach to the meso-, or intermediate-, level of analysis. Namely, they turned their attention to explaining state intervention and patterns of business-government, or state-society relations within particular industrial sectors. Such studies have convincingly demonstrated that generalizations about distinctive national political economic models are frequently difficult to defend, because the roles of states and other institutions within a given national economy vary significantly across time and economic sectors.

In accordance with such meso-level approaches to analyzing state-society relations, in the past decade a rapidly growing literature crossing political science, economics and sociology has converged around the concept of 'governance.' Governance is understood as "the political and economic processes that coordinate activity among economic actors." 

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While traditional scholarship along these lines focuses on markets, the state, and the modern corporation as alternative institutions or mechanisms of economic governance, more recent work has added to this list of institutions 'associations' and 'informal networks' in order to better articulate qualitatively distinct forms of economic coordination.\textsuperscript{52} Rejecting the notion of single, comprehensive national models of economic governance, scholars working in this vein have focused on analyzing the organization of production and its control within specific economic sectors.

In this dissertation I adopt the typology of Leon N. Lindberg, John L. Campbell, and J. Rogers Hollingsworth that includes six ideal-typical governance mechanisms: markets, hierarchies, associations, and monitoring, obligational, and promotional networks.\textsuperscript{53} There are two basic structural dimensions of this typology. The first entails the degree of formal integration of economic actors involved. On the informal end of this spectrum, actors or organizations attempt to influence each other’s behavior through arms-length interactions (e.g. markets). At the formal end of the continuum actors are coordinated through the command system of a bureaucratic hierarchy. The second structural dimension is the ‘range of interaction,’ that is the number of actors involved a particular exchange. This continuum ranges from bilateral to multilateral. Markets, obligational networks, and hierarchies tend to entail bilateral exchanges. Associations, monitoring and promotional networks are generally multilateral mechanisms of governance. Since they entail collective actions they are therefore are usually established to provide collective goods. Each governance

\textsuperscript{52} For example see Campbell, et. al, 1991, op. cit.; Streeck and Schmitter, 1985, op. cit.

mechanism also has a particular process associated with it, in that each has specific rules to define the terms of exchange and some means of coercion and consent to obtain compliance when actors deviate from these rules.

'Markets' are characterized by bilateral exchanges between economic actors on the basis of highly specific contracts. "That is, the actors clearly specify performances and prices through contracts that, when fulfilled, are self-liquidating and require no further interaction among the parties involved, such as in spot-market contracts."54 The actors in market exchanges are informally organized and remain autonomous from each other. Unlike corporate hierarchies, in markets there are no mechanisms for the planned coordination of economic actors' activities.

'Hierarchies' are "formal administrative and bureaucratic command systems within a single organization [established] to replace market contracting among autonomous exchange partners as the means by which they coordinate the flow of personnel, capital, and goods through the production and distribution processes."55 The rules of exchange within hierarchies are normally expressed as administrative commands based on employers' authority and centralized decision-making. Prime examples of hierarchies are the modern vertically- or horizontally-integrated corporation. Such corporations are frequently established to maximize the use of mass assembly or continuous process production.

Situated between markets and hierarchies in terms of degree of formal organization are 'obligational' networks. Exchange relations of this type are more formal than market relations and thus to some extent obtain advantages of hierarchies (e.g. reduction of


uncertainty), but they do not involve the loss of actors' organizational autonomy. Obligational networks entail relationships between firms that are less precisely specified and therefore more flexible and open-ended than market or "classical" contracts. 'Obligational contracting' between firms is intended to secure reliable or relatively permanent access to the resources and information on which the exchange partners depend. In this form of exchange actors seek a stable and long-term relationship that involves a limited amount of mutual control of each actors' actions. Long-term subcontracting relations, interlocking corporate directorates, franchising, and some types of joint ventures are prominent examples of such networks.

A 'monitoring' network is a governance mechanism that is "...primarily dedicated to the collection and sharing of information as a collective good."56 Such networks are often characterized by webs of interlocking directorates through which firms collect and share information as a means of "monitoring" the activities of each other. As suggest above, interlocks are of an obligational variety when they involve primarily bilateral relations intended for specific exchanges. Interlocks of the monitoring variety are more diffuse and involve a large number of actors. Monitoring networks have only weak mechanisms of coercion, and thus rely heavily on the consent or loyalty of participants to the exchange. They are generally established with the intent of enabling corporate leaders to identify broader industrial or economic problems and generate minimally coordinated responses or solutions to these problems.

The final network governance mechanism is the 'promotional'. These networks are based on explicitly negotiated and defined rules of resource exchange among a large number

of organizations, generally for the purpose of promoting the collective interests of a particular economic sector. An example of such a network would be an industry-wide research consortium, perhaps with government support. Thus a promotional network is distinct from an obligational in that the former is established with the intent of benefitting a large number of firms or an entire sector, the latter is intended to serve the narrower interests of a small number of firms. In promotional networks actors retain their organizational autonomy.

'Associations' "... are distinctive forms of multilateral governance in that they involve structured negotiations among organizations that mutually recognize each others' status and entitlements and that seek to create formal organizations with charters, bylaws, and procedures in order to implement relatively stable and formal agreements in pursuit of some common interests." Associations generally involve coordinating the activities of the same type of economic actors. Unions and business associations are two prominent examples of this governance mechanism. The rules that govern exchange between actors within an association are normally formal (voluntary) membership agreements. Associations attempt to provide their members "selective access to collective goods" and often can draw on state-sanctioning of their functional role to ensure member compliance with the association's rules of exchange.

In this broad-based literature much of the focus has been on explaining the emergence of a particular type or set of governance mechanisms within specific industrial sectors. Thus the notion of a 'governance regime' suggests that an economic sector may be characterized by the particular mix or combination of governance mechanisms. To the extent that "...actors organize themselves, adopt rules of exchange, and utilize means of compliance that

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are typical of one governance mechanism more than another... we speak of some governance mechanisms as being dominant relative to others within a governance regime."

Given the relatively dynamic nature of modern economies, attention has been devoted to studying the process of governance regime transformation in response to particular economic or even political changes. When actors perceive pressures to change they initiate a 'search process' for more suitable governance mechanisms. The two principle dynamics guiding governance transformation are the search for greater economic efficiency, and the struggles among economic actors for power and strategic control within economic exchange relations.

I will also follow Lindberg, et. al. in assuming the state to be theoretically and substantively distinct from these other mechanisms of governance. The state can influence the emergence and transformation of governance regimes in several ways that are typically unique to it. As a 'gatekeeper' the state can provide a channel for groups outside a given governance regime to influence it. The state may also act as a producer or allocator of resources and information that can affect exchange relationships. And finally, the state can influence economic actors through its role in the definition of property rights (i.e. regulatory measures). In many cases the most important role of the state in governance regimes may not be shaping their transformation but ratifying or stabilizing the regime "chosen" through the interaction of economic actors.

In the terms of this governance framework, standard accounts of the German political economy argue that it is dominated by corporate hierarchies commonly engaged in monitoring and obligational networks that are based on corporate interlocks. In the case of

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Germany, the banks are seen to dominate both types of networks, thereby creating a hierarchy of power within the business community. Associations are also assigned a prominent governance role. Based on the case studies presented in chapters 5, 6 and 7, I will argue that the traditional literature tends to overestimate the relative dominance of hierarchy as a governance mechanism in Germany, as well as the degree of hierarchical control or dominance by the banks. The case studies presented focus on the role of the state and banks, especially the savings and cooperative banks, in promoting and supporting the development of alternative governance mechanisms such as markets, and obligational and promotional networks involving larger numbers of small- and medium-sized firms. In these networks banks generally do not assume hierarchical dominance, or even enjoy an asymmetrical power relationship, vis-à-vis firms.

Since the early 1970s numerous sectors in the German economy have undergone significant transformation in their governance regimes. Common to many of these sectors is a movement hierarchical governance mechanisms. In other words, the shift toward post-Fordist production principles implies a shift toward non-hierarchical governance mechanisms (less formal and therefore more decentralized) within various sectoral governance regimes. The state and the banks contribute importantly to this through their growing provision of critical resources and information to smaller firms via networks. Even in an era of rapidly growing global economic integration and competition, the German banking system is amenable to decentralized patterns of economic adjustment and governance. Further, I argue that change in the German financial sector itself is a very political process in which Länder and local governments have a prominent but not well-understood role. Thus I will examine change in both the structure or governance regime of the banking sector itself, and how this has importantly altered the role of banks within sectoral governance regimes.
The insights gained through this governance framework are valuable, but I argue that there is yet more to be gained by taking an intermediate-level analysis one step further. Namely, I argue that an adequate understanding of economic governance in Germany must incorporate an analysis of subnational actors acting on territorially defined interests, and in particular an analysis of regionally distinct patterns of governance.\textsuperscript{59} Within certain sectors regional variations in the relative dominance of governance mechanisms can be discerned. For example, automobile production in northern Germany is markedly more hierarchically organized than in southern Germany. Such differences are strongly correlated with the distinct institutional histories of the region in which production occurs. In southern Germany local and regional promotional networks, many of which are organized to promote firms according to their geographic rather than sectoral location, are comparatively better developed. By providing smaller firms with critical resources these networks work against pressures on economic actors to incorporate economic exchange within a hierarchy. But such local and regional networks exist throughout Germany and the adoption of post-Fordist production strategies by economic actors is predicated on their expansion. In short, governance regimes can vary not only by sector, but by region as well.

\textsuperscript{59} A recent comparative anthology has begun to explore the role of regional business interest associations in the process of state and market building, suggesting that such associations may act to maintain market segmentation and decentralization in the state; see Coleman, William D., and Henry J. Jacek, eds. 1989. \textit{Regionalism, Business Interest and Public Policy}. London: Sage. The chapter by Schmitter and Lanzalaco argues for "putting the regions back in" to studies of state-society relations (and neo-corporatism in particular). They suggest that regions may now be the "optimal" level of organizational control from a public policy perspective, and thus the arena in which new corporatist arrangements might coalesce.
E. Outline of the Thesis.

The next chapter examines the emergence and evolution of the three major banking groups in Germany up to 1945. First, the chapter examines the struggles behind the development of the governance regime of the financial sector itself. It argues that the state (at the national and subnational levels) played a crucial role in creating a three-sector or group banking system. The emergence and maintenance of a three sector banking system contributes to the development and persistence of different sectoral and regional patterns of economic governance (or governance regimes). For example, the cooperative banking sector is a core element of an alternative model of industrial production/governance that emphasizes craft skills and network production. It forms the economic basis of some of the most successful regions and sectors in Germany today. These two association banking groups represent an alternative model of non-hierarchical bank-industry relations to that depicted in Hilferding’s finance capitalism.

Chapter 3 continues the historical analysis of the banking sector in the postwar period and the two lines of argument initiated in the preceding chapter. It argues that decentralization in the banking industry was preserved through state action, but also by the logic of group competition that required greater universalization (presence in all financial product markets) of all the banks, and by changes in the economy that made Mittelstand firms an increasingly important customer group for all the banks. The growing emphasis since the early 1970s on decentralization in the banking sector is partly a response to decentralization trends in other areas of economic activity (post-Fordism). In turn, the decentralization of financial institutions arguably reinforces decentralization in industry and the expansion of obligational and promotional networks without bank dominance.
Chapter 4 examines the changing pattern of industrial finance in West Germany and the evolution of bank-industry relations. It documents the growing role of the savings and cooperative banks in industrial finance and the growing orientation of the major commercial banks toward the Mittelstand. It is argued that the traditional tutelary role of the banks remains a defining feature of bank-industry relations in Germany, but is declining in relative importance to the mediator role of the banks vis-à-vis Mittelstand firms. The mediator role refers primarily to 'information mediation': It has become essential for banks to offer firms comprehensive business advice (including technical advice), to broker government subsidies, and to provide a complete range of financial services in order to be successful with the Mittelstand. In this role local banks and branches are increasingly embedded in local and regional promotional networks. The growing role of smaller firms in post-Fordist production pushes the banks to expand this role further.

Chapters 6 and 7 are case studies of North Rhine-Westphalia and Baden-Württemberg. In these chapters the concept of a 'regional promotional network' is developed. The growing provision of state resources to firms via promotional networks further undermines bank predominance and reinforces production in small and medium-sized firms and (obligational) networks. The two regional case studies concentrate on the role of banks in each region's economic governance, or more specifically, in Land industrial policy and regional industrial restructuring efforts. These cases suggest that regional organizations - particularly Land governments and regional banks - are increasingly important in governing the German economy.

Chapter 8 sets forth the arguments of the preceding two regional case studies with an examination of two examples of local industrial restructuring and the role of banks and government in this process. Both cases demonstrate how local economies can adapt
successfully to structural economic change based on an expanding Mittelstand, as opposed to adjustment through increasing hierarchical control (including firm concentration) as the organized capitalism model would suggest. These local case studies also help illuminate the growth of the banking sector's mediator role and the function this plays in industrial governance and change.
CHAPTER TWO:

The Three-Sector Banking System.

A. Introduction.

In the nineteenth century three distinct banking sectors or groups based on two different governance models emerged in Germany. By the turn of the century these three banking groups represented the three dominant types of banking institutions. The first type is the private commercial banking sector that is dominated by the so-called ‘Great Banks’ or ‘Berlin Banks.’ These Great Banks evolved into large, hierarchically-organized ‘branch banks.’ The second and third types are the public savings banks and the private cooperative banks. These two banking groups developed cooperative associations that encompass virtually all banks in their respective sectors.

This chapter examines the emergence and evolution of the three major banking groups in Germany up to 1945. It develops two key arguments: First, the chapter examines the struggles behind the development of the governance system or regime of the financial sector itself. It argues that two distinct governance regimes emerged within the banking industry: a hierarchical ‘branch bank’ model that dominated in the commercial banking sector, and an ‘association model’ that dominated the savings and cooperative banking sectors. The state - both as an actor and an arena in which conflicting interests competed - played a crucial role in the creation of a banking system based on three sectors.

The second key argument follows from the first: The emergence and persistence of a three-sector banking system helped maintain over time different sectoral and regional governance regimes. This is so because each of the two bank-sector governance regimes led to a distinctive type of relationship between banks and nonfinancial firms. Hierarchy in
commercial banking enabled a concentration of financial resources that could be transformed into bank dominance or at least strong influence in industry. The association banks were small and numerous and their associations were organized so as to maintain this deconcentration and decentralization. These banks also cultivated long-term relationships with firms that often went beyond a market relationship, but they could not assume a position of dominance in firms. Thus the type of bank-industry relationship described by the organized capitalism model represented only one type. A type that has probably been overestimated in terms of its prevalence during Germany’s period of initial industrialization and the interwar years.

In some sense each banking sector was a constituent component of three distinct socio- and political-economic spheres of the nation. The commercial banks focused on large firms and thus the regions and sectors where such firms dominated. This was the sphere of private organized capitalism. In the coal, steel, chemicals, electrical, and heavy machinery industries, large, hierarchically-organized firms tended to dominate production and distribution. Within these sectors, hierarchies and obligational networks in the form of corporate interlocks between large banks and firms were often the dominant governance mechanisms.\(^1\) In this manner the major commercial banks became integral organizations within various industrial sector governance regimes. In numerous cases more formal cooperation among firms within sector-specific cartels - in the governance framework terms these constitute a type of promotional network - became an important governance mechanism. Within these networks the banks have traditionally been considered the dominant

\(^1\) When actors try to influence corporate policy through interlocking directorate networks, this is considered an obligational network. Where such attempts are absent, these networks are of the monitoring type.
organization, thereby creating a hierarchy of power in which the banks occupied the pinnacle. Insofar as hierarchy was its dominant governance mechanism, the governance regime of the commercial banking sector itself was thus consistent with that of the industrial sectors with which it was most closely involved. Hierarchy in heavy industry and hierarchy in the commercial banking sector were mutually reinforcing institutions.

The public savings banks were an appendage of the state and focused on financing local authorities and their public works projects, as well as providing loans to individuals and small firms. Over the course of the late nineteenth and early twentieth century the savings banks gained greater autonomy from the state. To promote the interests of the entire savings bank sector, first regional and then a national savings bank association was formed. Over time, the associations play an increasingly greater role in the governance of the savings bank sector. The associations provide collective goods to member savings banks, enabling them to expand over time into industrial finance activities, particularly with Mittelstand firms.

Similar to the savings banks, the cooperative banks developed regional and eventually a national cooperative association to advance the interests of the entire sector. The cooperative banks were firmly rooted in the small firm craft and agricultural sectors. Both of these sectors, in turn, were heavily involved in the broader cooperative sector in which "self-help" through mutual aid - not profit maximization - was considered the fundamental organizational principle. Thus the cooperative banks, and later the savings banks, were the premier financial institutions in economic sectors and regions were smaller firms were more abundant. In such sectors and regions the dominant governance mechanisms have typically been promotional and obligational networks, but not ones in which a single or a few organizations dominate, and not ones based on corporate interlocks. In these networks participants are largely on an equal footing with each other, cooperating indirectly through
various regional economic organizations and directly through long-term contracting arrangements. In such networks the savings and especially the cooperative banks have been traditionally quite active. There is much evidence which demonstrates that such sectors and regions were not simply residual phenomenon that would someday succumb to the organizational principles of organized capitalism. Rather, many of these sectors and regions proved that their more decentralized economic governance mechanisms could also be successful in a presumably mass-production world.

Reflecting regional variations in sectoral composition and governance mechanisms, substantial variation among Germany's regions in the relative strength of the different banking groups emerged in the nineteenth century and continue to the present. The major commercial banks concentrated in and around the Ruhr, and in most major cities in Germany. Where the major commercial banks were strongest, the cooperative and public banking sectors tended to be weak. By the early twentieth century commercial cooperative banks covered all of Germany, but were most heavily concentrated in areas of industrial agglomeration with a large number of small supplier firms such as the Rhine-Main region of Hesse and the Rhine-Neckar region of Württemberg, and especially in areas where the tradition of mixing small-time farming and craft production dominated such as in Baden, Württemberg and the Siegen region of Northwestern Hesse. In other words, cooperative banking was most powerful where production was also dominated by smaller firms cooperating within obligations and promotional networks.

2. Bavaria is somewhat of an exception. In this state two private regional banks came to be the driving force of the regional banking industry. The dominance of regional banks in Bavaria is partly a reflection of a long tradition of etatism and the concentration of non-agricultural industry in Munich.
These regional differences did not result simply by happenstance but are manifestations of substantial differences in the structure of regional economies and the relationships between subnational governments, banks and firms which developed over the course of time. The organized capitalism model did not apply equally, if at all, to every region in Germany.

From the late nineteenth century to the present the savings and cooperative banks not only survived, but were able to gradually expand their market share vis-à-vis commercial banks because of three factors: the supportive actions of the state, the development of cooperation in associations, and their tight links to local economies and firms. The close symbiotic relationship between smaller banks and smaller firms helped both succeed in competition with larger banks and firms during Germany’s period of rapid industrialization and later.

Symmetrical to the evolution of the commercial banks, the savings and cooperative banks underwent a process known as "universalization." Over time these banks expanded their range of activities until they became, with some exceptions, universal banks like the major commercial institutions. The ability of these banks to develop their cooperative associations and universalize was essential to their competitiveness and that of firms which relied on them. Cooperation through associations enabled the savings and cooperative banks to compensate substantially for their smaller size. And the state - alternately through legislation, regulation, and direct intervention - played a crucial role in aiding the establishment and maintenance of these associations.

Thus the state, including both the central and Länder governments, played a crucial role in the structural evolution of the banking sector presented in this chapter. Since the mid-nineteenth century the German state has directly promoted the savings and cooperative banks
in order to preserve a particular social and market order. Namely, the state sought to support the lower classes, peasants, and small business through these local banking institutions. Thus the state expended considerable efforts to establish and maintain locally-oriented "rival" banking systems to the commercial banking sector.

B. 1800 - 1895: The Emergence of a Modern Banking Sector.

In the first half of the nineteenth century Germany's relative industrial backwardness was mirrored in the structure of its banking sector. Political fragmentation and traditional corporate society - guilds, the church, aristocracy and bureaucracy - helped prevent the integration of the loosely connected local capital markets which then existed. Private bankers in the major cities dominated what credit markets there were. Most of them were merchants and thus banking was largely a part-time business. The German states, including Prussia, usually kept tight control over their capital markets and private enterprise in general. A large portion of available capital flowed into government securities rather than industry. While industrial finance flowed largely through personal and familial relations.³

The second half of the nineteenth century witnessed dramatic changes in the German economy. As industrialization began to spread and deepen in mid-century the capital requirements of industry grew tremendously. To meet these needs, private bankers began to form consortia in the form of joint-stock credit banks. The free incorporation laws of the 1860s and 1870s, combined with the economic boom following unification, accelerated the growth of industry and the joint-stock banks. By the 1870s private bankers were rapidly falling from grace as the very banks they created quickly asserted their independence and

eventually dominated the national banking market. From here the traditional story of German banking is a very familiar one: The joint-stock, or Great Banks played a dominant role in industry, and through their "tutelage" of industry promoted rapid industrialization.

But while this story is familiar to many, the story of the cooperative and public savings banks is not well-known, or understood, outside of Germany. Well before the great Berlin banks made their mark in history, these two banking sectors had carved out a stable niche in German society. The public savings banks were firmly anchored to local governments and thus local markets. The cooperative banks consisted of small groups of individual entrepreneurs providing advances to each other when one individual alone did not have sufficient funds, be it for toolmaking or potato growing. By the end of the nineteenth century the three major banking groups of the present had congealed into their characteristics forms: the Berlin banks had become universal banks beginning to build branch networks, meanwhile the savings and cooperatives covered practically every town and hamlet and were slowly building up their association structures.

The Beginnings of the Savings Banks.

The history of the savings banks goes back into the late eighteenth century when the first banks were established for the purpose of poor-relief. In the early years of the German savings bank movement many institutions were private, philanthropic organizations. They were very simple institutions. They collected deposits and invested them in state and other guaranteed bonds, or lent their funds to local governments and occasionally individuals who

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could secure the loan with tangible property. After the post-Napoleonic political reconstruction of the German states, public savings bank systems were gradually initiated in each state.

In 1816 the Stein-Hardenberg Reforms established a legal foundation in Prussia for the establishment and administration of savings banks by local governments. In the 1820s and 1830s other states followed with new communal ordinances permitting local governments to operate a savings bank. The states were also generally interested in savings banks as instruments for poor-relief. Though state governments were occasionally directly involved in the creation of savings banks, they by and large left this to communal governments.

The nineteenth century was a new era for German cities and towns as the new communal reforms granted them extensive rights to self-administration. Moreover, the central governments of the German states relied heavily on local governments to administer their policies. The rapid growth of urban populations only reinforced the new political role of local governments. The instrumental value of a savings bank quickly became apparent to many local governments - especially as the banks began to generate profits. Local governments began to use their authority to bring existing private savings banks under their administration, or to create new ones. In some cases they used the profits of the bank to pay off the very loans they owed to the same bank. The savings banks quickly became an

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important resource to local governments, especially for the construction of urban infrastructure.\textsuperscript{7} Public savings banks were not legally independent entities but a department under the jurisdiction of local governments; their employees were civil servants, their honorary directors government officials.

In the mid-nineteenth century the governments of the German states began to take a more active role in their respective savings bank sectors. The conjunctural pressures of industrialization, liberalism, and nascent socialism threatened to disrupt the existing social order and thus undermine political control by the state. With this the savings banks began to appear to the conservative-minded states - Prussia and Bavaria above all - as more than just a convenient means to prevent pauperization. Instead they seemed an ideal instrument to prevent the growth of an urban, industrial proletariat by supporting production in agriculture and small firms. In several states promoting savings banks became a central tenet of a strategy to promote loyalty to the state and affirmation of the existing social order without resorting to state welfare subsidies or oppression. The public mission of the savings banks was to assist the lower classes to accumulate sufficient wealth so as to avoid future poverty and thus social disintegration.\textsuperscript{8}

For example, the 1838 savings bank regulations issued by the Prussian government represented the first efforts of this period to provide a legal basis for the homogenization of


the sector and its expansion.9 Through an 1854 decree, the Prussian government sought to promote the establishment of county savings banks (Kreissparkasse) which would provide services to an entire county and thereby serve the rural population as well as the urban.10 In other states, such as Württemberg, ministerial officials played a direct role in the founding of many savings banks. The Bavarian state was probably the most heavy-handed in this period, laying down strict and comprehensive regulations for its savings banks in 1843.11 At this time several states also set upper limits on savings deposits in order to keep them oriented to the lower classes. Several states began to pressure private savings banks to allow themselves to be communalized in order to bring them under the control of the state. In the first half of the nineteenth century many savings banks did not lend to individuals as this was not considered consistent with their purpose of promoting savings.12 But in the 1840s, encouraged by new legal regulations and directives from the states, savings banks began to increase their local lending to merchants, craftworkers, and farmers.

Thus the German states played a crucial role in the development of a savings bank sector by establishing the regulatory framework that would enable them to expand. Further


stimulated by the general social and economic development of the German states in the mid-nineteenth century, the number of banks expanded rapidly. Between 1840 and 1860, over 800 banks were established.\textsuperscript{13} But the savings banks were only partly successful in their conservative mission. Though they continued to expand steadily for the rest of the century, as did the savings deposits they held, the amount of personal credits they granted to small businesses and individuals declined as a percentage of their total lending. A combination of institutional and market factors led the savings banks to invest heavily in low-risk mortgage loans or state securities.\textsuperscript{14} Thus for most of the nineteenth century the savings banks played a limited role in German industrialization.\textsuperscript{15} This vacuum in the small firm lending market, however, was quickly filled by the cooperative banking sector.

\textit{The Early Cooperative Banks.}

The cooperative banks were an invention of necessity. With the growing commercial freedoms of the mid-nineteenth century and the re-stabilization of conservative political control after the liberal revolution of 1848, an economic upswing occurred. Joint-stock banks, manufacturing corporations and the factories they operated began to emerge in the German states threatening both urban craftsmen and rural cottage industry. Likewise, the

\textsuperscript{13} In 1836 there was a total of 280 savings banks in the German states. Pohl, Manfred. 1986. \textit{Entstehung und Entwicklung des Universalbankensystems}. Frankfurt: Fritz Knapp. pp. 37-47.

\textsuperscript{14} This was due partly to the fact that the savings banks were required by law to have a very high level of safety in their investments and individuals had difficulty meeting such standards. Moreover, there were still many local and state politicians and bureaucrats who felt that the savings banks should not be making personal loans. The expansion of the cooperative banks also relieved the savings banks of pressure to expand personal lending. See Henze, 1972, op. cit., pp. 35-46.

\textsuperscript{15} Still, indirectly, by mobilizing a tremendous amount of savings and channeling these into regional and national capital markets, the savings banks did in fact play an indispensable role. G. Wysocki, 1983, op. cit.
elimination of serfdom by all the German states around this time meant millions of peasants were on their own. Both farmers and craftsmen thus faced growing pressures to invest in order to compete. The general lack of credit available to these individuals was translated by the spreading "cooperative movement" of the mid-nineteenth century into the creation of small cooperative banks throughout the German states. These banks were either agriculture or commerce oriented. The commercial cooperative banks, known as Volksbanken, arose most quickly in small towns where local entrepreneurs knew and trusted each other enough to solve their credit problems through mutual assistance. The rural banks, known as Raiffeisenbanken, were generally much smaller than the Volksbanken and were typically part of agricultural cooperatives engaged in the mutual purchasing and selling of farm goods.

The father of the Volksbanken was Hermann Schulze-Delitzsch. A judge and mayor, Delitzsch recognized early the economic problems which craftsmen and small business faced. He believed that the best way for the Mittelstand to solve its capital problems and protect itself from the competition growing out of the new factories was through mutual assistance. In 1852 he created the first credit cooperative. But it was through his writings that Delitzsch had his greatest impact. In 1853 he wrote a pamphlet entitled the "Association Book for Craftsmen and Workers." Seeking a third way between socialism and large-scale capitalism, it promoted the formation of associations of production workers based on the principles of 'self-help' and mutual liability among members. Delitzsch's anti-socialist sentiments, but also his liberal convictions and thus disdain for state subsidies, found expression in the publication.\(^\text{16}\) It quickly became the 'catechism' of the urban cooperative movement in

\(^{16}\) Following the failed revolution of 1848 Delitzsch became an important figure in the emerging workers' movement. But by the late 1860s his liberal ideas lost their sway as the workers' movement took a strongly socialist direction. His dream of building a harmonious society based on a broad Mittelstand where production would be done to a large extent in
Germany. By 1859 there were 80 Volksbanken with more than 18,000 members spread over Germany. In that same year the first congress of Volksbanken took place in Weimar, out of which came a federation of Volksbanken. Thus within the span of a decade Delitzsch managed to create a self-sustaining and self-contained cooperative banking system.\(^\text{17}\)

Cooperative banking had two particularities that distinguished it from commercial banking: First, because the members needed long-term as well as short-term credit, the revolving short-term credit most commonly offered by commercial banks was not sufficient. Second, the general lack of customary collateral for their loans made it nearly impossible for the cooperative banks to refinance their funds from commercial banks. Moreover, Delitzsch and many other cooperative promoters believed that the cooperative sector should be self-sufficient - relying neither on commercial nor state organizations for help. Thus it became critical for the cooperative banks to circulate funds among themselves. To do this they joined in regional associations and created regional "central" clearing banks

\(^\text{17}\). In a parallel manner to Delitzsch, Friedrich Wilhelm Raiffeisen, led the formation and growth of the rural cooperative movement which bears his name. By 1883 over 1,000 rural cooperatives had been established, roughly half of which included a credit cooperative. Manfred Pohl, 1976, op. cit. p. 40. Somewhat ironically, in the early years of the cooperative movement local savings banks often played the role of co-initiator in the establishment of new cooperatives since they were seen as complimentary to the savings bank - the cooperatives provided personal loans to business while the savings bank concentrated on deposit-taking and mortgage and communal lending. In the 1870s this early symbiotic relationship gave way to growing direct competition as the cooperatives began to successfully compete for deposits and mortgage loans. G. Wysocki, 1983, op. cit., p. 178.
(Verbandskasse). In the 1860s competing groupings of cooperative banks emerged, separated by varying philosophical principles. Thus there was no single national association uniting them, and numerous banks acted as clearing or central banks for different groups of cooperatives. Establishing organizational unity within the cooperative banking sector - including a sole national central bank for all cooperatives in Germany - evolved gradually over the following decades.

Nonetheless, as will be argued throughout this and following chapters, the Volksbanken played a crucial role in the economic survival and development of Mittelstand firms through the late nineteenth and early twentieth centuries. This was especially true in regions such as Baden, Württemberg, Saxony, and the Bergische and Siegen regions where small-firm craft-based production was strong. In such regions a more decentralized pattern of industrialization occurred. In these regions large groups of small firms typically produced similar and/or complimentary goods, frequently maintaining a complex network of long-term production relations. In regions where obligational networks based on long-term relations were strong, firms frequently extended their cooperation in the late nineteenth century to create sector- or region-wide promotional networks to provide collective goods such as worker training. As Hollingsworth has argued, "... obligational relationships function most effectively when they are embedded in a rich set of promotional networks."

Cooperative banks were an extension of such obligational networks from the production to the financial realm. The name of cooperative banks is itself quite revealing:

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In the nineteenth century the Volksbanken were referred to as 'advance associations' (Vorschussvereine) since they had no credit creation mechanisms. Members simply pooled their money and borrowed from the bank as needed, in effect forming a simple holding company.\(^{20}\) Since the liability of the advance associations was generally unlimited, the members needed to know and trust each other a great deal. A sense of community and recognition of common interests were prerequisites to cooperative banking. The success of cooperative banks and of sectors and regions that were not dominated by hierarchy as a governance mechanism were therefore frequently highly interdependent, and to a large extent continue to be today.

*German Banking After Unification.*

The unification of the German States in 1871 generated a wave of entrepreneurial and speculative activity. Though several important national and regional joint-stock banks had been created in the first wave of joint-stock corporation foundings in the 1850s, banking markets were still dominated by private bankers and some 30 state note-issuing banks.\(^{21}\) In the ‘foundation years’ of the empire, however, the capacity of the banking system to meet the burgeoning capital needs of industry was taxed. Individual private bankers alone did not have sufficient capital to finance the projects of the growing industrial concerns - especially in the Ruhr. Creating such banks allowed them to jointly finance larger industrial projects and spread the risk among several shoulders. Thus from 1869 to 1872 private bankers all

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\(^{20}\) M. Pohl, 1976, op. cit., pp. 36-38, 68-71. The banks were also typically operated on a part-time, honorary basis.

\(^{21}\) In the mid-nineteenth century dozens of private and public mortgage banks were also established. While they were restricted to a narrow range of activities, the mobilization of capital otherwise tied up in land was an important contribution to Germany’s industrialization. See M. Pohl, 1982, op. cit., pp. 296-320. For a discussion of German Banking prior to 1870 see also Tilly, 1967, op. cit.
over Germany led a second major wave of joint-stock bank foundings. In this short period the three major commercial banks of today were established: In 1870 some 76 private bankers and industrialists from all over Germany contributed their capital to establish the Deutsche Bank. In the same year private bankers in Hamburg were joined by bankers from Berlin and Frankfurt in creating the Commerz und Disconto-Bank. And in 1872 the Dresdner Bank was established. In the following decades other large banks were established or moved to Berlin, thereby making the city the banking capital of Germany.

The economic boom, however, was short. By 1873-1874 a severe downturn ensued and the first concentration wave of the modern German economy - largely through the liquidation of insolvent firms - rolled over industry and banking. The big Berlin banks survived but realized they needed to expand if they were to have a more solid footing. By the early 1880s several of the joint-stock banks had outgrown even the largest private banking house. With the help of a new joint-stock law in 1884, the managing boards of the great banks obtained greater independence from the private bankers which had founded them. The law also boosted the power of the larger banks by making it more difficult for smaller banks

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22 All together, some 100 joint-stock banks were established between 1870 and 1873. See M. Pohl, 1986, op. cit., pp. 33-35.


24. By the turn of the century there were eight Great Banks in Berlin: the Deutsche, Dresdner, Discontogesellschaft, the Bank für Handel und Industrie (known as the Darmstädter Bank), the Schaffhausen'schen Bank, Berliner Handelsgesellschaft, Commerzbank, and the National Bank für Deutschland.
to underwrite and trade securities, thus forcing many to work through the big Berlin banks.²⁵ Pushed back into the provinces where the savings and cooperative banks were now providing ample competition, the private banking tradition fell into rapid decline - many taken over by provincial banks. But the Berlin banks also followed the private bankers into the provinces, first by establishing deposit taking branches, and second by acquiring holdings in regional banks. Until the very end of the century, however, this expansion was limited as the commercial banks continued to concentrate in major cities and the industrial centers of the Ruhr and Silesia.²⁶

The creation of joint-stock laws and regulations proved to be a critical factor in the subsequent development of governance regimes in the commercial banking and other industrial sectors. Such laws enabled the emergence of larger concentrations of capital and thus large, hierarchically organized firms. The creation and empowerment of corporate management boards enabled interlocking directorates to become a dominant mechanism of governance in several industrial sectors in Germany. As suggested in Chapter 1, this example demonstrates how a change in property rights by the state can critically shape the development of sectoral governance regimes. Stated another way, the state made possible the emergence of large commercial banks able to become directly involved in industrial governance.

The major commercial banks also responded to the downturn of the 1870s by changing the focus of their business from more speculative actions - underwriting and trading securities or financing new ventures with their own equity - to continuous financial relations

²⁵ M. Pohl, 1986, op. cit., p. 29.

²⁶ M. Pohl, 1976, op. cit., p. 271.
with firms. They began to provide short and long-term capital for industry primarily through current account credits - thus was the German tradition of the "house bank" born. The banks competed vigorously for the current account business of firms, for this was the portal to influence over the firm. In the 1880s the Berlin banks continued to expand their dominant position in industrial finance, firmly establishing the very close ties to industry which ostensibly empowered them to organize German capitalism. By the end of the century of the rapid concentration of both banks and industry, and the development of close interconnections between them were already coming to be seen as the defining characteristic of German industrialization.\(^{27}\)

In the last two decades of the century the savings banks faced a panoply of changing circumstances which challenged their ability to survive. First, while the savings banks sought to support the lower classes and small business, their ability to do so was limited. A property-secured personal loan was the only form of credit they could offer small business, yet most individuals and small businesses had insufficient collateral. The inability of the savings banks to create additional lending capital through 'float mechanisms' (i.e. cashless transfer payments, or checks), severely limited their lending expansion. Second, the cooperative banks, and to some extent even the Berlin Banks, were expanding their share of the deposit-taking and small business loan markets. Meanwhile, the rapid growth of large-scale industry and the general movement towards industrial concentration, cartels and syndicates were threatening the traditional craft and small-scale industry. The intensifying

\(^{27}\) See Neuburger and Stokes, 1974, op. cit., pp. 713-714; Wellhöner, 1989, op. cit.; Riesser, 1912, op. cit.; and Whale, 1968, op. cit. The 'house bank' is the firm's chief financial partner, defined practically by a current account connection. Current accounts were a chief source of industrial finance. In essence they are demand deposit accounts with a line of credit attached to them.
pressure to modernize caused the capital demands of the Mittelstand to outrun the capacity of both the savings and cooperative banks to supply them. Combined with growing competition in the banking industry, this worsening competitive situation of the Mittelstand created a drive for reforms within the savings bank sector to become more universal bank-like institutions.

The single most important and divisive issue in the savings bank reform debate was over the ability to conduct cashless transfer or checking (giro) accounts, an activity which at that time the commercial banks alone could carry out.\(^{28}\) Within the savings bank sector there were many who believed the savings banks should not engage in "commercial" activities as this would take them away from their public mission of promoting savings and serving communal needs. Reformists, in rebuttal, saw the savings banks as having a public mission to help preserve the threatened Mittelstand, as well as provide a market counterweight to the growing power of the commercial banks.\(^{29}\) The reform debates in the savings bank sector were stoked further by the sharpening class struggle in the 1880s.

In his fight against social democracy Bismarck sought to prevent proletarization through social insurance provisions. In this same vein, the savings banks were viewed as instruments of anti-socialism and worthy of further state assistance. On the other side, many leaders of the working class - the very group which the savings banks were supposed to save from socialism - denounced the concept of ‘saving’ as bourgeois and workers who saved as

\(^{28}\) A giro payments transfer system is functionally equivalent to a checking system, but rather than issue a check, a payer issues an instruction to his/her bank to transfer funds directly to another account. The predominant form of transfer payments in Germany are giro.

traitors.\textsuperscript{30} Caught in countervailing forces, a resolution of the savings bank reform debate would not come before the turn of the century. Nonetheless, in the closing decades of the 19th century the savings banks made important moves toward organizing themselves into associations; first to obtain political representation, and later to provide the basis for cooperation among banks.

Until the 1880s the savings banks were independent organizations with little or no formal relations among themselves. In this decade there were growing attempts to gain some form of unity and cooperation among the savings banks. The first success towards this end stemmed from an 1878 initiative by the Imperial government to establish a postal savings bank. Vehemently opposed to such an organization for fear of its competitive power, the savings bank joined together in defeating the proposal. Augmented by the desire to provide some form of liquidity equalization among themselves - as the cooperative banks were doing - and to obtain other common goals, regional associations of savings banks began to form. In 1884 several regional associations joined together to create a central "association of associations," the \textit{Deutscher Sparkassen-Verband}.\textsuperscript{31} In the ensuing years the association would seek to enlist all the savings banks and become the sole central association of the savings banks. Through the association and its publications the representatives of the banks pressed their demands on the government and carried on the debates over the future of the

\begin{footnotesize}
\begin{enumerate}
\item[31] G. Wysocki, 1983, op. cit., p. 186. It was not until 1892, however, that the Deutscher Sparkassenverband became the sole central association. It was an association of associations insofar as individual savings banks were not directly members of the Deutscher Sparkassenverband, but only through their regional associations.
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savings bank sector. In a society which was rapidly organizing itself into interest groups, the establishment of associations would prove essential to survival in the twentieth century.  

As in the savings bank sector, the cooperative banking sector found it increasingly difficult to meet the growing needs of its members towards the end of the nineteenth century. And like the savings bank sector, the collaboration of the state played a crucial role in the development of the cooperative banks. But in the two decades preceding unification, the German states, especially Prussia, had ambiguous positions regarding the cooperative movement as a whole. To the would-be protectors of the state and conservative social order, the cooperatives’ adherence to the ‘self-help’ principle made them potential accomplices in a liberal revolutionary movement. In the 1860s Bismarck castigated cooperatives as "war chests of democracy." He believed they could not survive without state support.  

In spite of this mistrust, the Prussian government acquiesced in 1867 to the demands of the cooperatives for a law that would help solidify their organizational character.  

Within a few years however, this law proved deficient. In 1876 the cooperatives asked for a new law, which they finally obtained in 1889. Combined with further amendments in 1896, the state’s willingness to create a new legal foundation for this form of socioeconomic organization opened the door to an expansionary phase for the cooperative banks. Prior to these initiatives members of a cooperative had unlimited liability for its

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34. In 1871 this became the Imperial Cooperative Law.
obligations - an institutional barrier to their expansion. But in the new legislation the liability of members was limited, thereby enabling the cooperative banks to offer short-term current account and acceptance credits to their members, just as the major banks offered to large firms. With these new forms of credit the cooperative banks made a qualitative jump in their functional and organizational character from simple 'advance associations' toward more formally organized universal banks.\textsuperscript{35}

Toward the end of the nineteenth century the attitude of the state towards cooperatives became markedly more interventionist. Gradually realizing that cooperatives were largely founded by conservative social groups, especially farmers and workers in the crafts sector, the state began to protect these groups from unbridled market competition. As increasingly important organizations in these sectors, the cooperatives began to appear as potentially useful instruments against socialism. In 1895 the Prussian government created the \textit{Preussische Zentralgenossenschafiskasse}, or \textit{Preussenkasse}, to act as a central bank for cooperatives. The Preussenkasse was an independent organization under public law and capitalized by the Prussian government. The bank held deposits from the Verbandskassen of the regional cooperative associations, for which it paid higher than market interest rates, and lent funds to the Verbandskassen at below market rates. The government made this two-way subsidization by the Preussenkasse possible by accepting below market interest rates on its deposits in the bank. In short, the Preussenkasse was an institution through which the Prussian government could support and subsidize both the urban and rural cooperative banks.

\textsuperscript{35} Among its many provisions, the 1889 law also forbade lending by cooperatives to non-members and required the cooperatives to establish supervisory boards and issue formal shares to members. The law helped resolve many of the differences within the cooperative sector in the preceding decades which had led to the separation between the commercial (led by Schulze-Delitzsch) and rural (led by Raiffeisen) cooperatives. M. Pohl, 1986, op. cit., p. 77.
or more precisely, to provide support for farmers and craftsmen through favorable credits. In the agricultural crisis of the 1890s, for example, the government used the Preussenkasse to channel badly needed funds to the rural cooperative banks.\textsuperscript{36}

The Prussian government maintained that the Preussenkasse was not an attempt to control the cooperatives, but a supportive measure intended to help them eventually achieve complete self-reliance since the cooperatives would eventually be allowed to take over the bank. However, a large segment of the cooperative sector - organized in the General Association created by the liberal Schulze-Delitzsch in 1864 - still refused to work with the state on the grounds that to do so would compromise their principle of self-reliance. They viewed the Preussenkasse as a tool of socially conservative government. Instead these cooperative used other banks for their central bank functions.\textsuperscript{37}

The Preussenkasse thus worked with cooperatives outside the General Association and also provided capital to help organize new cooperatives. The rift between pro- and anti-state groups in the cooperative sector was widened further in 1901 when the Preussenkasse helped form a rival commercial cooperative association.\textsuperscript{38} This division within the cooperative sector would only be resolved after World War I. In the meantime, the combined stimuli


\textsuperscript{37} The first central bank was the Deutsche Genossenschaftskasse von Soergel, Purthius \& Co., founded in 1860 in Berlin. While the bank was originally owned by various cooperative banks, it eventually fell into the hands of owners whose interests differed from those of the cooperative sector. Consequently the majority of its business was conducted with non-cooperative banks. Thus most cooperative banks relied instead on their Verbandskasse to carry out requisite central functions. In 1904 the bank was absorbed by the Dresdner Bank, thereafter continuing to serve as a central bank for many cooperatives as a department within the Dresdner Bank. Faust, 1977, op. cit., pp. 539-540; M. Pohl, 1976, op. cit., pp. 68-71.

\textsuperscript{38} Kluthe, 1985, op. cit., pp. 74-75.
of the 1889 Cooperative Law and the Preussenkasse unleashed a wave of new cooperative foundings.

In the course of the twentieth century this combination of cooperative ‘self-help’ and complementary ‘state-help’ would become a central principle guiding the relations between the state and Mittelstand, in particular the craft sector. Thus the general contours of the subsequent relationship between the state - most notably at the Länder level - and Mittelstand were established around the turn of the century. It was a relationship formed by a mutual desire to counter economic concentration and maintain social groups generally supportive of a conservative political order.

In this very same endeavor Craft Chambers were gradually established in the German states after 1897. Today, as organizations run by the craft sector in cooperation with the state, the Chambers play a central role in the administration of the regulations that help protect this sector. Thus a multitude of promitional networks were formed to help sustain the Mittelstand through the provision of collective goods such as worker training, product development, and capital. Such networks were typically organized on a sectoral and regional basis by state agencies, the Chambers, craft and small business sector associations, and cooperative banks. Though many networks were also open to all craft and Mittelstand firms within particular regions.

In summary, the German banking sector underwent dramatic growth and changes in the nineteenth century: From a series of isolated local banking markets controlled by private

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bankers, to a modern banking system serving international, national, and local markets. By 1895 the commercial banking sector was represented primarily by the eight big Berlin Banks and 86 provincial joint-stock banks. In less than forty years the commercial cooperatives had increased their numbers from 80 banks in 1859 with some 18,000 members, to 1,068 banks with over 500,000 members. The savings banks also demonstrated tremendous expansion, from some 300 banks around 1840 to well over 2,000 in the 1890s (see Table 3.1).

Towards the end of the century each of the banking groups began to expand into the traditional markets of the others, but numerous spatial, social, and economic barriers still kept them largely segmented. The savings and cooperative banks were not yet universal banks in the same sense as the commercial banks, but both made significant gains in organizing their respective sectors into associations. In the early part of the twentieth century the organizational cohesion of these associations would solidify and end them an indispensable tool to wage the political battles necessary to maintain the legal protection of their distinct organizational principles.\textsuperscript{40} By the turn of the century the growing demands of the Mittelstand for credit and the incursion of the major commercial banks into the provinces, forced the savings and cooperative sectors to universalize further in order to remain competitive. For all three banking groups the state’s actions regarding the definition of property rights through legislation were crucial to the formulation and sustained development of their respective governance mechanisms - hierarchy in the commercial banking sector and associations in the savings and cooperative sectors.

C. 1895 - 1931: Consolidating the Foundations for a Three Sector Universal Banking System.

This period in the development of the banking sector begins with the economic boom starting in 1895 and ends with the depression and banking crisis of 1931. During this time there was tremendous concentration in German industry and in the commercial banking sector. The Berlin banks dramatically expanded their presence in the provinces. The cooperative banks were coming into wider social and political acceptance and gradually moved toward a resolution of their internal divisions. The savings banks also made great strides toward organizational unity and closer cooperation due in large part to their eventual adoption of a giro system. With the endorsement of the Länder governments in the Weimar period, the savings banks moved more and more into commercial banking business. The commercial and cooperative banks joined together in a political campaign to push the savings banks back out. But the savings banks successfully defended their new role. Thus by the 1930s the hierarchical branch model of the commercial banks and the association banking model reached their mature form. The savings and cooperative banks had essentially become universal banks, though their balance sheets were still skewed toward their traditional lines of business.

The success of the cooperative and savings banks in Weimar Germany cannot be divorced from the surprising resilience of industrial sectors and regions where Mittelstand firms played a prominent role. In was in the 1920s, for example, when Baden-Württemberg became one of Germany’s premier industrial regions. Production in this region was done extensively in smaller firms - many of which were organized in networks - and largely for consumer products - food, textiles, automobiles - and for products that required a high degree of skilled labor such as precision instruments and machine tools. This suggested that even
in Germany sectoral governance regimes and bank-industry relations that deviated from the organized capitalism model could be quite successful.

_The Savings Banks._

The first critical toward universalization for the savings banks was their adoption of the giro system. The debate within the savings bank sector over the introduction of cashless payment systems spanned more than three decades before the giro system was finally adopted in the early twentieth century. The greatest opposition to this initiative continued to come from within the savings bank sector itself, not the state or the other banking groups. As early as 1894 the Prussian government presented a draft law which would have permitted the savings banks to not only conduct cashless transfers, but also underwrite securities. With these privileges the savings banks would be able to become true banks offering the most modern form of credit and payment options. But the savings banks and communal governments sharply refused this initiative, because the law also contained very restrictive investment provisions, including minimum required investments by savings banks in Prussian or Imperial government bonds. The banks believed these restrictions would place them at a competitive disadvantage. Communal governments perceived this as an attempt by the central authorities to impinge on their rights to self-administration. Thus the struggle over the adoption of the giro system also was further complicated by a conflict between local,

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41. Dieckmann, Jens. 1981. _Der Einfluss der deutschen Sparkassen auf die staatliche Wirtschaftspolitik in der historischen Entwicklung._ Frankfurt: Rita K. Fischer. p. 49 Dieckmann argues that the cooperative and commercial banks actually thought it would benefit the banking sector as a whole if the savings banks participated in a national giro system.
regional and central authorities over control of the savings bank sector. Unable to reach an agreement, the initiatives contained in the law lied fallow for more than a decade.\(^\text{42}\)

The position of many savings banks and communal governments against the giro system was eventually swayed by the efforts of Johann Christian Eberle. A mayor in Saxony and outspoken defender of the Mittelstand, Eberle campaigned for the giro system as a social and political obligation of the savings banks to provide short-term credit to the Mittelstand. He argued further that the sector must follow a decentralized credit policy, in other words, to lend funds in the same area in which they were collected in order to counter the concentration of industry and banking services in a few regions.\(^\text{43}\) This argument was particularly persuasive as the big Berlin banks were steadily increasing their efforts to gather funds from local markets which they typically channelled to large industry elsewhere, not back into the local Mittelstand. Attesting to this, a growing capital scarcity at the turn of the century was most severe outside the major urban centers.\(^\text{44}\)

\(^{42}\) In 1912 such a "forced investment law" was eventually passed in Prussia, as it had been in Saxony in 1907 and Bavaria in 1911. See Klüpfel, Wolfgang. 1984. "Entwicklungslinien im Sparkassenrecht." In Standortbestimmung: Entwicklungsrichten der deutschen Kreditwirtschaft, ed. Günther Aschauer, et al. Stuttgart: Deutscher Sparkassenverlag. pp. 117-118. Dieckmann notes that by this time other banking groups supported such laws, as they were starting to worry about savings banks getting into commercial banking activities (1981, op. cit., pp. 55-57). In Prussia the law was promoted by the Finance Minister Miquel, who also promoted the creation of the Preussenkasse in 1895. Together these measures suggest an increasing attempt by the Prussian government to use the savings and cooperative banks to effect its social and political goals. Henze, 1972, op. cit., pp. 39-40; and H. Pohl, 1982, op. cit., pp. 23-24.


While Eberle’s tireless campaigning softened resistance to the giro system among the savings banks, the coup de grâce was a severe capital shortage in 1907 resulting from the Imperial government’s adoption of the gold standard. The shortage brought heavy political pressure from numerous business associations to ease the credit shortage. To meet these demands, as well as to ease the drain on its gold reserves, the government sought legislation which would further de-monetize the economy through expanded cashless payment mechanisms. At this point the National Savings Bank Association mobilized all its forces and lobbied the Imperial government for their inclusion in the legislation. It had finally become clear to most people in the savings banks sector that participation in the giro system was essential to their survival. Thus in 1908 the savings banks obtained the right to implement transfer and checking accounts, and to operate current accounts and hold securities on deposit.45

This legislation, and the empowerment of the savings banks contained therein, was the first critical step in the transformation of the savings banks into universal banking institutions. Since the savings banks were regulated by the Länder, the Länder had to promulgate detailed legislation before their savings banks could actually take up a giro system. The spread of the giro system took many years, partly as a result of remaining resistance among different banks. The savings banks of Württemberg, for example, did not establish a giro system until 1916.46 But it was the implementation of the giro system and its organizational prerequisites which truly cemented unity among more than 3,000 savings


banks existing in the 1910s. This was primarily so because the introduction of giro accounts required central clearinghouses to carry out interbank transfers.

Thus the savings banks joined together in regional 'giro associations' (*Giroverband*) and established regional giro clearing banks known as a *Girozentrale*. In 1916 the Prussian regional associations united into a central giro association - the *Deutscher Zentralgiroverband* - and established a central clearing bank, the *Deutsche Girozentrale*, two years later in Berlin.  

Thus with the introduction of the giro system and the Girozentrale, the savings banks' hierarchical associational structure was solidified and extended. With the introduction of "bank-like" activities individual banks began to rely on cooperation with other banks for their competitiveness. Preventing competition among savings banks - a key function of the association - was a critical prerequisite to the future growth of cooperation. Ironically, it was probably the inflation of the early interwar years that made this progression to universal banking truly irreversible.

As inflation quickly accelerated after 1918 the traditional business of the savings banks, namely savings accounts and mortgage loans, rapidly declined. With a rapidly devaluing currency it simply made no sense to invest long-term or hold cash in low, fixed-interest rate accounts. To survive the savings banks needed to do more short-term and cashless business. Thus the recently adopted giro system quickly became indispensable to the savings banks. But this alone was still not enough. As inflation worsened, lawmakers

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47. The giro associations were set up as parallel and formally independent structures to the preexisting savings bank association in each region. But close personal and organizational ties between the savings bank and giro association in each region meant that they were practically the same organization.

48. Faust notes that as late as 1914 more than 1,100 savings banks were using the *Preussenkasse* as a central bank (1977, op. cit., p. 556). With the girozentrale, the savings banks finally achieved sector-internal institutions.
and regulatory authorities of the Länder found themselves forced to liberalize restrictions on
the savings banks, since the only alternative would have been to allow them to be slowly
choked out of existence.\textsuperscript{49}

But the savings bank policies of the Länder time were not simply reactions dictated
by an emergency situation, they also embodied the active pursuit of broader economic goals.
Länder promoted the liberalization of the savings banks laws so that the credit needs of local
Mittelstand businesses could be better provided for. The Länder governments believed that
the private banking sector was not providing sufficient capital to this category of firms.\textsuperscript{50}
And as later studies would show, they were largely correct in this belief. The major
commercial banks’ asset structure was skewed toward large firms in particular industrial
sectors. In regions where they had taken over provincial banks - which in fact they had been
doing in great numbers in the early interwar period - they generally provided less credit to
the Mittelstand than the provincial bank had. In the 1920s the Berlin banks were frequently
reproached for this.\textsuperscript{51}

By the end of the inflationary period in 1923 most German Länder had greatly
expanded the range of financial activities open to their savings banks, including securities

\textsuperscript{49} J. Wysocki, 1987, op. cit., p. 40. Moreover, several communal governments had
begun to establish their own commercial banks in order to circumvent the tight savings bank
regulations. This trend was not viewed favorably by Länder governments, as it would
enhance the autonomy of communal governments.

\textsuperscript{50} See Born, Karl Erich. 1983. "Vom Beginn des Ersten Weltkrieges bis zum Ende der
Weimar Republik (1914-1933)." In Deutsche Bankengeschichte, Vol. 3. Frankfurt: Fritz
Knapp. p. 52.

\textsuperscript{51} See Gehr, Martin. 1959. "Das Verhältnis zwischen Banken und Industrie in
University of Tübingen. p. 103-108.
trading for customer accounts and removal of upper deposit limits of savings accounts.\textsuperscript{52} Thus by the mid-1920s the savings banks had made great strides toward becoming universal bank-like institutions. The adoption of the giro system and other commercial business permitted them to greatly expand their lending to the Mittelstand and begin to compete in other markets with the commercial and cooperative banks.

\textit{The Cooperative Banks.}

In the first decades of the twentieth century the cooperative banks underwent similar transformations to the savings banks: Namely, individual banks became more "bank-like" in their activities, while the cooperative sector as a whole developed a three-tier associational structure and made great strides toward more systemic coordination and cooperation. Though the 1889 and 1895 cooperative legislation settled several of the issues involved in the sector's internal conflict over the desired nature of the cooperative system, remaining divisions within the competing associations inhibited efforts toward the establishment of a sole central bank and association. The cooperatives that refused state assistance worked with several banks. The cooperatives that accepted a state role in their system worked with the Preussenkasse as their central bank.

By 1920 the two competing associations of the commercial cooperative banks managed to unite and form the \textit{Deutscher Genossenschaftsverband}, or German Cooperative Association, though without solving the central bank question. According to Born the fusion initiative stemmed from the Craft Chambers which sought a more effective banking system

\textsuperscript{52} The savings banks had actually entered the securities business in 1915 when they were allowed to underwrite war bonds (and in fact they issued 25\% of all war bonds). By 1921 in Prussia the only business expressly forbidden for savings banks was currency trading on their own account. See J. Wysocki, 1987, op. cit., p. 41.
for craft firms.\textsuperscript{53} Faust suggests further that the tendencies toward nationalization in social
democratic Weimar Germany drove the competing associations to put aside their differences
in order to provide a unified front against a potential state takeover.\textsuperscript{54} In spite of this
advance in associational unity, the independent (and sometimes competitive) banking
activities of the Preussenkasse, Dresdner Bank, and numerous regional "central" banks still
represented a disharmonious system.

The hyperinflation of the early 1920s was a mixed blessing for the cooperative
banking sector. Like most other banks, the inflation wiped out much of their equity and
many cooperatives dissolved. The state, acting through the Preussenkasse, put a large
number of the remaining cooperatives - and the firms which depended on them - back on
their feet with an infusion of much needed capital.\textsuperscript{55} But most importantly, the cooperatives
moved closer toward their goal of complete self-administration and sufficiency when the
government restructured the Preussenkasse in 1924. The Prussian government allowed the
cooperatives to invest capital in the Preussenkasse via their various regional banks, thereby
giving them an equal voice in the directorship of the bank. Permitting the cooperative sector
to have direct influence over the bank represented a compromise solution over the "state
versus no state" debate. It also represented a victory for the cooperative sector against

\textsuperscript{53} Born, 1983, op. cit., p. 92.

\textsuperscript{54} Faust, 1977, op. cit., p. 282.

\textsuperscript{55} Funds to recapitalize the banks and for special credit programs for craft firms and
farmers flowed from the Reichsbank through the Preussenkasse. The Reichsbank funds were
guaranteed by the Imperial Finance ministry. Faust, 1977, op. cit, pp. 556-560. In the early
1920s many cooperatives began to change their legal status to joint-stock corporations in
order to maintain the real value of members' shares in the bank. The cooperative association
fought this trend rigorously, and with the help of some regulatory changes and the end of
inflation, stopped it. M. Pohl, 1986, op. cit., p. 82.
certain groups in the Prussian government that advocated extending the direct control of the Preussenkasse over the cooperatives. From the viewpoint of the cooperative sector this would have been a disastrous politicization of their system. The regional clearing banks were now committed to working with the Preussenkasse, thereby making it the central banking institution for the regional cooperative central banks and the vast majority of the individual cooperative banks.

Thus by 1925, the cooperative sector had developed a strong three-tier associational system: On the primary level were 1,349 commercial and 20,855 agricultural credit cooperatives; on the secondary level were forty-three regional banks - now known as Zentralkassen; on the tertiary level was the Preussenkasse. The state had played a key role in helping the cooperative sector to firmly institutionalize itself as a distinct but important component of the economy, and of society in general. Through their movement toward associational unity the cooperative sector also established a foundation for its future competitiveness, as well as increased political influence in Germany.

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57. Though the Dresdner Bank continued to work directly with over 1200 cooperative banks until 1939 when the Preussenkasse - in the meantime renamed the Deutschlandkasse - bought the Dresdner's cooperative division at the urging of the Imperial government. The Deutschlandkasse was finally the sole central credit institution for the cooperative sector. Faust, 1977, op. cit., pp. 578-580.


59. During the war the cooperative sector played a key role in securing the supply of goods and foodstuffs, thus earning greater respect outside the cooperative sector and especially in the state: The Weimar constitution formally recognized the cooperatives as a desirable component of the economy. See Kluthe, 1985, op. cit., pp. 89-93.
The actions of the Preussenkasse aided the rapid expansion of the banks in two important ways: First, the Preussenkasse pumped funds into the sector in time of crisis; and second, by pursuing a counter-cyclical interest rate policy, it attempted to maintain low and constant interest rates on cooperative bank deposits and loans. Thus while the Preussenkasse could not build a completely independent capital market for the cooperative sector, it could shield the sector from the worst ravages of the national market.\textsuperscript{60}

By the 1920s the cooperative banks, especially the commercial cooperatives and the Zentralkassen, had made their breakthrough into the traditional markets of the commercial banks. They were increasingly oriented toward short-term credit markets and developed significant securities business.\textsuperscript{61} But more than anything else, the intensifying competition among the cooperative, savings, and commercial banks in the 1920s was occurring through the incursion of the Berlin banks into local markets.

\textit{Commercial Banking.}

A rapidly expanding economy after 1895 also led to dramatic changes in the commercial banking sector. The voracious appetite of large industry for capital induced the big Berlin banks to reach out into the provinces to gather funds for their major customers. They did this first through deposit banks. By 1914 the eight big Berlin Banks together commanded over some 730 deposit banks and branches.\textsuperscript{62} But up to 1914 the Berlin banks' most important expansion strategy was to form "interest communities."

\textsuperscript{60} See Faust, 1977, op. cit., p. 552.

\textsuperscript{61} M. Pohl, 1986, op. cit., pp. 76-83.

\textsuperscript{62} G. Wysocki, 1983, op. cit., p. 180. See also Sprenger, Bernd. 1987. "Das Bankwesen im Zeitalter der Industrialisierung." Die Bank. 10: 576-579. As their name suggests, deposit banks generally were limited in their business to accepting deposits.
(Interessengemeinschaften) with provincial banks. Through small interlocking shareholdings with a series of regional banks, each Berlin bank expanded its influence over the national banking market without spending the large amounts of capital it would have cost to build its own branches.\textsuperscript{63} This joint-venture strategy - a form of obligational network - proved to be quite effective for the Berlin Banks.

In the period after 1914, however, the eight Big Banks shed this strategy for a more hierarchical form of control as they began taking over the banks in their 'interest communities,' especially in the Ruhr, Silesia, and Stuttgart. From 1914 to 1921 the eight Big Banks together absorbed eighty-three provincial banks.\textsuperscript{64} By the end of the inflation era the big Berlin banks had definitively gone beyond their own regional beginnings, having spread their reach all over Germany. The Deutsche Bank, for example, went from just six branches in 1900 to 173 by 1926; the Dresdner Bank took over sixteen banks between 1914 and 1924, attaining eighty-six branches by 1926; and the Commerz- und Discontobank went from eight branches in 1913 to 246 by 1924.\textsuperscript{65}

Perhaps more important than gaining branches, through takeovers the Berlin banks also gained connections to new firms, many of which were Mittelstand. For example the Deutsche Bank took over the Bergisch-Märkische Bank in 1914. The Bergische region, in

\textsuperscript{63} Manfred Pohl argues further that the presence of Reichsbank branches in most cities and towns inhibited the decentralization of the Berlin banks (1986, op. cit., p. 63).

\textsuperscript{64} Manfred Pohl notes that in 1918 there were 120 private commercial banks in Germany, but by early 1927 this number had shrunk to 65. The Ruhr and Silesia industrial regions were attractive primarily for their mining, steel and heavy industries. Stuttgart was increasingly important as a consumer goods manufacturing center, especially for the automotive industry (1986, op. cit., pp. 85-88).

\textsuperscript{65} The five other Berlin banks underwent equally impressive expansion in this period. M. Pohl, 1986, op. cit., pp. 62-69.
which the bank was founded and operated by local industrialists, was then as it is today an area in which small firm craft-based production is strong. But as noted above, this did not always translate into a supportive relationship between the Berlin banks and the Mittelstand sector in different regions of Germany. But where the Berlin Banks continued to afford the managers of these new regional branches considerable autonomy - such as in Stuttgart and the Bergische region - they were generally quite successful. Retaining and utilizing the knowledge of local conditions and contacts to local entrepreneurs held by the branch managers was critical.

In sum, this tremendous expansion of the major commercial banks between 1895 and 1924 allowed them to build up their deposit and lending activities with industry. Their expansion in this period also went well beyond the borders of Germany as the big Berlin banks vastly increased their international activities. Through consortia the banks expanded their underwriting of domestic and foreign state and industrial bonds - in the process taking a strongly dominant position over the domestic securities market.

But while there is no denying the concentration of bank and industrial capital in particular sectors and the close relationship between banks and large industrial firms in Imperial Germany, there is ample evidence which suggests that even at the presumed historical apogee of their power, the ability of the so-called Great banks to actually promote development was more circumscribed than traditionally claimed.67


67. See Tilly, 1966. op. cit.; also see Tilly, 1967, op. cit., and Riesser, 1912, op. cit. For an exceptional analysis of the banks in early industrialization and a review of this debate see Wellhöner, 1989, op. cit., esp. pp. 66-76. Some scholars have gone so far as to argue that the credit policies of these banks actually inhibited overall economic growth - see Neuburger and Stokes, 1974, op. cit. Rainer Fremdling and Richard Tilly criticize this argument on methodological grounds but share in its skepticism regarding the 'net growth
Wellhöner's exhaustive case studies of eight heavy industry firms in the Rhineland-Westphalia (mostly the Ruhr) region and the electronics giant Siemens - which virtually monopolized the electronics industry - and their relations to the banks from 1881-1882 to 1913-1914 is particularly revealing. He argues that the conditions necessary for bank dominance over these industrial firms rarely attained. In his findings increased concentration and cartelization in industry did not eliminate competition among firms, but merely transferred it from price other forms of competition. Nor did high bank concentration severely restrict competition among the banks. In fact, new areas of bank competition emerged in this period - competition for consortium leadership and shares, and for board seats. Thus when these firms needed external capital they typically shunned bank loans in favoring of the capital markets where they used competition among the banks - aided by the powers of their cartels - to limit bank influence.

Even when bankers sat on corporate boards their influence was limited: coordination between the banks and firms arose when their interests converged, when their interests diverged the firm managers generally won. Bank influence was limited by competition among the banks, but also importantly by the limited detailed knowledge that bankers had about the technical aspects of long-term investment decisions. Bankers acted as financial advisors. And even then they were not always listened to. When firms were in trouble, bank influence naturally rose. But bank influence subsided again after the firm regained its footing.

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In Wellhöner's depiction of bank-industry relations then, corporate interlocks among banks and industrial firms were more monitoring than obligational networks, insofar as the means of coercing behavior were more restricted than widely assumed. The main purpose of such interlocking directorates then was to increase the flow of information among participants, not for the banks to exert control of industry.\(^{69}\) In the late 1920s and 1930s the big Berlin Banks faced even greater difficulties in maintaining their own financial stability, let alone the influence that they did have in industry.

\(^{69}\) Of course there were exceptions to these general conclusions, but the exceptions went both ways: the Deutsche Bank tended to dominate Mannesmann, while Siemens had considerable influence over the Deutsche Bank. Wellhöner, 1989, op. cit., p. 245.
D. 1924 - 1931: From Crisis to Disaster.

The end of hyperinflation in 1923 marks the beginning of a key period in German banking history. For the big Berlin banks it was largely a time of consolidation since their financial strength and flexibility had been severely circumscribed by inflation and their expansion in the preceding decades. The savings and cooperative banks made further strides toward organizing their respective sectors and expanding their range of activities, especially into the traditional domains of the commercial banks. The 1920s were years of relatively intense bank competition in Germany. Following monetary stabilization in 1924 the commercial and cooperative banks fought the new role of the savings banks in commercial banking markets. The long struggle ended in victory for the savings banks. It was a critical victory not only for savings banks, but for the Mittelstand firms and regions that benefitted from increased attention by the banking sector.

In this period the savings banks as a group completed their movement toward a three-tiered associational structure: In 1924 the central association of savings banks - *Deutscher Sparkassenverband* - joined with the central giro association - *Deutscher Zentralgiroverband* - to create the *Deutscher Sparkassen und Giroverband* (DSGV), today’s central association of the savings banks. Now, on top of the local savings banks were numerous regional associations and a regional clearing bank (Girozentrale); on top of the regions was the central association and a central clearing bank. The DSGV quickly became an important

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70 A third association of communal banks organized outside the savings bank sector also joined in the new DSGV.
organizational force for the savings banks, particularly regarding the provision of collective goods such as advertising and a management training system.\textsuperscript{71}

In spite of a decline in their overall numbers, the savings banks were utilizing the opportunities gained during and after the war to greatly expand their commercial banking activities, especially short-term lending via current accounts - the traditional sphere of the private banks.\textsuperscript{72} As independent banks conducting more and more business on their own, including commercial lending, the Girozentrale helped lead the charge of the savings banks into the field of industrial finance.\textsuperscript{73}

In the mid-1920s a major political conflict emerged between the savings banks on the one hand, and the cooperative and especially the commercial banks on the other.\textsuperscript{74} Sensing growing competition from the savings banks at a time when they themselves were financially weakened, the commercial and cooperative banks launched a campaign to push the savings banks back into their comparatively limited pre-war role. They wanted the savings banks to get out of the short-term lending business, and used the argument that this sort of business (particularly current account lending) was a taxable commercial activity and therefore did not belong in the tax-free savings bank sector. They maintained that the earlier division of labor

\textsuperscript{71} In the late 1920s the first building savings banks were established; and in 1932 their own publishing house. Building savings banks (Bausparkassen) were a special form of bank designed to promote savings for home construction.

\textsuperscript{72} From a peak of about 3,100 in 1913, their numbers had declined to 2,622 in 1925. Inflation and communal reorganization accounted for the bulk of the fusions and liquidations. Deutsche Bundesbank, 1976, op. cit., pp. 67, 122.

\textsuperscript{73} From nine girozentrale in 1909, there were 32 by 1930. M. Pohl, 1986, op. cit., p. 90. The Girozentrale, however, were primarily active in communal lending.

\textsuperscript{74} This section on the 1920s battle between the public and private banks relies heavily on Dieckmann, 1981, op. cit. pp. 66-78; see also Kluthe, 1985, op. cit., p. 105, for a review of the cooperative banks' position on the savings banks.
in the banking sector in which the savings banks collected money and the commercial and cooperative banks lent it, should be restored through legislative initiative. Even the major interest association of the business sector - the Reichsverband der Industrie (RDI) - backed the demands of the commercial banks.\textsuperscript{75} Thus the state became an arena in which the different banking groups were to fight this battle.

But this battle went beyond the pursuit of narrow self-interest by the different banking groups. By 1924 conservative forces in Germany had managed to recapture the political high ground and return a bourgeois central government to power. Much of the social, political and economic gains made by the worker's movement and the SPD in the early Weimar years were successfully undone.\textsuperscript{76} Nonetheless, workers and the SPD remained a powerful political force. After 1925 they began to develop a new program for economic democracy - one in which communal corporations (e.g. savings banks) and organizations of self-help (e.g. cooperatives) were assigned an important role.\textsuperscript{77} And indeed the 1920s was a time in which state-owned companies were expanding their market presence.\textsuperscript{78} This program

\textsuperscript{75} Dieckmann, 1981, op. cit., p. 69. Though it also represented the Mittelstand, the Reichsverband was dominated by large firms which were more closely associated with the major commercial banks.


\textsuperscript{78} See Wurm, Franz F. 1969. \textit{Wirtschaft und Gesellschaft in Deutschland, 1848-1948}. Opladen: Leske. pp. 211-213. In the banking sector, for example, many large special and general purpose banks were created outside the savings bank sector by the central and Länder governments. The Reichskreditgesellschaft was created for a special purpose during the war, but by the mid-1920s it had grown to the proportions of the Berlin banks and began to
of economic democracy frightened most bourgeois groups. Conservative social forces, including the right-wing of industry (associated strongly with the heavy industry of the Ruhr), warned repeatedly that the socialists were slowly extending their power over society via the state.\textsuperscript{79} Against this background struggle between socialism and capitalism, the battle between the public savings banks and the private banks drew a great deal of public attention. In their attempt to beat back the savings banks the private banks repeatedly invoked the specter of "cold socialization."\textsuperscript{80}

In the process of defending their newly won markets, the savings banks developed a new self-definition of their social, economic, and political role. The savings banks portrayed their role - and that of the public sector in general - as subsidiary. Namely, they argued that they sought not to dominate the banking business but to fill in the gaps left between the large commercial banks and the small cooperative banks - such as in the area of public infrastructure and Mittelstand finance - or to undertake activities where the common good required a public presence. Finally, the savings banks characterized themselves as providing a needed counterweight to the growing centralization and concentration in the

\textsuperscript{79} But in the political arena this was a period of social partnership and class compromise. The RDI was controlled by its left-wing after 1925. This left-wing alliance of pro-export industries was conciliatory to the SPD and generally accommodated worker's demands on social policy. But the spread of the savings banks was presumably too egregious a case of creeping socialism for the RDI to accept it. The progressive faction included small and medium sized firms in the South and Southwest, but was led by the newer dynamic industries of electronics, machines, and chemicals in Berlin and the Rhineland. Abrahams, 1980, op. cit.

\textsuperscript{80} The years between 1926 and 1930 were known in Germany as the era of creeping, or "cold socialization." Dieckmann, 1981, op. cit., p. 78. This view of the savings banks continued through the early 1930s as attested by comments made in the 1931 annual report of the commercial banking association. See Born, 1983, op. cit., p. 52.
economy, behind which lurked the monopoly ambitions of the private sector.⁸¹ The battle between the public and private banks was carried out for three years in the public press, as well as in the corridors of power in Berlin and the Länder capitals.

The conflict was finally defused in early 1928 when the Prussian government issued its new savings bank ordinances, and the Imperial finance ministry issued its new tax regulations. Both rulings made clear that the current account and Mittelstand lending (with some exceptions) of the savings banks would continue to be tax-free. Thus the commercial and cooperative banks’ strategy to restore a stricter division of labor in the banking industry through the tax laws failed. Judging from the eventual outcome of the battle, it appears the savings banks successfully conveyed to both the public and the lawmakers the validity of their self-described role.

Having failed to win an outright victory, the commercial and cooperative banks decided to cut a deal with the savings banks instead that would limit bank competition. In 1928 the associations representing the three banking groups concluded a private (albeit state-sanctioned) Competition Accord. The private banks agreed to drop their opposition to the savings banks’ new role in exchange for some voluntary restraint. The primary concession by the savings banks was to stay away from large industrial loans.⁸² While the debate over

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⁸². The signatories also established regional courts to adjudicate any violations of the agreement. Dieckmann, 1981, op. cit., p. 71.
the appropriate role of the savings banks in the banking sector continued, the Competition Accord greatly reduced the immediacy of the issue.

Though the savings banks agreed to self-limit their role in the banking system, they made tremendous gains in other respects through their battle with the private banks. First, the attacks of the private banks helped create a stronger sense of collective identity in the savings bank sector and thus to solidify internal unity among the banks. Second, through their public campaign the savings banks gained a much greater and positive profile among the public, as well as greater influence with the authorities, parliaments, the press and business associations. The savings banks were more than ever in a position, and more than ever interested, to take a stand on broader policy issues and use their power to influence government. The savings banks now had sympathetic personal contacts at the highest levels of government. Finally, the protracted transformation in the savings bank's public mission was completed: the savings banks' chief function was no longer simply to protect the lower classes, but to support the middle classes, including Mittelstand firms.83

Since the Mittelstand was also the key clientele of the cooperative banks, the expansion of the savings banks into commercial lending and rural areas (where the cooperatives were long the only banks) made the 1920s an era of increasing direct competition between the two groups. In spite of the success of the savings banks, the cooperative banking sector also did well in this period.

The Cooperative Banks.

83 In this case 'Mittelstand' is understood as the middle class broadly defined, i.e. not just small and medium firms, but all groups falling in the middle income range.
As a result of their difficulties with inflation, the number of commercial cooperative banks declined from a peak of 1,549 in 1913 to 1,349 in 1925.\textsuperscript{84} But in the second half of the decade the remaining banks expanded steadily their balance sheets. By 1930 approximately one-quarter of all urban Mittelstand firms were cooperative members.\textsuperscript{85} And it was in the 1920s that the cooperative banks began to expand into new financial services by establishing, for example, cooperative insurance corporations. But the cooperative banking sector continued to have an up-and-down relationship to the state.

After the reorganization of the Preussenkasse in 1924 that had given greater influence in the bank to the cooperative sector, the relationship between the Preussenkasse and cooperatives greatly improved. For the cooperatives it was a long-standing organizational goal to gain complete self-reliance. Moreover, the Preussenkasse had helped restore the health of the cooperative sector and the firms dependent on these banks after the inflation. But soon this generosity came back to plague the Preussenkasse. In 1927 it had grave liquidity problems due to rising loan defaults in agriculture. In the following year the bank had to be reorganized (and recapitalized) once again. This time the authority of the Preussenkasse to directly supervise cooperative banks and loans was increased, much to the dismay of the cooperative sector.\textsuperscript{86}

\textsuperscript{84}. Deutsche Bundesbank, 1976, op. cit., p. 122.

\textsuperscript{85}. In agriculture over 50\% of all farms were cooperative members. Kluthe, 1985, op. cit., p. 101.

\textsuperscript{86}. Attempting to gain the upper hand on the severe problems of the agricultural sector, in 1930 the Imperial government and the Preussenkasse pressured the two major rural cooperative associations into fusion. This fusion was also made much easier by a preceding union between the competing interest associations of the agricultural sector. Born, 1983, op. cit., pp. 92-93; also Kluthe, 1985, op. cit., pp. 109-113; and Faust, 1977, op. cit., p. 569.
The state also aided the expansion of the cooperative sector through amending the Cooperative Law in 1922, 1926, and again in 1929. The general thrust of these revisions was to make the internal decision making process for large cooperatives easier through the introduction of member representative assemblies. The introduction of such assemblies also made the fusion of cooperatives much easier, but it also made it more difficult for mutual trust among members to play a significant role in the operation of the cooperative.\(^\text{87}\) The recovery of the cooperatives after inflation and their progress in building a unified association structure would prove crucial to maintaining their competitiveness vis-à-vis the savings banks and the much larger commercial banks in local Mittelstand markets.

*The Commercial Banks.*

Though all of the big Berlin Banks survived the hyperinflation, their equity capital was greatly reduced. Increasing competition put downward pressure on profits. At the same time their operating costs had grown dramatically, due in part to their earlier expansion during and immediately after the war. Thus lower profits in the late 1920s made it very difficult for the banks to rebuild their equity base. According to Pohl, the only significant new initiative by the major commercial banks in the 1920s was the introduction of savings accounts in 1928 - a "belated" response to the incursion of the savings and cooperative banks into traditional commercial bank markets.

For the German economy the second half of the 1920s were generally good years as production and exports rose. But it was also a time of widespread overcapacity in industry. Efforts to Taylorize and rationalize at this time resulted in further concentration among large firms. In 1925 the chemical giant I.G. Farben was formed, followed by the fusion of several

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\(^{87}\) The amendments also allowed cooperatives to purchase holdings in other firms, such as the new cooperative insurance companies. See Kluthe, 1985, op. cit., pp. 104-105.
major steel firms into the Vereinigte Stahlwerke in 1926. The concentration in industry meant the Berlin banks had even less influence over the increasingly assertive industrial concerns.\textsuperscript{88} The combination of weak balance sheets and weakened influence in industry led to fusion discussions among the banks. By restoring their own health and achieving greater size, the banks hoped to restore a more equitable power balance in their relations to industry.

In 1929 a consolidation within the ranks of the big Berlin Banks occurred: the Deutsche Bank and the Disconto-Gesellschaft merged, as did the Commerz und Privatbank merge with the Mitteldeutsche Creditbank. While these mergers returned a measure of health and power to these banks, the commercial banking industry as a whole was still weak. This structural weakness, as well as poor management decisions by many of the banks in the 1920s, were laid bare by the economic depression, growing political uncertainty, and the banking crisis of 1931. The crisis and the responses to it would definitively end the brief period of vigorous competition among the three major banking groups in the interwar period. This occurred not through the restoration of a division of labor among the banks, but through the introduction of strict national banking regulation.

\textit{The 1931 Banking Crisis.}

In July of 1931 a massive run on the banks touched off a widespread crisis in the German banking industry. The industry's collapse at this moment resulted from a combination of domestic and international political and economic factors. From the beginning of World War I to the end of hyperinflation in 1924 industrial modernization had been severely restricted for lack of funds. Following currency stabilization demand by

\textsuperscript{88} See M. Pohl, 1986, op. cit., pp. 86-89.
industry for capital was tremendous. But the banks' loss of equity capital due to inflation hampered their ability to lend. Thus both the banks and industry began to borrow heavily short-term funds from abroad. But being optimistic about the future, they invested these funds in long-term projects. Moreover, domestic interest rates were kept high in order to draw in the foreign capital needed to pay Germany's war reparations. Altogether this heavy borrowing by the state and private sector meant that Germany was highly-leveraged on short-term foreign funds. Finally, for the reasons discussed above, competition in the domestic banking market was intense, leading both to lower profits and high number of bad loans.

The downward spiral of the US and world trade after 1929 translated into a withdrawal of funds from Germany by foreign lenders. Because the German banks had lent most of these funds long-term, combined with the growing economic problems of industry and thus its inability to pay back such loans early, the demand by foreigners for their money severely tested the banks' liquidity. Chancellor Brüning's deflationary economic policy only hampered the ability of industry to repay. Many firms that could not repay ended up under bank ownership. Thus the major commercial banks greatly expanded their industrial portfolios but largely by default, not as part of strategic intervention in industry.

Political developments made foreign lenders even more nervous about the credibility and future of Germany when the Nazis became the second largest party in the Reichstag in September 1930, followed shortly by the announcement of a plan for a German-Austrian customs union. With public confidence already severely shaken, a massive run on Austria's largest bank in May 1931 soon spilled over into Germany. International efforts to maintain

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89. The German central bank, the Reichsbank, was largely under the control of foreign officials and thus unable to do much against the growing foreign debt, in spite of many warnings. See Born, Karl Erich. 1967. Die deutsche Bankenkrise 1931. München: R. Piper & Co., pp. 28-30. The section on the German banking crisis draws heavily from this work.
Germany’s liquidity through a capital infusion and rescheduling of reparations payments floundered, largely on the resistance of France. By the time a moratorium on German reparations payments was reached it was too late. Confidence in the Germany economy was destroyed and both domestic and international lenders demanded their funds. Capital flight from Germany surged.

At first the government hoped the banks could solve the problem themselves, but the commercial banks’ attempt to support each other through the creation of a guarantee syndicate failed. On July 13, the fourth largest commercial bank - the Danatbank - went under. Five days earlier the Dresdner bank had refused to merge with the Danatbank and was now threatened with the same fate.\textsuperscript{90} Hundreds of banks, including many savings banks and girozentrale, were likewise tottering on the brink. Over a thousand credit cooperatives dependent on the Dresdner for payments transfers were frozen by the Dresdner’s imminent demise. On July 28, the government was forced to intervene and created the Acceptance and Guarantee Bank to provide loans to the weakened institutions.\textsuperscript{91}

But by winter these loans proved insufficient and the state had to bail out numerous banks. The Dresdner was taken over by the government, infused with massive funds from the government Guarantee bank, and eventually forced to merge with the insolvent Danatbank. The Deutsche and Commerzbank protested this action, for it made the Dresdner larger than the two of them combined, but they too were dependent on a large infusion of capital from the state to remain liquid. The Commerz- und Privat-Bank was also forced to

\textsuperscript{90} The Danatbank was born of an earlier merger between the Nationalbank für Deutschland and the Darmstädter Bank. Kindleberger, 1984, op. cit., p. 127.

\textsuperscript{91} The \textit{Akzept- und Garantiebank} was capitalized with RM 200 million, 40\% of which came from the government, the remainder from the banks. M. Pohl, 1976, op. cit., p. 91.
merge with the Barmer Bankverein. With this last merger the onetime eight Big Berlin Banks were reduced to the three major commercial banks of today. In a final move the central government replaced the leadership of the nationalized banks in an effort to restore public confidence.92

Even more than the commercial banks, the savings bank sector suffered severely in the banking crisis. More than 70% of the credits disbursed by the government Guarantee Bank to shore up the banking system went to the savings banks!93 The primary problem of the savings banks was not a result of short-term borrowing - though this too was a problem especially for many girozentrale - but a result of short-term lending to communal governments. With growing social expenditures and declining revenues after 1929 communal governments borrowed heavily from their savings banks, in the process drawing down the reserves of the banks. With the rapidly degenerating economic situation in 1931 many communal governments essentially went broke. Unable to pay back their loans to their savings banks, the banks too went broke. Of the three major banking groups, only the credit cooperatives managed to escape the worst ravages of the crisis. Though the future of the cooperatives, tied into that of the banking industry as a whole, was also impacted by the consequences of the crisis.

Until 1931 regulation and legislation regarding the savings banks had been an exclusive affair of the individual Länder. The widespread liquidity and payments problems

92. The central government, in combination with the central bank, held over 90% of the equity of the Dresdner Bank; nearly 70% of the Commerzbank; and some 35% of the Deutsche Bank. The Deutsche managed to avoid majority control by the government through the infusion of equity capital from several of its "friends" in industry; see Eglau, op. cit. p. 31. After 1933 the government allowed the banks to buy back their shares such that by 1936 they were essentially re-privatized. Born, 1967, op. cit., pp. 176-177.

of hundreds of savings banks, however, prompted the central government to intervene. In an emergency regulatory decree the central government sought to guarantee the future stability of the savings banks by unleashing them from the worst machinations of local public authorities. Most importantly, the savings banks were made legally independent organizations, though with local public ownership and liability for deposits maintained. The decree required the separation of savings bank boards from communal administrations. The banks were also required to increase their liquidity reserves and adopt more restrictive credit policies.\textsuperscript{94}

The legal and organizational separation of the savings bank from the local government led to a significant change in the character of the banks. Whereas until then they were more or less "instruments" of local governments and thus local politics, the partial independence gained in 1931 gave them more influence over their own business practices, decisions, and goals. In the postwar era this new autonomy would prove crucial to an expanded role for the banks in the area of industrial finance.

The commercial banks used the banking crisis as an excuse to once again attack the commercial activities of the savings banks, but the head of the Reichsbank, Hjalmer Schacht, defended the savings banks. The Imperial Bank Sector Law (\textit{Reichskreditwesengesetz}, KWG) passed in 1934 again reconfirmed the right of the savings banks to exercise bank-like activities.\textsuperscript{95} In fact, the banking commission established to prepare the KWG criticized the credit policies of the major commercial banks, in particular their low level of lending to the Mittelstand. An overextension of credit on easy terms to large firms - to the detriment of

\textsuperscript{94} Mura, 1987, op. cit., pp. 50-60.

\textsuperscript{95} Dieckmann, 1981, op. cit., p. 82.
small and medium sized firms - was saddled on the commercial banks as one of the causes of the 1931 crisis.\textsuperscript{96} Commercial lending by the savings banks was therefore viewed positively by key government officials.

Beginning with the banking law of 1934 (KWG), the central government assumed regulatory powers over the banking system for the first time. The law introduced relatively tight regulations and gave the Reichsbank significant powers over the banking system. The KWG focused on preserving liquidity in the system, in part through redirecting capital away from large firms toward the Mittelstand. The question of separating commercial from investment banking activities, similar to the American Glass-Steagall Act, was raised but not given serious consideration. The universal banking principle was a firmly entrenched institution.\textsuperscript{97}

The cooperative banks survived the 1931 banking crisis relatively well, though in the following year it became necessary to once again reorganize and "rationalize" the Preussenkasse. Predominant government influence in the bank passed from the hands of the Prussian to the central government, which now owned 42.5% of the bank. It was renamed the \textit{Deutsche Zentralgenossenschafts-kasse}, or \textit{Deutschlandkasse}, and placed under the jurisdiction of the Imperial Finance Ministry. Decision-making in the bank was done by its General Assembly which, despite majority control by representatives of the government, seldom decided against the express wishes of the cooperative sector. Thus the state limited


\textsuperscript{97} Born, 1967, op. cit., p. 158.
its influence in the cooperative sector but continued to use the Deutschlandkasse as a channel to provide subsidies to agriculture and the Mittelstand. 98

Alongside reform and restoration measures for each of the three major banking sectors, policymakers addressed the question of excess competition in the industry. In the late 1920s the weakness of the banking sector, combined with an increasingly deflationary economy, led to growing demands on the government to regulate interest rates. In the wake of the banking crisis of 1931 the government finally permitted the different banking groups to hammer out loan and deposit interest rate agreements, which it then authorized. In December 1936 the banking industry was formally cartelized through another Competition Accord (Wettbewerbsabkommen). 99 Aside from interest rate controls, the banks agreed to other measures such as a severe restriction of advertising in order to reduce open competition. The new Accord and government regulations in effect represented a new industry-wide promotional network - with indispensable state sanctioning - intended to reduce excessive competition in order to enable the entire banking industry to regain its health. But this new governance mechanism did not severely impinge upon the associational organization of the cooperative and savings banks, nor upon the hierarchial organization of the commercial banks. In theory this could have served to increase the power of the banks in industry, but the conditions in Nazi Germany were far from normal.

As with the rest of German society, the National Socialists gradually took over control of the banking system. Using both indirect and direct methods - in particular the

98. For example, in 1932 the government channelled RM 200 million through the bank to support the recovery of small- and medium-sized industry. Faust, 1977, op. cit., pp. 575-576.

Reichsbank - the National Socialists gradually achieved strict control over credit and directed it according to the dictates of their political ambitions. The Berlin banks were re-privatized under the National Socialists. All three banks played a critical role in the expansion of arms production and the administration of the war effort. The Deutsche Bank alone had representatives on 380 supervisory boards of firms - including key arms producers - and controlled 30% of the stock transactions of large industry in 1942.\textsuperscript{100} The banks also played an important role in running the occupied territories. At home in Germany, the Nazi policy of 'aryanization' forced more than half the remaining private banking houses to sell - in most instances to the big three commercial banks.\textsuperscript{101} Thus the big banks benefitted substantially from Nazi rule, though their autonomy of action was circumscribed.

But not even the benevolence of the Nazis could restore the banks to their pre-1931 position. The combined volume of business of the big three commercial banks was substantially lower in the 1930s than in the previous decade, especially in securities business and international lending. The major commercial banks would not reach the same equity capital levels of 1913 until after World War II. The savings and cooperative banks on the other hand, recovered to their 1913 equity levels by the late 1930s on the back of rising savings deposits.\textsuperscript{102} Thus the savings and cooperative banks probably benefitted far more from the war effort than the commercial banks.

In order to avoid raising public consciousness, the government borrowed heavily from the nation but not directly. Instead the government essentially forced the banks to invest

\textsuperscript{100} G. Wysocki, 1983, op. cit., p. 177.

\textsuperscript{101} In 1932 there were 1,350 private bankers in Germany, by 1939 only 520 remained. Wandel, 1983, op. cit., p. 179.

\textsuperscript{102} M. Pohl, 1986, op. cit., p. 85.
heavily in state bonds. As the major financial institutions in the savings markets, the cooperatives and savings banks played a crucial role in mobilizing funds - a role reflected in their tremendous growth: In the 1930s the total assets of the savings bank and cooperative sector outgrew those of the Berlin banks many times. From 1932 to 1939 the combined shared of the Berlin banks of all banking business declined from 15% to 10%. The surge in their assets before 1945 helped the savings and cooperative banks begin the postwar era in a relatively favorable position vis-à-vis the big commercial banks.

E. Summary.

The history of the three major banking groups through the second World War shows the gradual construction of the 'association system' for the savings and cooperative banks, and the hierarchical 'branch system' for the major commercial banks. For all three banking groups the struggle to stabilize their control of certain market segments helped solidify these distinctive governance regimes. State regulations and resources also played a crucial role in their development and long-term stability. The viability of these different banking groups helped preserve a variety of sectoral and regional governance regimes.

The association banks developed strong connections to local and regional institutions and smaller firms. These close relationships and the commitment of a large number of state and other economic actors to maintain decentralized economic structures were essential to the success of these two banking groups. As the commercial banks began to expand into the

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provinces and compete with the association banks, these latter two groups were able to respond to this challenge through universalizing and by strengthening cooperation within their respective associations. By eliminating group-internal competition the association groups were able to marshal a collective strength against the big Berlin banks. The state played a critical role in supporting the universalization efforts of the association banking groups, partly in order to provide an effective competitive counterweight to the powerful commercial banks and to support particular socioeconomic groups.

The big commercial banks also proved themselves adaptable to changing circumstances, and there is little question that they played a central role in German industrial development. But there is ample evidence to suggest that their influence has been overestimated. In the 1920s the big banks also showed considerable financial weakness, due in no small part to their own mismanagement. Thus even following their collapse in the depression and subsequent stabilization the remaining Berlin banks continued to lose their shares of important financial markets to the savings and cooperative banks.

As a result of their drive to move into the traditional markets of the others, over time the internal organization - that is the governance regime - of the three banking groups began to appear more similar, though this convergence was just beginning to become apparent in the Weimar period. Interrupted by the depression, banking crisis of 1931, and the era of National Socialism, the twin processes of universalization and organizational convergence between the three banking groups continued in the postwar era.
CHAPTER THREE:

The Political Construction of Bank Competition.

A. Introduction.

In the postwar period steadily increasing competition among the three major banking groups led to significant changes in the organization of the banks, as well as fundamental changes in bank-industry relations. The growth of markets as a mechanism of governance within the banking industry was fostered partly by the desire of each banking group to expand its share of financial activities. But more importantly, the growth of market competition among banks was spurred by key state actions. These actions reflected both short and long-term policy goals of the Federal and Länder governments. Though competition fostered centralization and concentration within the banking industry in certain respects, I argue in this chapter that a considerable degree of decentralization in the control of capital resources was preserved through state action; by the logic of group competition that requires every bank to be in a position to provide all financial services; and by changes in the economy that made Mittelstand firms an increasingly important customer groups for all the banks.

Competition in the postwar period is increasingly in the form of "group competition" among the three major banking groups. In group competition each banking group attempts to compete with the others in all financial markets. This often requires the savings and cooperative banks to act as a single unit in the market. This competition, in turn, has fostered significant changes in the internal organization of the three banking groups. Beginning in the 1970s the major commercial banks extensively decentralized decision-making authority within their respective banks in order to compete more effectively for the
business of consumers and smaller firms. In so doing the major commercial banks have become more like a ‘federation’ of regional and local banks. The rules of exchange within the concern banks have in some respects become more consensual and less coercive, like that of the association banking groups.

The association banking groups, especially the cooperative banks, significantly centralized decision-making authority and concentrated resources within the association. All three groups now attempt to combine the advantages of decentralization with those of centralization within one organizational structure. They do so because continued success in one market segment requires each bank or group to be competitive in all. For example, the major commercial banks are traditionally dominant in the export credit markets. As Mittelstand firms have become increasingly export-oriented, holding on to their business became increasingly difficult for the savings banks and cooperative banks. Thus serving exporting Mittelstand firms became the springboard by which these banks jumped into international banking activities. Conversely, the strength of the commercial banks in international financial services has enabled them to gain more business with Mittelstand firms. The Mittelstand has perhaps become the most important firm customer group for the all of the banks, especially as this sector became more export oriented over time and large firms developed new sources of capital less subject to control by the big German banks. For all the banks the Mittelstand represents a key source of profits and growth in the postwar era. Thus the internal organization of the ‘association system’ has converged to a significant,

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albeit limited, degree with the hierarchical ‘branching system’ developed by the major commercial banks.

Contrary to what many would expect, even in a comparatively deregulated and competitive banking industry, the association governance mechanism has enabled a considerable degree of decentralization and deconcentration of capital to be maintained. With the aid of their associations many small banks have been able to compete successfully with local branches of the major commercial banks in the era of open bank competition after 1967. From 1952 to 1981 the combined assets of three major commercial banks declined from 16.9% to 8.8% of total bank industry assets: the combined share of total assets held by the savings banks and Girozentrale/Landesbanks rose from 32.7% to 38.6%; the cooperative sector’s shared increased the most in percentage terms, from 8.5% to 15.2%.

Today 14 of the 20 largest banks are publicly owned; about eight of every nine bank offices in the Federal Republic is either a cooperative or a savings office.

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Table 3-1. Number of Banks and Branches by Group

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</table>

* Three of these are the Berlin subsidiaries of the three major banks.

The organizational responses of the three banking groups to competition, in turn, reinforced the spread of competition in banking. Competition for the business of large firms, for example, increased substantially after the late 1960s. At this time the Landesbanks and regional banks of the cooperative group - as well as the cooperative DG Bank - extended their activities well beyond the functions they served for the local banks in their region. As a result, the relative size and importance of these upper level institutions in both groups increased. With these banks the association banking groups were able to expand their lending to large firms and conduct international banking activities in direct competition with
the commercial banks. The growth in the number of banks competing for large firms' business has enhanced the negotiating power of these firms vis-à-vis banks.

In the post-war period the savings banks aggressively pursued an expansion of their traditional customer base to include more business and industrial customers. The more the savings banks moved into commercial activities the more they were pressed to justify their public status and the privileges associated with it. They emphasized that their role as a competitive counterweight to the commercial banks, as well as their traditional function of supporting local and Länder governments and the Mittelstand required a greater market orientation. Though the stronger market orientation of the savings banks also threatens to undermine cooperation within their association. Subnational governments play a critical role in helping the savings banks maintain their competitiveness.

The rapid expansion and diversification of the membership base of the cooperatives not only brought growth for the banks, but change as well. A membership base increasingly consisting of workers - rather than firm owners - demands consumer banking services. The cooperatives responded to this change in membership but this response also made it increasingly difficult for them to distinguish themselves from any other small commercial bank. The relationship among the members and between the members and the managers is less a 'cooperative' one - less one of trust and a shared sense of community - and more a market one. Increasing demands by customers for more services combined with regulatory and other market changes to force thousands of cooperatives to merge. In spite of the decline in the absolute number of independent banks, competition among the three banking groups for smaller firms has also risen.

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Thus the state played a central role in promoting changes in all three banking groups, both as an actor - or set of actors - and as an arena. As an actor, the state promoted the expansion of market mechanisms in banking, sometimes against the opposition of the industry. Constructing stronger markets required the state to ensure that all three banking groups would be competitive. The liberal tenets of the social market economy laid down in the 1950s by Erhard set the liberalization process in motion. After 1969 the Social Democrats pushed the banking industry toward even greater competition. The Länder and local governments used regulation and direct control in the savings bank to further reshape the sector. As will be discussed more in Chapters 6 and 7, the growth of bank competition has also been furthered by the pursuit of industrial policy by subnational governments.

In periods of intra-industry conflict, the state has also been an arena where the banking groups sought to protect or gain market advantages and privileges and attack those of the others. But nearly all major intra-industry conflict also involved conflict between the Länder and local governments on the one side, and the federal government on the other. Acting through the Bundesrat, subnational governments sought to not only protect the interests of the banks they owned, but to defend their political autonomy - to defend the substance of federalism. Thus the respective competitiveness of each banking group is also importantly determined by the outcome of conflicts among political actors over intergovernmental relations.

This chapter analyzes the process of constructing more markets in the banking industry and the evolution of the organization of the banking groups. Chapter 4 will then argue in greater detail how competition and these changes in the organization or governance of the banking sector translate into changes in bank-industry relations - the key hallmark of which is greater financial autonomy for firms. Chapter 4 will also argue how the
preservation of a strong local orientation in the banking industry contributed to the conservation of different sectoral and regional governance regimes.


In the first decade after the war the banks were preoccupied with reconstructing their previous organizational systems. The federal and especially the Länder governments - since the Allies placed the Länder in charge of a great deal of banking policy - played a crucial role in rebuilding a universal banking system based on the three major groups. Toward the end of the reconstruction period in the late 1950s the processes of organizational convergence and expanding market competition would begin to accelerate.

Perhaps disrupted most by the war were the major commercial banks. The victorious Allies - fearful of any concentration of power - broke the three banks into a total of thirty independent regional banks. The new regional banks were forbidden to coordinate their activities. But as the Cold War intensified Allied policy toward the new Federal Republic was increasingly concerned with building a bulwark against the Soviets. This required the rapid economic reconstruction of the German economy and if it meant a recombination of power, so it would be. Thus in 1952 a new banking law permitted the post-war regional institutions of the three major banks to consolidate into nine banks - each of the former "great banks" could have one institution in each of the Western occupation zones. The law provided further that three years hence the regional arms of the banks could begin to cooperate via profit- and loss-sharing agreements. In the end of 1956 legislation was finally
passed which permitted the complete reconsolidation of the three banks in the following two years.⁴

The postwar years were also a period of reconstruction and reconsolidation for the savings banks. Immediately following the war the savings banks were allowed to continued working on a regional basis within the three occupied zones. Originally the occupation administrations sought to eliminate the girozentrale on the basis that they were an unnecessary form of concentration. But the savings banks managed to convince them that the girozentrale were essential. Subsequent to the reorganization/fusion of several Länder after 1949, several Girozentrale fused. Moreover, in most Länder the Land government became a direct shareholder in the Girozentrale.⁵ The Länder governments were generally seeking an established institution which could help them administer the vast number of reconstruction programs, as well as serve the governments’ general financial needs. The savings banks were generally willing to accommodate their respective Land governments. First, because the governments were offering much needed and scarce capital. Second, because it would reduce the probability that the Land government would establish another bank for these functions - a bank which would most likely be a competitor. In 1953 the regional associations reestablished the central association and named it again the Deutscher Sparkassen- und Giroverband (DSGV). In 1954 the central savings bank was permitted to resume its activities and the savings banks sector finally reassembled its three-tier associational structure.


⁵. The exceptions to this were the Saarland and Baden-Württemberg were the girozentrale remained solely in the hands of the regional savings bank association, and Hamburg where the girozentrale was wholly owned by the government.
With reconstruction moving ahead quickly the savings bank association set out to modernize the savings banks, making them more market-oriented and competitive enterprises without losing their status as communal institutions. Not all factions within the savings bank sector, however, favored this new direction for the banks. The introduction of consumer credits in 1952 occurred only after much heated internal debate in which the opponents argued that such business was inconsistent with the "public mission" of the savings banks. As in the past, the direction of the savings banks in the postwar era was steered between the pull of the market and the tug of the public sector.

After 1953 the Länder - at the behest of the DSGV - slowly began to promulgate new savings banks laws that firmly entrenched the drive to modernize the savings banks. The charter and organization of each bank would now be more like that of a private enterprise. The cornerstone of this new orientation was the extension of the 'self-administration' principle of the savings banks: each bank would now be able to hire and fire its own personnel without interference (at least direct) from their "owners" - the local government. In spite of these changes, the savings banks did not intend to become mere commercial banks as they retained their public ownership, their regional principle (which limited the operations of each savings banks to the border of the county or city that controlled it), and restrictions on their business activities. Moreover, communal governments insisted that the managing directors of the banks remain civil servants.⁶

After the war the cooperatives also found themselves in the position of having to rebuild their sector, and once again they needed the state. Because state support through the Deutschlandkasse ran counter to their principle of 'self-help', the cooperative banks sought

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⁶ While most Länder passed new savings banks laws in the 1950s, several Länder did not pass new laws until well into the 1960s. See Mura, 1987a, op. cit., pp. 53-56.
to establish a new central bank which they could control. In 1949 the Deutsche Genossenschaftskasse (DG Kasse, or BG Bank) was established in Frankfurt. The federal and Länder governments contributed capital to the new bank but, by its charter, their capital share was not allowed to reach 50% of total capital. In this way the cooperatives were assured that they would always control the bank. The DG Kasse was unique among German banking institutions as it was formed under public rather than private law, yet it was controlled by the private cooperative sector.

This mixed public-private nature of the DG Kasse and its treatment by the state reflected the still somewhat enigmatic institutional nature of the cooperative sector as a whole. In certain respects the state (and many cooperative banks as well) viewed the cooperative system as serving an important public interest function, since promoting economic prosperity and individual self-sufficiency among the membership were the chief goals of the cooperatives, not profit-maximization. Thus the DG Kasse was granted a tax-free status as recognition of its special public role. As in times past, in the reconstruction era the DG Kasse was an important channel through which state funds (including Marshall Plan) flowed to rebuild the Mittelstand. But like the savings banks following the war, the cooperative banks gradually became more formalized, market-like organizations.

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7. The commitment of the Länder to promoting the cooperative system was explicitly stated in seven postwar Länder constitutions. Kluthe, 1985, op. cit., p. 166. In the course of the 1960s the share of public ownership in the DG Kasse dropped to under 10%, reflecting the desire of the cooperative sector to reduce state support.

8. The chairman of the bank’s administrative board was to be from the cooperative sector. The majority of the seats were held by the cooperative banks; three were held by the federal government; three by representatives of the Länder governments; and one each by the Bundesbank and the Loan Corporation for Reconstruction (Kreditanstalt für Wiederaufbau). Faust, 1977, op. cit., pp. 583-586.

The evolution of the DG Kasse toward becoming a universal bank took an important step in 1957 when the government permitted it to issue its own bank bonds. For the first time the DG Kasse had direct access to the capital markets. The rest of the banking sector strongly opposed the creation of another direct competitor—especially one with special tax privileges. But the cooperative sector’s need for greater access to the capital markets was more influential with the lawmakers.

The role of the major commercial banks in industry during the reconstruction period did not square well with what the standard organized capitalism view suggests. Many of the contacts between the major commercial banks to industrial firms were quickly resumed after the war, though the partial dismantling of these banks by the Allies did hinder their involvement in industry to some extent and their ability to centrally direct their operations. Eglau notes that in the reconstruction period many of the big banks’ regional directors were akin to "local princes" in terms of their autonomy and connections to local industry. But the bigger problem for the commercial banks was perhaps that their traditional balance sheet structure did not correspond well to the demands of firms. One of the biggest needs of all

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10. Until then the DG Kasse refinanced itself with money from insurance companies and other banks such as the KfW. Faust, 1977, op. cit., p. 591.

11. Occupation authorities did force the disruption of selected long-standing bank-firm relations such as in the case of IG Farben. When this chemical giant was dismantled into three firms after the war the Deutsche Bank was only permitted to remain as the house bank for two (BASF and Bayer). The Dresdner Bank became the house bank for Hoechst. Herman Abs, head of the Süddeutsche Bank, one of the successor banks to the Deutsche Bank, was an especially sought after and willing advisor to industrial firms. By 1950 he already held 17 seats on supervisory boards. Eglau, 1989, op. cit., p. 42.

firms was long-term funds to finance the reconstruction of physical capital.\textsuperscript{13} But the commercial banks traditionally lent fewer funds on a long-term basis, especially to Mittelstand firms.\textsuperscript{14} Thus the savings and cooperative banks were far better positioned to finance the long-term capital improvement projects of firms. The very high personal savings rate in the 1950s also meant that these banks had ever-larger amounts of capital that they needed to invest.

Favorable tax laws and strong growth in the 1950s also translated into a very high rate of self-finance by firms.\textsuperscript{15} This was particularly true of several sectors where the commercial banks traditionally had a significant presence, such as the investment goods sector that benefitted from a high export rate. The high rate of self-finance generally translates into greater firm autonomy from the banks. Further usurping potential influence of the commercial banks in the recovery and early expansion of postwar industry was the state. State banks such as the Loan Corporation for Reconstruction (Kreditanstalt für Wiederaufbau, KfW) financed a considerable amount of industrial investment through the

\textsuperscript{13} From the early 1950s to the late 1960s the demand by firms and individuals was overwhelmingly for long-term funds. For statistics see Deutsche Bundesbank, 1976, op. cit., pp. 150-151.

\textsuperscript{14} In fact, at the 1958 annual congress of the commercial banking association Chancellor Adenauer appealed to the commercial banks to give more attention to the Mittelstand. Herbert Wolf, "Ein Bankentag ist keine Machtdemonstration," \textit{Frankfurter Allgemeine Zeitung}, 25 April 1990.

1950s.\textsuperscript{16} According to one estimate, from 1951 to 1955 the state financed on average 20\% of total gross physical capital investment.\textsuperscript{17} Thus the successful recovery of German industry after World War II, particularly the export sectors, was to a considerable extent engineered by state allocation of scarce resources and financed to a large degree from sources other than the major commercial banks. The three major commercial banks were certainly important for industrial recovery in the reconstruction period, but their ability to be so was strongly dependent on the state’s willingness to support their industrial investments through capital provision and state guarantees.\textsuperscript{18}

In 1957 and 1958 a conjuncture of several events made this period an important watershed in the evolution of the German banking system. First, in 1957 the new central bank - the Bundesbank - was established. Second, the Deutschmark was made freely convertible and capital controls eliminated, thereby opening the doors for the integration of domestic and international capital markets. In 1958 branching restrictions instituted in the early 1930s were eliminated by a decision of the Federal Constitutional Court (\textit{Bundesverfassungsgericht}).\textsuperscript{19} Prior to this measure, the establishment of a new bank or branch was possible only if the authorities determined a need for it. By the late 1950s

\textsuperscript{16} In 1948 the KfW was established by the state to administer Marshall Plan funds. The KfW’s board of directors was filled with representatives from the federal and Länder governments, the unions, and from all the major banking groups. Herman Josef Abs was one of the leading managers of the KfW.


\textsuperscript{18} The quasi-public agency Hermes, for example, was created in this period to provide state guarantees for private export loans made by the banks to German firms.

\textsuperscript{19} See Ellgering, 1987, op. cit., pp. 61-62. The court’s decision was part of a general effort to bring down competition-restricting practices in several sectors.
Germany’s ‘economic miracle’ translated into a rapidly growing pool of national savings. With the new branching free.lom in their hands, the banking sector sought to capture this growth in individual wealth through an explosion of branches. Between 1957 and 1978 the number of bank branches in the Federal Republic increased by 200%. Thus, owing in part to key state actions, by the late 1950s the German banking sector had been reconstructed largely in its prewar form and deregulated enough so that an upswing in competition would ensue.


After several years of debate between liberals and the more statist social democrats over the most desirable economic order, by the late 1950s the foundations of the West German ‘social market economy’ were being laid down. In the postwar years Federal Economics Minister Ludwig Erhard and his secretary Alfred Müller-Armack pushed for a largely neo-liberal economic order in which the state would only intervene where the market itself failed to produce the desired outcome. But neither was the social market economy supposed to be dominated by large concerns. The Cartel Law of 1957 sought to prevent the kind of concentration which had prevailed throughout much of Germany’s industrial era.

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21. In their 1959 Bad-Godesberg program the SPD formally accepted the reliance on private markets as the prime organizational feature of the economy.

22. In spite of the movement toward liberalism, the Mittelstand was permitted to reestablish some of its corporatist regulations with the Artisans’ Charter of 1953. This demonstrated historical continuity in the state’s protector and promotor role vis-à-vis the Mittelstand. Though the 1958 decision by the Federal Constitutional Court to lift the requirement of state approval for new bank branches also applied to the craft sector where similar restrictive regulations previously held. Stolper, et. al., 1967, op. cit., pp. 233-236, 258-261, 277-295.
With the completion of the reconstruction era culminating in the events of 1957, attention turned to revising the Banking Law of 1934. Eager to eliminate much of the dirigiste aspects of the law which had subjected the banking sector to tight state control under the Nazis, the state and banking groups set out to establish a legal and regulatory system consistent with the more liberal principles of the social market economy. Though the banking groups had their differences, they presented a unified front to federal lawmakers in order to reduce the state's role in the sector. The biggest difference between the banks and federal lawmakers was over interest rate regulation. After the war the state assumed the task of establishing interest rates in the banking sector. The banks wanted to return to a private cartel in which they would set interest rates with state approval. In the new Banking Law (KWG) of 1961 the Federal government retained its control over interest rate regulation, though it also suggested that eventually interest rates would be deregulated entirely.\textsuperscript{21} Thus the Federal government was setting the stage for interest rate competition and giving the banks time to prepare. In spite of concerted opposition by the Länder, the federal government also centralized banking supervision in the Bundesbank and a new Federal Banking Supervisory Office (\textit{Bundesaufsichtsamt für das Kreditwesen}, or BAKred).\textsuperscript{24} The savings banks, however, would continue to be subject to additional regulation by the Länder.

In the debates leading up to the KWG the state was also an arena in which each of the banking groups sought regulations which would improve its competitive position. The private banks - especially the cooperatives - levelled charges of unfair competition against


the savings banks. Due to their public nature, the savings banks enjoyed throughout their history several tax and regulatory advantages over the private banks. For example, the private banks claimed that the public guarantee of the savings banks’ liabilities gave them an inappropriate security advantage and allowed them to operate with less 'liable capital' (equity) than the other banks. The private banks also felt unfairly disadvantaged in their attempts to gain some of the banking business of the public sector. The fact that the savings banks were under much less pressure to maximize profits enabled them to emphasize market share over profit, thereby placing even more pressure on private credit institutions. So if they were going to become more ‘bank-like’ in their activities, the private banks reasoned, then the savings banks must also be subject to the same conditions.25

But in the final KWG the savings bank sector was successful in realizing most of its goals. In harmony with the savings banks’ demand, federal lawmakers agreed to maintain different equity and liquidity requirements for the various banking groups. Thus none of the three banking groups was forced to operate according to the exact same set of rules. Since the KWG did not resolve the ‘fair competition’ question to the satisfaction of the commercial and cooperative banks, the federal government established a ‘Competition Commission’ to examine the competitive conditions of the banking sector, and make recommendations on how to increase fair competition among the banks. Thus while the state pursued greater bank competition, it was also making sure that the legal and regulatory framework that supported three distinct banking groups remained sound.

In the meantime, bank competition steadily expanded, primarily through the establishment of new branches. The strong, steady growth of the economy, combined with

the introduction of state subsidies for saving and automatic wage deposits for workers, made mass consumer banking the driving force behind the expansion of the banking sector in the 1960s. Because of their strength in the savings markets, as well as their presence in practically every city and town, the savings and cooperative banks profited the most from this change. The commercial banks were forced to rapidly expand their branch networks if they were to avoid being reduced to small, albeit influential, investment banking houses.26

With the freedom to establish branches at will after 1957, the commercial banks finally had to a chance to reduce the disparities in their relative market strength in different regions of West Germany, and make up for the branches lost in the East. The loss of eastern branches was especially hard on the Commerzbank. At the end of the war the Commerzbank had branches in only eight cities in the entire southern half of western Germany.27 In spite of subsequent expansion by all the banking groups, in the 1960s there still existed substantial regional differences between them in terms of bank or branch density.

As before World War II, the major commercial banks were heavily concentrated in North Rhine-Westphalia - the industrial Rhine-Ruhr regions in particular. From 1952-1953 to 1963-1964 the big three commercial banks expanded their total number of branches here from just over 200 to nearly 600 - representing some 40% of all their branches combined. North Rhine-Westphalia had 25% more major commercial bank branches per capita than the national average; in terms of non-agricultural labor force, the state had 51% more commercial branches per worker than the nation as a whole. In these same terms the presence of the commercial banks was well below the national average in Schleswig-Holstein,


Hessen, Rhineland-Palatinate, the Saarland, Baden-Württemberg, and especially Bavaria. Thus through the 1960s the commercial banks continued to focus heavily on their traditional regions and sectors. In the 1950s the heavy industries of the Ruhr did well, but by the early 1960s at the latest it was clear that several of these industries faced long-term structural decline. As will be discussed in greater detail in Chapter 7, the commercial banks did not necessarily prove themselves as adept at dealing with these economic problems as the organized capitalism view would suggest.

The savings banks had an above national average presence in Lower Saxony, Schleswig-Holstein, Hesse, Saarland, and especially Baden-Württemberg. The savings banks were weakest in the three city-states of Berlin, Hamburg, and Bremen, and in North Rhine-Westphalia and Bavaria. The commercial cooperative banks had a below average presence in Bavaria, the three city-states, and North Rhine-Westphalia. They had an above average presence in Lower Saxony, Schleswig-Holstein, Hessen, Saarland, and Baden-Württemberg. Bavaria is unique among the Länder in that all three major banking groups had a below average presence there. Instead, the Bavarian banking market was dominated by the two large private regional banks.

Since the early 1960s the regional distribution and strength of the different banking groups have shifted, but this has not entirely eliminated historical regional distinctions. The big three commercial banks were in a comparatively poor position to profit from the two fastest growing regions in West Germany in the 1970s and 1980s - Bavaria and Baden-

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Württemberg. In Baden-Württemberg, for example, the cooperative and savings banks even expanded their combined share of the region's banking business since the mid-1970s - together controlling some 80% of the overall regional banking market in the late 1980s. Thus in spite of their expansion, the major commercial banks have not necessarily displaced indigenous banks that are so firmly embedded in their local economic and political environment. As we shall see in Chapter 6, Baden-Württemberg’s economy is marked by a large number of smaller firms that typically produce technology-intensive products utilizing a large amount skilled labor. A significant amount of production occurs within obligational networks that are supported by an extensive array of promotional networks. The success of the savings and cooperative banks in this region demonstrates their importance to its economy and their ability to adapt to the changing needs of local firms.

(insert complete table from Siepmannn here)

D. Post-1967: A New World for the Brave.

1967 was another watershed year for the banking industry, as it was for the Federal Republic as a whole. The Social Democrats (SPD) had just come into power in the federal government through the Grand Coalition with the Christian Democrats (CDU). With Ludwig Erhard - the "father" of the social market economy - as chancellor, and Karl Schiller of the SPD as Federal economics minister, the Stability and Growth Promotion Law (Stabilitätsgesetz) was passed in 1967. The law marked a shift in national economic policy toward Keynesianism. The Social Democrats intended to place more emphasis on growth and unemployment than their predecessors, who stressed price stability and balanced trade.\(^{30}\)

\(^{30}\) Christopher Allen argues that, ironically, the opposite actually occurred. See Allen, 1989, op. cit.
Schiller’s Federal Economics Ministry, with the concurrence of the central bank, successfully overrode the opposition of the banking industry in 1967 to fully deregulate interest rates.\textsuperscript{31} The Ministry believed that consequent competition among the banks would lead to a market-induced reduction in interest rates and thereby assist its new growth-oriented economic policies in ending the ongoing recession.\textsuperscript{32} While all the major banking associations formally opposed this measure at the final hearing, the banking industry was actually divided over the issue. The savings banks, which expected to be the prime beneficiary of liberalization because of their dominance in the deposit-taking markets, favored it, but preferred it to be done gradually.\textsuperscript{33}

For the banking industry two more key events took place in 1967. First, the Competition Accord from 1936 - which among other things prohibited banks from advertising - was eliminated. Second, the tax burden of the savings banks was raised. Since the KWG of 1961 the issue of tax privileges had become hotly contested. The rapid growth of savings deposits - which constituted the bulk of the savings banks’ tax-free business - translated into an ever large amount of profits for them. The commercial and cooperative banks were strongly lobbying the federal government to create more fairness by, among other things,

\begin{itemize}
  \item \textsuperscript{31} The approval of the Bundesbank - required by the KWG - may have been influenced by pressure from Schiller, but in any case it was also based on the bank’s belief that it would be able to sufficiently influence interest rates through its discount, reserve, and open market policies. The Federal Office of Banking Supervision also approved the liberalization. Dieckmann, 1981, op. cit., p. 175.
  \item \textsuperscript{32} See Dieckmann, 1981, op. cit., pp. 174-178.
  \item \textsuperscript{33} In 1962 the savings banks held 62% of all savings deposits in the Federal Republic. Dieckmann, 1981, op. cit., pp. 173, 176.
\end{itemize}
taxing the savings banks more. Rhetorical arguments with supporting empirical examinations flourished on both sides of the issue.\textsuperscript{34}

Even though the final report of the Competition Commission established in 1961 had not yet been submitted, the federal government decided to eliminate "illegitimate" tax advantages which particular groups enjoyed, including those of the savings banks. The federal government wanted to raise its revenues and believed that the savings banks no longer deserved such a high rate of subsidization. But this did not occur without a final battle. When a tax increase became imminent the savings banks launched an offensive to mobilize their supporters in the communal and Länder governments. Through the Bundesrat the Länder governments challenged the federal government's proposal. Ultimately the two sides agreed on a compromise tax rate.\textsuperscript{35} Thus the savings banks were partially successful in defending their privileges. But if there had been any hopes to the contrary, the following year would confirm that this was only a temporary reprieve.

In 1968 the federal government published the final report of the Competition Commission established in 1961. The Commission sought the middle ground in resolving the struggle between the banking groups over what constituted fair competition. On the one hand, the Commission acknowledged that certain reforms were necessary to establish fair competitive conditions. To this end the Commission recommended the removal of several "advantages" which the savings banks enjoyed, the most important of these was the gradual

\textsuperscript{34} Stützel, for example, concluded that the savings banks - and to a lesser extent the cooperative banks - did enjoy competitive advantages due to their tax privileges. Stützel, Wolfgang. 1964. \textit{Bankpolitik Heute und Morgen}. Frankfurt: Fritz Knapp.

\textsuperscript{35} Dieckmann, 1981, op. cit. p. 185. Instead of the 40% rate which the federal government sought the savings banks would be taxed at a rate of 35%. The commercial banks were taxed at a rate of 51%; the cooperatives at 32% - see Henze, 1972, op. cit., p. 122.
elimination of their tax-free status.  

36 On the other hand, the Commission refused to entertain the suggestion of the private banks that public banking per se automatically had unfair advantages and, moreover, was superfluous. Though its justifications may have been vague, the Commission reaffirmed the need for a public banking system and some of the special privileges that derived from this status. The report cited in particular the importance of the corrective (counterweight) function of the savings banks - in other words, ensuring that all social groups and the Mittelstand everywhere had access to banking services at competitive prices.  

37 The decision to gradually eliminate the tax privileges of the savings and cooperative banks reduced the intensity of the competition debate, though it did not eliminate it. Growing competition among three banking groups operating under varying rules meant that in the 1970s and 1980s the fairness question would continually be examined, debated, and fought over.  

38 In any case, the conjuncture of policy changes in 1967 and 1968 accelerated the pace of change in the banking industry. The state’s actions brought down the formal industry-wide promotion network (especially the interest rate cartel) that had helped maintain stability in the German banking system since the banking crisis of 1931.  

39 In its place the

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37. Henze, 1972, op. cit., p. 120. Moreover, the report defended the right of communal and Länder governments to have their own “house bank,” especially because private banks were not always able or willing to carry out this function in a satisfactory manner. Meyer-Könster, 1979, op. cit. p. 179.


state introduced more markets as governance mechanisms in the banking industry. Stronger bank competition had a profound impact on bank-industry relations in the subsequent decades. Though this impact was largely indirect, occurring through the organizational changes of the three major banking groups.

For the association banking groups this new era of competition, and their success, led to growing identity problems. As the cooperative banks grew and their membership expanded across social groups they found it increasingly difficult to distinguish themselves from other commercial banks. The savings banks groped to find a new definition of their public mission. For the association banking groups the process of defending their respective privileges based on the claim of their distinct character was complicated by their own growing confusion over what exactly made them distinct from the others. Ultimately these banking groups responded to the introduction of stronger markets in banking through a stronger orientation to market imperatives. This was not, however, a foregone conclusion. Rather, it involved considerable struggles within these banking groups and critical actions by the state to maintain markets.

*The Savings Banks after 1967: "Departure for new Shores."

The catalytic impact of the events of 1967 and 1968 was most immediate for the savings bank sector. In several Länder discussions began over the construction of larger girozentrale or Landesbanks through the fusion of state banks. Since Länder such as Baden-Württemberg, North Rhine-Westphalia, and Lower Saxony were themselves created through the postwar merger of previously separate political territories, there were typically several girozentrale and state-owned special purpose banks. The economic and political

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40. The Allies encouraged these reorganizations which were later approved in plebiscites.
circumstances of the late 1960s suggested to actors in the savings bank sector and Länder
governments that the time was ripe for a consolidation of these banks.

Fist, the savings banks and Girozentrale themselves saw several advantages in having
larger banks operating within the sector: Concentration in industry translated into demands
for larger credits. To hold on to these customers the Girozentrale needed to attain a
commensurate size. Because very large loans are made through consortia, the savings banks
could also benefit from these if their girozentrale, or Landesbank was the leading bank.\textsuperscript{41}
Competition from domestic and foreign banks was also beginning to put pressure on the
profitability of the girozentrale. In general, commercial lending was increasingly appealing
because it was a market where the savings bank sector could utilize the excess liquidity it
built up over the previous years to expand its market share.\textsuperscript{42}

For the savings bank associations, the fusion of banks, especially where there were
two Girozentrale in one Land, would help cut costs, strengthen the central bank function of
the Girozentrale, and help restore an appropriate size differential between the ever-larger
savings banks and their Girozentrale.\textsuperscript{43} There were also advantages to bank fusions for the
Länder governments. Fusing girozentrale and special purpose banks would build larger
Landesbanks with greater capacity to implement Länder economic policy. For example, in
the late 1960s the government of North Rhine-Westphalia launched a more aggressive

\textsuperscript{41}. Most of the Landesbanks also carry the official designation of girozentrale, the former
refers to their function as a state bank, the latter to their central bank function for their
region’s savings banks.

\textsuperscript{42}. This was larger due to the tremendous growth in saving deposits in the 1960s.

\textsuperscript{43}. On this list of factors see Stein, Eckart. 1971. \textit{Die Fusion der Girozentralen in
Nordrhein-Westfalen}. Würzburg: Physica Verlag, pp. 8-50; and Biehal, Manfred. 1984. \textit{Der
Württembergischer Sparkassenverband 1916-1982}. Berlin: Duncker and Humblot; and
restructuring campaign for the troubled Ruhr industrial region. Attaining a large Landesbank was seen as a great asset in this pursuit.

At the beginning of 1969 the first major public bank fusion occurred in North Rhine-Westphalia between the Rhenisch Girozentrale (RGZ) in Düsseldorf and the Westphalian Girozentrale (WGZ) in Münster. The merger occurred partly as a resolution of the RGZ's difficulties in finding a new president. But the merger was motivated by far more than the personal convenience of Ludwig Poullain, who became head of the new bank. Fusing the two banks also presented Poullain with an excellent vehicle to realize his ambitious plans for the savings bank sector.44

With the top leadership of both banks, the Land government, and Finance Minister of North Rhine-Westphalia all promoting the fusion, the Land legislature readily approved it. Legislators generally viewed this as a rationalization measure with little partisan political ramifications. Thus was the Westdeutsche Landesbank, or WestLB, born. On the basis of total assets alone the WestLB was then the largest bank in West Germany and the ninth largest in Europe.45 Though as Poullain himself noted, this was a deceptive fact since the major commercial banks had far more subsidiaries whose assets did not show up on their balance sheets.46

The creation of the WestLB hastened the fusion discussions in other Länder. Without fusions the savings bank associations in other Länder would run the risk of ceding more


45. At the end of 1968 the WestLB had assets of DM 7.1 billion; the Deutsche Bank had assets of DM 6.8 billion. See Stein, op. cit. p. 15.

46. Poullain, 1979, op. cit., p. 70. Moreover, within a few years the Deutsche and Dresdner banks passed the WestLB in total assets.
influence to the WestLB in the savings bank sector than would be desirable. Moreover, many Länder governments considered it desirable to have an equally powerful bank at their disposal.

In the following year the Norddeutsche Landesbank, or NordLB, was created through the fusion of four public sector banks in Lower Saxony. In other Länder the process of reconciling differences proved more difficult. In Bavaria various bank fusion proposals, including both private and public banks, had been in discussion since late 1967. The first proposal entailed a fusion between the two private Bavarian regional banks - the Bayerische Vereinsbank and the Bayerische Hypotheken- und Wechselbank (Hypobank). Sharing the banks' desire to counter the growing competition of the major commercial banks in Bavaria, the Finance Ministry of Bavaria actively promoted the fusion and suggested that the two private banks incorporate the public Bayerische Staatsbank into their plans.\(^47\) But the negotiations proved difficult and the two private banks became increasingly alienated. With the three-way fusion out of the picture the Vereinsbank and the Staatsbank merged in 1971.\(^48\)

In response to the WestLB merger and the proposed merger between the private Bavarian banks, a second fusion proposal had been initiated in 1969 between the girozentrale of Bavaria, the Bayerische Gemeindebank, and another special purpose public bank. In 1972

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\(^48\) With this merger the Staatsbank had essentially been privatized, though the Bavarian government now held 20% of the Vereinsbank’s stock (10% of voting shares). See Bössenecker, 1972, op. cit., pp. 68-79.
this fusion was completed and the Bavarian Landesbank was created.\textsuperscript{49} With these fusions the Bavarian government had attained ownership in three major regional banks: 20% of the private Vereinsbank, which acted as the leading bank for its bond sales; 50% of the Landesbank; and 100% of the Landesanstalt für Wiederaufbau (LfA). The LfA was created in 1950 as a special bank for reconstruction. Over time the Bavarian government increasingly used the LfA as a tool for industrial intervention.\textsuperscript{50}

In the late 1960s the two savings bank associations and the Land government of Baden-Württemberg also attempted to fuse their two Girozentrale. But after numerous proposals and rounds of negotiations an agreement between the Girozentrale could not be reached. Thus the Land government still had no Landesbank (i.e. no government ownership), though it did create a state industrial development bank - the \textit{Landeskreditbank} - through the merger of two state mortgage banks in 1972. Like the LfA in Bavaria, this bank became the primary industrial development bank of the Land government.

This series of bank mergers involving regional public banks unsettled many of the stable relations between the large commercial banks and large industrial firms. In the 1970s several of these large Landesbanks, as well as the two private Bavarian regional banks, became competitive suppliers of large industrial loans and holders of large packets of industry shares. Because the Landesbanks were co-owned by their Land government, this also meant


\textsuperscript{50} A few months prior to the creation of the Landesbank, the Gemeindebank and the Hypobank had actually signed a partnership agreement. This unusual private-public sector would have given the Hypobank greater access to the Landesbank's pool of savings. The Landesbank would have obtained greater opportunities in industrial finance. Under censure from the Federal Cartel Office this agreement was eventually rescinded. See Girke and Kopplin, 1973, op. cit.; M. Pohl, 1986, op. cit., p. 115.
that several Land governments became more directly involved in the affairs of regional industry. Through this back door there has thus been a significant introduction of state influence into bank-industry relations. Without the active role of the Land governments it is very likely that this increase in competition among banks for large firms would not have been as extensive.

Change in the savings bank sector, however, was not limited to the fusion of girozentrale. Ludwig Poullain had much more in mind. At the annual national congress of the savings banks in 1969 Poullain, who had also become president of the national association in 1967, outlined a nine-point reform plan for the savings banks. Poullain was convinced that the savings bank sector needed to be shaken of its bureaucratic stupor. If the savings banks did not adopt an offensive, market-oriented strategy, he argued, they would be overtaken by the other banks. Moreover, the future public mission of the savings banks must be different than in the past. Weaker social groups no longer needed special institutions to help provide them security. Instead the public mission of the savings banks must place greater emphasis on their "corrective function", in other words, assuring effective

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51 Nor were fusions and thus concentration limited to the girozentrale. In the late 1960s and early 1970s the Länder began to initiate communal reorganization and consolidations. Because the savings banks were attacked to communal governments, they too were forced to merge. From 880 savings banks in 1950 only 589 remained by 1986. See Mura, 1987b, op. cit., p. 27.

52 In his nine points Poullain emphasized the need to modernize through technology, more professional training, and carefully considered fusions between weaker savings banks. Greater cooperation within the association was essential to success. He believed that the managing directors of the banks must provide modern leadership through planning and strategy. The directors should no longer be civil servants (as was typically the case at this point) but professional managers paid competitive salaries. See Poullain, 1979, op. cit., pp. 48-63; and Poullain, Ludwig. 1969. "Sparkassenpolitik für Morgen." Sparkasse (86)6: 169-178.
competition in the banking industry. In emphasizing this corrective function Poulain was inspired by Karl Schiller.

With the publication of the Competition Commission report in 1968 under Schiller’s leadership, Schiller spoke out for this corrective function of the savings banks. He wrote, "the more the classic functions and credit business of the savings banks recede, the more it is incumbent upon the savings banks to legitimize their public legal status and the 'rest privileges' which are still associated with it today by actively supporting the work of the Länder and federal governments." At the 1969 annual congress of the savings banks Schiller supported Poulain’s views. He argued further that because the savings banks were regionally anchored institutions they countered concentration and animated competition in the banking industry. Thus through continuing their focus on local communal and Mittelstand business, but also by expanding into new areas, especially international and large industry business, the savings bank sector was to be the guarantor of bank competition in the Federal Republic. Since the removal of the savings banks’ tax privileges in 1967 was part of the federal government’s attempt to introduce more competition into the banking industry, Schiller was in effect using both a carrot and a stick to prod the savings banks into more aggressively challenging the other banking groups.

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54. Own translation as quoted by Meyer-Könster, 1979, op. cit., p. 150.

The 1969 congress of the savings banks was hailed in the press as a "new era for the savings banks." The savings banks sector was invigorated with a new sense of purpose and self-understanding, though the realization of the goals set out by Poulain was a long, difficult, and in the view of many today, still incomplete process. For the Landesbanks the new era consisted primarily of two new directions. First, the Landesbanks began to develop their international connections. The WestLB, for example, joined with three foreign banks to establish a consortial bank in London. The WestLB set a goal of having 25% of its assets in international transactions and achieved this by 1976. Secondly, the Landesbanks began to pursue more aggressively the business of large firms. In Germany's system of universal banking this also meant that they would begin to acquire large equity holdings in firms. By the early 1970s the Landesbanks were forcing their way into the elite club of the Big Three commercial banks, and the savings banks were firmly on their new market-oriented path.

The Cooperatives: Growth and Concentration after 1967.

In terms of growth, the liberalization measures of 1967 benefitted the cooperative banking sector the most. With their vast network of banks and branches the cooperatives were well-positioned to capture the fast-growing consumer banking business. But growth, 


59. Poulain writes that the major commercial banks practiced informal cartels. When it came to new stock issues or consortial loans the three banks divided up the business among themselves. After a year or so of resistance the commercial banks finally accepted the WestLB among the elites and regular granted the bank its share. Poulain, 1979, op. cit., p. 80.
as is often the case, had a large downside for the cooperative banks. After 1967 the rate of cooperative bank fusions grew quickly reaching several hundred per year in the early 1970s. Whereas in 1957 there were almost twelve thousand independent commercial and agricultural credit cooperatives, in 1987 there were just under 3,500.\textsuperscript{60} By and large it was simply growing competition with the other banking groups that forced the cooperatives to achieve better cost-efficiency through greater size. But fusions also indicated success. As cooperative banks expanded they encroached on the markets of other cooperatives. Thus many mergers within the cooperative sector were undertaken in order to eliminate group-internal competition.\textsuperscript{61}

The rapidly expanding membership ultimately transformed the demographics of cooperative membership and thus the banks themselves. Until the mid-twentieth century the membership of cooperatives was generally dominated (if not always in numbers, then at least in terms of control) by business owners, or in the case of the rural cooperatives, by farmers. But by the early 1970s two-thirds of cooperative members were not self-employed but blue- and white-collar employees. The business of the cooperatives changed with their membership. Savings and consumer services became essential to every cooperative. The general understanding of the Mittelstand concept was expanded in the post-war era to include

\textsuperscript{60} Between 1969 and 1975 the number of regional banks in the sector was reduced from sixteen to ten as a move toward a more rational and functional bank size. In this same period a discussion within the cooperative association over a change to a 2-tier associational system began. In such a system all the regional banks would be fused with the national DG Bank which would then work directly with the local cooperative banks. But resistance from the individual cooperative banks prevented any such reform. Helmut Faust, 1977, op. cit. p. 620.

\textsuperscript{61} Though cooperatives still remained comparatively very small banks. From 1972 to 1982 the average assets of a cooperative bank increased fivefold to DM 90 million. Zimmerman, 1984, op. cit, p. 29.
not only small- and medium-sized businesses but also the individuals of the growing middle class. This was in fact an important change for them, as originally their major purpose was commercial credit provision for which deposit-taking was a means to this end.⁶²

The growth of membership also changed the way the cooperatives conducted their business. Through the second world war the cooperatives typically had a few hundred members. On this scale the members were frequently well acquainted with each other, if not personally then with each others' business qualifications. In this environment the lending decisions of the bank board relied heavily on this personal knowledge and confidence, especially when collateral was insufficient. With this added information the cooperatives could lend based on the prospects of an investment. But with the growth of memberships this personal knowledge became rarer and the cooperative banks needed to become more formal and "bank-like" in their lending practices. The cooperative bank that was itself a joint-venture or obligational network involving a group of smaller firms is increasingly rare.⁶³ However, as will be discussed in greater detail in Chapter 8 cooperative banks continue to be integral actors in numerous sectoral and regional promotional networks.

Like Poullain for the savings banks, Georg Draheim, President of the DG Kasse from 1964 to 1972, sought to redefine and clarify the nature of the cooperative banks. For Draheim cooperatives were not "welfare institutions" but economic enterprises. Therefore they should operate by similar rules to other economic actors regarding liquidity, profit, and risk policies in order to ensure their long-term existence. But neither are cooperatives merely

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⁶² Nonetheless, the regular credit-taking members usually have a far greater interest in the bank and their influence in it is disproportionate to members who use the bank primarily for savings purposes. Neumann Manfred. 1985. Zeitschrift für das gesamte Kreditwesen. 2 (35).

economic enterprises like any other. Cooperatives have a double, "sui generis" nature: They are enterprises but also ‘member communities’ in which the goal of the members is to help one another. Profit maximization as a primary goal did not fit the cooperative ideal.\textsuperscript{64}

Their survival as a ‘unique species,’ however, required greater cooperation and unity. To enhance the organizational efficiency and political influence of the entire cooperative sector, a merger of agricultural and commercial cooperative associations was pursued. In 1971-1972 a sole peak association for the entire cooperative sector was created. Underneath the peak cooperative association was a new joint association of agricultural and commercial credit associations - the \textit{Bundesverband der deutschen Volksbanken und Raiffeisenbanken} (BVR).\textsuperscript{65}

The state also had an important role to play in the renewal of the cooperatives. In response to demands by the cooperatives, in 1974 the Cooperative Law was amended. The amended law provided the legal basis for the further "universalization" of the cooperative banks, lifting several restrictions on the business activities of the cooperatives. The most important change was the removal of the ban on non-member business. According to the amended law cooperative banks could conduct business with non-members if it served the interests of their members. Though the cooperatives still encourage all customers to become members, non-member business has became an important source of growth.

\textsuperscript{64} Helmut Faust, 1977, op. cit., pp. 599-615.

The new law also made the governing board of each bank legally responsible for its own actions. This change recognized the diminished capacity of cooperative members to directly operate their bank. Nonetheless, the board of each bank is still ultimately controlled by the membership through elections and therefore responsible to it. Despite these changes the cooperative banks are not full-fledged universal banks in the sense of the commercial banks as certain restrictions on them remain intact. For example, cooperative banks are not allowed to own other businesses which serve purely profit-making purposes. Thus by law, cooperative banks - and savings banks - cannot own shares in local firms and therefore cannot exercise a tutelary role. This role is reserved for their regional and central banks.

The critical legal distinction between the cooperatives and other economic entities remains the personal responsibility and liability of the membership for the organization. Since their beginning this emphasis on the individuals' responsibility for the cooperative has been institutionalized in what is known as the 'liability surcharge' (Haftsummenzuschlag). This principle obligates each member of the cooperative to cover its debts beyond the capital they invested in the bank. Should the banks' equity prove insufficient, each member is required to pay in additional capital in proportion to the number of shares each holds in the bank.

This liability surcharge has been critical to the success of the cooperatives because it is legally recognized in the KWG as equity in the bank. In the nineteenth century this artificially higher equity base made it possible for the cooperatives of capital-starved

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businesses to lend more to their members and borrow more funds from other banks than would otherwise have been possible. The 1974 amendments permitted cooperative banks to set limits on this surcharge and thus the liability of its members. This and other measures enhanced the equity accumulation potential of the banks by reducing the risk of membership and making cooperative shares more fungible.\textsuperscript{68} But while the liability surcharge may be less critical to the individual members, it remains very important to the success of the cooperative banks. And in spite of the growing objections of the other banking groups to this "unfair advantage" of the cooperatives, the state continues to support this unique status.

In 1976 the DG Kasse was given a new law, partly in compensation for the gradual loss of its tax-exempt status. In accordance with the growing market orientation of the cooperative sector, the new law lifted most restrictions on the bank's activities. The bank - now known as the \textit{Deutsche Genossenschafts-bank} or DG Bank - was permitted to conduct any business necessary to successfully fulfill its function of serving the cooperative banks. For example, the DG Bank no longer needed government approval for the acquisition of other firms. For the first time in its history the cooperative banking sector had a central bank with negligible direct government control.\textsuperscript{69} The state now accepted large-scale commercial credits, domestic and international consortial lending by the DG Bank insofar as they provide sound investments for the capital of the cooperative banks - and thus promoted the welfare of its members. And the DG Bank became another major competitor to the commercial banks for the business of large firms.

\textsuperscript{68} The shares of members in the bank could also be paid interest, thereby becoming quasi savings accounts.

\textsuperscript{69} While the elected general assemble is responsible for all major decisions, revisions in the charter of the DG Bank still require government approval. Faust, 1977, op. cit., p. 623.
In sum, by the mid-1970s the cooperative and savings banks responded to market pressure and state policy changes through a transition to a stronger market orientation. But this transition was neither easy nor smooth and would be tested many times in subsequent years. The preservation of market competition and the market-orientation of the association banking groups would need to be fought for and reaffirmed by these groups and the state.  

*The 1974 Crisis: An Industry under Pressure.*

Recession, major losses at several of the Landesbanks, and the collapse of West Germany’s second largest private banking house (I.D. Herstatt) in 1974 dealt a severe blow to the public’s trust in the banking system. The events raised questions about the security of deposits in the banking system and, more importantly, about the “power of the banks.” The first question was addressed through a series of emergency regulations and the strengthening of the banking sector’s private deposit insurance programs. The second question was turned over to a new commission known in the press as the Gessler Commission. The commission was charged with a thorough examination of the industry’s social and economic role and in particular the merits of a universal versus a divisionalized banking system, and the accumulation of power in the banks through equity holdings, supervisory board seats, and shareholder proxy voting.⁷⁰

Over the next few years the banking industry - the major commercial banks especially - would be the subject of numerous attacks from the public and the press. Many people called for a nationalization of the banking system. At its annual congress in 1975 the SPD

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passed a resolution calling for the elimination of the universal banking system. While the commission was continuing its investigation, emergency regulations were passed in 1976 that tightened restrictions on all the banks, especially credit restrictions, and strengthened the powers of the regulatory authorities. Ironically, the greatest impact of the new regulations was probably on the small cooperative banks - the banks with the least amount of power.

Federal authorities, especially the Bundesbank, saw an immense potential for disaster in the thousands of tiny banks. With their small staffs operating in a rapidly changing and increasingly complicated financial world the authorities believed that cooperative managers could too easily make mistakes. Thus the 1976 amendment required every bank in the country to have at least two directors. As the vast majority of cooperative banks had only one due to their small size, compliance was frequently met through mergers. The result was more concentration and stronger pressure to universalize further to cover higher costs.

In the savings bank sector the push into new markets in the 1970s, especially by the Landesbanks, helped the sector to grow, as well as maintain its overall competitiveness vis-à-vis the other banking groups. But it also brought problems, since the Landesbanks did not prove especially adept in their new role. Starting in 1973 a series of large loan defaults brought scandals to three of the largest Landesbanks - the WestLB, NordLB, and the Landesbank of Hessen (HELABA). In Hessen alone the losses amounted to more than DM 2 billion between 1974 and 1976, forcing the Land government to cover the bank’s losses out of its own treasury. There was even discussion of fusing the troubled HELABA with the

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72. This occurred mostly in rural areas. Cooperatives in towns and cities generally already had two directors.
stronger WestLB as a way out of the quandary. In several cases, though, the Länder governments were partly responsible for these scandals. The Landesbanks had made many of these loans to troubled firms under pressure from their governments.\textsuperscript{73} Fascinated by the power of the banks in their hands, the Länder had begun to use them for political purposes, often with little consideration for sound banking practices.

The mid-1970s crisis of the Landesbanks reached its peak with the dismissal of Ludwig Poullain in 1977. The man who symbolized the new role of the savings banks in West Germany was ousted from his post over allegations of corruption.\textsuperscript{74} Under pressure from the public, the savings banks, and Länder opposition parties to end their high-flying expansion, the Landesbanks initiated a strategic retreat. They liquidated many of their foreign offices and refocused their energies back on their regional markets.\textsuperscript{75} Land governments were forced to considerable lengths to defeat political campaigns that threatened to reverse the growing market orientation of the savings banks. Land governments remained committed to the market role of the Landesbanks in part because local and regional efforts

\textsuperscript{73} For example, in the early 1970s the NordLb bailed-out the ailing camera manufacturer Rollei under political pressure from the Land government. A few years later the firm went bankrupt anyway, costing the bank DM 700 million. "Unter Druck: Dauerstreit um Fusionen der Landesbanken." \textit{Capital}. October 1987, p. 2.

\textsuperscript{74} Poullain was eventually cleared of the charges. See Owen Smith, Eric. 1983. \textit{The West German Economy}. London: Croom Helm. pp. 238-240.

\textsuperscript{75} M. Pohl, 1986, op. cit., pp. 128-130. The reverberations from the scandals were felt far and wide. The savings banks demanded the Landesbanks focus on their regions since the former had to cover much of the losses of the latter. The ability of the Land governments to both manage and regulate their Landesbanks responsibly was questioned. See Büschgen, Hans E. "Klare Trennung zwischen Staatsaufsicht und Verwaltungsratmandat bei Landesbanken nötig," \textit{Handelsblatt}, 21/22 April 1978. The scandals of the 1970s touched off long-term studies and debates about the proper relationship between the Landesbanks and the political authorities responsible for them. See Knemeyer, Franz-Ludwig. 1986. \textit{Bankgeheimnis und parlamentarische Kontrolle bei Landesbanken}. Frankfurt: Fritz Knapp.
to overcome growing structural economic crises needed the help of strong public banks. \footnote{76}{In 1978 Chancellor Schmidt also defended the Landesbanks and explicitly cited their indispensable role in local and regional restructuring efforts. Sinnwell, Erwin. 1978. "Geraten die Landesbanken in Misskredit?" Zeitschrift für öffentliche und gemeinwirtschaftliche Unternehmen. 2(2):163-176.}

Nor could the savings banks and Landesbanks afford to retreat too far or allow their internal problems to sap their collective strength. In the 1970s the major commercial banks were stepping up their efforts to capture more of the consumer and Mittelstand banking markets.

For the major commercial banks the Herstatt crisis coincided with an important juncture in their internal development. Since their reconsolidation in the late 1950s, the major commercial banks had been steadily increasing their branches, buying up mortgage banks and other financial service organizations, and expanding their international presence - first through cooperation with foreign banks and later through the establishment of their own offices. \footnote{77}{M. Pohl, 1986, op. cit., pp. 116-123.}

By the mid-1970s the major banks began to realize they needed to undertake a major reorganization in order to effectively accommodate their ever broader range of activities and growing number of customers. Reorganization at this time was further motivated by declining profitability and competition from domestic and foreign banks. The commercial banks realized that they too needed to be more responsive to market demands. \footnote{78}{See Wielens, 1977, op. cit., pp. xiv, 6, 101.}

Finally, the rise of the Eurodollar and other international capital markets provided large firms with an alternative source of industrial finance. For the commercial banks this meant that lending to the Mittelstand was an increasingly important source of growth.

The Dresdner bank was the first to initiate a major reorganization. In 1972 the bank shed the organizational structure shaped in the 1950s by Allied policies that emphasized three
main regional administrative divisions within each bank. The Dresdner created one head
office and concentrated the third level from 40 to 14 main regional offices. This new
organization represented a centralization of the very top level of leadership, but on the whole
it was a decentralizing measure as the competencies and responsibility of the 14 regional
offices - as well as the branches below them - were expanded.

In 1975 the Deutsche Bank followed the Dresdner, likewise forsaking the three head
office structure and consolidating the number of regional offices from twenty-three to
fourteen.79 But the Deutsche Bank took this decentralization one step further than the
Dresdner by expanding the responsibility and authority of the lowest levels of its hierarchy
even more. The bank introduced a ‘profit-center’ system for coordinating relations among
units of the bank. In this system the performance of the fourteen regional offices and the 120
"self-balancing" branches for which they are responsible is measured by their individual
profit, rather than by customer or product targets and quotas. To motivate these branches
to maximize their profit while maintaining well-balanced asset and debt structures the bank
established internal prices on money transfers and services. The regional offices and self-
balancing branches conduct their own transfer payments via a Landeszentral-bank (regional
branch of the Bundesbank). The central office of the bank offers the branches a wide range
of auxiliary services.

Thus by mimicking the market through internal price incentives, coupled with
increased independence in the regional and self-balancing branches, these units operate more
autonomously in their respective markets. By reducing hierarchical control within the bank
concern, the major commercial banks came to operate much more like the two association

banking groups, especially the cooperatives. As will be explored more in Chapter 8, in the association groups the flow of services and capital between the local banks and their regional and national banks are increasingly governed by similar relations. The decentralization of the major commercial banks has been successful in gaining the business of consumers and Mittelstand firms.

But while the convergence between the hierarchical commercial banks and the association banking groups was evident, this process was not automatic. Critical differences between the groups remained which each sought to protect. In the early 1980s this attempt to protect their structural advantages flared again in a new round of intense political fighting among the groups. Once again the state was in a position to shape the mix of governance mechanisms in the banking industry, as well as the competitiveness of each banking group. The Revision of the Banking Law.

In 1979 the study commission called by the Federal government in 1974 to investigate the banking industry in order to recommend changes in the Banking Law (KWG) finally published its report. At the time of its inception the Gessler Commission was investigating an industry under intense scrutiny from a skeptical public. The power of the major commercial banks was criticized and the legitimate role of the public banks - increasingly commercially oriented - questioned.\(^8\) The Gessler commission, however, found no major faults in the universal banking system. Nor did the commission find there was an undue concentration of power - let alone its abuse - in the banking industry.

\(^8\) In spite of its public status, the savings banks sector has also been an avid defender of the market, and indirectly the major commercial banks. When their own legitimacy comes under attack, the savings banks, and especially the Landesbanks, invoke the argument that through competition they provide a control on the power of the major commercial banks. Nationalization of the commercial banks is therefore not necessary, and in fact undesirable. Maintaining effective group competition is the best way to control power.
But the commission did find important reasons for amending the KWG. It recommended that measures be undertaken regarding the definition of equity capital for the different banking groups - including the elimination of the liability surcharge of the cooperative banks. The report also recommended that banks be limited to holding no more than 25\% plus one share of a company's voting stock - exceptions being made for cases of firm rescues. This last recommendation fell far short of the limitations on bank shareholdings demanded by the Federal Monopoly Commission, the unions, and many Social Democrats - all of whom supported a 5\% limit. Even the liberal Federal Economics Minister Count Lambsdorff - otherwise an avid supporter of the private banking industry - favored a 15\% limit.\(^8\)

In the mid-1970s it seemed imminent that the Federal government would take steps to dramatically curtail the institutional sources of bank influence in industry. But within two years of the Gessler report's publication the main issue of political debate switched from the 'power of the banks' question to the 'liability capital,' or 'equity,' question. The 'power' question faded under the weight of two bad years for the major banks in which they not only parted with many of their largest shareholdings, but had a difficult time finding buyers for others. Renewed concern about increasing foreign control of German firms made the power of the banks seem more benign, if not desirable, to the Federal government.\(^8\) But if political support to curtail institutional bank power was fading, there was still ample support to force more competition into the banking industry.


\(^8\) Müller, 1981, op. cit.
In 1981 the Federal government sought to pass a subsidy reduction law as part of its deficit reduction plan. A key provision of the federal government’s proposal was to eliminate all remaining tax privileges for the savings and cooperative banks.\textsuperscript{83} The government argued that the business restrictions placed on the savings banks by Länder regulations were no longer significant. Moreover, what the savings banks were not allowed to do, their Girozentrale (Landesbanks) could. Thus the justification for tax privileges was no longer present.\textsuperscript{84}

This proposal unleashed a great outcry among both the association banking groups, but especially the saving banks. The issue of eliminating tax privileges was intimately linked to the debate around the reform of the banking law (KWG) and the equity capital question. The savings banks argued that the previous increases in their tax rate had already severely inhibited their ability to maintain an adequate capital base. Because the savings banks can only build up their equity through retained profits, they argued they were already disadvantaged vis-à-vis the other banking groups which could access outside sources of equity capital. If taxes were raised further the growth potential of the savings banks would be limited. Moreover, the federal Tax Office and the Federal Constitutional Court had both issued rulings in the mid-1970s that held the tax privileges of the savings banks to be justified by the limitations placed on their business practices.\textsuperscript{85}

\textsuperscript{83} In the mid-1970s the Federal government marginally raised their taxes twice.


\textsuperscript{85} Key limitations on the savings banks (which generally did not apply to the Landesbanks) included tighter credit restrictions for commercial loans; savings banks are not allowed to own shares in non-financial institutions, nor trade currencies and securities on their own account; and they are not allowed to issue their own bearer bonds.
The national savings bank association also argued that because of its decentralized structure and focus on the Mittelstand, the savings banks help preserve a decentralized economic structure. If the lawmakers wished to force the savings banks to be just like other banks - so reasoned Helmut Geiger, president of the national savings bank association - then they must be prepared to accept the broader social, political, and economic consequences.\textsuperscript{86} Geiger was attempting to remind federal officials that they have historically supported the savings banks exactly for these reasons of maintaining bank competition and economic decentralization.

Implicitly and often explicitly politicians and representatives of the savings bank sector also suggested that failure by the state to maintain an adequate basis for the savings banks to continue as communal organizations could be considered unconstitutional. The Basic Law (\textit{Grundgesetz}) guarantees communal self-administration and the savings banks are an indispensable building stone of this guarantee.\textsuperscript{87}

The Länder, acting through the Bundesrat, opposed the Federal government’s attempt to raise the taxes on the savings banks since it would increase federal revenues, but also raise the expenditures of the Länder and local governments to maintain adequate capitalization of

\textsuperscript{86} Geiger, Helmut. 1981. "Wettbewerb erfordert keine Änderung der Besteuerung." \textit{Sparkasse} 98: 160-162. The savings bank sector has longed been widely portrayed as a pillar of West German federalism. Thus for supporters of the savings banks any actions which threaten the connection between the banks and local and Länder governments imperil a fundamental political principle. See \textit{Handwörterbuch der Sparkassen}, op. cit., various parts.

\textsuperscript{87} For example, in a speech before the Bundesrat in early 1982 its president, Hans Koschnik, made this very argument. See excerpts from this speech as quoted in Koschnik, Hans. 1982. "Die Eigenkapitaldiskussion - Dokumente für den Haftungszuschlag." \textit{Sparkasse} 99(4): 171-196.
their banks. But the Länder also supported the savings banks for many of the same reasons which the banks themselves put forth - especially their focus on providing local banking needs to consumers and the Mittelstand.

When it became clear that these arguments would not prevent the federal government - ruled by a social-liberal coalition - from pursuing its tax plan, Geiger proposed that the savings banks be compensated by granting them a 50% liability surcharge (Haftungszuschlag) similar to that of the cooperative banks. For the savings bank sector, such a surcharge would do justice to the unlimited liability of communal and Länder governments for their banks by acknowledging this liability in the form of un-paid-in capital. The definition of what counts as liable capital was critical because German banks are permitted by the Banking Law (KWG) to lend up to a multiple of 18 times their capital. And in a banking industry with three major banking groups operating on different definitions of ‘liable capital,’ these definitions are the subject of recurrent and often sharp conflict.

The savings and cooperative banks could not prevent the passage of the Subsidy Reduction Law in 1981 which eliminated all their remaining tax privileges. But the savings bank association was successful in gaining a clear commitment from the federal parliamentary groups of the SPD and the CDU to compensate them in the upcoming revision of the KWG.

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90. Müller, 1981, op. cit. The cooperative banks had a 50% liability surcharge (Haftsummenzuschlag). With their own surcharge the liable capital of each savings bank would effectively be raised 50%.

with a liability surcharge. Immediately following the passage of the subsidy law Lothar Späth, Minister-President of Baden-Württemberg, introduced legislation in the Bundesrat to grant the savings banks a 35% liability surcharge. Nearly all the Länder strongly supported this measure during the ensuing KWG hearings and debate. Thus the savings banks had broad support in the federal, Länder and local parliaments and governments for their demand for a liability surcharge. Among the major political parties, only the liberal party (FDP), led on this issue by Count Otto Lambsdorff (also Federal Economics Minister), seemed strongly opposed to the measure. Thus the KWG debate was not only a power struggle among the banking groups, it also divided the governing coalition parties.

The cooperative and commercial banks also believed that the lawmakers must expand the possibility for all banks to build their equity, but opposed any liability surcharge for the savings banks. Alfred Herrhausen, head of the Deutsche Bank, argued that such a surcharge would permit "fictional" capital to be the basis for an additional DM 100 billion of credit capacity by an already competitive savings banks sector. He argued that the state presence

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92. The Länder had supported a liability surcharge for the savings banks during the 1961 revision of the KWG. In fact, the original Banking Law of 1934 already empowered the supervisory authorities to grant the savings banks such a privilege. See Koschnik, 1982, op. cit., pp. 171, 194.

93. In opposition to the liability surcharge Lambsdorff made a much-quoted statement: "He who doesn’t have any money, shouldn’t play banker." See Hahn, Oswald. 1986, op. cit., p. 436. For a summary of the SPD’s position see "MdB Lenartz: ‘Die KWG-Reform muss in dieser Legislaturperiode abgeschlossen werden’." Sparkasse 99(6): 235-237. The CDU was less committed to the notion of a liability surcharge for the savings banks, but was eager to put all the banks on a more equal footing, and favored the elimination of the liability surcharge for the cooperatives. See "Dr. Sprung: ‘Die KWG-Novellierung muss jetzt kommen.’" Sparkasse 99(2): 41-43.
in the banking sector was already too large and ran against the principle of state neutrality in the marketplace.\textsuperscript{94}

In an attempt to outmaneuver the savings banks, the cooperative and commercial banks also made a provisional "gentlemen’s agreement" with Federal regulatory authorities over reporting provisions. By cutting a deal without the savings banks, the other banks hoped to make reform of the KWG superfluous, thus eliminating the chance for lawmakers to recognize a liability surcharge for the savings banks.\textsuperscript{95} But in June of 1982 the federal government presented its proposed KWG amendments to parliament for approval. Among its many provisions the proposal included recognizing a 20\% liability surcharge for the savings banks. Unfortunately for the savings banks, Chancellor Schmidt and his ruling social-liberal coalition fell on a rare vote of no confidence before the KWG law could be amended. The new conservative-liberal coalition led by Helmut Kohl was not as favorably disposed to the savings banks. Their proposal in 1983 did not include a liability surcharge for the savings banks. The Bundesrat and savings banks continued to push for a liability surcharge but were unsuccessful.

In 1984 the KWG was amended, taking effect in 1985. A "peace settlement" among the warring banking groups, and between the Federal government and the Bundesrat, was reached through the introduction in the KWG of a new form of equity, or liable capital,

\textsuperscript{94} Herrhausen, Alfred. 1983. \textit{Wettbewerb und Regulierung in der Kreditwirtschaft}. Tübingen: J.C.B. Mohr. pp. 13-20. Instead of a liability surcharge, he proposed that all the banks should be permitted to count subordinated liabilities in their equity base up to an additional 20\%.

\textsuperscript{95} Müller, 1981, op. cit.
which all the banks could use - the *Genussschein*, or 'special participation right'. Additionally, the compromise solution included a gradual reduction of the liability surcharge of the cooperatives from 50% to 25%. These measures were successful in solving the equity problem insofar as a majority was found in the Bundestag for them, and the Bundesrat gave them reserved approval. The compromise solution was closest to the recommendations of the Gessler commission and the preferences of the federal regulatory officials. They preferred that all the banks be backed as much as possible by "real" capital.

In the true form of a compromise solution, each banking group obtained only some of its objectives. But the savings banks were probably the least satisfied with the settlement, arguing that the new provisions for equity capital were insufficient to meet their needs. The Bundesrat continues to support the savings banks ongoing demand for a liability surcharge, and thus the equity and fair competition questions remain open.

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96. The *Genussschein* is a hybrid debt and equity instrument. It provides risk-sharing, subordinated capital to the bank, but is paid back over a fixed number of years at a fixed interest rate.

97. Schroeter, Joachim. 1985. "Kreditwesengesetznovelle am 1. Januar 1985 in Kraft getreten." *Sparkasse* 102(2):49-51. For a summary of all the major amendments to the KWG in 1984 see Günther, Hans, and Wolfgang Arnold. 1985. "Die neuen Bestimmungen des Kreditwesengesetzes." *Die Bank* 1:27-34. Though the KWG also permitted other forms of non-voting, subordinated capital to be counted as equity in banks. All together, banks are allowed to add up to 25% to their liable capital through Genussschein and these additional instruments.


Thus the 1984 KWG revision pushed the association banking groups further along the path to a greater market orientation, since they would have to rely more than ever on their profits to maintain an adequate capital base. Moreover, the new regulations opened the door for savings banks to obtain capital from sources outside of government, which could potentially lead to 'creeping privatization' and 'de-communalization' of the savings banks.100 Competitive pressures on many savings banks have increased pressure within the savings bank association for this option. Thus the state's efforts to build and maintain market competition in the banking industry may also undermine the cooperation among savings banks critical to the maintenance of their association structure. Since the mid-1980s it is the savings bank group that has had the greatest difficulties in adjusting to changing institutional and market conditions.

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100. On this point see Koschnik, 1982, op.cit. Geiger attributed their failure to obtain a liability surcharge to the political strength of the cooperatives, the anti-public ownership sentiment of the ruling coalition in Bonn, the lack of commitment to the proposal by the regulatory agencies, and insufficient political will in some Länder to adequately defend their own interests vis-à-vis the federal government. Geiger, Helmut. 1985. "KWG-Reform: Zwiespältige Ergebnisse." Sparkasse 102(1):2-3.
E. After the KWG: Competition and Accelerated Convergence.

Starting from opposite poles, the structure and logic of group competition drives each banking group to attain the advantages of centralization and those of decentralization. Thus the outcome - or more likely the prerequisite - of competing in all markets at all levels is significant, albeit limited, assimilation between the groups in their internal structure and organization.\textsuperscript{101} For example, to be competitive with small Mittelstand firms increasingly requires not only local autonomy by bank or branch managers, but also the ability to provide services that only a strong, efficient "superstructure" can do cost-effectively. The superstructure can be either an association or a sufficiently large central bank organization.

Since the savings and cooperative banks already had an overwhelming local presence, organizational reform efforts in the past two decades focused heavily on "rationalizing" the secondary level. The national associations of the cooperatives and savings banks believe that only by further raising their efficiency on this level and maintaining a group internal division of labor can the vast majority of the local banks they serve provide the growing range of essential financial services at competitive prices. But reform is a long, difficult process in the association groups where decision-making is democratic. The movement toward the Single Market has heightened the sense of urgency in the association banking groups, though it has not so far altered the issues.

After the 1984 KWG amendments, the German savings bank association (DSGV) entered a period of growing internal division over the future direction of the savings banks. In the late 1980s the divisions sometimes appeared to verge on a sort of civil war. In spite

\textsuperscript{101} By 'structure' I mean the number and types of banks in each group at different levels. By 'organization' I mean the functional division of labor within each bank or group, the relations of authority or inter-organizational relations, and distribution of resources.
of an enormous financial potential, the savings bank association perceives itself as lacking long-term competitiveness.\textsuperscript{102} The group's dominant market share - close to one-half of the German banking market - rests in large part on traditional savings instruments which are expected to steadily decline in popularity. In international/export and investment banking, which are dominated by the major banks and expected by all to be the key markets of the future, the savings banks are relatively weak. While still the most profitable banking group, profits for the group as a whole have declined continuously since 1984.\textsuperscript{103}

Competitive pressures are driving many savings banks into direct, and more often indirect, competition with each other. Unless the savings banks can resolve their differences, this menacing erosion of the association structure could have negative implications for all banks in the sector, as well as the entire banking industry. Four key issues, among many, divide association members: the further liberalization of business restrictions on the savings banks; public ownership versus privatization; fusion of the Landesbanks; and the association internal division of labor/cooperation.

By law, savings banks are permitted to engage only in the activities which are expressly authorized by the lawmakers or supervisory authorities of the Land government.\textsuperscript{104} Many savings banks, especially the larger ones, find this principle increasingly inhibitive. They claim they cannot innovate, only imitate. Many banks would

\textsuperscript{102} With 263,000 employees, 17,000 branches, and DM 1.5 trillion in combined assets, the DSGV represents the largest banking union in the world. Two of every three citizens and three of every four firms has a savings bank account. "Stark gefährdet. Falsche Produkte, falsche Kunden: Deutschlands Sparkassen und Landesbanken gehen harten Zeiten entgegen." \textit{Der Spiegel}. 28 August 1989.

\textsuperscript{103} "Sparkassenorganization fast vor Zerreissprobe." \textit{Süddeutsche Zeitung}. 31 August 1989.

\textsuperscript{104} This principle is known as enumeration. The Landesbanken are not subject to it.
like to have local business representatives on their boards like the cooperatives, but for numerous reasons are unable to do so.\textsuperscript{105} Hence in recent years several Länder governments have worked with their savings banks to further liberalize regulations. In 1987 the government of Baden-Württemberg, as part of its very active industrial policy, was the first to respond in granting new capacities. A revision of the Land’s savings bank law expanded the lending capacities of savings banks, gave them the right to purchase and hold more securities from domestic and foreign exchanges, and to take direct equity participation in private firms. Similar legislation is pending in other Länder.

One of the chief problems with such liberalization is that it enables the large savings banks - several of which are really super-regional banks - to compete in markets previously reserved for their Girozentrale (Landesbanks). While this might spur greater competition for the business of large firms, it could undermine the ability of the association to effectively support the smaller savings banks.

All savings banks are especially concerned about their limited capacity to raise their equity. In recent years a small but vocal group of rebels within the association has pushed for the privilege of privatization as a way to solve this problem.\textsuperscript{106} But the opposition to privatization by most local and state politicians, and the majority of savings banks, is overwhelming. Opponents argue first that privatization of even just a few large savings banks would destroy the regional principle, and thus organizational unity, by enabling these

\textsuperscript{105} Instead they usually have political appointees made on the basis of their partisan association. Many savings banks feel restricted by a perceived trend to greater politicization. See Mura, Jürgen. 1979a, op. cit., pp. 100-129.

\textsuperscript{106} One of the most vocal proponents of partial privatization for savings banks is Walter Zügel, head of the Stuttgart savings banks. See Zügel, 1985, op. cit. Compliance with EEC regulations will also require most savings banks to substantially raise their capital.
banks to compete with other savings banks throughout the country. If the association is thus weakened, the smaller savings banks fear they would suffer a great disadvantage vis-à-vis their chief local competitor, the cooperative banks, since the cooperatives would still have the advantages of a strong association.¹⁰⁷ From a national perspective, many fear that privatized savings banks would eventually fall into the hands of domestic or foreign commercial banks looking to expand in Europe. Greater concentration in the banking sector, rather than more competition, would be the likely outcome.¹⁰⁸

One of the other major problems for the savings banks centers around the group internal division of labor and the Landesbanks. The Landesbanks are competing more and more with each other for the same customers. Their profitability is low. Long-term business lending, their chief source of income, is in decline. The bigger savings banks are not only using them less and less, they are also competing with them. This makes the cost of serving the smaller savings banks that much higher to the Landesbanks.¹⁰⁹ The internal division of labor which assured them of their cooperative functions, and to a large extent their income, is coming apart.

For example, a cornerstone of cooperation in the savings bank group is the ‘liquidity association.’ Under this arrangement the local banks are required to deposit their excess

¹⁰⁷ One potential compromise solution involves partial privatization via the creation of investment corporations through which residents will be able to make limited non-voting investments in their local savings banks. The Bavarians, generally conservative on savings bank issues, complain that this is still privatization, only through the back-door. Olthof, Günther. "Stille Gesellschaft vor den Kassen." Die Welt. 21 March 1989.


funds with their Landesbank which in turn lends these funds to other savings banks in the region or invests them. The Landesbank3, in turn, refinance the loans of the savings bank and act as lender of last resort. The Landesbanks are also assigned all the investment banking functions of the group, issuing bank bonds when more cash is needed and buying securities for their customers. Though this closed system served the savings banks well for most of their history, it too is being undermined. In Baden-Württemberg local savings banks can now deposit their funds with any other savings bank. In North Rhine-Westphalia the large savings banks - backed by the DSGV - are pushing the Land government to allow them to issue their own bank bonds. The Landesbank and many Länder politicians oppose this measure since it would undermine one of the Landesbanks primary functions in the group.

Just as the major problems of the savings banks center around the Landesbanks, so too do the major reform proposals. Many in the association are convinced they simply have too many Landesbanks. The DSGV believes fusing the Landesbanks would directly or indirectly solve the majority of the groups problems, and is critical to preventing a slide in the group's overall market share.110 In other words, to become more competitive in the international and export finance activities. According to Helmut Geiger, president of the DSGV, losing the export finance business of their Mittelstand customers poses the greatest danger to the future of the group.111 Thus reform is seen as necessary for success in competition for both large and small firms.

110. In asserting this position the DSGV was following the recommendations of an outside consultant that argued the group should become more concern-like in its structure. In other words, since they have no strong central banking institution the Landesbanken should fuse, and be empowered with some direct control over the local banks. "Sparkassenorganisation fast vor Zerreissprobe." Süddeutsche Zeitung. 31 August 1989.

While some advocate the fusion of all eleven Landesbanks into one, the more immediate and realistic goal espoused within the association is the creation of three or four Landesbanks. Yet even this may be too ambitious. The chief obstacle, among many, is the resistance of the Länder governments which typically own 50% of the Landesbank in their state. The Landesbank is considered and used by most Länder government as a major economic policy instrument.\textsuperscript{112} In the 1970s the Landesbanks became powerful instruments for the economic policies of the Länder governments. First, in most Länder the Landesbank administer and fund a significant share of the interest-subsidized lending under Länder and federal development programs. Secondly, for those occasions when the Minister-President acting as a white knight requires substantial capital to back up his ad hoc economic interventions such as the bail-out of a local firm, the Landesbank is his steed.\textsuperscript{113}

At one point the DSGV proposed that savings banks be allowed to conduct their investment and international banking business through the Landesbank of their choice. The Bavarian government, opposed to the fusion of Landesbanks, saw this as an attempt to induce such fusions by pitting the weaker Landesbanks against the stronger.\textsuperscript{114} Thus there is significant political regionalism inhibiting the fusion of Landesbanks. But this regionalism

\textsuperscript{112} For example see Streibl, Max. 1985. "Der Leistungsbeitrag der Landesbanken Girozentralen." \textit{Sparkasse} 102(2): 46-48. Streibl, who became the Minister-President of Bavaria in 1988, wrote that the state's interest in competitive Landesbanks could be justified, among other things, by it's interest in a balanced economic structure. Further, the Landesbanks are a legitimate means for the state to influence the structure of the credit sector and the economy in general.

\textsuperscript{113} For example, in July 1987 the Bavarian Minister-President Franz Josef Strauss used the Bayerische Landesbank to purchase 5% of Lufthansa AG as a step to prevent the airline's privatization by the federal government. \textit{Die Zeit}. 7 August 1987, p.13.

\textsuperscript{114} "Sparkassenorganisation fast vor Zerreissprobe." \textit{Süddeutsche Zeitung}. 31 August 1989.
can cut both ways. Should one merger be achieved, however this may occur, it is likely that more would follow. The Bavarian savings banks, for example, were dismayed by the proposed merger between the WestLB and Hessische Landesbank in 1989/1990, for not only would it have created the second largest bank in the Republic, but it would also firmly ensconce their Rhenish rivals in Frankfurt. The Bavarians (as well as the other Länder) would possible be closed out of an enlarged direct presence in the nation’s money capital. For the Bavarians there would be no better response than to create a "southern solution" in which the Bavarian Landesbank would join with those from Baden-Württemberg and Rhine Land-Palatinate.  

As of 1991 no fusions between Landesbanks had occurred. The WestLB and Hessische Landesbanks (HELEBA) had in principle reached a fusion agreement in 1989. But the banks could not agree on the monetary valuation of the HELABA’s worth and the merger fell through. Instead, the Land government of Hesse sold its ownership in the HELABA to its regional savings bank association in 1990. The Hessen savings banks believed that complete control over their own Landesbank would enable them to cooperate more closely and therefore compete more effectively. The only fusion on the secondary level of the savings banks that did occur was between the two Girozentrale of Baden and Württemberg. After nearly two decades of trying, these banks finally merged in the new Südwestdeutsche Landesbank (SüdwestLB). The SüdwestLB immediately joined the WestLB in a joint-venture

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115 For Franz Neubauer, president of the Bavarian savings bank association and former Bavarian cabinet minister, wrote that a "southern solution" would be optimal as these Länder share the same "progressive" economic policies and similarly structured economies. "Bayern wünscht sich 'grosse Südlösung'." Börsenzeitung 24 September 1987.
for international financial business. Such cooperation between the Landesbanks seems one of the most viable alternatives to fusion.\textsuperscript{116}

Still, without fusion of the Landesbanks many fear the association will erode from within and be beaten from without.\textsuperscript{117} While the top functionaries of the DSGV are struggling to revitalize the association, at the moment they seem to be capable only of presiding over its partial dissolution. The association is confronted with a seemingly paradoxical task - it must accommodate the struggle for greater independence among its banks yet maintain, or even increase, cooperation if it is to avoid becoming little more than a nominal confederation of banks. The decisions of Länder and local governments will play a crucial role in the outcome. While most governments are willing to experiment with their banks to keep them competitive, they are unlikely to cede control. Thus the savings banks will continue to steer a course - however many obstacles it presents - between the market and the state.

\textit{The Cooperative Banks after the KWG.}

The cooperative banks are the success story of the post-1967 era. In less than two decades they doubled their overall market share to nearly 20%. Their membership grew almost exponentially. Explanations for their success are many and none convincing by itself. One factor was surely the repeal of the prohibition on non-member business in the early


\textsuperscript{117} Horizontal fusion on the primary level, i.e. the savings banks, is also presently an issue. The DSGV believes that the optimal size for a savings bank to be able to economically offer the services necessary for future success is DM 1 billion. In 1989 more than half the savings banks fell under this level. Some consider vertical fusions between savings banks and a Landesbank as another possible solution, but this is generally regarded as tabu.
1970s; another their ability to capture a large share of the rapidly growing consumer market because of their vast number of banks. Many would cite their efficiency in cross-selling the specialized banking and other financial services (e.g. insurance) of association organizations. The cooperatives themselves see their decentralized structure and the individual’s identity as a ‘member’ as responsible for their success. Gundlach writes, "The main causes [for our growth in market share] appear to be decentralization - a trend, which is just being rediscovered in other economic organizations - and the factors which stand behind it, like motivation, the individual desire to succeed, freedom and social recognition in a closed social group."\(^{118}\)

In the 1980s, however, the cooperative banks ran into problems similar to those of the savings banks. The regional banks of the sector have come to do far more than just serve the liquidity needs of the individual banks. They compete with other large banks, including each other, in underwriting and large-scale lending activities. In the export business, the regional banks are working more with banks other than the DG Bank. Thus group-internal competition also plagues the cooperative banks.\(^{119}\) More importantly, the cooperatives’ steady expansion curve in market share flattened after 1985 thereby raising concerns about the future. As an organization they too are very weak in the key growth markets - investment and international banking - that are increasingly important for their traditional

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\(^{119}\). Though the cooperatives seem to have found more solutions than the savings banks. For example, in 1976 the DG Bank and the regional banks created an 'international pool'. Rather than competing with each other they thus pool their foreign loans and take profits according to a negotiated formula. "Genossenschaften: Grosses Zusammenrücken." Wirtschaftswoche. 18 February 1983.
Mittelstand customers. Failure to do so means risking the loss of Mittelstand firms to the major commercial banks. But, like the savings banks, to do these kinds of activities the cooperative leadership feels it needs greater capacity in its upper-tier banks. But unlike the savings bank association, the cooperatives appear to have the capacity to strengthen cooperation within their association.

The reason for the difference in outcomes may well be the strength of the cooperatives central banking institution - the DG Bank. The DG Bank is by far the largest bank in the cooperative group and plays an important leadership role in resolving organizational issues alongside the national association (the BVR), as well as spearheading the cooperatives' drive into new markets.

But, in contrast to the savings banks again, the more pressing problem for the cooperative sector, at least in the eyes of the DG Bank and central association leaders, is that the vast majority of cooperative banks are still very small - too small to afford the products, services and specialized staff with the know-how necessary to compete. But these local banks are the very reason for the success of the group. Thus the association is pursuing a strategy of strengthening these institutions - and thereby preserving the advantages of decentralization - through fusion of the regional banks with the DG Bank. The regional


121. Certainly one must also note their general independence from direct political control as is the case of the savings banks.

122. Or too small to withstand protracted regional slumps such as in the Ruhr region where, by some estimates, up to 80% of the cooperatives are near broke. "Genossenschaftsbanken: Auf den Kopf gestellt." Wirtschaftswoche. 17 January 1986.
banks would then become arms of the DG Bank and would primarily conduct business with larger clients under the direction of the central bank.

The cooperative association hopes to accomplish several goals simultaneously by moving to a two-tier associational structure: First and foremost, the reduced costs for the organization as a whole could be used to put more resources into developing investment and international banking capacities, to develop new products and improve price competitiveness, and to increase the equity of the DG Bank. By eliminating the independence of the middle-level, decision-making should also be more efficient, and the cost of services from the secondary level to the primary banking institutions reduced.

For the cooperative sector the proposal is highly divisive. While the new DG Bank would be formally controlled by the individual banks through a democratic process, the new structure would place thousands of tiny banks in charge of the second largest bank in the Federal Republic. Though the two-tier concept has been in discussion for close to twenty years, extended debate became heated battle in the late 1980s as its apparent inevitability grew. First, in 1987 the DG Bank was forced to takeover the badly mismanaged Bavarian regional bank. Thus the first fusion between a regional bank and the DG Bank was already accomplished. Then in 1988 the DG Bank made a detailed fusion proposal to the association. Shortly thereafter the North German regional cooperative bank announced its intention to fuse with the DG Bank regardless of any other decisions. On the other side of the fence, two of the regional banks strongly opposed the fusion. A major securities trading scandal involving the DG Bank and a French bank in 1990, however, forced association leaders to put further fusion negotiations aside for the time being.

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123. The majority voting bloc in the cooperative organization still lies with the thousands of local banks.
Nonetheless, many outside observers already describe the cooperative association as being 'concern-like,' because the DG Bank has achieved considerable direct influence over the group, much like the head office of the commercial banks exercises over its branches.\textsuperscript{124} When the internal organization of the major commercial banks is closely scrutinized, the convergence between the hierarchial branch model of the commercial banks and the association model, especially that of the cooperatives, seems even more clear.

\textit{The Branch Model of the Major Banks.}

In the 1980s the first key organizational change of the major commercial banks is their further internationalization - through the purchase of foreign banks and through establishing joint ventures. The second major organizational development is a continuation of the decentralization process that they initiated in the 1970s. As in the case of the association banking groups, for the commercial banks success in local, regional, national, and international banking markets is increasingly interdependent.

One prominent measure of decentralization - and certainly one most important to business customers - is the lending authority of each level of the bank. Since the 1970s all the major banks have delegated much greater authority to lower levels.\textsuperscript{125} As the banks do not publish information on this, it is difficult to determine exactly how much this changed. However, one local branch manager said his authority had been increased forty-fold in the

\textsuperscript{124} In essence becoming another branch bank like the major commercial banks. See Hahn, 1986, op. cit.; and "Genossenschaften: Grosses Zusammenrücken." \textit{Wirtschaftswoche}. 18 February 1983.

last twenty-five years and that he can now operate much like any other independent local bank. After accounting for inflation, that represents a real increase of 1,600 percent. The credit needs of nearly all small-and medium-sized firms can now be decided upon in the local or at most the regional branch. In a market where firms want fast credit approval, this local authority has become indispensable. And winning over the Mittelstand is increasingly vital to the commercial branch banks, as their lending patterns make clear: From 1972 to 1982 the share of credits to the Mittelstand in their total credits to firms increased from 28% to 37%. 

In early 1987 the major banks made another bold step. For the first time in their history they gave their regional offices (and in some cases key branches) the freedom to set their own interest rates on savings deposits. With this move the banks recognized that there is no national interest market but regional ones. Strong competition is forcing the banks to be more responsive to local market conditions in this manner as well. 

Along with greater authority comes greater accountability for branch profits. For example, in the Commerzbank, which decentralized in the 1980s like its competitors had in the 1970s, the assets and liabilities of each branch are now balanced individually, as well as the profit/loss position. Furthermore, each branch can measure its success by customer and product groups. Profit targets are set for each branch via negotiations between the central

126. Interview with a major commercial bank manager in Heilbronn, July 1989.

127. Credits are considered Mittelstand when the total credit engagement of a customer does not exceed DM 1 million at year end. Lubitz, Karl-Joachim. 1985. "Bankmarketing gegenüber mittelständischen Unternehmen." Bank und Markt. (9): 32-34.

128. It was then expected that similar freedom in setting interest rates on loans would follow. Schwarzer, Otto. "Schlagkraft von der Basis: Wie die Grossbanken sich für den Wettbewerb Rüsten." Süddeutsche Zeitung. 21 March 1987.
office planners and local managers. Each branch then has a range of competencies and rate setting authority which varies with the size and importance of the branch. Within these framework conditions, each branch can incorporate local information into its profit maximization strategies.

With this devolution of authority the role of the central office vis-à-vis the regional and local branches has changed. The relationship between center and periphery within the bank has become less authoritative and more based on consensus achieved through negotiation. The basic goals of the regional offices are strongly shaped by the central office, but the regional offices receive little detailed directives. The central office acts more like a service provider to regional and local branches. For example, the central office of the Deutsche Bank conducts market analyses of 300 local markets. The studies assess its local market share by customer group and product. Based on this information, the central office then offers local branches assistance in the form of group- or product-oriented sales promotion packages. Both strategic (long-term), and especially operative (short-term) planning are done in all three major commercial banks through a dialectical process between the central, regional and local offices. The major banks now like to portray their

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129. Heye, 1985, op. cit. While the branches participate in the planning process, the central office still has the upper hand in negotiations and final say.

130. As many analysts have noted, there are limits to the ability of the commercial banks to decentralize, as well as organizational problems associated with the now popular profit-center approach. For example see Süchting, Joachim. 1984. "Unternehmensführung in Banken und Sparkassen." In Standortbestimmung: Entwicklungslinien der deutschen Kreditwirtschaft, ed. Günther Aschauer, et. al. Stuttgart: Deutscher Sparkassenverlag. pp. 307-325


regional offices as similar in their autonomy to independent regional banks. Eglau also notes that these "banks within a bank" typically have a network of institutional relations with larger Mittelstand firms. For example, in 1988 representatives from 643 firms sat on the fourteen regional advisory councils of the Deutsche Bank. Many of these same firms in turn offer a seat on their advisory board to a bank member. While these boards have minimal decision-making roles, they help cement bank-firm relations and firmly root regional offices in their immediate corporate environment.

used a somewhat more centralized system of 'component' steering; see Büschgen, 1983, op. cit., pp. 217-220. The Commerzbank did not follow the other two major banks until the early 1980s when the new head of the bank, Walter Seipp, sought to shake up the bank which he saw as over-centralized and bureaucratic. See Owen Smith, 1983, op. cit., p. 222.


F. Summary: Politics, Competition, Convergence.

In the postwar era the formal and informal promotional networks that limited competition in the banking industry among the major German banking groups have been largely replaced by market mechanisms. The creation of markets and thus competition was brought about through a series of state actions, sometimes in opposition to the banking groups. Thus within the state there were several key actors that helped create and stabilize markets as governance mechanisms in banking. The growth of competition, in turn, fostered extensive organizational change within the three major banking groups. In a general sense, this process can be described as one of significant albeit partial, convergence among them.

First, with a vastly expanded network of local branches and the desire to increase their share of the mass banking markets, including small business, the major banks found both an organizational and market imperative to internally decentralize authority, control, and resources. Managers of regional and local branches now have far greater independence than even ten years ago. Second, the cooperative and savings bank groups, while still said to be "decentralized to the bone," are strengthening the upper levels of their organizations through concentration of financial resources and limited centralization of authority. A primary force behind these changes was, and still is, the need to preserve the independence and success of the smaller banks through a more cost-effective association.

The expansion of market mechanisms, combined with the organizational changes of the three banking groups as well as broader structural economic changes, has led to significant changes in bank-industry relations in Germany. Intense competition for the financial business of both large and small firms has generally raised the negotiating power of non-financial firms vis-à-vis the banks. Moreover, it has forced the banks to seek out a new role for themselves in industry, especially with smaller firms, that enhances their
importance to firms without or with less reliance on the traditional institutional sources of bank influence. These changes in bank-industry relations are the subject of the following chapter.

While competition and other factors furthered centralization and concentration in the association banking groups, a surprising among of decentralization has been preserved. Among other sources of evidence, this argument is supported by a comparative study of France and Germany which concludes that the relatively decentralized nature of the German banking industry helped maintain more even levels of economic development between regions within the Federal Republic. Decentralization in West Germany is defined by the presence of a large number of small banks and the internal decentralization of the major commercial banks.\textsuperscript{135} Strong decentralization has been preserved through the combined impact of Federal and Länder government actions, the logic of group competition, and structural economic changes that favored, among other things, production in smaller firms and regions where the major commercial banks have been traditionally weak.

Continued decentralization required repeated and consistent policy actions by the state that helped maintain the growing market-orientation and competitiveness of the association banking groups. When the banking groups used the state as an arena to seek comparative advantages, the state sought to preserve market governance in the banking industry by ensuring that group competition was preserved. If any one group failed, competition would be severely curtailed. The logic of group competition ensured that each group would seek to have strong decentralized and centralized financial capacities, since any group would suffer as a whole if it could not achieve substantial success in any major market segment. The

\textsuperscript{135} Hartmann, Manfred. 1977. \textit{Raumwirtschaftliche Implikationen der Organization der Kreditwirtschaft}. Berlin: Duncker & Humblot.
emphasis on decentralization by the banking groups was further promoted by the growing importance and demands of Mittelstand firms. With large firms increasingly independent of bank finance, these smaller firms are a critical commercial market for all the banking groups. To be successful with smaller firms, the banking groups must effectively utilize local knowledge and autonomy in order to build long-term bank-firm relations.

Finally, the organization of the savings bank sector and its growing market orientation must be understood as partly the outcome of actions by subnational governments. The desire by subnational governments, particularly Länder governments, to use the savings banks to promote the competitiveness of regional firms reinforced these trends in the savings bank sector. Länder and local governments fostered and harnessed the banks’ increasing market strength for expanded state intervention. Though because of its regionalized nature, this has also made the successful market adaptation of the savings banks as a national banking group more problematic, since each Land tends to place its interests in its own savings banks over those of the entire sector. The combination of structural decentralization with a commitment to local and regional economic prosperity and cooperation, makes the German banking system an important contributing factor to the maintenance and expansion of local capacities to govern economic change: first, because it serves to strengthen the regional economy as a collectivity - facilitating inter-organizational (and inter-firm) cooperation within the region; second, by expanding linkages between regional economies and the global economy.
CHAPTER FOUR:

Bank-Industry Relations: Bank Dominance or Bank-Firm Interdependence?

A. Introduction.

In this chapter I examine changes in the banking sector’s relations to industry. In the standard organized capitalism accounts it is the tutelary role of the banks vis-à-vis industry that helps distinguish the German system of industrial finance (or economic governance, if more broadly formulated) from those of other industrial nations. But I argue that the traditional tutelary role of the banks vis-à-vis industry must be understood as only one, and perhaps not even the most definitive, role of the banks. Since the early 1970s the West German banks have significantly expanded their ‘intermediary’ or ‘mediator’ role. With this shift in the banking sector’s role, relations between banks and industry are increasingly characterized by mutual dependence, and less by bank dominance or leadership of industry.

As noted earlier the mediator bank role refers not to the traditional function of capital provision or financial ‘intermediation,’ but to that of ‘information mediation.’ Whereas in their tutelary role banks have legally grounded decision-making powers in firms, when a bank has a strictly mediator relationship to a firm it has no formal decision-making role, though it may well influence certain firm decisions. Intermediary bank-firm relationships are generally characterized by a more balanced interdependence between the two partners. They are more prevalent between banks and Mittelstand firms than between banks and large firms, though relations between the banks and large firms also appear to be moving away from tutelage to mediation. As will be discussed more in the following chapters, in this role local banks and branches are increasingly embedded in local and regional promotional networks.
that typically cut across economic sectors. Thus the more banks play a mediator role, they tend to reinforce non-hierarchical governance mechanisms in the German economy.

The expansion of this type of bank-industry relations results largely from the growing importance of the Mittelstand as a customer group and its demands on the banks, as well as the declining dependence of large firms on the banks. As suggested by the analysis of organizational changes in the banking sector in the previous chapter, the expansion of this mediator role was also greatly enhanced by the existence of group competition among universal banks in the Federal Republic. Each of the three bank groups has attempted to provide every necessary service through a local bank or branch. To provide these services effectively - and thus to survive - each local bank or branch must be able to respond quickly, creatively and hence relatively autonomously to a firm’s demands. In the case of the commercial banks, their local branches rely on their respective concerns and subsidiaries to provide them with the services needed to operate effectively. In the case of savings and cooperative banks, they too need to cooperate with their association and its subsidiaries. All of this empowers local actors in the banking industry to respond to a greater variety of firm needs because they can combine resources from locally, nationally and internationally operating units.

While most of the literature sees the German system of industrial finance as dominated by the big commercial banks, I argue that three important changes in this system have occurred: First, in the 1970s and 1980s smaller banks assumed a greater role in financing industry. The growing dependence of the big commercial banks on the Mittelstand for commercial lending means that their local branches that do Mittelstand business have become increasingly important actors in industrial finance. In short this means that a growing portion of firm borrowing is being satisfied not by national or even regional banks,

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but by small banks and local branches operating in local markets. Second, because smaller banks and local bank branches generally pursue intermediary relationships to firms, the more they finance industry the more important their mediator role becomes in the economy. The third change is the growing role of the state in industrial finance. In sum, governments and local banks and branches are assuming a greater role in the co-ordination of economic activity - more specifically the allocation of investment capital - and thereby supporting the expansion of Mittelstand firms and the promotional networks on which many of them rely.

This chapter proceeds first with an examination of the changing pattern of industrial finance in West Germany and the evolution of bank-industry relations. The central focus is on how the tutelary role of the banks has declined relative to their mediator role. It is extremely difficult, if literally impossible given the inaccessibility of key information, to provide comprehensive and systematic evidence of the nature of all bank-firm interactions. Thus I attempt to provide a convincing argument based on changes in selected structural market and other institutional factors that hinder/favor bank control over industry. This chapter also provides evidence which documents the growing role of the savings and cooperative banks, as well as the state, in industrial finance. The growth of the state as a source of industrial finance for Mittelstand firms reinforces the banks' mediator role. The final focus of this chapter is an examination of the impact or consequences that bank actions have for industrial development.

B. The Changing Pattern of Industrial Finance and Bank-Industry Relations.

The West German banking sector has become one of the nation's leading growth industries, creating tens of thousands of jobs in the last two decades. In the course of this expansion, the banks have taken on new social and economic functions - especially in
consumer or retail banking. These new functions, however, have not come at the expense of the bank's industrial function: In Germany the system of 'industrial banking' remains strong. Industrial banking is understood as a system in which banks become more strongly involved in the affairs of industry by pursuing close working relationships with firm managers.¹ In the case of Germany there are three institutions that, according to most accounts, provide the major commercial banks with substantial influence in industry: large shareholdings in firms; an extensive number of seats on the supervisory boards of Germany's largest firms; and the right to exercise proxy votes at shareholders meetings on behalf of customers who deposit their stock with the bank. Bank influence is further enhanced by the structure of German capital markets and the banking industry: The high rate of firm dependence on the banks as a source of capital, combined with a substantial degree of concentration of capital in, and coordination among, the major commercial banks, gives the banks even more leverage over firms.

Dyson probably best states the widely believed consequences of this "large role for the banks in industry and the emergence of an industrial-banking oligarchy." First, the banks provide an 'early warning' system to identify weaknesses in industry and occasionally mount rescue operations. Second, the strong banks assure industry ready access to funds. Third, the banks exert financial discipline in industry. Fourth, the banks as initiators or organizers of industrial activity help screen industrial policy from the general arena of politics. Fifth, the detailed long-term and inter- and intra-sectoral studies done by the banks indicate their readiness to assume a long-term perspective regarding the firms they invest in, and therefore focus on securing market share and improving the long-term cost structure of firms through

¹. This definition taken from Cox, 1986, op. cit., p. 4.
the mobilization of financial, technical, and managerial resources. And sixth, the banks influence corporate policies through their ability to influence the appointment of top personnel.² To this Bayliss and Philip add that banks pool information about firms in each sector and supplement this with their own research to provide their firm clients with useful, specialized information.³ Because of this close relationship, the widespread belief about the German political economy is that the banks tend to assume greater risks and make longer-term financial commitments to firms based on the bank's assessment of the firm's long-term growth prospects.

In the following section I examine the recent evolution of these institutional and market sources of bank influence, as well as the supposed consequences for bank-industry relations outlined above.

Concentration and Coordination, or Competition?

Financial dependence of firms on banks is primarily a function of a) the availability of capital (which is determined both by its supply and its demand); and b) the degree of concentration and coordination among financial institutions. The growth of competition in the banking industry detailed in the previous chapter has, in critical respects, undermined concentration and coordination among German banks. This has occurred through the growth in effective competition for large and small firms, as well as the growing market share of industrial finance controlled by the smaller association banks.

In the 1960s and 1970s the West German banks enjoyed double-digit growth. In the 1980s average annual growth slowed substantially, but was still higher than the economy as

². Dyson, 1982, op. cit.

a whole. As table 4.1 shows, a disproportionate share of this tremendous growth was captured by the cooperative banking sector (11.5% to 16.9% of total bank business volume). The big commercial banks lost a significant percentage of their share of total bank business; the savings bank sector also took a slight loss. However, these losses in domestic share for the commercial and savings bank sectors probably reflect in part a shift of activity from the domestic to international markets on the part of the Landesbanks and big commercial banks. Convergence between the three major banking groups is clearly evident in the distribution of their loan portfolios by firm size and length of maturity - the mix of big and small firms, short- and long-term loans is increasingly similar in all three major banking groups (Tables 4.1, 4.2, and 4.3).

In loans to firms Table 4.2 shows a major decline in the market share of the big three commercial banks from 15.4% in 1972 to 11.9% at the end of 1982. In this same period the market shares of the savings and cooperative banking groups increased from 33.2% to 36.7%, and 12.9% to 17.4% respectively. In the mid-1970s the savings banks group surpassed the entire private commercial banking sector as the largest source of business loans. When only loans to manufacturing industry are considered (see Table 4.2), this shift between the three banking groups is even stronger. Contrary to what the organized capitalism model would lead us to believe, the savings and cooperative groups together provided roughly one-half of all loans to manufacturers in the early 1980s - the big three commercial banks provided less than one-fifth. Thus in the turbulent 1970s and early 1980s,

4. At the end of 1988 the business volume of the foreign subsidiaries and branches of the West German banks equalled 13% of the volume of business of domestic banks. Monthly Report of the Deutsche Bundesbank, April 1989. p. 15. The number of foreign branches by bank group is given in Table 4.1.
the savings and cooperative banks made tremendous gains over the big commercial banks in business lending.

Between 1982 and 1990 this trend was reversed, as the big commercial banks were able to make up some - though less than half - of the ground they had lost to the other banking groups in the 1970s. Given the growing emphasis by the big commercial banks on Mittelstand firms as well as the fact that domestic lending to large firms is declining, it appears the ability of the big banks to gain back some lost market share in firm lending in the 1980s was due in part to their growing success with the Mittelstand.\(^5\) This pattern of change in the commercial lending markets supports the argument that Mittelstand firms have become increasingly important to the whole banking industry. For the Deutsche Bank, the primus inter pares of German banks, well over half of its cash credits are to Mittelstand firms. The Deutsche Bank has taken to calling itself a bank of the Mittelstand. While this may be self-serving, it has a great deal of validity.

The strength of West German local banks in the 1980s stands in stark contrast to the experience of local banks in other countries such as the United States. Owens suggests that the deregulation of interest rates in the early 1980s in the United States led to a concentration of resources in national banks and shortages of capital for small firms.\(^6\) In West Germany


the post-deregulation era (after 1967) has witnessed more or less the opposite. The high number of banks and branches in the savings and cooperative sectors enabled them to capitalize on the growth of personal savings (Table 4.1). These banks channeled much of this back to one of their most important traditional client groups - local Mittelstand firms.

But the long-term decline of traditional savings and lending activities may shift certain advantages back to larger banks. The business of all banks is coming increasingly from inter-bank lending, securities trading and other services. The sources of bank income reflect this shift insofar as interest income has declined while commission income (fees made on service provision) continues to increase. While the savings and cooperative banks have showed strong growth in income from services, the regional and big commercial banks account for roughly one-half of all commission income received by banks.\(^7\) The strength of the big banks in securities trading helped make them substantially and consistently more profitable than the cooperatives and savings banks. Since bank lending to large firms is on a downward trend, the growing portion of bank business with large firms is services. As will be discussed below, this is another factor reducing the dependence of large firms on the banking system.

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\(^7\) From 1970 to 1988 lending to domestic non-banks as a percentage of business volume declined from 59.2% to 55%. For regional banks, 42% of their income comes from service provision; for the big banks this figure is 30%. Monthly Report of the Deutsche Bundesbank, August 1990, p. 20.
Table 4.1 Market Shares of Selected Bank Groups in Selected Balance Sheet Items.

<table>
<thead>
<tr>
<th>Bank Group</th>
<th>Year</th>
<th>Vol. of Business</th>
<th>Loans to Non-Banks*</th>
<th>Savings Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>total (short term)</td>
<td>(med/long term)</td>
<td></td>
</tr>
<tr>
<td>Commercial</td>
<td>1970</td>
<td>24.9</td>
<td>22.7</td>
<td>51.4</td>
</tr>
<tr>
<td></td>
<td>1978</td>
<td>25.1</td>
<td>22.5</td>
<td>46.1</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>23.6</td>
<td>23.7</td>
<td>48.1</td>
</tr>
<tr>
<td>(big banks)</td>
<td>1970</td>
<td>10.2</td>
<td>9.6</td>
<td>20.9</td>
</tr>
<tr>
<td></td>
<td>1978</td>
<td>10.6</td>
<td>9.6</td>
<td>18.6</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>8.9</td>
<td>9.2</td>
<td>20.8</td>
</tr>
<tr>
<td>Savings Banks</td>
<td>1970</td>
<td>38.5</td>
<td>37.8</td>
<td>27.5</td>
</tr>
<tr>
<td></td>
<td>1978</td>
<td>38.2</td>
<td>38.8</td>
<td>29.0</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>37.3</td>
<td>37.3</td>
<td>29.6</td>
</tr>
<tr>
<td>Cooperative</td>
<td>1970</td>
<td>11.5</td>
<td>9.0</td>
<td>16.7</td>
</tr>
<tr>
<td></td>
<td>1978</td>
<td>14.3</td>
<td>11.9</td>
<td>20.6</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>16.9</td>
<td>13.9</td>
<td>20.7</td>
</tr>
</tbody>
</table>

Source: Deutsche Bundesbank. Percentages do not add up to 100 because other categories of banks are not included. The numbers for the savings and cooperative bank groups include their respective local, regional and national banks. In the commercial bank category are big banks, private bankers, foreign banks, and regional and other commercial banks.

* Includes all loans to firms, individuals, and public authorities.
### Table 4.2 Market Shares of Lending to Enterprises by Major Bank Groups

<table>
<thead>
<tr>
<th>Bank Group</th>
<th>Year</th>
<th>Loans to Firms* (Mittelstand)**</th>
<th>Loans to Industry +</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial</td>
<td>1972</td>
<td>36.7</td>
<td>54.2</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>30.1</td>
<td>38.8</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>31.3</td>
<td>42.1</td>
</tr>
<tr>
<td>(Big Banks)</td>
<td>1972</td>
<td>15.4 (28.3)</td>
<td>28.2</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>11.9 (37.2)</td>
<td>18.2</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>13.8</td>
<td>22.4</td>
</tr>
<tr>
<td>Savings Banks</td>
<td>1972</td>
<td>33.2 (36.7)</td>
<td>26.1</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>36.7 (28.4)</td>
<td>33.2</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>33.6</td>
<td>30.6</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>1972</td>
<td>12.9 (91.8)</td>
<td>11.3</td>
</tr>
<tr>
<td></td>
<td>1982</td>
<td>17.4 (67.4)</td>
<td>17.5</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>15.3</td>
<td>17.3</td>
</tr>
</tbody>
</table>

Source: Deutsche Bundesbank. Own calculations.
Percentages do not total 100 because all banks are not included.
+ Shares calculated without mortgage loans on commercial property. This category includes manufacturing industries only.
* Shares include mortgage loans on commercial property. This category includes all firms as well as self-employed persons.
** Numbers in parentheses represent the percentage share of Mittelstand credits in that groups total loans to firms. Mittelstand credits defined as mortgage loans of no more than DM 1 million and credits where the total credit engagement of the bank in a firm does not exceed DM 1 million (source: Lubitz, Karl-Joachim. 1984. Bankmarketing gegenüber mittelständischen Betrieben. Frankfurt: Fritz Knapp; p. 11).
The Availability of Capital: Patterns of Industrial Finance.

Increased competition tends to undermine coordination among banks, as well as concentration among suppliers of capital because of Germany's group competition. Competition also generally increase the supply of capital by financial institutions. The greater availability of capital - for both large and small firms - translates into less opportunity for bank influence. It has long been taken for granted in the academic literature that German firms are highly dependent on the major commercial banks for investment capital.8

The most commonly examined statistics continue to suggest that bank loans are the major source of industrial finance. At the end of 1983, about 60% of the liabilities of West German firms consisted of bank loans; only 11% of liabilities were in the form of securities (stock shares and bonds). In Great Britain these figures were 25% and 36% respectively.9 In spite of a relatively large number of new stock issues in the 1980s, capital markets continue to play a minor role as a source of industrial finance in Germany. At first this seems surprising in light of the fact that the average equity capital of German firms has been steadily declining since the 1950s: In 1971, 26% of firms' liabilities consisted of equity capital; by 1981 this figure had dropped to 19%. Since German firms do not access capital markets to a significant degree, they presumably increase their debt to make up for this shortfall.

The comparatively underdeveloped capital markets and apparently heavy reliance on bank borrowing suggests that one of the frequently cited institutional prerequisites favoring the tutelary role of the banks is still intact. But a more careful examination of the sources


of investment finance reveals surprising results. In the 1970s and especially the 1980s, the largest West German firms have substantially increased their financial independence from the big banks. They have been able to do so first by accessing the international capital markets and, more importantly, by self-financing much of their investment with retained earnings.

Table 4.3 shows a more than 100% increase in the reserves held by firms from 1971 to 1989 (from 10% of liabilities to 21%). The largest German corporations have used various tax laws and accounting rules to literally stash away billions of Deutschmark annually. In effect, much of these reserves represent hidden equity, since they are provisions for future costs that firms can actually use in the present to invest in plant and equipment, securities, and the like. For example, Welzk claims that the investment boom of the West German automobile industry between 1979 and 1983 was financed entirely by the auto firms themselves with their reserves. Welzk calculated further that the share of bank credits in the total working capital of all publicly-traded manufacturing firms (Aktiengesellschaften) declined from 16.9% in 1974 to 6.6% in 1984.

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10. Welzk, 1986, op. cit., p. 93. Reserves as a percentage of equity are even higher in the chemical industry (p. 47).

Table 4.3  Structure of Liabilities of West German Firms.

<table>
<thead>
<tr>
<th></th>
<th>1971</th>
<th>1981</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Capital</td>
<td>26</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Debt</td>
<td>74</td>
<td>81</td>
<td>80</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- short-term</td>
<td>42</td>
<td>48</td>
<td>44</td>
</tr>
<tr>
<td>- long-term</td>
<td>20</td>
<td>19</td>
<td>16</td>
</tr>
<tr>
<td>- provisions*</td>
<td>10</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Deutsche Bundesbank. Own calculations.

* Reserves against future claims.
A new study by Edwards and Fischer comes to similar conclusions. After examining the sources and uses of funds by German industrial firms from 1970 to 1989, they conclude that retained earnings financed 62% of their investments; bank loans accounted for only 18%. If one focuses only on purchases of physical assets, German banks finance only 11% of such investments. The author’s comparison with Britain - the academic’s classic case of managerial autonomy - shows British firms use bank loans to finance 24% of their investments.  

Thus instead of declaring higher profits, many firms are building up their tax-free reserves and using this to finance their investments. The laws that make the building of plentiful reserves possible are not likely to change, as both the SPD-led Federal government in the 1970s and the CDU-led government in the 1980s promulgated favorable legislation. The largest and most profitable West German firms have clearly become less dependent on the banks for loans or equity capital. Lower demand by large firms for bank funds suggests that more capital is available. For the major banks this means less potential influence in firms. One study involving interviews with 350 finance directors of the 500 largest German firms concluded that the traditional bond between a firm and its house bank had noticeably loosened, largely as a result of bank competition. As a result of competition and thus low

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13. In 1974 the Social-Liberal coalition in Bonn, interested in expanding the pool of retirement funds for workers, changed the tax laws to favor this growth of voluntary reserves by firms. In 1986 a new federal Balance Sheet Law, passed over the opposition of the unions and interest groups representing shareholders, made it even easier for firms to build reserves. Welzk argues that the pension reserves represent a de facto subsidy by the state to these firms, favoring the growth of large profitable concerns over smaller firms that typically have more bank debt. Welzk, 1986, op. cit., pp. 44-56; 74-75.
returns, even the major banks themselves are apparently less interested in lending to large firms.\textsuperscript{14}

The growing independence of the largest firms does not mean, however, that the big commercial banks have been able to shift their tutelary role in industry to Mittelstand firms. Small firms have not been able to build the kind of reserves that many large firms, and thus remain much more dependent on bank loans to finance their investment. But intense competition among the banks for these firms generally prevents this from translating into unusual influence. The steady growth of state lending to the Mittelstand has also helped increase the availability of capital to these firms, thereby helping to keep lending rates by all banks to the Mittelstand lower.

Since most Mittelstand firms in West Germany are very reluctant to go public, efforts by the banks and the federal government to encourage this have met with limited success. Instead an alternative form of Mittelstand finance that promotes small firms without infringing on their autonomy has surged in the 1980s. This new form of equity capital is finding increasing appeal and utilization among smaller firms.

In the 1970s and early 1980s the issue of declining equity capital, especially among the Mittelstand, was an important topic in policy debates. The bank industry, supported through various measures by the Federal and Länder governments, responded to the capital problems of the Mittelstand by expanding funding for new and existing capital participation corporations (\textit{Kapital- or Unternehmensbeteiligungsgesellschaften}, KBGs). The first KBGs were established in the late 1960s, but they expanded most rapidly in the 1980s - aided by the passage of a new federal law in 1987 which encouraged the formation of more KBGs.

\textsuperscript{14} Eglau cites a study by the U.S. consulting firm Greenwich Associates (1989, op. cit., pp. 173-175).
All of the three major banking groups have established KBGs. In each Land there also exists a state-supported cooperative KBG in which all the bank groups participate along with other local business associations.\textsuperscript{15} These KBGs, which represent a form of promotional network, will be discussed in detail in later chapters.

The KBGs invest funds in firms which serve as equity. They provide another financial instrument to smaller firms which no longer want, or are able, to use conventional loans yet do not want to go public. These corporations typically take a capital participation in firms for a limited number of years (usually ten) and expected an annual profit-dependent dividend, but generally do not assume a management role. It is primarily in this respect that KBGs distinguish themselves from venture capital funds, which also exist in the Federal Republic. Venture capital funds usually invest only in technology-oriented business start-ups and realize their investment gains only after one of their firms makes a public stock issue.\textsuperscript{16}

The importance of KBGs and venture capital funds as alternative sources of financing for Mittelstand firms is expected to continue growing rapidly.\textsuperscript{17} At the end of 1989 a total of DM 2.7 billion had been invested in nearly two thousand firms in West Germany by more

\textsuperscript{15} For a lengthier discussion of this type of KBG see Chapter Five. While there are also KBGs independent of the banks, the majority of funds invested by KBGs as a whole stems from the banking sector.

\textsuperscript{16} Venture capital funds are also more frequently involved in guiding the management of the firms in which they have invested. Recently, however, the difference between KBGs and venture capital funds has diminished somewhat as both seek a broader distribution of their assets.

\textsuperscript{17} See Kann, Günter. 1988. "Trends in der Finanzierung kleiner und mittlerer Unternehmen." \textit{Der Langfristige Kredit}. Nos. 21/22. For some banks the KBGs may be a new strategy to prepare firms for public stock issues.
than 60 KBGs and venture capital firms. While the KBG does entail the investment of bank capital in firms, it generally does not create a traditional tutelary bank-firm relationship since the bank does not exercise a decision-making role. Moreover, KBGs organized under the provisions of the 1987 law are required to refinance their investments through selling shares to the public. Thus bank-operated KBGs will no longer be investing bank capital.

As argued in earlier chapters, the state has played an increasingly important role in industrial finance, primarily through the extension of grants and loans to firms. The majority of state loans to firms are on a long-term basis for new fixed capital investment. The largest state bank that promotes the Mittelstand, the KfW, estimates its market penetration to be quite high: Of manufacturing firms with annual revenues less than DM 5 million in 1985, the KfW financed 45% of their investment; for firms with revenues between DM 5 million and DM 100 million the share of the KfW in their investment ranged between 20% and 25%. Between 1982 and 1987, over 10% of all firms in the Federal Republic with annual sales between DM 5 million and DM 10 million received one or more KfW loan; this percentage climbs steadily with the size of the firm, reaching nearly 30% of all firms with sales between DM 50 million and DM 100 million. In 1987 alone the KfW lent DM

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18. Nonetheless, this is still a modest sum when compared to the value of the banks’ holdings of publicly traded securities (DM 300 million of this amount was held by cooperative KBGs); in 1989 banks held DM 15.6 billion of marketable equities (i.e. stocks and Genussscheine). Deutsche Bundesbank, Statistical Supplement No. 1; See also Faselow, Karl-Heinz. "Eigenkapital: Die solide Basis," Frankfurter Allgemeine Zeitung, 28 May 1990. In 1988 less than one-third of the total invested by KBGs was accounted for by venture capital funds. "Beteiligungsvolumen kräftig aufgestockt," Handelsblatt, 2/3 June 1989.

19. Lubitz estimates that 8-9% of long-term loans to the Mittelstand come from the state. Lubitz, 1984, op. cit., p. 140.

7.4 billion; of this, DM 5 billion went to small- and medium-sized firms. This sum is more than doubled when the several billion Deutschmarks of loans from other federal and Länder state banks are added to this.\textsuperscript{21}

Mainstream literature on West Germany suggests that the state plays a relatively minimal role in influencing bank decisions and thus the allocation of investment capital: Where desirable the state uses incentives, not intervention, to influence banks.\textsuperscript{22} But as Chapters 5 and 6 will show, Länder governments frequently use regional banks to directly intervene in the system of industrial finance. Even where government lending is consistent with an incentive approach, it is not without consequences for the behavior of firms and banks. State funds do have an allocative function since they are targeted to particular types of use, regions, sectors, and firm size. Moreover, because most state loans are generally for new investment only (not for replacement), they tend to support the most dynamic and fastest-growing firms. Also, the KfW itself sees one of its key roles in decreasing the difference in the cost of capital for smaller firms versus large firms. By minimizing this structural disadvantage for smaller firms, the state increases their potential growth. Moreover, the presence of state loans for the Mittelstand helps reduce price competition

\textsuperscript{21} In 1987 the LKB of Baden-Württemberg, the LfA of Bavaria, the IB of North Rhine-Westphalia, and the other major federal investment bank - the DAB - together granted approximately DM 7.5 billion of state-subsidized loans. See respective annual reports. There are many other smaller state banks whose loans would also have to be included in a complete account of state lending. For a complete accounting of all the bank holdings of the Länder and their functions see Dickertmann, Dietrich. 1985. "Die Kreditinstitute der Länder. Teil I." Zeitschrift für öffentliche und gemeinwirtschaftliche Unternehmen. 8(1):38-69; and Dickertmann, Dietrich. 1985. "Die Kreditinstitute der Länder. Teil II." Zeitschrift für öffentliche und gemeinwirtschaftliche Unternehmen. 8(2):164-186. In this second article Dickertmann argues that Länder-owned banks provide their respective governments with considerable intervention capacities.

\textsuperscript{22} For examples see Dyson, 1986, op. cit.; Zysman, 1983, op. cit.
among the banks on Mittelstand loans.\textsuperscript{23} This helps push the banks to compete on the basis of their ability to provide other resources and services - that is, to expand their mediator role for firms.

In the wake of German reunification new Länder investment banks are being established in the East, while several of the old Länder contemplate reorganizing and expanding their own financial institutions to do more economic promotion.\textsuperscript{24} We can therefore expect the presence of the state in financial markets to continue growing in both the eastern and western parts of Germany.

In sum, a brief review of the changing pattern of industrial finance shows the increasing financial independence of the large firms.\textsuperscript{25} As will be discussed next, this independence is a factor which is limiting the tutelary role of the banking system. Increased competition for Mittelstand firms and the growth of state funds for this group also combine to reduce these firms' dependence on any particular bank or banking group. This too limits the potential of the banks to control the decisions of firms.

\textsuperscript{23} An earlier study by the Economists' Advisory Group reached similar conclusions. They found in 1979 state loans equalled roughly 4% of all loans to the Mittelstand. Though this may seem small, the authors were convinced that the presence of savings and cooperative banks "... as well as state efforts to stimulate bank lending, have played a major role in channelling more resources into small firms in Germany than in the UK, though other factors are undoubtedly at work." Economists Advisory Group Ltd., 1981, op. cit., p. 267.

\textsuperscript{24} The creation of the IB in North Rhine-Westphalia seems to be serving as a model for Rheinland-Pfalz and Schleswig-Holstein; See Noll, Reinhold. "Bündelung der bisher bei verschiedenen Institutionen verstreuten Kompetenzen," Handelsblatt, 13/14 July 1990; and "Zum Sommer eine 'Investitionsbank' für Schleswig-Holstein?" Frankfurter Allgemeine Zeitung, 3 December 1990. Moreover, several of the old Länder "investment banks" are helping the new Länder build their own bank.

C. Banks and Industry: The Tutelary Role.

These statistics on industrial finance, however, give little information about actual changes in the institutional sources of bank influence. It is widely believed that the influence of the major commercial banks over large industry rests on a combination of market and institutional sources of power. The debate in Germany over the "power of the banks" is multi-faceted. Because comprehensive information over the lending activities of the banks is not publicly accessible, and because the facts regarding the banks' sources of influence are open to conflicting interpretations, the debate is also endless.

Starting in the mid-1970s there was a flurry of studies on the 'power of the banks,' including two studies by the Federal Monopoly commission and the Gessler commission.26 The most vehement criticisms of bank power were generally put forward by left-leaning academics, unionists, and Social Democrats. Most of these treatises brought forth little new empirical information, instead they presented their own interpretation of standard analyses of shareholding, board seats, and proxy voting. One notable exception to this was that of Pfeiffer, who painstakingly detailed the web of interlocking corporate relations around the Deutsche Bank.27 While Pfeiffer documents, to the extent possible, several instances of bank intervention in large firms, his study does not examine broader structural market and other institutional changes that determine the overall trends in bank-industry relations.


Moreover, other studies show that in several key industrial sectors, such as the chemicals industry, bank influence is comparatively low.28

Clearly, case studies supporting both sides of the 'power of the banks' debate can be found. The tutelary role of the banks in German industry will almost certainly remain an important aspect of bank-firm relations. The takeover of the arms manufacturer MBB by Daimler-Benz in 1989, in which the Deutsche Bank played a central role, demonstrated once again the potential power of the banks. This show of force by the Deutsche Bank renewed public attacks on the power of the banks. Led by the liberal Federal Economics Minister, Count Lambsdorff, the SPD, FDP and even many Christian Democrats - mostly those coming from the CDU's Mittelstand camp - supported legislation that would curb the power of the banks.29 But as many times before, little came of this legislative initiative. The political power of the banks to defend their economic power is strengthened by an alliance on this front among the three major banking groups.30

But while I argue that this tutelary role of the banking industry will continue, when understood in the broader context of economic structural change and other roles which

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28. In a 1989 article, Hermannus Pfeiffer used BASF as a case to demonstrate the Deutsche Bank's influence (1989, op. cit.). But in a study conducted by Wyn Grant, William Paterson, and Colin Whitston of the three major West German chemical firms - BASF, Bayer, and Hoechst - the authors argued that banks never played a major role in the chemical industry. These authors found the chemical firms to have substantial financial independence. Bank influence was largely limited to personnel policy, i.e. helping to remove bad managers. See Grant, et. al. 1988. *Government and the Chemical Industry: A Comparative Study of Britain and West Germany.* Oxford: Clarendon. pp. 101-134.


30. See "'Die Macht der Banken wird überschätzt'." *Frankfurter Allgemeine Zeitung* 17 May 1990. At a hearing of the Bundestag's economic committee, representatives from the banking groups argued that competition between the banks prevented any one from dominating the market.
banking industry plays in the economy, its relative importance for the functioning of the
economy appears exaggerated by most accounts.\textsuperscript{31} Important policy change and increased
market competition in the banking industry place tighter limits on the capacity of the banks
to intervene in corporate decision-making. To use Peter Katzenstein’s words, this does not
mean that intervention will not occur in the future, but the threshold has risen. This can be
better understood by examining changes affecting each of the three major institutional sources
of bank power.

\textit{Shareholdings and Proxy Voting.}

Since the early 1970s many other large banks have also assumed the potential to
exercise a tutelary role vis-à-vis industry through the purchase of major shareholdings. As
the case of the WestLB discussed in Chapter 6 shows, these banks consider this an
indispensable and profitable component of a major universal bank’s array of services and
activities. Thus support for maintaining the institutions that permit the banks to exercise this
role has spread to the other banking groups and to many bureaucrats and politicians in the
Länder. But in the case of the Landesbanks, the control of the Land governments over these
banks injects a certain amount of state influence into this system of bank-firm relations. Thus
the tutelary role of the banks can now be harnessed for politically-determined regional
economic development goals.

But perhaps more important, when a large bloc of shares in a firm go up for sale,
there is now usually much more intense competition among the banks to acquire the shares.
When this is the case, it gives the existing firm owners much greater bargaining power with

\textsuperscript{31} Baethge and Oberbeck, 1989, op. cit., argue that the control by the banks over a large
portion of the West German population’s financial transactions is now a more important
source of economic and social power than this traditional role.
the banks. Traditionally, when a firm wished to go public or issue new shares, it gave this business to its house bank and the terms were dictated by the banks. The bankers were more concerned with the needs of the investors - and they were frequently the largest investor - than the desire of the firm issuing the shares to maximize the share price while minimizing external control of its operations. Until 1986 the Deutsche Bank was the market leader, bringing fifteen of twenty-six new issues to the stock market. Now all the banks compete vigorously for the lead in underwriting consortiums, giving the firms a stronger hand in negotiating the terms. In 1988 the Deutsche Bank led only two of the fourteen new issues that year.\footnote{"Die Banken konkurrieren zunehmend um Neuemissionen," \textit{Frankfurter Allgemeine Zeitung}, April 13, 1991. Still, in 1989 the Deutsche managed to reassert some of its market strength, leading nine of twenty-three new issues.}

Alongside greater competition among the banks to acquire and underwrite shares in industry, beginning in the mid-1970s there appears to be a trend among the major private commercial banks to reduce the number of industry holdings they control. Examining the ten largest private banks in West Germany, Cammann and Arnold stated that the number of firms in which banks held at least ten percent of the shares (directly or indirectly) declined from 129 in 1976 to 86 in 1986.\footnote{These banks combined held 4.5\% of the nominal capital of all publicly-traded firms in 1976, but only 3.2\% in 1986. Cammann, Helmhuth and Wolfgang Arnold. 1987. "Anteilbesitz der Banken: Die Fakten." \textit{Die Bank} 3: 120-123.} Perhaps more importantly, the number of firms in which banks controlled more than 25\% of the shares - a blocking minority - fell from eighty-six to forty-five in this period. To this Arndt adds that of the fifty largest firms in the Federal
Republic, the private banks only hold more than 25% in two firms. More than three times an
many holdings were sold (sixty-three) as were purchased (twenty) in this period.34

Of the twenty purchases in this period, five were undertaken as a means to support a
weak firm through an infusion of needed capital, six were made primarily for the bank’s
investment purposes, five were made as a step toward placement of the firm’s shares in
private hands.35 Thus while in some cases the banks may purchase or hold shares in
industry in order to guide the development of firms or sectors, in most cases they seem to
acquire holdings for far less ambitious reasons, such as preventing loan defaults or simply
to make a substantial profit through speculation in securities trading. In fact, many of the
old industry holdings of the major commercial banks were acquired between 1923-1924 and
the early 1930s to save failing firms.36 But as we know from Chapter 2, the banks were
relatively weak in these years and failed themselves in 1931. This evidence on the tutelary
role of the banks seems to counter the organized capitalism model which suggests the banks
act strategically in the acquisition of firm holdings to guide industry through periods of rapid
economic change. Most holdings by banks do not appear to have been acquired simply to
exert control or influence in industry.37

34. These are Daimler-Benz and Karstadt, a major retailer. Of the 500 largest firms, the
private banks hold more than 25% in 13 cases. Arndt, Franz-Josef. 1986. "’Macht der
Banken’ gegen Macht der Fakten - Anmerkungen zu einer DGB-Publikation." Die Bank
12:641-643.

35. See Cammann and Arnold, 1987, op. cit., p. 122. Of the remaining four, one was
to prevent a takeover, and one was to secure the bank’s loans to the firm.


An initial explanation of this decline, or at best redistribution, in the quantitative dimension of the banks' tutelary role focuses on three factors. First, after a decade of public debate over the power of the banks, groups favoring a curb on the banks were finally able to exact some changes that appear to have actually affected bank behavior. Regulations in the new Banking Act (KWG) of 1984 made it less rewarding for banks to carry large holdings of non-bank shares on their balance sheets.\textsuperscript{38} In effect, the banks faced stronger incentives to either sell some of their holdings or find ways to get them off their books. Available evidences suggests both strategies have been pursued. The Dresdner Bank and the Commerzbank are believed to have significantly reduced their industrial holdings by the late 1980s. While some have speculated that this was done to bolster their income the solid profitability of the banks in this same period suggests - as their leaders contend - that the reduction of holdings is part of their long-term strategic plan.\textsuperscript{39}

Even the Deutsche Bank, whose shares in Daimler-Benz are worth more than the total industrial holdings of the Dresdner and Commerzbank combined - seems to have reduced at least the number of its large industrial holdings (25\% or more), if not its total holdings. In the era of Hermann Abs - who alone sat on dozens of corporate boards - the Deutsche Bank purchased large holdings as part of its competition strategy with the other big banks.\textsuperscript{40} But

\textsuperscript{38} The 1984 KWG revisions require the banks to report all holdings greater than 10\%, place upper limits on the total value of non-bank shares which the banks may hold, and reduce tax privileges associated with holdings of 25\% or more in firms. In most cases a holding of 10\% has now become the optimal size for the banks. "Abspecken und Ausgliedern," \textit{Wirtschaftswoche}. 21 June 1985.


\textsuperscript{40} Eglau, 1989, op. cit., pp. 66-67.
in the face of growing public concern over the power of the banks, in the early 1970s the Deutsche announced its intention to gradually sell off shareholdings, and especially to acquire no large packets on a permanent basis. Though there were some exceptions to this, the Deutsche Bank did sell off many large holdings in the 1970s and 1980s.

Still, there is also substantial evidence that the Deutsche and the other banks, have simply reduced many of their holdings to less than 24% or placed them in separate holding companies. Holdings of less than 10% do not have to be identified individually in bank balance sheets.\textsuperscript{41} In short, many bank holdings have become smaller and therefore hidden. On the one hand this does reduce some of the potential influence of the banks since one of the advantages of 25% or greater holdings was the veto power it gave the holder in major decisions within the firm. Ten percent alone will not grant the bank such a right, though several cases of bank intervention in firms indicates that this need not be an absolute barrier. Through coordination with other "friendly" shareholders the banks can still affect major decisions. The recent ability of the Deutsche Bank to build a voting bloc of more than 25% among large German firms to frustrate Pirelli's attempted takeover of Continental tire is an example.\textsuperscript{42}

Thus for all the major banks there are ample financial reasons to continue buying equity stakes in firms. The banks attempt to realize profits through the later resale of the

\textsuperscript{41} Though in 1993 much stricter EC reporting regulations will take effect, revealing many bank holdings previously known only to insiders.

shares, as well as parlaying their equity holding into additional business with the firm. Eglau also notes that tax laws still discourage the sale of many large equity holdings.  

Aside from their own holdings in industry, it has traditionally been argued that the control of proxy votes further enhanced the power of the banks in firms. The private commercial banks, and the big banks in particular, are still the most active in this role. In 1987 all banks together own about 8% to 9% of the shares in publicly-traded domestic firms. About one-half of all shares in domestic firms were held on deposit in the banks which are frequently given proxy voting rights for these shares. Of the shares deposited in the banks, the three major commercial banks together held 43%; the Landesbanks and savings banks together controlled another 16%; the cooperative sector about 5%.  

However, Eglau argues that the banks do not use proxy votes to influence firm policies. In 1988 the Deutsche Bank represented shareholders in 647 annual meetings. Only seven times did the bank advise shareholders to vote against the management board's recommendations. Large firms do, however, like the potential protection they derive from bank controlled votes against more hostile shareholders. This in itself, as Eglau notes, can lend the banks a fair amount of power. But he argues that proxy votes are more important to the banks because the underwriting quota of each bank for new share issues is partly determined by their share of proxy votes. Proxy votes are also important to the banks in that they are used to gain seats on firm supervisory boards. Thus representatives of the three


major commercial banks sit on the boards of roughly half the largest 100 firms in Germany. But control of supervisory board seats does not necessarily translate into bank influence.

*Supervisory Boards.*

According to most standard accounts, the banks use their combination of shareholdings, proxies and supervisory board seats to intervene in the affairs of industry. But the extent to which board seats and proxy votes are controlled by the banks has probably also been overestimated. According to Edwards and Fischer, in 1984 banks occupied only 8.4% of supervisory board seats and represented 16.8% of shareholders’ equity.46 Thus bankers rarely muster the majority of votes on a supervisory board. Even more importantly, the actual role of supervisory boards in firm decision-making is widely overrated: Most boards meet only twice a year, at most four times per year for a half day. They rarely discuss strategic planning; roughly one-half discuss the sale or purchase of equity in other firms; and only one third deal with bond issues or loans.47 Moreover, representatives from competing banks often sit on the same boards, and even then the firms do not limit their bank connections to these banks: Most large firms limit bank control by maintaining some ten or so core banking contacts.48

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46. Though other studies show a much higher rate of bank control over votes in the largest firms. According to the monopoly commission report, in the mid-1970s the banks directly controlled some 5% of the voting rights in firms. But when proxy votes controlled are added in, the banks control some 36% of the votes in the top 100 firms. Monopolkommission. 1978. *Hauptgutachten II: Fortschreitende Konzentration bei Grossunternehmen.* Baden-Baden: Nomos.

47. Edwards and Fischer, 1991, op. cit. Eglau makes a similar argument that the supervisory boards meet far too little for the banks to have much influence, at least through this channel. Eglau, 1989, op. cit., p. 135.

Thus supervisory boards do not necessarily represent an institution which brings bank and firm closer together, let alone lend the banks influence in the firm.\(^49\) Since supervisory boards do hire and fire the firm's management board, there is the potential to influence firms indirectly through personnel changes. But the principle role of bankers on the boards is to act as advisor in financial matters such as financing large investments and foreign exchange hedging. Based on his study of the Deutsche Bank, Eglau argues that power has shifted within firms from the supervisory board to the management board. Supervisory board members tend to follow the lead of the management board in order to show solidarity vis-à-vis worker representatives on the supervisory board. Since 1976, worker representatives have controlled half the seats on the supervisory boards.\(^50\) Bank representation on supervisory boards often does make a difference when the bank representative controls the chair of the board because the chair has the tie-breaking vote.

When it comes to supervisory board chairs, equity holdings and proxy votes, the Deutsche Bank stands above all other German banks. In 1988 the Deutsche Bank occupied 38 supervisory board chairs; the Dresdner, eleven and the Commerzbank, five.\(^51\) Thus it was perhaps startling news when recent press reports announced that the Deutsche Bank intends to reduce the number of (influential) supervisory board chairs which it holds in firms. Apparently the leadership of the bank believes that the interests of their firm clients would be better served if this board position is held by professionals with experience in the firm’s

\(^{49}\) Eglau also notes that bank managers compete for supervisory board seats as a means to boost their own careers. Thus suggesting that bankers on boards are motivated, at least in part, by their own narrower self-interest. Eglau, 1989, op.cit., pp. 129-130.

\(^{50}\) Eglau, 1989, op. cit., p. 167.

industry. As the case of Daimler suggests, the Deutsche Bank is apparently also increasingly
sensitive to the possibility that its business could suffer from industrial plans gone awry or
from conflicts of interest stemming from its control of supervisory chairs.\textsuperscript{52}

The banks want to maintain good relations with as many firms as possible. Getting
too involved in any single firm can be risky and alienating to other firms. For example, the
Deutsche Bank has close relations to the three largest electronics firms in Germany - AEG,
Bosch, and Siemens. The bank’s relations to Siemens goes back to the very beginning of
both firms in the late nineteenth century. But in the 1980s growing competition among
Siemens, AEG, and Bosch has strained relations between Siemens and the Deutsche Bank,
leading to reports that the Deutsche has lost some of the influence it had with Siemens.\textsuperscript{53}
Thus the difficulty of successfully managing the affairs of industry may also be a factor
limiting the tutelary role of the banks. In the next section I examine more closely some of
the ostensible benefits of Germany’s system of industrial banking.

\textit{The Impact of Bank Intervention.}

Contrary to what is widely asserted or assumed in the literature, the question remains
open whether the major commercial banks are capable of managing their industrial holdings
in a manner that is beneficial for the individual bank and its client firms, and whether their
management decisions promote the long-term economic development of the economy.\textsuperscript{54}


Adjustment to Turbulent Markets: The Automobile Industry.” In \textit{Industry and Politics in

\textsuperscript{54} In his 1989 attack on the banks, Lambsdorff was personally convinced that the tutelary
role of the German banks distorted competition and prevented an optimal allocation of
resources in the economy. According to Lambsdorff - and many other critics of the banks -
the raw figures on the bank's holdings in firms are misleading. Their true influence over
One of the primary arguments about the German banks is that their activities as initiators and organizers of industrial activity help keep industrial policy a largely private affair.

The relationship between the Deutsche Bank and Daimler-Benz represents the most prominent case of organized capitalism, but not necessarily an unambiguously successful case. In the mid-1980s Daimler swallowed several large industrial firms, beginning with the bankrupt electronics giant AEG in 1985, and ending with the armaments manufacturer MBB in 1989. The Federal government overrode tremendous political opposition to support this last merger because it wanted Daimler to rationalize the German aerospace industry. The government agreed to continue subsidizing Airbus production for a limited number of years, but otherwise left this industrial policy problem to the private sector. Since virtually every other national government is heavily involved in its aerospace sector, this is surely a critical case of the banks helping to relieve the state of this function.

But more than five years after Daimler began its diversification strategy all of its acquired firms continue to lose money, draining profits from the auto division and apparently depressing morale and raising dissatisfaction within the firm. With orders for planes declining, it is not clear just how well Daimler and the Deutsche Bank will be able to manage the rationalization of the aerospace industry. Bank industrial policy can also be bad industrial

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industry results from the combination of various avenues of influence, including the control of board seats and proxy voting rights. If one examines these more indirect methods of control, then the big banks together appear to have substantial influence, if not majority control, in the nation’s 50 largest enterprises. Protzman, Ferdinand. "Mighty German Banks Face Curb," New York Times. 7 November 1989. Pfeiffer makes arguments based on his analysis of the vast network of interlocking directorates and personal connections between the big banks and firms (1987a, op. cit.). See also Pfeiffer, Hermannus. 1987b. "Die ‘Macht der Banken’ und die Fakten." Die Bank 5: 270-275.

55. The Deutsche Banks owns roughly 29% of Daimler’s stock and controls three seats on its supervisory board, including its chair.
policy. And Daimler has apparently hinted that it would like to relinquish its control of Daimler’s supervisory board chair.  

In other sectors the banks have also demonstrated their potential impotence in leading industrial change. As will be discussed in Chapter 6, the banks have had considerable difficulty in trying to rationalize the steel industry. The state has arguably had as much or more to do with the steel industry’s present situation as the banks. The case of eastern Germany after reunification aids weight to this argument. In spite of the tremendous need for rationalization and change in eastern Germany, and in spite of growing pleas from many firms and politicians in the East for their help, the West German banks has so far invested little in East German industry. The banks display little interest in playing a vanguard role in promoting industrial change and recovery; instead, they seem to be interested only in helping East German firms find other buyers. While it would be incredulous for the West German banks to take over responsibility for most of the East, at the very least one would have expected them to get more directly involved in the affairs of industry. This may yet change, but as several banks have indicated, the task at hand might simply go far beyond their capacity and, more importantly, their willingness to assume risk.

The German banks are also said to use their knowledge and connections to come to the aid of weak firms before they reach insolvency. And if this does happen, then the banks

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take a long-term perspective and rescue the firm. But Edward and Fischer's study argues that rescue operations are becoming more difficult for the banks to carry out. In the 1980s a series of court battles indicated that banks could be held liable if their attempt to rescue a firm by delaying insolvency hurt other creditors. Now outside management consultants must approve all rescue plans. Surprisingly, even before these changes German banks more often let firms go under than rescue them.\(^{59}\) Not even the oft-noted and sometimes praised bank rescue of the electronics giant AEG speaks in favor of the banks. A consortium of banks wrote off loans and provided new equity to AEG, but only after the Federal government guaranteed much of AEG's new debt. Eglau also cites several cases, such as that of the firm Stollwerck, where the Deutsche Bank failed to foresee trouble in the firm before it was too late. In other cases, especially where a firm is still largely family held, the banks prefer to avoid conflict and defer to family leadership - even if this sometimes leads to the demise of the firm.\(^{60}\) It is probably only the largest firms with longstanding bank connections that can count on its bank or banks to help it through a serious downturn.

Standard accounts suggest that another important role of the banks is to assure firms ready access to funds. It does seem that German firms generally have ready access to capital, though this seems to be far more a function of market competition - as discussed above - and Bundesbank monetary policy. It has also been claimed that the extensive involvement of the banks in industry exerts financial discipline among firms. But it is rather difficult to ascertain whether disciplined firms are so because of their own diligence or because of bank monitoring. In the case of the largest firms, however, their financial

\(^{59}\) Edwards and Fischer, 1991, op. cit. In 1975 only one-third of corporations with loans in arrears were rescued by the banks.

\(^{60}\) Eglau, 1989, op.cit., pp. 138-143.
dealings are extensive and generally conducted by in-house staff. There is probably far too much activity for banks to oversee firms, especially on a daily basis.

Another important consequence of close bank-industry relations is that the major banks take a long-term perspective in their dealings with firms. The banks presumably use long-term sectoral analyses and mobilize financial, technical, and managerial resources to help firms reduce their long-term cost structure and thus improve potential profitability. Cable, for example, analyzed the correlation between bank 'control' of firms - defined by the number of supervisory board seats and voting shares they controlled - and profitability of 48 of the 100 largest German firms. He concluded that the bank control was positively correlated to firm profitability, primarily because a better flow of internal information between the bank and firm made the bank willing to lend more credit on more favorable terms. But this study rests on several questionable assumptions: First, as noted above the largest German firms are less and less dependent on the banks for funds. Thus bank lending plays little role in firm profits. Second, as Edwards and Fischer note, it is not certain that supervisory boards have access to all the important information about a firm. Finally, what German firms report as profits is problematic given the relatively loose accounting distinctions between profits and reserves for future claims. Cable also fails to examine variation in the involvement and impact of the banks in different sectors of the economy.

Table 4.4 provides a breakdown of the market shares of the three major banking groups in the manufacturing sector by branch. The table shows that all the major bank groups have a significant market share in all major industrial sectors, though a limited "division of labor" seems to exist between the commercial banks, on the one hand, and the

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savings and cooperatives, on the other. Because these branch categories are still aggregated, it is difficult to draw conclusions from this data as to whether one bank group tends to dominate a more narrowly defined industry - such as computer manufacturing. Nonetheless, it is interesting to note that with two exceptions the savings bank group is the largest lender in each sector. Moreover, the strength of the cooperatives and savings banks appears to be more in branches that involve primary, producer, and consumer goods. The big banks seem stronger in branches that involve the production of investment goods (electronics, motor vehicles, and machine tools).

But even in sectors where the major commercial banks are known to be heavily involved, it is not clear how much influence they really exert over the strategies of firms in those sectors as Grant et al's study of the chemical industry shows.\(^6\) In the 1980s the banks were also widely castigated for their failure to see the significance and therefore adequately promote the development of information-technology industries.

Perhaps the most striking feature of this comparison can be found in the categories (branches 3 and 4) which include the coal, iron, and steel industries. Contrary to what one would expect, given the long association between the big banks and German heavy industry, the savings banks have their biggest market share in these two branches (34.9% and 36.8% respectively). The big commercial banks have market shares in these branches (19.8% and 18.8%) that are well below their industry average (22.4%). These differences suggest, as will be argued in Chapter 6, that the big commercial banks may disengage from declining sectors or firms rather than guide them through their most difficult periods. While it may make sense from a profit perspective for the big commercial banks to invest in the fastest

\(^6\) Grant, et. al., 1988, op. cit.; Streeck, 1989a. op. cit.
growing sectors, this fact does not correspond to the notion expounded in standard accounts that a chief advantage and function of a tutelary banking system is its ability to prevent the problems of industry from becoming the problems of government.
<table>
<thead>
<tr>
<th>Industry total (from Table 4.2)</th>
<th>Commercial</th>
<th>(Big Banks)</th>
<th>Savings Banks</th>
<th>Cooperatives</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>42.1</td>
<td>22.4</td>
<td>30.6</td>
<td>17.3</td>
</tr>
</tbody>
</table>

**Market share by Branch**

1 - chemicals & oil refining

|                               | 57.7       | 26.8        | 21.9          | 11.4         |

2 - plastics & rubber

|                               | 43.1       | 24.4        | 31.3          | 14.8         |

3 - ceramics, glass & minerals

|                               | 39.1       | 19.8        | 34.9          | 17.3         |

4 - metals manuf. & processing

|                               | 36.5       | 18.8        | 36.8          | 14.4         |

5 - machines, machine tools, motor vehicles, office equipment, info processing equipment

|                               | 45.5       | 23.9        | 29.9          | 13.7         |

6 - electronics, optics, precision engineering, metal products

|                               | 47.7       | 26.6        | 26.1          | 13.9         |

7 - wood & paper products, printing

|                               | 34.3       | 18.9        | 34.3          | 22.1         |

8 - leather, textiles, clothing

|                               | 46.6       | 25.7        | 28.5          | 16.1         |

9 - food & tobacco processing

|                               | 30.4       | 15.5        | 33.8          | 27.3         |

Source: Deutsche Bundesbank. Own calculations.
A final presumed benefit of German-style industrial banking is that the banks provide specialized information that helps firms. But Grant et al argue that in the chemical industry banks have nothing to offer firms in terms of technical or market information. Given the growing complexity of technology and markets, this is likely to be true in other sectors as well. Banks surely do provide financial expertise - a function that the banks themselves publicly proclaim as their role in industry.

All of these criticisms suggest that the widely assumed influence of the German banks over industry is doubtful. But neither does this mean that bank influence is largely inconsequential, nor that German firms do not find advantages in having the institutions that give banks the potential to influence firms. Many managers of the large German firms are happy to have a large portion of their shares held by friendly firms, including banks. In fact, it is not unknown for a firm’s managers to deliberately seek out a particular individual or group of potential shareholders. Their chief concern is generally to avoid hostile takeovers. The ability of German industry to rally to the defense of Daimler in the mid-1970s and Pirelli in 1991 are clear cases of a small group of large German firms protecting one of their own.

It has long been common for German firms to own substantial shares in each other, and there is no sign that these elaborate networks of cross-shareholdings among Germany’s large firms are receding.63 German banks are intricately involved in many of these networks, but hardly in all of them. And as suggested by the arguments above regarding the reduced holdings of the major banks, the banks may still be part of such networks but do not necessarily dominate them. Such networks can also be used by firms to influence the banks. Some 45% of the Dresdner Bank’s stock, for example, is controlled by the German insurance

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giant Allianz and two other financial holding companies into which the Dresdner shareholdings of several other insurance and industrial firms have been pooled.\(^{64}\) Thus the Dresdner, and probably the other two major commercial banks, are also dependent on other firms in these corporate networks.

As Lindberg, et. al. suggest, such obligational networks among small cliques of firms appear to serve the purpose of stabilizing resource flows among them - particularly capital and information. The general symmetry of power that appears to exist between firms in these networks probably helps to stabilize them.\(^{65}\) In certain cases these networks also serve to coordinate the buying and selling of products, such as the Dresdner-Allianz alliance designed to promote the sale of banking and insurance services. And perhaps unique to Germany, many of them serve the purpose of exploiting tax regulations. Increasingly common are financial holding companies in which various firms pool their shares in a particular firm in order to reach the tax-exempt 10% threshold.\(^{66}\)

Many of these obligational networks also partly overlap with monitoring networks. Monitoring networks are generally more encompassing, cutting across many sectors, and involve more informal multilateral exchanges among firms. In 1988, of the 170 shareholder representatives in the supervisory boards of the twelve largest industrial concerns, as well as the big three commercial banks, Karstadt (Germany’s largest retailer) and Allianz, just

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\(^{64}\) Completing the circle, the Dresdner also controls substantial holdings in these very same firms, including Allianz. Allianz also holds substantial shares in other banks, including 10% of the Deutsche Bank. See Eglau, Hans Otto. "Vermachte! und Verschachtelt: Gegenseitige Beteiligungen der Konzerne machen die deutsche Wirtschaft unkontrollierbar," \emph{Die Zeit}. 23 August 1991.

\(^{65}\) Lindberg, et. al., 1991, op. cit., pp. 3-34.

over one-half (86) came from one of these very same seventeen firms. These monitoring networks serve the primary purpose of facilitating the flow of information among the financial-industrial elite. "They help corporate leaders identify problems concerning large numbers of companies, and facilitate the search for general solutions to those problems." But monitoring networks rely more on peer pressure and consent to obtain compliance among members. Coercive mechanisms are generally lacking.

Interestingly, Eglau argues that even without their institutional sources of influence - board seats, shares and proxy votes - the banks would continue to have significant influence. The personal contacts and the weight of the banks' opinions with managers would still be considerable. The Deutsche Bank is unique in using its network of personal contacts to attempt to strategically influence management appointments among many German firms. The bank's network includes not only supervisory board seats that it occupies, but also the many board seats occupied by representatives of "friendly" firms that are often willing to pursue the banks' interests. Thus the true potential influence of the banks is much more hidden, and therefore nearly impossible to quantify.

67. These firms included Daimler, VW, Siemens, VEBA, BASF, Bayer, Hoechst, RWE, Thyssen, BMW, Mannesmann, and MAN. The big three banks held 34 of these seats. After the revision of the Joint-Stock law in 1965, actual interlocking directorates were banned. Still, as Eglau notes, the banks and firms found other ways to maintain personal connections. Eglau, 1989, op. cit., pp. 241-243.


Extensive as this system of corporate interlocks may be, the flow of information and resources is not subject to the control of any single actor, nor are conflicts among firms eliminated. At the end of 1991, for example, the German steelmaker completed a successful hostile takeover of its rival Hoesch by quietly buying up large packets of stock from other firms and securing the backing of other major Hoesch shareholders. Hoesch’s lead bank, the Deutsche Bank, apparently knew nothing until it was too late. This episode echoes the inability of the major commercial banks to pressure the steel firms into a bank-designed sectoral rationalization plan in the early 1980s. It suggests that it may be increasingly difficult for the banks to turn obligatory or monitoring networks into promotional networks for the purpose of restructuring ailing industries.

There are also strategic reasons for the banks to be more cautious within these networks among large firms. The banks now have a much greater stake in the expansion of the Mittelstand. Using their influence to promote industrial concentration in large firms - as the banks did throughout much of their history as part of sectoral rationalization measures - is now more likely to be a self-damaging act for the major banks since it will reduce the customer pool of the banks. In fact, it might very well be that the earlier dynamic of organized capitalism in which bank and industrial concentration were held to be mutually reinforcing has been reversed: Many large firms have reduced their workforce and farmed out production and production-oriented services to independent small supplier firms. In turn, this deconcentration in industry appears to be favoring deconcentration and decentralization

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71. This point was made as well by the chief economist of the Commerzbank; see Wolf, Herbert. "Ein Bankentag is keine Machtdemonstration." Frankfurter Allgemeine Zeitung 25 April 1990.
in the banking industry.\textsuperscript{72} The big commercial banks must now carefully balance their interests in large and small firms; the latter cannot be ignored in favor of the former without suffering major consequences.

In sum, the tutelary role of the banks remains important in Germany’s political economy, though it has changed. The German banks now seem less intent on building empires of industrial holdings in order to influence industry. Much evidence suggests that the potential influence of the banks has declined significantly in the postwar era, due in large part to more intense bank competition. Aside from older holdings, the buying and selling of shareholdings now seems more focused on shorter-term profit-making. Nonetheless, it is clear that a far more heterogenous understanding of bank influence is required. Under certain conditions the banks can still play the tutelary role, but these conditions seem to obtain less and less frequently.

Moreover, the on-going processes of universalization and structural convergence between the three major banking groups means that buying, trading and managing shares in firms is but one of several increasingly important markets and functions for the banks. Alongside the predominance of consumer banking, an increasingly important function of the banking industry as a whole is its ‘intermediary’ function vis-a-vis Mittelstand firms. These other functions often stand in conflict and thus limit the banks’ willingness to get too involved in industry. In the next section I examine the economic significance of the Mittelstand in the German economy and the growth of the intermediary role of the banks. The surprising success of smaller firms in the last fifteen years - in spite of, or more likely

\textsuperscript{72} The process of mutually-reinforcing concentration between the large firms of industry and the big Berlin banks was at the heart of Hilferding’s understanding of a central dynamic of organized capitalism.
because of, rapid changes in the technology and the organization of production - has provided a critical impetus to this growing bank function.

D. The New Model of Bank-Mittelstand Relations: The Mediator Role.

In the course of a 1980s debate spanning Europe and North America, numerous studies sought to assess small- and medium-sized enterprises (SME) in terms of their contribution to innovation, employment growth, and corporate profitability. Many early studies argued that smaller firms performed well in the 1970s compared to large firms, thus contradicting the then prevalent notion that larger firms were generally superior to smaller firms. To explain this several scholars in West Germany took up the arguments emanating from the United States that the balance of competitive advantage had shifted from larger to smaller firms because of structural changes in market demand and production.

73 In aggregate terms the economic significance of the SME sector (defined as firms with less than 500 employees and DM 100 million in revenues) in the Federal Republic is comparable to the US, France, Britain, and Japan: SMEs account for more than 99% of all firms, 44% of gross investment, about two-thirds of total employment, and just under 50% of GDP. In West Germany SMEs also train more than 80% of all apprentices. See Irsch, Norbert. 1986. Small and Medium-Sized Enterprises and the Structural Change. Frankfurt: Kreditanstalt für Wiederaufbau. p. 4. In the mining and manufacturing industries SMEs account for roughly 30% of investment and 40% of employment.


75 For example see Schätz, Klaus-Werner. 1984. "Die Bedeutung kleiner und mittlerer Unternehmen im Strukturwandel". Institut für Welt-wirtschaft, Kieler Diskussionsbeiträge
However, some recent studies have given a somewhat less enthusiastic review of the economic potential and competitiveness of SMEs. Bade argues that the apparent shift of employment and investment from larger to smaller firms in the mid-1970s was probably due to the more cyclical behavior of large firms. While Irsch concludes that SMEs have increased their share of employment in the 1970s, he shares Bade's skepticism that this justifies the conclusion that smaller firms performed better than larger firms in terms of profitability or innovative capacity. Moreover, both Irsch and Bade contend that continued corporate concentration suggests that large firms may have increased their economic influence over industry, even while the number of small firms has risen. Thus an increase in the number of legally independent small firms does not necessarily translate into more decentralization of economic

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76. Thus by the early 1980s the respective share of large firms had shifted back to the level of the early 1970s. Bade, 1986, op. cit., pp. 264-265.

77. Ulrich Cramer concludes that the trend toward smaller firms can be largely explained by a shift in resources from the manufacturing to service sector. Examining employment trends by more narrowly defined sectors, he further concludes that economics of scale lose their importance in stagnant or declining sectors thereby leading to an increased use of external suppliers. This trend is greatest in manufacturing industries. See Cramer. 1990. "Der Trend zu kleineren Betrieben: Ergebnisse einer Auswertung der Beschäftigten-statistik für die Bundesrepublik Deutschland." In Kleinbetriebe im wirtschaftlichen Wandel, eds. Johannes Berger, et al. Frankfurt: Campus.

decision-making. Other critics suggest that the growth of small firms is due substantially to the reorganization of large firms in which production previously done in-house is shifted to external sources of production. Thus jobs are merely redistributed to smaller firms. But even where this is the case, it still means that where there was once a single large firm there are now many more smaller ones.

In sum, there seems to be general agreement that SMEs have made more than a proportionate contribution to the creation of jobs in the late 1970s and 1980s, though the question of relative competitiveness of large and small firms remains disputed. It does seem reasonable to assume, however, that size alone is not a sufficient indicator of efficiency or innovative capacity. The studies of SMEs in the 1980s show that they should not be considered prima facia a dependent and therefore second-class form of economic organization.

Success is conditioned by numerous factors internal and external to a given firm. In the case of SMEs, however, external or exogenous factors may play a larger role since smaller firms typically lack many resources which large firms have. The pressures for


80. A study by the Industriekreditbank, a private bank specializing in Mittelstand firm finance, suggests that Mittelstand firms are in fact profiting from this reorganization of large firms because it represents a shift from direct competition to a growing division of labor among large and small firms. The profitability of smaller supplier firms in the auto industry contradicts the popular notion that the large firms are doing this in order to squeeze costs. See "Kleine und mittlere Unternehmen profitieren von der Arbeitsteilung," Handelsblatt. 9 September 1988.

adjustment in small firms stemming from changes in markets, technology and intensified competition from domestic and international sources further exacerbate these gaps. There is wide agreement in West Germany among policy-makers and academics that SMEs, even efficient ones, tend to have certain size-related disadvantages vis-à-vis large firms which can be compensated for, at least partly, through an input of resources from organizations external to the firm. This assumption serves as the basis of the state’s policies toward the Mittelstand and its support for the development and expansion of promotional networks. This assumption also serves as the basis of the banks’ mediator role as well.\textsuperscript{82}

Because of the strength of the savings and cooperative banks in local markets - a fact made possible in part by the political support they received from Länder and central governments - growing competition for the business and loyalty of SMEs pushed all German banks to develop new strategies and attitudes toward their relationship with the small firm. In addition, the growing number of smaller firms in the late 1970s and 1980s presented the banks with a growing group that needed an increasing amount of external support. The major banks, the savings banks, and the cooperative banks have become increasingly active and innovative in their attempts to capture the business of the small firm. Each of the three major banking groups has been working toward the goal of providing comprehensive financial and business services under one roof. In other words, the banks aim to have the capacity to accompany a firm as it grows from two employees to two thousand. In so doing, the banks are consciously seeking to be what the banks themselves describe as the ‘external management arm’ of the small firm.

This emerging mediator role of the banks signifies that they are increasingly providing more than financial intermediation - that is channelling savings into credits for firms. The banks are facilitating or mediating the flow of non-financial resources to firms as well that can be understood broadly as information: Information about technology, business management, business partners, and markets. The banks seek to provide as much of this information as possibl., but since their knowledge is limited this role also requires them to build and expand relations to others who can provide what they cannot. Thus all the banks are becoming increasingly involved in existing sectoral and regional promotional networks.

At a minimum, the mediator role is different from the tutelary role in that the former does not involve bank ownership in the firm.83 Very few Mittelstand firms are publicly owned. Thus banks cannot control them by purchasing and controlling shares, or by holding seats on supervisory boards. Though many Mittelstand firms do have boards that typically exercise an advisory instead of control function. Many of these firms invite their house bank to participate in their advisory board in order to bring their valuable knowledge into the firm, but there are no formal mechanisms of board, and therefore bank, control. Because the mediator function is typically exercised vis-à-vis small and medium sized firms, it is local branches and banks that are its most important executors.

83. Recent statistics on the number of firms with an advisory board are not available, though by one estimate in 1969, one in seven limited liability firms (GmbH), the typical legal form of Mittelstand firms, had such a board. See Westhoff, Norbert. 1984. Bankenvertreter in den Beiräten mittelständischer Unternehmen. Bonn: Stollfuss. For discussions of increased firm independence vis-a-vis the banks, as well as the opportunities which the commercial banks now see for themselves in the Mittelstand market, see articles by various authors in "Arbeitskreis A 2: Wettbewerb im Firmenkundengeschäft." 1987. In Bankmanagement für neue Märkte: Chancen und Risiken an neuen Finanzmärkten mit neuen Produkten und neuen Wettbewerbern. Hans-Jakob Krümmel and Bernd Rudolph, eds. Frankfurt: Fritz Knapp.
As suggested in Chapter 3, the growing mediator role of the banks entails important organizational changes at the local level. In the case of the big banks, these local organizational changes are designed in part to help local branches utilize more effectively the greater authority they have gained through internal decentralization. Much of these changes are designed to enhance the ability of loan officers to be a knowledgeable advisor to client firms on all business matters. Banks are demanding that their officers learn to pull together the right resources within, or even outside, the bank to satisfy the customers' demands. But more than that, the officer is expected to actively help the firm identify internal and external threats to the present and future health of the firm, and to develop a long-term business strategy. Doing all this requires greater knowledge on the part of the officer; it requires advisors to get out of the office more and into the firm where, according to one banker, 90% of advising is done. In reflection of the expanded role of the lending officer for the firm, the German banks no longer call them firm 'advisors,' but 'caretakers.'

Thus satisfying the needs of Mittelstand firms requires ever greater local know-how and resources. But many smaller banks do not dispose over the necessary resources. To compensate for their smaller size, and thus avoid losing the business of Mittelstand firms as they grow, local savings and cooperative banks provide numerous services to customers via cooperative arrangements with other association organizations. In the area of export finance, for example, most local savings banks conduct their clients' business through a larger

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84. Now Firmenkundenbetreuer instead of Firmenkundenberater. For example see Landrock, Rudolf. 1990. "Überlegungen zum Profil von Firmenkunden-betreuern." Spurkasse 107(5):212-213. For a more detailed discussion of the changing workplace skills and requirements in the West Germany financial sector see Baethge and Oberbeck, op. cit. For a discussion of similar organizational trends in other countries see Bertrand and Noyelle, 1988, op. cit.
regional Landesbank. But in many cases local savings banks, especially larger ones, did not want to rely on the association. In conjunction with local and Land politicians they expanded the capacity for satisfying the needs of Mittelstand firms through local financial institutions.

For example, in 1978 the government of Baden-Württemberg issued new savings bank regulations based on its pioneering ‘tie-in theory’ (Anknüpfungstheorie). This theory harmonized the limitations of the regional principle with the need to conduct business outside the legal area by allowing such business when it had a direct personal or material connection to the bank’s local market area. The savings banks could now conduct extra-area business without special permission when it directly "tied into" the needs of the local economy, including export finance and consortial participation in the international lending of the Landesbanks. Other Länder soon followed with similar reforms in their savings bank regulations.

Through the 1960s banks did little more than a simple balance sheet analysis of firms applying for loans. Today, all the banks provide consulting services on a wide range of topics: foreign and domestic market analyses, technological development and innovation, joint

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85. This cooperation is also functioning in the provision of management consulting services. For example, in 1989 the Bavarian Landesbank and the Bavarian Savings Bank Association created a business consulting firm for SMEs - Bayern Consult. The new firm will focus primarily on helping regional businesses in their strategy and marketing efforts, and will also help satisfy the growing demands of local firms for business partners in foreign markets. See "Die Sparkassenorganisation gründet Beratungsfirma," Handelsblatt, 30 June 1989.

86. See articles by Ernst Wagener and Walther Zügel. 1983. Zeitschrift für das gesamte Kreditwesen. (9): pp. 9-12. As discussed in Chapter 6, the proponents of this regulation - the Land government and larger savings banks - had to first overcome the resistance of the smaller savings banks and their communal governments which feared they would be exposed to inestimable risks.

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venture and partnerships, organizational administration, and extensive short- and long-term financial and investment planning - the kind of planning which many smaller firms do not have the resources to undertake and therefore otherwise probably would not.\textsuperscript{87}

The banks have also worked to become information and education centers for their business clients. The big commercial banks, savings and cooperative associations all publish brochures and books on business and investment topics of particular interest to smaller firms. It is now commonplace for a local bank, whether a one-branch cooperative or savings bank or the local branch of a major bank, to organize seminars, workshops, or discussion groups for local business people. Such events are frequently done in cooperation with other local organizations such as the chambers.

Banks are also expanding the use of data bank services to provide information on such things as patents and technology, business partners, and state subsidy programs. In the export field - where small firms typically have the least experience - more and more local banks are linking themselves directly to an international electronic payments system to speed up transfers for local exporting firms. They are also using their international resources and data banks to help local firms identify new export markets, or find potential business partners abroad.\textsuperscript{88}

\textsuperscript{87} Whether the introduction of such services was a response to Mittelstand demands, or an attempt to create new markets, an increasing number of firms have come to expect that their bank provide consulting services on these topics. See Juncker, Klaus. 1985. "Zielgruppe Mittelstand: Unternehmenservice der Banken ausgeweit." \textit{Bank und Markt}. 11:5-10; and Lauer, Christoph. 1990. \textit{Diversifizierung des Angebots und Wettbewerbsperspektiven im Bankensektor}. Stuttgart: Messidor.

\textsuperscript{88} For one study on the banks’ role in helping Mittelstand firms in export markets see Rohrmeier, Dieter. 1987. \textit{Die Bedeutung der internationalisierung von kleinen und mittleren Betrieben für das Bankmarketing}. Munich: GBI-Verlag.
Helping firms find partners for cooperation - to help them build inter-firm or obligational networks - is an increasingly important objective of many banks. Lubitz cites case studies conducted in the early 1980s which showed that between 18% and 27% of Mittelstand firms cooperate in some way with another firm.\(^8\) According to these studies, the vast majority of firms that did not cooperate with another, claimed they did not because of an information deficit about potential partners. This is a deficit which the banks are trying to close. Thus in their growing emphasis on the Mittelstand all banks are supporting decentralized production of goods and services, rather than centralized, hierarchically governed production.

Because state grant and lending programs have become so ubiquitous, identifying, securing, and integrating these funds into the financial package for a firm’s investment has become increasingly important for customer satisfaction. All of the three major bank groups have developed in-house data banks to provide their business advisors ready information on the nearly 500 grant and lending programs offered in the country by the federal, Länder and local governments, as well as by the European Community.\(^9\) Since state subsidies flow to firms largely via the banks, the growth of state subsidies expands the role of the banks as an


\(^9\) While the major banks have learned the importance of this source of funds, they still pass through fewer Mittelstand funds than the savings and cooperative banks. A study by the KfW showed that the relative shares of the three major banking groups in loans they passed through from the KfW remained largely unchanged between 1974 and 1982. For the DAB in contrast, the percentage of funds dispersed through the major banks increased. See their respective 1982 annual reports.
intermediary between firms and the state. Therefore this also requires the banks to cooperate with other organizations involved in small-firm promotional networks.91

Financing innovation and the adoption of new technologies in Mittelstand firms is still a relatively new yet critical challenge for the banking sector. Some banks have developed special lending programs for high-technology start-ups and other innovation investments. Usually lacking in-house technical expertise, local banks readily refer their customers to local outside technical advisors for assistance. The banks themselves are increasingly utilizing these people in their own innovation programs. More typically the banking groups have created equity participation corporations (KBG) and venture capital funds to finance innovative firms.92

Since savings banks are generally prohibited by their regulations from holding equity in non-financial firms, establishing a KBG requires approval of the Land government. In North Rhine-Westphalia the Economics Ministry has approved KBGs for several of its savings banks in order to improve the availability of equity capital for Mittelstand firms.93

91. Partly as a result of increased state lending, banks are also more willing to finance investments based on expected success and not just on available collateral - a once unheard of practice. For an example see Köllhofer, Dietrich. 1989. "Moderne Verfahren der Bilanz- und Bonitätsanalyse im Firmenkunden-geschäft der Bayerischen Vereinsbank AG." Zeitschrift für betriebswirtschaftliche Forschung, 41(11): 974-981.

92. The KBG of the Deutsche Bank, which also invests venture capital, is the oldest and largest, with 1990 assets totalling DM 480 million in 180 firms. "Eigenkapital-Partner für den Mittelstand." Frankfurter Allgemeine Zeitung, 26 April 1991.

93. By 1988 the savings banks managed to established twenty-six equity participation corporations. Ten of these KBGs are subsidiaries of Landesbanks, four were formed through the cooperation of several savings banks, and twelve were established by individual savings banks. Most of these were created in the last ten years. By 1988 the combined total investment was DM 264 million in 220 firms. See Größel, Ulrich. 1987. "Beteiligungsfinanzierung - Wettbewerbs-faktor im Firmenkunden-geschäft." Sparkasse 104(9): 380-383; and Annual Report of the Deutscher Sparkassen- und Giroverband, 1988.
To minimize risk, the Ministry requires the savings bank to demonstrate sufficient technical knowledge, either in the forms of in-house personnel or through cooperation with another local organization such as a university, Chamber of Industry, or Landesbank.\textsuperscript{94} Thus technological information is another collective good that the banks seek to provide firms, either on their own or as part of a local promotional network. As in the case of the 'tie-in theory,' the active engagement of local and Land government officials is still critical to the success of the savings banks and their ability to act in this mediator role.

While each of the three major banking groups offers a very similar selection of services to SMEs there are comparative differences in their capacity to provide them efficiently. The major banks still dominate the export/international finance markets.\textsuperscript{95} For the major banks this strength has proven to be a key factor in acquiring new SMEs as steady customers and a major reason why the savings and cooperative banking associations have invested so much effort in building up their international capabilities. The savings and cooperative banks’ strength in deposit markets enables them to undersell the major banks with


\textsuperscript{95} One study by the savings bank association showed that only three percent of savings banks’ small- and medium-sized business customers use their savings bank for their export or import transactions. Poweileit, Manfred and Sigrid Ulrich. 1988. "Wenn der Groschen fehlt...". \textit{Manager Magazin}. 11:180-195.
greater frequency at the local level. The savings and cooperative banks are still the largest lenders to the Mittelstand.

From the perspective of the small firm, the big commercial banks present two important images (as the case studies presented in Chapter 8 verify): On the one hand, they are seen by many as the most professional and perhaps competent advisors on a range of subject matters. On the other hand, many small firms perceive the major banks to be only truly interested in the business of larger firms. The popular images of the savings and cooperative banks are in many ways the reverse; they are seen as more dedicated to the local economy and smaller businesses, but also less capable in sophisticated banking services.

The major banks still suffer from being the latecomer on the local banking scene. In spite of certain perceived advantages of the big banks, longstanding relationships between local banks and firms are still not quickly given up. The savings and cooperative banks have strong - and in certain ways almost exclusive - connections to local government, trade associations, education, research, and other institutions. Local branches of the major banks have been learning to utilize such local institutions, yet still seem to prefer to rely more on their own resources.

In sum, organizational adaptation and electronic technology have allowed the banks to greatly expand the services they provide to their business customers in an effort to become the external management arm of the Mittelstand. Coordinating the banks' funds and services

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96. This may well also be due to the fact that they are not (at least in principle) profit-maximizing banks. Also, an informal study of fourteen local banks in the Ulm region conducted by the local polytechnic showed the savings and cooperative banks to be, as a group, the best at advising for business start-ups. On an individual basis, however, one of the major banks did rank among the top three, and all the banks had improved in their scores over a previous test two years earlier. Liebig, Volkmann. 1987. "Beratungs- und Finanzierungsofferten von Banken und Sparkassen für Unternehmensgründer und den Mittelstand: Aspekte und Belege aus dem Wirtschaftsraum Ulm." Unpublished Mimeo.
with those provided by the state and other local institutions is an important component of their mediator role. Developing this role presents all the banks with similar organizational prerequisites - the banking groups must have strong local, national and international capacities. The hierarchical concern structure of the commercial banks and the association structure of the savings and cooperatives provide certain economies of scale to local branches and banks. This permits the local banks/branches to offer a growing number of services without necessarily moving decision-making or control to higher levels of the concern or association. 97 This convergence among the groups in the banking industry is not an inevitable or irreversible process. As discussed in Chapter 3, cooperation within the association banking groups, especially within the savings bank sector, is being tested. Those in the savings bank sector who wish to "go it alone" may yet come to dominate those who wish to intensify cooperation. The future path of the association banking groups will therefore strongly affect the extent to which the mediator role of the banks can develop.

E. Summary.

Much evidence suggests that standard organized capitalism accounts fail to provide an adequate understanding of the role of banks in industrial affairs. The traditional institutional sources of bank power have been weakened through increased bank competition and other political and economic changes. Relations among Germany's largest banks and

97. Here an important contrast with other political economies can be made. Friedman shows that in Japan as a firm gets larger, it typically switches from a local to a regional and eventually a national bank. In West Germany there is a similar association between firm size and type of primary bank connection, but it is probably much weaker because small firms that bank with a cooperative or savings bank can also remain with that bank or at least its association since local cooperative and savings banks will attempt to retain their growing customers through consortial lending within their association. See Friedman, David. 1988. The Misunderstood Miracle: Industrial Development and Political Change in Japan. Ithaca: Cornell University Press. pp. 174-175.
firms continue to be characterized by extensive corporate interlocks of both the obligational and a monitoring network types. But if banks once did assume a dominant position within such networks, there is much that suggests this is no longer the case. The vast majority of large firms are either free of direct bank presence within their ownership and decision-making processes, or have considerable autonomy despite bank ownership, proxy votes, and control of supervisory board seats. Banks continue to use these traditional mechanisms in part because the buying and selling of shareholdings is a profitable business. Occasionally their influence in firms is considerable, but the circumstances that enable such influence obtain in a relatively small number of bank-firm relations.

In this chapter many of the presumed benefits of extensive bank involvement in industry were examined. It has generally been argued or assumed that the German system of industrial banking was favorable to the overall, long-term development of the entire economy. But this too can be questioned. Banks have certainly played an important role in rescuing particular firms and sectors, but there are also many cases where bank intervention has harmed firms.

Three other important changes in the German system of industrial finance were discussed in this chapter. First, the decline in the power of banks vis-à-vis large firms is correlated with the growing importance of Mittelstand firms and the mediator relationship. Since the late 1970s Mittelstand firms have demonstrated considerable adaptive capacity and success in rapidly changing global markets. The demand for commercial bank funds is coming more and more from this group of firms. Thus contrary to what standard accounts of the Germany political economy would lead us to believe, smaller banks and local branches are playing an increasingly important role in the German system of industrial finance. The growing importance of the Mittelstand for all three major banking groups has dramatically
intensified competition for these clients. In turn, this is fostering the growth of the mediator bank-industry relationship. This is the third important change in the German system of industrial finance discussed in this chapter.

The fourth and final development is the growing role of the state in industrial finance since the mid-1970s. In several cases the Länder have fostered the emergence of their Landesbanks as major competitors for the business of large firms. As will be explored in the next two chapters, this new role for the Länder and their banks has injected stronger state influence into bank-industry relations. The state has also increased its presence in the markets that provide capital to Mittelstand firms. State-provided capital tends to reinforce the Mittelstand and the mediator role that the banks are pursuing vis-à-vis these firms. In the next chapters the impact of these changes in the German system of industrial banking on the evolution of sectoral and regional economic governance regimes will be explored.
PART II

CHAPTER FIVE:

Evolving Patterns of Economic Governance

A. Introduction.

One of my chief criticisms of standard accounts of the West German political economy is that they significantly underestimate the actual importance of non-hierarchical governance mechanisms in the Federal Republic. For this reason they generally have not provided a satisfactory explanation of the pattern of economic change evident in the Federal Republic since the late 1970s. Given the economic turbulence and rapid changes of the 1970s and 1980s, predictions based on the standard accounts would have suggested that these challenges would have been met largely through the coordinated actions of the large firms and banks. But as already suggested in the previous two chapters, the extent to which organized capitalism prevailed over the process of economic change in this period was more limited than widely assumed. The following three chapters develop the argument that a wide range of important industrial changes occur under governance mechanisms underemphasized in the organized capitalism model. Certain sectors and regions within Germany have historically been governed by regimes in which less formal integration or coordination among economic units occurs. In these cases governance mechanisms such as markets and networks are stronger and Mittelstand firms typically play a large role in the production of goods and services. The spread in Germany of what have been labeled post-Fordist production principles suggests that these non-hierarchical governance mechanisms may be equally, or in some cases more, effective as hierarchical mechanisms in coordinating producers. Ample
evidence suggests hierarchy as a governance mechanism is not necessarily the best response to the changing requirements of international competitiveness.

It was suggested in the previous chapter that the growing importance of smaller banks, local branches, and the mediator role of the banks is an outgrowth of the success and increasing importance of Mittelstand firms to the banks. The case studies in the following chapters will attempt to show how these local banks/branches acting in their mediator role aid Mittelstand firms and can be a constituent element of non-hierarchical governance mechanisms.

The case studies also seek to assess the role of the state, especially Länder governments, in shaping selected sectoral governance regimes and bank-industry relations. For this purpose I assume, following Lindberg and Campbell, that governance mechanisms, including markets, are intricately linked to the state. In their framework there are two key aspects to the state: the state as an actor (or set of actors), and the state as a political-institutional structure. As an actor, the state may or may not be acting autonomously, that is according to its own goals or preferences rather than those of dominant societal actors. Therefore the case studies focus primarily on showing how the state shapes governance regimes, and only secondarily on explaining state policy choices.

As a political-institutional structure, the state can be an arena where "state institutions provide differential access for various societal groups to influence or penetrate the economic policy-making process." State structures can also define distinctive locations of economic

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activity. As Markusen argues for the United States, I argue that the federal structure of the West German state played a crucial role in the development and persistence of regionally distinct economies.¹

Just as recent scholarship has argued that the role or importance of the major mechanisms of governance varies by economic sector, in the following cases I argue that a regional dimension can be added to this theoretical framework. In Baden-Württemberg markets and especially networks tend to play much greater governance roles. In Baden-Württemberg economic production is a significantly less hierarchically controlled or administered process, even in sectors that elsewhere are governed more by hierarchy. Corresponding to the organized capitalism model, North Rhine-Westphalia is a regional economy characterized by a high degree of hierarchical and associative (concertative) mechanisms of economic governance. Subnational governments in Germany have exhibited a tendency to consistently favor certain governance mechanisms over others in their policies.

In the Lindberg/Campbell framework the state has two broad types of policy tools that help constitute the economy: The state can provide and allocate resources and information, and the state can regulate the behavior of exchange parties through the formulation and enforcement of property rights. Through Mittelstand policies, the state promotes smaller firms and informal, multilateral exchange among them (networks) by investing in the provision of collective goods such as job training and education - two policy areas largely reserved for the Länder - and by providing subsidies to networks and firm associations (e.g. export promotion consortia). The Länder and local governments also

produce and allocate resources to Mittelstand firms indirectly by supporting the growing market orientation of the savings banks.

Over the 1970s and 1980s the state has also increasingly provided resources (i.e. subsidies) directly to individual firms. While Lindberg and Campbell argue that this type of resource provision tends to favor strategies of organizing exchange among actors bilaterally, there is little evidence in my case studies that suggests the growth of individual firm subsidies has undermined or weakened cooperation within multilateral Mittelstand networks.

The German Länder also have considerable potential to shape economic exchange through property rights. A prime example, already discussed in chapters 2 and 3, is the role of the Länder in the savings bank sector. By liberalizing the rules and regulations governing the savings banks and Landesbanks, the Länder have increased the range of activities they have engaged in. This has altered the balance of power among the different banking groups, in part by undermining the power of the major commercial banks, and led to significant changes in bank-industry relations - notably the rise of the mediator role.

This suggests that changes in the organization of the financial system and government economic intervention are interdependent. Change in the banking industry was driven forward by a combination of exogenous market forces, conflict within and between the banking groups within the political system, and state policy. This suggests, in contrast to Zysman, that the banking sector is not an exogenously determined variable which has limited, or defined, the nature and extent of state intervention. Rather the organization of the banking sector and its relationship to the state are in part the outcome of evolving conflicts and bargains between the state and actors in the banking sector. Groups on each side have acted to constrain and shape the others in line with their preferences and goals. Differences among Länder in their capacity to influence governance mechanisms in their regions reflect in part
the respective outcomes of these struggles. Thus I argue that the state and banks should be seen less as alternative institutions for implementing industrial policy and sectoral economic governance - as standard accounts tend to suggest - and more as intricately linked institutions.

Lindberg and Campbell speculate that "where state actors are relatively autonomous or have the organizational capacity to develop a coherent state interest, state actors may be more able to develop strategies in production and allocation and in property rights to favor multilateral exchange and the provision of collective goods, as well as alternatives to hierarchical governance." 4 I will argue that in the Federal Republic of Germany the policies of the Länder tend to favor multilateral exchange and cooperative strategies (networks) among producers. In many cases Länder policies have arguably been decisive in the constitution of sectoral governance regimes within their regions. Though more often these policies have played a crucial role in stabilizing such strategies and the governance regimes based on them. 5 Thus Länder, and even many federal policies, have been crucial to the maintenance of smaller firms and the sectoral governance regimes that do not fit the narrow organized capitalism perspective. The growing mediator role of the banks is, in a functional sense, highly complementary to these Länder strategies.

This does not necessarily mean that bilateral exchange and hierarchy are secondary means of organizing exchange in each Land, but merely that Länder policies more often tend to favor opposite strategies. Nor does this mean that Länder policies never promote


5. Lindberg and Campbell suggest that the production and allocation of resources by the state are likely to reinforce existing governance regimes (exchange strategies) "since these state actions have been primarily designed either to directly subsidize private accumulation or to provide public funds to privately appropriable infrastructures..." (1991, op. cit., p. 387).
hierarchy. In many cases the Länder actually view pro- and anti-hierarchy policies as complementary. As the case of North Rhine-Westphalia will show, from the 1950s through the 1970s the Land government sought to stabilize hierarchies in the region, notably in coal and steel production. Though in the 1980s the Land government increasingly favored policies to promote Mittelstand firms and multilateral exchange strategies (networks). Since the late 1970s several sectors in North Rhine-Westphalia, and in particular the Ruhr, show movement toward a mix of governance mechanisms characteristic of post-Fordism. Thus North Rhine-Westphalia's policies seem to be shifting in consort with changing production and exchange strategies in regional industry and are therefore likely to reinforce governance transformation in this direction.

As firms and sectors faced tremendous pressures to adapt their strategies to changed conditions in the 1970s and 1980s, the Länder governments became even more involved in their regional economies. The policies they pursued were developed and implemented increasingly independent of the federal government, and often in conflict. To understand how the Länder maintained their considerable capacity to shape governance regimes in the postwar period requires first a brief examination of intergovernmental relations in the Federal Republic.

B. The Federal State as a Distinctive Location of Economic Activity.

In spite of many attempts to increase central authority in the postwar period, the authority and capacity of subnational governments has remained strong. This strength is rooted in the historical development of the state, and political and administrative systems. "In Germany, the modern state in Max Weber's sense, with a centralized bureaucratic authority and sovereign power over a closed territory, developed not on the level of the
Empire but in its larger territorial components, such as in Austria, Prussia, Bavaria, and Württemberg...This pluri-centric political structure survived German 'unification' under Bismarck." As will be argued, the limited politico-administrative integration of the constituent states enabled regional economies to continue a semi-autonomous development through the present.

The German state has traditionally been based on 'horizontal administration' or a 'spatial federalism' that divided labor between the levels of the state not by policy area, as in the United States, but by function in the policy-making process. This principle fostered, among other things, the maintenance and expansion of lower levels of the bureaucracy over the central bureaucracy. More importantly, it preserved a high degree of autonomy for subnational governments and a high degree of dependence by the central government on their cooperation if national policies were to be successfully implemented. But minimal coordination was indispensable even in a strongly federal state. In the postwar period, the growth of the welfare state and the constitutional mandate for uniform social and economic prosperity throughout the nation increased the pressure for uniformity in policies and services. Over the course of the 1950s and 1960s several mechanisms for achieving greater policy coordination, or uniformity, were developed that were based in large part on horizontal cooperation among the Länder.

Nonetheless there were also pressures for centralization. The biggest push for centralization came in the late 1960s. At this time the attempt of the federal government to implement demand management practices required a host of institutional reforms. Fiscal

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relations between the Federal and other levels of government were modified in favor of the former. In turn, the Federal government used its new revenues to introduce a variety of programmatic initiatives which gave it a policy role in areas previously reserved for the Länder. For example, through the so-called "joint tasks" the federal government gained a role in the planning and financing of university construction, regional industrial policy, and the improvement of the agricultural economy and coastal preservation. To coordinate budgeting, regional planning, and infrastructure spending, all levels of government were incorporated into a hierarchical planning system. Reflecting its new role, from 1969 to 1975 the investments and investment subsidies of the federal government nearly doubled, mostly through the joint tasks. This system of intergovernmental relations was called Politikverflechtung in West Germany and alternatively labelled elsewhere as 'cooperative federalism,' 'joint policymaking,' or 'interlocking politics.'

In light of these changes many observers argued that a significant amount of centralization of decisionmaking authority occurred in the Federal Republic in the first three

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8. Through investment subsidies to the Länder the federal government also gained influence over urban renewal and transportation, hospital and social housing construction, and environmental protection policies, primary and secondary education and research institutes financed by the Länder.

9. In the fiscal arena, the tax system was gradually modified such that by 1980 approximately 80% of state tax revenues was shared between all three levels of government through a complicated quota system. As a result, the Länder and local governments have very little room for fiscal innovation. Katzenstein, Peter J. 1987. Policy and Politics in West Germany. Philadelphia: Temple University Press. pp. 49-50.

10. The seminal work in this field is that of Scharpf, et al, 1976, op. cit. Lehmburc defines Politikverflechtung "...as the establishment of intermediating structures [e.g policy committees] linking the politics - namely, the decision processes - and policies - the substantive responsibilities - of initially autonomous organizations." Lehmburc, 1989, op. cit., pp. 222.
post-war decades. But others envisioned a far more complicated story. As opposed to looking at the federal system as a one of hierarchic control between levels of government, the alternative view suggested that the federal system was a complex web of bargaining relationships between different units of government. In this perspective institutional reforms originally seen as enhancing central government power were reinterpreted. For example, though many reforms of the late 1960s and early 1970s did involve some transfer of powers from the Länder to the federal government, they were accompanied by an increase in Länder participation in federal decision-making: Namely, the power of the Länder to veto federal initiatives via such institutions as the Bundesrat and federal-Länder inter-ministerial committees was greatly increased. This power forced the federal and Länder governments to reach a consensus decision on most major policy initiatives. In the end, the centralizing efforts of the Federal government failed to produce major and lasting central policy direction. Even in the few policy areas where the federal government has sole


jurisdiction, its reliance on the Länder and local governments for implementation and administration forces it to reach consensus with them or expect failure.¹⁴

Greater policy uniformity in the Federal Republic was achieved not so much through increased vertical centralization as through intensified bargaining and cooperation among governments in the vertical and horizontal dimension. Pluri-centrism and decentralized decisionmaking processes and structures could be largely maintained because the "unitarization" of policy outputs was achieved in this manner.¹⁵ While the original emergence of cooperative federalism was attributed to the need for coordination in a state with relatively autonomous units and decentralized decisionmaking, by the mid-1970s it was widely, and ironically, considered inefficient, inflexible, undemocratic, and devoid of significant problem-solving capacity.

Consequently, dissatisfaction with the federal system in and outside of government grew steadily over the course of the 1970s. As political and economic crises intensified, the political system seemed equally incapable of responding. The ‘joint-tasks’ were considered failures. Calls and proposals for the "disentanglement" of governmental units, decentralization, and the like, emanated from all levels of the system. The Länder, especially the CDU-controlled Länder, used the Bundesrat to pressure the federal government to return

¹⁴. Garlich, for example, uses the case of highway construction to show how the information monopoly and local expertise of the sub-national governments provides them with significant bargaining power vis-à-vis the federal government. Garlich, Dietrich. 1980. Grenzen staatlicher Infrastrukturpolitik: Bund/Länder-Kooperation in der Fernstrassenplanung. Königstein/Ts.:Hain.

more fiscal and legislative authority to the Länder. In 1981-1982 the federal government cut ‘joint-task’ funds by 20%. But little actual institutional reform occurred. This does not mean, however, that the federal system failed to respond to changing societal problems and demands.

As Benz succinctly states, "[t]he sharing of functions in the federal system [made] it possible to shift the focus of policy-making from central regulation to decentralized implementation and to use discretionary powers of lower levels of government. When Land and local governments responded to the crisis of centralized policy-making [in the late 1970s], institutional structures of cooperative federalism provided the basis for a de facto decentralization without structural reform." In short, the federal system in Germany adapts to changes in political and socio-economic conditions through changing the mode or process of cooperation and the location of decision-making, not the structure. Substantial change in state policy-making was thus masked by the lack of visible institutional reform.

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17. The barriers to change were many, but primary among them were the resistance of ‘vertical alliances’ of policy specialists in the bureaucracies of all levels of government; the difficulty of eliminating programs in which all levels shared; and the strong desire of weaker Länder to not lose federal funds since to formally devolve responsibilities to lower levels would require an accompanying devolution of financial resources - a conflict which could not be resolved. On this see Gunlicks, 1986, op. cit.; and Benz, Arthur. 1989. "Intergovernmental Relations in the 1980s." Publius 19(4): 203-220.


19. Hesse argues in particular that local governments have played an especially important - if not the most important - role in maintaining the adaptive capacity (and therefore relative stability) of the political system to changing societal demands by providing them with a channel into the system. Hesse, 1987, op. cit.
C. The State as Producer and Allocator of Resources.

The preservation of considerable Länder autonomy and policy-making capacities enabled them to continue as significant producers and allocators of resources to firms in their regions. The principles of the federal administrative system also enable the Länder to play a large role in allocating resources emanating from the federal government. Like most other Western industrial nations, the decline of Keynesian macroeconomic policies in the late 1970s in the Federal Republic is mirrored by the meteoric rise of micro-level industrial intervention.\textsuperscript{20} In some cases state aid hindered change in governance regimes, in others it stabilized them or promoted their transformation.

Between 1973 and 1981 total government subsidies to the private sector grew at an annual rate of 7.8\%; total tax revenues grew 6.3\% in this period; while the value added of firms receiving subsidies grew at only 6.4\% (see Table 5.1).\textsuperscript{21} This growth in subsidies was so rapid that by the late 1970s it had become a hot political issue in public debate. Yet in spite of the Federal Subsidy Reduction Law passed in 1981, and the repeated efforts of both SPD and CDU-led federal governments, subsidies quickly resumed a strongly positive growth trajectory.\textsuperscript{22} From 1981 to 1984 subsidies again grew faster than GDP and total


state expenditures. Beginning in the mid-1970s a growing portion of these subsidies were directed to individual Mittelstand firms, Mittelstand networks and associations. Under intense public pressure from the public and Mittelstand firms, significant actions of the federal and Länder governments were consciously directed at countering concentration and hierarchy.

The federal government supports new investment in existing Mittelstand firms with low-interest loans, guarantees, and grants disbursed by various ministries and institutions directly to firms via their house banks. Off-budget support for the Mittelstand also comes heavily from two Federal-Länder development banks - the Deutscheausgleichsbank (DAB) and the Kreditanstalt für Wiederaufbau (KfW).\(^{23}\) While both of these banks have been operating several programs for SMEs since the early post-war years, the growth in lending under these programs has been especially strong since the 1970s. In 1970 the KfW granted a total of DM 838 million in domestic loans; in 1986 the KfW granted a total of DM 9.8 billion in domestics loans, DM 6.2 billion of which went to SMEs. In 1973 the DAB granted DM 33 million in loans for business start-ups, by 1983 such loans amounted to just over DM 1.4 billion.\(^{24}\) One of the largest areas of state resource provision is for firm start-ups. The federal and all Länder governments have business start-up programs that support

\(^{23}\) These banks use funds appropriated from the federal budget, their own funds raised on the market, and ERP funds. The ERP, or European Recovery Program, 'special fund' is a trust fund emanating from the post-war Marshall Program. It is used for economic programs and valued in 1985 at DM 15 billion. The KfW is Germany's tenth largest bank.

\(^{24}\) See the 1987 Annual Report of the KfW; and the 1983 and 1987 Reports of the DAB. Subsidies to firms stemming from bank profits are not included in the government subsidy figures cited above.
firms through soft loans and grants. While these sums may be small in comparison to all loans to the Mittelstand, state resources are typically targeted to funding the riskiest investments that smaller producers make and usually leverage considerable private capital funding as well. Thus the qualitative impact of state capital provision is probably far greater than its quantity suggests.

Aside from direct subsidies to firms, the federal and Länder governments increased their provision of resources to longstanding promotional networks organized along sectoral and/or regional lines. For example, the federal and Länder governments subsidize business consulting services provided to Mittelstand firms by their associations or other promotional networks. Beginning in the early 1980s the federal government began to subsidize technology advising services for both new and existing SMEs. The Federal ministries for economics and technology also initiated several new programs in the late 1970s and early 1980s to directly support R&D in small- and medium-sized firms. Consequently, from 1982 to 1985 the share of Mittelstand firms in total federal R&D expenditures rose from 26% to 31%.


26. In 1982 the federal government alone subsidized 699 cases of new firm advising services; by 1984 this number had risen to 2,774. Hennicke and de Pay, 1986, op. cit.

27. In 1981 total Federal support for research, development and innovation in the Mittelstand sector totalled DM 714.9 million. By 1986 this sum reached an estimated DM 1,017 million. Among the several programs developed between the BMFT and Economics Ministry for the Mittelstand, two are particularly noteworthy. The largest single program, created in 1979, provides subsidies for the salaries of R&D personnel in Mittelstand firms. In 1988 this program ended (one year earlier than originally scheduled) amid charges of widespread abuse. Kahlen, Rudolf. "Geld mach erfinderisch," Die Zeit (U.S. edition), 28 August 1987. In 1983, the BMFT also initiated a program to support the formation of technology-oriented firms (TOU). Federal Economic Ministry and the Federal Ministry for
In promoting new, innovative firms and industries the Länder have not left all to the federal government. In the 1980s seven Länder established their own technology or innovation program (bringing the total to ten of eleven western Länder). Here the emphasis has been on promoting technology-oriented advising services, specific R&D projects in firms, technology transfer programs, and the establishment of technology parks (business incubator facilities for new technology-oriented firms). In nearly all cases these policies are orientated to Mittelstand firms and encourage the expansion or formation of promotional networks and cooperative strategies in production.

Many Länder have also gone further in attempting to maintain non-hierarchical governance by stimulating the creation of networks. For example, several Länder have established equity participation corporations to provide an alternate source of equity capital for the Mittelstand. These corporations involve multilateral cooperation among a large number of economic actors and thus represent a form of regional promotional network. In the 1980s export promotion became another focal point of Länder economic development efforts. Their most visible efforts were the pursuit of cooperative agreements with regions in foreign countries. In numerous cases these efforts by Länder governments did stimulate the creation of obligational networks (especially joint-ventures and supplier relationships) involving Mittelstand firms from their region. Less visible but perhaps more successful was the provision of resources by Länder governments for the creation of new, or expansion of


existing, promotional networks orientated to assisting Mittelstand firms with exporting services.

The Länder regard support for the Mittelstand to be primarily their economic policy field within the federal system. The German Länder have a long history of an active role in their economies. But in the heady growth years of the 1950s and 1960s, and particularly during the Keynesian experiment, their role was often overlooked or seen as subordinate to that of the federal government. But when economic crises began in the mid-1970s, the Länder wasted no time in expanding their own structural programs and subsidies. The growth in Länder intervention was especially marked in the early 1980s. Between 1981 and 1984, for example, the value of financial subsidies by the Länder (and local governments) to firms grew 7.5% per year while their total expenditures only grew 1.5% annually. Financial subsidies by the federal government only grew at 3.7% per year, slightly above its total spending at 3.5% per year.29

The expansion of Länder intervention was partly a response to demands by regional firms, but they were also driven by economic and political competition among Länder governments.30 Since the increasingly prosperous southern Länder - Bavaria and Baden-


30. The resurgence of territorial politics was likewise evident in the attempts by Länder to recapture some of the economic prerogatives they felt they had lost to the federal government in the late 1960s and early 1970s. For example, cooperation in the 'joint tasks' (GA), a program of cooperative federalism intended to harmonize state investment incentives in poorer regions, became increasingly problematic. In the 1970s, seven of the eight non-city-state Länder established, or maintained their own regional promotion programs, in spite of the GA. In 1983 the Länder dispensed DM 468.4 million in subsidies under their regional programs. In that same year the value of subsidies (not including tax allowances) under the GA - financed equally between the Länder and federal government - totalled DM 334.2
Württemberg have two of the most interventionist governments, the flow of state subsidies is reinforcing disparate regional patterns of growth.\textsuperscript{31} The growth of subsidies as a result of firm demands suggests that these state policies are not made autonomously of heavy influence from societal actors. To a significant degree this is undoubtedly true. However, there are also numerous state actions that do demonstrate a relatively high degree of autonomy of state actors. To a significant extent, the competition among the Länder in the 1980s was driven by the preferences of state actors as demonstrated by the fact that many actions ran against the demands of economic actors in their regions. The Landesbanks have also proven to be ideal organizations for the relatively autonomous pursuit of Land government policy preferences.

In regions heavily dependent on declining sectors - such as Bremen and Hamburg in shipping and shipbuilding, or North Rhine-Westphalia in coal and steel - the Land government is intricately involved in sectoral rationalization programs along with the federal government. In many instances Land governments have used banks which they control to prop up firms in troubled sectors. Thus in certain cases Länder governments have played a central role in the transformation of several sectoral governance regimes, and have not simply served to stabilize those created by private economic actors.

\textsuperscript{31} These two Länder also receive a proportionately large share of federal subsidies to firms and federal investment. "Bayern und Baden-Würtemberg: Fingerhakeln im Süden." \textit{Wirtschaftswoche}. 24 May 1985; and Hennicke and de Pay, 1986, op. cit.

|-----------------------|-------|-------|-------|-------|-------|-----------
| Baden-Württemberg     | 35.0  | 47.8  | 267.9 | 261.0 | 211.8 | 605%      
| Bavaria               | 257.9 | 368.2 | 733.9 | 665.3 | 626.4 | 243%      
| North Rhine-Westphalia| 679.7 | 495.8 | 1,709.3 | 1,477.7 | 1,279.0 | 188%      
| Hesse                 | 23.8  | 35.9  | 47.6  | 54.4  | 55.0  | 231%      
| Niedersachsen         | 126.6 | 108.4 | 244.0 | 375.8 | 312.4 | 247%      
| Total all SNGs        | 1,853.3 | 1,564.5 | 3,753 | 3,786.7 | 3,536.8 | 191%      
| Federal Budget        | 3,232.8 | 3,772.1 | 6,735.6 | 7,364.6 | 7,552.2 | 234%      
| Tax Reductions        | 6,156.8 | 6,340.5 | 6,691.8 | 7,342.7 | 7,698.4 | 125%      
| Other +               | 1,604.6 | 2,492.1 | 7,448.9 | 6,681.1 | 7,899.6 | 492%      
| Total                 | 12,847.5 | 14,169.2 | 24,629.3 | 25,175.6 | 26,687.0 | 208%      

* Jüttemeier divides all state subsidies into four categories - agriculture sector, goods producing sector, service sector, and 'housing and private persons' (primarily social services). Subsidies in the 'goods producing sector' include, inter alia, subsidies for: research outside of universities; labor market programs; the manufacturing, mining and energy production sectors; regional economic programs; and environmental protection. Source: Jüttemeier, Karl Heinz. 1984. *Deutsche Subventionspolitik in Zahlen, 1973-1981.* Kiel: Institut für Weltwirtschaft.
+ Includes subsidies from the Federal Labor Office, ERP funds, European Community (though this is negligible) and the 'coal penny tax' introduced in 1978.


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D. Pressures for Change in Sectoral Governance.

According to Kern and Schumann, the ‘new concepts of production’ that are spreading quickly in West Germany are the following: to produce a diversity of products of high quality; to flexibly automatize the manufacturing process; to integrate production, maintenance and quality control functions; and to recruit and train highly skilled labor. These concepts are consistent with what has been generally labelled post-Fordism, because production according to these principles means a shift away from mass-produced, standardized goods to more customized goods produced in comparatively small batches. The general argument is that mass production is increasingly uncompetitive in markets where demand is fragmenting and thus increasingly uncertain. Many of these ‘new concepts’ - in particular higher quality goods achieved through intensified R&D and production with higher skill labor - are therefore widely seen as essential prerequisites for all advanced industrial nations to remain internationally competitive. And there is growing recognition that continued competitiveness increasingly requires collective goods - such as education and research - which the market as a governance institution frequently fails to produce in


sufficient quantities. In this case of market failure other institutions of economic governance, such as association, community, or state regulation, are increasingly important.

While there is still some debate about the importance of these post-Fordist concepts of industrial competitiveness, there is even greater debate about their implication for the organization of production; in other words, how production is organized within and distributed among firms. A number of studies argue that an emphasis on organizational flexibility favors production in smaller firms because their key competitive advantage vis-à-vis large firms lies exactly in their flexibility. Facing the same imperatives, large firms have also sought to increase their flexibility. This has been attempted through a variety of ways including the internal decentralization of decision-making and other responsibilities within the firm, as well as through expanding reliance on outside firms or organizations. Thus post-Fordism accords less importance to hierarchy (formal bilateral organization) and more to informal and multilateral exchange relations.

Several scholars have taken these arguments one step further and argued that within numerous industrial nations there are internationally competitive regions where production in the region is organized in networks of firms based on relational or 'cooperative contracting.' In these cases of industrial districts or 'industrial regionalism,' a spatially


agglomerated set of firms produce specialized, but complementary goods for common markets. The general argument advanced for the growth of such networks cites their competitive advantages under conditions of high market uncertainty and change. Production via networks of firms engaged in cooperative contracting - as opposed to vertically integrated production within a single firm - allows for higher degrees of flexibility to adjust quickly to market changes and may have certain advantages in promoting innovation and its diffusion.

But smaller firms in general, including those linked in cooperative networks, rely much more than large firms on outside organizations to provide them with essential producer services and resources not available within the firm. As will be discussed in the following chapters, heavy demand in the Federal Republic for such services and resources has been met with an expansion of complementary service firms in the private sector (such as banks in their mediator role), but also with an expansion of regional and local promotional networks supported by the state - especially where the services or resources demanded are collective.


goods such as vocational training or research and development.\textsuperscript{38} In this way small and medium-sized firms and inter-firm networks are intricately linked to state-supported promotional networks.

While the provision of services and resources by the state that are available in the private sector may at first seem redundant and therefore unnecessary (which is often the complaint by liberal-minded actors), it is exactly such 'redundancy' that distinguishes 'networks' from other types of inter-firm relations (e.g. hierarchies) and makes the former advantageous under conditions of high uncertainty. Among other things, such redundancy assures a firm immediate access to needed complementary resources - not available within the firm - even when an exchange partner fails to deliver since there are other partners available, be it the state acting through organizations in a regional promotional network or other firms.\textsuperscript{39}

Of course, the strength and importance of smaller firms and inter-firm networks vary significantly between regional economies within the Federal Republic. As suggested by Baden-Württemberg, certain regions have a historical preponderance of smaller firms that rely on institutional support cultures (promotional networks). Even where such firm networks may not be particularly strong, the growing need of firms everywhere for collective goods as suggested by post-Fordism is encouraging the expansion of state subsidies and state-supported promotional networks.


\textsuperscript{39} See "Netzwerke statt Stahlwerke." \textit{WZB-Mitteilungen}. March 1990.
According to Hollingsworth, in a post-Fordist system of quality production, capital formation is based less on capital markets and more on strong bank-firm links, extensive cross-firm ownership, and long-term ownership of equities.\textsuperscript{40} This description has long fit the German model of industrial banking. But as already discussed, strong bank-firm links are increasingly based on a much more symmetrical power balance between the two. Moreover, just as firms under post-Fordism must be more flexible, so must the banks. Banks must be more technology conscious and provide more information to firms - factors that I earlier labelled part of their mediator role.

The transformation to post-Fordist production systems has generally been a boon to Mittelstand firms, as it favors vertical disintegration and networks - subcontracting relations, cooperative contracting among small firms, joint-ventures, and the like. As suggested above, a substantial number of state industrial policies support post-Fordist production strategies. In this way the state plays a role in the transformation process of different sectors in which producers seek new strategies to adjust to changed market conditions and technology. Since the late nineteenth century Länder economic and banking policies contributed significantly to the stabilization of non-hierarchical governance regimes and sectors were post-Fordist-like production principles were always dominant. Since the mid-1970s they have done even more to stabilize and expand the Mittelstand and non-hierarchical governance.

E. Regional and Local Case Studies.

The following case studies demonstrate how changes in the structure and practices of the banking industry combine with government industrial policies to expand the capacity

\textsuperscript{40} Hollingsworth, 1991, op. cit. pp. 72-73.
of small- and medium-sized firms to adapt to economic change and thus promote the expansion of more decentralized (non-hierarchical) systems of economic governance. The two Land case studies are Baden-Württemberg and North Rhine-Westphalia.

North Rhine-Westphalia is the region that best represents the organized capitalism model. But even here there is ample evidence to undermine the orthodoxy of this view. In chapter 6, I argue that the government of North Rhine-Westphalia became a major actor in the adjustment process of the state’s economy. The Land government used its large Landesbank - in spite of recurrent political opposition - to extensively intervene in regional industry. While this arguably reinforced hierarchy in the region, in the 1980s the WestLB was used increasingly to promote decentralized industrial restructuring efforts by local governments and smaller firms. Likewise, government involvement in industry began to shift away from its traditional focus on large firms toward the promotion of small and medium sized firms. To a significant though limited extent, the mix of economic governance mechanisms and state policy in North Rhine-Westphalia is moving toward that of Baden-Württemberg.

Chapter 7 looks at Baden-Württemberg and explores the overall thesis arguments in the case that deviates the most from the organized capitalism model. Baden-Württemberg is one of the most industrialized and successful regional economies in Germany, yet the institutional preconditions of organized capitalism are weaker than elsewhere: economic concentration is lower because of the large number of small- and medium-sized firms, and industrial finance is controlled to a comparatively high degree by relatively small, local banks that do not exercise a tutelary role in industry. In this region industry is governed to a greater degree by markets, but also significantly by non-market (but non-hierarchical) relationships among firms as represented by institutionalized patterns of direct and indirect
cooperation among them obligational and promotional networks. Indirect cooperation among firms is extensively supported by Baden-Württemberg’s government.

Chapter 8 continues with an examination of two examples of Mittelstand firms and the critical support they receive from their local institutional environment. The first case is the city of Heilbronn in Baden-Württemberg: the second, the city of Solingen in North Rhine-Westphalia. Both cases demonstrate how local cooperation occurs and has expanded, aided by Länder government and bank initiatives. The types of organizations which comprise local promotional networks in each city are very similar. Both cases also demonstrate how local economies can adapt to structural economic change based on an expanding Mittelstand, as opposed to adjustment through increasing hierarchical control (including firm concentration) as the organized capitalism model would suggest.
CHAPTER SIX:

North Rhine-Westphalia: Regional Organized Capitalism?

A. Introduction.

If there is a single region that captures the spirit and reality of German organized capitalism it is surely the Ruhr in North Rhine-Westphalia. In the mid-nineteenth century the rich hard coal under the green pastures surrounding the Ruhr, Emsche, and Lippe rivers fueled the emerging industrial revolution in the German states, Prussia in particular. By the end of the century the Ruhr was the most heavily industrialized and densely populated region in Germany. Large, vertically integrated firms employed most of the region’s labor force to produce most of Germany’s coal, steel and iron, and much of its heavy machinery. The leading industrialists of the Ruhr and the nearby Rhine region were among the nation’s most politically powerful. Producer cartels and finance capital - bank funds invested in industry - were copious. Thus all the elements of classic organized capitalism were present and operating; a high degree of economic concentration, cartels, powerful trade associations, and large, tutelary banks. Time and again this relatively small group of powerful industrialists and bankers dictated the course of Ruhr industry, and influenced the political course of the German state. Whether because or in spite of this organized capitalism, the region enjoyed a century of prosperity on the strength of these industries.

But in the postwar period the Ruhr suffered the same fate as similarly structured regions across Europe. The declining demand for coal, discernible by the late 1950s, slowly transformed one of Germany’s premier ‘growth poles’ into a vortex of decay. The shrinkage of the coal industry, followed later by the steel industry, dragged along many of the smaller firms in the region that supplied them. The comparatively small number and weakness of
firms in other sectors in the region prevented them from absorbing the labor released by the large firms. By the late 1970s the one-time symbol of German industrial might was widely scorned in the Federal Republic as the filthy relic of a bygone era. But in numerous respects the decline of the coal and steel industries in Germany was a well-managed process. Production capacity was reduced, productivity greatly improved, the labor force drastically reduced while the big firms diversified by product and region, all while maintaining a comparatively high degree of industrial and social peace.

If we accept the standard organized capitalism arguments outline in Chapter 1, then we would expect this adjustment process to have been managed according to the negotiated agreement of the large firms and big commercial banks. And in many instances it was. But to describe the cases of coal and steel in the Ruhr as 'private industrial policy,' or 'organized private enterprise,' would be an injustice to the role of governments in producing the underlying consensus and funds that made this adjustment possible. Major changes in the organization of production in these sectors were deeply affected by a corporatist bargaining process involving the unions, federal and Land governments, firms, and the banks. In the cases of coal and steel the state has not remained at "arms-length" to industry. State intervention has been frequent and extensive, at times imposing solutions on industrial sectors unable to develop a consensus plan on their own. Thus the state played a decisive role in constituting the governance regimes of these sectors at key points in their transformation.

Even in the classic case of German organized capitalism - the steel industry - the big three banks so intricately involved in its affairs were eventually not able to manage its adjustment. It is state intervention that "saved" organized capitalism in the steel industry - that is the large firms and the bank capital invested in them - rather than the banks saving
the state from being bothered with the problems of industry.\(^1\) While this does not mean that organized capitalism is dead in the German political economy, it points firstly to the limits of private industrial policy, and secondly, to the critical and often underestimated role of governments in the economy.\(^2\) The cases of coal and steel and other sectors suggest that the capacity of the major banks to organize industry is consistently effective only on the individual firm level. Organizing the affairs of whole sectors is increasingly difficult. When whole industries face drastic decline the system of private industrial policy is overwhelmed and governments must step in.

In this chapter I will argue that the Land government of North Rhine-Westphalia became a major actor in the adjustment process of its economy. In contrast to the Mittelstand-oriented policy model of Baden-Württemberg, economic policy in North Rhine-Westphalia has traditionally focused on managing the problems of the large firms in its coal and steel regions. Because North Rhine-Westphalia did not exist as a unified political territory before 1946 the economic intervention capacity of the Land government had to be largely constructed in the postwar period. This construction process required a great deal of political will and occurred in large measure in order to address the problems of the Ruhr. The decentralized and flexible nature of West German federalism was an important factor permitting this form of "state-building" at a subnational level.

But the political will to build up the Land government's capacity was not pre-existent. The Christian Democrats controlled the Land government for all but two of its first twenty

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\(^1\) Zysman, 1983, op. cit., pp. 251-265, suggests precisely the opposite, that the West German state is neo-liberal in its economic policies because the big banks manage the affairs of industry.

\(^2\) As noted in Chapter One, Katzenstein makes a similar argument that centralized private, but also public, crisis management has become increasingly difficult. Katzenstein, 1989, op. cit., p. 341.
years until they were pushed from power in 1966 by the social democrats. The main sources of the SPD’s electoral support - ones carefully courted and won in the postwar period - were the unions and the workers of the Ruhr. Consequently under the control of this coalition the Land government developed an extensive and centralized industrial policy oriented to the particular needs of large, integrated firms and their workers that dominate in the Ruhr. Much of the state’s economic policies were intended to diversify the Ruhr economy primarily through the expansion of its physical and educational infrastructure. But this produced few visible results and state policy generally worked to preserve the hierarchical organization of production that predominated in the region.

A major instrument of state industrial policy is the Landesbank of North Rhine-Westphalia - the WestLB. By developing and using the capacities of the WestLB, including its ability to purchase large holdings of industrial stock, the Land government increasingly has been able to directly intervene in its economy in a relatively autonomous manner. In contrast to Baden-Württemberg, the comparative dominance of large firms and banks in North Rhine-Westphalia encouraged a form of government intervention to emerge that relies on bank control of selected firms. Via the WestLB the Land government has become increasingly important as a market actor in regional industrial finance, using the traditional institutional sources of bank influence to pursue its industrial policy goals.

Through the 1970s government intervention and the process of industrial adjustment in North Rhine-Westphalia was consistent with the tenets of the organized capitalism model to the extent that large, centralized actors frequently manage (or at least attempt to) the process of industrial change. But in the Land where hierarchy and bank dominance critically defined the patterns of industrial organization and business-government relations, there exists the possibility and actuality of divergence from this model.
In the 1980s the Land government moved toward decentralizing the economic policy making process to local actors, toward greater use of non-government organizations to formulate and implement policies, and toward more support for Mittelstand firms. In a dramatic turnaround from decades of traditional roles and processes, local governments, chambers, firms, banks and other actors in the Ruhr have launched countless cooperative initiatives aimed at promoting structural change. The dominant strategy has become that of fostering growth, jobs, and innovation by supporting the growth of the Mittelstand through the provision of collective goods. Several factors contributed to this transition in the 1980s, including the emergence of post-Fordism in the regional organization of production. Thus industrial governance regimes in North Rhine-Westphalia are beginning to look more like those of Baden-Württemberg - less hierarchy and less formal integration among economic producers. Though the particular institutional legacies and political constellation of North Rhine-Westphalia limit this sort of convergence.

This chapter continues with a brief discussion of the emergence of the Land government as an important state actor in the governance regimes of the regional economy. It then proceeds with a brief review of sectoral transformations in the coal and steel sectors. These cases demonstrate the limited powers of the major commercial banks and the growing state role in the economy. The chapter then focuses on the role of the Land government in the regional banking industry via its involvement in the savings bank sector. Finally, the chapter examines changes in the structure and organization of North Rhine-Westphalia's economy and the role that the Land government and banks are playing in this.

B. The Emergence of Land Government Intervention.

In 1945 and 1946 the Ruhr region was at the center of international politics as the
allies struggled over the future role of its critical industries. France demanded international control of the Ruhr to limit the power of Germany and assure itself access to critical raw materials. But the British and Americans followed different priorities in their approach to the Ruhr. After months of debate and negotiation the three western Allies agreed to establish a new German Land encompassing the Ruhr. Cobbled together from the Prussian provinces of the Rhine and Westphalia in 1946, the new Land of North Rhine-Westphalia became the largest in Germany.³

But the creation of a new Land did not automatically assure an effective Land government. The established communal and provincial state organs formed an effective political alliance and succeeded in negotiating with the British a markedly decentralized political-administrative system. Through the 1950s the Land government remained comparatively circumscribed in its autonomy by local, federal, and supranational political bodies. The weakness of the regional party system further inhibited the emergence of a strong Land government role in the economy. It was not until the late 1950s that the SPD and CDU emerged as the two dominant parties.⁴

³. For an excellent historical account of the early postwar period in North Rhine-Westphalia see Steininger, Rolf. 1990. *Ein neues Land am Rhein und Ruhr.* Cologne: W. Kohlhammer. The creation of two or three Länder of the territory that now comprises North Rhine-Westphalia was also considered. But popular and elite sentiment in the region seemed to favor the larger solution. The fact that the SPD would not have a majority in the larger solution may well have contributed to the U.S. decision in favor of it. (p. 264) Perhaps more important were geopolitical calculations. With the future of the Soviet zone uncertain, the establishment of a large Land in the West could serve one of two purposes: if a central government reemerged in Berlin, then a large, autonomous Land would help minimize the influence of the Soviets in the Ruhr and Rhine. If a western federal Germany emerged, then North Rhine-Westphalia would provide a cornerstone of the new federal state.

⁴. In the 1950 elections the Christian Democratic Party was the largest; but with only 36.9% of the vote it had to form a minority government with the catholic Center Party. In 1956 the government of Arnold fell on a vote of no confidence and was replaced by a coalition government including the Social Democrats (SPD), Liberals (FDP), and Center
External sources of constraint on the autonomy and capacity of the new Land government also remained strong. The overriding interest of outsiders in the coal and steel of the Ruhr was affirmed by the policies of the Allies and the new federal government in Bonn. Badly discredited by their support of the Nazi government, the coal and steel firms of the Ruhr were politically weak and faced serious challenges to their autonomy. Workers demanded they be "socialized." In an attempt to deflate the pressure for socialization several steel firms gave their workers codetermination rights in 1947. Still, in 1948 the parliament of North Rhine-Westphalia passed legislation - initiated by the SPD but with substantial support from the CDU - that provided for the socialization of the coal industry. But the Allies did not warm to this idea and gradually returned ownership of the firms to the previous shareholders, a policy supported by Adenauer. Thus by the early 1950s the threat to private ownership was averted. By transferring limited sovereignty to an international body, the accession of the Federal Republic to the ECSC pushed the question of the ownership of heavy industry even further out of reach. With the blessing of the ECSC and the federal government, the industrialists of the Ruhr were allowed to reestablish in large

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5. Rombeck-Jaschinski, Ursula. 1989. "Nordrhein-Westfalen im Nachkriegsdeutschland (1945-1958)." In Nordrhein-Westfalen und der Bund, ed. Hans Boldt. Cologne: W. Kohlhammer. The Minister-President of North Rhine-Westphalia, Karl Arnold, fought to get a seat with decision-making rights in the ECSC's high commission, but was forced to settle for observer status. Arnold found support from Bavaria in his efforts to prevent a redistribution of power from Land to federal government, but not enough from the other Land governments. Though with the formation of the EEC in 1957 all Land governments more actively sought to minimize their loss of sovereignty to the Federal government. (pp. 52-57)
degree their vertical and horizontal concentration and control over production.\(^6\)

Economic reconstruction and the outbreak of the Korean war placed great demands on the industries of the Ruhr and kept the federal government intimately involved in the economic management of the region. Under pressure from the Allies, the reluctant federal government passed the 1950 Investment Assistance Act and a special industry tax to divert private capital from other sectors to coal and steel. Still, between 1950 and 1954, 77% of long-term funds invested in these sectors came from the state.\(^7\) This suggests the state was far more crucial to the reconstruction of Germany's key industrial sectors - both as a provider of resources and through the preservation of private control - than the commercial banks. State policies forestalled pressure to change and critically aided the stabilization of the traditional economic structure and governance mechanisms of the region.

The economic miracle of West Germany in the 1950s, fueled by the coal and steel of the Ruhr, brought growth and prosperity to the region. The pressure of the early postwar years for direct state control of these industries was eased by the booming economy. With reconstruction completed by the mid-1950s the federal government, under the influence of its economics minister Ludwig Erhard, strived to construct markets and allowed private enterprise to largely retake control of the economy. Social partnership embodied in the institution of co-determination became the symbol of West Germany's successful postwar compromise between capital and labor. In economic policy the Land government of North Rhine-Westphalia adhered to the liberal principles of Erhard's 'social market economy.'

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\(^7\) Schaaf, 1978, op. cit., pp. 45-47.

The emergence of the coal crisis in 1958 was one of the first key tests of the federal government's commitment to liberalism. In the late 1950s the growing competitiveness of heating oil presented coal producers with tremendous pressures to reduce costs and capacity.\footnote{In 1958 Erhard liberalized the domestic oil market, thereby aiding the competitive advantage of heating oil and pressuring coal producers to cut output.} The federal government offered the industry some protection from imported coal and, after 1963, some financial incentives for rationalization. Erhard based the federal government's coal policy on his belief that the market, with some incentives to reduce overcapacity, could adequately deal with the industry's problems. The change in federal policy toward coal was dramatic: Up through 1957 the federal government was pushing the expansion of output. In the 1960s the federal government was actively promoting the closing of mines. The Land government introduced some coal assistance measures of its own, but largely deferred to Bonn.

This reliance on the federal government's market-oriented coal policy - probably perceived in North Rhine-Westphalia as passivity in the face of crisis - may well have cost the CDU control of the Land government. On the strength of its support among disgruntled voters in the Ruhr, the SPD closed the gap between itself and the CDU in the 1962 elections. The Land government of North Rhine-Westphalia implored the federal government to give greater priority to maintaining higher levels of coal consumption, but was unable to significantly alter Erhard's approach and unwilling to do more on its own. The CDU was
blamed by many for the problems of the Ruhr and rapidly growing federal subsidies could not stop the party’s slide.\textsuperscript{10} By 1966 annual subsidies to Ruhr coal had swelled to DM 2.5 billion, with only three percent coming from the Land government of North Rhine-Westphalia.\textsuperscript{11}

Traditionally dominated by the Communist and Center Parties, winning the Ruhr became a central postwar challenge for the Social Democrats. As the Communist and Center Parties faded in the 1950s, the CDU was able to gain the vote of many Christian workers.\textsuperscript{12} But by systematically building up a grass-roots network involving workers and unionists, and by championing the theme of industrial democracy, the social democrats turned the Ruhr into their stronghold. In the 1966 elections the SPD overtook the CDU for the first time as the largest party in the Land.\textsuperscript{13} After a few months of negotiation the FDP switched its


\textsuperscript{12} In 1954 the SPD received 43\% of the vote in the Ruhr; the CDU 34.7\%. In the 1958 elections the CDU increased its share of the Ruhr vote to 42.5\% and the SPD to 49.1\%. Both parties were able to make gains in the Ruhr as the votes of the collapsing communist and Center parties wandered to both the CDU and SPD. Bick, Wolfgang. 1985. "Landtagswahlen in Nordrhein-Westfalen von 1947 bis 1985: Trends und Wendepunkte in der politischen Landschaft." In \textit{Parteien und Wahlen in Nordrhein-Westfalen}, ed. Ulrich von Alemann. Cologne: W. Kohlhammer. pp. 203-208.

allegiance and formed a coalition government with the social democrats. Once in power the SPD sought to reward its supporters by publicly committing the Land government to responsibility for the more than five million inhabitants of the Ruhr. The deepening crisis of coal in 1966-1967 would test the strength of this commitment and the ability of the new ruling coalition to generate new policies that could affect long-term economic developments. More importantly, the coal crisis bared the weakness of organized capitalism and the commercial banks to manage dramatic sectoral transformation. The state pushed through the ultimate solution which, in effect, was de facto nationalization of coal.

*The Coal Crisis and the Social-Democratic Era.*

With emergence of the Grand Coalition in Bonn, and a social-liberal coalition in North Rhine-Westphalia in 1966, the political basis for the SPD’s Keynesian-inspired approach to economic management was set. The federal government, led by economics minister Karl Schiller, finally responded to the unions’ demands for a long-term coal plan. In March of 1967 Schiller brought together leaders of the unions and mining companies, officials from the Land governments of North Rhine-Westphalia and the Saarland, and economic experts for a series of negotiations known as the Concerted Action Coal. The unions first proposed the idea of consolidating all mines into one company. Schiller liked the idea and pushed it as a solution to the crisis. With growing pressure for consolidation the steel companies, which controlled much of the coal industry, became directly involved in the discussions. They came up with their own version of a consolidation plan known as the Rheinstahl Plan. After agreeing on the details, the federal government passed the Coal
Adjustment Act in 1968 based on the negotiated settlement of the Concerted Action Coal.\textsuperscript{14} The Act provided for the consolidation of the Ruhr mining companies on a voluntary and private basis into one conglomerate - the Ruhrkohle AG (RAG). The federal and Land governments guaranteed the corporation’s assets (up to DM 3.3 billion). The previous owners received RAG stock in proportion to the assets they contributed.\textsuperscript{15} The RAG began operations in 1970 with fifty-two mines, representing 75% of the Federal Republic’s coal output. This benefitted the coal and steel firms (and indirectly the major commercial banks) by saving them from having to close mines and write-off large losses. Though in order to remain economically viable it was agreed that coal production should be reduced according to a negotiated timetable. The coal talks also produced twenty year delivery contracts between the RAG and the steel and electric utility industries. This assured the RAG minimum sales quantity while assuring the steel and utility firms a steady supply of coal at world prices, since the state subsidizes Ruhrkohle to sell coal at a price well below its costs.\textsuperscript{16}

\textsuperscript{14} True differences did in fact proceed a settlement: the Land government and unions of North Rhine-Westphalia wanted a stronger social plan and codetermination measures, as well as greater efforts by the federal government to maintain higher levels of coal demand. The coal firms were also divided over the Rheinstahl Plan with firms more dependent on coal opposing those that were controlled by the steel industry (the Rheinstahl group included leaders of the Deutsche Bank and key national business associations, the BDI and DIHT). Schaaf, 1978, op. cit., pp. 280-290.

\textsuperscript{15} Roughly 60% of RAG’s capital was held by steel firms; another 30% by electric utilities. Since the federal government owned roughly 44% of VEBA, an electric utility, and VEBA owned 27% of Ruhrkohle, the federal government was in fact a major shareholder in Ruhrkohle. Schaaf, 1978, op. cit., pp. 316-320. Petzina argues that because of heavy state subsidization the RAG in fact represents a quasi-nationalized monopoly. Petzina, 1988, op. cit., p. 506.

\textsuperscript{16} The federal government pays RAG the difference between its production costs and the price at which it can sell. In 1986 a ton of coal cost DM 250 to produce but could be sold only at DM 200. See Brosch, Karl-Ernst. 1987. "Die staatliche Kohlepolitik." In \textit{Die}
In the 1970s the construction of the RAG proved faulty, as demand declined faster than expected and the firm continued to lose money. The owners, unions, and Land and federal governments had to negotiate several capital infusions to maintain RAG. Though Ruhrkohle nominally remained largely in private hands, it is so dependent on the state that it is for all intents and purposes a nationalized industry. The steel firms and the major commercial banks that were so heavily involved in them were thereby unburdened of a very troublesome problem by the state. This was not trivial assistance, as at the time several steel firms were facing considerable difficulties in steel markets and could ill afford to lose money through their coal operations. The late 1960s coal crisis also marks the emergence of the Land government of North Rhine-Westphalia as an influential economic agent. Following the lead of the social-liberal coalition in Bonn, the Land government of North Rhine-Westphalia adopted extensive structural policies consisting of regional, sectoral, and Mittelstand-oriented policies. The structural policy approach was intended to promote and guide the process of economic change in a manner that maintained the efficiency of private production while alleviating social hardship. In North Rhine-Westphalia regional and sectoral policies were given the most emphasis.

The first major regional policy initiative of the Land government was a special five-year Ruhr Development Program introduced in 1968. The program entailed a variety of new Land government initiatives, but it focused primarily on infrastructure development - transportation, schools, universities. By improving the infrastructure of the region the Land government hoped to improve the conditions for structural change and diversification away

from large-scale heavy industry through the development of new firms and industries. But diversification was slow and considerable effort was given by the Land government to propping up the coal industry. The coal policy of the Land government entailed extensive direct subsidies to RAG and other coal producers. Attesting to its growing importance, between 1967 and 1970 the Land government of North Rhine-Westphalia increased its share of state coal subsidies from 3% to just over 20%.18

The Concerted Action Coal came to be the model for numerous subsequent sectoral rationalization plans in the Federal Republic. In this new model of organized capitalism, the banks and firms were joined by the unions and governments in negotiating plans. Production usually remained in private hands, while the state, firms and banks would finance the restructuring and social plans to ease the economic hardship of the workers. But the sector that most reveals the limits of privately organized capitalism and the power of the major commercial banks, as well as the growing role of governments in sectoral governance and transformation, is steel.

*The State and Steel.*

In his seminal work Shonfield presented the rationalization measures of the steel industry in the early 1960s as a prime example of ‘organized private enterprise.’19

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17. In response to political pressure from other regions of North Rhine-Westphalia, in 1970 the Ruhr program was transformed into a Land-wide program with a five-year plan. The 1968 Ruhr program had a budget of DM 3.7 billion; the 1970 North Rhine-Westphalia program had a budget of DM 31 billion - primarily from the Land government, though the federal government also made a substantial contribution. See Schlieper, Andreas. 1986. *150 Jahre Ruhrgebiet: Ein Kapitel deutscher Wirtschaftsgeschichte.* Düsseldorf: Schwann. pp. 187-188.


Underscoring this portrait, in 1967 the big commercial banks rescued the giant steel firm Krupps from bankruptcy and aided its reorganization. In 1983 Zysman also cited the West German steel industry's ability to manage crisis without state subsidies as a tribute to the tutelary role of the big banks and the possibilities of "private collective management of industrial change". In the first few years following the onset of the world steel crisis in the mid-1970s the West German steel industry managed to modernize, reduce capacity, and shed tens of thousands of jobs. Thanks to successful social partnership with the unions, this process also occurred without substantial industrial strife. The German steel industry was one of the healthiest in Europe.

The relative success of German steel producers through the 1970s can be attributed to a significant degree to the cooperative strategy they pursued. Though the firms presumably could no longer create formal cartels, in the postwar period they continued to cooperate - often so closely that it in effect amounted to a cartel. In the 1966-1967 recession the German steel firms formed four regional cartels to stabilize markets and prices. Though technically not a formal cartel, these practices continued through the mid-1970s. Thus the

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ability of the industry to avoid catastrophic change was attributable in large part to its ability to organize a promotional network that entailed inter alia market sharing agreements and price coordination.\textsuperscript{24} What has often been overlooked, however, is the fact that many German steel firms relied on substantial state support intended to help stabilize the industry. From the Krupps bankruptcy in 1967 through the deepest crisis of the early 1980s the federal and Land governments where steel was produced increasingly subsidized these firms - some directly, others indirectly. At a minimum then, the management of crises in steel was hardly a pure case of private organized capitalism. Though when compared to other European countries, state subsidization was still relatively low through the late 1970s.

By the late 1970s conditions in the German steel industry had begun to deteriorate rapidly. Cooperation among the steelmakers was eroding as each firm sought to ride out the downturn in the hopes that competition would weed out the weaker steelmakers in West Germany and Europe. Though the German state had not been playing a dominant leadership role in its steel industry, by the early 1980s it became clear that none of the major firms and banks involved in the industry could provide the leadership - either alone or in consort - needed to orchestrate its orderly rationalization. As in the case of the coal industry, state involvement and subsidies eventually became crucial to the restructuring of steel.

Beginning in 1980 as series of "concerted negotiations" involving the firms, unions, and the federal and Land governments, including North Rhine-Westphalia, took place. Out of these talks came agreements from the federal and Land governments to provide subsidies to steel firms for research and development and pollution control investments, social assistance for laid-off workers, and job-creation programs. A special program for steel

\textsuperscript{24} The steel cartel of the European Community that helped limit competition among European producers surely also played a significant role.
regions was also added to the federal-Land joint-task regional program (GA) that provides tax incentives to steelmakers for investment in depressed areas.\textsuperscript{25} In the Saarland state involvement went even further. After pouring hundreds of millions of Deutsche marks into the firm Saarstahl, the firm was nationalized in 1986 with ownership divided between the federal and Saar government.\textsuperscript{26}

But these ad hoc measures were insufficient to deal with the long-term needs of the industry. At a critical juncture for the industry in 1981-1982, the major steelmakers were under strong pressure from the banks to negotiate a sector-wide rationalization plan. With billions of deutschmarks lent to the steel firms and the presence of representatives of all three big commercial banks in the supervisory boards of the five largest steel firms, the banks were presumably in a position to exercise a great deal of influence. In spite of this position, the banks' pressure on the steel firms to produce a sectoral plan failed. Various merger talks among steelmakers floundered. Instead each firm sought to enhance its own position in the market while lobbying for massive state aid. In the summer of 1982 the federal government faced demands from several large steelmakers for aid totalling DM 14 billion.

Seeking a solution to the crisis without taxing its budget, the new conservative-liberal coalition in Bonn formed a strategic alliance with the big banks, and instructed them to generate a private plan - without consulting the unions - that the state could back with DM 3 billion in subsidies. The bankers came up with a plan to form two steel groups or cartels - one in the Rhine and one in the Ruhr. But this too failed. The steel firms objected to the

\textsuperscript{25} In 1980 another five-year development program for the Ruhr had also just come into force. This program entailed funds totalling DM 6.9 billion, DM 5.4 billion from the Land government and the remainder from the federal.

\textsuperscript{26} Howell, et. al., 1988, op. cit. pp. 180-183. The state own 76% of Saarstahl, the remainder is owned by the Luxembourg steelmaker Arbed that also manages Saarstahl.
plan and formed effective counteralliances with their Land governments and the unions to defeat the plan of the federal government and commercial banks. The government of North Rhine-Westphalia opposed the plan for numerous reasons, including the belief that the Ruhr steel group would be the inherently weaker of the two. Subsequent merger or sectoral rationalization proposals also fell apart - sometimes due to intense conflict among the steelmakers to outposition each other, sometimes do to conflict among the federal and Land governments. For Land governments the first priority was to protect jobs in their territory. The federal government was concerned with saving as much of the industry with as little subsidies as possible - regardless of where jobs might be lost.

Thus the difficulty of resolving the steel crisis was compounded by growing tensions between the federal and Land governments - especially North Rhine-Westphalia. The root of this tension lies primarily in the collapse of the social-liberal coalition in Bonn and its succession by the conservative-liberal coalition. The conservative-minded federal government renounced the economic policies of the social democratic government in North Rhine-Westphalia as misguided. The new federal government was intent on reducing subsidies to private industry and initiated measures to this end. In response, the government of North Rhine-Westphalia accused the federal government of abandoning its responsibility to the Ruhr.

The Land government of North Rhine-Westphalia continued its Ruhr programs but an expansion of aid was limited by its burgeoning deficit. The cumulative burden of massive industrial aid in the 1970s was exacerbated by declining Land revenues in the 1981-1982 recession. In the mid-1980s economic growth in the Ruhr and North Rhine-Westphalia fell

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dramatically behind the rest of the Federal Republic. Predictions of the imminent collapse of the Ruhr were abundant. It seemed that many, including the federal government, had given up hope for the Ruhr and ceased to be concerned. When a new round of mass lay-offs in the steel industry were announced in early 1987, the isolation of North Rhine-Westphalia and the perceived indifference of the federal government seemed confirmed.

In early 1987 the Land government of North Rhine-Westphalia announced its latest multi-year Ruhr development program (ZIM). The Land government contended that the federal government was constitutionally obligated to finance two-thirds of the annual DM 500 million budget. But the federal government refused. When the steel firms announced the plant closures the Land government announced that it would raise its annual financial contribution to the Steel Program of the GA from DM 80 million to DM 180 million. Again the Land government demanded that the federal government do likewise, and again the federal government refused. In the following months tensions grew quickly in the Ruhr between the workers and the steel firms, and between the Land and federal governments. In September a corporatist solution negotiated among the traditional participants appeared to have resolved the conflict. But shortly thereafter it became known that three of the steel firms had secretly negotiated a plan that ran counter to that negotiated with the unions. Subsequently, workers began taking to the streets with a militancy not seen for quite some time in West Germany. Esser and Fach write, "The spontaneous occupation of the Krupp villa, the legendary temple of the grandeur of the German steel industry, symbolized the new radicalism. The disruption of the Krupp board of directors meeting was hardly less shocking: the protestors ate the bosses’ cold buffet and smoked their cigars."

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Some steel firms and members of the conservative-liberal government parties in Bonn wanted to make this latest social conflict a show of their political power. A Thatcher-like approach to industrial conflict resolution was advocated by many in this camp. But the federal government finally caved in to continued worker demonstrations backed by the demands of their union leaders and North Rhine-Westphalia’s government. Concerted action was revived in a series of regional and national steel conferences. The plant closings would go ahead as planned. In exchange, the big steel firms made a commitment to create new non-steel jobs in the Ruhr. The federal and Land government agreed that each, among other things, would contribute an additional DM 400 million over the next four years within the GA program. These funds would subsidize investments by non-steel firms in the Ruhr. Though the federal government still refused to contribute to North Rhine-Westphalia’s new ZIM program, the Land government proceeded with this initiative.

Thus in terms of rationalizing the steel industry, some modest results were finally achieved in 1988 when Krupp, Mannesmann, and Thyssen reached an agreement that reduced some steel capacity. But by and large steelmakers and the commercial banks have failed to generate a cooperative strategy to maximize the long-term prospects of the sector. The industry’s problems demonstrate that West Germany’s system of organized capitalism - particularly the presumed industrial leadership of the major commercial banks - has greater limits than is widely assumed. Bank “tutelage” in the industry could not produce a sectoral plan nor protect the state from demands for subsidies. In fact, sectors dominated by large firms and the banks may actually be more successful at gaining subsidies in times of dire


need as the coal and steel cases suggest. Such subsidies help reduce producer costs and thus relieve pressure to change. In effect, the state has done much to preserve a hierarchical organization of production in these sectors. Major changes in producer strategies - at least in coal and steel - are strongly affected by negotiations among the unions, firms, banks, and Land and federal governments. Attempts to implement major changes without agreement by any one of these set of actors have generally failed. Thus the state has been an important actor in the constitution of these sectors through the provision of resources and through the manipulation of property rights, such as its willingness to sanction quasi-cartels. But the state has also been important as an arena in which the various groups have pursued their conflicting strategies. The best example of this was the success of the unions and steel firms in allying with Land governments against the banks and federal government.

In contrast, the extensive rationalization of the clockmaking, clothing, and textile industries, which are characterized by a large number of smaller firms, proceeded without large amounts of direct government aid. Nor did this proceed according to some sort of sector-wide plan organized by major commercial banks and the industry's respective trade association. In short, in two sectors where the major commercial banks were heavily involved, they failed to provide the sort of industrial leadership or policy that the organized capitalism perspective suggests they would. In numerous other sectors the major commercial banks did not even attempt to assume such a leadership role.

These sectoral cases also testify to the growing economic role of the Land government of North Rhine-Westphalia. By building and maintaining its political base in the

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32. North Rhine-Westphalia had substantial clothing and textile industries that also underwent extensive change in this period. Esser and Fach, 1989, op. cit., pp. 246-247.
Ruhr, the SPD was able to gain power and implement more extensive structural policies guided by a philosophy of state planning within the parameters of the market. From 1966 to 1986 the Land government channelled DM 14 billion out of its budget to the coal industry alone. In the same period, the federal government invested some DM 28 billion, though DM 20 billion of this came directly from heating oil taxes.33

But the Land government did not restrict itself to subsidizing the privately-determined production strategies of major firms in the Ruhr. In the 1970s the Land government increasingly pursued its regional and sectoral policy aims through direct economic intervention. The Land’s capacity to affect producers’ decisions rested largely in its Landesbank - the WestLB. Beginning in the 1970s the Land government actively supported the expansion of the bank and frequently used it to support particular firms with loans or equity capital. The case of the WestLB is the most prominent example of how several Land governments have tapped the possibility for direct intervention in the affairs of industry presented by the West German system of universal banking.


Like the social-liberal government in Bonn, the Land government of North Rhine-Westphalia adopted an economic strategy based on structural policies formulated according to longer-term plans. In adopting structural policies the Land government did not seek to replace the market, but did believe that it could smooth the process of change and slow it where necessary for social reasons.34 The Land government attempted to steer and shape


34. See Landtag of North Rhine-Westphalia, Publication 7/4061 (16 July 1974).
market processes through altering incentives for firms and occasionally through direct intervention into markets. By the mid-1970s medium-term planning in the form of five-year programs found widespread favor.\textsuperscript{35} The unions provided the Land government with a solid base of support, even if its planning efforts did not go as far as they preferred.\textsuperscript{36} The pursuit of planning also meant substantial centralization within the Land’s political-administrative structure. Land ministries became the central coordinating instances for a wide range of policies and funds.\textsuperscript{37} Thus largely through the pursuit of structural policies the Land government centralized much control within the regional polity.\textsuperscript{38}

As argued in chapters 3 and 4, the banking system cannot be taken as an exogenous variable determining the pattern of government intervention and industrial adjustment. The case of the WestLB and Land government of North Rhine-Westphalia shows how the relationship between the two, as well as the WestLB’s relations to firms in the region, evolved through periods of conflict and negotiation between them. The interests of the bank and its managers did not always overlap with those of the Land government. The possibility for the WestLB to influence firm decisions directly through the traditional mechanisms of bank influence was preexisting, but the WestLB’s actual industrial policy role was not


\textsuperscript{37} For example, because the Ruhr was divided among more than one dozen political units, and because the Land government ignored proposals to create a strong regional Ruhr authority, regional policies for the Ruhr were largely developed and operated by the Land government.

\textsuperscript{38} On this point see Hüttenberger, 1985, op. cit., pp. 67-68.
inevitable and had to be constructed through the political will of the Land government. In this sense the Land government demonstrated considerable autonomy in its actions, utilizing existing institutions to create a new instrument for direct market intervention. In the 1970s the Land government and WestLB attempted to pursue a dominant role in leading the transformation of governance regimes in several regional economic sectors - coal, energy, and construction. But like the major commercial banks, they discovered that this was extremely difficult and that bank influence is likely to be consistently effective only on the individual firm level.

The Industrial Role of the WestLB.

In the early 1950s the Land government of North Rhine-Westphalia negotiated an agreement with its two regional savings banks association that permitted the government to buy into their respective girozentrale. Like other Länder, the government wanted to have a public bank at its disposal to handle financial matters on its behalf. Through the 1950s and 1960s the girozentrale administered some government business lending programs, but were otherwise not involved in the government’s economic policies. When the two girozentrale fused in 1969 the initiative came from the savings bank sector. After negotiating a settlement within the savings bank sector, Ludwig Poullain, head of the Girozentrale in Westphalia, teamed up with the Land's finance minister, Wertz, to persuade the Land government that a larger and more industrially active Landesbank would offer advantages to it and the regional savings bank sector.39 Once convinced, the Land government quickly moved enabling legislation through the parliament and the Westdeutsche Landesbank took form.40


40. Partisan conflict over the fusion was minimal, as suggested by the fact that the question debated most in parliament was the name of the new bank. See Plenary Protocol of
The ambitious new head of the bank, Ludwig Poullain, wasted no time in launching the WestLB into new markets. Poullain believed that an important function of all the Landesbanks was to provide a competitive counterweight to the big commercial banks. Poullain also wanted to make the WestLB a more profitable, competitive and influential bank. The WestLB’s goals were to increase its long-term industrial credits to large firms, to enter into international banking, and to begin acquiring shares in industry. The last two activities were controversial, and required significant public relations campaigns to assuage skeptical politicians and the fears of the public.

The WestLB argued that international banking was necessary for it to compete as a universal bank with the big commercial banks. Critics of this new role were concerned about the Land government becoming financially responsible for transactions conducted abroad, well beyond its purview. But the Land government supported the international expansion of the bank because it believed that its export-oriented economy could benefit from this.

But the most prominent and controversial new activity of the WestLB was its involvement in industry through shareholdings. Between 1969 and 1971 the WestLB purchased substantial holdings in several large firms. The bank itself claimed this new "industrial policy" was necessary to expand its market share and attain a better risk distribution in its portfolio by breaking out of North Rhine-Westphalia. Through the 1960s the Landesbanks formally held to a regional principle, doing business strictly within their home Land. But in practice this was gradually being eroded and by the early 1970s virtually all the Landesbanks were engaged directly and indirectly in national and international activities. The Landesbanks sought to be seriously engaged in business with large firms and

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the Landtag of North Rhine-Westphalia, 6/41 (22 October 1968).

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this compelled them to offer financial services that required more than a regional presence.\textsuperscript{41}

Poullain was also intent on breaking the cartel-like practices of the big commercial banks in underwriting, loan consortiums, and international business: By holding shares in a firm, the WestLB could demand a significant quota, if not the lead, in any underwriting consortium for that firm. After a year or so of resistance, the WestLB was accepted by the "big three" into the elite banking club.\textsuperscript{42} Finally, holding shares in industry was an important means for the WestLB to get other business with those firms, namely their borrowing and financial service business.

Pursuing an ‘industrial policy’ also had broader goals that were important to the more immediate interests of the Land government. Buying into firms would enable the WestLB to promote structural adaptation in North Rhine-Westphalia; to provide venture capital to promising firms in the region; and to bolster weak areas and markets within the Land by supporting troubled firms through capital infusions or preparing their merger with a stronger firm. At least in the beginning, the WestLB did not intend on using shareholdings to exercise an entrepreneurial (decisionmaking) function in the firms, but to support "promising" economic developments.\textsuperscript{43}

The first, largest, and most widely publicized purchase was 26% of Preussag - a conglomerate active in construction, energy and metals.\textsuperscript{44} The Preussag holding, however,

\begin{footnotes}
\item[41] The WestLB also purchased shares in banks outside of North Rhine-Westphalia so that it could more easily do industrial finance outside its home market without regulatory hindrance.
\item[42] Poullain, 1979, op. cit., p. 80.
\item[44] The Preussag holding was to serve as the cornerstone for the WestLB’s savings fund concept. The fund was intended to be like an American mutual fund: the bank would create a separate portfolio of holdings in firms - largely in Mittelstand firms - which the public
\end{footnotes}
became the very case in which the WestLB first came to exercise a tutelary role for an industrial firm. And it also became the first instance in which the Land government used this capacity of the WestLB to support its own economic intervention. In 1970 and 1971 Preussag's attempt to strengthen its balance sheet through diversification only led to a growing number of loss-making operations. Its share price plummeted and along with it the value of the WestLB's holding. In mid-1972 Poullain's patience ran out and he forced Preussag's CEO to resign. Poullain took over the chair of the firm's supervisory board in order to preside over a new strategy, namely to sell its loss-making divisions.

But one loss-making operation presented the WestLB with a dilemma: Preussag's coal mines in Westphalia were unprofitable, but it would be politically disastrous for the Land's industrial bank to "destroy" coal mining jobs. With the global energy crisis breaking out the Land government thought it prudent to save the mines and arranged for assistance to Preussag.45 As part of its "preference to coal" sectoral policy the Land government also made sure that the WestLB supported Ruhrkohle AG, even though the bank could have made a much better profit with its funds elsewhere.46 Thus the bank pursued its own interests, but also had to fulfill its political obligation to support industry in North Rhine-Westphalia, even if it did not represent the most profitable opportunity for the bank. As will be discussed below, over the 1970s the Land government and WestLB became increasingly involved in

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could then buy into. The fund idea was popular with the public, and Land and federal governments. But the fund was never realized because of legal factors that would have made it difficult, costly, and risky. The fact that many of these difficulties were known from the beginning suggests, as some suspected, that the WestLB may have been using the idea to silence the critics who saw its industrial policy as an attempt to concentrate more power in its hands. Girke and Kopplin, 1977, op. cit., pp. 66-68.


the coal and energy sectors.

Another sector where the Land government's policies combined with the public and commercial interests of the WestLB in an attempt to control its development was construction. Through its position as a Land, communal, and mortgage bank, the WestLB had longstanding and extensive lending engagements in the construction sector. In the early 1970s the bank wanted to apply its new industrial approach here as well in order to offer a more complete range of financial and other services in commercial, communal, and housing construction. The bank bought into numerous public and some private development corporations. The power of the WestLB to remake the Land's construction sector was further enhanced by its role in the distribution of public construction contracts. The WestLB also purchased holdings in construction firms in order to promote the development of construction technology, hold the line on wages, and to stabilize construction prices through various rationalization measures. By conducting market analyses the WestLB also sought to inject more systematic long-term planning into the construction markets. In effect, the WestLB aspired to achieve a position where it could lead a regional promotional network.

For the Land government there were also advantages to be gained from the WestLB's more extensive involvement in this sector. An orderly and stable construction market could only benefit its growing urban renewal and development programs. Even more important, construction is highly cyclical industry, as the 1974-1975 recession proved once again. As a sector dominated by small firms and providing hundreds of thousands of jobs, the Land government had much to gain if the WestLB succeeded in stabilizing employment in the industry.47 Thus the Land government and the WestLB came to be key actors in

constituting the construction sector’s governance regime.

But the WestLB and Land government soon discovered that their powerful position did not necessarily enable them to successfully guide the development of the sector. For example, in 1979 a scandal involving a large construction firm in the Land (Beton und Monierbau AG, BuM) broke. In the previous year the Land government, with approval of the parliament, had given a DM 80 million guarantee for a loan by the WestLB to BuM. The following year the firm went bankrupt and the WestLB was charged with having deceived the Land in order to save the bank’s loans and equity in Beton und Monierbau. The CDU charged the finance minister, and by implication the government, with complicity in this deception, incompetence, and misfeasance.48 Such episodes forced the Land government and WestLB to become more cautious in their approach to industrial intervention.

Nonetheless, by the mid-1970s the WestLB had radically transformed itself. The bank had opened several foreign branches and one-quarter of its balance sheet consisted of international activities.49 From its beginning in 1969 to the end of 1974, the WestLB increased the value of its equity holdings in other firms from DM 15 million to DM 791 million.50 Many of these early purchases were in large industrial firms. Though in the early 1970s the bank also invested capital in Mittelstand-oriented ventures such as the Land’s credit guarantee cooperative and economic development corporation. Most of the WestLB’s

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48. The affair was further colored by the WestLB’s lawsuit against the State Auditing Office for defamation. See Plenary Protocols of the Landtag of North Rhine-Westphalia 8/127 (8 February 1980), and 8/132 (16 April 1980).


engagements were initiated by the bank itself for a variety of business reasons. Even though the Land government typically denied that the WestLB was actively supporting its structural policies, several of the bank’s purchases were clearly made partly or primarily for reasons of structural policy. Preussag, for example, was seen as particularly important for the government’s coal policy. But in all cases the decision to buy shares in a firm necessarily involved the Land government through its representatives - most importantly the finance minister - on the bank’s administrative board. Thus if the government was not always using the bank as an instrument of industrial policy, it was always in a position to veto major bank decisions.

The commitment of the Land government to the new activities of the WestLB was strongly tested on several occasions during the 1970s. In 1973 several of the industrial purchases of the Landesbanks - especially in Hessen and Lower Saxony - went sour. These banks, and indirectly their governments and taxpayers, were forced to overs large financial losses. The WestLB also had some smaller engagements that failed, but it was rocked mostly by the loss of DM 250 million in 1974 in currency trading. These spectacular losses drew national attention to the Landesbanks and stirred much debate about the merits of their new activities. The Landesbanks, including the WestLB, were criticized for their risky ventures in international finance and industrial engagements. Many argued that the banks had bought into high-risk, low-margin business in order to expand into markets where they had few skills and still fewer reasons to be.

The Landesbank of Hesse subsequently sold its loss-making industrial engagements.

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But the WestLB saw no reason to reorient its strategy and maintained that its holdings in industry were beneficial for the regional economy.\(^{52}\) The Land government agreed with this position and stood by the bank.\(^{53}\) To underscore its commitment and involvement in the bank, after 1975 the government put more ministers on its administrative board. Even in the face of heavy criticism from the public, the political opposition, and the commercial banks the Land government saw no reason to scale back the WestLB’s activities - it was already far too important for the government’s economic policies. The readiness of North Rhine-Westphalia’s government to back the WestLB had implications well beyond its borders. The WestLB was the premier Landesbank leading all the savings banks toward a greater market orientation. If the Land government had backed down, competition in the German banking industry would most likely have suffered considerably.

Several observers have noted that the Landesbanks became increasingly politicized since the mid-1970s and conflicts of interest inherent in the structure of the banks came to hamper their effective operation: First, Land governments began to load the Landesbanks’ boards with politicians who had little bank experience; second, big losses by the banks became scandals subject to partisan conflict in election campaigns; and finally, the governments as regulators of their regional savings bank sector were responsible for the long-term viability of the banks, but as owners they also used the banks to engage in risky business for economic policy reasons.\(^{54}\) In sum, the 1970s became a period of struggle in North Rhine-Westphalia and other Länder to find an agreeable balance between the

\(^{52}\) Girke and Kopplin, 1977, op. cit., pp. 92-95


commercial interests of the banks and the policy interests of the Land governments.

In North Rhine-Westphalia Ludwig Poullain began to find political control of the bank an inevitable but increasingly bothersome factor.55 His attempt to circumvent the political control of the Land government in 1977 only intensified the desire of the Land government to extend its control over the bank.56 The agitated Minister-President Kühn immediately sought to gain more oversight and control over the bank by forcing the provincial associations to sell their equity in the bank.57 While the Land government supported the international activities of the bank, it wanted to ensure that it would have a greater role and not be circumvented. The provincial associations were outraged and charged that it was the Land government - not they - that had brought trouble to the bank, and promptly refused to sell-out. The Land parliament also decided at this point that it too should be more involved in supervising the bank.58 But this political struggle over the bank ended without any major shift in control between these political institutions. Even before the dust had settled on this matter, it was quickly overshadowed by a new scandal.

In January of 1978 Poullain was forced to resign under charges of impropriety.


56. In 1977 Poullain bought land in London to be used for the WestLB’s new branch, without consulting the Land government. He had discovered that with the complicity of the government’s representatives on the bank’s board, the support of the representatives from the savings bank and provincial associations was sufficient to make major decisions without informing the government itself.

57. There are two provincial associations (Landschaftsverbände) of communal governments in North Rhine-Westphalia. These associations provide some services to local government but generally have a minimal role in the Land’s political-administrative system, though each association held 16.7% of the WestLB’s equity and were therefore represented in its decision-making organs.

Poullain had accepted fees from a business partner and client of the bank. Poullain contended they were legitimate consulting fees, his accusers saw them as bribes. An investigation by the Land parliament concluded that, legal or illegal, it was an improper act and Poullain’s removal was therefore warranted. But the political pressure was not limited to Poullain. The Minister-President Kühn and his finance minister Halstenberg were charged with attempting to cover up the internal doings of the WestLB and the investigation into Poullain’s activities. Shortly after Poullain’s resignation the finance minister followed. The bank scandal required a political sacrifice.

Yet neither this nor the BuM scandal in the following year deterred the Land government from using the WestLB as an instrument of economic policy. There was wide agreement that a more effective supervisory process was needed, and to this end the Land government and parliament initiated a commission. But most important for the government and all the parties in the parliament was that, regardless of who was responsible for the problems of the bank, the WestLB should get out of the national and international headlines as quickly as possible in order to minimize damage to the bank’s image and therefore its business. Even the CDU in North Rhine-Westphalia no longer questioned the bank’s activities or state-ownership per se, only the manner in which the government operated the bank. By the late 1970s the industrial role of the bank had withstood several attacks and acceptance of this new role - in the political arena and the marketplace - was firmly

59. Poullain himself apparently claimed he was removed because he resisted the government's efforts to politicize the bank. See Publication of the Landtag of North Rhine-Westphalia 8/4557 (22 February 1979), p. 24.

entrenched.\textsuperscript{61}

Thus after a decade of active industrial intervention by the WestLB under the auspices of the Land government, the union between the two was firm. But it was clear that not only did the supervisory process need improvement, the bank itself needed to rethink its strategy. In the 1970s the WestLB grew strongly, but not as fast as its chief domestic rivals - the big commercial banks. In 1980 the bank was unable to pay a dividend and the next few years did not look promising. In 1981 the bank's profits dropped 30\% and its owners had to kick in more capital or the bank would be forced to sell some assets. While the big commercial banks had a difficult year as well, the WestLB’s poor results were attributed by many, especially its managers, to the low-profitability or even loss-making business that the bank did on behalf of the Land and local governments. Many politicians blamed the managers and called for more state control over the bank. Others floated the idea of privatizing it.\textsuperscript{62} Towards the end of 1981 a new compact between the WestLB and the Land government began to emerge with the appointment of Friedel Neuber to head the bank.

Neuber reorganized the bank and announced that decisions to purchase holdings in firms would henceforth be made with greater consideration of profitability and less consideration of the Land government's structural policy requirements. Still burdened with vestiges of its pre-1969 civil service bureaucracy, Neuber eventually went outside to hire the industrial management experience that the bank still seemed to lack. This was intended not so much to enable the WestLB to influence firm decisions, but to help the bank better assess

\textsuperscript{61} Support of the government and parliament for the WestLB is also verified by their willingness throughout the 1970s and 1980s to repeatedly raise the equity capital of the bank using funds from the Land's budget.

the prospects of its engagements. The Land government was willing to let the bank orient its operations more toward market requirements, yet by no means did this mean the end of the WestLB as an instrument of economic policy. This role of the WestLB, in fact, expanded further in the 1980s. This was possible in part because the Land government showed greater self-restraint in not forcing the bank into engagements with little or no hope of eventual profitability. The new working relationship between the bank and the Land government kept both intimately involved in the affairs of regional industry.

As part of its policies to stabilize Ruhr industry, over the 1970s and 1980s the Land government and WestLB came to be intricately involved as major actors in the various networks of interlocking shareholdings and directorates within and among the coal, steel and energy sectors. In so doing, the Land government and WestLB have been able to influence the strategies of producers in these sectors. For example, in early 1982 press reports indicated the Land government and WestLB were planning to build a large holding company of energy-related firms. The WestLB, the public sector, Ruhrkohle, and some steel firms were all supposed to bring shares of Ruhrkohle and several electric utilities into the holding. Since North Rhine-Westphalia accounts for roughly half of the Federal Republic’s energy production, if such an energy holding had coalesced the Land government would have been in an even stronger position to control or influence the energy sector, in particular the market for coal. The Land government denied that it had such a plan, though in fact a smaller

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version of this plan had already been realized, with nothing preventing its future expansion. Later, in 1984, several steel firms were interested in selling the Ruhrkohle holdings and the most interested buyers were the electric utilities. The Land government welcomed the utilities' interest in coal but was concerned that Ruhrkohle maintain a balanced distribution of ownership for fear that it could become a slave to one industry. Consequently the Land government instructed the WestLB to start purchasing more shares in Ruhrkohle.

The Land government has apparently also been prepared to get more directly involved in the steel industry if it saw developments adverse to its interests. The WestLB was ready to acquire a holding on a trust basis for a "third party" - such as the Land government - in the proposed Ruhr steel holding company being discussed in 1982. At the end of 1991 the steelmaker Krupp successfully completed a hostile takeover - a rare event in West Germany.

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64. The WestLB had placed its Preussag and VEW holdings into an energy holding. In the proposed expanded holding, the bank would contribute its holdings in Preussag and VEW, a large electric utility, and the public sector would contribute shares in VEW and RWE, another utility. The Land government would then induce the Ruhrkohle AG to contribute 6% of its own shares. The steel firms Hoesch and Krupp apparently were already interested in selling their combined 14% share in Ruhrkohle, and would contribute this to the holding company as well. See Publication of the Landtag of North Rhine-Westphalia 9/1568 (26 March 1982).


66. The government also encouraged the chemical giant BASF to acquire a holding in the company in order to encourage greater use of coal in the chemical industry. See Plenary Protocol of the Landtag of North Rhine-Westphalia, 9/98 (15 May 1984), pp. 5834-5835.

Germany - of Hoesch, a fellow Ruhr steelmaker. The takeover was secretly masterminded by Krupp boss Gerhard Cromme and Friedel Neuber, head of the WestLB and chair of Krupp's supervisory board. In the year leading up to the takeover Krupp secretly acquired 24.9% of Hoesch's voting stock. With another 30% of Hoesch's stock controlled by the WestLB and a Swiss bank, Hoesch's managers had little chance to mount a defense.68

But the WestLB did far more to make the takeover possible than simply throwing its vote behind Krupp. Over several years preceding the deal Neuber managed to displace the Deutsche and Dresdner banks as two of Krupp's major house banks. The Deutsche bank was also Hoesch's chief house bank and controlled the chair of Hoesch's supervisory board. Hence the takeover of Hoesch by Krupp proved to be an embarrassment for the Deutsche bank as it knew nothing of the mounting attack until the conclusion was foregone. Since the WestLB controls 40% of Preussag, which owns another one of Germany's major steel producers (Salzgitter), the Krupp/WestLB alliance has assumed a powerful position within the German steel industry. Cromme and Neuber apparently are hoping to further extend their growing influence by taking over eastern Germany's largest steel firm, Eko Stahl.69

Rightfully fearing lost jobs, workers in the Ruhr complained to their Minister-President, Johannes Rau. Rau claimed the Land government was not involved but it is extremely unlikely that the Land government was unaware, and therefore impartial, in the WestLB's major share transactions. Moreover, Rau sits on the board of the Krupp Foundation, which controls 75% of the Krupp concern, thus providing further evidence that

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Rau and top Land government officials were important actors in the takeover.\(^\text{70}\)

Consequently the Land government's policies for the coal, energy and steel sectors - all vital to its economy - constitute more than the absorption of the costs of adjustment by the state. Through direct involvement of the government itself via the WestLB's holdings in important firms the state can be a strategic actor in the transformation of market structures. Though the Land government and WestLB may not dominate the evolution of these sectors, it seems clear that the commercial banks no longer can either. Still, the North Rhine-Westphalians have demonstrated an ability to influence, in some cases strongly, the strategic choices of producers in these sectors and the nature of the relations among them. They have also shown they can compete with the major commercial banks for such influence in industry. And neither have the Land government and WestLB limited their industrial role to these sectors. In numerous other cases they have shown readiness and the capacity to intervene when the Land's interests are at stake.

For example, in 1990 Germany's largest charter airline, LTU, seemed on the verge of moving from Düsseldorf to Munich, no doubt with encouragement of the Bavarian government. The jobs of LTU were important to the Land government, but LTU was also a critical part of the government's long-term plans to build up the Land as a center for air traffic in Europe. To preempt this move the WestLB, acting with the support of the Land government, purchased a controlling interest in the firm.\(^\text{71}\) And in early 1991 a Swedish firm wanted to sell off parts of the Feldmühle concern in North Rhine-Westphalia.

\(^\text{70}\). "Eine feindliche Übernahme" Der Spiegel, 14 October 1991.

\(^\text{71}\). The active support of the Land government for the LTU purchase was confirmed in an interview in the Finance Ministry of North Rhine-Westphalia in August 1990. Also see "Die WestLB zieht es in die Flugtouristik," Frankfurter Allgemeine Zeitung, 14 December 1990.
Concerned that a break up of Feldmühle would threaten 20,000 jobs in North Rhine-Westphalia, the Land government and WestLB formed a coalition with the unions and managing board of Feldmühle in an attempt to purchase a controlling share of the firm. But other buyers were interested in Feldmühle, notably a group that included the Deutsche and Dresdner banks. After months of negotiation the commercial bank-led group beat out the WestLB and its coalition. But the ultimate sales agreement suggests that the WestLB and Land government may have been able to influence the deal, since the unions and managers at Feldmühle reportedly expressed satisfaction with the outcome.\textsuperscript{72}

Hence, even when the North Rhine-Westphalians lose a battle for control of a regional firm, they have proven they have considerable capacity to protect regional interests. It seems that the greater concern for sound business decision-making in the WestLB not only enhanced the bank’s competitiveness, but also its utility to the Land government by making it a more efficient institution. Indeed, in 1986 the WestLB announced a long-term strategy to build up its equity holdings in industry in order to compensate for declining lending business. And the WestLB held to its plan: In 1990 the WestLB bought thirty and sold eighteen holdings in firms, raising the total value of its holdings to DM 3.2 billion - a level comparable to the Dresdner and Commerzbank.\textsuperscript{73}

In the 1980s the Land government repeatedly demonstrated its commitment to the commercial expansion of the WestLB. Because the financially strapped local governments


\textsuperscript{73} "WestLB: Europastrategie kommt gut voran," \textit{Frankfurter Allgemeine Zeitung}, 17 May 1990.
had not been willing to keep up with necessary capital increases, the Land government was able to raise its share of the WestLB’s equity from 33% to just over 43%.\textsuperscript{74} With the provincial associations now holding less than 25% of the bank’s equity, effective control is shared between the Land government - the largest shareholder - and the regional savings bank association. And when the Land government’s own pockets are empty, it has been willing to risk political capital for the bank’s expansion.

In 1988 the Land government transferred several economic grant and lending programs from its ministries into a new Investment-Bank (IB) division of the WestLB. For the Land government it promised a more efficient execution of its policies with less direct political interference. For the WestLB it provided more business. For the other banks in the Land it constituted an unfair advantage for the savings banks since one of their banks - the WestLB - would be in charge of administering governments grants and loans to firms for which all banks compete. Despite continuing political challenges by the Land’s other banking groups the government has not rescinded this measure.\textsuperscript{75}

With the approval of the Land government, in 1989 the WestLB made a major push to expand its international capabilities with the purchase of the European branches of the British Standard Charter Bank. This merger was considerably expensive and controversial within North Rhine-Westphalia. But the Land government was convinced that the cost was

\textsuperscript{74} In line with new EC requirements, the Land government announced that it would raise the banks capital because the bank’s role in the economic development of the Land economy makes the bank in the "elementary interest" of the government. "Nordrhein-Westfalen prüft Kapitalerhöhung bei der WestLB," \textit{Frankfurter Allgemeine Zeitung}, 18 March 1991.

justified by the potential benefits for regional firms.\textsuperscript{76}

It has frequently been argued - especially after scandals - that public control of the Landesbanks is detrimental to the banks. And it has been argued that the interests of both the Landesbanks and Land governments would be better served if they had a much more distant relationship.\textsuperscript{77} The fact that in the 1970s and 1980s the Landesbanks generally performed more poorly than their commercial counterparts in terms of profitability added considerable weight to this argument. When talks among the Landesbanks in 1988 and 1989 failed to produce a major Landesbank fusion, the Länder were accused by many in the banking community of pursuing their narrow regional political interests over the interests of their banks. Some called for the Land governments to get out of the Landesbanks, and shortly thereafter the Land government of Hesse sold its interests in its Landesbank to the Hesse savings bank association.

But the Minister-President of North Rhine-Westphalia, Johannes Rau, made clear that his government would not only keep control over the WestLB but wanted to increase the

\textsuperscript{76} But to finance this and keep growing the bank needed more capital. Thus in 1991 the Land government attempted to merge its housing finance agency with the WestLB. This would have nearly doubled the equity of the WestLB, creating a tremendous potential for expansion. But this time outrage from the cooperative and commercial banks has not been limited to North Rhine-Westphalia. The national banking establishment has joined the ranks of protestors who claim that capital accumulated in a tax-free institution should not be transferred to a bank engaged in market competition. "Banken gegen weitere Begünstigung der WestLB," \textit{Frankfurter Allgemeine Zeitung}, 16 March 1991; "In aller Stille," \textit{Der Spiegel}, 26/1991, pp. 101-103.

\textsuperscript{77} In a detailed study of the Landesbanks Korbach concludes that the interests of the banks and Land governments are incompatible and each would be better served if the banks were privatized or returned to their more restricted role as before the late 1960s. Korbach, 1986, op. cit., p. 212-228.
bank's economic policy role even more.\footnote{\textit{Die Steine kommen durch den Ausstieg des Landes Hessen ins Rollen," Handelsblatt,} 19 June 1989. The Land governments of Hesse and North Rhine-Westphalia were in principle ready to merge their Landesbanks in late 1988 but could not agree on the asset value of Hessen's Landesbank. For North Rhine-Westphalia this merger would have represented a "coup", giving the WestLB a powerful presence in the nation's money capital - Frankfurt. The ultimate perception in Hesse that the bank fusion was becoming less a merger and more of a takeover by outsiders undoubtedly helped scuttle the deal.} Thus whether the bank's profitability suffered from government control or not, the WestLB has become an essential, and perhaps even the most important, economic policy instrument of the government. Given the prominence and leadership role of the WestLB within the savings bank sector, the position of the Land government of North Rhine-Westphalia on such issues is an important factor in determining the future direction of the public banking sector.

The shift in economic policies of the Land government in the 1980s toward more indirect promotion of Mittelstand firms has not diminished but expanded the role of the WestLB in the region: In the 1970s the WestLB built up its 'tutelary' role vis-à-vis firms, frequently doing so under considerations of structura: economic policy. In this role the Land government and WestLB attempted to influence the process of change in critical regional industrial sectors. In the 1980s and 1990s this tutelary role is augmented by an increasingly important 'subsidiary' role in which the bank uses its financial muscle, know-how, and international network to support Mittelstand firms in North Rhine-Westphalia. Thus the WestLB is being used increasingly to promote smaller firms and cooperation among them via obligatory and promotional networks. It does this through direct financing of Mittelstand firms, but also indirectly by supporting other regional organizations that comprise Mittelstand promotional networks. This new strategy of the Land government reflects a conscious recognition of the limited benefits of preserving traditional industrial hierarchies in the
region, as well as the potential gains from promoting re-industrialization on a more
decentralized pattern.

D. Changes in the Organization of Production and Bank-State-Industry Relations.

In the 1980s a new direction in the Land government's economic policies emerged.
The government turned increasingly toward policies in line with the Mittelstand promotion
models of the southern German states. These new policies indicated a movement away from
the emphasis on centralized sectoral structural policies pursued predominantly in the coal and
energy sectors since the late 1960s. Their adoption can be attributed to several factors:
First, the change was driven in part by the Land government's rapidly growing deficit, due
in good measure to its Ruhr subsidies. It was clear that after pumping billions of
deutschmarks into the Ruhr the loss of coal and steel jobs had only been slowed while too
few new ones had arisen to take their place. In spite of a conscious effort to promote such
structural change the diversification of the Ruhr was proceeding very slowly. Second, the
lesson was not lost on the government, unions, and other key social groups that jobs were
being created to a large extent in smaller firms in other sectors and other regions of the
Land. Thus Mittelstand-oriented policies were developed to reinforce these changes in the
organization of production. And finally, the runaway economic success of the southern
Länder fueled the belief in North Rhine-Westphalia that the government must do more to
stimulate the growth and creation of Mittelstand firms.

As the case of Baden-Württemberg will show, this model of firm promotion can be
done effectively and with a lower cost to the government by supporting firms indirectly
through aid to private and quasi-public organizations that provide production-oriented services
and goods. In so doing the government is expanding the scope and intensity of resource
exchange within regional promotional networks. More organizations, especially ones with a local focus, are being incorporated into these networks. In this sense North Rhine-Westphalia is becoming more like Baden-Württemberg. But the degree of convergence is limited by several factors including the preferences of the dominant groups in North Rhine-Westphalia's ruling coalition and the disposition of regional institutions to centralized control. This new direction in economic policy is symbolically reflected in a change of government rhetoric from 'planning' and 'steering' to 'decentralization' and 'endogenous development.'

*The Changing Structure and Organization of the Regional Economy.*

In the 1950s North Rhine-Westphalia was the premier industrial region of West Germany. Its coal and steel were critical inputs to the reconstruction of West Germany and West Europe. But by the late 1950s cheap oil began to replace expensive coal - a process encouraged by the Federal government in spite of its implications for the Ruhr. Of the more than 600,000 coal miners in 1957, just over 250,000 were still employed in 1970 - eventually dropping to under 150,000 by 1989. In spite of this precipitous plunge, the economy of North Rhine-Westphalia managed to grow in the 1960s at a rate only slightly below the national average. But just as the coal crisis seemed under control, crisis in the steel sector began to emerge. In the steel sector employment declined from 375,000 workers in 1970 to 288,000 by 1980; and to 181,000 by 1988. Even so, in 1987 roughly 45% of industrial employment (mining and manufacturing) was still in the coal and steel sectors.\(^7^9\) Through the 1970s the Land's growth rate had only slowly fallen behind the national average. But in the 1980s North Rhine-Westphalia fell far behind, seemingly uncoupled from the rest of the nation that began to boom in 1984 (see table 6.1). Largely as a result of the coal and


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steel crises North Rhine-Westphalia’s share of national gross domestic product dropped from 31.9% in 1950 to 26.1% in 1988.\textsuperscript{80}

Outside the moribund Ruhr region, however, the rest of North Rhine-Westphalia presents a much more stable and average economic profile. Table 5.2 shows a relative shift within North Rhine-Westphalia’s manufacturing sector away from traditional primary and producer goods (with the exception of chemicals) toward more investment goods production. Thus in its industry structure North Rhine-Westphalia is becoming more like the rest of the nation, though it remains distinct. The service sector now accounts for far more employment than industry. The contrast with Baden-Württemberg is notably stark (Table 6.1).

Overall, North Rhine-Westphalia accounts for 27.7% of total national sales in the mining and manufacturing sector. In all major branches within this sector North Rhine-Westphalia’s national share is greater than 27.7%, except in electronics and motor vehicles.\textsuperscript{81} In this respect North Rhine-Westphalia is the mirror image of its two fast-growing southern rivals - Baden-Württemberg and Bavaria - where electronics and motor vehicle production constitute a disproportionately large share of total output. Just as the dominance of heavy industry shaped early Land government economic policies, this weakness in the electronics sector and the low research intensity of firms in North Rhine-Westphalia were important factors shaping North Rhine-Westphalia’s economic policies in the 1980s, especially the intensification of the Land government’s technology policies.


\textsuperscript{81} North Rhine-Westphalia’s share of total national turnover in these two sectors is 15% and 18.4% respectively. Lamberts, Willi. 1988. "Die gewerbliche Wirtschaft Nordrhein-Westfalens in der Bewährung." In Die Wirtschaft des Landes Nordrhein-Westfalen, ed. Ludwig Bussmann. Cologne: W. Kohlhammer. p. 73.
The growing emphasis in Land government economic policy on the Mittelstand and promoting multilateral exchange strategies is correlated to actual changes in the organization of production in the region. Two key indicators of change in the organization of production are the size distribution of firms and the type of relations existing among firms. In terms of the size-distribution of production among firms, North Rhine-Westphalia is following what appeared to be a national trend in the 1980s toward smaller firms. From 1975 well into the 1980s the number of registered firms increased at a steadily growing rate, while total employment declined. The majority of these new firms have been in the service sector. The shift from mining, primary and producer goods to investment goods is also helping to reduce the overall level of economic concentration in North Rhine-Westphalia, since investment goods production tends to occur in a wider distribution of smaller firms. Thus even manufacturing appears to be more decentralized in the 1980s than in earlier years.

A study by Albach shows that the number of manufacturing firms with more than 20 employees in North Rhine-Westphalia rose from 26,023 in 1978 to 27,352 in 1984. Since total industrial employment declined in this same period, the average manufacturing firm dropped from 83.3 employees to 69.3. 82 The Land government claims that the number of industry firms with less than 20 employees increased 1,471 between 1977 and 1986 to 16,594. 83 Albach notes that many of these firms were established by former employees of large firms in the region (which also encouraged this) in order to provide their former employer with specialized production or production-oriented services. This type of

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decentralization of production and supplier-contractor relations is consistent with the post-Fordist model of production. The case of the turn-key plant construction industry is a prime example of this decentralization process in the Ruhr.

Several of the huge industrial concerns in the Ruhr, especially the big steel firms such as Krupps, have diversified into the construction of turn-key plants.\textsuperscript{84} In this industry one producer organizes the production of ready-made production complexes such as power plants, steel, and chemical factories. But unlike in the past, when large firms centralized production within their vast empires, in this industry the large concerns of the Ruhr play the role of "general contractor." They offer integrated system solutions to their customers - from manufacturing to maintenance to finance - but rely on a host of other smaller firms to provide the individual components.\textsuperscript{85} According to one estimate, by 1981 this industry already employed in the Ruhr some 60,000 workers directly and another 350,000 to 500,000 workers in supplier firms.\textsuperscript{86}

This case exemplifies what appear to be broader changes in the mix of governance mechanisms operative in the regional economy. Traditionally, the small firms of the Ruhr were heavily dependent on the large firms, rigid-hierarchical relations in which the large dominated the small were typical. Now many small firms are thriving and inter-firm

\textsuperscript{84} In 1990 turnkey plant construction accounted for 14% of revenues; machinery production accounted for 21%; and steel production for 50%. "Krupp scheint nach Generalüberholung wieder flott," Frankfurter Allgemeine Zeitung, 4 July 1991.


networks based on non-authoritative cooperation are beginning to form. Many of the smaller supplier firms of the Ruhr are finding new markets, thereby decreasing their dependence on a few large firms.\textsuperscript{87} But the revival of the Ruhr is by no means certain. Many of the Mittelstand firms still remain highly dependent on the large firms and the overall level of R&D activity in Ruhr Mittelstand firms remains comparatively low.\textsuperscript{88} The provision of production oriented services and critical business information for Mittelstand firms are also comparatively weak.\textsuperscript{89}

Thus there is an important deficit in the institutional environment that enables smaller firms and multilateral production strategies to thrive. It is exactly this deficit that the Land government is seeking to close with its new Mittelstand policies. By involving local actors in its technology policies the Land government is seeking to stimulate the creation of local networks - networks of firm cooperation and networks of cooperation among local governments and other organizations that can help firms locate and mobilize resources. Rightly or wrongly, the Land government's economic policies have been strongly influenced by numerous ideas of post-Fordist production.\textsuperscript{90}


\textsuperscript{90} The Land government has written explicitly about building networks through technology policy. For example see Publication of the Landtag of North Rhine-Westphalia, 10/3552 (p. 22).
In chapters 3 and 4 it was argued that all of the banks have increased their mediator role. In so doing they promote smaller firms and post-Fordist production strategies. It was also argued that the savings and cooperative banks were successful in the 1970s and 1980s in large part because of their focus on the Mittelstand. But in North Rhine-Westphalia the historic dominance of the major commercial banks limited the expansion of these other bank groups. This was the case in large part because of the relatively small number of Mittelstand firms in the Land, especially the Ruhr. The savings banks profited from the payroll and savings deposits of factory workers, but the dearth of entrepreneurs meant relatively few cooperative banks were formed in North Rhine-Westphalia. In Chapter 3 it was noted that roughly 40% of big commercial bank branches were located in North Rhine-Westphalia in the early 1960s. In 1987 these banks still had 36% of their branches in the Land, even though North Rhine-Westphalia accounted for only 26% of national GDP. While this says little about the actual regional market share of the big commercial banks, it clearly suggests that their traditional dominance in North Rhine-Westphalia remains intact. In this regard North Rhine-Westphalia is therefore also quite distinct from Baden-Württemberg, as presented in the next chapter.

However, savings and cooperative banks have been more successful in regions of North Rhine-Westphalia were production was traditionally done in smaller firms, such as the Bergische and Siegen regions. In these areas the savings and cooperative banks have historically played the critically supportive role within local obligational and promotional networks that their counterparts in Baden-Württemberg have. Though unlike Baden-Württemberg, this has not precluded the major commercial banks - notably the Deutsche - from playing an important role for Mittelstand finance. As noted above, through its takeover of a regional bank in the early twentieth century the Deutsche Bank established an extensive
network of Mittelstand customers in the Bergische region. Today the bank’s Wuppertal office - the capital of the Bergische region - has the largest credit volume of its fourteen regional offices.\footnote{Regional bank official directors also sit on the advisory boards of several larger Mittelstand firms in the region. Eglau, 1989, op. cit., pp. 251-252.}

But just as the Land government supported the growth of the WestLB in order to challenge the commercial banks for business and influence with larger firms, in the 1980s the Land government undertook numerous measures to increase the competitiveness of its savings banks for industrial finance with Mittelstand firms. The most important measures were key regulatory changes that expanded the permitted activities of the savings banks and the utilization of the WestLB to provide individual savings banks with more resources. Thus the government’s banking policies are also designed to flank its Mittelstand promotion strategy.
Table 6.1.
Selected Länder and Federal Economic Data.

<table>
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<tr>
<th></th>
<th>NRW w/o Ruhr</th>
<th>NRW</th>
<th>RUHR</th>
<th>FRG</th>
<th>BAV</th>
<th>B-W</th>
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<td>(1988 mio.)</td>
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<tr>
<td>% of workforce</td>
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<td>40.4</td>
<td>41.8</td>
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<td>% of workforce</td>
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<td>54.5</td>
<td>49.2</td>
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<td>4.3</td>
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<td>% of workforce</td>
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<td>58.1</td>
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<td>in large firms*</td>
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<td>% real GDP growth</td>
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<td>c: 1980-1988</td>
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<td>16.9+</td>
<td>22.3</td>
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<td>% of total R&amp;D personnel in FRG**</td>
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<td>23.1</td>
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Key: BAV = Bavaria; B-W = Baden-Württemberg; FRG = Federal Republic of Germany.
* Firms with more than 1,000 employees (1988).
+ FRG without NRW.
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<th>1986 % of GVA</th>
<th>1970 % of workers</th>
<th>1986 % of workers</th>
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<td>3.3</td>
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<td>5) consumer goods</td>
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<td>transportation</td>
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Total Workforce: 6,964,000

* Percentage of NRW's total gross value-added.
+ Percentage of NRW's total workforce.
A Social Democratic Mittelstand Model.

When government support for the Mittelstand moved to the forefront of regional and national politics in the mid-1970s the Land government of North Rhine-Westphalia followed suit. Between 1975 and 1978 a series of Mittelstand promotion measures were adopted including the introduction of a liquidity assistance program for troubled firms, a capital participation corporation, export promotion, technology promotion, and the extension of soft loan programs beyond craft and retail firms to manufacturing Mittelstand firms (see Table 6.3 and 6.4). The CDU, with a strong base of political support in the Mittelstand, pushed for a Mittelstand promotion law like that being adopted in other Länder. But the Land government deferred on this measure and ultimately argued that it would be superfluous. Moreover, if the government passed such a law the unions also wanted a labor market policy law that would legally obligate the government to specific policy goals. Both measures would have decreased the political maneuvering room of the government and thus it preferred to have neither written into law.\(^{92}\)

Despite these Mittelstand measures, through the 1970s the Land government continued to emphasize centralized regional and sectoral policies as the primary focus of its structural policies. Several observers have argued that actors in the Ruhr itself were comparatively passive in the face of their long-term crisis. Local governments and firms were accustomed to their problems being dealt with from the outside and many continued to believe that their problems were cyclical, not structural. The massive flow of subsidies largely reinforced traditional attitudes and production strategies. On a per capita basis the

\(^{92}\) See Plenary Protocol of the Landtag of North Rhine-Westphalia, 8/50 (16 June 1977), pp. 2794-2820. In fact throughout the 1970s the Land government resisted the union's demands for regional and local structural planning councils thereby demonstrating its ability to pursue a political course with some autonomy from its chief policy coalition partner.
Ruhr region was among the highest nationally in the receipt of government subsidies.93 And in the 1970s the Land government was probably the most important outside political actor regarding the Ruhr.

However, subsequent to the 1981-1982 recession, the deepening crisis of steel and cutbacks in Land government subsidies, markedly more aggressive local economic development initiatives began to multiply at fast pace. With the Land government admitting that - at least for the moment - its capacity to subsidize adjustment in the Ruhr had been reached, local governments and other organizations banded together in an attempt to fill the gap. As elsewhere in West Germany, many of these early local initiatives were inspired by the models and "myths" of Silicon Valley and Route 128 in the United States. Thus many local initiatives focused at first on constructing technology centers and parks intended to foster the creation of technology-oriented firms. But in many cities, notably in the Ruhr, local groups, organizations and governments went further to develop a broader set of complimentary initiatives that amounted to creation of new Mittelstand promotion institutions.

In the 1980s the Land government increasingly supported the expansion of local and regional promotional institutions and networks. In the 1970s the government was repeatedly criticized for focusing too heavily on the Ruhr and its large firms. Even the head of the German Federation of Labor in North Rhine-Westphalia apparently criticized the Land government's structural policies as being crisis-driven and neglectful of Mittelstand firms and

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their equally important workers. In the early 1980s debate over technology policy the willingness of the unions to back a more Mittelstand-oriented policy would provide a critical source of political support for the Land government.

In 1982 the CDU introduced a measure in the Land parliament that opened lengthy discussion and debate about technology policy. There was a growing belief among all the parliamentary parties and social groups that new technological challenges necessitated a new political and social approach to economic policy. On the more tangible side the issue of technology was being forced by an intensifying subsidy competition among the Länder that largely emanated from the South. In a much tighter fiscal bind than Bavaria or Baden-Württemberg, the Land government spoke out against this ruinous competition as provincial and egoistic and called on the federal government to initiate cooperative federalism in technology promotion in order to minimize Länder competition. The fact that federal technology funds flowed disproportionately to the southern Länder reinforced the belief that North Rhine-Westphalia was falling behind and that its firms were unfairly disadvantaged.

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94. Publication of the Landtag of North Rhine-Westphalia, 9/953 (5 August 1981). Government subsidies helped keep large firms in the Ruhr afloat, but these firms reinvested their profits largely outside of North Rhine-Westphalia, and especially outside the Ruhr. The coal and steel firms were not creating the new jobs that the unions thought they should and could.

95. Though the Ruhr remained the party's stronghold, the population of the Ruhr was steadily declining while the SPD's electoral support was growing faster outside the Ruhr. While a direct causal connection is difficult to demonstrate, it is likely that the SPD realized that much could be gained from providing more support to firms outside the Ruhr. See Bick, 1985, op. cit., p. 208.


The microelectronics industry was seen in West Germany, as throughout the industrial world, as the key sector of the future. In Bavaria and Baden-Württemberg these sectors were strong and growing fast at the same time these Land governments were heavily subsidizing R&D and technology transfer in Mittelstand firms. Heeding demands for action, the Land government sought to expand its own technology initiatives while seeking to differentiate its approach from that of Bavaria and Baden-Württemberg.

In 1984 the Land government called for a "concerted action" approach to economic modernization and held a conference with representatives from the unions, industry, and academia to develop - and legitimize - new initiatives. While the content and implementation process of North Rhine-Westphalia’s technology policies would come to resemble those of the southern Länder there were critical differences. In North Rhine-Westphalia the Land government sought to secure greater union involvement in the technology decisions of the government and individual firms. In practice this would mean that the government’s decision on applications by firms for technology related subsidies would consider the position of the unions or works council on the firm’s plans. While this was heavily criticized by business as giving workers de facto veto rights, the Land government needed to show workers that it would work to humanize technology and safeguard them from a one-sided adjustment burden due to technological change and the reorganization of work.

Up through 1980 Land government support for Mittelstand firms consisted largely of direct subsidies (Table 6.3). But in the 1980s the Land government shifted its efforts to creating and promoting other institutions that support the Mittelstand. In 1984 the

government marked the beginning of this conversion to more indirect Mittelstand promotion by pushing a controversial measure through the Land parliament. This measure provided government funds for a new center of technology transfer called ZENIT.\textsuperscript{98} The initiative as well as financial support for this project came from a group of Mittelstand firms. These firms wanted to create an organization run by the private sector that would provide a variety of technology related services to Mittelstand firms throughout the Land. ZENIT conducts some technical research of its own but acts largely as an information source, providing technical information to firms, information about capital sources such as venture capital, and finds cooperation partners for firms. ZENIT is also intended to act as a central consulting office for local technology centers throughout North Rhine-Westphalia. A few years later the Land government encouraged the WestLB to join ZENIT and contribute both capital and know-how to the consortium.\textsuperscript{99} Thus ZENIT itself represents a network that promotes individual Mittelstand firms and cooperative relations (obligational networks) among them.

Like Bavaria and Baden-Württemberg, the cornerstone of the Land government’s Mittelstand promotion model came to be technology policy. The shifting emphasis of Land government economic policies was aptly stated by the economics minister when he wrote regarding ZENIT and the growing number of local technology initiatives:

These enormous and admirable local efforts are not to be replaced through a centralized planning and steering "from above." The Model North Rhine-Westphalia in technology promotion therefore means decentralization, local consensus, cooperation and financial support as an impulse to self-help. In this sense the Land

\textsuperscript{98} The CDU in North Rhine-Westphalia labelled ZENIT dirigiste and centralistic. When compared to Baden-Württemberg’s Steinbeis Foundation, which exercises very similar functions, ZENIT does appear more centralized, though no more or less dirigiste. Plenary Protocol of the Landtag of North Rhine-Westphalia, 9/100 (13 June 1984), p. 6050.

\textsuperscript{99} The capital of ZENIT is held in one-third portions by the Land government, WestLB, and over seventy Mittelstand firms.
government will promote new forms of cooperation, setting in motion self-steering processes with financial support for a limited time and degressively structured... The Land government is resolved to answer the new technical challenges with new forms of state action.\textsuperscript{100}

In line with this new approach the Land government expanded its Mittelstand-oriented technology program from 1978 (TPW) with an additional program in 1985.\textsuperscript{101} This new program (TPZ) provides financial support for research projects in eight technology fields.\textsuperscript{102} But the TPZ program did not emphasize direct support to firms but indirect support through an expansion of the research capacity of the Land’s universities.\textsuperscript{103} Of the DM 12.5 billion spent on R&D in North Rhine-Westphalia in 1986, 20% came from the federal government and 17% from the Land government, and the rest from firms. According to Neuber the Land government’s share of R&D spending in North Rhine-Westphalia is relatively higher than other Länder.\textsuperscript{104} Thus the Land government plays an extensive role

\textsuperscript{100} Reimut Jochimsen, as quoted by the Economics Ministry of North Rhine-Westphalia. 1988. \textit{Technologieland NRW: 3 Jahre ZENIT}. Düsseldorf. p. 6 (own translation).

\textsuperscript{101} From its initiation in 1978 through 1983 the TPW supported roughly 400 research projects with DM 350 million. But in the early 1980s the Land government was still primarily funding R&D in large firms via its sectoral technology programs for coal and energy (introduced in 1974) and steel (introduced in 1980). These programs received approximately DM 250 million annually from the Land government. Plenary Protocol of the Landtag of North Rhine-Westphalia, 9/100 (13 June 1984), pp. 6032-6034.

\textsuperscript{102} These include environmental technology, energy, microelectronics, measurement and control technology, information technology, biotechnology, materials, and humanization of technology. The CDU’s technology proposals also included this form of technological steering, although its list of technical fields differed in part from the government’s.

\textsuperscript{103} An evaluation suggested that this program needs more emphasis on technology transfer and greater sensitivity to the needs of the regional economy. See Lehner, Franz, et al. 1989. \textit{Das Zukunftstechnologie-Programm des Landes Nordrhein-Westfalen: Eine Evaluationsstudie}. Bochum: Universitäts-verlag Brockmeyer.

in the provision of technical information and resources to small firms in the region.

But the Land government did not limit its support to Mittelstand firms and their networks to technology policy. In the mid-1980s the Land government also established a working group to overhaul its export promotion policies. Made up of government, bank and industry representatives, the group worked out a variety of new measures by which the Land government could promote the activities and coordination among the chambers and other industry organizations and associations that provide export-related services to Mittelstand firms.\textsuperscript{105} One of the key areas of Land support is subsidies for export consultancies coordinated by a private Mittelstand industry association. Through such consulting services many Mittelstand firms are also encouraged to seek cooperative solutions to their export efforts such as the use of private trading houses or export cooperatives. The city of Remscheid in the Bergische region, for example, has several foreign trading houses that specialize in exporting goods from local Mittelstand firms. The Land government is attempting to encourage the growth of similar obligational networks in other areas of the Land. Through such obligational and promotional networks the state promotes decentralized production and multilateral exchange strategies among firms.

The Land government supported the international expansion of the WestLB in part so that the bank could promote the exports of Mittelstand firms in North Rhine-Westphalia.

\textsuperscript{105} Subsidies for Mittelstand firms to receive private export consulting services - from 1980 through 1986, 960 firms received consulting subsidies (588 of these were industry firms). Other measures include the usual subsidies for trade fair participation and trade delegation excursions; in certain cases the Land government will also guarantee Mittelstand export loans made by other banks; though universities and other schools the Land government also offers extensive educational courses and training regarding export promotion and attempts to coordinate much of this with industry organizations and associations that do the same. See \textit{Aussenwirtschaftskonzept Nordrhein-Westfalen}. 1987. Düsseldorf: Der Minister für Wirtschaft, Mittelstand und Technologie.
In the mid-1980s the WestLB established a trade promotion department. This department works with the bank’s foreign branches to develop export markets and foreign production partners for regional Mittelstand firms. This is intended in large measure to be a service to the individual savings banks and their Mittelstand clients, and thereby allow these banks to compete with local branches of the major commercial banks which have strong foreign trade experience.\textsuperscript{106} In addition, the WestLB also played a formative role - along with the city of Cologne, the Industry and Commerce Chamber of Cologne and the Trade Fair corporation of Cologne - in the establishment of several specialized export consulting firms intended to promote Mittelstand exports from North Rhine-Westphalia into China, Japan and Korea.\textsuperscript{107}

In the late 1980s other government economic programs were also reoriented toward the indirect promotion of Mittelstand firms through strengthening their institutional support environment. The joint federal-Land regional promotion program (GA) has been a central instrument of the Land government’s economic intervention. In the 1980s the GA came under heavy criticism from many directions. The Council of Experts, a group that frequently analyzes and advises the federal government on its policies, criticized the GA as ineffective. The Council recommended that firm subsidies be reduced and responsibility for their dispensation decentralized to local governments. The Council used the example of the Ruhr to argue how numerous factors, including overly centralized control of the GA in Land

\textsuperscript{106} Though individual savings banks have also begun to establish cooperative arrangements with foreign banks intended to serve similar aims. For example, in 1990 the savings bank of Essen signed an agreement with a Barcelona bank in order to offer its Mittelstand clients cross-border services.

\textsuperscript{107} As a prime example of banks’ mediator role, the savings bank of Cologne, one of the largest in the Federal Republic, established a program in 1986 with very similar aims to WestLB-led initiatives. In particular the program seeks to promote cooperation among Mittelstand firms to solve their export problems. Leuenberger, Theodor, and Bernd Küppers. 1987. "Das Asia-Pacific-Center der Stadtsparkasse Köln," \textit{Bank und Markt} (9):28-34.
government hands, hindered structural change in the region. The Land government of North Rhine-Westphalia responded to this and other critical voices by petitioning the federal government to alter the GA rules so that GA funds could be used to support Mittelstand consulting offices, innovation in manufacturing and service firms, and the creation of local economic development plans.

Even when the pressure to resort more strongly to traditional sectoral policies grew in 1987 the Land government continued on this path toward promoting decentralized adjustment initiatives. On the surface the government's 1987 ZIM program appeared a throwback to its earlier centralized Ruhr development programs. In the midst of a major regional crisis. ZIM was initiated with broad consensus among the political parties and major social groups. Like earlier Ruhr programs ZIM encompassed a variety of measures to promote the region's development. But the real innovation of ZIM was not its content but the process by which funds were to be dispersed. Under ZIM the infrastructure projects to be funded were to be selected at the local level by a process of negotiation leading to consensus among the local unions, government, chambers, business associations and other relevant organizations. ZIM was thus intended to further increase cooperation among local actors in promoting structural adjustment. The CDU, unions, and Industry Chambers welcomed decentralization but expressed varying objections and reservations about this new

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109. See Plenary Protocol of the Landtag of North Rhine-Westphalia, 10/99 (26 January 1989), p. 9063. Since 1985 the GA has permitted the promotion of economic infrastructure projects of local governments such as the preparation of industry parks, transportation and energy facilities, continuing education institutions, and technology centers.
process, though so far all have been willing to participate.\textsuperscript{110} In designing ZIM the Land government consciously sought to follow with what it perceived to be the national and international trend toward decentralization and "public-private partnership."\textsuperscript{111} In this vein the Land government has attempted to find a role as a facilitator or catalyst for cooperation among firms and cooperation among local organizations in order to provide support to networks and associations of firms.

The city of Aachen provides one example of the creation of local promotional networks that is indicative of many other cities in North Rhine-Westphalia. While not located in the Ruhr, Aachen is an old coal mining town and has therefore suffered a similar decline. In the early 1980s the city government, local Chamber of Industry and Commerce, local savings banks and other organizations formed a non-profit organization for technology promotion. In 1983 this group established a technology center to house new, innovative firms many of which were started by students from the city’s technical university. The Industry Chamber and university also established a program to promote technology transfer out of the university into local firms. In 1987 this local group was joined by the Land government and WestLB in the creation of another center to promote the transfer of computer

\textsuperscript{110} The CDU and Industry chambers challenged the Land government’s emphasis on local consensus as a precondition to receiving ZIM funds. The CDU argued that ZIM created corporatistic local structural councils without sufficient democratic control. The chambers argued that the government was demanding consensus without working to build it, and that its efforts to tie technology promotion with social responsibility gives unions de facto veto rights. In 1989 the Land government yielded to pressure from regions not included in the ZIM by extending the program to the entire Land (now called ZIN). See Adam, 1988, op. cit.; and Plenary Protocol of the Landtag of North Rhine-Westphalia, 10/99 (26 January 1989), pp. 9051-9080.

\textsuperscript{111} In a specific reference to the anglo-american experience the Land government also let it be known that it hoped the large firms of the Ruhr would take a more prominent role in revitalizing the region. Publication of the Landtag of North Rhine-Westphalia 10/3552, pp. 21-22.
integrated manufacturing technology into local firms. And in 1988 six local savings banks, with permission of the Land government, established an equity participation corporation to provide investment capital for promising local Mittelstand firms.\footnote{Rosen, Paul. "Förderung technologieorientierter innovativer Existenzgründer - Konzept und Erfahrungen." \textit{Sparkasse}, March 1990, pp. 122-126.} In the 1980s the belief spread that this sort of local initiative was indispensable to saving the Ruhr.\footnote{Dortmund, Essen, and Oberhausen are notable examples of Ruhr cities that have developed similar economic development programs and cooperation.}

The savings bank sector of North Rhine-Westphalia has demonstrated considerable innovative capacity in finding new ways of supporting the Mittelstand. The WestLB and several savings banks have established equity participation corporations in the 1980s to provide capital to Mittelstand firms, especially those that are innovation-oriented.\footnote{Examples in North Rhine-Westphalia include equity corporations established in Gelsenkirchen, Aachen, Siegen, the Bergische Region, Essen, Cologne and Düsseldorf. Gröschel, 1987, op. cit., pp. 380-383.} Cooperation between the WestLB and savings banks has also enabled many savings banks to help selected Mittelstand firms go public. The ability to provide such services is crucial for savings banks to remain competitive with the major commercial banks in North Rhine-Westphalia.\footnote{Prautzsch, Wolf-Albrecht. 1990. "Börseneinführungen - Chancen für den Verbund." \textit{Sparkasse} 107(2): 54-56.} Bank services such as these which constitute part of all the banks' growing mediator role, are often combined with the services and resources provided to Mittelstand firms through local promotional networks. Thus even where banks may not be formally involved in promotional networks, their growing mediator activities provide Mittelstand firms with an alternative or supplementary source of critical resources.

In sum, in North Rhine-Westphalia there is movement toward the economic policy
model and pattern of industrial organization and governance evident in Baden-Württemberg. Sounding more like CDU dominated Länder, by the late 1980s the SPD and Land government in North Rhine-Westphalia were praising the Mittelstand as the motor of the region’s economy and decried the federal government’s plans to scale back its support for the Mittelstand.  

But institutional legacies such as the structure of North Rhine-Westphalia’s financial system - that is the predominance of large banks including the WestLB - have also favored the government’s pursuit of centralized and more direct intervention into its economy. The financial and technical capacities of the WestLB are being increasingly used to support the Land government’s Mittelstand policies and other local initiatives. The government of North Rhine-Westphalia is thereby able to utilize the advantages of a large, internationally active bank to support smaller regional firms.

E. Conclusion.

The cases of coal and steel show the limited capacity of West Germany’s system of private collective management or organized capitalism with bank dominance to manage the process of industrial change. In the face of severe contractions and long-term sectoral decline the burden of adjustment was increasingly assumed by the federal and Land governments. But the state did more than simply subsidize the decisions and production strategies of private producers. Through various mechanisms the state frequently played a decisive role in the transformation process of these sectors’ governance regimes. For example, through the WestLB and other means the Land government of North Rhine-

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Westphalia was able to alter the ownership structure of several firms, in effect altering the nature of existing relations among producers. The relative insulation of the WestLB from partisan and popular political influence made it an ideal instrument for relatively autonomous government intervention. Thus the role of governments in constituting governance regimes and managing the process of adjustment in the Federal Republic is greater than commonly believed.

Yet this criticism of the organized capitalism model focus primarily on the extent to which governments, as opposed to private actors, are controlling the system of collective economic management. Through the 1970s the process of industrial adjustment in North Rhine-Westphalia appeared consistent with that described in the secondary literature to the extent that a relatively small group of actors exercising extensive control or influence over their respective social, economic, or political spheres negotiate agreements on major industrial changes. In these cases state actions - especially those of the Land government - worked to a considerable extent to preserve the traditional hierarchical organization of production in these sectors in order to save jobs.

But the process of industrial adjustment in particular sectors and North Rhine-Westphalia as a whole appeared to significantly change in the 1980s. The evidence suggests that governance regimes in North Rhine-Westphalia are evolving in a manner that is expanding the range of actors included in economic production. Smaller firms performed well in the 1980s and were supported by new and expanding promotional networks. Through its infrastructure investments in collective goods such as technical training and R&D, as well as through aid to firm networks and associations, the state is encouraging more informal and multilateral production strategies in numerous sectors. Though clearly the extent to which smaller firms and post-Fordist production principles expand their presence in various sectors
in North Rhine-Westphalia will be determined by and large by private actors, not the state. Sectors dominated by large hierarchies are far more amenable to direct state control and direction than are sectors dominated by a large number of smaller producers. Though the evidence suggests that the state can play a crucial role in promoting these latter sectors by producing and allocating essential resources and information to them. The expansion of the banks' mediator capacities or role must also be viewed as an important component of a supportive institutional environment for Mittelstand firms. The Land government's support for its Landesbank and savings banks through resources and regulatory changes was to a significant degree designed to expand their role as a critical element of such an institutional environment. Hence these bank and state strategies are highly complimentary in promoting non-hierarchical production strategies and governance mechanisms.
### Table 6.3
State Funds Expended for Mittelstand Promotion in North Rhine-Westphalia (Mio. DM)

<table>
<thead>
<tr>
<th>Program Area</th>
<th>1975</th>
<th>1977</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial Aid</td>
<td>51.3</td>
<td>66.7</td>
<td>212.2</td>
</tr>
<tr>
<td>2. Grants for consulting, technology promotion</td>
<td>8.1</td>
<td>11.2</td>
<td>41.6</td>
</tr>
<tr>
<td>- (technology progs. alone)</td>
<td>2.6</td>
<td>3.8</td>
<td>31.1</td>
</tr>
<tr>
<td>3. Grants for education, training</td>
<td>11.0</td>
<td>27.4</td>
<td>43.5</td>
</tr>
<tr>
<td>4. Grants for research on the Mittelstand</td>
<td>0.8</td>
<td>1.8</td>
<td>1.1</td>
</tr>
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</table>

**Total** 71.2 107.1 298.4

(continuation)

<table>
<thead>
<tr>
<th>Program Area</th>
<th>1980</th>
<th>1981</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Financial Aid</td>
<td>215.6</td>
<td>116.5</td>
<td>80.4</td>
</tr>
<tr>
<td>2. Grants for consulting, technology promotion</td>
<td>75.5</td>
<td>63.2</td>
<td>50.8</td>
</tr>
<tr>
<td>- (technology progs. alone)</td>
<td>62.9</td>
<td>50.0</td>
<td>38.5</td>
</tr>
<tr>
<td>3. Grants for education, training</td>
<td>45.1</td>
<td>37.1</td>
<td>36.7</td>
</tr>
<tr>
<td>4. Grants for research on the Mittelstand</td>
<td>1.0</td>
<td>1.0</td>
<td>1.2</td>
</tr>
</tbody>
</table>

**Total** 337.1 217.8 169.1

Source: Ministry for Economics, Mittelstand and Transportation of North Rhine-Westphalia.
Table 6.4
Total Annual Volume of Loans to the Mittelstand Subsidized
by the Land Government of North Rhine-Westphalia (mio DM).

<table>
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<tr>
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</thead>
<tbody>
<tr>
<td>Value</td>
<td>80.9</td>
<td>104.5</td>
<td>168.2</td>
<td>512.7</td>
<td>603.5</td>
<td>314.4</td>
<td>306.7</td>
</tr>
</tbody>
</table>

Source: Ministry for Economics, Mittelstand and Transportation of North Rhine-Westphalia; and Investitions-Bank NRW.

In 1989 the two major federal investment banks (KfW and DAB) lent an additional DM 654.8 million to Mittelstand firms in North Rhine-Westphalia.

CHAPTER SEVEN:

Baden-Württemberg:

An Alternative Model of Economic Governance

A. Introduction.

Baden-Württemberg represents an alternative model of regional economic governance that does not correspond well to the precepts of organized capitalism. In the organized capitalism model the large firms, banks and trade associations manage the process of industrial change. In Baden-Württemberg the institutional preconditions for organized capitalism are weaker than elsewhere in Germany; economic concentration is lower because of the large number of small- and medium-sized firms, and industrial finance is controlled to a comparatively high degree by relatively small savings and cooperative banks that rarely exercise a tutelary role in regional industry.

In this region industrial change is governed to a greater degree by market and especially other non-hierarchical governance mechanisms. Well-developed patterns of direct and indirect cooperation among firms are institutionalized in obligational and promotional networks and associations. Thus production in this region is governed to a comparatively greater degree by multilateral exchange among producers and organizational structures less formal than hierarchies. Strongly vertically organized production such as is typical of North Rhine-Westphalia is rare in Baden-Württemberg. Large firms in this latter region are comparatively decentralized, relying on extensive networks of long-term subcontracting arrangements with local Mittelstand suppliers. In this and other respects, production in Baden-Württemberg was always closer to the post-Fordist than the Fordist model. Thus in
the 1980s and 1990s, as other sectors and regions in Germany have moved toward post-Fordist production principles, Baden-Württemberg and its Mittelstand firms and banks found themselves in a favorable position to profit from changed domestic and international economic conditions. Though Baden-Württemberg also faced considerable adjustment pressures, unlike organized capitalism, the major economic organizations of the region do not negotiate agreements among themselves and then dictate or coerce local industry to follow their plans. Rather, they help firms adjust to economic change by providing them with critical resources. This does not mean that large firms or banks do not play an important role in the region’s economy, but that non-hierarchical mechanisms of governance are comparatively strong in the region.

In Baden-Württemberg government intervention is largely subsidiary or market-conforming. The Land government relies on close cooperation with the major economic institutions of the region — chambers, associations, banks, and the like — to promote individual firms, sectors, and sub-regions. I label this set of state and private sector organizations the ‘regional promotional network’ because it entails regularized patterns of cooperation oriented toward the provision of resources and information to regional firms. This regional network began its evolution well over a century ago when both the states of Baden and Württemberg formed extensive organizational networks linking state and economy which cemented a mutually supportive relationship. Because economic production was highly decentralized in these regions, the links between state and economy were also largely decentralized. By focusing on the provision of resources to firm promotional networks and associations, government policy helped preserve a more informal organization of production and multilateral exchange relations among producers.
In spite of great political turmoil and changes in Germany over the decades, these patterns of state-society cooperation in vocational training, technology development and dissemination, and capital provision became institutionalized and maintained a relatively high level of consistency. In broad terms, this persistence can be explained by the notable success of the region's economy and the ability of regional actors to largely resist outside efforts to impose unwanted change. The preservation of regional political autonomy in the postwar period and Land government support for the Mittelstand and its networks, as well as the maintenance and strength of a decentralized regional financial system (Chapters 2 and 3), were critical institutional preconditions for Baden-Württemberg to maintain non-hierarchical sectoral governance regimes without bank dominance.

When Baden-Württemberg faced relatively severe economic problems in the 1970s, they were not addressed by centralized crisis management as was the case in other Länder. Rather, economic crisis was met primarily by a deepening of the traditional pattern of industrial governance. In the 1970s and 1980s the regional promotional network expanded tremendously, both in terms of its extent - number of organizations involved - and intensity - amount of resources flowing through them to firms. Much of the initiative for this expansion originated from the Land government as it sought to expand its role in the regional economy. To the extent that the expansion of government intervention and the regional promotional network were consistent with the regional ideology of cooperation and subsidiary state assistance, they were largely supported by the major groups that comprised the ruling policy coalition. These groups included farmers, craft workers, workers and owners of Mittelstand firms, and civil service groups.

Up through the early 1970s the government of Baden-Württemberg was one of the least interventionist Land governments in terms of subsidies to firms and state ownership of
industry. But in the 1970s and especially in the 1980s, the Land government attempted to intervene in the economy in a more direct and market-displacing (non-liberal) form. In the financial system, the Land government attempted to create a large regional bank under its control. Such a bank would have placed greater economic power in the hands of the Land government and enabled it to pursue a more centralized form of industrial policy, since such a bank could be used to influence the decisions of large firms in the region and, with the collaboration of some key organizations, to attempt sectoral rationalization plans. However, many groups resisted dramatic changes in business-government relations that deviated from the long-standing pattern. Institutional legacies and the dependence of the Land government on the other regional organizations therefore inhibited substantial deviation from established patterns of sectoral governance.

But neither did this interdependence between state and society in the region preclude all significant change. In the 1970s, general political and social consensus and the growing institutional capacity of Baden-Württemberg’s Land government enabled it to successfully pursue a different industrial development strategy from that of the federal government. And through state-controlled and other organizations participating in regional promotional networks the Land government was in fact able to increase its economic influence in the region. The growing share of the Land government in the finance of regional industry, as well as its efforts at restructuring the regional banking market, are prime examples of this evolution to greater intervention.

This chapter proceeds first with a brief overview of the historical development of Baden-Württemberg’s regional promotional network and industrial governance regimes. I then examine changes in economic policy and business-government relations since the late
the regional banking sector in order to support its industrial policy goals.

B. Decentralized Industrialization and Regional Promotional Networks.

Until World War I, the state of Württemberg was considered an impoverished industrial laggard. The neighboring state of Baden, in contrast, was one of the more prosperous regions in Germany, industrializing well-ahead of Württemberg. Though Württemberg’s industry "took off" only after the first World War, it became Germany’s second most industrialized and prosperous region by the end of the 1920s. This dramatic growth spurt was not the result of any particular factor - exogenous or endogenous - but the cumulative consequence of a long period of industrial gestation.¹

In the Depression years Württemberg unequivocally demonstrated that its industrial prowess was not a fluke. The region’s unemployment rate was approximately half that of the Reich. This anti-cyclical capacity of Württemberg’s economy has not failed in any downturn since. What helped the region maintain employment then, as now, was the prevalence of small, widely-distributed firms producing goods with skilled labor. The flexibility of production in such firms allowed them to quickly change their output to other goods in higher demand. If this was still insufficient, many firms put their employees on

¹. Megerle, 1982, op. cit. For an excellent discussion of economic and political regional differentiation in nineteenth century Germany see Fremdling, Rainer, and Richard H. Tilly, eds. 1979. Industrialisierung und Raum: Studien zur regionalen Differenzierung im Deutschland des 19. Jahrhunderts. Stuttgart: Klett-Cotta; also Tipton, 1976, op. cit. Tipton also argues that regions such as Württemberg followed a different pattern of industrialization. Because of political tensions between France and Germany in the inter-war period, government policies inhibited industrial development in the state of Baden, thereby significantly slowing the growth of its economy.
short work weeks in order to retain them for the imminent upturn. Stability was also aided
by a broad industrial base; the early consumer goods sectors were augmented by rapidly
growing investment goods - machinery, electronics, and motor vehicles - in the early 1900s.

This pattern of small-scale, decentralized industrialization arose of out particular
social and economic traditions of the region. Poor transportation connections helped keep
Baden, and especially Württemberg, relatively isolated from other regions of Germany until
late in the nineteenth century. The scarcity of natural resources and high cost of energy
favored industrial production that emphasized skilled processing and finishing. The
emphasis on skill and quality in production also restrained the centralization of production
as work had to follow the widely dispersed and generally immobile labor force. Reflecting
the organization of production, the banking sector in Baden and Württemberg was dominated
by a large number of widely dispersed savings and cooperative banks. Thus isolation and
other factors permitted this decentralized organization of production to firmly institutionalize
itself. The pattern of business-government relations and the early regional promotional
network - formed in the second half of the nineteenth century - also reinforced production
in small firms.

In 1848 the government of Württemberg created the Centralsielle für Gewerbe und
Handel, a new state organ charged with the promotion of industry. While run by the state,

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2. See Winkel, Harald. 1981. Geschichte der Württembergischen IHK's: Heilbronn,
In the Depression Württemberg had three times more Kurzarbeiter than the national average.
Such workers then typically used their extra time to work their fields.

3. Handwork was used extensively and thus the utilization of power-driven machinery in
the region was low relative to the rest of the nation. Megerle, 1982, op. cit., p. 112.

4. The revolution and economic crisis of 1848 also put significant pressure on the king
to adopt more liberal policies. Wauschkuhn, Friedrich-Franz. 1977. "Staatliche
representatives from industry and the crafts sector sat on its advisory council. The creation of the Centralstelle marked the beginning of a transformation in business-government relations. Commercial interests were slowly winning not only the support of the state, but their rights to independence and the self-administration of industry. Change continued with the creation of chambers of commerce and industry in 1855 in the key industrial cities of Stuttgart, Heilbronn, Ulm, and Reutlingen.

In 1855 the leadership of the Centralstelle was taken over by a legendary figure in Württemberg’s industrial history - Ferdinand Steinbeis. In popular lore today, Steinbeis is depicted as the father of industrialization in Württemberg and the symbol of the state’s economic leadership role in the region. Under the direction of Steinbeis, the Centralstelle systematized and expanded its industrial promotion efforts, shifting emphasis from mercantilist financial promotion to informational support of industry. The Centralstelle relied heavily on the Chambers and other organizations to help implement its initiatives. One of Steinbeis' primary goals was the technical modernization of local industry. "Technology transfer" was supported in numerous ways including sending young technicians and managers abroad to learn new technologies and through the creation of an exhibit hall at home to demonstrate modern machinery from abroad to local entrepreneurs.


6. Gottlieb Daimler, co-founder of Daimler-Benz, was one prominent beneficiary of this practice.
Probably most important of all, Steinbeis and the Centralstelle were leaders in the reform and expansion of vocational education schools in the region. Through his efforts a new system of higher-level vocational schools appeared throughout the state. Attendance at these schools was voluntary, and students were taught only by certified master technicians. The schools were under the control of local business and community leaders and were financed through student fees, the community and the Centralstelle. Starting from the first school in 1854 in Heilbronn, by the early 1870s Württemberg was covered with 155 such vocational schools educating over 100,000 students. Many of these Fachschulen were the direct precursors of today’s engineering polytechnics known as Fachhochschulen (FHS).

For most scholars it is clear that neither Steinbeis nor the state government of Württemberg can be considered the initiator of industrialization in the region, or even the primary motor behind it. But through a combination of "public" and "private" resources

7. Klagholz, Bernd. 1986. Die Industrialisierung der Stadt Heilbronn von den Anfängen bis zum Jahr 1914. Heilbronn: Stadtarchiv. From 1877 to 1911 more than half of the state's expenditures on economic promotion went to education. Kullen, Siegfried. 1983. Baden-Württemberg: Strukturen, Daten, und Entwicklungen. Stuttgart: F. Klett. pp. 239-240. For example, the Fachhochschule in Reutlingen traces its lineage back to 1855 when, through the combined efforts of the Centralstelle and local textile firms, a school was established to provided advanced training in textile production. Today this polytechnic is a leader in the design of advanced textile technology. The Centralstelle also later became the State Commerce Office (Landesgewerbeamt, LGA) which continues through the present as a state economic promotion agency.

focused on vocational education, technology development and transfer, capital provision, and technical advising, the local economy doubtlessly benefitted in numerable and often intangible ways. The Centralstelle and chambers became the core of a regional promotional network or networks that provided collective goods to Mittelstand firms. Relations between the state and economy were guided by the principle of the "self-administration of industry" in close cooperation with the state. In this "pact" between the state and industry the organizations representing the economy would assure "order" in their respective economic spheres, while the state’s role was subsidiary - to support industry primarily by supporting these organizations. This indirect method of support was to ensure that state assistance would remain "help for self-help" ("Hilfe zur Selbshilfe").

These patterns of decentralized industrial organization and business-government developed in the nineteenth century, continued through the twentieth century. By the 1970s the post-war state of Baden-Württemberg was heralded as West Germany’s Musterländer - the "little model state". Through this turbulent decade the state’s unemployment rate consistently hovered around one-half that of the Federal Republic, and its per capita GDP was a dependable five percent over the national average. Baden-Württemberg is the most heavily industrialized Land in the Federal Republic. With only 15.3% of the nation’s population, Baden-Württemberg provides over 20% of its manufacturing work force. In the dominant sectors of machinery, electrical products, and automobiles, this percentage climbs to over 25%. Baden-Württemberg also epitomizes an export-led growth model, exporting Ostfildern: Scripta Mercurae.

9. These three sectors together provided 51% of industrial employment, 49% of turnover, and 64% of the state’s industrial exports in 1986. Of every 1,000 inhabitants in Baden-Württemberg, 153 are employed in manufacturing (one-half of the state’s work force.) The national average is 112. See Statistics Office of Baden-Württemberg. 1987.
32.2% of its industrial output. This latter fact also attests to the international competitiveness of a regional economy in which non-hierarchical governance mechanisms are unusually strong.

While Baden-Württemberg has numerous large firms it also has more than its fair share of small- and medium-sized firms: in Baden-Württemberg Mittelstand firms account for 48.2% of commercial revenues in the state, nation-wide this figure is 41.8%. In the manufacturing sector, eighty percent of the state's firms have less than 500 employees and account for more than half of industrial employment. The archetypical firm of Baden-Württemberg is a medium-sized enterprise producing customized and specialty products with a high degree of skilled labor. Industrial production in Baden-Württemberg continues to


13. This characterization is particularly true of the machinery industry. Herrigel, 1989, op. cit.
display a relatively high degree of geographic decentralization, in spite of the large industrial agglomerations around Stuttgart and Mannheim.

A large percentage of these smaller manufacturing firms are part of a rich subcontracting tradition. The presence of flexible and innovative small firms undoubtedly contributed to more informal and multilateral production strategies even in sectors normally seen as dominated by large, hierarchically organized firms and mass-production. In a study of the German auto industry, Streeck notes that auto producers in southern Germany - Daimler-Benz and BMW - have organized production in a substantially different fashion from their northern competitors (VW, Opel and Ford). The southern firms rely considerably more on local supplier firms (especially craft firms) for parts, whereas northern firms are more strongly vertically integrated. Like Dore's 'relational contracting' in the Japanese context, these auto firms develop long-term contracting relations with suppliers that frequently involve shared responsibility for research and development. Thus many of the state's big and small firms are interdependently linked through intricate and efficient networks of long-term subcontracting, each accounting in good part for the success and expansion of the other.

In contrast to other regions where technical modernization often leads to a decline in the value of a skilled work force, in Baden-Württemberg skilled labor is increasingly important. This is reflected both in the relatively high proportion of craft workers (Handwerker) in the work force, as well as the growing percentage of skilled labor in industry. In this milieu, automation is used as much to compensate for the growing

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15. See also Sabel, Herrigel, Deeg, and Kazis, 1989, op. cit.

16. In 1986, 676,000 craft workers were employed in nearly 100,000 firms. On a per capita basis, Baden-Württemberg has over 20% more craft workers than the national average.
shortage of skilled labor in the region, as much as it may be used to displace the unskilled. The importance of skilled workers to the state's industries is also reflected in their demonstrated propensity to put their workers on shorter workweeks rather than fire them when times get tough.\textsuperscript{17} The labor force reciprocates in part through a comparatively greater willingness to participate in continuing education.\textsuperscript{18}

Skilled labor in the service of industry is also emphasized at higher levels. In 1986 the ratio of scientists and engineers to total work force engaged in the manufacturing sector was 6.5\% higher than the national average. The Land has a long tradition of cooperative research and technology transfer through dozens of industry-oriented research organizations, some of which are private but most are funded jointly by firms, trade associations, and the Land and federal governments.\textsuperscript{19} As such these research organizations represent Mittelstand promotional networks.

In sum, Baden-Württemberg's success is generated by innovative large and small firms which seem particularly adept at integrating new technologies into "traditional" industries - machine tools, autos, electrical products, textiles, office machinery, clocks and

\underline{From 1970 to 1986 the percentage of skilled workers among all industrial workers rose from 34.3\% to 45.6\%.}


\textsuperscript{18} In the 1970s and 1980s Baden-Württemberg had approximately 11\% of the nation's unemployed workers, but over 18\% of the unemployed participating in reeducation or continuing educations courses. Meisel, 1983, op. cit. p. 69.

\textsuperscript{19} In the same year the Land's per capita expenditures on science and research were nearly 14\% higher than the national average.
other fine mechanical instruments. The key factors of production - capital, knowledge, and skilled labor - are generated and distributed to a high degree through extensive networks of cooperating institutions. Baden-Württemberg has been able to adapt its industries - even ones considered elsewhere to have little future - without the dominance of the institutions of organized capitalism. Baden-Württemberg responded to the economic turbulence of the 1970s by expanding the resources flowing through regional promotional networks and associations to Mittelstand firms. This was done largely in a manner consistent with its distinct regional traditions.

Until the early-1970s Land government aid to industry expanded slowly and emphasized non-financial support for industry.\textsuperscript{20} Top priority was accorded by both the government and regional economic organizations to enlarging the capacity of the vocational training system and the business consulting promotional network.\textsuperscript{21} When the country faced its first post-war recession in 1966, the Land government of Baden-Württemberg actually cut back on its economic subsidies. The government consolidated its recession-weakened budget by concentrating direct state support for firms into fewer programs and tightened eligibility requirements. Thus in spite of strong demand for state funds by Mittelstand firms in 1968 and 1969, forty percent of grant applications were denied.\textsuperscript{22} The contraction of direct

\textsuperscript{20} Though in the reconstruction period, a severe shortage of capital induced the federal and Länder governments to become more directly involved in the finance of industry. Thus it was in the post-war period that Baden-Württemberg began continuous, systematized financial promotion. Before this time, financial promotion was irregular and largely a post-hoc response to economic emergencies. See Goldschmidt, Thomas. 1985. \textit{Öffentliche Kredithilfe im Rahmen der Mittelstands und Regionalphilpolitik in Baden-Württemberg}. Ph. D. diss. University Hohenheim.

\textsuperscript{21} Consequently the chambers of Baden-Württemberg began expanding their advising capacities. In 1963 the RKW followed and began building up an advising service with the help of state funds. In 1972 the Industry Chambers and RKW of Baden-Württemberg joined their consulting networks together. The RKW is the \textit{Rationalisierungskuratorium der deutschen Wirtschaft}, a private industry service organization with largely independent operating units in each Land. See Winkel, 1981, op. cit., pp. 597-603.

\textsuperscript{22} The program also sought to reduce the workload on the bureaucracy by eliminating loans from its bevy of promotion instruments. Thereafter all direct firm support would come in the form of grants. Testing of the technical and management capacities of applicants was largely dropped. Instead the government would rely more heavily on the judgement of the firm's bank. The average grant in this period was DM 5,600 for an average investment project of DM 177,000. 28% of the grants to SMEs were for business start-ups firms; 40% were for modernization measures. Publication of the Landtag of Baden-Württemberg. 5/3133 (19 June 1970). pp. 34-40.
support was made more palatable politically by the ongoing recovery and robust industrial expansion in the late 1960s and early 1970s.\textsuperscript{23}

Thus even in the face of recession and heavy demands by firms for support, the Land government of Baden-Württemberg remained comparatively liberal in its economic policy. This contrasted starkly with the federal and many Land governments which were rapidly expanding their intervention. The adoption of Keynesian-inspired demand management and structural policies - led by the Social Democrats in Bonn - indicated a preference among many policy-makers and the public for a greater state role in the economy. Though Baden-Württemberg was governed by a Grand Coalition from 1966 to 1972, the presence of the SPD in government did not lead to a significant alteration of the basic tenets of business-government relations in the region. The underlying social and political consensus on the proper role of the government was strong.

According to the Land government’s calculations, its expenditures in 1972 for direct financial support to firms was lowest of all Länder. In fact, the top three Länder each granted more than five times more funds to firms than Baden-Württemberg.\textsuperscript{24} Although in an atmosphere of growing regional competition among Länder governments this was more reason for embarrassment than congratulations. In the face of criticism by subsidy-seeking groups, the Land government justified its relatively low expenditures by pointing to higher

\textsuperscript{23} In 1970 Baden-Württemberg reached its highest ever level of manufacturing employment at 54.7% of the total work force. By 1986 this figure slipped to 47.4%. Statistics Office of Baden-Württemberg, 1987, op. cit.

\textsuperscript{24} The Economics Ministry of Baden-Württemberg calculated its expenditures for direct firm support (including funds dispersed under the regional GA program) at DM 27 million; that of North Rhine-Westphalia at DM 154 million; Bavaria DM 152 million; and Niedersachsen DM 149 million. Even in relation to population, work force, or tax revenues, Baden-Württemberg was still last. Publication of the Landtag of Baden-Württemberg, 6/1554 (30 January 1973).
than average expenditures in other areas, namely education. In the vein of the "help for self-help" principle, the government continued to rely on the chambers, trade associations, and other economic organizations to build up an efficient and extensive system of promotional networks for the Mittelstand.

But neither was the Land government entirely passive in the face of growing government intervention elsewhere in the Federal Republic. Less enthused about the philosophy of state economic planning being propagated elsewhere, the Land government and regional business groups in Baden-Württemberg focused instead on expanding regional promotional networks through new organizations. Because these organizations were established with substantial support and control by the private sector, they were not particularly controversial. These were organizations that regional firms would use largely to organize the provision of collective goods. Though in subsequent years these new organizations came to play a central role in the expansion of the Land government's market-conforming as well as market-displacing interventions.

In 1971 three such organizations were established: The first was an equity participation corporation called the *Mittelständische Beteiligungsgesellschaft Baden-Württemberg* (MBG). Established by the Land and federal governments, individual banks and the major regional banking associations, and regional chambers and trade associations, the MBG utilizes funds from each of the founding partners to provide equity capital to Mittelstand firms which do not wish to go public.25

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25. The impetus for the *Beteiligungsgesellschaft* came largely from the Federal Government when it made funds available in 1970 for their creation. The formation of such corporations followed quickly in most Länder.
The second organization was created by the fusion of four ‘credit guarantee communities’ (KGGs); one each for the crafts, retail, industry, and landscaping sectors. This new Surety Bank (*Bürgschaftsbank*) was to provide guarantees to local banks on a broad range of loans to Mittelstand firms for which the borrower had insufficient collateral. The basic purpose of the bank would be to promote the adjustment and dynamism of the regional economy by supporting high-risk economic activities. The financial risk associated with the bank’s function was in turn distributed among the regional associations of the cooperative and savings banks, the private banking sector, the chambers, and dozens of business associations that provided the bank’s equity. In addition, the federal and Land government provide long-term, low-interest loans which act as equity for the bank, as well as providing counter-guarantees for 70% of the bank’s liabilities.\(^{26}\) Accordingly, the credit committee of the bank is comprised of representatives from the associations, chambers, banks, and the Economics and Finance Ministries of the Land government. As the Mittelstand participation corporation (MBG) was founded at the same time by many of the same partners and had a complimentary mission, its operation was turned over to the Surety Bank.\(^{27}\) Though these two organizations provided non-collective goods to individual firms, they nonetheless constituted a new promotional network as they were intended to maintain the economic health of entire sectors and thus the whole region.

The third organization created in 1971 was the Steinbeis Foundation. Named after the legendary "father" of Württemberg industrialization, the private foundation’s purpose was to support the region’s Mittelstand through the provision of technical consulting services.

\(^{26}\) In other words, the Bank itself is at risk for only 30% of its guaranteed loan volume.

\(^{27}\) The MBG refines its participations from other local banks.
What the foundation did, in fact, was to take over the direction and operation of technical advising offices created after 1967 by the Economics Ministry at several of the engineering polytechnics in the Land. 28 After 1971, the number of technical advising offices and their contacts with industry steadily expanded under the foundation's guidance. This too was a new promotional network that provided selective access to technical information.

The early 1970s were also the beginning of a new era in the relationship between the government of Baden-Württemberg and the region's banks. In other Länder the Landesbanks provided their government convenient access to the capital markets where funds could be acquired to help the government fulfill its growing financial obligations in housing construction, community development, agriculture, public infrastructure, and economic promotion. The Land government of Baden-Württemberg clearly saw the utility of the Landesbanks for other Länder and was determined to have one of its own. Most importantly, in keeping with its liberal traditions, the government of Baden-Württemberg was the only one that had not previously acquired ownership in a Landesbank.

Since Baden-Württemberg as a political territory was created in 1952 through the voluntary union of Baden and Württemberg, there were two regional giro banks, or Girozentrale, and two regional savings bank associations. The solution for the Land government then, was to merge the two girozentrale with two smaller Land-owned special purpose banks. By bringing these other banks to the merger the government would control a substantial portion of the new Landesbank's equity. Since the fusion of public banks was

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28. After 1967 the Land government began to establish technical advising offices at the state polytechnics. These offices tapped the faculty's knowledge, or found an appropriate advisor or research institute, to help Mittelstand firms solve various technical problems.
largely seen as a matter of raising the efficiency of the public banking sector as well as the public administration, there was wide agreement on the need for fusions.²⁹

With no voting rights in either Girozentrale, the government's plan relied on successful persuasion of the boards of the two Girozentrale and regional savings bank associations. The Württemberg Girozentrale was eager to fuse, but the Baden Girozentrale was not to be persuaded. While acknowledging the future possibility of a fusion, the directors of the Baden bank and association were wary of losing control over their bank to the Württembergers, thereby exacerbating what they perceived as a growing imbalance of political and economic power between the two formerly independent states. Thus the fusion attempt apparently failed largely because of persistent regionalist sentiments within the Land. Though the Land government did not give up its goal of a Landesbank and would later try again.

In the meantime, the government settled for the fusion of the two smaller banks. With the creation of the new Landeskreditbank (LKB) in 1972, responsibility for the most of the state's financial Mittelstand programs was transferred out of the bureaucracy into a new, relatively independent institution. In regards to economic policy, this marked the reintroduction of direct lending by the Land government to Mittelstand firms.

The Steinbeis Foundation, the Surety Bank/MBG, and the LKB were critical additions to the regional promotional network since through these organizations public and private actors coordinated their activities in the pursuit of collectively defined goals. The definition of goals was done in part through the supervisory boards and committees of these

²⁹. The national savings bank association (DSGV) also considered it desirable for Baden-Württemberg to have one girozentrale. See Biehal, 1984, op. cit. See also Reiff, Hermann. 1985. Erlebtes Baden-Württemberg: Erinnerungen eines Ministerialbeamten. Stuttgart: W. Kohlhammer, pp. 174-175.
organizations where leaders of the Land government, representatives of industry, and the crafts and banking sectors regularly discussed the needs of the regional economy. The coordination of activities occurred through inter-organizational cooperation on a day-to-day basis. Though other Länder had similar organizations to these, the amount of resources that came to be provided to firms through non-government organizations in Baden-Württemberg’s regional promotional network was substantially higher. After the oil crisis and subsequent recession in 1974 the extended regional network came to life as the resources flowing through it were dramatically enlarged. Baden-Württemberg’s alternative model of non-hierarchical and multilateral industrial governance demonstrated considerable adjustment capacity. This success was particularly striking when compared to the adjustment difficulties of northern regions where hierarchical forms of governance were more prevalent.


Though Baden-Württemberg suffered far less in the 1974 recession than other regions of the country, the downturn still had serious consequences for its economy. The number of bankruptcies and the unemployment rate rose dramatically. The restrictive monetary policy of the Bundesbank was exacerbating the liquidity problems of firms in a region where gross capital formation had already been declining since 1969, especially among the Mittelstand. Industrial employment had been sliding since its peak in 1970. Most alarming, however, were emerging sectoral crises in textiles and clothing, leather goods (including shoes), and clock-making. The Mittelstand was especially hard hit: The number of self-employed, especially in industry, began to decline even more rapidly than it already had been. Employment in craft firms declined while industrial concentration was rising.30

30. See Table 7-1b. Much of this section relies on the following publication: Economics Ministry of Baden Württemberg. 1977. Mittel-standsbericht. Stuttgart.
These threats to the small firm raised concern not only among the Mittelstand itself, but also among Land politicians in all parties.

The Land government responded to escalating demands by local Mittelstand firms for help with several "emergency" programs. In the beginning of 1974 the government created special sectoral programs for the textile and clothing, leather goods, and shoe industries. Firms in these sectors were eligible for subsidized loans from the LKB for rationalization measures. Its chief purpose was to retain jobs by consolidating troubled firms in these sectors, or by supporting firms that hired workers laid-off elsewhere.\(^{31}\) Unlike other sectors such as coal and steel, in Baden-Württemberg sectoral crises were not "managed" by the big commercial banks or through a centralized crisis management effort involving concertation among governments, banks, firms, and unions. Rather, sectoral governance and the process of industrial change remained largely decentralized. Firms could call upon their trade associations, promotional networks and state subsidies to aid them in their adjustment, but there were no centrally-coordinated rational-ization programs. Though a few sectors in Baden-Württemberg went through an irreversible decline, such as (non-cuckoo) clock-making, several other traditional sectors adjusted very successfully. The textile and clothing industry, for example, shed thousands of jobs but managed to rationalize production and remain one of West Germany's leading export sectors.

In its first serious test at Keynesian demand management the federal government adopted several reflationary and industrial adjustment measures. But in the view of the

\(^{31}\) In mid-1974 this special program was turned into a general Liquidity Assistance program. Demand for loans under this program exceeded available funds within six months leading to a temporary moratorium. In 1975 nearly one-half of the LKB's DM 507 loans to firms were granted under this program. Originally scheduled for a limited time period, the program is still in existence today. Publication of the Landtag of Baden-Württemberg, 6/7284 (5 March 1975).
government of Baden-Württemberg these measures were insufficient and promoted industrial concentration by favoring large over small firms. Moreover, the Land government felt that Baden-Württemberg firms were not receiving their fair share of federal funds. These conflicts over economic policy between Baden-Württemberg and the federal government were part of growing regional and national partisan disagreements between the CDU and SPD over tax, monetary, social, wage, and fiscal policy. Political tensions between the CDU-led Land governments and the social-liberal federal government grew in the mid-1970s as the CDU attempted to use its majority in the Bundesrat to promote its alternative policy program and challenge the political authority of the federal government. The Land governments of Baden-Württemberg and Bavaria were the leaders in this concerted attack.32

Thus the perceived inadequacy of federal economic recovery measures and different policy preferences of the ruling coalition in Baden-Württemberg reinforced the Land government’s expansion of its alternative economic policy approach. In so doing the Land government of Baden-Württemberg consciously steered against what it labeled the "Mittelstand-hostile" policies of the Federal government.33 The capstone of this endeavor was the 'Mittelstand promotion law' (Mittelstands-förderungsgesetz, MFG). By making Mittelstand promotion a permanent legal obligation of the government, the MFG was to be a manifesto for government and a symbolic victory for Mittelstand groups. On a more practical level, the MFG fixed the parameters and orientation for a better systematized and expanded set of promotion measures. Though the federal government also adopted


Mittelstand promotion measures, the ardent efforts of the CDU to pass a federal Mittelstand promotion law failed. The conflict over Mittelstand policies, and the politicization of the Bundesrat in general, were indicative of the decay in cooperative federalism that had been initiated in the late 1960s. Increasingly Land governments used their capacities to independently pursue regional interests and policy preferences.

The ability of the Land government of Baden-Württemberg to pursue a line of policy that promoted Mittelstand firms and multilateral governance mechanisms is also partly explained by key developments within the Land's political and administrative systems. In 1972 the CDU won an absolute majority in the Land parliamentary elections and could govern alone - the first time in Baden-Württemberg's history that a single party controlled the Land government. From this strengthened political position, the CDU pushed through several reform measures of the political-administrative system that increased the power and control of the governing party. Perhaps the most important reform - one contested strongly by the bureaucracy - was to increase the number of top-level ministerial officials and bureaucrats that were political appointees. This expanded the possibilities for patronage but also further shifted power from the parliament to executive, since more members of parliament could be included in the government. The Land government also used this reform to increase its control over the bureaucracy and reorganize its ministries in accordance with its political goals such as the expansion of the Economics Ministry. Finally, the popularity and political strength of the government's Minister-President, Hans Filbinger,

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35. See Reiff, 1985, op. cit., pp. 180-184. Weinacht adds that raising the number of top political appointees was also intended to allow the Land government's Ministers to spend more time pursuing its interests in Bonn. Weinacht, 1978, op. cit., p. 332.
permitted him to concentrate more power in his executive Ministry (State Ministry). Thus unhampered by party coalition partners, the CDU and the conservative social groups that supported it were in a much better position to pursue their policy preferences.

After lengthy consultations with the chambers, business associations, the labor federation, and other organizations, the Land government passed its Mittelstand Promotion Law in 1975. The new Mittelstand Program entailed first and foremost a further expansion of funds for all existing promotion measures. From approximately DM 28.5 million in 1970, these expenditures had already risen to DM 93.5 million in 1975; in 1976 they rose to DM 147.4 million and in 1977 to DM 179.5 million (see Table 7-4a). Funds were expanded the most for construction of new vocational training centers, applied R&D, and loans and investment grants to firms. The high priority accorded to economic policy by the Land government was clearly demonstrated by the fact that at the very same time the government was drastically cutting costs in other areas.

Sharing the belief that greater government action was necessary, the Land government and regional economic organizations in Baden-Württemberg also launched several new cooperative initiatives to promote structural adjustment in firms. In this respect the Land government was increasing its traditional indirect promotion of the Mittelstand through the provision of subsidies to firm networks and associations, though it increasingly combined indirect support with direct or bilateral aid to firms.

36. The law also created a permanent state-wide committee of representatives from government, the crafts, industry, finance and unions to advise the Economics ministry on all Mittelstand programs.

37. The government also expanded its funding to the Steinbeis Foundation and the Surety Bank.
Perhaps the most visible new direction in government activism was its pioneering venture into the field of export promotion. While the economy of the region had long had a strong export orientation, the government now felt a duty to help the Mittelstand achieve greater stability and growth through expansion in foreign markets. The first measure was a new export loan guarantee program at the LKB.\textsuperscript{38} The government also began encouraging firms to join in export ‘communities’ or cooperatives that would help firms establish and administer export and foreign operations, particularly in areas outside the western industrialized countries. The government itself participated in the formation of an export cooperative involving over 200 firms in the investment goods industry named BAWEX.\textsuperscript{39} Despite strong support from the government and business community, BAWEX failed within a few years for various organizational reasons. It seemed that the regional economy was not prepared to develop such obligational networks. Or perhaps more likely, local firms’ export business was adequately handled by the banks and therefore they did not see a need for a new organization. Expanded government intervention that build more directly on existing organizations and patterns of cooperation fared much better.

While the business consulting activity of the state-supported promotional network had been growing steadily for many years, the government still believed that the network was

\textsuperscript{38} In 1977 the LKB established a general export loan guarantee program for SMEs. Up to this point the Economics Ministry was periodically granting such guarantees on a case by case basis. For example, in 1975 and 1976 Ministry gave 17 loan guarantees worth DM 70 million. Economics Ministry of Baden Württemberg, 1977, op. cit., p. 46.

\textsuperscript{39} The government also expanded its funding for export consultancies through its existing advising office network, and introduced subsidized export consulting for local craft firms. BAWEX is the \textit{Baden-Württemberg Export Gemeinschaft}. See Landtag von Baden-Württemberg. Publication of the Landtag of Baden-Württemberg, 6/7390 (10 March 1975); Economics Ministry of Baden Württemberg, 1977, op. cit., p. 39.
inadequate.\textsuperscript{40} Thus in 1975 the Industry Chamber of the Middle Neckar region (around Stuttgart) introduced free short-term consultation for Mittelstand firms. This program was an unqualified success and consequently extended throughout the Land in cooperation with the RKW and with the financial support of the Land government.

At the end of 1976 the government had also worked out a new Innovation Promotion Program - the first technology program among the Länder that awarded R&D grants directly to firms.\textsuperscript{41} In justifying this new policy direction the Land government argued that global structural changes were forcing the economy to concentrate on technically demanding products and processes - hence economic policy would increasingly have to be technology policy. While the federal government had initiated its technology policy several years earlier, it focused intentionally on large firms, and was therefore seen in Baden-Württemberg as promoting economic concentration and centralization at the expense of the Mittelstand.

Through cooperation with the Industry Chambers, Steinbeis Foundation, and several cooperative industrial research institutes, the number of technology transfers offices in the Land was dramatically increased within a few years.\textsuperscript{42} A Central Office for Technology


\textsuperscript{41} Publication of the Landtag of Baden-Württemberg, 7/4421. Alongside grants from the Economics Ministry for research projects, the LGA introduced conditionally repayable grants for the development of new products or processes. The LKB, in turn, would augment the development grants with subsidized loans for the equipment necessary to produce a new product.

\textsuperscript{42} The Steinbeis foundation, for example, now operated technical advising offices at fourteen Fachhochschulen (see Table 7-3). Using the recently established innovation service of the Mannheim Chamber as their model, the government and Industry Chambers established four more innovation offices at various Chambers by 1979. Finishing out the network of technical advising offices are the universities and basic research institutes, though these organizations are oriented far more toward cooperation with large industry. The government also supported the technical advising of Mittelstand firms through its support for
Advising and Transfer was also formed in the State Commerce Office (LGA). With an advisory board consisting of representatives from government, industry, academia, and the unions, the LGA was supposed to coordinate the activities and future development of the organizations in the technology network. Though in practice resistance to central direction kept the LGA's role to a minimum and hence the provision of technological information to firms through promotional networks remained decentralized.

The government of Baden-Württemberg characterized its new innovation program as long-term ‘risk community’ (*Risikogemeinschaft*) in which the decision to innovate would be left to industry, but the risk of innovation shared. Here, as in other programs, the Land government shared the functions of policy-making and implementation with a range of quasi-public and private organizations. This practice not only helped legitimate government policies, it also spread the costs associated with them among the key economic organizations of the region - notably the chambers and numerous firm associations - and individual firms. This form of indirect or market-conforming government intervention was consistent with long-standing relations between government and business in Baden-Württemberg. It was therefore strongly supported by regional economic organizations and groups comprising the

several cooperative industrial research institutes. This included five textile research organizations, one each in clocks and fine instruments, precious metals and alloys, and paints. The government also supports the research efforts of the Frauenhofer Society which conducts R&D projects under contract from private firms, as well as offering advisory services. In 1977 the Society founded a Technology Development Corporation to help SMEs gain greater access to their research findings. In 1977 the RKW in Baden-Württemberg also established such an office with support from the Federal Ministry for Technology.

ruling coalition.\footnote{In parliament the Social Democrats also supported the program in general. Only the FDP seem concerned that it might be too dirigiste. Publication of the Landtag of Baden-Württemberg, 7/1200 (10 February 1977).} These market-conforming measures expanded tremendously in the second half of the 1970s.\footnote{Land government expenditures for indirect (or 'supra-firm') measures rose from DM 22.4 million in 1975 to DM 68.7 million by 1979. See Table 7-4a.} By emphasizing the further extension of aid to firm associations and promotional networks, particularly outside the urban agglomerations, Baden-Württemberg's policies not only favored economic production in smaller firms but also multilateral exchange strategies (obligational networks) among them.

But what grew even faster in the 1970s was direct or bilateral support to firms in the form of financial aid from the Land government.\footnote{From 1975 to 1979 the value of loan subsidies and grants to firms increased from DM 36 million to DM 146 million. See Table 7-4a.} This shift is accounted for in part by a different perception of the region's economic problems. In contrast to the 1966-1967 recession, which was generally perceived as a cyclical phenomenon, the 1974-1975 downturn was seen to be a consequence of structural economic changes that the market alone could not master in a socially acceptable manner. The growing emphasis by the Land government on direct intervention met somewhat greater resistance and skepticism: The Chambers of Industry and Commerce warned that the Land government was becoming increasingly dirigiste through the LKB. But no concerted opposition to the expansion of direct government lending emerged - once in place subsidized loans and grants became too popular among firms in the region for any business interest group to strongly oppose them. Moreover, because local business groups participated in the decision-making process for a large percentage of government grants and loans, they could influence the flow of capital and
thus became partly accountable. The strong showing of the CDU in the 1976 Land elections also suggested that the broader electorate approved of the government’s response to the economic crisis.\textsuperscript{47} Though direct aid to Mittelstand firms is less likely to promote cooperative or multilateral exchange strategies in firms, it is likely that it did hinder or slow economic concentration. This is suggested by the fact that the majority of government loans were for business start-ups, a critical activity to the regeneration of the Mittelstand as a group and a economic process where many believed that governments had a valuable promotional role to play.

By 1980 manufacturing employment in Baden-Württemberg had reached its highest level since 1974. In spite of an overall decline in the number of craft firms in this period, the total number they employed increased. The downward trend in the number of self-employed persons reversed itself in 1976, climbing steadily into 1980.\textsuperscript{48} Thus the last half of the decade was a period of relative prosperity in the Federal Republic, and especially in Baden-Württemberg. The Land government felt confirmed in its expanded economic role in the region. Demand by firms for the state-supported consulting network, continuing education, and technology programs was rising strongly. The state’s industrial development bank, the LKB, had become a major instrument of industrial policy. The minimal parliamentary control over the bank accorded the leaders of the bank and Land government considerable flexibility in utilizing the LKB’s capacities.

Thus within a decade the Land government had radically increased its economic interventions: subsidies to firms increased roughly five-fold. In so doing, the Land

\textsuperscript{47} In the 1976 elections the CDU extended its share of the electorate to 56.7%.

\textsuperscript{48} The government attributed this reversal in part to its own special program to promote self-employment introduced in late 1977.
government demonstrated significant autonomy to develop and pursue its economic policies, even when its policy preferences deviated from those of the federal government. Yet even though the Land government had achieved an expanded role in the regional economy, Baden-Württemberg still subsidized its economy far less than the other large industrial Länder and continued to emphasize support for the Mittelstand (see Table 7-4b).

The lack of a Landesbank inhibited the Land government of Baden-Württemberg from engaging in the sort of large-scale firm bail-outs that other Land governments were attempting in the 1970s.49 But perhaps even more important, there was little political support for the Land government to get so directly involved in the affairs of large industry. When the electronics giant AEG ran into trouble in the early 1980s, the big commercial banks and the Landesbank of North Rhine-Westphalia pumped large sums of money into the firm. Though AEG employed thousands in Baden-Württemberg the Land government did not invest funds in the rescue attempt, but the government did provide subsidized loans to the hundreds of supplier firms affected by AEG’s troubles. This type of intervention was far more acceptable and technically easier in Baden-Württemberg.

The success of this response and various regional promotional networks in general was predicated on the strong participation of the many small banks in the region, since the success of organizations such as the LKB, Surety Bank, MBG, and to some extent even the chambers, depend importantly on the willingness of the banks to use them. And the savings and cooperative banks have a long tradition of cooperating with other local organizations to assist their firm clients. The structure of the banking industry in Baden-Württemberg is a key feature that distinguishes the Land from the rest of the nation:

49. The LKB could have been used for this but lacked the mandate, and more importantly, the know-how to actually buy into a firm and assist its turnaround.
In 1960, Baden-Württemberg had twice as many savings and commercial cooperative banks per capita than the national average. The major banks combined had only 11% of their branches in Baden-Württemberg; North Rhine-Westphalia, in contrast, had 37%.\(^{50}\) Measured in terms of market share based on the total volume of banking business, this structural hegemony of the savings and cooperative banks holds: A 1974 study showed that in Baden-Württemberg both these banking groups had regional market shares well above their respective national averages - together they controlled nearly 70% of regional bank business. All banks headquartered outside the state - including the major, regional, and foreign banks - had just over 10% of Baden-Württemberg’s banking business.\(^{51}\)

Thus the combined predominance of small firms and small banks created the demand and support for regional institutions and promotional networks that provide a wide range of production-oriented services, capital and information to firms. In the 1980s the traditional system of indirect Mittelstand support continued to expand, though the trend toward greater direct government aid to firms overshadowed it. The expanded intervention of the Land government was strongly associated with the goals and political power of its Minister-President, Lothar Späth. Späth, Minister-President since 1978, attempted to build up stronger, centralized organizations to fulfill his most ambitious economic goals. But

\(^{50}\) On a per capita (or even per worker) basis, this placed the Baden-Württemberg 20% below the national average. The cooperative banks/branches of Baden-Württemberg represented 29.2% of all commercial cooperative banks in West Germany: Likewise the savings banks represented 28.9%. Siepman, 1968, op. cit., pp. 99, 146, 193.

\(^{51}\) See Publication of the Landtag of Baden-Württemberg, 6/8052. The cooperative banks had an 18.7% market share of Baden-Württemberg’s total banking volume; nationally the cooperative banks had 9.3%: Likewise, the savings banks in Baden-Württemberg had 27.8% (nationally, they had 22.1%) - not including their central banks, which had an additional 22%. Thus the savings and cooperative sectors together had 68.5% of Baden-Württemberg’s banking business; vs. a 53% national average. Additional statistics from Monthly Report of the Deutsche Bundesbank, vol. 30, no. 8, 1978.

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Mittelstand firms and their organizations resisted the most interventionist efforts, especially when they were intended to aid large firms. Thus many of Späth's intervention practices did not become institutionalized, but remained ad hoc. Yet at the same time, Späth's distinct model of neo-conservative modernization had a significant impact on the regional economy, as well as on the national economic policy debate and policies in the mid-1980s. The model of business-government relations and economic governance practiced in Baden-Württemberg came to be widely imitated in other Länder and to some extent by the federal government.

The 1980s: Späth-Capitalism.

By the late 1970s public debt at all levels of the federal system had reached politically alarming heights and was accelerating. In large part responsible for this, subsidies by the state to the private sector became the object of widespread and heated debate. As such, the forces in favor of a cutback in subsidies represented a decisive challenge to the interventionism of the federal and Länder governments. In 1981 and 1982 the Land government of Baden-Württemberg followed the national trend and consolidated its budget, slashing expenditures across the board including economic and Mittelstand programs. But 1982 was also a year of mobilization. Confronted with a deep recession and fast rising unemployment, the government began hearings on a reordering of its economic policy. But the emerging economic policy agenda of the Land government was strongly influenced by Lothar Späth.

In the early 1980s Späth developed a program for economic and social renewal that embodied an odd, if not contradictory, blend of statism and liberalism. He argued that

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52. In the area of Mittelstand promotion this meant expenditures in 1981 of about DM 208 million, and in 1982 down to DM 179.1 million (expenditures peaked at just under DM 300 million in 1979 - see table 7-4b).
society was in the midst of the transition from the industrial to the information society. The state, so he claimed, had to force this modernization by promoting technological change. The market alone would not sufficiently develop the information infrastructure and know-how needed in the new society. The state cannot replace the market, but it must act as a mediator or catalyst - to be an "active subsidiary." In practice his policy program would entail "supply-side" measures - which the regional promotional network of Baden-Württemberg had long emphasized - and innovation-orientated structural policies that targeted Mittelstand firms and particular sectors. A more active state role required Späth to increase the intervention or steering capacity of the government while building a societal consensus on the need for technological change in order to legitimize this role.53

To achieve a high media profile and mobilize political support for a new economic development strategy, in 1982 the Land government established three "expert commissions" to generate medium- and long-term policy programs.54 In December of that year the government brought the commissions together to present their proposals not only to the key political and economic elite of Baden-Württemberg, but to a high-browed international audience as well. This conference embodied the recognition of global technological competition by local actors, and a statement of Baden-Württemberg’s intention to be among the winners. In 1983 the government of Lothar Späth set about finalizing its reorganized economic development model based on the commission reports. Meanwhile, the government wasted no time in acting upon some of its most important technology policy objectives.


54. One each for research, export promotion, and new communications technologies.
Immediately following the conference the Land government named a 'Government Commissioner for Technology Transfer'. The commissioner's basic assignment was to support and accelerate the adjustment of the Mittelstand to rapid technical change. Heeding warnings of further bureaucratization by key economic leaders, the government proposed that the principal agent for the commissioner not be a state agency but the Steinbeis Foundation. By April of 1983 an agreement was reached through which the commissioner - Johann Löhn - became head of the Steinbeis Foundation. In exchange the government financed a major expansion of the Foundation's capital and ongoing operations. With an expanded apparatus that was also better shielded from political conflicts because of the Foundation's quasi-private status, the Land government began implementing several new technology initiatives to promote R&D in Mittelstand firms and the technological modernization of non-innovative firms.

The now sixteen technical advising offices of the Steinbeis foundation were a proven success. In fact, the offices were so successful that they were approaching the limits of their capacity. The solution to this problem was to create technology transfer centers that would conduct research and development in very specifically defined technologies. The centers were to be largely self-financing through contracts with industry and staffed primarily by recent graduates of the engineering polytechnics. The centers also provided a forum for educating the workers in the firms where the new technologies were destined. Since they were built on traditional cooperation between the polytechnics and industry, new centers were rapidly established: By 1985 twenty-two centers had been established; by 1989, there were sixty-four transfer centers (see Table 7-3).

55. In 1983 nearly 800 professors, technicians, and students were involved in conducting 1,700 R&D contracts from industry and close to 2,000 consulting sessions (Table 7-3).
The year 1984 began with the introduction of the government's long-awaited new Economic Promotion Program (*Wirtschaftsförderungs-programm*, or WIP). The WIP had contained four policy areas: Mittelstand policy, technology policy, regional policy, and tourism promotion. Despite tremendous efforts, Späth was not able to realize all of his goals in the WIP. Späth wanted to eliminate strictly regional policies from the government's program because he considered them conservative and therefore inefficient. When it came to regional policy Späth argued for more market and less state. Instead, he wanted to use the money spent for regional promotion as a "fire department fund" that he could use largely independently of the parliament to help troubled firms quickly and without excessive bureaucracy. Späth was trying to create an interventionist capacity that other Land governments found in their Landesbanks.

But the Land parliamentary groups of the CDU and SPD resisted giving the Minister-President so much independent power. Moreover, many of the legislators represented districts that benefitted from regional policies and their constituents vehemently opposed a reduction in funding. The Economics Ministry sought to defend this policy area as well and joined in an alliance with the CDU and SPD to defeat Späth. Regional policy was retained, albeit at a slightly lower level of funding. In this case Späth failed to redirect resources toward his preferred policy areas. Nonetheless, Späth was able to devote substantial resources to technology policy which enjoyed a far broader base of support.

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Like many other subnational governments around the industrial world, one of the first technology initiatives of Baden-Württemberg was to attempt to recreate the Silicon Valley phenomenon. Through the technical assistance of the Steinbeis foundation and financial support from the Economics Ministry, the Land government eagerly supported the creation of technology parks intended to be ‘incubators’ for new technology-oriented firms. Baden-Württemberg’s model required that the initiative, planning and operation of such centers be done through local organizational coalitions.\textsuperscript{58} By the late 1980s, over a dozen parks had been established and more were planned.

Without local equivalents to the venture capital firms glorified for their role in fostering the high-tech boom in the U.S., Baden-Württemberg attempted to coordinate and direct several sources of funds toward the high-risk investments of Mittelstand firms: From the LGA came project-specific innovations grants; from the LKB came innovation loans; from the Surety Bank came loan guarantees; and from the Mittelstand Participation Corporation (MBG) came "venture capital" in this organization’s particular form of equity finance.\textsuperscript{59}

One of the most prominent new programs under the WIP supported the introduction of modern "unproven" technologies into firms either through a low-interest loan from the LKB or a grant from the LGA. As the government’s technology commissioner, Löhn was officially required to give technical approval of all supported projects. In practice, this form of direct firm support typically financed the introduction of CAD/CAM, numerically-controlled machine tools, and other related microelectronics technology into the production

\textsuperscript{58} These typically involved a university, the chambers, local governments and banks.

\textsuperscript{59} In 1983 the Federal government had already started a similar program for new technology-oriented firms (TOU), thus providing yet another source of funds.
systems of Mittelstand firms. The government complemented this measure by, among other things, strongly encouraging educational organizations to expand their continuing education courses related to these technologies.

Though much fanfare and media attention centered around these new initiatives, the "traditional" technology promotion programs and efforts were hardly neglected. Funding for research at the universities, Fachhochschulen, and the numerous applied industrial research organizations in the region was greatly expanded. To increase the transfer of technical information from these research organizations to regional industry the Steinbeis Foundation established eight new advising offices at universities and other research institutions. With these new offices Baden-Württemberg attained an extensive promotional network involving twenty-eight "contact" offices throughout the state where firms could go for technical advice or be put in contact with an appropriate technology organization.

The mid-1980s were also years of high-profile export promotion by the Land government and Lothar Späth in particular. In between jumping from one international trade fair to the next - with a full entourage of business representatives from home in tow - Späth sought "partner" regions in Europe, North America, and Asia.\(^{60}\) While these vaguely defined cooperation agreements brought little immediate results, the Minister-President held them out as promising long-term opportunities to promote industry in Baden-Württemberg.\(^{61}\)

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\(^{60}\) Because of his "wanderlust" as a spokesperson for local firms, he was dubbed by the press as the 'travelling salesman.'

\(^{61}\) Späth's alliances with other European regions became known as his "little EC." Through a series of international congresses on European integration the Land government of Baden-Württemberg hoped to take a leading role in shaping the intellectual debate and, perhaps, policy choices in the Community - with Stuttgart as the turntable of Europe. See "'Modell für die Zusammenarbeit'," Badische Zeitung, 29 October 1987; and "Plusterländle ohne Potenz," Der Spiegel, 29 January 1990.
On a more modest level and in keeping with the traditional pattern of business-government relations, the Land government, the Chambers of Industry and Commerce, and the Land Association of Baden-Württemberg Industry established a new Export Promotion Foundation in 1984. In addition to its own export promotion activities, the foundation intended to support and coordinate the numerous sources of export information, consulting, and education in the region.

The rejuvenation of the Land government’s industrial policy in the mid-1980s was confirmed by a sensational rise in subsidies. From a low of DM 179 million in 1982, subsidies in the Mittelstand program alone rose 66% in three years to DM 299 million (1985). Not surprisingly, one of the biggest increases came in expenditures for applied R&D. Through the cooperative efforts of the LKB, Surety Bank, MBG, Steinbeis Foundation, Economics Ministry, the Land government was able to direct substantial resources to its technology programs. In 1983 only 2% (by volume) of the LKB’s subsidized loans to firms went for innovation and technology promotion, and 56% of the loans were for business start-ups; in 1986, 38% of the LKB’s loans were for technology promotion, and 34% for start-ups (Table 7-4a). The Surety Bank backed many of the LKB’s and other bank loans for R&D investment projects in individual firms with guarantees, as well as equity capital (via the MBG) for firms in Baden-Württemberg’s technology parks. Coordination among these organizations is secured in part through the practice of basing lending/investment decisions on a technical evaluation of each project from the Steinbeis Foundation.

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62. In 1986 almost half of the MBG’s new participations went to technology-oriented investments, including firm start-ups. Annual Report of the Mittelstand Equity Participation Corporation, 1986; and Table 7-2f.
Within a few short years the Steinbeis Foundation became the "turntable" for technology promotion and cooperation in Baden-Württemberg. Internally, it is a highly decentralized organization in which the central administration minimally coordinates the activities of the numerous technology centers and advising offices. The vast majority of its "employees" are the professors and students distributed throughout the state working in direct cooperation with firms. When the foundation is asked to provide a technical evaluation for the LKB, Surety Bank, or other project, it calls upon appropriate professors from the state's universities and polytechnics. Thus Baden-Württemberg's technology policy was not dominated by one centralized agency, but relied on negotiation and cooperation among a large number of actors and organizations. This model afforded local groups greater autonomy in responding to the demands of local Mittelstand firms.

Combined with the subsidies flowing to Mittelstand firms from the conservative federal government after 1982, small firms in Baden-Württemberg and elsewhere in the Federal Republic were enjoying an unprecedented level of state financial support in the mid-1980s. Even though economic recovery was well underway by 1985, intense competition among the Länder kept subsidy levels rising. Through early 1986 the popularity of Späth's brand of economic policy also seemed to be rising. The regional and national press, unions, SPD, and business associations all seemed to find something positive in the Baden-Württemberg model. With the Social Democrats in disarray and strong public perception of

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63. From just over 600 consultancies and research projects in 1972, this number expanded to nearly 10,000 in 1986. Revenues from consulting and contracts rose from DM 190,000 to DM 22 million in this period. Subsidies from the Land government for limited consultancies for small firms provided an additional DM 5 million in revenue. Annual Report of the Steinbeis Foundation, 1986.
the Kohl government as inept, Lothar Spähth seemed like an increasingly rare political leader with a vision that could draw wide social support for an effective policy agenda.⁶⁴

This rapid expansion of Länder economic intervention was not without its critics. The Federal government was increasingly concerned with the ruinous effects of intense subsidy competition among the Länder. The Economics Minister, Lambsdorff, was the most vociferous in his condemnation of such competition as 'federal mercantilism.' He was particularly critical of Spähth and Strauss in Bavaria for their backdoor meddling in the Federal government's foreign economic policy. Spähth’s own brand of industrial policy was scornfully labelled 'Spähth-capitalism,' especially by other Länder which could ill-afford such competition.⁶⁵

Neither were Spähth’s economic policies spared from criticism at home in Baden-Württemberg - the eagerness of the Land government to promote local industry was beginning to make it appear as little more than a promotion agent of the economy - the Minister-President’s State Ministry was dubbed by some critics as the Stuttgart "MITI".⁶⁶ The Working Group of the Industry Chambers in Baden-Württemberg, for example, had voiced its disapproval of direct government financial assistance to firms as early as 1976.⁶⁷

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⁶⁵. Jungblut, Michael. "Manchmal helfen Ideen mehr als Geld....," (interview with Lothar Spähth) Die Zeit, 20 December 1985. Criticism of the Land government’s subsidy policies also came from the EEC which forced the government to alter or curtail some of its programs. For example, after 1984 liquidity assistance loans by the LKB could no longer made at subsidized interest rates.


With each new major economic policy initiative the group reminded the Land government that the best Mittelstand policy would be a reduction of the overall tax and social wage burden on small firms and the cessation of unjustified subsidies to large firms. In response to such criticism Späth publicly asserted his intentions to dismantle subsidies, but continued to pursue his ambitious economic plans.\textsuperscript{68}

Though subsidies to Mittelstand firms flowed even more freely after 1984 than for the previous four or five years, many entrepreneurs in the craft sector also grew more critical of the Land government. In the 1970s and early 1980s Mittelstand policy had focused primarily on promoting business start-ups and the craft sector was the prime beneficiary of this policy. By the mid-1980s Mittelstand policy became larger synonymous with technology policy, and the prime beneficiaries of technology promotion were not craft firms but larger Mittelstand firms (see Table 7-1e and Appendix to Chapter 7).

When in 1987 the Land government "won" a new Daimler-Benz automobile plant over dozens of competitors with a DM 70 million subsidy, the outcry among the Mittelstand - especially the craft sector - was tremendous. Späth was increasingly seen as favoring large firms over the Mittelstand and the Daimler case threatened to undermine support for the Land government among a key social group. Pressure on the government to redress this favoritism of large firms also came from inside the CDU. At the party congress in August the members of the CDU Mittelstand Union - an influential organization of party members concerned with the affairs of the Mittelstand - made no secret of its uneasiness with recent "anti-Mittelstand"

decisions of the government.\textsuperscript{69} The upcoming elections in early 1988 undoubtedly magnified the seriousness of the Mittelstand’s dissatisfaction in the eyes of the government. While the Land government had widened the circle of firms receiving state resources, it could not afford to neglect the very powerful crafts sector.\textsuperscript{70} Späth’s growing deviations from the traditional pattern of state support for firm networks and associations were straining his base of support.

Despite the widespread belief that the CDU would not win an absolute majority in the March 1988 election, Späth demonstrated his enormous political skills and succeeded in mobilizing sufficient support for the CDU to win a majority.\textsuperscript{71} The CDU’s victory was no doubt due in part to a timely response to the demands of the Mittelstand. In late 1987 the Land government announced a new Mittelstand ‘policy offensive’ that included a package of

\textsuperscript{69}. Specifically, the Union, as well as most Mittelstand firms, was very disturbed by the Daimler case: and by the new "water penny" tax that generated subsidies for farmers but business vehemently opposed. "Werben um die verärgerten Mittelständler", \textit{Mannheimer Morgen}, 3 September 1987. For Späth the Daimler subsidy was justified by the firm’s agreement to invest large sums in the Land government’s giant Science-City project in Ulm where an expansion of the university’s research capacities were to be joined by a series of public-private high-tech research institutes. See Thierer, Hans-Uli. "Die Geburtstunde einer Idee," \textit{Südwestpresse}, 7 October 1987.

\textsuperscript{70}. The crafts sector’s power stems from a combination of its economic importance (some 100,000 craft firms in Baden-Württemberg employ about 670,000 workers, equal to 16\% of its labor force), its tight organization and ability to act politically with a high level of cohesiveness, and its position as a traditional electoral support group for the conservative parties. The Mittelstand Promotion Law of 1975, for example, incorporated many of the demands of the craft sector which actively lobbied for its promulgation. In 1984 the craft sector of Baden-Württemberg published a catalogue of more than 100 demands on the Land parliament and government for the coming legislative period. While on the one hand denouncing growing state economic interference, on the other hand the list largely contained demands tantamount to pleas for more government subsidies.

measures. Thus key groups of the Land government's ruling coalition would not allow it to go too far astray from accepted norms. The traditional emphasis on Mittelstand promotion implemented in a comparatively decentralized manner through state subsidies to regional networks and associations continued to be the mainstay of government economic policy. Direct government aid to Mittelstand firms remained largely constant, if not declining in real terms, in the late 1980s and early 1990s.

Still, in the 1970s and 1980s significant changes occurred in the Land government's economic policies and its role in the regional economy. The extent and intensity of the regional promotional network was dramatically expanded. From 1972 to 1987, the total assets of the LKB rose from DM 9 billion to DM 40 billion, making the LKB one of the nation's top 20 banks. Under the government's economic promotion programs, the bank granted over 5,000 new loans, grants, and guarantees valued at DM 1.142 billion in 1987. This figure represents a tenfold increase in such lending over 1972, the bank's first year. In 1986 the Surety bank granted over 1,100 guarantees equalling DM 200 million. This represented one-third of all guarantees granted by credit guarantee cooperatives nationwide. Baden-Württemberg's cooperative equity corporation (MBG), for its part, took nearly 900 participations in Mittelstand firms from its beginning to the end of 1986, investing DM 126 million. As of 1986 the MBG held investments worth DM 75.7 million in 541 firms (Table 7-2). While these numbers may seem modest, all of West Germany's private venture capital

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72. See "Leistungsfähige Handwerksbetriebe als Wirtschaftsfaktor," Staatsanzeiger, 19 September 1987; and "Wichtige Teile des Zukunftsmanglasses bereits umgesetzt," Staatsanzeiger, 5 March 1988. A month before the elections, the LKB also introduced a new Mittelstand loan program which made an additional DM 450 million in favorable credits available to local firms.

firms together had investments totalling roughly DM 150 million in 1986. Through cooperative arrangements with organizations in other countries, Baden-Württemberg’s regional network has in some sense also become internationalized.74

There was also a marked trend in Baden-Württemberg to transferring the implementation of government economic policies out of the Economics Ministry and the State Commerce Office (LGA) to the quasi-public or private organizations of the regional promotional network. This was supported by the dominant business groups, because the programs would be implemented by organizations that were completely, or at least partially, under their control. On the other hand, this trend often drew criticism from the political opposition - and occasionally government ministries - because it made the Land government’s economic policies more insulated from parliamentary control.75

The success and expansion of the organizations of the regional promotional network were not solely conditioned by the expansion of government subsidies. Many of these organizations provide collective and non-collective goods and services directly to firms that are not state-subsidized. Thus the expansion of regional promotional networks is also a function of the generally strong growth of Mittelstand firms and their willingness to

74. Through initiative of the Land government an industrial park was established in Japan for German Mittelstand firms (nine of the first twenty-two firms are from Baden-Württemberg), and another one established in Baden-Württemberg for Japanese firms. Firms in the park are eligible for the resources of regional promotional network. Even such giants as Sony have successfully tapped into the regional network to improve the productivity of local facilities. Masuko, Takashi. "German state woos small, mid-sized Japan firms," The Japan Economic Journal, 20 May 1989; and "Späth: Deutsche Seite muss mehr Präsenz vor Ort zeigen," Handelsblatt, 19 November 1987.

75. Even though it is a state bank, the Land parliament frequently complained that it had too little control over the LKB. In 1987 the LKB assumed even more functions when it was given responsibility for implementing all of the government’s firm-specific promotion programs. Practically this meant that grants for R&D projects would no longer be dispensed by the LGA and Economics Ministry, but by the LKB.
cooperate. The strength of the Mittelstand and its 'self-help' organizations continue to distinguish the governance of industry and business-government relations in Baden-Württemberg from other Länder. By providing considerable resources directly to Mittelstand firms and to their networks and associations, government actions promote the maintenance of non-hierarchical governance mechanisms in the region. Even under considerable adjustment pressures and intense competition, production in Baden-Württemberg remains relatively decentralized.
Diagram 7-1

Principle Organizations of the Regional Promotional Network.
1989

Finance Ministry
(with supervisory authority
over the following…

Landeskreditbank
Baden-Württemberg

Economics Ministry
(with supervisory authority)

Landesgewerbeamt (LGA)

Surety Bank and
Mittelstand Participation
Corporation of
Baden-Württemberg

Steinbeis Foundation

Export Economy Foundation

Crafts Chambers (8)

Chambers of Industry
and Commerce (12)
D. Banks and Industrial Governance in Baden-Württemberg.

In the course of the 1970s, and particularly in the 1980s, the Land government under Lothar Späth attempted to act more strategically - to steer the development of the regional economy in a direction which it deemed desirable. One of the major instruments and objects of government industrial policy in Baden-Württemberg was the banking system. The case of Baden-Württemberg illustrates several of the arguments made in chapters 2 and 3. Most importantly, the case shows the considerable influence of the Land government over change in the regional banking sector. Through the growing amount of finance provided directly to firms by the government, regulatory changes, and promotion of bank mergers, the Land government was able to effect changes in the strategies and market power of several key regional financial institutions. Though this did not dramatically alter the region's industrial finance system, it did strengthen the market position of public sector banks, including those under the direct control of the Land government.

Since the early 1970s the Land government of Baden-Württemberg has become increasingly important source of industrial finance through the LKB. Through the LKB and direct grants the government has been able to influence the price of capital, as well as to direct it to particular firms and sectors in accordance with its policy priorities. For example, while the technology policy of Baden-Württemberg was designed to assist all qualifying firms, in practice a large percentage of the financial aid flowed to Mittelstand firms in the machine tool sector (see Appendix to Chapter 7). The continued success of this Mittelstand-dominated sector suggests that it has successfully integrated new microelectronic technology into the production process. In Baden-Württemberg this process of industrial change occurred through the independent decisions of individual entrepreneurs, but these decisions in favor of new technology were strongly encouraged by incentives provided through the
regional promotional network. In this respect the Land government’s involvement in industrial finance has worked to reinforce production in Mittelstand firms and thereby preserve non-hierarchical governance mechanisms in the region.

Through regulatory changes the government acted to preserve its decentralized banking system by promoting the expansion of the savings banks into more commercial banking markets. In spite of a long-term trend to concentration in the financial sector, Baden-Württemberg continues to have a comparatively decentralized banking sector. Even in the 1970s and 1980s, as the major banks intensified their efforts to win more consumer and Mittelstand business, the savings bank sector managed to maintain its near 50% share of Baden-Württemberg’s total banking business.76 Meanwhile, the cooperative sector increased its share of the region’s market from just under 20% in 1974, to 30% in 1988.77 The major commercial banks are also present in the region, some of them since the early twentieth century. But their relations to firms in the region are strongest with the large corporations and a relatively small group of larger Mittelstand firms. With the exception of export finance, the attempt of the major commercial banks to gain more of the Mittelstand market has faced stiff competition from the indigenous savings and cooperative banks.

The patterns of business-government relations and process of industrial change in Baden-Württemberg were strongly shaped by the structure of the banking system. When firms or sectors in Baden-Württemberg face serious adjustment problems there have been few

76. "Württemberg’s grösste Finanzgruppe nimmt Mass," in Schwäbische Zeitung, 8 November 1988. Bruno Rühl, President of the Württemberg savings bank association, set their overall market share at 49.5 percent. Though their share of domestic loans to businesses in Baden-Württemberg is 38.5 percent, in lending to craft firms, the sector’s share is 57 percent.

visible attempts to rationalize them through bank-determined plans. Rather, Mittelstand firms rely on their associations, various promotional networks and their close, but non-tutelary, relationship to a local bank. As suggested earlier, the strikingly decentralized banking structure of Baden-Württemberg is arguably an important factor aiding the preservation of a decentralized industrial structure.

Through personal contacts and political maneuvering, the Land government induced fusions among regional banks in order to raise the market share of indigenous banks, as well as its own intervention capacities. Though few firms in the region felt inadequately served by the banking system, the Land government under Späth wanted control of a bank large enough to carry out large-scale finance, as well as to build up a locally controlled financial institutions that could boost the export business of regional Mittelstand firms. For example, among his many efforts to promote Baden-Württemberg industry abroad in the 1980s, Späth developed an agreement with Hungary and helped convince a consortium of Baden-Württemberg banks to provide a DM 300 million line of credit to finance trade and economic ventures involving Baden-Württemberg and Hungarian firms. If the Land government controlled a Landesbank on the order of the WestLB, it believed it could generate similar arrangements more readily. The mixed results of the government’s bank mergers efforts, however, illuminate at once both the limits of government intervention and the significant extent of its influence over the evolution of the region’s banking sector.

The willingness of the Land government to alter the savings bank law and regulations in cooperation with the regional associations and banks shows how the evolution of the Land

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government's economic policy and the structure and functions of the regional banking system are interdependent: The savings banks and Land government are each dependent on cooperation with the other to maintain their ability to adapt to changing conditions. Furthermore, the bank fusion and regulation stories teach us that change in West Germany's banking system is not simply an economic process driven by market competition, but a process strongly influenced by political factors which themselves are shaped by particularities of history. The institutionalized patterns of cooperation, trust, and the mutual exchange of resources among the savings banks and local and regional governments built up over a long period of time delimit the alternatives for change. On a broader level, the story of these fusion attempts illuminates the region's reaction to growing international economic dependence as an attempt to maintain the foundation for local control over capital resources.

The Long Road to Fusion.

In September of 1973 the two largest savings bank in Baden-Württemberg announced their intention to merge. Both savings banks were eager to expand their business, especially in the lucrative, heavily-industrialized Middle Neckar region around Stuttgart. The Land government did not initiate this fusion, but it was firmly resolved to clear the political hurdles which stood in its way. Greatest resistance came from the savings banks in Württemberg and their Girozentrale which would face increased competition from these bigger savings banks. The opposition tried to block the fusion by citing it as a violation of the regional principle, since the fusion would allow the Stuttgart savings banks (Girokasse)

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79. These were the Girokasse Stuttgart, the savings bank of the capitol city, and the Württembergische Landessparkasse, a savings bank which for unique historical reasons operated branches throughout the former state of Württemberg.
to operate beyond its assigned region. The government countered this with the argument that the existing savings banks in the Middle Neckar region were sufficiently strong to compete effectively, and that invigorated competition would benefit the Mittelstand. The Land government argued further that this fusion had political importance beyond the creation of a new savings bank - that this was an important contribution to the widely agreed upon need to strengthen the competitiveness of the public banking sector.

After lengthy negotiations among the savings banks and the Land government an agreement was finally reached. As part of the deal several measures to minimize competition within the savings bank sector were to be initiated. Once sufficient political support solidified, Baden-Württemberg’s savings bank law was amended in January 1975 to authorize the fusion of the two savings banks. The Landesgirokasse Stuttgart (LGK) was created with ownership divided equally between the city of Stuttgart and the Land government. More importantly, the debate over this savings bank fusion had given new life to public discussion over a solution of Baden-Württemberg’s "Landesbank problem". In a resolution accompanying the amendment, the Land parliament voted overwhelmingly that the government should continue to promote the fusion of the two Girozentrale and two public mortgage banks in the Land. If such a merger was not voluntarily achieved by January 1, 1978, then the Land government was instructed to use its legal authority to compel a fusion.

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80. Moreover, they argued that the communal reforms from a couple years earlier had already taxed the resources of the Land’s savings banks as many fusions and the exchange of branches were required to conform with the new county boundaries. To now foist more competition on them through this new bank, opponents argued, would be an irresponsible act by the government (subsequent to reforms in 1973 the number of savings banks in Württemberg was reduced from thirty-seven to twenty-five in 1973. In Baden the number of banks went from ninety-five to seventy-one). See Publications of the Landtag of Baden-Württemberg, 6/3642; 6/6657; and 6/6662. For a general discussion of administrative reform in this period see Katzenstein, 1987, op. cit., pp. 254-274.
While the parliament and Land government considered a fusion of the Girozentrale primarily an affair of the savings banks, it justified this ultimatum in the name of greater political significance; namely, that it was essential to further the political integration of the two previously independent states, and to promote needed concentration in the public banking sector.\textsuperscript{81} The government immediately intensified its campaign and reopened official negotiations with the two savings bank associations.

Given its failure to achieve the fusion of the girozentrale in 1970-1971, this time the Land government decided to pursue at least two potential routes to a large Land-owned bank. While negotiations with the savings banks proceeded, the government initiated a parallel fusion plan involving the \textit{Badische Bank}, the \textit{Württembergische Bank}, and the \textit{Handelsbank Heilbronn}. The first two banks were the former central (note-issuing) banks of their respective states and majority-owned by the Land government. The latter was the only significant private regional commercial bank in Baden-Württemberg. After long and difficult negotiations with the principal shareholders of the Handelsbank - among them were the Deutsche Bank and Bosch - a merger agreement was finally reached in late 1977. The new \textit{Baden-Württembergische Bank}, or BW-Bank, was expected to function primarily as a private commercial bank, though the Land government owned the controlling share and intended to use the bank for "house bank" functions.\textsuperscript{82} With the BW-Bank the Land government

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{81}] See Biehal, 1984, op. cit.; and Publication of the Landtag of Baden-Württemberg, 6/6999. Though Baden-Württemberg had existed since 1952, fear that the next referendum would rescind this political union helped prevent the government from taking any action regarding the banks until the early 1970s. See Schäfer, Waldemar. "Trotz vieler Bemühungen ist keine Ba-Wü-Laba in Sicht," \textit{Handelsblatt}, 19 October 1977.
\item[\textsuperscript{82}] As the 'house bank' of the government, the BW-Bank would, for example, hold its bank deposits and lend it funds as necessary. The BW-Bank remained one of Bosch's house banks as well.
\end{enumerate}
\end{footnotesize}
believed it had moved a step closer to its ultimate goals: First, it had created a bigger indigenous bank to strengthen the regional banking sector. Second, the Land government also apparently believed it could coax the Girozentrale into a merger by offering them a merger with the commercially strong BW-Bank.

After two years of negotiations the Landesbank fusion attempt foundered once again on the resistance of the Baden savings bank association. Though a voluntary agreement had failed, the Land government had the option of forcing a fusion based on the Land parliament’s 1975 resolution. But the government chose not to pursue this option since it would risk alienating the savings bank sector, and more importantly, a series of bad loans at the Württemberg girozentrale and the serious problems of Landesbanks in other Länder soured the readiness of legislators to attempt a momentous political battle for a somewhat discredited cause.\textsuperscript{83} Many political and economic leaders thought it fortunate that Baden-Württemberg had not had a Landesbank under government control. Various discussions continued among the Land’s two savings bank associations in subsequent years but no agreement was reached and there were no more concerted attempts by the Land government to force one until 1984.

With his highly-touted economic policy up and running, bejeweled with a major technology program, Lothar Späth decided it was time to see if his string of political successes could be extended into a government-controlled Landesbank. Späth wanted a powerful regional bank attuned to the needs of local firms and able to complement the government’s industrial policy through, among other things, a strong focus on export and

\textsuperscript{83} Again, see Schäfer, "Trotz vieler Bemühungen ist keine Ba-Wü-Laba in Sicht," \textit{Handelsblatt}, 19 October 1977; Biehal, 1984, op. cit.
technology finance.  According to the Land government’s statements, a big Landesbank was needed especially for the Mittelstand, since only a strong bank orientated to Baden-Württemberg could ensure that regional capital would benefit regional firms in good times and bad. Always in competition, the Land government of Baden-Württemberg also sought to mimic the Bavarian government insofar as its industrial policies were often supplemented with supportive actions by the three large Bavarian regional banks. Finally, the invasion of these Bavarian banks into Baden-Württemberg was taking away business from local banks. It was simply unacceptable, so the Minister-President argued, that local firms should get credit more easily in Bavaria than in Baden-Württemberg.  

Späth favored a four-way fusion model which, in addition to the two Girozentrale, would include the LKB and the Landesgirokasse. The latter two institutions were attractive fusion partners for the Girozentrale: the LKB, because it had a strong equity base; the Landesgirokasse, because it had 240 branches and was the only bank of the four with any

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84. Through a Landesbank Späth and many others hoped to break the monopoly of the commercial banks in the export finance market since the savings banks of Baden-Württemberg finance only 6% of the region’s exports, while the Deutsche Bank alone finances 60%. "Südwest-Bankenfusion," in Wirtschaftswoche, 30 August 1985. pp. 113-116.

85. The BW-Bank, a natural candidate for fusion given majority-ownership (54%) by the Land, was actually out of reach. The four other major shareholders, but especially Bosch and the Deutsche Bank, refused to go along with the plan. Since they had a ‘blocking minority,’ the Land government had no options. See Spiess, Felix. "Schwierigkeiten mit einer neuen Bank," Süddeutsche Zeitung, 21 December 1985.
tangible export-finance experience. If the four-way fusion were to succeed, the new bank would be larger than the Dresdner Bank, the nation’s second largest.

In this latest attempt at a Landesbank merger, Späth would encounter much of the same opposition as his forerunners. The private banking association was conclusively opposed, arguing that Baden-Württemberg’s export business was already well-served by the private banking sector.\(^87\) The cooperative banks opposed the fusion on the grounds that a competitive disadvantage would arise if the government economic programs of the LKB were administered by the rival savings bank organization via its Landesbank.\(^88\) As in previous attempts, the Württemberg Girozentrale was ready to fuse. This time it had more to offer as it had put together an impressive growth record since the last fusion attempt in 1977. Ever fearful of being further marginalized in the Land’s banking sector, the Baden Girozentrale and savings banks were still skeptical. But slow growth of the Baden Girozentrale and growing competition in banking markets was making a “go-it-alone” strategy less promising for the future.

Neither could Späth afford to neglect his own cabinet and the parliament where sufficient support was by no means guaranteed. Some politicians were still concerned that a big Landesbank might embroil the government in monstrous financial fiascos as they had continued to do in other Länder. And as before, the savings banks could exert great pressure

\(^{87}\) Though many commercial bankers also saw an opportunity through the creation of a new Landesbank since, they figured, it would take years before the new bank could get its house in order. In the mean time, this would give the other banks a competitive advantage. See Spiess, Felix. “Schwierigkeiten mit einer neuen Bank,” Süddeutsche Zeitung, 21 December 1985, p. 25. Also “Bankenfusion in Baden-Württemberg,” Wirtschaftswoche, 4 April 1986, pp. 145-146.

in parliament if they so chose. The leader of the powerful CDU parliamentary group, Erwin Teufel, was from Baden. If he chose to oppose the fusion he could decisively condemn it.

Through 1985 negotiations dragged on. The endless shift of proposals, strategies, interests, and tactics by the numerous actors involved made it seem, at times, that an agreement would be impossible to reach. By April of 1986, after relentless pressure and persuasion by Späth, it finally appeared that the Landesbank would become reality. Informal agreement had been given from all parties except the Baden savings banks, but even they were now expected to follow suit.\(^8^9\) However, the Landesbank did not come without concessions. To assuage the local savings banks, the Landesgirokasse would have to shed one-third of its branches. To assuage the cooperative and commercial banks, the state lending programs administered by the LKB - which represented two-thirds of its balance sheet - would not be brought into the Landesbank.\(^9^0\) As negotiations entered the finalizing stage in June the path to a new Landesbank took an unexpected and ominous turn. Suddenly the Landesgirokasse, which was supposed to entice the Baden Girozentrale into the merger with its strong assets and know-how, backed out of the deal.

The Landesgirokasse cited the recently mounting losses of the Baden girozentrale as the main reason for a negative decision. But Späth felt personally betrayed by Walter Zügel, the aspiring head of the Landesgirokasse, and Manfred Rommel, mayor of Stuttgart. Both men had been supporters of the fusion plan from the beginning. Zügel, in fact, was one of its greatest boosters. Späth was convinced that Zügel backed out only so that he could privatize the Landesgirokasse - a very large and commercially successful savings banks - and


free himself of the "yoke" placed on his bank by the savings bank law.  
This defeat for Späth ended his eighteen-month long battle for a Landesbank. A few days later he announced that the plan was dropped and that he would not pursue the legal channel to force a merger, claiming that with all the trust destroyed among the parties, a fusion could no longer have a positive outcome.  

Yet even in defeat Späth remained determined to build up the Land government termed its critically "underdeveloped service sector." Späth sought to merge banks in which the Land government had a controlling interest, including the Baden-Württembergische Bank. But when these attempts also failed, Späth switched his strategy once again. Instead of building a large state-controlled bank, he would help regional private financial organizations build an all-finance concern. In the summer of 1987 the Land government announced its intention to sell just over 18% of the BW-Bank’s shares to two insurance groups in the state which already held shares in the bank. Bonded together through interlocking shareholdings, this large financial group would command the three components of an all-finance concern; insurance, mortgage banking, and commercial banking services.  

The two Girozentrale, for their part, had actually continued talking to each other after the collapse of the four-way Landesbank fusion plan in June of 1986. Their persistent structural problems - primarily declining usage by their savings banks - had kept them at the table. In Württemberg the relationship between the savings banks and their Girozentrale was under great strain. The savings banks of Württemberg are all actually medium-sized banks  

91. But with half the shares of the LGK in the government’s hands, as well as supervisory authority, Zügel could do little in this regard without the blessing of the Land government. See Bischoff, Jörg, and Gerhard Eigil, "Späth hat die Folterwerkzeuge parat gelegt," Stuttgarter Zeitung, 20 June 1986, p. 3.  

with much greater assets than the average savings bank in Germany. This size combined with strong local roots has made the Württemberg savings banks very competitive in regional industrial finance markets. Yet at the same time they are too small to carry out the international financial activities that Mittelstand firms increasingly demand. This is where the Girozentrale is supposed to play a leading role for the savings banks, but in Württemberg the Girozentrale is widely perceived as having too little to offer the individual savings banks.  

By late 1987 the leadership of the Baden and Württemberg savings bank associations had worked out an agreement that ensured a carefully balanced distribution of power and functions within the new bank between Stuttgart and Mannheim (headquarters of the Württemberg and Baden Girozentrale, respectively). The new bank was named the Südwestdeutsche Landesbank Girozentrale, or SüdwestLB. As the central bank of the Southwest's savings banks, the SüdwestLB could now strengthen its service role through expanded economies of scale. As a large commercial bank, the SüdwestLB would focus on expanding its international and investment banking operations. In justifying the fusion, the savings bank associations pointed in particular to the need to better serve Mittelstand firms

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93. Additionally, at this time the DSGV was zealously promoting cross-border fusions between Landesbanks as a solution to their nation-wide structural problems. The growing possibility of mammoth Landesbanks that would dominate the savings bank association put further pressure on the two Girozentrale of Baden-Württemberg to merge.

94. The geographic ambiguity of the name - the 'Southwest German' Landesbank - showed the readiness of the bank to consider cross-border fusions after it got its own house in order. "Die Vertikale Integration hat zunächst Priorität," Handelsblatt, 6 March 1989.
and effectively compete for their business. The new Landesbank began operating on the first day of 1989 - nearly twenty years after the first attempt to merge the Girozentrale.

Since 1970 the Land government pursued the creation of Landesbank that it could control. The difficulty of reaching consensus on a Landesbank, in spite of tremendous efforts by the Land government, reflected the complexity of the task: On a narrower level, success required overcoming a multitude of conflicting interests, ranging from the fear of competition by banks to the fear of lost jobs (both among employees and generously remunerated board members). Many actors in the savings bank sector were also eager to avoid greater Land government control over the regional savings bank group. On a broader level, the attempt to create a Landesbank embodied two distinct, though related, political battles: the first one within the Land’s political-administrative arena; the second within the savings bank sector.

Within the state, the fusion attempts created a battle between the Land and local governments over political control of the public banking sector. In an era when the political agenda - at all levels - was strongly focused on economic development, the public banks represented important resources for intervention-minded authorities. Because the attempt by the Land government to create a Landesbank affected the savings banks directly, it impinged upon the right of the communities to self-administration and thus their political autonomy. The local savings banks and their communal governments wanted to maintain a strongly decentralized savings bank system, while others believed that maintaining the savings banks’

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95. See Faisst, Lothar, and Rühle, Bruno. 1988. "Die Südwestdeutsche Landesbank Girozentrale." Sparkasse, September. The new bank became the nation’s fourth largest Landesbank, and one of the top 100 banks (in terms of assets) worldwide.
competitiveness as a group required concentration - through government intervention if necessary.

Within the savings bank sector, the Landesbank fusion was also a microcosm of the issues, interests, and institutions shaping the intense national debate over the future of the public savings banks. The fusion proposals, especially the four-way solution of Lothar Späth, had considerable implications for the major organizational principles of the savings bank system. The suggestion of altering the regional principle, public-ownership, or three-tier structure - growing issues of debate within the organization nationally - is enough to incite passionate war-faring between factions. When Zügel and Späth made the Landesgirokasse - a savings bank - an indispensable part of the Landesbank proposal, the National Savings Bank Association (DSGV) quickly mobilized a counter-campaign. For the DSGV a savings bank is simply not to be fused with a Landesbank since it would violate the principle of communal savings banks. In an article written in the DSGV's journal a board member of the DSGV resoundingly condemned the Landesgirokasse’s involvement since this precedent would not only damage the basis of competition within the banking sector as a whole - namely, a successfully functioning group competition predicated on cooperation within the association banking groups - but it would also profoundly threaten the very structure of the West German state with its principles of communal self-administration and decentralization.\footnote{See Tiedeken, Hans. 1985. "Sparkassen in Gefahr." \textit{Sparkasse}, August.} Not surprisingly, Zügel has become a pariah for the DSGV and a maverick for others within the public banking sector that favor greater independence for savings banks.
These two political arenas, within the state and within the savings bank organization, are increasingly intertwined through a growing politicization of the savings bank sector. Attaining consensus on decisions regarding the savings banks is made the more difficult since the interests and goals of the savings banks do not always mesh perfectly with those of the politicians. "Cross-sector" alliances between government and savings bank officials fall along a spectrum from "conservatives" who seek to preserve all of the fundamental association principles and structure, and "progressive" forces which are willing to greatly modify or even abandon some of these principles.  

Probably the most prominent alliance among progressives in Baden-Württemberg was that between the Land government and the Landesgirokasse, or more specifically, between Lothar Späth and Walter Zügel. Even though relations between the two were strained after the 1986 Landesbank fiasco, in 1987 the government did not prevent the LGK from becoming the first savings bank to open an office in New York and the first one not located in Frankfurt to be granted a seat on Germany's major stock-exchange.

At the annual Württemberg savings bank congress in 1988, Lothar Späth, to the dismay of many of those present, announced that his government would consider allowing a partial privatization of selected large savings banks. Clearly the Landesgirokasse led by Zügel, who had long made his consuming aspiration for privatization widely known, would be the first in line should such a legal change occur. In his speech Späth made clear his view that the coming integrated European market presented an even greater challenge to the public

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97. As discussed in chapter 3, two of the key issues center on the equity problem of the savings banks (which in turn touches on the privatization debate and the communal connection of the savings banks); and the lifting of restrictive regulations.

banks and the financial sector in general than it did to industry firms. Since increasing centralization in the service sector cannot be stopped, so he argued, the government must take an offensive, forward-looking strategy. To allow Stuttgart to fall further behind Frankfurt and Munich as an attractive location for the European financial community would be damaging to the local economy.  

Späth proclaimed his commitment to the basic principles of the savings bank sector, but left no doubts that the financial sector in Baden-Württemberg still needed many changes, including larger banks. True to his words, in 1990 and 1991 further mergers were seriously attempted between the Landesgirokasse and the Landeskreditbank; between the Landesgirokasse and four large savings banks in the Middle Neckar region; and between the Landeskreditbank and the SüdwestLB. But for various reasons - including resistance to government control - these attempts have failed. But even without fusions the Land government is finding ways to further increase its influence over industrial finance: In 1990 the law governing the Landeskreditbank was amended to permit the LKB to expand its commercial banking operations in which it competes directly with other banks. Since the Land government has failed to buy its way into a Landesbank, it may well be attempting to transform the LKB - now known as the L-Bank - into a big commercial bank that can be used for government interventions.

Neither has the lack of direct control by the Land government precluded the Landesbank from playing a supportive role to the Land government’s industrial policies. In its first year the SüdwestLB took several new initiatives to promote exports by local firms, one of the main goals behind Späth’s attempt to fuse the Girozentrale. For example, one of

the SüdwestLB’s first actions was to sign a cooperation agreement with a Tokyo trading house. Together they planned to advise and assist Baden-Württemberg firms entering the Japanese market. To quickly establish a presence in export finance and other European markets, the SüdwestLB also took a 25% stake in WestLB Europa AG - a subsidiary created by the Westdeutsche Landesbank to operate its vastly-expanded European office network.\textsuperscript{100} In contrast to other Landesbanks, the SüdwestLB has so far taken an extremely cautious approach to purchasing large holdings in firms. Its strategy appears to build upon and expand the types of activities and producer relations (obligational and promotional networks) historically dominant within the region.

In sum, though the Land government failed to realize its most ambitious bank sector goals, along the way it managed to significantly change the structure and development path of the region’s banking sector. In its alternating roles of owner and regulator, the Land government successfully stimulated or guided three major bank mergers - the Landesgirokasse, the Landeskreditbank, and the BW-Bank (see Diagram 7-2). Each of these banks represents one of the region’s major banks today and has very close ties to the Land government. In a less overtly interventionistic manner, the Land government further impacted the nature of the banking sector through other banking and more general legislation. For example, the savings bank mergers following the administrative reforms of the early

\textsuperscript{100} Apparently the SüdwestLB, at the behest of local savings banks, is also considering establishing an industrial park in Japan for Mittelstand firms. See "SüdwestLB wird in Japan Aktiv," Frankfurter Allgemeine Zeitung, 5 December 1989; and "SüdwestLB beteiligt sich an WestLB Europa AG," Frankfurter Allgemeine Zeitung, 23 February 1990.
1970s; or the liberalization of the savings bank code in 1986 and 1987 that enabled the savings banks to substantially expand their commercial banking activities.\textsuperscript{101}

The involvement of the Land government in the regional banking system further shows how important features of Germany’s industrial finance system - the price of capital, the allocation of capital, and the type of relationships between banks and firms - are being influenced through government intervention. In these respects the evolution of the state’s and regional banking sector’s role in economic governance regimes appear to be strongly interdependent. In spite of efforts and pressures to promote concentration and thus hierarchies, both the Land government’s economic policies and the market strategies of the region’s banking are strongly oriented to promoting the Mittelstand and strategies of multilateral cooperation among them in the pursuit of their collective interests.

\textsuperscript{101} The Land government of Baden-Württemberg is widely regarded as the most progressive savings bank regulator.
<table>
<thead>
<tr>
<th>Year</th>
<th>Banks Merged</th>
<th>New Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>Badische Landeskreditanstalt and Württembergische Landeskreditanstalt</td>
<td>Landeskreditbank Baden-Württemberg (LKB)</td>
</tr>
<tr>
<td>1975</td>
<td>Girokasse Stuttgart and Württembergische Landessparkasse</td>
<td>Landesgirokasse Stuttgart (LGK)</td>
</tr>
<tr>
<td>1977</td>
<td>Badische Bank, Württembergische Bank, and Handelsbank Heilbronn AG</td>
<td>Baden-Württembergische Bank (BW-Bank)</td>
</tr>
<tr>
<td>1989</td>
<td>Landesbank Stuttgart Girozentrale and Badische Kommunale Landesbank - Girozentrale</td>
<td>Südwestdeutsche Landesbank - Girozentrale (SüdwestLB)</td>
</tr>
</tbody>
</table>
E. Conclusion.

In the traditional model of business-government relations in Baden-Württemberg, government plays a largely subsidiary role in the economy, providing aid to firms indirectly via subsidies to firm networks and associations. This model was built on the particular needs and preferences of the strongly Mittelstand dominated regional economy. Government policy favors informal organizational and multilateral exchange strategies among producers primarily through its traditionally extensive support for collective goods such as education and technical training, as well as research and development. The state thus plays a crucial role in maintaining and expanding the promotional networks that are a supportive corollary to the extensive number of obligational networks in the region, regardless of whether these obligational networks consist of subcontracting relations between large and small firms or cooperative contracting among Mittelstand firms.

In the 1970s and 1980s the Land's regional promotional network was greatly expanded in terms of its extent - via new organizations - and its intensity - via the expansion of resources flowing through it to firms. This expansion was at times initiated unilaterally by the Land government, at other times by business organizations in cooperation with the government. The expansion and emphasis on this model was conditioned by several factors: The relative autonomy of the Land from the federal government, combined with the ascendance of the CDU to stable political dominance, allowed the Land government to assert greater control over its bureaucracy and more consistently pursue its own policy preferences; economic crisis and structural changes also raised the demand by Mittelstand firms for the resources provided through the regional promotional network; and the existence of the LKB

\[102\] And at other times through the dynamic interaction of the organizations in the network that created its own logic of organizational expansion.
and very effective cooperation with banks in the region enabled the flow of resources through the regional promotional network to expand quickly without requiring organizational or procedural changes.

The LKB itself became an effective instrument for the Land government to begin changing its relationship to firms. Through the rapid growth of direct subsidies to firms the Land government was able to steer the price and flow of capital to particular firms, sectors, and market activities (such as innovation). Thus the Land government was able to move away from its traditionally liberal philosophy toward greater dirigisme. But the expansion and centralization of economic intervention in the Land government was limited in key respects by the resistance of Mittelstand groups and associations. Their resistance was effective in part because government intervention relied heavily on their organizational capacities as they were further removed from bureaucratic and parliamentary political interference. In this respect increased government intervention capacity went hand-in-hand with encroachments on government autonomy, thereby preventing a radical alteration in Baden-Württemberg’s distinct regional model of business-government relations.

The economic strength of its economy and relatively stable social consensus on business-government relations enabled Baden-Württemberg as a region to exert substantial independence from outside economic and political forces. In the 1970s Baden-Württemberg went against the stream of national politics by emphasizing decentralization and support for the Mittelstand economy. In the 1980s its neo-conservative economic program and practices, which emphasized active government support for the Mittelstand and reconciliation of social groups, contrasted sharply with the orthodox neo-classical program of the federal government that focused on reducing the state’s role and wage suppression as the means to economic revitalization.
The predominance and resilience of small firms and banks with non-tutelary or non-hierarchical relationships strongly circumscribed the kind of bank dominance over industry associated with organized capitalism in regional sectoral governance regimes. In contrast to Shonfield's characterization of the West German political economy, with a few exceptions Baden-Württemberg is not a system of economic coordination by bankers. Rather, it is a system of multiple loci of direct and indirect cooperation - as well as competition - among firms. Cooperation is frequently mediated and supported, but not controlled, by the Land government. The government's actions in the banking sector were largely intended to promote the Mittelstand and its supportive institutions. Unlike North Rhine-Westphalia, the Land government of Baden-Württemberg failed to build the kind of institutional capacity in the form of a Landesbank that would have enabled it to intervene and shape the strategies of large firms. In Baden-Württemberg industrial governance and change remains comparatively decentralized.
APPENDIX TO CHAPTER SEVEN:

Market Penetration and Impact of State Promotion Efforts

in Baden-Württemberg.

Through the 1970s and early 1980s the main emphasis of firm-specific Mittelstand promotion programs in Baden-Württemberg was on the support of business startups. In the early to mid-1980s emphasis shifted strongly from general business startups to technology promotion, including aid for specific R&D projects in Mittelstand firms, aid for the introduction of new technologies into existing firms (technology transfer), and for technology-oriented business start-ups. In this section I examine briefly the growth of subsidies in these two areas and attempt to provide indicators of the extent to which these programs may have influence the decisions and strategies of private producers.

After a relatively slow start in the mid-1970s the support of business startups by the government of Baden-Württemberg exploded.¹ From 441 loans worth about DM 20 million in 1974, to 3,800 loans worth DM 223.1 million in 1979 (Table 7-5f). An independent study of the Middle Neckar region in Baden-Württemberg showed that in 1974, 3.4% of all business startups received state loans; by 1979 this percentage had reached 17.9%.² After dipping to about 2,500 start-up loans in 1981, the number of promoted startups climbed back to the range of 3,500 to 4,000 per year in the mid-1980s. Because the start-up loans of the government of Baden-Württemberg, granted by the LKB, can be combined with Federal

¹. In state promotion programs ‘business start-ups’ include the takeover of existing firms by first-time business owners.

loans for business startups, a firm receiving assistance will typically finance 50-80% of its initial investment with state funds. Table 7-5f shows that in the 1980s loans for business startups by the Federally-owned DAB Bank approximately doubled the amount of state funds flowing to start-up firms in Baden-Württemberg.

Results of studies by the LKB and outside institutes indicate that firms which received state loans at their founding, in comparison to those which did not, demonstrate higher rates of growth and profitability, employ and educate more people, and have a substantially lower insolvency rate. In a 1985 study, roughly half the firms surveyed said they would not have started their business without state support and that state aid was an important factor in the firms success. In another survey approximately three-quarters of all firms sampled were familiar with the loan programs of the LKB and the DAB, and nearly all of these firms had applied for loans from these sources.

A 1981 study showed that 88% of all start-ups occurred after consultation with an outside advisor. In most cases (64%), the firms sought advice from a tax consultant. Consulting subsidized through the regional promotional network was used by about half of all start-up firms. The 1985 study also showed that the firms of entrepreneurs that received

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4. Furthermore, 38% of firms indicated awareness of the Surety Bank; 15% of the Mittelstand Participation Corporation. Zahn, 1985, op. cit.

5. Zahn, 1981, op. cit. One half of the firms surveyed sought consultation from their bank before starting; 20% consulted with an Industry Chamber; 30% with a Crafts Chamber; 17% their trade association; 11% the LKB (multiple choices were possible).
state funds and participated in state-supported educational seminars, or received state-
subsidized consulting, demonstrated significantly higher growth and employment rates than
those which did not. As these results suggest, the demand for state-subsidized consultancies
has also risen dramatically since the mid-1970s: between 1975 and 1985 the overall number
of state-subsidized consultancies rose from 10,686 to 17,569 - equal to 64.4% (see Table 7-7).

Though the growth numbers of start-ups and consultancies supported through the
regional promotion network are impressive, no policy or program has probably had such an
explosive growth as the technology programs. From 1978 to 1983, 398 R&D projects in
individual firms were supported with DM 91.5 million (see Table 7-8). At this point in time
the government estimated that 3.4% of Baden-Württemberg's manufacturing firms with more
than 20 employees had received support under this program. From 1984 (the first year of
the new technology program) to 1986, 1,799 technology projects were supported in 1,441
firms. Of these firms, 669 were manufacturing firms with more than twenty employees
(there are approximately 7,300 such firms in Baden-Württemberg). This suggests that nearly
10% of all industrial manufacturing firms received support from the Land government under
its technology programs in these three years. In individual sectors, this percentage is much
higher: in the machine tool sector I estimate that some 20% to 30% of the firms with more
than twenty employees received support under the technology programs of Baden-
Württemberg; in the electronics sector, approximately 15% to 20% of such firms received

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7. See Euba, Norbert. 1985. "Ziele und Wirksamkeit staatlicher Gewerbeförderung
dargestellt am Beispiel Baden-Württemberg." In Dieter Cansier and Dietmar Kath, eds.
support. These two sectors combined accounted for roughly 40 - 50% of the total funds distributed to individual firms for technology promotion in this period.\textsuperscript{8}

The actual value of technology subsidies generally ranged between five and fifteen percent of the total investment for the firm's project.\textsuperscript{9} Of the loans for the introduction of modern technologies, fifty-five percent were granted to firms for the purchase of numerically-controlled machinery.\textsuperscript{10} In craft firms, this percentage was even higher. For the many supplier firms receiving these loans the adoption of such modern machinery was, and still is, critical to their ability to satisfy the demands of their customers for higher quality production. But the question whether this level of state support was necessary to modernize Baden-Württemberg industry, and the machine tool sector in particular, cannot be answered unequivocally.

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\textsuperscript{8} These calculations are based on statistics provided by the Fraunhofer Institut für Systemtechnik und Innovationsforschung in Karlsruhe at an October 1987 meeting in the Economics Ministry of Baden-Württemberg. Percentages presented in this paragraph are my own based on information from these sources and on the assumptions that (1) there were 7,300 manufacturing firms with more than twenty employees in Baden-Württemberg in these three years (this number probably overestimates the actual - see Table 7-1b); and (2) that no single firm received more than one grant or loan between 1984 and 1986. The actual percentage of firms receiving support is thus likely to be somewhat lower as some firms do receive multiple subsidies.

\textsuperscript{9} For R&D projects (the C-I program), up to 50% of costs can be funded by state grants; the average grant per firm between 1984 and 1986 was DM 295,000 (for projects with a total investment of more than DM 400,000, the grant from the Land government must be partially repaid, depending on the project's success. For technology transfer loans (the MT program), which usually finances 50-70% of the total investment, the average loan was DM 415,000. For grants disbursed under the MT program, 15% of the material and 50% of personnel costs can be funded, the average grant was DM 743,000. Source: Fraunhofer-Institut. Euba, 1985, op. cit. estimated that all state subsidies (Land and federal funds) to manufacturing firms in Baden-Württemberg between 1977 and 1982 represented four percent of their total new investment.

\textsuperscript{10} Of the craft firms receiving MT loans (29% of total MT loan volume between 1984 and July 1987 went to craft firms), 77% was for the acquisition of CNC machines. Source: Landeskreditbank.
The government’s technology transfer program is based on the assumption that state measures would support the introduction of new, untested technologies in firms. The novelty of such technology, and therefore the firm’s inability to estimate and bear the risks of its introduction into its production system, provides the justification for state support. But a survey by the Land’s Economics Ministry in 1982 showed that of the state’s some 1,100 machine tool firms, 60% already employed numerically-controlled machinery in their production. Half of these firms produced numerically-controlled machine tools themselves.\textsuperscript{11} In 1987 a preliminary study of Baden-Württemberg’s technology programs could only deliver ambiguous conclusions: It was not clear whether the state’s policy had led to a significant increase in technology-oriented investments beyond that which would have occurred without state support.\textsuperscript{12}

In sum, the promotion programs of Baden-Württemberg have attained a remarkable degree of market penetration but with ambiguous consequences. On the one hand, larger and often very profitable firms were substantially subsidized in the 1980s, primarily as a result of the Land governments technology policy. While the need for such subsidies was controversial, they did benefit many Mittelstand firms but also larger firms in the state via the modernization of their suppliers. Moreover, because state support for firm investment projects is always conditioned upon a minimum amount of self-finance, these economic policies tend to have a pro-cyclical nature - promoting investment when the economy is already rising. On the other hand, a large share of the programs and funds continue to

\textsuperscript{11} See Publication of the Landtag of Baden-Württemberg, 8/3523.

\textsuperscript{12} These conclusions were made based upon a study conducted and presented by the Frauenhofer Institute in Karlsruhe at an October 1987 meeting in the Economics Ministry of Baden-Württemberg.
benefit smaller firms and are widely accepted in the state as useful and effective, if not essential. For the Land government itself, the perceived positive impact of state support on the investment and innovation climate has immeasurable political symbolic value. It demonstrates the government's responsiveness to the demand of local firms, and readiness to support for firms that are willing to invest, innovate, and create jobs.\textsuperscript{13}

\textsuperscript{13} Schmid, 1989, op. cit., in his study on the impact of regional economic promotion in Baden-Württemberg, argues that while these policies may have little actual impact on local economies, their psychological benefit for local firms, unions, politicians, and other groups is tremendous.
### Table 7-1

**Selected Economic Statistics of Baden-Württemberg**


<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>6.3</td>
<td>-3.1</td>
<td>5.3</td>
<td>4.1</td>
<td>2.9</td>
<td>4.7</td>
<td>2.8</td>
<td>0.6*</td>
<td>-0.6*</td>
<td>1.0*</td>
<td>2.8*</td>
<td>3.2*</td>
<td></td>
</tr>
</tbody>
</table>

* In 1980 prices. 1986 = 3.8%


**Percentage Share of Manufacturing Employees by Employment Size of Firm.**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10 - 49</td>
<td>8.3</td>
<td>8.1</td>
<td>7.6</td>
<td>7.0</td>
<td>7.4</td>
</tr>
<tr>
<td>50 - 99</td>
<td>8.0</td>
<td>7.5</td>
<td>8.2</td>
<td>8.1</td>
<td>7.8</td>
</tr>
<tr>
<td>100 - 499</td>
<td>27.5</td>
<td>25.1</td>
<td>25.4</td>
<td>24.9</td>
<td>25.2</td>
</tr>
</tbody>
</table>

Subtotal: 43.8 40.7 41.2 40.0 40.4

| 500 - employees        | 56.2 | 59.3 | 58.8  | 60.0  | 59.6  |

Total Employed by all firms (mio.): 1.47 1.53 1.54 1.60 1.50

Total Number of Firms: 9,094 8,983 7,775 7,719 7,262

* Numbers do not include employment in mining firms, or firms with less than 20 employees.

Table 7-1 (continued)
c) Export Quota of the Manufacturing Sector in Baden-Württemberg. (percentage export revenue of total revenue)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>20.1</td>
<td>24.0</td>
<td>26.5</td>
<td>32.0</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th></th>
<th>Exports</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1976</td>
<td>1986</td>
</tr>
<tr>
<td>Value</td>
<td>41.9</td>
<td>95.2</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>NFDI in Baden-Württemberg</th>
<th>NFDI by Baden-Württemberg Firms Abroad</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>1985</td>
</tr>
<tr>
<td>10.4</td>
<td>17.2</td>
</tr>
</tbody>
</table>

### Table 7-2

**Selected Statistics from the Surety Bank and Mittelstand Participation Corporation of Baden-Württemberg**

#### Surety Bank:

##### a) Number of Guarantees by Selected Firm Categories*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Guarantees</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Craft firms</td>
<td>248</td>
<td>286</td>
<td>381</td>
<td>338</td>
<td>428</td>
<td>400</td>
</tr>
<tr>
<td>- Industry</td>
<td>135</td>
<td>179</td>
<td>169</td>
<td>156</td>
<td>239</td>
<td>271</td>
</tr>
<tr>
<td>- Retail</td>
<td>132</td>
<td>163</td>
<td>290</td>
<td>247</td>
<td>358</td>
<td>206</td>
</tr>
<tr>
<td>- Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>605</td>
<td>736</td>
<td>1,043</td>
<td>893</td>
<td>1,302</td>
<td>1,113</td>
</tr>
</tbody>
</table>

##### b) Volume of Guarantees by Selected Firm Categories (million DM)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firm Category:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Craft firms</td>
<td>23.6</td>
<td>31.3</td>
<td>51.6</td>
<td>44.3</td>
<td>82.6</td>
<td>83.8</td>
</tr>
<tr>
<td>- Industry</td>
<td>35.5</td>
<td>43.2</td>
<td>38.4</td>
<td>40.2</td>
<td>92.4</td>
<td>117.2</td>
</tr>
<tr>
<td>- Retail</td>
<td>14.4</td>
<td>19.6</td>
<td>33.3</td>
<td>31.3</td>
<td>60.6</td>
<td>49.2</td>
</tr>
<tr>
<td>- Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>83.4</td>
<td>111.3</td>
<td>150.5</td>
<td>135.5</td>
<td>291.7</td>
<td>307.1</td>
</tr>
</tbody>
</table>

* Includes guarantees on loans and participations. Since 1985 the Surety Bank also offers guarantees on equity participations in Mittelstand firms.
c) Distribution of total accumulated guarantee volume granted by Selected Firm Categories.

<table>
<thead>
<tr>
<th>Firm Category</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Craft Firms</td>
<td>30.1</td>
</tr>
<tr>
<td>Industry Firms</td>
<td>32.8</td>
</tr>
<tr>
<td>Retail Firms</td>
<td>18.7</td>
</tr>
<tr>
<td>Other Firms</td>
<td>18.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Total Accumulated Volume of Outstanding Guarantees by the Surety Bank
as of 12.31.86 = DM 683.8 million

---

**Mittelstand Participation Corporation:**

d) Number of Participations and their Value, 1972-1986.

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Number</th>
<th>Amount Invested (mio. DM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972-82</td>
<td>581</td>
<td>64.4</td>
</tr>
<tr>
<td>1983</td>
<td>43</td>
<td>5.8</td>
</tr>
<tr>
<td>1984</td>
<td>74</td>
<td>11.0</td>
</tr>
<tr>
<td>1985</td>
<td>108</td>
<td>20.8</td>
</tr>
<tr>
<td>1986</td>
<td>95</td>
<td>23.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>901</strong></td>
<td><strong>125.7</strong></td>
</tr>
</tbody>
</table>
Table 7-2 (continued)

e) Distribution of total accumulated value of outstanding participations by Selected firm categories:

<table>
<thead>
<tr>
<th>Firm Category</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Craft Firms</td>
<td>22.1</td>
</tr>
<tr>
<td>Industry Firms</td>
<td>57.7</td>
</tr>
<tr>
<td>Retail Firms</td>
<td>14.3</td>
</tr>
<tr>
<td>Other Firms</td>
<td>5.9</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Total Accumulated Outstanding Participations as of 12.31.86 = 541
Total Accumulated Value of Outstanding Participations as of 12.31.86 = DM 75.7 million

f) Participations in Technology-oriented Startup Firms.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>Volume (mio. DM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>15</td>
<td>4.25</td>
</tr>
<tr>
<td>1985</td>
<td>19</td>
<td>3.83</td>
</tr>
<tr>
<td>1986</td>
<td>28</td>
<td>4.87</td>
</tr>
<tr>
<td>Total</td>
<td>62</td>
<td>12.95</td>
</tr>
</tbody>
</table>

Table 7-3

Selected Statistics from the Steinbeis Foundation

<table>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Personnel:</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Full-time</td>
<td>12</td>
<td>28</td>
<td>74</td>
<td>127</td>
<td>170</td>
</tr>
<tr>
<td>Part-time</td>
<td>740</td>
<td>818</td>
<td>869</td>
<td>1,188</td>
<td>1,419</td>
</tr>
<tr>
<td><strong>Revenues from consulting/R&amp;D (mio. DM):</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>4.4</td>
<td>4.9</td>
<td>7.5</td>
<td>13.7</td>
<td>22.2</td>
</tr>
<tr>
<td>1983</td>
<td>1,500</td>
<td>1,700</td>
<td>1,823</td>
<td>2,357</td>
<td>2,571</td>
</tr>
<tr>
<td><strong>General Consultancies:</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>0</td>
<td>400</td>
<td>1,700</td>
<td>2,770</td>
<td>2,118</td>
</tr>
<tr>
<td>1983</td>
<td>1,000</td>
<td>1,400</td>
<td>2,450</td>
<td>3,585</td>
<td>4,180</td>
</tr>
<tr>
<td><strong>Technical Evaluations for Public Funds Applications by Firms:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>28</td>
<td>88</td>
<td>180</td>
<td>533</td>
<td>712</td>
</tr>
<tr>
<td>1983</td>
<td>0</td>
<td>98</td>
<td>551</td>
<td>1,053</td>
<td>1,692</td>
</tr>
</tbody>
</table>

Table 7-4

State Funds Expended for Mittelstand Promotion in Baden-Württemberg (Mio. DM)

a) Expenditures for Mittelstand Promotion by Program Area (selected years).

<table>
<thead>
<tr>
<th>Program Area</th>
<th>1970</th>
<th></th>
<th>1975</th>
<th></th>
<th>1976</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>1. Supra-firm Support</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Occupational Educ</td>
<td>10.5</td>
<td>36.8</td>
<td>22.4</td>
<td>24.0</td>
<td>28.5</td>
<td>19.3</td>
</tr>
<tr>
<td>- Applied R&amp;D</td>
<td>(2.5)</td>
<td>(8.8)</td>
<td>(11.1)</td>
<td>(11.9)</td>
<td>(14.0)</td>
<td>(9.5)</td>
</tr>
<tr>
<td>2. Capital Provision</td>
<td>15.3</td>
<td>53.7</td>
<td>35.8</td>
<td>38.3</td>
<td>62.2</td>
<td>42.2</td>
</tr>
<tr>
<td>3. Services of the LGA</td>
<td>2.7</td>
<td>9.5</td>
<td>4.0</td>
<td>4.3</td>
<td>2.8</td>
<td>1.9</td>
</tr>
<tr>
<td>4. Special Programs/Funds</td>
<td>-</td>
<td>-</td>
<td>31.4</td>
<td>33.6</td>
<td>53.9</td>
<td>36.6</td>
</tr>
<tr>
<td>Total</td>
<td>28.5</td>
<td>100.0</td>
<td>93.5</td>
<td>100.0</td>
<td>147.4</td>
<td>100.0</td>
</tr>
</tbody>
</table>

(continuation)

<table>
<thead>
<tr>
<th>Program Area</th>
<th>1979</th>
<th></th>
<th>1982</th>
<th></th>
<th>1985</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>1. Supra-firm Support</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Occupational Educ</td>
<td>68.7</td>
<td>23.0</td>
<td>69.3</td>
<td>38.7</td>
<td>121.5</td>
<td>40.7</td>
</tr>
<tr>
<td>- Applied R&amp;D</td>
<td>(32.1)</td>
<td>(10.7)</td>
<td>33.0</td>
<td>(18.4)</td>
<td>26.5</td>
<td>(8.9)</td>
</tr>
<tr>
<td>2. Capital Provision</td>
<td>145.9</td>
<td>48.8</td>
<td>97.2</td>
<td>54.3</td>
<td>139.0</td>
<td>46.5</td>
</tr>
<tr>
<td>3. Services of the LGA</td>
<td>4.6</td>
<td>1.5</td>
<td>4.8</td>
<td>2.7</td>
<td>13.3</td>
<td>4.4</td>
</tr>
<tr>
<td>4. Special Programs/Funds</td>
<td>79.8</td>
<td>26.7</td>
<td>7.7</td>
<td>4.3</td>
<td>25.1</td>
<td>8.4</td>
</tr>
<tr>
<td>Total</td>
<td>298.9</td>
<td>100.0</td>
<td>179.1</td>
<td>100.0</td>
<td>298.9</td>
<td>100.0</td>
</tr>
</tbody>
</table>
Table 7-4 (continued)

b) Total Expenditures for Mittelstand Promotion.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>28.5</td>
<td>93.5</td>
<td>147.4</td>
<td>179.5</td>
<td>255.3</td>
<td>298.9</td>
<td>276.5</td>
<td>207.9</td>
<td>179.1</td>
<td>233.9</td>
<td>225.5</td>
<td>298.9</td>
</tr>
</tbody>
</table>

1. 'Supra-firm support' includes subsidies for the following: occupational and continuing education (including the construction of cooperative training facilities); business consultancies (including federal funds); the promotion of inter-firm cooperation; information and documentation; institutes conducting applied R&D; trade fairs and exhibits; measures to develop foreign markets.

2. 'Capital Provision' includes subsidies to reduce interest rates on LKB loans; investment grants to firms; and ongoing measures.

3. 'Services of the LGA' include subsidies for continuing education programs; information and documentation (including consulting); and exhibits and Design Center.

4. 'Special Programs/Funds' includes the program to maintain apprenticeships and combat youth unemployment; and until 1980 profits of the LKB used to subsidize its loans to firms (which between 1975 and 1980 averaged approximately DM 30 million per year).

Table 7-5

Selected Statistics of the Landeskreditbank Baden-Württemberg

a) General: (mio. DM)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>9,125</td>
<td>16,209</td>
<td>27,259</td>
<td>40,611</td>
</tr>
<tr>
<td>New Loans</td>
<td>1,166</td>
<td>2,939</td>
<td>5,013</td>
<td>8,734</td>
</tr>
<tr>
<td>Total Loans outstanding</td>
<td>7,966</td>
<td>14,236</td>
<td>22,249</td>
<td>32,299</td>
</tr>
</tbody>
</table>

b) Volume of New Loans/Grants to Firms in All Promotion Programs: (mio. DM)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>115</td>
<td>507</td>
<td>554</td>
<td>621</td>
<td>688</td>
<td>1,142</td>
</tr>
</tbody>
</table>

* This includes, among other programs, all the Mittelstand programs, the Liquidity Assistance program, the Loan Guarantee program, and the Export Promotion Program.

c) New Loans/grants to firms in the Mittelstand Program:**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Number</td>
<td>1,698</td>
<td>2,455</td>
<td>5,434</td>
<td>3,064</td>
<td>4,276</td>
<td>3,935</td>
<td>3,765</td>
</tr>
<tr>
<td>Total Volume (mio. DM)</td>
<td>182,807</td>
<td>276,735</td>
<td>525,400</td>
<td>228,100</td>
<td>455,000</td>
<td>584,000</td>
<td>586,000</td>
</tr>
</tbody>
</table>

** The composition of programs comprising this category has changed over time. In the mid-1980s the Mittelstand program consisted of the LKB's: a) business startup program b) technology program c) environmental protection d) regional promotion e) tourism promotion.

(continued)
Table 7-5 (continuation)

d) Distribution of Loans/Grants in the Mittelstand Program by Selected Categories:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>% of total volume</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>received:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- craft firms</td>
<td>29.3</td>
<td>33.2</td>
<td>23.5</td>
</tr>
<tr>
<td>- industry firms</td>
<td>20.1</td>
<td>16.0</td>
<td>47.1</td>
</tr>
<tr>
<td>- retail firms</td>
<td>19.1</td>
<td>20.1</td>
<td>11.1</td>
</tr>
<tr>
<td>- hotel/gastronomy</td>
<td>23.9</td>
<td>17.8</td>
<td>8.3</td>
</tr>
</tbody>
</table>


e) New Loans by Mittelstand Program (mio. DM)

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1984</th>
<th>1985</th>
<th>1986</th>
<th>1987@</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program:</td>
<td>vol.</td>
<td>%</td>
<td>vol.</td>
<td>%</td>
<td>vol.</td>
</tr>
<tr>
<td>Business Startups</td>
<td>242.2</td>
<td>56.1</td>
<td>245.0</td>
<td>61.7</td>
<td>200.2</td>
</tr>
<tr>
<td>(TOU)#</td>
<td></td>
<td></td>
<td>(11.5)</td>
<td></td>
<td>(11.5)</td>
</tr>
<tr>
<td>Innovation/</td>
<td>8.8</td>
<td>2.0</td>
<td>32.1</td>
<td>8.1</td>
<td>127.0</td>
</tr>
<tr>
<td>Technology</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environment</td>
<td>9.5</td>
<td>2.2</td>
<td>13.5</td>
<td>3.4</td>
<td>11.1</td>
</tr>
<tr>
<td>Regional</td>
<td>129.2</td>
<td>29.9</td>
<td>76.5</td>
<td>19.3</td>
<td>84.7</td>
</tr>
<tr>
<td>Tourism</td>
<td>42.3</td>
<td>9.8</td>
<td>29.6</td>
<td>7.5</td>
<td>31.6</td>
</tr>
<tr>
<td>Total</td>
<td>432.0</td>
<td>100.0</td>
<td>396.7</td>
<td>100.0</td>
<td>454.6</td>
</tr>
</tbody>
</table>

# TOU represents volume of loans for technology-oriented startups.
@ 1987 figures include 129 technology grants valued at DM 43.4 million.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of loans</th>
<th>Amount (mio. DM)</th>
<th>Amount (mio. DM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>441</td>
<td>19.1</td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>609</td>
<td>25.9</td>
<td></td>
</tr>
<tr>
<td>1976</td>
<td>975</td>
<td>42.3</td>
<td></td>
</tr>
<tr>
<td>1977</td>
<td>1,455</td>
<td>75.0</td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>2,731</td>
<td>173.1</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>3,800</td>
<td>223.1</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>3,059</td>
<td>141.7</td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>2,493</td>
<td>115.6</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>2,644</td>
<td>142.9</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>3,733</td>
<td>242.2</td>
<td>247.3</td>
</tr>
<tr>
<td>1984</td>
<td>3,989</td>
<td>244.9</td>
<td>235.0</td>
</tr>
<tr>
<td>1985</td>
<td>3,528</td>
<td>200.2</td>
<td>242.2</td>
</tr>
<tr>
<td>1986</td>
<td>2,958</td>
<td>196.8</td>
<td>272.6</td>
</tr>
<tr>
<td>1987</td>
<td>2,620</td>
<td>177.4</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>35,035</td>
<td>2,020.2</td>
<td></td>
</tr>
</tbody>
</table>

Table 7-6

(selected years)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Crafts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- short-term</td>
<td>6,607</td>
<td>6,713</td>
<td>7,565</td>
<td>6,696</td>
<td>8,342</td>
<td>9,923</td>
</tr>
<tr>
<td>- intensive/special</td>
<td>134</td>
<td>215</td>
<td>1,064</td>
<td>660</td>
<td>313</td>
<td>58</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(289)*</td>
<td>(808)*</td>
</tr>
<tr>
<td>Industry</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- short-term</td>
<td>389</td>
<td>628</td>
<td>889</td>
<td>553</td>
<td>1,023</td>
<td>815</td>
</tr>
<tr>
<td>- intensive/special</td>
<td>545</td>
<td>590</td>
<td>410</td>
<td>494</td>
<td>565</td>
<td>583</td>
</tr>
<tr>
<td>Services</td>
<td>3,011</td>
<td>3,804</td>
<td>4,052</td>
<td>4,448</td>
<td>5,084</td>
<td>5,382</td>
</tr>
<tr>
<td>Total</td>
<td>10,686</td>
<td>11,950</td>
<td>13,980</td>
<td>12,851</td>
<td>15,616</td>
<td>17,569</td>
</tr>
</tbody>
</table>

* since 5.1.83 federal and Land programs for intensive consultancies for craft firms have been separated.

Notes: ‘Short-term’ consultancies last up to two days and are free. ‘Intensive or special’ consultancies are those lasting longer than two days. In the crafts sector they are conducted by advisors employed by the sector, i.e. by the craft chambers and various craft associations. In 1975 there were 37 such full-time advisors; in 1985 there were 51. Intensive and special consultancies are conducted by independent advisors or consulting organizations.

In industry, the Industry Chambers organize the consulting system and the RKW conducts the consultancies, usually employing independent consultants.

In the service sector the various associations provide the advisors. This category includes: retailers, wholesalers, printers and bookstores, hotel and restaurants, and certain professional practices (architects).

Table 7-7

Technology Promotion in Baden-Württemberg.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Promoted Projects*</th>
<th>Grant Volume (mio. DM)</th>
<th>Loan Volume (mio. DM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>60</td>
<td>9.4</td>
<td>1.8</td>
</tr>
<tr>
<td>1979</td>
<td>57</td>
<td>12.5</td>
<td>1.5</td>
</tr>
<tr>
<td>1980</td>
<td>66</td>
<td>10.3</td>
<td>3.9</td>
</tr>
<tr>
<td>1981</td>
<td>44</td>
<td>9.0</td>
<td>3.7</td>
</tr>
<tr>
<td>1982</td>
<td>83</td>
<td>10.0</td>
<td>7.9</td>
</tr>
<tr>
<td>1983</td>
<td>88</td>
<td>12.7</td>
<td>8.8</td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>398</td>
<td>63.9</td>
</tr>
<tr>
<td>1984</td>
<td>162</td>
<td>23.7</td>
<td>39.6</td>
</tr>
<tr>
<td>1985</td>
<td>506</td>
<td>48.9</td>
<td>138.5</td>
</tr>
<tr>
<td>1986</td>
<td>773</td>
<td>58.4</td>
<td>232.5</td>
</tr>
<tr>
<td>1987</td>
<td>792</td>
<td>43.4</td>
<td>210.8</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>2,631</td>
<td>238.8</td>
</tr>
</tbody>
</table>

* Includes grants and loans dispensed by the LGA and LKB for R&D projects in firms, technology transfer, and technology-oriented business startups.
CHAPTER EIGHT:

Heilbronn and Solingen:

Case Studies of Local Industrial Governance and Change.

A. Introduction.

The success of the savings and cooperative banks, the organizational convergence among the three major banking groups toward a looser hierarchical association of banks, the rise of the banks' mediator role, and the growth of Land and federal government intervention, are all correlated with economic changes in the economy that may be summarized as the emergence of post-Fordist production principles. These principles entail a generally more decentralized organization of economic production (including obligatory networks) in which firms rely more heavily on access to external resources and collective goods such as education and technological information. Such resources are provided inter alia through promotional networks involving various governments and economic organizations and by banks acting in their mediator role. As discussed in chapter 4, growing demands by the Mittelstand for external resources and information and growing state provision of resources including capital to firms are pushing the banks to expand their mediator role. In turn, the decentralization of banks and growth of their mediator role arguably reinforces non-hierarchical forms of economic governance without bank dominance.

The growth of direct and indirect firm subsidies by the federal and Länder governments would not have been possible without expanding the capacities of local organizations, since the utilization of state funds and other state-supported organizations that provide essential resources to Mittelstand firms is coordinated to a great degree at the local level. These local organizations that provide resources to smaller firms, including those
which originate from the federal and Länder governments, comprise what I call local 'small firm support systems.' In the sense that such systems are intended to benefit all firms in a local economy, they are a form of local promotional network. Like the regional promotional networks existing at the Land level, these local small firms support systems operate largely without a sector-specific focus. Though they often have sector-specific effects.

In this chapter I review the results of two case studies in which the patterns of economic governance and changes in two local economies and the role that local banks play therein are analyzed. The cases are the small industrial cities of Heilbronn in Baden-Württemberg and Solingen in North Rhine-Westphalia.¹ For these case studies interviews were conducted with local officials and firm customer managers in various banks representing the three major banking groups. The interviews assessed their views regarding three subject areas: their role in the local small-firm support system; the changing nature of local bank competition and bank-firm relations; and changes in the relationship between local bank or branch and other levels within its respective association or concern. While two cases are obviously not sufficient to make generalizations regarding all banks and local governance regimes, they serve to illustrate several of the key arguments presented in earlier chapters: These cases show the convergence between the local banks or branches in their internal organization, services, prices, and external strategies/relations to firms. They reveal increasing similarity between local banks in their structural and functional relations to their

¹. Interviews in Heilbronn were conducted in June and July of 1989. The banks included in this study included two of the three concern banks, the commercial cooperative bank, the county savings bank, and the Baden-Württembergische Bank - a regional commercial bank. Interviews in Solingen were conducted in August 1990. Banks interviewed here included the cooperative bank and the three concern bank branches. The Bank für Gemeinwirtschaft (at the time being sold by the unions to private investors) and the savings bank of Solingen declined interviews.
organizational superstructure, be it a concern or association. And they show increased attempts of all local banks and branches to act in a mediator role for Mittelstand firms.

These cases also verify the expansion of direct cooperation or coordination between local banks or branches and the state, as well as demonstrating how the provision of financial and other resources by the banks and governments to Mittelstand firms has increased and aided a decentralized process of economic adjustment. In these cases structural change is not a process dominated by a limited number of banks and firms. Rather, change is a process shaped partly by market forces and partly by the cooperative exchange of resources among firms and the organizations of the small-firm support system. The cases represent a decentralized system of economic governance in which non-market mechanisms play an important role - like the organized capitalism model - but these relationships exist among non-oligopolistic and non-hierarchical organizations that do not seek to dominate an entire sector or region. In short, these are not cases of local organized capitalism, but present an alternative governance regimes that appear to be successful in their own right.

Heilbronn was selected because its industrial structure is well-diversified, both by sector and firm size, yet strongest in the machine tools, auto, and electronics sectors as is the rest of Baden-Württemberg. Solingen was selected because its economy is comparable in size to Heilbronn and likewise strongly dominated by Mittelstand firms. Both Heilbronn and Solingen have undergone tremendous structural change in the postwar period: Heilbronn from a strongly consumer-goods to a predominately investment-goods oriented manufacturing sector; Solingen from a "monostructural" to a well-diversified manufacturing economy. In both cases structural change relied heavily on the creation of new firms in growing sectors, and in both cities business start-ups receive immense support and attention from their respective small-firm support system.
In both cases the local economy strongly exhibits organizational characteristics exemplary of post-Fordism. Heilbronn is characterized by the strong presence of Mittelstand firms that have long-term supply relationships to larger auto assemblers in the region. As suggested in chapter 7, the comparatively low degree of vertical integrations in Baden-Württemberg’s automakers is due in large part to the abundant regional supply of advanced, innovative Mittelstand firms that produce high-quality goods. Solingen represents a classic case of an industrial district in which the local economy - comprised largely of small firms - can be viewed in some sense as a single unit of production. Thus to the extent that such post-Fordist principles are spreading in the Federal Republic, these two cases may to some extent serve as models for other firms, sectors, and local economic development oriented organizations.

B. Heilbronn.

In spite of its relatively close proximity to Stuttgart and the heavily industrialized Middle Neckar region, the city of Heilbronn developed relatively independently of that agglomeration.2 By the end of the nineteenth century Heilbronn was the leading industrial city in Württemberg. In Heilbronn, as in the rest of the region, consumer goods such as clothing, textiles, and especially food products were the dominant sectors. But while the investment goods industries gained predominance in Württemberg as a whole in the 1920s, in Heilbronn this transition only occurred after the Second World War. In spite of rapid growth after the war, structural change in Heilbronn brought many ups and downs for the

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local economy. On the whole, manufacturing employment continued to expand in the post-war period until its 1970 peak of about 27,000. But in the following decade some ten thousand manufacturing jobs were lost, forcing the city to diversify into services. Today, with its manufacturing work force of about 19,000, the city remains an important industrial center, though it is no longer the leading one in Baden-Württemberg.

A review of Table 8.1 shows the four largest sectors by employment in the city and county of Heilbronn to be autos, machine tools, food products, and electronics. The dominance of the auto sector in the county statistic reflects the presence of the Audi-NSU factory in nearby Neckarsulm and hundreds of local supplier firms. The fastest growing manufacturing branches in the postwar period, and the two largest in the 1980s, were machine tools and electrical products. This too is partly, but hardly exclusively, the result of the growth of automobile production in the region. Thus in spite of an overall decline in manufacturing jobs, employment in key sectors expanded dramatically.

The city's economy also embodies a balanced size mixture of firms: Of the 127 manufacturing firms with more than 20 employees operating in the city in 1980, 11 had more than 500 employees; of the remaining Mittelstand firms, 15 had between 200 and 500

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4. The city population in 1988 was 112,000; the population of Heilbronn county (including the city) was 365,000. In 1987, manufacturing employment represented approximately 37.5% of total employment in the city: Statistisches Jahrbuch 1987: Stadt Heilbronn. Heilbronn: Einwohneramt. 1987.

5. In 1951 there were roughly 1,500 workers employed in machine tool production, and virtually no electronics firms. In the late 1980s there were more than 4,000 workers employed in machine tool firms, and nearly 4,000 in electronics.
employees, and 101 less than 200 employees. In 1988 there were 110 manufacturing firms remaining in the city. Since the total number employed in manufacturing has remained relatively constant since the late 1970s, this would suggest that the average firm size has increased slightly. However, in 1988 there were more than 1,400 craft firms employing over 14,000 people in the city which the above statistics do not reflect. The largest and fastest growing category of craft firms are engaged in metal-related production, including machine tools. Thus while manufacturing employment in firms with more than twenty workers has changed little in the 1980s, employment in craft firms that manufacture industrial goods has risen. This suggests that employment and production - at least in certain manufacturing sectors - has grown fastest in the very smallest of firms. In spite of rapid structural change in the local economy, Heilbronn's 1987 unemployment rate was only 5.4%, well below the national average of 8.9.

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6. *Impressum: Heilbronn und das Hinterland.* Heilbronn: Kreissparkasse Heilbronn. 1981. Like the rest of Baden-Württemberg, the city and county's firms are strongly export-oriented. In 1988 the 110 manufacturing firms in the city generated 22.2% of their revenues from exports; the export quota of the 231 firms in the county was 37.6%. Annual Report of the Heilbronn Chamber of Commerce and Industry, 1988. p. 6

7. Of the 9,502 registered craft firms in the Franken region, 3,616 were metal-related. On average, each craft firm also employs one apprentice. Annual Report of the Heilbronn Crafts Chamber, 1988. pp. 7-10.

8. For all of Baden-Württemberg the unemployment rate was 5.1%.
Table 8.1
Employment by Selected Manufacturing Sectors (1978-1988) in Heilbronn (percentage of total manufacturing employment)

<table>
<thead>
<tr>
<th></th>
<th>City 1978</th>
<th>City 1988</th>
<th>County 1988</th>
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</thead>
<tbody>
<tr>
<td>machine tools</td>
<td>21</td>
<td>23</td>
<td>19</td>
</tr>
<tr>
<td>metalworking</td>
<td>5</td>
<td>8</td>
<td>7</td>
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<tr>
<td>automobile</td>
<td>7</td>
<td>8</td>
<td>46</td>
</tr>
<tr>
<td>electronics</td>
<td>15</td>
<td>20</td>
<td>4</td>
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<tr>
<td>food</td>
<td>14</td>
<td>15</td>
<td>4</td>
</tr>
<tr>
<td>chemicals</td>
<td>6</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>paper products</td>
<td>9</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>other</td>
<td>23</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
<tr>
<td><strong>total actual</strong></td>
<td><strong>20,275</strong></td>
<td><strong>19,092</strong></td>
<td><strong>35,459</strong></td>
</tr>
</tbody>
</table>

Source: IHK Heilbronn: Percentages are own calculations.

The lineages of the banks in Heilbronn reach far back into its history. The county savings bank, the Kreissparkasse, was established in 1851. In 1987, the Kreissparkasse had total assets of DM 4.6 billion and operated 143 branches throughout the county. It is by far the largest bank or bank branch in Heilbronn. The Volksbank in Heilbronn - the commercial cooperative bank - traces its origin back to the year 1909. Always among the largest cooperative banks in Württemberg, the bank still managed tremendous growth in the last thirty years: in total assets, the bank grew from DM 16.1 million in 1957 to DM 596 million in 1988; in this same period membership grew from 1,000 to almost 11,000.
The Baden-Württembergische Bank (BW-Bank) also has strong roots in Heilbronn. In 1901 local merchants gathered together and founded the Heilbronner Gewerbekasse AG. Their idea was to create a bank which would drive local industrialization through lending and direct investment in firms - just like the Berlin banks. Later the bank became the Handelsbank Heilbronn which was fused with other regional banks in 1977, becoming the BW-Bank (see Chapter 7). The Heilbronn office is now one of three main branches of the BW-Bank and operates thirty sub-branches in its surrounding region (a legacy of the Handelsbank). While a precise assessment of the branch's assets is not available, bank officials estimate it at a few hundred million Deutschmarks - roughly comparable to the assets of the two concern bank branches included in the study. These two concern banks came to Heilbronn in the early part of the twentieth century through takeovers of local banking houses and provincial banks in Heilbronn or Stuttgart. Each of the concern bank branches in Heilbronn is considered a branch of its respective regional office in Stuttgart. Additionally, each of the Heilbronn concern branches operates four or five sub-branches.

Banks and the Local Small-Firm Support System.

As an important early center of industrial activity in Württemberg, government and private sector actors in Heilbronn established numerous institutions to support local firms through work force training, research and development, and other resources. In the 1980s many of these organizations dramatically expanded their activities and the amount of resources they made available to firms. As in numerous other cases, therefore, these institutions form a rich resource environment crucial to the success of local Mittelstand firms and firm networks.

Heilbronn was one of the first cities in Württemberg to establish its own Chamber of Industry and Commerce (IHK), and Crafts Chamber (HWK). These chambers are
responsible for firms in four counties surrounding the city of Heilbronn, known collectively as the region ‘Franken’. There is also a Fachhochschule (polytechnic) in Heilbronn that operates under the auspices of Baden-Württemberg’s Steinbeis Foundation - a technology advising office and three technology transfer centers. The firms of Heilbronn reacted positively to these new technology initiatives and are utilizing them at a fast-growing rate, reflecting the previous pattern of successful cooperation between the FHS and local firms.⁹

In the city’s small-firm support system, the chambers are a key source of information and organizer of local cooperation. They provide a wide variety of services to local firms using their own resources, but also through cooperation with other local organizations such as the polytechnic. In the area of technology transfer, for example, the chambers help local firms use the data bank services available at the polytechnic. In 1988 the Industry and Commerce Chamber hired its own innovation consultant to advise local firms on technology-related problems, on the availability of state loans, and on where to find specialists at universities or other firms. The Chamber also operates technology seminars for local firms, as well as numerous information exchanges for firms offering and seeking patent and license, innovation, and cooperation partners. As elsewhere in the Federal Republic, the chambers play a major role in the local vocational training system. They are responsible for testing all students but also play a key role in translating the demands and needs of local firms into course curriculum. Thus the chambers are important contributors to keeping the labor force

⁹. The FHS was established in 1962. As of July, 1987, the three transfer centers at the FHS conducted research in applied electronics, applied computer science, and electric current technology. In 1985, over 100 students, professors and technicians working part-time in these, and conducted 292 consultancies and 241 R&D projects for a combined billings of about DM 1.3 million, sixth highest among the sixteen Steinbeis operated technology locations. Source: Unpublished data from the Steinbeis Foundation. For comparison, 1983 billings totalled about DM 382 thousand. In 1989 another transfer center for business management was opened in Heilbronn.
qualifications congruent with the changing needs of the local economy. The chambers also promote the exchange of information between firms in the region by sponsoring various committees in which firms from particular branches meet regularly to discuss their problems and prospects.

In regard to state funding for firms, the chambers advise firms on the conditions and availability of programs, as well as providing public lending authorities with evaluations of the applications from firms in their district. In Heilbronn both chambers provide hundreds of evaluations annually, the majority of which are for loans from the Landeskreditbank of Baden-Württemberg.\(^\text{10}\) Since approval of the application by the firm's chamber is a prerequisite for a state loan, the chambers are in a position to influence the investment activity of the local economy. However, the chambers are generally interested in helping their firms secure state funds and use their role in the process to help ensure the success of the project: By being involved in the approval process the chambers screen out applicants who lack the formally required skills to start their own firm, or projects that bear little promise given the local market conditions. In practice the chambers probably approve well over 90% of loan applications. But it is likely that this indicates careful screening of firms before the application is filed. Thus individuals wishing to start a new firm typically go to their chamber - often with the encouragement of their banker - in the early stages of planning. The chambers use this opportunity to provide these individuals with critical information through seminars and individual advising. Thus the local small-firm support system not only makes resources available to firms, it is also structured to provide them with an incentive to utilize the multiple resources available through local organizations. In this

\(^{10}\) In 1988, the HWK made 431 loan evaluations and 686 individual firm consultancies; the IHK made 545 evaluations. See respective annual reports.
manner the local system promotes structural change in the economy through supporting the formation of new enterprises.

The market penetration of state support programs for firms in the Heilbronn area is significant. Calculated simply as a percentage of the total number of firms, a very rough and simple estimate shows that approximately 2-3\% of the firms in the city and county received a loan, grant, or guarantee from the LKB in 1988.\textsuperscript{11} While this percentage may at first seem small, if one assumes each firm is granted only one state loan at time, the percentage of all firms in the region holding a state loan at any given time will be several times this number since virtually all state loans are long-term (at least four years). And neither is the LKB the only state or quasi-state source of capital for firms in the region - the federal development banks and the Surety Bank and Mittelstand Participation Corporation of Baden-Württemberg are others that provide considerable funds.\textsuperscript{12} Moreover, since manufacturing firms receive a disproportionate share of the LKB’s loans, the percentage of firms in this sector is higher than elsewhere. Reflecting the widespread consensus on the need for a state

\textsuperscript{11} For instance, in 1988 the LKB granted to firms in the city of Heilbronn: 51 loans totalling DM 9.2 million; three grants totalling DM 982 thousand; and six loan guarantees worth DM 2.5 million. In the county of Heilbronn, the LKB granted an additional 208 loans worth DM 52 million, and 13 grants worth DM 2.5 million. In 1988, there were 2,735 firms in all sectors in Heilbronn; and 7,846 firms in the country. Dividing 60 loans, etc. by 2,735 yields a percent of 2.2\%; dividing 221 by 7,846 yields 2.8\%. Using comparable statistics form the same sources for 1986 and 1987 the percentage of firms receiving Land support was also between 2\% and 3\%. Source: LKB of Baden-Württemberg.

\textsuperscript{12} The latter, for example, granted 53 craft firms and 60 non-craft firms in the Franken region guarantees and participations worth a total of DM 52.5 million in 1985. Annual Report of the Surety Bank Stuttgart, 1986, p. 40. For craft firms in the region of Franken, at least, the LKB is the largest source of state funds having provided 61\% of all public loans in 1988 which equalled DM 67.4 million: the DAB provided approximately 33\% of these loans, with the remainder coming from other banks. Annual Report of the Heilbronn Crafts Chamber, 1988, p. 33.
role in new firm formation, roughly half of the total number of LKB loans to firms in Heilbronn are for business start-ups.

The banks in Heilbronn play a direct and indispensable role in the implementation of these programs. In all the banks surveyed for this study these programs were, in general, viewed as useful for local firms and the bank itself. Nonetheless, substantial differences in attitude and utilization of these programs by individual banks do exist. The Volksbank is probably the most aggressive user of public loan programs in the city. The bank has long considered these programs critical to its success and the satisfaction of many of its customers. While there is a "natural fit" between cooperative banks and many public loan programs - since both have a relatively high percentage of craft firms in their client pool - the Volksbank in Heilbronn still stands out as a high user of these funds, even among cooperative banks of comparable size. In 1988 the bank granted DM 185 million in new loans of which approximately 70% were commercial. Since about 16% of its total credit volume was refinanced with public funds, this suggests that just over 20% of its commercial loans were from Land and Federal government lending institutions. As a percentage of its firm customers receiving public loans, this figure would be even higher. But the Volksbank hardly has a local monopoly on public funds.

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13. For the protection of confidentiality, in this section certain facts and names must be omitted or left unspecified. Where possible or unavoidable, the identity of the particular bank in question is disclosed. Where necessary the banks will be identified consistently as bank A, B, etc.

14. The two most frequently cited advantages of public loans for the banks where their utility in the acquisition of new business or for general customer satisfaction.
In absolute terms the Kreissparkasse probably passes through more public funds than the cooperative or other banks.\textsuperscript{15} Of the some DM 2 billion in outstanding commercial loans in 1987, DM 120 million (or 6\%) represented public funds. The lower utilization of public funds by commercial bank customers reflects first and foremost their different client structure, namely fewer small firms, but also a distinctly less aggressive attitude about "selling" their clients on these loans. While the distinction is subtle, since every bank will readily advise customers as to the availability of these funds and submit applications on their behalf, it is not without impact. The one clear exception is the case of a business start-up. The pervasiveness of public funds for start-ups has by and large created an atmosphere in which both firm and bank take it for granted that they will be part of the finance package.

The commercial banks surveyed stated that public loans were not very important for their business in terms of total lending, but all readily included public loans into a client’s total finance package. Because the concern banks have, on average, larger firms as clients, they tend to use more funds from the main federal bank (KfW) and fewer from the LKB or Surety Bank than other banks in the city.\textsuperscript{16} In general, the smaller the investment the lower the interest of the bank in public loans (as is true to some extent for all the banks). Several banks admitted that in cases where the application process is difficult, such as in environmental protection loans that require numerous independent evaluations, and especially when the investment project is relatively small, the bank may not push the customer to apply.

\textsuperscript{15} These banks did not cite figures.

\textsuperscript{16} Statistics of the LKB, Surety Bank, KfW, and DAB confirm this.
However, if the bank fails to advise a client on such funds, who later discovers this, then the bank is likely to lose the customer. And all of the banks surveyed (except for concern bank B) mentioned pecuniary advantages for themselves in public funds, since the interest spread for the bank on public loans is frequently greater than that which could be had with loans financed from the capital market. Because the interest rate and spread on public loans is fixed, they also provide the banks with a predictable refinancing of their loans. For this same reason state funds also help to stabilize the financing of Mittelstand firms, thereby increasing their chances of success. Thus, at a minimum, the competitive situation forces all the banks to utilize public funds, even if they occasionally do so begrudgingly. The cooperative and savings banks, perhaps because they have more experience with state loan programs, seemed more favorably disposed to them.

The banks also discriminate among public programs, recommending those to its customers that are most advantageous from a tax perspective or that offer longer term loans. Thus an important function of the banks and chambers in the small-firm support system is to advise firms on public loans and to help them select among the hundreds of programs available. The utilization and therefore effectiveness of federal and Land government programs depends significantly on the advising of local banks and chambers, in effect making them the critical link between the state and firms. In this way federal and Länder industrial policies may be "steered from below" toward local needs.

In general, all the banks in Heilbronn considered cooperation with public financial institutions to be successful. While several banks still complained over the long processing time required (typically ranging from four to ten weeks), they also noted that the public banks are sufficiently flexible and have become more dynamic in recent years, willing to take a greater direct role (and perhaps more risk) in local investment projects. For example, the
BW-Bank noted that in the past few years the Surety Bank of Baden-Württemberg and the Mittelstand Participation Corporation have contacted the bank looking for candidates. Earlier these public banks waited for the other banks to bring them business. The savings and cooperative banks also viewed the Landeskreditbank as a generally useful partner for financing larger investment projects. While all the Heilbronn banks said they prefer to handle problem or insolvency cases in-house, the banks have used the LKB or Surety Bank for help in such instances. These responses by the banks in Heilbronn indicate that the Land government’s involvement as an actor in local industrial finance markets has grown significantly. Importantly, this involvement is largely done in cooperation, not competition, with local financial institutions. Since it is the savings or cooperative bank that is more likely to use state banks in this way, the Land government has arguably enhanced the competitive capacity of smaller local banks relative to the local branches of commercial banks that can readily draw on the resources of their concern.

The banks in Heilbronn were also asked about their relationship to, or utilization of, the Fachhochschule (FHS), Chambers, and Steinbeis foundation. The thesis of a growing mediator role by the banks suggests that the frequency and depth of contacts (exchange of resources) among the banks and other organizations should increase. In general, the commercial banks seem to have fewer contacts to other organizations: Bank B has sent a half-dozen or so firms to the FHS for technical advising or R&D assistance on projects. For technical credit rating needs, the bank uses outside experts/consulting firms which often leads

17. The liquidity assistance program of the LKB - which provides finance for troubled firms - has flourished in the 1980s. But as the representative from concern bank A explained; since a large part of the risk of loans made under the liquidity program is carried by the house bank anyway, they might as well make the loan themselves. Another bank cited the extensive paperwork involved in such cases as an obstacle to choosing the LKB for cooperation.
indirectly to the FHS (employed by the consulting firm). But for established firms the bank is likely to rely more on the overall financial condition of the firm for its lending decision. This bank reported little direct contact to the Steinbeis Foundation, although some of its firms received technology grants from the Land government in which the foundation was involved as evaluator.\textsuperscript{18} Bank A reported contact with the Steinbeis Foundation in the context of public loan/grant programs. Outside this context, the bank used the foundation once for a technical evaluation and has referred clients to it. The BW-Bank reported little direct contact with the FHS, but its experience with the Steinbeis Foundation was reported as both extensive and valuable in, and on several occasions outside, the context of public loans.

A comparison based on the interview results suggests that the local savings bank was the most active bank in the local small-firm support system, especially regarding technology transfer. Not only was the bank educating some personnel to do modest general technical credit ratings, it often used the Steinbeis Foundation for consulting and not just in connection with a public loan. Working very closely with the FHS, the bank is trying to build what it calls "unity", or an axis, between itself, the FHS, and its firms. Specifically, the bank sponsors occasional gatherings with FHS professors and twenty or so of its firm clients. The bank hopes that these informal sessions will interest the professor and their students in the problems of its firms, and lead to student research projects or contracts with the FHS.\textsuperscript{19} This provides a clear example of the bank mediator role: The savings bank is utilizing its unique position to build or mediate the flow of resources/information between firms and other local institutions.

\textsuperscript{18} In the case of grants, the bank is often not directly involved.

\textsuperscript{19} The manager interviewed is a member of the Mittelstand working group at the IHK. The groups discusses a variety of problems and potential solutions for small firms.
The Volksbank has a very close relationship to the crafts chamber. The majority of the members on the supervisory organs of the bank are also members of the Crafts Chamber, including the president. To preserve its solid base of craft firm customers, the bank supports the young craft workers organization through a variety of informational programs. Also, the bank frequently sends its clients to either of the chambers for additional consulting. While the other banks would hardly deny the usefulness of the chambers, or the fact that they often refer clients to them, the Volksbank was the only bank surveyed to expressly attach great importance to the Chambers as a source of information for firms. The Volksbank considered the Chambers vital for the success of its customers, in some cases purportedly 'saving' some of the bank's clients. In regards to technology, the bank has had contact with the Steinbeis Foundation, but only in connection with public loans or grants. For technical advising, the bank refers clients to the FHS, Steinbeis, or private consultants.

In sum, the cooperative and the savings bank in Heilbronn seem to place a higher value than the commercial banks on the resources and cooperation of local small-firm support institutions. This probably reflects several factors; first, the smaller firms, especially craft firms, are more likely to seek the advice of the chambers, and the savings and cooperative bank are the two primary "banks of choice" for such firms. Second, because of historical institutional ties, these banks probably have more direct personal connections to the FHS or Chambers. All the banks will readily refer clients to outside consultants, be it for tax, legal, technical, or management questions. And even though the commercial banks seem to select private consulting channels over the public network, they often end up tapping this network indirectly, and perhaps unknowingly. Before moving to the next section, I present two brief, but telling examples that illustrate how cooperation among organizations in the local small-firm support system works. Each is a case from a different bank in Heilbronn, and each
involves cooperation between the local bank, the LKB, and the Steinbeis Foundation - as technical evaluator - and the chambers - as evaluator of the market conditions for each project.

The first case involves a technology-oriented start-up firm. A few years ago some engineers in a local machine tool firm developed new product and technology ideas, but their employer showed no interest in them. So the group decided to establish its own firm to develop and produce computer integrated manufacturing (CIM) technologies and products. As the first Mittelstand firm with fully-integrated CIM in West Germany, it itself was to be a prototype. The new firm would also operate a small technical education center to conduct training courses for CIM technicians. The entrepreneurs secured an agreement with Daimler-Benz according to which the new firm would supply Daimler with its technologically-advanced machinery and train Daimler workers in its CIM training center.\textsuperscript{20} Fortified with this agreement, the group turned to a local bank in Heilbronn to secure the needed finance (in the range of several million Deutschmark).

For the local bank the project embodied many risks and it set the cooperation of the LKB as a condition for its own participation. Under its government technology program, the LKB promised a grant to the group. With a little more difficulty, the bank and group also managed to secure a grant from the Economics Ministry of Baden-Württemberg to support the training center. With these grants in hand, the group set up shop in a more remote locale of the region where it would also be eligible for low-interest state loans under the Federal and Land regional development programs. In the interview, the house bank admitted that without the support of the Land government, the project would probably not have succeeded.

\textsuperscript{20} IBM also expressed interest to the group in its project.
The possible alternative would have been to seek funds from a venture capital corporation. Now established but still in the beginning stages, the bank suggested that the firm will likely solicit more equity from the Mittelstand Participation Corporation within a few years.

The second case is the story of a Mittelstand firm that makes and prints packaging products. The firm was established in 1980 with heavy dependence on one buyer. When a few years later this buyer demanded the firm meet higher quality standards, its very existence was threatened. Needing more equity to leverage the necessary finance, the local bank helped the firm search for another partner. Eventually an Austrian firm was found. With its new partner (and now majority shareholder), the firm set out to build a whole new factory. Total investment would run over DM 30 million. To meet the quality challenge, the firm took a bold, innovative step. It sought to purchase a prototype corrugated board-making machine from a Bavarian state firm. Over 100 meters long and costing more then DM 10 million, the bank and firm considered it an untested technology and applied for support from the LKB. In a meeting with the LKB and Economics Ministry, the state authorities agreed that as a new technology the purchase of the machine could be subsidized under the technology promotion program of the LKB. The firm chose to receive its support in the form of a grant. In addition, the project as a whole also qualified for support from the KfW under its Mittelstand program. The KfW financed about 70% of the total investment at a rate slightly more favorable than the market rate. The firm's Heilbronn house bank financed the rest.

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21. The firm received a grant equal to about 6.5% of the machine's cost.

22. This last story also demonstrates the potential power of small, nimble banks over big, lumbering banks: Originally one of the local concern banks was involved in the project but was dropped by the firm when it could not decide fast enough.
Competition and the Changing Relations between Bank and Firm.

In this next section I examine the growth and changing nature of competition among the local banks/branches. I look specifically at the impact of growing competition on the internal organization of the local banks and their external strategies vis-à-vis their competitors and their clients. In the 1980s there are two indisputable facts in the Heilbronn banking market: First, there is tremendous competition between banks and gains are largely made only at the expense of another. Second, the savings bank is the dominant bank against which all the others measure their success. This dominance is indicated by the large discrepancy between the total assets of the savings banks and the other banks, as indicated above. It can also be seen in their disparate client bases: the savings bank indicated it had roughly 2,000 Mittelstand firm customers; all the other banks indicated they had between 400 and 600. The other banks also acknowledged that the savings bank is the 'price-leader' in the local market. This is attributable in good measure to its strength in the local savings market that provides it with relatively inexpensive capital.

As was true of the rest of the Federal Republic, in the late 1970s the big commercial banks in Heilbronn intensified their efforts to acquire Mittelstand clients. As they pushed out into the Mittelstand market, it brought them more and more into direct competition with the cooperative and savings banks. Bank D noted that one of the concern banks had

23. In the 1980s other banks moved in to the city or began forays into the local market from Stuttgart. For example, one bank noted that the Industriekreditbank AG, working from its Stuttgart office, was increasingly active in Heilbronn. Another banker noted that with 1992 they could expect more of such to come from other banks settling in Stuttgart - and that these banks will pursue the most "interesting" (i.e. most profitable) customers in Heilbronn.

24. While I indicated in earlier chapters that the profit-motive was an important motivation for this, concern bank A suggested it was a response to the needs of the Mittelstand; to their demands to be cared for "skin-close."
started sending out top-level managers to recruit new firm business, a new competitive practice. Bank C stated that the other concern bank had become very aggressive in the last few years, taking more risks and offering markedly better conditions on its loans. Even so, in interviews the savings and cooperative banks - the two traditional competitors in the Mittelstand banking market - continued to identify each other as their main competitor. They did, however, acknowledge growing competitive pressure from the big three concern banks, even for the business of craft firms (though in this client group it was more limited).

The intensification of competition has had profound impacts on all of the banks' internal organization and on their strategies, both for acquiring new customers and for satisfying existing clients. At some point in the 1980s all the banks initiated internal reorganizations. First, all the banks except bank C separated processing, or back-office functions, from customer "caretaking." 25 Second, all the banks except bank E separated private customer from firm customer business. 26 In other words, firm customer advisors would only deal with firm, not personal business. In all banks the main objective, however, was the same: free up personnel to spend more time in contact with customers. All the banks stressed that getting out into the firms is more important than ever for acquiring new and maintaining old clients, even if the client does not need anything at that particular moment. 27 Thus bank E, for example, set a goal of initiating face-to-face contact at least once a year with all firm customers and a spending a minimum 8 hours with all its primary

25. Bank C has a mixed system of processing and caretaking, or advising, of customer business.

26. Three years ago this bank adopted a system of "all-finance advisers" in which any given customer would have only one advisor at the bank for all services. In some respects this is the exact opposite change from the other banks.

27. Bank B said 90% of all advising is done on the premises or the firm.
customers. Consistent with the rest of the banking sector in West Germany, the banks in Heilbronn also vastly expanded their range of electronic technology-based consulting services.

Competitive pressures have also forced the banks to identify "target groups." For example, the commercial banks have all set a minimum firm size for the clients which they will actively pursue, though no bank would turn away profitable business from firms under this level. In keeping with their traditions, the savings and cooperative banks have no minimum size strategy. As a whole, intensified competition has clearly favored the bargaining power of the firm customer vis-à-vis its bank. Firms have learned to expect more, better, and faster service. All the banks acknowledged that most firms now also maintain at least two bank connections. Further, they agreed that traditional loyalty by firms to their house banks had declined somewhat. Even so, the manager of one concern bank noted that declining loyalty does not necessarily indicate an absence of such, as many times when he solicited new Mittelstand clients they reputedly professed loyalty to the bank which was willing to support them many years ago - back when the concern banks ignored them, or worse, turned them away. Thus competition means the banks must simply do more for their firms. Regarding the Mittelstand this largely means expanding their mediator role. And the closer and more frequent contacts between the banks and their Mittelstand clients is providing the banks with a better knowledge base for exercising this role.

When the local Heilbronn banks are compared on their tutelary relations to firms, there is practically little difference between them. None of the local banks or branches directly owns shares or equity in local firms. For the concern banks that do hold shares in

28 Though one of these banks suggested that a bank will naturally tend to invest more time in more profitable clients.
a few local firms, these are managed from the central office in Frankfurt. If the holdings are large enough, the bank may have representatives on the supervisory board, but if so, they come from the Frankfurt, or perhaps Stuttgart, office.29 Because of its long history in Heilbronn as an industrial bank, the Handelsbank Heilbronn had significant holdings in a few local firms. After becoming part of the BW-Bank, the new leadership of the bank decided to concentrate on being a bank 'partner' by selling much of its holdings and reducing all remaining holdings to a minority ownership position. By 1988 this process was completed.30

The dearth of direct investment by local banks does not preclude local firms from having investment partners, as many of them do, but rather that such capital comes from independent venture capital or capital participation corporations such as the Mittelstand Equity Participation Corporation. Concern bank B reported 15% of its firm clients had received equity from one of these sources. The other banks reported much lower percentages. Thus in this local market firms appear to rely heavily on bank borrowing for their external funds. Though the factors cited above indicate this has not inhibited a growth in firm autonomy from the banks.

When asked to assess their comparative strengths, the cooperative bank claimed that it had as much "know-how" in the Mittelstand banking business as anyone, and when it

29. In the entire region of Franken there are only thirty-nine publicly-held firms (i.e. AGs). Heilbronn Chamber of Industry and Commerce. 1988. Zahlenspiegel. August. The local branches of the concern banks do conduct the daily business transactions of large local corporations which use the concern bank as its house bank.

30. Even with these sales, however, personal connections between the bank and a few Heilbronn firms via their supervisory boards continue. The Kreissparkasse and Volksbank have no comparable history to the BW-Bank, though the former does have managers who sit on a few corporate boards.
comes to business start-ups, even more. The exception, of course, is the case of international banking, or export finance. The savings bank also noted that its huge pool of local savings, combined with less pressure to maximize profits, allowed it to accept a smaller interest spread and therefore generally have the lowest prices in town.\textsuperscript{31} The BW-Bank cited its historical connection to the city and the quality of its personnel as its competitive advantage. The concern or commercial banks both noted their strength in international (export) banking, as well as the close personal contact they maintain to their clients. When asked, all the banks claimed to be as fast or faster in making their credit decisions as the next. Ascertaining which bank is "fastest" is next to impossible, but what is clear from their claims is the centrality of this to competition. Moreover, it suggests that the comparative strengths and weakness of a local bank or branch are closely connected to its respective association or concern, and less inherent to the local bank or branch itself as might otherwise be assumed. The successful execution of the mediator role depends on effective cooperation or coordination within the concern or association combined with local autonomy.

\textit{The Changing Relations between a Local Bank and its Association or Concern.}

In the competition for Mittelstand business, one of the main aspects has become the ability of the bank to decide on a firm's credit request quickly. As legally independent banks, the cooperative and savings banks make all decisions in-house. Within each of these banks individuals have a given level of decision-making competence; after a certain loan level, decisions are made in a credit committee. For the other banks the structure is much the same, except that when the sum of a loan reaches a higher level it is decided upon in Stuttgart, or even Frankfurt. The key question for the commercial banks then, is how much

\textsuperscript{31} According to the Kreisparkasse, two-thirds of commercial businesses in the county have a savings account with it.
credit competence to give to each individual branch. If it is too little, then it will take too long to decide on many loans and they may be lost to a competitor that can decide on the spot.

As discussed in chapters 3 and 4, to win more Mittelstand business the concern banks discovered they needed to decentralize more lending authority. In Heilbronn this trend was confirmed by both concern banks. In bank A the decentralization of credit competence had been "drastic," especially in the last few years. This enabled the branch to make much faster decisions and virtually all lending decisions to the Mittelstand between its Heilbronn and Stuttgart branches. Within bank B similarly strong decentralization has been implemented since the late 1970s. Managers here felt they could now act genuinely independently. Moreover, the irrevocable need to be close to the customer and flexible assured them that decentralization was there to stay and, if anything, would continue.32

But the concern banks have recently discovered that decentralizing lending authority alone is not enough. To win more Mittelstand clients the banks are being forced to compete not just on speed and services, but price as well. And the other banks in Heilbronn attested to more aggressive price competition from the concern banks. Nonetheless, the concern banks have to date made only limited moves to decentralize interest-rate setting authority. The local branches have to work within a relatively narrow range of prices. It is in this

32. Concern-internal competition is not unknown in these banks. While each branch has an assigned market area, there is no formal "protection" from other branches. Branches from one area can serve a firm in another if the client approaches the bank or wishes to maintain pre-existing connections. But the branch cannot actively pursue such a client. Moreover, the need to keep in close contact with clients provides a "natural" barrier to such competition. Thus for local branches of commercial banks there exists a de facto "regional principle" similar to that of the association banks. The advent of all-finance in the concern banks is adding another dimension to local branch autonomy as they are frequently able to choose between different insurance companies or mortgage banks within the concern.
decision-making area where local managers felt most bound to the directions of their central office. For the BW-Bank the story is similar to the concern banks, though there are two important distinctions: First, the farthest away any decision goes is Stuttgart; second, because the branch in Heilbronn was formerly an independent bank and still one of the largest within the bank, it enjoys a special position and has a relatively wide range of competencies.

Another increasingly important aspect of competition for the Mittelstand is the export finance field. As discussed in earlier chapters, the weakness of the savings and cooperative banks is a matter of the whole association, not the individual bank. Unless these banks build up their own foreign network, their competitiveness in this area is determined by their associations. The international business of these banks is handled by their respective regional central banks in Stuttgart. In Heilbronn, as all over in the Federal Republic, the Kreissparkasse and Volksbank frequently lose customers, or at least their international business, to the concern banks. In Heilbronn, only 20% of the Kreissparkasse’s Mittelstand firms export. Concern bank B, in contrast, reported that 80% of its firm clients export. Managers in both the association banks made clear their frustration with this structural weakness.

But from the perspective of the local concern bank branch, this dependence is much the same within its broader organization. Both independent local banks and local branches rely on functionally-similar organizational supra-structures to conduct the international transactions of local firms. The difference is that the concern banks have the experience, contacts, and foreign network and reputation which serve their local branches well.

The supra-structures of the association banks, however, are not without comparative strengths. In the area of all-finance the savings and cooperative banks are far ahead of the
others. In this regard, both the savings and cooperative banks believed cooperation within their respective associations was successful and provided them a competitive advantage in the domestic market. For the other banks the all-finance strategy of their respective concern or group was just beginning to make an impact in the local branch. Thus when it comes to the introduction of new products or services, the similarity between the association and concern banks is also visible. In both cases higher levels of the organization provide information and, if necessary, training for local bank/branch employees.

Growing assimilation between the association banking groups and the concern banking groups continues and its impact can be seen at all levels of their respective organizations. The forces driving this assimilation at the local level do not appear likely to change. Local branches of the major commercial banks are becoming similar in their autonomy to independent local banks. Local association banks and local branches of concern banks rely in similar ways on their respective organizational superstructure for technical and financial assistance. Local autonomy of financial institutions backed by the resources of a larger organization enable all of these banks to offer more resources to Mittelstand firms and expand their mediator role. In this respect the case of Heilbronn also supports the arguments of chapter 3 regarding limited organizational convergence between the two association banking groups (savings and cooperatives) and the major commercial bank concerns. Still, caution must be taken in making this argument. An independent local bank remains different from a local branch of a big bank: Hierarchical control still exists within the concern banks, although this is declining in critical areas. The associations must rely primarily on cooperation for internal coordination.

The case of Heilbronn shows how structural change can occur successfully without organized capitalism. The adaptation of firms to economic changes was not a centrally-
directed process, yet firms received extensive support through the various organizations and the Land government whose supportive actions comprise the local small-firm support system. In the next case, Solingen, the process of adaptation is quite similar, even though the regional institutional context is less supportive of this model of economic governance.

C. Solingen.

Solingen is a small, but very heavily industrialized city located in the Bergische region of North Rhine-Westphalia. The Bergische region, which encompasses the nearby cities of Wuppertal and Remscheid as well, is heavily industrialized on a well-diversified basis, both in terms of sectoral and firm-size distribution of production. Beginning with the manufacture of swords in the middle ages, the town of Solingen has made its name renowned worldwide for quality cutting instruments such as knives, flatware, and scissors. Cutting instruments and flatware continue to be the largest single manufacturing sector in Solingen, though its share in the city’s overall economy has declined from 38% of manufacturing employment in 1952, to just under 19% in 1988 (Table 8.2). As employment declined rapidly in Solingen’s centuries-old cutlery industry, it rose in other, newer industries - automobile parts and electronics in particular. In spite of this diversification, total manufacturing employment in Solingen and the Bergische region has declined substantially since 1970. Yet compared to the rest of the nation, or even other industrialized countries

33. In 1987 employment in manufacturing per 1,000 population was 137 in Solingen; in the famous industrial region of the Ruhr this figure was 109; in North Rhine-Westphalia as a whole 117; in the Federal Republic 116. All economic statistics regarding Solingen in this section provided, except where otherwise noted, by the Chamber of Industry and Commerce for Wuppertal, Solingen, and Remscheid.
which underwent a general shift from manufacturing to service sector employment, the
Bergische economy continues to have a very strong manufacturing base.

The 1981 recession was particularly difficult for the city of Solingen, as growth was
slow and unemployment rose to double-digit figures and remained high even as it declined
elsewhere in West Germany. But after 1985 soaring export demand helped the region’s
manufacturing firms to nearly close this growth gap. Unemployment dropped to within 0.4%
of the national average by 1989.\textsuperscript{34} Thus by the end of the 1980s Solingen seemed to have
been relatively successful in adapting to the rapid economic changes of the previous fifteen
years. In spite of the steep decline in manufacturing employment, in 1987 Solingen was one
of only a handful of cities in North Rhine-Westphalia in which manufacturing employment
accounted for more than one-half of total employment.

Table 8.2 shows that the number of manufacturing firms with more than twenty
employees declined substantially, suggesting that successful adaptation was based in part on
economic concentration. But the total number of firms in manufacturing has actually risen
since the early 1970s.\textsuperscript{35} With total manufacturing employment declining this means that on
average manufacturing firm size in Solingen has declined. The traditional small-firm
structure of Solingen therefore survived the turbulent 1970s and 1980s. The average firm
size in the cutlery industry has always been and continues to remain very small, in spite of
a dramatic drop in the number of home workers engaged in the industry. The largest cutlery

\textsuperscript{34} From 1970 to 1987, however, the population of Solingen declined from roughly
179,000 to 159,000, suggesting that unemployment may have been higher without this out-
migration. By 1990 the population had risen to some 164,000. For Solingen industry 27.5% 
of its revenue comes from exports; for cutlery alone the export rate is 37.4%, for machine
tools 47.1%.

\textsuperscript{35} In 1972 there were 1,115 manufacturing firms, in 1989 there were 1,237.
firm in the city, Henckels, has just over 500 employees. Traditionally, production in this industry has rested on a high division of labor and therefore cooperation among firms in Solingen. This system of inter-firm networks based on 'cooperative contracting' - a form of obligational network - made the city a classic case of an industrial region or district, and continues to do so to the present. In such a system small skill-intensive firms specialize in one part of the production chain. These firms are linked together in long-term relationships that are typically open-ended and continuous.\textsuperscript{36} In the case of the cutlery industry, production via cooperative contracting might take the typical form where a drop-forgel foundry makes the base piece of a knife; a highly-skilled workers hones the knife edge in his home shop; a third firm makes the wooden handle for the knife; and a fourth firm assembles the final product. Thus rather than being produced in a vertically integrated firm, the knife is produced through the cooperation of autonomous but linked local producers.

A 1989 study of over 100 Solingen cutlery firms showed that 25\% to 35\% of these firms cooperated with other firms in purchasing, sales and marketing, and advertising. Such cooperation helps small firms to reduce their individual overhead costs. About half of the firms surveyed indicated they would be interested in using new telecommunications technologies to contract out their administrative office work, allowing them to focus on production.\textsuperscript{37} According to the study, about 70\% of firms cooperated with another firm in production. Thus the willingness of firms to continue to specialize in complimentary production and to voluntarily coordinate their efforts remains high.

\textsuperscript{36} For a brief discussion of cooperative contracting see Hollingsworth, 1990, op. cit., pp. 59-61.

In the remainder of this section I will examine the process of adjustment in Solingen and show how the local banks and government promote small firm growth and contribute to local cooperation among producing firms and between these firms and other organizations that provide them essential resources. The case focuses on the cutlery industry to illustrate this process. Though not all firms and sectors in Solingen are engaged in cooperative contracting, the cutlery industry is still the city’s most important single sector and provides the best illustration of how Mittelstand firms benefit from increased state support and the banks’ mediator role.

The literature suggests that production in the form of cooperative or relational contracting must be minimally coordinated in order to succeed. The case of Solingen does not provide sufficient evidence to conclude that either local governments or local banks/branches alone act as the primary coordinating mechanism of such inter-firm network production. Coordination occurs through various informal pacts among firms, as well as the actions of local institutions including the cutlery industry’s trade association. However, the literature also suggests that successful cooperative contracting requires a rich environment of local institutions to provide firms with external resources. Thus the actions of local government agencies and the banks and their cooperation with other local organizations do provide an important basis for production via firm networks. The extent to which a firm actually uses external resources depends, in part, on the local institutional context in which it operates. Some studies suggest that areas in which local actors cooperate effectively, state
resources are used more extensively and with greater impact. The case of Solingen, as well as that of Heilbronn, lends support to this view.

Table 8.2

<table>
<thead>
<tr>
<th>Firms* (absolute)</th>
<th>Employment</th>
<th>Turnover</th>
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<tbody>
<tr>
<td>Total</td>
<td>282</td>
<td>219</td>
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By Branch:

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<tbody>
<tr>
<td>Metal Products (cutlery)</td>
<td>116</td>
<td>89</td>
<td>30.8</td>
<td>29.5</td>
<td>28.2</td>
<td>27.5</td>
</tr>
<tr>
<td>Auto Parts</td>
<td>16</td>
<td>9</td>
<td>11.0</td>
<td>14.4</td>
<td>14.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Electronics</td>
<td>10</td>
<td>12</td>
<td>12.1</td>
<td>11.6</td>
<td>14.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Foundries</td>
<td>15</td>
<td>11</td>
<td>9.7</td>
<td>9.4</td>
<td>8.6</td>
<td>7.0</td>
</tr>
<tr>
<td>Machine tools</td>
<td>24</td>
<td>17</td>
<td>10.2</td>
<td>9.3</td>
<td>8.7</td>
<td>8.9</td>
</tr>
<tr>
<td>others</td>
<td>101</td>
<td>81</td>
<td>26.2</td>
<td>25.8</td>
<td>25.9</td>
<td>27.1</td>
</tr>
</tbody>
</table>

Source: Industry of Chamber and Commerce for Wuppertal, Solingen, Remscheid.
* This is only firms with more than 20 employees, including craft firms that manufacture goods.

Like Heilbronn in Baden-Württemberg, there are a host of local and Land organizations supporting the development of firms in Solingen. Through their support these organizations promote the creation and stability of Mittelstand firm associations and non-hierarchical forms of networks. The Chamber of Industry and Commerce in Solingen was established in the middle of the 19th century, though in 1977 the three Chambers of the Bergische region were directed by the Land government to merge in correspondence with recent communal reorganizations. The Chamber provides alone and in cooperation with other organizations a variety of services to local firms. These services are oriented toward providing individuals and firms with information via continuing education courses, providing firms information about other firms seeking cooperation, and offering firms technology advising services through an office at the technical academy (polytechnic) in Wuppertal. The chambers of Solingen also advise firms and evaluate their applications for public funds.

The city government of Solingen has also long been involved in local industry. In 1872 the city established a continuing education school to promote the training of craftsmen. In the 1980s the government continued to see vocational education as one of its main contributions to the local economy and has invested substantial sums to upgrade the city’s schools. Until the 1980s the city also operated in conjunction with the cutlery industry trade association a research office for cutlery and an office for materials testing. These two offices played a critical role for the local cutlery industry as tester, researcher, and advisor. Through this cooperative facility all local firms were able to learn about new materials and

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39. Key organizations in Solingen include the city Office for Economic Promotion, city planning office, the Commerce Supervisory Office (Gewerbeaufsichtsamt) - in charge of enforcing myriad industrial regulations, the local Federal Labor Office, local business associations and unions.
methods. Thus through cooperation among themselves and with the city government the hundreds of small firms in the cutlery industry could develop and disseminate technological information which a single firm could most likely not have done acting on its own.

The successive closure of these two offices in the 1980s - largely because of the city’s financial difficulties - threatened to end a long tradition of cooperative research and development in Solingen. It was immediately clear to the cutlery industry’s trade association (IVSB) that if nothing was done a large technical vacuum for local firms would arise. As a short-term measure the IVSB made an arrangement with a similar cooperative research institute in nearby Remscheid. Under this agreement Solingen’s cutlery firms could have individual research and testing projects conducted and get technical advising. But the cutlery firms organized in the IVSB wanted to revive their branch-oriented cooperative research in which results were disseminated to all members through seminars. The city of Solingen was also concerned about the future of its cutlery industry. By joining the Cooperative Research Society in Remscheid in 1989, the city government enabled it’s cutlery industry to gain access to these research facilities and again conduct its own branch-specific research. This cooperative research is also supported financially through the federal and Land governments. Thus the cutlery industry was able to continue this essential form of cooperation by widening the circle of organizations that contributed directly and indirectly to it. The maintenance of cooperative research and the dissemination of this knowledge is vital to the continuation of inter-firm network production. Without it the smaller firms in the district are more likely to fall behind in their technology.

Inter-firm cooperation and the process of adjustment, however, are by no means limited to efforts coordinated by the industry’s trade association or the city government. In the 1970s, for example, several local cutlery firms pooled their know-how with a machine
tool firm to develop jointly a precision automatic grinding machine for knife blades. Until such a machine could be built at a sufficient level of quality this work was done in the centuries-old traditional method - namely, by the highly-skilled handwork of the local craftsmen. This heavy reliance on individual skilled labor permitted thousands of workers to grind their blades at home, thus enabling highly decentralized production coordinated by the more formally organized firms in the region. With the successful development of automatic grinding machines production began to be centralized and much of the demand for handwork, and thus workers, declined. However, this did not reduce the need for highly skilled labor in the cutlery industry. Rather, the type of skills required changed, and the local educational system has gone to great lengths to meet this need.

The automation of the cutlery industry was also critical for the long-term success of the industry which was under intense pressure from competitors in the Far East. Unable to compete on price, the cutlery firms in Solingen had to push their traditional emphasis on high-quality products even more, while at the same time trying to reduce costs. All the banks interviewed for this study, however, noted that many cutlery firms have transformed themselves from production to distributing firms - buying wares in the Far East and reselling them in the industrialized countries. In the 1980s the cutlery industry’s share of overall manufacturing employment continued to decline, but at a much slower rate than in earlier years. The number of firms has also declined, partly due to centralization of production, others due to closure. Still, hundreds of firms remain in the industry, most of them with less

40. This information was provided by the Commerzbank in Solingen.

41. Though the local industry discourages this to some extent through the "Solingen Law" which prevents firms from selling products with the city’s name on them unless they are made, or substantially improved, within the city limits.
than twenty workers. According to Best, a fully developed industrial district must be capable of changing the process and organization of production, as well as the products it produces.\textsuperscript{42} Through extensive cooperation and assistance from the local small-firm support system Solingen's cutlery industry has managed to do all of this, even though it has not preserved all the jobs in this branch. And through the creation of new firms in this and other sectors the local economy has maintained a comparatively high level of manufacturing employment. In short, the industrial district has diversified its product range.

One of the major long-term problems for the local economy, and another area where cooperation and consensus among local actors is vital to their individual and collective survival, has been securing sufficient land for industrial use. Solingen suffers from an especially acute shortage of industrial land and an undesirable hodge-podge pattern of residential and industrial land usage. The shortage of land has clearly limited the expansion and even technical modernization of numerous local firms, and in some cases has induced them to relocate elsewhere.\textsuperscript{43} In 1968 the city government created an economics committee consisting of representatives from the city council, local industry and unions. The committee deliberates and advises the government on a range of policy issues related to local economic development. To some extent the committee constitutes a local corporatist body as its recommendations are more often than not followed by a city council that tends to avoid detailed involvement in local economic development efforts. Over the 1970s the committee became increasingly active under the dominance of representatives from the city's traditional

\textsuperscript{42} Best, 1990, op. cit., p. 206.

industries. Among the many issues it engages, the committee normally determines which firms may purchase or lease new industrial space from the city. This property is usually sold at a steep discount from its market value and thus represents a subsidy from the city government as well.\textsuperscript{44} This form of subsidy has also been used frequently to induce firms outside Solingen to locate in the city.

Because the demand for industrial land exceeds the supply, the committee exercises a selection function. Some local political actors have denounced the committee as a "subsidy distribution cartel." In any case, local government officials and representatives of local firms help steer the development of the local economy by determining which firms are given favorable locations.\textsuperscript{45} In many cases relocated firms subsequently underwent tremendous expansion. In cases where generous incentives provided by the city could not induce firms to relocate, the city has also resorted to various coercive means. Though in the early 1980s city officials gradually came to see relocation as a limited solution to the city's land-use problems. Increasingly the city government and various local governmental agencies coordinated their efforts to keep firms in their existing locations by finding innovative ways to help them comply with various regulatory requirements. For example, for one firm the city and local Commerce Supervisory Office provided financial assistance to help it construct

\textsuperscript{44} Land is typically sold at a 33\% discount. Though the Solingen SPD has claimed that Land has been discounted as much as twice that. See Nassmacher, 1987, op. cit., p. 198. This also helps prevent firms from being crowded-out of the city because of real-estate speculation.

\textsuperscript{45} From 1981 to 1984, for example, seventy-six firms were able to purchase 246,000 square meters from the city. Nassmacher, 1987, op. cit., p. 197.
a new building on its existing site that incorporated necessary sound-dampening technology.\footnote{Nassmacher argues that the Commerce Supervisory Office (Gewerbe-aufsichtsamt) is one of the key local institutions for assisting firms in modernizing at their present sites because of its wide-ranging regulatory responsibilities. Nassmacher, 1987, op. cit., p. 253; 297-298.}

Since 1978 this attempt by local actors to assist firms has been augmented by a special Land government program for the Bergische region that provides subsidized loans to help foundries and drop-forgeries modernize and comply with regulations, especially regarding noise emissions, either through investment in their present sites or through relocation to ones. In each successive year roughly ten firms have received funds through this program. In many cases these loans were also used to rescue a firm, and thus indirectly boost the cutlery industry, by financing expansion and essential technical modernization.\footnote{The government and industry chamber of Solingen played an important role in the creation of this Land program. From 1978 to 1989, 108 firms received loans under it. The city also used Land and federal urban renewal funds, and since 1984 funds from a new Land program for recycling old industrial sites, to provide financial assistance to firms renovating their existing buildings.}

With control of the city council passing to a SPD-Green coalition in 1984 the city's economic policy took a new direction. Since the early 1970s the local SPD had been advocating a greater local government economic development role. But rather than raising subsidies to firms or subsidizing outside firms to locate in the city, the SPD preferred a policy that emphasized the development of local firms through expanded information services. Thus the new council endorsed the creation of a technology advising office for local firms. This proposal was first advocated in the late 1970s by the head of the local office of the German Labor Federation, but was repeatedly defeated by the local CDU that was more closely allied with the city's traditionally conservative Mittelstand firms. In the
mid-1980s the new head of the local Federal Labor Office sought increased cooperation and information exchange with the city’s office for economic promotion. The goal was to better assist firms that were prepared to expand or locate in the city by securing in advance the needed workers with appropriate skills.⁴⁸ This initiative of the Labor Office went beyond its mandated role and thus provides an indicator of the strong willingness of many local actors to extend cooperative practices.

Since the late 1970s, and especially since the creation of the North Rhine-Westphalia’s ZIN program in 1989, cooperation on a wider level has also begun to develop among the three cities that comprise the Bergische region. Within the first year of its existence the ‘regional conference’ of the three Bergische cities initiated two projects to be supported through the Land’s ZIN program. The first project is to establish a small firm “incubator” facility. The second project is to establish a new regional office for consulting. The goal of the consulting office would be to provide a central office in the region that could increase the utilization of information and expertise available in the region by firms.

In sum, the local small-firm support system, which includes the chambers, local trade associations, city government, has played a central role in promoting comparatively successful adaptation to economic change. According to Nassmacher, cooperation among the various local government agencies, chambers, and banks in Solingen is well developed compared to other cities in the Federal Republic.⁴⁹ Land and local government support for


⁴⁹. Though Nassmacher also argues that cooperation is more often based on finding the least-common denominator among these organizations, rather than building consensus. The chambers also prefer to keep some distance to local agencies in order to preserve their autonomy. Finally, Nassmacher notes that the exclusion of the Commerce Supervisory Office in the city’s economic committee could be increasingly detrimental to local promotion efforts. Nassmacher, 1987, op. cit., pp. 293-298.
local Mittelstand firms through direct aid and through indirect assistance, such as support for cooperative research in the cutlery industry, has promoted hundreds of local firms and thus supported the continuation of non-hierarchical governance mechanisms in local industry - in particular the continuation of cooperative contracting arrangements.

In spite of these efforts by local actors, when compared to Heilbronn and the Franken region in Baden-Württemberg, firms in the Bergische region apparently do not receive nearly as much financial support from the Land and federal governments. These two regions are roughly comparable in terms of population, number of industry firms with more than 20 employees, and number employed in manufacturing. Yet in 1987 and 1988 the Industry Chamber of the Franken region made roughly three to five times as many evaluations of subsidized loan and loan guarantee applications by firms. In other words, this suggests that Mittelstand firms in Baden-Württemberg receive substantially more Land and federal support than Mittelstand firms in North Rhine-Westphalia.

Since this simple comparison itself must be used with caution, explanations of this difference must also be tentative. But as the previous case studies of these two Länder suggest, the difference is probably due in large measure to the different sectoral and spatial emphasis of the two Land governments: in North Rhine-Westphalia funds flow

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50. In 1987 the Franken region had a population of 727,000; 782 industry firms (more than 20 employees), and a manufacturing work force of 103,000. The Bergische region had a population of 645,000; 737 industry firms and a manufacturing work force of 105,000.

51. In 1987 and 1988 the Chamber of Industry and Commerce in Franken made 464 and 564 loan and loan guarantee evaluations; the Chamber in the Bergische region made 159 and 111 respectively. While loan evaluations by the Chambers does not cover all state grants and loans to firms, it does represent a large majority of them. Moreover, it can be reasonably assumed that the success rate of loan applications and average subsidy value of each loan or guarantee are comparable between the two regions.
disproportionately to the old coal and steel region of the Ruhr.\textsuperscript{52} From this it appears that local economies with strong networks of inter-firm and inter-organizational cooperation in North Rhine-Westphalia must be more self-sufficient than their counterparts in Baden-Württemberg. Though as discussed in chapter 6, in the 1980s the Land government began to increase its support for local development efforts and Mittelstand firms.

\textit{The Solingen Banks.}

The savings bank of Solingen is the oldest and largest banking institution in the city (founded in 1840). In 1989 the savings bank had total assets equal to DM 2.7 billion and DM 1.9 billion of outstanding loans, more than half of which were commercial loans. The cooperative bank in Solingen also has a long history in the city, but merged with the cooperative bank of nearby Remscheid in 1987 due to financial instability.\textsuperscript{53} Thus the 1989 total DM 1 billion in assets - and DM 757 million in outstanding loans - held by this bank are spread over the two cities. All three of the major commercial banks are present in Solingen as well: the Deutsche Bank and the Commerzbank since the early decades of the twentieth century, the Dresdner Bank since 1956. The largest among these three banks had total assets of approximately DM 1 billion, but only DM 300 to DM 400 million in outstanding loans in 1989. Thus in terms of sheer financial size, the savings bank is roughly three to four times larger than its main local competitors.

\textsuperscript{52} Moreover, a rough calculation shows that the Bergische region has roughly 4% of North Rhine-Westphalia’s population but receives less than 2% of Land funds; Heilbronn, in contrast, accounts for 6% of Baden-Württemberg’s workforce yet receives about 12% of Land funds.

\textsuperscript{53} This merger was undertaken largely to save the cooperative bank of Solingen where general economic hardship in the 1970s and 1980s was compounded by mismanagement.
One important component of the banks' mediator role is passing through state funds to firms. Though Solingen may receive fewer state funds than other regions in North Rhine-Westphalia, all the banks claim that the amount of state funds they pass through has increased over time. Two of the three commercial bank branches described state funds as important for their customers, though they could not say that state funds constituted a large part of their assets. One commercial bank noted that state funds presented some 5% to 10% of its loans. The cooperative bank set this figure at 10% to 20%. Since awareness among firms regarding the existence of state funds has risen, all the banks consider them important for their business. Moreover, for the commercial banks state funds represented a cheap source of capital for the bank. Since the commercial banks tend to be less competitive on price, being able to offer lower-cost state loans was seen by two of them as a competitive boost. There was also consensus among the Solingen banks in the belief that state funds do not create new investment in firms, but reward those who invest. Though the banks varied in their assessment of whether state programs were useful or useless subsidies for firms.

Regardless of their attitude, all the banks reported increased utilization of state funds.

The bank representatives in Solingen were also asked to assess their relations and cooperation with other local organizations that provide support to firms. As in Heilbronn, cooperation among local organizations seems to be greatest in the case of business start-ups. First, because start-up firms typically receive substantial support from state funding sources.

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54. There was also consensus that tax reductions would probably be more helpful to firms than state loans and grants, a preference which most firms themselves also hold. Two of the main arguments for tax incentives are that they require no paperwork and firms do not have to "compete" for them, i.e. all firms can benefit. See Behrens-Bamberg, Wolfgang. 1984. Steuerliche Anreize bei innovativen Investitionen kleiner und mittlerer Industrieunternehmungen unter vergleichender Berücksichtigung nichtsteuerlicher Hilfen. Stuttgart: Poeschel.

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Second, because many start-up firms lack collateral and therefore are frequent recipients of loan guarantees from the North Rhine Westphalia’s credit guarantee cooperative (KGG). Finally, start-up firms usually seek a great deal of advice from the banks, chambers, and other sources. As one local banker stated it, in the case of start-ups a “three-way union” among the firm’s bank, respective chamber, and trade association typically arises to guide the new venture. This bank considered the chambers very useful organizations, and used them as a source of information about the local economy and even to help find cooperation partners for their firm clients. In contrast, another concern bank branch stated that since the chambers were public authorities, they were by their nature not useful for the bank.

On the whole, the banks in Solingen assessed their working relationships to state organizations positively. The new investment bank of the Land government (a department of the WestLB), however, was given mixed reviews. Two of the banks felt that the savings bank in Solingen would unfairly benefit from the fact that the WestLB - acting in its capacity as a state bank - was now administering all of the Land government’s loan programs. One commercial bank noted that it already had to fight the belief in many local firms that state funds are more easily obtained through the savings banks. The irony is that the efforts of the Land government to use the WestLB to expand its Mittelstand-oriented industrial promotion efforts may in fact be hindered by this - at least in the short run - if the other banking groups are hesitant to work with the WestLB.

Several of the banks noted that one of their most important partners was a firm’s tax advisor. One commercial bank noted that firms typically trust their tax advisor more than the bank. Thus winning the trust and building a cooperative relationship with a firm’s tax advisor was an important means to satisfy the needs of firms and to acquire new customers. The cooperative bank noted that it places a great deal of value on a close working
relationship with the tax advisor, partly in order to compensate for its comparative
disadvantage vis-à-vis the commercial banks in electronic-based consulting services. In sum,
in Solingen cooperative relationships between the banks and other local organizations seems
to vary more strongly than in Heilbronn, though this difference seems to rest more on the
individual disposition and histories of the banks than on identifiable structural differences
between the two cities.

As elsewhere in Germany, competition in the Solingen bank market has grown
tremendously. And the Solingen banks responded to competition in a similar manner to other
German banks, including the expansion of their consulting services for firms. In Solingen,
however, utilization of these services by local firms has increased too slowly in the view of
the banks.\(^{55}\) Several bankers attributed this to the very small average firm size which makes
many of the banks' services too expensive or unnecessary given the size of the firm. One
banker also believed this reluctance reflected a desire on the part of many firms to not
come too dependent on its bank. Nonetheless, several bankers saw a great need and
growth potential for their advising services since the many family-owned firms in the city are
usually dominated by technically, but not managerially qualified leaders.

All the banks agreed that the quality of their personnel and advising to firms, not loan
conditions, was the key factor to success in banking. Building trust through competence and
continuity of support is indispensable to a long-term relationship. Since the savings bank is
the price leader in the local market, the other banks attempt to stay within an acceptable
distance to the savings bank while emphasizing superior advising and spending more time

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\(^{55}\) The Deutsche Bank, for example, claims that only 5% of Mittelstand firms have used
electronic data bank services.
with the firms.\textsuperscript{56} All the banks have adopted an internal organization model which frees
firm customer caretakers from processing duties and allows them to go into the firms more
frequently. The Solingen commercial banks also confirmed the trend toward increased
internal decentralization in terms of lending competency discussed in chapters 3 and 4. All
of them felt that they had sufficient lending authority to satisfy virtually all loan demands by
firms without consulting higher levels.\textsuperscript{57}

Several of the banks reported that numerous firms in Solingen have problems with
insufficient equity capital. But none of the banks in Solingen had more than a few cases
where its concern or association-owned equity participation corporation (KBG) had invested
equity in local firms. Perl apps because of this gap, the savings bank of Solingen established
an equity participation corporation in 1990 along with the savings banks of Wuppertal and
nearby Düsseldorf. Though the owners of this KBG intend to support firms with an above
average growth potential, not to save local firms which are struggling.

In terms of firm and sectoral modernization, the banks of Solingen seem to be
satisfied with adhering to their mediator role. The modernization and transformation of the
cutlery industry, for example, is apparently occurring without a formally organized branch
or region-wide modernization plan. Neither the trade association of cutlery firms, the Land
government, nor the banks have attempted to play any sort of tutelary role within the branch,

\textsuperscript{56} There was also another interesting parallel to the Heilbronn case: one of the
commercial bank branches in Solingen reported that the dominance of the savings banks was
also attributable to the relationships established between the savings bank and local firms in
1950s when only the savings banks had substantial funds to lend long-term.

\textsuperscript{57} One commercial bank branch reported that lending competence had been increased six
times since 1978, and that only ten or so loan requests per year could not be decided by the
branch alone.
as the big commercial banks have often attempted in other cases. The banks did not seem particularly concerned about the cutlery industry’s adjustment troubles, and some bank managers voiced relief that the local economy had become more diversified and hopefully therefore less crisis-prone. But this does not mean that the adaptation of the cutlery industry is occurring through a pure market process. As discussed earlier, extensive direct and indirect cooperation among firms within their association and obligational and promotional networks continue to play crucial governance roles. As one banker described it, the owners and managers of the firms in the branch know each other well and regularly exchange information during their encounters in meetings at their association, the chambers, and the local technical school. Thus cooperation, shared knowledge, and a sense of community and mutual interest serve to minimally coordinate the efforts of firms without resorting to a hierarchically directed rationalization effort.

But if the banks are not so closely involved in restructuring the cutlery industry, economic change in the local economy has still presented them with new challenges. One banker noted that the trend to greater out-sourcing of production by larger firms aided the expansion of smaller firms, but the concurrent pressure to raise product quality and hold larger inventories presented these supplier firms with greater financial burdens. To support such firms the banks needed to be more flexible and innovative than in the past. In this respect local banks and branches play a critical role in the expansion of post-Fordist organizational principles.

In terms of technology transfer, the banks’ advisors readily assisted their firms in finding sources of technical information, and certainly encourage them to keep up with new developments. But when it came to financing innovation or the introduction of new production technologies, the bank’s lending decision tended to rely more on the financial
strength of the firm than on the promise of the technology. Thus the banks realize there are clear limits to their involvement in the technical modernization of local industry, and that this aspect of a firm’s development is therefore better served by helping the firm secure the needed expertise elsewhere in the local area.

The banks in Solingen also report changes similar to the Heilbronn banks regarding concern or association-internal relations. The commercial, cooperative and savings bank all have their own department for international transactions, and can thus serve many of their firm clients export needs in-house. For other services or products both the concern and association banks rely on subsidiaries within their respective group. Although the larger savings and cooperative banks are increasingly asserting their independence vis-à-vis their associations by selecting partners based on their competence and price, not on their membership in the same association. By having more than one subsidiary for a given product or service, the commercial banks have often given their branches a similar independence.

In certain respects the savings and cooperative banks of Solingen are more self-reliant than the commercial bank branches in the area. One commercial bank, for example, reported that alongside the decentralization trends, there was a trend to centralizing certain ‘back-office’ administrative functions. Accordingly, the number of employees in the branch was reduced from 200 to 160 within two years. Payment transfers are now carried out by higher levels of the bank, much like smaller savings and cooperative banks rely on their regional banks to make such payments. Thus among the commercial banks the direction of
development seems to be toward more local autonomy and control over services and factors directly affecting customers, accompanied by centralization of selected processing tasks.\textsuperscript{58}

In sum, the case of Solingen also demonstrates how Land and federal industrial policies and the intermediary role of the banks support Mittelstand firms and local cooperation in adapting to economic change. But this case also shows that successful local cooperation cannot always compensate entirely for broader economic changes, as the problems of the cutlery industry indicate.

D. Conclusion.

Local small-firm support systems exist throughout the Federal Republic. But the extent of their cooperation, the services and collective goods they offer to firms, and the amount of resources they receive from Land and federal governments varies substantially. Both Heilbronn and Solingen are strongly industrialized local economies in which a large number of Mittelstand firms are actively supported by local organizations. Though in the case of Solingen local actors seem to be more self-reliant insofar as firms here appear to receive substantially less financial support from their Land government. In both cases, the local small-firm support system is most active in promoting business start-ups, though they are increasingly active in other areas as well.

The growing emphasis of the banking sector on the Mittelstand, and along with this the growth of their intermediary role, harmonizes with the expanded efforts of the state to promote the growth of Mittelstand firms through individual and collective support. The mediator role of the banks also reflects the limits on their capacity to influence the

\textsuperscript{58} Bertrand and Noyelle, 1988, op. cit. report a similar trend elsewhere.
development of a particular firm or branch. Banks support firms by becoming more closely linked to the local institutional environment in order to expand the resources and information they can offer firms. Thus the mediator bank role is in some sense the antithesis of the tutelary - the former acknowledges the autonomy of firms by casting the banks in a comprehensive supportive role; the latter embodies a reduction of firm autonomy through bank influence.

The growing number of smaller firms in the late 1970s and 1980s coincided with the growing interest of the big commercial banks in this firm category. To argue that one of these trends alone led to the other would be a tenuous hypothesis, but the evidence presented here does support the conclusion that each tends to reinforce the other. In the case of small firm network production, or cooperative contracting, the support of the Länder and banks for smaller firms seem to be important, though alone not sufficient, prerequisites for this model of production. The case of Solingen, corroborated by other studies, implies that medium sized firms (approximately 50 to 500 employees) probably benefit more than smaller firms from expanded state Mittelstand support and the mediator role of the banks. The very smallest firms may simply be too small to invest the time necessary to learn about, pursue, or afford many of the resources available to them.\(^{59}\) These firms appear to rely more on traditional sources of support such as the free advising available from the chambers. Medium sized firms, on the other hand, continue to need many of the resources being offered through local small-firm support systems while being able to make the initial investment required to obtain many of them.\(^{60}\) For the banks, medium sized firms also generally offer the largest

\(^{59}\) The one clear exception to this is the case of firm start-ups.

\(^{60}\) Based on a nation-wide survey Geiser concludes that virtually all firms seek information from their bank regarding financial alternatives for planned investments. But
profit opportunities since they still rely strongly on conventional bank finance and can afford the more expensive consulting services of the banks. But for both small and medium sized firms, local small-firm support systems - backed by the Länder and federal governments - can be flexible enough to offer each critical outside assistance.

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firms with more than fifty employees were much more likely to seek additional information from other sources such as the chambers, trade associations, and other state agencies. Awareness of the availability and types of state financial assistance programs was also substantially higher among firms with 200 to 500 employees, than among firms with less than twenty. Nearly 80% of firms in this larger category claimed they had received at least one state loan/grant (on average, each firm received 2.4 loans); while just under 40% firms in the smallest category had received state assistance (on average 0.5 per firm). Geiser, Josef. 1980. Zum Investitionsverhalten mittelständischer Betriebe. Göttingen: Otto Schwarzter. pp. 93-100.
CHAPTER NINE:

Germany Beyond 1992.

At the beginning of this dissertation, I set out to explain three interrelated trends in the German economy, all of which began in the late 1960s or early to mid-1970s. These trends are the expanding share of the market for industrial finance controlled by non-commercial local and regional banks; the rapid growth of industrial intervention by the state, especially the Länder governments; and the decentralization of industry, especially as reflected in the growth of small and medium-sized firms. These developments ran counter to the tenets of the organized capitalism perspective which depicts German industrial governance and change as being guided, if not directed, by the negotiated agreements of centralized private sector actors. As so many observers have argued or assumed, it is the large commercial banks that are presumably at the center of Germany’s system of organized capitalism. Through their control of shares in firms, their control of seats on supervisory boards, and their ability to control large amounts of proxy votes, the banks are in a unique position to strongly influence the major decisions of many, in not most, of Germany’s largest firms. Given their extensive power and overview of the German economy, the banks were ostensibly in a position to take a long-term perspective on industrial developments and mobilize resources and coordinate the actions of firms in line with the long-term needs of the economy. The role of the state in the economy is held to be largely subsidiary, supporting the negotiated settlements of private industry with regulatory measures and occasionally financial assistance. This view of the German economy and the role of the banks in shaping industry remains widely accepted in the comparative political economy literature.
While there is undoubtedly a great deal of truth in this standard account, the 'system of coordination by banker,' as Shonfield labelled the German political economy, must be more clearly understood as the exception and not the rule. And since the late 1960s the ability of the banks to intervene so extensively in the affairs of industry has slowly but markedly weakened. Large banks continue to have extensive holdings in large firms and are often in a position to influence corporate decisions. But in an aggregate sense, the evidence suggests that this has not precluded firm managers from further extending their financial and decision-making independence from banks. In short, the banks can still potentially intervene into the internal affairs of firms, but the financial and institutional barriers to such intervention and control are growing.

As the influence and importance of the large commercial banks as a source of industrial finance has waned, the influence and importance of the state and savings and cooperative banks has grown. The rise of one set of institutions and decline of the other are not coincidental. The power of the large commercial banks has been reduced partly as a result of growing competition from the savings and cooperative banking groups, as well as the attempt by state actors to gain greater influence over economic activities. Thus I have sought to argue that our understanding of the prevalent structures and processes of how the German economy functions must be revised. Corresponding to recent trends in the literature, this study suggests that a more heterogenous model must be developed. The institutions that structure economic relations among private sector actors and between the state and private sector actors vary significantly by sector and often by region.

I focused on analyzing the role of state actors and banks in the economy because both are distinct from other sets of actors in that the banks (or more broadly financial institutions) and the state are the major suppliers of capital – the universal commodity that is a
prerequisite for virtually all economic activity. The state and banks are therefore potentially involved in all producer decisions. In this regard I drew on the work of Zysman and others that depict the organizational or institutional character of a nation’s financial system as a critical determinant of the strategic choices of other economic actors, including state actors. But I differ from Zysman in that my evidence suggests that the financial system is not exogenously determined, but is very much an endogenous variable within the web of relations and interactions among economic actors.

For example, the three sector banking structure was created and sustained through periods of crisis by state intervention. The challenge to the commercial activities of the savings banks in the interwar years and the postwar years were repelled by state actors in accordance with particular social and economic policy goals such as the maintenance of bank competition, the prevention of excessive economic concentration, and the preservation of the financial basis for production in Mittelstand firms. The savings and cooperative banks were also sustained in part by the state because they were effective mechanism for distributing state resources to private producers without requiring the state to build up its own bureaucracy. In this respect, the savings and cooperative banks constitute part of a strong politico-administrative tradition in Germany of utilizing what Katzenstein described as para-public institutions to implement public policy. In a similar vein, state actors, especially in the Länder, promoted the commercial expansion of large state-owned banks in order to counteract the power of the large commercial banks, as well as to use these public banks for industrial intervention. The relationship between Land governments and their Landesbanks exemplifies both the comparatively discreet nature of state intervention in the Federal Republic and the constant process of negotiation and coalition formation between state and private sector actors over the policies and resources that help structure relations of
production. While the Federal Republic has often been depicted in the literature as a system of negotiated change, my evidence suggests that the power of state actors within such negotiations is frequently greater than the literature suggests.

A. The Changing Face of Bank-Industry Relations.

I have argued that the traditional tutelary role of the German banks has declined relatively to their mediator role as a result of growing bank competition, the growing financial independence of large firms, the growing importance of Mittelstand firms as bank clients, and the growing role of the state as a source of industrial capital. These arguments are based in part on my implicit assumption of a ‘resource dependence’ theory. A prominent theory within the literature on inter-organizational relations, the resource dependency perspective holds that firms or actors cooperate with each other in order to reduce uncertainty and secure scarce resources. When a firm seeks external resources it opens the door to potential influence by the supplier of that resource.¹ Thus in the case of bank-firm relations it is the dependence of the firm on the bank for capital that creates the potential for bank influence in the firm. But the ability of the bank to exercise such influence is strongly affected by other institutional factors. As noted in the introduction to this study, I assumed the critical institutional or structural conditions regarding bank influence to be the supply of capital, the demand for capital, and the degree of concentration and coordination among suppliers. There are also institutional factors that are specific to each bank-firm relationship such as control of board seats and voting rights in firms. But since changes in these specific

¹. A prominent exposition of this view is found in Pfeffer, Jeffrey and Gerald Salancik. 1978. The External Control of Organizations: A Resource Dependence Perspective. New York: Harper & Row. The resource dependence model is also commonly the basis of bank control theories.
factors are difficult to analyze systematically, I have focused on examining changes in the broader structural conditions of bank influence.

The growth of market competition among the banks proceeded on several fronts. Most visible is the growth of competition over lending to firms. Here the growing market orientation of the savings and cooperative banks, especially since the liberalization measures of the 1960s, greatly intensified their pursuit of commercial clients. The strength of these two banking groups in deposit-taking markets enabled them to compete very effectively on the basis of price with the often much larger commercial banks. This was especially true of lending to the Mittelstand. Competition for lending to large firms likewise intensified in this period, primarily as the result of the entrance of new domestic competitors into this market segment such as the Landesbanks. In the era of open competition market share for bank loans to industry shifted substantially from the commercial banking sector to the savings and cooperative sectors. This suggests that a certain amount of deconcentration of the capital supply has occurred as the number of financial institutions that a typical firm - be it large or small - could obtain capital from has grown. For example, until the 1960s a typical Mittelstand firm seeking bank capital would normally have a choice of two to three banks - the local savings bank, a cooperative bank, and perhaps a regional bank. Today this firm would probably find more than a dozen financial institutions ready to lend it funds. Large firms generally have an even greater choice of institutions.²

². An intra-European comparison reveals surprising results: In the late 1980s West Germany had over 4,000 independent banks. Great Britain, France, and Italy all had less than 1,000 independent banks. In terms of asset concentration, Germany had the lowest after Luxembourg. Molyneux, Philip. 1989. "1992 and its Impact on Local and Regional Banking Markets." Regional Studies 23(6): 523-533.
This deconcentration also means that attempts by the banks to coordinate among themselves their lending decisions, and thus the flow of capital in the economy, have also become increasingly problematic. The larger the number of competitors, the more difficult it becomes for the banks, especially the large banks in their dealings with large firms, to develop a joint strategy and pursue collective action vis-à-vis an individual firm or a set of firms. With more competitors it is likely to be easier for the firm to find a bank willing to support it when others will not. The inability of the major commercial banks to force a rational-ization plan on the German steel industry in the early 1980s illustrates the difficulties of ‘coordination by banker.’ The Dresdner and Deutsche Banks had tried but failed to coax two of their major clients, Krupp and Hoesch respectively, into a merger. Less than ten years later this merger was achieved, but not through coordination among the banks. Rather it was achieved by the WestLB displacing the Dresdner bank as Krupp’s chief bank and secretly assisting a coup against the Deutsche Bank. Hence, as suggested in chapter 4, a lower degree of concentration and coordination among suppliers of capital tends to raise the independence of firms from the banks.

A second key determinant of firm dependence on the banks, and therefore of bank influence, is the extent to which firms are dependent on the capital resources that banks supply. Over the 1970s and especially beginning in the 1980s the profits and retained earnings of German firms have grown dramatically. Many firms, especially large firms, have been able to finance their investments increasingly from their own financial reserves. Thus the demand by German firms for external capital has also declined, thereby further inhibiting bank influence. The billions spent by Daimler for its 1980s acquisitions, for example, came out of the firm’s reserves. The Deutsche Bank makes money from Daimler profits primarily through the dividends paid on its shares, not on bank loans. This points to
the fact that as bank lending to large firms declines, one of the more important ways for the banks to earn money from large firm clients is through investment banking activities - underwriting new bond and stock issues, and trading and owning corporate shares. German banks are therefore unlikely to drastically reduce their aggregate shareholdings. At the same time, however, individual holdings are becoming smaller and more likely to be held only as long necessary to realize a solid profit. Thus while the banks may continue to have considerable ownership in industry, the influence in corporate decision-making that the banks derive from their institutional position in firms is weakening.

The large banks are reducing many of their largest shareholdings to smaller positions, typically to no more than 10% of a firm's shares. The 10% ownership gives the bank certain tax advantages, but it also places the bank's voting power well below the 25% required for a 'blocking minority' in major corporate decisions. Thus the ability of a bank to intervene in a firm in which it holds shares is increasingly dependent on its ability to gain the support of several other shareholders, be they banks or other non-financial firms. The attempt by Pirelli to take over the German tiremaker Continental in 1991 is a case in point. The Deutsche Bank is Continental's chief house bank. When the challenge by Pirelli became known the Deutsche Bank had to rely on its connections and influence to induce several other German firms (notably from the auto sector) to either acquire significant shares in Continental or commit their existing shares and votes to a joint defense. After a long struggle, the Deutsche Bank eventually succeeded. But to all external appearances it was a highly costly victory, both in terms of money and in terms of lost prestige, and perhaps some influence, for the Deutsche Bank. Thus the large German banks will continue to own shares in firms, but competition among the banks for underwriting business, share ownership and supervisory board seats also mitigates bank influence.
In sum, I have argued that the comparative political economy literature tends to overestimate the degree of bank control over firms in Germany. I have done so by focusing the changes in the growing supply of capital and the lower degree of concentration and coordination among suppliers. These factors work against bank influence. I have also reviewed evidence regarding the ability of the banks to use board seats, voting shares in firms, and proxy votes as sources of influence. Again, there is much to support the argument that it has become more difficult for banks to use these as mechanisms of influence. One of the key factors engendering these structural and institutional changes is the growth of competition among the banks. As already noted, state actors were crucial to the creation of three banking groups that form the basis of competition. Without the establishment and state-sanctioning of the associa-tional organization of the savings and cooperative banks, it is highly unlikely that they would have been able to compete with the commercial banks as successfully as they have. Periodic and cumulative pro-competition regulatory and tax policy changes by the federal and Länder governments in the postwar period pushed the three groups to greater direct competition with each other. Through these changes in regulation, the state also changed the power relations among these different banking groups. This, in turn, affected the ability of the different banks to pursue particular market strategies and facilitated the decline of the banks’ tutelary role and the rise of their mediator role.

Though I have argued that the ability of the banks to intervene in the internal affairs of other firms has declined, several banks continue to remain more directly involved in corporate decision-making. Thus an interesting set of questions remains: Under what circumstances are the banks likely to exert or attempt to exert control or influence over non-financial firms? What are the most important sources of influence? When it does occur, what are the consequences of bank intervention? In the course of this study I provided pieces
of answers to these questions. Here I will only attempt to summarize briefly what I consider initial and still incomplete arguments.

The Landesbanks and other large state-owned banks appear to intervene in firms frequently because of regional economic development considerations. Even though most Land governments have taken a somewhat more restrictive role in their Landesbanks, they are still in a position to veto bank decisions and continue to coordinate the bank’s ‘industrial policy’ with their own. Here ‘industrial policy’ is understood as a concern and plan for the long-term economic development a particular region or sector. The WestLB may no longer have to buy bankrupt firms at the behest of the Land government, but its major acquisitions are frequently made with the intent to not only make a profit but to influence industrial developments in North Rhine-Westphalia in a direction deemed desirable by the Land government.

The pursuit of ‘industrial policy’ by the large commercial banks, in contrast, seems to have declined somewhat as the impetus for bank intervention. The banks’ failure to turn around the coal and steel industries, or even to develop consensus among producers in these sectors, revealed their growing weakness. So far they have refused to assume such a responsibility in restructuring the economy of the former GDR, despite many pleas for greater bank involvement. Case evidence suggests that among the three largest commercial banks it is primarily the Deutsche Bank that still demonstrates an interest in industrial policy. The Deutsche-Daimler axis and the expansion of Daimler to a dominant position within the German aerospace industry is a case in point, but also a rare case. In this respect the personalities of the bank’s top leadership also seems to play an important, if difficult to assess, role in determining a bank’s decision to get more deeply involved in firm affairs. Like the doyen of German banking, Herman Abs, Alfred Herrhausen was very active as the
supervisory board chair in numerous firms. But his successor, Hilmar Kopper, has adopted a more cautious and less ambitious approach to industrial policy.

As the German economy becomes increasingly open to foreign investors, bank shareholdings in non-financial firms, and vice-versa, are increasingly important as a means to prevent hostile takeovers. The recent expansion of interlocking shareholdings involving the Allianz insurance company, Dresdner Bank, and several large industrial corporations appears to have occurred largely for just this reason. This network was probably not established in order for these firms to exert direct control over decision-making in each other, but to preclude an outsider from the group from gaining unwanted control in a "member" firm. Finally, it must be mentioned that in cases where banks get more directly involved in firm decisions, it is frequently, if not most often, done in order to save the bank's investment in the firm. In these cases bank influence is more a reaction than part of a forward-looking strategy.

Earlier chapters suggested that the relative importance of different sources of bank influence has changed as well. Loan dependence by large firms on the banks is relatively low. Supervisory board seats, with the exception of the chair, now appear to be much less significant than many had assumed. Instead, extensive bank influence seems predicated on a combination of significant ownership in the firm by a bank and the willingness of the firm's managers to cooperate with the bank's representative (who normally would occupy the chair of the firm's supervisory board). Thus, as Eglau suggests, good personal relations and consensus between the firm's and the bank's managers may be far more important than formal mechanisms of control. The ability of the steel firms to defy many of their banks' preferences in spite of extensive bank loans and ownership helps illustrate this.
The final question regards the consequences of bank intervention. The chapter on North Rhine-Westphalia suggested that the ability and/or willingness of the banks to develop, or aid in the development, of sectoral rationalization plans is declining. But on an individual firm basis, the banks have demonstrated their continued ability to rescue troubled loans through continued financial support. Perhaps even more important than capital in such instances, is the bank's role in promoting the appointment of new, and presumably more competent, managers for the firm. Though there are also many cases, far more than the standard accounts of Germany imply, in which the banks fail to rescue a firm or do not even attempt to do so. The banks' willingness to take greater risks for a firm seems strongly correlated to number of years that the bank and firm have had close connections, as well as the "too big to fail" rule. The more bank intervention seems tied to defending against hostile takeovers, the more one might question the presumed ability of the banks to act in the long-term interest of industry. A merger between Pirelli and Continental may well have benefitted both, but accounts suggest that the Deutsche Bank ultimately followed the desire of Continental's management to remain independent, not some plan that indicated Continental would be more successful without Pirelli.

If direct financial control of firms by banks is an elusive means for bank influence (i.e. bank tutelage), is there still a somewhat looser form of bank dominance or 'bank hegemony'? Based on their study of the U.S., Mintz and Schwartz developed the argument that banks (financial institutions) enjoy structural hegemony within domestic economies.

Structural hegemony operates when the actions of one social institution (or coordinated group of institutions) determine the viable options available to other institutions and individuals. If such constraint regularly occurs in a social system, the leadership of the dominant structure exercises a non-interventionist leadership that
allows for coordination of the various contained social formations without either covert coercion or systematic ideological manipulation.\(^3\)

Given the position of the banks in the German economy, and if the Mintz and Schwartz theory is valid for all capitalist systems, then one would expect this notion to apply to Germany. According to this view the banks do not need to exert direct control in order to strategically shape the incentives that corporate decision-makers face. Simply through their ability to direct broad capital flows to or away from specific sectors or firms the banks have the power to support or sanction other (resource dependent) actors. Some evidence suggests that this theory helps explain relations between banks and firms in the German case. Direct bank involvement in corporate decision-making appears to be declining, yet networks of interlocking shareholdings and directorates involving the large banks and firms appear to be expanding. Earlier I called these obligational networks. On top of such obligational networks are even broader monitoring networks constituted by overlapping multiple board memberships of a relatively small group of economic elites. At a minimum these networks serve to keep managers of the largest German firms relatively well-informed about conditions in other firms and sectors.

But what is not clear is whether the banks are at the center of these networks in the sense of occupying the pinnacle in a hierarchy of decision-making power. Since the financial dependence of many large firms on the banks is minimal, and many large banks depend on alliances with non-financial firms to protect themselves from takeover threats, it is not clear that the banks are actually in a hegemonic position. In short, the system-wide asymmetry

of power presumed in both the bank control and bank hegemony perspectives is not readily evident. Moreover, these interlocks are based on significant resource exchange among the participants, but this does not necessarily mean that they wish to use this for anything more than mutual monitoring (sharing of information). Interlocking shareholdings may simply serve a prophylactic purpose, not as a mechanism of coordination. Episodes of coordination among large German firms and banks are evident, but the bank is not always in the dominant position.

Lastly, the bank hegemony perspective also rests importantly on the assumption that there is a high degree of concentration of capital and coordination among financial institutions (based on a strong perception of common interests). As already discussed, the evidence suggests that the concentration of capital resources is comparatively low in Germany and intensified competition has made coordination among the banks more difficult. What, then, is the final picture of the German economy that emerges from this discussion? What this suggests is that the banks should not be seen as capable of anything more than periodic coordination or control of economic actors, and when this occurs, it usually involves one or a few firms. But the large financial and non-financial firms in Germany clearly continue to have extensive but normally loose (non-market) networks of relationships. These interlocks seemed designed largely to assure corporate managers of stable and "reliable," or at least more predictable, stock ownership in their respective firms. An interesting question, that only the future can answer, is what impact the fuller integration of the European market will have on corporate Germany's ability to maintain such alliances. Evidence so far suggests that the basis for such coordination is likely to erode. But I anticipate the last part of this conclusion.
B. Post-Fordism, the Mittelstand, and Bank Mediation.

The preceding discussion on bank-firm relations pertained largely to those existing between large financial and non-financial hierarchies - the core institutions of the organized capitalism model. However, one of my main arguments has been that standard accounts of the German political economy overemphasize these governance mechanisms, while underestimating the importance of smaller financial and non-financial firms and non-hierarchical governance mechanisms. In this next section I summarize the role of banks in non-hierarchical governance mechanisms and relations between banks and Mittelstand firms. I have maintained that the banks' relations to firms can vary considerable between different sectoral and regional governance regimes.

In regimes where smaller firms and non-hierarchical mechanisms have a greater role, the banks' mediator role is generally far more significant than their tutelary role. Hence in these regimes the savings and cooperative banks have traditionally been the most important financial institutions. As in the tutelary role, in their mediator role banks are generally a long-term partner to the firm. But in the mediator role the provision of capital by the bank to a firm typically does not open the door to influence over internal firm decision-making. The mediator role actually implies that the banks need to provide more non-financial resources to firms because competition has made capital more readily available to firms and Mittelstand firms generally cannot be controlled through bank ownership. The mediator role of the banks has expanded in response to the growing significance of Mittelstand firms as bank clients, as well as competition among the banks for these clients. The increased mediator role and competition for the Mittelstand are also partly the result of the growth in the number of small firms and their significance for production within numerous sectors.
Many governance regimes in the Federal Republic have evolved in a direction consistent with the principles of a post-Fordist production system. Since this often entails the vertical disintegration of production and the expansion of production via linked but autonomous firms (obligational networks), one of the key roles of the banks in facilitating and stabilizing such governance mechanisms is in their commitment to Mittelstand firms. Because Mittelstand firms are typically more dependent on external resources than large hierarchies, their viability is often much more problematic and susceptible to sudden environmental changes. Changes in technology and international competition have narrowed the margin of error that most smaller firms have. This places greater requirements on the banking system. The banks must be more willing to support the risky innovative activities of smaller firms. Even though the German financial sector has not developed venture capital funds to the extent of the United States, individual banks have become more willing to support innovative activities and establish new financial institutions - such as equity participation corporations - designed to do much the same thing. Another key role of the banks is to promote the formation of new firms. Given the relatively high rate of Mittelstand firm bankruptcies, post-Fordist production requires a high rate of new firm formation in order to sustain decentralized production. By spreading risks, loan guarantee cooperatives and state loans for start-ups have increased the overall capacity of the banking system to finance new ventures.

Providing firms with non-financial resources is the central dimension of the banks' mediator role. Banks are increasingly trying to provide Mittelstand firms with managerial and technical information they need. They do so either by drawing on in-house resources or by drawing on their position as a constituent organization in local or regional promotional networks. The banking system is increasingly focused on promoting the creation of
obligational networks and multilateral governance mechanisms - characteristic of post-Fordism - by aiding firms in their search for cooperation partners.

Because the savings and cooperative banks have traditionally focused on the Mittelstand, they have been able to expand their overall share of the markets for industrial finance as these firms account for an ever greater percentage of bank borrowing. But their ability to expand their mediation functions, and thus compete with the commercial banks, depends in part on their ability to preserve associational cohesion. For example, a local cooperative bank can offer more international services to an exporting Mittelstand firm if the association, or more specifically the DG Bank, has a strong international presence.

Likewise, the large commercial banks have substantially decentralized their internal operations since the early 1970s. They have done so in order to compete more effectively in local and regional banking markets. In the process, the banks themselves have become less hierarchical in their internal organization. Their bureaucratic command systems have softened as the consensual or participatory elements of internal coordination have grown. Thus the large commercial banks have also increased the capacity of their local and regional branches to exercise a mediator function. By establishing an ability to play a similar role to the savings and cooperative banks for Mittelstand firms engaged in non-hierarchical governance mechanisms, the commercial banks have more than compensated for lost lending to large firms.

Stated another way, the large banks in Germany are not only capable of promoting the hierarchical coordination of economic production, they are also capable of promoting non-hierarchical and non-market coordination. For example, in their mediator role they can provide important resources for relational or cooperative contracting among Mittelstand firms, especially where they form an industrial district. In their tutelary role they generally
promote hierarchies. Because bank competition is group competition, the capacity to do both is a major boost to the overall competitiveness of all three major banking groups. This capacity is also important because post-Fordism does not mean the elimination of corporate hierarchies. Though post-Fordism does suggest that even hierarchies are increasingly distributing parts of their production chain among external suppliers, thereby promoting the expansion of production in smaller firms.\(^4\)

Most scholars have argued that German industry never fully adopted mass production principles (Fordism).\(^5\) This was due to a number of factors including institutional arrangements that inhibited the pursuit of mass production and/or encouraged the continuation of a more decentralized organization of production. The three sector banking system was one of these institutional conditions. The case of Baden-Württemberg, where a large number of Mittelstand industry firms extensively engaged in cooperative practices and a large number of small savings and cooperative banks coexist, implies that the more decentralized organizational character of production in the region was preserved in no small way because of a well-developed local banking system. Organizational theory suggests this is so because the strong local banking system reduced uncertainty among firms regarding access to capital and thus helped reduce pressures to centralize production. By the same logic, the three group banking system with its growing emphasis on ‘mediation’ importantly facilitates the current extension of post-Fordist principles. As some studies have already hinted, a

\(^4\) In some cases the large firm may dominate its network of small supplier firms to the extent that it approximates hierarchical control. Though numerous cases suggest that many supplier firms reduce their dependency on a given hierarchy by building relations to numerous exchange partners. And many large firms have actually created relations of interdependence with key suppliers.

\(^5\) For example, see Kern and Schumann, 1989, op. cit., pp. 88-89.
comparison with other industrial nations might very well reveal that Germany has a surprisingly productive and competitive Mittelstand in large part because of its three sector banking system.

Moreover, such a comparison might suggest that a strong local banking system and the mediator role allow German banks to play a comparatively greater functional role in the creation and success of non-hierarchical systems of production. Studies of the "Third Italy" and other regions where small firm production is prevalent suggest that a strong local bank is an important ancillary institution for these decentralized systems of production. But few, if any, explore the actual or potential role of the banks beyond securing an adequate provision of capital for local firms. In Germany capital provision remains the chief economic function of local banks, but this thesis suggests that the mediator role of German banks means they have increasingly important additional functions. German banks increasingly provide necessary non-financial resources to firms, as well as support other local institutions that provide other needed resources, especially collective goods. Thus even as the tutelary role of the German banks may decline, the German banking system seems likely to continue to distinguish itself from other national banking systems in the character of its relations to firms.

C. The State and Economic Governance.

A number of comparative studies on industrial restructuring have argued that there is a general trend among major industrial nations toward post-Fordist or similar principles, be it in the form of the Japanese 'meta-enterprise model,' or in the form of 'linked industrial

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complexes' of smaller firms as in the Third Italy. In all of these studies one of the key roles of the state is to provide or support the production of collective goods via promotional networks, associations, and other organizations. And the two goods widely seen as the most important are education and technological information. These are two essential resources that small firms in particular tend to seek from external organizations. With the growth of bank competition and state provision of capital assuring most Mittelstand firms access to funds, it appears probable that these other non-financial resources may be more difficult for firms to generate themselves or procure. And since these collective goods are more easily produced by the state or through collective institutions, I believe this helps explain why the German banking system alone is increasingly less sufficient as an institutional mechanism for generating industrial policy. Through the production and allocation of such resources the state encourages the expansion and helps stabilize less formal and more multilateral governance mechanisms and regimes based on them. Through its ability to define property rights (regulation) the state is also in a position to influence the move toward post-Fordism. The state must promote cooperative strategies among organizations: between firms and sources of R&D; between suppliers and customers; and between smaller firms. The state may also encourage production in small firms by granting them special rights. In Italy such

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provisions are extensive, and the German Artisans Code accords craft firms selected privileges as well.\(^9\)

The evidence presented in this study provides further support for these arguments on the role of the state in post-Fordism. The German state, at all levels, has vastly expanded its provision of capital resources and collective goods to firms - especially Mittelstand firms - since the early 1970s. In Baden-Württemberg this has generally been the role of the state since the mid-nineteenth century. In North Rhine-Westphalia, the state has also supported the expansion of the educational system and R&D but these institutions and policies have been strongly oriented toward the large hierarchical firms of the region. It is only since the early 1980s that the Land government has reoriented much of its industrial policy toward the promotion of Mittelstand firms and non-hierarchical mechanisms of economic governance.

Hence North Rhine-Westphalia represents an interesting test case regarding the question of what role the state can have in shaping the transformation of governance regimes. Specifically, can North Rhine-Westphalia create the kind of sectoral and regional governance regimes characteristic of Baden-Württemberg? Weiss, based on a study of Italian small firms, argues that systems of small firm production do not necessarily emerge out of specific, historically-bound social structures such as traditions of artisan and family production. Rather, a public infrastructure that encourages a skilled labor force and cooperation among producers can achieve much the same result. In her view, cooperative relations among firms result from institutional incentives more than a "culture of community" (solidarity, communitarian values).\(^10\)

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\(^10\). Weiss, 1988, op. cit. pp. 196-211.
This suggests that state policy in North Rhine-Westphalia can have an impact on the organization of production in the region. But institutional change is normally slow and bounded by the legacies of the past. And it is partly for this reason that I have argued that the ‘governance’ literature must also examine governance mechanisms and regimes along a regional or territorial dimension. Specific economic sectors and industries are typically spread across a wide territory, yet all producers operate within spatially-distinct and often divergent institutional contexts that structure their incentives and thus production strategies. There are many regional studies which demonstrate that some local or regional economies foster innovation more than others, and that these differences are only partly accounted for by differences in the sectoral composition of each economy.\textsuperscript{11} In economic governance, territory still matters.

As stated in the introduction, one of the goals of this study was to show some central ways in which the state influences the emergence, stabilization, and transformation of governance regimes in the Federal Republic. The two regional case studies of North Rhine Westphalia and Baden-Württemberg demonstrated that both Land governments became increasingly involved in their respective regional economies. Consistent with the hypothesis of Lindberg and Campbell, in both cases Land government industrial policy tended to reinforce the dominant regional mechanisms of economic coordination; hierarchy in the case of North Rhine-Westphalia, and obligations and promotional networks in Baden-Württemberg.\textsuperscript{12} Though in the 1980s each Land government also attempted in some ways to do more than stabilize existing governance regimes. Each tried to steer or pressure the

\textsuperscript{11} For example see Adyalot and Keeble, 1988, op. cit.

\textsuperscript{12} Lindberg and Campbell, 1990, op. cit., p. 387.
evolution of certain regimes in a new direction. This raises the question of what drives government policy. How do we explain the policy choices of the Land governments? To what extent is the state, in this case the Land governments, autonomous in the formulation and pursuit of industrial policy?

Much of the recent political economy literature has focused on the growing restrictions on the ability of national governments to pursue autonomously generated industrial policies. Subnational governments have long been seen as even more circumscribed in their autonomy as well as capacity to influence the decisions and strategies of economic actors. But the evidence on Germany suggests that to a certain extent we can examine the Land governments as states in themselves, and analyze them using the models others have generated to explain national policy choices. Drawing on such models, I would argue that policy choices, state capacity for intervention, and relations between the state and societal actors are conditioned primarily by four variables: the organization of the state, the organization of production (and the particular problems of firms), the relationship between the state and financial system, and the composition and stability of the dominant social coalition.\textsuperscript{13} In both regions policy in the 1980s was also influenced by ideological debates and dominant ideas - often imported from abroad - about the requirements for future economic competitiveness. But I assume that the impact of ideas on policy is usually filtered by these other institutional factors.

In the postwar period the Land government of North Rhine-Westphalia was able to gradually centralize administrative control within the Land. Like other Land governments, over time power also shifted from Land parliaments to Land executives because of the

\textsuperscript{13} Similar institutional models can be found in Hall, 1986, op. cit.; Zysman, 1983, op. cit.; Gourevitch, 1986, op. cit.; and Samuels, 1989, op. cit.
growing importance of joint policymaking (cooperative federalism) in the Federal Republic. The centralization of administrative control and the growing autonomy of the executive from legislative scrutiny greatly enhanced the capacity of the Land government for economic intervention. Regarding economic policy, the dominant social coalition included the working class as represented by the unions that organized Ruhr workers, and the capitalists and managers of the large firms in the region. The convergence of interests between these two groups around the preservation of traditional Ruhr industries and organization of production (hierarchies) strongly shaped the policy choices of the Land government. The power of these interests is also reflected in the activities of the WestLB. The creation of the WestLB provided an extremely powerful instrument for Land government intervention. But its managers have their own preferences and market strategies that often diverge from those of key state actors. Thus government policy choices and intervention in North Rhine-Westphalia are also strongly influenced by the process of negotiation between these two sets of actors.

In Baden-Württemberg the reorganization of the Land’s political and administrative systems in the early 1970s enhanced the autonomy of the Land government vis-à-vis the Land parliament and opposition political parties. It also increased the capacity of the Minister-President and his cabinet to control government bureaucracies. Both of these changes enabled the Land government to pursue its policy choices with less political interference.

Second, the coalition of groups supporting the CDU in government was stable in this commitment and was generally in consensus on what constituted the proper economic role of the Land government. The coalition supported the expansion of government intervention in the 1970s, though parts of this coalition expressed reservations regarding the growth of direct intervention. Third, the strong economic and political significance of Mittelstand firms
made them the primary focus of government economic policies. Government policy strongly reflected the functional needs of Mittelstand firms. Finally, the organization of the financial or banking system in Baden-Württemberg critically shaped the role of government in the economy. The Land government was unsuccessful in its attempt to create a large bank capable of large-scale industrial intervention, and thus had less capacity to influence the strategies of large firms in the region.

In both cases government policy is not simply a reflection of the regional economic structure or a predetermined response to changes in technology or the structure of international markets. Politics and choice still mattered. But this does not yet address the question of to what extent state actors in these cases were autonomous of societal actors. This study has not been an attempt to systematically explore this problematic in the case of Germany, but the evidence presented here does support the claim that both Land governments were in fact able to act autonomously of dominant social groups. For North Rhine-Westphalia the relative political insulation of the WestLB allowed the government to act with significant autonomy. Thus the Land government was able to promote the takeover of Hoesch by Krupp even though the unions, on whose support the SPD depends, vehemently opposed it. By playing the demands of workers against those of capitalists the Land government has been able to create notable, if limited, room for independent action. In Baden-Württemberg, autonomous state actions in the 1980s regarding its economy seem to have been closely tied to the personal political power and preferences of Lothar Späth. Before and after him the policies of the Land government seem to diverge little from the preferences of the dominant economic actors.

In sum, I would apply Samuel's assessment of the relations between state and society in Japan to the Federal Republic: The state derives its strength from the convergence of
public and private interests within a network of formal and informal interactions. Where interests diverge the state may sometimes prevail, but its intervention are most effective when preceded by a negotiated consensus. When describing the Federal Republic as a ‘semi-sovereign’ state Katzenstein expounded the view that the autonomy (sovereignty) of the state was bounded by its dependence on a range of societal actors including para-public institutions. But if anything, my cases suggest that society is not as strongly centralized in the Federal Republic as Katzenstein characterized it. Many of the most influential links or networks between the state and society are at subnational levels. Thus I think the Federal Republic is best understood as a ‘decentralized network state.’

Among major industrial nations the Federal Republic is differentiated by the fact that it has subnational governments with considerable autonomy within the state politico-administrative system, and considerable institutional capacity for intervention at the Land level. American states may enjoy similar or even greater political autonomy from the federal government, but their efforts at industrial intervention in the 1980s were far less pervasive than those of the German Länder. For the German Länder the banking system is a crucial constituent element of the regional network enabling them to affect the choices of economic actors. In this respect, Zysman’s eloquent exposition of the financial system’s central role for state intervention is still very persuasive.


15. In his 1989 anthology Katzenstein did highlight the role of subnational institutions in the economy, though continued to maintain that regional patterns of state-society relations are largely a derivative of national patterns. I believe that the national and regional patterns are much more interdependent in their evolution.

D. Economic Governance and the Reunifications of Germany and Europe.

Given the dramatic changes implied by the reunification of Germany and the completion of the internal European market, this study would be less compelling without at least an initial analysis of how these events might affect its major conclusions. My short answer is that I believe my analysis of the banking system and state intervention will be valid well into the future. The lessons of history, of course, suggest that at least some important changes may be expected. Thus I finish with some speculative comments, beginning with German reunification.

The reunion of the two Germanies will probably have far less impact on the German banking system and its role in the economy than the Single Market. The former East German banking system was nominally structured liked that of the West: Savings and cooperative banks accounted for most deposit-taking business and lending to the Mittelstand. In reality, the banking system was highly centralized with the central East German state bank (Staatsbank) controlling virtually all capital flows within the system. After reunification the West German savings and cooperative banking groups quickly moved into the East to assist the newly independent savings and cooperative banks (roughly 200 and 100 institutions respectively) adapt to a market economy, particularly their technical modernization and staff training. These two banking groups continue to account for the bulk of the rapidly swelling bank deposits in the five new Länder. The greatest challenge they face is to build up their loan portfolios. Under the old system these banks did very little lending to firms. Under the new system there are relatively few Mittelstand firms demanding loans. But this situation is changing very quickly.

The number of business start-ups has grown rapidly and the Federal government has channelled considerable sums through the banking system to new firms. Thus the West
German system of state Mittelstand support is being rapidly reproduced in the East. This includes the other institutions that provide the Mittelstand with skilled labor, technological information (R&D support), and managerial consulting. After more than forty years of central planning there is a strong political mandate to decentralize the eastern economy. These banks and other institutions are the central elements of the state’s strategy. But this alone will not determine the relatively stable governance regimes that have yet to emerge. The actions of the Trust Agency, in charge of privatizing and (increasingly) rationalizing the old state firms, will be crucial to the outcome.

The major West German commercial banks have also established a very strong presence in eastern Germany. And in spite of the pleas by the national savings bank association to create one Landesbank for all of the five new Länder, the western Landesbanks moved quickly into the East in search of large firm customers. Western state banks have also teamed up with various Land governments in the East, providing the technical expertise for newly established Land government development banks. In spite of the enormous need to rationalize former state firms and move them into the hands of private investors, the large banks have been relatively conservative. While the banks are competing vigorously for new clients in the East, they are generally avoiding risky engagements. They have purchased very few holdings in eastern firms, though they have played an important role in helping match other private investors with firms looking for capital. Thus in spite of an apparently prime opportunity to revive their tutelary role, so far this has failed to materialize.

European integration, in contrast, has already had considerable impact on the German banking system and state intervention. Within the savings bank sector the drive toward greater concentration, particularly in the form of Landesbank fusions, was strongly motivated by the imminent completion of the internal market and expectations of greater foreign
competition. While no major fusion has occurred, the Landesbanks bear the burden of preparing the savings bank sector for more competition. While the major Landesbanks continue to maintain several European offices, the joint-venture between the WestLB and SüdwestLB that operates a much larger European network than any other Landesbank is likely to be the model for the rest of the association. Likewise, among the cooperative banks the approach of European integration and EC financial regulations (especially capital adequacy requirements) has generated considerable response. The push to fuse the remaining regional cooperative banks with the central DG Bank, and pressure for small cooperatives to merge are part of this. As part of their European strategies the savings and cooperative associations have also been working to extend cooperative arrangements with their counterpart associations in other European states.

The major commercial banks have also developed strategies for the Single Market. The Deutsche Bank vastly expanded its European branch network through the acquisition of a British bank. But by and large the German banks are attempting to build up their European presence through cooperative pacts (joint-ventures or interlocking shareholdings) with domestic banks in other countries. While these measures by all the banking groups are intended to increase their presence abroad, first and foremost they are intended to prepare them for an expected surge in bank competition in Germany. The German banks are not likely to quickly lose market share to foreign competitors, but there is no reason to think that greater foreign competition will do anything but further weaken the tutelary role of the German banking system.

For Land governments European integration also presents considerable challenges. The Land governments are generally supportive of the Community but fear an over-centralization of policy decision-making. Not surprisingly, they advocate that European
government and administration must be as local as possible - a 'decentralized Europe of regions.' Most of the German Länder have their own representatives in Brussels, seeking to protect the Land’s interests. Nonetheless, to a certain extent the Länder have developed conflictual relations with the EC regarding their economic intervention. Since the early 1980s the Commission has sought to enforce the Community’s anti-subsidy rules. The comparatively wealthy German Länder such as Baden-Württemberg have, in spite of much protest, by and by bowed to the pressure of the Community and reduced subsidies. But this has only stiffened the resolve of Baden-Württemberg and the other Länder to fight for their autonomy within the Community.  

Expanding the capacity of the regional (Land) promotional networks by building up quasi-state or societal organizations occurred in this manner primarily for two reasons; first, it corresponded to the traditional relationship between government and industry in Germany which accorded industry a great deal of influence over state support measures; and second, because it provided the Land governments with greater independence from the control of the Land Parliament and, more recently, from the EC. In other words, a quasi-state system provides greater possibilities to exclude those who might interfere or circumscribe its operation. As Jüttemeier suggests, this trend to getting subsidies "off the books" of the government seems to apply to several of the Länder, and to some extent even the Federal


18. The Social Democrats and the unions in particular have been increasingly critical of their exclusion from the organizations of the regional promotion system. See Publication of the Landtag of Baden-Württemberg, 10/896; Wertel, Klaus. "SPD: Betriebsräte müssen bei Landeshilfen mitreden können." *Badische Zeitung*, 5 January 1989.
government. Viewed in another light, however, the expansion of a quasi-state regional promotional networks and state banks can be seen as an effective strategy by regional governments and industry to maintain their autonomous capacity to adapt in a rapidly changing world.

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