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The Fate of Deutschland AG

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Why does the same crisis provoke different reactions—return to Glass-Steagall or return to Deutschland AG—on either side of the Atlantic?

What can be learned from examining the history of Germany's corporate financial system and how can it inform future policies?

I. The Problematic

The notion of Deutschland AG refers to the interconnectedness of corporate ownership and control, particularly the relationships between banks and industry, which enabled the most powerful bankers and company managers to influence corporate decision-making throughout the economy. Some describe the phenomenon as a "vast network between the financial and industrial sector consisting of personal as well as financial ties."[1] A broader interpretation takes the concept to mean that "managers pursued not only the economic interests of their own companies, but also considered general interests of the national economy."[2] This latter construal of "Deutschland AG" brings to mind the related concept of "organized capitalism," whereby these financial-industrial networks helped steer the economy and—in marked contrast to the Anglo-American system—buffer it from the natural forces of the free-wheeling market.

This mutual protection of corporate managers, however, meant that shareholders often suffered from underinvestment and slack profit drive. In the 1990s, Germany's large universal banks strove to compete on a global scale in the highly-profitable investment banking segment. The banks began to extricate themselves from long-standing equity stakes and board membership, thereby opening up these companies to new shareholders, often with stronger demands for share appreciation. This process, along with the desire on the part of German companies to access international (particularly U.S. and British) capital markets, necessitated a move toward transparency and other improvements in corporate governance. The 2005 ouster of Werner Seifert, chief executive of Deutsche Börse, at the hands of U.S. and British investors, seemed to epitomize the new reality that corporations and their managers must confront market forces head on and either satisfy investors—"maximizing shareholder value"—or endure the consequences.

As the financial crisis began to freeze up financial markets, devastate equity values, and drive many financial firms into insolvency, observers around the world began to tie this upheaval to the regulatory and institutional changes that had taken place over the previous ten to twenty years. In Germany, a number of questions arose: Did the financial crisis reveal a dark side of unfettered market capitalism? Did widespread adoption of the Anglo-American system create the environment that allowed excessive risk-taking in the financial sector? Would the return to organized capitalism—to the system of Deutschland AG—prevent this kind of disaster in the future? On the other side of the debate, some noted that the continued persistence of the stakeholder model in Germany prevented layoffs on the scale seen elsewhere,[3] suggesting that certain beneficial components of the German model remain intact and have buffered the German economy—or at least its workers—once again.

In the following, I take a quick tour of the trends and cycles of inter-corporate relationships in Germany and consider the potential costs and benefits of the German model as it has evolved over time. I conclude with some thoughts on what lessons modern policymakers might draw from a broader perspective on financial systems and corporate governance: one that appreciates both long-run patterns and international comparisons.

II. The Long-Run View of Corporate Ownership and Control

Deutschland AG was not an entirely new concept for Germany. The fundamental notion of interconnectedness of the major industrial and financial interests—along with a close relationship between those economic giants and the state—arose in varying, if less wide-reaching and institutionalized, ways centuries earlier. Formal corporate governance ties naturally took hold only after the liberalization of incorporation law in the mid-nineteenth century, and more extensively after the first boom in joint-stock company (*Aktiengesellschaft*) formation during the period of rapid industrialization in the early 1870s (*Gründerjahre*) and the even bigger wave of initial public offerings after 1895. Corporate boards, particularly those of large companies listed on the major stock exchanges (the leader of which was Berlin at the time), became home to the leading bankers and industrialists. The 'biggest linkers'—the likes of Sal. Oppenheim—held upwards of 100 board positions.[4] Yet banks and industrial firms did not build up extensive capital ownership networks during this era, and in fact, banks avoided taking substantial, long-term equity stakes in non-financial firms, as the banks' investors viewed such stakes as evidence of an unsuccessful flotation business. Germany's securities markets flourished at the turn of the twentieth century, and despite some market-constraining regulation in 1896 and the appearance of powerful banks, operated with considerable liquidity and efficiency.[5]

The upheaval of the wars and the interwar economic crisis wrought many changes on Germany's corporate finance and governance system, and the relative liberalism of the late nineteenth century obviously vanished quickly. Already in 1917 Walther Rathenau published his "Vom Aktienwesen" and began to develop the notion of the corporation as responsible to the broader public; a principle with definite links to nineteenth century thought, but one that was only codified in the shareholding law of 1937. The Nazi regime encouraged privatization and delisting of corporations from the stock exchange. At the end of World War II, Germany faced a severe crisis in corporate ownership and control. The Nazi regime had expropriated an enormous amount of equity capital, while extensive further holdings had been lost, destroyed, or abandoned in bank vaults during the Second World War. The dire need for financing reconstruction created an equity gap, and banks in many cases stepped in to salvage bad debts with debt-for-equity swaps—thus, putting large equity stakes onto the books of the universal banks. The more intricate intercorporate networks that made up Deutschland AG began to emerge in the 1950s, as non-financial firms built up cross-shareholdings and networking of board memberships intensified.

The postwar German model diverged from the pre-war system in crucial respects. While owner-entrepreneur firms predominated in the earlier period, control began to move from owners to managers in the later period. Among very large firms, ownership dispersion led to competing stakeholders and the onset of the stakeholder model. The postwar emphasis on social-market principles significantly increased the ostensible role of labor in corporate decision-making—for the first time dictating the representation of unions, alongside banks and corporations, on corporate boards. The networks of cross-ownership of equity stakes (*Kapitalverflechtungen*) sometimes became complex and difficult to unwind.

Yet unwind they did, at least in part. German reunification, along with broader European market integration, caused a partial unraveling of Germany's intercorporate networks. The lifting of capital gains taxes on the banks' long-term equity stakes allowed them painless exit from these capital links. Meanwhile, banks began to take fewer seats in supervisory boards of large companies, and the largest banks proclaimed their plans to remove themselves from supervisory board chairmanships.[6] Still, 'Deutschland AG' is not exactly dead. Loosening networks of equity stakes notwithstanding, corporate firms remain interconnected in some quarters, and these ties—even absent the ownership stakes—still provide something of a mutual protection arrangement for corporate managers.[7] Thus, the German system today stands at a cross-road between the Deutschland AG of the 1960s-80s and the American shareholder-value paradigm of the past two decades. Where the system will end up depends in large part on the response of policymakers to the current financial and economic crisis, of course, within the limits of overarching European regulation. The decisions about what road to follow ought to take into account the costs and benefits of the German model over a long horizon, rather than reacting to crisis conditions without serious reflection and analysis of what really caused the problem.

III. The Costs and Benefits of the German Model

The German model of finance and corporate governance has been viewed both with great favor and with major criticism over the past century and a half. As do most such assessments, the evaluations tend to relate to the state of affairs at the given point in time. Thus, during the post-WWII boom, observers suggested that the German emphasis on close financing and governance relationships promoted a long term perspective on corporate investment that spurred greater growth and economic stability, and that meanwhile preserved social equity.

As the post-reunification recession set in, public and academic scrutiny focused on the problems in the German system. Intercorporate shareholding had taken on pyramid-like forms and allowed certain firms to gain control of others with minimal ownership; a scheme that allowed managers of controlling firms to effectively expropriate small shareholders in the subordinated firms. Further hindering transparency, the ascent of labor into formal positions of control arguably moved informal control outside of the boardroom. In some cases, corporate management became inbred, protecting each other from hostile takeovers and preventing the proper functioning of the market for corporate control. Corporate governance scandals erupted in such major corporations as DaimlerChrysler, Deutsche Bank, Mannesmann/Vodafone, Siemens, and VW. All of these issues raised concerns that the German system not only enabled insiders to defraud investors but could also actually slow down economic growth, particularly by permitting crony capitalism or insider lending to dictate the flow of resources not necessarily to the highest-return investments. Such malfeasance would hamper efficiency, dampen innovation, and ultimately hem in corporate profitability and the overall vibrancy of the economy.

This back and forth raises the question: Does the institutional setup actually matter for the big-picture of corporate and economic performance? Some would argue that the German relationship orientation promotes far-sighted corporate thinking, albeit at the cost of transparency and small investor protections. Similarly, its emphasis on distributional fairness promotes more income equality across classes and dampens the effects of recessions compared to the Anglo-American system but also suppresses high-tech innovation and limits the upside of economic growth.

An examination of international patterns over several decades puts the German experience in better perspective. To start with the corporate governance arena, Germany is certainly not alone in scandalous behavior. Even with its market-oriented system, the U.S. hosted its own round of scandals in the past decade: Enron, Tyco, and WorldCom top the list. And the current financial crisis laid bare seriously flawed corporate governance in the financial sector—an ultimately destructive system of incentives for excessive risk-taking among financial firms, the fleecing of shareholders through outsized executive bonuses, and the regulatory capture (or at least incompetence) of those tasked with monitoring the financial system. At the macro level, compared with its economic cohort—the UK, France, and the U.S., for example—Germany has experienced similar business cycles and has suffered similar, and in some regions worse, levels of unemployment. The cozy relationships among firms in Germany have arguably hampered the liquidity and efficiency of financial markets, but they have arguably bolstered the business of large financial institutions. While Germany clearly fell behind the United States in the realm of high-technology innovation during the 1990s, Germany has clearly surpassed the U.S. in ‘medium-technology’ innovation in its traditionally strong areas of industry.

At the bottom line, overall per capita income, economic growth, and productivity have remained strong in Germany over the long run and have run in line with that of the UK and other wealthy nations. Thus, the institutional differences have clearly mattered at the company level and over shorter periods, and they have likely created different distributions of resources in the economy. But they have made less impact at the macro-level and over long horizons.

IV. Lessons From the Past?

Most discussions of the German model look at the very recent past. This short-term view worries that the current financial crisis once again reveals the dark side of unfettered market capitalism and suggests that the creeping adoption of the Anglo-American system created the environment that allowed excessive risk-taking in the financial sector. The ‘presentist’ view might even argue that the return to organized capitalism—to the system of Deutschland AG—would prevent this kind of dis-

aster in the future. The longer-term view offered here provides deeper insights into the likely fate of the system—particularly of the inter-corporate and bank-industry relationships that make up Deutschland AG—in the aftermath of the financial crisis. That view suggests that the organization of financial systems, and of the institutions that comprise them, evolves over time in response to political and economic forces—some common to all systems, others idiosyncratic. These institutional differences obviously produce some variation in outcomes, but we generally cannot ascribe to them any significant, long-term effects on corporate performance or economic growth.

The long-term view, particularly one that incorporates international comparisons, also suggests that institutional design does not cause and cannot prevent financial crises. Looking back over the past century or more, we can see that financial crises always prompt public outcry over the behavior—and usually therefore the organization—of financial markets and institutions. Germany is not alone in this pattern. Indeed, in the U.S., most of the defining regulation of the financial system has been born out of crises. Very often, that regulatory impulse has targeted the structure of large-scale banking and of financial markets as well as the corporate governance relationships between finance and industry. In the Great Depression, the U.S. Glass-Steagall Act and the creation of the Securities and Exchange Commission (SEC) stand as the key examples. In light of the current financial crisis—labeled the Second Great Depression by some—prominent commentators have taken aim at the 1990s liberalization of banking laws (Joseph Stiglitz, for example[8]), and some have gone so far as to call for the reenactment of Glass-Steagall (most recently by Robert Reich in his commentary on NPR[9]), even as the last two independent U.S. investment banks have converted to bank holding companies.[10]

This discussion raises something of a puzzle: Why does the same crisis, and effectively the same set of circumstances, prompt American observers to suggest returning to Glass-Steagall separation of banking activities, and at the same time spur Germany-watchers to ponder the return of Deutschland AG? These two policy recommendations hit at different, albeit related, issues within of the financial system. The issues are linked, in the sense that they relate to how different financial functions may be combined, how separate corporate entities may interact with and even control each other, and more broadly, how potential conflicts of interest may be mitigated (or not). The two types of regulatory impulses do have one key feature in common: retrenchment.

If Germany and the U.S. were simply to return to their post-WWII systems, they would be eschewing historical analysis and the long view. By rigorously examining and understanding the history of Germany's corporate financial system, we can avoid the post-hoc fallacies that have people pinning this crisis on the most recent developments in financial regulation and racing to reverse those changes in the hope of preventing a future calamity. As Joseph Stiglitz rightly put it in his *Vanity Fair* article last January: "Behind the debates over future policy is a debate over history—a debate over the causes of our current situation. The battle for the past will determine the battle for the present. So it's crucial to get the history straight."[11] Financial historians could not agree more. Getting the history straight will lead to new and improved regulation of the financial system and corporate governance.

NOTES

[1] Christian Kellermann, "Disentangling Deutschland AG," in *Surviving Globalization?: Perspectives for the German Economic Model*, ed. Stefan Beck, Frank Klobes, and Christoph Scherrer (Dordrecht, Netherlands: Springer, 2005). See the network diagrams for 1996-2006 at <http://www.mpifg.de/aktuelles/themen/doks/Deutschland_AG_1996bis2006.pdf>.

[2] Herbert Kitschelt and Wolfgang Streek, *Germany: Beyond the Stable State* (London: Frank Cass, 2004).

[3] "Germany's flawed corporate governance," *The Economist,* 6 August 2009.

[4] Dieter Ziegler, "Die wirtschaftsbürgerliche Elite im 20. Jahrhundert: eine Bilanz," in *Grossbiirger und Unternehmer: Die deutsche Wirtschaftselite im 2O.Jahrhuttdert,* ed. Dieter Ziegler (Gottingen: Vandenhoeck & Ruprecht, 2000).

[5] Refer to the 'bank power' debate associated with Hilferding: Rudolf Hilferding, *Finance Capital. A Study of the Latest Phase of Capitalist Development*, ed. Tom Bottomore (London: Routledge & Kegan Paul, 1981).

[6] See the discussion and references cited in Caroline Fohlin, "The History of Corporate Ownership and Control in Germany," in *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, ed. R. Morck (NBER series, University of Chicago Press, 2005).

[7] Martin Hellwig, "Zur Problematik einer Staatlichen Kontrolle ausländischer Beteiligungen an deutschen Unternehmen als *Beitrag zu einer strategischen Industriepolitik,"* in *Expertise für den Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung* (Bonn: Max-Planck-Institut zur Erforschung von Gemeinschaftsgütern, October 2007).

[8] Joseph Stiglitz, "Capitalist Fools," Vanity Fair, January 2009, <http://www.vanityfair.com/magazine/2009/01/stiglitz200901>.

[9] Robert Reich, "Avoid Bailouts: Restore Glass-Steagall," Marketplace commentary, 4 November 2009, <http://marketplace.publicradio.org/display/web/2009/11/04/pm-reich/>.

[10] Andrew Ross Sorkin and Vikas Bajaj, "Shift for Goldman and Morgan Marks the End of an Era," *The New York Times*, 21 September 2008, <http://www.nytimes.com/2008/09/22/business/22bank.html>.

[11] I am taking Stiglitz's quote out of context. He was actually blaming the financial crisis in part on the repeal of Glass-Steagal, a position with which I disagree.

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