SUMMARIES OF LECTURES in ECO 303Y1:

the Economic History of Modern Europe, to 1914

for the Academic Year: 2012 - 2013

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Updated: Thursday, 14 February 2013

XVIII. Week no. 18: Lecture no. 23: for 13 February 2013

Section V: the Rapid Industrialization of Germany, 1815 - 1914 . A common theme of all these lectures is the increased role of the state in German economic development and industrialization.

Lecture no. 23: German Banking and Financial Organization, 1815 to 1914.

1. **The Importance of banking and financial institutions for German industrialization in the 19th and early 20th centuries:**

a) **This lecture analyses the significance and great success of German banks:** most especially the Investment Banks or 'universal banks' or Kreditbanken in financing German industrialization from the 1850s, and especially from the 1870s.

b) **As we saw with banks in the British Industrial Revolution,** so also German banks proved to be vitally important in providing both the lubricant and the fuel for the industrial machine:
i) the lubricant in the form of paper money, credit, financial intermediation, etc.;
ii) the fuel, in the form of financing the working capital needs of the Industrial Revolution with short term credit.
iii) The radically new difference was the role of banks in financing long-term, fixed capital formation.

c) **These financial aspects of modern banking provide the veritable life blood of any modern economy, in terms of both Leverage and Liquidity:** for which a proper and feasible balance is the requisite for economic stability and growth
i) **Leverage:** in financing asset accumulation by borrowing: so that a ten-percent loan can finance the acquisition of assets with ten times the market value – but not to extend leverage so much that readily pricked asset bubbles are created.
ii) **Liquidity:** always a problem with financial and economic crises
(1) in general: to ensure an adequate supply of short term credit and an adequate supply of money and financial intermediaries to permit the economy to function efficiently, at low cost
(2) in particular: the ability of debtors to use cash to redeem short term loans without having to liquidate other, investment-earning assets (and to avoid doing so at fire-sale prices)

d) **most economic crises are caused by financial crises:** which inevitably lead to de-leverage and consequent lack of liquidity:
i) so that firms cannot borrow and lack funds to meet their financial obligations
ii) 19th and early 20th century Germany largely escaped these dual problems of leverage and liquidity, thanks especially to the successful and almost always profitable functioning of its new investment banks.

2. The Gershenkron Thesis and Banking-State model of financing industrialization:

a) **The focus or our financial analysis in the Gerschenkron model:** it stipulates that 19th-century 'Late Starters' or 'backward countries', such as Germany (or Prussia and eastern Germany) and Russia, simply could not follow the British model:

i) it was not only impractical, was impossible to rely merely on market forces and laissez-faire economics.

ii) Instead, a strongly interventionist role of the state was required, in all sectors;

iii) in industry, and alliance of the state with the radically new joint-stock investment or universal banks was necessary for industrialization to grow and succeed

b) **Universal Bank: is now the most common term for the new investment banks:**

i) because they provided all of the traditional functions of banking; i.e.,

(1) traditional, British-style deposit and transfer banking, with extensive discounting facilities,

(2) combined with financing fixed capital formation: in the form of long-term loans and in terms of underwriting IPOs – in stock and bond issues.

ii) The focus of the lecture is on Gerschenkron's particular thesis for Germany.

c) **The first part of the thesis explains why the Investment Banks were necessary:**

i) to fill a large vacuum in the capital markets, i.e., in the absence of those long-developing British financial institutions that had made investment banks unnecessary in 19th century Great Britain;

ii) to finance a take off into rapid industrialization in large-scale heavy industries, now dominated by metallurgy, for which current technology and scale requirements, in international competition, meant far larger-scale initial capital investments than were required for the British Industrial Revolution;

iii) to accommodate a socially and culturally different society,

(1) one dominated still by conservative, wealthy landowners -- those with the most income and savings for investments -- who were far more inclined to invest in land, mortgages, and government bonds than in business and commercial enterprises.

(2) Thus if investment banks could attract their savings deposits, or investments in the banks, they could channel those savings into direct industrial investments (in terms of both short-term and long-term credit, and underwriting).

(3) The crucial historical fact that none of these investment banks failed and that generally they remained highly profitable – paying dividends or interest returns of 6% to 8% – explains why and how they succeeded in attracting the savings and investments of the wealthy landowners;

d) **The second part of the Gerschenkron thesis concerns his views on the outcomes:**

i) **The eight great investment banks (Kreditbanken, D-Banken, universal banks, etc.)** successfully financed the rapid development and growth of large scale German industries by filling the pre-existing vacuum in German capital markets:

(1) in particular in mining and metallurgy (coal, iron, steel); transport (railways and steam shipping); and the new electrical industries.

(2) In providing a surrogate stock market – selling both IPOs and marketing existing stocks and bonds – before the final and complete formation of the Berlin, Frankfurt, and Hamburg stock exchanges.

ii) **Growing Investment Bank control over the major industries that they financed**: especially by holding shares in the industrial firms that they financed in selling IPOs

iii) **Investment banks promoted the development of German cartels:** especially those engaging in oligopolistic competition (to be elaborated in the next lecture, on German industrialization)

iv) **Investment banks promoted far more and far better industrial research** (technology) and market research

e) **We then dealt with the subsequent critics of the Gerschenkron thesis, focusing on four:**

i) Neuberger and Stokes (1974); Edwards and Ogilvie (1996); Fohlen (1999, 2003, 2006); Burhop (2006): read the full lecture notes analysing, discussing, and critiquing their views, accompanied by many tables (to sustain their and my own conclusions.

ii) **In essence the critics contend that:**
(1) the Gross Banken misallocated resources and misdirected economic growth by favouring and subsidizing their specific clients,
(2) That they discouraged the formation and progress of alternative or rival financial institutions that could have provided a more competitive and less biased approach to industrialization.
(3) That their role, being restricted to only a few major industries, was far less important than is traditionally assumed (an argument that contradicts the other criticism)
(4) for other criticisms: see the full lecture notes
(3) Carsten Burhop, the latest, is the most balanced: agreeing with Gershenkron on their importance up to the mid or late 1880s, and partially agreeing with the critics for the period thereafter, up to 1914

iii) **I concluded by quoting Charles Kindleberger:** 'The great investment banks constituted less than a tenth of the total assets of financial assets, but were found at the critical margin affecting economic growth.'

iv) **My only qualification was that in fact these banks accounted for over a quarter of such total financial assets by 1914** – and even more if we take account of their cooperation in financial syndicates with other German banking institutions

3. **German Imperial State or Central Banking:**

a) **The last and very brief part of the lecture dealt with the role of the new German Central Bank:**

i) **the Deutsche Reichsbank,** formed in 1875, from the former joint-stock bank, the Royal Bank of Prussia,

ii) **with a monetary unification under the gold standard** and a bank monopoly on the money supply.

b) **In essence, its historical significance is one of positive neutrality:** it did what was required of a central bank, without being responsible directly for economic growth but without being responsible for any economic disasters or even liabilities.