Chapter 23

PUBLIC BANKING IN GERMANY: AN OVERLOOKED KEY TO ITS ECONOMIC STRENGTH

"[S]avings banks appear to provide a 'European Advantage' over the United States and other countries without these institutions. . . . [S]avings banks retained a significant comparative advantage in terms of organizational network and lending discretion that was critical for ushering small and medium enterprises through economic downturns."

--- Kurt von Mettenheim, et al., *Government Banking: New Perspectives on Sustainable Development and Social Inclusion from Europe and South America (2008)*[420]

Germany, like Japan, managed to rise phoenix-like from the ashes of war. Industrial development in both cases was undergirded by a strong tradition of public and cooperative banks. Today, EU rules are stripping the large German public banks of some of their traditional strengths; but the local public and cooperative banks are still going strong.

Less than ten years after World War II, people were already talking about a German economic miracle. The war had left the country with a collapsed economy that had degenerated into barter. In 1947,

German industrial output was only one-third its 1938 level, and a large percentage of its working-age men were dead. Twenty years later, the German economy was the envy of most of the world. In the second half of the twentieth century, Germany went on to become Europe's economic powerhouse.[421]

By 2003, a country half the size of Texas had become the world's leading exporter, producing high quality automobiles, machinery, electrical equipment, and chemicals. Only in 2009 was Germany surpassed in exports by China, which has a population of over 1.3 billion to Germany's 82 million. In 2010, while much of the world was still reeling from the 2008 financial collapse, Germany reported 3.6 percent economic growth. Today, it is the largest and most robust economy in the Eurozone.[422] Manufacturing contributes 25 percent of Germany's GDP, more than twice that in the UK.

Germany's dramatic comeback has been variously attributed to debt forgiveness by the Allies, currency reform, the elimination of price controls, and the reduction of tax rates.[423] But while those factors may have freed the country from its economic shackles, they do not fully explain its phenomenal rise from a war-torn battlefield to world leader in manufacturing and trade.

An overlooked springboard to Germany's recovery is its vast network of public and cooperative banks, including the publicly-owned banking groups called *Landesbanken* and the municipally-supervised, cooperatively-owned savings banks called *Sparkassen* (singular *Sparkasse*). After the war, these public and cooperative banks helped family-run provincial companies get a foothold in world markets. As the system was described by Peter Dorman in 2011:

> [The Landesbanken] are publicly owned entities that rest on top of a pyramid of thousands of municipally owned savings banks. If you add in the specialized publicly owned real estate lenders, about half the total assets of the German banking system are in the public sector. (Another substantial chunk is in cooperative savings banks.) They are key tools of German industrial policy, specializing in loans to the Mittelstand, the small-to-medium size businesses that are at the core of that country's export engine. *Because of the landesbanken, small firms in Germany have as much access to capital as large firms;* there are

> no economies of scale in finance. This also means that workers in the small business sector earn the same wages as those in big corporations, have the same skills and training, and are just as productive.[424]

Public, private, and cooperative banks compose the "three pillars" of the German banking system, with fierce competition among them. Big international private banks serve the big enterprises, while public banks serve the regional enterprises and SMEs (small and medium-sized enterprises). The German economy is 90 percent SMEs, and public and cooperative banks are essential to their efficient operation. Cooperatives also serve most SMEs, as well as their own members. By 1999, public and cooperative banks dominated German domestic lending. Private banks accounted for less than 20 percent of the market, compared to more than 40 percent in France, Spain, the Nordic countries, and Benelux.[425]

The Profitability of Philanthropy

In a June 2011 paper titled "Alternative Banking: Competitive Advantage and Social Inclusion," Kurt von Mettenheim and Olivier Butzbach trace the origins of the public and cooperative banks to the charitable pawnshops developed five centuries ago. While modern banking was emerging from the transformation of money lenders into merchant banks in 16th century Europe, Catholic orders and monarchies in Italy and Spain were encouraging the creation of pawnshops to reduce usury and the power of urban money lenders, as well as to expand the supply of money available in the marketplace. Public and cooperative banks were thus already in competition with the "usury banks" in the late Middle Ages. They sprang up at the local level but soon had a significant share of the market. The authors write:

> Instead of profit maximization, early alternative banks were founded by religious orders, public concession or philanthropists with the mission of consolidating a capital base and endowment able to cover the budgets of charitable institutions. The accumulation of deposits and endowments was such that several decades after founding, alternative

banks generally emerged to gain significant market share of domestic banking.[426]

These banks wound up financing governments:

> The Monti di pietà, or elaborate pawnshops, emerged during the 16th and 17th century with large capital reserves and a patrimony that became essential to finance crown and court, especially for war and to repress rebellions. The Monti soon set up their own banks. Those banks were public in nature and performed banking activities that were already quite distinct from the burgeoning merchant bank business.

As early as 1572, this public banking model was being exported to Northern European monarchs. More than two centuries later, savings banks emerged in Northern Europe, followed in the mid-nineteenth century by cooperative banks. They all competed with the private, for-profit banks, forcing down interest rates and providing affordable credit.

Although they sprang up at the grassroots level, they were aided by government from the top. Authorizations granted by government allowed the alternative banks to extend their activities into a territory usually controlled by the usury bankers, quickly making them dominant in the market.[427]

The German Sparkassen – Local Savings Banks

The local German savings banks grew from this cooperative philanthropic model. The first German savings bank was set up by academics and philanthropically-minded merchants in Hamburg in 1778, and the first municipal savings bank with a local government guarantor was founded in Goettingen in 1801. The municipal savings banks were so effective and popular that they spread rapidly, increasing from 630 in 1850 to 2,834 in 1903. Today the savings banks have over 15,600 branches and offices and employ over 250,000 people, and they have a strong record of investing wisely in local businesses.[428]

Germany's public and cooperative banking sector now includes seven publicly-owned Landesbanken (regional banking groups) and 420 cooperatively-owned Sparkassen (municipally supervised savings

banks). The Landesbanken function as "universal banks" operating in all sectors of the financial services market, but the system is not one of top-down hierarchical control. Rather, the local Sparkassen are autonomous and have jurisdiction over the larger regional Landesbanken. The alternative German banks emerged as local and regional associations that then linked to form regional, national and international networks. These networks allowed them to compete when banking was opened to globalization and trade liberalization in the 1990s, achieving economies of scale while retaining their core principles. Contrary to the predictions of liberal economists, they were not squeezed out but maintained or increased their market share across Europe.

In 2009, the Sparkasse system (including the Landesbanken) had total assets of 2,364 billion euros, or 35.5 percent of the German banking sector's total assets. That made the system the third largest banking group in the world, behind the French BNP and UK's RBS. It held 38.7 percent of the German market in bank deposits and 28.1 percent of the lending market. Similarly, in Spain in the late 2000s, the Spanish savings banks, called Cajas de Ahorro, held 39 percent of domestic bank assets, 50 percent of deposits, and 46.9 percent of Spanish loans.[429]

Richard Werner contrasts the German system to that in the UK, where five Highstreet banks make up 95 percent of the banking system and lend largely for financial speculation. In Germany, large nation-wide banks make up only about 13 percent of the banking system, which is overwhelmingly locally based, supporting the small and medium sized enterprises that provide 80 percent of employment in any economy. Seventy percent of banks are locally-owned and controlled (42.9 percent savings banks and 26.6 percent cooperative banks). These banks are legally required to invest locally, and they do not lend for speculation but lend to productive firms that add to real GDP. To grow and prosper, they must do so in partnership with the local productive economy. The system is not extractive but is supportive and sustainable.[430]

European savings banks are also required by law to contribute to social improvements. German savings banks direct part of their revenues to foundations active in culture, social assistance and philanthropy. French savings banks must reserve half their dividends to fund

social responsibility programs. Spanish savings banks are required to channel all after-tax profits that are not used to build reserves into activities fulfilling their social mandate, or Obra Social.[431]

These social services have not hurt profitability. To the contrary, write von Mettenheim and Butzbach, alternative banks have *outperformed* private, for-profit banks, not just in market share but in profitability and efficiency. Several recent studies have shown at least slightly higher cost efficiencies with savings and cooperative banks than with private banks.[432]

Targeted for Privatization

Public and cooperative banks continue to be the most profitable and stable sector of the German banking system, but the reputation and standing of the Landesbanken began to be challenged starting in the mid-nineties, when they emerged as competitors in international markets. The privately-owned banks, led by Deutsche Bank AG, enlisted the EU in the attack. Peter Dorman writes:

> [T]he EU doesn't like the landesbanken. They denounce the explicit and implicit public subsidies that state ownership entails, saying they violate the rules of competition policy. For over a decade they have fought to have the system privatized. In the end, the dispute is simply ideological: if you think that public ownership should only be an exception, narrowly crafted to address specific market failures, you want to see the landesbanken put on the auction block. If you think an economy should be organized to meet socially defined needs, you would want a large part of capital allocation to be responsive to public input, and you'd fight to keep the landesbanken the way they are. (There is a movement afoot in the U.S. to promote public banking.)

The slings and arrows aimed at German public banking in the last decade were tracked in a July 2011 article by Ralph Niemeyer, editor-in-chief of *EUchronicle*, titled "Commission's Dirty Task: WESTLB Devoured by Private Banks."[433] He noted that after 1999, the major private banks left sustainable traditional banking to gamble in collateralized debt obligations, credit default swaps, and derivatives.

Private German banks accumulated an estimated €600 billion in toxic assets through their investment banking branches—assets for which German taxpayers wound up providing guarantees. Deutsche Bank AG was amassing its record profits almost exclusively through its investment banking division, which made a fortune trading credit default swaps on Greek state obligations. This investment eventually turned sour, and the German government was forced to bail out the financial institution into which Deutsche Bank AG had dumped these toxic assets.

While the large private banks were betting in the ephemeral casino of the financial markets, lending to the physical, productive economy was left to the locally-owned savings banks. The Sparkassen were more efficient in serving average citizens and local business than the private, for-profit banks, because they were not stock companies that had to satisfy shareholders' hunger for ever-larger dividends.

Niemeyer maintains that the private banks wanted to break up the market dominance of the public banks to get a bigger piece of the pie. In 2011, the slice of the German pie held by private banks was only 28.4 percent. Deutsche Bank AG, which dominated the segment, had a mere 7 percent market share, leaving it well behind the public banks owned by municipalities and communities.

According to Niemeyer, the German private banks used the European Commission to achieve their ends. Ever since the early 1990s, the Commission had been lobbied by these banks, and by Deutsche Bank AG in particular, to attack the German government over the country's "inflexible" public banking sector. The IMF, too, had long been demanding that any competing public monopolies in the German banking market be broken up, citing their market "inefficiencies."

When the Landesbanken resisted turning to investment banking with its skyrocketing profits, they were branded as bureaucratic and "unsexy." Pressured to increase their returns on behalf of their government owners, they got sucked into the derivatives, collateralized debt obligations (CDOs), and mortgage-backed securities (MBS) being peddled largely by American banks, which misrepresented them as triple A. (This was mentioned in Michael Lewis' *The Big Short:Inside the Doomsday Machine*. A trader shorting the mortgage market asks: "Who's on the other side, who's the idiot?" The answer is: "Düsseldorf.

Stupid Germans. They take ratings agencies seriously. They play by the rules."[434])

The Landesbanken lost billions in what Niemeyer calls "the Goldman Sachs, Deutsche Bank and Lehman Brothers Ponzi schemes." But the extent to which they became involved in highly speculative transactions, he says, was "laughable in comparison with the damage done by private banks, for whom taxpayers are now providing guarantees."

It was the Landesbanken and Sparkassen that had supplied the local economy with liquidity when the private banks withdrew to bet in the financial casino. Yet it was their failings rather than the private banks' on which the media focused their attention. Why? Niemeyer observes that the large private banks largely control the media. He writes:

> In order to win back this important market share, it has become a prerogative to destroy public banking in Germany completely. This unpopular move could never come from the German government itself, so that's why the [European] Commission is being employed for this dirty job.

The Price of Success

In their heyday, the Landesbanken were stable and secure banks that were able to lend at low interest rates because they had the full faith and credit of the government and the public behind them. By eliminating the profit motive, focusing on the public interest, and relying on government guarantees, they succeeded in turning bank credit into a public utility.

Today, however, their public legs are being knocked out from under them. In 2001, the European Commission ruled that the Landesbanken would be deprived of their explicit state credit guarantees, forcing them to compete on the same terms as private banks. They still had an implied government guarantee, but the European Banking Authority is now refusing to count that, too, in the banks' "stress tests" for banking solvency. Meanwhile, the large private-sector banks have acquired implicit state guarantees themselves, on the theory that they are "too big to fail."

The German example demonstrates that success itself is no guarantee, in the face of a relentless onslaught of propaganda by large privately-owned banks driven to increase the profit share of their management, shareholders and wealthy clients. Peering behind the propaganda, however, the public banking model that helped underwrite Germany's economic success may be the fast track to a financial system that serves the local economy rather than international high finance.

While the internationally competitive Landesbanken have been under attack, the locally-based Sparkassen have emerged relatively unscathed and continue to flourish. Since they are local savings banks with a surplus of deposits over loans, they do not need money from international financial markets or state guarantees. They do not have guarantees at all but are self-insured. They have a wide deposit base and prudent lending practices, and they are not dependent on foreign ratings agencies to attract creditors and investors. If they are forced into a European banking union that imposes the losses of profligate foreign banks on the more prudent members, however, they may yet be brought down.

Bowing to Brussels

In August 2012, the European Commission insisted that the 6,000 banks in the euro area be centrally supervised to prevent future financial crises. Objections came chiefly from the Germans. According to *The New York Times*:

> [S]ome Germans are highly sensitive about giving up authority over their large public banking system, which is partly controlled by states, districts and cities, and that has cast some doubts over the goal of turning the proposal into European law by the year's end.
>
> Klaus-Peter Flosbach, finance policy spokesman for the parliamentary group of the ruling party in Germany, the Christian Democrats, told the daily newspaper Süddeutsche Zeitung that it was "completely wrong" for the European Central Bank to regulate the hundreds of German savings banks, called Sparkassen. Germany's regional banks, or

Landesbanken, were severely hit by the financial crisis in 2008 and 2009.

Writing in *The Financial Times,* the German finance minister, Wolfgang Schäuble, said supervision should focus only on those banks that could pose a threat to the entire European financial system, while some central policy makers at Germany's central bank, the Bundesbank, have expressed wariness about expanding the European bank's powers.[435]

Despite these objections, in December 2012 a deal was struck to establish a Single Supervisory Mechanism, with the European Central Bank at its center. According to *Bruegel*:

> From press reports, the ECB will directly supervise all banks above €30 billion in total assets, as well as some smaller banks, and will have some form of backseat authority on all other smaller ones. . . . This covers not only large banks but also medium-sized ones, in total probably somewhere between 75 and 85 percent of the system's total assets. . . . The exclusion of small banks is not really justifiable from a technical or analytical perspective. But it was also arguably unavoidable given Germany's central role in the decision process and its unique political and banking structures, which grant enormous political influence to the savings banks.[436]

An accord was finalized in March 2013 that would give the ECB powers to supervise Eurozone banks from mid-2014. According to *RTÉ News*:

> The deal envisages that banks with assets of €30 billion, or larger than one-fifth of their country's economic output, are supervised by the ECB rather than national supervisors.
>
> The next pillar of a banking union should be the creation of a central system and fund to close troubled banks, rather than leaving it to individual countries such as Cyprus or Ireland to have to manage alone.
>
> However the reluctance of Germany and other economically strong countries to underpin such a fund means it will be hard to set up.[437]

According to a release from the Luxembourg Bankers' Association

> The SSM constitutes the first block of the Banking Union, which encompasses also a single EU Deposit Guarantee Scheme and a single EU Resolution Scheme set up under the control of a EU Resolution Authority, and a single set of rules (the single rulebook). The motivation for creating the Banking Union is to restore confidence in the Euro-zone's capacity to overcome the current crisis, paving the way towards a more complete fiscal, economic and political integration.[438]

"Paving the way toward a more complete fiscal, economic and political integration": skeptical observers say that was the goal of the Eurozone all along . . . .