Publicly-owned Banks as an Instrument of Economic Development: The German Model

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Publicly-owned banks were instrumental in funding Germany's "economic miracle" after the devastation of World War II. Although the German public banks have been targeted in the last decade for takedown by their private competitors, the model remains a viable alternative to the private profiteering being protested on Wall Street today.

One of the demands voiced by protesters in the Occupy Wall Street movement is for a "public option" in banking. What that means was explained by Dr. Michael Hudson, Professor of Economics at the University of Missouri in Kansas City, in an interview by Paul Jay of the Real News Network on October 6:

> [T]he demand isn't simply to make a public bank but is to treat the banks generally as a public utility, just as you treat electric companies as a public utility. . . . Just as there was pressure for a public option in health care, there should be a public option in banking. There should be a government bank that offers credit card rates without punitive 30% interest rates, without penalties, without raising the rate if you don't pay your electric bill. This is how America got strong in the 19th and early 20th century, by essentially having public infrastructure, just like you'd have roads and bridges. . . . The idea of public infrastructure was to lower the cost of living and to lower the cost of doing business.

We don't hear much about a public banking option in the United States, but a number of countries already have a resilient public banking sector. A May 2010 article in *The Economist* noted that the strong and stable publicly-owned banks of India, China and Brazil helped those countries weather the banking crisis afflicting most of the world in the last few years.

In the U.S., North Dakota is the only state to own its own bank. It is also the only state that has sported a budget surplus every year since the 2008 credit crisis. It has the lowest unemployment rate in the country and the lowest default rate on loans. It also has oil, but so do other states that are not doing so well. Still, the media tend to attribute North Dakota's success to its oil fields.

However, there are other Western public banking models that are successful without oil booms. Europe has a strong public banking sector; and leading it is Germany, with eleven regional public banks and thousands of municipally-owned savings banks. Germany emerged from World War II with a collapsed economy that had degenerated into barter. Today it is the largest and most robust economy in the Eurozone. Manufacturing in Germany contributes 25% of GDP, more than twice that in the UK. Despite the recession, Germany's unemployment rate, at 6.8%, is the lowest in 20 years. Underlying the economy's strength is its Mittelstand—small to medium sized enterprises—supported by a strong regional banking system that is willing to lend to fund research and development.

In 1999, public banks dominated German domestic lending, with private banks accounting for less than 20% of the market, compared to more than 40% in France, Spain, the Nordic countries, and Benelux. Since then, Germany's public banks have come under fire; but local observers say it is due to rivalry from private competitors rather than a sign of real weakness in the sector.

As precedent for a public option in banking, then, the German model deserves a closer look.

From the Ashes of Defeat to World Leader in Manufacturing

Germany emerged Phoenix-like from its disastrous defeat in two world wars to become Europe's economic powerhouse in the second half of the 20th century. In 1947, German industrial output was only one-third its 1938 level, and a large percentage of its working-age men were dead. Less than ten years after the war, people were already talking about the German economic miracle; and twenty years later, its economy was the envy of most of the world. 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% economic growth.

The country's economic miracle has been attributed to a variety of factors, including debt forgiveness by the Allies, currency reform, the elimination of price controls, and the reduction of tax rates. But while those factors freed the economy from its shackles, they don't explain its phenomenal rise from a war-torn battlefield to world leader in manufacturing and trade.

One overlooked key to the country's economic dynamism is its strong public banking system, which focuses on serving the public interest rather than on maximizing private profits. After the Second World War, it was the publicly-owned Landesbanks that helped family-run provincial companies get a foothold in world markets. As Peter Dorman describes the Landesbanks in a July 2011 blog:

> They 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. [Emphasis added.]

The Landesbanks function as "universal banks" operating in all sectors of the financial services market. All are controlled by state governments and operate as central administrators for the municipally-owned savings banks, or Sparkassen, in their area.

The Sparkassen were instituted in Germany in the late 18th century as nonprofit organizations to aid the poor. The intent was to help people with low incomes save small sums of money, and to support business start-ups. The first savings bank was set up by academics and philanthropically-minded merchants in Hamburg in 1778, and the first 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 operate a network of over 15,600 branches and offices and employ over 250,000 people, and they have a strong record of investing wisely in local businesses.

Targeted for Privatization

The reputation and standing of the German public banks were challenged, however, when they emerged as competitors in international markets. 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 US to promote public banking.)

The vicissitudes of German banking in the last decade were traced in a July 2011 article by Ralph Niemeyer, editor-in-chief of EUchronicle, titled "Commission's Dirty Task: WESTLB Devoured by Private Banks." He notes that after 1999, the major private banks left the path of 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, for which German taxpayers wound up providing guarantees. Deutsche Bank AG was feeding its record profits almost exclusively through its investment banking division, which made a fortune trading credit default swaps on Greek state obligations. When this investment turned sour, the German government had to bail out the financial institution into which Deutsche Bank AG dumped these toxic assets.

While the large private banks were betting on the casinos of the financial markets, lending to businesses and the "real" economy was left to the public Sparkassen, which were more efficient in serving average citizens and local business because they were not stock companies that had to satisfy shareholders' hunger for ever-larger dividends. Today the market share of private banks in Germany is only 28.4%, and Deutsche Bank AG dominates the segment. But with its 7% market share, it is still well behind the public banks owned by municipalities and communities.

Neimeyer says the private banks wanted to break up the market dominance of the public banks to get a bigger piece of the pie themselves, and they used the European Commission to do it. The Commission had been lobbied since the early 1990s by German private 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 demanded that any competing public monopolies in the German banking market be broken up, citing their "inefficiencies." When the German public Sparkassen and Landesbanken were reluctant to turn to investment banking with its skyrocketing profits, they were branded as bureaucratic and "unsexy." When they were pressured to increase their returns for their government owners, the German Landesbanken did get sucked to some extent into derivatives and CDOs (fraudulently rated triple A). But while they "lost billions in the Goldman Sachs, Deutsche Bank and Lehman Brothers Ponzi scheme," Niemeyer says the extent to which they became involved in highly speculative transactions was "laughable in comparison with the damage done by private banks, for whom taxpayers are now providing guarantees."

It was the public banks and Sparkassen that supplied the real economy with liquidity, and that stepped in for the private banks when they withdrew to bet in the financial casino; but it was on the failings of the Landesbanken and Sparkassen that the media focused their attention. The real motive, says Niemeyer, was that the large private banks wanted the public banks' market share themselves:

> 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

The German public banks were brought down by knocking their public legs out from under them. Previously, they had enjoyed state guarantees that allowed them to acquire and lend funds at substantially better rates than private banks were able to do. But in 2001, the European Commission ruled to strip the Landesbanks of their explicit state credit guarantees, forcing them to compete on the same terms as private banks. And today the European Banking Authority is refusing to count the banks' implicit state guarantees in their "stress tests" for banking solvency.

The upshot is that the German public banks are being stripped of what has made them stable, secure, and able to lend at low interest rates: they have 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, the German public banks were able to turn bank credit into the sort of public utility described by Prof. Hudson.

The example of Germany shows that even success is no guarantee in the face of a relentless onslaught of propaganda by large privately-owned banks interested only in making money for their CEOs, wealthiest clients and shareholders. But peering behind the propaganda, the public banking model that helped underwrite Germany's economic success might be the fast track to a U.S. banking system that serves Main Street rather than Wall Street.

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