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Promotional banks as an instrument for improving the financing situation of small and medium-sized enterprises in the transition economies of Central and Eastern Europe: Some observations based on the development of the German financial system

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Promotional Banks as an Instrument for Improving the Financing Situation of Small and Medium-Sized Enterprises in the Transition Economies of Central and Eastern Europe

Some Observations Based on the Development of the German Financial System

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Summary

Ten years after the start of the transition process in Central and Eastern Europe, the establishment of a viable sector of private small and medium-sized enterprises (SMEs) and the design of an efficient financial system are two of the most important tasks facing economic policy-makers in those countries and also the multilateral and bilateral development organisations. Numerous projects have been, and are still being initiated with the goal of systematically promoting the SME sector by improving their financing situation.

One approach specifically designed to achieve these tasks is the strategy, currently being pursued by Kreditanstalt für Wiederaufbau (KfW) on behalf of the German government, which centres on the establishment of "promotional banks". The approach is based on the hypothesis that a financial sector organised according to the principles of private enterprise is a necessary precondition for economic development. However, such financial sectors tend not to provide SMEs, defined by economic policy-makers as a priority sector, with the long-term financing they need, even though in principle the commercial banks may have the requisite credit technology. The commercial banks' reluctance to finance SMEs is attributed to the fact that they do not have access to (sufficient) long-term funds and/or to the fact that they do not regard lending to the target group as a potentially profit-maximising business.

The promotional bank approach seeks to overcome this market failure by channelling inexpensive long-term funds to the target group via local commercial banks and savings banks, which bear full liability for the loans. However, to be able to achieve its economic policy goals, the promotional bank itself should not be committed to profit maximisation. Rather, it must be majority-owned by state and/or public sector entities.

A unique feature of this approach is that KfW's own history and organisational structure serve as a model for project design. There are two reasons why this should be so: one is that KfW's main line of business in the Federal Republic of Germany is the promotion of the small and medium-sized enterprise sector; the other is that KfW made a decisive contribution to the reconstruction of (West) Germany after the Second World War. Not least in comparison to the development bank approach, which is generally regarded as having failed, the (successful) activities of KfW in Germany are therefore seen as decisive empirical proof of the hypothesis that promotional banks can be an effective instrument for improving the financing situation of the target group in the transition economies of Central and Eastern Europe and the Newly Independent States.

Analysis of post-war Germany and the role of KfW in its development shows, however, that KfW did not in fact adopt the promotional bank approach in the early years, but that it initially functioned as a bank for reconstruction in the classic sense. Not until 1971 did KfW begin to apply the promotional bank approach on a major scale. Yet at that time the prevailing conditions in West Germany, both in the small and medium-sized enterprise sector and in the financial sector, were very different from the situation in

which these sectors operate in the transition economies. Whereas in Germany a *Mittelstand*, a sector of well-established medium-sized firms, had evolved over several decades under a largely market-based economic order, in the transition economies almost all of the private enterprises were founded comparatively recently, and are having to struggle for survival in an uncertain market environment. The great mass of these firms fall into the category of micro and small enterprises, and accordingly their situation is very unpredictable: businesses enter and exit the market from one day to the next, and are likely to move abruptly from one line of business to another.

A comparison of banking systems reveals similarly substantial differences between the (West) Germany of the 1970s and the transition economies of today. Whereas in Germany all of the indicators used to measure financial system development (volume of outstanding loans to the private sector as a percentage of gross domestic product, short- versus long-term lending, interest rate differentials) showed favourable trends or could be read as a sign of stability, the banking systems of most transition economies are extremely crisis-prone, and contribute either not at all or only very selectively to the financing of the private sector in general, i.e. not only small and medium-sized enterprises but also many large ones have very limited access to credit. An important reason for this is the banks' lack of appropriate credit technologies, which leads to high rates of non-performing loans. This difference can also be attributed not least of all to the fact that the post-war German banking system was able to look back on a long and successful tradition within a market-based environment, whereas the banking systems of Central and Eastern Europe and the NIS are having to be built up from scratch and consequently lack any such tradition.

Moreover, since 1948, the corporate governance of KfW has been characterised by a delicate balance between professional banking practice on the one side and on the other, a politically defined mission, state ownership and government influence. Yet judging by the relationship between the political and the economic spheres in most of the reforming transition economies, it appears highly unlikely that the new promotional banks will be able, solely on the basis of their respective founding laws and charters, to achieve and maintain such a balance. In many transition economies, state institutions are often dominated or at least influenced by the financial interests of those who have gained economically from the transition process. Distrust of state institutions appears to be particularly strong among the private sector, i.e. the very target group that the promotional bank approach seeks to support.

These differences in regard to the most important categories on which the promotional bank approach depends – target group, banking system and corporate governance – suggest that the promotional banks in the transition economies, with the possible exception of the most advanced reforming countries, face a daunting task if their intention is to reach a significant percentage of the target group, and especially the small enterprises, by applying the approach as it stands. The available – albeit insufficient – empirical evidence does not contradict this assertion. To date, promotional banks have only gone into operation in those countries that have already reached a relatively

advanced stage of the transition process. Furthermore, the SME business of these promotional banks appears to consist primarily of lending to the larger firms within this target group. Accordingly, they have probably done little to alleviate the credit rationing to which micro and small enterprises are subject. And finally, the SME business does not necessarily play the dominant role in relation to the other lines of business (e.g. infrastructure and housing finance) which, according to the theory behind the approach, a promotional bank may also pursue but only as a supplement to the core business of SME support. From the standpoint of development policy, there is nothing wrong with this shift of emphasis, given that there is an obvious need for support in these areas. However, since the primary task of the promotional bank approach, by definition, is to promote not only medium-sized but also small enterprises, and the financial sector as a whole, it is questionable whether even the promotional banks that are already in operation are actually achieving the goals for which the approach was designed.

In the hope of finding another historical precedent that might yield more useful lessons for the design of promotional measures aimed at improving the financing situation of the target group in a situation characterised by an emerging private sector and a banking system in the process of being built up, the paper analyses the development of the target group, the banking system and enterprise financing in 19th century Germany. This analysis reveals a number of parallels with the present situation in many transition economies: For one thing, the target group consisted mainly of micro and small enterprises and the banking system had to evolve without recourse to previous experiences. For another, it is found that not (only) long-term loans to finance fixed asset investments, but (also) short-term loans to finance working capital were appropriate services provided by commercial banks to small and medium-sized enterprises during that phase of financial system development. And finally, the "interventions" that took place in the German financial system of the 19th century to improve the target group's access to financial services were precisely not based on the principles behind the promotional bank approach. Instead they came in the form of the savings banks and credit co-operatives, i.e. entities that were not second-tier institutions, were not founded as a consequence of government initiatives, and did not engage in long-term lending, or at least only to a very limited extent. Rather, the origins and evolution of the savings banks and credit co-operatives exhibited features which are characteristic of the financial institution-building approach to development projects.

Every historical situation is unique. Consequently, every comparison between historical situations is inevitably problematic. If, despite these reservations, historical comparisons occupy such a large part of the present paper, it is because the explicit and implicit equation of two historical situations – post-World War Two Germany and post-Cold War Central and Eastern Europe – is a central argument put forward by the advocates of promotional banks to justify that approach. The detailed comparative analysis presented here comes to an unambiguous conclusion: it is inadmissible to equate the two historical situations, especially in terms of the target group, the banking system and the corporate governance environment, i.e. the categories that define the promotional bank approach. Hence the comparison cannot be accepted as evidence that the promotional bank

approach is a suitable instrument for improving the financing situation of small and medium-sized private-sector enterprises in the transition economies. Before a conclusive evaluation can be given, however, more detailed empirical analysis of the results achieved in the transition economies to date is needed. Bearing in mind just how important the development of the financial system and the SME sector is for the national economies of the countries concerned, it is to be hoped that such an analysis will be presented soon.

1. Introduction[*)]

In the countries of Central and Eastern Europe the transition from central planning to a market-based economic system has been underway for almost ten years now. At the start of this process, discussion focused on the macroeconomic orientation that policy-makers should pursue, and on the relative merits of gradual adjustment versus "shock therapy". In the mid-1990s, however, structural issues came to the fore. Among these "second-generation transition issues"[1], two of the most important are the establishment of a viable sector of small and medium-sized enterprises, and the design of an efficient financial system.

Numerous development co-operation projects sponsored by multilateral and bilateral organisations couple these two issues, either explicitly or implicitly, in that the projects aim to promote the small and medium-sized enterprise (SME) sector specifically by improving their access to financing.[2] The underlying assumption on which all these projects are based is that the financial systems in the transition economies are unable or only partly able to satisfy SMEs' financing needs; and that an inadequate supply of credit for this target group forms a significant obstacle to growth and development in the regions in which the projects operate.

One approach specifically designed to address these problems is the establishment of "promotional banks". On behalf of the German government, Kreditanstalt für Wiederaufbau (KfW)[3] has supported the establishment of such banks, and aided in their design, in a total of 13 Central and Eastern European countries to date.[4] The key feature of KfW's approach is that it not only acts as a consultant to the promotional banks in question, but also draws upon its own history, mission and organisational structure as a

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*) The author is head of the economic research department at Internationale Projekt Consult (IPC) GmbH, Frankfurt, and also lectures at the University of Würzburg.

1 See: The World Bank (1995)

2 See Pissarides (1998), Rühle/Winkler (1994).

3 The department responsible is Department KSb, which belongs to the division "Promotion of the German Economy". The company "KfW Finanzierungsplanungs- und Beratungsgesellschaft mbH" [KfW Financing Planning and Advisory Services] was founded for the purpose of carrying out such projects; it receives an order from GTZ to provide the technical support. KfW (via FpB GmbH) is thus a sub-contractor to GTZ, i.e. it acts as a consultant from GTZ's point of view.

4 KfW (1998), p. 68.

model for the project design.[5] KfW's principal business is the promotion of the German SME sector through the provision of external capital on favourable terms and conditions (in regard to interest rates, maturity, repayment of principal and premature redemption). The aim is to compensate for a supposed weakness of financial sectors, including Germany's – namely, that "essentially creditworthy would-be borrowers are either unable, or only partially able ... to meet their needs for long-term credit" (Stein/Kirchner (1980), pp. 337f). Moreover, KfW has the reputation of being the financial institution that made a decisive contribution to re-building (West) Germany after the Second World War: It provided the financial resources needed to solve the problems of financing reconstruction. If it is assumed that the task facing Central and Eastern Europe after the end of the Cold War is the same as that which faced Germany after the Second World War, namely, to establish a "social market economy", then the promotional bank would appear to be a highly appropriate instrument for achieving similar ends in the economies of Central and Eastern Europe, judging by the empirical evidence from (West) Germany.

The promotional bank approach is not only based on Germany's experience with KfW after the Second World War, however. Rather, its underlying philosophy – that banks are an important means through which to foster economic development – is derived from Germany's financial and economic history over the last 200 years. The pertinent lessons to be drawn from this history can be summed up as follows:

1. The financial system as a whole, and the banking system in particular, can make an important contribution to the process of industrialisation and/or industrial modernisation. A statement such as "Without the financial commitment of the major banks, the rapid build-up of the new industries, in which Germany soon assumed a leading position, would not have been conceivable" (Pohl, M. (1993), p. 268) sums up the received wisdom found not only in the specialist literature on the economic history of Germany in the second half of the 19th century, but also in many standard history books used in secondary schools and colleges.[6]

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[5] See KfW (1997), p. 5; the Spokesman for the Board of Management, Vogt, has spoken of this approach as "exporting KfW's own way of doing things", in: FAZ, 18 May 1993, p. 17.

[6] See, for example, Prokasky (1988), pp. 123f.

2. The banks performed this "pace-setting function" (Wellhöner/Wixforth (1990), p. 12) primarily by providing financial resources in the form of long-term credit, which served as the basis for large-scale and productive investments. Today, the provision of long-term credit remains the predominant feature of the German banking system, particularly when contrasted with the American and British banking systems; this difference is underscored in the theoretical and economic-policy discussions on the advantages and disadvantages of the respective systems.[7]

3. Although the banking system thus played a highly important role in Germany's industrial development, the banks' promotional efforts were restricted almost exclusively to large-scale enterprises. Small and medium-sized enterprises, in contrast, had almost no access to bank loans, whether long-term or short-term, i.e. they were subject to credit rationing. Small savers, as well, were more likely to be discouraged from accumulating deposits at private banks than encouraged to do so. On the whole, from 1850 to 1914, the banking system in Germany provided "development assistance for the strong" (Tilly (1986)).

4. It took the establishment of state and public-sector banking institutions – or, in more general terms, financial institutions not solely obligated to pursue (short-term) profit maximisation – to integrate small and medium-sized enterprises, as well as small savers, into the formal financial system. Even today, on the eve of the 21st century, the institutions that were established at that time remain ubiquitous features of the German banking landscape: the savings banks, the credit unions, and the agricultural credit co-operatives.

Thus, Germans do not have any difficulty with the idea of banks functioning as instruments to promote industrialisation processes, or with interventions in the banking system by state or public-sector entities which have priorities other than (short-term) profit maximisation. Based on positive experiences in Germany's past, both notions have positive connotations among the general public, all the more so when the beneficiaries are small and medium-sized enterprises.[8]

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[7] See, for example, Dewatripont/Maskin (1995), Carlin/Richthofen (1995).

[8] H. A. Winkler ((1985), p. 187) refers to another specifically German experience which makes the promotion of SMEs a key task for politicians and economic policy-makers, a task which the state has an obligation to perform: According to this view, after global economic crisis broke out at the end of

This predilection on the part of German observers, particularly those whose views were shaped in large part by West Germany's historical experiences, is often difficult for non-Germans, particularly those from the English-speaking world, to understand. Indeed, as regards its implications for the design of SME financing projects in Central and Eastern Europe, they may even reject this approach out of hand.[9] Not only do Anglo-Saxons not have the peculiarly German perspective connected with West Germany's experiences after the Second World War; their own financial and economic history gives them an almost diametrically opposed view in which the undesirability of large banks in general, and state banks in particular, is more or less a given.[10] In regard to development policy, the poor record of state development banks in many countries since the end of the Second World War has only served to strengthen this Anglo-Saxon conviction. For it can be said of such banks that "with few exceptions, their performance was dismal: lending decisions were often based on political considerations rather than on economic criteria; loan supervision and recovery were very weak; and such innovations also suffered from high levels of overstaffing and large overheads." (Caprio/Vittas (1997), p. 13)

The parallels between German reconstruction after the Second World War and the reconstruction of Central and Eastern Europe after the Cold War, which appear obvious from a (western) German viewpoint, also play only a secondary role in the Anglo-Saxon perception. Instead, Anglo-Saxon thinking is dominated by a concept of transition which, after decades of state ownership and operation of the economy, involves the creation of an economy based on private entrepreneurship and the market mechanism. Accordingly, the aim in the economies of Central and Eastern Europe must be to force the state out of the economy, and out of the financial sector in particular. From this perspective, proposals which aim to re-introduce the state as a direct or indirect participant in the market, as in the case of the German promotional bank approach, appear almost anachronistic.

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the 1920s, the ensuing panic among the *Mittelstand* (Germany's small and medium-sized businesses) enabled National Socialism to grow into a mass movement and helped to destroy the first German republic.

[9] The author bases this statement on his own experiences in numerous conversations in connection with designing SME financing projects in the transition economies of Central and Eastern Europe since 1994.

[10] See remarks on this subject by Tilly (1989).

However, the Anglo-Saxon standpoint on SME financing is also based on the conclusion that too little credit is being extended to small and medium-sized enterprises in transition economies; and it too regards the establishment of a viable sector of private small and medium-sized enterprises, along with an efficiently functioning financial sector, to be of key importance to the success of the transition process. Rather than a promotional bank approach, however, the concept favoured in the Anglo-Saxon view is one which builds on the principles of "institution building, commercial approach and financial system orientation" (Pissarides (1998), p. 7). The focus is on direct intervention at the level of the commercial banks, starting either with existing institutions (the downscaling approach) or with the establishment of new, target group-oriented commercial banks (the upgrading approach).[11] The whole range of instruments available to development finance comes into play, i.e. the acquisition of equity stakes in new or existing institutions and the exercise of the corporate governance functions associated with such holdings; the extension of lines of credit to finance loans to the target group; and technical assistance in various forms, e.g. management services agreements, advisory assistance to institutions in establishing target group-oriented credit divisions, or the design of training programmes. Examples of such projects[12] include the EBRD's Russia Small Business Fund, KfW's German-Ukrainian Fund, FEFAD Bank in Albania (KfW/GTZ), Micro Enterprise Bank in Bosnia-Herzegovina (EBRD/IFC/FMO), Microfinance Bank of Georgia (KfW) and Fundusz Micro in Poland (USAID).[13]

The following paper will present an analysis of the promotional bank approach as an instrument of SME financing. The goal is to determine to what extent the merits of this approach, as demonstrated in the development of the German financial system, might also make it an appropriate instrument for the promotion of the SME sector in Central and Eastern Europe.[14] First, the concept of a promotional bank will be explained in

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[11] See Krahnen/Schmidt (1994), Schmidt/Zeitinger (1994) and Holtmann/Rühle/Winkler (1999) on these two approaches.

[12] For more on the individual projects, see EBRD (1995), p. 145; Wallace (1996); German Federal Ministry of Economics/KfW (1998), KfW (1998a) pp. 21 and 55f, Balsen, W. (1998, 1999).

[13] The projects supported or initiated by KfW are managed by the division of KfW which is responsible for carrying out financial co-operation with developing countries at the request of the German Federal Government.

[14] This methodology – examining the financial and economic history of the developed countries in order to gain insights and derive recommendations for policies, or, as in the present case, project designs which could be adopted in developing countries and transition economies – is particularly favoured

detail (Section 2). This will be followed by a comprehensive analysis of the post-war period in Germany and the role of KfW in financing small and medium-sized enterprises (Section 3); this will serve as a means of determining the extent to which it is valid, with regard to SME financing, to draw parallels between the post-war period in Germany and the transition period which began in Central and Eastern Europe at the start of the 1990s (Section 4). Next, the role of banks in the financing of enterprises in Germany since the start of the 19th century will be discussed in detail, as a basis for further comparison with the situation in Central and Eastern Europe (Section 5). It will become apparent that although the public-sector nature of a promotional bank is, in fact, an important argument that can be made against applying the KfW model in Central and Eastern Europe, it is not by any means the decisive argument. Rather, the factor which makes the promotional bank an ill-suited approach to improving the target group's access to credit in the transition economies is that the environment in which KfW operated – and still operates –differs fundamentally from that of Central and Eastern Europe in terms of both the strength of the financial system and the nature of the target group.

On the other hand, however, the development of the German financial system in the nineteenth century, and the interventions in the financial system of that time by public-sector entities that were not geared to (short-term) profit maximisation, would seem to indicate that promotional activities should be implemented at the level of the commercial banks themselves. Ultimately, the question of which approach is most suitable can only be answered conclusively on an empirical basis. Therefore, the paper concludes (Section 6) by underscoring the need for detailed analysis of the performance of the promotional banks founded in Central and Eastern Europe to date, and then for comparison with the performance achieved by approaches being implemented at the level of the commercial banks.

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among specialists in financial system development; see, for example, Caprio/Vittas (1997), Humphrey/Sato/Tsurumi/Vesala (1996), pp. 20f, Gorton (1985), p. 267.

2. The Promotional Bank Approach

2.1 Rationale, Goals and Instruments

Promotional banks are an instrument of government economic-growth and structural policy "deployed in an attempt to exploit the development potential of a market economy to the maximum." (Streit (1991), p. 131). The promotional bank approach is therefore based on the assessment that a financial sector organised solely on the basis of private enterprise cannot achieve this:[15] "The central task of a functioning financial market is to direct the ... scarce financial resources into what are defined by economic policy as priority areas. Even in developed market economies it has been found that this task is not performed to a sufficient degree by the banking system. For this reason, promotional banks have been and are being created to carry out the functions that are not being satisfied by the central banks and the commercial banks" (KfW (1997), p. 4) Small and medium-sized enterprises are regarded as a priority sector of the economy because their emergence is "a decisive element in the transition to a different economic system." "They respond flexibly to changing market conditions and make a substantial contribution to the creation of competitive jobs." (KfW (1997), p. 4).

In other words, like all the other project approaches in the area of SME finance, the promotional bank concept is based on the diagnosis that the financial system of a given country is not capable of providing the target group with an appropriate supply of credit. However, it differs from other approaches in that the term "appropriate" is defined very narrowly, insofar as it is taken almost exclusively to mean the provision of long-term finance, which is seen as a necessary precondition for the implementation of productive investment projects:[16] "Insufficient access to long-term financing is a serious problem for most SMEs in Central and Eastern Europe." (KfW (1997), p. 4) As in the developed

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[15] The following analysis is based closely on the presentation of the promotional bank approach published by KfW on its website (KfW (1999, HP)) under the heading "Principle", and also on the brochure "KfW-Förderbankenberatung" [KfW Advisory Services to Promotional Banks], (KfW (1997)).

[16] The study by Caprio/Demirgüc-Kunt (1997) contains empirical evidence to support this hypothesis. However, the analysis also shows that the size of the productivity gains achieved through an investment financed with long-term funds depends crucially on whether the funds are provided by the banking system endogenously as a consequence of the market process or whether they represent an outflow of subsidies, i.e. a result of state interventions in the financial system. If the latter is true, the correlation between the productivity of the investments and the term structure of the loans is not only no longer clearly positive, but in some instances even turns out to be negative.

western economies, SMEs lack – in the absence of a promotional bank – a "secure basis" for investment decisions, which puts them at a serious disadvantage in competition with large companies. In this respect, promotional banks help to minimise the "disadvantages due to company size" (Kolb (1996), Harries (1998), p. 122). Furthermore, the reference to the "loans at favourable interest rates" which a promotional bank is supposed to initiate implies that the credit facilities currently available to the target group in the banking market, if any, are too expensive.[17]

Private-sector commercial banks do not offer this "appropriate", i.e. long-term, finance either because they in turn do not have access to sufficient long-term funds, or because long-term lending is not profitable enough by comparison with short-term lending or other financial products. In that case, broadening a bank's range of products to include long-term credit to the target group would run counter to the goal of profit maximisation which private-sector commercial banks are obliged to pursue.

The promotional bank approach addresses these constraints by offering the commercial banks long-term funds at cheap rates, thus allowing them to offer long-term loans to the target group on a profitable basis. It is assumed that the commercial banks have access to a credit technology which enables them to keep the risk-related costs and transaction costs associated with target group lending down to within acceptable limits, i.e. which enables them to earn an interest margin which, although not unacceptably large from the point of view of the promotional bank, is nonetheless large enough to be compatible with the commercial banks' profit-maximising motive.

However, this assumption cannot be made in the Central and Eastern European context: since long-term funds are in very short supply, the banks have not yet had an opportunity to develop an efficient long-term lending technology (KfW (1997), p. 4). Therefore the principles underlying the classic promotional bank approach have been modified somewhat insofar as a promotional bank in a Central or Eastern European country is also expected to assist the local commercial banks in developing such a credit technology in the first place.

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[17] In OECD economies, small and medium-sized enterprises have to pay interest rates that are between two and five percentage points higher than large ones; see Pissarides (1998), p. 3.

Finally, the structural and economic policy goals that can be pursued by means of a promotional bank are not solely confined to SME development. “According to the economic policy objectives of the government, promotional banks also finance infrastructure investments and environmental protection measures, the privatization and restructurization of state-owned enterprises, or housing modernization measures.” (KfW (1999, HP)) Nonetheless, descriptions of this approach always prioritise the SME sector, not only in the context of KfW’s domestic business in Germany, but also in connection with the tasks of newly founded or yet-to-be founded promotional banks in Central and Eastern Europe. Thus, on the basis of these descriptions, long-term SME finance can be regarded as *the* raison d’être of a promotional bank.

2.2 Corporate Governance and Position Within the Financial System

The credit rationing faced by the target group is largely attributable to considerations of profit maximisation on the part of the commercial banks, which make them less willing to assume risks than would be desirable from the point of view of the economy as a whole (Streit (1991), p. 133). It therefore follows that promotional banks should precisely not be obliged to maximise their profits. This can only be assured if they are majority-owned by government or public-sector entities, for only then will they be able to function as instruments of the desired development-oriented economic policy. Consequently, the majority of the members of a promotional bank’s board of administration or, as the case may be, its supervisory board will be government representatives.

The promotional bank approach is based on the subsidiarity principle: promotional banks – in accordance with the rationale for creating them – act only to the extent necessary to offset the market failure that has been diagnosed, i.e. in providing funds earmarked for specific structural and economic policy aims and in setting the terms and conditions under which those funds are to be made available. This is reflected in the fact that promotional banks, by their very design, do not compete with commercial banks because they function solely as second-tier institutions. As a rule, a promotional bank will not lend directly to the target group, but will channel funds to the final borrowers via local commercial banks and savings banks. “The intermediate banks assume the full liability for the loans.” (KfW (1999, HP))

The promotional bank approach is therefore confined to addressing the identified weaknesses of the financial market which are attributed solely to the lack of long-term funding and/or the desire of the local commercial banks to maximise their profits. Hence, the key to alleviating or even overcoming the credit rationing faced by the target group is to provide onlending funds on appropriate terms and conditions. If, on the other hand, it were found that the commercial banks were neglecting the target group because they did not have the credit technology needed to serve that clientele effectively, the promotional bank approach would not be a suitable means of combating credit rationing. It would be unsuitable because either the promotional bank would find itself unable to disburse its funds, or the commercial banks would have to incur credit risks that they were incapable of managing and controlling. Not only would this weaken the financial system as a whole, but the promotional bank itself would get into (financial) trouble sooner or later because its debtors, the banks, could fall into arrears as a result of defaults on the part of their borrowers.

Because of its role as a second-tier institution, a promotional bank does not need a large staff, nor a branch network, to issue loans to the target group – it can simply use the human resources and the branch networks of the commercial banks. Nor does a promotional bank pursue any particular, politically motivated projects, as its evaluation of applications for funds will be based solely on prudent banking criteria, i.e. only on the "economic feasibility of the measures to be financed", not on their political expediency. These are the characteristics which place promotional banks "– at the interface between politics and economics – as an institution which supports the economic policies of the government of the country in question and does so with the flexibility and efficiency of a commercial organisation." (KfW (1997), p. 4)

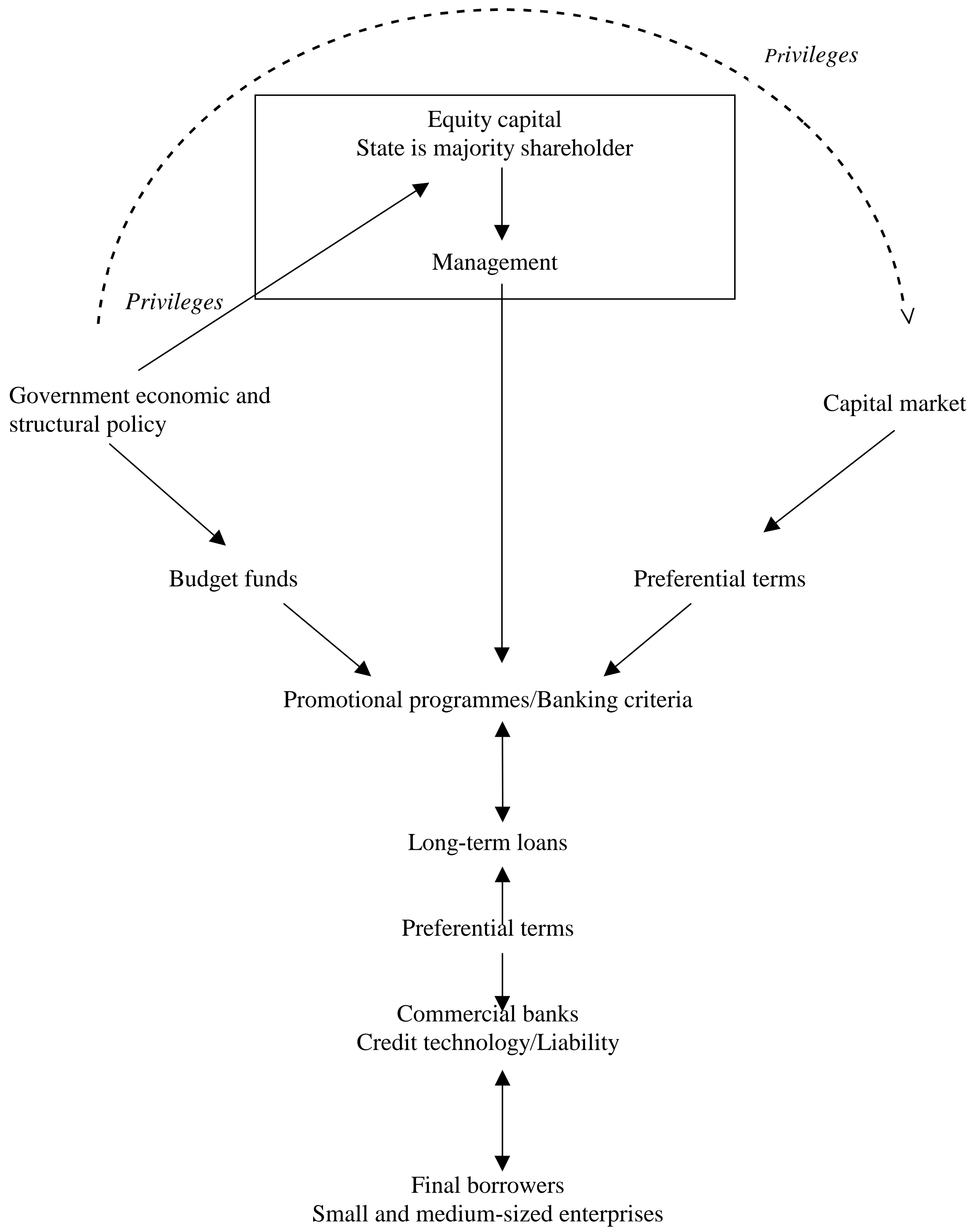
While providing cheap loanable funds to commercial banks, a promotional bank will enjoy various government-sanctioned privileges with regard to its own funding. For one thing, the approach implies that the promotional bank should be exempted from paying taxes and also dividends. For another, the government should guarantee the bank's liabilities. The purpose of the latter arrangement is to render the promotional bank independent of government funding, at least in the medium-to-long term. This is necessary if only because, given the precarious situation of public finances in the countries of Central and Eastern Europe, it is the only way to ensure that the

promotional bank has a sufficiently broad impact.[18] The promotional bank must therefore be in a position to raise large volumes of funds on favourable terms in the capital market. To help it to do so, the state guarantee is supposed to give the institution the status of a good credit risk in the local capital market, even in comparison to the privately owned commercial banks. If it were to succeed in playing a pioneering role here which other banks were soon able to emulate, it would also have contributed to the further development of the capital market of the country in question.

Overview 1.1 summarises the characteristics of a promotional bank's corporate governance structure and its position within the financial system of the country in which it is based, as defined by the concept under discussion here. The objective of a promotional bank is to promote small and medium-sized enterprise by providing long-term loans at low interest rates. When designing its programmes, it adheres to a general framework defined by government but is not bound by government directives regarding their specific practical implementation. The implementing agencies with which it collaborates are privately owned commercial banks which function as channelling institutions. They allow themselves to be used as instruments because the terms on which they are offered loanable funds by the promotional bank are sufficiently attractive to render long-term lending to the target group compatible with their goal of profit maximisation. The promotional bank can offer these cheap rates because it is able to draw upon government funds and/or funds available on favourable terms and conditions in the local or international capital markets.

[18] KfW's response is to provide the promotional banks of Central and Eastern Europe with start-up funding for jointly developed credit programmes. This is to avoid a situation in which "the advisory assistance fails to bear fruit or make a lasting impact due to a lack of specific opportunities to apply the advice received and to a lack of lending practice." (KfW (1997), p. 6).

Overview 1.1: **Main Characteristics of the Corporate Governance Structure and the Position of a Promotional Bank Within a Country's Financial System**



2.3 Some Remarks from the Point of View of *Ordnungspolitik*

Like any other government intervention in a market, the promotional bank approach, which involves intervening in the financial markets, is open to criticism from the point of view of *Ordnungspolitik* (see, for example, Streit (1991), pp. 20f).[19] This is because the rationale for state action rests on a comparison of an unrealisable ideal allocation of resources – in this case, all creditworthy firms receive credit – with the reality that many firms, especially small and medium-sized ones, are subject to credit rationing. According to this view, reality's poor performance compared to the ideal is attributed exclusively, or at least primarily, to the fact that the individual actions of the economic units do not conform to the collective standard of value – or, in this specific case: the activities of profit-maximising private commercial banks do not lead to the optimum level of external financing from the point of view of the economy as a whole.

Practically every economics textbook contains a chapter showing that this diagnosis does not automatically justify government intervention (see, for example, Streit (1991)). Rather, it is first necessary to examine the causes of the "market failure"[20] in terms of their economic implications. Especially in the area of corporate finance, key insights have been provided by the economics of information over the past 30 years.[21] According to this view, the establishment of external financing relationships requires the deployment of mechanisms – signalling, screening/monitoring, self-selection – which establish incentive compatibility between borrowers and investors. The aim here is to avoid the problems of moral hazard or adverse selection which investors would otherwise face on account of an asymmetrical distribution of information. The reason why the market does not provide as much external finance as would be desirable from the point of view of the economy as a whole is therefore that the banks do not apply these mechanisms, possibly because they are too expensive, or because they may simply not be available. If they are not available, it may be due to shortcomings in the legal environment, preventing creditors from using the courts to enforce the terms of their loan contracts (e.g. the right to seize collateral), or it may have to do with the economy's

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[19] A leader in the *Frankfurter Allgemeine Zeitung* (FAZ), commenting on KfW's 50th anniversary, described the German promotional bank as a "foreign body in the market economy" (Krause (1998), in: FAZ, 12.06.1998, p. 15).

[20] Pissarides (1998), p. 1 describes the credit rationing experienced by small and medium-sized enterprises as "capital market failure".

[21] For an overview, see Schmidt/Terberger (1996), Part V, pp. 376ff.

stage of development. For example, if one accepts that reputation is an important instrument at the disposal of the borrower for signalling incentive compatibility with the lender (see Diamond (1989, 1991), Breuer (1995)), then it will obviously be more difficult to reduce credit rationing in a market economy that is only just beginning to evolve than it would be in a market economy that has existed for many years and has stable enterprise and banking sectors.

Thus, the theory of financing rooted in the economics of information offers an alternative explanation of the credit rationing faced by small and medium-sized enterprises, an explanation which goes beyond the conflict between individual and collective interests, i.e. the profit-seeking interests of private commercial banks versus the interests of the economy of a whole. Rather, the alternative theory argues that the failure of reality to live up to the ideal of a credit market in which all creditworthy borrowers receive loans at a uniform interest rate is due to a complex set of external factors which lead to credit rationing. These external factors, characterised by asymmetric information distribution, cause the market participants to incur transaction costs and information acquisition costs which cannot be eliminated or reduced until the commercial banks have developed appropriate technologies. This view casts the commercial banks in a role that is diametrically opposed to that which they play in the diagnosis on which the promotional bank approach is based. Rather than seeing them as the cause of credit rationing on account of their desire to maximise profits, the alternative view regards commercial banks as the most important instrument available for solving credit rationing problems.

At the same time, account also needs to be taken of the problem that governments will not necessarily be capable of correcting market imperfections. Governments themselves are obviously not perfect, and when considering the promotional bank approach, or indeed any other government intervention, the “costs and inherent laws of (economic) policymaking and political action” (Streit (1991), p. 21) need to be factored into the equation. This can mean that intervention produces even worse results than if the market were left to its own devices. Therefore it is necessary to ascertain whether, and under what conditions, a promotional bank can operate “efficiently and flexibly”, i.e. under what conditions the intervention would cause no adverse side effects, or at least only minor ones, and would thus be preferable to the market solution.

In response to these fundamental concerns about government interventions into market mechanisms, two arguments can be put forward in defence of the promotional bank approach:

1. The subsidiarity principle: As long as it merely provides loanable funds to the commercial banking system and refrains from lending directly to the target group, the promotional bank will not be competing with commercial banks – for asset-side business, at least – but supporting them. In this respect it could be argued that despite the privileges granted to a promotional bank and despite its public-sector status, it represents a form of government intervention that conforms to, rather than conflicts with, market forces.

2. KfW as a model: In terms of their objectives, corporate governance and position within the financial system, promotional banks are supposed to be modelled on Kreditanstalt für Wiederaufbau itself, which was founded in 1948 in order to ensure that the GARIOA[22] funds were deployed efficiently. There is nothing in the post-war history of KfW and the West German banking system to indicate that the actual development, to which the promotional bank, i.e. KfW, contributed, was any worse than what could have been achieved by a financial system that had relied solely on the market and private initiative.

To clarify whether there is any empirical evidence to back up the objections of principle which could be raised against the promotional bank concept, it therefore makes sense to start by asking whether KfW actually followed the promotional bank approach in practice, and if so, on what basis.

[22] GARIOA = Government and Relief in Occupied Areas.

3. KfW: From a Bank for Reconstruction to a Promotional Bank

3.1 The Positioning of KfW in the West German Financial System

Judging by the literature[23] on the history of KfW, the free-market concerns, although based entirely on theoretical considerations, were and are evidently of considerable practical importance. The publication of the “13 Principles for the Reconstruction Loan Corporation” on 12 June 1948 immediately sparked off a discussion about whether the establishment of a central funding institution for the reconstruction of Germany should not be seen as state-subsidised, and thus unfair, competition for the commercial banks.[24] The problem was that the channelling principle which is central to the concept of a promotional bank was not firmly embedded in the initial proposals, which seemed instead to imply that the new institution would have an unconditional right to lend directly to enterprises. There was therefore a danger that – for example, if commercial banks refused to bear prior liability for a loan to an enterprise on account of insufficient security – KfW would step in with a direct loan, thus entering into direct competition with the commercial banks but with a distinct advantage over them thanks to its privileged position on the funding side. Instead of subsidiarity, KfW’s effect would then have been to substitute itself for the commercial banks, i.e. instead of stimulating lending activities under market conditions, it would have made commercial lending more difficult, if not impossible.

But by the time the Law Concerning the Kreditanstalt für Wiederaufbau was passed on 5 November 1948, these objections had been taken into account in several respects:[25]

- First-tier lending was limited to exceptional cases which require the approval of the Board of Directors;

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[23] The following account was based on the studies by Pohl, M. (1973) and Harries (1998). Harries worked for KfW for 35 years, and served on the Board of Management from 1986 to1996.

[24] See Pohl, M. (1973), p. 23, p. 26, and Harries (1998), pp. 14f. In light of the discussion on the potential role of promotional banks in Central and Eastern Europe it is remarkable to note that even as long ago as 1947/48 the American authorities took a critical view of a central financial institution for the reconstruction of Germany. It was not until the British pointed out that the Americans themselves had founded their own “Reconstruction Finance Corporation” in Washington in 1932 in the wake of the Great Depression that the U.S. authorities were persuaded to approve the new institution (see Harries (1998), pp. 8ff).

[25] Harries ((1998), p. 12) points out that, once again, the influence of the Americans was far from insignificant.

- Short-term loans could only be made with the approval of the Bank deutscher Länder, the forerunner of the Bundesbank;
- the state guarantee on KfW's liabilities was limited to interest payments;
- KfW was forbidden to operate branches.

This last provision at least prevented KfW from extending bank loans directly to small and medium-sized enterprises on a cost-covering basis, which would have necessitated a much larger staff and a sizeable branch network. Furthermore, the Law made it clear that the economic justification for KfW's activities was to provide commercial banks with long-term funding that was to be channelled into reconstruction projects, funds to which the commercial banks had little or no access (Pohl, M. (1973), p. 27).

Nonetheless, during the early years another conflict arose between KfW and the commercial banks, this time on the liability side. It was precipitated by KfW's plans to issue its first two bonds in the capital market, purchasers of which were also to enjoy tax concessions.[26] The representatives of the banks and savings banks on KfW's Board of Directors voted against the issue of both bonds because they again feared unfair competition from KfW for their own institutions on account of its privileges and the additional tax advantages.[27] When it came to a vote on the bond which was to be issued to finance manufacturing industry, this view was shared by exactly half of the members of the Board of Directors. The tie had to be broken by the casting vote of the chairman, who decided in favour of the bond (Pohl, M. (1973), pp. 65ff).

Generally speaking, though, "in setting up KfW Germany had acquired a central reconstruction financing instrument that exhibited none of the characteristics of a commercial bank." (Pohl, M. (1973), p. 36) However, another reason why the relationship between KfW and the commercial banks was largely free from tension was that, in its early years, KfW mainly engaged in the kinds of business that the commercial banks were unable or unwilling to take on themselves.

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[26] In the end, only the housing bond carried a tax concession.

[27] Concerns of this kind were voiced as an issue of principle even before KfW was founded; see Pohl, M. (1973), p. 37.

3.2 1948–1971: KfW as a Bank for Reconstruction

Analysis of KfW's lending activities in its first few years of operation reveals two things: first, it operated only to a limited extent as a promotional bank; and second, small enterprises were of virtually no significance as a target group. In the late 1940s and early 50s, KfW saw its main task in "issuing loans to the primary industries, such as coal, iron and steel, gas, water and electricity... Only later were loans to the other industries considered." (Pohl, M. (1973), p. 47) Although direct loans were originally intended to be the exception, in fact they became almost the rule for KfW, especially in its lending to the energy industries and coal mines, as the firms that operated in these sectors were not regarded as bankable by the commercial banks on the grounds that their documentation was incomplete (Harries (1998), p. 41). Given the sectors involved (see also Table 3.1) and KfW's small staff, it is hardly surprising that the recipients of these loans were almost exclusively large firms (Pohl, M. (1973), p. 55). Harries ((1998), p. 27) describes KfW's activities in those first few years as "a small team making big deals".

The figures for the industrial programmes suggest that here too it was the upper end of the medium-sized enterprise sector rather than the lower end of the small business sector that received finance. For example, under the first tranche of the ECA[28] in 1950 "some 581 enterprises received a total amount of DM 234 million" (Pohl, M. (1973), p. 62), which works out at an average loan amount of about DM 400,000. The planning for the third ECA tranche included "the remainder of the industrial sector... 485 different firms from all industries with a combined credit volume of more than DM 763 million." (Pohl, M. (1973), p. 89), meaning that the average amount was DM 1.57 million.

Lending to small enterprises accounted for no more than a tiny fraction of KfW's business. In the context of the Job Creation and Investment Programme, with a total volume of DM 496.89 million, a mere DM 90.91 million was issued in the form of small loans to craft enterprises, small businesses and small-scale trade and industry (Pohl, M. (1973), pp. 204f.). Of the DM 1.12 billion loaned by KfW to manufacturing industry and shipbuilding up to 1953, just DM 54 million went to small and medium-sized industry (Harries (1998), p. 44). It is interesting to note that this amount was extended as a blanket loan to Industriekreditbank, IKB, implying that when it came to SME finance, KfW did not exercise its "right and duty not only to assess the creditworthiness of the

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[28] ECA = Economic Commission Administration.

liable bank, but each individual client." (Pohl, M. (1973), p. 32)[29] By 31 December 1953 KfW had lent a total of DM 162.2 million to craft enterprises and other small businesses, including the blanket loan to IKB; this accounts for just under 3% of its total lending volume (Pohl, M. (1973), p. 225).

In 1952 KfW launched its first SME programme with a volume of DM 24 million, and from 1955 on KfW shifted its promotional lending increasingly from primary industry to manufacturing industry, trade and craft enterprises (KfW (1997a), p. 8). It became clear that both the banks and the target group first needed to be persuaded to use these funds: "Long-term loans have to be particularly carefully vetted and secured. Given the fairly small average credit amounts at this time of only DM 35,000, some banks often considered their profit margin, as prescribed by the KfW, insufficient. Only slowly did the realisation spread that the KfW's credit programmes for the SME sector were quite an attractive financing alternative for small firms and their house banks, especially as they could be redeemed prematurely at any time in spite of the fixed rates of interest. It was not until after 1958 that the KfW achieved a sizeable loan commitment volume of more than DM 100 million per year in its SME programmes."[30]

However, it was not until 1971 that programmes were initiated that fully embraced the promotional bank concept described in section 2, i.e. programmes for which KfW raised funds in the capital market which it lent to commercial banks on inexpensive terms so that they in turn could onlend to small and medium-sized enterprises at prescribed rates (Harries (1998), p. 220). The volume of funds committed annually rose from DM 500 million in 1971 to DM 6 billion in 1989 (Harries (1998), p. 122). It was at this point that KfW definitively ceased to be a bank for reconstruction and became West Germany's promotional bank.

For the purposes of comparing KfW as Germany's promotional bank with the promotional banks of Central and Eastern Europe, the first conclusion that can be drawn

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[29] That micro and small loans cannot be issued by a centralised organisation with a small staff of highly specialised personnel operating without a branch network was also evident in the agricultural sector: "The further distribution of the loans to the final borrowers was performed directly by these credit institutions, or by their regional and local affiliates. KfW had no option but to apply this procedure because of the wide dispersion and fragmentation of the loans into small and very small amounts." (Pohl, M. (1973), p. 63; a similar account is given by Harries (1998), p. 42).

[30] Harries (1998), p. 57; on the problems of putting the promotional bank approach into practice in Germany, see also Pohl, M. (1973), pp. 48f.

is therefore the following: even if 1955 is defined as the year in which KfW started to promote small and medium-sized enterprises, the conditions that prevailed in Germany at that time were no longer comparable with those which obtain in economies that are striving to catch up with the West or struggling to make the transition to a market-based system.[31] This is especially true of the situation of the target group and the banking system, i.e. the key factors underlying the promotional bank approach. Very soon KfW was able to work with a re-established SME sector and a functioning banking system within a stable macroeconomic environment.

3.3 Small and Medium-Sized Enterprises in the Federal Republic of Germany: A New Beginning Based on a Long-Standing Tradition

When people today think of Germany in the immediate post-war period, the pictures and associations that come to mind – as a result of either personal experience or what they have learned at school, from history books or from TV – suggest that a completely fresh start was made in 1945. The collapse had been total, not only of the political system but also of the country's economy: factories, infrastructure and housing destroyed, shortages of consumer goods and primary products, a worthless currency, and an economic system that, after 12 years' of Nazi rule, six of them under wartime conditions, was increasingly dominated by the state. As far as the economy was concerned, the new era began in 1948, encapsulated in such terms as currency reform, social market economy and economic miracle.

[31] In 1955 per capita income in West Germany had already risen above the levels recorded for the German Reich in 1938 (see Buchheim, C. (1997), p. 87).

Table 3.1: **Development of the Enterprise Sector of the Federal Republic of Germany – Selected Indicators**

Sectors	No. of enterprises	in %	Average no. of employees per firm	in % of all employees
Manufacturing industry				
1950	765,994	36.1	9.02	48.7
1961	545,338	26.1	18.43	49.3
1970	415,523	22.8	24.77	49.3
1987	336,561	16.0	25.50	39.2
Trade				
1950	684,242	32.3	3.29	15.9
1961	778,123	37.2	4.61	17.6
1970	646,904	35.5	5.57	17.3
1987	585,073	27.9	6.63	17.7
Services				
1950	383,694	18.1	2.86	7.7
1961	476,378	22.8	3.87	9.0
1970	482,286	26.5	4.34	10.0
1987	802,325	38.2	5.57	20.4
Construction				
1950	181,617	8.6	9.01	11.5
1961	165,242	7.9	13.10	10.6
1970	157,984	8.7	13.87	10.5
1987	181,598	8.7	10.27	8.5
Transport and communications				
1950				
1961	80,757	3.8	15.17	8.7
1970	80,692	3.9	18.73	7.4
1987	75,044	4.1	19.21	6.9
	81,039	3.9	18.67	6.9
Banking and insurance				
1950				
1961	10,415	0.5	19.15	1.4
1970	15,427	0.7	28.22	2.1
1987	18,490	1.0	33.59	3.0
	80,052	3.8	12.23	4.5
Agriculture and forestry				
1950	9,507	0.5	4.42	0.3
1961	24,693	1.2	3.58	0.4
1970	21,591	1.2	4.63	0.5
1987	28,195	1.3	4.89	0.6
Energy, water, mining				
1950				
1961	3,136	0.1	260.67	5.8
1970	3,549	0.2	204.75	3.6
1987	3,327	0.2	157.87	2.5
	3,010	0.1	161.19	2.2
Total				
1950	2,119,362	100.0	6.69	100.0
1961	2,089,442	100.0	9.77	100.0
1970	1,821,149	100.0	11.46	100.0
1987	2,097,853	100.0	10.44	100.0

Source of basic data: Federal Statistical Office

This view of the situation, correct though it is as far as it goes, nonetheless conceals the fact that there was not only collapse but also continuity. One important aspect of

continuity was the survival of numerous enterprises. According to Table 3.1 there were 2.1 million firms in West Germany in 1950 with an average of 6.69 employees each. Despite the wave of new business starts following World War II – which is discussed in more detail below – it is hardly likely that all, or even most, of these firms were starting completely from scratch. The relatively high average number of employees per enterprise is in itself an indication of this.[32] Hence, the majority of these firms will already have been in existence prior to 1939.[33]

Table 3.1 also shows that in the three dominant sectors – manufacturing, trade and services – average firm size, measured in numbers of employees, was already growing in the 1950s and 60s, a basic trend which indicated that the enterprise sector was enjoying stable development. In contrast, the figures for the energy, water and mining sectors underscore the structural change that has taken place in Germany over the past 50 years.

As already mentioned, Germany experienced a wave of business starts in 1945, as large numbers of local citizens and ethnic Germans expelled from the former German territories of Eastern Europe tried to build a new life for themselves (see Schierenbeck (1991), p. 76). The evolution of these enterprises is particularly interesting because they can be regarded as prototypes of the enterprises that were set up in Central and Eastern Europe after 1989. The statistics show that "two thirds of the new firms that were set up after the war disappeared again after only a few years." (Schierenbeck (1991), p. 76) Many failed because they were unable to come to terms with the hard budget constraints that were imposed with the advent of the new currency, the D-mark, and also because, after years of working in what had been a more or less centrally planned economy, they

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[32] Since 1850 there has been a steady upward trend in the size of companies in Germany. In 1850 there were 1.5 – 1.7 employees per firm, in 1895 1.9, in 1939 3.3 and in 1972 7.6; see Fischer (1976), p. 557.

[33] As far as craft enterprises are concerned, this assertion is supported by the following empirical evidence: in the area that became West Germany (the old Länder, excluding Saarland and West Berlin) there were 792,079 craft enterprises ("Handwerksbetriebe") in 1939; 11 years later, in 1950, 864,429 craft enterprises were counted in the same area (see Winkler, H. A. (1985), p. 189). The figure for 1950 includes subsidiary craft enterprises ("handwerkliche Nebenbetriebe") and a number of trades that were not counted as "Handwerk" in 1939.

Just how many of the firms recorded in 1950 must have existed before 1933 and therefore had experience of a free market economy can be deduced from the following statistics: 20%, i.e. rather more than 15,000 of the 72,000 firms stored in the database maintained by the firm *Kompass* in 1999 (!) were founded between 1750 and 1933.

were stuck in a way of thinking that emphasised the technical aspects and intrinsic values of products but was short on commercial expertise. "The outcome of the phase immediately preceding and following the currency reform could be described as follows: Although the young companies were initially able to earn high sales revenues with their 'ersatz' and 'utility' products, they failed to make a name for themselves and were unable to withstand the competition from the established brand-name articles. The decisions of many of the young entrepreneurs were influenced by rather dangerous aspects of mass psychology. They lacked a solid grounding in business management." (Schierenbeck (1991), p. 78)

These figures are useful as a means of comparing the respective operating environments faced by the promotional bank KfW and the promotional banks of Central and Eastern Europe. They suggest that if in the period 1948–1959 KfW had geared its activities primarily to the target group of newly established businesses, it could have got itself and – to the extent that commercial banks might have been involved in this lending business – the banking system as a whole into serious financial trouble, especially if it had concentrated on long-term loans. As it turned out, however, KfW started in the mid-1950s to concentrate on promoting an SME sector in which most of the firms, i.e. potential borrowers, had already been operating in a market environment for years or even decades and whose "institutional memory" was clearly oriented towards the market economy. Thus the risk of lending to SMEs, either for KfW or for commercial banks, was never so great as to make it impossible to achieve the goal of long-term lending on the basis of the promotional bank approach.

Box: KfW as a Promotional Bank in the New Länder of eastern Germany

This review of the post-war years may be interesting from a historical point of view, but one could argue that it is comparatively irrelevant to an analysis of whether the promotional bank approach is suitable for Central and Eastern Europe today. Yet while it would be fair to point out that in the post-war period KfW was operating only to a very limited extent as a promotional bank, this objection would certainly not apply to its role in the new Länder of eastern Germany. Between 1990 and 1997, KfW funded 107,000 loans to the target group, with a commitment volume of DM 46.4 billion (KfW (1998), p. 28). And regardless of how valid one believes a comparison between post-war West Germany and the transition economies of Central and Eastern Europe to be, there is no denying the fact that the situation in eastern Germany at the start of the 1990s was

more similar to that of other Central and Eastern European states than was the situation in West Germany after World War Two.

Table 3.2: **Company Registrations and Deregistrations in the New German Länder (Selected Sectors)**

	Registrations				Deregistrations			
	Total	Industry	Craft enter-prises	Trade/ Hotels and catering	Total	Industry	Craft enter-prises	Trade/ Hotels and catering
1991	292,997		27,207	138,009	99,767		12,109	48,091
1992	214,316	9,820	22,366	98,822	120,768	3,398	11,028	62,316
1993	190,032	8,663	20,630	85,767	119,557	2,938	11,351	60,757
1994	170,782	8,976	19,838	74,068	119,300	3,377	12,573	59,251
1995	170,204	10,508	19,493	73,373	131,187	4,577	15,232	65,262

Source: Federal Statistical Office

This is especially true of small and medium-sized enterprises, which, apart from some 150,000 private craft enterprises, manufacturing and service businesses that already existed in eastern Germany when it was still the GDR (Giese (1995), p. 505), could only have emerged after 1990. Table 3.2 gives an indication of the development of this sector over the period 1991–1995 based on the number of companies registering for the first time and on those deregistering.

Clearly, as in post-war West Germany, the first two years after German unification saw new businesses mushroom, especially in the trade and the hotel and catering sectors. However, also like their counterparts in post-war West Germany, only some of the new businesses proved capable of surviving. Thus, while the number of new registrations tended to decline in the first half of the mid-1990s, there was a steady rise in the number of firms deregistering. In 1995 the net increase in the number of firms based in the new Länder was only 40,000, as against nearly 200,000 back in 1991.

At the same time, there was a rise in the incidence of insolvency proceedings and the total volume of claims filed in connection with these proceedings (see Table 3.3). In

1995 the claims against firms in the new Länder and Berlin amounted to over DM 8.9 billion, or 38.5% of all claims registered against enterprises and self-employed professionals in the Federal Republic as a whole.

Table 3.3: **Number of Insolvency Proceedings and Total Claims Filed Against Companies and Self-Employed Professionals in the New Länder**

Year	No. of insolvency proceedings	Total claims filed (in DM billion)
1991	392	n.a.
1992	1,092	4.51
1993	2,327	4.93
1994	3,911	4.5
1995	5,874	8.94*
1996	7,419	n.a.
1997	8,126	n.a.

* incl. Berlin (West)

Source: Federal Statistical Office, *Fachserie 2, Reihe 4.1* and *Reihe 4.2*

Germany's commercial banks fuelled the start-up boom in the new Länder with credit, much of it with special funds, provided in particular by KfW.[34] But there can be no doubt that KfW's promotional activities would not have been possible if the West German banks had not been so swift to move into eastern Germany. This was crucial for the first two eastern German SME programmes launched by KfW in February and July 1990 – and indeed, not only for those two: "Both programmes had to be routed through banks. The rapid construction of the banking industry in East Germany ensured a quick start for these programmes." (Harries (1998), p. 165)

Eventually, though, more and more SMEs experienced problems servicing their loans from commercial banks. Thus, every year since 1994 the Bundesbank's annual analysis of the earnings situation of German credit institutions has mentioned considerable writedowns at the eastern German banks, presumably caused by defaults on the part of the large number of "young enterprises" that borrowed from them.[35] As a consequence,

[34] See Giese (1995), p. 506.

[35] See Bundesbank (1995), p. 29, Bundesbank (1996), p. 40, Bundesbank (1997), p. 46 and Bundesbank (1998), p. 41.

commercial banks began to be more and more restrictive in their lending to the SME sector. Various officials of professional associations and political representatives of the SME lobby criticised this business policy, which they interpreted as unjustified credit rationing on the part of the banks. Against the background of the arguments put forward by the advocates of the promotional bank approach for Eastern Europe, it is interesting to note that KfW itself rejected these criticisms and defended the commercial banks against the charge of unfair discrimination (Harries (1998), p. 174).

Ultimately, the rediscounting institutions were also affected by the economic difficulties of eastern Germany's SME sector. Between 1994 and 1997 "write-downs of and value adjustments on loans and certain securities and increase of allowances for possible loan losses" which KfW had to undertake rose by 127%, while claims against customers increased by only 28% during the same period, and total assets by only 8.6%. Although the 1997 Annual Report makes no explicit mention of regional differences, the trend among eastern German SMEs suggests that when the Notes on the Financial Statements speak of "the higher risks to the bank on domestic SME finance and on equity finance with venture capital" (KfW (1998), p. 96) which necessitate higher provisioning, they are referring in particular to KfW's investments in eastern Germany.

Thus, according to the figures and statements issued by the German banking system, in these days of economic and institutional renewal, lending to the target group in eastern Germany is clearly a relatively risky business. Yet the banking and financial system of the Federal Republic of Germany was and is strong enough to absorb these risks. For one thing, SME business is far from being the most important activity of Germany's banks; for another, business in other areas has been good over the past few years, driven not least of all by the steady downward trend of interest rates since 1994. Another reason why the level of risk in the SME business is relatively limited is that over the past ten years a massive transfer of personnel and know-how from West to East has taken place. To borrow from the terminology of development finance, the eastern German banking system has been on the receiving end of a vast array of development policy instruments: Both the downscaling and the upgrading approaches to financial institution building have been pursued – in the shape of training programmes, on-the-job training, the appointment of western German management staff, and the introduction of western German corporate governance structures, either through takeovers of existing

institutions (e.g. the savings banks)[36] or through the aggressive expansion of branch networks (private commercial banks)[37]. In other words, the formerly West German banking industry has implemented a huge technical assistance programme for the eastern German banking system.

Thus, in the reconstruction of the eastern Länder, the enlarged Federal Republic of Germany is now benefiting for the second time from a long tradition of banking and a body of experience which it has built up continuously since the early 19th century. Yet whereas in Germany there is a banking system strong enough to organise the building of a commercial banking sector in the former GDR on its own, in the other Central and Eastern European countries no such banking system existed.

3.4 The Financial and Banking System of the Federal Republic of Germany: A New Beginning Based on a Long-Standing Tradition

Continuity amid change after 1945 characterised not only the enterprise sector but also the German banking system. Table 3.4 shows clearly that although there were fewer private commercial banks, co-operative banks and savings banks in 1950 than in 1939, it would be misleading to say that after 1945 the institutions that made up German banking sector had to be rebuilt from the ground up.[38] Indeed, the number of employees in the banking system rose during this period by roughly 10%.

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[36] See Giese (1995), p. 505

[37] See N.N. (1992), p. 358.

[38] Even the breakup of the big banks, which took place on the orders of the American authorities, was reversed in 1957; see Pohl, M. (1983), pp. 231 ff

Table 3.4: **Changes Within the Western German Banking Sector 1939–1950 in Terms of No. of Workplaces and Employees**

Categories of banks	No. of workplaces				No. of employees			
			1950 vs.1939				1950 vs. 1935	
(based on the 1959 workplace counting system)	1939	1950	+/-	of which, workplaces with 200 or more employees	1939	1950	+/-	of which, workplaces with 200 or more employees
Public-sector banks	274	295	+21	+5	5,547	8,952	+3,405	+2,278
Private-sector banks	1,849	1,723	-126	+7	33,684	39,916	+6,232	+3,456
Co-operative banks	8205	6,213	-1,992		23,918	22,220	-1,698	-2
Credit institutions regulated by public law	234	274	+40	+6	7556	10,423	+2,867	+3,079
Savings banks	4,044	3,647	-397	-2	36,619	36,802	+243	-350
Other	1,211	1,973	+752	+4	3,869	7,429	+3,560	+1,226
Financial, banking and stock trading sectors, total	15,827	14,125	-1,702		111,193	125,802	+14,609	+9,687

Source: Essenwein-Rothe, I. (1959), p. 58

The “institutional memory” of the banking sector was even better endowed than that of the enterprise sector – many banks can trace their activities back to the second half of the 19th century. Indeed, if one includes the private bankers who played a major role in the founding of joint stock banks during the 1870s, the traditions go back even further, some as far as the early 19th century (see Pohl, H. (1982) and Pohl, M. (1982, 1982a)).

The post-war West German banking system not only emerged from a long and for the most part market-oriented process of development, but was also immediately in a position to provide financial services to enterprises throughout the country, as Table 3.5 shows.

Table 3.5: **Workplaces and Employees in the Financial and Banking Sector on the Territory of the Federal Republic of Germany as of 13 Sept. 1950**

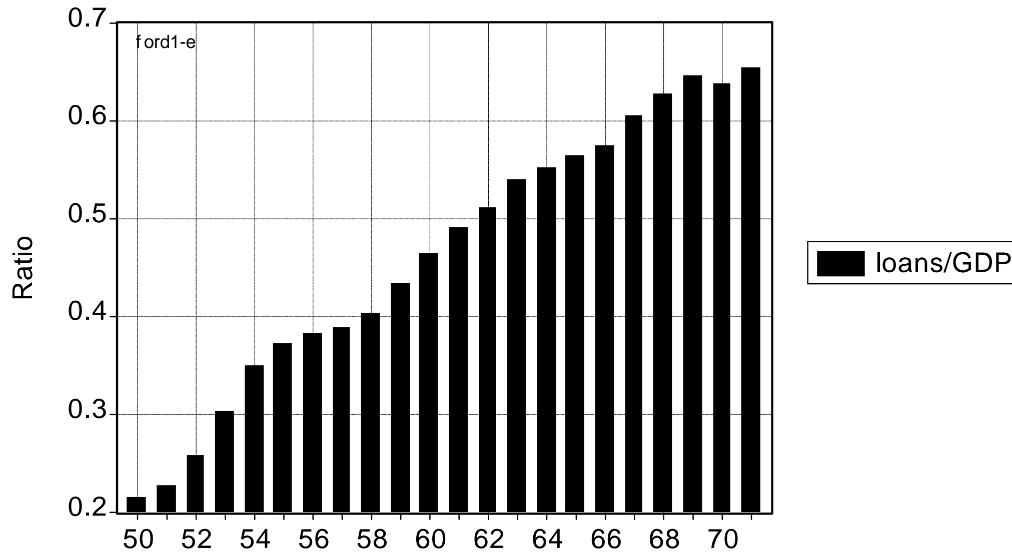
	Workplaces			Employees		
Länder of the Federal Republic	total	in %	per 10,000 inhabitants	total	in %	per 10,000 inhabitants
Schleswig-Holstein	982	7.0	3.3	6258	4.9	24.1
Hamburg	499	3.5	3.1	8213	6.5	51.5
Bremen	106	0.8	1.9	2445	1.9	43.8
Lower Saxony	2188	15.5	3.2	14787	11.7	21.6
North Rhine-Westfalia	2746	19.5	2.1	29371	23.1	22.2
Hesse	1002	7.1	2.3	14133	11.2	32.7
Rhineland-Palatinate	924	6.6	3.1	7832	6.2	26.1
Bavaria	2463	17.5	2.7	22942	18.1	25.1
Baden-Württemberg	3180	22.5	4.9	20787	16.4	32.1
	14090	100.0	3.0	126768	100.0	26.5

Source: Essenwein-Rothe, I. (1959), p. 60.

Immediately after the currency reform, the banks started lending to firms and private individuals again – hesitantly at first, but increasing steadily as the years went by. As Fig. 3.1 shows, the total volume of outstanding loans issued by the banking system to enterprises and private individuals grew continuously throughout the period 1950–1971 from 21% to 65% of gross domestic product.[39]

[39] During this period, loans to enterprises and private individuals as a share of the combined total assets of the banking system fluctuated within the narrow band of 51–57%.

Fig. 3.1: Outstanding Volume of Loans to Enterprises
and Private Individuals in Relation to GDP, 1950 - 1971

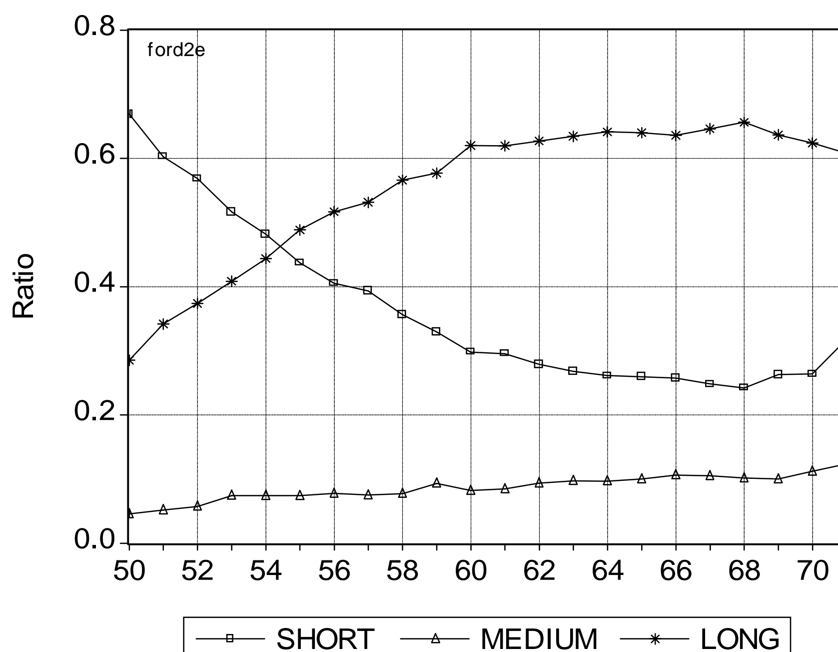


Source of Basic Data: Deutsche Bundesbank, Federal Statistical Office

Whereas initially – not least because of the macro- and microeconomic risks associated with Germany's political and economic renewal – most loans were short-term, by 1955 the volume of long-term loans relative to total lending volume had already overtaken that of short-term loans (see Fig. 3.2).[40] The volume of long-term loans continued to rise in relative terms until 1960, when it settled at around 60% of total lending.

[40] Until 1968 loans with an agreed term of under 6 months were regarded as short-term. Loans with maturities of between 6 months and 4 years were medium-term and loans with terms of 4 years upward were classified as long-term. After 1968 the threshold for short-term loans was extended to one year, in line with international standards; see Bundesbank (1988), p. 40.

Fig 3.2: Short, Medium and Long-Term Loans in Relation to Total Outstanding Volume of Loans to Enterprises and Private Individuals



Source of Basic Data: Deutsche Bundesbank

That the German banking system was efficient in its lending operations can be deduced from the differential between lending and borrowing interest rates.[41] As Fig. 3.3 shows, the differential between loan and deposit interest rates never exceeded 7.5 percentage points, even if the (low) rate of interest on savings deposits with statutory notice periods is taken as the representative deposit interest rate.[42]

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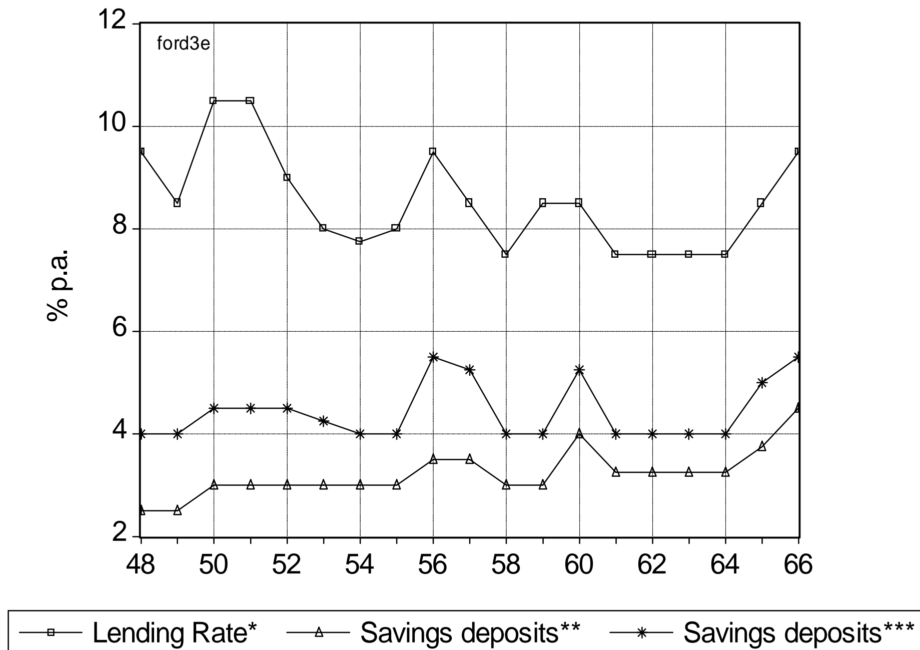
[41] On the validity of interest rate differentials as an indicator of efficiency, see Johnston/Pazarbasioglu (1995).

[42] It should be pointed out that until 1967 the commercial banks' loan and deposit interest rates were tied to the rates set by the Bundesbank. Nonetheless, the interest rate differential can still be seen as an indicator of efficiency because the German banking system was able to earn a profit with these spreads.

Fig. 3.3: Credit Institutions' Interest rates on Loans and Deposits as of Year-End, 1948 - 1966



Source: Deutsche Bundesbank

* = advances on current account
** = with statutory withdrawal notice
*** = term deposits, 12 months to 4 years

The figures and trends presented above tell us nothing about the extent to which small and medium-sized enterprises had access to long-term loans prior to 1971. Hence they also give no indication of whether and to what extent KfW, in the role it assumed in the West German banking system from 1971 on, namely as a promotional bank, helped to counteract a market failure with regard to the financing of SMEs. However, what the analysis does show is that the German commercial banks, thanks to their (lending) experience acquired in a market-based economic environment, were already in the first few years after the currency reform an important source of finance, in both quantitative and also qualitative terms, for the German enterprise sector as a whole. Corporate lending in general and also long-term corporate lending were already successful and profitable businesses for the banks in 1955, and all the more so in 1971.

Accordingly, the analysis shows that the development of the West German financial system and the example of KfW cannot be cited as empirical evidence to support the claim that a promotional bank can help commercial banks to develop the financial

expertise they require in order to engage in long-term lending. The German commercial banks had developed the capacity for long-term lending to enterprises long before KfW started to provide funding for long-term loans to small and medium-sized enterprises on a significant scale. KfW may have promoted long-term lending to the *target group*, but it did not promote long-term lending as such, since at that time the commercial banks were already issuing long-term loans and applying the appropriate technology as a matter of routine.

3.5 KfW's Corporate Governance Structure

One of the criticisms levelled against the promotional bank approach is that the state, as the main or indeed the sole owner of the bank, may influence its operations to such an extent that decisions are no longer based (solely) on banking criteria but are dominated by considerations of political expediency or, in the worst case, motivated by the desire for personal gain, i.e. there is a danger that the bank's policies will be determined by corruption and nepotism. This criticism is founded in the problems that have been encountered at development banks all over the world, as mentioned in the introduction (The World Bank (1989), pp. 67ff).

Advocates of the promotional bank approach counter this argument by pointing out that, while this problem may be endemic to development banks, promotional banks are immune to it because they generally function merely as a provider of funds to the private commercial banks and it is the latter institutions which bear liability for the loans. As described above, however, the present-day promotional bank KfW has in the past – and particularly during its first few years of operation – also acted as a direct lender on a large scale. And those who favour the promotional bank approach are openly willing to concede that the promotional banks of Central and Eastern Europe will also be forced to resort to the instrument of direct lending, especially during the start-up phase. Nonetheless, they take the view that it will be possible to prevent abuses of the system, and thus the ultimate failure of the approach, provided that the right people are appointed to the supervisory bodies, including representatives not only of the government but also of other institutions, including some from the private sector. The corporate governance structure of the institution, as defined in the respective act of parliament establishing the bank and in its charter, is therefore seen as a decisive factor for success.

These considerations also played an important part in the founding and development of KfW. As mentioned earlier, the Law Concerning the Kreditanstalt für Wiederaufbau delineated the institution's functions by making the "13 Principles" more specific. Also noteworthy in this context are the following provisions of the Law and KfW's charter:

- Article 7, paragraph 1 of the Law stipulates that the Chairman of the Board of Directors and his Deputy must be "personalities with special experience in financial affairs".

- According to the version of the Law dated 5 November 1948, the Board of Directors was to be composed of, alongside the Chairman and Deputy Chairman, three representatives of central government (initially the Economic Council, then, once the Federal Republic had been established, the Federal Government), three representatives of the Länder, one representative of the Bank deutscher Länder, three representatives of trade unions, four representatives from the banking sector and one representative from each of the following sectors: industry, agriculture, craft/skilled trades and housing. Given that the Chairman and Deputy Chairman, "personalities with special experience in financial affairs" came from the banking industry, this meant that the representatives of the shareholders – the Federal Government and the Länder – were in a minority on this supervisory body. Moreover, the (private) enterprise sector and the commercial banks had a built-in majority insofar as the vote of the Chairman counted double in the event of a tie. Although these allocations of power are, for the most part, of little practical relevance insofar as an effort is generally made to reach decisions by consensus, the governance structure, at least at a formal level – i.e. as defined in the first KfW Law and the Charter – does not give any indication that the institution was state-dominated.

The key factor behind the success of KfW as a bank for reconstruction – and in this the two frequently cited authors of KfW's history are in agreement (Pohl, M. (1973), pp. 18ff, Harries (1998), pp. 18ff) – was not so much the formal terms on which it was founded, but rather the outstanding personalities of the individuals appointed as Chairman and Deputy Chairman, namely Dr Otto Schniewind and Hermann J. Abs. Both were without a doubt "personalities with special experience in financial affairs", who before taking up their posts at KfW had for much (Dr Otto Schniewind) or indeed all (Herman J. Abs) of their professional lives held executive positions at large commercial banks.

Yet bankers exercised a dominant influence not only through their chairmanship of the Board of Directors but also, and indeed, especially on the Board of Management. Article 6 of the KfW Law allowed the Board of Directors to appoint one of its members to the Board of Management, and on the basis of this clause, dubbed "Lex Abs", Hermann J. Abs was called to serve on that executive body, thereby becoming the "key figure in the allocation of funds" (Pohl, M. (1973), p. 45) during KfW's earliest years. Abs repeatedly insisted, both to the commercial banks and to the government,[43] that KfW loans should be executed through the banks. Thus, he was unmoved by complaints from the banks against the "strict rules applied by KW in cases where the final borrowers or the banks defaulted on their loans" (Pohl, M. (1973), p. 49). Furthermore, he took the standpoint that a limit on the liability of the commercial banks should be granted only in those cases "in which the final borrower could theoretically be regarded as eligible to issue securities", as he was aware of the moral hazard problem facing KfW if it agreed to cover (part of) the (credit) risk, namely that "individual banks would be overly generous in their lending" (Pohl, M. (1973), p. 49). It was again Abs who rejected calls for Industriekreditbank to have a monopoly as the channelling institution for KfW's industrial loans. "He also wanted other credit institutions to be involved, leaving the choice up to the final borrower. At the same time, he was against giving Industriekreditbank the exclusive right to perform credit analysis." (Pohl, M. (1973), p. 48).

Thus it was – not exclusively but in particular – thanks to Abs' personal qualities that KfW succeeded in maintaining the balance between state ownership and sound banking practice that it was designed to achieve, not only in its operations but also in the basic thrust of its business policies towards its main partners, namely the government and the commercial banks. Abs "was able to prevent the KfW from encroaching on the territory of the still dismembered big commercial banks – e.g. from acting as principal banker to the large public sector of the economy, as the Reichs-Kredit-Gesellschaft had done up to the end of the war to the annoyance of the major banks. He was in a position to ensure that the KfW kept within its limits as he saw them. On the other hand, his influence on the private banking sector also helped the KfW to market its credit and its bonds on the

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[43] Even before they were appointed to KfW's Board of Directors, both Dr Schniewind and Hermann J. Abs had demonstrated that they were strongly averse to attempts by politicians to sway banking policy, and were willing to resign rather than bow to political pressure. Shortly before joining KfW's Board they had turned down offers to lead the Bank deutscher Länder because they failed to win for the ruling council of the Bank the right to veto loans to the public sector (see Pohl, M. (1973), pp. 21f, and Harries (1998), p. 20).

liabilities side of the balance sheet. Much convincing had to be done in both cases in the beginning." (Harries (1998), p. 20).

Whereas political influence on KfW's operations, especially in the initial years, was relatively minor, both formally and in terms of substance,[44] it increased steadily as time progressed, at least at the formal level. The amendment of the KfW Law, passed at the end of 1951, already shifted the balance of power on the Board of Directors: the Federal Government, the Länder and, for the first time also the municipalities, could now designate a total of 11 members, as opposed to the previous six, while the number of representatives from the banking industry and the (private) enterprise sector was raised by only one, from eight to nine, so that they now accounted for only one third of the Board's membership.[45] The dominance of the political sphere is also reflected in the fact that, since 1973, the current Federal Minister of Finance has automatically been named Chairman of the Board of Directors. In response to a critical enquiry as to whether this arrangement was in accordance with the terms of Article 7, sentence 7 of the KfW Law, the then Minister of Finance Helmut Schmidt remarked "that, as the head of the Money and Credit department at the ministry, he was ipso facto particularly experienced in the banking field – an approach which all his successors were happy to adopt."[46]

Did these changes turn KfW into an institution whose operations are no longer conducted according to sound banking principles? The empirical evidence suggests that it did not.[47] However, the history of KfW shows that an evolution in that direction cannot be eliminated through laws and statutes but only by the individuals actively involved, be they politicians, bankers or representatives of particular interest groups within the economy. That Helmut Schmidt and his successors to the office of finance minister were, are and will be chairmen of KfW's Board of Directors, and not – as in the

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[44] Harries (1998), p. 44, implies that this could by no means have been taken for granted; otherwise he would hardly have thought it necessary to state that "No clear priorities are discernible... in the financing of manufacturing industry between 1949 and 1953; hence it must be assumed that funds tended to be allocated fairly indiscriminately – a practice that is particularly prevalent whenever political pressure distorts the policy priorities."

[45] In 1997, 17 of the 35 members of the Board of Directors were delegates from local, regional or Federal government bodies, while the (private) business sector and the banks each held seven seats and the trade unions four.

[46] Harries (1973), p. 109. Harries also mentions other developments that subjected KfW to increased political pressure during the 1970s.

[47] Harries speaks of a "harmonious balance" (Harries (1998), p. 110) between the public-sector shareholders and sound banking practice.

1950s and 60s – qualified bankers, is of relatively little consequence for KfW's business operations as long as it conducts most of its transactions through the banking system and as long as the politicians, represented by the finance minister, adhere to this principle. But whether this remains the case depends on the willingness of politicians to continue along this road; it cannot be guaranteed by the wording of the institution's charter or by legislation: "It must be remembered that key questions, such as subsidiarity, the public interest in the context of financing or the KfW's relationship with commercial banks, can be regulated only imperfectly through legal concepts. More important is close and constructive collaboration between the German government, the KfW and the commercial banks in keeping with the particular needs of the epoch." (Harries (1998), p. 16)

The lesson to be learned from KfW's history is therefore that laws, articles and regulations cannot in themselves be regarded as the decisive factors in ensuring that a promotional bank is able to successfully pursue its allotted tasks. It is therefore necessary to examine whether in the countries of Central and Eastern Europe the promotional bank approach can offer ways, independently from the setting of formal parameters, of ensuring "close and constructive co-operation" between the government, the promotional bank and the commercial banks of those countries based on the subsidiarity principle.

3.6 Lessons from KfW's History for the Promotional Bank Approach in Central and Eastern Europe

Analysis of KfW's history indicates that if one's aim is to demonstrate that the promotional bank approach can be applied successfully in an economy that is undergoing a phase of reconstruction, then KfW itself is not necessarily an appropriate example to take. It should be remembered that during the actual reconstruction phase – i.e. the years 1949–1959 – KfW's main activity was not the promotion of small and medium-sized enterprises but the financing of primary industry, housing and infrastructure projects, i.e. the kind of business which, according to the theory behind the promotional bank approach, should be a mere adjunct to the institution's core business, SME finance. Moreover, much of the financing was provided in the form of direct loans. In other words, KfW was successful as a bank for reconstruction despite the fact that it neither lent predominantly to small and medium-sized enterprises, nor did

it mainly channel funds via commercial banks to the final borrowers, i.e. despite the fact that it did not actually apply the promotional bank approach at all.

In the mid-1950s KfW began to operate as promotional bank for SMEs. Its lending was limited at first, and it had to overcome considerable resistance on the part of the commercial banks. It was not until 1971 that the activities of an ideal-typical promotional bank became KfW's core business, which they have remained ever since.

By 1971, however, both the SME sector and the banking system were operating again in established structures whose origins in Germany can be traced well into the second half of the 19th century. These structures had developed endogenously under market conditions, interrupted only by the First World War and the Nazi era. Many of the small and medium-sized enterprises that emerged after World War II could therefore look back on a long tradition, and thus had considerable experience of operating in a market environment and also a sizeable core of experienced personnel. In a qualitative sense, the picture was the same in the banking sector, which also very quickly resumed its traditional role, namely as a provider of (long-term) corporate finance.

In the Federal Republic of Germany, KfW did not assume the role of a promotional bank until mature market conditions prevailed in the SME and financial sectors. In other words, the main problem which the promotional bank approach is designed to address – the difficulty experienced by SMEs in gaining access to long-term loans from the commercial banks in order to be able to compete with the large firms – was the only one that remained to be solved by the time KfW became a promotional bank in the classic sense. In the Federal Republic of the early 1970s, many of the other typical obstacles to SME finance did not exist, or no longer existed. Against this stable background in the enterprise and financial sectors, changes in KfW's corporate governance structure were largely irrelevant.

When the Berlin Wall came down and KfW became a promotional bank for eastern German enterprises, it was again able to operate through a stable, well-established financial and banking system. The West German commercial banks had very rapidly established themselves in the new Länder and had engineered a huge transfer of know-how and capital. Even under these favourable conditions, however, many of the newly established firms in the east found themselves in a precarious situation soon after 1990, and their problems were reflected in the balance sheets of the banks that had lent to them, and of the second-tier institutions that had provided the funds. In this respect, the

example of the Germany’s eastern Länder may perhaps serve as an indication of the scale of the difficulties confronting the promotional bank approach in the countries of Central and Eastern Europe where no such banking system exists.

4. SMEs, Banks and Enterprise Financing in Transition Economies

4.1 Promotional Banks in the Transition Economies: How Their Market Environment Differs from the Environment in which KfW Operated in Post-war West Germany

The key argument that is advanced to demonstrate the suitability of the promotional bank approach as a means of overcoming the credit rationing to which SMEs are subject in Central and Eastern Europe and the New Independent States is that empirical evidence can be cited to show that KfW has performed this function in the Federal Republic of Germany. However, the discussion presented in the preceding chapter showed that KfW did not really begin to serve as a promotional bank in the strict sense until fairly late in the game, and specifically that it hardly ever assumed this role during the years 1948–1959, i.e. during the immediate post-war period. Thus, in West Germany the concept of the promotional bank did not have a chance to prove its practical worth until after the post-war period of change and transition – especially for the enterprise sector and the banking sector – was largely over.

Nonetheless, it is important to look closely at the situation faced by Germany after 1945 (or, as the case may be, after 1948), and that of the Central and Eastern European countries and the NIS after 1989, to see what they have in common and how they differ. Even a superficial comparison shows that, especially if the focus is on economic aspects, there are more differences than similarities. Indeed, "unlike the situation in Western Europe in 1947/48, Eastern Europe is not faced with the consequences of wartime devastation, but rather with the results of a process involving the destruction of the foundations of economic activity over a period of at least 35 years, and in some cases 70 years. People there were not forced to do without a market economy for ten years; for Eastern Europeans, the market economy is a completely unknown system whose workings have never even been described to them." (Hahn (1992), p. 756)

In Germany after the Second World War, large parts of a stock of real capital that had been created under the conditions of a market economy had been physically destroyed. By contrast, in Central and Eastern Europe and the Soviet Union in 1989 the stock of real capital that had been accumulated under a system of central planning, while perhaps outdated, was still physically intact. However, the citizens of states bordering on the EU were the only people in this large group of countries who might still have known something about a market-based system and the institutions needed to make it function.

In post-war Germany, though, the older generation, i.e. those over 40, could draw on their own experience acquired prior to 1933 in a market economy, and were familiar with the workings of the institutions that underpin a market system.

A classification of the individual transition economies in terms of the level of economic development they achieved prior to the Second World War underscores the significance of this difference in terms of countries' historical exposure to and experience with a market-based system. For example, the "Visegrad countries" – i.e. the Czech and the Slovak Republics, Poland and Hungary – and also Slovenia and Croatia were all once part of the Austro-Hungarian Empire, and later, either as independent states or as parts of Yugoslavia, they all underwent a process of development quite similar to that experienced by Germany. But this was not true, or true to only a very limited degree, of the countries of Southeastern Europe and Ukraine, Russia and the other CIS countries.[48] This institutional and economic heritage is also one of the factors which can be cited to explain why, ten years after the initiation of the transition process, a comparison of the individual countries' progress and successes in reforming their economic systems yields a clear ranking along regional lines (see EBRD (1998), p. 29, and Fig. 4.1). If the relative degree of progress is measured with the help of a reform index based primarily on "soft" institutional factors,[49] the Visegrad countries and Slovenia and Croatia have travelled the farthest along a road that is seen as eventually leading to the creation of a proper market economy, while the former Soviet republics in Central Asia still have the longest way to go.

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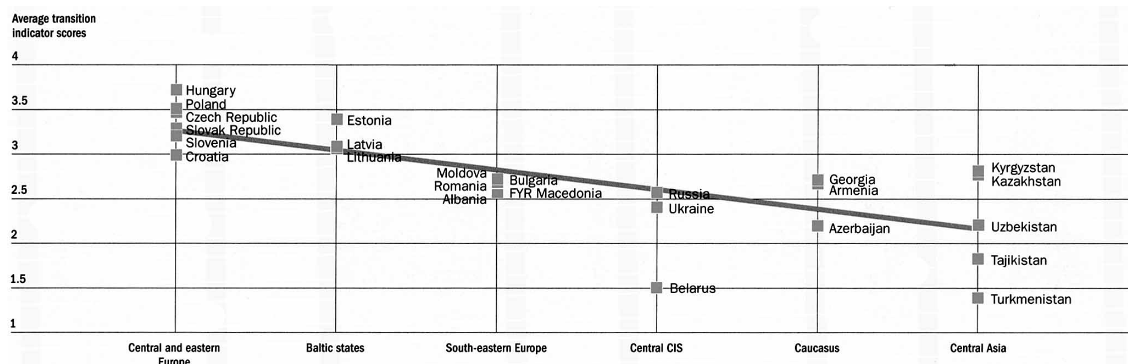
[48] According to Borchardt ((1984), p. 75), these differing national levels of development have their origins in pre-industrial times. He finds evidence of considerable differences in pre-industrial Europe between the "comparatively advanced countries of the North-west, the Mediterranean countries which had once been the most advanced but had in the meantime become relatively backward, and the relatively undeveloped countries in the East".

[49] In addition to the share of gross domestic product generated by the private sector, the index draws on qualitative assessments of the progress made in the reform of enterprises, markets and trade, and the financial-sector reform; see EBRD (1998), pp. 26f.

Fig. 4.1: **The Transition to a Market Economy: How Countries and Regions Compare**



Source: EBRD (1998), p. 29

These regional differences are important because an assessment of the promotional-bank approach must not only take into account the many fundamental ways in which the economic and institutional environment found in the transition economies in 1989 differed from the one that existed in West Germany in 1948. It is also essential to bear these differences, highlighted by the above chart, in mind as they have significant implications for the development of small and medium-sized enterprises and of commercial banks – two sectors that are of central importance for this approach.

4.2 Characteristics of the Private Small and Medium Enterprise Sector in Transition Economies

The transition process which began in 1989 gave the countries of Central and Eastern Europe and the states which were to emerge from the Soviet Union an opportunity to officially permit, and indeed encourage, private economic initiative for the first time in decades. Table 4.1 shows the progress that has been made in "re-privatising" economic activity in the former socialist countries since 1989, as measured by the share of gross domestic product generated in the private sector.

The growth of the private sector in these countries over the last ten years has had two sources: the privatisation of former state-owned enterprises and the creation of new businesses. Although the focus in the initial period following the end of communism was almost exclusively on efforts to privatise and restructure the state-owned firms,

today it is clear that the private sector in transition economies consists primarily of new enterprises, i.e. ones founded since 1989.[50] This is why the vast majority of the private enterprises operating in transition economies are small and micro enterprises, as is underscored by the data on the size distribution of registered enterprises (see Table 4.2).

Table 4.1: **The Share of Gross Domestic Product Generated in the Private Sector (%), 1989/1998**

Country	1989	1998
Albania	na	75
Armenia	8.1	60
Azerbaijan	na	45
Belarus	1.2	20
Bosnia and Herzegovina	na	35
Bulgaria	7.2	50
Croatia	8.5	55
Czech Republic	4.1*	75
Estonia	17.7**	70
Georgia	17.6	60
Hungary	22.4	80
Kazakstan	15.0	55
Kyrgyzstan	na	60
Latvia	na	60
Lithuania	10.4	70
Moldova	na	45
Poland	28.6	65
Romania	13.0	60
Russia	5.3	70
Slovak Republic	4.1*	75
Slovenia	8.3	55
Tajikistan	na	30
Ukraine	8.8	55
Uzbekistan	9.8**	45

* Czechoslovakia
** 1991

Source: EBRD (1993), pp. 62f; EBRD (1998), p. 26

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[50] See EBRD (1995), p. 139. This is due not least to the fact that while it proved possible to rapidly privatise small medium-sized state enterprises, the number of such enterprises was relatively small, given the preference for large-scale economic units which was characteristic of central planning. The privatisation of large enterprises turned out to be considerably more difficult than the transfer of smaller operations to private ownership, and this continues to be the case.

Table 4.2: **Small and Medium-Sized Enterprises in Selected Transition Economies**

Country	Number of registered enterprises (total)	Small and medium-sized enterprises: breakdown by number of employees				
		0-9	10-49	10-99	50-249	100-499
Albania						
1994	45,751	44,951		728		72
1995	57,068	56,193		807		68
1996	59,019	57,495	966		436	
1997	61,445	59,984	937		411	
Azerbaijan						
1994	992	0		0		992
1995	1,227	0		0	*100-249 employees*	1,277
1996	13,926	11,862		1,944	19	
1997	17,151	13,556		3,411	89	
Belarus						
1996	na	na		na		na
1997	21,279	na		na		na
Bulgaria						
1994	na	na		na		na
1995	187,602	168,840		190		
1996	52,043	na		na		na
1997	na	na		na		na
Croatia						
1994	134,289	45,500		4,145		885
				50-200 employees		
1996	55,428	3,442		896		na
1997	52,616	3,850		824		na
Czech Republic		*0-24 employees*		*25-99 employees*		
1994	167,013	147,347		12,482		5,463
1995	203,472	183,763		13,364		5,274
1996	236,535	215,903		14,506		5,098
1997	na	na		na		na

Country	Number of registered enterprises (total)	Small and medium-sized enterprises: breakdown by number of employees				
		0-9	10-49	10-99	50-249	100-499
Estonia						
1994	21,934	14,721		6,493		639
1995	24,220	16,727		6,825		597
1996	25,130	18,498	5,797		1,196	
1997	15,586	18,856	5,839		1,161	
Georgia						
1995	na	8,200	1,400			na
1996	27,437	20,578	5,487		1,372	
1997	40,908	30,681	8,182		2,045	
Hungary						
1994	101,247	59,037		34,577		7,633
1995	116,928	87,885		22,293		6,750
1996	1,049,590	1,016,641	26,678			na
1997	998,264	965,754	26,738			na
Kazakstan						
1994	55,193	32,564		19,336		2,893
1995	na	na		na		na
1996	na	na		na		na
1997	na	na		na		na
Kyrgyzstan						
1994	7,233	1,367		1,231		95
1995	na	na		na		na
						100-240 employees
1996	5,106	5,106		388		55
1997	na	na		na		na
Latvia			*10-25 employees*		*>25 employees*	
1994	na	na	na			
1995	17,539	12,581	2,633		1,947	
1996	na	na	na		na	
1997	na	na	na		na	

Country	**Number of registered enterprises (total)**	**Small and medium-sized enterprises: breakdown by number of employees**				
		0-9	**10-49**	**10-99**	**50-249**	**100-499**
Lithuania						
1994	33,659	na		na		na
1995	35,445	46,902		7,512		1,434
1996	48,778	33,071	10,243		5,464	
1997	54,172	na	na		na	
Macedonia						
1994	29,157	na		28,557		600
1995	32,881	na		na		na
1996	34,592	na	34,061		531	
1997	33,445	na	32,934		521	
Moldova						
1994	59,721					
1995	81,888					*100-249 employees*
1996	19,315	12,477		4,032		784
1997	na	na		na		na
Poland		*0-50 employees*			*51-250 employees*	*>250 employees*
1995	2,110,786	2,082,924			22,239	5,623
1996	na	na			na	na
1997	na	na			na	na
Romania						
1994	443,218	286,307		132,309		3,998
1995	499,288	na		na		na
1996	541,607	507,168	30,316		9,027	
1997	573,051	516,850	34,672		8,965	
Russian Federation						
1996	2,505,000	na		na		na
1997	2,711,000	na		na		na

Country	Number of registered enterprises (total)	Small and medium-sized enterprises: breakdown by number of employees				
		0-9	10-49	10-99	50-249	100-499
Slovak Republic						
1994	34,334	28,178		5,346		1,792
1995	41,705	34,015		6,004		1,376
1996	50,913	42,114		6,869	1,930	
1997	297,838	42,836		6,504	3,257	
Slovenia						
1994	31,300	26,000		3,000		1,100
1995	33,609	29,731		2,892		841
1996	na	na		na		na
1997	na	na		na		na
Tajikistan						
1994	10,000	4,800		490		10
1995	10,000	5,400		570		15
1996	na	na		na		na
1997	na	na		na		na
Ukraine						
1996	93,091	na		na		na
1997	na	na		na		na

Source: UN (1996, 1999)

Although caution must be exercised when interpreting the statistics compiled in the various countries, the overall pattern is unambiguous: the share of the total number of SMEs (defined as enterprises with fewer than 100 employees) which is accounted for by micro and small enterprises ranges between 90 and 95 percent, and in some countries it even exceeds 95 percent. These figures are confirmed by the results of other investigations.[51] The proportion of micro enterprises, i.e. businesses with 0 – 9 employees, is seldom lower than 70 percent, and in the more advanced countries, where it can be assumed that statistics are more accurate, shares of up to 96 percent (Hungary) are reported.

In addition to formally registered enterprises, the private sector in most countries also includes a large number of businesses that operate informally as well as sole proprietorships (one-man or one-woman businesses). The available data on such businesses show that there are up to eight times as many economic units of this type than there are officially registered businesses which have the status of autonomous legal entities (UN (1996), pp. 23f.).[52] Moreover, large informal sectors consisting of one-person businesses are found not only in the less advanced economies; informal economic activities also account for a sizeable share of total output in the countries that have made more progress in the transition to a true market economy. Thus, for example, in the mid-1990s in Hungary the informal sector contributed 26 percent of GDP, while in Estonia informal businesses accounted for 35 percent of all private economic activity (EBRD (1995), p. 140). And based on the experience of Latin American countries, it can be assumed that in recent years the share of the total workforce that is employed in the informal sector has tended to increase rather than decrease in a number of the transition economies – namely, those that have had to contend with serious macroeconomic instability and/or financial crises and the resulting adverse impacts on the level of real economic activity.

The sectoral distribution of activities also exhibits a clear pattern across the entire range of countries, with trade and service businesses accounting for the lion’s share of all SMEs and manufacturing enterprises usually making up significantly less than 30

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[51] See, for example, the overview in EBRD (1995), pp. 147ff. Studies conducted by the author and his colleagues since 1993 in Albania, Armenia, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakstan, Macedonia, Romania, Russia and Ukraine for KfW, EBRD and IFC confirm the accuracy of the figures drawn from the literature which are cited in the following.

[52] See also Borish/Noel (1996).

percent of the total.[53] And while the nature and relative importance of the various economic activities undertaken in the SME sector is fairly predictable insofar as one finds a roughly similar breakdown in almost every country, conditions at the level of the individual enterprise are rather unstable. Indeed, enterprises enter and leave its component markets so often and so quickly that national statistical offices are frequently unable to maintain accurate records on the status of registered businesses: For example, an EBRD survey of Bulgarian SMEs in 1995 found that "only 20 per cent of registered private enterprises in manufacturing were active, while the rest had gone bankrupt, relocated, changed their activities, or had never operated as enterprises, ..." (EBRD (1995), p. 140). The young businesses that make up the SME sector also frequently switch from one product or service to another, and it is not uncommon for entrepreneurs who exit one market to try their luck in a completely different line of business. In addition, a single enterprise will often engage in various kinds of activities in various sectors (EBRD (1995), p. 141).

Thus, as can be seen from the above discussion of the essential characteristics of the SME sector in the transition economies, it is quite unlike the small and medium enterprise sector that existed in West Germany after the Second World War. Of course, there is one obvious way in which it is similar to the SME sector in post-war West Germany: small and medium-sized businesses in the transition countries are now faced with the task of accumulating a stock of capital, as were Germany's small and medium enterprises after the war. But in Germany most SMEs were able to acquire the capital they needed by supplying goods and services in markets in which ways of doing business and the "rules of the game" were long established, having been shaped – and institutionalised – by a society that had historically encouraged free enterprise and individual economic initiative. Moreover, businesses in post-war Germany had the advantage of being able to operate in an overall economic environment that was relatively well known to them and also relatively stable. By contrast, the SMEs in the transition economies are operating in societies which have not yet developed or established generally recognised rules and "traditions" for the conduct of business activities. And they are also faced with an overall economic environment which is new to them and is also very unstable as well. Thus, even if the transition economies had financial systems which were as experienced in dealing with the private sector as was West Germany's financial system after the war, they still might not be any better off.

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[53] See UN (1996), pp. 29f.

Indeed, it is doubtful whether even a relatively advanced and sophisticated financial system like the one with which Germany rebuilt its economy would have the specific tools and capabilities needed to make small and medium enterprise lending a commercially viable undertaking in a typical transition economy.[54] And, as will be shown in the following section, financial and banking systems of this type do not exist in the transition countries.

4.3 The Banking System in the Transition Economies

The banks in post-war West Germany had a long history of operating in an environment shaped by the mechanisms, institutions and assumptions characteristic of a market economy, and as they entered the new era after the currency reform of 1948 they could draw upon a large number of credit relationships that had been built up within such an environment. However, the situation in the transition economies in the years 1989–1991 was quite different: in the former communist countries, financial institutions either had to be started from scratch after 40 (or 70) years of central planning (this was the case with private commercial banks) or had to be given a completely new role (this was the case with the state-owned banks). Unlike the situation in West Germany during the post-war period, the task facing the transition economies was thus "to create a functioning financial system where none had existed before." (EBRD (1998), p. 92).

By and large, the state banks that existed in almost every former communist country at the beginning of the transition process were specialised banks that had been set up when the old monobank, which was a characteristic feature of Soviet-style central planning, was dismantled with a view to creating a two-tiered banking system. How quickly such institutions were established after the formal end of the communist regime was a function of the commitment to economic reform shown by national governments. It is fair to say, though, that in the period prior to the initiation of reforms geared to restructuring the economies of the region and moving towards a market-oriented system, the economic function of these banks remained largely the same as it had been when they were divisions of the old monobank. They continued to be responsible solely for monitoring and directing the payment flows between enterprises and for mobilising the

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[54] This is an important constraint that was highlighted by Caprio/Summers in a relatively early contribution to the literature; see Caprio/Summers (1993), p. 9.

savings of private households. Under central planning, it was neither necessary nor feasible for banks to endeavour to guide the allocation of resources in such a way as to maximise the efficiency of their use, which is of course the principal function of financial systems in western market economies. Thus, as the former communist countries embarked upon their journey from central planning to a market-based system, their state-owned financial institutions were almost completely unequipped for the tasks they would face as the economic environment changed. Specifically, they had had almost no experience in assessing and managing credit risk, the use of loan security, credit monitoring and the other key elements of financial intermediation.[55]

Some transition economies responded to the challenge of creating a new banking system by adopting a laissez-faire policy in the area of bank licensing. Thus, for example, during the initial phase of the transition to a market-oriented system in the former Soviet Union a large number of new banks were licensed (see Table 4.3). At first such institutions were established by large state-owned enterprises, but soon private enterprises also began to set up banks. In most cases, though, these banks were not really intended to engage in financial intermediation. Rather, they were created in order to permit their owners to exploit the advantages offered by the "financial repression" which characterised the workings of the financial systems of most, if not all, of the former communist countries at the time; specifically, these banks were used to allow their owners to borrow at strongly negative real interest rates.[56] Hence, these institutions also went into business without having acquired the tools and skills needed to analyse the creditworthiness of enterprises. And this meant that even if the banks in transition economies had been interested in catering to the credit demand of small and medium enterprises (and most of them were not, given their intended functions and the prevailing macroeconomic conditions), they would have drawn the (false) conclusion that lending to SMEs would entail both excessively high costs and inordinately high risks, and thus that it would not make sense for them to try to serve this target group.

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[55] On this point, see also Gelb/Honohan (1991) and Caprio (1995), p. 263.

[56] The World Bank called these institutions "agent banks", while using the term "channel banks" for the state-owned institutions. See The World Bank (1993).

Table 4.3: **Number of Banks Operating in Selected Transition Economies** (figures in brackets show the number of majority foreign-owned institutions)

Country	1994	1995	1996	1997
Belarus	48(na)	42(1)	38(1)	38(2)
Bulgaria	40(1)	41(3)	42(3)	28(7)
Croatia	50(na)	54(1)	57(4)	61(7)
Czech Republic	47(13)	45(13)	44(14)	41(15)
Estonia	22(1)	18(4)	15(3)	12(3)
Macedonia	6(3)	6(3)	8(3)	9(3)
Hungary	43(17)	42(21)	41(25)	41(30)
Kazakstan	184(6)	130(6)	101(9)	82(22)
Latvia	56(na)	42(11)	35(14)	32(15)
Lithuania	22(0)	12(0)	12(3)	11(4)
Poland	82(11)	81(18)	81(25)	83(29)
Russia	Na	2295(19)	2029(23)	1697(26)
Slovak Republic	19(4)	25(9)	24(9)	25(9)
Slovenia	44(6)	41(6)	36(4)	34(4)
Ukraine	228(1)	230(1)	229(6)	227(12)

Source: EBRD (1998), pp. 154 – 197.

With the advent of stabilisation programmes, which were designed and implemented with external support (the efforts of the IMF and the World Bank played a key role here), a hard monetary budget constraint was introduced, entailing a shift to positive real interest rates – in some cases, extremely high positive real interest rates. This hard budget constraint supplanted the soft constraint that had previously been in effect, and thus the days of negative, and in some cases very strongly negative, real interest rates were over. However, the emergence of positive real rates confronted most banks, whether state-owned or private, with extremely difficult, and in some cases insoluble, problems in their lending business with enterprises. Most notably, it meant that if banks' operations in this area were to be viable, they would now have to be able to accurately assess the creditworthiness of enterprises before issuing loans to them.[57] By and large, they turned out to be incapable of carrying out sound credit analyses, and in many

[57] As regards Russia, see Winkler (1995), Winkler (1996).

transition economies the majority of banks are still unable to adequately assess credit risks, as is shown by the high arrears rates computed by the EBRD for selected national banking systems:

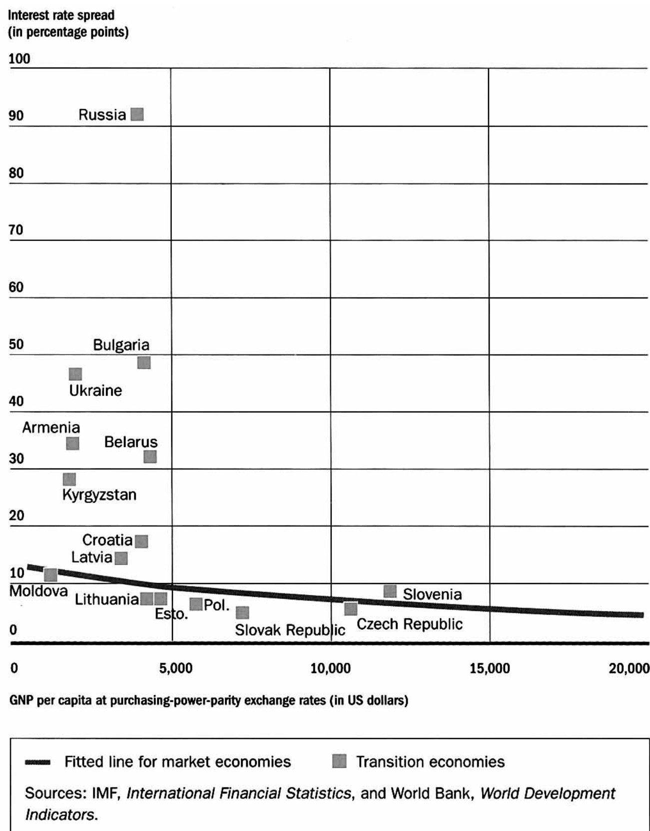
Table 4.4: **Non-performing Bank Loans in Selected Transition Economies** (computed as a percentage of total outstanding loans in the banking system)

Country	1994	1995	1996	1997
Belarus	8.4	11.8	14.2	12.7
Bulgaria	6.8	12.6	14.6	12.9
Croatia	12.2	12.9	10.7	9.8
Czech Republic	34.0	33.3	30.0	28.8
Estonia	3.5	2.4	2.0	2.1
Macedonia	na	na	42.8	35.6
Hungary	17.6	10.3	7.2	3.6
Kazakstan	na	14.9	19.9	7.7
Latvia	11.0	19.0	20.0	10.0
Lithuania	27.0	16.7	32.2	28.3
Poland	28.7	20.9	13.2	10.4
Russia	na	5.9	5.1	3.5
Slovak Republic	30.3	41.3	31.8	33.4
Slovenia	22.0	13.2	14.3	12.3
Ukraine	5	13	12	11

Source: EBRD (1998), pp. 154 – 197, p. 133

With non-performing loans ranging between 10 and 30 percent of their portfolios, “banks in transition economies have not been able to generate significant profits from customer loans” (EBRD (1998), p. vii) – despite the fact that spreads between deposit and lending rates in many countries significantly exceed the differentials found in market economies with comparable per capita income levels (see Fig. 4.2).

Fig. 4.2: **Spread Between Deposit and Lending Rates in Selected Transition Economies and Per Capita Income Level**



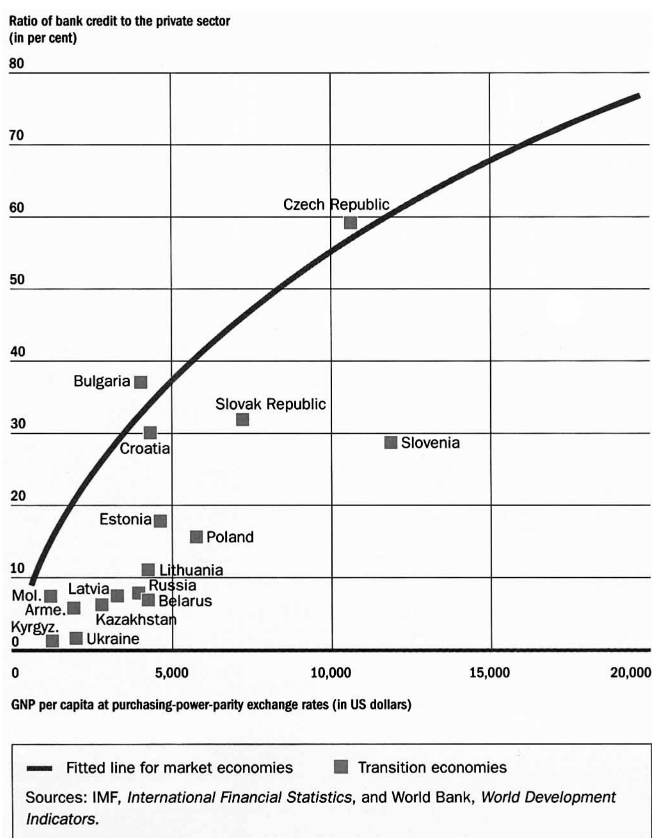
Source: EBRD (1998), p. 95

The large losses incurred by commercial banks when they attempted to engage in financial intermediation by lending to private sector entities, in conjunction with substantial, in some cases extreme, levels of macroeconomic instability, have led to financial and banking crises in many transition economies in recent years (see EBRD (1998), p. 100, and Pissarides (1998), p. 2). In some countries it turned out that as much as 40 percent of the total assets of the banking system were worthless.

In view of the problems and constraints outlined in the preceding discussion, it is not surprising that in the transition economies the volume of bank lending not only to SMEs, but to the private sector as a whole, is very small. And even if allowance is made for the low per capita income levels found in most former communist countries, the extent of

bank lending to the private sector is still shown to be much lower for the transition economies as a group than it is for market economies (see Fig. 4.3).[58]

Fig. 4.3: **Bank Loans as a Percentage of Gross National Product in Relation to Per Capita Income Levels**



Source: EBRD (1998), p. 94

Instead of financing the private sector, the banks in many transition economies are increasingly focusing on financing the public sector, i.e. treasury bills account for a large percentage of their total assets.[59] Not only SMEs but the entire private sector is subject to credit rationing, and not only long-term but even short-term loans are not (or no longer) being offered by the banking systems of transition economies.

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58 The positive correlation between per capita income and various indicators of the level of financial system development, e.g. the relationship between M2 and GDP or that between credit to the private sector and GDP, is a “stylised fact” derived from recent empirical research on the nature and origins of economic growth; see, for example, King/Levine (1993).

59 See Borish/Noel (1996), EBRD (1998), p. vii and p. 94, and Winkler (1996, 1998).

In general, an analysis of the banking systems of the transition economies points to the conclusion that not only do the financial systems and the commercial banks fail to satisfy the needs of the *target group*, but that there is effectively no financial system, or at best one that is only just starting to develop. Only in the countries whose reform programmes have come furthest, e.g. the Czech Republic, Hungary and Poland, might one possibly describe the shortage of long-term funds as being a major problem facing the financial system. In other countries, the financial institutions are struggling even to provide short-term loans to finance working capital (see Pissarides (1998), p. 4 and p. 17, EBRD (1998), p. 128).[60]

Thus, if SMEs are the victims of credit rationing in these countries, this cannot be attributed to profit maximisation motives on the part of commercial banks which give large firms precedence over the target group, and offer them more favourable maturities and interest rates. In this respect, the initial situation in most of the transition economies is different from the one which the promotional bank approach was designed to overcome. Therefore, the commercial banks are not likely to relax their restrictive lending policies towards the target group just because a state-owned, non-profit-maximising institution, i.e. a promotional bank, provides earmarked funds via various credit programmes. On the contrary, the type of credit rationing that is currently being experienced in the transition economies is due to the inability of the banks to apply mechanisms for creating incentive compatibility between borrowers and lenders. In other words: what is missing is a credit technology that would be appropriate to the radically changing circumstances in the transition economies.

The reality of Central and Eastern Europe and the NIS contrasts starkly not only with the ideal environment for a promotional bank but also with the situation of the West German financial system up to 1971, the year in which KfW began to function as an SME-oriented promotional bank on a large scale. In other words, there is little in West Germany’s post-war history, an era which was, moreover, characterised by macroeconomic and financial stability, that would seem, a priori, to justify the choice of KfW as a model for projects aimed at improving the financing situation of SMEs in Central and Eastern Europe.

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[60] Private micro, small and medium-sized enterprises must therefore rely primarily on internal financing; see Cornelli/Portes/Schaffer (1996).

4.4 Corporate Governance

Promotional banks are state institutions. The state provides the equity, its representatives – normally – have a large majority on the supervisory board, the members of the management board are appointed at least partly on political grounds or are (former) politicians themselves. Nonetheless, these institutions are not supposed to base their (lending) decisions on political considerations but solely on banking criteria, as stipulated in the laws governing their establishment and in their respective charters. However, the history of KfW itself has shown that it is not so much the formal founding documents but rather the motives and incentives of the main actors which determine the course that a promotional bank will take, i.e. whether it will actually perform the tasks assigned to it or whether it tries to establish itself as an "old style" state development bank.

To try to examine the motives and incentives of the individuals responsible for the running the 13 promotional bank projects in the transition economies would not only be impossible but also futile. For one thing, no member of a supervisory or management board would make official statements contradicting the principles contained in the laws and charters of the institution he or she represents; for another, even if it were possible to analyse the personalities of the individuals concerned based on their previous records, this would still not yield any reliable information on how they react when faced with specific credit decisions. In the transition economies, finding local "personalities with special experience in financial affairs" is inherently impossible because no comparable financial system existed prior to 1989. Most of the leading figures, not only those who (are supposed to) carry responsibility at the promotional banks, have either come to prominence somehow under the old system and/or were brought to the fore by the upheavals themselves.

Accordingly, the question whether present conditions in Central and Eastern Europe make it appear likely that the delicate balance which promotional banks must keep in order to be successful – the balance between their political mission on the one hand and the execution of that mission according to sound banking principles on the other – can only be approached via an analysis of the characteristics of those countries' state sectors

in general.[61] And on this basis, the answer is an unambiguous No: “Many states of the region face extremely low levels of public confidence and trust, thus undermining their authority to establish institutions that effectively alter the behaviours and practices of the population.” (EBRD (1998), p. 23).

The few economic winners of the transition process are increasingly taking advantage of this institutional vacuum by using the state machinery to further or protect their financial interests. This has led to the creation of a “policy-making environment characterised by the capture of the state by powerful economic interests, discretionary intervention by state bureaucrats into the market and high levels of corruption. In this environment, the state has been unable to finance itself ... to enforce hard budget constraints on enterprises, to promote good corporate governance or to maintain investor and popular confidence in the market.” (ibid.)

Despite official claims to the contrary, these developments are also and indeed particularly impacting on the financial sector; in many countries the state is still using its influence on the commercial banks, even the privately owned institutions, “to continue extending credit to loss-making enterprises.” (ibid.) In this environment, which is particularly characteristic of Southeastern Europe and the NIS,[62] it seems illusory to expect that those in charge of a state-owned promotional bank will be better able to withstand this pressure than the non-state commercial banks merely because of the wording of the respective Law or the promotional bank’s charter.[63]

However, even if one assumed, for now, that such an expectation were not unrealistic, the success of a promotional bank would also depend on the extent to which the target group were willing to believe in the impartiality of this new state institution. After all, they would be presenting their loan application, and the attached documents, not only to the commercial bank but also to the promotional bank. Again, the question of whether

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[61] In many transition economies, and especially in the CIS, the general legislation – the body of laws and directives – is applied and enforced only to a limited extent; see EBRD (1998), pp. 39ff.

[62] See Brunnetti/Kisunko/Weder (1997a)

[63] The author is anxious to point out that this remark is not meant to suggest that all individuals in responsible positions in the countries concerned are corrupt or willing to accept bribes. Rather, the remarks reflect the general experience that in an environment in which corruption and nepotism are rife, very few people will be able to succeed in standing up to external pressure and behaving in a manner contrary to general expectations.

the target group would trust the new institution cannot be answered specifically for promotional banks, but only for state institutions in general. Table 4.5 contains the results of a worldwide survey of private enterprises in which they were asked to rank the problems they faced in order of the degree to which those problems disrupted or obstructed their activities. The survey revealed that corruption and political instability are seen as crucial problems in Central Europe and the NIS, whereas in the developed economies of the West they play only a minor role (see shaded areas of Table 4.5).

Table 4.5: **The 15 Most Serious Obstacles to Business Activities Faced by Private Enterprises** (Ranking based on a survey of private enterprises)

Problems	World	Devel-oping countries	Devel-oped countries	Central and Eastern Europe	NIS	Southern Africa	Latin America/ Caribbean	Middle East/ North Africa	Southern/ Southeast Asia
Tax regulations and/or high taxes	1	1	1	1	1	2	5	3	1
Corruption	2	2	8	3	3	1	1	2	6
Financing	3	3	4	2	6	6	4	4	8
Inadequate supply of infrastructure	4	5	7	5	9	3	2	1	2
Crime and theft	5	4	9	6	4	4	3	14	11
Inflation	6	6	12	4	8	4	7	8	3
General uncertainty on costs of regulations	7	8	6	8	5	5	9	6	7
Political instability	8	7	11	7	2	2	6	7	12
Labour relations	9	10	2	10	13	13	8	10	4
Regulations on foreign trade (imports/exports)	10	9	10	13	7	9	10	5	10
Safety or environmental regulations	11	12	3	11	15	12	11	12	13
Regulations for starting business/new	12	13	5	12	11	13	12	9	5
Foreign currency regulations	13	11	13	13	10	10	13	13	9
Price controls	14	14	14	15	12	14	15	11	14
Terrorism	15	15	15	14	14	15	14	14	15

Source: Brunetti/Kisunko/Weder (1997), p. 60

On closer analysis, the results also indicate that the rankings of the individual problems in Central Europe and especially in the NIS exhibit greater similarities with those of developing countries (Southern Africa, Latin America/Caribbean, Middle East/North Africa) than with those of the developed economies or Asia/Southeast Asia.[64] To demonstrate this point, let it be assumed that the rankings may be defined as significantly different if the private sector of one group of countries ranks a given problem more than three places higher or lower than that of another group of countries. According to this classification, the differences between the transition economies and those of the developed countries are generally larger than those between the transition economies and the developing countries (see Table 4.6).

Yet it is not only in quantitative terms that the problems perceived by the private sector in the transition economies are more closely comparable to those in developing countries than in the developed world. The results presented in Table 4.6 indicate that the differences between the transition economies and the developed countries or the countries of Southern and Southeast Asia are primarily associated with the role of the state in the economy. In transition economies, corruption and political instability are two manifestations of the weakness of the state which are seen as urgent problems. In contrast, government regulations which in developed economies are felt by the private sector to be restrictive – labour relations, safety and environmental standards, regulations on starting a business – are regarded as less of a problem in transition economies, either because such regulations do not exist at all or, if they do, they are not (indeed, cannot be) enforced, or can easily be circumvented. This is, of course, another manifestation of the weakness of the state.

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[64] Through many discussions with government officials, bankers and academics in transition economies, the author has found that people in the reforming countries of Central and Eastern Europe resent their situation being likened to that of developing countries. Therefore, it should be emphasised that to compare the two sets of countries here is in no sense to deny that huge differences exist between them in terms of human capital, industrialisation and technological advance.

Table 4.6: **No. and Type of Priority Differences (more than 3 rankings) between CEE/NIS and Other Groups of Countries**

	Central and Eastern Europe	NIS
Developed countries	6 (Corruption, inflation, political instability, labour relations, safety or environmental regulations, regulations for starting business/new)	7 (Corruption, crime and theft, inflation, political instability, labour relations, safety or environmental regulations, regulations on starting business/new)
Southern Africa	3 (Financing, political instability, regulations on foreign trade)	2 (Inadequate supply of infrastructure, inflation)
Latin America/ Caribbean	1 (Taxation)	6 (Taxation, inadequate supply of infrastructure, general uncertainty on costs of regulations, political instability, labour relations, safety or environmental regulations)
Middle East/ North Africa	5 (Inadequate supply of infrastructure, crime, inflation, regulations on foreign trade, price controls)	3 (Inadequate supply of infrastructure, crime and theft, political instability)
Southern/ Southeast Asia	6 (Financing, crime and theft, political instability, labour relations, regulations on starting business/new, foreign currency regulations)	6 (Inadequate supply of infrastructure, crime and theft, inflation, political instability, labour relations, regulations on starting business/new)

Source: Own compilation based on Brunetti/Kisunko/Weder (1997), p. 60

When comparing the CEE/NIS countries with developing country groups, in contrast, the main difference that stands out is in the respective perceptions of the category “inadequate infrastructure”, which is seen by the private sector in developing countries, but not in the transition economies, as a major obstacle to development. This indicates the relevance of the remarks made at the start of this section on the stock of real capital that was built up over the last decades in Central and Eastern Europe and has not been destroyed. In other words, the infrastructure is there to be used, largely independently of the type of economic system. However, aside from this difference between transition economies and developing countries, which is immediately obvious to any observer and is confirmed by the private sectors of the respective countries, the analysis reinforces the view that in regard to the private sector’s assessment of the categories relating to the state and its actions the transition economies, and especially the NIS, are closer to the developing countries than to the developed countries.

All in all, therefore, we can conclude that the promotional banks in Central and Eastern Europe have to operate mainly in an environment which, particularly in terms of the ability and willingness of the state and its institutions to adhere to its own laws and regulations, is similar to that which prevails in developing countries. This gives grounds to doubt that the appropriate design of laws and charters, or of internal working and decision-making procedures, will in itself be enough to prevent promotional banks from suffering the same fate as most development banks, i.e. to prevent lending policies from being determined by political and/or personal interests rather than by sound banking criteria.

4.5 Summary of the Differences Between the Transition Economies and the Federal Republic of Germany as Environments for the Implementation of the Promotional Bank Approach

A comparative analysis of the situation in post-war Germany with that of the transition economies after the end of the Cold War allows the following conclusions to be drawn regarding the target group, the banking system and the conditions for corporate governance of state-owned or public-sector institutions, all of which are key to the success of the promotional bank approach (see Overview 4.1).

The stylised comparison shows that there is a danger that the promotional banks in the transition economies will prove incapable of operating on the basis of the approach described in section 2 of this paper for the following reasons:

- The vast majority of the target group consists of businesses so small that – as with KfW in the immediate post-war period – lending to small businesses organised through and also controlled by the promotional banks would involve excessively high transaction costs. This would prompt the promotional banks to focus on the upper end of the target group, which would mean that only a tiny percentage of the total number of SMEs would be reached.

- The commercial banks lack the technology needed to lend to the private sector at their own risk, i.e. to assume liability for the loans on behalf of the promotional banks. If the transaction costs and the – as the banks see it – higher risk of lending to the smaller firms in particular are factored into the calculations, it is also doubtful whether the differential between the cost of the funds received from the promotional

bank and the lending interest rate the commercial banks are allowed to charge on loans to final borrowers will be sufficiently large to persuade the commercial banks that lending to the target group is a worthwhile venture.

Overview 4.1: **Comparison Between Post-1945 Germany and Post-1989 Central and Eastern Europe in Terms of the Key Categories for the Promotional Bank Approach: Target Group, Banking System and Corporate Governance**

Category	West Germany	Central and Eastern Europe
Target group: Private small and medium-sized enterprises	For the most part, established, relatively large firms with experience of operating in a market-based economy under hard budget constraints	Almost exclusively newly formed (very) small firms, or older larger firms, but with no experience of operating in a market-based economy under hard budget constraints
Banking system	Almost exclusively, established financial institutions with experience of (short- and long-term) lending to (known) businesses in a stable macroeconomic and financial environment	Almost exclusively newly founded, mostly small privately owned banks, or old, large, formerly state-owned commercial banks with little or no knowledge of lending practices and which, furthermore, have to cater to newly established enterprises or existing enterprises operating under changed conditions
Corporate governance of the promotional bank	Formal basis (law, charter) is appropriate to the overall political and economic setting	Formal basis (law, charter) is at odds with the overall political and economic setting

Source: Own compilation

Both arguments[65] lead to the hypothesis that promotional banks will

- have difficulty disbursing their funds, or will be exposed to higher-than-expected credit risks,
- primarily lend to the large medium-sized firms, and/or
- start lending directly to the target group.

[65] In this context it is remarkable that of the eight qualitative indicators of transition compiled by the EBRD every year, the financial sector indicators and the indicator “Governance & enterprise restructuring” are the ones in which the scores are lowest on average for all countries.

If the last of these three possibilities materialises, there will almost automatically be a concentration on the upper end of the target group, as promotional banks have no branches and employ only a small staff, and are thus incapable of deploying the kind of credit technology that would enable them to lend to the target group on a cost-covering basis. Moreover, if a promotional bank engages in direct lending, there will be an increase in the already existing risk that it too be affected by the adverse political and economic environment. In other words, despite the terms of the law and the charter, political and personal factors may after all come to determine lending decisions.

As has already been mentioned several times, the transition economies should not be regarded as a homogenous group. The regional differences that characterise the transition process as a whole are will presumably be reflected in all three categories referred to in Overview 4.1. In other words, the deviation of reality from the assumptions on which the promotional bank approach are based is probably most pronounced in the NIS and the countries of Southeastern Europe, whereas it is less severe in the countries where reforms have reached a more advanced stage.

4.6 Promotional Banks in Transition Economies – A Tentative Assessment of Achievements to Date

As the cautiously worded heading of this section implies, it is hardly possible to subject the hypothesis formulated above to empirical testing. This is partly because there is not enough data on those indicators that would permit a quantitative analysis of promotional banks' activities, especially on the number, average volume and arrears rate of the loans funded by the individual promotional banks. Nor is it possible to ascertain the extent to which loans are being issued directly to the final borrowers by the promotional banks themselves or – as called for by the classic version of the approach – channelled via commercial banks. And finally, it is totally impossible to judge the extent to which political factors influence or have influenced lending practice, whether in connection with funding for credit proposals submitted by the commercial banks or with direct lending to the final borrowers. However, since this paper focuses on the suitability of the approach in terms of its basic design, an examination of the results achieved to date will serve merely to determine whether they are in line with the hypotheses derived from the comparison of the two operating environments (post-1945 Germany and post-1989 Central and Eastern Europe) with regard to the key categories for the promotional bank approach: target group, banking system, and corporate governance.

It is possible to formulate three statements which describe the results achieved to date by promotional banks and projects involving advisory assistance to promotional banks:

1. Almost all of the already operating promotional banks that are being advised and/or funded by KfW are located in the transition economies that have progressed furthest along the road to reform.[66] They are the Croatian Bank for Reconstruction and Development (HBOR), the Hungarian Investment and Development Bank (MBFB), the Slovakian Guarantee and Development Bank (SZRB), the Lithuanian Development Bank (LDB), Optiva Bank in Estonia and UkrEximBank in Ukraine.[67]

2. The Croatian promotional bank HBOR, on which detailed information is available, has become actively involved in all of the operational businesses provided for under the design on which it was based, i.e. it not only runs SME programmes but also finances infrastructure and housing projects. KfW alone has provided it with credit lines totalling DM 110 million, of which DM 50 million was (supposed to be) used for infrastructure finance. HBOR has also established partnerships with other international financial institutions and serves as an executing agency for their programmes. For example, in September 1998 it signed a loan agreement with the World Bank for a total of DM 65 million, to be spent on financing infrastructure and environmental measures. It is also co-operating with the EBRD, and more specific data are available on the DM 50 million EBRD credit line. It was used to finance loans to "companies operating and owning tourist facilities throughout Croatia, in amounts ranging from DM 165,000 to DM 5.5 million, on a commercial basis. The project can be regarded as very successful; only one year after starting to operate, despite a delayed start caused by problems in obtaining a government guarantee, 93 per cent of the credit line had been disbursed, with 60 sub-projects." (Pissarides (1998), p. 13). HBOR was also the first promotional bank which succeeded in issuing a bond on the Euromarket (KfW (1997), p. 7).

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[66] By the end of 1998, KfW had provided credit lines totalling DM 450 million to promotional banks in Central and Eastern Europe. More than half of this amount, namely DM 280 million, went to the institutions in Croatia and Hungary.

[67] All of these institutions are banks which had already been established as development banks or had functioned as state foreign-trade banks (so-called forex banks or export-import banks) prior to the collapse of communism or had evolved from such institutions. As a result, the advisory assistance provided by KfW was designed to bring about an institutional reorientation and/or a reorientation of their business policies in line with the promotional-bank approach. The example of Optiva Bank, which describes itself as a regular commercial bank, shows how difficult it is to effect such a reorientation.

3. In transition economies that are lagging behind in the reform process, the promotional banks receiving advisory assistance from KfW are not yet operational, or have not even been founded,[68] even though the advisory services date from as long ago as 1993 (in the case of Bulgaria) (KfW (1997), p. 7).

These observations support the hypotheses advanced in the previous section, or at least they do not contradict them. The problems which have repeatedly delayed the establishment of, or the start of operations at, promotional banks in many transition economies – or indeed have led to some projects of this kind being shelved altogether – appear to fall into the categories that were identified at a theoretical level as problems inherent to the approach. In particular, the principle that funds should be channelled to the target group via commercial banks is frequently violated, with the institutions choosing instead to issue loans directly to the final borrowers. In Lithuania, for example, the balance sheet of the Lithuanian Development Bank for 31 December 1998 shows that only 4.5% of its outstanding lending volume was accounted for by "channelled loans", i.e. credits to the target group granted by commercial banks. In other words, more than 95% of the loans were issued directly to enterprises (Lithuanian Development Bank (1999)).

And to cite another pertinent example, the "Business Development Bank" in Russia failed to establish itself in the market as a promotional bank.[69] It appears that the DM 50 million line of credit extended by KfW in 1996 has not yet been utilised by the Russian promotional institution. One must assume that the prevailing conditions in the financial sector made it impossible for the Russian institution to initiate lending to small and medium-sized enterprises from the position of a promotional bank. Consequently, the available development assistance funds have not reached the target group. Adverse political and economic circumstances may also have impeded the implementation of the promotional bank approach in Russia, but without more detailed information it is not possible to determine the extent to which this has been the case.

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[68] In contrast to the activities in the above-mentioned countries, advisory assistance in these countries is usually geared to creating completely new promotional banks.

[69] On the origins of the Business Development Bank, see for example N.N. (1993), in: FAZ 28.4.1993, p. 17 and N.N. (1994), in: FAZ 14.2.1994, p. 13.

In Southeastern Europe the difficulty of establishing promotional banks or launching operations appears to be due to several factors. For one thing, almost all of the countries in this region are politically unstable. This makes it more difficult to realise a project which – as has been shown – depends on political leadership both at a formal level (for the passing of laws) and at an operational level (for the appointment of supervisory board members and management personnel). However, even in those cases where promotional banks have been set up, the dominance of the political sphere has had a negative impact. In Macedonia, for example, the change of government that took place in October 1998 impeded the establishment and launch of the Macedonian promotional bank because its General Manager and the members of its Board of Directors – officials from the ministries represented on the Board – had been appointed by the outgoing government and were therefore no longer certain of government backing. Situations like this cause delays, the consequences of which must ultimately be borne by the target group, who are made to wait that much longer for an appropriate supply of credit facilities. Thus, in the current political and economic environment, promotional banks have not always proved to be the "flexible and efficient" instrument at the interface between the state and the market that the concept in its classic form suggests they should be.

Yet there is cause to doubt whether political instability alone is responsible for the difficulties that are hampering attempts to put the promotional bank approach into practice in these countries. After all, politicians in the countries involved have themselves called for the promotional banks to be set up (KfW (1997), p. 5). Furthermore, as already mentioned, KfW generally offers the prospect of a credit line for a newly founded promotional bank to kick-start its lending activities and avoid a situation in which "the advisory assistance fails to bear fruit or make a lasting impact due to a lack of specific opportunities to apply the advice received and to a lack of lending practice." (KfW (1997), p. 6). These lines of credit are known as "Ungebundene Finanzkredite" (UFK) [Non-Specific Financing Credits], and are guaranteed by the German government. Under these circumstances, every political leadership that takes over responsibility for running a country could be expected to have an interest in seeing a promotional bank establish itself and go into operation. Therefore, it seems unlikely that political instability per se is the sole cause of the problems facing the promotional bank approach in Southeastern European countries.

Three other possible explanations suggest themselves:

1. The high cost of establishing a promotional bank, i.e. the provision of equity, which has to borne by the government budget.
2. Resistance to the promotional bank approach on the part of the local central banks or the IMF and/or the World Bank based on objections of a macroeconomic,[70] banking supervisory[71] or political nature.
3. When political leaders in transition economies apply for support in establishing a public-sector bank, the kind of institution they have in mind is essentially a classic development bank that practices direct lending to the target group, rather than a promotional bank of the KfW type. Indeed, the politicians feel that, given the diagnosed inability and/or unwillingness of the local commercial banks to offer loans to the target group, there is (also) an objective urgent need for such a bank; in other words, the call for such an institution need not be (solely) based on political considerations. However, the interest of the politicians starts to wane when the implications of the promotional bank approach become clearer to them, i.e. when they appreciate that the responsibility for lending operations and credit decisions is supposed to lie with the commercial banks.

The available information on the promotional bank in Croatia also appears to confirm the hypotheses advanced in the preceding section. On the one hand, Croatia is a country which, after the war with Serbia and the end of hostilities in Bosnia-Herzegovina, has had a comparatively stable political climate, even though the conditions for sound corporate governance have not been entirely favourable. After the government had approved the establishment of a promotional bank based on the KfW model, the project was successfully implemented – also in terms of its formal components (the passing of an appropriate law and charter) However, judging by the credit lines which the bank has received from KfW, lending to SMEs appears not to be such a dominant line of business as the model would seem to call for. The scale of its housing and infrastructure finance activities almost certainly outweighs its SME financing by a significant margin. Moreover, the details of the EBRD credit line mentioned by Pissarides (1998) indicate that very few businesses at the lower end of the target group are being reached: on this

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[70] As a rule, central banks are particularly eager to prevent lending on the basis of subsidised interest rates, which they see as undermining their stability-oriented interest rate policy. There have even been episodes in KfW’s history when the Bundesbank expressed concerns about KfW’s activities as a promotional bank; see Harries (1998).

[71] Here the main objection is to the special status enjoyed by a promotional bank which exempts it from compliance with banking supervisory regulations.

basis, the average loan size works out to DM 775,000.[72] In the tourist industry, in particular, Croatian firms have substantial experience, given that this business was flourishing long before 1989. Therefore, based on the theoretical considerations presented earlier in this paper regarding the importance of experience in the enterprise sector, it is hardly surprising that the credit line was disbursed relatively quickly.

Viewed overall, the results of KfW's advisory services to promotional banks and the activities of the banks themselves demonstrate the importance of bearing in mind that, especially with regard to efforts to create appropriate financing facilities for SMEs in transition economies, "the specific current scenario and setting cannot be compared with the situation in Western Europe at the end of the Second World War." (Harries (1998), p. 45) The institutional, political and economic parameters are quite different today, and point to the conclusion that the promotional bank approach, as it has been practised on a large scale in Germany by KfW since 1971, is either not at all suited to the transition economies, or can only applied with a different objective and/or focus. Even in those transition economies where they are already operating, the impression created by the promotional banks is that they are in essence classic development banks with an SME department whose main focus is on medium-sized enterprises, rather than SME promotional banks which concentrate primarily on medium and small enterprises, while the other tasks of development banks, e.g. infrastructure and housing finance, are mere sidelines.[73] In principle, there would be no reason to object to such a shift of priorities, or business policy, as long as sound banking criteria were being applied, i.e. provided that the known weaknesses of development banks did not manifest themselves. After all, it is an undeniable fact that in the countries concerned the modernisation of infrastructure and housing and the promotion of medium-sized firms are important tasks

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[72] In its annual report for 1998, the Lithuanian Development Bank states that the average size of the loans in its portfolio is EUR 640,000, which is equivalent to around DM 1.2 million; see Lithuanian Development Bank (1999).

[73] On its web site (http://www.mfb.hu/english/index.htm) the Hungarian development bank MFB describes its lending activities as follows: "MFB plays a key role in facilitating the transformation of the Hungarian economy by providing loans to industrial companies, particularly operating in the fields of infrastructure, telecommunications, food and food processing, and pharmaceuticals. In addition, the Bank is also active in the energy, chemical and environmental sectors. Its clientele includes concession companies (i.e. companies given concessions to operate state assets, e.g. roads, telecommunications, etc.), enterprises carrying out large-scale capital expenditure projects and foreign owned multinational companies. Furthermore, MFB pays special attention to supporting small and medium-sized enterprises, a sector that plays an important role in the development of the Hungarian economy." As of end-1997, MFB's total outstanding loan portfolio accounted for roughly 26% of its total assets.

from the point of view of development policy. However, it should be noted that under the present policies, the activities of the promotional banks are not contributing to an improvement in the situation of the great mass of small businesses, which account for more than 90% of the target group, and they are also not promoting financial sector development. Yet precisely these tasks have been defined as the key objectives of the promotional bank approach.

This raises the question of whether other historical precedents exist which might more appropriately serve as models for projects designed to achieve these objectives – promotion of small businesses and the financial sector – in the institutional and (political–)economic environment of the transition economies. The following chapter argues that there are valuable lessons to be learned from the development of the German financial system in the 19th century.

5. Banks and Enterprise Financing in 19th Century Germany

5.1 Introductory Remarks on the Relevance of Historical–Economic Analysis as a Basis for Recommendations Regarding the Transition Process in Central and Eastern Europe

"It is an economy with simple production techniques in small operating facilities; petty merchants and usurers are as despised as they are necessary. Progress in agriculture is seriously impeded by an outdated agrarian order. Chronic underemployment of the workforce is one of the main problems, and despite moral appeals, the masses are hardly willing to save at all... The economy relies to a considerable extent on other countries,... Monetary stability is periodically under threat and sometimes the currency has been utterly ruined by ill-conceived government measures."[74]

This is not a description of a backward Eastern European transition economy, but a characterisation of the English economy in the 17th century. Borchardt (1984, p. 86) uses it to illustrate the suitability of historical–economic analysis for providing development policymakers with a referential framework which enables them "to identify problems more clearly, to ask the right questions and point to answers that might be of interest", though he does not claim that economic history can offer quick and easy solutions to the problems of today.

Borchardt demonstrates that not only English but also and in particular German economic history may serve as a point of reference for present-day development policy issues by imagining what would happen if a team of consultants were commissioned – say, by the World Bank or KfW – to visit 18th century Germany and prepare a study on the country's economic situation. Some of the results of the fictitious "fact finding mission" presented by Borchardt can readily be applied to the question of which are the most suitable instruments to promote SME financing in transition economies. For example, the hypothetical mission to 18th century Germany would have reported that it was difficult to "impose state authority over the particular interests of traditional forces, and (the mission) would have reported incredible instances of corruption. Yet what they may have found most horrifying of all was the blatantly unjust distribution of incomes, with a very narrow, very high peak at the top of the social pyramid, and below it a broad

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[74] Borchardt (1984), pp. 75f., quoting Fisher (1957); re-translated by the author.

base of mass poverty." (Borchardt (1984), p. 77). There are obvious similarities between this account and the description of present conditions in a number of transition economies contained in section 4.4 of this paper, based on the EBRD's Transition Report.

Since the theory behind this historical approach appears plausible, and since parallels clearly exist between past societies and present-day transition economies, as the above example shows, the author feels encouraged to present a brief financial sector study of 19th century Germany, applying the same approach as he has used on numerous occasions in the past to prepare (or co-author) studies for bilateral and multilateral development organisations.[75] Specifically, the study addresses four issues:

a) How far has the private small and medium-sized enterprise sector developed? What are the essential characteristics of this sector?

b) Which institutions comprise the financial sector? How do the commercial banks operate on the assets side of their balance sheets, and how do they finance this asset-side business?

c) How can the financing situation of the target group be described?

d) Which measures is the government taking to improve the target group's financing situation?

The aim is to discover whether and to what extent further parallels can be drawn between the current situation in Central and Eastern Europe (a–c) and which conclusions can be drawn with regard to the design of efficient interventions by governments and/or bilateral and multilateral donors (d) to improve the financing situation of small and medium-sized enterprises in the private sector.

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[75] In this respect, the present section follows up an intuition expressed by Caprio (1995), p. 259, that "a model of 'back to the future' might be appropriate in the financial sector, looking more to how industrial countries' financial systems functioned in the 18th and 19th centuries, when less reliance was placed on the government as a guarantor and supervisor, than on its late 20th-century manifestation."

5.2 The Development of the Small and Medium-Sized Enterprise Sector in 19th Century Germany

The development of a sector of private small and medium-sized enterprises in Germany began with the introduction of *Gewerbefreiheit* (freedom of trade; free access to trade), which took practical effect in Prussia, the largest German state, when the Hardenberg Tax Edict of 1810 was issued. This edict stated that persons wishing to open a business establishment had to meet only a single requirement, i.e. that they merely had to obtain a tax certificate, and this meant that the guilds could no longer set rules for market entry (Henning (1973), pp. 62f). It is very difficult to assess the (quantitative) impacts of this new legal situation during the first half of the 19th century with any precision because there is insufficient statistical data available on this period (Henning (1973), p. 66). It is fair to say, though, that as a result of the introduction of freedom of trade, the number of master craftsmen, and the number of business establishments, rose over the short term, particularly in rural areas. By the same token, it seems clear that, over the medium term, the increasing competition also led to the closure of establishments.

Table 5.1: **Increase in, and Sectoral Composition of, Employment in Germany, 1780 – 1970**

Year	Primary sector (%)	Secondary sector (%)	Tertiary sector (%)	Total employment (in millions)
1780	65	19	16	10.0
1800	62	21	17	10.5
1825	59	22	19	12.6
1850	55	24	21	15.8
1875	49	30	21	18.6
1900	38	37	25	25.5
1914	34	38	28	31.3
1935	30	38	32	29.9
1970*	5	48	47	30.1

* West Germany

Source: Henning (1973), p. 20

Given the sectoral breakdown of employment (see Table 5.1), it would appear that, overall, the first half of the 19th century was still characterised by a relatively large degree of stability as regards the basic structure of the economy. Indeed, between 1780 and 1850, employment in agriculture declined by a total of only 10 percentage points,

while the figures for the secondary and tertiary sectors each increased by only 5 percentage points. But overall employment rose considerably during this period, increasing from 10 million to just under 16 million. However, the increment was rather small compared with the one recorded for the subsequent 70-year period.

Table 5.2: **Employment in Crafts/Skilled Trades in Prussia in 1849 and 1895**

Crafts/Trades	1849			1895		
	Breakdown:			Breakdown:		
	Total number employed in craft/trade	Self-employed	Wage earners	Total number employed in craft/trade	Self-employed	Wage earners
1. Bakers and confectioners/ pastry cooks	43 819	26 447	17 372	111 974	38 251	73 723
2. Butchers	27 769	18 372	9 397	86 549	34 189	52 360
3. Stonemasons	64 516	10 470	54 046	224 293	19 495	204 798
4. Carpenters and shipwrights	49 198	10 191	39 007	87 776	11 558	76 218
5. Painters, etc.	8 068	4 301	3 767	76 782	19 869	56 913
6. Glaziers	6 789	4 939	1 850	7 138	3 818	3 320
7. Potters	12 472	5 119	7 353	26 520	5 670	20 850
8. Cabinetmakers	70 953	42 971	27 962	170 856	51 495	119 361
9. Cartwrights	25 438	18 284	7 154	43 377	17 529	25 848
10. Coopers	21 305	14 904	6 401	19 932	8 569	11 363
11. Wood turners	12 097	6 758	5 339	19 493	5 919	13 574
12. Tailors	106 177	17 429	35 748	266 851	142 987	123 864
13. Shoemakers	136 610	87 969	48 641	192 472	112 736	79 736
14. Furriers, capmakers	7 570	4 447	3 123	9 241	4 580	4 661
15. Hatters	2 414	1 475	939	10 376	1 309	9 067
16. Glovers	2 401	1 300	1 101	7 036	2 266	4 770
17. Makers of trim-mings for clothing & upholstery	2 339	1 295	1 044	11 971	1 082	10 889
18. Ropemakers	6 753	3 991	2 852	5 636	2 578	3 058
19. Tanners	13 881	5 748	8 133	16 174	2 649	13 525
20. Saddlers, paperhangers	16 159	10 043	6 116	46 791	17 241	29 550
21. Bookbinders	6 723	3 290	3 433	24 299	5 204	19 095
22. Watchmakers	4 156	2 830	1 326	13 076	6 805	6 271
23. Goldsmiths, silversmiths	3 334	1 689	1 645	6 460	2 009	4 451
24. Barbers, hairdressers	9 068	6 429	2 639	29 992	14 258	15 734
Grand totals	660 009	363 601	296 408	1 515 065	532 066	982 999

Source: Kocka/Mütter (1984), pp. 166f

Table 5.2 shows the earliest comprehensive statistics that could be obtained by the author on what would today be called the small and medium-sized enterprise sector. Thus, 1849 marks the beginning of the period for which one can make well-founded statements on the composition of the SME sector. The above data on employment in crafts and skilled trades in Prussia in 1849 and 1895 show that in the mid-19th century more than half of the total number of persons employed in the occupations covered by the data were self-employed. In other words, the average number of persons employed as wage earners by enterprises in crafts/skilled trades was less than one. And 50 years later, the situation had not changed all that much: on average, there were still fewer than two persons in dependent employment in crafts/skilled trades for every self-employed person working in this part of the economy.

This initial evidence that micro and small enterprises accounted for the bulk of all private economic activity in 19th century Germany is confirmed by the data for the second half of the century. Although industrialisation was already in full swing during this period, and medium-sized and large enterprises were rapidly gaining in importance, micro and small enterprises with 50 or fewer employees continued to account for both the majority of enterprises and the bulk of employment in industry and crafts/artisanal production (mining was an exception here); and the dominance of small and very small establishments was even more pronounced in the service sector (see Table 5.3). Even as late as 1907, just under one-third of all persons employed in industry and crafts/artisanal production worked in micro enterprises with between 1 and 5 employees, and such businesses still accounted for almost 90% of the total number of enterprises operating in these areas.

Table 5.3: **Share of the Total Number of Establishments and of Total Employment Accounted for by Enterprises of Various Sizes (%)**

a) Industry and crafts/artisanal production

Year	1-5 employees		6-50 employees		More than 50 employees	
	Share of total number of enterprises	Share of total employment	Share of total number of enterprises	Share of total employment	Share of total number of enterprises	Share of total employment
1875	n.a.	63.6	n.a.	n.a.	n.a.	n.a.
1882	95.9	59.8	3.7	17.4	0.4	22.8
1895	92.8	41.8	6.5	24.7	0.8	33.5
1907	89.8	31.2	8.9	26.4	1.3	42.4

Source: Fischer (1985), p. 407

b) Services (includes some skilled trades)

Year	1-5 employees		6-50 employees		More than 50 employees	
	Share of total number of enterprises	Share of total employment	Share of total number of enterprises	Share of total employment	Share of total number of enterprises	Share of total employment
1882	96.1	75.6	3.8	20.2	0.1	4.2
1895	94.6	69.7	5.2	24.2	0.2	6.1
1907	93.8	61.6	5.9	26.6	0.3	11.8

Source of underlying data: Henning (1996), p. 881

Micro and small enterprises also accounted for the bulk of the establishments in the trade sector (according to the available figures, there were 617,000 trade enterprises in 1882 and 1,088,000 in 1907); indeed, at the beginning of the 20th century only 6.6% of all trade enterprises had more than 50 employees (Fischer (1985), p. 409).

Thus, overall it is clear that even during the part of the 19th century when Germany was rapidly industrialising, "one cannot speak of ...an imperative in all sectors to form large-scale enterprises (concentration and centralisation of capital)." (Plumpe (1996), p. 51). The economic reasons for the lack of such an imperative are well-known. They are the same reasons as those that are advanced today to make the case for promoting the private micro and small enterprise sector in many countries, and especially in the transition economies: the fact that these enterprises, which are particularly flexible and efficient, are in a better position than large enterprises to satisfy the demand for custom-made goods, the demand for goods produced in small production runs, and generally, the demand for high-quality, well-made products (particularly handmade goods) (Henning (1996), p. 878).

In terms of a qualitative assessment of the evolution of the German economy and of enterprise financing in the 19th century, the development of this sector is of particular interest. Indeed, in the final analysis the profits earned in the trade and craft enterprises that existed in the first half of the 19th century were the source of the capital that was needed in the second half of the 19th century to build larger enterprises and introduce capital-intensive production methods (Klein (1971), pp. 124f). Thus, micro and small enterprises operating in precisely these two sectors laid the foundation for the creation of industrial firms in the second half of the 19th century – whether such firms were created directly through the transformation of these small businesses into industrial enterprises, or indirectly through the use by their proprietors of capital derived from

retained profits to join forces with other investors and found new industrial enterprises (once the necessary legal framework had been put in place, such equity participations could also be effected through the purchase of shares) (Pierenkemper (1990), pp. 88ff.). And the banking system played an important role in this process of capital mobilisation and allocation.

5.3 The Development of the Banking System in 19th Century Germany[76]

a) *The origins of banks in Germany and the nature of their asset-side business in the early years*

The first modern banking firms were created in Germany at the beginning of the 19th century (Kindleberger (1993), p. 118). As a rule, they had their origins in (trade) enterprises, i.e. their capital base consisted of holdings of financial assets which had been accumulated internally through the retention of profits (Tilly (1967), p. 159, Pohl, H. (1982), p. 75, Feldenkirchen (1982), p. 83). Formally speaking, these institutions were private banking houses (*Privatbankiers*), i.e. banking establishments operated by "sole proprietors and managing partners who engaged in banking business by using their own capital and assuming unlimited liability up to the value of all of their assets ... and with sole authority to make decisions." (Pohl, M. (1991), p. 38). They decided to establish banking firms because, as merchants, they knew from their own experience that there was an effective demand for finance from external sources, and specifically, they knew this because "in addition to, and in conjunction with, their business of supplying goods, they had also engaged in the business of supplying money" (Klein (1982), p. 245) Thus, in many cases they carried on serving borrowers to whom they had already lent repeatedly in the past, and thus continued long-standing financing relationships, the only difference being that they now assumed a different role – that of a formal financial institution rather than that of a merchant – when providing funds to these customers (Hauswald (1995), p. 30).

In view of their origins, the banks still operated either largely or exclusively as "closed shops" during the first half of the 19th century. Their clientele consisted almost

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[76] The discussion presented in this section and in Section 5.4 is based largely on material contained in Winkler (forthcoming)

exclusively of enterprises and individuals who were well-known to the bankers as a result of many years of personal experience in dealing with them in trade and financing transactions, and who thus had established their creditworthiness beyond a doubt (Feldenkirchen (1982), p. 86, fn. 31). For this reason, a bank had only very limited scope to branch out and expand the size of the area or region it served. It was generally recognised that only "a banker who lives in the district, who has always lived there, whose whole mind is a history of the district and its changes, is easily able to lend money safely there. But a manager deputed by a single central establishment does so with difficulty. The worst people will come to him and ask for loans. His ignorance is a mark for all the shrewd and crafty people thereabouts. He will have endless difficulties in establishing the circulation of the distant bank, because he has not the local knowledge which alone can teach him how to issue that circulation with safety." (Bagehot (1873), pp. 43f.).

In the mid-19th century this close link between lenders and borrowers assumed a new form in Germany as the recently founded joint stock banks began to participate directly in the establishment of firms and initiate the foundation of enterprises, either alone or in concert with others: "Particularly during the first twenty years of their existence, the four banks that were established during the period 1848 - 1856 (A. Schaaffhausen'scher Bankverein, Bank für Handel und Industrie, Berliner Handels-Gesellschaft, Disconto-Gesellschaft) served primarily as investment banks. They focused on the acquisition and placement of shares in industrial enterprises, and not only assisted in founding firms but in some cases also took the lead in establishing new companies." (Pohl, M. (1982a), pp. 277f)

It should be noted, though, that such involvements in the foundation of industrial enterprises were more the exception than the rule.[77] Indeed, the granting of short-term credits to meet working capital needs accounted for most of the lending business of the private bankers and the first joint stock banks: "Most credits extended by private bankers (and by the *Kreditbanken* that followed them) were ostensibly short term in nature, because ***that form of credit was in the banking tradition*** [author's emphasis], and because working capital – relative to fixed capital – was of great importance in the German economy before 1870." (Tilly (1967), p. 177) That this was indeed an important

[77] Pohl, H. (1985), p. 75; Tilly (1967, p. 160) characterises such activities as a "relatively local phenomenon."

tradition in banking is shown by the fact that the following principle is set forth in the charters of both the Schaaffhausen'sche Bankverein and the Darmstädter Bank für Handel und Industrie: "The bank is authorised to engage in all forms of banking business, i.e. those types of business in which it can withdraw the funds it has committed ***easily and at any time*** [author's emphasis], should it have a need for these funds."[78]

Overall, by adopting this policy of focusing on short-term lending and dealing almost exclusively with borrowers who were well-known to them, the banks were able to avoid many information- and incentive-related problems that are usually associated with the provision of external finance. Accordingly, by around 1870, when the pace of industrialisation increased markedly, most of the banks were already experienced in dealing with credit risks. But while the *quality* of lending operations was thus sufficient to enable the banks to support the further development of the real economy, in *quantitative* terms their lending activities were not yet able to make a significant contribution to this process. Hence, it is now time to look at the banks' liability-side business, i.e. the ways in which they funded their lending and other asset-side operations.

b) How banks funded their operations

Up until the mid-19th century, the banks funded their operations largely by increasing their equity capital or by retaining profits, i.e. via internal financing (Tilly (1967), p. 161). To the extent that they incurred liabilities by issuing debt instruments, these were used by the banks' customers primarily as a means of payment; both bank notes and other instruments that could be utilised in the payment of debts were issued. Legal tender in the form of coins was either in short supply, or, if there was an adequate supply, the great variety of coins in circulation often made it difficult to assess the quality of currency. This made it easier for the banks to fund their operations by issuing bank notes and other debt instruments that could be employed as means of payment. Indeed, there was strong demand for liabilities offered by "respected issuing houses" (Borchardt (1976, p. 10)) which could be used as a means of payment even if these did not bear interest. As a result, the liability side of German banks' balance sheets in the mid-19th century was dominated by instruments issued in conjunction with lending

[78] Borchardt (1961), p. 415, quoting Riesser (1905).

activities which were intended to serve as means of payment and were largely non-interest-bearing, and by equity capital. By contrast, other funding options – i.e. demand deposits, time deposits and savings deposits, which are of principal importance today – played only a secondary role in terms of their contribution to total liabilities and equity.[79] As late as 1872, equity capital still accounted for 45% of the consolidated balance sheet total of the German banking system of the German banking system still came to 45% (Stützel (1964), p. 46).

Obviously, though, just because a bank is very well capitalised, i.e. just because its equity accounts for a large proportion of total liabilities and equity capital, it will not necessarily have, in absolute terms, a large volume of funds available for lending. And in fact, from 1850 on, the private banking houses, which operated independently of one another, increasingly found that, as individual institutions, they were no longer in a position to satisfy the demand for funds exhibited by Germany's emerging (large-scale) industrial enterprises. Thus, as soon as the requisite legal foundations had been created, a number of private bankers founded joint stock banks, which, in the years after 1870, rapidly supplanted the private banking houses as the country's leading financial institutions (Edwards/Ogilvie (1995), p. 9). Deutsche Bank, Dresdner Bank and Commerzbank, which are still operating today, were the three most important banks of this new type.

Although the joint stock banks dominated the German banking system after 1870, initially there was little change in the structure of the liability side of the banks' balance sheets, i.e. in the role of equity capital as a funding source. Table 5.4 provides data on equity and short-term liabilities as percentages of total liabilities and equity capital for five commercial banks. The figures underscore that, even at the larger institutions, the ratio of equity to total liabilities and equity capital remained at around 30% up until the end of the 19th century (Deutsche Bank was an exception here). Thus, in terms of its quantitative significance as a funding source, equity capital was still almost as important at the end of the century as demand deposits (i.e. very short-term liabilities). Following the establishment of a national payments system, which was initiated by the Reichsbank in 1870 (Goodhart (1988), Pohl, M. (1982a), p. 282), the banks began offering demand

[79] The same can be said for banks in the U.S. during this period: "In contrast to modern practice, however, capital stock – not deposits – was the principal means to this end [i.e. the foundation and expansion of banks – author's note]." Lamoreaux (1986), S. 653f.

deposit facilities. Deutsche Bank was the first institution to enter this market, serving both firms and private households, and as there proved to be a sizeable demand for these new liability-side products, the other joint stock banks soon followed suit.

Table 5.4: **Equity Capital (EC) and Short-Term Liabilities (Deposits and Accounts Payable = D/AP) as Percentage of Total Liabilities and Equity Capital for Selected German Commercial Banks, 1882 – 1913**

Year	Bank für Handel und Industrie		Berliner Handels-gesellschaft		Deutsche Bank		Disconto-Gesellschaft		Schaaffhausen'-scher Bankverein	
	EC	D/AP	EC	D/AP	EC	D/AP	EC	D/AP	EC	D/AP
1882	40.95	32.80	59.69	29.45	35.02	42.10	35.48	45.20	40.43	29.84
1890	44.17	25.46	37.30	32.53	17.72	48.01	28.18	47.48	36.92	32.85
1894	39.73	24.95	37.87	32.46	16.33	54.57	23.46	50.92	30.00	39.74
1899	44.61	24.93	34.35	31.16	17.26	55.24	29.94	39.67	35.03	33.35
1903	35.60	39.25	32.19	34.98	13.13	64.77	25.20	41.71	29.33	40.43
1907	25.14	55.09	23.19	49.37	10.69	67.55	19.98	47.11	24.41	40.67
1913	16.36	62.09	19.97	53.87	8.91	70.28	16.15	54.43	22.44	53.27

Source: Feldenkirchen (1982), pp. 103f

It was not until after the turn of the century that equity began to be eclipsed on a significant scale by demand deposits. After 1900 the proportion of equity capital declined considerably, while the share of total liabilities and equity capital accounted for by demand deposits increased, rising to a level of over 50% at all of the banks covered by Table 5.4. Nonetheless, German banks continued to have very sizeable capital resources. In fact, as measured by capitalisation levels, the three largest firms in Germany in 1913 were banks, and of the top 25 no fewer than 17 were banks (Tilly (1992), p. 94).

5.4 Enterprise Financing in the 19th Century

From the above characterisation of the asset-side business of the private banking houses and the first joint stock banks it can be surmised that the quantitative significance of financial intermediaries for the financing of entrepreneurial activities at the start of the 19th century was small. Among the many enterprises that existed, only those few which had been well known to the private bankers for a long time, i.e. those entrepreneurs who had built a reputation as shrewd businessmen and thus as creditworthy borrowers, could rely on finance provided by banks. As already indicated, entrepreneurial activities were to a large extent financed with internal funds, drawn either from current operating profits or from the accumulated profits of previous periods. Accumulated profits were particularly important as a source of finance for the building of the industrial enterprises, whose capital often came originally from profits earned during a previous phase in the firm's history, when it was still a trade business (see Tilly (1967), p. 156, Pohl, H. (1985), p. 77, Klein (1971)). Other sources of capital included family, friends and relations (see Pierenkemper (1990), Klein (1971)), so that it was often difficult to draw a clear dividing line between the entrepreneur's business and his private household (Kocka (1979), pp. 103ff).[80]

However, it should also be noted that these "entrepreneur families" were interested in external finance only to a limited extent. For one thing, it was "long considered very unusual, almost immoral, to run up debts." (Borchardt (1961), p. 411) For another, the entrepreneurs feared that by borrowing capital they would be exposing their businesses to external scrutiny and possibly even attempts to influence business policy, a situation which they were anxious to avoid. "Independence was a family tradition." (Pohl, H. (1985), p. 76) This striving for independence expressed itself not only in the entrepreneurs' desire to limit their borrowing to a minimum, but also in an "aversion and opposition" to the very real opportunities that existed for raising external equity: "The desire for self-sufficiency and independence caused many founding entrepreneurs to reject the idea of converting their firm into a joint stock company, even though their refusal meant that they largely denied their business access to the capital market." (Pohl, M. (1991), p. 44)

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[80] For example, it took 24 years before the firm Krupp received its first bank loan; up until then, almost all of the enterprise's external financing had come from members of the family; see Pierenkemper (1990).

This tendency to be negatively disposed towards borrowing external funds was reinforced by the fact that, up to the middle of the 19th century, investment volumes, even among industrial enterprises, were still relatively small (Klein (1971), p. 120). In this respect it was perfectly rational for enterprises to finance fixed asset investments largely with their own funds. However, the existing banks played an important role in making this possible, precisely because they were willing to provide short-term loans to finance working capital, thus leaving internal resources free to be invested in long-term real capital (Tilly (1967), p. 174).

As already mentioned, the operating environment changed in the second half of the 19th century. Many firms were no longer able to raise the required amounts of capital internally or from the informal financial sector. This need for external finance led on the one hand to the establishment of joint stock companies by non-financial enterprises, i.e. to external equity financing, the hitherto scarcely used method of raising funds which was broadly disliked by entrepreneurs. On the other hand, the demand for credit also increased, prompting the banks to set up joint stock banks, as also described above.

Both developments made it impossible to continue providing capital almost exclusively on the basis of personal acquaintance. A typical principal-agent problem had now evolved between, on the one side, the now more numerous bank owners, some of whom invested considerable sums of money in order to supply their bank with the equity it needed, and on the other side, the bank's management. Behind this principal-agent problem lies the same information problem as the one that characterises any external financing relationship: How could the bank's owners check whether, and to what extent, the task of monitoring the borrowers, a task which the bank's owners had delegated to the bank's management, was actually being carried out, if the management based its credit decisions solely or primarily on personal relationships with and/or personal knowledge of the borrowers?[81,82]

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[81] "Joint stock banks being of course obliged to act through agents and by a principal, and therefore under the restraint of general rules, cannot be guided by so nice a reference to degrees of difference in the character of responsibility of parties; nor can they undertake to regulate the assistance to be granted to concerns under temporary embarrassment by so accurate a reference to the circumstances, favourable or unfavourable, of each case." Bagehot (1873), p. 122. The theoretical basis of this principal-agent problem was first explained by Jensen/Meckling (1976).

The truth of the statement that "there is no more unsafe government for a bank than that of an eager and active manager, ... for the manager may easily glide into dangerous and insecure transactions, nor can the board effectually check him" (Bagehot (1873), p. 127), became clear in Germany after the law governing joint stock companies was liberalised and the wave of new company starts came to an end in the mid-1870s. Many of the newly founded joint stock banks had to go into liquidation, and the recession in the real economy was followed by financial crisis (Edwards/Ogilvie (1995), p. 7, Pohl, M. (1982a), p. 226).

Two conclusions were drawn from these experiences: On the one hand, the state introduced tougher requirements for the founding of a bank as a joint stock company.[83] On the other, the banks' business policies changed. In order to contain the risks arising from the control problem which the owners had with their managers, the asset-side business became largely formalised (Pohl, H. (1982), p. 121). This meant that the banks largely abandoned the kind of lending practices that were tantamount to equity investments and/or were based solely on personal relationships, and increasingly went over to financing firms with short-term loans backed by collateral. Accordingly, short-term loans on current account as a share of total lending in Germany rose "from 50.8% in 1883 to 70.7% in 1909, while the share of long-term credit (securities) dropped from 12% in 1883 to 0.3% in 1913."[84]

In the literature there is disagreement over the correct way to evaluate this predominance of formal, short-term advances on current account, given that as a rule these loans were repeatedly rolled over so that they were, de facto, long-term loans (Wellhöner/Wixforth (1990), pp. 15ff). A major reason for the increase in current account lending was that it became a precondition for the issuing and start-up business. Now, in contrast to the practice in the 1850s and 60s, the banks initially prefinanced a company's shares with a

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[82] This control problem is even more acute in the relationship between depositors, i.e. providers of external capital, and bank managers. It is one of the central arguments advanced to justify state regulation of the banking sector; see Dewatripont/Tirole (1996).

[83] This was a regulatory instrument that had already been introduced in England under Peel's Act of 1845 (Bagehot (1873), p. 123) which imposed relatively high entry barriers to the banking market. On the one hand, it afforded the existing banks protection against competitors and thus ensured that, even if their investment decisions were relatively risk-averse they would still earn a sufficiently large return. On the other hand, the high entry barriers kept the banking market free from banks which were exposed to a greater risk of moral hazard.

[84] Pohl, H. (1985), p. 80; similar findings are reported by Pohl, M. (1991), p. 41.

loan. The shares were issued later, after the investment had already been made. “The issue enabled the advanced funds to be repaid and the new firm could continue to conduct its normal business.” (Pohl, M. (1982a), p. 282). As the timing of the issue depended on the state of the stock market, this prefinancing arrangement could sometimes run for a term of several years. Wellhöner/Wixforth ((1990), p. 23) even regard the banks’ role as mediators between industrial enterprises and the capital market as their single main contribution to industrial accumulation. This puts a slightly different slant on the hypothesis expressed in the introduction that the particular contribution of Germany’s (large) banks to the industrialisation process was the provision of long-term finance.

However, the question of whether the increasingly important practice of lending on current account should properly be regarded as short- or long-term lending is less relevant than it might first appear to be. For, even if all overdraft loans were regarded as long-term loans, empirical research has shown that “even in the phase of uninterrupted, continuous expansion of the accumulation process, firms ... did not rely on long-term credit on current account as the primary factor in financing the growth of their business. ... Instead, self-financing through reinvestment of a portion of the profits and provisions for capital consumption, and funds raised in domestic and foreign capital markets, from the entrepreneur’s family and from institutional alternatives to the private banking sector, were much more important means of corporate finance.” (Wellhöner/Wixforth (1990), p. 17).

Based on the empirical evidence, the overall picture of corporate finance in Germany in the second half of the 19th century shows that the volumes of funds being supplied by the banking system had undergone almost a quantum leap since the first half of the century. The manner in which the funds were provided, i.e. the credit technology, also changed to the extent that the personal element increasingly gave way to credit decision-making based on formal, interpersonally verifiable criteria. Both developments add weight to the theory that the emergence of the large banks and their (credit) investments accelerated the rapid industrialisation of Germany in the post-1870 era. However, internal financing and other, informal, sources of finance continued to play a significant role in the financing of entrepreneurial activity.

For the financing of small and medium-sized enterprises, however, the question of whether the loans on current account provided by the large banks should properly be regarded as short- or long-term finance is largely irrelevant, as the vast majority of these

firms were in any case excluded from the development of enterprise financing in post-1870 Germany (Pohl, M. (1991), p. 44). The target group continued to face credit rationing by the formal financial system. Thus they were forced to satisfy their financing needs mainly by drawing on internal sources and/or tapping informal sources of external funds (family, friends and moneylenders).

5.5 Interventions in the Banking System by the State and by Not Exclusively Commercially Oriented Institutions to Improve the Financing Situation of Small and Medium-Sized Enterprises: The Emergence of Target Group-Oriented Institutions

In the economic history literature, the consensus view is that direct state interventions in the financial market for the specific purpose of promoting enterprise in general, i.e. not (only) small and medium-sized enterprises, took place only to a limited extent in the 19th century (Henning (1996), p. 160). Although under the mercantile system of the 17th and 18th centuries, when the state was heavily involved in directing the economy, state banks were set up whose purpose was to promote trade and industry, “in the 19th century they were above all institutions whose function was to conduct the state’s money transactions and above all to procure credit for the state. The state banks were hardly involved at all in the financing of industry.” (Pohl, H. (1982), pp. 125f) Even these limited interventions are open to the question raised in Chapter 2 as to whether they truly overcame a market failure or whether in fact it would be more appropriate to say that they caused a failure of the state. For, even with regard to this early period, criticisms could be raised “which in particular emphasise the difference between the declared aims of the actions and their actual economic effects. Frequently, measures that were subjectively intended to promote development turned out to be objective impediments to development.” (Borchardt (1976a), p. 244)

In general, therefore, it can be said that there were no significant state interventions in the financial system with the aim of promoting small and medium-sized enterprises. Nonetheless, there was an awareness of the problem of the target group’s lack of access to financial services and the adverse economic and social effects of this rationing. And the response to it came in the shape of savings banks and credit co-operatives, the first of which were set up as the result of private initiatives, often motivated by charitable

intentions.[85] It was not until a later stage in the development of these institutions that the state became involved as a founder and regulator (in the case of the municipal savings banks (Pohl, M. (1982), p. 203)) or simply a regulator (in the case of the credit co-operatives (Pohl, M. (1982a), p. 338)).

The savings banks emerged in the late 18th and early 19th century as the result of an analysis which concluded that the existing financial institutions were systematically denying members of the poorer social strata – day labourers, domestic servants and journeymen – access to financial services, and in particular the opportunity to put aside small amounts of savings in interest-earning deposits (Pohl, M. (1982), p. 195). As a logical consequence, up until the First World War the savings banks concentrated almost exclusively on doing liability-side business with this target group. Their main clientele consisted not of people who lived below the poverty line, "but rather the target group was recruited from among those who, although above the poverty line, found themselves in unstable circumstances and were under constant threat of descending into poverty." (Pohl, M. (1982), p. 196).[86] Initially, the mobilisation of savings proved a laborious business for the savings banks. "Quantitatively, ... the savings banks seem to have been of minor importance" prior to 1870. "They were dependent upon voluntary savings to a much larger extent than banks and bankers were, and their development was thus a growth-induced rather than a growth-inducing phenomenon." (Tilly (1967), p. 165)[87] It was not until after 1870, when industrialisation began to pick up speed and economic growth was stronger, leading to a continual increase in mass incomes, that the

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[85] See Geiger (1994), p. 12; Pohl, M. (1982), pp. 202ff.

[86] In other words, neither the savings banks nor the credit unions/co-operative banks catered to the "poorest of the poor". This insight is relevant to financial sector projects targeted at micro and small enterprises because sustainable, i.e. cost-covering micro credit programmes are often criticised for not serving the poorest of the poor. Evidently the founders of the savings banks and credit co-operatives were already aware that the two aims – cost coverage and sustainability on the one hand, provision of financial services for the poorest of the poor on the other – could not be achieved simultaneously. Yet surely no-one would deny that, from the point of view of social policy, both the savings banks and the co-operative movement were institutions worthy of support, which indeed they received when appropriate laws were passed.

[87] It very quickly became clear that the mobilisation of small savings entailed high transaction costs. "In order to keep administrative costs down, the savings banks were staffed almost exclusively by part-timers with regular jobs elsewhere. This shortage of staff meant that the counters were usually open on only one or two days a week, making it impossible for many wage-labourers and domestic staff to take their money to the bank." Pohl, M. (1982), p. 196. The high transaction costs of a deposit business involving very small amounts are an important reason for recommending that target group-oriented financial institutions should not yet offer this service when they have only just gone into operation. See Schmidt/Zeitinger (1994), pp. 86ff.

success story of the German savings banks movement also took on a quantitative dimension.[88] The decisive breakthrough came in 1908 when the savings banks became a modern banking enterprise by introducing the giro system. This gave them the opportunity –based on Germany's new Cheque Act – to participate in the national cashless payments system: "it was here that, boosted by the economic and political developments of the following years ... , the savings banks seriously entered the business of 'banking', ..." (Geiger (1994), p. 15).

The savings banks' asset-side business in the 19th century was dominated by mortgage loans, government securities and municipal loans (Pohl (1982a), p. 327, Tilly (1967), p. 165). Effectively, lending to micro, small and medium-sized enterprises did not take place, indeed it could not take place because neither farmers nor craftsmen and other small business could provide the high levels of collateral that the savings banks required from their borrowers (Pohl, M. (1982), p. 203).[89]

It was the credit co-operatives in particular that moved in to fill this gap. In urban areas they were known as "Volksbanken" [People's Banks], and specialised in catering to the credit needs of craftsmen and small manufacturers (Pohl, H. (1982), p. 123). Their goal was to enhance the ability of small and medium-sized businesses to compete with large enterprises: "To be able to compete with the large firms, the craftsmen needed capital to purchase machinery and modern tools, and to build up larger stocks of raw materials. However, small businesses had not been able to accumulate much equity, and banking institutions which, in their lending policies, were willing to make allowances for the shortage of collateral among small and medium-sized enterprises, did not exist." (Pohl, M. (1982a), p. 202.)

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[88] For details, see Pohl, M. (1982a), p. 325.

[89] Some members of the savings bank movement did, however, realise that by setting these collateral requirements, the savings banks were in effect excluding themselves from another major potential source of business, as well as the payment transaction business from which they were excluded by law. "In the period 1890–1908 the journal "Sparkasse" ran numerous articles advocating the introduction of chequeing and current account services. Johann Christian Eberle, a mayor in the state of Saxony, made a particularly forceful case for the introduction of a progressive, socially-oriented and reformed savings bank system. Above all, he demanded improvements to the asset-side business, and particularly the savings banks' lending business, so that they would be able to provide short-, medium- and long-term business loans to *Mittelstand* firms." (Pohl, M. (1982a), p. 323).

Initially the co-operative societies did not confine their activities to banking and credit, but also pursued other social and political ideals and goals, such as caring for neglected children, providing work for the unemployed and ex-convicts, or setting up popular libraries. However, it soon became clear "that the different activities could not be directly reconciled within one and the same co-operative, or under one and the same set of by-laws. One by one, co-operative societies ceased to pursue their other activities directly until eventually only the lending business remained." (Pohl, M. (1982), p. 209).[90]

The "professionalisation" of the banking business[91] and the establishment of an administration that operated strictly according to sound banking principles (Pohl, M. (1982a), p. 337) was also inevitable for another reason: The members of the co-operatives not only acquired shares in the business and thus supplied the co-operative banks with their capital base, but also, jointly and severally, bore direct, primary and unlimited liability for the bank's debts (Pohl, M. (1982), p. 205). This meant that due care needed to be taken in the conduct of the lending business, which explains why the co-operative banks, like the other commercial banks, focused on short-term loans,[92] in the form of bills wherever possible (Pohl, M. (1982a), p. 338), in order to guarantee the solvency and liquidity of the credit co-operatives. In other words, the credit co-operatives engaged in "target group-oriented banking" in the tradition of the commercial banks.

Like the savings banks, the co-operative banks also experienced a significant increase in business volume from 1870 on. For example, the combined outstanding loan portfolio of the Volksbanken grew from 61.03 million marks in 1865 to 1781.16 million marks in 1913. During the same period the number of credit co-operatives increased from 498 to 1,093 and their total membership from 165,595 to 815,065.

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[90] This finding of the historical–economic analysis is also relevant to the design of present-day micro and small enterprise credit programmes in developing countries and transition economies insofar as it supports the view of those who argue that projects of this type should not try to pursue many different social-policy and development-policy goals simultaneously, no matter how legitimate those goals may be in themselves. See Schmidt/Zeitinger (1994), p. 44.

[91] The credit co-operatives were not managed by unpaid volunteers "but by full-time professionals, and the managing directors were remunerated accordingly." (Pohl, M. (1982a), p. 338).

[92] Due to the specific features of agricultural production, this was not the case at the rural credit co-operatives, the *Raiffeisenbanken*; see Pohl, M. (1982a), p. 210.

5.6 Small and Medium-Sized Enterprises, Banks and Enterprise Financing in 19th Century Germany and in the Transition Economies of CEE/NIS – Parallels and Implications Regarding the Suitability of the Promotional Bank Approach as an Instrument for Improving the Financing Situation of the Target Group

The preceding analysis of the German financial sector in the 19th century describes a situation which coincides in two respects with the situation facing the target group in the transition economies of the late 20th century:[93]

1. When Germans were granted the freedom to choose their trade or profession (*Gewerbefreiheit*), a large private sector of micro, small and medium-sized enterprises evolved, much as it did in the transition economies when the communist-era prohibition on private enterprise was lifted. In both cases, the vast majority of micro and small enterprises during the first years (and in Germany, decades) were one-person operations or family businesses.

2. In 19th century Germany, as in today's transition economies, SMEs were subject to credit rationing unless they had personal connections or long-standing business relationships to the people in positions of authority within the emerging financial system. Micro, small and medium-sized enterprises therefore had to rely largely on internally generated funds and on the informal financial sector to finance their activities.

The "financial sector study" on 19th century Germany also shows, however, that the target group did not only perceive this credit rationing as an obstacle. At least as far as the external provision of equity or quasi-equity, or external long-term debt financing is concerned, the demand was not so great as might have been supposed given the "shortage of capital" of which the target group itself also complained (Borchardt (1961)). Some of the explanations put forward to account for this phenomenon could also be applied to the transition economies. For example, Pissarides (1998, p. 11) mainly attributes the target group's hesitancy in drawing on venture capital funds for Central and Eastern Europe to the "reluctance of SMEs' managers to accept an outside

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[93] It should be noted that this comparison is not intended to imply that the transition economies are at the same level of development as the German economy of the 19th century.

shareholder and their exaggerated perception of the value of their companies," i.e. to the desire to remain independent which also characterised the first generation of German entrepreneurs in the 19th century. In Albania the target group-oriented financial institution FEFAD (now FEFAD-Bank) often found that borrowers wanted to repay their loans ahead of the agreed maturity date, even though the average term was only 18 months, which in the context of the present-day Federal Republic of Germany would be regarded as a rather short maturity. The experience of other first-tier target group-oriented financial institutions, such as those which are implementing the projects initiated by KfW, EBRD or IFC, as referred to in the introduction, confirms that credit demand is focused primarily on working capital.[94] This means that, in the context of a newly emerging sector of private micro, small and medium-sized enterprises the initial hypothesis on which the promotional bank approach rests, namely that an appropriate supply of financing for the target group is one that consists exclusively or at least primarily of the "provision of long-term financing", does not stand up to empirical investigation.

The case of 19th century Germany is an example of a financial system that developed largely endogenously, i.e. one that was not triggered by external forces or by government action but was driven almost entirely by private enterprise. Given that a similar pattern of development was observed in other now-developed economies,[95] and also given that no alternative scenarios of successful financial system development processes are available for comparison, it makes sense to examine this process for evidence of characteristics which might serve as a reference for policies aimed at replicating such a development in other parts of the world and in another age. Space does not permit a discussion of the details of the theoretical considerations on which the following selection is founded.[96] What follows is therefore merely a brief inventory of the characteristics in question:

1. Banks evolve out of successful enterprises, many of them trade enterprises, which on the one hand have sufficient financial strength to put up the original capital, and on the other, through their activities in the real economy, have already acquired a core

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[94] See also Caprio (1995), p. 250.

[95] See Winkler (1998) and Winkler (forthcoming).

[96] See Winkler (forthcoming).

of (credit) customers to whom they can successfully provide financial services and especially credit.

2. At first, a bank's asset-side business consists almost exclusively of short-term loans to enterprises known personally to the bank's owner(s) and/or manager(s).

3. At the start of their operations, banks have a high equity ratio.

4. In the course of the developmental process, the credit business becomes increasingly formalised, progressively allowing banks to dispense with personal references. More of their lending is now long-term, but short-term loans continue to predominate. Meanwhile on the liabilities side, as the system of cashless payments expands, external funds in the form of demand deposits become an increasingly significant funding instrument, causing the equity ratio to decline.

The conditions that prevailed in the transition economies when financial systems in those countries started to develop in the early 1990s were quite different from those that existed in Germany in the early 19th century, as outlined in Chapter 4. Nonetheless, after nearly ten years of transition, parallels between the two situations are undoubtedly visible. For example, the more successful of the new, small, privately owned banks in the transition economies, e.g. in Bosnia-Herzegovina, Georgia, Macedonia and Armenia, are operating on basis that is definitely similar to that of the private bankers in Germany 150 years ago: founded by successful (trade) enterprises, they provide short-term loans to known enterprises on the basis of a relatively high equity ratio, and are increasingly engaging in (cashless, international) payment transactions.[97]

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[97] In one of the author's financial sector studies, the small, private-sector banks that had been operating for a number of years in the country in question was praised for pursuing this policy. This prompted criticism on the part of the client that had commissioned the study on the grounds that it is precisely this policy which is responsible for the fact that the majority of the target group are denied access to financial services. The misunderstanding, which was cleared up in a subsequent discussion, lay in the different points of view and different assumptions which led the author and the client to their respective assessments. These differences can be summed up as follows: If the emerging, small private banks do not possess a generally applicable credit technology which enables them to lend to firms, including those that are not well known to them, without incurring intolerably high risk-related costs, then their concentration on lending to known firms, or on other, less risky lines of business, such as payment services, is a rational response to this lack of an appropriate credit technology, and as such it should be welcomed. From the point of view of the target group, on the other hand, this behaviour is obviously to be condemned because it causes them to experience credit rationing.

Given that the promotional bank approach claims to support financial system development in transition economies, the evidence presented here poses the following question: Is it not the case that the declared intention of the promotional bank approach – to issue relatively large, long-term loans – in fact presupposes the existence of a financial system which has already reached a higher stage of development than the present financial systems of the transition economies, and especially of those countries which have made least progress towards reform? If the initial stages of financial system development are traditionally characterised by short-term lending on the basis of a high equity ratio, as the analysis of the development of Germany's financial system in the 19th century would seem to demonstrate, then a promotional approach that emphasises long-term lending by commercial banks on the basis of increased borrowing of funds (from the promotional bank) appears inappropriate – also from the point of view of the intended suppliers of credit, the commercial banks.

Finally, the development of the German financial system shows that one cannot simply assume that catering to the target group will automatically be a high priority for the commercial banks as they compete with each other for market share. This observation endorses the view of all bilateral and multilateral donors that – assuming that the justification for supporting SMEs is now generally undisputed – active intervention in the financial sector on behalf of this target group is a necessity. In the 19th century there were no bilateral or multilateral donors, and hence the German example cannot serve directly as a model for the design of financial sector projects of this type. Nonetheless, there are lessons to be drawn from emergence of the German savings banks and credit co-operatives. Here were two groups of institutions which devoted themselves to serving the target group – one providing mainly asset-side services, the other offering liability-side products – and whose establishment was motivated partly by the realisation that the target group was being neglected by the existing commercial banks, and partly by the recognition that the target group deserved to receive financial support. Furthermore, these initiatives were set in motion either by "donors" in the shape of prominent individuals and charitable foundations (in the case of the savings banks) or by socially-, liberally- and commercially-minded figures (in the case of the urban and rural credit co-operatives), and in this respect they can legitimately be compared with the projects initiated by the donor community in developing countries and transition economies.

On the issue of how (or with which type of project) the financing situation of micro, small and medium-sized enterprises can be improved, the following features of the German savings banks and Volksbanken provide valuable pointers:

1. They are first-tier financial institutions, i.e. they were founded at the level of the commercial banks.

2. They were founded and capitalised not by the state but by individuals and institutions that wished to further the interests of the target group. It was not until the savings banks and credit co-operatives had already established themselves that the state gradually imposed a formal, regulatory framework on their evolution by passing appropriate laws.

3. They pursued a business policy of "professionalisation", commercialisation and concentration on doing financial business with the target group. As both groups of institutions evolved, this led to the following consequences:
   - the charitable element (but not the target group orientation!) soon declined in significance and was eventually abandoned altogether,
   - cost efficiency and economic viability became a priority, and a professional management with banking experience was put in charge of achieving this,
   - on the credit side, the Volksbanken embraced the "banking tradition" of focusing on short-term loans to finance working capital, while on the deposit side, the savings banks introduced (cashless) payment facilities which gave its customers additional encouragement to accumulate savings.

Given the parallels that exist between 19th century Germany and the present-day transition economies in terms of the stage of development attained by both the target group and the financial system, it is reasonable to conclude that the development of the German financial system in the 19th century can serve as a valid reference for financial sector projects aimed at promoting small and medium-sized enterprises in Central and Eastern Europe and the NIS. Assuming this to be true, the pointers listed above make clear that the promotional bank approach lacks most of the features that characterise the "intervention" in the banking system represented by the 19th century German savings banks and credit co-operatives: Instead of being first-tier commercial banks, promotional banks are second-tier institutions; instead of relying on private or at least non-state initiatives, the state plays a dominant role in the creation of the promotional

banks; instead of following the banking tradition of focusing initially on short-term lending, the promotional bank approach advocates long-term lending with funds borrowed from the promotional bank. Conversely, almost all of the features listed above are embodied, albeit in various ways and combinations, in the donor-initiated project designs that are based on the principles of "institution building, commercial approach and financial system orientation". The only significant difference is that the institutional form chosen as the executing agency in the modern upgrading approach is not that of the co-operative bank but rather that of a target group-oriented private commercial bank initiated jointly by several different donors. One reason for this rejection of the co-operative bank set-up is that past projects based on co-operative banks in developing countries achieved disappointing results in practice (Krahnen/Schmidt (1994), pp. 52ff, Schmidt/Zeitinger (1994), p. 20); another is that in most transition economies the co-operative idea has been discredited by the communist past, so that efforts to rehabilitate it and help it to achieve a breakthrough in practice would either be doomed to failure or would take up an inordinate amount of time. The situation with savings banks is different, however. The Russian savings bank, Sberbank, for example, is a key partner of the Russia Small Business Fund project. At this institution, technical and financial co-operation is being used to encourage and accelerate the process of development which took place in the German savings banks system at the start of the 20th century.

6. The Suitability of the Promotional Bank Approach as an Instrument for Developing the Financial System and SME Financing in the Transition Economies – A Question of Situation Analysis and Empirical Results

In the preceding chapters the promotional bank approach was analysed against the background of various situations. As the proponents of this approach refer to the activities of KfW in the Federal Republic of Germany as a central empirical proof of the validity of their hypothesis that the promotional bank concept is a suitable instrument for improving the financing situation of small and medium-sized enterprises in the transition economies of Central and Eastern Europe and the NIS, the analysis focused initially on the development of post-World War Two Germany and the role of KfW. This investigation revealed that in the early post-war years – certainly until 1955 and arguably until 1971 – KfW did not pursue the promotional bank approach towards the target group in any practical sense. On the contrary, it acted as a successful reconstruction loan corporation in the classic mould, thanks largely to the outstanding banking experience of its two most important founding figures.

In 1971, when the promotional bank approach was developed and put into practice on a large scale by KfW, the prevailing conditions in the West German SME sector were very different from those under which these enterprises operate in Central and Eastern European transition economies. Whereas in Germany from 1971 on KfW's aim as a promotional bank was to counteract a competitive disadvantage which established small and medium-sized enterprises were facing vis-à-vis large enterprises, the promotional banks in the transition economies were and still are confronted with a situation in which a target group consisting almost exclusively of micro and small enterprises is having to fight for survival in an unfamiliar market environment characterised not least of all by an extremely crisis-prone financial sector. The financial institutions in these countries are in any case either not at all active in the financing of the private sector as a whole, i.e. large enterprises as well as small and medium-sized ones, or they are very selective in their lending, a policy which stems from their lack of appropriate credit technologies, as is reflected in their high percentage of non-performing loans.

Moreover, judging by the relationship between the political and the economic spheres in most of the reforming transition economies, and bearing in mind the prominent role of politicians in defining a promotional bank's mission, appointing its owners and guiding its business policies, it appears highly unlikely that the new promotional banks will be able to match the delicate balance between professional banking practice and political

influence that has characterised the corporate governance of KfW since 1948. These differences in regard to the most important categories on which the promotional bank approach depends – target group, banking system and corporate governance – suggest that the promotional banks in the transition economies, with the possible exception of the most advanced reforming countries, face a daunting task if their intention is to reach a significant percentage of the target group, and especially the small enterprises, by applying the approach as it stands. The available – albeit insufficient – empirical evidence does not contradict this assertion. To date, promotional banks have only gone into operation in those countries that have already reached a relatively advanced stage of the transition process. Furthermore, the SME business of these promotional banks appears to consist primarily of lending to the larger firms within this target group. Accordingly, they have probably done little to alleviate the credit rationing to which micro and small enterprises are subject. And finally, the SME business does not necessarily play the dominant role in relation to the other lines of business (e.g. infrastructure and housing finance) which, according to the theory behind the approach, a promotional bank may also pursue but only as a supplement to the core business of SME support. From the standpoint of development policy, there is nothing wrong with this shift of emphasis, given that there is an obvious need for support in these areas. However, since the primary task of the promotional bank approach, by definition, is to promote not only medium-sized but also small enterprises, and the financial sector as a whole, it is questionable whether even the promotional banks that are already in operation are actually achieving the goals for which the approach was designed.

Finally, given that the operating environment of the target group in the transition economies is characterised by an emerging private sector and a banking system in the process of being built, it seemed appropriate to consider whether lessons could be drawn from the history of Western societies at a comparable stage of development which could then be applied to promotional strategies for improving the financing situation of the target group. To this end, the development of the target group, the banking system and enterprise financing in 19th century Germany was analysed. Not only quantitative but also qualitative parallels were found to exist between this period in Germany's economic history and the present situation in many transition economies. Two results of this situation analysis were of particular interest for an assessment of the promotional bank approach. First, from a demand-side and also a supply-side perspective, it could be argued that the most appropriate form of financing – i.e. the type of loans which commercial banks should provide to small and medium-sized enterprises during such phases of financial sector development – is not so much the long-term loan to finance

fixed asset investments, but rather the short-term loan to finance working capital. Second, the "interventions" that took place in the German financial system during the 19th century in order to overcome the credit rationing experienced by the target group, or more generally, to give the target group access to financial services, were based on principles diametrically opposed to those behind the promotional bank approach. The institutions involved were not second-tier institutions, they were not founded on government initiative, and they did not engage, at least to any great extent, in long-term lending. Rather the origins and development of the German savings banks and credit co-operatives exhibit the features that characterise the institution-building approach to development finance projects.

Every historical situation is unique. Consequently, every comparison between historical situations is inevitably problematic. If, despite these reservations, historical comparisons occupy such a large part of the present paper, it is because the explicit and implicit equation of two historical situations – post-World War Two Germany and post-Cold War Central and Eastern Europe – is a central argument put forward by the advocates of promotional banks to justify that approach. Presumably, if it had not been for this historical context, the suitability of the approach would have been subjected to more critical scrutiny, given that its aims and spheres of activity are markedly similar to those of the development banks, which the majority of development finance practitioners, even in Germany, now regard as failures. In fact, the detailed comparative analysis presented in this paper comes to an unambiguous conclusion: it is inadmissible to equate the two historical situations, especially in terms of the target group, the banking system and the corporate governance environment. Hence the comparison cannot be accepted as evidence that the promotional bank approach is a suitable instrument for improving the financing situation of small and medium-sized private-sector enterprises in the transition economies. Before a conclusive evaluation can be given, however, more detailed empirical analysis of the results achieved in the transition economies to date is needed. Bearing in mind just how important the development of the financial system and the SME sector is for the national economies of the countries concerned, it is to be hoped that such an analysis will be presented soon.

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