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The SPD Opened the Window to "the Locusts" – They Should Now Shut It Again

Recommendation to the Government of Germany

by André Nilsen

INTRODUCTION

Germany has all of a sudden been thrown into a highly charged capitalism debate centered on the increasing power of Anglo-American institutional investors.

There was always a certain level of concern in Germany that the growing role of pension funds, insurance companies, and mutual funds over time would lead to a greater emphasis on short term shareholder value to the detriment of the long term interests of other stakeholders.

However, the spotlight was cast on more dangerous species of institutional investors as Franz Müntefering, the chairman of the ruling SPD social democratic party, recently denounced Anglo-American investment banks, private equity compa-

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MAIN POINTS
The SPD facilitated the power of hedge funds seen in the Deutsche Börse coup by breaking the financial system, strengthening institutional investors, and making industry vulnerable. It is time to abandon this misguided political strategy and restore Germany's comparative advantage.

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nies, and hedge funds as "locusts" that wreck havoc on the German corporate economy.

Shortly after spelling out his worries, with virtually perfect timing, British hedge fund TCI spectacularly succeeded in forcing the resignations of Rolf Breuer as Chairman and Werner Seifert as CEO of Deutsche Börse, marking a watershed in the development of German capitalism only matched by Vodafone's unprecedented hostile takeover of Mannesmann a few years ago.

The SPD, however, can largely blame itself for the deteriorating state of German capitalism. It is during their time in government that Germany has carried out a number of key legislative reforms that have broken up the traditional financial system, strengthened institutional investors, and made domestic industry more vulnerable.

The SPD has in pursuit of a deeply misguided political strategy caused considerable harm to Germany's comparative advantage as an industrial nation. However, although the awakening is belated, it is not too late to repair the damage.

BREAKING UP DEUTSCHLAND AG

The single most destructive legislative reform carried out by the SPD is the abolition of capital gains tax on sales of cross-shareholdings in 2000. The effect has been a destabilizing change in the ownership structures of the financial system as the nexus of cross-shareholdings among corporations has begun to unravel.

Already before the SPD came to power in October 1998, however, they had taken firm steps to undermine the system of cross-shareholdings. Politician Hans Martin Bury and academic Theodor Baums orchestrated the Bundestag's adoption of far-reaching legislative reforms in the KonTraG act on behalf of the SPD while the party was still in opposition. This act placed restrictions on the practice of cross-directorships that accompany cross-shareholdings as well as on the role of banks as key participants in these networks.

As the glue that has kept the German corporate economy together as a cohesive, balanced, and cooperative whole is vaporizing, the system is broken into atomistic, volatile, and competitive pieces.

This has also done more than anything to encourage the defection of Deutsche Bank and Allianz from their traditional roles as system integrators, guardians of stability, and responsible coordinators.

A NEW BALL GAME

The system of cross-shareholdings was characterized by strategic investors. Each strategic investor was a blockholder in each company. Each strategic investor owned a large percentage of each company and invested only in a limited number of companies, with each stake forming a substantial commitment. Most strategic investors pursued long term industrial aims as opposed to short term financial objectives. They exerted influence over companies through dialogue on supervisory boards.

In the new corporate landscape, many of the blockholders that used to form part of cross-holdings offloaded their stakes into the capital market. There the blocks have fragmented and most of the individual stocks have quietly been soaked up by Anglo-American institutional investors.

Although institutional investors as a group constitute one of the largest categories of owners in the economy as a whole, each institutional investor is almost always a minority shareholder in each company. Each institutional investor owns a small percentage of each company but invests in a large number of companies, so that each investment forms a tiny part of a vast diversified portfolio. Most institutional investors pursue short term financial objectives as opposed to long term industrial aims. They exert influence over companies, supervisory boards, managing boards, and corporate strategy by using either their financial leverage in hostile takeover bids or their voting power in the general meeting.

FLIRTING WITH GLOBAL CAPITAL

The institutional investors were indeed well placed to act boldly when the SPD broke up Deutschland AG by abolishing the capital gains tax on sales of cross-shareholdings in 2000. Their hands had already been strengthened by a series of capital market promotion acts introduced over the 1990s.

Three acts had already been introduced by the CDU but when the SPD came to power in October 1998 they decided to take this agenda even further, leading to a fourth act in 2002.

The effect has been to make companies more reliant on corporate finance from capital markets dominated by institutional investors which at the same time had their rights and powers significantly boosted by these legislative reforms.

The SPD's romance with global capital reached its height with the 2004 investment modernization law which paved the way for admission of and investment into hedge funds in Germany.

EXPOSING THE CROWN JEWELS

As these SPD-reforms ensured that German companies were wrestled out of their cross-shareholdings and thrust into the strengthened hands of foreign institutional investors, SPD-legislation had already seriously impaired the ability of domestic industry to resist the tight embrace of global capital.

The KonTraG act mentioned above, which was masterminded by the SPD while they were still in opposition before they came to power in October 1998, was not only damaging because it contributed to the erosion of the system of cross-shareholdings. It was most harmful because it stripped German companies both of their clothes and their arms in front of foreign institutional investors.

On the one hand, the KonTraG rendered German companies naked by requiring them to include segment breakdowns and cash flow statements in their financial reports (these provisions were further sharpened by the SPD with the 2002 transparency and disclosure act). Since these changes revealed the hidden reserves they traditionally have relied upon to ensure long term stability, the effect has been to make German companies extremely attractive targets for institutional investors looking for short term profits.

On the other hand, the KonTraG rendered German companies vulnerable by outlawing pre-bid takeover defences such as multiple voting rights, voting rights caps, and maximum voting rights. Since most other countries – e. g. the United States, France, Sweden – allow pre-bid takeover defences, the effect has been to make German companies fairly easy targets for hostile takeovers compared to most foreign companies, notwithstanding the fact that the takeover act allows post-bid takeover defences by permitting boards to take actions to fend off bids.

SURPRISE, SURPRISE! THE LOCUSTS HAVE LANDED!

The combined effect of all the legislative reforms introduced by the SPD has been a tremendous influx of Anglo-American institutional investors. Not only those with the acceptable face of capitalism, such as pension funds, insurance companies, and mutual funds, also those with its less pleasant face, such as private equity companies and hedge funds

Most importantly, however, these institutional investors have arrived fully armed with all the new rights and powers given to them by the SPD. Indeed, given the very success of the ultra-liberal legislative reforms of Mr Müntefering's party, Mr Breuer and Mr Seifert never had a chance in the jaws of the locusts. In this light, one can be forgiven for likening Mr Müntefering's condemnation of institutional investors with Captain Renault's outburst in Casablanca, "I'm shocked, shocked to find that gambling is going on in here!".

WHAT TO MAKE OF IT

The explanation of the SPD's legislative reforms lies in their political strategy. As the SPD prepared for the 1998 election, they tried to mimic the policies and rhetoric that had produced the electoral success of New Labour in the UK the year before, even to the point of rebranding themselves as the Neue Mitte.

A key part of this political strategy involved courting the middle classes with a business friendly attitude while reassuring the lower classes with a commitment to shake up traditional capitalist interests. The political message – perfectly embodied in the KonTraG – was to attract institutional investors to boost the economy while dismantling the networks of blockholders, reducing the power of banks, and removing the protection of managers.

However, minority shareholders such as institutional investors have traditionally been marginal outsiders in the German system where the dominant insiders instead have been stakeholders such as blockholders, banks, managers, and workers. Although these stakeholders of course have had differences, they have none the less had more in common than any of them have had with minority shareholders.

Promoting institutional investors, on the one hand, therefore hurt blockholders, banks, managers, and workers equally. And attacking blockholders, banks, and managers, on the other hand, not only hurt these groups but also hurt workers since the entire stakeholder approach was undermined. This was therefore a deeply misguided political strategy. It damaged the interests of German upper, middle, and lower classes alike. The only ones who benefited were Anglo-American institutional investors.

The evaluation of the SPD's legislative reforms must be based on their impact on the economy. Far from boosting the economy, however, they have caused considerable harm to Germany's comparative advantage as an industrial nation.

The ultra-liberal legislative reforms have boosted the role of the market in finance and corporate governance. As a consequence of the institutional complementarities among the different spheres of the economy, these market forces spill over into labour relations, vocational training, and technological development as well.

Germany's comparative advantages, however, such as industrial peace, specialized skills, and incremental innovation, rely on coordination by non-market institutions. Faced with brutal market forces, these complex non-market institutions break down, which means that Germany loses the ability to sustain its comparative advantages.

WHAT TO DO WITH IT

Although the SPD is only now beginning to realize the considerable harm caused by its legislative reforms, it is not too late to repair the damage.

To restore Germany's comparative advantage as an industrial nation, the SPD should use their power in government to make policies that are complementary to and support the non-market institutions that sustain industrial peace, specialized skills, and incremental innovation.

- The SPD should abandon their ultra-liberal approach to corporate finance and ownership structures. First, they should reign in institutional investors by kicking out hedge funs, regulating private equity companies, and keeping a close eye on investment banks. Second, they should encourage a greater role of banks. Third, they should discourage a further erosion of cross-shareholdings.

- The SPD should make sure that corporate governance protects the common interests of stakeholders such as German blockholders, banks, managers, and workers rather than the narrow interests of minority shareholders such as Anglo-American institutional investors. First, they should use the transposition of the EU takeover directive into German law as an opportunity to permit pre-bid takeover defences again. Second, they should use the Biedenkopf commission as an opportunity to strengthen co-determination.

- The SPD should strengthen vocational training. First, they should increase the funding for the training institutions. Second, they should create financial incentives for the participating companies. Third, they should create financial incentives for the young trainees. Fourth, they should encourage continued close cooperation between business associations and labour unions.

- The SPD should strengthen technological development. First, they should encourage continued joint R&D collaboration among companies supported by research associations. Second, they should discourage development of markets for technology – such as a labour market for scientists, an M&A market for technology companies, and a market for patents and licenses.

There are two preconditions for this policy agenda to work. On the one hand, the SPD has to adopt a fresh academic paradigm to frame policy. The narrow and flawed Chicago-style economics and law framework that their current academic advisers have relied on to drive the ultra-liberal legislative reform should be scrapped. Instead the broader and sounder political economy approach developed by a new generation of academics and advisers should be adopted to generate legislative reforms focused on industrial competitiveness.

On the other hand, the SPD has to adopt a firmer stance at the European level. The naïve and misguided Lisbon-agenda that animates current ultra-liberal legislative initiatives in the EU should be brought to an end. Instead the sophisticated and rigorous social market economy model should be embraced as the template for legislative initiatives in the EU focused on stability, growth, employment, productivity, welfare, and competitiveness.

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