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Did banks cause the German industrialization? ☆

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Abstract

In this paper, we discuss the causal relationship between growth of bank assets and economic performance (economic growth, capital accumulation, productivity). We analyze new data for German banking (Burhop, C., 2002. Die Entwicklung der deutschen Aktienkreditbanken von 1848 bis 1913: Quantifizierungsversuche. *Bankhistorisches Archiv* 28, 103–128.) and improved national accounting data (Burhop, C., Wolff, G.B., 2005. A compromise estimate of Germany's Net National Product 1851–1913 and its relevance for economic growth and cycles. forthcoming, *Journal of Economic History*.) with several recent VAR/VEC based causality tests. Only weak evidence for a causal influence of banks on economic performance on a nation-wide level is detected. On the other hand, the results support the bank-led growth hypothesis for the modern sector of the German economy. In particular, joint-stock credit banks positively influenced capital formation during the early decades of Germany's industrialization.

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1. Introduction

The investigation of the banking-growth-nexus is an evergreen in German economic history, in development economics, and in general economics alike. This paper contributes to the ongoing debate by combining a new data set for German banking (Burhop, 2002), improved national accounting data (Burhop and Wolff, 2005), and recent econometric methods (Sims et al., 1990; Toda and Phillips, 1993; Toda and Yamamoto, 1995).

Nineteenth-century Germany is one of the most intensely studied cases of the banking-growth-nexus in economic history (see Fohlin, 1999a; Guinnane, 2002). The idea of a positive impact of large German joint-stock credit banks on economic growth dates back to the writings of Jeidels (1905), Riesser (1910), and Hilferding (1910). It was reintroduced into the debate by Gerschenkron (1962), who hypothesizes that moderately backwarded economies—like Germany during the 19th century—can accelerate their growth by setting-up modern institutions such as joint-stock banks.

This idea was formalized by Da Rin and Hellmann (2002). In their model, banks may act as catalyst for industrialization if they are sufficiently large to provide capital for a critical mass of firms, and if banks possess sufficient market power to make a profit from coordination of industrial activities. In this framework, banks can propel an economy from a self-perpetuating low equilibrium to a sustainable high equilibrium: banks thus can become the driving force in a big push towards industrialization. Banks, for example, can finance a critical mass of firms at below-market interest rates. Firms outside that critical mass are financed at market rates. Banks are interested in financing some firms at lower rates, since profits will be higher after industrialization. They are able to finance some firms at below market interest rates if they have sufficient market power for price discrimination and cost advantages. Such costs advantages are most likely for large banks, since they can realize economies of scale and scope.

Microeconomic theory of banking identifies several ways in which financial intermediaries operate within a world involving information and transaction costs (see Levine, 1997 for an overview). Basically, banks and other financial intermediaries have five fundamental functions: they mobilize savings, allocate resources, exert corporate control, facilitate risk management, and ease the trading of goods, services, and contracts. In addition, banks can successfully screen credit applications, allocating credits only to the most promising investment opportunities, and thereby, fostering technological innovation (King and Levine, 1993a,b). Cost advantages of large banks can emerge from these functions. Large banks may have more screening and monitoring experience since they have more customers and credit applications. They have more power in exerting corporate control since their credits are important for firms. In addition, risk diversification is easier using a large portfolio.

On the other hand, a number of endogenous growth models do not show a causal relationship between financial development and economic growth, e.g., Greenwood and Jovanovic (1990) and Pagano (1993). Pagano, for example, argues that financial development can influence growth by altering the saving rate. Financial development may reduce the saving rate, since consumers have better protection against liquidity

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