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Financialization and Institutional Change in Capitalisms: A Comparison of the US and Germany

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Abstract: This paper analyzes and compares the process of financialization and itsconsequences for political economic institutions in the United States and Germany. It advances the argument that the best way to explain institutional change and cross-national diversity is through an actor-centered institutional approach that recognizes how actors innovate within institutional and structural constraints to new pressures for change. It is argued that the high degree of financialization and market liberalization of the US economy was not pre-determined by structural forces or American culture, but a combined product of structural forces, institutional features of policymaking, and political choices. In Germany there is much less financialization than in the US, but it still led to institutional changes that opened up more space for some firms to construct firm-level institutional complementarities that deviate from the traditional German economic model. This supports a more general conclusion that, under conditions of financialization and globalization, national-level institutional complementarities may be waning in advanced economies, giving way to greater internal diversity and a proliferation of divergent firm and sectoral-level institutional complementarities.

Keywords: financialization, US, Germany, varieties of capitalism

JEL Classification Numbers: P50, L50, J50, G38

1. Introduction

The process of financialization has become a central object of study by political economy scholars. In general terms, financialization refers to the growing influence of financial actors (whether direct or mediated via markets) over the real economy (i.e., control financialization) and the growing portion of corporate revenue and profits deriving from financial transactions (i.e., profit financialization). This process is evident across the OECD economies, with a systematic growth in financialization generally beginning in the 1980s (Epstein and Jayadev 2006; Krippner 2005; Davis 2009). Financialization is both a product and cause of broader market liberalization processes – encompassing product, service, and labor markets – that spread across the advanced economies over the last thirty years. As such, examining financialization focuses attention one of the key (if not the main) causal mechanisms of institutional change in advanced economies and is essential to any account of institutional change in national political economies. It appears the recent global financial only slowed the financialization processes, and there is little reason to think that the profound expansion of financial market influence over capitalism will be dramatically rolled back.

For much of the last twenty years, financialization was seen as the key driver in the erosion of distinct varieties of capitalism and convergence on a largely liberal model of capitalism, including its focus on shareholder value as the dominant norm for corporate management (Lazonick and O'Sullivan 2001). It is argued that increasingly mobile capital demanded deregulation of financial activity and fostered convergence in corporate governance arrangements that would facilitate cross-border investment flows. Even those who did not believe the convergence thesis viewed financialization as a monolithic and irresistible force of liberalization that eroded non-market coordination mechanisms among firms and between capital and labor. However, it is now clear that, while financialization is an ubiquitous process in the advanced economies, the degree and consequences of financialization are quite varied (e.g., Engelen at al 2008; Wood and Wright 2010). And though there has certainly been notable cross-national convergence in financial market structures and corporate governance regulations, it is not clear that national models have, on the whole, become more similar. Moreover, the impact of financialization within different national economies varies considerably.

Convergence and mainstream economic theories would predict comparable rates, or at least converging rates, of financialization in both cases examined in this article. Some convergence theories see isomorphic pressures toward shareholder value ideology as a key driver, while others emphasize the role of global financial actors, especially institutional investors, as agents of change. Yet another group emphasizes the application of hegemonic power by the US (with some aid from the UK) in promoting an "Anglo-American" model of finance that favors American and British financial institutions in global markets. Regardless of which causal pathway is emphasized, all convergence theories predict that national economies will converge toward the Anglo model, even as that Anglo model itself becomes more financialized.

In contrast, Varieties of Capitalism (VoC) theory predicts relatively limited financialization of coordinated market economies and thus limited convergence between them and liberal market economies (LME). This prediction is rooted in the argument that economic actors (chiefly firms) would resist extensive liberalization and financialization because of their material and strategic interest in maintaining a system of "patient capital" that facilitates firm strategies based on investment in specific assets – firm and industry-specific labor skills, joint R&D, joint production and relational contracting. Because specific assets are not easily turned to new purposes, firms need reliable sources of investment capital that will support them through temporary downturns in demand.

That said, Hall and Soskice (2001) did note that if CMEs were to converge on LMEs, it would be through the power of financial actors who would drive a market logic and market coordination mechanisms into other institutional domains through the institutional complementarities that link the different domains of the economy. In the case of LMEs, such as the UK, VoC expected that financialization would strengthen market coordination (and competition) in all institutional domains and for all size firms.

One can also identify a third perspective on financialization that emphasizes three structural variables as the key determinants of the degree of financialization. The first structural variable is the availability of sufficient amount of mobile capital (i.e., deep and liquid capital markets); the second is the presence of sufficient number of large and influential shareholder value-oriented investors (i.e., a large funded pension system or functional equivalents); and finally, adequate managerial discretion over the extent and direction of factor mobility, including capital and labor (i.e., deregulated product and labor markets; See Engelen et al 2008; Morgan and Kubo 2005).

This paper advances the argument that the best way to explain the extent and pattern of institutional change, as well as cross-national diversity, is through an actor-centered institutional approach that recognizes how actors innovate within institutional and structural constraints to new pressures for change[1]. The extent of innovation or institutional change, and thus the degree of financialization and cross-national convergence, is also constrained at the macro level by the dominant domestic political coalition. The contrasting cases of the US and Germany show extensive financialization and liberalization in both, but also substantial differences in the degree and pattern of change. To some extent this is not surprising from the perspective of institutional theory, which predicts gradual, path dependent change. However, this leaves open the question of explaining specific instances of institutional changes that do not conform to common predictions: Stated more specifically, the paper will argue that the high degree of financialization of the US economy was not pre-determined by structural forces, but a combined product of structural forces, institutional features, and political choices. A similar theoretical frame is applied to Germany which, although it did not financialize or liberalize as much as the US and other advanced economies, exhibits a greater degree of these in some respects than many would have predicted. The case of Germany also illustrates well a common pattern in many advanced economies; namely, that institutional changes adopted by governments have opened up more space for firms – especially large, but even small firms – to choose their own firm-level institutions, i.e., to construct a diverse set of firm-level institutional complementarities. Thus some firms in Germany have chosen a more shareholder-oriented approach and increased their use of contingent labor, while others hew more closely to the traditional stakeholder model. This supports a more general conclusion that national-level institutional complementarities may be waning in advanced economies, giving way to greater cross-national and internal diversity and a proliferation of divergent firm and sectoral-level institutional complementarities (e.g., Deeg and Jackson, 2007; Woods and Lane, 2012).

2. Financialization and institutional change in the US model of capitalism

From the late 1930s to 1970s the US model of capitalism was based loosely on a Keynesian growth model. The state pursued policies to simulate and maintain aggregate demand and promoted core sectors of the economy such as housing and infrastructure construction. Collective bargaining and pro-labor policies were widely accepted in the public and corporate spheres, while bargaining agreements influenced wages and working conditions across much of the economy. Product market regulation – including financial – was fairly extensive. After WWII, promoting the expansion of global trade was a tenet of the American growth strategy. Industrial policy in the US was more covert than in other advanced economies, but extensive in certain sectors, especially those related to defense (Vogel 1996). Politically, this era was dominated by the Democratic New Deal coalition – the urban working class, southerners, farmers, and much of the middle class.

The American manufacturing sector was dominated by Fordism and large, vertically-integrated firms. The Fordist model relied on unskilled and semi-skilled workers, and was thus compatible with a general skills-based training system (Thelen 2007). It was complemented by weak forms of stakeholder corporate governance and an acceptance of unionized labor, made possible in part by regulated product markets, US global economic dominance, and a relatively high degree of managerial autonomy – and thus relative indifference to financial market demands – arising from the generally dispersed and passive nature of corporate ownership (Davis 2009). It was also during this era that corporate provision of "welfare" in the form of health insurance and defined benefit pensions came to be the norm, made by possible by tax incentives and relatively muted market and financial pressures on corporate managers.

One could readily argue that several institutional complementarities marked this model. One would be that weak stakeholder governance and unionization (de-commodified labor) were complementary to regulated markets and the demand-led growth model. In retrospect, though, some of the institutional complementarities in the US model may not have been that strong, since their maintenance depended as much on political factors (voluntary compliance more than legal requirement) as on economic efficiency gains. With the onset of product market deregulation in the late 1970s, the competitiveness problems of US industry in that same decade, the decline of the supporting New Deal coalition (due in good part to the defection of southern Democrats from the party), shifts in technology and other structural economic conditions, a rapid shift occurred in preferences of employers regarding labor relations and finance/corporate governance during 1980s (Deeg 2012b).

During the 1980s US corporate governance shifted from a system of managerial dominance with a weak norm of stakeholder governance to a system of shareholder value governance (O'Sullivan 2009). External financial actors gained greater influence over corporate managers via takeover activity, use of performance pay, and shareholder activism (driven in part by the rise of institutional investors). The shift cannot be attributed to any single, major reform. Rather, it was more a result of the new leveraged buyout wave and pressure from activist buyout funds; this was facilitated further by regulatory and tax rulings favoring the use of stock options for executive compensation (Davis 2009; O'Sullivan 2009).

Whether incidental or intentional, the complement to this shift in corporate governance was a corporate assault on organized labor. From the early 1950s to the early 1970s, the unionization rate in the US hovered around 30 percent of the labor force. The rate began declining during the 1970s and accelerated rapidly during the 1980s (it now stands at roughly 12% overall and 7% in the private sector: Lehne 2005; Godard 2009). The extent of union decline in the US is unique among advanced economies and cannot be linked to major formal institutional reforms. Rather the attack on unions and their decline was possible because the preceding period of relatively peaceful cooperation between management and labor rested to a considerable degree on management's voluntary acceptance of organized labor representation.

The decline, then, occurred to a great degree through anti-labor interpretations and enforcement of existing labor laws and regulations by the President, federal bureaucracy and courts. These changes in labor and corporate governance institutions were facilitated politically by President Reagan's anti-government movement (Prasad 2006, 67-70): Deregulation, a smaller state, and freer markets were touted as the solution to the economic ills of the 1970s and early 1980s.

By the early 1990s, the US model had coalesced around a new model based on a different set of complementarities: deregulated and decentralized labor markets combined with shareholder-oriented finance and corporate governance to produce a system with a highly flexible allocation of productive resources – regarded within the US and by VoC theory as a chief competitive advantage of a liberal market economy (LME). Today there are few statutory or normative restrictions on layoffs by employers and the US has the most flexible labor force in the OECD[2]. Labor and wage flexibility are further enhanced by the comparatively low replacement rate and duration for unemployment insurance. The American model was also no longer organized by and around large integrated firms, but by markets guided by financial imperatives (also Davis 2009).

But how do we explain this pattern of change, and what role did institutional complementarities play in shaping it? From a theoretical perspective, the evolution of US capitalism over the last three decades accords well with the Varieties of Capitalism (VoC) prediction that inherently liberal market economies (LMEs) will, under increased competitive pressures, become even more liberal (i.e. market oriented) in their economic governance (Hall and Soskice 2001). Yet this theory gives us little to explain or predict the degree to which an LME will liberalize, nor does it help us understand why the US economy so heavily financialized, i.e. dependent on finance-driven activity for economic growth. It also does not help us understand why the US model came to rely increasingly on excess leverage by banks and especially consumers as its source of growth. There are a variety of structural theories that explain liberalization and financialization in the US, but this paper will argue that structural factors alone are insufficient. Rather, answering these questions requires a historical examination that also incorporates the role of US-specific institutions and the political coalitions that emerged to reshape the rules defining the US model.

The central feature of change in American capitalism is without doubt the financialization of its economy. First, the financial sector expanded as a portion of the economy – from 1975 to 2004 total stock and bond market capitalization grew from 102% to 289% of GDP (Deeg 2010, 316); the portion of corporate profits accruing to financial firms and to financial transactions of non-financial firms rose dramatically from around 10% in the early 1980s to 40% in the early 2000s (Krippner, 2005, 2011); the influence of financial firms over corporate management decisions expanded through the rise of shareholder value principles (Perry and Nölke 2005); institutional investors and nonbank financial institutions ("shadow banking") became major pillars of the industry; the financial behavior of households also changed dramatically, as pension funds and mutual funds became the central vehicle for saving and investment (Langley 2008; Davis 2009).

While VoC theory offers a economic functionalist explanation of the financialization of the US economy, other theories offer political functionalist explanations. Krippner (2011), for example, argues that the US was confronted by three crises as economic growth slowed during the 1970s; a social crisis of heightened distributional conflicts; a fiscal crisis as the growing cost of social benefits increasingly outstripped revenue to pay for them; and a legitimation crisis for the state, given its inability to handle the first two crises, leading to a loss of trust in government. The state's ad hoc responses to these crisis led to three interrelated policy shifts that created a macro environment conducive to financialization: First, deregulation of financial markets in 1970s; second, increasing dependence/reliance on foreign capital to finance deficits (starting in 1980s); and third, a radical change in monetary policy. These policy shifts led to a credit boom that stimulated more consumption and investment while increasing foreign capital flows to finance US deficits. The expansion of private consumption and the resulting growth allowed the US government to reduce conflicts over finite state resources. Thus, a self-reinforcing political dynamic of financialization ensued.

Schwartz (2009) argues that the creation and growth of a residential mortgage-backed securities (RMBS) market in the 1990s, a product of both private sector initiative and government policy, boosted investor demand for mortgages, in turn driving down interest rates and allowing consumers to borrow against their home equity in order to increase consumption. Simultaneously, global disinflation made US-originated RMBS an attractive investment for global capital which helped finance the rising US current account deficit. Together these produced a strong demand stimulus during the "long 1990s" (1991-2005) and high economic growth rates. The comparatively high growth of the US economy boosted overseas investment by US multinationals and purchases of financial assets abroad by banks. Thus, like Krippner, he sees the financialization dynamic as driven in large part by the unintended outcomes of policy choices and structural changes that yielded superior economic results, which, in turn, reinforced policymakers' belief that the US model of financial capitalism was a superior and durable model.

These structural theories do highlight important contributors to financialization in the US, perhaps most importantly the role of positive feedback effects between economic growth based on demand/credit expansion and subsequent policy choices. Schwartz also highlights the US' unique position as the world's largest economy and global reserve currency which facilitated a growth strategy based on leverage and huge inflows of foreign capital: This is surely another structural variable that helps explain why financialization could proceed as far as it did in the US.

Yet, like most structural explanations, they are prone to excessive functionalism in their accounts. From a comparative perspective, Krippner's argument does not help us understand why other advanced economies, faced with the same set of crises during the 1970s, liberalized to a much lesser degree. Also, both Krippner and Schwartz's argument rest on the significance of increased cheap capital (i.e. borrowing) as the salve that solved political problems for US politicians. While there is much evidence in favor of this, borrowing by governments and private leverage as a political solution is common cross-nationally (contemporary Greece comes to mind as a good example), yet is not associated with American levels of financialization. Thus, we need to go further in order to understand the unique degree of financialization in the US and the historically contingent events that turned broad structural forces into specific and distinct outcomes.

While this paper is too short to develop a full theoretical and empirical account, we suggest that the structural factors highlighted by Krippner and Schwartz and the role of complementarities highlighted by VoC, be combined with a actor-centered historical-institutional (HI) account which allows for greater indeterminacy in the evolutionary path of US capitalism and thus highlights the politics behind it. The HI account adds two important variables to explaining the outcome, namely the institutional character of the US legislative and regulatory structure on one hand, and social and political coalitional dynamics on the other. These other two variables help us understand why some liberalization measures were resisted for long periods of time, even by the financial sector, and how both the Democratic and Republican parties became proponents of financialization because of electoral strategies and shifting ideology, and not simply because of the positive functionality of financialization. Moreover, there were several contingent events in the 1980s and 1990s – financial crises – that might well have derailed the liberalization movement (thus limiting financialization) and understanding why these did not requires a historical account.

3. The politics of institutional change in the US

The critical juncture that set the US economy on the road to finance capitalism was the Reagan presidency (1981-88). The opening for Reagan was created by the breakdown of the New Deal coalition, which had dominated national politics and supported the more 'managed' (coordinated) capitalism that prevailed from the 1930s to the 1970s. The Coalition broke down largely as a result of the realignment of Southern Democrats to the Republicans in the wake of Civil Rights actions in the 1960s, the decline and political disaffection of the working class, and the defection of many middle class voters to Republicans (Edsall and Edsall 1992). While some segments of the business community were early supporters of Reagan's neo-liberal turn, his success rested in good part on winning over substantial segments of working and middle class voters (Prasad 2006). By the time of his reelection in 1984, Reagan had built a strong electoral coalition spanning the upper and middle classes, with a good deal of working class support as well. In short, from the early 1980s to the early 1990s the center of American politics shifted significantly to the right (Abramowitz and Saunders 1998): This strengthened support for the neo-liberal policies pushed by the Republican party and ultimately forced centrist Democrats – led by Bill Clinton – to largely embrace them as well.

Beyond these shifts in voter preferences and the party system, two institutional aspects of the American system contributed to a high degree of financialization. The first is the well-known fragmented nature of the legislative process and powerful influence of special interests; the second is the fragmented financial regulatory bureaucracy. In the 1980s increasingly global financial markets intensified competition for capital and financial services which US financial interests repeatedly used as a successful argument with legislators to further deregulation (Suarez and Kolodny 2011; Kapstein 1996). In addition to key legislative reforms, fragmentation of regulators meant that a deregulatory move by one regulator often begat a process of 'competitive deregulation,' i.e., "competing" regulators usually came under pressure from the banks they regulated to match the first (Deeg and Lütz 2000). The naming of Alan Greenspan as head of the Federal Reserve Bank in 1987 accelerated this dynamic, since Greenspan was a firm believer in the self-regulatory capacity of markets and a staunch advocate for financial deregulation.

Of the many financial deregulatory moves in this period, one of the most significant and most contentious reforms centered on dismantling the barriers between commercial and investment banking established by the Glass-Steagall Act of 1932. The elimination of these barriers was not inevitable and occurred piecemeal over a period of nearly twenty years. The gradual elimination of market segmentation had a profound effect on the US financial system: it facilitated the growth of "too big too fail" financial institutions; enabled banks to engage in much riskier business and expose depositors to those risks; and facilitated the growth of the 'shadow' banking system. The push for elimination began during the 1980s when major US commercial banks began pressuring regulators in the US to permit banks to enter into investment banking (Deeg and Lütz 2000; Helleiner 1994). Federal Reserve Chairman Alan Greenspan used the Fed's regulatory authority to permit Bank Holding Companies – primarily supervised by the Federal Reserve – to engage in limited investment banking activities. Over the next decade Greenspan unilaterally used his regulatory discretion to increase the scope of permitted activities in several steps. Meanwhile, repeated attempts at formal reform were blocked in Congress by investment banks and insurance firms which did not want competition from commercial banks (Suarez and Kolodny 2010). In short, division among segments of the financial industry and their ability to exploit the fragmented legislative process stifled this liberalization dynamic for many years.

Other events during the late 1980s might well have halted or slowed financial liberalization had they not been managed effectively by regulators and Congress. The first was the savings and loan crisis that began in the mid-1980s and stretched into the 1990s. Despite costing taxpayers billions of dollars, the diversion of this problem into an independent agency and the drawn out nature of the crisis minimized the political backlash against deregulation (Cassell 2003). The second was the stock market plunge in October 1987 that set off widespread panic among investors. But Greenspan deftly calmed financial markets, effectively rescuing Wall Street and thereby reassuring the public and politicians that financial deregulation was safe to continue. This was the first of several "Wall Street rescues" by Greenspan that, after the financial crisis, came to be viewed by many as a major contributor to moral hazard in the finance industry and the excessive leverage and risk-taking that built up in the US financial system during his term.

The economic success of the American economy under Clinton in the 1990s, including the dot.com boom, was seen in the US as validation of its emphasis on deregulated markets. During this era the US was the most influential global standard setter in financial regulation, accounting, corporate governance, and labor market regulation (Posner 2010). Given this context, the second half of the 1990s brought another wave of reforms that accelerated the expansion of finance capitalism. The two most significant reforms were the 1999 Financial Services Modernization Act (FSMA) and the Commodity Futures Modernization Act (CFMA) of 2000. The FSMA formerly ended the regulatory separation of commercial and investment banking (Glass-Steagall) that had held sway since the 1930s. This reform fully opened the door to universal banking and increased capital ties between commercial banks and other non-banking financial institutions. In practical terms this meant that large banks could expand their securities business and proprietary trading – a very profitable, but risky source of income – and also channel funds to private equity and hedge funds. The CFMA was a cornerstone in the legislative edifice that codified laissez-faire and created the financial boom and bust of the 2000s. The Act circumscribed – rather than enhanced – the ability of regulators to regulate a wide range of the financial derivatives that were rapidly growing on Wall Street. The political coalition behind the

CFMA was powerful, including business leaders, top regulators, and leaders of both political parties.

Altogether these and other deregulatory measures - or failures to regulate - helped fuel the very rapid growth of securitization and derivatives markets, including the mortgage-backed derivatives, at the heart of the 2007-09 crisis. They were in no small part the product of a convergence between Democratic and Republican party leaders on a policy preference of laissez-faire (Suarez and Kolodny 2011). Beyond ideological convergence and the success of industry lobbying, it is worth highlighting that the dramatic growth of defined-contribution pension and mutual funds which, since the early 1980s, has also created a structural interest among American households in financialization because their economic security is ever more dependent on financial market returns (as opposed to wage income)[3]. In short, for much of the late 1990s and early 2000s average Americans benefitted from financialization, as disinflation, rising equity markets and innovations in housing finance made cheap borrowing to fuel consumption possible (Schwartz 2009; Langley 2008). Leveraged consumption also compensated to a significant degree for the stagnant or declining real wages for much of the working population (Davis 2009)[4].

At the outset of the 1980s it was not a foregone conclusion that the US model would evolve into the strongly liberalized financial capitalism we find in the present. While the Reagan presidency was critical in starting down this path, the present form of capitalism is the result of many subsequent changes in both formal and informal institutions. Many of the outcomes were intended, some unintended. This reflects in part the fact that major reform happens infrequently in the US due its fragmented legislative process. Rather, reforms tend to occur cumulatively and often in a haphazard fashion, shaped by court decisions, legislative measures at the federal or state level, or through regulatory decisions. Thus institutional change tends to be evolutionary, marked by processes of displacement and drift (Streeck and Thelen 2005). There are also undoubtedly some institutional complementarities that acted as important causal sources. For example, the rise of shareholder value in finance and corporate governance during the 1980s almost surely accelerated corporate efforts to weaken or break unions as part of the major corporate restructuring wave undertaken in the 1980s. And even though the American welfare state has expanded during this period in some dimensions, the increased reliance on tax-subsidized private pension savings added significant impetus to financialization.

4. Financialization of the German model of capitalism

In the comparative capitalisms literature, Germany is normally viewed as the antipode of the American model of capitalism. As a ‘coordinated market economy’ (CME), the postwar German model was characterized by relational banking (i.e., “patient capital”), known in Germany as “hausbanks.” Relational banking rested on three pillars - bankers’ extensive presence on the corporate boards of large firms, extensive bank equity investment in many large firms, and long-term lending. Relational banking also existed for small and medium sized enterprises. While unionization rates were never close to Scandinavian levels, collective bargaining agreements were routinely extended to the large majority of workers. Moreover, labor's institutional influence in corporate governance was secured through two levels of co-determination: representation of employees on company boards (50% in the largest firms), and works councils. Manufacturing export sectors also exhibited various forms of non-market coordination, including strong sectoral associations that, among other things, facilitated technology transfer and relational contracting within supply chains.

Starting in the late 1980s, the German model came under various pressures for change, ranging from European market integration to German re-unification, and inbetween rising competition in export sectors with new opportunities for corporations to outsource parts of the production chain in Central Europe. This short paper does not permit a comprehensive examination of change in German capitalism, so, like the US case, I focus on financialization pressure as a source of institutional change in German capitalism. Like other coordinated capitalisms, over time financialization pressures became substantial in Germany, especially from the late 1990s onward. As a result, there have been substantial institutional changes in the German model of capitalism, though no clear agreement on whether this represents a dramatic break from the past (Jackson and Sorge 2012), or institutional adaptations that preserve the core institutions of the model (Hall and Thelen, 2009). In this section I review some evidence of both profit and control financialization in Germany, discuss possible explanations for them, and assess the current institutional character of the German model with a particular attention to the position of labor.

Conceptually, profit financialization entails the relative growth of profits from financial transactions vis-à-vis the sale of goods and services. There are numerous potential indicators of profit financialization, including rising financial sector revenue relative to economic output (GDP), rising financial flows relative to GDP, rising profit rates for financial firms, rising relative profitability of financial firms compared to non-financial firms, increased share of profits derived by non-financial firms from financial activity, and rising financial sector employment relative to other sectors.

A review of evidence finds little support for increased profit financialization in Germany. The strongest evidence in favor of profit financialization is that bank revenue rose from around 15% of GDP in the 1980s and early 1990s to move between 15 and 20% during the late 1990s and 2000s (Deeg 2012a). Also, banks increasingly derived their revenue from from market trading/securities transactions. On the other hand, when looking at trends in banks return on equity, bank profits as a portion of all corporate profits, and profits from financial activities made by non-financial companies, there is no evidence of profit financialization in Germany (Deeg 2012a). In other words, unlike in the US where financial services became a larger part of the economy and the power of financial institutions became quite substantial, in Germany the "power of the banks" diminished in many respects. For not only did they fail, as a group, to profit from the growth of financial markets and innovations, but relationship banking also declined; many large firms became quite independent of banks (by mutual choice), and even smaller firms underwent an altered relationship to their banks (as discussed later).

How might we explain the surprising lack of profit financialization in Germany? VoC theory assumes that financial institutions have incentives to engage in relational banking, i.e., to act as providers of "patient capital" and eschewing the market-based financial activities. The theoretical rationale for this lies in the argument that, in an environment where public information on company finances is poor, banks will seek long-term relationships with firms and rely on direct monitoring mechanisms of their loans and investments in firms (rather than indirect market monitoring). Financialization should, in theory, reduce information asymmetries and facilitate an erosion of relationship banking. Thus VoC theory provides us with an explanation for why relationship banking declined in Germany (at least between many large firms and banks), but it does not help us explain why some firms shifted from relational banking while others did not, nor why a shift to a more market-based financial system did not lead to profit financialization in Germany.

As in the US case, structural features of the German economy are also important for understanding this outcome. In the German banking system savings and cooperative banks play a major role, particularly in retail and small business banking. Collectively these banks are a major source of business lending and the vast majority of savings and cooperative banks continued to focus on conventional banking throughout the last twenty years. For the most part, these banks have been consistently profitable but because of their public and cooperative status (which prohibit consolidation with commercial banks), they are satisfied with relatively low profit rates. It is only a handful of large commercial banks and some of the Landesbanken (regional banks of the savings bank sector) that shifted toward a strong investment banking orientation during the 1990s, and most of these were not particularly successful at it[5]. Indeed, only the Deutsche Bank has been consistently successful in investment banking, both within and outside Germany, and much of Deutsche's investment banking is done in New York and London. The Dresdner Bank was successful during the 1990s, but after being bought by the insurance giant Allianz in 2002 its investment banking fortunes waned and the bank was finally sold to Commerzbank during the 2009 financial crisis with the aid of a huge subvention from the German federal government. The Commerzbank, for its part, never invested heavily in investment banking and instead continues to focus primarily on domestic corporate and retail banking (Hardie and Howarth 2009). It has often been argued, especially by the commercial banks in Germany, that the persistence and large market shares of savings and cooperative banks have hindered bank consolidation in Germany and led to low profitability overall for banking.

Partly for this reason, large German banks, including the Landesbanken,, have been "forced" to focus heavily on wholesale, investment, and international banking rather than domestic banking. And it is in fact this group of banks, especially the Landesbanks, that suffered the greatest financial losses during the 2008-09 crisis.

Another part of the answer has to be sought on the "demand" side of the market. First, small and medium-sized German firms have been generally well-served by the existing system and have not sought – to the same degree as in neighboring countries – new kinds of market-based finance (see Deeg 2009). Second, while many large German firms have indeed shifted their external financing banks loans to market sources, and often engaged in financial activities themselves as a source of profits, they have not been limited to the domestic market. With easy access to London and New York, the demand to expand domestic securities business has arguably been somewhat weakened[6]. Finally, German household savings, i.e., demand for securities, has grown significantly over the last two decades. But when compared to other advanced economies, Germans still channel considerably more of their assets into bank deposits. Moreover, in Germany pension funds amounted to only 3.6% of GDP with only 12.7% of that invested in equities (date for 2003: Barker 2010, p. 80). In short, the demand side for securities has not grown dramatically, thus limiting the shift from banks to markets in Germany and preserving institutional space for firms to maintain hausbank relationships if they choose.

Aside from profit financialization, we also consider control financialization which, in practical terms, refers to the degree to which 'shareholder value' norms and institutions have replaced the traditional stakeholder institutions of German corporate governance. For our purposes, control financialization refers to the growing influence (control) of financial firms and financial markets over the management priorities and practices of non-financial corporations. In essence, the concept attempts to capture the increased orientation of corporate managers to maximizing profitability, using financial criteria to guide corporate decision-making, and increasing focus on shorter-term financial objectives. Some key indicators of rising control financialization include increased financial disclosure and transparency regulations and corporate governance practices which provide outsiders with greater information about firms; the adoption of explicit profitability targets as key mechanism of management within firms; increased reliance on equity finance by non-financial firms, because this enhances the potential influence of outside owners; a shift in corporate ownership from blockholders to dispersed (minority) shareholders or institutional investors with a sole interest in return on equity (hedge, private equity and investment funds); the decline of insider control measures, such as restricted voting rights; and the growth of a market for corporate control (measured via M&A activity).

In terms of formal corporate governance regulations, the differences between Germany and liberal market economies like the US have narrowed substantially. For example, publicly-traded firms in Germany now use International Accounting Standards (following an EU Directive in

2005). If one looks at broad composite measures of shareholder orientation by publicly traded firms, Germany now scores only somewhat below shareholder value countries like the UK (Barker 2010, 17). But composite measures mask significant variation among large German firms, some of which have embraced shareholder value, while others rejected it (and others chose a middle ground). Moreover, numerous studies indicate that the adoption of shareholder value by many German firms is more superficial or shallower in some respects than appears at first sight. Boersch (2007), for example, finds that even in German firms that have explicitly adopted many shareholder value practices, management does not follow many other shareholder value practices that would undermine their traditional emphasis on technology-driven investment strategies. Fiss and Zajac (2004) find that many German firms adopted the language of shareholder value without substantially altering their actual practices. And the firms that were more likely to adopt actual shareholder value practices appear to be more influenced in this regard by their own blockholders than by outside investors. In the past, blockholding banks in Germany (and elsewhere) did not pressure managers for shareholder value; though in the late 1990s and 2000s some banks began to do so (though they also began to exit from blockholding; see Fiss and Zajac 2004).

Despite various pressures to undermine labor co-determination, these institutions have formally endured. Indeed, many have argued that works councils became more important over time, most importantly through their increased capacity to agree to firm-level deviations from sectoral wage agreements (Rehder 2003). The reverse side of this process, however, is that many believe works councils and board level co-determination have evolved into “co-management” institutions in which the norms and preferences of managers have come to dominate over those of workers (Beyer and Hoepner 2003). Firm-level “pacts” became common during the protracted corporate restructuring of the late 1990s and early 2000s and these pacts always meant worker concessions, typically wage and working conditions in exchange for job guarantees. Beyond this dynamic, labor market reforms in the early 2000s accelerated the growing division between labor market “insiders” still protected by collective agreements and job security, and labor market “outsiders” (as in most countries, insecure work – part-time and temporary – has grown significantly in Germany). Finally, union membership has declined substantially in Germany, and never was very strong in the old East Germany. Thus the underlying social power of German unions has weakened.

Contrary to the predictions of VoC theory, some recent studies on German and UK manufacturing SMEs provide strong evidence that there has been more control financialization among German than British SMEs. In Germany, this change has been driven in part by diffusion process from large to smaller firms, but mostly it is driven by German banks. In the 2000s German banks began using formal credit rating systems to assess the creditworthiness of loan applicants. The early adoption of credit ratings among German banks was in good part an outgrowth of changing ideas in the banking industry about best practices, but in the second half of the 2000s it became de facto mandatory under new German regulations adopted to fulfill Basel II requirements (as well as EU financial directives)[7]. The requirement of credit ratings enabled banks to demand more financial disclosure and transparency from their SME customers. In turn, these demands pushed many SMEs to upgrade and professionalize their accounting and financial management practices. But rather than weakening the historical relationship banking, this represented a formalization of relationship banking. While personal trust is still important, the foundation of that trust has shifted from informal reputation (indirect monitoring) to direct monitoring via information disclosure (Bluhm and Martens 2008, 48). Firms with weak reputations have used increased financial disclosure to improve their standings with banks. With credit monitoring, banks gain more potential leverage over SMEs because they are getting more info and on a more regular basis. When firms run into trouble, banks are now in a stronger position to influence management decisions. For bank lending decisions, collateral is less important than in the past while cash flow, solvency and profitability numbers have become more important (Geppert and Martens 2008). These changes have not led to markedly less reliance on bank borrowing, and German SMEs continue to show high levels of satisfaction with their banks (Geppert and Martens 2008, 49). Another surprise finding from Geppert and Martens is that performance pay for managers is significantly more widespread in German than in British manufacturing SMEs (2008, p. 70). In essence, then, German banks and SMEs responded to growing financialization pressures by learning to adapt their practices in a manner that sustained the historic institution of the 'hausbank' – even as German SME owners and managers widely eschew the idea of shareholder value as a management principle.

Altogether, from this data we draw a picture of notable but still comparatively limited financialization in the German case. Indeed, increased profit financialization appears non-existent, at least in terms of profits derived by German banks and non-financial firms from financial transactions or investments. It is hypothesized that this is due largely to a number of structural factors, including a prominent role of savings and cooperative banks in Germany that are less profit-oriented and remain more oriented to conventional banking activities. There is some evidence of increased control financialization, though by most indicators relatively few listed German firms (albeit often very large ones) have become highly exposed to financial market pressures. German SMEs have been more financialised than many would expect, but this has been done in manner that recasts but sustains the conventional close, long-term relationships between firms and banks. Shareholder value has certainly become more important in corporate Germany, although its effects in practice are quite uneven. Thus it seems more apt to continue to describe Germany as having evolved into a system of "enlightened" shareholder value (Vitols 2004), i.e., still a stakeholder system although one more attuned to financial objectives and profitability. Banks have clearly reduced their role as shareholders and monitors of corporate management, but this appears to have had little effect on corporate strategies based on investment in specific assets.

How should we explain this overall pattern of institutional change, and what role did complementarities play? VoC theory predicts that firms in coordinated market economies like Germany will resist institutional changes that would undermine the core institutional complementarities that sustain their production strategies of incremental innovation (and successful resistance is aided by consensual political systems). But support for this argument is mixed: German firms and banks defended some of the institutions seen in VoC as vital to the system while pressing for changes in others. For example, on one hand German firms (and unions) may have defended, or at least not outright attacked, the institutions that facilitate labor-management cooperation. But on the other, German firms and banks pressed for major changes that ultimately undermined relational banking for many (mostly large) firms. VoC assumed that banks respond to the decisions of non-financial firm to favor long-term loans (or bonds) over equities as a primary source of external finance; by and large banks are “institution takers” in the Varieties of Capitalism model, with little incentive to abandon the institutional equilibrium of relational banking. Yet, since the early 1990s the large German banks made great efforts to transform the German financial system into a more market-based one. Banks were driven by an individual market interest in expanding into investment banking and global markets, while political actors were driven by a desire to maintain the global competitiveness of the German financial sector (Deeg 2005; Busch 2009). Viewed in this light, “patient capital” in the form of relational banking between large banks and firms appears may not to have been an essential institution for a coordinated market economy in Germany.

One can also find support for the structural theories, as the size of the German securities market continues to lag far behind that of other advanced economies, as does pension fund development and labor market deregulation (but not product market)[8]. But structural factors are partly (perhaps mostly) endogenous in their origins, even if they do not change quickly. For example, pension funds remain small in Germany but this is because pension reform in the 1990s largely left the existing system in place while simply expanding incentives for the creation and funding of defined contribution pension plans. This was because there was no political coalition behind a more radical shift to a defined contribution system.

Ultimately, then, an explanation of cross-national differences, such as between Germany and the US, must recognize that reform and institutional change possibilities are fundamentally conditioned by the dominant political coalition. During the postwar era the German economy and economic policy came to be defined by a corporatist coalition involving workers and corporate managers (joined by blockholding owners), supported in the political arena by the Social Democratic (SPD) and Christian Democratic (CDU) parties, respectively. This coalition sustained the system of stakeholder corporate governance and bank-based finance that defined the

German model. During the 1990s there was a shift toward a "transparency coalition" as new outside owners – institutional investors – pressed for greater corporate transparency and more shareholder value orientation. In this coalition, workers joined 'new' owners in a coalition against managers and blockholding owners. Under this coalition, best represented in the political arena by the SPD-Green coalition under Schroder from 1998 to 2005, extensive finance, corporate governance, and pension reforms were passed that fostered a shift from banks to markets, and from stakeholder to shareholder value – but within limits acceptable to this coalition, which were limits that fell short of those common in liberal economies like the US. With the return to a conservative coalition and, more importantly, the financial crisis of 2008-09, the transparency coalition may even be shifting back toward a corporatist coalition (Engelen et al 2008).

5. Conclusion

In this paper I have sought to, first, examine some broad indicators of the degree of financialization (and associated liberalization) in the US and Germany. While both cases broadly conform to the predictions of VoC theory, each case also deviates from those predictions in important ways. VoC theory cannot explain the degree to which the US financialized, nor that some firms and sectors in Germany financialized (and liberalized) more than theory would predict. In this paper I sketched an explanation for these cases that incorporated a key aspect of VoC theory, namely that institutional change is shaped by actors desire to create institutional complementarities for themselves, with identification of key structural conditions, key institutions in the political realm that shape policy and reform outcomes, and supporting political coalitions. While not a parsimonious theory, this actor-centered institutional approach provides a more comprehensive and in-depth explanation.

In terms of the actual mechanisms of institutional change, we find actors in both Germany and the US respond to institutional changes and competitive pressures through a variety of processes – institutional layering, recombination, and experimentation (see Streeck and Thelen 2005). An excellent example of experimentation and recombination is German banks using credit ratings to recast their relationship to firm clients in a way that gives banks new capacities to monitor and influence SMEs. Yet, given the importance of business lending to these banks, this was not used to diversify into market-based financial activities but to sustain the traditional Hausbank relationship on new terms and preserve the long-established advantages of long-term bank finance. An excellent example of institutional layering leading to greater institutional diversity is the emergence of a third type or pillar of innovation and innovation finance in Germany centered around venture capital and private equity (Deeg 2012).

This last example points to a more general empirical finding advanced in this paper: namely, that financialization and liberalization have generally loosened institutional strictures on strategic choices by firms. In effect, the "space" for firms to construct diverse firm-level complementarities to advance particular business models has become greater. This internal diversity in both cases is facilitated by the fact that, while some of the new rules and regulations regarding finance and corporate governance require specific changes in behavior, most of them provide leeway for interpretation, deviation, or choice in how firms respond to them. Deregulation of labor markets creates similar choice and diversity, even in the case of Germany where declining unionization rates, expanded opportunities to utilize precarious labor, and use of non-German workers (via subcontracting) further divides the labor market into those with secure jobs and steady wages, and those without either. Thus in Germany we see a greater diversity of firm models: some large firms have chosen to adopt finance and corporate governance practices that move them much closer to those of US-based firms (though largely retain the traditional labor model, at least formally). Yet other large firms mostly resist or accommodate the financialization pressures by selectively adopting shareholder value practices. This appears to happen largely with firms controlled by large blockholders with no desire to divest their holdings. Even among small and medium-sized firms we see more diversity. Though this paper did not explore such diversity in the US model, here too one might argue that liberalization has opened more space for firm-level diversity.

In closing, it is worth asking the question of how the 2008 financial crisis and subsequent recession have affected the trajectory – and politics – of institutional change explored in this paper. While the crises begat notable changes in both cases, it is not clear that the trajectory developed over the past twenty to thirty years has been radically altered in either case. While there have been important banking reforms in both cases, these are largely designed to curb the excesses that emerged in the years leading up to the crisis, but not to alter the new forms of finance that emerged in each case. So far, the political coalitions that emerged in both countries behind more liberalized economy remain powerful and in neither country has a strong pro-regulation coalition emerged. In the US, it is the very "vulnerability" of the legislative process that enabled the American financial sector to beat back most of the post-crisis regulation that might have significantly altered financial markets, especially for derivatives. In this respect the US model of capitalism as it evolved over the last thirty years has largely survived the crisis and the basic American faith in the virtue of markets is still largely intact. While Germany never embraced liberalization to the same extent, here too there is only a weak political movement to undo the key labor market and corporate governance reforms of the previous fifteen years. Thus there is little reason to think there will be a significant rollback of labor de-commodification, nor anything more than a modest resurgence of relationship banking.

Notes

[1] Parts of this paper rely on Deeg 2012a and Deeg 2012b.

[2] The US has the lowest employment protection index score and shortest average employment tenure of all the OECD countries (Pontusson 2005, 120).

[3] In 1980, about 6% of US households held mutual fund investments; by 2000, nearly half did (Davis 2009, 18).

[4] From 1973 to 2000 real US household income of the bottom quintile rose just 10%; the second quintile just 15%; while the highest quintile gained over 60% (Pontusson 2005, 35).

[5] The major source of profit financialization is the expansion of securities markets and trading activities which is the primary focus of investment banking. Profits from trading activity have also been much higher (though more volatile) than conventional lending.

[6] This points to another important caveat: namely, the data above does include profits made in Germany by foreign financial institutions. Whilst foreign financial institution activity certainly grew substantially over the last twenty years, when compared to the UK it is still relatively small.

[7] In Germany 2/3s of SMEs had a bank rating by 2005 (Geppert and Martens 2008, p. 64).

[8] German product market competition is nearly as vigorous as in the UK (Barker 2010, 130-5).

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