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Article — Digitized Version

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Intereconomics

Suggested Citation: Hankel, Wilhelm (1969) : Improvement of direct investment stirrups, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 04, Iss. 11, pp. 343-346, <https://doi.org/10.1007/BF02928133>

This Version is available at:

<https://hdl.handle.net/10419/138275>

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Improvement of Direct Investment Stirrups

A Talk with Dr Wilhelm Hankel, Bonn

The purpose of the risk-bearing association is to encourage a stronger role of banking in foreign investments. If a bank takes a share of at the most 50 p.c. in a foreign company, this participation is endowed by the guarantee fund of the risk-bearing association. After 5 or 10 years, however, the bank must sell its share to its partner or a third party. We asked Dr Wilhelm Hankel, Director of the Department for Money and Credit in the Federal Ministry for Economic Affairs about the advantages of this new stirrup for direct investments.

QUESTION: Foreign investments are at the moment very much in fashion. Is the Federal Ministry for Economic Affairs following that fashion?

ANSWER: I should have thought we had set the trend, not followed it. One of the reasons why in my opinion we have been leading in this matter is that for a long time already the need for such a fashion has made itself clearly felt. The Federal Republic, which for decades has been an important exporting country, is, as far as its creditor status is concerned, still rather behind the times. Germany exports without at the same time granting credits and investing to the extent it should. It was from the structural point

of view a necessity for the Federal Republic to consolidate its position as exporter by transforming it into an equivalent creditor position.

As you know, the share of exports in our GNP is almost as large as our total investments. Foreign investments, on the other hand, are merely marginal in relation to both GNP and total investments. This is structurally an unsound proportion.

Relation between Exports and Foreign Investments

QUESTION: Would you say there exists a particularly sound relationship between the level of exports and that of foreign investments?

ANSWER: Certainly not quantitatively. The demand that 5 p.c. of exports should be backed by investments abroad is very arbitrary and a very rough-and-ready rule. I believe one could establish a relationship by dividing total investments into investments at home and investments abroad. If for instance there exists a definite relationship between home and foreign demand, as is the case with us, then this relationship should also be reflected in the investment structure. If you assume that between 25 and 27 p.c. of German industry's business is done with foreign customers, then this should also be reflected in the structure of industrial investments.

QUESTION: What special aims is the Federal Ministry for Economic Affairs pursuing in encouraging foreign investments?

Objectives

ANSWER: The Minister for Economic Affairs has repeatedly pointed out that in the field of investments abroad, the same criteria apply as in the fields of production and investments at home; they are a matter for business to decide. Firms must themselves realise that, if they want to secure their outlets abroad they will have to establish production units and sales organisations abroad. It is therefore in each case a matter for management to decide how best to maintain the firm's foreign markets. A welcome by-product of such a policy is the favourable effect it has on the balance of payments, but this effect is not our primary aim, as some of our critics maintain.

Sharing the Risks

QUESTION: Your latest device in your catalogue of measures to encourage foreign investments is the concept of the risk-bearing association. What obstacles do you hope to clear away by this device?

ANSWER: The device of the risk-bearing association is intended as an additional weapon in our armoury. Its purpose is twofold. In the long run, it is meant to cover the risk of the investor, and on a medium-term basis it should help the investor to obtain the necessary financial help by making the guarantee available also to banks. In this manner, banks will for the first time be given a chance to participate in foreign investments, during a transitional period, as partners of industry. Our aim is not only to relieve the firm of the risk, but at the same time to relieve the firm's balance sheet for a certain transitional period by making it possible for its own bank or, for that matter, any

other bank, to get in on the deal.

QUESTION: Now to the question of how to provide the capital for the risk-bearing association. Who is to provide the proposed DM 50 mn?

ANSWER: In principle, the German economy—industry in particular, but also commerce, and credit institutions. According to what formula the interested parties wish to divide the initial finance among them is a matter for them to decide. Much can be said, however, in favour of credit institutions taking a larger part than industry, because for credit institutions it will be additional business, an entirely new kind of business that is being opened up for them by the guarantor.

State Guarantee

QUESTION: But would not the credit institutions and others providing capital have to advance their funds free of interest?

ANSWER: The DM 50 mn constitute the initial capital to endow the guarantee fund. This means that the joint guarantors will have to be prepared to defray this amount which is required to launch the risk-bearing association. It does not mean, however, that 100 p.c. of the amount must be paid in immediately. It is only a stand-by credit of DM 50 mn to be drawn upon in the event of the risk-bearing association incurring losses. It thus constitutes no absolute, but only a partial strain on the liquid resources of the partners.

QUESTION: Assuming losses are incurred which eat into these DM 50 mn, what guarantees have the investors?

ANSWER: In the event of losses, the risk-bearing association is primarily responsible for the whole amount. But—and this is the second part of the scheme—for every loss incurred and for which the association is chargeable there exists a back-to-back

guarantee by the State. However, this reinsurance would not cover 100 p.c., but according to our conception $66\frac{2}{3}$ of the proved losses which would be taken over by the general guarantee budget.

Incentives for Credit Institutions

QUESTION: But the question is what are the incentives for interested banks to participate in the scheme, if, within a measurable space of time, they must again sell their participations?

ANSWER: I would not put it this way. I would say: This scheme enables the German banking world to build up for the first time a business in participations. Hitherto, German banks were for many reasons in no position to help very much with the financing of participations. At most they confined themselves to the advancing of funds for the financing of participations. Now they can participate directly and can in this manner extend their service to customers with state backing.

Difficult Calculation

QUESTION: It is the experience of the German Development Company (DEG) that in the case of foreign investments one must reckon in certain circumstances with the possibility of losses during the first four or five years. But, according to your scheme, it is precisely the period after which the banks are supposed to sell their participations. Now, if at this point in time you assess the value of the undertaking—for instance on its earning power—that value is likely to have remained at best constant, but may possibly even have declined.

ANSWER: In the short view this is correct, but not, if one takes a long view, as surely one must in this case. One should proceed from the assumption that by the end of the investment period the project has been turned into a viable proposition with a relatively certain

expectation of yielding profits. I should think it would be entirely consistent with the principles of business management, if one were to calculate the value of the participation on the basis of the ultimate value of the whole undertaking, and this, in my opinion, would leave the banks with a fair profit.

QUESTION: Is this method to be employed also to finance new enterprises?

ANSWER: Most certainly, for, after all, four to five years are a very long running-in period. Our experience with German aid capital has taught us that after four or five years quite a number of projects—particularly in the industrial sector—have by then long become operational, having entered the profit-earning stage. After all, we are dealing here not with any vast infrastructure, but with a typical industrial project which takes a short time to realise and to mature.

No Joint Company

QUESTION: You expect then the bankers to act as entrepreneurs. They are to look ahead four years at the end of which an undertaking is supposed to have developed sufficiently to yield a profit. If entrepreneur they must become, why should they not undertake the venture by themselves?

ANSWER: Because it would be inadvisable to expect a bank to shoulder excessive risks. In the long run, a bank is not supposed to take on any produc-

tion risks; its function is to act as midwife in the sense that it puts the initial capital at the disposal of the investor, who is quite prepared to take upon himself the long-term production risk. Now that the banks in Germany have fortunately gone into the participation business—by way of holding companies for instance—there is no reason why they should not take part in the proposed risk-bearing association, for this scheme is, if you like, nothing other than a platform from which to launch participations abroad. The only difference is that here we do not aim at the institutionalised form of a foreign holding company, for industry must at all cost remain free in its choice of banks.

QUESTION: From the point of view of the entrepreneur, the great advantage of your plan is that it relieves the strain on the balance sheets of the firms making the investments. But what will happen in actual fact? The firm's bank which participates in the investment knows exactly how liquid the firm is; it will therefore be able to estimate its ability to buy back the bank's share in the venture four years hence as it is contractually obliged to do. Will not the bank simply judge the firm's ability to pay in exactly the same manner as if the whole transaction had been financed on credit?

ANSWER: Yes and no. Naturally, every bank will have a good look at the credit position and the credit rating of the firm proposing to make a certain

investment before taking on the preliminary financing of a foreign investment. But the great advantage of our scheme is that the entrepreneur, though he is obliged eventually to take over the bank's share, need not pay for it out of his own resources. It would for instance be open to him to procure the funds he needs at a certain point in time to buy back the participation by launching a loan. Our banks would therefore only provide the preliminary finance for what the firm will subsequently consolidate by a funding operation on the capital market.

Smaller Firms Handicapped?

QUESTION: But this would also mean, wouldn't it, that the firm is able to have recourse to the capital market—a way which in actual fact is open only to large firms and the very big concerns. Would it not be correct to say, therefore, that your scheme operates to the disadvantage of the small and medium-sized businesses?

ANSWER: This is a good question. I deliberately mentioned earlier the capital investment companies, whose business it is to enable small and medium-sized industrial undertakings to make use of the facilities of the capital market. It is quite conceivable that, once our scheme has got going, it will prove useful also to medium-sized companies and not only to the large concerns, which are by tradition keenly interested in investments abroad. True, medium-sized firms have

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no means of tapping the capital market, but there is a way of compensating for this disability. When the time comes to take over the bank's participation, they can obtain the necessary funds from such organisations as the Credit Institute for Reconstruction (Kreditanstalt für Wiederaufbau), the Industrial Credit Bank (Industriekreditbank) or some investment corporation. All this is, so to say, built into our scheme.

QUESTION: Do you see any possibility at all for smaller and medium-sized undertakings to take part in foreign investments on a significant scale? Up to now, the position has been, that facilities for helping them existed, but that, by and large, it was the large concerns that lent them a helping hand.

ANSWER: Correct. That is why in working out our scheme we laid particular stress on the importance of acquainting the middle layer of industry with the possibilities open to them in the field of foreign investments. For hitherto the position has been that large-scale German enterprises financed their investment transactions practically out of their own resources. For them there would have been no need to create this special risk-bearing association. Its purpose is precisely to attract into the foreign investment field those who because of the well-known risk element and the difficulties of obtaining the necessary finance have up to now kept out of it.

The Influence of the State

QUESTION: Now a question about the role of the state, which has a hand in the scheme as a guarantor. What advantages has the state really in assuming these underwriting obligations?

ANSWER: The advantage is simply that it modernises its own apparatus. By pooling its own activities as a reinsurer with the risk-covering facilities the

German economy provides of its own accord, the state will be in a position to give more effective aid to industry when it requires capital for investment purposes.

QUESTION: You say in your draft proposal that the influence of the state is excluded. Is this really so, or does not the state in fact exercise an influence through its voice in the committees of the Hermes Credit Insurance Corporation or the Credit Institute for Reconstruction?

ANSWER: The influence of the state is not completely eliminated. That would not be feasible under the budget law as it stands today, because the state may be called upon to honour its obligations as a reinsurer. But this influence diminishes as the cooperation of private interests increases. Our aim is to attach the risk-bearing association to a reliable institution in order that it may become operative at once, if possible. Fortunately, the Credit Institute for Reconstruction has already agreed in principle to administer the scheme. At the Credit Institute, a decision-making body would have to be set up—an authorising committee whose approval would be required for any credit guarantees to be granted. On this committee would be represented the grantor of the guarantee, i.e. industry itself, commerce and banking, but, needless to say, also the reinsurer. But—and this is the new feature—the reinsurer, that is the state, would be only one of several partners.

QUESTION: You estimate that the initial capital of DM 50 mn multiplies to DM 1,000 mn. How do you arrive at a figure twenty times as high?

ANSWER: Twenty times the original figure is based on the experience of the insurance companies. They reckon with a multiplier of twenty. It has been found that with a certain guaranteed capital, which need

not even be fully paid up, it is possible to cover risks 20 times as large; in other words, DM 50 mn is sufficient to cover risks totalling DM 1,000 mn.

Impartial Approval

QUESTION: Is the scheme going to operate in favour of certain branches of industry or in favour of certain companies?

ANSWER: This might be the case, if we did not make sure of the absolute impartiality of the authorising committee. I personally would like to see the committee composed in the following manner: ex-officio members would be the manager of the Credit Institute for Reconstruction and the representative of the public authorities as reinsurers. Other members would be drawn from the bodies representing the interests of various branches of industry. In my opinion, competition between various sectors is less likely to be a problem than relations between large and small-scale enterprises. As you quite rightly said, big companies have a much greater interest in the scheme than small businesses. Admittedly, the latter also have the possibility of making use of the scheme, but experience has shown that they suffer from a certain handicap in comparison with the big companies. For this reason, we are proposing that the large corporations exercise a measure of voluntary restraint in making use of the new guarantee scheme. It must at all cost be avoided that with a guarantee fund of DM 50 mn and a total risk cover of DM 1,000 mn only six or seven firms get a chance. Herein lies the possible risk of a conflict of interests.

But to judge by the discussions that have taken place with representatives of various interested bodies, there are grounds to feel reasonably optimistic in this matter. For all the associations have promised to harmonise the interests of large and small firms.