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No. 209

**ENTREPRENEURIAL ACTIVITY,  
BANKING AND FINANCE, HISTORICAL  
ASPECTS AND THEORETICAL  
SUGGESTIONS**

by

Erik Dahmén

Paper prepared for the IUI Conference on  
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## CHAPTER 2

### Entrepreneurial Activity, Banking and Finance: Historical Aspects and Theoretical Suggestions

Erik Dahmén

#### 2.1 The Theme

The theme of my paper is the nature of interaction between financial and "real" business activities and the large development potential of a creative combination of the two. One question runs throughout the paper: Can these two dimensions of economic activity really be analytically separated as is conventionally done by assumption in theoretical literature? My paper argues that such assumptions are analytically unsound since they detract attention from the very foundation of the firm as a dynamic, continuously decision making entity. Industrial activity in general is composed of firms exploring the vast space of business opportunities that exists on the basis of their technological, organizational and, not least, financial competence. This being so, economics should not primarily look for models of industrial dynamics on axiomatic grounds. Putting empirical evidence together in a structured fashion is a very good substitute and the best way of formulating relevant hypotheses within the framework of causal analyses. In presenting this theme I will draw a great deal on my own experience as an economic adviser to The Stockholm Enskilda Bank, which meant working for about 30 years with Dr. Marcus Wallenberg who was both industrial entrepreneur and banker.

#### 2.2 Basic Concepts of Economic Dynamics

The notion of economic *transformation* – not growth – is central for my argument. I see innovative entrepreneurial activity, and creative destruction as the essence of economic dynamics. This is conceptually broader than the

traditional entry and exit formulation, in which well defined units come and go, or stay in the market, being one of the deceptive tricks to keep the real and financial dimensions separate. Another trick is to construct growth models where capital formation reflects either the propensity to invest or current saving. These two variables do not have much to do with the dynamics of entrepreneurial activity, nor with financial systems, since savers and investors and agents of these actors are not supposed to play an active role. In my model innovative entry and exit occur both in markets and within the administrative systems called firms. Financial intermediation of real activities occurs under both the internal allocation regime of the firm and in financial markets. The relative efficiency of these types of intermediations determines the relative mix of markets and hierarchies. Thus, the two dimensions cannot be kept separate. I furthermore extend the notion of a "firm" to a structured mix of market mechanisms, administrative systems and entrepreneurial activity. This makes measurement and formalization much more difficult, but this is no excuse for reverting to theoretical constructs that are mathematically tractable but too easily misleading. I see no excuse for young scholars to side-step the real challenge I pose and keep repeating the well known static stuff we have heard so many times before. Static general equilibrium models belong to the history of important economic doctrines, but not to the frontier of economic research.

### 2.3 The Various Function of the Financial System

The main functions of the financial system can be classified by making a distinction between three different types of activities: (A) Short-term financial intermediation, (B) long-term financial relationships, and (C) venture financing. It is obvious that many business firms, especially large ones, internally engage more or less in all three activities both on the supply (financing) and the demand (user) side, thereby establishing an *internal financial market* (see also Eliasson 1968, 1976, 1984). The bulk of financial activities is of course concerned with short-term liquidity management, corresponding to the (A) activity. A large part, however, concerns investment allocation and investment financing, i.e. the (B) activity. Innovative ventures (C) are to a great extent internally financed and hence the perhaps most important internal financing activity. Ventures are normally separated from

routine management whereas it is often difficult to draw a clear line between, on the one hand, ordinary long-term investments and their financing and, on the other hand, the financing of high risk ventures. It is not necessary to go into the details of this in order to make it stand out clearly that the financial market at large and the business firm both rest on the same principal footing.

Before introducing and elaborating the concept of an "*industrial bank*" (the bank and the associated firms, the industrial bank group), that covers both "real" business and financial activities in various integrated ways that can release great innovative potentials, it is appropriate to go through the three main *bank* functions that appear in various forms, and from time to time in different proportions, in the financial system.

## 2.4 The Various Dimensions of Banking

### A. *Classical Banking*

Banks act as *intermediaries*, as service institutions and organizers of – and dealers in – short- and long-term markets. Credits are in principle supplied to all credit-worthy borrowers and short credits are often rolled over from year to year. Investment selection mechanisms are working within industry and trade without any direct and considerable influence from the financial sphere. This implies that the banking system as such does not generate dynamic forces. Neoclassical theory provides a fair representation of this banking activity. Provided that corporate and capital gains taxes do not interfere in the market mechanisms, financial intermediation is supposed to lead to an optimal use of *existing* resources, i.e., to *static efficiency*.

This A kind of activity has never been dominant in its pure form but has always existed as an element in a mix of bank activities. It is, however, clear enough that studies of this type of banking only are not sufficient to understand the dynamic interaction of financial and real activity, notably innovation, entrepreneurship and investment. This does not exclude that innovations in "passive" banking itself may have important dynamic effects on industry and trade. A striking example is offered by what in the second half of the 19th century happened in many European countries. The efficiency of the financial system was very much increased when banks generally became holders of clients' transaction money instead of being mainly dependent on

equity capital, note issues, loans and various sorts of savings deposits. This innovation, in combination with the establishing of a great number of new banks and bank offices, made it possible to *create* credit. Important interactions between banks and long-term markets were also attained as such markets could now take over short-term bank credits and thus increase the liquidity capacity of the banking system.

This new financial system was well developed before World War One and no doubt played an important role in furthering economic development. Maybe it was not accidental that Wicksell (1898) and Schumpeter (1912) integrated these characteristics in their theoretical models.

The role of the financial system thus could be very important even without direct banking involvement in industry and trade. The role of banks, however, is far from fully described without a reference to the fact that many banks actually were not at all "passive". Some of them managed to circumvent laws tailored to prevent them from becoming more active in industry and trade. Sometimes this occurred with the tacit consent of the authorities or because of delays and deficiencies in tightening loopholes. This brings me to the B and C kinds of banking.

#### ***B. Long-term Financial Relations***

In a way banks have been similar to trading firms with their stable relations with a number of "faithful" company clients whom they reciprocally served as "members of the family". A few of the clients were normally owned by the banks, their affiliated companies or shareholders. "Members of the family" were normally given priority in times of tight monetary policies. In that sense there may have been an element of discrimination. Bank managers may have joined the board of a client company but mainly as observers and advisors or in order to make sure that nothing "unfaithful" occurs that breaks "the trust of common interest". Occasionally the object may also have been more effective short-run financial control of company expenditures but not even in this latter case bankers took a more active part in a client's business.

Financial control was not applied for managerial and entrepreneurial strategic intervention as long as the long-term health of the company was not threatened.

Relations like these between the bank and the clients can be seen as a means of attending to the bank business. It does not imply influence on the industrial and trading sector in order to achieve monopoly profits in corporations where the banks, their affiliates or shareholders have an interest as owners. The early periods of industrialization exhibited so called "financial capitalism" in some countries. Today, however, bank behavior vis-à-vis industry and trade of the B kind represents something different. It is rational from the viewpoint of a bank as an optimizer of its service to industry and trade and thus also as a maximizer of its profits in the long run. This, however, does not exclude that a bank-industry group could form a symbiotic compound of importance particularly in the case of risky ventures that take a long time to mature as a profit generating business.

An interesting question is whether oligopolistic financial markets exhibiting competition between large industrial banking groups have any particular influence on industry and trade compared to the less close and stable relations between atomistic players envisaged by classical theory. In view of the fact that the markets in dynamic economies are not "perfect" in the classical sense but instead to a great extent characterized by competition through innovating entrepreneurship, more or less closely spun relations between banks and industrial corporations might well be more efficient in financing innovative activities than "perfectly" competitive credit and capital markets.

It should be added that present trends as regards industrial organization and financial markets, and not least the widespread internationalization of entrepreneurial activities, tend to loosen the ties between banks and many of their clients. Changes of ownership and control within the industrial and trading sectors, sometimes involving extensive internationalization, force many banks to choose between two kinds of relationship: Either the bank accepts such loose ties with some large clients, which sometimes enter banking business themselves, or it tries to knit together groups of firms in which it attempts to get a more or less central position. Tax legislation and corporate tax law, however, often prevent the most efficient relationships from being formed. This is also one of the reasons why industrial bank-industrial firm configurations have since long differed significantly between nations. The same observation, however, also tells that if a bank achieves a dynamic central coordination function of a group of clients or firms, an efficient balancing of innovation and entrepreneurship may be accomplished.

This balancing by definition means that financial and real activities have been integrated.

### *C. Venture Financing*

Banks and their affiliated companies, i.a. holding companies, may be actively involved in industrial entrepreneurial activities. Such involvement sometimes come about because much lending has become tied up in frozen loans and because banks are forced to take over failing companies in order to protect their claims. This was often the case in the depressions of the interwar period, but it has happened only occasionally after World War II. Such takeover cases usually begin with financial reconstructions and normally involve a change of management to be followed by changes in both ownership and entrepreneurship responsibility. For natural reasons such involvement most commonly occur when the firm-bank relations have been of the kind B.

There are, however, bank involvements in industry which have nothing to do with frozen loans and takeovers. A bank may become an integrated part of a group of enterprises in which it has a stronger position than mentioned under B above. In such cases, justifying the concept "bank related group", you mostly find industrial entrepreneurs who make use of a bank not only and perhaps even very little as a supplier of loans and other traditional bank services but as a resource in a wider sense, sometimes even as an element in an entrepreneurial jig-saw puzzle. Such relations between a bank and its affiliated investment companies, on the one hand, and industrial entrepreneurial activities, on the other are characteristic of what can be approximately called an "industrial bank" or "industrial banking group". Such groups have proved to be a strong dynamic factor in many economies. The Swedish case of the Wallenberg group and the role played by The Stockholm Enskilda Bank (SEB) is a particularly good illustration.

#### 2.5      The Wallenberg Industrial Bank

This section to a great deal builds on a recently published monograph, by Håkan Lindgren (1988) on The Stockholm Enskilda Bank 1924–45.

Through SEB and its many affiliated companies, the Wallenberg family has exerted a historically unique influence on Swedish business life. Despite its moderate size, the bank maintained its distinctive character for a long time, a fact that can primarily be attributed to a continuity in management and business activities. This in turn could be achieved because a dominant block of shares in the bank was kept intact and was passed on between generations of the same family. As the activities were intimately linked with the personal interests and connections of the bank's management and the Wallenberg family it is appropriate to use the term "the Wallenberg group".

The close-knit structure of the Wallenberg business organization was its basic strength, which was manifested i.a. in a prompt, unbureaucratic style of decision making and close, personal relationships. At the same time, this system – based on a bank whose clients were primarily found among a concentrated group of closely related manufacturing corporations – raised its own special demands. As a part of the relationship between SEB and the manufacturing corporations, the bank assumed partial responsibility for its client companies. This commitment involved not only a readiness to meet emergency credit needs, but also responsibility for reconstruction in time of crisis and "the placing of all our experience and connections at the borrower's disposal". Maintaining a high payment capability in relation to potential client needs became a necessity for SEB as an industrial bank, and it was one of management's most cherished goals.

Another specific aspect of the Wallenberg group's combined use of ownership and management functions appears to have been innovative organizational work involved in "transforming technology into economy". In many respects Swedish business had been run by technicians, and during the interwar period the art of engineering very often was in the driver's seat. It was not until after the Second World War that the reaction to this came on a broad front, when modern marketing methods were introduced from the U.S. The Wallenberg group management were early in emphasizing that entrepreneurial activity involved not just the efficient organization of technology and production, but also the manufacturing of products that could be adapted to market needs. The bank often had an important role to play even in this connection, i.a. in arranging credit facilities.

This last statement leads us to one of the most significant characteristics of the Wallenberg group, the mutual resources support between SEB and its affiliated financial and investment companies. This

support was within the group as well as between the bank and the industrial companies that were integrated within a network of ownership, interlocking directorates and other relations. Despite the mutual dependence between the various members of the Wallenberg group, SEB in many different ways constituted a decisive resource for the affiliated companies as well as the corporations linked to the group. The bank served, partly through two investment companies, as an extremely important capital resource. The Providentia group of corporations were very closely tied to the bank, whereas the Investor corporations were more independent. Both groups financed a significant share of their business with loans from the bank. The Providentia corporations' business was managed as if it was the bank's own. Interest payments on loans from SEB were made very irregularly, depending on how bank management wished to utilize eventual surpluses from company activities. Part of the profits could be immediately returned to the bank through interest payments, and the return could also be postponed to a later date by setting aside reserves for depreciation. The business activities of the Investor group were viewed in a different light by the bank management. This group pursued its activities separately from the bank. SEB provided loans on strict banking terms, and the normal market interest rate was paid to SEB as lender.

The three legs of the group's total business – the bank, affiliated companies and industrial companies – in many ways operated as a coherent, synergistic unit, where the whole represented something greater than the sum of its parts. This unit, illustrating an amalgamation of industrial and financial capital, developed a common culture that proved to be particularly conductive not only to technological innovation but also to the creation of markets by combinations of various entrepreneurial activities. This stands out clearly in the numerous examples of how Wallenberg family members and bank management became involved through such activities in filling the order books of companies linked to the group and sometimes also of other clients. This can be described along a falling scale from an active utilization of connections, engagements in a client company's current business in order to create new, or expand existing, markets and, as the most long-term indicator, initiatives and investments, i.a. the establishment of new companies. Several such cases, including mobilization of capital resources, illustrate how

"development blocks" were promoted through a sequence of complementarities in different fields.<sup>1</sup> This means that the group's most important activities belonged as far as the banking business was concerned, to categories B and, most characteristically, C whereas other banks run the A and B and only occasionally the functions C, in particular its financial reconstruction activities.

Most large Swedish firms, and above all large export oriented and/or international firms, have in one way or another been associated with the Wallenberg Group during all of or most of their 20th Century history. In many cases this association has been based on minority ownership by the Wallenberg family or related persons. "Association" is normally characterized by a relation to the Bank (SEB); that is through a type B banking activity. In many cases type C relations have developed, i.e., the firm has been managed by a Wallenberg family member or related person. The liquid, and well consolidated and well managed bank with its affiliated institutions have been looked at as a resource, as a means to support business, not as a business (objective) in itself. This is an important characterization. The Wallenberg business objectives were related to the business group of manufacturing firms, as a whole, not only to the economic interests of the bank. This also means that the individual economic interests of the group member companies now and then had to be subordinated the interest of "the Group". Such a "systems approach" to run a group of companies can only be organized on the basis of a joint ownership base.

Ericsson, Alfa-Laval, SKF, Astra, Swedish Match, Gambro and Tetra Pak are all examples of large corporations<sup>2</sup> that have had type B relations to SEB, but at times, especially during crisis phases, also type C relations. The latter type C relations are fewer, but the most interesting ones, since they capture the type of dynamic interactions between financial and business ("real") activities, that is the theme of my paper. STORA, Atlas Copco, Saab-Scania and ASEA have had "type C relations". To illustrate the synergy

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<sup>1</sup> This concept was introduced in Dahmén (1942), and further developed in my dissertation, Dahmén (1950), that in 1971 was published by the American Economic Association Translation Series under the title *Entrepreneurial Activity and the Development of Swedish Industry, 1919–1939*, Richard D Irwin, Inc., Homewood. I have recently elaborated on particular aspects of the concept in Dahmén (1988).

<sup>2</sup> See Table 1 in Eliasson's introductory words, this volume.

effects associated with such an integration of manufacturing business and finance I will use ASEA as a case. The ASEA history has been amply covered by business history research and includes particularly interesting examples on the productivity potential of development block formation.<sup>3</sup>

*ASEA*, the Swedish General Electric, had an important but not central position in the first phase, in the 1890s, of the electrification of Sweden, a development block that later played a driving role in the industrialization of Sweden. This first phase was characterized by large growth potentials but missing links and thus structural imbalances. Lack of well functioning markets for venture capital made ASEA very sensitive to general business downturns and tight financial markets. The Wallenbergs participated financially, but were at the time not very active as entrepreneurs in the market for heavy electrical equipment. There was so far no Wallenberg group, only two brothers and a bank, and ASEA – at this time – was not a "Wallenberg company". The family and SEB got a decisive position when, at the beginning of the 20th century, ASEA met with serious difficulties threatening the company's further existence. A financial reconstruction was followed by installing a dynamic management and by very active entrepreneurial, often innovative activities and "combinations", including also the financial sector, which made it possible to release the potentials of a development block in which ASEA eventually became the dominant high voltage power enterprise. SEB mobilized large capital resources not only to finance the company's deliveries but also to bridge gaps between inventions and innovations and even to establish new firms as customers. The first electrical development block was by and large completed before the outbreak of World War One. Given available technologies and other relevant factors a "structural balance" had been reached.

After the war a new electrical development block emerged, characterized by a number of new links connected with electrification on a much broader side than before. A Wallenberg Group had now been established with members of the family and SEB as suppliers of financial resources, directly and not the least indirectly, through affiliated investment companies. The entrepreneurial activities of the Wallenberg group represent a perfect example of type C integration of industrial and financial entrepreneurship. Within the

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<sup>3</sup> Glete (1983).

framework of this new, in space and time extended electrical development block ASEA acquired an even more central position than before. The Wallenberg Group, the "Wallenberg Industrial Bank", was active in promoting the expansion of enterprises within the Group and in many other sectors of the economy, i.a. through creating market engagements in infrastructure and shipping, but its role in the electrical development block stands out as the most illuminating example that has been the subject of much interesting research by economic historians.<sup>4</sup>

## 2.6 Bank Activities, Economic Transformation and Ownership Structures

The important aspects of industrial dynamics discussed above lead us into a problem area that has much to do with ownership and control.

The interaction of banking financial activities and "real" manufacturing business activities, including institutional conditions and ownership structures can be described as a *transformation process*. This process takes two forms;

1. Suppose that the scene is dominated by promising business opportunities contributing – if realized – to economic development. A potential "*positive transformation pressure*" exists. Even a "passive" banking system (A) would under these circumstances release a development dependent basically on entrepreneurial competence and business cultures outside the financial sphere. This is likely to be the case irrespective of the characteristics of the ownership structure of industry and trade. However, more active banks being more or less closely related to groups of owners can be of particular importance.
2. Suppose industrial structure, both as regard technology, composition of output and choice of markets for various reasons, has not kept up with world market development and is in need of fundamental restructuring. A "*negative transformation pressure*" then exists. Many enterprises have to adjust to a new market situation, i.a. by streamlining their production capacity and/or by finding new products and markets. If they do not succeed they may have to shut down or to be taken over by

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<sup>4</sup> See for instance Gasslander (1956, 1959), Glete (1983), and Lindgren (1988).

other enterprises. In this case the banks and their holding companies are not likely to be "passive". Activities along the lines indicated by B and C almost certainly come into play. The character of the interaction between the banks and the firms and the success of the operation will be very dependent on the organization and composition of dominant owners. A *highly decentralized ownership structure* may facilitate restructuring in the case of positive transformation pressure. Traditional market mechanisms can be supposed to function smoothly.

A "*rather concentrated*" *ownership structure* with powerful groups of owners who are industrialists with well established bank relations is more likely to engineer a swift restructuring than a detached institutionalized ownership structure lacking industrial experience. Without industrial experience diverging views and vested interests will dominate and time consuming negotiations, involving not only competing banks but also governments and local authorities as well as labor unions easily leads to non-converging, deadlocked situations. Recent experiences clearly point in this direction. Banks can be active in restructuring if their relations are of the "*trading firm*" variety (B). They are very likely to be active in the variety C. If there is one main, or at least one clearly dominating owner in a crisis ridden branch there are no rivals of importance and thus no conflicts of interest. Such a situation is bound to facilitate restructuring. This is particularly so if there are related banks that can be supposed to be involved in the process and to offer, or to be able to arrange, financing facilities and other important services.

## 2.7 Summing Up

Conclusions based on close observations from the real world come out very clearly and strongly. Long-term survival of a firm critically depends on its ability to manage and finance the venture side of business where suppliers and users of funds need a critical common denominator of "*shared knowledge*". The art is to organize this merger such that venture activity is successful in the long term without sacrificing short-term production efficiency. In the firm real and financing activities mix directly. There is a multitude of organizational substitution possibilities between the bank, the market and the

firm. My observations tell the story that the "industrial bank" constitutes a particularly interesting and successful organizational technology to simultaneously handle the long term and the short term, i.e., to be both short-term efficient and long-term innovative. My conclusion thus is that the industrial banking group of firms has proved to be a superb organizational design to combine innovative, entrepreneurial and short-term operations activities.

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