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Who's afraid of big bad banks? Bank competition, SME, and industry growth

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Frankfurt School – Working Paper Series

No. 197

**Who's afraid of big bad banks?
Bank competition, SME, and industry
growth***

by Robert Inklaar, Michael Koetter, Felix Noth

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Abstract

We test how bank market power influences technical change and resource allocation of informationally opaque firms. We use a dataset with approximately 700,000 firm-year observations of German small and medium-sized enterprises (SME) to identify the effect of bank market power using the dependence on external finance per industry and the regional demarcation of the German banking market. Market power generally spurs aggregate SME growth. Banks need to realize sufficient margins to generate useful private information. Bank market power spurs both technical change and reallocation of resources, but it reduces SME growth in industries that depend heavily on external finance.

Key words: growth decomposition, reallocation, banking, market power
JEL: E22; G21; O16; O41

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1 Introduction

Does bank market power help or hinder growth of informationally opaque firms? And how do banks influence growth of such firms: do they help them to grow more productive or help the more productive firms to grow? Both channels are important according to recent literature,¹ but this paper is the first to distinguish the effect of technical change (firms growing more productive) and resource allocation (growth of more productive firms). Thereby we contribute to the literature analyzing how bank market power influences growth of firms as well as to the literature that emphasizes the importance of resource allocation across firms for aggregate productivity.²

Theoretical arguments and empirical outcomes suggest that bank market power could help or hurt firm growth.³ Banks with market power may hurt growth if they can extract rents from existing lending relationships. The ability to lock-in firms may in turn remove incentives for banks to finance more productive new entrants (Cetorelli and Strahan, 2006; Cetorelli and Gambera, 2001). Market power may be particularly problematic for small and medium-sized enterprises (SME), which tend to be informationally opaque and hence rely more strongly on bank funding.⁴ Alternatively, if bank market power is too low, it may remove banks' incentives to generate information on borrowers (Marquez, 2002). This can lead to a misallocation of resources, as banks do not develop enough information to identify the most productive firms (Dell'Ariscia and Marquez, 2004). Similarly, if intense competition means that banks cannot extract rents from firms' innovative investments, they may not lend to make such investments (Petersen and Rajan, 1995).

In this paper, we analyze the effect of bank market power using a novel dataset covering a sample of around 100,000 informationally opaque small and medium-sized enterprises (SME) in Germany between 1996 and 2006. We combine this dataset with prudential data of all banks in Germany. We estimate how much of growth is due to input growth, technical change and

¹ E.g., Beck et al. (2000), Carlin and Mayer (2003), Wurgler (2000), Kerr and Nanda (2009) and Aghion et al. (2007).

² See for example Basu and Fernald (2002), Syverson (2011), Hsieh and Klenow (2009), Basu et al. (2009) and Petrin et al. (2011).

³ Petersen and Rajan (1995) and Zarutskie (2006) find positive effects; Canales and Nanda (2012), Black and Strahan (2002) and Cetorelli and Strahan (2006) find negative effects; Berger et al. (2007) find no effect. See also Demirgüç-Kunt and Maksimovic (2002) and Beck and Demirgüç-Kunt (2006) on firm growth and financial services.

⁴ See Petersen and Rajan (1995) and Zarutskie (2006).

resource reallocation. Firms contribute positively to resource reallocation if the marginal product of inputs exceeds the marginal costs of those inputs.⁵ To identify the relation between bank market power and growth components, we exploit the regional demarcation of banking markets in Germany in the vein of Jayaratne and Strahan (1996). According to Rajan and Zingales (1998) we employ a difference-in-difference approach to explain industry-region specific output with region specific banking market power, industry specific dependence on external finance, and their interaction.

Distinguishing between the effect of bank market power on technical change and on resource reallocation is the main contribution of this paper. In addition, our firm-level and bank-level dataset allows us to look at this relationship in more detail, by investigating more and less opaque firms and different types of banks (commercial, savings and cooperative banks).⁶ The within-country setting also avoids the concern that cross-country differences in financial systems and institutions may not be sufficiently controlled for (Claessens and Laeven, 2005).

We find that bank market power significantly increases SME growth by stimulating technical change and resource reallocation. An increase of Lerner indices by 1-percentage point increases aggregate SME output growth by 0.12-percentage point when evaluated at the median industry dependence on external finance.⁷ This increase is due to higher technical change and reallocation in approximately equal parts. We find several indications that growth effects are largest for less opaque firms. But SME in industries that depend substantially on external finance exhibit negative growth in response to increasing Lerner markups. Overall, banks seem to require some minimum markups to generate useful private information to permit an efficient selection and monitoring of risks, which ultimately leads to growth. However, even small cooperative banks can extract rents from locked-in SME, ultimately resulting in negative aggregate firm growth.

Our results differ from those of Cetorelli and Gambera (2001) and Claessens and Laeven (2005), who find a negative effect on industry growth of bank concentration and bank competition, respectively. An important difference of our sample that may reconcile results is the fact that it consists of SME rather than aggregate industries. Our findings are thus in line with Zarutskie (2006) and the result of Cetorelli and Gambera (2001) that young (presumably smaller) firms tend to benefit from increasing banking market concentration. Furthermore, the German banking system has amongst the low-

⁵ This approach is similar to that advocated by Basu and Fernald (2002), Basu et al. (2009) and Petrin et al. (2011).

⁶ See, e.g., Canales and Nanda (2012).

⁷ Or differently: a one standard deviation increase in the Lerner index increases output growth by 0.15 of a standard deviation.

est concentration ratios in Cetorelli and Gambera (2001) and highest competition scores in Claessens and Laeven (2005). Our results could thus be indicative of nonlinearity in the market power-growth relationship: if market power is too high, rent extraction and lock-in effects have their greatest impact. But if market power is too low, not enough useful information is developed to identify the most productive firms and investment projects.

The rest of the paper is organized as follows. Section 2 presents the method and data to estimate and decompose output growth. We discuss main results in Section 3 and conclude in Section 4.

2 Method and data

2.1 Reduced form

To identify the effect of regional differences in banking competition on SME growth per industry, we follow Rajan and Zingales (1998). We collapse the firm-level data by region ($r = 1, \dots, 67$) and industry ($k = 1, \dots, 22$) in each year ($t = 1996, \dots, 2006$) and regress the dependence on external finance (ED) of industry k and average Lerner indices (LI) per region r in a difference-in-difference setting on industry output growth and its components (total input growth, factor reallocation and technical change) V_{rkt} :

$$V_{rkt} = a_{rk} + a_t + b_1 ED_k + b_2 LI_{rt} + b_3 (ED_k \times LI_{rt}) + \epsilon_{rkt}. \quad (1)$$

We assume that the dependence on external finance differs across industries for structural reasons. If bank market power fosters growth, we expect that industries with a higher ED grow at a different rate in regions with less competitive banking markets, after controlling for industry-region and time specific effects. We measure equilibrium dependence on external finance using Compustat data for U.S. firms because we assume that they face the least financing constraints.⁸

The identification strategy exploits two particularities of our sample of German SME and banks. First, it is a reasonable assumption that the SME in our sample, all customers of regional savings banks and allocated to one of the 22 industries in the EU KLEMS database (O'Mahony and Timmer,

⁸ As in Rajan and Zingales (1998), ED equals capital expenditures less cash flow from operations divided by capital expenditure. Cash flows are the sum of operational cash flow plus increases in inventories and payables less decreases in receivables. As an alternative, we also used debt/asset ratios based on Amadeus data for firms in Germany, France, and the UK (Fernández de Guevara and Maudos, 2011).

2009), are active in only one of the 67 regional markets defined by the German Savings and Loan Association.⁹ Second, the vast majority of German banks, savings and cooperative banks, do not serve customers outside their region by self-imposed regulation. Therefore, it is a reasonable assumption that market power in one region does not determine market power in another region. But *within* regions, SME can turn to different banks to demand financial services. Therefore, we consider differences in average market power between regional markets and (weighted) average growth of industries within these regional markets.

Table C.1 shows summary statistics of the variables specified in Equation (1) and we explain in the remainder of this subsection how to obtain the data for aggregate growth Y ; its three components; the Lerner index LI and the Hirschman-Herfindahl Index HHI as alternative measures of regional bank market power.

– Table C.1 around here –

2.2 Output growth decomposition

Firms can grow by increasing inputs or through technical change, but for the economy, it also matters *which* firms grow. Specifically, if more resources go to firms with high marginal products compared with marginal costs, this benefits the economy (Basu et al., 2009). Below we discuss how these different elements are measured.

For firm i at time t , we denote output as Y , labor as L , capital as K , materials and other intermediate inputs as M , and technology as A . Firm technology is represented by the output elasticity β of each input. We specify for each industry k a Cobb-Douglas production function and use the Wooldridge (2009) GMM variant of the Levinsohn and Petrin (2003) estimator to account for simultaneity of factor demand and productivity at the firm-level.

$$\ln \text{Sales}_{it} = \beta_0 + \beta^L \ln L_{it} + \beta^K \ln K_{it} + \beta^M \ln M_{it} + \epsilon_{it}. \quad (2)$$

To aggregate firm-level dynamics to industry growth (components), we estimate Equation (2) for each of the 22 industries we distinguish.¹⁰ Firm-level data comprise 696,119 observations on German SME between 1996

⁹ The industries are shown in Tables A.1 and A.2, respectively. We exclude two groups that comprise urban centers that are geographically not adjacent and host most of Germany's multinational enterprises.

¹⁰ We exclude mining due to large outliers.

and 2006 obtained from the German Savings and Loan Association. Descriptive statistics are shown in Table C.2.¹¹

–Table C.2 around here –

The data represent financial accounts of all corporate firms that applied for a loan. Only firms with at least three available balance sheets are sampled.¹² The sample is unique regarding the coverage of very small firms for which financial accounts are conventionally not available, but that account for a substantial share of total output in the German economy. Average (median) firm sales are slightly less than €5 million (€1 million). Thus, according to the EU definition of SME, almost 65% of our sample consists of micro firms (up to €2 million sales). Another 25% is small (up to €10 million sales) and a further 8% is medium (up to €50 million sales). Only 2% of the firms in the sample are large. 25% of the firms are in manufacturing, 25% are construction firms and 50% are in services, mostly business services such as accountants, lawyers, etc. (see Table A.1).

Table A.2 in Appendix A shows the parameter estimates of Equation (2) together with each industry’s measure of dependence on external finance. Output elasticities are precisely estimated and broadly comparable to the corresponding industry cost shares from EU KLEMS. Intermediates exhibit on average the largest elasticities, followed by labor and capital. The industry cost shares show a similar pattern.¹³ The sum of the elasticities is smaller than one, indicating decreasing returns to scale.¹⁴

Next, we decompose output growth into the two “conventional” components and a reallocation component. The latter reflects the argument of Basu et al. (2009) that the growth of aggregate output in excess of the cost-weighted growth in inputs is relevant for welfare. Denoting the cost share of each input by c , we decompose firm output growth as:

$$\Delta \ln Y_{it} = \sum_k c_{it}^k \Delta \ln X_{it}^k + \sum_X [(\beta_{it}^k - c_{it}^k) \Delta \ln X_{it}^k] + \Delta \ln A_{it} \quad \text{for } k = L, K, M. \quad (3)$$

The first term in Equation (3) is the contribution of a change in inputs to output growth. The second term compares the marginal product β to the

¹¹ Table A.1 in Appendix A describes the data to estimate Equation (2) per industry.

¹² We also exclude all firms with less than two consecutive years of data, in which some production information is missing, or either labor expenses or material costs are larger than sales. We winsorize at the 1st and 99th percentile of all production function variables to control for outliers.

¹³ The correlation between elasticities and industry cost shares is high at 0.65.

¹⁴ Growth regression results reported below are robust to different methods to estimate output elasticities.

marginal cost c of each input. It is a measure of reallocation since a shift of one unit of input from a low-marginal product firm to a high-marginal product firm is beneficial for the economy. The third term of Equation (3) is the contribution of technical change to output growth.

Growth components in Equation (3) are all defined at the firm-level whereas we identify in Equation (1) the impact of regional bank market power on *industry* growth by exploiting between-region differences. Therefore, we aggregate firm-level growth components to the industry level using so-called Domar weights v_{it} , which is the two-period average ratio of nominal output over aggregate value added.¹⁵

We decompose output growth rates at the industry level into the contributions of total input growth, reallocation and technical change as:

$$\Delta \ln X_{kt} = \sum_i v_{it} \left(\sum_k c_{it}^k \Delta \ln X_{it}^k \right) \quad (4a)$$

$$\Delta \ln R_{kt} = \sum_i v_{it} \left(\sum_k \left[(\beta_{it}^k - c_{it}^k) \Delta \ln X_{it}^k \right] \right) \quad (4b)$$

$$\Delta \ln A_{kt} = \sum_i v_{it} \Delta \ln A_{it} \quad (4c)$$

Our empirical analysis therefore uses $\Delta \ln V_t$, $\Delta \ln X_t$, $\Delta \ln R_t$ and $\Delta \ln A_t$ as dependent variables in the estimation of Equation (1).

2.3 Banking market competition

The decomposition in Equations (4a)-(4c) is an important innovation to study the nexus between banking market competition and real sectors' growth. For example, Cetorelli and Strahan (2006) find that more concentrated banking markets pose higher entry barriers for firms because banks protect existing clients and their relation with these firms. Such a decline in contestability may then facilitate factor accumulation of large incumbents at the expense of subduing both innovations, i.e. technical change, and the reallocation of production factors from low-productivity to high-productivity firms. So far, both aspects are neglected. Therefore, we relate more directly to theoretical growth studies that emphasize the potential role of financial market imperfections to hamper the reallocation of factors among firms, such as Aghion et al. (2007) and Herrera et al. (2011).

¹⁵ See Appendix A for details on Domar weights.

We use the Lerner index to measure the market power of individual banks.¹⁶ Lerner indices equal the markup between average revenues and marginal cost, scaled by average revenues. Both are obtained from latent class stochastic cost and profit frontiers to avoid the confusion of market power and inefficiency and to account for the heterogeneous banking industry in Germany (Greene, 2005; Koetter et al., 2012). A higher Lerner index means that banks can set prices well above marginal costs and thereby indicates less competition (a higher degree of market power). We allocate bank-specific Lerner indices to regional markets in which firms operate and use the average Lerner index across banks as our indicator of regional bank market power. Since the measurement of competition in banking is a debate in its own right, we also specify a measure of regional banking market concentration, the Hirschman-Herfindahl Index (*HHI*) based on total bank assets.¹⁷

3 Results

3.1 Baseline

We estimate Equation (1) and specify aggregate growth ($\Delta \ln Y$) and the growth components, input growth ($\Delta \ln X$), technical change ($\Delta \ln A$), and resource reallocation ($\Delta \ln R$), as the dependent variable to identify the effect of bank market power. Table C.3 shows the baseline results based on a sample covering 14,913 region-industry observations for the period 1996 to 2006.¹⁸

– Table C.3 around here –

The direct effects of both bank market power and the dependence on external finance are significantly positive for output growth as well as technical change and reallocation. In line with, for example, Beck et al. (2000) and Carlin and Mayer (2003) the effect on factor accumulation as a source of output growth is insignificant. The differential effect of bank market power at different levels of external dependence is significantly negative for aggregate output growth, technical change, and reallocation.

¹⁶ See Table B.1 and Appendix B for a description of bank-level data and method.

¹⁷ See Carbó et al. (2009) for an overview of measures of market power. Further alternatives included market shares and concentration ratios, which we do not report to conserve on space. The use of loans or deposits instead of total assets does not affect the results shown below either.

¹⁸ Standard errors are clustered at the region-industry level (Donald and Lang, 2007). Clustering by region-year or by industry-year does not affect the results.

The overall effect of market power on growth components depends on the level of dependence on external finance. Therefore, we evaluate the (total) marginal effect of market power on growth (components) at the 5th, 25th, 50th, 75th, and 95th percentile of the *ED* distribution, as shown in the bottom panel. Considering marginal effects across the *ED* distribution is important to account for the heterogeneity of structural external funding needs per industry (see Table A.2 in Appendix A and Cetorelli and Gambera, 2001).

For this sample of SME, bank market power spurs aggregate industry growth significantly. An increase of average Lerner indices by 1% increases output growth by 0.14% for the least dependent sectors. Accordingly, an increase of market power by one standard deviation from 13.8% to 22.3% would increase industry growth by 1.2%, which is 0.15 of a standard deviation. In light of average output growth of 1.6% these effects are economically significant. Generally, the magnitude of the effect is smaller, the more an industry depends on external finance.

This positive effect of bank market power on output growth (components) contrasts at first sight with Cetorelli and Gambera (2001) and Claessens and Laeven (2005), who find a negative relation between banking market concentration measures and industry growth across countries. A first important difference of our study that may reconcile these results is that industry growth in our study refers to the growth of *SME*, rather than all firms in an industry. The present findings are thus in line with Zarutskie (2006), who reports that increasing banking market competition implied stiffer financing constraints and less investment for small, private U.S. firms. Also note that Cetorelli and Gambera (2001) report that especially young firms, which tend to be small, benefit from increasing banking market concentration. Hence, our results based on generally opaque SME seem less contradictory after all.¹⁹

A second important element to consider is that market power in Germany is relatively low. In Cetorelli and Gambera (2001), the German banking market is among the least concentrated and in Claessens and Laeven (2005), the degree of competition in Germany is among the highest. It could well be that for average levels of market power, lock-in effects and rent extraction hurt growth of non-financial firms, but that at lower levels of market power, such as in Germany, the negative effects of cutthroat bank competition prevail.

A third important difference concerns the reallocation component that other studies omit. The last column of Table C.3 shows that technological change

¹⁹ We test below more explicitly if firm opacity and associated larger information asymmetries affect the relation between bank market power and industry growth.

and reallocation account similarly to aggregate output growth. At the median level of dependence on external finance, an increase of market power by 1% increases technological change by 0.06% whereas the reallocation effect across SME amounts to a sizeable 0.04%. This result suggests that one of the key intermediation functions fulfilled by banks, namely to screen and identify the most promising SME, is executed more effectively if banks have reasonable profit margins. A positive effect of market power on the reallocation component of SME growth is in line with theoretical banking studies that show how increasing contestability of banking markets leads to a deterioration of loan quality due to less information of lower quality generated by banks (Marquez, 2002; Dell’Ariccia and Marquez, 2004; Hauswald and Marquez, 2006). The last column in Table C.3 shows also, however, that growth due to reallocation turns insignificant for high dependence on external finance beyond the 75th percentile of the *ED* distribution. This effect is in line with studies showing that banks reap monopoly rents after locking-in credit-constrained customers (Degryse and Ongena, 2005; Berger et al., 2007), such as those SME that depend most heavily on bank finance.

A final important difference of our study and previous work pertains to the measurement of banking market competition. Whereas many study consider the concentration of banking markets to approximate bank market power,²⁰ the (non)competitive conduct of banks depends according to Boone (2008) on the contestability of a market. To test if the difference in measuring competition drive our results, Table C.4 shows estimates when specifying the Hirschman-Herfindahl-Index (HHI) based on total banking assets per region.

–Table C.4 around here –

Qualitatively, concentration results confirm those obtained for regional averages of Lerner indices. Higher concentration spurs aggregate growth via technological change as well as reallocation. The magnitude of these effects is somewhat lower compared to the baseline results.

In sum, we find in line with Petersen and Rajan (1995) and Zarutskie (2006) that the effect of bank market power on growth is positive. The cost of powerful banks extracting rents from locked-in customers thus seem outweighed in this SME sample by the gains from banks being able to generate better information about opaque borrowers. In line with Cetorelli and Gambera (2001), the positive effect of bank market power on SME growth declines with higher industry dependence on external funds.

²⁰ For example, Cetorelli and Gambera (2001) or Cetorelli and Strahan (2006).

3.2 Firm size effects

The effect of banking market competition on aggregate industry growth depends in general on the degree of information asymmetry that banks have to resolve. Black and Strahan (2002) and Canales and Nanda (2012) show that smaller and younger firms, which are more opaque, face larger financing constraints in less competitive banking markets. Whereas the available data does not include information on the age of firms, an important feature of the sample is that the vast majority of firms are very small SME.

More than half of all firms (as well as observations) are so-called micro firms according to the EU taxonomy, i.e., they have sales or total assets of less than €2 million and employ less than ten employees. Around 88% of all firms (observations) are micro firms or small enterprises with less than €10 million in sales or total assets and not more than 49 employees. Less than 2% of the sample are large corporations with more than 249 employees and €50 million (€43 million) in sales (total assets). In terms of total output, the SME in our sample account for around 1/7 of aggregate German GDP according to the national accounts. Thus, we do not dare to draw general inference on industry growth in Germany from our study. But we argue to shed light on the relation between banking competition and aggregate growth for the important SME sector of the German economy.

Table C.5 shows specifications of Equation (1), where we collapse firm-level data per industry-region and year for micro firms and the group of larger, non-micro firms separately.

–Table C.5 around here –

The coefficients of direct and interaction terms shown in the top panel confirm by and large the positive effects of both *LI* and *ED* as well as the negative differential effect. However, conditional marginal effects of aggregate micro firm growth in the left panel are insignificant. As such we find little evidence to support the conjecture that banks with market power lock-in credit constrained customers to extract rents (Rajan, 1992). However, there is also no evidence that larger markups in banking benefit the smallest firms in the economy.

The right panel of Table C.5 shows in turn that larger, less opaque firms drive the positive growth effect of larger Lerner markups realized by banks. The effect of a 1%-increase in bank market power on aggregate growth of the least dependent medium and large firms of 0.13% closely resembles the effect shown for the entire sample in Table C.3. The marginal effects for the decomposition are less significant due to the reduced variation when collapsing over the subsample of non-micro firms. The result that especially

technical change requires some market power of banks is confirmed fairly clear though. Apparently, sufficient profitability buffers in the banking industry are necessary to also finance riskier investments that lead to technological advances. Reallocation, in turn, is only significant at the 10%-level for the lowest dependence on external finance. This result indicates that it is especially the reallocation of resources *across* micro and larger firms rather than the optimal allocation of resources within these size categories that matters for aggregate industry growth.

3.3 *Risky firms*

Whereas size is a frequently employed proxy of firms' opacity, it is firm risk that interacts with the market power of banks (Keeley, 1990; Boyd and De Nicolo, 2005; Martinez-Miera and Repullo, 2010), potentially leading to inefficient lending choices (Dell'Ariscia and Marquez, 2004).

Table C.6 shows results for data collapsed across three different groups of SME that are distinguished according to their Altman Z-score (Altman, 1968).²¹ Risky firms comprise firms in the bottom quartile of Z-score distribution, those with an Altman Z-score below 1.69. Stable firms are the 50% of firms that have Z-scores between 1.68 and 4.29 and very Stable firms are in the top quartile with Z-scores above 4.3.

–Table C.6 around here –

The effect of increasing market power on industry growth (components) of these three groups of firms differs substantially. Aggregate output growth per industry of the riskiest firms increases significantly if Lerner markups are larger as long as their structural dependence on external finance remains below the 50th percentile. Contrary to the results for the entire German sample of SME, this effect is driven by factor accumulation growth. These enterprises may thus not be important innovators but seem to lack the funding of their ongoing operations if banks have not enough capacity to assess their business. This result also hints at the need for some market power of banks to render the costly state verification of generally opaque firms worthwhile.

Reallocation, in turn, reduces industry growth of risky firms significantly, an effect that is stronger if the structural reliance on external finance grows.

²¹ Altman's Z-score is calculated on the basis of firms' balance sheet data as the weighted sum of five ratios (with weights in parantheses): working capital to total assets (1.2), retained earnings to total assets (1.4), earnings before interest and tax to total assets (3.3), equity to liabilities (0.6), and sales to total assets (0.99).

Banks with sufficient margins thus seem to actively prevent resources from being allocated to the unproductive SME with high risk. Banks with sufficient profits may be willing to invest resources to identify opaque firms with viable business models. However, they also invest resources to continuously monitor the performance of these risky firms in their customer portfolio, taking action in terms of preventing factor accumulation if productivity is too low.

Stable firms do not respond significantly to changes in banking market power across most of the *ED* range across industries. Very stable firms, in turn, suffer from larger market power of banks due to the negative contribution of technical change. Both the effect on factor accumulation and the reallocation component of growth are insignificant. This result is in line with Benfratello et al. (2008), who show for small Italian firms that less banking development reduces the likelihood of (process) innovation activities. Banks with market power seem to restrict themselves to financing "bread and butter" factor accumulation of risky firms, rather than technology advancements of stable firms.

3.4 *Incorporation of firms*

Next to size and riskiness, information asymmetries differ among SME according to their form of incorporation. Private proprietorships provide ex ante fewer financial information to potential lenders due to lighter publication requirements and grant ex post weaker titles to collateral due to simpler procedures regulating personal insolvencies. Public incorporation, in turn, implies standardized and frequent publication of financial accounts, stricter legal procedures in case of insolvencies, and minimum capital requirements.²² Table C.7 shows results for data collapsed across private and public firms.

– Table C.7 around here –

The results for informationally more opaque privately incorporated SME show that an increase in bank market power barely affects aggregate growth. Larger markups among banks thus seem to provide little additional scope to conduct costly screening that might translate into spurring aggregate growth significantly.

²² Private forms of incorporation are sole proprietorship, private partnerships (Gesellschaft bürgerlichen Rechts), and general partnerships (Offene Handelsgesellschaft). Public incorporations are limited partnerships (Kommanditgesellschaft, Gesellschaft mit beschränkter Haftung), stock companies (Aktiengesellschaft), and combinations thereof (KG. a.A., GmbH & Co KG).

The positive aggregate growth effect of bank market power estimated for public firms is similar in magnitude compared to the entire sample. According to the small business lending literature, banks increasingly rely on standardized rating technologies requiring financial accounts information also for SME (Berger et al., 2007). Public firms are obliged by law to generate and publish such financial data whereas private firms are not. The prime driver of aggregate growth among public firms in Table C.7 remains technological change. But factor accumulation is also weakly significant if the dependence on external finance is low. Reallocation is insignificant, again corroborating that the ability of banks to facilitate reallocation across *all* SME rather than within the group of public SME contributes significantly to growth.

3.5 *Market power and soft information*

One essential advantage attributed to banks in the SME lending literature is their ability to extract "soft" information from credit relationships (Berger et al., 2001). For a subset of the SME in our sample, we observe firms' ratings by the bank as used in Puri et al. (2011). We observe if credit officers add soft information that changed the overall firm rating from the financial rating, which is solely based on financial accounts data provided by credit applicants. Table C.8 shows the results for SME with relevant soft information in the left panel and for the other group of firms in the right panel.

– Table C.8 around here –

We find no evidence for significantly different growth responses to changes in bank market power for aggregate growth (components) pertaining to firms with and without soft information. Most likely the sample of firms receiving a rating is too small as reflected by the drastically reduced number of region-industry year observations in either group. Since we cannot ascertain if the absence of a rating is due to a lending relationship without any rating or due to missing data in our sample, we are also hesitant to compare aggregate SME growth for firms with and without rating information.

3.6 *Ownership of banks*

An important feature in German banking is the large heterogeneity of banks regarding their regional scope, business models, and ownership (Krahen and Schmidt, 2004). Privately owned commercial banks are the smallest group and usually offer a broad scope of universal banking services to private and corporate clients. The second largest group are government-

owned savings banks. Regional savings banks are *de jure* required to limit their operations to local markets that do not overlap. The fact that they are government-owned and that their mandate explicitly involves the support of the regional economy, suggests there is clear potential for inefficient credit allocation (Khwaja and Mian, 2005; Dinç, 2005). The largest group of banks are small, mutually-owned cooperative banks. Like savings banks they serve primarily regional customers and adhere to a self-imposed principle of regional demarcation as well.

As shown by Canales and Nanda (2012), differences in the organizational form of banks can entail very different effects of market power on credit choices. Therefore, we specify in Table C.9 direct terms of the Lerner index as well as interaction terms separately per banking group.

– Table C.9 around here –

Conditional marginal effects of commercial banks' market power on aggregate SME growth are significantly positive. This effect is primarily due to enhancing technical change. As such, this result suggests that privately-owned, larger banks do particularly well at spotting innovative SME.

For government-owned savings banks, we find in turn largely negative marginal effects on aggregate growth. These effects are insignificant for the largest part of the *ED* distribution, but for SME that rely the least on external finance, the results indicate a significant decline of 0.1% in industry growth in response to a 1%-increase of savings bank market power. The last column in Table C.9 provides some indication that especially reallocation across SME operating in the tails of the *ED* distribution are affected by savings bank market power. Interestingly, aggregate SME growth in the most dependent industries benefits from increasing savings bank market power. This result could indicate the public mandate of these banks to grant especially credit to the most constrained firms in their regional market. Overall, however, we find only weak significance for the effects of market power of savings banks on aggregate SME growth.

Mutually-owned cooperative banks' market power increases aggregate SME growth as well. Contrary to their commercial peers, however, this positive effect of larger cooperative Lerner indices is confined to industries up to the median dependence on external finance. Aggregate SME growth in industries that depend extremely high on external funds appear to suffer from lock-in effects by local cooperatives and exhibit a decline in aggregate growth of 0.12% if Lerner indices increase by 1%. A second important difference between commercial and cooperative banking market power is the lack of evidence that cooperatives foster technological change, but seem crucial to growth by facilitating the reallocation of resources from

low-productivity to high-productivity SME. Potentially, these banks are too small to finance significant technological advancements, but possess the local expertise to successfully identify the most productive SME.

4 Conclusion

We exploit the regional banking market structure prevailing in Germany to identify the effects of bank market power on aggregate industry output growth of small and medium-sized enterprises (SME). To this end, we combine comprehensive SME data with prudential regulatory bank data on market power. The novel SME sample allows us to estimate three different growth components: input growth, technical change, and a term that captures gains from the reallocation of production factors from unproductive to more productive SME.

During the period 1996 and 2006, bank market power enhanced aggregate output growth of SME at the industry level. A 1%-increase of average bank Lerner indices per region increases aggregate SME output growth by 0.12% at the median level of industry dependence on external finance. Aggregate output growth is primarily due to technical change, but the reallocation of resources from low-productivity SME to high-productivity SME is also of economic significance.

Our results suggest that banks require some profit margins to successfully conduct their selection function of credit risks, which seems an important channel how banks affect the real economy. We find that aggregate SME growth of less opaque firms that are larger and publicly incorporated benefits most from an increasing ability of banks to realize markups. Likewise, risky firms grow faster due to factor accumulation in response to higher average market power, which may otherwise not have been financed by banks facing competition.

Importantly, the available micro data also sheds light on the darker sides of bank market power. Especially stable SME that depend heavily on external finance suffer if bank market power increases. We also find that increasing market power of cooperative banks has negative effects on SME from highly dependent industries. Thus, even for very small banks, regional market conditions are decisive in their effect on the real economy.

Overall, we conclude that reasonable markups in banking are beneficial because they permit the generation of important private information needed for an efficient selection and monitoring of risks and, ultimately, growth. At the same time, even small banks may extract rents from locked-in firms

that depend heavily on external finance, which may entail negative growth. Hence, regional market conditions should matter for antitrust policies rather than considerations of bank size alone.

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A Appendix A: Domar weights

We collapse the firm-level decomposition at the industry level by weighing the three terms of Equation (3). Aggregate output nets out intermediate deliveries:²³ $P_t^V V_t = \Sigma_t(w_{it}L_{it} + r_{it}K_{it})$, where V is value added and P^V is the price of value added. Hulten (1978) shows that aggregate output growth equals the appropriately weighted sum of firm output growth rates, $\Delta \ln V_t = \Sigma_t(v_{it}\Delta Y_{it})$, where:

$$v_{it} = \frac{1}{2} \left(\frac{P_{it}Y_{it}}{P_t^V V_t} + \frac{P_{it-1}Y_{it-1}}{P_t^V V_{t-1}} \right). \quad (\text{A.1})$$

v_{it} represents the so-called Domar weight, which determines the contribution of each firm to aggregate output growth. Note that output includes intermediate inputs whereas aggregate value added excludes intermediate inputs. Thus, the sum of all Domar weights is typically greater than one.

To link banking competition and output growth at the industry level, we use total industry value added from the EU KLEMS database. Hence, the weighted sum of firm output growth typically sums to less than industry output growth because we cover less than the whole industry but we know firm output growth contributions to total industry output growth.

²³ Gross domestic product (GDP) at the level of the economy or industry value added. We dismiss industry subscripts here for ease of exposition.

Table A.1
Sales, labor, capital, and material data per industry

	Sales		Labor		Capital		Material		N
	Mean	SD	Mean	SD	Mean	SD	Mean	SD	
Agriculture	0.91	2.88	0.21	0.57	0.83	1.91	0.44	1.81	30636
Food products	7.48	17.57	1.38	2.86	1.66	4.30	4.21	11.27	26885
Textiles, apparel & leather	9.78	17.06	2.22	3.65	1.48	3.50	5.55	10.26	5935
Wood products	4.21	10.12	0.95	2.02	0.86	2.66	2.40	6.25	12183
Paper, printing & publishing	7.10	15.62	1.92	3.64	1.61	4.39	3.40	8.70	15106
Chemical products	14.22	22.75	3.06	4.66	2.83	5.96	7.38	13.09	3614
Rubber & plastics	8.90	14.98	2.29	3.42	1.88	4.15	4.57	8.66	11366
Stone, clay & glass	6.32	12.88	1.65	3.20	1.84	4.46	2.96	6.45	10062
Metal products	5.43	12.19	1.58	2.99	1.17	3.21	2.64	7.07	41822
Machinery	8.90	16.18	2.59	4.09	1.44	3.77	4.39	9.01	21302
Electrical & electronic equipment	6.38	14.24	1.80	3.45	0.93	3.08	3.13	7.90	22098
Transport equipment	13.14	22.46	3.11	4.95	2.85	6.78	7.53	13.65	4603
Miscellaneous manufacturing	6.07	12.97	1.51	2.93	1.14	3.06	3.11	7.61	11557
Utilities	25.11	29.41	3.21	4.54	17.29	14.75	15.24	18.62	1714
Construction	2.29	5.94	0.73	1.54	0.31	1.23	1.15	3.53	135488
Motor vehicle trade	6.46	12.31	0.70	1.59	0.73	2.06	5.00	9.17	61745
Wholesale trade	10.22	18.69	1.11	2.33	0.90	2.77	7.49	13.26	66419
Retail trade	3.57	11.42	0.61	2.12	0.51	2.69	2.31	7.30	93295
Hotels & restaurants	0.87	3.11	0.27	0.83	0.53	1.53	0.25	1.43	41438
Transport & storage	5.07	11.04	1.27	2.51	1.50	4.35	2.31	6.77	24532
Telecommunications	6.18	15.32	1.24	2.75	2.30	7.19	3.39	9.64	760
Business services	5.05	12.93	1.10	2.59	4.07	10.13	2.42	7.55	61348

Notes: Table A.1 shows descriptive statistics for firms' sales, capital and labor and material expenditures per industry. The sample comprises 696,119 observations (197,934 firms) for 11 years between 1996-2006. *N* denotes the number of firm-year observations per industry.

Table A.2
Industry production function parameter estimates

	Labor		Capital		Intermediates		<i>ED</i>	Share of:	
	β_l	SE	β_k	SE	β_m	SE	Mean	<i>N</i>	Firms
Agriculture	0.225	(0.003)	0.061	(0.003)	0.351	(0.010)	-32.30	0.043	0.053
Food products	0.345	(0.006)	0.031	(0.004)	0.507	(0.016)	3.53	0.038	0.034
Textiles, apparel & leather	0.366	(0.013)	0.023	(0.006)	0.424	(0.024)	0.89	0.008	0.008
Wood products	0.303	(0.008)	0.012	(0.004)	0.466	(0.018)	-0.11	0.017	0.016
Paper, printing & publishing	0.396	(0.007)	0.023	(0.004)	0.354	(0.013)	5.98	0.021	0.020
Chemical products	0.391	(0.016)	0.004	(0.010)	0.365	(0.038)	42.73	0.005	0.005
Rubber & plastics	0.367	(0.009)	0.030	(0.005)	0.441	(0.018)	5.28	0.016	0.014
Stone, clay & glass	0.345	(0.008)	0.024	(0.006)	0.427	(0.018)	1.76	0.014	0.013
Metal products	0.437	(0.005)	0.033	(0.003)	0.331	(0.007)	1.07	0.059	0.055
Machinery	0.395	(0.007)	0.029	(0.004)	0.406	(0.011)	6.55	0.030	0.029
Electrical & electronic equipment	0.387	(0.007)	0.023	(0.003)	0.417	(0.009)	9.16	0.031	0.029
Transport equipment	0.338	(0.013)	0.021	(0.006)	0.448	(0.024)	4.87	0.007	0.007
Miscellaneous manufacturing	0.351	(0.011)	0.028	(0.006)	0.378	(0.016)	2.06	0.016	0.015
Utilities	0.112	(0.015)	0.067	(0.042)	0.436	(0.056)	-0.26	0.002	0.003
Construction	0.364	(0.003)	0.022	(0.002)	0.355	(0.004)	24.19	0.192	0.187
Motor vehicle trade	0.183	(0.003)	0.023	(0.002)	0.666	(0.009)	0.83	0.087	0.082
Wholesale trade	0.178	(0.003)	0.022	(0.002)	0.603	(0.010)	2.12	0.094	0.089
Retail trade	0.204	(0.002)	0.016	(0.001)	0.616	(0.009)	1.64	0.132	0.135
Hotels & restaurants	0.407	(0.006)	0.034	(0.003)	0.290	(0.011)	0.66	0.059	0.061
Transport & storage	0.490	(0.008)	0.062	(0.006)	0.130	(0.005)	-13.50	0.035	0.036
Telecommunications	0.415	(0.024)	0.035	(0.028)	0.230	(0.035)	8.58	0.001	0.002
Business services	0.404	(0.003)	0.043	(0.004)	0.299	(0.004)	8.86	0.087	0.103

Notes: Table A.2 shows coefficient estimates based on the Wooldridge (2009) GMM estimation strategy of the Levinsohn and Petrin (2003) control function approach. The sample comprises 696,119 observations for 197,934 firms between 1996 and 2006. Reported coefficients and standard errors (SE) for labor (β_l), capital (β_k) and material (β_m) resulting from employing the Wooldridge (2009) GMM estimation on Equation (?). External dependence (*ED*) is the period-average share of debt in total liabilities of UK firms for each industry. *N* and *Firms* report the share of observations and firms per industry, respectively.

B Appendix B: Estimation of Lerner indices

We account for systematic differences across banks by estimating a *latent* stochastic cost (*TOC*) and profit before tax (*PBT*) frontiers (Greene, 2005). Banks produce interbank loans (O_1), commercial loans (O_2), securities (O_3), and off-balance sheet activities (O_4). We specify prices of fixed assets W_1 (rent and depreciation over fixed assets), labor W_2 (personnel expenditure over employees), and borrowed funds W_3 (interest expenditure over interest-bearing liabilities), specify equity Z as a netput, and a time *trend*. Parameters differ per technology regime j . Regime membership probabilities are

estimated, rather than stipulated. We specify:²⁴

$$\ln TOC_{kt|j} = f(\ln O_{kt|j}, \ln W_{kt|j}, \ln Z_{kt|j}, trend; \alpha_j, \beta_j) + v_{kt|j} + u_{kt|j}. \quad (B.1)$$

We assume the random term $v_{kt|j}$ to be *i.i.d.* for each class j and normally distributed with zero mean, $v_{kt|j} \sim N(0, \sigma_{vj}^2)$. Inefficiency follows a half normal distribution. Denoting explanatory variables $\ln O_{kt}$, $\ln W_{kt}$, $\ln Z_{kt}$ with x_{kt} for short, the likelihood function is (Greene, 2005):

$$LF(k, t|j) = f(TOC_{kt|j}|x_{kt|j}, \alpha_j, \beta_j, \sigma_j, \lambda_j) = \frac{\phi(\lambda_j \epsilon_{kt|j} / \sigma_j)}{\phi(0)} \frac{1}{\sigma_j} \phi\left(\frac{\epsilon_{kt|j}}{\sigma_j}\right), \quad (B.2)$$

where $\epsilon_{kt|j} = TOC_{kt} - \alpha_j - x'_{kt}\beta_j$, $\lambda_j = \sigma_{uj} / \sigma_{vj}$, $\sigma_j = \sqrt{(\sigma_{uj}^2 + \sigma_{vj}^2)}$ and ϕ is the standard normal density. Conditional on the firm being in class j , the contribution of each firm to the likelihood function is $LF(k|j) = \prod_{t=1}^T LF(k, t|j)$. The unconditional likelihood for each firm is averaged over the latent classes using the prior probability as weights to membership in group j :

$$LF(k) = \sum_{j=1}^J P(k, j) LF(k|j) = \sum_{j=1}^J P(k, j) \prod_{t=1}^T LF(k, t|j). \quad (B.3)$$

$P(k, j)$ is the prior probability of bank k 's membership in class j , which are estimated with a multinomial logit conditional on production factors in the kernel. We specify Equation (B.1) as a translog, impose the necessary restrictions, and describe the data in Table B.1, which illustrates the need to account for different banking types.

We use Lerner indices to measure competition per bank, which equals $L_{kt|j} = (AR_{kt|j} - MC_{kt|j}) / AR_{kt|j}$. In competitive markets, marginal costs $MC_{kt|j}$ equal average revenues $AR_{kt|j}$. Low values of the Lerner indices $L_{kt|j}$ indicate more competition. We use group-specific cost parameters from Equation (B.1) to calculate the group-specific marginal costs as:

$$MC_{kt|j} = \sum_m^4 \frac{\partial \ln TOC_{kt|j}}{\partial \ln O_{mkt|j}} \times \frac{TOC_{kt|j}}{\sum_m^4 O_{mkt|j}}. \quad (B.4)$$

Average revenues, in turn, are predicted from the stochastic frontier model:

$$AR_{kt|j} = \sum_m^4 \frac{(\widehat{TOC}_{kt|j} + \widehat{PBT}_{kt|j})}{O_{mkt|j}}. \quad (B.5)$$

²⁴ Profit inefficiency is subtracted because it reduces profits.

Table B.1
Descriptive statistics on banking competition arguments

Variable		National banks	Local banks			Total
			Commercial	Savings	Cooperative	
<i>Number of observations</i>		324	2,505	8,678	29,554	41,061
O1	Interbank loans	45,400.0	842.0	162.0	37.1	471.0
		41,300.0	2,810.0	323.0	110.0	5,480.0
O2	Customer loans	59,600.0	1,690.0	987.0	168.0	903.0
		75,400.0	5,870.0	1,550.0	463.0	8,660.0
O3	Securities	37,100.0	729.0	423.0	62.4	471.0
		46,400.0	2,940.0	580.0	196.0	5,320.0
O4	Off-balance sheet	26,400.0	410.0	99.1	18.2	267.0
		32,600.0	1,630.0	184.0	73.5	3,740.0
W1	Price of fixed assets	25.76	49.32	17.54	18.46	20.20
		26.07	392.80	226.33	300.78	292.25
W2	Price of labor	83.66	85.53	50.46	51.46	53.58
		33.43	415.73	197.47	21.81	138.59
W3	Price of borrowed funds	4.49	6.57	3.56	3.44	3.66
		1.34	93.97	0.80	0.86	23.23
Z	Equity	4,330.0	170.0	75.5	14.2	70.7
		4,890.0	463.0	115.0	35.0	592.0
TOC	Total cost	7,270.0	189.0	88.8	15.6	98.9
		7,700.0	525.0	128.0	37.4	949.0
TA	Total assets	163,000.0	3,520.0	1,670.0	286.0	2,060.0
		228,000.0	10,300.0	2,440.0	764.0	24,900.0

Notes: Table B.1 shows mean and median values for all variables to estimate banks' cost function as in Equation (B.1). The data are originally sourced from the German central bank. It covers all commercial, cooperative, and savings banks in operation between 1993 and 2008.

C Appendix C: Tables

Table C.1
Growth components, dependence on external finance, and bank competition

Varibale	Abbreviation	Mean	SD
Output growth	$\Delta \ln Y$	0.0160	0.0620
Input growth	$\Delta \ln X$	0.0078	0.0672
Technical change	$\Delta \ln A$	0.0066	0.0306
Reallocation	$\Delta \ln R$	0.0016	0.0459
External dependency on finance	ED	0.2185	1.2329
Lerner	LI	0.1379	0.0840
Herfindahl Index	HHI	0.1846	0.1130

Notes: Table C.1 shows descriptive statistics for all variables used to estimate Equation (1). The sample comprises information for 14,913 observations for 11 years, 22 industries, and 67 regions. $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b) following Basu et al. (2009); *ED* represents dependence on external finance calculated as in Rajan and Zingales (1998); *LI* represents Lerner indices net off operational inefficiency for each German region over time. *HHI* is a Hirschman-Herfindahl Index per region.

Table C.2
Descriptive firm-level statistics 1996-2006

	Mean	SD
Sales growth (%)	1.57	28.2
Growth of intermediate inputs (%)	1.15	43.4
Growth of labor (%)	0.79	31.7
Growth of capital (%)	-2.05	56.9
Average Domar weight (%)	0.01	0.04
Average intermediates share	0.48	0.22
Average labor share	0.26	0.16
Average capital share	0.26	0.17

Notes: Table C.2 shows firm-level information for 696,119 observations of German SMEs between 1996-2006. Growth rates of sales, intermediates, labor and capital show mean *yoy* changes in % for all firms in this sample. The average Domar weight reports mean contribution of each firm to aggregated output growth. Average shares for intermediates, labor and capital show values for rolling two year averages of each input to sales ratio.

Table C.3
Aggregate growth components and Lerner indices

Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i>	0.1081*** (0.028)	0.0146 (0.026)	0.0574*** (0.014)	0.0361** (0.018)
<i>ED</i>	0.0070*** (0.001)	0.0016 (0.001)	0.0014** (0.001)	0.0040*** (0.001)
<i>LI</i> \times <i>ED</i>	-0.0220*** (0.006)	-0.0016 (0.005)	-0.0084*** (0.002)	-0.0119*** (0.004)
N	14,913	14,913	14,913	14,913
R2	0.2910	0.1770	0.1990	0.1080
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles				
5 th (<i>ED</i>)	0.1400***	0.0170	0.0698***	0.0535***
se	0.0321	0.0271	0.0156	0.0196
25 th (<i>ED</i>)	0.1160***	0.0152	0.0606***	0.0405**
se	0.0289	0.0271	0.0135	0.0171
50 th (<i>ED</i>)	0.1160***	0.0152	0.0606***	0.0405**
se	0.0289	0.0258	0.0143	0.0177
75 th (<i>ED</i>)	0.0937***	0.0135	0.0519***	0.0283
se	0.0269	0.0296	0.0143	0.0179
95 th (<i>ED</i>)	0.0577**	0.0108	0.0381**	0.0089
se	0.0259	0.0257	0.0131	0.0179

Notes: Table C.3 shows baseline regression results of Equation (1) for 14,913 observations for 11 years, 22 industries, and 67 regions. Fixed effects for 1,448 region-industry pairs and years are included but not reported. $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.4
Banking concentration

Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>HHI</i>	0.0340*** (0.011)	-0.0158 (0.011)	0.0236*** (0.006)	0.0261*** (0.007)
<i>ED</i>	0.0034*** (0.001)	0.0014 (0.001)	-0.0003 (0.001)	0.0022** (0.001)
<i>HHI</i> \times <i>ED</i>	-0.0037 (0.004)	-0.0008 (0.004)	-0.0000 (0.002)	-0.0029 (0.003)
N	14,913	14,913	14,913	14,913
R2	0.290	0.177	0.199	0.107
Marginal effect of <i>HHI</i> conditional on <i>ED</i> percentiles				
5 th (<i>ED</i>)	0.0394***	-0.0147	0.0236***	0.0304***
se	0.0115	0.0135	0.00764	0.00722
25 th (<i>ED</i>)	0.0353**	-0.0155	0.0236***	0.0272***
se	0.0155	0.0107	0.00596	0.00969
50 th (<i>ED</i>)	0.0353***	-0.0155	0.0236***	0.0272***
se	0.0124	0.0110	0.00593	0.00842
75 th (<i>ED</i>)	0.0315***	-0.0163	0.0236***	0.0242***
se	0.0110	0.0110	0.00596	0.00713
95 th (<i>ED</i>)	0.0255**	-0.0176	0.0236***	0.0194***
se	0.0110	0.0132	0.00697	0.00713

Notes: Table C.4 shows baseline regression results of Equation (1) for 14,913 observations for 11 years, 22 industries, and 67 regions. Fixed effects for 1,448 region-industry pairs and years are included but not reported. $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *HHI* is a Hirschman-Herfindahl Index per region. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.5
Firm size

Firm group	Micro firms				Non-micro firms			
Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i>	0.0008 (0.003)	0.0062 (0.005)	-0.0010 (0.002)	-0.0044 (0.004)	0.0807** (0.037)	0.0354 (0.034)	0.0277* (0.015)	0.0177 (0.019)
<i>ED</i>	0.0004** (0.000)	-0.0002 (0.000)	0.0000 (0.000)	0.0006*** (0.000)	0.0088*** (0.001)	0.0029** (0.001)	0.0017** (0.001)	0.0042*** (0.001)
<i>LI</i> × <i>ED</i>	-0.0017*** (0.001)	-0.0008 (0.001)	-0.0003 (0.000)	-0.0006 (0.001)	-0.0299*** (0.006)	-0.0090 (0.006)	-0.0110*** (0.003)	-0.0099** (0.004)
N	13,253	13,253	13,253	13,253	13,613	13,613	13,613	13,613
R2	0.137	0.131	0.126	0.152	0.310	0.186	0.207	0.117
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles								
5 th (<i>ED</i>)	0.00334	0.00735	-0.000512	-0.00350	0.125***	0.0485	0.0439***	0.0322*
se	0.00368	0.00538	0.00164	0.00417	0.0359	0.0349	0.0157	0.0194
25 th (<i>ED</i>)	0.00152	0.00654	-0.000835	-0.00418	0.0929**	0.0390	0.0322**	0.0217
se	0.00351	0.00552	0.00159	0.00403	0.0377	0.0369	0.0151	0.0204
50 th (<i>ED</i>)	0.00152	0.00654	-0.000835	-0.00418	0.0929**	0.0390	0.0322**	0.0217
se	0.00351	0.00551	0.00167	0.00406	0.0403	0.0338	0.0151	0.0197
75 th (<i>ED</i>)	-0.000401	0.00568	-0.00118	-0.00490	0.0604	0.0293	0.0202	0.0109
se	0.00347	0.00535	0.00161	0.00411	0.0377	0.0342	0.0167	0.0197
95 th (<i>ED</i>)	-0.00287	0.00457	-0.00161	-0.00583	0.0168	0.0162	0.00409	-0.00351
se	0.00366	0.00538	0.00161	0.00406	0.0354	0.0349	0.0157	0.0210
Descriptive statistics of dependent variable								
Mean	-0.000869	-0.00179	-0.000106	0.00103	0.0173	0.00935	0.00690	0.00106
SD	0.00976	0.0122	0.00383	0.00797	0.0625	0.0706	0.0312	0.0498

Notes: Table C.5 shows baseline regression results of Equation (1) for two firm categories for 11 years, 22 industries, and 67 regions. Micro firms comprise firms that have less than 2 million Euro total asset and/or sales and less than 10 employees. Non-micro firms comprise all other firms in the sample. Each sample is produced by collapsing the whole sample by region, industry, year and size category. Each regression includes fixed effects for all region-industries pairs and years (not reported). $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.6
Firm risk

Firm group	Risky firms				Stable firms				Very stable firms			
Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i>	0.0117 (0.009)	0.0222** (0.010)	-0.0003 (0.005)	-0.0102* (0.006)	-0.0144 (0.020)	-0.0174 (0.021)	-0.0035 (0.009)	0.0064 (0.012)	-0.0272* (0.016)	-0.0179 (0.016)	-0.0127 (0.008)	0.0035 (0.011)
<i>ED</i>	0.0011** (0.000)	-0.0004 (0.001)	0.0002 (0.000)	0.0013*** (0.000)	0.0033*** (0.001)	0.0005 (0.001)	0.0005 (0.001)	0.0023** (0.001)	0.0024*** (0.001)	0.0009 (0.001)	0.0004 (0.000)	0.0011* (0.001)
<i>LI</i> × <i>ED</i>	-0.0035 (0.002)	0.0007 (0.002)	-0.0010 (0.001)	-0.0032** (0.001)	-0.0090** (0.004)	0.0001 (0.005)	-0.0040** (0.002)	-0.0051 (0.003)	-0.0100*** (0.003)	-0.0056 (0.004)	-0.0035** (0.002)	-0.0009 (0.003)
N	10,966	10,966	10,966	10,966	12,909	12,909	12,909	12,909	10,794	10,794	10,794	10,794
R2	0.182	0.147	0.164	0.130	0.244	0.159	0.176	0.108	0.294	0.138	0.232	0.079
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles												
5 th (<i>ED</i>)	0.0169* se 0.0101	0.0212** 0.00969	0.00107 0.00505	-0.00539 0.00562	-0.00127 0.0202	-0.0175 0.0215	0.00239 0.0101	0.0138 0.0126	-0.0125 0.0168	-0.00964 0.0168	-0.00765 0.00816	0.00482 0.0104
25 th (<i>ED</i>)	0.0133 se 0.00922	0.0219** 0.0101	7.58e-05 0.00505	-0.00873 0.00597	-0.0107 0.0218	-0.0174 0.0233	-0.00183 0.00923	0.00849 0.0138	-0.0228 0.0163	-0.0154 0.0168	-0.0112 0.00865	0.00387 0.0112
50 th (<i>ED</i>)	0.0133 se 0.00922	0.0219** 0.0101	7.58e-05 0.00498	-0.00873 0.00575	-0.0107 0.0201	-0.0174 0.0214	-0.00183 0.00947	0.00849 0.0138	-0.0228 0.0160	-0.0154 0.0162	-0.0112 0.00799	0.00387 0.0123
75 th (<i>ED</i>)	0.00941 se 0.00890	0.0226** 0.0101	-0.000975 0.00535	-0.0123** 0.00621	-0.0205 0.0202	-0.0173 0.0230	-0.00619 0.00964	0.00297 0.0125	-0.0338** 0.0160	-0.0216 0.0168	-0.0150* 0.00826	0.00286 0.0110
95 th (<i>ED</i>)	0.00480 se 0.00936	0.0235** 0.0110	-0.00223 0.00523	-0.0165** 0.00575	-0.0336 0.0213	-0.0172 0.0215	-0.0120 0.00947	-0.00441 0.0126	-0.0467*** 0.0158	-0.0289 0.0183	-0.0195** 0.00816	0.00166 0.0110
Descriptive statistics of dependent variable												
Mean	-0.00174	-0.00113	-0.00108	0.000475	0.00915	0.00436	0.00394	0.000843	0.00854	0.00467	0.00359	0.000273
SD	0.0167	0.0166	0.00968	0.0103	0.0379	0.0413	0.0187	0.0276	0.0288	0.0347	0.0141	0.0251

Notes: Table C.6 shows baseline regression results of Equation (1) for three firm categories for 11 years, 22 industries, and 67 regions. Risky firms comprise firms with an Altman Z-score below 1.69. Stable firms have Z-scores between 1.68 and 4.29. Very Stable firms have Z-scores above 4.3. Each sample is produced by collapsing the whole sample by region, industry, year and risk category. Each regression includes fixed effects for all region-industries pairs and years (not reported). $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.7
Public versus private incorporation

Firm group	Private firms				Public firms			
Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i>	0.0004 (0.007)	-0.0048 (0.008)	0.0023 (0.003)	0.0028 (0.004)	0.0852*** (0.030)	0.0502 (0.038)	0.0343** (0.014)	0.0007 (0.027)
<i>ED</i>	0.0005 (0.000)	0.0002 (0.000)	-0.0002 (0.000)	0.0006** (0.000)	0.0072*** (0.001)	0.0038** (0.002)	0.0015** (0.001)	0.0020* (0.001)
<i>LI</i> × <i>ED</i>	-0.0018 (0.001)	0.0011 (0.001)	0.0001 (0.001)	-0.0030*** (0.001)	-0.0204*** (0.006)	-0.0110* (0.006)	-0.0077*** (0.003)	-0.0017 (0.004)
N	11,637	11,637	11,637	11,637	14,247	14,247	14,247	14,247
R2	0.206	0.140	0.160	0.111	0.273	0.163	0.202	0.111
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles								
5 th (<i>ED</i>)	0.00299	-0.00639	0.00218	0.00720*	0.115***	0.0664*	0.0457***	0.00318
se	0.00833	0.00766	0.00320	0.00412	0.0288	0.0390	0.0139	0.0297
25 th (<i>ED</i>)	0.00117	-0.00525	0.00228	0.00414	0.0928***	0.0543	0.0372***	0.00133
se	0.00763	0.00809	0.00300	0.00430	0.0306	0.0390	0.0139	0.0263
50 th (<i>ED</i>)	0.00117	-0.00525	0.00228	0.00414	0.0928***	0.0543	0.0372***	0.00133
se	0.00763	0.00764	0.00296	0.00412	0.0282	0.0420	0.0150	0.0276
75 th (<i>ED</i>)	-0.000703	-0.00407	0.00238	0.000994	0.0713**	0.0427	0.0291**	-0.000432
se	0.00716	0.00764	0.00350	0.00437	0.0334	0.0358	0.0133	0.0276
95 th (<i>ED</i>)	-0.00305	-0.00260	0.00250	-0.00295	0.04150	0.0266	0.0178	-0.00288
se	0.00701	0.00746	0.00320	0.00411	0.0306	0.0370	0.0133	0.0256
Descriptive statistics of dependent variable								
Mean	0.00158	0.000205	0.000690	0.000690	0.0139	0.00688	0.00574	0.00124
SD	0.0122	0.0143	0.00551	0.00956	0.0566	0.0642	0.0279	0.0457

Notes: Table C.7 shows baseline regression results of Equation (1) for two firm categories for 11 years, 22 industries, and 67 regions. Private firms comprise all sole proprietorships in the sample. Public firms comprise limited liabilities and firms that issued shares. Each sample is produced by collapsing the whole sample by region, industry, year and governance category. Each regression includes fixed effects for all region-industries pairs and years (not reported). $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.8
Soft information in SME ratings

Firm group Dependent variable	Soft information change rating				Soft information do not differ from financial rating			
	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i>	0.0118 (0.033)	0.0131 (0.038)	-0.0022 (0.018)	0.0009 (0.023)	0.0320 (0.040)	0.0304 (0.045)	0.0012 (0.015)	0.0004 (0.021)
<i>ED</i>	-0.0005 (0.001)	-0.0020 (0.002)	0.0001 (0.001)	0.0015 (0.002)	0.0013 (0.002)	0.0004 (0.003)	0.0003 (0.001)	0.0007 (0.002)
<i>LI</i> × <i>ED</i>	0.0010 (0.004)	0.0097 (0.008)	-0.0014 (0.002)	-0.0073 (0.006)	-0.0028 (0.004)	-0.0034 (0.004)	0.0011 (0.003)	-0.0005 (0.003)
N	4,106	4,106	4,106	4,106	2,511	2,511	2,511	2,511
R2	0.369	0.302	0.361	0.308	0.433	0.427	0.451	0.439
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles								
5 th (<i>ED</i>)	0.0102	-0.00182	-5.97e-05	0.0121	0.0359	0.0351	-0.000286	0.00108
se	0.0345	0.0396	0.0184	0.0238	0.0399	0.0555	0.0218	0.0192
25 th (<i>ED</i>)	0.0110	0.00620	-0.00120	0.00605	0.0339	0.0326	0.000513	0.000734
se	0.0336	0.0396	0.0178	0.0237	0.0402	0.0443	0.0155	0.0201
50 th (<i>ED</i>)	0.0110	0.00620	-0.00120	0.00605	0.0339	0.0326	0.000513	0.000734
se	0.0336	0.0380	0.0190	0.0227	0.0399	0.0458	0.0154	0.0321
75 th (<i>ED</i>)	0.0120	0.0152	-0.00247	-0.000720	0.0308	0.0289	0.00169	0.000225
se	0.0331	0.0383	0.0184	0.0238	0.0463	0.0443	0.0157	0.0219
95 th (<i>ED</i>)	0.0134	0.0294	-0.00450	-0.0115	0.0176	0.0128	0.00676	-0.00197
se	0.0335	0.0420	0.0180	0.0259	0.0399	0.0434	0.0154	0.0201
Descriptive statistics of dependent variable								
Mean	0.00315	0.00129	0.00146	0.000399	0.00189	0.000816	0.000844	0.000231
SD	0.0197	0.0192	0.0106	0.0121	0.0149	0.0163	0.00692	0.00824

Notes: Table C.8 shows baseline regression results of Equation (1) for two firm categories for 11 years, 22 industries, and 67 regions. The first sample comprises firms for which their savings bank has soft information that change the rating decision. The second sample comprises firms for which soft information do not change their financial rating. Each sample is produced by collapsing the whole sample by region, industry, year and information category. Each regression includes fixed effects for all region-industries pairs and years (not reported). $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time. The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

Table C.9
Growth and competition by banking group

Dependent variable	$\Delta \ln Y$	$\Delta \ln X$	$\Delta \ln A$	$\Delta \ln R$
<i>LI</i> (CB)	0.0202*** (0.006)	0.0018 (0.006)	0.0124*** (0.004)	0.0060 (0.004)
<i>LI</i> (CB) \times <i>ED</i>	-0.0026 (0.004)	-0.0040 (0.004)	-0.0003 (0.002)	0.0017 (0.002)
<i>LI</i> (SB)	-0.0420 (0.036)	-0.0179 (0.034)	-0.0030 (0.017)	-0.0212 (0.019)
<i>LI</i> (SB) \times <i>ED</i>	0.0375** (0.018)	0.0072 (0.020)	0.0044 (0.009)	0.0259* (0.014)
<i>LI</i> (CO)	0.0477* (0.025)	0.0141 (0.025)	0.0113 (0.012)	0.0224 (0.017)
<i>LI</i> (CO) \times <i>ED</i>	-0.0720*** (0.015)	-0.0083 (0.016)	-0.0196** (0.008)	-0.0442*** (0.012)
<i>ED</i>	0.0116*** (0.004)	0.0019 (0.004)	0.0037** (0.002)	0.0060*** (0.002)
N	14,869	14,869	14,869	14,869
R2	0.292	0.177	0.200	0.108
Marginal effect of <i>LI</i> conditional on <i>ED</i> percentiles				
Commerical banks (CB)				
5 th (<i>ED</i>)	0.0239***	0.00768	0.0128**	0.00340
se	0.00921	0.00619	0.00515	0.00372
25 th (<i>ED</i>)	0.0211***	0.00325	0.0125***	0.00532
se	0.00674	0.00546	0.00334	0.00558
50 th (<i>ED</i>)	0.0199***	0.00136	0.0124***	0.00613
se	0.00619	0.00881	0.00382	0.00380
75 th (<i>ED</i>)	0.0185***	-0.000885	0.0123***	0.00710
se	0.00613	0.00895	0.00348	0.00401
95 th (<i>ED</i>)	0.0143	-0.00749	0.0118**	0.00995
se	0.00910	0.00554	0.00459	0.00605
Savings banks (SB)				
5 th (<i>ED</i>)	-0.0970*	-0.0285	-0.00942	-0.0591**
se	0.0518	0.0517	0.0188	0.0194
25 th (<i>ED</i>)	-0.0558	-0.0205	-0.00459	-0.0307
se	0.0393	0.0333	0.0253	0.0340
50 th (<i>ED</i>)	-0.0383	-0.0172	-0.00253	-0.0186
se	0.0359	0.0489	0.0164	0.0299
75 th (<i>ED</i>)	-0.0174	-0.0131	-7.43e-05	-0.00418
se	0.0342	0.0324	0.0224	0.0203
95 th (<i>ED</i>)	0.0439	-0.00133	0.00713	0.0381
se	0.0441	0.0369	0.0171	0.0186
Cooperative banks (CO)				
5 th (<i>ED</i>)	0.153***	0.0262**	0.0400***	0.0872
se	0.0397	0.0424	0.0165	0.0244
25 th (<i>ED</i>)	0.0743***	0.0171	0.0185	0.0387***
se	0.0277	0.0246	0.0200	0.0150
50 th (<i>ED</i>)	0.0406*	0.0133	0.00935	0.0180
se	0.0241	0.0223	0.0137	0.0292
75 th (<i>ED</i>)	0.000412	0.00864	-0.00155	-0.00668
se	0.0222	0.0287	0.0109	0.0164
95 th (<i>ED</i>)	-0.118***	-0.00491	-0.0336***	-0.0791***
se	0.0320	0.0338	0.0118	0.0193

Notes: Table C.9 shows baseline regression results of Equation (1) for 14,913 observations for 11 years, 22 industries, and 67 regions. Fixed effects for 1,448 region-industry pairs and years are included but not reported. $\Delta \ln Y$ is aggregate growth; $\Delta \ln X$ is input growth as in Equation (4a); $\Delta \ln A$ is technical change as in Equation (4c); $\Delta \ln R$ is a reallocation term as in Equation (4b); *ED* represents dependence on external finance calculated from Compustat database for matching US industries over time; *LI* represents Lerner indices net off operational inefficiency for each German region over time for each banking group: commercial banks (CB), savings banks (SB) and cooperative banks (CO). The bottom panel depicts marginal effects conditional on different levels of dependence on external finance ranging from 5th to 95th percentile. Clustered standard errors by region-industry are in parentheses. *** p<0.01, ** p<0.05 and * p<0.1 denote significance.

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