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The Demise of the Mittelstand

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Summary:
The Mittelstanders form the backbone and trusty barometer of the German economy.

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According to a survey of German executives by the influential Ifo think tank, German business confidence rose in January 2003 for the first time in eight months - albeit imperceptibly, from 87.3 to 87.4. A poll conducted by ZEW, another brain trust, confirmed these findings. On past form, though, this confidence level heralds a contraction of 5-6 percent in industrial production.

This is consistent with other dismal figures: negligible growth, stiflingly high real interest rates imposed by the European Central Bank, an export-discouraging strong euro and a disheartening surge in unemployment to more than 10 percent. German woes are compounded by a global recession, the evaporation of entire industries (such as telecoms) and a sharp, universal decline in investments.

The main victims are the Mittelstand - the 1.3-3.2 (depending on the definition) million mostly family-owned German small to medium enterprises (SMEs). Of every 1000 German businesses, 997 are Mittelstand by one liberal definition. The real figure is closer to one third. Strict criteria reduce it to one in thirty firms.

These differences of opinion reflect the fuzziness of the concept which has more to do with the style of ownership and management and with a unique historic-cultural background than with objective, economic yardsticks.

The Mittelstanders form the backbone and trusty barometer of the German economy. They engage close to 22 million workers and apprentices as well as well over 3 million "self employed" (owner-employees) - 70 percent of Germany's total active workforce. More than two fifths of all commercial turnover in the country are generated by them as well as half the value added and one third of all exports.

The investment requirements of Mittelstand firms total $20 billion annually. But access to capital is narrowing. Tottering local banks are risk averse, the capital markets are lethargic, private investors are scared and scarce. The Basle 2 capital adequacy requirements will considerably increase the cost of bank loans to risky borrowers, as are most Mittelstand firms.

According to a survey by Kreditanstalt für Wiederaufbau, the German state-owned development bank, one third of all companies found access to bank credits restricted in 2002. In the 12 months to March 2002, German banks approved 7 percent fewer new credits. Listed banks reduced lending by a debilitating one sixth.

According to The Economist, lending to Handwerk (craft) companies declined by half between 1993-2003. Public sector savings banks, hitherto the main source of Mittelstand financing, are hobbled by an increasingly intrusive European Commission. The Neuer Markt, touted as Germany's answer to NASDAQ, slumped by staggering 96 percent and was merged out of existence.

The family is not what it used to be. Less than 40 percent of Mittelstand businesses are handed down the generations nowadays. Many are forced to introduce pesky outside investors and directors, or hired management. The banks are far more inquisitive than they used to be. A traditional long-term, epochal, business horizon gives ground to a quasi-American focus on the tyranny of the bottom line. Capital spending, product development and job security all suffer.

Founders are often to blame, unable as most are to calmly contemplate their own death, or retirement and prepare a plan for orderly succession. It is at these junctions of regime change that most business failures occur, according to Sir Adrian Cadbury, author of "Family Firms and their Governance".

According to Creditreform, quoted by The Economist, a record 37,700 companies went under in 2002. The Financial Times puts the figure at 45,000. And 2003 witness another bumper crop. The figures, according to the Institut für Mittelstandsforschung in Bonn, are even more harrowing. In 2001, 386,000 startups were liquidated and 455,000 formed to yield 69,000 new firms.

New startup formation is at a low ebb. In 1991, net creations amounted to 223,000, in 1995 - 121,000, in 1998 - 100,000. The picture is especially grim in the east. About 129,000 net new startups sprouted there in 1991. But the dilapidated east succeeded to spawn only 6000 a decade later with its bloated and venal construction sector all but wiped out. Again, 2002 was only marginally better.

Half-hearted measures declared by the fragile coalition government on January 6,

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2003 - grandiosely titled the "Mittelstand Offensive" - are unlikely to reverse the tide of red ink. Less red tape, more generous financial support, simplified accounting and a fusion of the country's cumbersome development banks will do little to help the flood ravaged east, for instance, where crumbling domestic demand cripples local entrepreneurship.

Eastern businessmen sorely lack management experience and skills. Their networks of customers and suppliers are thin on the ground. Most of them are single-product outfits. Successes are few and far between and usually involve foreign equity-holders. Luckily, the labor market in the east is more flexible than its ossified and bureaucracy-laden western counterpart. Hourly labor costs - wages plus inanely vertiginous and generous social benefits - are also substantially lower in the eastern Lander.

An arthritic and worker-friendly regulatory framework and a pro-big business tax regime have, indeed, burdened the Mittelstand. Still, if anything, Germany's labor market has been liberalized under Chancellor Schroeder's governments and tax rates went down across the board. One must look elsewhere for the causes of the inexorable deterioration of the country's SMEs.

It is remarkable that the decline of the Mittelstand coincides with an unprecedented surge in small to medium scale entrepreneurship in both developed and developing countries. It would seem that Germany simply spectacularly pioneered what has become, decades later, an economic fad.

Indeed, it is Germany's overwhelming success - its post-war industrial miracle - that harbored the seeds of its decline and fall. Sated, rich people make bad risk-taking entrepreneurs. Germany's unification was its last attempt at rejuvenation. It failed because the west chose to smother the east with an unrealistically priced Deutschmark, a tangle of rules and regulations, an artificial construction bubble and a forced liquidation of its industrial base.

If it ain't broke, don't fix it, goes German folk wisdom. On the surface, everything functions impeccably: German infrastructure is gleaming, its healthcare efficient, its environment pure, its welfare unsurpassed. Why tinker with success? - wonders the average citizen of this regional economic powerhouse. Only lately did a few brave souls admit that the miracle has been consumed and that Germany, unreformed, may be facing a Japanese decade.

Germany's second attempt at revitalization is unfolding outside its borders. The enlargement of the European Union to incorporate countries in central and east Europe is largely a German project. Cheap labor, abundant raw materials, hungry, growing consumer markets in the new members - promise to resuscitate the German industrial sector.

Big German firms have taken note of this repossessed hinterland and moved decisively - but not so the Mittelstand.

Preoccupied by their multidimensional crisis, they failed to colonize the east. Battered by cost pressures, better-informed customers, aggressive international competition, dizzying and costly technological changes, spiraling needs for investment in R&D, vocational training and marketing - the Mittelstand companies are punch-drunk and more xenophobic and self-destructively "independent" than ever.

One would be hard pressed to find a substantial Mittelstand representation in the German drive to diversify abroad either by establishing a presence in major export markets, or by sourcing from cheaper countries. As the Center for Advanced Studies at Cardiff University notes, Mittelstanders rarely out-source to key suppliers, maintain open-book accounting, engage in simultaneous engineering, sign long-term contracts, or reduce the number of direct suppliers as part of implementing a lean production strategy.

Many SMEs function as family employment agencies rather than as properly governed businesses. From hubs of innovation and early adoption of bleeding edge technologies - the Mittelstanders have lately become the bastion of paralytic conservatism. Most of them support self-interested liberalization and deregulation. But few would know what to do with these poisoned chalices, having become far less competitive than they used to be in the 1970s.

So, is the Mittelstand sector doomed?

Not according to a report published in 2001 by the Institute for Development and Peace at the Gerhard-Mercator University in Duisburg. The authors believe that, despite all the shortcomings of the Mittelstand business model, it could serve as a blueprint for the countries of Latin America and other developing regions.

The Mittelstand have survived largely intact wars and devastation, division and unification. There is no reason why they should not outlive this second round of globalization - they did marvelously in the first round, a century ago. But the government must recognize the Mittelstand's contribution to the economy and reward these struggling firms with a tax, financing and regulatory environment conducive to job creation, innovation, ownership continuity and exports.

The reason for hope is that Germany is finally waking up. Universities offer courses in family-orientated management. Offline and online exchanges - such as

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EuroLink - connect German SMEs to willing private equity investors, strategic partners and fund managers. Small business service centers and one stop shops proliferate.

An army of consulting and trading firms proffer everything from management skills to networks of contacts. Others peddler seminars, Web design and Internet literacy syllabi. Software companies like SAP, IBM and Sybase maintain special small business departments. Think tanks and scholarly institutes devote increasing resources to the SME phenomenon. There is even an Oscar award for Mittelstand excellence.

Initiatives spring in the most unlikely places. DG Bank teamed up with the German daily "Die Zeit" to "promote small businesses who have innovative ideas". Mittelstand trade fairs (for instance in Nuremberg last year) are well-attended. Venture capitalists, portfolio managers and headhunters monitor developments closely.

The Business Angels Network of Germany (BOUND) is a group of individual investors who also contribute time and management know-how to fledgling technology startups. Lobbying and advocacy groups, specialty publications, public relations firms - all cater to the needs of German SMEs.

It looks less like a funeral than a resurrection.