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The German Financial System

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Preface

This report on the German financial system is one of 15 studies of national financial systems undertaken as part of the research project Financialisation, Economy, Society and Sustainable Development (FESSUD) financed by the European Commission under the Seventh Framework Programme. The report attempts to present a summary of the existing research and the most recent available data on the German financial system within in a framework that is broadly compatible with the studies undertaken in the other participating countries. The results of the study were first presented at the annual conference of the FESSUD project held in Berlin in October 2012, and were revised in February 2013. The authors are greatly indebted to Tatjana Kulp, Gayane Oganesyan and Christian Raffer, who, as student assistants, provided invaluable research support for the study.
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List of abbreviations

AG  Aktiengesellschaft (Joint-stock corporation)
AnSVG Anlegerschutzverbesserungsgesetz (The Law on the Improvement of Investor Protection)
BaFin Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
BAWe Bundesaufsichtsamt für den Wertpapierhandel
BBankG Bundesbankgesetz (Bundesbank Act)
BCCI Bank of Credit and Commerce International
BdL Bank Deutscher Länder
BEA Bureau of Economic Analysis
BillKoG Bilanzkontrollgesetz (The Law on Control of Financial Statements)
BillReG Bilanzreformgesetz (The Law on the Introduction of International Accounting Standards and on the Protection of the Quality of Audits)
BIS Bank for International Settlements
CR Concentration ratio
DAI Deutsche Aktieninstitut (German Institute for Stocks)
DB Deutsche Bahn
DBP Deutsche Bundespost
DCGK Deutscher Corporate Governance Kodex (German Corporate Governance Code)
DEA Data envelope analysis
DFA Distribution free approach
DGB Deutscher Gewerkschaftsbund (Federation of German Trade Unions)
DM Deutsche Mark (German mark)
DSGV Deutscher Sparkassen- und Giroverband (German Savings Banks Association)
DTB Deutsche Terminbörse (German Derivatives Exchange)
EAA Erste Abwicklungsanstalt
EAEG Einlagensicherungs- und Anlegerentschädigungsgesetz (Directive on Depositor Guarantee and Investor Protection)
ECB European Central Bank
ECU European Currency Unit
EMS European Monetary System
EMU European Monetary Union
EU European Union
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>FBSO</td>
<td>Federal Banking Supervisory Office</td>
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<tr>
<td>FDI</td>
<td>Foreign direct investment</td>
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<td>FFEP</td>
<td>Financial Reporting Enforcement Panel</td>
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<tr>
<td>FI</td>
<td>Financial Index</td>
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<tr>
<td>FMSA</td>
<td>Bundesanstalt für Finanzmarktstabilisierung (Federal Agency for Financial Market Stabilization)</td>
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<tr>
<td>FMStErgG</td>
<td>Finanzmarktstabilisierungergänzungsgesetz (Supplementary Act to Stabilize the Financial Market)</td>
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<td>FMStG</td>
<td>Finanzmarktstabilisierungsgesetz (Financial Market Stabilisation Act)</td>
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<tr>
<td>FT</td>
<td>Financial Times</td>
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<tr>
<td>GDP</td>
<td>Gross domestic product</td>
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<tr>
<td>GDR</td>
<td>German Democratic Republic</td>
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<tr>
<td>Gov.</td>
<td>Government</td>
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<tr>
<td>G-REIT</td>
<td>German Real Estate Investment Trust</td>
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<tr>
<td>GSOEP</td>
<td>German Socio Economic Panel</td>
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<tr>
<td>HH</td>
<td>Households</td>
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<tr>
<td>HICP</td>
<td>Harmonised Index of Consumer Prices</td>
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<tr>
<td>HRE</td>
<td>Hypo Real Estate Holding AG</td>
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<tr>
<td>IG BCE</td>
<td>Industriegewerkschaft Bergbau, Chemie, Energie</td>
</tr>
<tr>
<td>IKB</td>
<td>Industriekreditbank (Deutsche Industriebank) (German Industrial Bank)</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>Ins.</td>
<td>Insurance company</td>
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<td>IPO</td>
<td>Initial Public Offerings</td>
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<td>KAGG</td>
<td>Gesetz über Kapitalanlagegesellschaften (Revision of the Investment Companies Act)</td>
</tr>
<tr>
<td>KapMuG</td>
<td>Kapitalanleger-Musterverfahrensgesetz</td>
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<tr>
<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau</td>
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<tr>
<td>KonTraG</td>
<td>Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Law on Control and Transparency in Enterprises)</td>
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<td>KWG</td>
<td>Kreditwesengesetz</td>
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<tr>
<td>LBB</td>
<td>Landesbank Berlin</td>
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<td>LBBW</td>
<td>Landesbank Baden-Württemberg</td>
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<tr>
<td>LTV</td>
<td>Loan to value ratio</td>
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<tr>
<td>M&amp;A</td>
<td>Mergers and acquisitions</td>
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<td>MaRisk</td>
<td>The Minimum Requirements for Risk Management</td>
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<td>MBCB</td>
<td>Mortgaged-backed covered bonds</td>
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<td>MFI</td>
<td>Monetary financial institution</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>MMMF</td>
<td>Money market mutual fund</td>
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<td>NFC</td>
<td>Non-financial corporation</td>
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<td>NIPA</td>
<td>National Income and Product Accounts</td>
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<td>NPISH</td>
<td>Non-profit institutions serving households</td>
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<tr>
<td>NUTS</td>
<td>Nomenclature of Units for Territorial Statistics</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OFI</td>
<td>Other financial institution</td>
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<tr>
<td>REIT</td>
<td>Real Estate Investment Trust</td>
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<tr>
<td>ROW</td>
<td>Rest of the world</td>
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<td>RRE</td>
<td>Risk-return efficiency</td>
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<tr>
<td>SFA</td>
<td>Stochastic frontier analysis</td>
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<td>SMEs</td>
<td>Small and medium enterprises</td>
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<td>SoFFin</td>
<td>Sonderfonds Finanzmarktstabilisierung (Financial Market Stabilisation Fund)</td>
</tr>
<tr>
<td>SPV</td>
<td>Special purpose vehicle</td>
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<tr>
<td>TFA</td>
<td>Thick frontier approach</td>
</tr>
<tr>
<td>THA</td>
<td>Treuhandanstalt</td>
</tr>
<tr>
<td>TUG</td>
<td>The Transparency Directive Implementation Law</td>
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<tr>
<td>UMAG</td>
<td>Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts</td>
</tr>
<tr>
<td>UMTS</td>
<td>Universal Mobile Telecommunications System</td>
</tr>
<tr>
<td>ver.di</td>
<td>Vereinigte Dienstleistungsgewerkschaft</td>
</tr>
<tr>
<td>VorstOG</td>
<td>Vorstandsvergütungs-Offenlegungsgesetz (Law on the Disclosure of Management Compensation)</td>
</tr>
<tr>
<td>WGCGB</td>
<td>West German Central Bank</td>
</tr>
<tr>
<td>WGZ</td>
<td>Westdeutsche Genossenschafts-Zentrale (Bank)</td>
</tr>
<tr>
<td>WoBauG</td>
<td>Wohnungsbaugebet (Law for the promotion of housing construction)</td>
</tr>
<tr>
<td>WpÜG</td>
<td>Wertpapiererwerbs- und Übernahmegesetz (Securities Acquisition and Takeover Act)</td>
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Summary

I. Development and structure of the German financial system

1. The historical development of the German financial system

The development of the German financial system has been characterised by two key features, both of which have their origin in the country’s pattern of industrialisation in the second half of the nineteenth century. The first is that Germany is a prime example of a bank based financial system. As a so-called ‘late developer’ (Gerschenkon), Germany required large amounts of capital in order to industrialise rapidly, and this was mobilised primarily by banks. A major role was played by large joint-stock banks which were established in the early 1850s and the early 1870s. The second key feature is that, in addition to profit-oriented commercial banks, the German financial system has also included two other sectors that are not primarily motivated by making a profit, namely the publicly-owned savings banks, and the cooperative banks. By 1913 the German banking system consisted of a private sector, dominated by eight big banks, a large public savings bank sector, and a somewhat smaller cooperative sector. In the 1920s, the big private banks faced major challenges from inflation and competition from foreign banks, and three big banks emerged as a result of mergers and failures. At the end of the Second World War, the three big private banks were broken up because of their complicity in German war crimes but, following successful lobbying, were allowed to re-establish themselves as unified institutions in the 1950s. The big banks played a major role in financing larger firms during Germany’s post-war reconstruction, while the savings banks and the cooperative banks contributed significantly to the growth of Germany’s very successful small and medium sized enterprises.

2. The growth in finance and its role in the decades of financialisation

The value of financial assets in the German economy grew rapidly in the 1990s, both in absolute terms as well as relative to GDP. While in the 1980s the ratio of financial assets to GDP grew on average by 1.6% a year, this increased in the period from 1991 – 2000 to 6% a year. The activity of banks, as measured by the ratio of deposits, bank loans and securities held by banks to GDP, also grew strongly in the later period. At the same time the size and activity of financial markets has grown, although to a lesser extent. Despite the growth of financial markets, however, they are still rather underdeveloped by international comparison. The financial sector’s shares in value added and employment registered modest increases from 1970 to 1980. From 1980 until 2012, however, the
share in value added remained relatively stable, but with quite large short-term fluctuations, while the share in employment declined slightly.

More significant changes can be observed in the non-financial corporate sector. Non-financial corporations have increased the share of their investments assigned to financial assets; a larger part of their profits has been generated from financial sources; and the share of their earnings distributed to financial investors has increased.

The household sector, unlike in many other developed countries, has not shown a tendency towards increasing indebtedness. Rather, private households have shown a tendency to hold a larger part of their savings in more risky, marketable assets, substituting investment fund shares, and direct holdings of shares and bonds for claims against banks and insurance companies.

Institutional investors grew rapidly in the decade from 1990 to 2000. However, their size is still small by international comparison. Over all, the data and comparisons suggest that the growth of finance is a quite recent and still relatively modest phenomenon in Germany.

3. The structure of the German financial system

The German financial system has historically been a prime example of a bank-based system although, in contrast to most other developed capitalist countries, a significant part of the banking system has consisted of publically-owned savings banks and cooperative banks that are not driven primarily by the search for profits. By 2012, private banks accounted for 38% of banking assets, the publically owned savings banks for 29.4% and the cooperative banks for 11.8%.

Big private banks had traditionally functioned as house banks to big industrial companies, but investment and borrowing by industry declined after the 1970s. In the mid-1980s, the big private banks responded by promoting the development of securities markets in Germany with the aim of increasing their earnings from investment banking activities. This has resulted in some strengthening of the role of securities markets since the 1990s, although banks continue to occupy a predominant position in the German financial system.

Amongst non-bank financial institutions, insurance companies have historically been the most significant, although investment funds expanded very rapidly in the 1990s, and are now almost as large. Pension funds have been much less significant. Highly leveraged financial institutions, such as hedge funds and private equity funds, have also had a relatively limited presence in Germany.
4. Germany’s integration into international financial markets

Germany abolished all controls on international capital flows in 1981 and, in the course of the 1980s, the country’s international financial integration increased steadily, but from a low base. Between the late 1990s and 2008, when Germany generated a large current account surplus, international financial integration increased strongly, with a marked growth of both portfolio investment and bank lending from Germany to other countries. The bank lending was predominantly to other European countries, with the largest part going to euro area countries. German banks also extended their lending in the US during this period and, in addition to funds from Germany, German banks drew extensively on funds raised in the US itself. As a result, German banks were strongly exposed to the financial crisis when it broke in the US in 2007. Following the dramatic deepening of the crisis in September 2008, German international financial integration was partly scaled back and German banks reduced their lending abroad at the same time that there was an outflow of foreign funds held in German banks. However, as a result of increased international financial uncertainty following the outbreak of the financial crisis, there was a large inflow of funds from other countries into German government bonds, which consequently registered unprecedentedly low interest rates.

5. European financial integration

In the 1980s, lending by banks in Germany to other countries increased but was rather limited, and less than half the lending was to countries in the EU. From the second half of the 1990s, however, lending by banks in Germany to other countries increased strongly, above all lending to EU countries, which rose from 12% of German GDP in 1990 to 78% in 2008. Some two thirds of lending to EU countries was to euro area countries, and much of the remaining third was to Britain, reflecting the role of London as an international financial centre, where German banks conduct much of their international business.

Lending by banks in Germany to other euro area core countries increased strongly from the mid-1990s to 2008 but, following the deepening of the financial crisis, it ceased to increase further and remained around the same level until 2012. By contrast, while lending to countries in the euro area periphery increased even more strongly up to 2008, this was followed by a marked process of disengagement from 2010, when the debt crisis first broke in the euro area, and by 2012 lending to the peripheral euro area countries had fallen by almost a half.

Since the onset of the financial crisis, Germany has accumulated large positive balances with the euro area’s Target 2 clearing system. While small net balances were also built up by Finland, the Netherlands and Luxemburg, the deficits were at first primarily due to Ireland, Greece and Portugal,
but since 2011 these have been eclipsed by the negative balances accumulated by Italy and especially Spain.

6. Regulatory framework: Financial market regulation in Germany

The regulatory regime in Germany from the 1930s, when a wide range of new measures were introduced, up to the 1990s could be characterised as a stakeholder-oriented and bank-based model. Regulations stabilised the widespread system of house-banks and the extensive cross-holdings of shares between big financial and industrial companies. Formally, a universal banking system existed, but investment banking was in practice unimportant. This started to change in the 1990s, gained speed following the election of the Schröder government in 1998, and triggered a transition to a regime where shareholders’ interests began to gain importance in regulations.

From 1995, Germany initiated changes that aimed to move the financial system in the direction of a more Anglo-Saxon type system. Regulatory changes aimed at strengthening the power of shareholders, and at limiting the influence of banks. This has led to a three fold decline in banks’ direct involvement in corporate governance: in the number of bank representatives on company supervisory boards; in banks’ majority ownership in large firms; and in banks’ role in proxy voting.

The regulatory changes were promoted by German governments in an attempt to strengthen the position of Germany as a host for international financial markets, and by the European Commission, which pushed for financial market harmonisation in Europe as part of a neoliberal agenda. However, the German financial system has not changed substantially. Although Germany has clearly been moving away from a purely bank-based model, it has not adopted a market-based one. Although the legal changes would have permitted the development of a much more capital-market based system, this has not happened.

II. Competition, profitability and efficiency

7. The nature and degree of competition

At a national level, concentration measures and the number of independent organisations indicate a very low level of concentration in the German banking sector. However, if the cooperative and the public sectors are each considered as large, single institutions, concentration ratios are much higher.

The interest margins of German banks are slightly higher than in some other developed capitalist countries, such as Japan and France, but since 1995 margins have shown a downward trend. This can
be related to increased competitive pressure in the deposit market due to the entrance of new financial institutions, in particular money market funds.

At a regional level, concentration is considerably higher. Focusing on big cities and measuring competition by the number of branches in a certain area, savings banks and cooperative banks are the main players in the retail markets, while the big German banks are fringe players.

Before 1995 the market for investment banking services was small, highly concentrated and dominated by German-owned banks. Since 1995, however, the market has grown, and foreign-owned banks have become much more important, securing between 45% and 65% of business during the period from 1995 to 2012. The entrance of these new competitors led to a decline in the concentration ratios. However, the market for large IPOs today is dominated by a relatively small number of international investment banks, and only two German banks, Deutsche Bank and Commerzbank, belong to the big players.

8. The profitability of the financial sector

The profitability of German banks, measured by the rate of return on equity or on assets, has been low by international comparison since the early 1980. Pre-tax profitability tended to fall from the early 1980s until the recent crisis, although after-tax profitability did not. The pre-tax profitability of the cooperative banking sector has been higher than that of the private banking sector, with the latter being far more volatile. It has also been higher than that of the public savings banks because of the particularly low profitability of the Landesbanken. After-tax profitability converges and private banks gain relatively most from government re-distribution.

The profit share of the financial corporate sector has shown no pronounced trend since the early 1980s, but has fluctuated quite widely, with major declines during the crisis in the early 2000s and the most recent financial and economic crisis. The profit share of the non-financial corporate sector started from a lower level in the early 1980s, but then showed a tendency to rise until the recent crisis with only minor fluctuations. Since the early 2000s, it has exceeded the profit share of the financial corporate sector.

The rate of return of the financial corporate sector has shown a falling trend, as with the case of the banking sector. Although the financial and the non-financial sectors had similar rates of return on equity in the early 1990s, in contrast to the financial sector, the rate of return tended to rise in the non-financial sector until the recent crisis.
9. The efficiency of the financial sector

The evidence regarding the efficiency of the German system is mixed. For international comparisons, it is important to note that a large part of the German system consists of savings and cooperative banks that do not aim at maximising profits. Hence, profit efficiency may be lower than for countries which have only profit-oriented banks. Savings banks use part of their surplus to promote community activities and are also obliged to provide financial services to all customers, regardless of the profitability of the business relationship. Additionally, it seems that savings banks lend at rates below those charged by the private and cooperative banks. The primary aim of cooperative banks, in turn, is to benefit their customers and members.

Studies that compare efficiency among different parts of the banking system at the national level find that local banks from all groups (private, cooperative and public) seem to be superior to the big nationally active banks in terms of efficiency. Among local banks, public and cooperative banks are found to be more efficient than private banks. There is therefore no evidence that opening up the public sector for private capital would improve the efficiency of the German banking system.

Studies which investigate the possible sources of inefficiency of banks find that the suboptimal size of German banks is not a significant factor. Furthermore, since the optimal size for banks is not known, and the threshold where risk-return decisions are found to deteriorate is rather low, there is little evidence that a consolidation strategy would improve efficiency. There is also no evidence for the existence of significant economies of scope. This indicates that a separation of investment and commercial banking would not have a negative effect on efficiency.

III. Finance and the non-financial sector

10. The changing roles of availability and uses of funds

In the 1990s, the main source of funds was derived from households’ financial surplus and these were used principally to finance the financial deficits of non-financial corporations and the government. From 2002 until 2008, however, in addition to households, non-financial corporations also generated financial surpluses, and the surpluses were employed to finance the government deficit and rising financial investment in the rest of the world. Since 2009, the scale of the financial flows has declined somewhat, but households and non-financial corporations have continued to supply funds, while the government and the foreign sector has continued to absorb them.

Households place a large part of their financial surplus with intermediaries, in particular banks and insurance companies, and to a lesser extent investment companies. It is therefore these intermediaries who have been primarily responsible for deciding how to allocate the funds between
different forms of financial investment, and who may therefore have been in a position to have exercised an influence over corporate governance.

In the early 1990s, the most important shareholders in companies were non-financial corporations, but such cross-holdings subsequently declined quite strongly. The second most important shareholders were households, although their holdings also declined subsequently, partly due to a shift towards indirect holdings through institutional investors. The most striking increase in shareholdings has been that by foreign investors, whose holdings increased substantially between 1995 and 2008.

11. Sources of funds for business investments: the non-financial corporate sector and small and medium-sized enterprises (SMEs)

The profitability of the non-financial business sector increased considerably from the early 1990s until the Great Recession, but investment in capital stock has been weak since the mid-1990s following the end of the German re-unification boom, and was particularly weak in the early 2000s. There seems to be some evidence that the ‘preference channel’ and the ‘internal means of finance channel’ constrained investment in capital stock under the conditions of financialisation and the increasing shareholder value orientation of management. An increasing share of received financial profits (interest and dividends) in the operating surplus indicates an increasing orientation of the management of non-financial corporate business towards investment in financial assets, as compared to investment in capital stock (‘preference channel’). An increasing share of dividends paid out to shareholders in operating surplus indicates a decrease in internal means of finance available for fixed investment purposes (‘internal means of finance channel’).

As in other countries, internal means of finance are the most important source of investment finance for German corporations; the contributions of equity issues have historically been negligible and they have been negative since the mid 1990s, indicating share buybacks in this period. Bank credit, which is the major external source of finance in Germany, as well as corporate bond issues, were not necessary for real investment finance but have been used for the acquisition of financial assets since the mid 1990s.

SMEs and non-corporate firms also finance investment predominantly from internal sources, albeit to a lower degree than non-financial corporations. Periods of high investment are associated with increasing credit and increasing debt-capital ratios and vice versa.
12. The involvement of the financial sector in the restructuring of the economy

After World War II the German company network was characterised by strong ties between management, capital, and labour and by a low level of M&A activity. M&A activity increased in Germany from the 1990s, mainly as a result of developments associated with German unification, and continued to rise in the 2000s. The increase was a little smaller than in Europe as a whole, and much smaller than in the USA or Britain. Although Germany did not adopt an Anglo-US-American type of M&A regime, changes in the strategy of bigger German banks and enterprises encouraged M&A from the early 1990s on. This was supported by the policies of the German government and the European Commission. These developments involved moderate changes rather than a decisive leap towards a liberal market economic model with easy and frequent takeovers. Hostile takeovers have not been very common in Germany and, if they take place, they are generally of a more of a managed type, involving a compromise between all the stakeholders. The German M&A regime can be judged as a hybrid, combining elements of a market radical approach with a strong non-market stakeholder orientation. Vodafone’s hostile takeover of Mannesmann in 2000 was a shock for the traditional German corporate governance model and led to a form of consensus that takeovers should be possible, but not in a market radical way.

13. Privatisation and the financial sector

The structure of the German banking system, involving private, public and cooperative banks, has not changed significantly in recent years, despite some pressure for liberalisation and privatisation. In other sectors of the economy, however, privatisation has had an impact. In quantitative terms, the post-unification wave of privatisations in East Germany was the most important. It was organised by the federal agency Treuhandanstalt, whose aims were to save as much as possible of East German industry. The Treuhandanstalt created supervisory boards for companies, searched for prospective buyers interested in long-term company growth, and also guaranteed post-privatisation participation in both funding and restructuring. Whether planned or not, in practice, the Treuhandanstalt’s activity resulted largely in the takeover of East German enterprises by West German companies. Because of the Treuhandanstalt’s extensive role, that of financial institutions was quite limited.

Another important field for privatisation concerned public utilities. This was in part motivated by a desire to either raise revenue or to sell off loss-making units, and in part a response to European Commission directives. Privatisation has affected former state monopolies such as the postal, telecommunications and, to some extent, transport sectors. The health-care sector was never a state monopoly, but public hospitals have been increasingly privatised since the early 1990s. The process
of privatisation has created new markets where financial institutions have been able to expand their activities.

The process of privatisation has been partially reversed since the onset of the most recent crisis, as several privately-owned financial institutions were either partly or completely nationalised. The Hypo Real Estate Holding AG was completely nationalised, while Commerzbank was partially nationalised. Several Landesbanken also required considerable government support.

14. The financial sector and private households – culture and norms of the financial system

After a decline in the private saving rate during the 1990s, the average propensity to save out of disposable income has increased since the new economy crisis. The main reasons for this increase were as follows: first, the redistribution of income at the expense of the labour share of income and of low-income households; second, an increase in precautionary saving since the early 2000s in the face of weak growth, high unemployment and ‘reform policies’ aimed at the deregulation of the labour market and reduced social benefits; and third the absence of wealth effects on consumption.

The savings of private households are directed mainly to deposit and saving accounts with banks, and to policies with private insurance and pension funds. The significance of shares and investment funds increased during the new economy boom in the second half of the 1990s, but has since returned to the level of the early 1990s. The attractiveness of stock markets and the rise of a ‘stock market culture’ in Germany were, therefore, very short-lived. The relationship of the total financial assets held by private households to nominal GDP has seen a tendency to increase since the early 1990, as has the relationship of real estate wealth to GDP. However, financial and real estate wealth are extremely unequally distributed and inequality increased in the early 2000s.

Financial liabilities tended to increase slightly in relation to disposable income in the course of the 1990s, but then declined somewhat between the new economy crisis and the Great Recession, and are still low by international comparison. However, low income households are increasingly facing serious problems of over-indebtedness. While the main component of household debt is housing loans, loans for consumption are of minor importance in the aggregate.

15. The real estate sector and its relation to the financial sector

In Germany, unlike many other countries, a real estate bubble did not develop in the 2000s. The stability of the German real estate market is the result of a combination of specific institutional features. Firstly, government intervention in the real estate sector led to a diversified supply of
housing in all housing segments. Although the government has reduced its active role in the sector in recent decades, the established structures continue to prevail. There was a sufficient supply of rental dwellings, so that households only decided to purchase their own homes when it appeared beneficial. Secondly, a relatively conservative system of real estate financing has contributed to the stable development of the real estate market. Those factors appear to have reinforced each other and to be beneficial for the system as a whole. The most important financial investors in the real estate market are open or closed real state funds. These have, until now, been relatively unattractive for international investors due to a lack of transparency and the way they are taxed. While this has meant that less capital has been available, it may have sheltered the German market from foreign capital inflows that could have led to Germany also developing a real estate bubble. Since the Great Recession there have been signs that a real estate bubble could develop in Germany in the future due to very low interest rates, a distrust of monetary forms of wealth and the limited supply of appropriate property in bigger cities.

IV. Finance, distribution and crisis

16. Inequality and the financial system in Germany

Inequality of market incomes as measured by the Gini coefficient started rising following German unification in 1990. Since the early 2000s there has also been an increase in inequality in disposable income due to a decline in the real disposable income of the bottom half of the distribution. Top income shares increased substantially during the 1990s, with a significant contribution of salaried income. High unemployment and low economic growth in Germany during the first half of the 2000s were accompanied by excessive wage moderation, which had major consequences for the low-skilled workforce in particular. This was accentuated by the introduction of measures to deregulate the labour market and the absence of a legal minimum wage. As a result, since the early 2000s, income dispersion has become very pronounced in Germany.

With regard to the functional income distribution, the wage share began to decrease in the mid-1990s and the decline was especially marked in the early 2000s. This was due, on the one hand, to the shrinking of the government sector where the profit share is, by definition, zero, and, on the other hand, to the falling wage share in the non-financial corporate sector, while retained earnings and the rentier share increased. The non-financial sector employs the bulk of the low-skilled workforce, and has been able to increase the share of profits at the expense of wages due to the diminishing power of trade unions following the deregulation of labour markets, and to the threat of outsourcing. The wage share has been relatively stable in the financial sector which normally employs high-skilled staff and where the concentration of the so-called ‘working rich’ is higher,
something that is consistent with the observation that the rise in top incomes was driven largely by salaried income.

17. Crisis and macroeconomic policies

German macroeconomic development prior to the crisis can be characterised as export-led mercantilist, as compared to the debt-led consumption boom or domestic demand-led types of developments in other major countries. Against this background the foreign trade and the financial market channel of transmission of the crisis to Germany were most important. The foreign trade channel became effective, because the openness of the German economy had rapidly increased since the mid-1990s, and the growth of aggregate demand had been driven largely by net exports. Rising current account surpluses meant an increase in net foreign assets which were mainly held by commercial banks. This made the sector particularly vulnerable to the financial market channel of transmission of the crisis.

Regarding policy reactions towards the crisis, the immediate bailout of the financial sector detained the financial crisis in Germany and prevented a financial meltdown. Economic recovery was mainly driven by German exports in the course of the recovery of the world economy, and it was strongly supported by expansionary fiscal policies in 2009 and 2010. However, this German type of recovery suffers from two major drawbacks. First, to the extent that it was driven by net exports, it had to rely on the neo-mercantilist type of development that had contributed considerably to world and regional imbalances and to the severity of the impact of the crisis on Germany itself. It therefore laid the seeds for further imbalances, fragilities and vulnerabilities of the German economy, and it has contributed significantly to the persistent crisis in the Euro area. Second, as a political precondition for the German stimulus packages, the so-called ‘debt brake’ was introduced into the German constitution, which will limit the room for manoeuvre for German fiscal policy in the future. And since this type of fiscal austerity has also been imposed on the Euro area via a tightened Stability and Growth Pact and a new Fiscal Compact, it will mean restrictive fiscal policies for the Euro area too, thereby driving major parts into deflationary stagnation, which will in turn feed back negatively on German exports and growth.
I. Development and structure of the German financial system
1. The historical development of the German financial system

1.1. Introduction

The development of the German financial system has been characterised by two key features, both of which have their origin in the country’s pattern of industrialisation in the nineteenth century. The first is that external finance for non-financial firms in Germany has been supplied predominantly by banks – indeed, Germany provides one of the archetypal examples of a bank-based financial system. The second key feature is that, while a small number of big banks played a dominant role amongst the privately-owned commercial banks, the German financial system has also included two other sectors that are not primarily motivated by making a profit, namely the publicly-owned savings banks and the cooperative banks. The aim of this chapter is to briefly outline the development of the German financial system prior to the significant transformation which began in the 1980s. To this end, it is possible to identify three main periods: from the time of industrialisation up to 1914; the troubled inter-war years; and the post-war period of reconstruction and rapidly rising prosperity.

1.2. German industrialisation

Private banks played a leading role in organising and financing the construction of the German railways in the 1830s and 1840s (Tilly, 1994, p. 230). Although there was some industrial development in the 1840s, notably the growth of the textile industry in Saxony, industrialisation was still quite limited and the decisive shift to industrial capitalism occurred between 1850 and 1870 – that is, before the establishment of a unified German state (Blackburn, 2003, p. 135). Private banks based in Cologne played an important role in financing investment in the Ruhr area, but mainly to entrepreneurs who they knew personally. The most important financial development in the 1850s was the formation of joint stock banks.

The key role of the joint stock banks in financing industrialisation in Germany was highlighted in the influential comparative study by Alexander Gerschenkron (1962). In Britain, according to Gerschenkron, industrialisation had been a gradual process and the accumulation of capital in the industrial sector was able to draw on the earnings from trade and from capitalist agriculture, and later from industry itself. While banks also made a contribution in Britain, it was primarily through providing short-term credits to finance trade. Germany, by contrast, was what Gerschenkron
describes as ‘a late developer’. Given Britain’s established industrial dominance, there was a need to quickly establish large units of production which could benefit from economies of scale. An important precedent for developments in Germany was the establishment of the Crédit Mobilier in France in 1852. Although the French initiative soon foundered, it pioneered the notion of providing long-term bank loans to finance industrial development. This idea was taken up and adapted in Germany and led to the creation of universal banks which provided long-term finance for investment.

The first wave of joint stock banks was created in the 1850s and included the Disconto Gesellschaft (1851), the Darmstädter Bank (1853), and the Berliner Handelsgesellschaft (1853); a second wave followed in the early 1870s, and included the Deutsche Bank (1870), the Commerz- und Disconto-Bank (1870), the Deutsche Nationalbank (1871) and the Dresdner Bank (1872). These banks played an important role in the setting up of joint-stock companies in the industrial sector, often investing a part of their own capital in the enterprises (Feldenkirchen, 1991, p. 123). By the 1870s, Germany had established a capitalist economy with a major industrial sector.

Following the creation of a unified German state in 1871, seven existing currencies were consolidated into a single currency in 1873, and a single central bank, the Reichsbank, was established in 1876. The Bank Act of 1875 authorised certain banks to issue currency, but by 1905 note issue was restricted to only four regional Notenbanken apart from the Reichsbank. Banks were generally not subject to regulation other than the general laws applying to all German companies (Frohlin, 2007, pp. 21-23).

The initial phase of industrialisation was characterised by considerable financial instability and crises in 1847-48, 1857-58 and 1873-76 brought down many firms and especially banks (Tilly, 1988, p. 283). The crisis which broke in 1873 was especially severe and marked the end of an investment boom which had begun in 1869, and which was fuelled by the influx of five billion francs (equal to a quarter of German GDP) which France was required to pay as an indemnity following its military defeat by Germany in 1871. When the bubble burst in May 1873 it had an impact throughout western Europe and the US. In Germany it led to the widespread failure of firms, a fall in wages, in profits and in prices, and inaugurated a period of slower growth which continued, with some cyclical variation, until 1896 (Blackburn, 2003, pp. 144-45).

The second phase of industrial expansion in Germany took place between the 1880s and 1914. During this time Germany developed, in the words of Blackburn, from ‘a respectable European industrial nation to a major world power’ (Blackburn, 2003, p. 237). In 1880 Britain produced twice as much steel as Germany; by 1913 the position was reversed. It was in this period that the banks really came into their own: ‘in general reinvested profits, reserves and share issues hardly covered the high
investment requirements of German industry. The role of banks was therefore decisive, much more so than it had been in the first phase of industrialisation up to the 1870s.’ (Blackburn, 2003, p. 244) By 1913, eight German banks had grown into big banks; the three largest enterprises by balance sheet were banks; and of the 25 largest enterprises 17 were banks (Feldenkirchen, 1991, p. 116).

The big banks’ business was concentrated primarily on large firms in specific branches of the economy: mining and metal production, mechanical engineering, and the chemical and electrical industries. Banks provided firms in these sectors with long-term loans, but they did so through short-term loans which could be rolled over. The banks, in turn, could if necessary refinance loans by issuing securities on the capital market. The big banks also played an important role in underwriting shares issued by industrial concerns. In all this they benefited from a close relation with the state. The Reichsbank provided a very reliable source of liquidity, with virtually unlimited discounting facilities. As a result, German banks could get by with much less liquidity than British banks, as bills of exchange could be seen as close substitutes for central bank notes (Tilly, 1988, p. 284).

The banks consciously took advantage of their position as creditors to increase their influence over companies that were faced with financial difficulties. Feldenkirchen (1991, p. 126) cites the example of Krupp where, following payment difficulties, a short-term loan to finance a new plant was replaced by a nine-year loan at a higher interest rate, and the company was obliged to allow a representative of the bank to join the company board to monitor future developments. In an attempt to prevent the banks from gaining influence, companies such as Siemens consciously restricted their growth so as to avoid requiring external finance.

In contrast to the first phase of industrialisation, by the 1880s banks tried to avoid direct shareholdings in companies so that they would not suffer losses when the value of shares fell in the event of a company facing difficulties (Feldenkirchen, 1991, p. 129). However, when companies were faced with financial difficulties, banks would convert loans into share holdings and, in this way, the banks obtained seats on company supervisory boards. A further important development was that, in response to the intensified competition and declining profitability which set in following the onset of the 1873 financial crisis, the big banks promoted the formation of cartels to prevent competition between firms in which they had an interest. By insulating large firms from competition, they provided them with planning security and in this way bolstered their profitability.

The powerful position which the German big banks built up has been highlighted by a number of writers who have pointed to the big banks’ takeover of smaller banks, their rising shareholdings in big industrial companies, and their increasingly important position on company supervisory boards. Perhaps most famously, on the basis of the German experience, Hilferding (1910) argued that financial capital and industrial capital had come to merge under the dominance of financial capital to
create what he termed ‘finance capital’. Subsequent writers have criticised Hilferding, arguing that – while his analysis might have been valid for the later 19th century – by the early 20th century industrial companies had gained greater independence and increased their bargaining power in relation to the banks: as firms merged, more than one big bank was represented on the supervisory board; furthermore, the financial needs of giant industrial firms had become so large that share issues were usually handled by a consortium of banks. But even Hilferding’s critics agree that the relation between the big banks and big industrial concerns was very close (Tilly, 1988, p. 280; Deeg, 1999, pp. 77-79).

The focus of the big banks on large industrial projects meant that they neglected lending to other sectors, including agriculture, housing and small businesses. As a result, lending to small businesses was left to the savings banks, the cooperative banks and to small private banks. The savings banks (‘Sparkassen’) were set up by city and county governments, and became a significant source of finance during the period of industrialisation. The first savings bank was founded in Göttingen in 1801 and the number then increased rapidly, especially after 1815 when local authorities were granted greater autonomy in determining their economic and social policies. The savings banks provided artisans and, as wages rose in the course of the nineteenth century, industrial workers, as well as parts of the urban and rural middle class with savings accounts. By 1900 there were 2,700 savings banks in Germany, and one third of the population had an account with them. The money that was saved in this way was used primarily to finance housing and public investment in utilities and infrastructure. Because each bank was required to limit its activities to its own local area, the savings banks ensured that the provision of credit was distributed throughout the country. In addition to the local savings banks, regional associations or Landesbanken were established to promote regional economic development and to provide the local savings banks with investment facilities. The first of these was the Westfälische Provinzialhilfskasse, set up in Münster in 1832. Between 1851 and 1910, the savings banks are estimated to have supplied some 26 per cent of the total credit in Germany – exactly the same figure as the profit-oriented commercial banks (DSGV, 2010, p. 7).

The cooperative banking sector originated in the mid-19th century with credit cooperatives formed by self-employed craftsmen and small farmers, many of whom faced great financial difficulties as industrialisation got underway. The first urban cooperative bank (Volksbank or people’s bank) was established in 1862 in Darmstadt on the basis of a credit cooperative that had been founded in 1852. The first rural cooperative bank (Raiffeisenbank, after the movement’s founder, Friederich Wilhem Raiffeisen) was set up in 1864 (DGRV, p. 1). The cooperative banking sector then grew rapidly and by 1859 there were 80 credit cooperatives with 18,000 members and they created regional associations
in order to refinance loans and circulate funds amongst themselves. The 1889 Cooperative Law allowed credit cooperative to offer current account credits to their members, transforming the cooperatives from loans associations to more formally organised banks (Deeg, 1999, p. 34-6). Between 1851 and 1910 cooperative banks are estimated to have accounted for 8 per cent of the total credit extended in Germany (DSGV, 2010, p. 7).

The rapid growth of the savings banks and the cooperative banks, both of which had established an extensive network of branches, prompted the big private banks to also set about building up a network of branches in the 1890s in an attempt to capture a larger part of the country’s savings. However, according to figures cited by Frohlin (2007, p. 41) this was only partly successful: by 1913, while the joint stock banks accounted for 27 per cent of the financial system’s assets, the savings banks accounted for 32.7 per cent.

1.3. The inter-war period

During the interwar period, German big banks were faced with two major challenges: firstly, to rebuild their balance sheets in the aftermath of the First World War and the onset of inflation; and secondly, to combat competition from foreign banks in the 1920s and from the savings banks in the 1930s.¹

The big banks’ capital had been eroded by inflation, especially in 1919, and by 1924 the real value of their capital and reserves had been reduced to just one third of that in 1913. Furthermore, large depositors had shifted their deposits abroad resulting in extensive capital flight. The big banks responded by taking over a large number of private banks and smaller joint-stock banks. This process had actually begun in 1913, prior to the war, but it intensified in the period 1919-23, and continued more moderately between 1924 and 1929. There were also a number of significant mergers between big banks. In 1922 the Bank für Handel und Industrie, Darmstadt, merged with the Nationalbank, to form the Damstädter- und Nationalbank (‘Danat Bank’), which was centrally involved in promoting industrial restructuring and which was seen as introducing far greater competition between the big banks. Then in 1929 the Mitteldeutsche Bank merged with the Commerzbank, and the Deutsche Bank merged with the Disconto Gesellschaft to form a much larger institution than any of the other German big banks (Balderston, 1991, pp. 562-3).

Monetary stabilisation in 1923-24 was based on establishing the goldmark as a unit of account, and in the following period the big banks began to expand, but with a smaller capital base than before.

¹ This section draws largely on Balderston (1991).
1914. In contrast to the pre-war period, the ability of the Reichsbank to provide a liquidity guarantee was limited by international conditions and the requirement that Germany adhere to the gold standard. Furthermore, between 1924 and 1929, there was a major influx of foreign capital into Germany. Some of this was mediated by the big German banks, but there was also a significant expansion of lending by foreign banks directly to German firms (Balderston, 1991, pp. 565-9). In the face of intense competition and low profitability, the German big banks engaged in riskier lending (Tilly, 1996, p. 414). Then in 1927, the collapse of the stock market meant that the big banks could no longer raise additional capital by issuing shares. Although the big banks continued to have the same number of seats on company boards as before the war, the influence of the banks was reduced as many bigger firms bypassed local banks and borrowed directly from abroad (Balderston, 1991, p. 592).

The economic expansion which began in 1924 came to an end with a wave of deposit withdrawals that began in 1929 and culminated in the banking crisis which broke in 1931. The loss of deposits began after German intransigence led to a breakdown of reparations negotiations in Paris and intensified after the Reichstag rejected proposals for fiscal cuts in 1930. At first the withdrawals affected primarily reichsmark deposits, suggesting that the initial concern involved convertibility, but by 1931 the withdrawals affected both reichsmark and foreign currency deposits (Balderston, 1991, pp. 582-4). The crisis was detonated by the failure on 13 July 1931 of the Danat Bank, which following rapid expansion had become the second largest bank after the Deutsche Bank. To prevent a collapse of the banking system, the government closed all the banks from 14 July to 5 August 1931 and intervened either directly or through a subsidiary of the Reichsbank to recapitalise the big banks. The Danat and the Dresdner Bank were merged under the name of the Dresdner, with 91 per cent of the share capital owned by the state; 69 per cent of the Commerz- and Privatbank and 35 per cent of the Deutsche Bank-Disconto Gesellschaft were also owned by the state (Balderston, 1991, p. 597).

In the 1930s, the big banks’ business stagnated. There was little industrial investment until 1936, and bank business was constrained by currency controls introduced at the time of the banking crisis, and subsequent controls on the capital market introduced by the Nazis. Although elements within the Nazi party had advocated breaking the power of the banks, the state holdings in the big three banks that emerged from the banking crisis were privatised in 1937 (Balderston, 1991, pp. 600-02).

During the inter-war period the savings and cooperative banks strengthened their position. Savings banks had been granted the right to open checking accounts in 1908, and the first clearing system was established by savings banks in Saxony in 1909, with other regions subsequently following suit. The decisive development for the savings bank sector occurred in 1918 with the creation of the Deutsche Girozentrale in Berlin, which created a clearing system which linked the savings banks in all
the regions. In some regions, the clearing function was exercised by the regional Landesbanken, which acted as central banks to the savings banks in their regional state, and, even where separate clearing houses had been set up, by the end of the 1930s, these had merged with the regional Landesbanken (DSGV, 2010, p. 8). In this way, an effective national system of public banks was created. The savings banks were also affected by the banking crisis in 1931, in particular as a result of illiquid loans to local authorities, and they had to turn to the Reichsbank for support. In response to the crisis, in 1931 the savings banks – which until then had been part of local government administrations – were granted legal autonomy, a move designed to ensure that bankrupt local authorities would not be able to draw on the savings banks’ reserves. The new law also determined that, with the exception of a few existing independent institutions, in future only publicly-owned savings banks could call themselves ‘Sparkassen’. In the aftermath of the crisis, the savings banks grew strongly. Between 1933 and 1938, while deposits at the big private banks increased by 39 per cent, those at the savings banks increased by 68 per cent and those at the cooperative banks also rose by 62 per cent. Some two-fifths of the increase in the deposits at the savings banks was used to fund loans to the government (Balderston, 1991, pp. 600 & 603).

1.4. The post-war period in West Germany

At the end of the Second World War, the three big private banks that had emerged from the crisis in the early 1930s were each broken up into 10 regional institutions and senior bank executives were imprisoned for their complicity in German war crimes. Nevertheless, as a result of a successful political campaign by the banks, the ‘Big Bank Act’ of March 1953 allowed a partial amalgamation of the regional institutions, and from 1956 the complete reestablishment of the big banks was allowed. The Deutsche Bank and the Dresdner Bank were re-established as unified institutions in 1957 and the Commerz Bank followed in 1958 (Tilly, 1996, p. 417).

The big banks continued to have a strong relation with industrial firms and between 1950 and the early 1970s some 60 per cent of each banks’ lending was directed at manufacturing industry (Tilly, 1996, Figure J2). However, the relative importance of the big banks in the German banking system declined in the post-war years. In 1950 the big banks accounted for 19 per cent of banks’ assets, but this fell in the course of the decade, and by the 1960s and 1970s their share had fallen to around 10 per cent, as shown in Table 1.1.
Table 1.1: Share of bank business, Germany, 1950 – 1988 (%)

<table>
<thead>
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<tr>
<td>Universal banks</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Private banks</td>
<td>36.4</td>
<td>24.4</td>
<td>24.9</td>
<td>24.9</td>
<td>23.6</td>
</tr>
<tr>
<td>Big banks</td>
<td>19.1</td>
<td>11.3</td>
<td>10.2</td>
<td>10.4</td>
<td>8.9</td>
</tr>
<tr>
<td>Regional banks</td>
<td>12.8</td>
<td>10.4</td>
<td>10.7</td>
<td>10.9</td>
<td>11.4</td>
</tr>
<tr>
<td>Foreign banks</td>
<td>1.5</td>
<td>1.9</td>
<td>1.7</td>
<td>1.5</td>
<td></td>
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<tr>
<td>Other private banks</td>
<td>4.5</td>
<td>2.7</td>
<td>2.5</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Savings bank sector</td>
<td>30.8</td>
<td>35.7</td>
<td>38.4</td>
<td>38.5</td>
<td>37.3</td>
</tr>
<tr>
<td>Regional associations</td>
<td>10.8</td>
<td>13.5</td>
<td>15.6</td>
<td>16.5</td>
<td>15.6</td>
</tr>
<tr>
<td>Savings banks</td>
<td>20.0</td>
<td>22.2</td>
<td>22.9</td>
<td>22.0</td>
<td>21.7</td>
</tr>
<tr>
<td>Credit cooperative sector</td>
<td>12.4</td>
<td>8.6</td>
<td>11.5</td>
<td>14.0</td>
<td>16.9</td>
</tr>
<tr>
<td>Regional institutions</td>
<td>3.7</td>
<td>2.8</td>
<td>3.8</td>
<td>4.2</td>
<td>4.6</td>
</tr>
<tr>
<td>Credit cooperatives</td>
<td>8.7</td>
<td>5.8</td>
<td>7.7</td>
<td>9.8</td>
<td>12.3</td>
</tr>
<tr>
<td>Specialised banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage banks</td>
<td>5.9</td>
<td>17.2</td>
<td>13.6</td>
<td>13.0</td>
<td>13.9</td>
</tr>
<tr>
<td>Banks with special functions</td>
<td>10.2</td>
<td>8.4</td>
<td>6.5</td>
<td>6.7</td>
<td></td>
</tr>
<tr>
<td>Postal banks</td>
<td>2.4</td>
<td>1.9</td>
<td>2.0</td>
<td>1.5</td>
<td></td>
</tr>
</tbody>
</table>

Source: Edwards and Fischer (1993, p. 100)

The small private banks, whose assets were in any case much smaller, also registered a marked decline in their share of assets in the same period. Together, the share of the big banks, the regional private banks and the small private banks fell from 36 per cent of total assets in 1950 to around 25 per cent in the 1960s and 70s.

The big banks continued to play an important role in the corporate governance of non-financial companies, both through owning shares and through smaller investors delegating their voting rights. According to Bundesbank data for 1964, banks owned 5 per cent of shares and held the proxy votes for 50.5 per cent of shares, giving them control over 55.5 per cent of shareowners’ votes (Edwards and Fischer, 1993, p. 112). The ownership of shares by banks was concentrated in the large banks, and this was reflected in the membership of the supervisory boards of non-financial companies. A government survey of 425 joint-stock companies in 1960 found that the banks had a total of 795 representatives on company boards, and of these 211 were the chair of the board. According to the survey, the big private banks accounted for 423 of the representatives (53.2 per cent) and 119 of the positions as chair of the board (56.4 per cent) (Edwards and Fischer, 1993, p. 115).

The big banks also had a dominant position in underwriting new share issues. By law, only banks could apply to issue new shares. A syndicate of banks would negotiate a price with the company that wished to issue shares, and then the banks would offer the shares for sale to the market. A survey of 76 banks in 1976-77 showed that the big banks acted as leader of the syndicates in 60 per cent of the cases (Edwards and Fischer, 1993, p. 117). Of the big banks, the Deutsche Bank played the most...
important role, although it should be noted that the new issue market has been rather small in Germany.

The relative decline in the share of the big banks in bank business is explained by the growing share of the savings banks and the cooperative banks, as can be seen in Table 1.1. In the case of the savings banks, the primary savings banks maintained their share of bank assets at around 20 per cent. By providing finance for local business they contributed significantly to the success of West Germany’s small and medium enterprises in the post-war period. At the same time, the regional Landesbanken succeeded in expanding their share of lending, and they began to compete with the big private banks for business with larger firms. Between 1950 and the 1970s, they increased their share of business from 10 to over 15 per cent, and by 1975, they accounted for four of the biggest 10 banks in West Germany. Together, the local and regional savings banks increased their share of business from 30 per cent in 1950 to 38 per cent in the 1970s. There was also an increase in the share of the cooperative bank sector, notably in the 1970s. In 1974, cooperative banks were allowed to conduct business with non-members and, in 1976, the cooperatives central organisation was renamed the Deutsche Genossenschaftsbank, or DG Bank, and most legal limits on its activities were lifted, so that it was able to conduct large-scale credit operations, providing additional competition for the big private banks (Deeg, 1999, pp. 54-55).

The position of the big banks faced a further major challenge in the 1970s. The onset of the 1973-75 international recession marked the end of the post-war boom and in West Germany, as in the other advanced capitalist countries, it led to a marked decline in fixed investment. As a result, the big banks were hit by a sharp fall in the demand for loans from big manufacturing firms, which now no longer required significant external financing. One of the reactions of the big banks was to try and compete with the local savings banks and the cooperative banks by developing their business with small and medium enterprises, but they had less experience in working with this sector, and it was not a success (Deeg, 1999, pp. 80-87 and 116-121).

Faced with a decline in their traditional business with big industrial firms, the big banks responded in the mid-1980s by setting up a consortium to promote the development of what they called Finanzplatz Deutschland – Germany as a financial centre (Deeg, 1999, p. 87 et seq.). A key feature of this proposal was to encourage the expansion of securities’ markets, something which, until then, had played a subordinate role in Germany’s predominantly bank-based financial system. For the big banks, this offered the prospect of generating income from fees through investment banking activity, rather than relying on their traditional income from lending.
References


2. The growth in finance and its role in the decades of financialisation

2.1. Introduction

To date, there is no generally accepted definition for financialisation. A relatively broad characterisation of the term is given by Epstein (2005, p. 3) for whom ‘financialisation means the increasing role of financial motives, financial markets, financial actors, and financial institutions in the operation of the domestic and international economies.’

More concretely, Stockhammer (2007, p. 2) identifies the following phenomena characterising financialisation: the deregulation of the financial sector and the proliferation of new financial instruments, the liberalisation of capital flows and instability in exchange rate markets, a shift toward market-based financial systems, the emergence of institutional investors as major players on financial markets, the booms and busts in asset markets, shareholder-value orientation and changes in corporate governance of non-financial business, increased access to credit by previously underbanked groups, changes in the level of (real) interest rates.

For Krippner (2005, p. 174) financialisation is a ‘pattern of accumulation, in which profits accrue primarily through financial channels, rather than through trade and commodity production. ‘Financial’ here refers to activities relating to the provisions (or transfer) of liquid capital in expectation of future interest, dividends or capital gains.’

One can see that financialisation covers a range of phenomena; some are of a quantitative nature, while others of a more qualitative nature.

This chapter will employ empirical data to assess how, and in which areas the growth of finance has manifested itself in Germany. Based on the short theoretical review given, there are different dimensions one can look at. First a general overview on the growth of financial assets held by the German domestic sectors will be presented. Subsequently, in an international comparison, the size and activity of banks and financial markets is assessed. To find out whether a structural shift of the production pattern towards the financial industry has taken place, the value added and employment of the financial industry is reviewed. Thereafter, a closer look at the non-financial corporate, as well as at the household sector, is taken, since for the US, it was found that financialisation led to different changes in those sectors. Finally, a look at the importance of institutional investors in
Germany is taken. A more detailed treatment of the interaction of the financial sector with the non-financial sectors of the economy will be provided in part III of this study.

2.2. Financial assets in the German economy

From 1960 until 1980, financial assets in per cent of disposable income grew on average by 2.9 per cent per year (Deutsche Bundesbank, 1994). Figure 2.1 presents outstanding financial assets owned by domestic sectors as a percentage of GDP since 1983. In the 1980s, growth fell below the average of the previous decades and the ratio of financial assets to GDP grew at 1.6 per cent per year relatively slow. Starting from 1991 the relatively stable pattern changes. We observed very high growth from 1991 to 2000; financial assets in per cent of GDP grew with an average rate of 6 per cent per year in this period. This seems in particular caused by a strong growth in outstanding bank loans (see figure 2.7) and from 1995 onwards additionally by a strong increase in share prices (see figure A14.1) Thereafter, average growth of the financial assets to GDP ratio is almost negligible and very unstable with high positive growth in some years and negative growth in others.

Figure 2.1: Financial assets held by domestic sectors, Germany, 1983 – 2011 (% of GDP)

A more detailed picture of those developments is given by Figures 2.2 – 2.4. Banks (referred to as Monetary Financial Institutions (MFIs) in the official European statistics) obviously increased their activity, growing strongly in assets from 1991 – 2000. Also remarkable are the increased financial activities of the non-financial corporations. Their liabilities, as well as assets shifted upwards by about 50 percentage points. On the other hand, households increased their financial assets, while their liabilities remained nearly constant, so that we see an increase in their net position. The
counterpart to this is the government sector. The percentage of financial assets held by the government sector is relatively stable, but we can see an increase in financial liabilities from 37 per cent in 1991 to 87 per cent of GDP in 2011. Therefore, we see a strong decline in the net-position of the government sector over the period.

Starting in 1991 the sector of other financial institutions emerged and grew with remarkable speed. In 1991, the size of financial assets held by the sector equalled 10 per cent of GDP. Already by 2011, this figure reached 70 per cent of GDP. This sector includes non-bank and non-insurance financial institutions, and for the most part consists of investment funds. This indicates an increased role of institutional investors in the German financial system.

Figure 2.2: Financial assets by sector, Germany, 1991 – 2011 (% of GDP)

![Figure 2.2](image1)

Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations

Figure 2.3: Financial liabilities by sector, Germany, 1991 – 2011 (% of GDP)

![Figure 2.3](image2)

Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations
Financial linkages with the rest of the world have also increased rapidly. While foreign financial claims on the domestic economy were around 50 per cent in 1991, this figure grew to above 200 per cent by 2011. The same picture emerges for the claims of domestic sectors on the rest of the world. Overall, from 2006 onward, we see an increase in the net-position of Germany against the rest of the world.

To sum up, we can see that the increase of financial assets observed for Germany since 1991 can be explained on the one hand by an overall increase in the intermediation activities of banks, and in part by the occurrence and the rapid growth of a new form of intermediaries - institutional investors. The non-financial corporations increased their overall financial linkages by increasing financial assets and liabilities, but they did not change their net-position. The household sector increased its financial assets, while liabilities remained largely stable, so that its net position improved. Correspondingly, the government sector and more recently the rest of the world experienced a deterioration of their net-financial positions.

2.3. Size and activity of banking and financial markets in an international comparison

The following part uses OECD, World Bank and Bundesbank data to compare the size of different financial markets and actors internationally. Figures 2.5 to 2.8 look at indicators of the activity and size of the banking sector. Figure 2.5 shows the size of the banking sector’s balance sheet to GDP.
While this ratio is relatively low for the US, it is quite high for Germany and France. This ratio highlights the importance of banks as financial intermediaries in those economies.

Figure 2.5: Balance sheet size of banking sector, 1979 – 2009 (% of GDP)

Figure 2.6 shows bank deposits to GDP. Deposits grow relatively steadily, in line with credit growth shown in Figure 2.7. Both ratios grew relatively strong from 1993 – 2001, and have stagnated thereafter. In international comparison, both ratios are high, especially compared to the US, which again shows the importance of banks in Germany.

Another interesting feature can be seen in Figure 2.8. From 1993 to 2001, banks rapidly increased their holding of financial securities. Hence, besides playing an important role in granting loans and creating deposits, banks also play an important role in security markets.

Source: OECD (2012), European Commission (2012), own calculations
Notes: The data is retrieved from the OECD's bank profitability statistics and tries to include all institutions that conduct ordinary banking business. However, the institutional coverage of banks may not be the same for every country.
Overall, the aforementioned indicators show that the German banking system steadily extended its activity compared to overall economic activity (measured by GDP) over the examined period, with particularly strong growth in the 1990s and a slow-down in the 2000s. Comparing the activity of German banks internationally shows that banks play a more important role than in the US, and by many measures, than in the other European countries we examined. In addition, their role as actors in financial markets has increased since the 1990s.
In Figures 2.9 and 2.10, the size of the domestic private and public bond markets\(^1\) are depicted. It can be seen that the German domestic market for government securities became more important. There are two main reasons for this: first, the overall increase in indebtedness of the German public sector; second, the increased reliance of the public sector on this market, instead of bank financing.\(^2\) In addition, if one looks at Figure 2.11, another trend becomes apparent. In 1990, the entire outstanding debt securities of the public sector and the size of the domestic market for public bonds, each accounted for 20 per cent of GDP. That means all issues of public debt securities were classified by the Bank of International Settlements (BIS) as targeted at local investors. By 2009, the total outstanding amount of public debt securities was equal to about 50 per cent of GDP. The amount of outstanding domestic public debt securities (as defined by the BIS) stood at only 40 per cent. Hence, an increasing part of new public debt issues during this period were targeted at international investors.

The domestic market for private debt securities (see Figure 2.10) is largest for the US. For Germany, this market has gained importance from 1990 and onward. This movement seems mainly driven by the increased issuing activity of banks, which increased their outstanding debt securities from under 35 per cent of GDP in 1989 to about 65 per cent by 2001 (see Figure 2.12). From 2000 to 2009 the private domestic bond market shrank. However, this movement is not driven by a decreased issuing activity of the corporations, as one can see by looking at the amount of outstanding debt securities depicted in Figure 2.12. Outstanding securities stay roughly at the same level until 2009. The decline of the size of the domestic bond market is largely driven by the fact that more of the issues are classified by the BIS as international.\(^3\)

At the same time, the domestic bond markets grew in other continental European countries so that, by today, they are more significant than the German market.

To sum up, the size of the private domestic German bond market increased from 1990 – 2000. Increased issues by banks in this domestic market mainly drove this increase. From 2000-2009, the amount of outstanding debt securities was between 65 and 70 per cent of GDP. However, an

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1 Domestic debt securities are defined by the BIS as issues by residents in domestic currency, targeted at resident investors. For the classification of issues the BIS uses characteristics of the debt security such as currency of denomination, location of secondary and primary markets and governing law. The graphs do only include debt securities that were targeted for the domestic market but not issued by domestics that were designed for international investors.

2 At the beginning of 1991 41% of the outstanding German government debts was loans against domestic banks. This figure decreased to only 21% by July 2011 (Source: Deutsche Bundesbank, 2012a).

3 In 1989, international debt securities were equal to 1 per cent in total debt securities outstanding. By 2000, that figure increased to 20%, and by 2009, international debt securities made up 43% of total debt securities outstanding (BIS, 2012a).
increased number of new issues were placed internationally, so that the domestic market lost in importance. For non-financial corporations, debt securities are still a negligible source of finance, despite the fact that they tripled their outstanding debt from 1.5 per cent of GDP in 1989 to 4.5 per cent in 2009. It’s interesting that other financial institutions (OFIs) increasingly have used debt securities to raise funds in the markets since 2006. While there were no outstanding debt securities in 2005, they amounted to 5.8 per cent of GDP outstanding by 2012.

Figure 2.9: Domestic public bond market capitalisation, 1990 – 2009 (% of GDP)

Source: Beck and Al-Hussainy (2010)

Figure 2.10: Domestic private bond market capitalisation, 1990 – 2009 (% of GDP)

Source: Beck and Al-Hussainy (2010)
Figures 2.11 – 2.16 show indicators of the size and activity of stock markets in the respective countries. By looking at the number of listed companies and the stock market capitalisation, it becomes clear that, at least regarding their size, stock markets play a more important role in the Anglo-Saxon countries, and also more recently in France. In Germany and Italy, they seem to be less important. The graphs also show relatively clearly the stock market price inflation at the end of the 1990s. While the overall size of the stock market in Germany increases in the 1990s and 2000s, it is still relatively small. A similar picture can be seen if one looks at the activity in the stock markets. Both, total value traded and turnover ratio, are relatively low for Germany, even though an overall increase of activity can be observed. It is interesting that the stock market turnover ratio was the highest for Germany at the end of the 1980s. In this period, it was higher than in all the other countries. A comparative trading activity was only reached in the stock market boom at the end of the 1990s, and again, at the end of the 2000s.
Figure 2.13: Number of listed companies per 10,000 population, 1988 - 2009

Source: Beck and Al-Hussainy (2010)

Figure 2.14: Stock market capitalisation, 1989 – 2009 (% of GDP)

Source: Beck and Al-Hussainy (2010)

Figure 2.15: Stock market total value trade, 1988 – 2009 (% of GDP)

Source: Beck and Al-Hussainy (2010)
From this first investigation, one can see that the overall financial activity in Germany has increased. The size and activity of the banking sector in relation to GDP has increased. Likewise, the stock market became bigger and more active. Germany is regarded as a typically bank-based financial system (Levine, 2002, p. 399). This is confirmed by the figures presented here. We find that the banks in Germany are relatively active, and that they play an important role as intermediaries, in particular in comparison to the US.

At the same time, financial markets play a minor role in Germany. Despite their growth in recent years, stock markets, in particular, are still relatively underdeveloped in Germany. This is true for their size, as well as for their activity. And even here banks play an important role. They substantially increased their holdings of financial securities during the phases when financial markets started to expand, and at the same time, are also major issuers in the private bond market. Thus, there seems to be a high interdependence between the activity of banks and financial markets.

Overall, it appears that, compared to other developed countries, the growth in finance and in financial markets in particular is a relatively recent and modest phenomenon in Germany.

2.4. Increased financial activity in the German economy

As already shown by the international comparison, finance does increase its role in Germany, but comparatively slowly. This is confirmed by Figures 2.17 and 2.18 from the German national accounts. Looking at the share of the financial sector in total gross value added, one can only see a slight increase. Starting with a share of 3.5 per cent in 1970, the contribution of the financial sector increased to 4.5 per cent by 1980. Thereafter, a structural shift is not apparent, even though the
financial sector’s contribution increased to about 5.5 per cent during the years of the stock market boom.

Figure 2.17: Gross value added of the financial sector, Germany, 1970 – 2010 (% of total gross value added)

![Graph showing gross value added over years]

Source: Statistisches Bundesamt (2006, 2012), own calculations;
Notes: Redefinition of categories 1991

Likewise, employment does not indicate a shift of the German economy towards financial services. Employment increased from about 2.6 to almost 3.5 per cent of total employment in the 1990s. After this, the relative importance of the financial sector in providing employment decreased. The absolute employment in the sector stayed for the most part stable after 1990. However, there is a shift of
employment from the traditional financial and insurance services towards ancillary activities. This could be related to outsourcing and pooling of activities, such as payment services. At a first glance, the figures do not indicate an increase, but rather a relative decrease in the importance of the financial sector in the German economy.

2.5. Financial activities of non-financial corporations

However, even though the German financial sector itself does not show a particular strong increase in size or activity, financialisation could also manifest itself in an increase in the financial activities of non-financial corporations (NFCs). Crotty (2005, p. 104) shows that in the US, NFCs responded to relatively low profits from their commercial and industrial activities, to the pressure from finance, and to the high returns that were made by financial corporations in two ways. On the one hand, they were using their available funds to acquire financial assets instead of acquiring investment goods. On the other hand, they established new or extended existing financial subsidiaries. The other perspective on the same phenomenon is described by Krippner (2011, pp. 3 - 4), who notes that a larger part of non-financial firms’ in the US profits accrues from financial activities.

A similar trend is apparent for German non-financial corporations. Figure 2.19 shows the composition of NFCs balance sheets from 1992 to 2009. As found by Crotty (2005) in the case of the US, NFCs in Germany have increased their financial holdings from about 32 per cent of total assets in 1992 to almost 44 per cent in 2009. The ratio of financial assets to tangible assets shows that, while holdings of financial assets were about 55 per cent of tangible assets in 1992, they peaked at 110 per cent by 2002. From there, the ratio fell when share prices collapsed.

Those figures, however, most likely understate the increased financial investment by German NFCs. Germany was characterised by large cross-shareholdings between companies for reasons other than financial investment. This network was partially dissolved during the late 1990s and 2000s. The divestment of those strategic cross shareholdings pulls the actual increase in financial activity of the German NFCs downwards, so that the actual phenomenon is understated by the figures presented here.

4 See chapter 3, Figure 3.2
Figure 2.19: Asset composition of non-financial corporations, Germany, 1992 – 2009 (%, € billion)

Figure 2.20: Portfolio income and profits of non-financial corporations, Germany, 1980 – 2011 (€ billion)

Figure 2.21: Portfolio income of non-financial corporations, Germany, 1980 – 2011 (% of total profits)

Source: Deutsche Bundesbank and Statistisches Bundesamt (2010)

Source: Statistisches Bundesamt (2006, 2012), own calculations

Source: Statistisches Bundesamt (2006, 2012), own calculations
This is reflected in the portfolio incomes of non-financial corporations. Figure 2.20 and 2.21 show data on profits and financial sources of income for NFCs. The share of financial income in total profits was stable in the 1980s, or even showed a slightly declining trend. After a spike around 1990, the share remained at about 16 – 17 per cent, only to rise remarkably in the 2000s up to about a third of total profits.

Figure 2.22 shows the gross financial payments made by the firms as a share of their cash flows. The gross payout-ratio is relatively high in 1980, falls thereafter, and shows an upward trend starting around 1990. The downward trend from 1980 – 1990 is mainly due to declining interest payments in this period, as well as falling dividends and profit withdrawals. The upward trend after 1990 is explained only by increasing dividends and profit withdrawals. Interest payments still register a downward trend. The spread and acceptance of the shareholder value doctrine in Germany could be a possible explanation for this development. However, as one could see from Figure 2.22, NFCs accumulated larger portfolios of financial assets themselves, and thus, received higher portfolio incomes. If higher outflows are compensated by higher inflows, the internal means of finance for the company sector as a whole do not actually change.

Figure 2.23 shows the net-financial payments of German NFCs. Looking at those net-figures reveals that net financial payments have not increased. However, this overall trend is caused by three very different developments. One still can see that the amount of internally generated funds paid out to the owners has been growing since the 1990s. Contrary to this, net interest payments have been slowly declining since 1980. Additionally, while retained profits from foreign direct investment (FDI) were close to zero in most years from 1980 to 2002, German firms made increasing profits on their FDI in the years after 2002. This, together with the declining net-interest payments, superimpose the increasing payouts that firms have to make to their owners, so that overall payout of funds to financial investors is relatively stable around 50 per cent of cash flows.

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5 Cash flow = operating surplus + depreciation
6 Profit withdrawals refers to the payout of profits to owners of corporations that are not joint stock companies, e.g. limited liability companies, partnerships, etc.
To sum up, while the financial sector itself does not show clear indications of financialisation, we find some peculiar features that are associated with it in the non-financial corporate sector. NFCs have restructured their balance sheets and hold a larger amount of financial assets. This is reflected in their profit and loss accounts. NFCs receive a growing part of their income from financial investments. At the same time, NFCs are under pressure from financial markets, which extract a larger part of their internal means of finance. However, the German NFCs compensate for this by increasing their own financial incomes.

In Figure 2.24, we look at NFCs’ outstanding liabilities as a percentage of GDP. The instruments are priced with their respective market value. This explains the huge fluctuations in the amount of outstanding shares. For the other and more stable instruments, one can see that the amount of...
outstanding loans slowly decreases, while other equity⁷ are increasing steadily with a jump at around 1999 and 2000 when a lot of new equity was raised. The value of outstanding debt securities is slowly increasing but is still negligible.

**Figure 2.24: Liabilities and outstanding equity of non-financial corporations, Germany, 1991 – 2010 (% of GDP)**

![Figure 2.24: Liabilities and outstanding equity of non-financial corporations, Germany, 1991 – 2010 (% of GDP)](image)

*Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations*

**Figure 2.25: External financing of non-financial corporations, Germany, 1991 – 2010 (% of GDP)**

![Figure 2.25: External financing of non-financial corporations, Germany, 1991 – 2010 (% of GDP)](image)

*Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations*

After looking at new external financing in Figure 2.25, it becomes apparent that the most important sources of finance until 2001 were loans. Furthermore, one can see that the increase in outstanding shares in the balance sheet of NFCs is largely due to valuation effects. The actual amount of finance raised was about 10 per cent of GDP for the period from 1998 – 2001. After this, the overall amount of the raised external financing falls sharply, and other equity make up a larger part of new financing.

⁷ Other equity refers to the equity of corporations that are not joint-stock companies, e.g. limited liability companies, partnerships, etc.
raised in this period. Overall, it does not seem as if NFCs rely much more on markets than in earlier periods for raising additional external finance. Only during the period of the stock price boom, significant amounts of new equity were raised. Debt securities still do not play a very important role, but increase in significance. In any case, a clear trend towards markets for financing is missing. All in all, it appears that NFCs have depended increasingly less on external financing since the turn of the century.

2.6. Changes in household behaviour and balance sheets

As mentioned above, financialisation led to better access to credit for households in many countries. This, in tandem with booming asset prices, caused higher consumption, lower saving and higher debt levels of households (Stockhammer, 2007, p. 9). Whether or not such a shift in household behaviour is apparent in Germany will be examined in this part.

Figure 2.26 shows the overall debt levels of German households. The data is taken from the flow of funds account of the German Bundesbank, so that it includes businesses that are not constituted as corporations or quasi-corporations. One can see that the overall debt level of the household sector increased until 1999. This increase in indebtedness could be related to reunification and the subsequent building boom. This is confirmed by Figure 2.27. Most of the increase in debt levels is due to housing loans and to a minor extent, due to commercial loans. Increased debt-financed consumption does not seem to play a large role. The upward trend in indebtedness of private households switches to a downward trend after 1999.

Figure 2.26: Liabilities of private households, Germany, 1990 – 2010 (% of GDP)

Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations
There could be different explanations for this. On the one hand, the access to credit is still relatively restricted. In particular, the types of loans that are easily accessible are not very widespread in Germany. For example, credit cards do provide actual credit, but normally a negative balance on a credit card account has to be paid at the end of each month. Banks normally provide overdraft facilities on checking accounts, but those are relatively limited and depend on monthly income. Therefore, those easy-to-access loans are not as widespread in Germany as in other countries. Additional credit requires a more deliberate decision, which includes talking to a loan officer and signing a formal contract. The low and even declining proportion of short-term loans underpins this hypothesis (figure 2.26).

Another explanation can be derived from Table 2.1, which depicts households’ debt to disposable income in various developed economies. Compared to the other large continental European economies (France, Italy, and Spain), Germany’s households already had a relatively high debt level in 1995. More importantly, while net wealth was increasing in most countries from 1995 to 2005, it stayed relatively stable in Germany during this period. Therefore, there was neither better access to credit due to higher collateral value, nor was there an incentive to increase consumption due to a wealth effect.
### Table 2.1: Household gross debt and net wealth, 1995 -2005 (% of annual disposable income)

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Source: Andre et al. (2007, p. 9)

Note: * For year 2004 instead of 2005.

Debt refers to total liabilities outstanding at the end of the period.

Net wealth is defined as non-financial and financial assets minus liabilities.

### Figure 2.28: Financial assets of households, Germany, 1991 – 2010 (% of total assets)

Source: Deutsche Bundesbank (2012), own calculations
Another aspect one can look at to find evidence for the growth of finance is the form in which private households hold their monetary wealth. Figure 2.28 shows the development of different types of assets in household portfolios. It is apparent that there was a shift in the form of German wealth holding. In 1991, 48 per cent of financial wealth was held in the form of bank deposits and 27 per cent consisted mainly of pension rights or claims against insurance companies. Hence, about 75% of the entire portfolio was held in relatively safe assets against some intermediary. Only 15 per cent of the households held ownership rights directly or indirectly through investment funds. At the height of the stock market boom this figure reached 29 per cent, but fell back to 23 per cent just before the financial crisis in 2007. In particular, wealth held in investment funds gained importance during this period. Generally, portfolios have become more diversified and have included a greater share of risky assets since the early 1990s. The overall trend could be due to two reasons: either households have become less risk-averse, or the high wealth households, whose share in total wealth holding has increased, tend to hold a higher share of risky assets in their portfolios. However, the share of these more risky assets in total wealth is still low in comparison to the US, for example. Van Treeck et al. (2007) find for the US in the period 1990-2006 a share that is between 33 and 40 per cent.

Another angle to look at Figure 2.28 is the amount of securitised assets in total wealth holding. An increase could be a sign for a trend towards a more market-based system. By 1991, households held about 20 per cent of their wealth in marketable assets. One can see a relatively rapid increase until 2000 to about 31 per cent. Shortly before the financial crisis hit, this figure was at 25 per cent, so that one can conclude that there has been a shift in the form of wealth holding towards more marketable assets. However, this trend is relatively slow, and the growth is limited to larger holdings of investment certificates, while the share of directly held debt and equity securities has not changed. Despite the increase, comparable figures for the US show that the share of securitised assets held in German households’ portfolios is still low. The share for the US fluctuated between 34 – 38 per cent in the period of 1990 – 2006 (Van Treeck et al., 2007).

2.7. The rise of institutional investors

Crotty (2005) notes that institutional investors gained ground as shareholders of the US corporate sector in the 1980s and 1990s. Institutional investment is a highly competitive business where short-term performance is important for the allocation of funds. By its design, it imposes this short-term view on the management of productive firms, and forces them to focus more on short-term share price development, rather than on long-term company performance (Crotty, 2005, p. 92). The size of the investment fund sector could, therefore, be used as one indicator for the financialisation of an economy.
In Germany investment funds are classified as open- and closed-end. Closed-end investment funds are normally set up for a specific project and for a specific time. If they have collected the targeted amount of funds for the respective project they are normally closed and no further investment is possible. The funds are mostly organised as GmbH & Co. KGs (comparable to limited liability companies) and are not obliged to pay out the share of an investor on demand. By the end of 2011 there were about 3,250 of those funds. They had a total volume of 198.6 billion euro and managed equity of 98.6 billion euro. Their main investment segments were real estate with a total volume of 72.1 billion euro, ships (51.5 billion), movables/aircrafts (45.7 billion), life insurance secondary markets (8.1 billion), energy (7.4 billion) and private equity (7 billion) (Scope Analysis Research, 2012).

Open-end funds are normally set up and managed by an asset management company. The funds are treated as separated assets from the company's assets and the asset management company is normally obliged to pay out the share of the fund to the respective investor on demand. According to the German Funds Association by 2011 there were about 77 of those asset management companies in Germany. The funds managed by those companies can be distinguished into Spezialfonds (special funds) and Publikumsfonds (investment funds). While regular investment funds are open to the public, special funds are normally launched and accessible only for institutional investors, such as insurance companies, banks or foundations, and are not open for small individual investors.

By the end of 2010 the assets under management of investment funds were 710 billion euro. They can be distinguished by their investment focus. The most relevant categories are funds focused on equity (238 billion euro) and on fixed income instruments (157 billion). Additionally, there are mixed funds (151 billion), guaranteed investment funds (35 billion), money market funds (42 billion), and open real estate funds (86 billion). Additional 815 billion euro were managed in special funds for other institutions by the end of 2010 (BVI, 2012a). Of those, 125 billion euro were managed for banks, 270 billion for insurance companies, 131 billion for pension corporations, 201 billion for other corporations and 42 billion for private non-profit organisations. (Deutsche Bundesbank, 2011a). According to the BVI (2012a) for insurance companies this is about 26 per cent of their entire actuarial reserves and for pension corporations it is about 41 per cent of their funds.

Looking at the total number of managed funds in Figure 2.29, one can see that the fund industry was very small until 1970. In fact, it grew from 2 funds in 1950 to 172 funds by 1972. From there on, special funds in particular gained importance. The growth in investment funds only picked up at around 1990. After the stock market boom in Germany, the number of special funds decreased, while the number of investment funds have grown rapidly since 2005.
Figure 2.29: Number of open end funds, Germany, 1950 – 2010

Source: BVI (2012)

Figure 2.30: Assets under management by open end funds, Germany, 1960 – 2010 (% of GDP)

Source: BVI (2012)

Figure 2.30 shows the assets under management as per cent of GDP. While in 1980 total assets were below 1 per cent, they grew to about 13 per cent in 1990. After 1994, the growth of assets under management increased rapidly once again. In the earlier phase, the increase was largely driven by an increase in new funds raised. Later on, however, the increase in the assets under management seems largely due to valuation effects caused by share price inflation. In 2003 – 2005, the assets decreased in value again due to the deflation of asset prices.

Hence, one can see a definite increase in the importance of institutional investors in Germany. Beginning from the early 1990s, they have gained importance. This trend gained strength, in particular, during the stock market boom at the end of the 1990s.
However, international comparison of the size of this sector shows that investment funds are still of minor importance in Germany. Looking at the wealth held in investment funds per capita, the development of institutional investors is still very insignificant in comparison to other European countries, Canada, Australia or the US. However, the comparison only includes investment fund shares directly held. Many Germans hold life insurance contracts through which they indirectly invest in special funds. These are not included in this statistic.

2.8. Conclusion

This chapter looked at the most common indicators for financialisation found in the literature and attempted to give a first overview of financialisation in the German economy. Many of the points raised here will be analysed in more detail in later chapters, so interpretations of the data are kept relatively short at this point.

We first looked at the flow of funds accounts to determine the overall amount of financial assets in the German economy. Total monetary wealth as a percentage of GDP has increased rapidly since 1990. In particular financial linkages with the rest of the world have increased. Other financial institutions (non-banks) became more important as holders of financial assets and liabilities.
However, the most remarkable growth in holdings of financial assets and liabilities was found in the banking sector.

Looking at the different parts of the German financial system, we find that financial activity has increased in relation to GDP. Both banks and financial markets have grown in size and in activity. However, comparing their importance internationally, we find that financial markets are relatively underdeveloped despite their recent growth, while banks continue to account for most intermediation. This confirms the general view about Germany being a predominantly bank based system.

Looking at the share of the financial sector in value added and employment in the German economy we did not find that it increased its importance significantly. From 1970 to 1980 we find a slow increase, but thereafter the share of the financial sector in value added remains rather stable and employment in the financial sector even has been decreasing since 1995.

Looking at non-financial firms we find increasing financial activity. Their holding of financial assets has increased. This is true in absolute amounts as well as in comparison to productive assets. Accordingly, a larger part of their profits is generated by financial activities. At the same time overall financial payments (interest and dividends) have increased, so that net financial payments as a share of cash-flows stayed stable. However, this is driven by two different trends. On the one hand, we have lower interest payments; on the other hand payments to shareholders went up. Hence, we have an indication of increased financial activity by non-financial corporations and, possibly, some indication of an increased shareholder value orientation.

We also looked at the indebtedness and the asset composition of households. We could not find increased borrowing for consumption or a particularly high indebtedness of the household sector. Portfolio shifts towards more risky assets and more marketable assets were apparent. However, the share of those assets in the financial portfolio of the household sector is still low compared to for example the US.

Lastly, we looked at the importance of institutional investors and found that they grew rapidly from 1990 to 2000 and then again from 2006 on. However, in international comparison the amount of financial wealth managed by institutional investors is still relatively low.

Over all, the data we examined in this chapter suggests that the growth of finance is a quite recent and still relatively modest phenomenon in Germany.
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Statistisches Bundesamt (2012), Genesis-Online Data Base, available at: https://www-genesis.destatis.de/genesis/online
3. The structure of the German financial system

3.1. Introduction

The German financial system has historically been a prime example of a bank-based system although, in contrast to most other developed capitalist countries, a significant part of the banking system has consisted of publically-owned and cooperative banks that are not driven primarily by the search for profits. In the 1980s, the big banks played an important role in promoting the development of securities markets in Germany with the aim of increasing their earnings from investment banking activities. This has resulted in some strengthening of the role of securities markets, although banks continue to occupy a predominant position in the German financial system. Amongst non-bank financial institutions, insurance companies have historically been the most significant, although investment funds expanded very rapidly in the 1990s, and are now almost as large, while pension funds remain much less significant. Highly leveraged financial institutions, such as hedge funds and private equity funds, have a relatively limited presence in Germany.

3.2. Banks

In Germany there is no restriction on banks conducting both commercial and investment banking activities and, as a result, most German banks are, in principle, universal banks. The universal banks fall into three main groups: private banks, which accounted for 38 per cent of banking assets in 2012; a publically-owned savings bank sector, with 29.4 per cent of banking assets; and a cooperative banking sector with 11.8 per cent of banking assets (see Table 3.1). The official statistics, slightly confusingly, refer to the first group as commercial banks, presumably to signify their profit-making orientation, but all three groups carry out what are usually referred to as commercial banking activities (accepting deposits and making loans) as well as, to varying degrees, engaging in investment banking activities (advising and dealing in activities related to securities markets). To avoid confusion, the profit-driven capitalist banks will be referred to as the private sector. In addition to the universal banks there are also a small number of special purpose banks which accounted for 20.4 per cent of banking assets in 2012.

The total number of banks in Germany is high compared with other major European countries, both in absolute numbers and in relation to the size of the population, with 1,988 institutions in 2012. However, this is slightly misleading since it is mainly explained by the large number of local savings
banks and credit cooperatives, which are linked within their respective sectors through mutual
guarantees and regional or central institutions (IMF, 2011, p. 7).

Private banks

The official statistics published by the Deutsche Bundesbank distinguish between three forms of
private banks: big banks, regional banks and branches of foreign banks. Six institutions were
designated as big banks in 1980 but, as a result of failures, mergers and takeovers, the number had
fallen to four by 2010 (see Table 3.1). Despite the decline in the number of institutions, the big banks’
share of total bank assets has risen quite markedly: it stood at around 10 per cent in the 1980s and
most of the 1990s, but then increased to 18 per cent in 1999 and to 25 per cent in 2010.

The Deutsche Bank is by far the largest of the big banks and, surprisingly given the size of Germany’s
economy, it is the country’s only major international player. In 2010 its assets amounted to 1.9
trillion euro, almost three times as large as the next largest German bank (see Table 3.2). Prior to the
onset of the crisis, the bank famously strove for a rate of return on equity of 25 per cent. The bank
has pursued an aggressive policy of international expansion and was an important participant in the
 provision of subprime mortgages and the packaging of subprime mortgages in opaque securities in
the US, where it has faced numerous civil and criminal court cases.¹ In December 2012 former staff
claimed that the bank had only managed to avoid requesting a government bailout at the height of
the crisis because it did not reveal large losses on the value of dubious securities it held.²

The Commerzbank is the second largest big bank, with assets in 2010 of 754 billion euro. In 2009 it
took over the Dresdner Bank, which had been the second largest bank but which suffered large
losses. The Unicredit Bank, which was formed from the merger of two medium sized Bavarian banks
in 1998, is the third largest of the big banks, with assets of 372 billion euro in 2010. The Bundesbank
also includes in its category of big banks the Post Bank, which was split off from the Deutsche Post in
1990 and sold off in 2004. It had assets of 214 billion euro in 2010. However, the Deutsche Bank,
which first purchased shares in the Post Bank in 2008, raised its holding to 93.7 per cent in 2012, so it
cannot really be regarded as a separate institution.

¹ In May 2012 Deutsche Bank agreed to pay 202 million dollar to settle charges that it defrauded the US
government over the resale of risky mortgages (BBC News, 10 May 2012). Other fines include 553 million dollar
by the Department of Justice for tax-oriented transactions for clients between 1996 and 2002 (FT, 21
December 2010); 7.5 million dollar by the US Financial Industry Regulatory Authority for negligently
misrepresenting delinquency rates on subprime related securities it sold (Wall Street Journal, 22 July 2010); 2.5
million pound in fines and compensation imposed by the British Financial Services Authority for irresponsible
lending mortgage practices (FT, 22 February 2011); and 887,000 dollar by the Korean Financial Services
Commission for manipulating the country’s stock market (BBC, 25 February 2010).

² Deutsche hid €12bn losses, say staff, Financial Times, 6 December 2012.
### Table 3.1: Banks by banking group, Germany, 1980 – 2012

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<tr>
<td><strong>Total</strong></td>
<td>3,359</td>
<td>100.0</td>
<td>2,987</td>
<td>100.0</td>
<td>2,038</td>
</tr>
<tr>
<td><strong>Private banks</strong></td>
<td>162</td>
<td>23.5</td>
<td>290</td>
<td>27.1</td>
<td>254</td>
</tr>
<tr>
<td>Big banks</td>
<td>6</td>
<td>9.8</td>
<td>4</td>
<td>15.4</td>
<td>5</td>
</tr>
<tr>
<td>Regional banks</td>
<td>100</td>
<td>10.5</td>
<td>199</td>
<td>9.8</td>
<td>157</td>
</tr>
<tr>
<td>Branches of foreign banks</td>
<td>56</td>
<td>1.7</td>
<td>87</td>
<td>2.0</td>
<td>92</td>
</tr>
<tr>
<td><strong>Savings bank sector</strong></td>
<td>611</td>
<td>38.6</td>
<td>580</td>
<td>35.3</td>
<td>461</td>
</tr>
<tr>
<td>Landesbanken</td>
<td>12</td>
<td>16.5</td>
<td>13</td>
<td>19.8</td>
<td>12</td>
</tr>
<tr>
<td>Primary savings banks</td>
<td>599</td>
<td>22.1</td>
<td>567</td>
<td>15.5</td>
<td>449</td>
</tr>
<tr>
<td><strong>Cooperative sector</strong></td>
<td>2,304</td>
<td>14.8</td>
<td>2,039</td>
<td>12.5</td>
<td>1,259</td>
</tr>
<tr>
<td>Regional institutions</td>
<td>10</td>
<td>4.0</td>
<td>4</td>
<td>3.6</td>
<td>2</td>
</tr>
<tr>
<td>Primary cooperative banks</td>
<td>2,294</td>
<td>10.7</td>
<td>2,035</td>
<td>8.8</td>
<td>1,257</td>
</tr>
<tr>
<td><strong>Special banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage banks</td>
<td>39</td>
<td>13.6</td>
<td>32</td>
<td>14.6</td>
<td>22</td>
</tr>
<tr>
<td>Building and loan associations</td>
<td>0.0</td>
<td></td>
<td>32</td>
<td>2.5</td>
<td>26</td>
</tr>
<tr>
<td>Special purpose banks</td>
<td>17</td>
<td>6.4</td>
<td>14</td>
<td>7.9</td>
<td>16</td>
</tr>
<tr>
<td><strong>Memo item</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign banks</td>
<td>148</td>
<td>4.1</td>
<td>138</td>
<td>11.4</td>
<td>150</td>
</tr>
<tr>
<td>of which majority owned foreign banks</td>
<td>61</td>
<td>2.1</td>
<td>46</td>
<td>9.4</td>
<td>40</td>
</tr>
</tbody>
</table>

*Source: Deutsche Bundesbank (2012)*
Table 3.2: The 50 largest banks, Germany, 2010

<table>
<thead>
<tr>
<th>Rank</th>
<th>Bank</th>
<th>Assets 2010 € billion</th>
<th>Branches</th>
<th>Employees</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Deutsche Bank AG, Frankfurt/M. *</td>
<td>1,905.6</td>
<td>3,083</td>
<td>102,062</td>
<td>Private</td>
</tr>
<tr>
<td>2</td>
<td>Commerzbank AG, Frankfurt/M.</td>
<td>754.3</td>
<td>2,170</td>
<td>59,101</td>
<td>Private</td>
</tr>
<tr>
<td>3</td>
<td>KfW Bankengruppe, Frankfurt/M.</td>
<td>445.5</td>
<td>70</td>
<td>3,543</td>
<td>Public</td>
</tr>
<tr>
<td>4</td>
<td>DZ Bank Frankfurt/M.</td>
<td>383.5</td>
<td>19</td>
<td>26,800</td>
<td>Cooperative</td>
</tr>
<tr>
<td>5</td>
<td>Landesbank Baden-Württemberg, Stuttgart</td>
<td>374.4</td>
<td>1</td>
<td>13,061</td>
<td>Public</td>
</tr>
<tr>
<td>6</td>
<td>Unicredit Bank AG, München</td>
<td>371.9</td>
<td>927</td>
<td>19,146</td>
<td>Private</td>
</tr>
<tr>
<td>7</td>
<td>Bayerische Landesbank, München</td>
<td>316.4</td>
<td>1</td>
<td>10,853</td>
<td>Public</td>
</tr>
<tr>
<td>8</td>
<td>Eurohypo AG, Frankfurt/M.</td>
<td>229.0</td>
<td>16</td>
<td>1,278</td>
<td>Private</td>
</tr>
<tr>
<td>9</td>
<td>Norddeutsche Landesbank Girozentrale, Hannover</td>
<td>228.6</td>
<td>18</td>
<td>4,211</td>
<td>Public</td>
</tr>
<tr>
<td>10</td>
<td>Postbank AG, Bonn</td>
<td>214.7</td>
<td>1,100</td>
<td>20,672</td>
<td>Private</td>
</tr>
<tr>
<td>11</td>
<td>WestLB AG, Düsseldorf</td>
<td>191.5</td>
<td>20</td>
<td>4,473</td>
<td>Public</td>
</tr>
<tr>
<td>12</td>
<td>Deutsche Pfandbriefbank AG, Unterschleißheim</td>
<td>186.8</td>
<td>7</td>
<td>919</td>
<td>Private</td>
</tr>
<tr>
<td>13</td>
<td>Landesbank Hessen-Thüringen Girozentrale, Frankfurt/M.</td>
<td>166.2</td>
<td>13</td>
<td>6,010</td>
<td>Public</td>
</tr>
<tr>
<td>14</td>
<td>NRW.Bank, Düsseldorf</td>
<td>156.8</td>
<td>2</td>
<td>1,224</td>
<td>Public</td>
</tr>
<tr>
<td>15</td>
<td>HSH Nordbank AG, Hamburg/Kiel</td>
<td>150.9</td>
<td>18</td>
<td>3,852</td>
<td>Public</td>
</tr>
<tr>
<td>16</td>
<td>Deka Bank Deutsche Girozentrale, Frankfurt/M.</td>
<td>130.3</td>
<td>6</td>
<td>3,683</td>
<td>Private</td>
</tr>
<tr>
<td>17</td>
<td>Landesbank Berlin Holding AG, Berlin</td>
<td>129.9</td>
<td>1</td>
<td>5,985</td>
<td>Public</td>
</tr>
<tr>
<td>18</td>
<td>ING-DiBa AG, Frankfurt/M.</td>
<td>96.3</td>
<td>1</td>
<td>2,696</td>
<td>Private</td>
</tr>
<tr>
<td>19</td>
<td>WGZ Bank AG Westdeutsche Genossenschafts-Zentralbank, Düsseldorf</td>
<td>94.1</td>
<td>3</td>
<td>1,573</td>
<td>Cooperative</td>
</tr>
<tr>
<td>20</td>
<td>Landwirtschaftliche Rentenbank AG, Frankfurt/M.</td>
<td>83.8</td>
<td>1</td>
<td>229</td>
<td>Public</td>
</tr>
<tr>
<td>21</td>
<td>DG Hyp Deutsche Genossenschafts-Hypothekenbank AG, Hamburg</td>
<td>63.4</td>
<td>6</td>
<td>454</td>
<td>Cooperative</td>
</tr>
<tr>
<td>22</td>
<td>Landescreditbank Baden-Württemberg - Förderbank (J-Bank), Karlsruhe</td>
<td>61.0</td>
<td>2</td>
<td>1,222</td>
<td>Public</td>
</tr>
<tr>
<td>23</td>
<td>DKB Deutsche Kreditbank AG, Berlin</td>
<td>55.2</td>
<td>17</td>
<td>1,134</td>
<td>Public</td>
</tr>
<tr>
<td>24</td>
<td>SEB AG, Frankfurt/M.</td>
<td>49.1</td>
<td>174</td>
<td>3,284</td>
<td>Private</td>
</tr>
<tr>
<td>25</td>
<td>Dexia Kommunalbank Deutschland AG, Berlin</td>
<td>48.7</td>
<td>1</td>
<td>84</td>
<td>Private</td>
</tr>
<tr>
<td>26</td>
<td>BHW Bausparkasse AG, Hamelin</td>
<td>44.9</td>
<td>1</td>
<td>1,545</td>
<td>Private</td>
</tr>
<tr>
<td>27</td>
<td>Aareal Bank AG, Wiesbaden</td>
<td>44.9</td>
<td>1</td>
<td>991</td>
<td>Private</td>
</tr>
<tr>
<td>28</td>
<td>WL Bank AG Westfälische Landschaft Bodenkreditbank, Münster</td>
<td>43.9</td>
<td>4</td>
<td>293</td>
<td>Cooperative</td>
</tr>
<tr>
<td>29</td>
<td>Bausparkasse Schwäbisch Hall AG, Schwäbisch Hall</td>
<td>41.4</td>
<td>1</td>
<td>764</td>
<td>Cooperative</td>
</tr>
<tr>
<td>30</td>
<td>Berlin-Hannoversche Hypothekenbank AG, Berlin</td>
<td>40.7</td>
<td>5</td>
<td>441</td>
<td>Private</td>
</tr>
<tr>
<td>31</td>
<td>Deutsche Apotheker- und Arztenbank eG, Düsseldorf</td>
<td>38.8</td>
<td>75</td>
<td>2,419</td>
<td>Cooperative</td>
</tr>
<tr>
<td>32</td>
<td>Hamburger Sparkasse AG, Hamburg</td>
<td>38.2</td>
<td>180</td>
<td>5,622</td>
<td>Independent</td>
</tr>
<tr>
<td>33</td>
<td>Deutsche Hypothekenbank (Actien-Gesellschaft), Hannover/Berlin</td>
<td>36.0</td>
<td>9</td>
<td>368</td>
<td>Private</td>
</tr>
<tr>
<td>34</td>
<td>IKB Deutsche Industriebank AG, Düsseldorf/ Berlin</td>
<td>35.7</td>
<td>12</td>
<td>1,613</td>
<td>Private</td>
</tr>
<tr>
<td>35</td>
<td>Münchener Hypothekenbank eG, München</td>
<td>35.2</td>
<td>1</td>
<td>366</td>
<td>Cooperative</td>
</tr>
<tr>
<td>36</td>
<td>Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale, Bremen</td>
<td>34.8</td>
<td>2</td>
<td>1,028</td>
<td>Public</td>
</tr>
<tr>
<td>37</td>
<td>Volkswagen Bank GmbH, Braunschweig</td>
<td>32.8</td>
<td>1</td>
<td>631</td>
<td>Private</td>
</tr>
<tr>
<td>38</td>
<td>Santander Consumer Bank AG, Mönchengladbach</td>
<td>31.5</td>
<td>176</td>
<td>1,802</td>
<td>Private</td>
</tr>
<tr>
<td>39</td>
<td>Sparkasse Köln Bonn, Köln</td>
<td>29.3</td>
<td>112</td>
<td>4,905</td>
<td>Public</td>
</tr>
<tr>
<td>40</td>
<td>Westdeutsche Immobilien Bank AG, Mainz</td>
<td>25.9</td>
<td>13</td>
<td>477</td>
<td>Public</td>
</tr>
<tr>
<td>41</td>
<td>Kreissparkasse Köln, Köln</td>
<td>24.5</td>
<td>216</td>
<td>3,829</td>
<td>Public</td>
</tr>
<tr>
<td>42</td>
<td>Wüstenrot Bausparkasse AG, Ludwigsgurg</td>
<td>23.9</td>
<td>500</td>
<td>2,132</td>
<td>Private</td>
</tr>
<tr>
<td>43</td>
<td>Düsseldorfer Hypothekenbank AG, Düsseldorf</td>
<td>20.6</td>
<td>1</td>
<td>50</td>
<td>Private</td>
</tr>
<tr>
<td>44</td>
<td>LFA Förderbank Bayern, München</td>
<td>20.5</td>
<td>1</td>
<td>311</td>
<td>Public</td>
</tr>
<tr>
<td>45</td>
<td>IBB Investitionsbank Berlin, Berlin</td>
<td>19.9</td>
<td>1</td>
<td>670</td>
<td>Public</td>
</tr>
<tr>
<td>46</td>
<td>DVB Bank SE, Frankfurt/M.</td>
<td>19.3</td>
<td>13</td>
<td>579</td>
<td>Private</td>
</tr>
<tr>
<td>47</td>
<td>Landesbank Saar, Saarbrücken</td>
<td>19.0</td>
<td>5</td>
<td>516</td>
<td>Public</td>
</tr>
<tr>
<td>48</td>
<td>BHF-Bank AG, Frankfurt/M.9)</td>
<td>18.7</td>
<td>14</td>
<td>1,500</td>
<td>Private</td>
</tr>
<tr>
<td>49</td>
<td>HSBC Trinkaus &amp; Burkhardt AG, Düsseldorf</td>
<td>18.6</td>
<td>9</td>
<td>2,440</td>
<td>Private</td>
</tr>
<tr>
<td>50</td>
<td>Mercedes-Benz Bank AG, Stuttgart</td>
<td>18.2</td>
<td>9</td>
<td>1,353</td>
<td>Private</td>
</tr>
</tbody>
</table>

Source: Karsch (2011, p. 50), own translation

Notes: * Consolidated with Postbank, parts of ABN Amro and Sal. Oppenheim/BHF Bank; † Without 4,500 affiliates of Deutsche Post.
The big banks have traditionally acted as house banks to Germany’s big industrial concerns, providing long-term loans and sitting on company supervisory boards as a result of the ownership of shares and exercising the proxy vote of small shareholders. Since the 1970s, however, big firms’ fixed investment has not increased as strongly as in the initial post-war decades and their need for external finance has declined. Furthermore, big firms have begun to obtain some external finance from the bond market. As a result lending by big banks to non-banks, which accounted for around 75 per cent of big banks’ assets in the 1960s, has declined sharply in importance. In the 1980s and early 1990s it stood at around 65 per cent of assets, but then fell strongly, declining to some 45 per cent of assets in 2007, when the financial crisis began, and a mere 25 per cent of assets in 2011.

**Figure 3.1: Lending by private banks to non-banks, 1980-2011 (% of banks’ assets)**

![Figure 3.1: Lending by private banks to non-banks, 1980-2011 (% of banks’ assets)](image)

*Source: Deutsche Bundesbank (2012)*

The big banks initially reacted to the decline in their traditional business by seeking to expand lending to small and medium enterprises but this proved rather unsuccessful due to the strong established relationship between the local savings banks and small and medium enterprises. The big banks then turned to promote the development of securities markets where they could earn fees from investment banking activities (Deeg, 1999, pp. 87-89). In order to develop investment banking, Deutsche Bank purchased the London-based investment bank Morgan Grenfell in 1990 and the New York-based Bankers Trust in 1998. For the same reason Dresdner Bank purchased London-based Kleinwort Benson in 1995. This created the basis for greater activity in international financial markets, and Deutsche Bank has actually based its investment banking activities in London. The shift towards investment banking and the decline in the importance of lending activity has been reflected in the source of big banks’ earnings. The share of net interest in big banks’ total income (net interest plus fees) declined from just under 80 per cent in the early 1980s to under 60 per cent in 2000, although it then increased again to almost 70 per cent in 2008 and 2009.
Figure 3.2: Ownership networks between financial and non-financial capital, Germany, 1996 & 2004

Source: Höpner and Lothar (2006, p. 2 & 5)

Note: The colors of arrows indicate the kind of capital participation:
yellow = finance – finance
red = industry – industry
orange = finance – industry
The shift towards investment banking activity has meant that the close link with specific industrial and commercial firms through the ownership of shares and seats on company supervisory boards has become a disadvantage in gaining business from other, non-related, companies. Consequently, while banks continue to hold shares as financial investments, they have sought to divest themselves of their large holdings in specific companies. This process of divestment received a strong impetus when the 50 per cent capital gains tax on the proceeds from sales of shares was abolished by the Social Democratic – Green government in 2002. The marked decline in the links between banks and non-bank enterprises between 1996 and 2004 can be seen in the network diagrams shown in Figure 3.2.

The second group of private banks includes smaller joint stock banks, most of which operate on a regional basis, and privately-owned banks, some of which have a long history. The number of banks in this group increased from 100 in 1980 to a peak of 200 in 2000, but then declined to 168 at the start of 2012. Many of these banks are very small and since 1980 this group’s share of total banking assets has remained around 10 per cent. The group includes two significant foreign owned banks, the Dutch-owned ING-DiBa (rank 18 with 96 billion euro assets in 2010) and the Spanish-owned Santander Consumer Bank (rank 38 with 31 billion euro assets). It also includes several banks set up by industrial companies, notably the Volkswagen Bank (rank 37 with 33 billion euro assets) and the Mercedes-Benz Bank (rank 50 with 18 billion euro assets).

The third group of private banks are the branches of foreign banks. Their number has increased very significantly, from 20 in 1980 to 310 in 2012. Nevertheless, although their share of assets doubled during this period, it remained very small, amounting to just 3.6 per cent in 2012.

**Savings Banks**

The savings bank sector consists of the primary savings banks, or Sparkassen, the regional Landesbanken, and the Deka Bank. The Sparkassen are owned by local city and county governments. They are required to serve the public interest in their local community and, although they are required to avoid making a loss, profit maximisation is not their primary aim. They act as bankers to small and medium enterprises, with which they have close local contact, and they are required to meet all requests for a bank account. Most working-class and many middle-class citizens have their accounts at the Sparkassen, which enjoy a high degree of public trust. Each Sparkasse operates in a

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1 There are independent savings banks in Hamburg, Frankfurt, Bremen and Dresden which are self-controlled, and which do not benefit from state guarantees, but which otherwise fit in this sector (Hackethal, 2004, p. 79).

2 At the height of the financial crisis in late 2008, the British Broadcasting Corporation (BBC) reported that concerned citizens were withdrawing their deposits from the big private banks and opening accounts at the Sparkasse in central Berlin’s Friedrich Strasse.
specific geographic territory and, depending on their size, may have many branches, but they are prohibited from competing with Sparkassen outside their territory.

As a result of a process of rationalisation, the number of Sparkassen has declined, from 599 in 1980 to 426 in 2012. Perhaps more significantly, Sparkassen assets have not grown as rapidly as those of the private banks and, as a result, their share of total bank assets has declined, from 22.1 per cent in 1980 to 12.7 per cent in 2012. Unlike the case of the private banks, there has not been a strong shift away from lending to non-banks, and such loans have accounted for around 70 per cent of assets throughout the period since 1980, as shown in Figure 3.3. The close relation between Sparkassen and small and medium enterprises has ensured that in Germany such enterprises have had greater access to credit than in many other developed capitalist countries, and this has been a key factor in explaining the sector’s success. The Sparkassen have also been more willing than private banks to continue providing credit when companies are under stress. Because of their focus on lending to small and medium enterprises, the Sparkassen were far less affected by the financial crisis in 2008-09 and, whereas private banks curtailed lending in response to large losses, lending by the Sparkassen remained relatively stable.

**Figure 3.3: Lending by savings and cooperative banks to non-banks, 1980-2011 (% of banks’ assets)**

![Graph showing lending by savings and cooperative banks to non-banks from 1980 to 2011](image)

*Source: Deutsche Bundesbank (2012)*

The second level of the savings bank sector is made up of the regional Landesbanken. They are generally owned jointly by regional associations of the Sparkassen and the regional state governments.³ The number of Landesbanken increased from 9 in 1980 to a peak of 14 following German reunification but, as a result of losses and a series of mergers and takeovers, the number had fallen to 9 again by 2008. The Landesbanken originally had two functions: to act as banker to the regional state, and to act as central banks for the Sparkassen in their region. However, they have also

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³ There is also some cross-ownership between the Landesbanken. For details of the ownership structure see IMF, 2012, p. 6.
developed a wide range of commercial and investment banking activities, and compete directly with the big private banks for business. The increased importance of investment banking activity for Landesbanken is reflected in the declining importance of business based on lending to non-banks. This accounted for around 65 per cent of their assets throughout the 1980s and 90s, but then fell to just over 50 per cent in the mid 2000s (Figure 3.3).

The Landesbanken formerly benefited from a guarantee from the regional states, and this enabled them to raise capital through selling bonds at a slightly lower interest rate than the private banks. The private banks had long considered this as unfair competition and, following a successful appeal to the European Commission, they succeeded in obtaining a judgement which required the regional states to end such guarantees from 2005. Following the end of this guarantee, the Landesbanken sharply increased their investments in foreign securities (see IMF, 2012, p. 8), including large holdings of complex US mortgage-backed securities, much of which was held in special purpose vehicles established in Dublin. Following the onset of the financial crisis and the collapse in value of these complex securities several Landesbanken registered large losses and required substantial state support.

There is also a third level in the savings bank sector. This consists of the Deka Bank, which is owned jointly by the Landesbanken and the German Savings Banks Association (DSGV). The Deka Bank was formed from a merger of the Deka Bank investment company and the Deutsche Girozentrale (the German savings banks clearing centre) in 1999 and serves as the central asset manager for the whole savings bank sector. The Landesbanken and the Deka Bank together accounted for 16.5 per cent of bank assets in 1980 and this increased to 19.8 per cent in 2000 although, following the losses at the Landesbanken, this fell back to 16.7 per cent in 2012.

While the record of the Landesbanken is more problematic than that of the highly successful local Sparkassen, the existence of such a large publicly-owned savings bank sector is a striking feature of German capitalism. In his study of German banks, Hackethal (2004, p. 81) observes that, although the Sparkassen are formally independent, the division of labour in the savings bank sector is similar to the hierarchical structure of the big private banks, and concludes that the savings bank sector might be considered as ‘one large bancassurance entity’ – in which case, he notes, it would form the largest banking institution in the world.

**Cooperative Banks**

The cooperative banking sector consists of two levels, the primary cooperative banks and two regional institutions. The number of primary cooperative banks has fallen sharply since the 1970s as a result of a process of rationalisation intended to reduce operating expenses, but there were still
1,121 at the start of 2012. The credit cooperatives are owned by their members, although they also provide retail banking services to non-members. Since the 1980s, loans to non-banks have accounted for around 70 per cent of their assets (Figure 3.3) and, like the Sparkassen, they have not significantly expanded their investment banking activities. The primary cooperative banks share of total banking assets has fallen very slightly, from 10.7 per cent in 1980 to 8.4 per cent in 2012.

The cooperative sector includes two regional institutions which act as central banks for the primary credit banks. The DZ Bank, which was formed by a merger in 2001, has around 900 members. The WGZ Bank (Westdeutsche Genossenschafts-Zentrale) has some 210 members in the Rhineland and Westphalia. These banks also compete with private banks for commercial and investment bank business. However, although the importance of lending to non-banks has increased, by 2005 such loans only accounted for just over 30 per cent of assets. The two regional cooperative institutions’ share of total bank assets has declined very slightly, from 4.0 per cent in 1980 to 3.4 per cent in 2012.

**Specialised banks**

In addition to the universal banks, there are three groups of banks which have specialised functions. One group consists of mortgage banks, which provide loans to purchase property and raise money from long-term deposits and the issue of bonds. In 1980 there were 39 mortgage banks but the number has fallen steadily, and since 2009 there have been 18. The largest is Eurohypo which was formed in 2001 through a merger of the mortgage banking subsidiaries of Deutsche Bank, Dresdner Bank, and Commerzbank, and which ranked as Germany’s ninth largest banking institution in 2010 (Table 2.2). The mortgage banks share of total bank assets fell from 13.6 per cent in 1980 to 6.9 per cent in 2012.

Another group of specialised banks is made up of building and loan associations. These are institutions where households commit themselves to save regularly for a specific period and, after having saved an appropriate amount, are eligible for a mortgage to buy a home. In 2012 there were 23 such institutions, but they accounted for only 2.3 per cent of total banking assets.

The other group of specialised banks provide funding to promote investment in specific sectors of the economy. There were 17 such institutions in 1980 and, following small variations, the same number existed in 2012. The largest is the publically-owned KfW (Kreditanstalt für Wiederaufbau) which raises money by issuing bonds guaranteed by the government, and provides finance for investment in infrastructure and other government supported projects in Germany and abroad. The group also includes the IKB (German Industrial Bank), whose purpose is to provide financing for small and medium enterprises, but which had to be rescued in 2007 after making large losses on
mortgage-related securities in the US, and was subsequently privatised (see chapter 13). In 2012, the special purpose banks accounted for 11.2 per cent of total bank assets.

3.3. Securities markets

Until the 1980s the German financial system was strongly bank based but following the end of the Bretton Woods system and the abolition of capital controls, there was greater competition from foreign financial institutions, and the big banks were keen to develop new business opportunities linked to investment banking. In the mid-1980s a consortium of big banks launched an initiative which later became known as ‘Finanzplatz Deutschland’, to encourage the development of securities markets in Germany and to promote Germany, and in particular Frankfurt, as a financial centre (Deeg, 1999, pp. 87-88). This initiative was welcomed by big firms and by the German government, and was supported by several new Laws on the Promotion of Financial Markets. The first two in 1990 and 1994 were introduced by a Christian Democrat led government; the third, and most significant, was introduced in 1998 by the newly elected Social Democrat led government (see chapter 6 for details).

The main securities market in Germany is in Frankfurt, although there are also five smaller exchanges in other cities. The Frankfurt Stock Exchange, which originated in the 16th century, was run until 1991 by the Frankfurt Chamber of Commerce. In 1990, a new company called the Frankfurter Wertpapier AG was founded, and this was renamed the Deutsche Börse (German stock exchange) AG in 1992. Deutsche Börse runs the Frankfurt Stock Exchange and an electronic trading system called Xetra. Deutsche Börse was originally owned by banks (81.9 per cent) with smaller holdings by the regional exchanges (10.1 per cent) and traders (5.3 per cent), although the banks have been reducing their holdings since 2001 and Deutsche Bank sold its 9.3 per cent share to institutional investors in 2002 (Theissen, 2004). Deutsche Börse attempted to take over the London Stock Exchange in 2005 but this was blocked by its new institutional investors who objected to a possible dilution of earnings – one of Germany’s first cases of such investor activism. In 2011 Deutsche Börse and New York Stock Exchange – Euronext agreed to combine.

The Deutsche Terminbörse (German Derivatives Exchange, DTB) was established at the initiative of the big banks in 1988 as a screen based futures and options exchange. It began trading in 1990 in fierce competition with the London International Financial Futures Exchange. Following the creation of DTB, equity commissions in Germany halved, but banks as owners of Deutsche Börse, benefited

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Hamburg and Hannover, Berlin and Bremen, Dusseldorf, Munich, and Stuttgart.

**Figure 3.4: Eurex**

The growth of the stock market received an important impetus with the privatisation of a number of several major state-owned enterprises in the 1990s, including Lufthansa (partial privatisation in 1994, full privatisation in 1997) and Deutsche Telekom (1996) (see chapter 13). Increased stock market activity was also associated with the acquisition by foreign investors of significant holdings in major companies, including Siemens, Deutsche Bank, E.On, Commerzbank and, as already noted, the Deutsche Börse itself. In the late 1990s, when German stock market prices registered a boom, closely following trends in the US, two new exchanges were founded. The Neue Markt for so-called growth stocks, strongly modelled on the New York Nasdaq, was opened in 1997, and the SMAX for smaller companies was launched in 1999, but neither survived the collapse of the stock-market bubble in 2000, and they were closed in 2003.

A further initiative which was, in part, intended to strengthen the role of securities markets in Germany was the reform of the pension system introduced by the Social Democratic led government in 2001. In Germany, there is a high level of public pension provision and pension payments account for some 10-11 per cent of GDP as compared with 6-7 per cent in the US and Britain. The pension
reform was launched in response to various perceived problems, including an aging population, increasing early retirement and a high unemployment rate, but it was also intended to increase the flow of funds to Germany’s capital markets. The key feature of the new policy was to reduce public pensions from 70 to 67 per cent of previous net income, and to provide tax incentives for employees to invest up to 4 per cent of their income in private pensions (Vitols, 2004).

Despite the expansion of the role of securities markets in the 1990s, they still play a relatively restricted role in Germany. There was a rapid expansion in the issue of bonds by companies raising external finance, but from a very low base, and by 2010 outstanding bonds amounted to only 145 billion euro, while the value of outstanding bank loans was 1,474 billion euro (Deutsche Bundesbank, 2012). Stock market activity had increased, but market capitalisation in 2010 was equal to 43 per cent of GDP, even lower than the EU average of 67 per cent, and considerably below the US figure of 119 per cent (IMF, 2012, p. 11). The attempts to promote a so-called ‘equity culture’ had met with limited success: the number of citizens who held shares increased from 3.2 million in 1988 to 6.2 million in 2000 but, following the collapse of the stock market bubble, this had fallen to 3.9 million in 2011 (Table 3.3). The number of share and investment fund holders was slightly larger, rising from 5.6 million in 1997 to 12.8 million in 2001, but this too then fell, reaching 8.5 million in 2011, a very much lower figure than in the US, where some 50 per cent have very much below the figure in the US. In summary: the corporate bond market is small, equity market capitalisation is low, and households hold their wealth mainly in bank deposits or insurance funds (see chapter 14 for details).

### 3.4. Shadow banks

The shadow banking system refers to activities related to credit intermediation, and liquidity and maturity transformation that take place outside the regulated banking system (ECB, 2012, p.8). In the US, shadow banking institutions played an important role in the onset of the recent financial crisis, in particular through entities involved in securitisation, such as special purpose vehicles. There is no agreed definition of exactly what should be included in the shadow banking system and relevant data has only recently begun to be collected. There is, however, a general consensus that in Germany the shadow banking system is small.

The Deutsche Bundesbank (2012) employs a rather broad definition of the shadow banking system. According to this, the largest component of the shadow banking system in Germany is a group of institutions which it calls ‘open-end mutual funds’, whose value amounted to 1.3 trillion euros in
September 2012 (see Figure 3.5). The total size of these funds is equal to around 15 per cent of the assets of the regulated banking system. This is very much smaller than in the US. Estimates by the New York Federal Reserve, while based on a different approach, indicate that the US shadow banking system had assets of around 14 trillion dollars in 2011, equal to some 110 per cent of the assets of the country’s regulated banking sector.

**Figure 3.5: Assets held under management by open-end mutual funds in Germany (€ billion)**

Hedge funds and money market funds, which have been the focus of much discussion about the shadow banking system, accounted for a very small part of the Bundesbank figures (1.6 billion euro and 5.4 billion euro respectively in September 2012). Some three-quarters of the total were held in specialised funds created for institutional investors (bond funds, equity funds and mixed securities-based funds). The Bundesbank points out that, since these funds provide capital to banks, enterprises and the government, they are potentially important channels through which financial contagion might be transmitted if institutional investors are faced with serious losses. Furthermore, some 70 per cent of the holdings of these funds were in foreign issued securities, thereby exposing investors

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5 Our own attempts to replicate the ECBs estimates of the size of the shadow banking sector indicated that for Germany the figure was around 500 billion euro in 2010 and 2011, which is even smaller than the Bundesbank figure.

6 The figure for money market funds had stood at 33 billion euro in 2006, but following the onset of the financial crisis in 2007 there was a large outflow of funds, partly due to the turmoil in US money market funds.
in these funds to possible losses suffered abroad (see Deutsche Bundesbank, 2012, Table 6.1 for details).

Although the shadow banking system in Germany is rather small, banks in Germany are also connected extensively with the global shadow banking system (Deutsche Bundesbank, 2012, p. 74). As with US banks, German banks set up special purpose vehicles in off-shore financial centres in order to circumvent German regulatory and tax requirements, and these were used to hold complex securities based on US mortgages. Details of the German owned vehicles are shown in Table 3.3 for June 2007, shortly before many of them suffered large losses with the onset of the crisis. The table brings out that, in addition to the major private banks, the Landesbanks were also heavily involved. The vehicles set up by the publicly-owned IKB and the Saxon Landesbank, which were the largest owned by German banks, both made large losses and were closed; as a result of the losses the banks themselves had to be rescued and were subsequently taken over.

Table 3.3: German banks’ special purpose vehicles in offshore centres, June 2007

<table>
<thead>
<tr>
<th>Bank</th>
<th>Vehicle</th>
<th>Location</th>
<th>$ billion</th>
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<tr>
<td>Bankgesellschaft Berlin</td>
<td>Check Point Charlie</td>
<td>Delaware, US</td>
<td>2.1</td>
</tr>
<tr>
<td>Bayern Landesbank</td>
<td>Giro Lion Funding</td>
<td>St Helier, New Jersey</td>
<td>7.4</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>Kaiserplatz Funding</td>
<td>Delaware, US</td>
<td>9.4</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Bills Securitisation (closed 9/2007)</td>
<td>St Helier, Jersey</td>
<td>0.0</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Rheingold Securitisation</td>
<td>St Helier, Jersey</td>
<td>7.2</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Rhein-Main Securitisation</td>
<td>St Helier, Jersey</td>
<td>7.5</td>
</tr>
<tr>
<td>Dresdner Bank</td>
<td>Silver Tower Funding</td>
<td>George Town, Caymen Islands</td>
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</tr>
<tr>
<td>DZ Bank</td>
<td>Coral Capital</td>
<td>London</td>
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</tr>
<tr>
<td>Helaba</td>
<td>Opusalpha Funding</td>
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</tr>
<tr>
<td>HSH Nordbank</td>
<td>Poseidon Funding</td>
<td>St Helier, New Jersey</td>
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</tr>
<tr>
<td>Hypo-Vereinsbank</td>
<td>Arabella Funding</td>
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</tr>
<tr>
<td>Hypo-Vereinsbank</td>
<td>Salome Funding</td>
<td>Dublin, Ireland</td>
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</tr>
<tr>
<td>IKB</td>
<td>Rhineland Funding Capital (closed 1/2008)</td>
<td>Delaware, US</td>
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<tr>
<td>LBBW</td>
<td>Lake Constance Funding</td>
<td>Bangore, Ireland</td>
<td>9.1</td>
</tr>
<tr>
<td>Sachsen Landesbank</td>
<td>Ormond Quay (closed 03/2008)</td>
<td>Dublin, Ireland</td>
<td>17.9</td>
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<tr>
<td>West Landesbank</td>
<td>Compass Securitisation</td>
<td>Dublin, Ireland</td>
<td>8.4</td>
</tr>
</tbody>
</table>

Source: DZ Bank, 2008

As an indicator of the overall size of German banks’ links with foreign shadow banks, the Deutsche Bundesbank uses the German banking sector’s balance sheet items with foreign ‘other financial institutions’ (OFIs, Deutsche Bundesbank, 2012, p. 75). It notes that German banks’ liabilities to foreign OFIs have been falling since the onset of the crisis, declining from around 200 billion euro in 2006 to 138 billion in September 2012. However, it warns of the possible impact of international contagion, and notes that German banks continue to borrow from US money market funds, a source of funding which notoriously dried up suddenly in 2008.
3.5. Conclusion

The German government, prompted by a consortium led by the big private banks, began in the 1990s to promote a shift away from Germany’s historically bank-based financial system to a more market-based financial system. While there has been a limited development of financial markets in Germany, the financial system remains primarily bank based. The different sectors of the banking system fared very differently in the course of the recent financial crisis, with important parts of the large non-profit cooperative and savings banks remaining substantially unscathed. The cooperative sector continued a process of rationalisation to establish a smaller number of more viable units directed primarily at serving small businesses. The local primary savings banks provided a stable and reliable source of credit for Germany’s very important small and medium enterprise sector, and this was scarcely dented by the crisis. By contrast the regional organisations of the savings banks fared less well, with some making significant losses on injudicious financial investments in the US. The private banking sector is dominated by four big banks. A fifth big bank, the Dresdner, which had been the second largest, failed to survive the crisis and was taken over by the Commerzbank. The Deutsche Bank, which is by far the largest of the private banks, had aggressively expanded its investment banking activities prior to the crisis. It was a major player in the provision and dubious packaging of mortgages in the US itself and was involved more widely in the rapid expansion of an extensive range of highly risky transactions. Together with a small number of other very big US and European banks it was centrally involved in the developments which led to the onset and impact of the recent financial crisis.
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<td>8,167</td>
<td>7,843</td>
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<td>7,928</td>
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<td>thereof with shares and/or investment funds and/or certificates</td>
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<td>6,190</td>
<td>6,221</td>
<td>11,828</td>
<td>12,659</td>
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Source: Infostat-Opinion poll by Deutsches Akademieinstitut
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4. Germany’s integration into international financial markets

4.1. Introduction

In the late 1960s as the US dollar came under pressure, the West German economy was buffeted by very large inflows of capital, and from 1968 to 1973 the German authorities imposed increasingly restrictive controls in an attempt to limit the inflows. However, German banks responded by opening international branches and used these to evade the controls, which consequently had only a limited impact (Hewson and Sakakibara, 1977). In late 1973, Germany began to relax its controls, and controls were fully abolished in 1981.

As the following analysis demonstrates, Germany’s international financial integration increased steadily, but from a low base, in the 1980s. It then deepened rapidly during the business expansion in the second half of the 1990s and, following a temporary weakening during the 2001-02 recession, again increased very strongly up to 2007. Following the sharp deepening of the financial crisis at the end of 2008, however, there was a significant international disengagement in 2009, and this was only partly recuperated in 2010 and 2011.

4.2. Current account developments and net capital flows

Since the 1980s, Germany’s current account balance has been characterised by three distinct periods. In the 1980s Germany registered a rising trade surplus, and this was reflected in a current account balance which rose to a peak in 1989 of 4.2 per cent of GDP (Figure 4.1) or the equivalent of 58.9 billion euro (Figure 4.2). Following German unification in 1990, there was a sharp deterioration in the country’s trade balance and throughout the 1990s Germany registered a small but persistent current account deficit, which increased towards the end of the decade to reach 1.9 per cent of GDP or 35 billion euro in 2000. Then in the 2000s, after the introduction of the euro and the end of the 2001-2002 international recession, the country registered an exceptionally strong increase in its trade surplus, and by 2007, the final year of the expansion, its current account surplus had risen to 7.5 per cent of GDP, or 181 billion euro. Since the onset of the crisis, the current account surplus has

1 All data, unless otherwise specified, is from Deutsche Bundesbank (2012)
declined slightly but, at around 6 per cent of GDP or 150 billion euro a year, it remained very high between 2008 and 2011.

**Figure 4.1: Current account balance, Germany, 1980 – 2011 (% GDP)**

![Current account balance, Germany, 1980 – 2011 (% GDP)](source)

**Source:** Deutsche Bundesbank (2012)

**Figure 4.2: Balance on current account and capital account, Germany, 1980 - 2011 (€ billion)**

![Balance on current account and capital account, Germany, 1980 - 2011 (€ billion)](source)

**Source:** Deutsche Bundesbank (2012)

**Figure 4.3: Net capital inflows, Germany, 1980 - 2011 (€ billions)**

![Net capital inflows, Germany, 1980 - 2011 (€ billions)](source)

**Source:** Deutsche Bundesbank (2012)
In the 1980s, the rising current account surplus was matched in part by a steadily rising net outflow of direct investment, but the largest net outflows were attributable to net other investment (Figure 4.3), which was mainly due to bank transactions (MFIs). In the 1990s, the small current account deficit was matched by a small capital account surplus, but it is striking that the scale of the net capital flows had increased since the 1980s. Net direct investment registered a steadily rising outflow, but this was more than offset by the increase in capital inflows which were due principally to net portfolio investment and especially net other investment, which was mainly attributable to bank transactions.

Between 2002 and 2007, when the current account surplus soared, there was a very large increase in the net outflow of other investment, again mainly reflecting bank transactions, although there was also a rising outflow of net direct investment and net portfolio investment. Between 2008 and 2011, net direct investment continued to register outflows each year and net portfolio investment registered significant outflows in two of the years. Net other investment also registered some large outflows, although in contrast to previous years, when this item was dominated by bank transactions, this was principally due to the Bundesbank’s acquisition of claims on the European Central Bank (ECB) through the TARGET 2 clearance system, as private claims against peripheral Euro Area countries were replaced by central bank claims in 2010 and 2011.

### 4.3. Capital outflows and capital inflows

**Figure 4.4: Capital outflows, Germany, 1980 – 2011 (€ billion)**

The outflow of capital from Germany is shown in Figure 4.4. The annual outflow increased in the 1980s, rising from 27.8 billion euro in 1980 to 129.2 billion euro in 1989. The largest outflows were registered by banks, followed by portfolio investment and then direct investment. In the first half of the 1990s annual outflows declined slightly, but in the second half of the decade they rose strongly, to reach 358.4 billion euro in 2000. The largest outflow was recorded by portfolio investment,
followed by bank outflows and then direct investment. Following a short decline at the start of the 2000s, annual outflows then again increased very strongly from 2004, more than trebling, to reach 693.8 billion euro in 2007. Although direct investment rose, the largest outflows were due to big increases in bank transactions and portfolio investment.

Following the onset of the crisis, total capital outflows from Germany declined very markedly in 2008 and 2009. In 2009 the total capital outflow fell to only 21.4 billion euro, primarily because outflows of portfolio investment and direct investment were largely offset as German banks repatriated 176.6 billion euro of funds. In 2010 and 2011 banks continued to repatriate funds, albeit on a smaller scale. However, the total outflow increased somewhat, above all due to the Bundesbank’s acquisition of ECB assets through the TARGET 2 clearing system.

**Figure 4.5: Capital inflows, Germany, 1980 – 2011 (€ billions)**

![Graph showing capital inflows for Germany from 1980 to 2011.](image)

Source: Deutsche Bundesbank (2012)

Notes: MFI = Monetary Financial Institutions.

The inflow of capital to Germany is shown in Figure 4.5. Total inflows were low in the 1980s (generally under 30 billion euro), and consisted predominantly of portfolio investment. Total inflows increased in the 1990s, especially in the second half of the decade, and reached 392.6 billion euro in 2000. Inflows of bank deposits increased in significance, and towards the end of the decade direct investment also rose. During the economic downturn in 2001 – 2003 inflows fell, but they then increased strongly to reach a peak of 483.7 billion euro in 2007, primarily due to large inflows of portfolio investment. Following the onset of the crisis, however, the total inflow of capital fell to almost zero in 2008, and there was a net withdrawal of funds amounting to 134 billion euro in 2009. This was a result of a collapse in portfolio investment in the country and, more particularly, a significant withdrawal of bank deposits.

In the case of portfolio investment, both outflows and inflows were predominantly in investments in debt securities rather than equities, as can be observed in Figure 4.6. In the case of the outflows, the main exceptions were associated with the period of stock market booms between 1996 and 2000, when some 50 per cent of outflows were accounted for by equities, and in 2007 and 2008 when German investors reduced their holdings of foreign equities. In the case of inflows, the main
exception was between 1996 and 2001, although there were also rising inflows in 2005 to 2007 which subsequently were reversed in 2008.

**Figure 4.6: Outflows and inflows of portfolio investment, Germany, 1980 – 2011 (€ billion)**

Source: Deutsche Bundesbank (2012)

The inflow of foreign capital into German bonds in the 1980s was predominantly into government paper. During the 1990s, foreign investors also began to purchase private issues, and in the period from 2001 to 2007, inflows to private issues were slightly larger than those into government paper. Following the onset of the crisis, however, this changed completely. From 2008 to 2012, foreign investors began to reduce their holdings of private bonds, most notably in 2009 when foreign investors dumped almost 100 billion euro of private German bonds. By contrast, during the same period, foreign investors increased their holdings of German government bonds in every year.

**Figure 4.7: Inflows of foreign capital into public and private bonds, Germany, 1980 – 2012 (€ billion)**

Source: Deutsche Bundesbank (2012)
4.4. International investment position

Germany’s net international investment position strengthened between 1980 and 1990, rising from 30 billion euro (3.7 per cent of GDP) to 269 billion euro (20.5 per cent of GDP) (see Figures 4.8 and 4.9; data is for December each year). During this period, it was primarily banks and companies that built up a positive net international position, but this was partly offset by a rise in foreign holdings of German government bonds. Between 1991 and 1998, Germany’s positive net international investment position was almost entirely eliminated. Although companies continued to increase their net international position, this was more than offset by an increase in the net liabilities of banks together with a continuing rise in foreign holdings of German government bonds.

From 2000 onwards, Germany’s net international position once again strengthened, and very significantly so. By the end of the business expansion in 2007 it had risen to 643 billion euro (26.5 per cent of GDP), and it continued to rise, so that by 2011 it stood at 845 billion euro (32.6 per cent of GDP). Companies continued to increase their net international position and, up to 2008, banks also increased their net foreign assets. However, after 2008, banks began to reduce their foreign exposure, although at the same time the net assets of the Bundesbank increased (principally due to a rise in assets with the ECB through the TARGET 2 clearing system).

Figure 4.8: Net international investment position, Germany, 1980 – 2011 (€ billion)

Source: Deutsche Bundesbank (2012)
Notes: MFI = Monetary Financial Institutions.
4.5. International indebtedness

While the net international investment position of Germany has been positive since the 1980s – and very strongly so since the turn of the century – different sectors of the German economy have been borrowing abroad and this has been reflected in a rising stock of external liabilities. This section will review the borrowing abroad by different sectors of the German economy; the following section will focus on the foreign lending of one particular sector, namely the banks.

Germany’s gross external indebtedness increased from 213 billion euro (23.2 per cent of GDP) in 1980, to 449 billion euro in 1990 (34.3 per cent of GDP) (Figures 4.7 and 4.8). It then rose very strongly in the 1990s, to reach 2,128 billion euro (90.7 per cent of GDP) in 2000, and it continued to rise, reaching 3,766 billion euro (151 per cent of GDP) by 2011.
In the 1980s, the largest components of Germany’s foreign indebtedness were accounted for, roughly equally, by banks’ foreign liabilities and foreign borrowing by German enterprises. However, since the 1990s, banks have increased their foreign debt very significantly, and government foreign indebtedness has come to occupy the second place, while enterprises’ foreign debt has grown much less. By 2007, when the financial crisis first erupted, the foreign indebtedness of German banks stood at 1,816 billion euro (74.8 per cent of GDP) and that of the government at 737 billion euro (30.4 per cent of GDP). The figure for foreign borrowing by enterprises in Germany was equal to 399 billion euro (16.4 per cent of GDP) while that for foreign borrowing by German owned firms abroad was equal to 247 billion euro (10.2 per cent of GDP).

Following the onset of the crisis, Germany’s gross foreign borrowing declined slightly in 2009, but it then increased again in the following two years. The decline was principally due to banks, which reduced their international indebtedness between 2007 and 2011 by some 200 billion euro to 1,608 billion euro. However, during the same period, the German government increased its foreign indebtedness by over 500 billion euro to reach 1,273 billion euro, largely as a result of foreign investors purchasing government bonds.

### 4.6. International bank lending

International lending by banks in Germany increased steadily from 90 billion euro in 1980 to 456 billion euro in 1996 (Figure 4.12). It then increased much more markedly from the late 1990s until 2008, when it reached a peak of 2,495 billion euro. In the aftermath of the crisis it then began to decline, and had fallen to 1,948 billion euro by mid-2012.

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2 Due to a lack of disaggregated time series data, this figure is probably understates the true amount since separate figures for the liabilities to affiliated enterprises abroad, which have been negative in recent years (reverse investment), were not available.
Deutsche Bundesbank figures do not show full details of which countries were the recipients of bank loans from Germany before 2001. However, from 2001 when full details become available, it can be seen that some 80 per cent of lending was to countries within Europe. In 2008, the year when lending peaked, 1,162 billion euro (46.8 per cent of the total) was to countries in the Euro Area; 560 billion euro (22.5 per cent) was to the UK; 119 billion euro (4.8 per cent) was to other EU countries; and 155 billion euro (6.2 per cent) was to European countries outside the EU (of which Switzerland accounted for around half). In the same year, lending to the US by banks in Germany amounted to 238 billion euro (9.6 per cent). However, unlike lending to European countries, which was largely funded from Germany, funds from Germany only amounted to somewhat less than one half of German banks’ total lending in the US as foreign branches of German banks also raised substantial amounts in the US itself – thereby significantly increasing German banks’ exposure to the financial crisis when it broke in the US.³ Most of the remaining amount in 2008 was made up of lending to the Cayman Islands (79 billion euro), other countries in the Americas (38 billion euro), and Asian countries (109 billion euro). It is noticeable that a significant part of international lending by banks in Germany was to ‘black holes’ or international banking centres, including the UK, Luxemburg (which accounted for 187 billion euro of the Euro Area figure in 2008) and the Cayman Islands.

Some details of the currency composition of international lending by banks in Germany are shown in Figure 4.13. It can be seen that, prior to 1999, approximately 50 per cent of international lending was denominated in Germany’s own currency. However, the share of lending denominated in euros increased rapidly after 1999. In 2008 72 per cent of international lending was denominated in euros and 19.5 per cent in US dollars, with a small amount in other currencies.

³ The peak lending by German banks in the US was in October 2008. Total consolidated lending amounted to 600 billion euro of which 257 billion euro originated from banks in Germany.
4.7. Conclusion

Germany’s international financial integration increased strongly between the late 1990s and 2008. This was characterised by a marked growth of German portfolio investment abroad and in lending abroad by banks in Germany. Although there was also a significant increase in foreign portfolio investment in Germany, this was not as large as the German investment abroad. The lending abroad by banks in Germany was predominantly to Europe, with the largest part going to Euro Area countries. German banks also extended their lending in the US during this period and, unlike the lending in other countries, in addition to funds from Germany, German banks also drew extensively on funds raised in the US itself. As a result, German banks were especially exposed to the financial crisis when it broke in the US in 2007. Following the dramatic deepening of the crisis in September 2008, German international financial integration was partly scaled back, with a marked decline in both German financial investment abroad and foreign financial investment in Germany. German banks reduced their lending abroad at the same time that there was an outflow of funds held in German banks. But with the increasing financial uncertainty there was a large inflow of funds into German government bonds.
References

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Data Sources

Deutsche Bundesbank (2012), Time Series Data Base, available at:

5. European financial integration

5.1. Introduction

This chapter will first outline key institutional milestones in the process of financial integration in the European Union. It will then examine the growth of German banks’ cross border lending since the 1980s, and the relative importance of such activity in Europe as a whole, in the countries of the European Union and in the Euro Area. This will be followed by a more detailed analysis of bank lending and bank liabilities to the countries of the Euro Area core and the Euro Area periphery.

5.2. Key steps towards financial integration in Europe

The first proposal to promote monetary integration in Europe was set out in the Werner Report of 1970. This aimed to achieve monetary union by 1980 but had to be abandoned as a result of the economic and financial turmoil associated with the breakdown of the post-war fixed exchange rate regime in 1973 and the onset of the first major synchronised international recession in 1974-75. This led to several major bank failures, including that of the Herstatt Bank in Germany in 1974. In the face of widening exchange rate fluctuations between members of the European Community, the European Monetary System (EMS) was launched in 1979. This aimed to maintain exchange rates between the currencies of member states to within 2.25 per cent of a central value defined in terms of European Currency Units, or ECUs, a new unit of account created from a weighted basket of the currencies of the participating countries.

The first step towards financial integration was a European Commission White Paper of 1983, which called for a better allocation of savings and investment in Europe, but which in itself did not have a great impact. However, the subsequent White Paper, issued in 1985 with a timetable for the completion of the internal market, included specific proposals for removing barriers to the free circulation of financial products in the European Community based on the principle of ‘home country control’. These proposals were reflected in the Single European Act of 1986, which led to the Directive on the free movement of capital, which came into force in 1990; the second banking directive of 1989 (see chapter 6); and the Investment Services Directive of 1993, which introduced the single passport for banks and investment firms, also based on ‘home country control’. This was

\[\text{1 The following details draw on ECB (2012).}\]
followed in 1989 by the Delors Report, which proposed a three-stage process for creating a monetary union in Europe.

As is well known, the Maastricht Treaty of 1992 established the legal basis for the European Monetary Union, which was initially planned to occur by 1998. Progress towards monetary integration was temporarily shaken in 1993 by a crisis in the EMS. The EMS, although set up as a multi-lateral system, was in practice strongly based on the Deutsch Mark. In 1992, German interest rates were increased sharply by the Bundesbank to combat a supposed risk of inflation associated with the country’s post-reunification investment boom. As a result, in 1993 several countries faced major speculation against their currencies due to doubts about their government’s ability or willingness to defend their exchange-rate pegs in the EMS. Britain left the system and the currency bands were widened to plus or minus 15 per cent against the central ecu rate but the process of monetary unification was reaffirmed, and in 1994 the European Monetary Institute, the forerunner of the European Central Bank (ECB), was established to facilitate the process. In June 1998, the ECB was established, and in January 1999 the euro was introduced as the common currency in eleven European states.

In the summer of 1999, immediately following the introduction of the common currency, the European Commission launched the Financial Services Action Plan, a highly ambitious programme involving 42 separate measures which member states were to implement in national legislation by 2005 with the aim of promoting financial integration in the EU (ECB, 2012, p. 36).² This was followed in 2001 by a set of proposals by a Committee of Wise Men chaired by Alexandre Lamfalussy which led to the establishment of three bodies for coordinating the regulation of banks, securities markets, and insurance and pension funds across EU member states. However, while this strove to ensure the application of common regulations in different countries, it did not address the key issue of financial linkages between different countries (ECB, 2012, p. 88).

The process of monetary unification, and the associated measures to promote financial integration, led to a rapid increase in cross-border financial transactions in the Euro Area. This was strongly reflected in the development of Germany’s financial institutions from the late 1990s up to 2008. However, following the dramatic deepening of the international financial crisis in 2008, and the onset of the Euro Area debt crisis 2010, the process of financial integration has been partially interrupted. German financial institutions have sought to disengage from some countries, although Germany has also been the beneficiary of very large inflows of capital from crisis stricken countries in the Euro Area periphery.

² For a more critical account of the Financial Services Action Plan see Frangakis (2009).
5.3. The growth of bank lending in Europe

Lending by banks in Germany to other countries, and specifically to Europe, is shown in Table 5.1. Total foreign lending increased slowly from 6.8 per cent of banks' assets in 1980 to 11.2 per cent in 1990; it then increased more rapidly to 17.2 per cent of assets in 2000 and even more rapidly in the following period, reaching 32.9 per cent of assets in October 2008 (106.9 per cent of GDP), when foreign lending reached a peak. It then declined considerably following the intensification of the international financial crisis, to 22.2 per cent of assets in July 2012. Figures for lending to Europe as a whole are only available from 2001, and these show that a large part of the foreign lending by banks in Germany was to Europe. In 2001, lending to Europe was equal to 14.9 per cent of banks' assets and this increased to 26.0 per cent in 2008 (84.5 per cent of GDP), before declining to 17.6 per cent of assets in 2012.

Figures for lending by banks in Germany to EU countries are available for the whole period from 1980, and it can be seen that such lending accounted for only 2.5 per cent of banks' assets in 1980 (4.1 per cent of GDP). This was not only rather small; it was equal to only a little more than one third of German banks' international lending. However, such lending then increased strongly, rising to 5.8 per cent of assets in 1990, 10.8 per cent in 2000 and 23.9 per cent -- a quarter of bank lending -- in 2008 (77.6 per cent of GDP), before declining somewhat to 16.2 per cent of assets in 2012.

Since the establishment of the European Monetary Union in 1999, lending to Euro Area countries has accounted for about two-thirds of lending to EU countries, rising from 7.2 per cent of bank assets in 2000, to 14.9 per cent in 2008 (from 21.3 to 48.2 per cent of GDP). A large part of the remaining one-third of lending to EU countries is accounted for by lending to Britain, reflecting the role of London as Europe's principal financial centre, and the fact that German banks conduct much of their international business through London.

Lending by banks in Germany to European countries outside the EU is relatively limited. It increased from 1.8 per cent of banks' assets in 2000 to 2.1 per cent in 2008 (from 5.4 to 6.9 per cent of GDP), and had declined to 1.4 per cent by 2012. Of this, around one third is accounted for by lending to Switzerland.
<table>
<thead>
<tr>
<th></th>
<th>Dec-80</th>
<th>Dec-90</th>
<th>Dec-00</th>
<th>Oct-08</th>
<th>Jul-12</th>
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<td>1,273.7</td>
<td>2,775.6</td>
<td>6,083.9</td>
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<td>2,089.3</td>
<td>1,532.2</td>
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<td>656.5</td>
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<td>1,409.8</td>
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<td>NA</td>
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<td><strong>Lending to other EU</strong></td>
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<td>726.7</td>
<td>476.7</td>
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<td><strong>Britain</strong></td>
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<td>55.1</td>
<td>177.1</td>
<td>597.9</td>
<td>358.6</td>
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<td>170.0</td>
<td>122.4</td>
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<tr>
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<td>7.5</td>
<td>37.6</td>
<td>63.8</td>
<td>50.2</td>
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<td>NA</td>
<td>73.5</td>
<td>106.2</td>
<td>72.2</td>
</tr>
</tbody>
</table>

|                                |        |        |        |        |        |
| **% of total bank balance**    | 100.0  | 100.0  | 100.0  | 100.0  | 100.0  |
| **Foreign lending**            | 6.8    | 11.2   | 17.2   | 32.9   | 22.2   |
| **Lending to Europe**          | NA     | NA     | 14.9*  | 26.0   | 17.6   |
| **Lending to EU**              | 2.5    | 5.8    | 10.8   | 23.9   | 16.2   |
| **Lending to Euro Area**       | NA     | NA     | 7.2    | 14.9   | 10.7   |
| **Lending to other EU**        | NA     | NA     | 3.6    | 9.0    | 5.5    |
| **Britain**                    | 0.6    | 2.0    | 2.9    | 7.4    | 4.1    |
| **Other**                      | NA     | NA     | 0.7    | 1.6    | 1.4    |
| **Lending to other Europe**    | NA     | NA     | 1.8    | 2.1    | 1.4    |
| **Switzerland**                | 0.1    | 0.3    | 0.6    | 0.8    | 0.6    |
| **Other**                      | NA     | NA     | 1.2    | 1.3    | 0.8    |

|                                |        |        |        |        |        |
| **% of GDP**                   | 161.5  | 212.4  | 297.1  | 324.6  | 330.0  |
| **Foreign lending**            | 11.1   | 23.8   | 51.2   | 106.9  | 73.3   |
| **Lending to Europe**          | NA     | NA     | 44.3   | 84.5   | 57.9   |
| **Lending to EU**              | 4.1    | 12.4   | 32.1   | 77.6   | 53.3   |
| **Lending to Euro Area**       | NA     | NA     | 21.3   | 48.2   | 35.3   |
| **Lending to other EU**        | NA     | NA     | 10.8   | 29.4   | 18.0   |
| **Britain**                    | 0.9    | 4.2    | 8.6    | 24.2   | 13.6   |
| **Other**                      | NA     | NA     | 2.1    | 5.2    | 4.5    |
| **Lending to other Europe**    | NA     | NA     | 5.4    | 6.9    | 4.6    |
| **Switzerland**                | 0.2    | 0.6    | 1.8    | 2.6    | 1.9    |
| **Other**                      | NA     | NA     | 3.6    | 4.3    | 2.7    |


*Notes: * 2001
5.4. Bank lending to Euro Area countries

Since the onset of the financial crisis, a marked polarisation has become evident between the financial position of a group of countries in Northern Europe, which – adapting terms from Latin American dependency theory – has become designated as the Euro Area core, and a group which includes a number of countries in Southern Europe plus Ireland, which has become known as as the Euro Area periphery.

Lending by banks in Germany to core Euro Area countries increased strongly from the mid-1990s, when the transition to monetary union began, until 2008, when the financial crisis deepened. Total lending to this group of countries rose from 95 billion euro in 1995 to 599 billion euro in 2008, and it then remained around 600 billion euro in the following four years. The country with the largest outstanding loans was Luxemburg (187 billion euro in 2008), reflecting its position as a banking centre. This was followed by France (166 billion euro in 2008), the Netherlands (119 billion euro) and Austria (80 billion euro).

![Figure 5.1: Lending by banks based in Germany to core Euro Area countries, 1982 - 2012 (€ billion)](source: Deutsche Bundesbank (2012))

The liabilities of banks based in Germany to core Euro Area countries also increased, but the expansion began in the early 1990s (i.e. a little earlier than the expansion of lending to these countries), when liabilities amounted to around 50 billion euro, and they ceased to rise significantly after around 2000, remaining around 250 billion euro until 2012 (Figure 5.2). The largest amounts again involved Luxemburg (136 billion euro in 2008), followed by France (75 billion euro) and the Netherlands (36 billion euro).

A comparison of the figures for the lending to Euro Area countries, with the liabilities to those countries indicates that in the second half of the 1990s – a time when Germany had a small current account deficit -- lending was slightly exceeded by liabilities. However, in 2000, bank lending and bank liabilities to the Euro Area core were almost balanced, and in the subsequent years, when
lending grew but liabilities remained roughly unchanged, the excess of lending over liabilities increased steadily, and from 2008 until 2012 it stood at around 350 billion euro. If Luxemburg is excluded, the balance of lending over liabilities between 2008 and 2012 stood at around 300 billion euro.

**Figure 5.2: Liabilities of banks based in Germany to core Euro Area countries, 1980 - 2012 (€ billion)**

Source: Deutsche Bundesbank (2012)

The lending by banks in Germany to countries in the Euro Area periphery began to increase in the second half of the 1990s, as it had in the case of lending to Euro Area core countries. However, the amount involved was initially much smaller. In 1995, outstanding loans to the Euro Area periphery amounted to 38 billion euro, but the figure then increased very strongly (Figure 5.3). In 2000 it had risen to 159 billion euro and by 2008 it had reached 544 billion euro. Unlike the case of the core Euro Area countries, however, since 2010 banks in Germany have been disengaging from the Euro Area periphery, and by 2012 lending to this group of countries had fallen by almost a half, to 298 billion euro. Lending to Italy had fallen from 165 billion euro to 95 billion euro; to Spain from 186 billion euro to 107 billion euro; and to Ireland from 135 billion euro to 59 billion euro. Over the same period lending to Greece fell from 30 billion euro to 22 billion euro, and to Portugal from 28 billion euro to 15 billion euro.

**Figure 5.3: Lending by banks based in Germany to peripheral Euro Area countries, 1982 - 2012 (€ billion)**

Source: Deutsche Bundesbank (2012)
Liabilities to Euro Area periphery countries also increased from the mid-1990s, but from a very low base (Figure 5.4). From 10 billion euro in 1995 they increased to 35 billion euro in 2000 and to a peak of 81 billion euro in 2007. They then fell sharply, reaching 43 billion euro in 2012.

A comparison of bank lending and bank liabilities to Euro Area peripheral countries shows that lending was much larger than liabilities, with the difference rising from 121 billion euro in 2000 to 465 billion euro in 2008, and then declining to 255 billion euro in 2012.

Figure 5.4: Liabilities of banks in Germany to peripheral Euro Area countries, 1980 – 2012 (€ billion)

Source: Deutsche Bundesbank (2012)

5.5. Target 2 balances

At the time of European monetary unification in 1999, the European Central Bank created the Trans-European Automated Real Time Gross Settlement Express Transfer System (Target) to provide a link between the real-time gross settlement systems which existed in each of the participating states. This system of linking national settlement systems was superseded in November 2007 with the creation of Target 2, which established a single unified system which could be used for settling payments both between banks in the same country and between banks in different Euro Area states.

The original Target and its successor, Target 2, were conceived as systems for settling payments between banks. However, as Hans-Werner Sinn and Timo Wollmershaeuser (2011) have pointed out in a much discussed paper, since the onset of the financial crisis, and in particular since the deepening of the crisis in the Euro area in 2011, the national central banks of the Euro area states have built up substantial claims and liabilities with the Target system (see Figure 5.5). Germany, the Netherlands, Luxemburg and Finland have built up claims against the system, while Portugal, Ireland, Greece and above all Italy and Spain have built up liabilities with the system.³

³ Claims and liabilities against the Target system are subject to the same interest rates as deposits and loans with the ECB.
Sinn and Wollmershaeuser (2011) argue that, since Germany has by far the largest claims against the Target system, it is in effect financing via the Euro system the current account deficits of the Southern European countries, and that this has enabled those countries to avoid the conditionality that would have been attached to loans from the Euro area’s rescue fund: ‘Target credit drawn by GIIPs countries from the Bundesbank through the ECB system far exceeds the official loans given to them by the Eurozone countries combined.’ They also argue that this is exposing the German central bank to the possibility of very large losses in the event of a collapse of the Euro area.

Sinn and Wollmershaeuser’s analysis has been strongly disputed by Paul De Grauwe and Yuemei Ji (2012). They demonstrate that, for most countries, there is little correlation between current account deficits and the accumulation of liabilities with the Target system. Rather, they argue, it is primarily speculative capital movements prompted by fear and panic which led to the accumulation of claims and liabilities with the Target system. For example, they write, if the sovereign debt crisis in Spain led German creditors to stop rolling over loans to Spanish financial institution, and these turned to the Bank of Spain for funding, while the German banks unloaded their claims on the Bundesbanks, this would lead to a surge in Target imbalances. De Grauwe and Ji also challenge the claim that the Target balances have created risks for Germany. Firstly they point out that, in relation to the size of their economies, Germany’s target claims are smaller than those of the Netherlands,
Finland and Luxemburg. More fundamentally, however, they argue that by choosing to run a current account surplus, Germany has acquired claims on the rest of the world, and they accept that this could involve a degree of risk. But, they insist, this risk is not related to the size of the country’s claims on the Target system, since these relate only to the composition of its foreign claims rather than their total. According to De Gruwe and Ji: ‘the explosion of the Target claims of Germany since 2010 cannot be interpreted as an explosion of the risk of foreign exposure for Germany. This risk increased moderately in this period because Germany continued to accumulate current account surpluses. It could have decided to reduce its current account surpluses but did not do so. As a result, the increase in the risk of foreign exposure was entirely the country’s own decision. It cannot be blamed on the Target system’.

5.6. Conclusion

In the 1980s, lending by banks in Germany to other countries increased but was rather limited, both in relation to banks’ assets and as measured in terms of German GDP. Furthermore, the figures suggest that much of German banks’ international lending at this time was to countries outside Europe. In the second half of the 1990s, lending by banks in Germany to other EU countries began to increase strongly. Some two thirds of this was to Euro area countries, and much of the remaining third was to Britain, reflecting the international role of London, where German banks conduct much of their international business. Following the outbreak of the Euro area crisis in 2010, lending to Euro area core countries stabilised around the existing level, while lending to countries in the Euro area periphery was sharply reduced. While Germany has built up large claims on the ECB’s Target2 system, these claims to not appear to reflect unconditional financing of peripheral countries’ current account deficits, but rather speculative capital flows to Germany prompted by fear and panic.

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4 According to De Grauwe and Li (2012) in 2011, the ratio of Target claims to GDP was 24 per cent for Germany, 25 per cent for the Netherlands, 40 per cent for Finland and 278 per cent for Luxemburg.
References

De Guwe, Paul and Yuemei Ji, ‘What Germany should fear most is its own fear. An analysis of Target2 and current account imbalances’, CEPS Working Document, No. 368, September 2012


Data Sources


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6. Regulatory framework: financial market regulation in Germany

6.1. Introduction

This chapter is divided into three parts. First, a historical overview is given, which summarizes financial market regulation in Germany until the 1980s. Only in the 1990s, and especially in the 2000s did bigger changes take place. These changes will be discussed in the second part. The third part analyses more recent changes in financial market regulation, which were mainly triggered by European harmonisation in this field. In the final part, a general judgment about the development of financial market regulation is given.

6.2. History of German financial market regulation

Germany has had a long tradition of banking regulation dating as far back as 1899, when mortgage banks and public sector savings banks were subject to regulation and supervision, including equity capital regulation. The beginnings of German banking regulation on a general scale with a supervisory authority and licensing requirements could be found in the 1930s. The German Banking Law (Kreditwesengesetz, KWG) of 1934 was a response to the deep banking crisis, which hit Germany during the deep recession and deflation of the early 1930s. In 1931, the Danatbank, the second biggest bank in Germany at the time, broke down and triggered a systemic banking and financial crisis. As a result, the law of 1934 introduced licensing and mandatory supervision of all banks. Among other things, capital requirements, the amount of lending to single borrowers, as well as institution’s investment in real estate became subject to regulation. It was also the first time that a public organisation that dealt with banking supervising was created - the Supervisory Office for Credit Matters (Aufsichtsamt für das Kreditwesen) (Tilly, 2009). The 1934 German Banking Law remained as the basis of German banking supervision after World War II until the 1980s.

In the immediate post-war period, the German banking system became regionalised, and financial institutions operating in all of Germany were not allowed. Accordingly, financial market regulation was carried out on a state level. In 1957, the Deutsche Bundesbank, the German central bank, was created based on the model of the US Federal Reserve. Before the Deutsche Bundesbank was

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1 This part is mainly based on Crane and Schaede (2006), Jackson and Moerkes (2005) and Krahnen and Schmidt (2004).
established, an institution called the Bank Deutscher Länder that was established by the Allies carried out the function of monetary policy after the currency reform of 1948 and the introduction of the German Mark. In 1956, the policy to regionalise banking in Germany came to an end and big private banks could once again act on a national level. National banking supervision became necessary again. The German Banking Act of 1961 established uniform banking supervision on a central level under the authority of the independent Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen, FBSO). Under the Act, the FBSO was required to formulate three principles of bank’s capital adequacy and liquidity: Principle I limits credit risk, Principles II and III address maturity mismatch, like the provision in the Banking Act of 1934. Limits on banking activities, portfolio composition or lending activities, ceilings on deposit interest rates, or restrictions on bank branching have not played a major role or were abolished much earlier than in other countries. The law required the Bundesbank to play a major role in supervision, and it still does. The Bundesbank supported the FBSO, which had far-reaching rights to supervise ongoing business activities of banks, including intervention in management decisions and imposing moratoria. The Bundesbank involvement in supervision provided it with all the necessary information with regards to monetary policy, bank supervision and crisis management (informational economies of scope). However, the Bundesbank’s involvement in supervision blurs the clear-cut distinction of who actually makes the regulation.

Typical for German financial market supervision was the full acceptance of a universal banking system, and at the same time, the implicit support of a bank-based financial system. Financial market regulation led to a lack of transparency and accountability, a low protection of minority shareholders and tendencies of insider trading. Large shareholdings among financial institutions like banks and insurance companies were legally allowed. Such cross-holdings were also common among big industrial companies, as noted in chapter 3. The network of cross-ownership between the big financial institutions, big German industrial enterprises, and between the group of financial institutions and the group of industrial enterprises became the backbone of the so-called ‘German Model’ after World War II (Streeck, 2009). The network between banks and enterprises was additionally strengthened by delegation of voting rights to banks at shareholder meetings by private asset holders, who transferred asset management to their banks. Part of the system after World War II was also the control of some of the big companies by the state (like the key role of public ownership of Volkswagen after World War II) or rich families (like the car manufacturer BMW, which is to today, dominated by the Quandt family). Investment banking would have been legally possible

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2 Sometimes the ‘German Model’ was also named ‘German-stock-company’ (‘Deutschland AG’).
in spite of the fact that banking supervision did not support it.\(^3\) However, until the 1980s, there was no interest from financial institutions, industrial enterprises or politics to develop investment banking in Germany.

Overall banking regulation corresponded to the German system of house-banks, with one well-informed bank as the main creditor of a company. The German system very much reflects Joseph Schumpeter’s view of bankers as the ephors of the economy that heavily influence investment behaviour and management of productive firms (Schumpeter, 1912).\(^4\) Financing of firms via the issue of new shares or debt-securities, although legally possible, played a very unimportant role in Germany (for more details see chapter 11).

Prior to the 1990s, the regulatory framework remained relatively stable, apart from several amendments to the Banking Act of 1961 that were triggered by difficulties with single institutions. Two amendments are worth mentioning. The 1976 Second Amendment of the German Banking Act was a response to the default of Bankhaus Herstatt in 1974, which took place due to its large speculative positions in foreign exchange. The default had an effect on banks worldwide and prompted several other regulatory changes. The FBSO also introduced Principle Ia to limit open positions in foreign exchange and commodities to at most 30 per cent of bank capital. In addition, banking regulation worldwide was affected by the Herstatt default. The Basel Committee on Banking Supervision, a committee of banking supervisory authorities was established in 1974 as a consequence of the Herstatt default. In 1988, the Committee recommended the Basel Accord, subsequently known as Basel I, as principles of banking supervision. Basel I then became enforced by law in industrial countries. Basel I primarily focused on credit risks. Assets of banks were classified and grouped in five categories according to credit risk. Banks were then required to hold capital equal to 8 per cent of the risk-weighted assets. The near collapse of a private bank (Bankhaus Schröder, Münchmeyer & Hengst) in 1983, due to large loan losses, showed holes in German supervision (the problems were discovered by the Association of Private Banks, rather than by the FBSO) and led to another Amendment of the German Banking Act in 1985. This Amendment already introduced an 8 per cent rule similar to Basel I, called for capital requirements to be calculated on a consolidated basis, and introduced a stricter limit for lending to a single borrowing entity. Principle Ia was also revised to cover price risk from derivatives and interest rate exposures, as a result of this near-default.

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\(^3\) The ‘German Model’ included more than a bank based financial system and cross equity holdings. Strong unions and employer’s organisation, a corporatist coordinated wage bargaining mechanism and a specific vocational education system were also important elements of the model.

\(^4\) In classical Greek, ephor means ‘one who oversees’. In ancient Sparta ephors shared power with the Spartan kings.
6.3. Movement towards a more market-based and deregulated financial system

The beginnings of the reform phase of the 1990s under the Kohl government

Under the conservative-liberal Kohl government (1982 – 1998), starting from 1985 and gaining pace in the 1990s, the German financial system was affected by a sequence of reforms. However, the big changes came with the deregulation wave of financial markets (and labour markets) after the election of Gerhard Schröder and his Social Democratic – Green coalition in 1998. Changes from the 1990s onward were partly driven by European Commission initiatives to harmonise financial markets in the EU. Also new recommendations on banking laws and regulations first issued by the Basel Committee on Banking Supervision in June 2004 which later became Basel II influenced financial reforms. Basel II among other things allowed banks to use own risk models to calculate equity holding and pushed for additional disclosure requirements with the aim to allow market participants to judge the soundness of financial institutions. In substance Basel II made the banking system more market driven. In this section, we summarise developments until the Social Democratic – Green coalition came into power.

In 1990, the First Financial Market Promotion Act (Erstes Finanzmarktförderungsgesetz) was enacted, which aimed at modernising the legal framework of Germany’s financial markets to structural changes in the global setting. It was the first unified capital market law in German history, and was the first law to have investor protection as one of its objectives (Bradley and Sundaram, 2003). Among other things, the existing stock market transaction tax was abolished in 1991. There were several forces pushing for this legislation (Jackson and Moerkes, 2005). The harmonisation of European capital markets was one of the reasons, but large private German banks, including Deutsche Bank and Dresdner Bank were interested in expanding in new business areas, including investment banking on an international level. This has to be seen from the background of more German firms beginning to list on New York and Tokyo Stock Exchanges, the development of the international bond market, and the use of new technologies that allowed long-distance trading (Schaede, 2000). Last but not least, the Kohl government wanted to promote and strengthen the role of Germany in international financial markets.

The Second Financial Market Promotion Act of 1994 (Zweites Finanzmarktförderungsgesetz) went much further by allowing money market funds. An initial step towards financial liberalisation occurred in 1984 and 1985 when the issue of Deutsche Mark (DM)-denominated zero-coupon bonds and DM-denominated Certificates of Deposit were permitted. The 1994 Act also broadened the legal forms for venture capital funds through an Amendment to the Investment Company Act (Gesetz über
Kapitalanlagegesellschaften, KAGG), prohibited insider trading, and established a Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel, BAWe) similar to the one existing in the US. The anti-insider trading legislation met severe opposition prior to 1994. After Germany failed to succumb to the European Commission Directive by the original date of compliance, the European Commission instituted infringement proceedings against Germany in October 1992. It was only in 1994 that Germany finally passed the required insider trading law, thereby becoming the last European Community member state to prohibit insider trading. Before the 1994 Act, insider trading was regulated by Gentleman’s Agreements and moral codes, which were binding only in case of voluntary submission by private contracts. The various insider-trading scandals in the four years prior to the passage of the Act were harmful for foreign investors’ confidence in Germany’s securities markets. Hence, according to the opinion of the European Commission, the enactment of anti-insider trading legislation was deemed as key to fostering international competitiveness of German financial markets, and to opening those markets further for international investors (Pfeil, 1996).

**Intensified reforms under the Schröder governments from 1998 onward**

The Social Democratic – Green coalition (1998 – 2005) did not only continue financial market reforms, but intensified them. This development was partly pushed for by the European Commission. In this part, developments in the capital market from 1998 onward are summarised (Hein and van Treeck, 2008).

The Sixth Amendment of 1998 to the Banking Act implemented EU Investment Services, Capital Adequacy, and Post-Bank of Credit and Commerce International Bank (BCCI) Directives (Crane and Schaede, 2006). These changes aimed at harmonising supervision of investment firms and banks. As a result, investment firms were now supervised according to the same rules as credit institutions. This amendment reflected a major change in rules on consolidation and large credits. The concept of the trading book was introduced. The trading book includes all securities that institutions regularly buy and sell on the secondary market on a speculative basis. These securities are accounted for according to their daily market value on asset markets. In the banking book institutions keep securities which are meant to be held until they mature. These securities are not used for short-term speculation. The revision allowed banks to use their own internal risk-assessment models with respect to their trading books.

The Third Financial Market Promotion Act (Drittes Finanzmarktförderungsgesetz) of 1998, also known as Law on Control and Transparency in Enterprises (Gesetz für Kontrolle und Transparenz im Unternehmensbereich, KonTraG), expanded the legal form of money market funds by allowing special private retirement savings options that could be held in such funds. Although the aforementioned
provision was in the interest of the big banks that wanted to increase the scope of the money market activities in order to increase profitability, the Act was initiated to improve supervision, increase transparency and limit cross-governance among the largest firms (Jackson and Moerkes, 2005). The Act affected the laws governing activities of corporations, stock exchanges, and accounting principles, and focused on shareholders’ interests. It permitted the buy-back of shares, and allowed for stock options to become a form of executive pay. Also, it included restrictions on banks’ proxy voting powers. Banks were prohibited from proxy voting if they voted on proprietary holdings exceeding 5 per cent of the firms’ equity capital at the same annual meeting, challenging the immense voting power of the big banks (Schaede, 2000). The Act was held back a year, due to unions’ opposition of the provision reducing the size of supervisory boards and number of union representatives (Jackson and Moerkes, 2005). However, the Act was passed without any changes, and was expected to turn Germany’s securities market into a level playing field and increase competition.

The Fourth Financial Market Promotion Act,\(^5\) which came into force in 2002, aimed to implement the 1997 Basel Core Principles for Effective Banking Supervision. The Act further enhanced investor protection, increased market integrity and transparency. The Act had a profound effect on rules governing prudential supervisory legislation. In 2002, the Federal Financial Supervisory Authority (\textit{Bundesananstalt für Finanzdienstleistungsaufsicht}, BaFin) was established as a new financial services supervisor that integrated the fragmented German financial market supervisory institutions. This new supervisory authority was put in place to more effectively monitor the constantly changing financial environment, thus extending BaFin’s authority compared to old organisations.\(^6\) A single integrated authority was also a response to the blurring of the distinction among segments of financial markets, partly due to integration of companies with specialised financial institutions, or establishment of large financial groups. With the rise of financial conglomerates, mortgage-linked business, private retirement provision and new financial products, there was a need for an integrated supervisory authority that would treat ‘same business’ that carries the ‘same risks’ with the ‘same rules’ (Yu, 2005). The Act also expanded the permitted investments, particularly of German open-end


\(^6\) For example, BaFin was now authorized by the Act to investigate and sanction the manipulation of exchange and market prices. More importantly, it was now able for the first time to issue binding orders if it feared that a re-insurer was not able to meet its liabilities at all times or had violated existing laws. Measures to combat money laundering and funding of terrorism were also included. Credit institutions were now obligated to maintain certain information about clients’ accounts in a separate database that could be accessed by the BaFin by means of automated procedures, and the establishment of an internal security system was now made mandatory by law (BaFin, 2002).
real estate funds. The revision eliminated investment restrictions that were deemed as no longer needed, including not only those related to open-end property funds, but also derivatives. Another effect was improvement of competitive positions of small and medium-sized companies towards large investment companies.

A whole series of laws tried to change behaviour in capital markets and corporate governance. In 2004, the Investment Modernization Act (Investmentmodernisierungsgesetz) permitted the establishment of hedge funds, which were allowed to employ unlimited leverage. Investment funds were allowed to have a leverage of two and act in derivative markets without any limit. In the same year, the Law on the Improvement of Investor Protection (Anlegerschutzverbesserungsgesetz, AnSVG) further strengthened restrictions on insider-trading and introduced better measures against market malpractices. The Law on the Introduction of International Accounting Standards and on the Protection of the Quality of Audits (Bilanzrechtsreformgesetz) introduced International Financial Accounting Standards and strengthened the independence of the auditor (Köhler, 2010). The Law on Control of Financial Statements was passed in the same year, and established the Financial Reporting Enforcement Panel as an independent enforcement authority to examine financial statements. Under this Law, the aforementioned panel was allowed to take appropriate steps to enforce necessary corrections of accounting irregularities. The Law on Corporate Integrity and Modernisation of the Right of Rescission Law (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, UMAG) was passed in 2005 (Köhler, 2010). It introduced the business judgment rule as the new standard for management. It also made it easier for minority shareholders to bring liability claims against members of the management board and the advisory board. The same year, the Law on Capital Market Test Cases (Kapitalanleger-Musterverfahrensgesetz, KapMuG) was passed. It made group litigation possible and introduced the possibility of test case litigation to establish whether market information was falsely given. The 2005 Law on the Disclosure of Management Compensation (Vorstandsvergütungs-Offenlegungsgesetz, VorstOG) is an example of a shift from private information bias toward making information more available to the public. For example, it obligates stock corporations to individually disclose what their management board members earn. However, it allows shareholders to opt out of disclosure of individual board member remuneration if they have at least three-quarter majority at the general meeting. Furthermore, the Transparency Directive Implementation Law (Transparenzrichtlinie-Umsetzungsgesetz, TUG) required the

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7 ‘The reason for this rule is to acknowledge that the daily operation of a business can be innately risky and controversial. Therefore, the board of directors should be allowed to make decisions without fear of being prosecuted. The business judgment rule further assumes that it is unfair to expect those managing a company to make perfect decisions all the time. As long as the courts believe that the board of directors acted rationally in a particular situation, no further action will taken against them’ (Investopedia, 2012).
management board of listed firms to confirm the balance sheets, and introduce new share
ownership notification rules.

In 2007, the Real Estate Investment Trust Law (REIT-Gesetz) established a new form of joint-stock
company which is focused on real estate management and is free from corporate taxes. In fact, such
real estate companies have to distribute at least 90 per cent of their profits whereas only individuals
or institutions receiving such payments are responsible to pay taxes. The Amendment of the
Investment Companies Act (Investmentänderungsgesetz, InvÄndG) of 2007 reduced information
duties of investment funds, and decreased the required capital for capital investment companies
from 730,000 to 300,000 euro.

Two measures were taken after the crisis of 2008-2009. The German Corporate Governance Code
(Deutscher Corporate Governance Kodex) aimed at filling holes in previous legislation, strengthening
supervisory boards, and reducing incentives for bank managers to increase short-term profits
(Köhler, 2010). Under the German Corporate Governance Code, the management board was
required to manage the enterprise with the objective of sustainable creation of value in the interests
of the enterprise and its various stakeholders. This Code also included measures affecting
cooperation between the management board and the supervisory board, as well as those directly
regulating the supervisory board. The Minimum Requirements for Risk Management dealt with risk-
bearing capacity, risk concentrations, stress tests, liquidity risk, interest rate risks, consolidated
group-level risk management, compensation systems, technology and organisation, organisational
and operational structure of lending and trading business.

Supporting takeover and restructuring of the enterprise system
Changes in tax laws in 2000 – 2001 abolished the capital gains tax on the sale of shares by
corporations, which was previously 50 per cent (Schaeede, 2000; Edwards et. al., 2003). At the same
time the corporate tax rate was cut to 25 per cent from 40 per cent for undistributed profits and 30
per cent for distributed profits. The abolishment of the capital gains tax allowed German financial
institutions and companies to sell shares from other companies and other property without a high
tax burden. This tax policy provided incentives for not only inter-corporate ownership to decrease,
but also for banks to reduce their equity holding of the corporate sector. Thus, tax laws added to the
reduction in cross-share-holding in Germany. It should be noted that new legislation was passed in
2009 (Abgeltungssteuer), which established a uniform tax of 25 per cent on all forms of capital
incomes, incl. realised capital gains (Dechert Tax Group, 2009).

Further development with the same aim was the Securities Acquisitions and Takeover Act
(Wertpapiererwerbs- und Übernahmegesetz, WpÜG) of 2002 which for the first time regulated
mergers with and acquisitions of publicly traded German firms. The legislation substituted the former voluntary ‘Takeover Guidelines’ formulated by the Stock Exchange Advisory Commission to which DAX 30 firms voluntarily subscribed (Schaede, 2000). The law now establishes guidelines including: all shareholders have to be treated equally; the same information has to be offered to all shareholders; management could not take defensive measures that harm shareholders; a mandatory bid (same buying price to all shareholders). In the early 2000s mergers and acquisition increased significantly. With the hostile takeover of Mannesmann by Vodafone in 1999, and the surprising announcement of Deutsche Bank and Dresdner Bank merger (that did not go through), the EU moved to pass the Takeover Directive to harmonise European takeover procedures. The EU’s 13th Directive was voted against by Germany in 2001 because it included the ‘obligation of neutrality’ on behalf of the management board when dealing with hostile takeover bids. This provision was seen as disadvantageous for Germany. Instead, Germany passed its own takeover law as an alternative to the EU’s Directive. The German Securities Acquisitions and Takeover Act of 2002 allowed management to adopt defensive measures under the condition of the supervisory board’s approval. This exemption from the general rule of neutrality is unique for Germany, and allows German firms to defend hostile bids in ways prohibited elsewhere in the EU. This can be interpreted as Germany’s resistance to EU’s push toward a market-based corporate governance system (Crane and Schaede, 2006).

Deposit insurance

Before the Herstatt default in 1974, no universal deposit insurance system existed. Following the default, deposit insurance schemes were introduced separately for cooperative, public and private banks following the logic of a private club model. This means the banks could manage their schemes themselves. The cooperative and the savings bank sectors each have systems that guarantee the viability of all member institutions. Therefore, all kinds of deposits are indirectly and completely insured. These initiatives prevented the German government from implementing a publicly managed deposit insurance scheme (Beck, 2001). In 1998, under the EU Directive on Depositor Guarantee and Investor Protection of 1994, additional statutory deposit insurance schemes were set up, one for private banks and one for public banks. However, insitutes that belong to a guarantee scheme that ensures the viability of all member institutions are not obliged to participate in the statutory schemes. Therefore, the cooperative sector and the savings bank sector institutions are not part of those statutory schemes. Members of the statutory system for public banks are therefore mainly governmental development banks, etc. Both newly created schemes are managed within the respective groups, separately from the existing voluntary deposit insurance schemes, but under the

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8 For further details see chapter 12.
regulation and supervision of the then Federal Banking Supervisory Office, and now of the Federal Financial Supervisory Authority (BaFin). The protection provided by the statutory deposit protection schemes was initially limited to 20,000 euro per depositor in 1994, but then extended to 50,000 euro in 2010 and to 100,000 euro in 2011 (Schich, 2008, p. 16). Additionally, an insurance scheme which covers security trading firms which are not banks was set up at the Bank for Reconstruction and Development. This scheme covers claims of investors at those institutions up to 20,000 euro.

6.4. Conclusion

The period from the 1930s, when major regulations were introduced, up to around 1990 could be characterised as stakeholder-oriented and bank-based. Regulations stabilised the typical system of German house-banks and share cross-holding among big financial and industrial companies. Formally, a universal banking system existed. However, investment banking was completely unimportant.

Things started to change in the 1990s, gained speed during the Schröder government from 1998 onward, and triggered a ‘transition regime’ (Bradley and Sundaram, 2003) where shareholders’ interests began to gain importance in regulations. Various measures were taken to ensure investors’ protection and to strengthen capital markets. From 1995, Germany embarked on a path of changes that aimed to move the financial system in the direction of a more Anglo-Saxon approach, including a more shareholder-oriented regime. Not only did the regulatory changes include provisions aiming at strengthening the power of shareholders; they also sought to limit the influence of banks. As Crane and Schaeede (2006) point out, there has been a three fold decline in banks’ direct involvement in corporate governance: in the number of banks among members of the supervisory board; in the majority ownership in large firms; and in the system of proxy voting.

Regulatory changes where pushed by German governments that wanted to strengthen Germany as a host for international financial markets, by the European Commission that pushed for financial market harmonisation under a neoliberal agenda based on the belief that more deregulated financial markets would increase economic efficiency and growth, and by interests of the bigger players in the financial markets, especially the private banks, to follow German multinationals and become bigger international players. This also was supported by tax policy.

A different story is whether the German financial systems changed substantially. Although Germany has clearly been moving away from a purely bank-based model, it has not adopted a market-based one. From the legal structure, a much more capital market based system would have been possible. But, as other chapters show, in substance, not much has happened. There is a big gap between the
regulatory regime in Germany and the actual financial system. This shows that the full possibilities permitted by the legal changes were not entirely taken up.
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<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Main Features</th>
<th>Reasons</th>
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<tbody>
<tr>
<td>1899</td>
<td>Mortgage banks and public sector savings banks were subject to regulation and supervision, including equity capital regulation.</td>
<td>limited maturity mismatch between assets and liabilities required to hold cushion-capital</td>
<td>ensure the ability of banks to pay off their customers insurance in case banks had to sell off their illiquid assets</td>
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<td>1931</td>
<td>Banking regulation initiatives</td>
<td>later formulated into the German Banking Law licensing requirements bank supervision addressed not only public savings banks and mortgage banks</td>
<td>response to default of Danatbank regulation to reflect the fundamental structure of German banking system</td>
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<td>1934</td>
<td>German Banking Law (Reichsgesetz über das Kreditwesen) beginning of banking regulation on a general scale consolidated 1931 banking regulation limited amount of lending to single borrowers, institution’s investment in real estate and long-term interest to certain portion of capital. reflected unique structure of German banking system basis of banking regulation in Germany until 1990s</td>
<td>need to consolidate banking regulation initiatives further regulation to address potential bank losses in case of a bank run</td>
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<td>1937</td>
<td>Cartel-like agreements on loan and deposit interest rates private, cooperative and public banks coordinated business decisions and ceilings on loan and deposit interest rates on the Central Credit Committee platform</td>
<td>reduced competition among banks and ensured stability</td>
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<td>1948</td>
<td>Bank Deutscher Länder (BdL) oversaw, monitored and supervised regional central bank offices</td>
<td>need for a nation-wide central bank shift of banking regulation authority from the Allies’ military administration to the BdL</td>
<td></td>
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<tr>
<td>Currency reform</td>
<td>establishment of DM and monetary over barter transactions the BdL now had the power to issue currency</td>
<td>need for own currency rebuilding of Germany</td>
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<tr>
<td>BdL became known as West Germany’s Central Bank (WGCW) modeled after the Federal Reserve System in the US each of the 11 states had own subsidiary central banks and branch systems issued own currency, the DM official mandate to ‘safeguard the currency’ under a pegged to the US Dollar exchange rate system</td>
<td>need to support the currency and ensure stable exchange rates</td>
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<td>1957</td>
<td>Bundesbank Act (Bundesbankgesetz, BBankG)</td>
<td>the BdL or WGCB became an independent central bank, Deutsche Bundesbank</td>
<td>independent central bank</td>
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<td>no full monetary policy authority</td>
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<td>could independently choose instruments in maintaining pegged exchange</td>
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<td>official mandate to 'regulate the amount of money in circulation and</td>
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<td>and of credit supplied to the economy with the aim of safeguarding</td>
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<td>the currency'</td>
<td></td>
</tr>
<tr>
<td>1958</td>
<td>Branching restrictions were abolished</td>
<td>banking institutions were allowed to open branches everywhere in the</td>
<td>to allow private banking institutions and</td>
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<tr>
<td></td>
<td></td>
<td>country without passing a public needs test</td>
<td>banking system to grow</td>
</tr>
<tr>
<td>1961</td>
<td>German Banking Act (Kreditwesengesetz)</td>
<td>established uniform banking supervision centralised at the federal</td>
<td>ensure soundness of the banking system</td>
</tr>
<tr>
<td></td>
<td></td>
<td>level under the authority of an independent Federal Banking</td>
<td>integration of banking supervision</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Supervisory Office (FBSO)</td>
<td>informational economies of scale</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FBSO formulated Principles I, II, and III of banks’ capital adequacy</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>and liquidity</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>required Bundesbank to engage in ongoing supervision</td>
<td></td>
</tr>
<tr>
<td>1965</td>
<td>Interest rate regulation by the Federal Banking</td>
<td>the German Banking Act of 1961 was used by the FSBO to regulate loan and</td>
<td>replaced cartel agreements among banks</td>
</tr>
<tr>
<td></td>
<td>Supervisory Office (FBSO)</td>
<td>deposit interest rates</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest rate regulation completely abolished</td>
<td>interest rates were allowed to freely adjust to market conditions</td>
<td>promote competition among banks</td>
</tr>
<tr>
<td>1968</td>
<td>‘Gentlemen's Agreement’</td>
<td>Bundesbank entered into an agreement with commercial banks</td>
<td>Bundesbank’s support of commercial banks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>prohibited foreign banks from underwriting issues of DM-</td>
<td>protection of domestic banks from foreign</td>
</tr>
<tr>
<td></td>
<td></td>
<td>denominated bonds by foreign issuers</td>
<td>competition</td>
</tr>
<tr>
<td>1969</td>
<td>First group specific deposit insurance schemes</td>
<td>deposit insurance in case of defaults</td>
<td>prevent systemic crises</td>
</tr>
<tr>
<td></td>
<td></td>
<td>prevent systemic crises</td>
<td>need for deposit insurance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>private banks formed groups and agreed to provide necessary funds in</td>
<td>make deposits more appealing to the public</td>
</tr>
<tr>
<td></td>
<td></td>
<td>case of a sudden need to repay depositors</td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>Insider Trading Guidelines (Insiderhandelsrichtlinien)</td>
<td>insider trading regulations similar to the moral codes of conduct</td>
<td>close-knit and private corporate culture</td>
</tr>
<tr>
<td></td>
<td></td>
<td>no criminal prosecution measures</td>
<td>among companies and banks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>binding only in case of voluntary submission by private contracts</td>
<td></td>
</tr>
<tr>
<td>1974</td>
<td>Default of Bankhaus Herstatt</td>
<td>had an effect on banks worldwide</td>
<td>prevent large speculative positions in foreign exchange</td>
</tr>
<tr>
<td>Event</td>
<td>Description</td>
<td>Response/Reason</td>
<td></td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Introduction of Principle Ia</td>
<td>limited open positions in Forex and commodities to 30 per cent of bank capital</td>
<td>response to default of Bankhaus Herstatt</td>
<td></td>
</tr>
<tr>
<td>Establishment of the Liquiditäts-Konsortialbank GmbH</td>
<td>provide liquidity to solvent institutions in need</td>
<td>prevent future defaults</td>
<td></td>
</tr>
<tr>
<td>Expert group on ‘Grundsatzfragen der Kreditwirtschaft’</td>
<td>dealt with fundamental issues of the banking industry</td>
<td>prevent future defaults</td>
<td></td>
</tr>
<tr>
<td>1975 Enlargement/adjustment of group-specific deposit insurance schemes for public savings banks</td>
<td>private club model of deposit insurance that now included public savings banks</td>
<td>need for deposit insurance after default of Bankhaus Herstatt no publicly managed deposit insurance schemes</td>
<td></td>
</tr>
<tr>
<td>1976 Second Amendment to the German Banking Act (Zweites Gesetz zur Änderung des Gesetzes über das Kreditwesen)</td>
<td>new rules for large loans to single borrowers new rules on credit files FBSO authorised to audit single institutions without specific reason explicit limits on bank losses that oblige FBSO to close the bank</td>
<td>mainly a response to the default of Bankhaus Herstatt to prevent future defaults and ensure stability</td>
<td></td>
</tr>
<tr>
<td>1977 Enlargement/adjustment of group-specific deposit insurance schemes for private banks</td>
<td>private club model of deposit insurance that now included private banks</td>
<td>no publicly managed deposit insurance scheme deal with the potential problem of moral hazard from the start de-motivate banks to take on massive-risks in general</td>
<td></td>
</tr>
<tr>
<td>1977 Enlargement/adjustment of group-specific deposit insurance schemes for cooperative banks</td>
<td>private club model of deposit insurance that now included private banks</td>
<td>no publicly managed deposit insurance scheme deal with the potential problem of moral hazard from the start de-motivate banks to take on massive-risks in general</td>
<td></td>
</tr>
<tr>
<td>1980 Expansion of the ‘Gentlemen’s Agreement’</td>
<td>prevented the introduction of substitutes to deposits prohibited products of the late 1970s financial innovation like NOW accounts and commercial paper</td>
<td>support of commercial banks on behalf of Bundesbank shielded German commercial banks from financial innovation and foreign competition cultural characteristic of German banking</td>
<td></td>
</tr>
<tr>
<td>1983 Near collapse of Bankhaus Schröder, Münchmeyer &amp; Hengst</td>
<td>showed holes in supervision discovered by the Association of Private Banks, not by FBSO</td>
<td>large loan losses</td>
<td></td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
<td>Details</td>
<td>Implications</td>
</tr>
<tr>
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<tr>
<td>1985</td>
<td>Third amendment to the German Banking Act (Drittes Gesetz zur Änderung des Gesetzes über das Kreditwesen), implementation of the 83/350/EEC</td>
<td>Capital requirements to be met on consolidated basis, new limit for lending to a single borrowing entity of 50 per cent of capital, banks were no longer allowed to build-up credit pyramids through subsidiaries without adequate risk-based capital adjustments, revised Principle Ia to cover risk from derivatives and interest rate exposures</td>
<td>Response to the near collapse of Bankhaus Schröder, Münchmeyer &amp; Hengst</td>
</tr>
<tr>
<td>1986</td>
<td>Abolition of the 'Gentlemen's Agreement'</td>
<td>Move toward the Anglo-Saxon financial culture</td>
<td>Promote competition, reverse industry cartelisation, integration into world financial markets</td>
</tr>
<tr>
<td>1986</td>
<td>Permission to issue DM-denominated zero-bonds</td>
<td>Move away from post-war German system of bank-based governance towards de-regulation and more market-oriented processes</td>
<td>Financial globalisation and innovation, desire to become more competitive on international markets</td>
</tr>
<tr>
<td>1990</td>
<td>First Financial Market Promotion Act (Finanzmarktförderungsgesetz)</td>
<td>First unified capital market law in Germany, first law to have investor protection as objective, emergence of shareholder value orientation, aimed at strengthening domestic demand for non-traditional investment activities, shift toward market-based system</td>
<td>Modernise the legal framework of Germany’s financial markets, transpose EU Directive, response to structural changes in global setting, large private banks wanted to become ‘truly’ universal</td>
</tr>
<tr>
<td>1993</td>
<td>Fourth amendment to the Banking Act (Viertes Gesetz zur Änderung des Gesetzes über das Kreditwesen und anderer Vorschriften über Kreditinstitute), implementation of the EU’s Solvency Directive and Capital Adequacy Directive</td>
<td>Implemented EU’s Solvency Directive and Capital Adequacy Directive, raised the threshold for large loans to be reported to the Bundesbank’s credit register to 1,500,000 dollar</td>
<td>Reflected growth of banking in Germany from financial globalisation, transpose EU Directives</td>
</tr>
<tr>
<td>Year</td>
<td>Act Description</td>
<td>Changes</td>
<td>Notes</td>
</tr>
<tr>
<td>------</td>
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<tr>
<td>1994</td>
<td>Second Financial Market Promotion Act (Zweite Finanzmarktförderungsgesetz)</td>
<td>introduced money market mutual funds (MMMFs), broadened legal forms for venture capital funds through an Amendment to the Investment Company Act, prohibition of insider trading, establishment of Federal Supervisory Office for Securities Trading</td>
<td>insider trading scandals, harmonisation of legislation with the EU, international enforcement efforts and technological developments, improve Frankfurt’s international competitive position</td>
</tr>
<tr>
<td>1995</td>
<td>Fifth amendment to the German Banking Act (Fünftes Gesetz zur Änderung des Gesetzes über das Kreditwesen und anderer Vorschriften über Kreditinstitute), implementation of the 92/30/EEC</td>
<td>implemented new rules on consolidation and large credits</td>
<td>growth of banking</td>
</tr>
<tr>
<td>1998</td>
<td>Law on Transparency and Control in Corporations (Third Financial Market Promotion Act) (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG)</td>
<td>expanded legal form of MFs, allowed special private retirement savings options that can be organised into MFs, improved supervision, increased transparency, limited cross-governance among the largest firms, allowed buy-back of shares, restrictions on banks’ proxy trading</td>
<td>improve Germany’s financial competitiveness, limit banks’ power over largest borrowers, shareholder-value maximisation, return on equity at the top of the list, turn Germany’s securities market into a level playing field, increase competition</td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
<td>Details</td>
<td></td>
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<tr>
<td>------</td>
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</tr>
<tr>
<td>2001</td>
<td>Tax Reduction Act</td>
<td>Established a statutory system of depositor insurance in case of defaults. Complemented the private bank deposit insurance scheme under GBA and Liquidity Bank. First time that insurance was provided for investors. Membership in deposit insurance schemes made mandatory. Insured stability. Prevent moral hazard and excessive risk-taking.</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>Revision of the Investment Companies Act</td>
<td>Eliminated investment restrictions, including related to open-end property funds and derivatives. Improvement of competitive positions of small and medium-sized companies towards large investment companies. Allowed more flexibility for German investment and trading activities, specifically for acquiring real estate in other countries. Transactions increased in size, and investments were pursued in major markets. Increased competition of open-end funds with closed-end funds in Germany by allowing them buy up larger assets.</td>
<td></td>
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<tr>
<td>Year</td>
<td>Law Title</td>
<td>Description</td>
<td>Impact</td>
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<tr>
<td>2004</td>
<td>The Law on the Improvement of Investor Protection (Anlegerschutzverbesserungsgesetz, AnSVG)</td>
<td>strengthened insider-trading law&lt;br&gt;introduced better measures against market malpractices.</td>
<td>limit influence of stakeholders&lt;br&gt;shareholder-value orientation</td>
</tr>
<tr>
<td>2004</td>
<td>The Law on the Introduction of International Accounting Standards and on the Protection of the Quality of Audits (Bilanzreformgesetz, BilReG)</td>
<td>introduced IFRS accounting standards and strengthened the independence of the auditor</td>
<td>strengthen auditor’s independence</td>
</tr>
<tr>
<td>2004</td>
<td>The Law on Control of Financial Statements (Bilanzkontrollgesetz, BilKoG)</td>
<td>established the Financial Reporting Enforcement Panel (FFEP) as an independent enforcement authority to examine financial statements</td>
<td>accounting irregularities</td>
</tr>
<tr>
<td>2005</td>
<td>The Law on Corporate Integrity and Modernisation of Rescission Law (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, UMAG)</td>
<td>introduced the business judgment rule as the new standard for the liability of the members of the management board through a company&lt;br&gt;made it easier for minority shareholders to bring liability claims against members of the management board and the advisory board</td>
<td>shareholder-value orientation in corporate governance&lt;br&gt;Anglo-Saxon finance culture</td>
</tr>
<tr>
<td>2005</td>
<td>The Law on Capital Market Test Cases (Kapitalanleger-Musterverfahrensgesetz, KapMuG)</td>
<td>made group litigation possible&lt;br&gt;introduced the possibility of test case litigation to establish whether market information was falsely given</td>
<td>investor protection</td>
</tr>
<tr>
<td>2005</td>
<td>The Law on the Disclosure of Management Compensation (Vorstandsvergütungs-Offenlegungsgesetz, VorstOG)</td>
<td>required stock corporations to disclose what management board members earn&lt;br&gt;allowed shareholders opt out of disclosure of remuneration in case of ¾ majority</td>
<td>public information instead of private</td>
</tr>
<tr>
<td>2005</td>
<td>The Transparency Directive Implementation Law (Transparenzrichtlinie-Umsetzungsgesetz, TUG)</td>
<td>required the management board of listed firms to confirm the balance sheets&lt;br&gt;introduced new share ownership notification rules</td>
<td>-</td>
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<tr>
<td>Year</td>
<td>Event</td>
<td>Description</td>
<td>Source</td>
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<tr>
<td>2008-2009</td>
<td>The German Corporate Governance Code (Deutscher Corporate Governance Kodex)</td>
<td>improve supervisory boards; reduced incentives for bank managers to increase short-term profits</td>
<td></td>
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<td></td>
<td>The Minimum Requirements for Risk Management (MaRisk)</td>
<td>dealt with risk-bearing capacity, risk concentrations, stress tests, liquidity risk, interest rate risks in banking books, consolidated group-level risk management, compensation systems, technology and organisation, organisational and operational structure of lending and trading business</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>Act on the Improvement of the Investor Protection and the Functionality of the Capital Markets (Gesetzesentwurf zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarktes)</td>
<td>reform of the right of investors to redeem shares in open-end real estate funds at any time and without notice</td>
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<td></td>
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<td>ten open-end real estate funds that held about 30 per cent of the industry’s market, closed and froze the redemption of shares by June 2010</td>
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</tbody>
</table>

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II. Competition, profitability and efficiency
7. The nature and degree of competition

7.1. Introduction

Analyses of competition in Germany’s banking sector often describe the German banking system as stable but rather uncompetitive (Fischer and Pfeil, 2004). It is argued that regulators restrict competition among the German banks and shelter the banking system from foreign competition and non-bank financial service providers. According to this view, there is a trade off between the stabilising effects of bank market power and the efficiency gains from more intense competition. European integration has, in recent years, led to deregulation and the removal of anti-competitive regulations in the whole of Europe (Fischer and Pfeil, 2004, pp. 291-292). This may have led to major changes in competition in the German financial sector. In this chapter, we mainly try to evaluate the current degree of competition in the banking sector by presenting different measures that can give an indication of concentration and competition, as well as by outlining the relevant literature that deals with this topic.

7.2. Concentration on the national level and international comparison

Simple and meaningful measures of market structure and competition for the banking industry, which allow for national, international and inter-temporal comparison and evaluation, exist only to a very limited degree (Fischer, 2005, p. 7). Judging simply by the number of legally independent banks, Germany is heavy on banks in comparison to other European countries. In 2010, there were 0.2 institutions per 10,000 inhabitants (France 0.05; Italy 0.13; US 0.52). The number of branches, however, is not particularly high. In Germany, there is one branch per 2,200 people (France 1,640, Italy 1,770) (OECD, 2012). However, one has to note that in Germany’s three pillar system and in the public and cooperative sector in particular, there are many very small banks that only act within a region, do not compete with banks in other regions, and play only a minor role at a nationwide level (for details see chapter 3). Hence, the large number of credit institutions in Germany does not necessarily indicate a large degree of competition.

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1 This trade-off view mainly stems from the industrial organisation literature, and is the most commonly held position in public discussions. However, a prevailing conception in the area of banking theory is that too fierce competition in the banking sector can reduce stability (Krahnen, 2005, VII).
A better measure for concentration is therefore the business volume of banks. Standard indicators based on this measure are the Herfindahl Index and the Concentration Ratio (CR). The Herfindahl Index gives the sum of the squares of each institution’s respective market share. A value of 10,000 means that one bank controls the entire market. A value below 1,000 indicates a low degree of concentration, while a value above 1,800 indicates a high degree of concentration (DIW, 2004). The Concentration Ratio gives the largest banks’ share of the business. For example, the CR3 gives the share of the 3 largest banks.

The European Central Bank (ECB) calculates the aforementioned indicators for the EU member states on a regular basis. Table 7.1 gives the Herfindahl Index for selected countries, as well as the unweighted average of all EU and Euro Area countries. Table 7.2 shows the CR5 – the combined market share of the 5 largest banks.

Table 7.1: Herfindahl Indices, 1997 – 2009

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<td>133</td>
<td>140</td>
<td>151</td>
<td>158</td>
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<td>173</td>
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<td>174</td>
<td>178</td>
<td>183</td>
<td>191</td>
<td>206</td>
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<tr>
<td>France</td>
<td>449</td>
<td>485</td>
<td>509</td>
<td>587</td>
<td>606</td>
<td>551</td>
<td>597</td>
<td>623</td>
<td>727</td>
<td>726</td>
<td>679</td>
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<tr>
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<td>210</td>
<td>220</td>
<td>190</td>
<td>260</td>
<td>270</td>
<td>240</td>
<td>230</td>
<td>220</td>
<td>328</td>
<td>344</td>
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<tr>
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<td>208</td>
<td>221</td>
<td>250</td>
<td>264</td>
<td>282</td>
<td>307</td>
<td>347</td>
<td>376</td>
<td>399</td>
<td>394</td>
<td>449</td>
<td>412</td>
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<tr>
<td>EU 25/27 unw. average</td>
<td>1185</td>
<td>1198</td>
<td>1186</td>
<td>1171</td>
<td>1135</td>
<td>1106</td>
<td>1106</td>
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<td>1106</td>
<td>1106</td>
<td>1106</td>
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<tr>
<td>EA 12/16 unw. average</td>
<td>383</td>
<td>429</td>
<td>468</td>
<td>508</td>
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Table 7.2: CR5, 1997 – 2009 (%)

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<td>17.0</td>
<td>19.0</td>
<td>19.0</td>
<td>20.0</td>
<td>20.2</td>
<td>20.5</td>
<td>21.6</td>
<td>22.1</td>
<td>21.6</td>
<td>22.0</td>
<td>22.0</td>
<td>22.7</td>
<td>25.0</td>
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<tr>
<td>France</td>
<td>40.0</td>
<td>41.0</td>
<td>43.0</td>
<td>47.0</td>
<td>47.0</td>
<td>44.6</td>
<td>46.7</td>
<td>44.7</td>
<td>51.9</td>
<td>52.3</td>
<td>51.8</td>
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<td>25.0</td>
<td>25.0</td>
<td>23.0</td>
<td>28.8</td>
<td>30.6</td>
<td>27.0</td>
<td>26.0</td>
<td>26.8</td>
<td>26.2</td>
<td>33.1</td>
<td>33.0</td>
<td>34.0</td>
</tr>
<tr>
<td>UK</td>
<td>24.0</td>
<td>25.0</td>
<td>28.0</td>
<td>28.0</td>
<td>28.6</td>
<td>29.6</td>
<td>32.8</td>
<td>34.5</td>
<td>36.3</td>
<td>35.9</td>
<td>40.7</td>
<td>36.5</td>
<td>40.8</td>
</tr>
<tr>
<td>EU 25/27 unw. average</td>
<td>59.5</td>
<td>59.8</td>
<td>59.5</td>
<td>59.0</td>
<td>59.3</td>
<td>59.0</td>
<td>59.5</td>
<td>59.6</td>
<td>59.6</td>
<td>59.6</td>
<td>59.6</td>
<td>59.6</td>
<td>59.6</td>
</tr>
<tr>
<td>EA 12/16 unw. average</td>
<td>45.0</td>
<td>47.0</td>
<td>49.0</td>
<td>51.0</td>
<td>51.9</td>
<td>52.8</td>
<td>53.2</td>
<td>52.9</td>
<td>56.7</td>
<td>56.4</td>
<td>56.7</td>
<td>57.0</td>
<td>57.0</td>
</tr>
</tbody>
</table>


It can be seen that Germany ranks very low in both indices. With a Herfindahl Index of 206, it has one of the least concentrated markets in Europe. The CR5 indicates that the 5 largest banks accounted for only 25 per cent of total business in 2009. The ECB (2005, p. 10) attributes these low figures of concentration partly to the fact that larger countries generally have more fragmented banking markets, and to the large public and cooperative sector. Both indices show that Germany follows the overall trend in the EU, which is toward a more concentrated banking sector. The figures calculated by the ECB have some drawbacks. The most important drawback for this analysis is that the ratios are calculated on individual bank / institution levels and not on consolidated banking group data.
which should be of particular importance for measures of concentration (European Commission, 2006, p. 43).

In the following, we try to overcome this shortcoming and calculate the CRs based on consolidated group data. Using consolidated data, we get a CR3 of 37 per cent and a CR5 of 46 per cent for Germany. The five largest institutions are Deutsche Bank AG, Commerzbank AG, KfW Banking Group, DZ Bank AG and Landesbank Baden-Württemberg (LBBW) (see also Table 3.2). These ratios are already considerably higher than those the ECB has calculated.

**Figure 7.1: Balance sheet size of banks, Germany, 2010 (% of total sector balance sheet)**

[Graph showing balance sheet size of banks, Germany, 2010 (% of total sector balance sheet).]

In Germany, however, there is an additional issue, which should be taken into account. The savings bank sector and the cooperative sector (including their respective regional organisations) are very similar to the structure of a big bank. Together with the fact that the institutions of the respective groups do not compete with each other and closely cooperate in many areas, one could consider the savings bank sector and the cooperative sector, each as one large bank (Paul and Süchting, 1998, p. 32). Taking this into account, we plot Figure 7.1., where the size of each of Germany’s largest banks’ balance sheets is illustrated. It should be noted that we include the balance sheet size of the cooperative and savings bank groups as a whole. With these adjustments, a very different picture regarding concentration and dominance in the German banking industry emerges. Now, the biggest group is the savings bank sector, followed by Deutsche Bank AG, the cooperative sector, Commerzbank AG, and the KfW Banking Group. In this case, concentration is distinctively higher, with a CR3 of 65 per cent and a CR5 of 79 per cent. Moreover, the Herfindahl Index would be above 1800, which would mean a high degree of concentration. In addition, one has to note that Figure 7.1
includes two development banks – the KfW banking group and the NRW Bank. These are not in direct competition with the rest of the banking sector, but rather cooperate with them to fulfil their respective mandates. Taking this into consideration, we highlight the dominance of the savings bank, the cooperative groups, and some large private sector banks in the German banking industry.

However, these ratios and indices can only give a very crude picture of concentration. First of all, banking includes a range of different products, which differ remarkably with regards to their relevant markets. While retail banking services and loans for small companies may be offered by many institutions, very large loans or merger and acquisition (M&A) services may only be offered by a small group of banks. Furthermore, taking the balance sheet as a proxy for business volume may be suitable only for some categories of banking services like loans or deposits, but not for others like underwriting. Therefore, a detailed examination of different business areas is worthwhile.

7.3. Retail banking and regional markets

An important issue for measuring concentration is to decide whether to look at the regional or the national level. This probably depends to a large extent on the product category one is interested in. For most retail products, such as deposits and loans to private households and small and medium sized enterprises, different studies confirm that customers shop around for better rates only in relatively narrow areas (Fischer and Pfeil, 2004, p. 312). Therefore, a regional scope seems adequate for analysing concentration in the markets for retail products.²

The importance of identifying the right market is demonstrated by a study of the European Commission (2006, pp. 53-57). It focuses on retail banking activity in Europe and calculates Concentration Ratios at regional and national levels. Using the proxy of administered current accounts, it finds very low Concentration Ratios for Germany at a national level. However, focusing on regions (NUTS2)³, the Concentration Ratios become very high in Germany. This can be explained by the fact that, at a national level, there are altogether more than 2000 legally independent savings banks.

² One could argue that with increased use of technology in the provision of banking services this delineation has become obsolete. However, at least by now this is not the case. Fischer (2005) provides evidence for the US that in particular in deposit and loan services for average households and small firms the geographical distance has not changed between 1989 and 1998. The European Commission (2006) finds that direct distribution channels like internet banking remain a compliment rather than substitute to branch banking. Despite the fact that the importance of direct banking is growing in Germany (in 2007 16% of all German adults were customers of a direct bank, in 2000 it was only 6%), for most users it is only the second bank, while their main bank is still a traditional bank (Hartmann-Wendels et al., 2010, p. 41).

³ NUTS refers to Nomenclature of Units for Territorial Statistics. It is a standard that divides countries into subdivision. On the NUTS2 level there are regions with a population size of 0.8 – 3 million. In Germany those subdivision are the so-called Regierungsbezirke.
and cooperative banks. At a regional level, however, high Concentration Ratios are explained by the so-called regional-principle: usually only one savings bank and a few cooperative banks are active, which leads to relatively higher Concentration Ratios.

Similar results of relatively high concentration on regional levels are presented by Fischer (2005), who calculates Herfindahl Indices based on the number of branches of one institution in a certain region for 1996 - 2000. He finds increasing consolidation and relatively high concentration in Germany. The index shows average values of 2,000 for the regions of West Germany, and 3,250 for regions of East Germany.

Another study of Fischer and Pfeil (2004) underpins Fischer’ results. They use data on bank branches from 1996 in 83 German cities with more than 100,000 inhabitants. The average CR1 is at 40 per cent. The average CR2 is at 55 per cent and the CR3 at 65 per cent. Fischer and Pfeil (2004) note that the big German private banks appear to be fringe players in most local retail markets. On average, Commerzbank, Deutsche Bank, Dresdner Bank and Hypovereinsbank owned a combined share of 21 per cent of the local branch network, while the local savings banks operate 40 per cent of local branches and cooperative banks run 22 per cent of the branches.

Looking at those two aforementioned studies, it becomes apparent that the German retail banking sector is characterised by a relatively high degree of concentration. However, high concentration does not necessarily mean low competition or higher prices. We will look therefore at the interest margins of German banks in international comparison in the following part.

7.4. Interest rate spreads in Germany and in international comparison

OECD data on bank profitability, bank balance sheets and short-term interest rates were used to calculate a range of figures that can give an indication of the competition among banks (for more details on profitability see also chapter 8). One can first look at the banks’ interest spread as an overall indicator for competition in the banking sector. For this, we calculated the average interest received on interest bearing assets and paid on liabilities, and then took the difference between the two results. The result is depicted in Figure 7.2.

---

4 Differences in interest rate spreads over time and between countries can also be caused by other factors, such as cost structures or risk premiums. To use the spreads as indicators for competition it is assumed here that those other factors are equal between countries and unchanged over time.
For Germany, the interest spread fell from 1984 to 1999; before this period, it increased from 2.4 to 2.9 per cent. Since 1999, the spread has remained relatively stable at around 1.8 per cent. Since the year 2000, the comparative figures for Japan and France have been consistently 0.25 to 0.50 percentage points below the German average. Italy has slowly converged towards the other countries from a relatively high level. Assuming the same cost structure in all countries, competition in Germany seems to be a little lower than in France and Japan, but much higher than in Italy. However, the relatively negligible difference could also be simply related to cost differences, etc. In conclusion, the overall decline in the spread indicates increasing competition in the German banking sector.

In order to get a better idea about the exact developments in the markets for deposits and loans, Table 7.3 depicts more detailed data for Germany. In this case, we took excess of the average interest return on assets over the short term interest rate, and the excess of the short term interest rate over average rate paid on liabilities for German banks. As one can see in the periods from 1980 – 1994, banks could refinance below the average market rate. This changed in subsequent periods, where they had to pay more than the short-term market rate for their liabilities. As Germany had no interest rate regulations at the time that could explain this, it seems as if banks had a certain degree of market power to pay their lenders consistently less than the short-term market rates. This seems to change after 1995, when banks’ costs of refinancing were permanently above the short-term market rate.

A possible explanation for this increase in the refinancing costs of banks can be found in the emergence of money market funds in Germany. For a long time, the Bundesbank resisted allowing money market funds to operate in Germany, mainly due to monetary policy reasons. Harmonisation attempts on a European level forced the Bundesbank to give up its resistance, so that the first money
A money market fund was licensed in 1994. Evidence of the impact of this on banks can be found by looking at the deposit margins of banks, which is the difference between the money market rate and rates on time and savings deposits of equal maturity. Monthly data shows that while deposit margins were relatively stable between 1.8 and 1.4 percentage points from the beginning of 1993, they almost immediately began to decline with the licensing of the first money market funds at the end of 1994 (Fischer and Pfeil, 2004, pp. 321-323). In particular, savings and cooperative banks started to offer innovative and higher yielding forms of saving as competitive pressure picked up (Deutsche Bundesbank, 1997, pp. 51–53). Margins stabilised at about 0.6 percentage points in 1996 (Fischer and Pfeil, 2004, p. 323).

The premium, defined here as the excess of the average interest return that banks earned on their assets over the short term interest rate was consistently lower in the period 1980 – 1994 than in the period thereafter. Banks seemed to have been able to compensate for the cost pressure on the liability side by increased returns on the asset side. However, they were not able to do so completely, which explains the overall declining margin. Using the available data, we cannot distinguish if they had the market power to pass on the costs to their customers, or if they engaged in different or more risky activities to keep up their margins.

Table 7.3: Bank margins, Germany, 1980 – 2009 (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess of the average interest return over the short term interest rate</td>
<td>0.03</td>
<td>1.70</td>
<td>-0.21</td>
<td>2.49</td>
<td>2.13</td>
<td>2.07</td>
</tr>
<tr>
<td>Excess of the short term interest rate over average rate paid on liabilities</td>
<td>2.64</td>
<td>0.75</td>
<td>2.52</td>
<td>-0.51</td>
<td>-0.34</td>
<td>-0.28</td>
</tr>
<tr>
<td>Average short term interest rate*</td>
<td>8.46</td>
<td>5.11</td>
<td>7.98</td>
<td>3.53</td>
<td>3.28</td>
<td>3.08</td>
</tr>
<tr>
<td>Average spread</td>
<td>2.67</td>
<td>2.44</td>
<td>2.30</td>
<td>1.98</td>
<td>1.79</td>
<td>1.79</td>
</tr>
</tbody>
</table>

Source: OECD (2012), own calculations
Notes: * In this case, the OECD uses the 3-month interest rate that is usually the interbank offer rate, or the rate associated with Treasury bills, Certificates of Deposit or comparable instruments. For Germany, it is the 3-month ‘European Interbank Offered Rate’ from 1999.

Judging by the interest margin, competition in German banking seems to be as strong as in other countries. The interest margin already began to decline since the 1980s. However, competition for deposits seems to have become fiercer in Germany since 1994. Not so much among banks themselves, but more due to competition from new non-bank competitors. The banks compensated for this increase in costs by increasing their yields on the asset side.
7.5. Competition in investment banking

The market for underwriting issues of shares and bonds is very different from the retail banking market. Compared to retail banking, it is a global market and comprehensive data is not easily available. Fischer and Pfeil (2004) conduct an analysis of the German market for Initial Public Offerings (IPOs). They calculate Concentration Ratios and the Herfindahl Indices for IPOs of German entities. The results are depicted in Table 7.4.

One can see that the volume of IPOs was relatively small in the years 1990 – 1994. The market was highly concentrated with only between 4 and 7 lead underwriters conducting all issues. The big German private banks dominated (Deutsche Bank, Dresdner Bank, Commerzbank) the market. The only public bank that competed in the underwriting business was the WestLB, one of the German Landesbanken (Fischer and Pfeil, 2004, p. 314).

The number and volume of IPOs picked up in 1995, and the market became more fragmented with more banks competing for business. From 1995 onward, a significant number of foreign banks began to compete in the market. With increased business volume, the market became more contested. The Herfindahl Index indicates only a moderate degree of concentration since 1997.

Table 7.4: Market structure in IPO underwriting, Germany, 1990 – 2000

<table>
<thead>
<tr>
<th>Year</th>
<th>IPO volume (€ mio.) [No. of IPOs]</th>
<th>Herfindhal - bookrunners*</th>
<th>No. of banks acting as lead underwriter</th>
<th>CR3 - Bookrunners</th>
<th>% share of foreign banks in total volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1545.13 [34]</td>
<td>0.32</td>
<td>5</td>
<td>90.05%</td>
<td>0</td>
</tr>
<tr>
<td>1991</td>
<td>1494.84 [19]</td>
<td>0.30</td>
<td>7</td>
<td>84.81%</td>
<td>0</td>
</tr>
<tr>
<td>1992</td>
<td>373.98 [9]</td>
<td>0.34</td>
<td>4</td>
<td>89.34%</td>
<td>0</td>
</tr>
<tr>
<td>1993</td>
<td>475.78 [11]</td>
<td>0.37</td>
<td>4</td>
<td>94.41%</td>
<td>0</td>
</tr>
<tr>
<td>1994</td>
<td>596.73 [15]</td>
<td>0.28</td>
<td>7</td>
<td>77.44%</td>
<td>1.01</td>
</tr>
<tr>
<td>1995</td>
<td>3583.03 [20]</td>
<td>0.29</td>
<td>10</td>
<td>89.12%</td>
<td>35.64</td>
</tr>
<tr>
<td>1996</td>
<td>9054.48 [14]</td>
<td>0.32</td>
<td>9</td>
<td>98.65%</td>
<td>33.24</td>
</tr>
<tr>
<td>1997</td>
<td>2429.75 [36]</td>
<td>0.13</td>
<td>16</td>
<td>47.07%</td>
<td>26.42</td>
</tr>
<tr>
<td>1998</td>
<td>4098.87 [79]</td>
<td>0.08</td>
<td>29</td>
<td>38.52%</td>
<td>27.09</td>
</tr>
<tr>
<td>1999</td>
<td>12731.013 [175]</td>
<td>0.11</td>
<td>46</td>
<td>47.47%</td>
<td>50.12</td>
</tr>
<tr>
<td>2000</td>
<td>25556.29 [153]</td>
<td>0.17</td>
<td>43</td>
<td>65.12%</td>
<td>44.03</td>
</tr>
</tbody>
</table>

Source: Fischer and Pfeil (2004, p. 314)
Notes: for the calculation of market shares, the authors double counted the volume of that issue if two or more banks act as bookrunner for one single issue.
A bookrunner is the main underwriter in equity or debt issuance.
*The Herfindahl Index here runs between 1 and 0 instead of 10,000 and 0.
In Table 7.5 we extend the period of consideration to October 2012, but include only IPOs above 50 million euro. We find a similar picture for the period until 2000. Until 1994, the volume of IPOs was low and the market was highly concentrated. Four banks only shared the market for big IPOs, the big private banks Deutsche Bank and Commerzbank, one public bank Bayern LB, and one foreign bank Goldman Sachs. The market share of foreign banks was, however, only 5 per cent. Market concentration was very high. In the period 1995 – 1999 the volume of IPOs increased by a factor of 20. Concentration fell to a medium degree, while foreign penetration increased remarkably. In particular US-investment banks played an important role. In the period after 2005 the overall volume of IPOs decreased and the market also became less concentrated.

Table 7.5: Market structure in IPO underwriting with volumes above € 50 million, Germany, 1990 – 2012

<table>
<thead>
<tr>
<th>Period</th>
<th>Average yearly IPO volume, in € mio.</th>
<th>CR3</th>
<th>CR5</th>
<th>Herfindahl-Index*</th>
<th>Big 5 Bookrunners</th>
<th>foreign share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990 – 1994</td>
<td>271.51</td>
<td>95%</td>
<td>100%</td>
<td>0.41</td>
<td>Commerzbank, Deutsche Bank, BayernLB, Goldman Sachs</td>
<td>5%</td>
</tr>
<tr>
<td>1995 – 1999</td>
<td>5253.76</td>
<td>52%</td>
<td>74%</td>
<td>0.13</td>
<td>Commerzbank, UBS, Deutsche Bank, BNP, Daiwa Securities</td>
<td>61%</td>
</tr>
<tr>
<td>2000 - 2004</td>
<td>5571.82</td>
<td>65.1%</td>
<td>85.5%</td>
<td>0.19</td>
<td>Deutsche Bank, Goldman Sachs, Commerzbank, UBS, Morgan Stanley</td>
<td>46%</td>
</tr>
<tr>
<td>2005 - 2012</td>
<td>3095.63</td>
<td>45.4%</td>
<td>64.3%</td>
<td>0.11</td>
<td>Deutsche Bank, JPMorgan, Morgan Stanley, UBS, Goldman Sachs</td>
<td>66%</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank (2012), own calculations

Notes: IPOs of German Companies with minimum issue volume of 50 million euro, 2012 only until October. The data provider corrects the past data, when a bank is acquired by or merges with another bank. The transactions conducted are allocated to the new owner in the case of an acquisition and to the new institute in case of a merger, e.g. Commerzbank also includes the IPOs organised by Dresdner Bank, Deutsche Bank includes IPOs organised by Sal. Oppenheim. That means that the concentration measures overstate the actual concentration for the earlier years. *The Herfindhal Index here runs between 1 and 0 instead of 10,000 and 0.

Pfeil and Fischer (2004) also look at the underwriting of bond issues in Germany. Table 7.6, taken from their analysis, shows the top ten book runners for euro-denominated bonds issued or guaranteed by German entities. The overall market appears more fragmented. The most important players were the Deutsche Bank and Dresdner Bank. Commerzbank was the eighth biggest player in the market. Apart from the aforementioned, there was no other German bank among the top 10 underwriters. Indeed, big US-investment banks dominated this business.
Table 7.6: Market structure of euro-denominated bond underwriting, Germany, 2001

<table>
<thead>
<tr>
<th>Position</th>
<th>Bank</th>
<th>Volume in € mio.</th>
<th>No. of issues</th>
<th>% share in volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Dresdner Kleinwort Wasserstein</td>
<td>26.552</td>
<td>168</td>
<td>10.45</td>
</tr>
<tr>
<td>2</td>
<td>Deutsche Bank</td>
<td>24.209</td>
<td>113</td>
<td>9.53</td>
</tr>
<tr>
<td>3</td>
<td>JP Morgan</td>
<td>21.617</td>
<td>40</td>
<td>8.51</td>
</tr>
<tr>
<td>4</td>
<td>Merrill Lynch &amp; Co.</td>
<td>21.446</td>
<td>68</td>
<td>8.44</td>
</tr>
<tr>
<td>5</td>
<td>Salomon Smith Barney Int.</td>
<td>16.113</td>
<td>59</td>
<td>6.34</td>
</tr>
<tr>
<td>6</td>
<td>Morgan Stanley Dean Witter</td>
<td>16.047</td>
<td>68</td>
<td>6.32</td>
</tr>
<tr>
<td>7</td>
<td>Goldman Sachs &amp; Co.</td>
<td>13.660</td>
<td>53</td>
<td>5.38</td>
</tr>
<tr>
<td>8</td>
<td>Commerbank Sec.</td>
<td>10.180</td>
<td>92</td>
<td>4.01</td>
</tr>
<tr>
<td>9</td>
<td>Barclays Capital</td>
<td>9.866</td>
<td>74</td>
<td>3.88</td>
</tr>
<tr>
<td>10</td>
<td>UBS Warburg</td>
<td>8.077</td>
<td>27</td>
<td>3.18</td>
</tr>
</tbody>
</table>

Source: Fischer and Pfeil (2004, p. 315)

A similar picture emerges in the M&A business. For the period analysed, only the Deutsche Bank and the Dresdner Bank played an important role, while a large part of business was conducted by the big US-investment banks (Fischer and Pfeil, 2004, pp. 314-315).

The general situation in investment banking services in Germany at the turn of the century can therefore be described as follows: the German market for investment banking services was heavily invaded by the big US-investment banks. Only the Deutsche Bank and the Dresdner Bank, whose business model is explicitly geared towards investment banking, played an important role in this market (the Dresdner Bank was taken over by the Commerzbank in 2009). The other German banks have had difficulties establishing themselves in this market (Fischer and Pfeil, 2004, p. 315).

7.6. Conclusion

Measured by the common concentration measures and by the number of independent organisations the concentration in German banking is amongst the lowest in Europe. However, when we consider groups and see the cooperative and the public banking sector each as one big institution, we get remarkably higher Concentration Ratios. However, especially for banking, which includes a variety of activities, looking only at the size of the institutions can only give very crude indications about the actual competition in the different market segments. Looking at the regional markets, which is appropriate for the retail business, we find relatively high concentration. Looking at big cities and measuring competition by the number of branches of different institutions in a certain area, it is

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5 For further details see chapter 12.
found that savings banks and cooperative banks are the main players in the retail markets, while the big German banks are rather fringe players. Looking at interest margins we find that there is not much difference to other industrialized countries and that they shrunk in particular since 1995. In particular the entrance of other financial institutions (money market funds) increased competitive pressure in the deposit market.

For investment banking services, the market has only begun to grow since around 1997. The relatively small market was served mainly by German banks and the degree of concentration was very high. When the market started to grow an increasing number of foreign banks became active, so that the market share of foreign banks fluctuated between 40 per cent and 60 per cent in the periods since 1995. The increased number of active players led to a fall in the Concentration Ratios. However, the market for big IPOs is still dominated by a relatively small number of international investment banks. Only two German private banks, namely the Deutsche Bank and the Commerzbank do play an important role in this market today.
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8. Profitability of the financial sector and sub-sectors

8.1. Introduction

This chapter starts with a comparison of the profitability of the German banking sector with that of other developed capitalist economies. It then takes a closer look at the profitability of the sub-sectors of the German banking sector before briefly comparing the profit shares and profitability in the financial corporate sector as a whole with those in the non-financial corporate sector. We try to cover the whole period from the early 1980s till the most recent past if data is available.

8.2. Profitability of the German banking sector in international comparison

In a study on the German banking sector, Hackethal (2004) found deteriorating interest margins in several countries (Germany, France, Italy, UK and the US among others) over the period from 1985 to 1999. Interest margins in Germany were low in this period and were only undercut by those in France, which might imply a high degree of competition in the German banking sector in international comparison – in the previous chapter 7 on competition, however, we have provided a more differentiated picture. The relative importance of fee-based business like asset management, underwriting, advisory services and trading activities had increased internationally, and Hackethal (2004, p. 89) found some indications of a ‘global shift in the focus of banks from traditional commercial banking towards more capital market-oriented services’. However, he admits that ‘(a)lthough German banks have started to catch up, they still seem to be far behind in this regard’. Furthermore, whereas Anglo-Saxon banks had managed to translate this transition in activities into higher returns on equity, in particular by means of cutting costs, German banks had been less successful in this respect and had suffered from falling returns on equity. As a result, by the late 1990s, the return on equity of German banks fell short of that in the US and the UK, but still exceeded rates in France and Italy.
Extending the analysis by Hackethal (2004) till 2009 with data from OECD (2012), we find that the German banking sector as a whole since the early 2000s did not manage to improve the return on equity and the return on assets significantly. The rates of return on assets and on equity have shown a tendency to fall, and the relative position of German banks has even deteriorated, so that it has fallen behind France and Italy, and in some years even behind the crisis ridden Japanese banking sector (Figures 8.1 and 8.3). If government taxation is taken into account, the rates of return on assets and equity after taxes do not show a falling tendency anymore (Figures 8.2 and 8.4). However, the relative position of German banks in terms of profitability does not improve – the German banking sector, together with that of Japan, still shows the lowest rates of return among the countries in the data set. According to the IMF (2011), weak profitability of German banks in international comparison is mainly due to weak revenue generation and less to higher costs, although German banks, and in particular, public savings banks, also show a higher than average...
cost-income ratio. The IMF (2011, p. 17) concludes from this: ‘Arguably, the poor returns in the domestic markets have led the larger and more internationalised banks to take on increase leverage and invest more heavily abroad in search for higher returns.’ In the next section we will check whether this has improved profitability of private banks relative to public and cooperative banks, in particular.

**Figure 8.3: Return on equity (before tax) of the banking sector, 1979 – 2009 (%)**

![Graph showing return on equity before tax for various countries from 1979 to 2009.](image)

Source: OECD (2012)

**Figure 8.4: Return on equity (after tax) of the banking sector, 1979 – 2009 (%)**

![Graph showing return on equity after tax for various countries from 1979 to 2009.](image)

Source: OECD (2012)

### 8.3. Internal comparison of the profitability of the German banking sector

For the comparison of profitability of the subsectors of the German banking sector and its relevance for overall profitability of this sector, we have to bear in mind that in Germany’s universal banking system, 80 per cent of all banks are not strictly profit maximising; around 20 per cent belong to the
public savings bank sector, which in 2012 accounted for close to 30 per cent of total banks’ assets and close to 60 per cent are part of the cooperative banking sector, which in 2012 accounted for close to 12 per cent of total banks’ assets (see Table 3.1 in chapter 3 of this study).

It is striking that the returns on assets before taxes of the public savings banks (without Landesbanken, the regional institutions of the public savings bank sector) and the cooperative banks (without regional cooperative banks) have exceeded the rate of return of the private banks almost consistently since the early 1970s; the latter’s rates of return have also been fluctuating more violently (Figure 8.5). Only when taxation is taken into account do the rates of return of the different subsectors converge (Figure 8.6). For the rates of return on equity a similar pattern emerges. Before taxation this rate has had a tendency to be higher for the public savings and the cooperative banks (without Landesbanken and Genossenschaftliche Zentralbanken) since the mid 1990s, and only in single exceptional years (1998, 2005, 2007) we observe a higher rate of return on equity before taxes in the private banking sector, which is far more unstable (Figure 8.7). However, when taxation is taken into account, the rates of return on equity of the subsectors tend to converge, with the rate in the private banking sector still fluctuating more extensively (Figure 8.8). Although taxation reduces the rates of return in each sector, it relatively favours the private banking sector.

1 This observation is hard to reconcile with the IMF’s (2011, pp. 14-21) finding that German public savings banks, on the one hand, face a higher than average cost-income ratio, and on the other hand provide implicit subsidies to their customers through lending at lower than market rates.
Figure 8.6: Return on assets (after taxes) by banking group, Germany, 1968 – 2010 (%)

Figure 8.7: Return on equity (before taxes) by banking group, Germany, 1994 – 2010 (%)

Figure 8.8: Return on equity (after taxes) by banking group, Germany, 1994 – 2010 (%)

Source: Deutsche Bundesbank (2011)
Including the Landesbanken and the regional cooperative banks into their respective subsectors, profitability ranking slightly changes. Before taxation, the rates of return on assets and equity in the cooperative banking sector are more favourable, and the public sector and private banks show similar profitability, with the rates of return of private banks being more unstable (Figures 8.9 and 8.11). After tax, rates of return converge again, and in particular, the rates of return of private banks improve relative to the public and cooperative sectors (Figures 8.10 and 8.12).

**Figure 8.9: Return on assets (before taxes) by banking group, Germany, 1968 – 2010 (%)**

![Figure 8.9](image1)

**Source:** Deutsche Bundesbank (2011)

**Figure 8.10: Return on assets (after taxes) by banking group, Germany, 1968 – 2010 (%)**

![Figure 8.10](image2)

**Source:** Deutsche Bundesbank (2011)
This change in profitability ranking is due to the particular low profitability of the Landesbanken. This also becomes obvious when looking at the profitability of the big banks in each sector and applying the same criteria as above. Regarding the rates of return on assets before taxes we find that the big private banks display above average profitability, with higher volatility, whereas the big banks in the public savings banks sector, the Landesbanken, perform well below average (Figure 8.13). The regional cooperative banks perform close to average. A similar pattern emerges for the rate of return on assets after taxes (Figure 8.14). Looking at the rate of return on equity, the advantage of the big private banks, compared to the big banks in the cooperative banking sector, disappears, whereas the Landesbanken are lagging behind as well. This is true for this rate of return before and after taxes (Figures 8.15 and 8.16).
Figure 8.13: Return on assets (before taxes) for big banks, Germany, 1968 – 2010 (%)

Source: Deutsche Bundesbank (2011)

Figure 8.14: Return on assets (after taxes) for big banks, Germany, 1968 – 2010 (%)

Source: Deutsche Bundesbank (2011)

Figure 8.15: Return on equity (before taxes) for big banks, Germany, 1994 – 2010 (%)

Source: Deutsche Bundesbank (2011)
Summing up so far, the profitability of German banks in international comparison has been below average since the early 1980s; pre-tax profitability has shown a tendency to fall from the early 1980s till the recent crisis, whereas after-tax profitability has not; pre-tax profitability of the public savings banks, excluding the Landesbanken, and the cooperative bank sectors, excluding the Genossenschaftlichen Zentralbanken, has been higher than that of the private banking sector with the latter being far more volatile, whereas after-tax profitability has shown no clear hierarchy. Including the Landesbanken and the Genossenschaftlichen Zentralbanken into their respective sectors preserves the pre-tax profitability advantage of the cooperative sector, but not of the public sector savings banks, because of the particular low profitability of the Landesbanken. After-tax profitability convergences and private banks gain relatively most from government re-distribution. With respect to the big banks in each of the sectors, pre- and after-tax profitability of the big private banks has been above average, whereas the big public savings banks, the Landesbanken, have performed well below average, at least with respect to the rate of return on assets.

8.4. Comparison of the profitability of the financial corporate sector with the non-financial corporate sector

Comparing rates of return across different sectors is a difficult task, in particular, when it comes to the comparison of non-financial and financial corporations because the sources of profits are radically different. Whereas the non-financial sector still derives most of its profits from the production of goods or services, although with a falling tendency as shown in chapter 2 of this study, the non-financial sector – by definition – gains a major part of profits from interest differentials in borrowing and lending. Furthermore, it is unclear what should be taken as a denominator when
calculating rates of return because due to its specific borrowing and lending activities the balance sheet of the financial sector gets dramatically expanded when compared to the non-financial sector. In this section we will therefore only compare sectoral profit shares derived from production and sectoral rates of return on equity.

The sectoral profit share relates the sectoral operating surplus to the sectoral value added and provides some information about distribution of net value added produced in each sector between capital and labour. In an earlier study on the US and Germany, Dünhaupt (2012) found for Germany that since the early 1980s the wage share in the financial corporate sector has been fluctuating around 70 per cent without any long-run downward or upward tendency, whereas the wage share in the non-financial corporate sector having been around 75 per cent until the mid 1990s showed a considerable downward tendency from then until 2006 and therefore fell to the level of the financial corporate sector. This has dominated the fall in the wage share in the corporate sector as a whole since the early 1980s. Our data broadly confirm this finding (Figure 8.17). The profit share in the non-financial corporate sector, starting from a lower level in the early 1980s, has shown a tendency to rise since then, in particular, since the mid 1990s until the recent crisis with only minor fluctuations, and has exceeded the profit share in the financial corporate sector since the early 2000s. The latter has shown no pronounced trend, but has displayed wide fluctuations with massive declines during the crises in the early 2000s and the most recent financial and economic crises.

Figure 8.17: Sectoral net operating surplus, Germany, 1980-2011 (% of sectoral net value added)

Source: Statistisches Bundesamt (2012)

For the calculation of the rates of return on equity we started from the net operating surplus of each sector, subtracted interest and rent payments, and added capital income received, i.e. interest, dividends and rents. These profits net of interest have then been related to the equity advanced in each of the sectors. Of course, this rate of return on equity is a pre-tax rate. As can be seen in Figure 8.18, the pattern for the financial corporate sector broadly replicates the falling trend for the banking sector.
sector discovered above. What is striking is that, although the financial and the non-financial sectors had a similar rate of return on equity in the early 1990s, in the non-financial sector we observe a rising trend since then contrasting the falling trend of the financial corporate sector. This rising trend can be, at least partly, related to the rising profit share in the non-financial corporate sector – financial corporations have not seen such an increase.

Figure 8.18: Sectoral returns on equity, Germany, 1992 – 2009 (%)

![Graph showing sectoral returns on equity](source)

Source: Statistisches Bundesamt (2012)

8.5. Conclusion

Regarding profitability of the financial sector we can summarise our main findings as follows.

Profitability of German banks in international comparison has been below average since the early 1980s; pre-tax profitability has shown a tendency to fall since the early 1980s till the recent crisis, whereas after-tax profitability has not. Pre-tax profitability of the public savings banks, excluding the Landesbanken, and the cooperative bank sectors, excluding the regional cooperative institutions, has been higher than that of the private banking sector with the latter being far more volatile, whereas after-tax profitability has shown no clear hierarchy. Including the Landesbanken and the regional cooperative institutions into their respective sectors preserves the pre-tax profitability advantage of the cooperative sector, but not of the public sector savings banks, because of the particular low profitability of the Landesbanken. After-tax profitability convergences and private banks gain relatively most from government re-distribution.

Comparing the profit shares of the financial corporate sector to the non-financial corporate sector, we have found that the former has shown no pronounced trend since the early 1980s, but has displayed wide fluctuations with massive declines during the crises in the early 2000s and the most recent financial and economic crises. The profit share in the non-financial corporate sector, however,
starting from a lower level in the early 1980s, has shown a tendency to rise since then, in particular, since the mid 1990s until the recent crisis with only minor fluctuations, and has exceeded the profit share in the financial corporate sector since the early 2000s.

For the rate of return of the financial corporate sector we have also found a falling trend, as for the banking sector. Although the financial and the non-financial sectors had similar rates of return on equity in the early 1990s, in the non-financial sector we observed a rising trend since then contrasting the falling trend of the financial corporate sector. This rising trend can be, at least partly, related to the rising profit share in the non-financial corporate sector – German financial corporations have not seen such an increase.
References


Data Sources


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9. Efficiency of the financial sector

9.1. Introduction

There is a general perception that the efficiency of German banks is low. Sheldon (2000) refers to some prevailing expert knowledge that suggested around 2000 that the German banking system is rather inefficient. This view does not seem to have changed by the onset of the financial crisis, when the German Council of Economic Experts characterised the German banking system as having low profit and cost efficiency (SVR, 2008), nor during the further course of the crisis when the German banking system proved relatively resilient (IMF, 2011). Also the prescribed remedy is relatively uniform and unchanged. The German Council of Economic Experts, the IMF and also the OECD (Hüfner, 2010) urge consolidation in the cooperative and public banking sector through mergers and acquisition and for an opening up of the public banking sector for private capital.

This chapter will assess the available literature on the efficiency of the German banking sector to see whether this widely held view is supported by the evidence and, if so, whether there is evidence that the prescribed opening up of the public and cooperative banking sector for private capital and general consolidation would be helpful to improve efficiency. Therefore, we will first give a general overview of the different approaches and techniques used to determine efficiency of banking. Thereafter, we will examine international studies, where the efficiency of the German banking system is compared with that in other countries. Subsequently, we will look at studies that solely focus on Germany and the efficiency of different segments of the German banking system. Before some conclusions are drawn, it is looked at the effect of mergers and acquisitions on the efficiency of German banks.

9.2. Approaches towards efficiency

In the literature on bank efficiency an attempt is made to measure the departure of single banks from an optimal input-output relation. The degree of inefficiency is defined as the distance of a bank from a production frontier, which is the optimal input-output relation found in the observed sample and which provides the benchmark. If a bank’s actual production point lies on the frontier, it is perfectly efficient. If it is below the frontier, it is regarded as inefficient, with the ratio of observed output to potential output, giving the level of efficiency of a particular bank. For example, if the efficiency score of a bank is calculated as 90 per cent, the respective bank could reduce its cost by 10 per cent without altering its output vector.
The main approaches in this area can be categorised by the applied assumptions and techniques to
determine the efficient frontier. Parametric approaches estimate the frontier with statistical
methods, while non-parametric approaches use linear programming to calculate piecewise linear
segments of the efficient frontier. The parametric approaches need to impose an explicit functional
form for the frontier, as well as for the deviations from this frontier. Non-parametric methods do not
need to make these a-priori assumptions. Furthermore, one can distinguish between stochastic and
deterministic approaches. With regards to the latter, deviations from the efficient frontier are
completely attributed to inefficiency, while the former also allows for random noise. Two main
methods are stochastic frontier analysis (SFA), which is stochastic and parametric, and data envelop
analysis (DEA), which is deterministic and non-parametric (Fiorentino et al., 2006). The thick frontier
approach (TFA) is used less often; it assumes that cost differences within a quartile of, for example,
the least efficient banks is due to random effects, while the cost differences between the quartiles
are due to inefficiency. The distribution free approach (DFA) is based on the assumption that
efficiency persists, while random errors cancel each other out over time (Maudos, et al., 1999).

One of the main problems for the studying of efficiency is that it seems that the results are not
robust to the technique applied. For US-Data this is shown by Bauer et al. (1998) and for European
banks by Weill (2004). For German data large differences between SFA and DEA are reported if the
samples are not homogenous enough (Fiorentino et al., 2006).

Besides the differences in the methods the authors apply, studies differ in the variables that define
input and output. While for regular non-financial firms the choices may be relatively straightforward,
the definition of banks’ inputs and outputs is more difficult, and may change the measured efficiency
considerably. The choice of inputs and outputs depends on the author’s view on the function of the
banking sector. Authors following the production approach see the function of banks mainly in
servicing deposit and loan accounts. Hence, output is defined as the number of accounts and input as
the banks’ operating costs. In contrast, the intermediation approach stresses the banks’ role as
intermediaries between depositors and borrowers. Output is therefore defined as investments and
loans, while inputs are operating costs and deposits. There are also combinations of both approaches
(Sheldon, 2000). Overall, the variety of choices researchers have to make leads to a relatively low
consistency of the measured efficiency across studies (Fiorentino et al., 2006).

The different studies also focus on different forms of efficiency. Basically, one can distinguish profit
and cost efficiency. Cost differences can stem from two sources: inefficient operations, meaning the
above mentioned deviation from a best practice frontier (frontier inefficiency\(^1\)) or unexploited economies of scale or scope, meaning a suboptimal size or output mix (Sheldon, 2000). Profit efficiency, in turn, describes banks’ ability to generate revenue, by choosing the right combination of prices for output and quantity of input (framework with market power) or the amounts of input and output quantities (perfectly competitive markets) (Maudos et al., 1999).

9.3. Efficiency of the German banking sector in international comparison

In the following we will first look at studies that compare the efficiency levels of different countries against a best-practice frontier build from an international sample of banks.

Sheldon (2000) gives a good overview of older cross-country studies published between 1994 and 1999. Some of them focus on cost efficiency, some measure profit and cost efficiency. According to some ‘expert’-knowledge prevailing around 2000, banks in Germany and France, as well as in most southern European countries should be less efficient than banks in the rest of Europe. Among the reasons for this in the case of Germany more severe regulation, public policy and financial conservatism are mentioned. Contrary to this view, in the nine studies that include Germany, Germany ranks three times among the most efficient systems and never among the least efficient ones.

An interesting earlier study that included Germany was conducted by Lozano et al. (1997). They use data envelop analysis (DEA) and take a production approach regarding their choice of inputs and outputs to compare the efficiency of banks in Belgium, Denmark, France, Germany, Italy, Luxembourg, the Netherlands, Portugal, Spain and the UK. While most international studies did build a common frontier from all banks and regarded the differences in efficiency as attributable to bank managerial decisions, the authors included variables that account for country specific environmental factors. The environmental factors taken into account include the general economic development, the geographic conditions, as well as the regulatory and competitive framework. The data they use included 612 banks of which 203 were German. Only private commercial banks were examined in

\(^1\) ‘Frontier inefficiency has come to be termed X-inefficiency, an expression coined by Leibenstein (1966). However as originally conceived, X-inefficiency only pertained to technical inefficiency, which refers to the excessive use of factor inputs to achieve a given output level (deviations from a production frontier), and excluded allocative inefficiency, which pertains to the use of factor combinations at odds with relative factor prices. Together, technical and allocative inefficiency constitute deviations from a minimum cost frontier.’ (Sheldon, 2000, p. 2) In the following, we will use the terms frontier inefficiency and X-inefficiency interchangeably, since that is quiet common in the literature.
this study. They first measured the internal efficiency for each country separately. Here, Germany shows low relative efficiency. With an average efficiency of 51.4 per cent it ranks amongst the lowest together with France, the UK and Luxembourg. However, this means only that there are large efficiency differences among German banks, while, for example, for Italy, which has an average efficiency of 85.6 per cent, the deviations from the most efficient practice found in the Italian sample are smaller. Nothing can be said about the absolute efficiency difference between German and Italian banks, since the efficiency score only expresses the deviation from the most efficient bank in each country separately. Pooling the data and building a common international frontier without considering the environmental factors they obtain efficiency levels between 16.4 per cent for Portugal and 52.5 per cent for Luxembourg. Germany ranks fourth with an average efficiency of 39.9 per cent, and is just behind Belgium and the Netherlands. When they include the environmental variables the picture changes considerably. Spain seems to be most efficient now, given its environmental conditions, while Germany ranks fifth. Eventually, they note that the larger and the more heterogeneous the sample of one country is, the more likely a larger number of inefficient banks enters the score. Therefore, they modify the data set to correct this and eventually find that, considering their national environmental circumstances, Spain and Denmark have the most efficient banking systems. Germany ranks third with an efficiency score of 96.5 per cent. The models suggest that about 20 per cent of the inefficiency observed for Germany is not due to managerial inefficiencies, but because of environmental factors, e.g. a lower density of deposits.

Maudos et al. (1999) conduct an international study using different parametric approaches to measure cost-, as well as profit efficiency of banks in 11 EU-countries. They obtain their data from the Bankscope database and include 879 banks for the period from 1993 – 1996 (468 from Germany). Regarding their choice of inputs and outputs they follow the intermediation approach. For their preferred truncation point of 5 per cent they find average EU-values for cost efficiency of 90.7 per cent to 91.4 per cent depending on the estimation method. Germany scores between 86.5 and 87.3 per cent and ranks ninth regarding cost efficiency. Looking at profit efficiency the estimated EU-average is between 82.6 and 84.3 per cent. Germany scores between 82.7 and 86.8 per cent and ranks fourth or fifth.

Sheldon (2000) used data envelop analysis (DEA) and a production approach to examine cost- and profit efficiency for different countries for the period 1993 to 1997. In the sample of 17 European countries Germany ranks thirteenth for cost efficiency and twelfth for profit efficiency. When the author corrects for risk, Germany moves up in both categories by two ranks. The study also notes that the variation of bank efficiency in Germany is particularly low. A low variation means that within Germany the efficiency differences are low, which points to a relatively competitive banking market.
Regarding economies of scale, the study finds a mixed picture for Germany. Depending on whether risk is included or not, the German banks are either too large or too small. For the whole sample of all countries the author reports an optimal size of 0.5 – 1.5 billion US-dollars in total assets. However, scale efficiency seems to be of minor importance. Only 10 per cent of the measured inefficiency is related to suboptimal size, and the rest is related to X-inefficiency.

Casu and Molyneux (2000) use data envelop analysis (DEA) and follow the intermediation approach to estimate the inefficiency of banks in France, Germany, Italy, Spain and the UK for the period from 1993 to 1997. They focus on the 150 largest institutions in each country and remove some country-specific institutions, so that the employed sample consists of 530 banks. They employ what they call a bootstrapping technique to overcome some of the weaknesses of DEA. Additionally they regress country-specific and environmental factors on the obtained efficiency measures to estimate their effect on efficiency. The results suggest the UK has the most efficient banks, followed by Germany, France, Spain and Italy in 1997. The average inefficiency of German banks is 23.8 per cent. Looking at their estimations to explain the efficiency differences among the countries, they find that country-specific factors are still the most important determinant of efficiency. According to their view this could be related to different regulations, but also to different managerial strategies. In line with most other studies they did not find evidence of an influence of the ownership type (public, private, cooperative).

In a cross-country study Carbo et al. (2002) compare the efficiency of savings banks between different countries. They use stochastic frontier analysis (SFA) and an intermediation approach to provide efficiency estimates for a sample from 1989 to 1996, containing data for 140 – 850 savings banks per year for 12 countries. For Germany they find scale inefficiency of about 7.5 per cent, which is slightly better than the EU average. Regarding X-inefficiency, German savings banks reach a level of 21.2 per cent and rank third most efficient in the sample behind Sweden (there is only one Swedish bank in the sample) and Austria. The average X-inefficiency is 21.8 per cent. They find that measured X-inefficiency is lower for smaller banks. It is interesting to note, that not all savings bank sectors follow the same model in the different countries. The authors distinguish the state-model (typical for Germany – savings banks are non-profit oriented and owned by municipal authorities), the mixed model (Spain – owned by municipal authorities, depositors and employees), and the in-transition and marketised model (e.g. Italy or UK – savings banks are mostly demutualised or in the transformation process). The results seem to suggest that X-inefficiency is larger in the marketised and in-transition models. It is not clear to the authors, though, whether this is caused by the chosen model or by other factors.
Bos and Schmiedel (2006) use a new method of estimating a meta-frontier that allows for a fairer international comparison of different groups of banks. They include large commercial banks from 15 European countries in their sample and compare cost and profit efficiency for the period 1993 - 2004. With their method they find relatively high cost efficiency for German banks of 84.1 per cent (seventh rank, average 79.8 per cent). However, profit efficiency for German commercial banks is very low. Germany ranks last with an efficiency score of 43.3 per cent (average 58.4 per cent).

The German Council of Economic Experts asked the IMF to update a previous study on the efficiency of the German banking system for them. It estimates the cost efficiency of German banks in international comparison using the stochastic frontier approach (SFA). The sample is restricted to banks with assets above 500 million US-dollars and therefore covers only 757 German banks. The reported results suggest that German banks are the least efficient among a sample of French, Italian, Spanish, British and American banks (SVR, 2008).

9.4. **Efficiency of different segments of the German banking sector**

The following section looks at studies that focus on Germany in particular and measure the internal efficiency or the efficiency of different segments of the banking sector.

Berger and Humphrey (1997) reviewed existing studies on efficiency of banks. Overall, they identified 130 studies among which 3 dealt with Germany. Here efficiency scores for Germany of 77 - 81 per cent, 93 per cent and 54 - 61 per cent were found in studies published in 1995 and 1996.

Lang and Welzel (1998) specify a multi-product translog cost function and follow the thick-frontier approach (TFA) to analyse the efficiency of the German banking sector. They apply the intermediation approach. They construct their sample from different sources, so that it includes 1,490 banks, of which 200 are private banks, 373 savings banks and 975 cooperative banks. Therefore, they cover about 40 per cent of the German banking sector. With their approach they are able to distinguish different cost factors. They find that positive economies of scale effects are only achieved up to an average balance sheet size of 1 to 2.5 billion euro. They thereafter find mild diseconomies of scale. Distinguishing operational costs from other costs, they find that the negative size effect stems mainly from the higher costs of raising deposits for large banks, while average operational costs still fall with increasing output. They also find no or negative economies of scope. This indicates no advantage from having universal banks. However, they do not consider the effect which combining different activities has for risk diversification.

A particularly interesting study was carried out by Altunbas et al. (2001). They examine the efficiency differences between different types of ownership within the German banking market, distinguishing
public, private and cooperative banks. The authors employ stochastic frontier analysis (SFA) and the distribution free approach (DFA) and chose the intermediation approach for their choice of inputs and outputs. Their sample covers the time between 1989 and 1996. They produce efficiency estimates based on individual frontiers for all three ownership types as well as on a common frontier. They find positive economies of scale for all types of banks, which means that larger banks exhibit higher efficiency. Based on their estimates, they find that the mutual and public banks are slightly more cost and profit-efficient than their private counterparts. This is a finding that clearly runs counter to the general perception of the inefficiency of public firms compared to the private ones.

An IMF study by Hauner (2004) tries to find the reasons for efficiency differences among large German and Austrian banks using date envelope analysis (DEA). His sample comprises 97 banks with total assets above 5 billion and covers the period 1995 – 1999. He finds that on average German banks are more efficient than Austrian ones. German cost efficiency is at 66 per cent, while Austrian is at 42 per cent. Looking at the scale efficiency he finds that medium sized banks (balance sheet size of 10 – 100 billion euro) are most efficient, followed by small banks (less than 10 billion euro) and with large banks being least efficient (more than 100 billion euro). However, the scale inefficiency is negligible compared to other forms of inefficiencies. Using regression analysis to examine the factors explaining efficiency differences, he finds positive results for scale, but negative ones for scope. That means that in general, large banks would be favourable\(^2\), but diversification could be rather detrimental. Additionally, he finds that cooperative banks do not deviate from private banks regarding their efficiency, while state-owned banks are more cost efficient. The authors relate this to favourable credit ratings due to state-ownership, supported by the fact that the included dummy for non-state-owned savings banks is negative. The author has to condition his argument, however, due to the fact that most of the funding of savings banks comes from deposits.

Koetter (2005a) measures efficiency within the German banking system. He follows the intermediation approach and uses stochastic frontier analysis (SFA) on a sample of 32,211 observations for the years 1993 – 2003. Unlike other studies, using this methodology the author gives up the assumption of perfect input markets and uses alternative input-prices depending on the regional market a bank is operating in.

Comparing the results of the standard model with the model that uses alternative input prices the mean efficiency falls from 91.5 to 87.7 per cent. Koetter finds also that banks located in Eastern Germany perform consistently worse regarding cost efficiency. Besides this he groups the banks into

\(^2\) This result is at odds with what he found earlier when he compared sub-samples. Therefore, he also tests for a U-shaped cost curve, but the results still suggest positive economies of scale for all size classes.
four categories: local private banks, local cooperative banks, local savings banks and as a fourth group nationally active banks from all groups. In the standard model it is found that local cooperative banks are the most cost-efficient, local savings banks come second, nationally active banks of all groups are third and, finally, local private banks are last. If input prices are considered, large banks rank last and private local banks third.

Looking at profit efficiency, Koetter (2005a) finds that with the standard model he obtains an average inefficiency level of 64.7 per cent, and with alternative input prices of 64.3 per cent. Regarding the regional profit efficiency, one cannot find a clear pattern anymore, but most of the banks located in eastern states perform relatively well now. As with cost efficiency nationally active banks perform worst, followed by local private banks. Local savings banks rank first and cooperative banks second. Besides size, the following factors are found to increase cost-inefficiency: more risky assets; active risk management, and too high market concentration.\(^3\)

Koetter (2006) uses stochastic frontier analysis (SFA) and estimates efficiency scores for the whole German banking system for the period 1993 – 2004. Regarding his input and output decision he follows the intermediation approach and also includes off-balance sheet items. Different from other studies, besides the common cost and profit efficiency, he measures risk-return efficiency (RRE). He uses the utility maximisation assumption and obtains with the help of what he terms an Almost Ideal Demand System the expected return and associated risk. From this he quantifies the RRE, which shows the ability of banks to choose an efficient combination of risk and returns. A RRE of 90 per cent would, for example, mean that returns could be 10 per cent higher without increasing the exposure to risk. While the focus is on RRE, the author also obtains cost efficiency and profit efficiency measures. Cost efficiency amounts to 77.1 per cent and profit efficiency to 55 per cent. Those values are in a normal range. The measured RRE is higher at 83.8 per cent. From the large difference, in particular between profit- and risk-return-efficiency, the author concludes that the simple measure of profit efficiency fails to include the possibility that banks may consciously chose less return in exchange for a less risky portfolio. This in part could also explain the rather bad results regarding profit generation for German banks in international comparison. If it is not adequately accounted for the incurred risks, and German bank managers are relatively more risk-averse, than only looking at profit efficiency will bias the results in favour of more risk-prone banking systems. Koetter (2006) also controls for group-specific effects, as well as for size. He finds in his preferred specification that local savings banks are the most risk-return efficient, followed by local

\(^3\) The author did not find a negative cost-efficiency effect from higher concentration per se. Only from a certain level on, he finds a negative effect from high concentration on cost efficiency, which he relates to foregone cost saving due to a lack of market pressure.
cooperatives, local private commercial and, finally, nationally active banks⁴. Additionally, he finds increasingly worse risk return efficiency with size. The negative effect starts from a mean balance sheet size of 339 million euro – far smaller than many banks in Germany.

9.5. The effect of mergers on efficiency of the banking sector

This section will briefly examine the results of studies that tried to measure the effect of mergers on efficiency. Lang and Welzel (1999) examine the effect that mergers among cooperative banks had on their efficiency. The sample comprises all Bavarian cooperative banks and mergers that took place in the period from 1989 – 97. All together they examine 283 mergers. They are able to distinguish between size- and X-efficiency. As an average value for the sample, they find X-efficiency of 92 per cent for the sample. For the effect of mergers they find that there are no substantial cost decreases due to the size effect of mergers. The mean effect of a merger ranges from +0.5 per cent in costs if no branch of the acquired bank is closed to -2.1 per cent when all branches of the acquired bank are closed. Additionally, they cannot find any evidence for X-efficiency gains of the merged banks, i.e. there is no transfer of superior management skills and the like.

The results regarding the cost-benefits of mergers are confirmed by Koetter (2005b), who finds that only every second merger is a success, and that the gains in cost efficiency are around a mere percentage point. For Germany those results indicate that there is much more to gain from increasing management efficiency at a given scale instead of pushing for consolidation within, or even across, the different subsectors of private, public and cooperative banks.

Another recent empirical study adds to the evidence of the effect of mergers and acquisitions on bank efficiency. Georgiev (n.d.) compares merged and non-merged savings banks in Germany regarding different accounting measures. It is found that merged banks improve their return on equity and also their cost-income ratio. He does not, however, measure where those improvements come from (increased market power, economies of scale, etc.). He examines the results of the mergers further by looking at the effect on deposit rates and lending to small and medium sized enterprises (SMEs). He distinguishes between large mergers (merged bank larger than 2 billion US-dollars) and small mergers (merged bank smaller than 2 billion US-dollars). Here he finds that there is a positive effect through mergers on lending to SMEs for small mergers only. For large German mergers he finds a positive effect in the long run which, however, is countered by a general negative effect of bank size on lending to SMEs.

⁴ Includes Commerzbank, Deutsche Bank, Dresdner Bank, Hypovereinsbank, Postbank, regional cooperative institutions and the Landesbanken.
9.6. Conclusion

The international evidence regarding the efficiency of the German system is mixed. There are studies in which evidence for a relatively inefficient system is found. But at the same time, there are as many studies that rank it as intermediate, and there are also studies which put it among the top three. This is mostly the case if the authors consider country specific factors or keep the sample relatively homogenous so that, for example, only commercial banks or savings banks are included.

Judging profit- and cost efficiency comparisons on an international level, one has to keep in mind that a large part of the German system consists of cooperative and savings banks that are not aiming at maximising profits. Hence, profit efficiency may be lower than for countries which have only profit oriented banks. Savings banks use part of the surplus to promote community activities and are also obliged to provide financial services to all customers, regardless of the profitability of the business relationship. Additionally, it seems that savings banks lend below market rates and therefore provide subsidised finance to firms. Cooperative banks, in turn, try to benefit their customers and members. In particular, studies that do not integrate those differences in their estimation models will overestimate cost-inefficiency and underestimate profit efficiency.

Looking at the national level, most of the studies find that local banks are normally superior to the big nationally active banks in terms of efficiency. Additionally, most studies find that regarding profit and cost efficiency public and cooperative banks do not perform worse than private banks and in most cases even perform better. Additionally, it is found that taking the risk return trade-off into account and calculating risk return efficiency that small local banks are more efficient than big nationally active banks. Among local banks public and cooperative banks are more efficient than private banks. There is therefore no evidence that opening up the public sector for private capital would improve the efficiency of the German banking system.

Regarding the optimal size to maximise economies of scale, there is no clear consensus. However, all but one study find that from a certain size, there are diseconomies of scale. The suggested size in total assets of the studies is 0.5 – 1.5 billion US-dollars (Sheldon, 2000), 1 – 2.5 billion euro (Lang and Welzel, 1998) and 10 – 100 billion euro (Hauner, 2004). Regarding the optimal risk return choices, a negative effect was measured above an average size of 339 million euro (Koetter, 2006). Since most studies found the optimal scale in a lower range, one should rather take these as a desirable target size. If we take the optimal size at 2.5 billion euro, about 28 per cent of the savings banks could increase their scale efficiency through mergers, as could about 90 per cent of the cooperative banks.

Additionally, Hauner (2004) first finds lower efficiency levels for larger banks, but positive economies of scale in all size classes.

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5 Additionally, Hauner (2004) first finds lower efficiency levels for larger banks, but positive economies of scale in all size classes.
(DSGV, 2011 and BVR, 2011). Adding the evidence that only small parts of inefficiency are explained by suboptimal size, the fact that the optimal size is not known and the rather low threshold where risk return decisions deteriorate, the consolidation strategy to improve efficiency does not seem to be the most promising road. This is particularly true if one keeps in mind the evidence on mergers that suggest rather limited improvements in efficiency and the negative effect of bank size on loans to small and medium sized companies, which are an important part of the German economy. Additionally, some of the scale effects may already be achieved by cooperatives and savings banks due the pooling of activities within the group that promise positive economies of scale. By contrast the big German banks are way above the largest estimated optimal size. If the current too-big-to-fail discussion actually leads to a downscaling of those institutions, the result may even be efficiency gains.

Additionally, the few studies that tried to find evidence for economies of scope did not find any, or even negative effects of combining different forms of output. From an efficiency point of view, a separation between investment and commercial banking might therefore not be a problem.
References


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**Data Sources**


III. Finance and the non-financial sector
10. The changing roles of availability and sources of funds

10.1. Introduction

The following chapter tries to shed some light on the ownership and the sources of funds for corporations and economic institutions. Here, we will first have a look from a sectoral perspective to find out which sectors have a surplus and which have a deficit of funds. Thereafter, we will have a short look at the portfolio decision of households to determine in which form they hold their financial assets (intermediaries or direct investment). Since the households are not directly investing their funds into companies but prefer to put them with intermediaries, we look at the distribution of ownership shares within the economy to determine whether changes have taken place since the 1990s. A more detailed discussion of the relationship of the financial sector with the non-financial business sector and the private household sector will be provided in chapters 11 and 14.

10.2. Financial balances of different sectors

The net-financial flows of the main sectors of the German economy for the period from 1991 to 2012 are shown in Figure 10.1. Households accumulated financial surpluses over the entire period. These were absorbed until around 2001 mainly by the government and non-financial corporations (NFCs). Thereafter, the NFCs switched to a net-saver position. The banks also started accumulating a surplus of financial assets. These surpluses of funds were taken up by the government and to a large extent by the foreign sector.

Koo (2009) argues that the reason why German non-financial corporations switched to a net-saver position was a balance sheet recession caused by the bursting of the stock market bubble in 2000. The collapse of share prices left many companies with excessive debt and some were even technically insolvent. However, even if the balance sheet was severely damaged, most firms still had a working business model and positive cash-flows. He argues that German firms used their cash-flows to pay down debt and repair their balance sheets. He also argues that when German households increased their savings after 2000 that made the situation even more serious than in Japan. Fiscal policies were restricted by the Maastricht Treaty and therefore the government could only take up the other sectors’ surpluses to a limited degree. Recessionary tendencies, stagnating wages and competitive firms in Germany and strong growth in other parts of the Euro area then led to the increasing export surpluses which enabled firms to slowly repair their balance sheets. This however was achieved by pushing the foreign sector into a net-deficit position.
The net financial position of the main sectors of the German economy is shown in Figure 10.2. At the beginning of 1991 the picture was as follows. Households were the main net owners of financial funds (983 billion euro), while all other sectors were net borrowers. The largest part of the funds was absorbed by non-financial corporations (715 billion euro) and to a considerable part abroad (216 billion). The rest was absorbed by the government (110 billion) and the financial sector (156 billion) which was also in deficit.

Since then households have strengthened their net financial position to reach about 3,250 billion euro by mid-2012. Firms only increased their net indebtedness to 1,390 billion, and the main part of the household savings were taken up by the government, which faced an increasingly negative net position during this period (-1,349 billion). The financial sector continued to register a small negative position until the onsest of the recent financial crisis, when it moved into a positive position. This was mainly due to a strong improvement in the position of the banking sector (which appears to been driven mainly by valuation changes). Since 2006 the position of the rest of the world (ROW) also deteriorated remarkably.
To sum up, up until 2001 the main borrowers of funds are non-financial corporations and the government. Funds are provided largely by private households and the financial sector’s position is close to balance. However, since 2002, the dynamics of the system have changed. While households are still the main suppliers of funds, non-financial corporations joined them in most years after 2002. With the government only partly absorbing these surpluses, lending to the rest of the world has increased.

10.3. Portfolio decisions of private households

As one can see from Figure 10.3 (and in the more detailed analysis in chapter 14) households do not provide funds directly to borrowers, but deposit them largely with intermediaries. Direct equity investments are relatively small. Also direct investment in debt securities is of minor importance. The main part of financial surpluses is placed with intermediaries, particularly with banks and insurance companies and to a lesser degree with investment funds. This is reflected in the balance sheets (Figure 14.6 in chapter 14) of the households. At the end of 2010, 84 per cent of their financial claims were against financial intermediaries. Therefore, despite the fact that the eventual owners of the funds are mainly private households, the investment decisions are made by intermediaries. Those decisions have a decisive influence on the distribution of funds in financial markets and may therefore also influence corporate governance.
10.4. Ownership of the German corporate sector

As most funds have been placed with financial intermediaries, rather than invested directly in corporations, to find out more about the ownership of the corporate sector, this section will examine who holds the ownership rights directly and is therefore in a position to influence corporate governance.

The holdings of different sectors of domestic companies’ outstanding shares by market value are shown in Figure 10.4. In 1991 the most important shareholders were non-financial corporations. However, their share declined constantly until 2006. The second most important shareholders were households, which held about 20 per cent of the outstanding shares, but also with a declining trend, so that by 2012 they only held 10 per cent of the outstanding shares directly. This could be related to the increase in the share of other financial institutions (including investment funds), which rose from 1991 until around 2000. Possibly, private households reduced direct holding of shares in favour of indirect holdings in the form of investment funds. Banks also decreased their holdings of shares slowly from 1997 on. The most remarkable trend however is the increase of foreign shareholdings. While in terms of market value foreigners only held 10 per cent of the value of German stock companies in 1995 they had increased their holdings to 38 per cent by 2008. Here, one can see the general trend towards more internationalisation during this period.
The ownership of German firms that are not joint stock companies is shown in Figure 10.5. The largest share (27 per cent) of equity was held by the government in 1991. However, the government’s share then declined and ranged between 5 and 10 per cent in the period up to 2000.
Then with the onset of the financial crisis, the government increased its share again, both in absolute and relative terms.

The share held by the non-financial corporate sector varied between 20 and 25 per cent over the period. Households decreased their holdings from around 23 to 10 per cent between 1999 and 2012. Insurance companies and banks had relatively low shares of 2 and 4 per cent respectively in 1991. They increased their shares in 1998 and 1999 but then reduced it again. Other financial institutions increased their holdings from 2 to 6 per cent over the period. Again, we can see the strong increase in importance of the foreign sector since around 1995, and by 2012 it held some 44 per cent of the equity in these firms.

To sum up, the main trend to be found in the ownership of the German corporate sector is the increased share of foreign equity holdings. While one cannot be sure which foreign institutions hold the shares, Beckmann (2007) notes that a large part of the foreign holders in 2002 were US and British institutional investors. The German sector of other financial institution (largely investment funds) also increased its share holdings in the German corporate sector. By contrast, non-financial corporations held their capital holdings relatively stable. However, the German Monopoly Commission notes that at least in the circle of the largest 100 non-financial corporations the number of cases where one company holds shares in another of those companies has decreased. While in 1996 there were 40 cases among the big non-financial corporations this had decreased to 9 in 2010 (Monopolkommission, 2012). Hence, at least for the big companies the value of larger share holdings in other companies has decreased and the stock holdings seem to have adopted the character of a financial than a strategic investment. As already discussed in chapter 3, insurance companies and banks reduced their capital holdings as well. While the big financial companies held equity of other big companies in 103 cases in 1996, this had fallen to 28 by 2010. (Monopolkommission, 2012) Private households and the government decreased their direct share holdings over the observed period as well.

Hence, the ownership structure changed in favour of national and international institutional investors. Additionally, the trends in cross-shareholdings among the big German companies are consistent with the argument that shareholdings in other firms are seen to a lesser extent as strategic investments, and more as financial investments.
10.5. Conclusion

The net financial position of the main sectors in Germany show that households have been in a surplus position and that non-financial corporations, as well as the government have had a deficit position. The foreign sector has also been in deficit position, particularly since 2000, a period when non-financial corporations also switched to a net-saver position.

The largest net-lender, the household sector, do not invest directly, but instead deposit their savings with financial intermediaries. In Germany these have traditionally been banks and insurance companies although, in the last 20 years, investment funds have also become more important.

An examination of the ownership structure of the German corporate sector found that as indicated in chapter 3, the network of cross-company investments has dissolving to some degree, as banks and insurance companies have divested. The reduction of cross-shareholdings among German big companies is consistent with the argument that non-financial corporations hold equity in other firms more for financial reasons than before. At the same time institutional investors in Germany have grown in importance as owners of German corporations. In particular the foreign sector increased its holdings of shares in German firms. Although precise figures are not available, it appears that a large part of these foreign investors are also institutional investors.
References


Data Sources


11. Sources of funds for business investments: non-financial corporate sector and small and medium-sized enterprises (SMEs)

11.1. Introduction

In the literature analysing the macroeconomic effects of financialisation, it has been argued that, apart from the redistributive effects to be discussed in chapter 16 of this study and the effects on consumption and saving of private households to be analysed in chapter 14 of this study, financialisation has affected investment in capital stock negatively (Hein, 2012). Financialisation has been characterised by increasing shareholder power vis-à-vis management and workers, an increasing rate of return on equity and bonds held by rentiers, and an alignment of management with shareholder interests through short-run performance related pay schemes, bonuses, stock option programmes, and so on. On the one hand, this has imposed short-termism on management and has caused decreasing managements’ animal spirits with respect to real investment in capital stock and long-run growth of the firm. On the other hand, it has drained internal means of finance for real investment purposes from the corporations, through increasing dividend payments and share buybacks in order to boost stock prices and thus shareholder value. These ‘preference’ and ‘internal means of finance’ channels have each had partially negative effects on firms’ real investment in capital stock, and hence on long-run growth of the economy to the extent that productivity growth is capital embodied (Hein, 2012, p. 2).

Econometric evidence so far is mainly focussed on the US. In an earlier study, Stockhammer (2004b) has taken the share of interest and dividends in profits of non-financial business as an indicator for the relevance of short-term profits in management’s preferences. The share of dividends and interest in profits will be negatively associated with real investment. Using annual data for the business sector and applying time series estimations for France (1978-1997), Germany (1963-1990), the UK (1970-1996), and the US (1963-1997), Stockhammer finds evidence in favour of his hypothesis for France, the US, and maybe also the UK, but not for Germany. The results for Germany are not surprising, because the regulatory changes associated with financialisation only started in the 1990s, as was outlined in chapter 6 of this study.

Van Treeck (2008) has introduced interest and dividend payments, each in relation to the capital stock, into the estimation of the determinants of the rate of capital accumulation in the non-financial corporate sector of the US (1965-2004) using annual data for his time series estimations. He finds
that dividend and interest payments each have a statistically significant negative effect on capital accumulation, indicating the validity of the finance constraint given by internal means of finance. The value of the negative coefficient on dividend payments also exceeds the one on interest payments, which is interpreted as evidence for ‘shareholder value orientation’ of management: higher dividend payments, thus, do not only negatively affect investment via internal means of finance, but also indicate a change in firms’ (or management’s) preferences.

Onaran et al. (2011) in their time series study for the US (1962-2007) find a positive effect of the non-rentier profit share on real gross private domestic investment, but a negative effect of the rentier profit share (net dividends and net interest payments of the domestic industry as a share of nominal GDP), which severely dampens a positive impact of unit gross profits on investment through the ‘internal means of finance’ channel.

Orhangazi (2008) has used firm-level data on non-financial firms in the US (1972-2003) with a focus on the manufacturing sector in a dynamic panel-estimation approach. He finds that financial profits (the sum of interest and equity income in net earnings) have a negative impact on real investment for large firms, indicating short-termism in favour of short-term financial profits and at the expense of long-term profits from investment in capital stock. For small firms, however, the effect of financial profits on real investment is positive, because financial profits seem to ease the financing constraint for these firms. The effect of financial payments (interest expense, cash dividends, purchase of firms’ own stock) on investment is negative for the whole panel.

This chapter will present descriptive statistical data for Germany on the relevant empirical indicators for the potential channels of influence of financialisation on real investment. It starts with a brief overview of the changes in the sectoral composition, addressing the relevance of the financial relative to the non-financial corporate sectors, profitability, and investment in capital stock in section 2. Section 3 will focus on the sources and the uses of profits (gross operating surplus) of the non-financial corporate sector. Section 4 will then deal with investment and capital stock finance of the non-financial corporations, and section 5 will present some evidence on this issue for non-corporate business and small- and medium-sized enterprises (SMEs). Section 6 will summarise and conclude.

### 11.2. Sectoral composition, profit shares and real investment

As was already mentioned in chapter 2 of this study, the German economy has not seen any significant shift in the sectoral composition of the economy towards the financial corporate sector over the last decades. On the contrary, from the mid 1990s until the Great Recession in 2008/09, it was the shares of the non-financial corporate sector in gross value added and in gross operating
surplus of the economy as a whole, which tended to increase, mainly at the expense of the non-corporate business included in the household sector (Figures 11.1 and 11.2).

The profitability of the non-financial corporate sector, indicated by the share of gross operating surplus in gross value added of the sector, showed a strong tendency to increase from the early 1990s until the Great Recession, whereas the financial corporate sector was rather characterised by a highly fluctuating profit share without a pronounced trend till then (Figure 11.3).¹ It was only during

¹ See also chapter 8 of this study for more details of profitability in the financial sector.
the recovery from the Great Recession in 2010 and 2011 that the profit share of financial corporations managed to catch up with non-financial corporations.

**Figure 11.3: Sector gross operating surplus, Germany, 1991-2011 (% of sector gross value added)**

![Graph showing sector gross operating surplus, Germany, 1991-2011](image)

Source: Statistisches Bundesamt (2012b), own calculations

However, the significant improvement of profitability in the non-financial corporate sector in the course of the 1990s and early 2000s was not accompanied by strong investment in capital stock. On the contrary, the share of fixed capital formation by the private sector as a whole in GDP saw a strong tendency to decline after the peak during German unification boom in the early 1990s (Figure 11.4). In the business cycle of the early 2000s until the Great Recession, the share of private investment in GDP was at a historical low. Also, the contribution of gross investment to real GDP growth has shown a tendency to decline since the German unification boom of the early 1990s. Therefore a closer look at sources and uses of profits of the non-financial corporate sector will be taken in the following section.

**Figure 11.4: Gross fixed capital formation of the private sector, Germany, 1960 – 2011 (% of GDP)**

![Graph showing gross fixed capital formation of the private sector, Germany, 1960–2011](image)

Source: European Commission (2012), own calculations
11.3. Sources and uses of profits of non-financial corporations

Empirical analyses of the effects of financialisation on investment in capital stock of non-financial corporations have taken the financial profits of non-financial corporations as an indicator for the ‘preference channel’ of financialisation and shareholder value orientation effects on real investment. Rising financial profits indicate an increased preference of management of non-financial business for short-term profits obtained from financial investment, as compared to profits from real investment, which might only be obtained in the medium to long run. As Figure 11.6 shows, this is exactly what can be found for German non-financial corporations since the early 2000s. Property income, consisting of interest, distributed income of corporations (i.e. dividends, property income attributed to insurance policy holder and rents) increased significantly as a share of gross operating surplus after the new economy crisis. This increase has been driven both by an increase in interest payments received in a period of low interest rates, and by an increase in dividend payments obtained. The increase in the relevance of both types of financial profits indicates an increasing relevance of financial investment, as compared to investment in real capital stock of non-financial business.²

² See also chapter 2 of this study where the change in the composition of the stock of assets held by non-financial corporations is shown.
Another indicator for the effects of an increasing shareholder value orientation of management on investment in capital stock is the share of profits distributed to shareholders. Retained profits are an important determinant of investment in capital stock, because they lift the finance constraints firms are facing in incompletely competitive financial markets. Therefore, an increasing share of profits distributed to shareholders may hamper real investment through the ‘internal means of finance channel’ mentioned in the introduction to this chapter. Figure 11.7 shows that such a phenomenon can be observed for German non-financial corporations. The share of distributed property income in the gross operating surplus tended to rise since the mid 1990s. This increase has been driven almost exclusively by an increase in the share of distributed income of corporations, i.e. dividends, whereas the share of interest payments in the gross operating surplus has stagnated or even declined.

The decomposition of the sources and the uses of the gross operating surplus of non-financial corporations suggest, therefore, that both the ‘preference channel’ and the ‘internal means for finance’ channel may have contributed to weak private investment in Germany since the mid 1990s. A closer examination of real investment finance of non-financial corporations in the next section will provide further support for this suggestion, which would of course need more careful econometric examination, too.

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3 See Kalecki’s (1937) on the ‘principle of increasing risk’ and the importance of own funds as a determinant of investment, as well as Stiglitz and Weiss (1981) on credit rationing in markets with imperfect information. For empirical support see Fazzari et al. (1988), Hubbard (1998), Ndikumana (1999) and Schiantarelli (1996).
Figure 11.7: Uses of operating surplus of non-financial corporations, Germany, 1991-2011 (% of sector gross operating surplus)

Source: Statistisches Bundesamt (2012b), own calculations

11.4. Real investment finance of non-financial corporations

Following the method proposed by Corbett and Jenkinson (1997), which focuses on net financial flows between macroeconomic sectors, van Treeck et al. (2007) have examined gross investment finance of the German non-financial corporate sector from 1960 to 2005.\(^4\) Here, this type of analysis is extended to the most recent data available until 2010.\(^5\) The method of calculation for the different sources of financing of gross investment is described in Table 11.1.

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\(^4\) See also van Treeck (2009).

\(^5\) In 2006 and 2007, the data shows a very large acquisition of financial assets. According to the Bundesbank, this is related to a change of used primary sources for the flow of funds compilation. Those adjustments led to large discrepancies between the national accounts and the flow of funds accounts. The Bundesbank used other receivables as its correction position. Since there is no information provided how the correction has influenced the data, net acquisition of other assets in our sample is set equal to zero, which is close to the average of this position in the other years, to make the data fit with the data obtained from the national account data.
As van Treeck et al. (2007) show, in the period from 1960 to 1989 in West Germany the most important part of finance of gross investment for the non-financial corporate sector as a whole was internal means of finance, i.e. corporate savings plus capital consumption allowances. Between 70 and 90 per cent of gross investment finance was provided by these sources. External finance was mainly bank credit, which amounted to 10 – 20 per cent of gross investment finance. Equities and corporate bonds played only a negligible role; in some periods, the contribution of corporate bonds was even negative.

As can be seen in Figures 11.8, the dominance of internal means of finance continued for non-financial corporations in united Germany from 1991 – 2010, with an even rising trend. In the last 5-year period considered, 2006 – 10, internal means of finance even exceeded gross investment and were partly used to reduce the stock of external finance by means of share buybacks and the repayment of bank credit. The contributions of new equities have been negative since the mid 1990s, because corporations made extensive use of changes in the legalisation allowing share buybacks in 1998. And since the early 2000s, the contribution of bank credit also has been negative, which means that non-financial corporations have reduced their stock of debt with commercial banks. Positive contributions of outside finance were provided by bank credit during the 1990s, which accounted for around 20 per cent of gross investment in this period, by wealth transfers in the early 1990s, and by corporate bonds in the early 2000s.
The effects of the pattern of development of investment finance of the non-financial corporate sector on gross debt, in relation to the capital stock and to the balance sheet of this sector, can be seen in Figure 11.09. Gross indebtedness, including bank credit and corporate bonds, had a tendency to increase from the early 1990s until 2010, with a brief exception in the early 2000s. The development of the capital stock lagged behind so that a clearly rising trend for gross indebtedness in relation to the capital stock can be seen, which increased from roughly 65 per cent in the early 1990s to close to 90 per cent in 2009. The major part of this increase took place in the second half of the 1990s during the new economy boom. With respect to the financing of the capital stock, a substitution of equity by debt finance has taken place, which makes corporations more vulnerable in times of economic crisis, because debt financing is associated with fixed payment commitments, whereas equity is not. If gross debt is related to the total assets held by the non-financial corporate sector, no clear trend is visible any more. This ratio has remained around 40 per cent. Obviously, non-financial corporations have made use of additional debt in order to expand their holdings of financial assets, as has already been shown in chapter 2 of this study.
11.5. Real investment finance of small and medium-sized enterprises (SMEs)

Data and information on investment and capital stock finance of SMEs is more difficult to obtain than for non-financial corporations. This section draws on two different sources. The first is from the Mittelstandspanel of the Kreditanstalt für Wiederaufbau (KfW). Out of around 3.8 million SMEs (annual sales below 500 million euro) in Germany, the representative annual panels have covered 9,000 to 15,000 firms.

According to investment finance data provided by the KfW Mittelstandspanel in Table 11.2, the main source of finance for German SMEs between 2005-10 was own sources, which are mainly retained earnings, and to a negligible degree financial sources provided by the owner(s) of the firm (KfW, 2011). The share of own sources in investment finance varied between 43 and 51 per cent and was thus considerably lower than the share of internal finance for the non-financial corporate sector in the same period. Within the group of SMEs, it was particularly high in very small firms (less than 5 employees) and in the large SMEs (more than 50 employees). Bank credit was the main external source of investment finance, varying between 27 and 36 per cent. Furthermore, subsidies were an important contribution to investment finance, varying between 11 and 15 per cent. In particular, medium-sized SMEs (5 – 49 employees) benefited from this public assistance.

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1 For details see KfW-Research (2012). For a more detailed discussion of investment and capital stock finance of the German Mittelstand see KfW (2011) and Hommel and Schneider (2003).
What can be observed for the few years in this data is that in an economic upswing (2006, 2007), the share of bank credit in investment finance goes up and the share of own sources goes down, whereas in an economic downswing and recession (2008, 2009) these developments are reversed.

Table 11.2: Sources of investment finance of SMEs by number of employees, Germany, 2005-10 (% of total investment finance)

<table>
<thead>
<tr>
<th></th>
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<th>2004</th>
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<tr>
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<td>17.4</td>
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<td>7.8</td>
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<td>14.5</td>
<td>13.8</td>
<td>19.9</td>
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<tr>
<td>10 to 49</td>
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<td>17.7</td>
<td>15.8</td>
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<td>50 and more</td>
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<td>10.0</td>
<td>11.6</td>
<td>11.1</td>
<td>13.2</td>
<td>10.5</td>
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<td>11.1</td>
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<td>13.4</td>
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<td>48.0</td>
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<td>42.0</td>
<td>22.9</td>
<td>27.7</td>
<td>26.4</td>
<td>41.6</td>
<td>33.1</td>
<td>32.2</td>
<td>37.8</td>
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<td>5 to 9</td>
<td>53.0</td>
<td>31.3</td>
<td>41.5</td>
<td>33.9</td>
<td>35.6</td>
<td>39.2</td>
<td>33.3</td>
<td>38.5</td>
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<tr>
<td>10 to 49</td>
<td>35.0</td>
<td>34.7</td>
<td>33.0</td>
<td>37.6</td>
<td>38.8</td>
<td>33.9</td>
<td>35.2</td>
<td>33.5</td>
</tr>
<tr>
<td>50 and more</td>
<td>30.0</td>
<td>34.6</td>
<td>22.2</td>
<td>30.1</td>
<td>31.2</td>
<td>28.4</td>
<td>26.1</td>
<td>21.8</td>
</tr>
<tr>
<td>Total</td>
<td>35.0</td>
<td>30.7</td>
<td>27.5</td>
<td>30.9</td>
<td>36.1</td>
<td>32.0</td>
<td>30.5</td>
<td>31.0</td>
</tr>
<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Less than 5</td>
<td>13.0</td>
<td>15.2</td>
<td>14.2</td>
<td>13.4</td>
<td>5.6</td>
<td>4.7</td>
<td>5.8</td>
<td>6.5</td>
</tr>
<tr>
<td>5 to 9</td>
<td>7.0</td>
<td>18.1</td>
<td>9.6</td>
<td>8.5</td>
<td>11.2</td>
<td>6.2</td>
<td>5.2</td>
<td>6.2</td>
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<tr>
<td>10 to 49</td>
<td>7.0</td>
<td>15.4</td>
<td>11.7</td>
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<td>10.7</td>
<td>8.6</td>
<td>5.2</td>
<td>9.4</td>
</tr>
<tr>
<td>50 and more</td>
<td>10.0</td>
<td>13.0</td>
<td>7.5</td>
<td>10.2</td>
<td>8.2</td>
<td>10.2</td>
<td>5.9</td>
<td>9.3</td>
</tr>
<tr>
<td>Total</td>
<td>10.0</td>
<td>14.5</td>
<td>10.3</td>
<td>11.1</td>
<td>8.4</td>
<td>8.0</td>
<td>5.7</td>
<td>8.1</td>
</tr>
</tbody>
</table>

Notes: 1 for 2003 - external funds.

Looking at the financing structure of the capital stock, the equity ratio of SMEs has continuously increased from 2005 until 2010 (Table 11.3). This trend is true for all size classes of SMEs. However, the equity ratio is still positively correlated with the size of SMEs, that is, the larger the SME, the higher the equity ratio.
In international comparison, German medium-sized enterprises (annual sales between 10 and 50 million euro) managed to increase their equity ratio considerably from the early 2000s until 2008 before the Great Recession, albeit from lower basic values in 2001 (Table 11.4).7

Table 11.3: Average equity ratio of medium-sized companies by number of employees, Germany, 2005 – 2010 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10</td>
<td>15.1</td>
<td>14.7</td>
<td>13.8</td>
<td>16.1</td>
<td>18.2</td>
<td>17.9</td>
<td>19.8</td>
<td>20.6</td>
<td>21.6</td>
</tr>
<tr>
<td>10–49</td>
<td>14.8</td>
<td>16.1</td>
<td>18.9</td>
<td>18.0</td>
<td>20.3</td>
<td>22.5</td>
<td>23.9</td>
<td>24.8</td>
<td>25.5</td>
</tr>
<tr>
<td>50 and more</td>
<td>22.6</td>
<td>24.5</td>
<td>27</td>
<td>27.2</td>
<td>27.5</td>
<td>28.1</td>
<td>29.0</td>
<td>29.4</td>
<td>28.6</td>
</tr>
<tr>
<td>Total</td>
<td>19</td>
<td>20.4</td>
<td>22.5</td>
<td>22.5</td>
<td>23.9</td>
<td>24.6</td>
<td>25.4</td>
<td>26.3</td>
<td>26.6</td>
</tr>
</tbody>
</table>


Table 11.4: Equity ratios of medium-sized companies (sales: 10 – 50 million euro) in manufacturing industry in international comparison, 2001 & 2008 (%)

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Spain</th>
<th>France</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>28.0</td>
<td>44.7</td>
<td>35.8</td>
<td>27.5</td>
</tr>
<tr>
<td>2008</td>
<td>36.2</td>
<td>46.8</td>
<td>39.8</td>
<td>33.0</td>
</tr>
</tbody>
</table>

Source: KfW-Research (2011)

As the KfW panel only covers the most recent development, information provided by the flow of funds and the sectoral national accounts for the household sector, which includes non-corporate business (and non-profit organisations), is taken into account as a second source. To what extent non-corporate business overlaps with SMEs, however, remains an open question. This data shows that the commercial credit stock of non-corporate business in relation to nominal GDP increased from the early 1990s until the new economy crisis 2000/01, and then decreased again until the Great Recession 2008/9 (Figure 11.10). This pattern is broadly in line with gross investment of non-financial business as a share of GDP (Figure 11.11). In the 1990s this value was considerably higher (8-9 per cent) than in the early 2000s until the Great Recession (around 6 per cent). Periods of high investment are associated with rising indebtedness, because non-corporate business increases external finance in the form of credit, whereas periods of low investment allow for a decrease in external finance, and hence credit. With a time lag, this reduces debt-capital ratios and improves equity ratios (Figure 11.12).

7 It should be noticed, however, that the database for Table 11.4 is not the same as in the KfW Mittelstandspanel. Table 11.4 includes SMEs with sales of 10 – 50 million euros per year, whereas in the KfW Mittelstandspanel, SMEs with sales below 500 million euro per year are included.
Figure 11.10: Credit stock of non-corporate business, Germany, 1990 – 2010 (% of GDP)

Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations
Note: The credit stock of non-corporate business is taken to be equivalent to the commercial credit stock of the household sector

Figure 11.11: Gross investment of non-corporate business, Germany, 1991 – 2011 (% of GDP)


Figure 11.12: Commercial credit stock of non-corporate business, 1992 - 2010, Germany (% of capital stock of non-corporate business)

Source: Deutsche Bundesbank and Statistisches Bundesamt (2010), Deutsche Bundesbank (2012), own calculations
11.6. Conclusion

In this chapter, dealing with the relationship between the financial sector and the non-financial business sector, and with investment and capital stock finance in particular, it has been found that there has not been a major shift in relevance or in profitability in favour of the German financial corporate sector relative to the non-financial corporate sector since the early 1990s. Effects of financialisation on investment could only be detected by closer examination of non-financial business in general, and the non-financial corporate sector in particular. Although the profitability of this sector increased considerably from the early 1990s until the Great Recession, investment in capital stock was weak since the mid 1990s after the German re-unification boom, and in particular in the early 2000s until the Great Recession.

The decomposition of sources and uses of operating surplus of the non-financial corporate sector revealed that indeed some evidence for the ‘preference channel’ and the ‘internal means of finance channel’ constraining investment in capital stock under the conditions of financialisation and increasing shareholder value orientation of management could be found. An increasing share of received financial profits in the operating surplus indicates an increasing orientation of management of non-financial corporate business towards investment in financial assets, as compared to investment in capital stock. An increasing share of dividends paid out to shareholders in operating surplus indicates a decrease in internal means of finance available for capital stock investment purposes.

The examination of the development of investment and capital stock finance of non-financial corporations supports this assessment. Internal means of finance are the most important source of investment finance; the contributions of equity issues have historically been negligible and they have been negative since the mid 1990s, indicating share buybacks in order to keep share prices high in this period. Bank credit, as well as corporate bond issues as the major external source of finance in Germany, were not necessary for real investment finance but were used for the acquisition of financial assets since the mid 1990s taking the non-financial corporate sector as a whole: gross debt-capital stock ratios have increased significantly, whereas gross debt-balance sheet ratios have not.

SMEs and non-corporate firms predominantly finance investment from internal sources, albeit to a lower degree than the non-financial corporations. They can only draw on credit when external investment finance is required. Investment in capital stock and credit finance are positively correlated. This means that periods of high investment are associated with increasing credit and increasing debt-capital ratios. Periods of weak investment are correlated with decreasing credit and rising equity ratios.
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https://www.destatis.de/DE/Publikationen/Thematisch/VolkswirtschaftlicheGesamtrechnung
12. The involvement of the financial sector in the restructuring of the economy

12.1. Introduction

This chapter will first give a brief overview of legal reforms that shaped the control and ownership structures of German companies since the 1990s and enabled the emergence of the market for corporate control. It will also discuss the changing role of banks in German corporate governance and their orientation towards investment banking and support of merger and acquisition activities (M&A henceforth) in the non-financial corporate sector (section 2). In sections 3 and 4 some data will be presented on the development of M&A activity in Germany (post-unification) and the ‘character’ of M&A in Germany, i.e. the presence or absence of hostile takeovers. Finally, in section 5 the role of financial institutions in M&A activities is discussed, with the focus on their involvement in the cases of hostile takeovers.

12.2. Changes in German corporate governance since the 1990s

The German Stock Corporation Act (Aktiengesetz) of 1965 was focused on the internal legal relationships of stock corporations and provided no rules to control the formation of de facto industrial groups. It particularly did not regulate takeovers (Rieckers and Spindler, 2004). This law fitted to the German corporate sector which was characterised by a formal and informal network of big companies and big private banks. However, beginning in the 1990s policy and also some of the big companies and financial institutions wanted to change this traditional structure. Between 1990 and 2002 four laws were passed by the federal legislature promoting financial markets (Schmid and Wahrenburg, 2004, see also chapter 6 of the present study about financial market regulation). This process has taken place amidst increasing stock market activity, an increasing role of capital markets (itself the result of changes occurring in financial structures) and, globally, turbulent M&A activity.

The most important law for this topic was passed in 2002; the Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz, or WpÜG). This takeover regulation – in particular mandatory bid rules\(^1\), board neutrality and the possibility of mounting defences against takeovers – is especially important in setting the environment for hostile takeovers. The Securities Acquisition

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\(^1\) Once a shareholder acquires at least 30% of the company shares, he is obliged to make an offer to purchase the remaining shares of that company at a fair price.
and Takeover Act’s most controversial issue is the management board’s obligation to maintain neutrality during a takeover bid. Albeit the early drafts suggested a strict neutrality code for target company’s management, the final version allows substantial space for manoeuvre for the management board to oppose a takeover, especially in the form of preventive actions. For instance, the use of so-called poison pills – a strategy where an attempt is made by the target company to make its stock less attractive to the acquirer company\(^2\) – is allowed prior to the publication of the decision to make a public offer (Rieckers and Spindler, 2004).

Furthermore, the German Corporate Governance Code (*Deutscher Corporate Governance Kodex*, or DCGK) was adopted in February 2002, expanding on the 1998 Law on Control and Transparency in Enterprises (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, KonTraG henceforth), with the particular aim of amending the ‘inadequate focus on shareholder interests’ and the ‘inadequate transparency of German corporate governance’ (Commission of the German Corporate Governance Code, 2012).

The Security and Takeover Act and the German Corporate Governance Code have made some contribution to the process of German law transformation towards more capital-market oriented rules. The aim was to give financial markets a bigger role, increase transparency in the traditionally not very transparent German capital market, to make it more attractive for foreign companies to invest in Germany, and to make it easier for takeovers, believing that such policies should make the German financial market more efficient and trigger growth. Also external pressures existed since the mid 1990s to redirect the traditional German system of corporate governance towards a more market-based US or British type of governance. In particular, pressure came from the European Commission which demanded a whole set of law adjustments in Germany. Looking back, the most relevant changes regarded investor protection (increased protection of small/minority investors) thus strengthening the interest of shareholders, as well as a more explicit framework for transparency and the monitoring of management. Although this has not made Germany institutionally comparable to the United States, some form of ‘hybridisation’ of the German institutional and corporate governance system came to existence (Höpner and Jackson, 2006, Beyer and Höpner, 2003).

The stock market traditionally played a limited role in Germany until the 1990s. In the 1980s there were less than 500 listed companies (Schaede, 2000) and, as discussed in chapter 10, fund raising through the stock market was exercised only by a few of the largest firms. The German corporate

\(^2\) The ‘flip-in’ strategy consists of offering the existing shareholders (but not the acquirer) to buy shares on a discount price.
governance system as well as the financing of listed companies was deeply influenced by the banking system. Schaede (2000, p. 9), for instance, reports that in 1992, ‘of the 30 companies included in the DAX index, eleven supervisory board chairmen and 25 per cent of all supervisory board members were bankers’. Traditionally the mutual corporate ownership, i.e. cross-shareholding was a common feature of the German corporate governance system. Banks and insurance companies, furthermore, had a substantial influence on large companies, not only through direct ownership but also extensively through the exercise of proxy voting, where banks have the ability to vote on behalf of their customers who hold shares in banks’ custody (Rieckers and Spindler, 2004). This right used to be exercised automatically and without additional costs for banks.

For decades the pattern of corporate governance and financing in Germany, with the loans from the ‘housebank’ being the major creditor for German firms, had been stable. It was outlined in chapter 3 how this pattern began to change in the 1990s. This was due primarily to the reorientation of German big banks toward investment banking which before more or less did not exist and their increasing unwillingness to continue being the providers of cheap credit and to maintaining tied relationships with the firms. In addition, some of the big German companies wanted to become global players and needed support from banks. The reason for this change in banking sector activities is the occurrence of global banking and the increasing role of investment banking which induced large German banks to enter this business. German big banks (led by the Deutsche Bank) embraced more profitable investment banking activities while marginalizing high cost low return retail banking and diminishing their involvement in the corporate governance of German firms (Schaede, 2000).

Advisory activity in merger and/or acquisition deals has become an important aspect of investment banking, and it is incompatible with banks having insider relations with firms which could become targets of hostile takeovers. Strong motive to ‘retreat’ was the sharp public criticism and protests which took place after several episodes of ‘conflict of interests’ occurred (see section 5 of this chapter). Moreover, close ties with domestic industrial companies are in conflict with the reputation building on the international financial markets (Beyer and Höpner, 2003).

Rieckers and Spindler (2004) argue that the role of German universal banks in the system of corporate governance has substantially decreased also because lending money to corporations became riskier. Shareholders’ loans are considered as ‘equity replacing’ if it is provided when, or held after, the company undergoes financial difficulties. This stems from the belief that the company in difficulty would not obtain this financing otherwise (from a ‘neutral’ third party), and this also refers

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3 ‘A study of the 24 largest widely held companies in 1992 revealed that banks represented an average 84% of the votes attending the annual shareholder meeting, and the big three banks – Deutsche, Dresdner and Commerzbank – accounted for an average of 35% of total votes.’ (Schaede, 2000, p. 8)
to the bank that acts as a major stockholder for the company in question. During eventual insolvency procedure, such loans are treated as subordinate to other loans. Further changes that reduced the presence of German universal banks on supervisory boards of companies are related to changes in depositary voting right (*Depotstimmrecht*) and the introduction of proxy voting, based on the Law on Control and Transparency in Enterprises (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, KonTraG) of 1998, and on the Act on Registered Shares and the Exercise of Voting Rights (*Namensaktiengesetz*) of 2000.

These developments loosened the ties between German corporate companies and big banks including big insurance companies. Moreover, firms started to reduce their capital invested in cross-shareholding with the aim of expanding globally and putting it to more profitable use (Schaede, 2000). Tax policy supported this by the abolition of capital gains tax in 2002.

Table 12.1 shows the changes of share ownership from the 1990s on. The role of banks and of the government decreased, cross-firm-ownership decreased until 2007 but has since risen again, and the share of insurance companies and other non-bank financial institutions, as well as of foreign investors, increased.

### Table 12.1: Share ownership by sector Germany, 1991-2011 (% of total)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-financial firms</td>
<td>42.3</td>
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<td>35.6</td>
<td>36.6</td>
<td>34.8</td>
<td>41.2</td>
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<tr>
<td>Banks</td>
<td>12.5</td>
<td>12.9</td>
<td>13.0</td>
<td>9.2</td>
<td>5.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Insurance firms</td>
<td>4.9</td>
<td>6.3</td>
<td>4.5</td>
<td>5.4</td>
<td>5.8</td>
<td>9.2</td>
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<td>Government</td>
<td>5.4</td>
<td>4.2</td>
<td>3.5</td>
<td>3.2</td>
<td>1.9</td>
<td>2.6</td>
</tr>
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<td>Investment firms and other</td>
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<td>18.2</td>
<td>16.9</td>
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<td>Foreign</td>
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<td>8.2</td>
<td>13.9</td>
<td>17.3</td>
<td>26.9</td>
<td>19.3</td>
</tr>
</tbody>
</table>

*Source: Deutsche Bundesbank (2012), own calculations*

### 12.3. Empirical development of M&A activity in Germany

M&A were rare in Germany up until the early 1990s, as compared to other European countries. Following the unification of Germany in 1990, a wave of mergers started between the eastern and western parts of Germany and continued throughout the decade (Höpner and Jakson, 2006). Not only non-financial firms, but also banks attempted to increase their size, resulting in several mergers. In 1997 the Munich-based Bayerische Hypo-Bank merged with Bayerische Vereinsbank as part of the ‘regional strategy’ (Andreani, 2003). Then in year 2000 the German banking group Hypovereinsbank

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* Aktiengesetz §221, n.31 et seq., quoted in Rieckers and Spindler (2004).
and the Austrian group Bank Austria Creditanstalt agreed on one of the biggest mergers in the European banking system.

Figure 12.1 shows the overall development in the number and transaction value of M&A in Germany. Since 1990, the volume of M&A activity in Germany reached a peak in 2000, primarily due to the Vodafone and Mannesmann deal (see below). Following a high in year 2006, M&A activity shows a downward trend during the Great Recession, with the lowest number of transactions in the last two decades. As M&A activity in the 1990s was directly linked to the German unification process as West German firms were acquiring GDR firms, we can conclude that other M&A activities increased only in the 2000s substantially, and the volume of M&A dropped sharply with the start of the Great Recession. According to Schröder et al. (2011), major reasons for the increase in M&A activities are to be found in the processes of globalisation, the rise in commodity prices, the availability of low-interest financing as well as in the growth of hedge fund activity and increasing private equity funds.

Figure 12.1: Number and transaction value of M&As, Germany, 1990-2010 (number (lhs), $ billion (rhs))
Table 12.2 presents the biggest M&A deals in Germany from 1998 to 2011, showing that the most important deals occurred at the turn of the millennium, with of course the Vodafone-Mannesmann deal being an outlier with respect to its transaction volume.

In terms of percentage of GDP, it can be broadly concluded that in Germany the ratio of transaction value of M&A to GDP oscillates between 1 - 2 per cent (not considering the Vodafone-Mannesmann deal), where values below 1 per cent are considered periods with weaker, and those slightly above 2 per cent periods with stronger M&A activity (Schröder et al, 2011).

Table 12.2: Biggest M&A-deals, Germany, 1998 - 2011

<table>
<thead>
<tr>
<th>Rank</th>
<th>Year</th>
<th>Acquiror*</th>
<th>Target*</th>
<th>Transaction Value (€ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1999</td>
<td>Vodafone AirtTouch PLC</td>
<td>Mannesmann AG</td>
<td>204.8</td>
</tr>
<tr>
<td>2</td>
<td>1998</td>
<td>Daimler-Benz AG</td>
<td>Chrysler Corp</td>
<td>36.8</td>
</tr>
<tr>
<td>3</td>
<td>2000</td>
<td>Deutsche Telekom AG</td>
<td>VoiceStream Wireless Corp</td>
<td>30.8</td>
</tr>
<tr>
<td>4</td>
<td>1999</td>
<td>Mannesmann AG</td>
<td>Orange PLC</td>
<td>30.2</td>
</tr>
<tr>
<td>5</td>
<td>2001</td>
<td>Allianz AG</td>
<td>Dresdner Bank AG</td>
<td>22.5</td>
</tr>
<tr>
<td>6</td>
<td>1999</td>
<td>Rhone-Poulenc SA</td>
<td>Hoechst AG</td>
<td>20.5</td>
</tr>
<tr>
<td>7</td>
<td>2006</td>
<td>Bayer AG</td>
<td>Schering AG</td>
<td>17.0</td>
</tr>
<tr>
<td>8</td>
<td>2005</td>
<td>Unicredito Italiano SpA</td>
<td>Bayerische Hypo- und Vereinsbank</td>
<td>15.1</td>
</tr>
<tr>
<td>9</td>
<td>2007</td>
<td>Continental AG</td>
<td>Siemens VDO Automotive AG</td>
<td>11.4</td>
</tr>
<tr>
<td>10</td>
<td>2008</td>
<td>Schaeffler KG</td>
<td>Continental AG</td>
<td>11.1</td>
</tr>
<tr>
<td>11</td>
<td>2007</td>
<td>E.ON AG</td>
<td>Endesa Italia</td>
<td>9.1</td>
</tr>
<tr>
<td>12</td>
<td>2009</td>
<td>RWE AG</td>
<td>Essent N. V.</td>
<td>8.3</td>
</tr>
<tr>
<td>13</td>
<td>2010</td>
<td>PPL Corporation Ltd.</td>
<td>E.On US LLC</td>
<td>5.7</td>
</tr>
<tr>
<td>14</td>
<td>2010</td>
<td>Merck KGaA</td>
<td>Millipore Corp.</td>
<td>5.3</td>
</tr>
<tr>
<td>15</td>
<td>2008</td>
<td>Commerzbank AG</td>
<td>Dresdner Bank AG</td>
<td>5.1</td>
</tr>
</tbody>
</table>

*or merger partner

Sources: Institute for Mergers, Acquisitions and Alliances (2012)

German M&A activity measured in number and value has been slightly below the European average during the last decade. Figure 12.2 shows that, relative to GDP, M&A were lower in Germany than in Italy and France and much lower than in the US and Britain which both showed M&A activity around twice as high as in continental European countries (Jackson and Miyajima, 2007). Schröder et al (2011) also argue that Germany fell behind Europe and especially the US and Britain during the 1990s because of tax disadvantages which suppressed M&A. After the changes in the Tax Reduction Act (Steuererleichterungsgesetz) in 2000 and the repeal of the corporate capital gains tax in 2002, M&A in Germany increased moderately.
12.4. The character of M&A in Germany

To understand M&A activity in Germany it is necessary to take into account the German corporate governance system including legal rules and the tax system as well as informal rules and prevailing business ideologies. Höpner and Jackson (2006) pointed out that it is the presence or absence of hostile takeovers that reflect a fundamental distinction between national systems of corporate governance. In this sense, the view of the German corporate governance system as a deeply traditional stakeholder model, embedded in institutions which seem to act as strong barriers against hostile takeovers, has been shaken by the increasing merger activity in the 1990s and in particular by the hostile takeover of Mannesmann by Vodafone in 1999-2000.

Jackson and Miyajima (2007, pp. 11-14) argue that in general a beneficial environment for M&A would consist of: higher investor protection (shareholder rights); concentrated ownership (this makes easier the transfer of control, albeit it could be an inhibiting factor for hostile takeovers); and low employment protection, i.e. not many legal obstacles with regard to the imminent lay-off of workers.

Rickers and Spindler (2004) have described as one of the characteristic features of the German corporate governance that the shareholders with smaller holdings are relatively unprotected since during the general meeting of shareholders the formation of a blocking minority would require more than 25 per cent of the share capital. Schaede (2000) agrees, arguing that until the mid 1990s
minority shareholders were marginalised given the proxy voting. Minority shareholders were also disadvantaged by the fact that firm’s management could impose voting right restrictions. As late as 1995, 20 large stock corporations had announced voting rights restrictions. It is not always clear whether a company had done this, since these restrictions could have been filed with a local trade registry without a public announcement. Corporate raiders, attempting to take over a German firm, were thus on occasion negatively surprised (Schaede, 2000). Furthermore, shares could be issued with trading limits (selling could occur only given the explicit permission of the issuing company) and due to this, as well as the voting rights restrictions mentioned above, takeovers happened rarely and hostile takeovers were close to being impossible in Germany. However, the shift towards shareholder value orientation became more apparent since the mid 1990s. Big German companies such as Bayer, Daimler-Benz and Hoechst explicitly proclaimed shareholder value principles and increased the transparency of company reports (Beyer and Höpner, 2003). By the late 1990s, not only companies predominantly owned by institutional investors, but also those affected by the international product market competition endorsed shareholder value as their guiding principle. This was supported by the changes in the legislation regarding stock corporations. KonTraG introduced the ‘one share, one vote’ principle which gave more rights to minority shareholders, but also meant higher ownership dispersion. Coupled with the dissolution of ties between banks and corporations, German companies became more vulnerable in the market for corporate control. However, as M&A usually imply corporate restructuring which includes – sometimes substantial – lay-offs, Germany’s traditional high employee participation in the form of co-determination and trade union involvement and relatively strict employment protection laws have been acting as an inhibitor to takeovers, especially when hostile.

**Table 12.3: Attempts of hostile takeovers, 1991-2005**

<table>
<thead>
<tr>
<th></th>
<th>Hostile attempts</th>
<th>Sold to raider</th>
<th>Sold to alternative bidder</th>
<th>Remained independent</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>18</td>
<td>12 (67%)</td>
<td>4 (22%)</td>
<td>4 (22%)</td>
</tr>
<tr>
<td>Germany</td>
<td>6</td>
<td>5 (83%)</td>
<td>0</td>
<td>1 (17%)</td>
</tr>
<tr>
<td>Japan</td>
<td>6</td>
<td>1 (17%)</td>
<td>0</td>
<td>5 (83%)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>176</td>
<td>74 (42%)</td>
<td>34 (19%)</td>
<td>68 (39%)</td>
</tr>
<tr>
<td>United States</td>
<td>332</td>
<td>73 (22%)</td>
<td>103 (31%)</td>
<td>156 (47%)</td>
</tr>
</tbody>
</table>

*Source: Jackson and Miyajima (2007)*

Table 12.3 shows the number of attempted hostile takeovers for France, Germany, Japan, the UK and the US for the period 1991-2005, and their outcomes. Japan and Germany are countries with least hostile takeover attempts, although in the German case the majority of attempts were successful. For this reason Jackson and Miyajima (2007) argue that despite the weakening of the institutional barriers to M&A during the 1990s and 2000, Germany still shows characteristics of a predominantly...
coordinated market economy. Relatively low degree of hostile takeovers – especially considering the size of the economies – would indicate that Germany has experienced mostly the ‘consensus-type’ of M&A.

12.5. Involvement of financial institutions in corporate restructuring

In this section the role of financial institutions in M&A activities is discussed, focusing in particular on the few cases of hostile takeovers and on the reaction of the German public to these new developments.

Investment banks play a role in M&A deals via several channels: as consultants, by providing support in the valuation of the target and the acquisition premium, and by actively taking part in the negotiation processes. The role of investment banks in financing M&A deals is less clear, although they have the ability to mobilise the capital needed in such deals. Especially difficult is to obtain data on finance provision, as all of the banks’ activities regarding M&A fall under the aspect of ‘financial advisory’.

Schröder et al (2011, pp. 30-41) present the results of a survey undertaken with 115 companies with at least one M&A activity during the period 2005-2010. The aim was to investigate the importance of investment banks in corporate decisions of German companies. Survey results indicate that the advisory activities of investment banks related to M&A have been evaluated ‘very important’ or ‘important’ by approximately 50 per cent of the companies asked. Schröder et al (2011) also report that larger companies which have their own internal M&A department have, interestingly, attributed higher importance to investment banks’ involvement than other participants, which indicates that there has been no tendency of replacing external services provided by financial institutions by internalisation.

Figure 12.3 shows the most important financial advisors to the M&A sector in Germany from the beginning of 2010 until October 2012. The ranking is weighted on the basis of the value of M&A deals in which a financial institution was involved. The Deutsche Bank is the major player in German M&A sector, by participating in USD 91.325 billion worth of M&A deals cumulatively since 2010. It is followed by the US based Goldman Sachs and Morgan Stanley.
German universal banks, by orienting themselves towards investment banking activities and reducing their monitoring role and participation on supervisory boards of firms, have both increased their interest in M&A as the new profitable business practice, and stopped acting as a barrier to hostile takeovers. Actually, banks started participating in and supporting hostile bids.

Prominent examples are the takeover of Hoesch by Krupp in 1991, when Krupp was supported by its house bank WestLB which at the same time held a 12 per cent stake in Hoesch; or the merger between Krupp AG and Thyssen in 1998, where Deutsche Bank advised Krupp in an unfriendly takeover bid while having a seat on the Supervisory board of Thyssen (Höpner and Jackson, 2006).

The most notable example is the Vodafone-Mannesmann case of 1999/2000.

The Vodafone-Mannesmann deal was one of the largest in the world. Mannesmann was a German engineering and mobile phone group, and Vodafone at the time had been a smaller UK mobile phone operator. The CEO of Mannesmann Klaus Esser, the head of IG the trade union IG Metall Klaus Zwickl, as well as the German government were opposed to this deal. It was argued later that the vulnerability of Mannesmann came from the dispersed ownership structure: unlike other German companies, Mannesmann had 70 per cent of foreign shareholders, including US institutional investors, who were more easily convinced that the deal was in shareholders’ interests. But more importantly, banks did not play a defensive role for Mannesmann (Höpner and Jackson, 2006), even though Josef Ackermann from the Deutsche Bank was a member of the Supervisory Board of the company. At the same time, investment banks became heavily involved in the deal by providing consultancy for both parties. Mannesmann was advised by Morgan Stanley, Merrill Lynch and JP Morgan, and Vodafone by Goldman Sachs. The latter had actually been the advisor of Mannesmann during its acquisition of Orange Inc in 1999. The outcome of the takeover led, as usual with such...
deals, to the destruction of part of the firm taken over. Orange from Mannesmann was sold to France Telecom. Shareholders gained a 120 per cent rise of the share price in a 6-month period. The former CEO of Mannesmann, Klaus Esser, retired with an additional 30 million euro ‘golden handshake’.

German public opinion strongly opposed the hostile takeover and was shocked. A bitter taste remained indicating that many German interest groups, politicians, journalists, etc. did not want a US-British-type of hostile takeover. Klaus Esser was, in fact, put on trial for ‘breach of fiduciary duty’ (Höpner and Jackson, 2006) albeit later being found not guilty. The Vodafone-Mannesmann case made clear that takeovers in Germany are possible and increased, but that the development of hostile takeovers as in the US or Britain would lead to wide resistance in Germany.

12.6. Conclusion

M&A activity increased in Germany from the 1990s, mainly associated with unification, and have continued rising in the 2000s. The increase was a little smaller than in Europe as a whole, and much smaller than in the US or UK. The increasing presence of non-bank financial institutions and especially the decisive orientation of German universal banks towards investment banking activities have acted in support of M&A. Investment banks in Germany operate similarly to those in other countries on several grounds in the field of M&A: on an advisory level, providing support in the valuation of the target and the acquisition premium, during the negotiation process, and also as capital providers although this role is empirically difficult to quantify. Of non-bank financial institutions, hedge funds seem to engage most in speculative investment in M&A.

The economic environment favourable to M&A has been strengthened by higher minority shareholder protection, the loosening of ties between banks and non-financial corporations with regard to corporate governance, somewhat lower employment protection, and the shift in managerial ideologies away from a long-term growth focus. The changes in German corporate governance which provided more space for the development of the market for corporate control occurred in a specific political environment. In the late 1990s the Social Democratic – Green coalition tried to move Germany towards a more market driven system of corporate governance.

Although it cannot be said that Germany turned to an Anglo-US-American type of M&A regime, policies in Germany and from the European Commission as well as changes in the strategy of bigger German banks and enterprises encouraged M&A from the early 1990s on. Yet these developments could be considered more as moderate steps rather than decisive leaps towards imitating a liberal market economic model with easy and frequent friendly and hostile takeovers. In the market for
corporate control, for instance, the new German takeover code still allows some defence mechanisms (for instance, poison pills) in case of hostile takeover attempts. Hostile takeovers are not very common in Germany and if they take place they are more of a managed type, searching for compromise with all stakeholders. This is also due to the fact that in bigger companies German trade unions play an important role and can make hostile takeovers very costly for an investor. The German M&A regime can be judged as a hybrid, on the one side combining elements of a market approach and on the other side strong non-market stakeholder orientation. The Vodafone-Mannesmann hostile takeover in 2000 was a shock for the traditional German corporate governance model and led to a kind of consensus that takeovers should be possible, but not in a market radical way.
References


Data Sources

Deutsche Bundesbank (2012), Time Series Data Base, available at:


13. Privatisation and the financial sector

13.1. Introduction

In Germany, a big wave of privatisations took place in East Germany immediately after unification in 1990. This was organised by a public agency, the Treuhandanstalt. In this biggest German privatisation wave the involvement of financial institutions was quite limited. Regardless of the early 1990s wave of privatisation, however, Germany enacted privatisation programmes in most of its public utilities sectors. Here the involvement of the financial sector was more significant. In this chapter, after outlining the developments in privatisation within the financial sector in Germany since the 1980s (section 2), other relevant cases of privatisations are discussed, with the aim of establishing the link with developments in the financial system. In section 3 first the post-unification wave of privatisations in East Germany is briefly described, then some ‘national champions’ privatisation cases are discussed. The focus here is on the postal and telecommunications, transport, and health care sectors. The global financial crisis took its toll in Germany as well, and government needed to intervene and rescue several financial institutions, as well as completely nationalise one banking group. The extent of government interventions during the financial crisis, with particular focus on the cases of privatisation, liquidation, and nationalisation of financial institutions will, finally, be the theme of the section 4 of the present chapter.

13.2. Privatisations in the German banking sector

After WWII most of the major European countries (UK being the exception) were characterised by a high degree of publicly owned banks and insurance companies. For some countries in Europe, this began to change gradually during the 1980s with the increasing dominance of neoliberal economic thinking, and culminated at the end of the 1990s when the public banks were under great economic, political and ideological pressure. Germany with its three-pillar banking system, however, largely avoided the fundamental liberalisation of the 1990s (Krahnen and Schmidt, 2004). In the period 1982-2000, only 5 cases of bank privatisation took place in Germany (the first one was in 1988), which was 4 per cent of the overall value of privatisations in the country. When considering all banking sector privatisations in the EU15 countries for this period, Germany’s share was only 6.2 per cent in terms of number and 8.2 per cent in terms of value of privatisations (PRESOM, 2008, p.1).

As it was shown in chapter 3 of this study, the publicly owned saving banks sector has continued to be an important part of the German banking sector during the 1990s and the 2000s. German big
banks have tried to push for the privatisation of the public savings banks, but this attempt has had no important consequences; only a couple of savings banks changed their legal form to stock corporations but the number is negligible.

13.3. Privatisation programmes in Germany: relation to the financial sector

Germany has resisted enacting privatisation programmes for quite a long time, relative to other major industrialised countries. At the beginning of the conservative-liberal government (1982) the leading politicians began committing themselves to privatisation, primarily with regard to the state ownership of industrial companies (Beyer and Höpner, 2003). Little really occurred, though, until the late 1980s when the European Commission and the European Court of Justice pushed for European market integration and competition reforms which includes privatisation. The pressures from Europe and finally the unification of Germany made privatisation a hot issue on the policy agenda.

The biggest wave of privatisations in German history took place in the early 1990s in East Germany. This privatisation programme was strongly and effectively state controlled and has occurred exclusively via the purposely established holding company – the Treuhandanstalt – thus the financial sector involvement in these processes was very limited.

Figure 13.1: Central government’s revenues from privatisation, Germany, 1984 – 2001 (DM billion)

Source: Beyer and Höpner (2003, p. 189); data from German Ministry of Finance

In addition to the East German privatisation programme, Germany also began to divest the state ownership of the up to then state monopoly sectors such as telecommunications. Figure 13.1 shows the revenue of the government from privatisation in the period 1984-2001, where we can see that the revenue substantially increased from 1997-2001. Note that this refers not to the number of
privatisations, but to revenues accruing to the central government due to privatisation. Revenues where not nearly as high in the years of the biggest privatisation wave which took place in East Germany in the years 1991-1994 as the Treuhandanstalt sold East German state-owned companies at knock-down prices.

In the next part of this subsection the post-unification privatisation wave in East Germany will be discussed, and then we will focus on the most relevant cases of privatisation of public utilities in Germany, namely the telecommunications and postal sectors, transport and health sector (the privatisation of hospitals).

Privatisation in East Germany

Unlike most of the Eastern European countries which also experienced a big wave of privatisation in the early 1990s but did it to a large extent through voucher schemes, Germany organised the privatisation and restructuring of East German companies through the Treuhandanstalt (THA), a public agency which sold East German companies individually to investors. Already in early 1990, shortly before the unification in October of the same year, the agreement was made that the ownership of all state-owned companies would be transferred to a purposely created public agency, at which point the companies employing more than 2,000 people would be converted into stock corporations, AGs, and otherwise to limited liability companies, GmbHs (Carlin and Mayer, 1994). The THA would then become ‘the major vehicle for restructuring and privatisation’ (Müller, 2001, p. 2161), privatising more than 13,800 companies and parts of companies in four and a half years.

The creation of the THA meant that for the process of privatisation not only the sale price but broader social criteria should be taken into account (employment, industrial and/or regional policy etc.). From 1991 on the process of controlled structural change and privatisation of state-owned companies set in: the THA established Supervisory Boards in larger companies which, after examining the company’s conditions and in most cases replacing the old management, worked jointly with the newly appointed managers in devising the vertical and horizontal restructuring process. Restructuring proposals were then discussed with the THA. Here it is important to understand that the THA aimed at ‘restructuring through privatisation’ (Müller, 2001) by firstly transferring ownership (i.e. actually privatising), and in the second phase implementing the restructuring process via new owners. In fact, the THA did not let the market decide on the ownership (in auctions, for instance,

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1 Besides vouchers also auctions and other instruments were used. Poland was an exception as voucher privatisation did not play a big role in the country.

2 Had the aim been only the maximization of sales proceeds, the privatisation would have been done through an auction of assets, and not via delegation to the THA which sold assets individually.
ownership is granted simply to those who have the best access to finance); rather it sought to find proprietors with the long-term interest and capability to implement a sound corporate strategy. The THA would then, in many cases, remain involved by subsidising the costs associated with restructuring. In this way, the old debt of state-owned companies was taken over by the THA and later became part of the public debt. This procedure was quite advantageous to West German companies which now could simply buy potential East German competitors and include them into their internal division of labour.

In the early stages of THA activity a large number of companies were actually re-privatised, namely restituted to their previous owners. This was, however, conditional on the THA judgement that the new/former owners were able to take over effectively the businesses. With regard to the forms of privatisation in the more traditional sense of the term, horizontal mergers with West German companies were most common, which caused the massive transfer of ownership from East to West Germany. This was one of the reasons for the THA welcoming management buy-outs and/or buy-ins which were used in particular for strengthening the *Mittelstand*. Approximately every sixth privatisation would take this form (Müller, 2001). This occurred mostly in the service sector and rarely in manufacturing, and the managers came mostly from inside the company (i.e. management buy-outs were more frequent than the management buy-ins). The THA was thus very supportive of this form of privatisation, as it was the most, if not the only, way to keep the ownership of the company in East Germany.

In the remaining cases, the THA retained the industrial core activities and eventually took over the restructuring itself, or proceeded with liquidation.

In general, the THA thus supported West German capital. Foreigners were not able to get any significant share of East German companies. East Germans also were not able to get a large share of GDR property as there was too little capital in the form of monetary wealth in East Germany. It should also be mentioned that East Germany became largely de-industrialised as East German companies had a lower productivity level than West German companies and wages in East Germany adjusted faster to West German levels than productivity. At the end of the day, in most cases the ownership of the privatised (and/or restructured) surviving East German company was transferred to West German companies through horizontal mergers, and, to a lesser extent, to owners abroad.

During the privatisation processes handled by the THA, banks didn’t play any significant role in terms of financing East German companies. West German banks were not interested in providing finance to companies with uncertain prospects and amidst ad-hoc restructuring.
Telecommunications and postal services

The privatisation of traditional public sector monopolies and public utilities was promoted by institutions on the European level through directives and regulations. In Germany the dominant neoliberal discourse also led to the privatisation of state-owned companies beyond the privatisations in East Germany.

The Commission of European Communities (1987) issued the ‘Green Paper on the Development of the Common Market for Telecommunications Services and Equipment’, where it was proposed that the terminal equipment and enhanced telecommunication services be liberalised within and between countries. In Germany at the time the federally operated Deutsche Bundespost (DBP) comprised postal, telecommunication and financial services. In 1989 Germany passed its first postal reform (Poststrukturgesetz or Postreform I) resulting in the restructuring of the DBP and disentangling the three types of activities which were now exercised by three autonomous units: Deutsche Post, Deutsche Telekom, and Postbank. The entrepreneurial functions were separated from the political influences. All three units were still fully in public ownership, yet the aim of the first postal reform was to prepare the grounds for following liberalisation and privatisation (Drews, 2006).

The second postal reform was passed in 1995 where the necessary legal amendments were made to privatise the three postal corporations (then transformed into incorporated companies). In March 1996, the ‘Full Competition Directive’ of the European Commission requested free entry into all parts of telecommunications. National parliaments of member states were to enact it immediately and by 1998 it ought to be fully in effect (Knieps, 2004). In December 1997, the first EU Postal Directive was passed, on the basis of which Germany enacted the Postal Act (Postgesetz) in early 1998 which established a regulatory authority and obliged the Deutsche Post to grant the competitors access to its own networks.

Immediately after the second postal reform the German Federal Government held all shares of the Deutsche Post AG; the privatisation process began with an initial public offer in November 2000 (Drews, 2006).

The privatisation of Deutsche Telekom was a particularly interesting case as it became a turning point in the perception towards the stock market participation of the German traditionally risk-averse population. In 1996, a massive advertising campaign was undertaken depicting the shares of the Deutsche Telekom as ‘people’s shares’ (Volksaktien). There was a huge response by the public, and

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3 The regulation of these monopolies was the competence of the Federal Ministry of Post and Telecommunication.

4 The Postbank was incorporated and entirely sold to the Deutsche Post in 1999 (Beyer and Höpner, 2003)
for many German households this was the first time they had purchased shares. For this reason, one might have considered this privatisation strategy as the one most effective to transform the public opinion and ‘stimulate the development of the German capital market’ (Beyer and Höpner, 2003, p. 189).

However, the market value of Telekom shares dropped from its peak of more than 100 euro in March 2000 to less than 10 euro in mid-2002, and oscillated between 10 and 18 euro up until 2009. Since then the share value has barely exceeded the 10 euro benchmark (Investor Verlag, 2012). From a long-term perspective, thus, the privatisation of the Deutsche Telekom was all but a success story for developing the German capital market. Considering the concept of ‘Volksaktien’, one can conclude that the general public in Germany has become very cautious about the privatisation of former state-owned enterprises via the stock market. In chapter 3 of this study it was already pointed out that the German ‘equity culture’ had at best limited success. The number of people holding shares did, in fact, double around the year 2000 with respect to late 1980s, but by the end of 2000s this number dropped significantly (see Table 3.3). 5

Railways

The railway reform (Bahnstrukturreform) of 1994 resulted in the creation of the Deutsche Bahn AG, the German national railway company, as a commercial company in total government ownership (Knieps, 2004). Deutsche Bahn AG (DB) has thus replaced the two separate West German (Deutsche Bundesbahn) and East German (Deutsche Reichsbahn) railway companies.

The privatisation of the DB was agreed upon by both the conservative and social democratic parties in 2005, yet the political debate intensified in 2007 when the social democrats required that the privatisation procedure include the issue of a minimum of 25 per cent of the so-called ‘people’s shares’ (see the case of Deutsche Telekom above), so to contain the influence of bigger private investors (Huffschmid, 2008). In 2008 a different model was decided upon, which would split the Deutsche Bahn into two separate corporations, the first one for the infrastructure which would be 100 per cent in public ownership (and would take on the largest part of the debts), and the second one for transport and logistic activities, which corresponds to around 90 per cent of the business activities and should be gradually opened (with an immediate offering of 24.9 per cent of the company shares) to private investors. The 2008 decisions however did not come to pass: due to uncertainties related to the financial crisis, the decision was postponed, and since then talks have not been resumed with regard to privatisation of the Deutsche Bahn.

5 See also chapter 14 of this study.
Hospital sector

The German hospital sector has undergone a long process of restructuring since the 1990s, characterised by the decline in the number of hospitals and hospital beds, on the one hand, and the rise in the number of hospital privatisations (Schulten, 2006). Major drivers for this, from the regulatory point of view, were the 1993 change in the hospital financing from the full cost coverage to capped hospital budgets system, and the 2003 introduction of the hospital reimbursement system that is based on diagnosis related groups. Pressures towards shorter lengths of stay in hospital increased, which resulted in the drop of the average length of stay from 10.1 days in 2000 to 8.5 days in 2006 (Weil, 2011).

With regard to ownership, there are essentially three types of German hospitals: public, non-profit, and private (investor-owned). All three types of hospitals benefit to some degree from state funding. Since the early 1990s the share of public hospitals has been decreasing, while the opposite holds for investor-owned hospitals. This shift was not due to specific liberalisation policies in the health care sector (as we have seen in the telecommunications and postal services) because there has never been a public monopoly in this sector. The shift towards more investor-owned hospitals was rather influenced by changing political, economic and social conditions which supported the commercialisation of the health care sector (Schulten, 2006). From 1991 to 2004, the share of public hospitals (in terms of number of hospitals) decreased from 46 to 36 per cent, whereas the share of private ones increased by approximately as much (from 14.8 to 25.6 per cent). The share of non-profit hospitals remained thus roughly the same (slightly decreased from 39.1 to 38.4 per cent) in this period (Schulten, 2006).

The reasons for ongoing privatisations in the German health care sector are to be found in the troublesome financial positions of large, public hospitals and in the changes in the German hospital financing system, where full cost compensation is no longer guaranteed. Of the large public teaching hospitals, every third was facing bankruptcy by 2006 (Weil, 2011). Thus for budget reasons, privatisation of public hospitals is convenient both for eliminating the responsibility of municipalities and federal states to cover the ongoing financial deficits, and because of the sale revenue. Incentives for privatisations could also be found in the easier access to finance and the ability to raise necessary funds from capital markets and benefit from the revenues obtained from selling the state property. Increasing presence of private hospitals has also meant that the health care sector in Germany is

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6 These are owned by German federal states, regions or municipalities.
7 Run for the most part by various welfare institutions and churches.
ever more opened to private capital markets. This was, actually, claimed to be one of the major reasons for privatisation under the conditions of fiscal austerity policies.

13.4. Financial institutions and the government during the financial crisis

At the time of the outbreak of the financial crisis, the German legal and institutional framework did not provide for any comprehensive mechanism for rescuing or restructuring distressed banks. In the period from August 2007 until September 2008 (fall of the Lehman Brothers), the German government provided capital injections, credit lines and/or guarantees for four German banks: Sachsen LB, Bayern LB, West LB, and Deutsche Industriebank (IKB) (Hüfner, 2010). When, however, in September 2008 the Hypo Real Estate Holding AG (HRE) ran into serious trouble (see below for a more detailed description) and the government had to proceed with complete nationalisation, the decision was made to establish a Federal Agency for Financial Market Stabilisation (Bundesanstalt für Finanzmarktstabilisierung, FMSA henceforth) in October 2008. At the time this was thought of as a temporary institution which would operate until the imminent danger of a financial market collapse had passed. It should be noted that the troubled institutions did not run into problems because of domestic non-performing loans and a domestically caused financial crisis. All of them bought toxic foreign products or were involved in the shadow banking sector abroad.

Alongside the FMSA, the Special Financial Market Stabilisation Fund (Sonderfonds Finanzmarktstabilisierung, SoFFin henceforth) was set up to interact directly with the financial institutions which apply for a rescue. Three main instruments of the SoFFin consisted in: guarantees up to 400 billion euro with the aim of overcoming short-term liquidity bottlenecks; recapitalisation up to 80 billion euro in form of equity or silent participation; and the assumption of risk positions with the fund taking on some of the banks’ risky claims and securities (Pleister, 2011). Theoretically, the SoFFin also was able to give guarantees for special purpose vehicles (SPVs) but in practice this never occurred.

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8 Neither the German central bank (Deutsche Bundesbank) nor the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) have the authority to step in for the purpose of rescuing commercial banks.

9 Once the threat of bank failures and bank runs was contained, the priority shifted towards identifying and removing bad assets thus addressing the balance sheet problems of the banking sector (Hüfner, 2010). A law was passed in July 2009 on the establishment of ‘bad banks’, according to which applicants are permitted to move their risk positions that are not part of their core business to a ‘bad bank’ set up by SoFFin. But this possibility was not used.
The introduction of the FMSA and of the SoFFin made up the immediate, ‘rescue phase’ of dealing with the financial crisis. The subsequent, ‘restructuring phase’ consisted in changing the legal framework and establishing permanent mechanisms for dealing with systemic bank crises. In January 2011, the Restructuring Act (Restrukturierungsgesetz) was passed with the aim of ‘providing an institutionalised legal framework for winding up banks that are too big to fail’ (Pleister, 2011, p. 160). The Restructuring Act, which was later integrated into the German Banking Act (Kreditwesengesetz), made the FMSA a permanent feature of German financial system architecture. All the potential future measures established by the Restructuring Act are planned to be funded by the bank levy, which is to be collected annually from all German banks. The target funding amounts to 70 billion euro, and it is to be managed by a bad bank created by the Restructuring Fund. However, this fund is considered to be too small for a systemic financial crisis.

Over the course of the financial crisis, SoFFin has not drawn upon the entire funds available for guarantees: in the peak period this amounted to 174 billion euro out of 400 billion euro, and on 31 October 2012 the amount outstanding was 4.5 billion euro. As for the involvement of SoFFin in recapitalisation, there are currently 18.8 billion euro outlays, of the total commitment of 80 billion euro (FMSA, 2012).

Figure 13.2: Guarantees by SoFFin, Germany, 2008-2010 (€ billion)

Source: IMF (2011, p. 9); data from FMSA
Notes: SoFFin – Special Financial Market Stabilisation Fund; HRE – Hypo Real Estate; FMS or FMSA – Federal Agency for Financial Market Stabilisation.

10 In April 2009 another law was passed – the Supplementary Act to Stabilize the Financial Market (Finanzmarkttabilisierungergänzungsgesetz, FMStErgG) – in the context of the nationalisation of Hypo Real Estate Holding.

11 See FMSA (2012).
Table 13.1: SoFFin guarantees, excluding Hypo Real Estate, Germany (€ billion)

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<td>9.7</td>
<td>7.3</td>
</tr>
<tr>
<td>HSH Nordbank AG</td>
<td>9.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Commerzbank AG</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>SdB (Lehman Brothers)</td>
<td>5.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Bayerische Landesbank AöR</td>
<td>4.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Düsseldorfer Hypothekenbank AG</td>
<td>2.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Aareal Bank AG</td>
<td>4.0</td>
<td>1.2</td>
</tr>
<tr>
<td>FMS Wertmanagement AöR</td>
<td>15.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Corealcredit Bank AG</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>55.6</strong></td>
<td><strong>28.2</strong></td>
</tr>
</tbody>
</table>

Source: FMSA (2012)

Notes: SdB – Sicherungseinrichtungsgesellschaft deutscher Banken mbH; SdB is a banking entity created in January 2009 in support of the Deposit Protection Fund of the German private commercial banks. The scope of the Deposit Protection Fund is to secure the deposits of all the customers of the private commercial banks up to a ceiling of 30% of the relevant liable capital of each member banks. SdB has upon its creation received the 6.7 billion euro SoFFin guarantee, which would allow to pre-finance future proceeds from the estates of insolvent Lehman Brothers entities.

Figure 13.2 and Table 13.1 show the guarantees provided by the SoFFin between 2008 and 2010. The guarantees for the Hypo Real Estate Holding AG (HRE) are distinguished from the other guarantees. From the last quarter of 2009 and during most of 2010, the HRE received the bulk of SoFFin support. The HRE is also the only financial institution that was completely nationalised during the financial turmoil in Germany. The Commerzbank was only partly nationalised.

The savings banks and the Landesbanken are publicly owned and therefore benefited from state guarantees in the case of default. This arrangement was very important for Landesbanken due to their market refinancing, but was much opposed by the private banks which claimed unfair competition. At the insistence of the European Commission, the guarantee obligation of the federal government for the Landesbanken was abolished in February 2002. However, existing liabilities of the Landesbanken were still covered and a phasing-out period until July 2005 was granted. It is argued (see Hüfner, 2010) that this created the wrong incentives for the Landesbanken, which started to invest in foreign securities abroad. In this period, complex investments based on the US mortgage market in particular promised significant returns. Whereas private banks started divesting themselves of foreign assets in 2007, Landesbanken kept increasing their portfolios well into 2008 (Hüfner, 2010). The financial meltdown thus had a very large negative impact on the German Landesbanken. It is noteworthy that Landesbanken frequently paid higher dividends than profits earned or even distributed dividends when they realised losses. Obviously public owners used them dysfunctionally to reduce budget deficits (see Table 13.2).
Table 13.2: Earnings and dividends of Landesbanken, Germany, 2007 – 2009 (€ million)

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Earnings before taxes</td>
<td>Dividends</td>
<td>Earnings before taxes</td>
</tr>
<tr>
<td>1</td>
<td>Bayern LB</td>
<td>255.0</td>
<td>122.0</td>
<td>-5,166.0</td>
</tr>
<tr>
<td>2</td>
<td>Helaba</td>
<td>402.0</td>
<td>34.0</td>
<td>-53.0</td>
</tr>
<tr>
<td>3</td>
<td>HSH Nordbank</td>
<td>148.0</td>
<td>241.0</td>
<td>-2,794.0</td>
</tr>
<tr>
<td>4</td>
<td>LBB</td>
<td>306.0</td>
<td>60.0</td>
<td>9.0</td>
</tr>
<tr>
<td>5</td>
<td>LBBW</td>
<td>355.0</td>
<td>89.0</td>
<td>-2,569.0</td>
</tr>
<tr>
<td>6</td>
<td>West LB</td>
<td>-1,498.0</td>
<td>0.0</td>
<td>26.0</td>
</tr>
<tr>
<td>7</td>
<td>Nord LB</td>
<td>503.0</td>
<td>167.0</td>
<td>22.0</td>
</tr>
<tr>
<td>8</td>
<td>Saar LB</td>
<td>7.3</td>
<td>8.4</td>
<td>-79.8</td>
</tr>
</tbody>
</table>

Source: Schäfer (2010, p. 119)

As soon as the crisis broke out, two Landesbanken – Sachsen LB and Landesbank Baden-Württemberg (LBBW) – were forced to merge in January 2008. Sachsen LB was the first bank in need of assistance, and in 2007, the federal state of Sachsen responded by providing 2.75 billion euro of guarantees (IMF, 2011). However soon after, the Sachsen LB was taken over by the LBBW. In June 2009, LBBW itself needed to be rescued.

Most of the remaining Landesbanken ran into trouble as well and had to be bailed out by their respective federal governments on the one hand, and by the SoFFin on the other hand. Bayern LB incurred large losses due to its investments in the US subprime mortgage market. HSH Nordbank, created in 2003 through a merger between the Hamburger Landesbank and the Schleswig-Holstein Landesbank, reported losses on its credit investment portfolio in 2008. In February 2009 HSH Nordbank received 3 billion euro in capital and 10 billion euro in guarantees from its major shareholders, the states of Hamburg and Schleswig-Holstein, but subsequently was granted 30 billion euro in guarantees from SoFFin (see also Table 13.3. below).

West LB and Hypo Real Estate are the only two institutions for which the German government has established bad banks, which operate as public bodies under the supervision of the FMSA.

West LB was owned jointly by the federal state of North-Rhine Westphalia and two regional saving banks’ associations. The attempted rescue and restructuring of the West LB by the German

12 In late 2009 for West LB and in mid 2010 for HRE. The ‘bad bank’ concept later became one of the cornerstones of the Restructuring Act of 2011.
government consisted of setting up a bad bank EAA (Erste Abwicklungsanstalt) at the end of 2009, and transferring 77 billion euro worth of assets and liabilities (mostly securities and structured loans, priced at book value) from the West LB to EAA in 2010 (IMF, 2011). Finally, however, in July 2012 West LB became the first German Landesbank which was dissolved as a result of the financial crisis.

Table 13.3: Measures in response to financial crisis, Germany, 2007 - April 2011

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>Aug.</td>
<td>IKB received €3.5 billion from public and private banks. Sachsen LB receives credit line of €17 billion from savings bank group and €2.75 billion in guarantees from the state of Saxony.</td>
</tr>
<tr>
<td></td>
<td>Dec.</td>
<td>Landesbank Baden-Württemberg takes over Sachsen LB.</td>
</tr>
<tr>
<td>2008</td>
<td>Mar./Apr.</td>
<td>WestLB receives €5 billion first loss guarantee from its owners.</td>
</tr>
<tr>
<td></td>
<td>August</td>
<td>KfW agrees to sell its 50 percent share of IKB to investor Lone Star.</td>
</tr>
<tr>
<td></td>
<td>Sept.</td>
<td>BaFin prohibits naked short-selling of selected instruments.</td>
</tr>
<tr>
<td></td>
<td>Oct.</td>
<td>Hypo Real Estate receives liquidity support with package worth €35 billion from the Federal government, banks, and financial sector firms to prevent collapse, subsequently increased to €50 billion. Government announces public commitment to fully protect household deposits. Finanzmarktrassistenzgesetz is passed creating SoFFin and providing framework for €480 billion in guarantees, recapitalizations, and asset purchases.</td>
</tr>
<tr>
<td></td>
<td>Nov.</td>
<td>Commerzbank is granted €15 billion in guarantees (of which €5 billion are taken) and receives €8.2 billion in the form of a silent participation from SoFFin (at end-2008). Bayern LB is granted €15 billion in guarantees (of which €5 billion are taken, subsequently reduced to €2.8 billion) and receives €10 billion in capital from state of Bavaria.</td>
</tr>
<tr>
<td>2009</td>
<td>Jan.</td>
<td>Commerzbank to receive additional €10 billion from SoFFin, made up of a silent participation amounting to €6.2 billion and a capital increase of 25 percent of ordinary shares plus one share held by the Federal government against payment of €1.8 billion.</td>
</tr>
<tr>
<td></td>
<td>Feb.</td>
<td>HSH Nordbank receives €3 billion in capital and €10 billion in guarantees from states Hamburg and Schleswig-Holstein. Hypo Real Estate support reaches total of €52 billion in guarantees from SoFFin.</td>
</tr>
<tr>
<td></td>
<td>March</td>
<td>HSH Nordbank is granted €30 billion in guarantees from SoFFin (of which €17 billion are taken and €13 billion are subject to conditions). SoFFin buys shares in Hypo Real Estate worth €60 million.</td>
</tr>
<tr>
<td></td>
<td>April</td>
<td>Finanzmarktrassistenzerganungsgesetz is passed, including an option for public takeover of banks as a last resort. SoFFin buys shares in Hypo Real Estate worth €124 million. Landesbank Baden-Württemberg receives €5 billion in capital and €12.7 billion in guarantees from state Baden-Württemberg.</td>
</tr>
<tr>
<td></td>
<td>May</td>
<td>BaFin extends prohibition of naked short-selling.</td>
</tr>
<tr>
<td></td>
<td>June</td>
<td>SoFFin to provide €2.96 billion in capital to Hypo Real Estate.</td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>“Bad-Bank”-Act is passed allowing the establishment of winding-up institutions.</td>
</tr>
<tr>
<td></td>
<td>Oct./Nov.</td>
<td>Hypo Real Estate is nationalized after squeezing out shareholders with compensation of €158 million and receives additional €3 billion in capital from SoFFin, with guarantees extended until end-June 2010.</td>
</tr>
<tr>
<td></td>
<td>Dec.</td>
<td>Winding-up institution created for WestLB to take on up to €85 billion portfolio of assets and liabilities. WestLB core bank to receive €5 billion in capital support from SoFFin.</td>
</tr>
<tr>
<td>2010</td>
<td>April</td>
<td>WestLB split into core bank and a residual €77 billion portfolio is transferred to the winding-up institution EAA.</td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>Winding-up institution created for Hypo Real Estate to take on up to €210 billion portfolio of assets and liabilities.</td>
</tr>
<tr>
<td></td>
<td>Oct.</td>
<td>Hypo Real Estate is split and a €176 billion portfolio is transferred to the winding-up institution FMS.</td>
</tr>
<tr>
<td></td>
<td>Dec.</td>
<td>Availability of new financial stability measures supported by SoFFin expires at end-2010.</td>
</tr>
<tr>
<td>2011</td>
<td>Jan.</td>
<td>New bank restructuring law in force that allows for special resolution measures and establishes a restructuring fund.</td>
</tr>
<tr>
<td></td>
<td>Feb.</td>
<td>Revised restructuring plan for WestLB with different options, including possibility to increase the size of the portfolio transferred to the winding-up institution EAA.</td>
</tr>
<tr>
<td></td>
<td>April</td>
<td>Further details of restructuring plan for WestLB submitted to the European Commission.</td>
</tr>
</tbody>
</table>

Source: IMF, 2011, p. 11
The banking group Hypo Real Estate Holding AG (HRE) is the only case of a complete bank nationalisation by the German state during the financial crisis. The HRE was facing severe liquidity problems in September 2008, mostly due to its subsidiary, Depfa bank, and the government injected capital to the amount of 10 billion euro. The HRE was heavily engaging in the subprime mortgage market and had large amounts of mortgage-backed securities held by its several special purpose vehicles. As greater intervention became indispensable, the banking group HRE was nationalised by the German government in 2009,\textsuperscript{13} and a bad bank, FMS Wertmanagement, was established in 2010 (IMF, 2011). The restructuring plan in April 2009 (also finally approved by the European Commission in July 2011) consisted of 10 billion euro of capital, 20 billion euro of asset relief, and 145 billion euro of liquidity guarantees (EC, 2011).

Another interesting case was the one of IKB (Deutsche Industriebank), a German bank specialising in the financing of manufacturing, which during the years leading up to the crisis had speculated in the US subprime mortgage sector. This was done by its purposely established SPV, ‘Rhineland Funding Capital’, and had made profits for the IKB in the initial years but then in 2007, as the subprime mortgage market broke down, the losses amounted to some 10 billion dollars (Huffschmid 2008). The owners of the IKB were, at the time, various private banks and institutional investors, but the largest shareholder (38 per cent) was the German publicly-owned KfW (Kreditanstalt für Wiederaufbau). IKB’s loss was the largest single loss in German banking history since World War II. A rescue package was set up for the IKB in July 2007 for 3.5 billion dollars. Seventy per cent of these costs were carried by the KfW, and of the remaining thirty per cent the bulk was borne by the federal government (Huffschmid, 2008). Later that year the KfW pumped another 1 billion dollars into the IKB whereby its ownership of the IKB increased to 45 per cent. The KfW was desperate to sell, but no buyers could be found. By 2008, the KfW had injected additional capital and owned 90.8 per cent of the IKB. In August 2008, this majority stake was sold to Lone Star, a private equity investor form the US, for only 137 million dollars. The German state lost in total 11 billion dollars during one year of attempted rescuing of the IKB.

Of the private banks it is worth mentioning briefly the case of the Commerzbank, which also benefited from a government rescue fund. A capital injection in May 2009 amounted to 25 per cent of the bank’s equity, although the government ‘kept in the back’ and considered this loan to be temporary. In fact, Commerzbank has now repaid all of its debt.

The biggest German bank, the Deutsche Bank AG, never asked for an intervention. However, the Deutsche Bank was able to load off substantial parts of its risky loans to the IKB before the outbreak

\textsuperscript{13} This was the first bank nationalisation in German history in the post-war period.
of the crisis (Huffschmid, 2008). Additionally, the Deutsche Bank came under serious attack for avoiding to register losses incurred during the crisis, which would amount to 12 billion US dollars (FT, 6 December 2012). Bank traders namely did not record mark-to-market, misvaluing a large position in derivatives structures (the so-called leveraged super senior trades). Had it accounted for its positions correctly, the Deutsche Bank would have needed to ask for a government bailout.

Bank runs and the collapse of the banking system in Germany were avoided. However, it meant a significant increase in government debt with severe implications for future macroeconomic policies as will be outlined in chapter 17.

It can be claimed that a breakdown of the German banking and financial system in general could be avoided by government intervention, partly by guarantees and partly by nationalisation. German banks became more cautious to give credit to the private sector in Germany; however, a credit crunch comparable to some southern European countries did not take place in Germany. In so far the stabilisation of the financial system was successful. There was also in Germany the danger of bank runs. This was avoided by the official promise by Chancellor Merkel and Finance Minister Steinbrück in early October 2008 to guarantee for all bank deposits in Germany without any limit. The stabilisation of the German financial system increased government debt significantly, whereas the federal budget as well as state public households were severely affected (see also the analysis of macroeconomic policies in chapter 17.)

13.5. Conclusion

The existence and the relative size of the German three-pillar banking system did not change much in spite of some pressures for liberalisation and privatisation. What did occur were increased mergers within pillars, presumably in response to competitive pressures, but the share of bank assets that are in public ownership has not declined or changed significantly in the last two to three decades.

In other sectors, however, Germany experienced important privatisation processes: in terms of number, the post-unification wave of privatisations in East Germany was the most important, but this was a special case and caused by the breakdown of the GDR. The privatisation of public utilities was also important. This was in part due to ideological motives, partly pushed by the European Institutions and partly caused by the desire to raise public revenues or sell loss-making units. These two types of privatisation waves were thus qualitatively very different. The divestment of public ownership of former GDR companies was organised by the federal agency Treuhandanstalt. Its stated tasks were to save as much as possible of East German industry, to create supervisory boards and find prospective buyers interested in long-term company growth and to guarantee post-privatisation
participation in both funding and controlling the restructuring activities. In practice this amounted to supporting West German capital. For this reason, the role of the financial institutions in this process was contained.

However, increased pressures for the liberalisation of public utilities driven by changing political and economic ideologies, and often at the request of the European institutions, resulted in the privatisation of traditional state monopolies such as the postal, telecommunications and to some extent transport sectors (the health care sector was never a state monopoly, but hospitals have been increasingly privatised since the early 1990s).

This has created new markets also for the financial institutions to expand their activities, and has opened the former public utilities to small and large investors. In the case of the Deutsche Telekom of 1996, the strategy of advertising ‘people’s stock’ did cause a temporary change in the attitude of the German population toward stock market participation. However, the spectacular loss of value of Telekom shares since 2000 has reversed this trend and arguably made the German public even more cautious than before.

The recent financial crisis provided another link between the government and the financial sector. Most of the banks that needed intervention were Landesbanken which are publicly owned, yet the crisis resulted in the dissolution of one of these, West LB, after several failed attempts at privatisation. On the other hand the German Industriebank, IKB, whose major shareholder before the crisis was the government-owned development bank KfW, was privatised i.e. sold to a US based private equity company after enormous losses for the government which took over all of its debts. There was also a partial nationalisation in the case of Commerzbank, but the only case of complete nationalisation was the Hypo Real Estate Holding AG in 2009.
References


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Data sources


14. The financial sector and private households - culture and norms of the financial system

14.1. Introduction

This chapter will focus on the relationship between the financial sector and the private household sector in Germany since the early 1980s where possible. It will start with an overview of the development of income distribution and the composition of the income of the private household sector in order to provide some background. Then, it will take a look at the consumption and saving of private households, before examining the composition of private households’ saving and wealth in more detail. Finally, it will provide some data on house ownership, mortgage debt and credit card debt. The overall purpose of this section is to single out the country-specific effects of financialisation on the private household sector, which in general is said to contribute to re-distribution at the expense of wage incomes, on the one hand, and to provide, in principle, the conditions for increasing debt-financed consumption, on the other hand (Hein, 2012). However, the latter condition might not materialise for several reasons, as will be seen below for the case of Germany.

14.2. The development of income distribution and the components of private household sector income

As will be shown in detail in chapter 16 of this study, Germany has seen a tendency of declining labour income shares since the early 1980s, increasing inequality in household income and a rising income share of top incomes since the mid 1990s (Anselmann and Krämer, 2012; Bach et al., 2009; OECD, 2008; Hein, 2011a, 2011b). In this respect, the German development is generally in line with that of other developed capitalist economies affected by financialisation, with the degree of redistribution in favour of profits and top incomes even exceeding some of the other countries.

These redistributive tendencies are reflected in the development of the composition of income of the private household sector (including non-corporate business and non-profit organisations) (Figure 14.1). The main source of gross income of the private household sector is wages, albeit at a declining tendency. The share of wages in total gross private household income has come down from

\footnote{Figure 14.1 presents the net interest and rent receipts of households, since gross values would be driven by changes in interest rate levels.}
around 72 per cent in the mid-1990s, to below 68 per cent in 2006, and has only recovered slightly since then. The share of dividends and profit payouts has increased from close to 10 per cent in the mid-1990s to close to 16 per cent in 2006, and has remained at that level ever since. Income from insurance is of minor importance, but has increased slightly. It should be noted that the gross income of the private household sector in the national accounts also includes profits of non-corporate business, the share of which has a mild tendency to fall.

Figure 14.1: Primary gross income of the household sector\textsuperscript{2} by type, Germany, 1980 – 2011 (% of total)

![Graph showing primary gross income by type from 1980 to 2011.]

Source: Statistisches Bundesamt (2011), own calculations

14.3. Consumption and saving of private households

Before German unification, the net saving rate of West German households out of disposable income was around 13 per cent (Figure 14.2), which was significantly above the saving rate in the US and the UK and also France, but below that of Japan and Italy. After unification, the saving rate for united Germany saw a tendency to decline in the course of the 1990s and by 2000 had fallen below 10 per cent. However, when the new economy crisis hit in 2000/01, this tendency was reversed and the saving rate has increased well above 11 per cent since then.\textsuperscript{3} Klär and Slacalek (2006) relate this increase to three main causes: 1. redistribution of income at the expense of the labour income share and the low income households; 2. increasing precautionary saving since the early 2000s in the face of weak growth, high unemployment, and ‘reform policies’ aiming at the deregulation of the labour

\textsuperscript{2} The Federal Statistical Office includes households and non-profit institutions serving households in the household sector. In the following when we refer to the household sector we use this wider definition.

\textsuperscript{3} Whereas the tendency of a falling saving rate was stopped and partly reversed in France, Italy and Japan after the new economy crisis, it continued in the US, the UK and even in Japan until the Great Recession.
market and a reduction of social benefits (Agenda 2010, Hartz-Laws); and 3. the absence of wealth effects on consumption.

**Figure 14.2: Net saving of the household sector, Germany, 1980 – 2011 (% of net disposable income)**

Saving rates out of profit income are generally higher than out of wages, and the propensity to save out of household income increases with the level of household income. Estimates of propensities to save (or to consume) out of wages and out of profits usually find differentials between 0.32 (Hein and Vogel, 2008) and 0.44 Onaran et al., (2011) for Germany. The decrease in the wage share has, therefore, contributed to the increase in the overall propensity to save. There is also considerable evidence that a higher propensity to save is associated with a higher level of individual household income, irrespective of the source of income, as Figure 14.3 suggests. Van Treeck et al. (2007) could not find any indication that the high income households have decreased their propensity to save between 1993 and 2003, when income was redistributed in their favour. However, adding the most recent data for 2008 an overall decline in the saving rates in all income classes can be found, so that also the average savings rate declines. This, however, seems to contradict the development of the saving rate taken from the national accounts and referred to above and it is also in contrast to the study of Brenke (2011), covering more recent data from the German Socio Economic Panel (GSOEP), which reports that households in the bottom half of the distribution have slightly reduced their saving rates after 2000, whereas households in the upper half of the distribution, particularly in the top decile, have slightly increased their saving rates, which has overcompensated for the falling saving rates in the lower parts of the distribution.4

4 Van Treeck and Sturm (2012) preliminarily conclude from this evidence that the relative income model, according to which consumption expenditure is affected by relative income (‘keeping up with the Joneses’), has little explanatory power for Germany.
Figure 14.3: Propensity to save out of monthly disposable income by income group, Germany, 1993 – 2008

a) 1993 (in DM)

b) 2003 (in Euro)

c) 2008 (in Euro)

Source: van Treeck et al. (2007, p. 76), Statistisches Bundesamt (2008), own calculations
Linking redistribution to changing saving behaviour, and reviewing the related literature on Germany, van Treeck and Sturm (2012, p. 67) argue ‘that there seems to be a general consensus that the rise in the saving rate after 2000 can be to a large extent attributed to precautionary saving in the face of higher income insecurity, policy uncertainty and a widespread fear of status loss’. They conclude that rising inequality led to a widespread feeling of insecurity even within the upper-middle class, which in public discussions is reflected as the ‘erosion of the middle class’. The higher precautionary saving motive is attributed both to the worries about expected future income from the public pension system and to uncertainties about the effects of labour market reforms.

Wealth effects on consumption have been examined extensively in the econometric literature. Studies have shown that (financial and housing) wealth is a statistically significant determinant of consumption in many countries (Boone and Girouard, 2002; Ludvigson and Steindel, 1999; Mehra, 2001; Onaran et al., 2011). However, Dreger and Slacalek (2007) obtained that the marginal propensity to consume out of financial and housing wealth in capital-market based countries has been significantly higher than in bank-based countries. Therefore, they conclude that these effects are of minor importance in the case of Germany, a typical bank-based country. Furthermore, German households’ wealth increases have been fairly moderate since the mid-1990s, and German house prices have not seen any significant tendency to rise since then.\(^5\) This chapter will examine the development of financial wealth in more detail in the next subsection.

Because of the increasing propensity to save out of disposable income, consumption demand has been weak in Germany, particularly, after the new economy crisis of 2000/01. Compared to the cycle of the early 1980s until the early 1990s, the contributions of consumption demand to real GDP growth had already declined in the business cycle of the 1990s, but they became almost negligible in the 2000s, with the exception of 2006 and 2011 (Figure 14.4).

\(^5\) See also Klär and Slacalek (2006) and Hein (2011b).
14.4. Household wealth and indebtedness

Figure 14.5 shows the composition of the annual flows of saving of the private household sector (here including non-corporate business and non-profit organisations) from 1991 to 2010 (as a percentage of nominal GDP). As can be seen, contributions to insurance and pension funds were almost constant over time, whereas there were major changes in the relevance of other components. In the course of the new economy boom of the late 1990s, household investment in shares gained ground in Germany at the expense of more traditional types of saving in different bank accounts and (government) bonds. However, after the new economy crisis, household investment in shares became negative for several years. The attractiveness of the stock markets and the rise of a ‘stock market culture’ in Germany was, therefore, very short-lived, as we have already discussed more extensively in the previous chapter 13.\(^6\) Bank accounts became more important again, and until the Great Recession and the concomitant euro crisis, (government) bonds were also a major type of households’ saving. However, when the crisis hit in 2008, this type of saving became negative, i.e. households in the aggregate sold bonds to other sectors.

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\(^6\) This is confirmed by data of the Deutsche Aktieninstitut (German Institute for Stocks). The number of holders of shares or investment fund shares that are invested in shares peaked in 2001 at 12.9 million and declined then until 2010 to 8.2 million. It has been increasing since then again, and in the first half of 2012 there are 10.2 Million direct or indirect share holders. However, the experts of the institute reason that this is not due to a general shift in perception of German investors but rather due to special factors, like fears of inflation and low yields in other asset classes (DAI, 2012). For more details see also chapter 3 of this study.
This pattern of saving behaviour and financial wealth allocation of the German private household sector is reflected in the composition of private households’ financial wealth, depicted in Figure 14.6. Most of the financial wealth is held as currency and bank deposits, with a slight decline until the new economy crisis, and a rise following the Great Recession. The claims against insurance companies are the second most important form of financial wealth, with a slightly rising trend, particularly since the early 2000s when the pay-as-you-go pensions were cut and capital stock-based pensions became subsidised by the government (Riester-Rente, Rürup-Rente, etc.). The weight of shares increased in the second half of the 1990s until the new economy crisis, and has considerably lost in importance since then. The share of bonds slightly declined running up to the new economy crisis, gained in importance after it, and declined again after the Great Recession. The share of wealth held in investment funds increased significantly up to the new economy crisis, remained constant until 2005, and has declined since then. Taking direct and indirect (investment funds) wealth held in shares together, stock markets were attractive to German households in the second half of the 1990s until the new economy crisis, but this tendency was very short-lived. In particular after the Great Recession the share of wealth held in shares declined once again, almost reaching the values of the early 1990s.
Figure 14.6: Financial assets of private households (including non-corporate business and non-profit organisations), Germany, 1991 – 2010 (% of total)

Source: Deutsche Bundesbank (2012), own calculations

Next, real assets and distributional issues are included in the overview of the composition of household wealth. Furthermore, the development of financial liabilities of this sector is addressed. Real and financial net wealth (including real estate, net financial assets, claims against private insurance companies, shares and ownership of firms, gold, jewellery, art objects, etc.) is extremely unequally distributed among households and individuals in Germany, and the degree of inequality had actually increased prior to the Great Recession, as a recent study by Frick and Grabka (2009) based on GSOEP data has shown. The Gini coefficient for net wealth distribution among adults rose from 0.777 in 2002 to 0.799 in 2007. The median value was at 15,000 euro in 2002 and at 15,288 euro in 2007, while the medium value was at 80,055 euro in 2002 and at 88,034 euro in 2007. 27 per cent of the adults did not have any wealth at all or were even in debt, whereas the upper 10 per cent had an average net wealth of 220,000 euro per person. The wealthiest 10 per cent held 61.1 per cent of net wealth in 2007 (57.9 per cent in 2002), while the bottom 50 per cent had hardly any wealth (1.3 per cent of total net wealth in 2002, 1.2 per cent in 2007). Net wealth of the poorest decile was negative: -1.2 per cent in 2002 and -1.6 per cent in 2007.

As can be seen in Figure 14.7, households’ financial assets increased in relation to disposable income from the early 1990s up to the new economy crisis 2000/01. This increase was mainly driven by private saving invested in financial assets, and, particularly in the second half of the 1990s, by the

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7 Claims against the public pay-as-you-go pension system are not included.
increase in the prices of shares. In the years after the new economy crisis, financial wealth in relation to disposable income stagnated because of positive saving but declining stock market prices, and it started to rise again from 2004 until the Great Recession.

The most important assets held by private households are real estate assets (Figure 14.7). The relation to disposable income continuously increased from the early 1990s until the Great Recession. This development was exclusively driven by new acquisition of real estate by private households, because residential property prices did not increase at all in Germany since the mid 1990s (Figure 14.8). On the contrary, unlike many other countries, the period from the early 2000s until the Great Recession even saw a slight decrease in the residential property price index. In this respect, the development in Germany completely differed from the ones in France, Italy, the UK and the US. The degree of house ownership in Germany increased from the early 1990s until the early 2000s, but has stagnated since then (Table 14.1). For more details on the real estate sector see chapter 15 of this study.

Figure 14.7: Assets and liabilities of households, Germany, 1992 - 2008 (% of disposable income)

Figure A14.1 in the Appendix shows the development of the DAX30, the most important share price index for Germany. The Index rose from about 1700 in 1995, to almost 6000 in March 2000.
Figure 14.8: Residential property prices, 1995 - 2010 (Index 2002 = 1)

Source: Bank of International Settlements (BIS) (2012), own calculations

Table 14.1: Housing status of households, Germany, 1993 – 2008 (%)

<table>
<thead>
<tr>
<th>Year Reference day: 1 January</th>
<th>Germany</th>
<th>Former territory of the Federal Republic</th>
<th>New Länder and Berlin-East</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tenant</td>
<td>Owner</td>
<td>Tenant</td>
</tr>
<tr>
<td>1993</td>
<td>61.0</td>
<td>39.0</td>
<td>55.0</td>
</tr>
<tr>
<td>1998</td>
<td>59.7</td>
<td>40.3</td>
<td>56.4</td>
</tr>
<tr>
<td>2003</td>
<td>57.0</td>
<td>43.0</td>
<td>54.4</td>
</tr>
<tr>
<td>2008</td>
<td>56.8</td>
<td>43.2</td>
<td>54.3</td>
</tr>
</tbody>
</table>

Source: Statistisches Bundesamt (2012a)

Financial liabilities in relation to disposable income have slightly increased from the early 1990s until the crisis in 2000/01, and have shown a declining tendency since then (Figure 14.7). As already discussed in chapter 2 (Table 2.1), this contrasts with many other countries, where private household gross debt continued to increase relative to disposable income in the early 2000s. In international comparison, German private household gross debt to disposable income ratios were still relatively low prior to the Great Recession. However, (potential) over-indebtedness is a problem for the very poor households in Germany (see Table A14.2 in the appendix).

Finally, this section looks at available data on the types of liabilities of the private household sector (including non-corporate business and non-profit organisations). As can be seen in Figure 14.9, the most important component is housing loans. In relationship to nominal GDP, housing loans increased from 1990 until the early 2000s, and have been decreasing ever since. Consumption credit is of minor importance.

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9 See also Debelle (2004).
importance. Relative to GDP, this type of credit slightly increased in the course of the 1990s until the crisis 2000/01, and since then has shown a falling tendency.

**Figure 14.9: Loans to households by type, Germany, 1990 – 2011 (% of GDP)**

![Graph showing loans to households by type, Germany, 1990 – 2011 (% of GDP)](image)

Source: Deutsche Bundesbank (2012), European Commission (2012), own calculations

The importance of households’ credit card debt is difficult to assess in the case of Germany, because of the lack of data. As can be seen from Table A14.1 in the Appendix, the number of credit cards issued has increased continuously since the mid 1990s. However, 97.5 per cent of credit cards only have a payment function.

### 14.5. Conclusion

The composition of income sources of the private household sector in Germany has changed since the mid-1990s, with the share of wages decreasing and the share of distributed profits (dividends and profit payouts) increasing. After a decline in the private saving rate during the 1990s, the average propensity to save out of disposable income has increased since the new economy crisis. The main reasons for this increase were the redistribution of income at the expense of the labour income share and the low income households, an increase in precautionary saving since the early 2000s in the face of weak growth, high unemployment and ‘reform policies’ aimed at deregulation of the labour market and reduced social benefits, as well as the absence of wealth effects on consumption. Therefore, growth contributions of private consumption were particularly weak in Germany in the early 2000s, prior to the Great Recession.

The savings of private households are mainly in deposit and saving accounts with banks, and in contributions to private insurance and pension funds. The relevance of shares and investment funds increased during the new economy boom in the second half of the 1990s, but has since returned to the values of the early 1990s. The attractiveness of stock markets and the rise of a ‘stock market
The relationship of total financial assets to nominal GDP or disposable income of private households has seen a tendency to increase starting from the early 1990s, with the exception of a few years in the aftermath of the new economy crisis and the decline in stock market prices. Although house prices have not increased, the relationship of real estate wealth to GDP or to disposable income has continuously increased since the early 1990s. However, financial and real estate wealth are extremely unequally distributed in Germany, and inequality has actually increased in the early 2000s.

Financial liabilities to disposable income ratios slightly increased in the course of the 1990s, but tended to decline between the new economy crisis and the Great Recession. While the main component of household debt is housing loans, loans for consumption are of minor importance and their significance even decreased after the new economy crisis in the early 2000s. Credit card debt does not seem to play a role. However, lack of data does not allow drawing further conclusions. Overall, private household debt in Germany is low by international comparison, and did not show any tendencies to increase in the cycle before the Great Recession.

However, what is true for the aggregate private household sector must not be true for low income households. Saving propensities for incomes below 1500 euro were negative in 2008, saving rates in the bottom half of the personal income distribution have fallen in the early 2000s, and the net wealth of the poorest decile of wealth distribution was negative. (Potential) over-indebtedness is, therefore, a problem for the very poor households in Germany.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cards issued in the country (thousands)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cards with a cash function</td>
<td>80,454</td>
<td>84,960</td>
<td>91,324</td>
<td>99,250</td>
<td>106,323</td>
<td>125,508</td>
<td>119,392</td>
<td>116,355</td>
<td>114,836</td>
<td>113,311</td>
<td>104,217</td>
<td>123,558</td>
<td>125,714</td>
<td>129,595</td>
<td>130,223</td>
</tr>
<tr>
<td>Cards with a debit function</td>
<td>71,814</td>
<td>7,5760</td>
<td>81,145</td>
<td>9,0210</td>
<td>99,177</td>
<td>93,234</td>
<td>93,658</td>
<td>90,015</td>
<td>88,502</td>
<td>91,577</td>
<td>89,709</td>
<td>100,740</td>
<td>100,667</td>
<td>101,762</td>
<td>102,197</td>
</tr>
<tr>
<td>Cards with a delayed debit function</td>
<td>13,540</td>
<td>14,200</td>
<td>15,179</td>
<td>17,040</td>
<td>17,747</td>
<td>17,969</td>
<td>19,694</td>
<td>20,203</td>
<td>20,432</td>
<td>21,141</td>
<td>18,260</td>
<td>18,991</td>
<td>20,522</td>
<td>21,613</td>
<td></td>
</tr>
<tr>
<td>Cards with a credit function</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>3,452</td>
<td>3,221</td>
<td>3,704</td>
<td>3,728</td>
<td></td>
</tr>
<tr>
<td>Cards with an e-money function</td>
<td>22,000</td>
<td>35,000</td>
<td>60,700</td>
<td>60,700</td>
<td>67,333</td>
<td>62,597</td>
<td>62,817</td>
<td>63,372</td>
<td>64,575</td>
<td>65,906</td>
<td>77,774</td>
<td>79,889</td>
<td>86,006</td>
<td>95,280</td>
<td></td>
</tr>
<tr>
<td>of which: cards with an e-money function which have been loaded at least once</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>4,428</td>
<td>4,453</td>
<td>4,863</td>
<td>5,185</td>
<td></td>
</tr>
<tr>
<td>Total number of cards (irrespective of the number of functions on the card)</td>
<td>85,354</td>
<td>89,960</td>
<td>96,324</td>
<td>107,250</td>
<td>116,923</td>
<td>125,624</td>
<td>121,019</td>
<td>118,395</td>
<td>117,840</td>
<td>123,390</td>
<td>118,770</td>
<td>132,258</td>
<td>133,586</td>
<td>139,137</td>
<td>139,021</td>
</tr>
<tr>
<td>of which: cards with a combined debit, cash and e-money function</td>
<td>n.a.</td>
<td>n.a.</td>
<td>60,700</td>
<td>60,700</td>
<td>60,700</td>
<td>58,885</td>
<td>61,525</td>
<td>62,574</td>
<td>62,398</td>
<td>65,441</td>
<td>64,168</td>
<td>66,099</td>
<td>76,783</td>
<td>81,263</td>
<td>85,149</td>
</tr>
<tr>
<td>Memo</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retailer cards</td>
<td>4,900</td>
<td>5,000</td>
<td>5,000</td>
<td>8,000</td>
<td>10,600</td>
<td>7,400</td>
<td>7,700</td>
<td>8,500</td>
<td>9,300</td>
<td>10,500</td>
<td>12,600</td>
<td>11,400</td>
<td>10,100</td>
<td>n.a.</td>
<td></td>
</tr>
</tbody>
</table>


2. Includes cards with a credit function up to 2006.

3. Cards with an e-money function which are credit balanced at the end of the period.

4. Part of delayed debit function (charge cards). The German word *Kreditkarte* is used for both credit and charge cards.

Table A14.2: Over-indebtedness of private households, Germany, 1989 – 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Over indebted households in million(^1)</th>
<th>Over indebted households due to outstanding loans only in million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>1.2(^2)</td>
<td>-</td>
</tr>
<tr>
<td>1994</td>
<td>2(^3)</td>
<td>-</td>
</tr>
<tr>
<td>1997</td>
<td>2.68(^4)</td>
<td>-</td>
</tr>
<tr>
<td>1999</td>
<td>2.77(^5)</td>
<td>-</td>
</tr>
<tr>
<td>2002</td>
<td>3.13(^6)</td>
<td>2.4(^5)</td>
</tr>
<tr>
<td>2003</td>
<td>-</td>
<td>2.9(^5)</td>
</tr>
<tr>
<td>2004</td>
<td>-</td>
<td>2.88(^5)</td>
</tr>
<tr>
<td>2005</td>
<td>-</td>
<td>1.9(^5)</td>
</tr>
<tr>
<td>2006</td>
<td>-</td>
<td>1.6(^5,6)</td>
</tr>
</tbody>
</table>

\(^1\) Over a longer period of time, despite a reduction in living standards, income and wealth are not sufficient to settle existing liabilities

\(^2\) West Germany


\(^6\) Reasons for the reduction are not clarified yet. It is to note that besides loan liabilities there are a range of other liabilities (rent arrears, liabilities towards public institutions, utility companies or catalogue companies), which are not included in the study by Zimmermann. Additionally, it is to note that the data from the socioeconomic panel is based on a voluntary survey and that it might represent the situation of low income households insufficiently

Source: Deutsche Bundesregierung (2008, p. 185)

Figure A14.1: DAX, Germany, 1988 - 2012 (December 1987 = 1000)

Source: Deutsche Bundesbank (2012)
References


Frick, J. and M. Grabka (2009), ‘Gestiegene Vermögensungleichheit in Deutschland’, DIW Wochenbericht, April, pp. 54-67, Berlin, DIW


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https://www.destatis.de/EN/FactsFigures/SocietyState/IncomeConsumptionLivingConditions/Housing/Tables/HousingStatusTimeComparison_EVS.html
15. The real estate sector and its relation to the financial sector

15.1. Introduction

Unlike other countries Germany did not develop a real estate bubble in the 2000s and was not affected by a fall in real estate prices and non-performing loans created by the bust phase of real estate bubbles. We argue here that the relative stability of the German real estate market is the result of a combination of specific institutional features. Firstly, governmental intervention in the real estate sector led to a diversified supply of housing in all segments. This was achieved not only by incentives, but also by the direct provision of housing through public associations. Even though the government has decided to reduce its active role in the sector in recent decades, the established structures still prevail and stabilise the market today. There was a sufficient supply of rental dwellings, so that households only decided to purchase their own homes when it was beneficial to buy and a sustainable financing plan was possible. Secondly, a relatively conservative system of real estate financing contributes to the stable development of the real estate market. Banks have access to long-term, stable and low-cost funding allowing them to provide long-term finance to the households. At the same time, banks ask for sufficient own capital before they finance real estate investment by households. Those factors seem to reinforce each other and seem to be beneficial for the stability of the system as a whole.

For an in-depth analysis of real estate market this chapter will outline the most important features of the German real estate sector and draw conclusions. With this objective in view, first the institutional and political framework for the real estate sector will be outlined. After this the macroeconomic relevance of the sector in Germany will be examined. Thereafter, some stylised facts about the long-term developments in prices and economic activity in the real estate sector will be outlined. Last, the relations between the financial and the real estate sector will be examined. Here we will look in particular at the typical financing structures of real estate investments and acquisitions. Also, a short overview of the position of financial investors in this market will be given. In general, there is only limited and very fragmented data on the real estate sector in Germany. The most comprehensive data is on the residential real estate market, so that in most parts we will present data concerning residential real estate, and only where available we will also present data concerning commercial real estate.
15.2. Historical background and institutional framework

Looking at different types of housing markets Germany belongs to a model which is characterised by a large part of the population living in rental residences and the share of owner-occupied housing is only around 40 per cent. Housing finance is specialised and highly regulated. This is supposed to create more stable but generally less active markets (Giucci and Strubenhoff, 2003, pp. 20-21). The development of this particular model in Germany has historical roots.

The housing market in Germany prior to World War II

Until the First World War, residential property was seen purely as a private economic good, and hence the supply of housing space was left to the market. Therefore, rental prices were also a pure market issue. The only limiting regulations were general usury laws. There was neither social protection of tenants, nor subsidies for the construction of residential property. With the urbanisation processes during the industrialisation of the late 19th century the demand for housing in cities increased rapidly. This led to strong growth in private construction of new housing in the cities. The developers had an interest in creating as many separate apartments in one building block as possible to rent out to low-income households, which were the majority of the population. Due to the lack of urban planning and governmental regulation, a rapid overcrowding with enormous grievances occurred in the cities. For example, in Berlin the average number of residents per housing block at the beginning of the 20th century was 75.9. The comparable figure for 1990 is 10.3. Already in those times speculative trading of building land occurred and increased land prices in cities to very high levels not affordable for working class households.

The provision of small dwellings for low-income households was particularly insufficient, and rents for these were relatively high. This fostered the development of other, not purely profit-oriented, providers of dwellings. For industrial firms the lack of flats and high rents meant a lack of industrial workers and high wages. Therefore, big companies started to construct and provide company housing. The construction and provision was often organised in sub-companies, which later on were often transformed into non-profit housing associations. Additionally, in response to the increasing pauperisation of working class households in the cities between 1845 and 1860 a movement was

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1 Scandinavian and English-speaking countries follow the homeowner model, with owner-occupation ratios of 60-70%, high transaction levels and more favourable credit facilities, supported by highly liberalized financial markets. Spain, Italy, Greece follow the Southern European model. It is characterised by very high levels of ownership (80%) caused by constrained tenure availability. The private rental sectors were weakened by high inflation levels in combination with restrictive rent controls. A significant social rental sector was never developed in these countries. This is explained by the prevailing welfare regime, which is characterised as ‘family-based’, so that the state does not play a large role in the provision of welfare benefits, including social housing (Giucci, Strubenhoff 2003, 20-21).
formed that promoted the construction of housing for low-income households. This led to the foundation of the first non-profit housing associations in 1848 in Berlin. Also, cooperatives were formed to provide affordable housing. The first housing cooperative was formed in 1862. However, they only played an important role in housing construction after 1918.

After World War I views on housing changed. While until then it was mainly seen as a purely private economic good, it was now also regarded as a social good/commodity. This also changed the attempts regarding regulation of the housing market. Under the social democratic government in the Weimar Republic relatively strong interventions and controls in the housing market were established. Rents were fixed and flats were distributed according to governmental planning. Also, the first laws regarding the protection of tenants were passed. This reduced private profits in this area, so that new construction decreased and the maintenance of existing dwellings was also neglected. This led the state to provide subsidies and tax incentives to keep up the supply of housing. In particular, the activities of building cooperatives and non-profit housing associations were supported, which became an important element of public housing policy. From 1930 onward the non-profit status was institutionalised, and in 1940 the Limited Profit Housing Act\(^2\) (Wohngemeinnützigkeitsgesetz) was passed. At the beginning of the 1930s, the housing problem was regarded as solved and state-controls in the housing market were lifted. However, with the beginning mobilisation for war in 1935 rent controls were re-established.

**The legal framework of the housing market after World War II**

A large part of the German housing stock in the big cities was destroyed during World War II. After the war, this along with the influx of displaced Germans led the government to impose strict controls in the housing market. In parallel to the introduction of the so-called social market economy under the Christian Democratic Government, housing policy followed the principles of a social housing market economy. The government tried to follow policies to uphold the private supply of housing. However, the social aspects dominated policies at the time. It was to be ensured that rents stayed affordable for lower-income groups. From 1950 onward the controls became less restrictive, and with the introduction of the First Federal Rent Law (1. Bundesmietengesetz) rents were allowed to increase gradually. In 1960 the Law for the Reduction of Controls in the Housing Market and for a Social Rent- and Housing Law (Gesetz zum Abbau der Wohnungzwangswirtschaft und über ein

\(^2\) Tax benefits for housing associations with a non-profit status were connected to a variety of constraints. The aim of the company and the use of its funds were restricted to the provision of housing. The prices had to be oriented at the costs, so that profit maximization was hampered. A maximum dividend of 4% on the nominal capital was allowed. Larger profits had to be reinvested. Additionally, the provision of housing was primarily focused on persons in need (Hain, M., 2008).
soziales Miet- und Wohnrecht) was passed under the Minister of Housing and Construction Paul Lücke. This law attempted to make housing investment profitable and, at the same time, rent increases socially acceptable. In particular, the regulations on the termination of rental contracts were renewed and made more landlord-friendly, a large part of flats’ rent control was abolished, and to balance this, housing benefits were introduced (low-income households could apply for housing allowances covering the difference between a bearable rent and the actual market rents) (Gondring, 2009, pp. 6–13).

After World War II the government limited the commodification of private housing provision. It introduced certain measures to stimulate private building activity and thus, increase the supply of housing (Gondring, 2009, pp. 6-13). This was necessary because after World War II about 4.5 Million housing units were needed (Voigtländer, 2010). In 1954 the first Law for the Promotion of Housing Construction (1. Wohnungsbaugesetz, WoBauG) was passed. It laid the foundation for public subsidies for the construction of rentable housing. This was mainly aimed at cooperatives and other non-profit housing associations (Gondring, 2009, pp. 6-13). Similar programs were introduced in other countries. However, the program in Germany was different in two ways. Firstly, the program was mainly designed to stimulate private rental building activity.\(^3\) Secondly, the quality of the erected property was relatively high making it also an alternative for middle-class households. This is reflected in the wording of the law, which explicitly aims at providing housing for broad sections of the population. This is different from the UK, for example, where tenants of social housing were stigmatised. So, the social housing scheme after World War II laid the foundations for Germany’s large and diversified rental market (Voigtländer, 2010). A second Law for the Promotion of Housing Construction (2. WoBauG) was passed in 1956 and introduced tax benefits for the construction of individual property.

Due to the high inflation rates, at least by German standards, in the 1970s property was in high demand and a flight to ‘concrete gold’ was triggered. This led to strong increases in rents, so that a law for the protection of existing rental contracts was passed. In particular, it ruled out the possibility of terminations for variations of contract\(^4\), which was used as an instrument to increase rents for existing contracts. Additionally, the Federal Constitutional Court made clear in a range of decisions that the constitution puts some social responsibilities on the owners of private housing, which supports the view of housing as a social good until today (Gondring, 2009, 6-13).

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\(^3\) However, if associations wanted to make use of the subsidies they had to calculate their rent according to their costs, so that the subsidies were passed through to the renter in the form of lower rents.

\(^4\) Termination for variation of contract is basically a cancellation of the renting contract by the landlord with the offer of establishing a new contract with different conditions, e.g. a higher rent.
In 2002, the Law for the Promotion of Housing Construction (2. WoBauG) was replaced by the Residential Support Act (*Wohnraumförderungsgesetz*). In contrast to the former law, the focus shifted from relatively broad sections of society to mainly low-income households.

Already in 1990, the benefits and restrictions for non-profit housing associations were repealed, so that today there is no legal separation anymore between the different housing associations (Gondring, 2009, pp. 6-13). However, it seems that even after the repeal of the law most of the associations did not pursue a purely profit-driven strategy, but kept a statute oriented at the goals of the Limited Profit Housing Act (*Wohngemeinnützigkeitsgesetz*) from 1940. (Hain, 2008).

**Privatisations of public housing since the 1990s**

In 2006 the German public authorities still owned 11 per cent of the housing stock that is available for rent (Figure 15.1). However, in particular the federal government, but also municipal authorities and the Länder, decided to reduce their direct influence in this market and started selling parts of the housing stock to private investors in the 1990s. There are no official statistics available that can give information about the size and number of those privatisations. However, the tenant association in Germany (*Deutscher Mieterbund e.V.*), combines information from different sources (press, company reports, etc.) which provides a relatively good picture of the general trends.

According to their information, large scale privatisation started with the purchase of the Deutschbau (Gemeinnützige Deutsche Wohnungsbaugesellschaft mbH) by the daughters of the Deutsche Bank and E.ON (a German energy company). Since then they recorded 58 transactions, where parts of the public housing stock were sold to private entities. In sum, there were about 800,000 housing units sold and the volume of the transactions is estimated with 28 billion euro in the period 1997 to mid 2012.

Hain (2008) provides a detailed view of all (private and public) transactions between 1999 and 2006. He finds that there were 1.277 Million housing units traded. The public authorities accounted for 57 per cent of those sales, while 43 per cent of the sales were made by private entities. Large public transactions in this period were the sale of railroad worker housing stocks (114,000 flats) and the sale of the housing stock (82,000 flats) owned by the Federal Insurance Institution for Employees (*Bundesversicherungsanstalt für Angestellte*). Private sales were mainly conducted by industrial companies and other private German owners, e.g. banks. Large transactions were the sale of 137,700 flats by E.ON or 48,000 flats by Thyssen-Krupp. The largest group of buyers are foreign investors. They bought between 1999 and June 2006 642,000 flats in Germany (and sold 42,000). Other

---

Data in this section was provided by the Deutsche Mieterbund e.V. if not indicated otherwise.
German entities purchased 247,000 flats. The public authorities bought 280,000 flats. However those were mainly reorganisations of ownerships among public entities. All over, in this period there was a net of 442,000 flats sold from public to private entities. Also industrial company reduced their holding of flats by 196,000 flats. The only large net buyers were foreign investors, which purchased 600,000 flats.

This corresponds with the data from the German tenant association, which list the five largest housing associations active in Germany. According to them by March 2006 those are Deutsche Annington (255,000 flats), Fortress (120,000 flats), Cerberus (113,000 flats), Corpus (54,000 flats) and Blackstone (40,500 flats). All but Corpus are British or American companies.

Hence, while the public authorities and industrial companies reduced their role in the housing market, international investors became more important during this period.

**Housing stock in the former German Democratic Republic (GDR) after German reunification**

Here, one also has to mention the specific situation of the housing stock in the former German Democratic Republic (GDR) after German reunification. The municipal housing administration owned about 3.5 million apartments. Those were transferred into independent real estate associations, mostly wholly or largely owned by municipal authorities. However, one of the main problems for those associations was that the loans with subsidised interest rates granted during the GDR times were transformed into private debt with regular market interest rates – a decision which benefitted the banks. The municipal and cooperative housing associations were therefore heavily burdened by those past debts. Since those debts could not be serviced by the rent-revenues of those associations, rents were allowed to rise (Baba et al., 2010). From 1991 – 1993 rents increased six fold. The share of rent expenditures (less housing allowances) in income increased fourfold (FES, 1999). However, since this was not enough to stabilise the associations, eventually the Old Debt Assistance Law (Altschuldenhilfegesetz) was passed and came into force in January 1994. This allowed the housing associations to transfer some of their debt to the Inherited Debt Fund (Erblastentilgungsfonds), which was solely served by the federal state. However, to be able to do so, the housing associations needed to agree on privatising 15 per cent of their housing stock. Overall, the Inherited Debt Fund took over 14 billion euro of old debt and 3.6 billion euro of interest payments. About 12 billion euro of old debt remained with the housing associations (Baba et al., 2010).

With the economic situation worsening and an increasing number of unoccupied flats (about 16 per cent in 2002), it was realised that a supply surplus of certain types of housing in East Germany existed. This led to a modification of the Old Debt Assistance Law, so that additional debt relief for
the tearing down of empty flats could be received. This modification was part of a larger program of
the government, which focused on the restoration of inner-city districts and a reduction of the
overall vacancy rates in East Germany. Until 2010, this led to the demolition of 275,000 apartments.
Vacancy rates had been reduced to about 10 per cent by 2008, and on average, the housing
associations are able to generate positive profits today (Baba et al., 2010).

15.3. Size and composition of the German real estate stock

As we have already shown in chapter 14, the stock of real estate is an important part of German
national wealth and an important part of households’ portfolios. The Federal Statistical Office
calculated the value of real estate in Germany at 6,613 billion euro (3,925 residential, 2,688 non-
residential) and of building land at 2,118 billion euro in 2008. This is 86 per cent of total national
wealth (net of foreign liabilities) (Deutsche Bundesbank and Statistisches Bundesamt, 2010).

To get a more detailed view of the composition of the German real estate stock, Table 15.1 provides
estimations for the value and size of different forms of real estate in Germany. One can see that
measured by value 73 per cent is residential real estate and 27 per cent is commercial real estate.
The ownership structure in the housing market can be further subdivided as in Figure 15.1. It can be
seen that a relatively smaller part is owner occupied (40 per cent) and a larger part of the housing
stock is available for rent (60 per cent). The latter can be subdivided into professional-commercial
renters and small private renters. Interestingly, the larger part of the housing is let by those small
private landlords, which own on average about 1 – 2 houses, which they normally manage
themselves. This group owns about 37 per cent of the total housing stock. About 23 per cent of the
housing stock is managed by professional-commercial organisations. Those can be distinguished by
the importance of their profit motive. The municipal, public and other building associations together
with the cooperatives manage about 60 per cent of the professionally managed housing stock, or 12
per cent of the total housing stock. Their main focus is still the provision of housing for low-income
households and for particular target groups (such as homeless, pregnant or disabled persons). The
professional commercial renters are even more diversified. The group consists of traditional holders
of company houses, banks and insurance companies and some new actors like funds and stock
companies. Despite the privatisation of public housing in the recent past, today there are only about
4 million housing units (or 10 per cent of the total housing stock) available for investment from
institutional investors. Whether this will increase is questionable. On the one hand, the financial
difficulties of many municipal authorities may lead to for further privatisation of public housing stock.
On the other hand, the general rejection in the population and the increasingly tight housing
situation in some bigger cities may prevent, or at least slow down, further privatisation of publicly owned housing stock (Stachen and Stinauer, 2011).

Table 15.1: Composition of the real estate stock by type, Germany, 2012

<table>
<thead>
<tr>
<th>Type of use</th>
<th>Calculation</th>
<th>Value in billion euro</th>
<th>Share in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dwellings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner occupied</td>
<td>17.5 Mio. appartments x 250,000 Euro</td>
<td>4,375</td>
<td>73</td>
</tr>
<tr>
<td>Available for rent</td>
<td>22.5 Mio. appartments x 100,000 Euro</td>
<td>2,250</td>
<td></td>
</tr>
<tr>
<td>Commercial</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office space</td>
<td>410 Mio. sqm. x 1,700 Euro/sqm.</td>
<td>700</td>
<td>27</td>
</tr>
<tr>
<td>Retail</td>
<td>120 Mio. sqm. x 3,400 Euro/sqm.</td>
<td>410</td>
<td></td>
</tr>
<tr>
<td>Hotel</td>
<td>1.5 Mio. rooms x 60,000 Euro/room</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>Commercial or business premise</td>
<td>2.6 billion sqm. x 420 Euro/sqm.</td>
<td>1,100</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>8,900</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: BulwienGesa AG (2012a), updated estimation spring-report 2003 of Immobilienzeitung, own illustration

Figure 15.1: Ownership structure of the housing stock, Germany, 2006

Ownership Structure in the German Housing Market 2006

Stock of Flats in Germany: 39 617 thousand Flats  100%

Commercial Companies: 9 217 thousand Flats  23 %
  Cooperatives: 2 217 thousand Flats  5 %
  Municipal Companies: 2 434 thousand Flats  5 %
  Public Companies: 2 06 thousand Flats  1 %
  Private Sector*: 4 059 thousand Flats  11 %

Private Rental: 14 507 thousand Flats  37 %

Owner-occupied: 15 893 thousand Flats  40 %

Single- and Two-Family-Houses: 5 421 thousand Flats  14 %
  Flats: 9 086 thousand Flats  23 %

Single- and Two-Family-Houses: 12 821 thousand Flats  32 %
  Flats: 3 081 thousand Flats  8 %

*Private Sector Proprietors/Companies, Banks, Insurance Companies, Real-Estate Funds, other Companies as well as Non-profit-oriented Organizations.

Source: Stinauer and Stachen (2011, p. 14), our translation

15.4. Relevance of the real estate sector for German economic activity

The real estate sector generates employment and adds value in three different areas: real estate management, construction and financing. Table 15.2 gives an overview of their importance for the German economy before the Great Recession. We will look at the three areas in turn.
Table 15.2: Employment and value added in the real estate sector, Germany, 2008

<table>
<thead>
<tr>
<th>Unit</th>
<th>Real estate management</th>
<th>Construction</th>
<th>Financial services</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross value added billion Euro</td>
<td>263</td>
<td>95</td>
<td>37.24</td>
<td>395</td>
</tr>
<tr>
<td>Share of total gross value added %</td>
<td>12.4</td>
<td>4.5</td>
<td>1.8</td>
<td>18.7</td>
</tr>
<tr>
<td>Employees in thousand</td>
<td>428</td>
<td>2364</td>
<td>339.57</td>
<td>3132</td>
</tr>
<tr>
<td>Share of total employees %</td>
<td>1.1</td>
<td>5.9</td>
<td>0.8</td>
<td>7.8</td>
</tr>
</tbody>
</table>


Notes: The share of financial services gross value added depending on real estate was calculated with the share of real estate loans in total loans to the domestic sector (=49 per cent). The same method was applied to calculate the employment of the financial sector that is related to real estate financing.

The group of real estate management is the most important regarding gross value added. Overall, it adds 263 billion euro to total gross value added (12.4 per cent of total gross value added) as of 2008. The Federal Statistical Office provides more detailed insights in its structure survey for 2009 and divides the real estate management into 4 subgroups: buying and selling of own real estate (6 per cent of total revenues in 2009), renting or leasing of own real estate (79.5 per cent), real estate brokerage (4.5 per cent) and management of real estate (10 per cent). Employment in the sector takes a much lower share (Statistisches Bundesamt, 2012b, p. 8). With 428.000 employees, those activities only contribute 1.1 per cent to total employment in Germany.

The picture is reversed for the construction sector. It adds 95 billion euro or 4.5 per cent to total gross value added. This includes also non-market transactions, like households’ own construction works, non-paid neighbourly help, informal labour and voluntary activities in the non-profit sector. The share in employment in this sector is much higher. The sector employs 2,364,000 people and provides almost 6 per cent of total employment in the economy.

Figure 15.2: Gross value added by sector, Germany, 1970 – 2011 (% of total value added)

Source: Statistisches Bundesamt (2006, 2012), own calculations
Figure 15.3: Employment by sector, Germany, 1970 – 2011 (% of total employment)

Figure 15.2 and 15.3 show the shares of the construction sector and of real estate management activities since the 1970s. The construction sector declined in importance regarding value added, as well as regarding employment since 1970. This downward trend was only interrupted by the construction boom after 1990, as a result of German unification. In general, real estate management activities have become more important in gross value added. From 1970 to 2008 they increased their share from about 6.5 to 12 per cent. Employment developed similarly, increasing its share from 0.4 to 1.1 per cent. Overall, the sector has become more important regarding value added. However, its importance for employment has declined.

For the financial sector the real estate sector is also important, because an important business line is the provision of loans for real estate investment and purchases. About 49 per cent of all outstanding loans of the banking sector in 2008 were classified as real estate loans (Deutsche Bundesbank, 2012). So, a certain part of the financial activity is directly related to the real estate sector and should be accounted for, when one is looking at the importance of real estate in Germany. In the national accounts the banking sector and its value added and employment is not subdivided by activities. However, the data on loans from the Bundesbank can give a first indication. In 2008 the share of real estate loans in total domestic loans was 49 per cent. So, if one regards this as an indicator of the importance of real estate in banks’ overall business, the real estate sector is responsible for around 37 billion euro in value added and about 340,000 jobs.6

Adding all three areas together, the real estate sector is responsible for 18.7 per cent of total gross value added and provides 7.8 per cent of total jobs in the German economy in 2008 (Table 15.2).

---

6 Since the banks have lots of other activities, where some are not even showing in the balance sheet, this rough estimation probably overestimates the share of real estate related financial services.
Table 15.3: Gross value added of real estate related sectors, 1991 & 2008 (% of total value added)

<table>
<thead>
<tr>
<th></th>
<th>Construction</th>
<th>Real estate management</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>6.0</td>
<td>4.0</td>
<td>8.9</td>
</tr>
<tr>
<td>France</td>
<td>6.6</td>
<td>6.7</td>
<td>10.5</td>
</tr>
<tr>
<td>Italy</td>
<td>6.2</td>
<td>6.2</td>
<td>9.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.6</td>
<td>5.8</td>
<td>7.1</td>
</tr>
<tr>
<td>UK</td>
<td>5.9</td>
<td>6.1</td>
<td>7.6</td>
</tr>
<tr>
<td>USA</td>
<td>3.8</td>
<td>4.3</td>
<td>11.0</td>
</tr>
<tr>
<td>Japan</td>
<td>9.4</td>
<td>5.8</td>
<td>9.3</td>
</tr>
<tr>
<td>Austria</td>
<td>7.4</td>
<td>7.1</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Source: OECD (2012), own calculations
Notes: 1 real estate management figure for 1992 instead of 1991
2 real estate management figure for 1992 instead of 1991

Table 15.4: Employment in real estate related sectors, 1991 & 2008 (% of total employment)

<table>
<thead>
<tr>
<th></th>
<th>Construction</th>
<th>Real estate management</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>7.3</td>
<td>4.9</td>
<td>0.6</td>
</tr>
<tr>
<td>France</td>
<td>6.9</td>
<td>6.6</td>
<td>1.1</td>
</tr>
<tr>
<td>Italy</td>
<td>6.2</td>
<td>6.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>6.5</td>
<td>5.2</td>
<td>0.8</td>
</tr>
<tr>
<td>UK</td>
<td>4.8</td>
<td>4.9</td>
<td>0.8</td>
</tr>
<tr>
<td>USA</td>
<td>4.2</td>
<td>5.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Japan</td>
<td>9.8</td>
<td>7.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Austria</td>
<td>7.9</td>
<td>7.2</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: OECD (2012), own calculations
Notes: 1 real estate management figure for 1992 instead of 1991

However, using internationally comparable calculations the gross value added of the real estate sector in Germany is lower than for many other European countries and similar to that of the UK and the US (see Table 15.3). In particular, the share of the construction industry is relatively low. The same is true for employment (see Table 15.4). Overall, economic activity in Germany hinges less on real estate management and construction than in other European countries (with exception of the Netherlands) and seems to be equally important as in the US and the UK.

15.5. Investment in real estate

The construction of new residential and non-residential buildings is an important part of investment and therefore of private demand. Figure 15.4 and 15.5 illustrate the share of real estate investment in GDP and the growth contributions to nominal GDP by different types of real estate investment.

One can see in Figure 15.4 that in 1970 the combined investment in real estate amounted to almost 15 per cent of GDP (11 per cent private, 4 per cent public). The public sector decreases its investment in real estate constantly, so that its share by 2011 amounts only to 1.3 per cent. Also, the private
sector decreased its investment in real estate, so that private real estate investment stands at only 8.6 per cent of GDP in 2011. Growth contributions of construction activities to GDP are displayed in Figure 15.5. Two more or less strong booms in real estate investment can be identified. One in the 1970s, which was interrupted by the recession in 1974 and 1975, and which could be related to a run into real assets due to the inflationary pressure of the time, and a second one lasting from 1989 to 1995, which was triggered by process of German reunification.

**Figure 15.4: Real estate construction, Germany, 1970 – 2011 (% of GDP)**

**Figure 15.5: Contribution of real estate construction to the growth of nominal GDP, Germany, 1970 – 2011 (percentage points)**

Source: Statistisches Bundesamt (2012), European Commission (2012), own calculations, data until 1990 provided by Statistisches Bundesamt
Notes: Until 1990 West Germany only.

Source: Statistisches Bundesamt (2012), European Commission (2012), own calculations, data until 1990 provided by Statistisches Bundesamt
Notes: Until 1991 West Germany only.
Those cycles can also be observed in Figure 15.5 where the growth contributions of real estate investment to GDP are depicted. Here, one can see that after 1995 the growth contributions of private real estate investment were mostly negative. This only changed in 2006 when activity picked up again and contributions became positive.

**Figure 15.6: Mortgage loans outstanding to domestic enterprises and private households, Germany, 1968-2011 (% of GDP (lhs), € billion (rhs))**

Looking at Figure 15.6, which gives the ratio of mortgage loans to GDP and total mortgage loans one can see a remarkable difference in the two periods. While during the 1970s mortgage loans grew in line with GDP, the increase in construction activities in the early 1990s seems to be financed by a strong expansion of loans. This has increased the stock of debt relative to GDP in Germany to unseen levels and signals the reunification real estate boom. The build up of overcapacity and the
increase of indebtedness during the period of strong construction investment in the 1990s (Figure 15.4) are possible explanations for the lasting stagnation of the real estate sector in the following period.

To grasp the overall importance of real estate investment in shaping the economic cycles, it may be worthwhile looking at its importance in total investment, which is one of the more volatile components of demand. Total private investment fluctuated in the period from 1970 to 2011 between 22 and 17 per cent of GDP. Figure 15.7 shows how the different parts of private investment in GDP developed since the 1970s. Investment in construction and machinery tended to move together until the early 1990s. Then construction increased strongly, whereas investment in machinery and equipment declined. Starting in the mid 1990s the share of construction activity in GDP declined until it stabilised in 2006. The investment in machinery, equipment and other products in contrast shows two more cycles, one peaking in 2000 with the new technology boom, and a second one starting around 2004 and ending with the onset of the financial crisis.

15.6. Real estate prices and rents

It is particularly difficult to get a comprehensive picture of rent- and price developments in Germany. There is a range of statistics by the Federal Statistical Office. However, the information provided is not very far reaching or the time series are not particularly long. The Deutsche Bundesbank concludes that the time series of the BulwienGesa AG give the most realistic picture of actual developments (Bulwien, 2007, pp. 21-22). It is an index that summarises purchasing prices, as well as rents for residential and commercial real estate. Until 1990 the employed sample is comprised of 50 West-German cities, thereafter it comprises 125 German cities (BulwienGesa AG, 2012).

Figure 15.8 and 15.9 show the index for real estate prices from 1975 – 2011. One can relatively easy identify two main phases. The first one until 1994 which is marked by a general upward trend and which includes the relatively rapid increases that occurred in the process of reunification from 1989 on. And a second one, lasting from 1995 until today, where we see first the collapse in prices after the reunification boom and a long lasting stagnation of prices thereafter.
Figure 15.8: BulwienGesa property market index, Germany, 1975 – 2011 (Index 1990 = 100 (lhs), % (rhs))

![Property Market Index Chart]

Source: BulwienGesa AG (2011), own illustration
Notes: Until 1990 only West-Germany

Figure 15.9: BulwienGesa commercial and residential property market index, Germany, 1975 - 2011 (Index 1990 = 100 (lhs), % (rhs))

![Commercial and Residential Market Index Chart]

Source: BulwienGesa AG (2011), own illustration
Notes: Until 1990 only West-Germany

Table 15.5: Indices and nominal changes of real estate and consumer prices, Germany, 1975 - 2011

<table>
<thead>
<tr>
<th></th>
<th>Property Market Index (Over-All)</th>
<th>Residential Property Market Index</th>
<th>Commercial Property Market Index</th>
<th>Consumer Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Market Index (Over-All)</td>
<td>55.5</td>
<td>120.8</td>
<td>120.9</td>
<td>117.8</td>
</tr>
<tr>
<td>Residential Property Market Index</td>
<td>55.8</td>
<td>124.3</td>
<td>134.4</td>
<td>122.6</td>
</tr>
<tr>
<td>Commercial Property Market Index</td>
<td>55.0</td>
<td>116.4</td>
<td>104.0</td>
<td>111.7</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>63.5</td>
<td>117.0</td>
<td>151.3</td>
<td>84.2</td>
</tr>
</tbody>
</table>

Source: BulwienGesa AG (2011), own calculations
Table 15.5 summarises the most important statistics for those two phases. In the phase from 1975 to 1994 prices in residential and commercial real estate increased on average by 4.3 and 4 per cent per year respectively. With the consumer price inflation in this phase only averaging 3.3 per cent investors in real estate gained in real as well as in nominal terms. In the second phase lasting from 1995 to 2011 average real estate prices did barely change. Residential real estate prices did only increase by 0.5 per cent per year, while consumer prices increased by 1.6 per cent per year. Therefore, owners of residential real estate lost in real terms. The picture is even worse for owners of commercial real estate. Here prices declined on average by 0.7 per cent per year, so that they lost in real as well as in nominal terms. Only in 2008 did the index for commercial real estate achieve its level from 1990 again.

Both indices started an upward movement in 2005. However, since 2009 in particular residential real estate has registered strong price increases. Overheatings and bubbles in the real estate markets are topics discussed in the media already. Current studies, however, regard those price increases still as justified by fundamentals (see for example Eilers (2012) or Deutsche Bundesbank (2012b)). In particular for bigger cities the Bundesbank attributes the price increase in parts to financial investments and sees the danger of price exaggerations (Deutsche Bundesbank, 2012b).

Overall, price cycles are a typical phenomenon in real estate markets. However, the German property cycle after the mid 1990s is relatively flat by international comparison. It is also to note that real estate prices moved opposite to the international trends (Gesellschaft für Immobilienwirtschaftliche Forschung, 2009). Volatility in residential real estate prices in Germany is particularly low. Prices in Germany fluctuated only half as much as those in the Netherlands, UK or Spain. The same is true to a lesser extent for commercial real estate. This can be explained in part by the predominance of fixed interest loans in the financing of real estate in Germany. Empirical analyses showed that a one percentage point increase in the short term interest rate leads to a fall in house prices of 6.4 per cent within a two year period in the UK. In Germany, prices only fall by 0.2 per cent (Gesellschaft für Immobilienwirtschaftliche Forschung, 2009, p. 10). The higher interest rate volatility for both existing and new real estate loans in the UK, for example, leads to a much stronger real estate cycle then in Germany. It is also important to note that in Germany unscheduled repayments of loans are normally discouraged by a prepayment penalty. So, repayment and refinancing of real estate loans for lower interest rates are discouraged. Additionally, variable rate loans, where the interest rate is indexed to the central bank rate, are unusual, so that there is no automatic adjustment of rates. Therefore, changes in monetary policy only affect disposable income of households gradually with the phase-out of the interest fixation periods (Herr and Stachuletz, 2010).
Table 15.6: Institutional differences in national mortgage markets and the mortgage market index

<table>
<thead>
<tr>
<th>Country</th>
<th>Mortgage Equity Withdrawal</th>
<th>Refinancing (fee-free prepayment)</th>
<th>Typical Loan-to-Value Ratio (percent)</th>
<th>Average Typical Term (years)</th>
<th>Covered Bond Issues (percent of residential loans outstanding)</th>
<th>Mortgage-Backed Security Issues (percent of residential loans outstanding)</th>
<th>Mortgage Market Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Yes</td>
<td>Limited</td>
<td>80</td>
<td>25</td>
<td>—</td>
<td>7.9</td>
<td>0.69</td>
</tr>
<tr>
<td>Austria</td>
<td>No</td>
<td>No</td>
<td>60</td>
<td>25</td>
<td>2.2</td>
<td>—</td>
<td>0.31</td>
</tr>
<tr>
<td>Belgium</td>
<td>No</td>
<td>No</td>
<td>83</td>
<td>20</td>
<td>—</td>
<td>1.9</td>
<td>0.34</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
<td>No</td>
<td>75</td>
<td>25</td>
<td>—</td>
<td>3.6</td>
<td>0.57</td>
</tr>
<tr>
<td>Denmark</td>
<td>Yes</td>
<td>Yes</td>
<td>80</td>
<td>30</td>
<td>58.5</td>
<td>0.1</td>
<td>0.82</td>
</tr>
<tr>
<td>Finland</td>
<td>Yes</td>
<td>No</td>
<td>75</td>
<td>17</td>
<td>2.6</td>
<td>—</td>
<td>0.49</td>
</tr>
<tr>
<td>France</td>
<td>No</td>
<td>No</td>
<td>75</td>
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1 Calculation of the Index: For “mortgage equity withdrawal” and “refinancing (fee-free prepayment),” values of 0, 0.5, and 1 are assigned to each country depending on whether mortgage equity withdrawal and free repayment are nonexistent, limited, or widespread, respectively. For the other four variables in the Table, each county is assigned a value between 0 and 1, equal to the ratio to the maximum value across all countries.

Source: Cardarelli et al. (2008, p. 107)

Notes: Mortgage Equity withdrawals are possible in Germany from a legal point of view. They are however very uncommon and not used often.

15.7. The relation of the real estate sector with the financial sector

The relation between the financial system and the real estate sector encompasses different dimensions. On the one hand, the financial sector is involved in financing residential as well as commercial real estate. On the other hand, financial investors see real estate as an asset. In the following paragraphs these areas will be examined.

Overall, the German market for real estate financing is relatively conservative. According to Cardarelli et al. (2008) Germany belongs together with Italy still to the most regulated real estate markets (see also Table 15.6). Generally, households do not acquire real estate before they have sufficient equity. Banks can cover the lower interest rates if they refinance themselves through mortgage covered bonds, and the lower interest rates for loans from building and loan associations after saving a certain amount of money in such institutions sets incentives for households to build up a stock of equity first. Also banks are cautious and, by international comparison, provide only a low ratio of loans to the value of real estate. Usually real estate is not used as collateral for other types of household credits, for example consumption credits. Long term financing and fixed interest rates on housing loans shelter real estate markets from the effect of short term interest rate fluctuations.
Unlike in other countries a subprime market did not develop. This is not related to a lack of supply, but rather because of a lack in demand. After all, the large residential rental market offers sufficient alternatives to entering into an expensive and insecure loan contract.

Financing real estate acquisition and construction plays an important role for the banking sector in Germany. While the share of mortgage loans to domestic enterprises and resident individuals accounted for 37.5 per cent of total bank lending to this customer group in 1970, it had increased to 46.8 per cent by 2010. Overall, there was an amount of outstanding housing loans of 1.1 trillion euro at the end of 2010 (Deutsche Bundesbank, 2012). Some institutions are specialised in the financing of real estate only, but real estate financing also plays an important role for universal banks. While building and loan associations have focused on the financing of housing for private households, mortgage banks are specialised in providing large loans to residential and commercial real estate associations. For others, e.g. the savings banks, residential and commercial real estate financing is an important part of a diversified product portfolio (Voigtländer, 2010). Other non-bank institutions do not play an important role in the financing of real estate. In Germany the German Banking Act (Gesetz über das Kreditwesen, KWG) enforces that institutions engaged in the lending business (granting money loans or acceptance credit) are credit institutions. Therefore, mortgage lenders are by definition banks and fall under the supervision and regulation of the German Federal Agency for Financial Market Supervision (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin). There are only a few exceptions to this rule. One is the public Reconstruction Loan Corporation (Kreditanstalt für Wiederaufbau, KfW) and another one within certain limits are insurance companies (London Economics, 2008). However, their importance as lenders in this market is rather low. In 2005 insurance companies had only a combined market share of 6 per cent (Statistisches Bundesamt, 2007, p. 110).

In Figure 15.10 the market shares in the residential real estate market in 2012 for the different banking groups are given. The savings banks with a total market share of 29 per cent are the main providers of housing loans, followed by the group of private banks (big banks and regional banks) with a market share of 25 per cent and the credit cooperatives that provide about 20 per cent of the total loans in this line of business. Mortgage banks only play a minor role and provide 7 per cent of all housing loans.\(^7\)

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\(^7\) This was different up to 2005 until when mortgage banks had the special allowance to issue mortgage covered bonds, but were in turn limited in the kind of business they were allowed to conduct. In 2005 a new law came into force that now allows most banks to acquire a license to issue mortgage backed bonds, without having to restrict their business. Therefore, those special banks lost in importance.
The banks with special purposes had a particularly strong growth of 95 per cent in their outstanding loans between 2000 and 2006. In particular, the public Reconstruction Loan Corporation (Kreditanstalt für Wiederaufbau, KfW), which belongs to this group, was able to increase its market share with a special program for home ownership.

Overall, the German banks see, in particular, the financing of residential real estate projects as a safe haven. This is reflected in the survey conducted by the German Bundesbank. While since the start of the financial crisis the requirements for loans have increased in almost all areas, there were barely any changes in the standards for the financing of residential housing. To a large part that can be contributed to the sustainable lending practices banks applied already before the crisis (Voigtländer, 2010, p. 51). Generally, mortgage loans can be differentiated regarding their loan-to-value ratio, necessary collaterals and the interest rate fixation period. In the following the typical characteristics of mortgage loans in Germany shall be discussed.

Although mortgage loans can have a relatively long maturity, interest rate fixation periods can be shorter. In Germany a fixation period of about 5 to 10 years or even more is common. The share of new variable rate loans accounted for only 15 per cent of all new loans in 2007 (ECB, 2009, pp. 25-28). It has to be taken into account that in Germany, in comparison to a number of other countries, it is not possible to restructure the loan without penalty payment if interest rates go down (see Table 15.6).

Regarding the loan to value ratio (LTV), German customers as well as banks are rather conservative. Typically, the LTV in Germany for a first time house buyer is around 70 per cent (Euro Area average
79 per cent). Additionally, households with lower income normally provide higher equity ratios to keep the loan burdens low. This is contrary to what can be found in the US where the LTV ratio increases for lower income households (Voigtländer, 2010, pp. 58-59). Additionally, the value of the collateral is calculated on the basis of the so-called Beleihungswert\(^8\), while in most other countries it is based on the current market value (see also Table 15.6). Also, so-called sub-prime loans are uncommon in Germany.

Many of those factors are not prescribed by law, but have developed due to specific characteristics of the German housing market and the refinancing practices of banks. Demand as well as supply side factors play an important role.

In many countries, like the US or the UK, there is only a very small and concentrated market of apartments and houses for rent available, which has normally a relatively low quality or is concentrated on niches. Therefore, living in rented property is not a real alternative in those countries and everyone that can obtain financing will buy his own property. Differently, Germany has a well-developed market for rental housing (between 55 – 60 per cent of the German housing stock is available for rent\(^9\) – see Figure 15.1). Therefore, private households only purchase housing when they decide to use it in the longer term. In those cases the flexibility and the lower interest rate of variable rate loans are less important than planning reliability provided by loans with long-term fixed interest rate, so that the latter one is the preferred option for housing finance. Additionally, since low income households have the alternative to live in rented property, there was no demand for subprime loans in Germany, despite the fact that banks could offer such products from a legal point of view (Voigtländer, 2010, pp. 55).

Refinancing practices play an important role on the supply side. While regular deposits are still the most important source of refinancing mortgage loans, so-called Pfandbriefe (mortgaged-backed covered bonds – MBCB) play an important role in Germany. Those bonds are debt obligations secured by a portfolio of real estate assets. The issuer stays fully liable for all interest and principal payments. The assets are held on the balance sheet of the issuer and all obligations related to the bonds are backed by the exclusive claim on the cover pool. The cover pool eligibility criteria are quite conservative by international standards. Only up to 60 per cent of the Beleihungswert may be taken into account as collateral. This does not mean that banks cannot lend more than 60 per cent of the Beleihungswert. However, any excess cannot be funded via MBCBs and so funding in excess of the 60 per cent is

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\(^8\) Beleihungswert is the value of the land and the building which can with a high degree of certainty be obtained at any point in time in the future.

\(^9\) However, there is a slow trend towards more owner-occupied housing visible. The ownership rate increased from 39% in 1993 to 43.2% in 2008 (Statistisches Bundesamt, 2012a).
per cent becomes more expensive for banks (IMF, 2011, pp. 5-7). MBCBs are relatively widespread
and normally have a relatively long maturity. The amount of outstanding covered mortgage bonds
was 225 billion euro (20 per cent of all real estate loans) and their maturity was normally more than
5 years (68 per cent) or even more than 10 years (30 per cent). Due to the high safety of covered
bonds the refinancing is also very cheap, so banks can refinance themselves with an interest rate
only a little higher than for German government bonds. Therefore, banks are able to offer their
customers long-term financing for housing for a relatively low interest rates without having to take
over the maturity risk. This system of refinancing leads to certain incentives that can explain partly
the structure of housing finance in Germany. The fact that MBCBs can only be used for funding up to
60 per cent of the Beleihungswert forces banks to tap alternative sources of funds, which are
normally associated with higher costs. These costs are passed through to the customers if they have
higher financing requirements.\footnote{For example the ING DiBa asks for an interest premium for loans above 60\% of the Beleihungswert of 0.10 percentage points, above 80\% of 0.35 percentage points and above 95\% for 1 percentage point (ING, 2012)} This works as an incentive for households to use a higher share of
equity (Voigtländer, 2010).

An additional feature of German housing finance is the use of loans from building and loan
associations. Those associations refinance themselves by the savings of their future loan customers
and therefore are a closed circuit that is relatively sheltered from capital markets. To be eligible for a
loan from those associations the borrowers need to save a certain amount of money over a certain
period of time first. Normally, they are paid interest at below the market rate, but are allowed to
take out a low interest rate loan after the saving period. In the German system of housing finance the
principle loan is made by a bank and a supplemental loan is made by the building and loan
association. This loan is typically junior to the first loan and therefore does not affect the loan-to-
value ratio of the first bank (Giucci and Strubenhoff, 2003). Therefore, both factors, the use of the
Pfandbrief as a means for refinancing and the prior saving for eligibility for a low-cost loan at a
building and loan association act as incentives for high equity ratios in housing finance. This together
with the alternative of renting suitable housing makes households save a bit longer and acquire
sufficient equity first to keep the overall loan burden low. This is also confirmed by Table 15.6, which
shows that Germany belongs to the group of countries with a low relation of real estate credit to the
value of real estate. Hence, one can see that the banks play an important role in the real estate
sector by providing long-term stable funding and the real estate sector seems to be a relatively safe
and stable business for the banking sector. Additionally, with the MBCBs a very safe asset almost
similar to a government bonds is provided to investors in capital markets.

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\footnote{For example the ING DiBa asks for an interest premium for loans above 60\% of the Beleihungswert of 0.10 percentage points, above 80\% of 0.35 percentage points and above 95\% for 1 percentage point (ING, 2012)}
A further feature of the German real estate market is that the so called mortgage equity withdrawal, meaning using a mortgage for other purposes than buying or investing in the mortgaged property is very uncommon in Germany and not demanded by households, despite the fact that it is possible from a legal point of view. It only amounts to 1 to 2 per cent of all new mortgage loans in 2007 (ECB, 2009, p. 27). This is a big difference for example to countries like the US or UK (see also Table 15.6).

15.8. Institutional investors in the real estate sector

Besides the direct investment into real estate, a range of financial institutions has been established that allow investors on the capital market to invest indirectly in real estate. The most important forms of indirect investment in Germany are closed and open real-estate funds, real estate equities, Real Estate Investment Trusts (REITs) and private-equity investors (Beteiligungsgesellschaften).

Among different forms of indirect real estate investment the closed fund is the most important form measured by fund volume. Closed real estate funds are mostly constituted as partnerships for a certain project and a single fund is founded by the initiating company. Therefore, the number of such funds is relatively high. In 2006 there were 1865 closed real estate funds, 701 of them were focused on residential real estate and about 1164 on commercial real estate. In 2008 they had a volume of about 200 billion euro (in 1993 only 49.8 billion). The average equity share is according to the Feri EuroRating around 50 per cent for closed funds (Voigtländer, 2010). On average the funds raised new equity of about 4.7 billion euro per year between 1993 and 2008 (Voigtländer, 2010). German banks play an important role in this segment. Looking at the big three initiating companies, which constitute about 35 per cent of the total market volume (Scope Analysis Research, 2012, p. 148), all three of them are closely related to banks.11

Open real estate funds are the second significant form of indirect investment into real estate. They are normally set up and managed by an asset management company (Kapitalanlagegesellschaft) as a separate asset pool. Currently, in the business field of real estate there are 23 asset management companies active in Germany, which manage 46 different open real estate funds (BVI, 2012). Legally open real estate funds are able to finance half of their assets with borrowed funds. In practice, the funds make use of this possibility to a differing degree. Actual debt ratios in 2012 ranged from 12.4 to 50.7 per cent. From 2015 onward the maximum regulatory debt ratio will be lowered to 30 per cent. This new regulation is mainly supposed to make the product safer for investors and may in part be a reaction to the trouble the funds have had during the financial crisis (Scope Analysis, 2012a).

Figure 15.11 shows the net-equity acquisition and the total equity invested in those funds from 1980 to 2010. It becomes apparent that their volume gained in importance mainly between 1994 and 2003 and then remained largely constant. By the end of 2011 they managed equity of about 85 billion euro. Additionally, special funds\textsuperscript{12} invested in real estate had equity of about 40 billion euro under management at the end of 2008 (Voigtländer, 2010).

Another way in which investors can participate indirectly in the real estate sector is through real estate stock companies. Those have specialised in the management or the trading of real estate property. However, for Germany this investment class does not play a big role. The number of real estate stock companies was 94 by the end of 2006 (Leibold, 2007). In April 2008 the value of real estate stock companies traded on stock markets amounted to only 16 billion euro (for example UK had 58 billion euro, and France had 60 billion euro). The minor significance of such stock companies becomes even more apparent if one is looking at the free float\textsuperscript{13} per person. In Germany it amounts to 55 euro per inhabitant. For Austria, the UK, and the Netherlands the values are more than 10 times higher (Voigtländer, 2010).

At the beginning of 2007 the so-called G-REIT (German Real Estate Investment Trust) was introduced to attract foreign investment into the German real estate market. They are similar to real estate stock companies; however, they have certain tax advantages which make them particularly attractive.

\textsuperscript{12} Special funds are funds constituted mostly for institutional investors. They are not open to the general public.

\textsuperscript{13} Amount of shares that is held by small investors and that actually is available for trade.
to foreign investors (Voigtländer, 2010). However, until 2011 the overall attractiveness of G-REITs to investors seems to have been low, and by 2011 only 4 REITs were registered with 2 in preparation. The estimated size of those funds was about 6.5 billion euro (REITs Deutschland, 2012).

Private-equity investors are a relatively recent phenomenon in the area of real estate. However, their acquisition of former publicly owned residential real estate stock has attracted public debate. After the acquisition of large housing stocks by private equity investors, media and tenant associations reported lack of maintenance as well as rent increases and a neglect of contractual social obligations. This led to widespread opposition to their acquiring further public housing stock, which was only partly successful however.

Similar to closed real estate funds private-equity funds in the area of real estate are initiated by banks, insurance companies or wealthy individuals. Their strategy is to invest in undervalued assets, restructure them to increase economic profitability and sell them for a higher price. The use of high leverage is relatively common for such funds. In particular, restrictions on other types of investment vehicles led to the use of private equity companies. However, due to the financial crisis, the market for private equity companies in the real estate sector broke down because banks were no longer willing to finance their high leverage (Voigtländer, 2010).

It becomes apparent that the market for indirect real estate investment is dominated by open and closed real estate funds. Those types of investments are mainly of interest for domestic investors. Other forms like REITs or real estate stock companies, which are more liquid for investors and more transparent and therefore better suitable for foreign investors, have until now not played an important role in Germany (Gesellschaft für Immobilienwirtschaftliche Forschung, 2009).

15.9. Conclusion

The German real estate market is characterised by a large and diversified rental market. A large part of the managing associations in the rental market do not follow a purely profit driven strategy. This large market acts as a stabiliser for the real estate activity in Germany. Affordable rents and high quality of the available apartments allow households to wait for the purchase of own property until their financial situation allows for the purchase. The financing structure sets incentives for the households to actually do so.

Overall, the German market for real estate financing is relatively conservative. Germany belongs together with Italy still to the most regulated real estate markets. Generally, households do not acquire real estate before they have sufficient equity. Banks can cover the lower interest rates if they refinance themselves through mortgage covered bonds, and the lower interest rates for loans from
building and loan associations after saving a certain amount of money in such institutions sets incentives for households to build up a stock of equity first. Also banks are cautious and, by international comparison, provide only a low ratio of loans to the value of real estate. Usually real estate is not used as collateral for other types of household credits, for example consumption credits. Long term financing and fixed interest rates on housing loans shelter real estate markets from the effect of short term interest rate fluctuations. Unlike in other countries a subprime market did not develop. This is not related to a lack of supply, but rather because of a lack in demand. After all, the large residential rental market offers sufficient alternatives to entering into an expensive and insecure loan contract.

The most important financial investors in the real estate market are funds. Those are until now relatively unattractive for international investors due to a lack of transparency and taxation. Even if that means lower capital is available in this market, it may have sheltered the German market from foreign capital inflows that could have led to a real estate bubble also in Germany.

All this explains why real estate prices have been relatively stable since the mid-1990s and a bubble could be avoided.
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IV. Finance, distribution and crisis
16. Inequality and the financial system in Germany

16.1. Introduction

This chapter attempts to describe the effects of financialisation on income distribution in Germany since the 1980s. Firstly, the trends in the functional distribution of income are reviewed, and the evolution of wage, profit and rentier income shares for Germany from 1980-2008 is described. Here a distinction will be drawn between the income shares in the financial and the non-financial sectors. Secondly, it looks at developments in the personal distribution of income. This is based on an analysis of the Gini coefficients for market and disposable incomes, the distribution among income fractiles and the development of top incomes. Finally we will discuss the potential effects of financialisation on the observed developments of distribution.

16.2. Functional income distribution

Functional income distribution is concerned with the wage share and the profit share. However, profits can be divided into retained earnings, and rentier income (net property income). Figure 16.1 distinguishes the shares of retained earnings, rentier income, and the compensation of employees in net national income for the period 1980-2008. It can be seen that the wage share in Germany decreased in the 1980s from 65 to 61 per cent, although it recovered in the early 1990s following German unification due to the higher wage share in East Germany. From 1994, however, a decrease in the wage share can be observed, with a more pronounced trend after 2000, reaching a low point of 56 per cent in 2008.

The share of retained earnings in net national income shows no clear trend. It fluctuates around 3 per cent, reaching close to 6 per cent in 1990 and in 2008, and falling to around 1 per cent in the mid 1990s and in the early 2000s. The share of rentier income (net property income) tended to increase, rising from 11 per cent in 1980 to 18 per cent in 2008. In particular in the early 2000s, one can observe a sharp decline in the wage share, and a rise in the shares of retained earnings and rentier income.
Rentier income (net property income) can be decomposed into four categories: net interest income, net rent, property income attributed to insurance holders, and dividend income. Whereas the first three components exhibited little fluctuation from 1980 to 2008, the dividend income share doubled from 7 to 14 per cent of net national income in this period (Dünhaupt, 2010). A rising rentier share in the face of the decreasing wage share in Germany can most likely be linked to an increasing shareholder-value orientation in Germany in the broader context of financialisation, in particular since the mid 1990s, when major changes in the regulation of the financial sector were introduced (see chapter 6). In order to better understand the causes of the falling wage share in Germany and its relationship with financialisation, developments in the financial and the non-financial corporate sectors will be examined separately.

Figures 16.2a and 16.2b show the development of income shares in the non-financial and the financial corporate sectors for the period 1980-2008. The wage share in the non-financial corporate sector registered a pronounced decrease from 80 to 68 per cent of net value added since the early 1990s, whereas the wage share in the financial sector was roughly stable at around 70 per cent (and even higher in years 2000-2003).¹ In the non-financial sector, the lower wage share is accompanied by an increase of the shares of both retained earnings and rentier payments in net value added, in particular since the early 2000s.

¹ For a more detailed description of the profitability in the financial sector see chapter 8.
Figure 16.2a: Income shares in the non-financial corporate sector, Germany, 1980-2008 (% of net value added)

Source: Dünhaupt (2010, p. 29), data from Federal Statistical Office, Germany

Figure 16.2b: Income shares in the financial corporate sector, Germany, 1980-2008 (% of net value added)

Source: Dünhaupt (2010, p. 29), data from Federal Statistical Office, Germany
Dünhaupt (2010) points out that these developments differ from those observed in the US, where the wage shares were relatively constant in both sectors. Furthermore, in the US a strong shift occurred with respect to the weight of the financial sector, whose contribution to the total net value added of corporations increased steadily from the 1980s. This has not been the case in Germany, as can been seen from Figure 16.3. The non-financial sector has maintained a major role in Germany contributing, on average, 93 per cent of the total net value added of the corporate sector as a whole. Despite the attempt to create the Finanzplatz Deutschland, Germany has not developed a financial hub like London or New York.

The fall in the wage share in the non-financial sector and the high contribution of non-financial corporate activity to the total net value added explain why the overall wage share in Germany has decreased in the last 15 years or so. To this, however, has also contributed the shrinking of the government sector which is a non-profit sector. Table 16.1 shows the sectoral shares of the government, private households, and the financial and the non-financial corporate sector in nominal gross value added for the period from 1991 to 2011. A moderate decline in the share of general government, from 11.6 per cent in 1996 to 9.9 per cent in 2008, can be observed. This contributed to the fall in the aggregate wage share.
Table 16.1: Shares of the general government in nominal gross value added, Germany, 1991-2011 (%)

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<td>4.8</td>
<td>10.7</td>
<td>23.5</td>
</tr>
<tr>
<td>2005</td>
<td>61.4</td>
<td>4.5</td>
<td>10.5</td>
<td>23.6</td>
</tr>
<tr>
<td>2006</td>
<td>62.1</td>
<td>4.3</td>
<td>10.2</td>
<td>23.5</td>
</tr>
<tr>
<td>2007</td>
<td>63.1</td>
<td>3.8</td>
<td>9.9</td>
<td>23.3</td>
</tr>
<tr>
<td>2008</td>
<td>62.9</td>
<td>3.5</td>
<td>9.9</td>
<td>23.7</td>
</tr>
<tr>
<td>2009</td>
<td>60.6</td>
<td>4.7</td>
<td>10.7</td>
<td>23.9</td>
</tr>
<tr>
<td>2010</td>
<td>61.1</td>
<td>5.0</td>
<td>10.5</td>
<td>23.4</td>
</tr>
<tr>
<td>2011</td>
<td>61.4</td>
<td>4.9</td>
<td>10.5</td>
<td>23.2</td>
</tr>
</tbody>
</table>

Source: DeStatis, own calculations

16.3. Personal income distribution

This section describes the development of the personal distribution of income in Germany since the 1980s. The Gini coefficient for market and disposable incomes, distribution across income deciles, and the distribution of top incomes will be considered.

The Gini coefficient of market income indicates a tendency towards a more unequal personal income distribution in most industrialised countries since the mid 1980s, as shown in Table 16.2. In Germany, the inequality of market incomes rose considerably, with the Gini coefficient rising by 0.065 from the mid-1980s to the late-2000s. Only Finland, Italy, Portugal, the UK, and Japan witnessed a more dramatic increase in market income inequality.

Inequality in disposable incomes is indicated by the Gini coefficient after government redistribution and this also shows that Germany became more unequal between the mid-1980s and the late 2000s (Table 16.2). Although in a number of countries the inequality of disposable incomes actually decreased over the last three decades (Belgium, France, Greece, Ireland, and Spain), in Germany the Gini coefficient for disposable income increased by 0.044. This increase was exceeded only by Sweden and Finland. The figure for Germany also indicate that the Gini coefficient for disposable income in Germany was relatively stable until the second half of the 1990s and that the increase...
occurred almost entirely between the late 1990s to the late 2000s. Nevertheless, despite this increase, inequality in the distribution of disposable income in Germany is still moderate by international comparison.

Table 16.2: Gini coefficients for market and disposable income, selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>mid-80s</th>
<th>around 1990</th>
<th>mid-90s</th>
<th>around 2000</th>
<th>mid-2000s</th>
<th>late 2000s</th>
<th>Change from mid-80s/around 1990/mid 90s until late 2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>0.433</td>
<td>0.472</td>
<td>..</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.449</td>
<td>..</td>
<td>0.472</td>
<td>0.464</td>
<td>0.494</td>
<td>0.469</td>
<td>0.020</td>
</tr>
<tr>
<td>Finland</td>
<td>0.387</td>
<td>..</td>
<td>0.479</td>
<td>0.478</td>
<td>0.483</td>
<td>0.465</td>
<td>0.078</td>
</tr>
<tr>
<td>France</td>
<td>..</td>
<td>..</td>
<td>0.473</td>
<td>0.490</td>
<td>0.485</td>
<td>0.483</td>
<td>0.010</td>
</tr>
<tr>
<td>Germany</td>
<td>0.439</td>
<td>0.429</td>
<td>0.459</td>
<td>0.471</td>
<td>0.499</td>
<td>0.504</td>
<td>0.065</td>
</tr>
<tr>
<td>Greece</td>
<td>0.426</td>
<td>..</td>
<td>0.446</td>
<td>0.466</td>
<td>0.454</td>
<td>0.436</td>
<td>0.010</td>
</tr>
<tr>
<td>Ireland</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Italy</td>
<td>0.420</td>
<td>0.437</td>
<td>0.508</td>
<td>0.516</td>
<td>0.557</td>
<td>0.534</td>
<td>0.114</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.473</td>
<td>0.474</td>
<td>0.484</td>
<td>0.424</td>
<td>0.426</td>
<td>0.426</td>
<td>-0.047</td>
</tr>
<tr>
<td>Portugal</td>
<td>..</td>
<td>0.436</td>
<td>0.490</td>
<td>0.479</td>
<td>0.542</td>
<td>0.521</td>
<td>0.085</td>
</tr>
<tr>
<td>Spain</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>0.461</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.404</td>
<td>0.408</td>
<td>0.438</td>
<td>0.446</td>
<td>0.432</td>
<td>0.426</td>
<td>0.022</td>
</tr>
<tr>
<td>UK</td>
<td>0.419</td>
<td>0.439</td>
<td>0.453</td>
<td>0.512</td>
<td>0.500</td>
<td>0.506</td>
<td>0.087</td>
</tr>
<tr>
<td>US</td>
<td>0.436</td>
<td>0.450</td>
<td>0.477</td>
<td>0.476</td>
<td>0.486</td>
<td>0.486</td>
<td>0.050</td>
</tr>
<tr>
<td>Japan</td>
<td>0.345</td>
<td>..</td>
<td>0.403</td>
<td>0.432</td>
<td>0.443</td>
<td>0.462</td>
<td>0.117</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>mid-80s</th>
<th>around 1990</th>
<th>mid-90s</th>
<th>around 2000</th>
<th>mid-2000s</th>
<th>late 2000s</th>
<th>Change mid-80s/around 1990 until late 2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>0.236</td>
<td>..</td>
<td>0.238</td>
<td>0.252</td>
<td>0.265</td>
<td>0.261</td>
<td>0.025</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.274</td>
<td>..</td>
<td>0.287</td>
<td>0.289</td>
<td>0.271</td>
<td>0.259</td>
<td>-0.015</td>
</tr>
<tr>
<td>Finland</td>
<td>0.209</td>
<td>..</td>
<td>0.218</td>
<td>0.247</td>
<td>0.254</td>
<td>0.259</td>
<td>0.050</td>
</tr>
<tr>
<td>France</td>
<td>0.300</td>
<td>0.290</td>
<td>0.277</td>
<td>0.287</td>
<td>0.288</td>
<td>0.293</td>
<td>-0.007</td>
</tr>
<tr>
<td>Germany</td>
<td>0.251</td>
<td>0.256</td>
<td>0.266</td>
<td>0.264</td>
<td>0.285</td>
<td>0.295</td>
<td>0.044</td>
</tr>
<tr>
<td>Greece</td>
<td>0.336</td>
<td>..</td>
<td>0.336</td>
<td>0.345</td>
<td>0.321</td>
<td>0.307</td>
<td>-0.029</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.331</td>
<td>..</td>
<td>0.324</td>
<td>0.304</td>
<td>0.314</td>
<td>0.293</td>
<td>-0.038</td>
</tr>
<tr>
<td>Italy</td>
<td>0.309</td>
<td>0.297</td>
<td>0.348</td>
<td>0.343</td>
<td>0.352</td>
<td>0.337</td>
<td>0.028</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.272</td>
<td>0.292</td>
<td>0.297</td>
<td>0.292</td>
<td>0.284</td>
<td>0.294</td>
<td>0.022</td>
</tr>
<tr>
<td>Portugal</td>
<td>..</td>
<td>0.329</td>
<td>0.359</td>
<td>0.356</td>
<td>0.385</td>
<td>0.353</td>
<td>0.024</td>
</tr>
<tr>
<td>Spain</td>
<td>0.371</td>
<td>0.337</td>
<td>0.343</td>
<td>0.342</td>
<td>0.319</td>
<td>0.317</td>
<td>-0.054</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.198</td>
<td>0.209</td>
<td>0.211</td>
<td>0.243</td>
<td>0.234</td>
<td>0.259</td>
<td>0.061</td>
</tr>
<tr>
<td>UK</td>
<td>0.309</td>
<td>0.354</td>
<td>0.336</td>
<td>0.352</td>
<td>0.331</td>
<td>0.342</td>
<td>0.033</td>
</tr>
<tr>
<td>US</td>
<td>0.337</td>
<td>0.348</td>
<td>0.361</td>
<td>0.357</td>
<td>0.38</td>
<td>0.378</td>
<td>0.041</td>
</tr>
<tr>
<td>Japan</td>
<td>0.304</td>
<td>..</td>
<td>0.323</td>
<td>0.337</td>
<td>0.321</td>
<td>0.329</td>
<td>0.025</td>
</tr>
</tbody>
</table>

Source: Hein (2013, p. 8); data from OECD (2012)

Notes: Gini coefficient is based on equivalised household income
Table 16.2 shows that inequality of market incomes started rising in Germany in the 1990s and kept increasing up to the late 2000s, but Biewen (2002) has argued that market income inequality in West Germany did not undergo much change in the period 1980-1996, whereas inequality increased in East Germany immediately after unification. Figure 16.4 shows developments in the Gini coefficient for both market and disposable incomes, distinguishing between East and West Germany. It shows that, although market incomes started to be more unequally distributed in the 1990s – with this trend, in fact, being much more pronounced in the East Germany – the German tax and transfer system acted as a buffer (van Treeck and Sturn, 2012). East Germany is characterised by a higher degree of redistribution, i.e. a larger gap between the Gini coefficients for market and disposable incomes. Inequality of disposable incomes in East and West Germany increased mostly in the early 2000s.

Figure 16.4: Gini coefficients for real yearly equivalised market income (dotted lines) and disposable income (solid lines), Germany, 1983-2007

Source: Van Treeck and Sturn (2012, p. 84), data from German Socio-Economic Panel (GSOEP)

The distinction by income deciles makes most clear the divergence of income experienced by income groups of German households. Figure 16.5 shows that a strong growth in real disposable income.

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2 In their analysis, Anselmann and Krämer (2012) refer to real equivalent annual net household income, which is a modified OECD equivalence scale. The OECD scales are based on assigning each household type a value proportional to its needs, i.e. they correct for ‘economies of scale’ with regard to the number of persons forming a household. The modified scale, in particular, assigns a value of 1 to the head of the household, and values of 0.5 and 0.3 for each additional adult or child, respectively, who is part of that household.
occurred for the highest income decile, with deciles 6-9 experiencing a small increase. The bottom four deciles, however, all saw a decline in their real disposable incomes between 1999 and 2009.

**Figure 16.5: Growth of mean real income across different income deciles, Germany, 1999-2009 (%)**

![Graph showing growth of mean real income across different income deciles]

*Source: Anselmann and Kramer (2012, p.9), data from Grabka (2011)*

*Notes: Data are based on annual surveys of private households in Germany. Capital gains are excluded.*

A longer-term perspective on the evolution of the top decile income share for market incomes is shown in Figure 16.6. It can be seen that, after having been at a historical low from the 1950s to the early 1980s, the top decile began to rise in the late 1980s. In 1998 it accounted for 35.5 per cent of
overall incomes, with the trend towards more unequal income becoming stronger in the following decade and by 2007 it had increased to 38.1 per cent (Anselmann and Krämer, 2012).

Anselmann and Krämer (2012) point out that in Germany the rise in top income shares was driven largely by an increase in salaries, rather than capital income. This development can be explained by the increasing compensation for top managers and financial professionals, which resulted in the phenomenon of the ‘working rich’. This contributed significantly to the increase in inequality in the personal distribution of income, while at the same time holding up the wage share. This could be an explanation for the stable (and relatively high) wage share in the financial sector, especially since underpaid low-skilled labour is of relatively minor importance in this sector.

Similar results also were found by Dünhaupt (2011) when decomposing the gross market income of the top 1 per cent of the income share for Germany (Figure 16.7). Although the data provided does not extend beyond 2003, one can see the increase in the relative importance of top management salaries compared with capital income and business income.

**Figure 16.7: The top 1 per cent income share in gross market income and its composition, Germany, 1992, 1998 & 2003 (% of total)**

![Bar chart showing income share composition](chart.png)

Source: Dünhaupt (2011, p. 27), data from Bach, Corneo and Steiner (2009)
Notes: Business income refers to the taxable income from agriculture, forestry, unincorporated business enterprise, and self-employed activities, including professional services. Capital income includes all capital income from private investments, except income from business activity (Bach et al. 2009).

In sum, the most notable feature of personal income distribution in Germany has been the increasing income dispersion in market incomes since the mid-1990s, and in disposable incomes since the early 2000s. In fact, according to the OECD (2008), Germany is one of the countries where income dispersion increased the most from 2000 to 2005. Workers in the bottom half of the distribution have witnessed their real disposable incomes declining or at best stagnating in the first decade of the

3 The high salaries of sports and movie stars and similar professions also contributed to this development.
2000s. By contrast, the income share of the top decile income share, in particular, was increased strongly from the mid-1990s until 2007. It can also be observed that salaries became more important relative to business and capital income for those in the top 1 per cent of gross market income. Taken together, Germany moved from a country which, by international comparison, had a relatively equal distribution of income to one with a degree of inequality that is around the average for OECD countries.

16.4. Effects of financialisation on income distribution in Germany

One approach in the literature (see, for instance, Hein, 2012, pp. 21-32), linking financialisation to the functional distribution of income draws on Kalecki (1954). According to this approach, income shares are mainly determined by firms’ price setting behaviour. Firms in the industrial sector, operating in incompletely competitive markets, set prices by applying a mark-up, which has to cover overhead costs and firms’ gross profits. The mark-up is positively related to the degree of concentration within the sector and to overhead costs (including salaries, interest and dividend payments), and is negatively related to the importance of price competition relative to other forms of competition. Also in the Keynesian tradition a link between financialisation and functional income distribution exists to the extent that the interest rate established in financial markets determines the profit rate (Keynes 1930; Keynes 1936, Chapter 17; Heine and Herr 2013, Chapter 4.6). Regarding the effect of workers’ bargaining power, Kalecki and Keynes agreed that in a closed economy under a high degree of price competition higher costs lead to higher prices without changing functional income distribution. Higher nominal unit labour costs are passed on in the same way as an increase in the value-added tax. However, in an international environment nominal wage development and thus trade union bargaining power can influence functional income distribution. If the nominal exchange rate and international prices for tradable goods are given and increases in domestic unit labour costs are below foreign increases in unit labour costs, profit margins and profit shares of domestic producers will rise. In this, the power and the strategies of trade unions affect the mark-up and distribution. This is especially important for Germany, because here nominal unit labour costs growth fell substantially behind the rest of the European Monetary Union with its per definition fixed nominal exchange rate.

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4 The degree of concentration within the sector, and the importance of price competition relative to other forms of competition, have been merged under the heading “degree of price competition in the goods market”.

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Table 16.3: Financialisation and the gross profit share

<table>
<thead>
<tr>
<th>Stylized facts of financialization (1-7) and neo-liberalism (8-9)</th>
<th>Determinants of the gross profit share (including (top) management salaries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Rising dividend payments</td>
<td>...</td>
</tr>
<tr>
<td>3. Increasing interest rates or interest payments</td>
<td>...</td>
</tr>
<tr>
<td>4. Increasing top management salaries</td>
<td>...</td>
</tr>
<tr>
<td>5. Increasing relevance of financial to non-financial sector (investment)</td>
<td>...</td>
</tr>
<tr>
<td>6. Mergers and acquisitions</td>
<td>+</td>
</tr>
<tr>
<td>7. Liberalisation and globalisation of international finance and trade</td>
<td>-</td>
</tr>
<tr>
<td>8. Deregulation of the labor market</td>
<td>...</td>
</tr>
<tr>
<td>9. Downsizing of government</td>
<td>...</td>
</tr>
</tbody>
</table>

Notes: + positive effect on the gross profit share, – negative effect on the gross profit share, ... no direct effect on the gross profit share.

The first row of Table 16.3 lists those factors which potentially influence functional income distribution. Besides the determinants of the mark-up, the table includes two additional factors which influence the gross profit share directly. These are the prices of imported raw materials and semi-finished products, an increase of which, ceteris paribus, (via higher material costs relative to wage costs) raises the profit share, and the sectoral composition of the economy, because different sectors have different profit shares. The left-hand column of Table 16.3 includes several ‘stylised facts’ of financialisation and neo-liberalism which can affect the gross profit share and thus the functional distribution of income through the factors or channels listed in the first row.

Looking at the determinants of the profit share, three of them seem to be uniquely affected by financialisation and neo-liberalism: the bargaining power and activity of the trade unions, overhead costs and the gross profit targets, and the sectoral composition of the economy (see Hein, 2013 for a review of the empirical support in the literature). For Germany this implies the following effects of financialisation on distribution:
1. Trade union bargaining power was weakened by high unemployment, in particular since the mid-1990s, decreasing trade union density, reduced wage bargaining coverage, in particular in East Germany, and also by the downsizing of the public sector. Under these conditions, trade unions even agreed to be part of the alliance for jobs, vocational training and competitiveness, aiming at improving international price competitiveness by wage moderation (European Industry Relations Observatory 1998). The deregulation of labour markets in Germany, especially after the re-election of Chancellor Gerhard Schröder in 2002 (Agenda 2010, Hartz Laws) and general process of globalisation with increasing possibilities for outsourcing also added to low wage increases in Germany.

2. Rising overhead costs and gross profit targets related to financialisation seem to have imposed a negative effect on the wage share, too. Increases in interest and dividend payments were associated with a rising profit share in national income. In particular rising dividend payments were a consequence of an increasing shareholder-value orientation. Furthermore, top management salaries increased as an effect of aligning managers with shareholders’ interest. However, this is not reflected in the wage share, because management salaries are part of the compensation of employees in the national accounts and thus of the wage share. Therefore, subtracting top management salaries would have made the wage share fall even more pronouncedly (Dünhaupt 2011).

3. The sectoral composition effect of financialisation on the profit share refers to the relative importance of financial companies, non-financial companies, and the government sectors in value added. In Germany, the shrinking government sector, which is non-profit by definition, has contributed directly to the increase of the profit share, whereas there has been no effect through changes in the relevance of the financial sector relative to the non-financial sector.

Not only functional, but also personal distribution was adversely affected by financialisation. The sharp rise of top incomes in the share of income brought about by increasing dividend payments and sharply rising top management salaries, has increased the inequality of personal market incomes. The weakening of trade union bargaining power through several channels has affected in particular the low wage sector, which has increased in size markedly. Furthermore, the distribution of disposable incomes has become more unequal as a result of cuts in social benefits, the lack of sufficiently progressive tax rates and lower corporate taxes, associated with the neo-liberal policy agenda.
16.5. Conclusion

An analysis of the functional income distribution in Germany shows that the wage share declined slightly during the 1990s and then more pronouncedly in the following decade. If the financial and the non-financial sectors are distinguished, this decrease in the wage share can be seen to be almost entirely due to a falling wage share in the non-financial corporate sector.

The increase in the gross profit share was made possible through an increasing shareholder value orientation and the profit claims of rentiers. For Germany we observe a steady rise in the rentier share of income from the 1990s. Also the share of top management salaries in national income increased, which dampened the fall in the wage share. A loss of trade union bargaining in the face of high unemployment and the deregulation of the labour market led to wage moderation, which also contributed to the falling wage share. Furthermore, the shrinking of the not-for-profit government sector reinforced the fall in the wage share.

Personal inequality of market and disposable incomes has increased strongly in Germany since the beginning of the 2000s. Whereas market income inequality started to rise during the 1990s, government policies kept disposable income inequality roughly stable in that decade, but allowed for an increase in the following decade. Nonetheless, disposable income inequality in Germany is still relatively moderate by international comparison.
References


**Data sources:**


German Socio-Economic Panel Study (2010) SOEP monitor 1984-2010: Time Series on selected Indicators about ‘Living in Germany’, available at: [http://www.diw.de/de/diw_02.c.222727.de/soepmonitor.html](http://www.diw.de/de/diw_02.c.222727.de/soepmonitor.html)
17. Crisis and macroeconomic policies

17.1. Introduction

This chapter will briefly review the German macroeconomic policy regime in the era of ‘financialisation’ in general, and during the business cycle before the Great Recession 2008/09 in particular. This will provide the foundations for a discussion of the transmission of the financial crisis to Germany, the macroeconomic policy responses, and for an outline of the impact of German economic policy making on the development of the broader euro crisis, which started in 2010. The latter, however, will not be treated here.

17.2. The German macroeconomic policy regime in the era of finance-dominated capitalism

Germany has seen a tendency of declining labour income shares since the early 1980s, increasing inequality in household income and a rising income share of top incomes since the mid 1990s (Anselmann and Krämer, 2012; Bach et al., 2009; OECD, 2008; Hein, 2011a, 2011b). And against the background of these tendencies of redistribution, as one of the main characteristics of the ‘macroeconomics of finance-dominated capitalism’ (Hein, 2012b), the economic development in Germany has been dominated by a decoupling of profits and private investment in capital stock since the early 1980s. This meant rising corporate profits and weak private investment, as has been analysed in more detail in van Treeck et al. (2007) and in van Treeck (2009). This pattern was only interrupted by the unification boom in the first half of the 1990s (Figure 17.1).

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1 Major parts of this chapter are based on Hein and Truger (2010, 2011), with some updates and amendments where necessary.

2 See the review in chapter 16 of this study on inequality.
For the development since the mid 1990s, this pattern can at least partly be attributed to the increasing dominance of finance and the related effects on investment in capital stock, as was argued in chapter 11 of this study on sources and uses of funds of non-financial business in Germany. Major steps towards the liberalisation and deregulation of financial markets took effect in this period: in 1991 the abolition of the stock exchange tax, in 1998 the legalisation of share buybacks, in 2002 the abolition of capital gains taxes for corporations, and in 2004 the legalisation of hedge funds.³

Furthermore, as has been analysed by Bibow (2003, 2005), Herr and Kazandziska (2011) and Hein and Truger (2005, 2007a, 2009) in more detail, restrictive macroeconomic policies and weak domestic demand have contributed significantly to weak investment in capital stock, and hence to the mediocre growth and employment performance in Germany since the mid 1990s and, in particular, after the 2000/01 recession. Increasing uncertainty, caused by policies of ‘structural reforms’ and deregulation in the labour market (Agenda 2010 and Hartz-laws), subsidies for capital-based private pension schemes (‘Riester’- and ‘Rürup’-pensions), and redistribution at the expense of (low) labour income and in favour of profits and high income recipients associated with nominal wage moderation, have led to an increase in the propensity to save of private households since 2001, and contributed to weak consumption demand.⁴ Finally, high unemployment and pressures on trade unions caused moderate wage increases and contributed to inflation rates below the Euro Area average, leading to above average real interest rates. This made Germany particularly vulnerable to the ‘anti-growth’ bias (Bibow, 2002, 2006, 2007; Hein, 2002; Hein and Truger, 2007b) in the

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³ For a more detailed account of changes in the regulatory framework for the financial sector in Germany see chapter 6 of this study.
⁴ See chapter 14 of this study on the effects of financialisation on the household sector in Germany.

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monetary policies of the European Central Bank (ECB). And the attempts of fiscal policies to balance the budget, by means of expenditure cuts in periods of weak private demand have reinforced weak domestic demand without reaching the consolidation target.

The only driving force of mediocre growth remained high and increasing export surpluses. The degree of openness of the German economy increased significantly: in 1995 the ratio of nominal exports to nominal GDP was 24 per cent, but it increased to 47 per cent by 2008 (European Commission, 2010). Current account surpluses quickly reached more than 4 per cent in the years after the 2000/01 recession, peaking at 7.5 per cent of GDP in 2007. It was, therefore, increasing net exports and current account surpluses, which allowed for the decoupling of profits and investment in Germany, in particular in the 2000s. From a macroeconomic perspective the following equation, derived from national income accounting, has to hold, as pointed out by Kalecki (1971, p. 82):

\[
\text{Net profits net of taxes} = \text{Gross investment} + \text{Export surplus} + \text{Government budget deficit} - \text{Workers' saving} + \text{Capitalists' consumption}.
\]

Therefore, with weak investment and consumption, as in the case of Germany, the realisation of profits mainly depends on the export surplus and on government budget deficits. The foundations for rising German net exports were laid, on the one hand, by extreme wage moderation, which increased the price competitiveness of German producers in international markets, and, on the other hand, by low domestic demand making imports fall short of rising exports. The characteristics of the German ‘export-led mercantilist’ type of development, as compared to the ‘debt-led consumption boom’ type in Spain, the UK and the US, and the ‘domestic-demand led’ type in France and Italy are summarised in Table 17.1. The debt-led consumption boom type of development is characterised by negative financial balances of the private household sector, positive financial balances of the external sector, and hence current account deficits, high growth contributions of private consumption and domestic demand, and negative growth contributions of the balance of goods and services. The domestic demand-led type is characterised by positive financial balances of the private household and external sectors, and hence current account deficits, positive growth contributions of domestic demand without a dominance of private consumption, and negative growth contributions of the balance of goods and services. The export-led mercantilist type is characterised by positive financial balances of the domestic sectors as a whole, negative financial balances of the external sector, and

\[5\] See Hein (2012a, 2012b) for more extensive discussion of different types of development of capitalist economies prior to the Great Recession.
thus current account surpluses based on restrictive wage policies, low inflation and weak domestic demand. This meant only small positive growth contributions of domestic demand, but high growth contributions of the balance of goods and services.

Table 17.1: Key macroeconomic variables for France, Germany, Italy, Spain, the UK and the US, average values for the business cycle from the early 2000s – 2008

<table>
<thead>
<tr>
<th>Financial balances of external sector as a share of nominal GDP, per cent</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Spain</th>
<th>UK</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial balances of public sector as share of nominal GDP, per cent</td>
<td>-3.18</td>
<td>-2.09</td>
<td>-3.16</td>
<td>-0.03</td>
<td>-3.26</td>
<td>-3.50</td>
</tr>
<tr>
<td>Financial balance of private sector as a share of nominal GDP, per cent</td>
<td>1.93</td>
<td>7.64</td>
<td>1.57</td>
<td>-7.07</td>
<td>1.02</td>
<td>-1.47</td>
</tr>
<tr>
<td>Financial balance of private household sector as a share of nominal GDP, per cent</td>
<td>3.80</td>
<td>5.90</td>
<td>3.91</td>
<td>-1.54</td>
<td>-2.37</td>
<td>-1.68</td>
</tr>
<tr>
<td>Financial balance of the corporate sector as a share of nominal GDP, per cent</td>
<td>-1.87</td>
<td>1.74</td>
<td>-2.34</td>
<td>-5.53</td>
<td>3.55</td>
<td>0.21</td>
</tr>
<tr>
<td>Real GDP growth, per cent</td>
<td>1.64</td>
<td>1.44</td>
<td>0.73</td>
<td>3.02</td>
<td>2.21</td>
<td>2.08</td>
</tr>
<tr>
<td>Growth contribution of domestic demand including stocks, percentage points</td>
<td>2.13</td>
<td>0.85</td>
<td>0.81</td>
<td>3.82</td>
<td>2.43</td>
<td>2.15</td>
</tr>
<tr>
<td>Growth contribution of private consumption, percentage points</td>
<td>1.24</td>
<td>0.18</td>
<td>0.44</td>
<td>1.74</td>
<td>1.52</td>
<td>1.75</td>
</tr>
<tr>
<td>Growth contribution of public consumption, percentage points</td>
<td>0.38</td>
<td>0.16</td>
<td>0.27</td>
<td>0.93</td>
<td>0.47</td>
<td>0.36</td>
</tr>
<tr>
<td>Growth contribution of gross fixed capital formation, percentage points</td>
<td>0.56</td>
<td>0.49</td>
<td>0.08</td>
<td>1.14</td>
<td>0.51</td>
<td>0.13</td>
</tr>
<tr>
<td>Growth contribution of the balance of goods and services, percentage points</td>
<td>-0.50</td>
<td>0.58</td>
<td>-0.08</td>
<td>-0.81</td>
<td>-0.23</td>
<td>-0.07</td>
</tr>
<tr>
<td>Net exports of goods and services as a share of nominal GDP, per cent</td>
<td>-0.52</td>
<td>5.56</td>
<td>-0.07</td>
<td>-4.69</td>
<td>-2.83</td>
<td>-4.88</td>
</tr>
<tr>
<td>Change in labour income, share as percentage of GDP at current factor costs, from previous cycle, percentage points</td>
<td>-0.97</td>
<td>-2.71</td>
<td>-0.88</td>
<td>-3.71</td>
<td>-1.26</td>
<td>-1.25</td>
</tr>
<tr>
<td>Growth rate of nominal unit labour costs, per cent</td>
<td>2.01</td>
<td>0.17</td>
<td>2.95</td>
<td>3.31</td>
<td>2.44</td>
<td>2.05</td>
</tr>
<tr>
<td>Inflation (HICP growth rate), per cent</td>
<td>1.98</td>
<td>1.78</td>
<td>2.36</td>
<td>3.33</td>
<td>2.04</td>
<td>2.83</td>
</tr>
<tr>
<td>Growth rate of nominal effective exchange rates (relative to 23 countries), per cent*</td>
<td>1.84</td>
<td>2.09</td>
<td>1.92</td>
<td>1.53</td>
<td>-1.25</td>
<td>-2.15</td>
</tr>
<tr>
<td>Growth rate of real effective exchange rates (relative to 23 countries), per cent*</td>
<td>1.98</td>
<td>0.14</td>
<td>3.12</td>
<td>2.82</td>
<td>-1.90</td>
<td>-2.05</td>
</tr>
</tbody>
</table>

Source: European Commission (2010), own calculations
Notes: The beginning of a business cycle is given by a local minimum of annual real GDP growth in the respective country
* increase means an appreciation
As can be seen from the sectoral financial balances – each in relation to nominal GDP – in Figure 17.2, in particular in the period from the early 2000s until the Great Recession, both the private household sector and the corporate business sector in Germany were running financial balance surpluses, indicating both weak consumption and private investment demand. The government sector was in deficit until 2007, although fierce consolidation efforts were made from 2002 until 2006, and it was the external sector (RoW) running increasing deficits, meaning rising German current account surpluses, which acted as a stabiliser for weak domestic economic activity and for the profits of the private sector.

Those countries relying on debt-led consumption as a driver of aggregate demand in the face of redistribution at the expense of labour income and low investment in real capital stock, for example the US, the UK, and Spain, had to rely on the willingness and the ability of private households to go into debt – and of the rest of the world to supply credit. By contrast the stagnating German neo-mercantilist model had to rely on the willingness and the ability of the rest of the world to go into debt. Contrary to public and political opinion before the crisis, this German model has been as fragile as the debt-led consumption boom type of development. The moderate growth rates were dependent on the dynamic growth of export markets, and hence an expansion of the world economy. At the same time, increasing capital exports to the more dynamic economies carried the risk of contagion in the case of a financial crisis in these markets. And both channels became effective during the present crisis, as will be outlined in the next section.
17.3. The crisis 2008/09 and economic policy responses

The transmission of the crisis starting in 2007 to Germany

As can be seen in Table 17.2, the 2008/09 recession in Germany proved to be particularly strong by international comparison. Whereas real GDP in the US – the country of origin of the financial crisis – dropped by 3.5 per cent, the fall in German real GDP was more than 5 per cent, and it was also clearly larger than in the Euro Area (EU-15) as a whole. This was mainly due to the fact that, as a neo-mercantilist economy mainly driven by export demand, Germany was particularly hard hit by the global slowdown and the dramatically falling export demand, as can be seen in Table 17.3. One striking feature of the German slowdown, however, must be stressed: although the recession was stronger in Germany than in many other economies, the loss in employment and the corresponding increase in the unemployment rate were much smaller (Table 17.4). This can be partially explained by a dramatic rise in short-time work, heavily subsidised by the government, and the extensive use of the so-called working-time accounts, allowing firms to flexibly adjust their labour volume without sacking workers (see OECD, 2010; SVR, 2009b; Will, 2011).

Table 17.2: Real GDP growth, 2007 – 2013 (%)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012*</th>
<th>2013*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>3.4</td>
<td>0.8</td>
<td>-5.1</td>
<td>3.6</td>
<td>3.1</td>
<td>1.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Austria</td>
<td>3.7</td>
<td>1.1</td>
<td>-3.6</td>
<td>2.5</td>
<td>3.0</td>
<td>0.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.8</td>
<td>0.9</td>
<td>-2.7</td>
<td>2.2</td>
<td>2.0</td>
<td>0.4</td>
<td>1.3</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>3.9</td>
<td>1.8</td>
<td>-3.5</td>
<td>1.6</td>
<td>1.3</td>
<td>-0.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Greece</td>
<td>3.0</td>
<td>-0.2</td>
<td>-3.2</td>
<td>-3.5</td>
<td>-6.9</td>
<td>-5.3</td>
<td>-1.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>5.2</td>
<td>-3.0</td>
<td>-7.0</td>
<td>-0.4</td>
<td>0.7</td>
<td>0.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Spain</td>
<td>3.5</td>
<td>0.9</td>
<td>-3.7</td>
<td>-0.1</td>
<td>0.7</td>
<td>-1.6</td>
<td>-0.8</td>
</tr>
<tr>
<td>Portugal</td>
<td>2.4</td>
<td>0</td>
<td>-2.9</td>
<td>1.4</td>
<td>-1.6</td>
<td>-3.2</td>
<td>-0.9</td>
</tr>
<tr>
<td>France</td>
<td>2.2</td>
<td>-0.2</td>
<td>-3.0</td>
<td>1.6</td>
<td>1.7</td>
<td>0.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Italy</td>
<td>1.5</td>
<td>-1.2</td>
<td>-5.5</td>
<td>1.8</td>
<td>0.5</td>
<td>-1.7</td>
<td>-0.4</td>
</tr>
<tr>
<td>EU-15</td>
<td>3.0</td>
<td>0.2</td>
<td>-4.4</td>
<td>1.9</td>
<td>1.5</td>
<td>-0.1</td>
<td>0.9</td>
</tr>
<tr>
<td>UK</td>
<td>3.5</td>
<td>-1.1</td>
<td>-4.4</td>
<td>2.1</td>
<td>0.7</td>
<td>0.5</td>
<td>1.9</td>
</tr>
<tr>
<td>US</td>
<td>1.9</td>
<td>-0.3</td>
<td>-3.5</td>
<td>3.0</td>
<td>1.7</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Japan</td>
<td>2.2</td>
<td>-1.1</td>
<td>-5.5</td>
<td>4.5</td>
<td>-0.7</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>China</td>
<td>14.2</td>
<td>9.6</td>
<td>9.2</td>
<td>10.4</td>
<td>9.2</td>
<td>8.2</td>
<td>9.3</td>
</tr>
</tbody>
</table>

Source: OECD (2012a)
Note: * Forecast by the OECD
Table 17.3: Key macroeconomic variables, Germany (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012*</th>
<th>2013*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Gross domestic product</td>
<td>3.4</td>
<td>0.8</td>
<td>-5.1</td>
<td>3.6</td>
<td>3.1</td>
<td>1.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Real private final consumption expenditure</td>
<td>-0.2</td>
<td>0.5</td>
<td>0.0</td>
<td>0.6</td>
<td>1.4</td>
<td>1.1</td>
<td>1.7</td>
</tr>
<tr>
<td>Real government final consumption expenditure</td>
<td>1.4</td>
<td>3.1</td>
<td>3.3</td>
<td>1.7</td>
<td>1.4</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>Real gross fixed capital formation</td>
<td>5.0</td>
<td>1.1</td>
<td>-11.4</td>
<td>5.2</td>
<td>6.6</td>
<td>2.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Real total domestic expenditure</td>
<td>1.9</td>
<td>3.1</td>
<td>-2.5</td>
<td>2.3</td>
<td>2.4</td>
<td>1.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Real exports of goods and services</td>
<td>8.3</td>
<td>2.1</td>
<td>-13.6</td>
<td>13.4</td>
<td>8.4</td>
<td>4.4</td>
<td>6.2</td>
</tr>
<tr>
<td>Real imports of goods and services</td>
<td>5.6</td>
<td>3.0</td>
<td>-9.2</td>
<td>11.5</td>
<td>7.5</td>
<td>4.7</td>
<td>6.7</td>
</tr>
<tr>
<td>Unemployment rate - as a percentage of labour force</td>
<td>8.3</td>
<td>7.2</td>
<td>7.4</td>
<td>6.8</td>
<td>5.7</td>
<td>5.4</td>
<td>5.2</td>
</tr>
<tr>
<td>General government financial balance - % of GDP</td>
<td>0.2</td>
<td>-0.1</td>
<td>-3.2</td>
<td>-4.3</td>
<td>-1.0</td>
<td>-0.9</td>
<td>-0.6</td>
</tr>
<tr>
<td>Short-term interest rate, per cent</td>
<td>4.3</td>
<td>4.6</td>
<td>1.2</td>
<td>0.8</td>
<td>1.4</td>
<td>0.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Nominal unit labour costs</td>
<td>-0.8</td>
<td>2.3</td>
<td>5.5</td>
<td>-1.2</td>
<td>1.4</td>
<td>3.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Compensation per employee</td>
<td>0.8</td>
<td>2.1</td>
<td>0.0</td>
<td>2.0</td>
<td>3.0</td>
<td>2.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Harmonised consumer price index</td>
<td>2.3</td>
<td>2.8</td>
<td>0.2</td>
<td>1.2</td>
<td>2.5</td>
<td>2.3</td>
<td>2.0</td>
</tr>
<tr>
<td>Current account balance - as a percentage of GDP</td>
<td>7.5</td>
<td>6.2</td>
<td>5.9</td>
<td>6.0</td>
<td>5.7</td>
<td>5.4</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Note: * Forecast by the OECD, nominal unit labour costs and compensation per employee by European Commission

Table 17.4: Unemployment rate, 2007 – 2013 (% of labour force)

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012*</th>
<th>2013*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>8.3</td>
<td>7.2</td>
<td>7.4</td>
<td>6.8</td>
<td>5.7</td>
<td>5.4</td>
<td>5.2</td>
</tr>
<tr>
<td>Austria</td>
<td>4.4</td>
<td>3.8</td>
<td>4.8</td>
<td>4.4</td>
<td>4.1</td>
<td>4.6</td>
<td>4.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>7.5</td>
<td>7.0</td>
<td>7.9</td>
<td>8.3</td>
<td>7.2</td>
<td>7.5</td>
<td>7.8</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>3.5</td>
<td>3.0</td>
<td>3.7</td>
<td>4.4</td>
<td>4.4</td>
<td>5.3</td>
<td>5.7</td>
</tr>
<tr>
<td>Greece</td>
<td>8.3</td>
<td>7.7</td>
<td>9.5</td>
<td>12.5</td>
<td>17.6</td>
<td>21.2</td>
<td>21.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>4.6</td>
<td>6.0</td>
<td>11.8</td>
<td>13.6</td>
<td>14.5</td>
<td>14.5</td>
<td>14.4</td>
</tr>
<tr>
<td>Spain</td>
<td>8.3</td>
<td>11.3</td>
<td>18.0</td>
<td>20.1</td>
<td>21.6</td>
<td>24.5</td>
<td>25.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>8.0</td>
<td>7.6</td>
<td>9.5</td>
<td>10.8</td>
<td>12.8</td>
<td>15.4</td>
<td>16.2</td>
</tr>
<tr>
<td>France</td>
<td>8.0</td>
<td>7.4</td>
<td>9.1</td>
<td>9.4</td>
<td>9.3</td>
<td>9.8</td>
<td>10.0</td>
</tr>
<tr>
<td>Italy</td>
<td>6.1</td>
<td>6.8</td>
<td>7.8</td>
<td>8.4</td>
<td>8.4</td>
<td>9.4</td>
<td>9.9</td>
</tr>
<tr>
<td>EU-15</td>
<td>7.4</td>
<td>7.4</td>
<td>9.4</td>
<td>9.9</td>
<td>10.0</td>
<td>10.8</td>
<td>11.1</td>
</tr>
<tr>
<td>UK</td>
<td>5.4</td>
<td>5.7</td>
<td>7.6</td>
<td>7.9</td>
<td>8.1</td>
<td>8.6</td>
<td>9.0</td>
</tr>
<tr>
<td>US</td>
<td>4.6</td>
<td>5.8</td>
<td>9.3</td>
<td>9.6</td>
<td>8.9</td>
<td>8.1</td>
<td>7.6</td>
</tr>
<tr>
<td>Japan</td>
<td>3.8</td>
<td>4.0</td>
<td>5.1</td>
<td>5.1</td>
<td>4.6</td>
<td>4.5</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Source: OECD (2012a)
Note: * Forecast by the OECD

The German Council of Economic Advisors has identified three potential channels by which the crisis could have been transmitted into the German economy (SVR, 2009a). The foreign trade channel, the financial market channel and the enterprise or direct foreign investment channel. According to this analysis, the foreign trade and the financial market channels were the most important ones, whereas

6 See also Horn et al. (2009a, 2009b, 2009c) for detailed analysis of causes and transmission of the crisis to Germany.
there seems to be no indication that the enterprise/direct foreign investment channel had a specific role to play for Germany. It is argued that the foreign trade channel became particularly effective because of the rapid increase in the German dependence on exports, which was already highlighted above: between the mid 1990s and 2008, the share of exports in German GDP almost doubled. Furthermore, export specialisation in more volatile sectors and products (investment goods and cars in particular) contributed to the severity of the crisis in Germany. In case of the financial market channel, it is argued that a high correlation in changes of asset prices, for example in long-term interest rates and stock market price indices, could already be observed before the crisis. However, the direct economic effects of asset price collapses on Germany have been less important than in other countries, because wealth effects on consumption are estimated to be small or even non-existent, and the effects on investment via Tobin’s q or the balance sheet channel have also been unclear in empirical studies.

According to the SVR (2009a), however, a peculiar financial transmission channel of the crisis into Germany has been active, which is closely related to the rapidly increasing German current account surpluses in the course of the early 2000s. Net foreign financial assets held by German wealth owners rapidly increased up to 700 billion euro in 2007 (SVR, 2009a, p. 91). Most of these foreign assets were held by German banks such that the ratio of foreign assets to equity of the German banking sector increased tremendously (Figure 17.3). While the entire foreign exposure stood at about 2.7 times banks’ equity in 1995, it had increased to 7.6 at the end of 2007. In particular, the amount of securities of foreign banks and non-banks increased in relative importance. The biggest absolute increase was, however, in loans to foreign banks. In particular, the German Landesbanken, which were among the first German financial institutions to get into trouble when the financial crisis started in the US in 2007, contributed to this development.

Overall, the SVR (2009a) concludes that the more intensive and particular integration of the German financial and non-financial enterprises into the global economy has contributed significantly to the more severe recession in Germany as compared to many of the other economies. This was intensified by global uncertainty associated with the crisis, increasing vulnerability due to integration in production, and the pro-cyclicality of the global financial system. Debt defaults in the financial sector were not only a cause of the crisis, but the following reduction in credit supply also intensified the crisis of the non-financial sector.
The bailout of the financial sector

The immediate response of the German Bundestag was the Financial Market Stabilisation Act ("Finanzmarktstabilisierungsgesetz, FMStG"), the establishment of the Federal Agency of Financial Market Stabilisation ("Bundesanstalt für Finanzmarktstabilisierung, FMSA") and the Special Financial Market Stabilisation Fund ("Sonderfonds Finanzmarktstabilisierung, SoFFin") as part of the FMSA in October 2008 (SVR 2009b, chapter 4). The SoFFin was endowed with 480 billion euro in order to re-capitalise banks and to provide them with guarantees. In the first year, until October 2009, 127 billion euro were used for financial guarantees, 22 billion euro for re-capitalisation, and 6 billion euro for taking over risk (Table 17.5). Until March 2012, the maximum engagement of the SoFFin was 168 billion euro for financial guarantees, 29 billion euro for re-capitalisation, and 6 billion euro for taking over of risk (FMSA, 2012). These measures were sufficient to detain the financial crisis and to prevent a financial meltdown in Germany. However, the drawback was a considerable contribution to the rise in the government gross debt-GDP ratio, which increased from 65 per cent in 2007 to 83 per cent in 2010 (European Commission, 2012). This increase was also caused by the expansionary fiscal policies as a response to the crisis, which will be discussed in the following section.

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7 For the history and the details of the FMSA see FMSA (2012). See also chapter 13 of this study.
**Table 17.5: Stabilisation aid of SoFFin, Germany, 08.10.2009 (€ billion)**

<table>
<thead>
<tr>
<th>Guarantees</th>
<th>Billion Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>thereof:</td>
<td>127.7</td>
</tr>
<tr>
<td>Hypo Real Estate</td>
<td>52</td>
</tr>
<tr>
<td>HSH Nordbank</td>
<td>30</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>15</td>
</tr>
<tr>
<td>BayernLB</td>
<td>15</td>
</tr>
<tr>
<td>IKB</td>
<td>5</td>
</tr>
<tr>
<td>Aareal Bank</td>
<td>4</td>
</tr>
<tr>
<td>Düsseldorfer Hypothekenbank</td>
<td>2.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity injections</th>
<th>Billion Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>thereof:</td>
<td>21.9</td>
</tr>
<tr>
<td>Commerzbank</td>
<td>18.2</td>
</tr>
<tr>
<td>Hypo Real Estate</td>
<td>3</td>
</tr>
<tr>
<td>Aareal Bank</td>
<td>0.53</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Risk Assumptions</th>
<th>Billion Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>WestLB</td>
<td>5.9</td>
</tr>
</tbody>
</table>

*Source: SVR (2009b, p. 123)*

**Macroeconomic policies and recovery from the crisis**

The global financial and economic crisis led to remarkably fast and strong economic policy reactions in many countries (OECD, 2009). As an immediate measure, central banks provided extensive liquidity to money markets, thereby meeting their ‘lender of last resort’ functions. And, to a different extent in different economies, monetary policy and fiscal policy switched to expansion in order to tackle the crisis of the real economy. In what follows, a brief overview of the development in Germany in 2009/10 will be given.

Monetary policy has, of course, since the start of the euro in 1999, no longer been a German but a Euro Area-wide policy instrument in the hands of the ECB. With respect to its role as a lender of last resort, the ECB acted in a very fast and internationally coordinated manner, thereby saving the financial system from collapse. However, with respect to interest rate policy, the ECB basically followed ‘business as usual’, which can be described as ‘too little too late’ (Hein and Truger, 2007b) as compared with the US Fed (Figure 17.4). In July 2008, when the dramatic economic slowdown could not be ignored any longer, the ECB even increased the key interest rate by 25 basis points to 4.25 per cent with recourse to inflationary dangers. However, as Figure 17.5 makes clear, the strong increase of the Harmonised Index of Consumer Prices (HICP) since autumn 2007 has been due almost entirely to the rise in food and oil prices; and there were no clear signs of second round effects. The single-minded preoccupation of the ECB with inflation, and the ill-conceived concentration on headline inflation as expressed by the HICP, is confirmed by the fact that the ECB started cutting interest rates only after oil prices – and consequently the HICP – had started to fall. The coming dramatic real
The economic slowdown was completely ignored by the ECB: interest rate cuts came well after GDP had started to fall strongly, as can be seen in Figure 17.6. This late reaction of the ECB was disadvantageous in particular for those Euro Area member countries which were hit hard by the crisis, like Germany. But the consistently low nominal interest rates since then (the slight increase in 2011 had to be reversed quickly) have favoured all Euro Area member countries. This provided an additional impetus for countries like Germany where economic expansion had already resumed.

**Figure 17.4: Key interest rates, ECB vs. Fed, 1999 – 2012 (%)**


**Figure 17.5: ECB key interest rate and inflation, Euro Area, 1999 - 2012 (%)**

![Chart showing ECB key interest rate and inflation, Euro Area, 1999 - 2012 (%)](source: ECB (2012), own calculations)

*Notes: HICP – Harmonised index of consumer prices*
Turning to wage policies and the development of nominal unit labour costs as a major determinant of prices and inflation in the course of and after the crisis, in Table 17.3 it can be seen that nominal unit labour cost growth increased in 2008 and 2009. However, this was exclusively due to the usual decrease in labour productivity in the course of the crisis because of labour hoarding, actively supported by the government. Compensation per employee growth did not show any acceleration in the course of the crisis. Furthermore, even during the recovery after the crisis, the higher rates of change of compensation per employee are expected to generate unit labour cost growth between 2010 and 2013 (Table 17.3), which on average are well below the Euro Area inflation target of below but close to 2 per cent. Therefore, there is no indication that wage policies in Germany will leave the pre-crisis path of wage moderation, contributing to German neo-mercantilism identified in section 2 in this chapter.

Ever since the late 1970s German fiscal policy had built up a more than 25 year old tradition of procyclical restriction in previous recessions (Hein and Truger, 2007a). However, in the 2008/9 crisis, fiscal policy reacted in a remarkably counter-cyclical way. After some hesitation and some merely ‘cosmetic’ measures, in the first months of 2009 a substantial stimulus package for 2009 and 2010 was enacted (Table 17.6). Overall, the packages together with some additional measures included substantial increases in public investment, as well as tax relief for business and households. The cumulative stimulus for 2009 and 2010 amounted to 3.1 per cent of 2008 GDP, which is certainly above the Euro Area average level (OECD, 2009). However, the US stimulus package had a volume of more than 5 per cent of GDP in the period 2008-2010, and was therefore substantially bigger (OECD, 2009). In 2009, fiscal policy in the US was not only more expansive with respect to the discretionary stimulus packages, but also on an overall basis, taking into account the workings of automatic stabilisers.
Table 17.6: Budgetary effects of fiscal packages and additional measures, Germany, 2009-2010 (€ billion)\(^1\)

<table>
<thead>
<tr>
<th>Fiscal Package I</th>
<th>2009</th>
<th>2010</th>
<th>2009+2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Investment Support</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) public infrastructure (roads)</td>
<td>1.32</td>
<td>1.40</td>
<td>2.7</td>
</tr>
<tr>
<td>b) support for regions</td>
<td>1.00</td>
<td>1.00</td>
<td>2.0</td>
</tr>
<tr>
<td>c) credit programme for energy-efficient construction</td>
<td>0.20</td>
<td>0.10</td>
<td>0.3</td>
</tr>
<tr>
<td>d) further credit programmes</td>
<td>0.04</td>
<td>0.22</td>
<td>0.3</td>
</tr>
<tr>
<td>2. Tax Relief for Private Households</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) motor vehicle tax exemption</td>
<td>0.38</td>
<td>0.14</td>
<td>0.5</td>
</tr>
<tr>
<td>b) tax incentives for services in private households</td>
<td>0.90</td>
<td>0.90</td>
<td>0.9</td>
</tr>
<tr>
<td>3. Tax Relief for Businesses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) accelerated depreciation allowances (25%)</td>
<td>1.94</td>
<td>4.33</td>
<td>6.3</td>
</tr>
<tr>
<td>b) special depreciation for small and medium size enterprises</td>
<td>0.24</td>
<td>0.37</td>
<td>0.6</td>
</tr>
<tr>
<td>Sub Total</td>
<td>3.87</td>
<td>7.13</td>
<td>11.0</td>
</tr>
<tr>
<td>4. Measures by the Federal Labour Market Agency</td>
<td>0.3</td>
<td>0.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td>4.2</td>
<td>7.6</td>
<td>11.8</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Fiscal Package II</th>
<th>2009</th>
<th>2010</th>
<th>2009+2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Public Investment (local communities)</td>
<td>4.0</td>
<td>12.0</td>
<td>16.0</td>
</tr>
<tr>
<td>2. Support for Innovational Research</td>
<td>0.5</td>
<td>0.5</td>
<td>0.9</td>
</tr>
<tr>
<td>3. Support for Motor Vehicle Demand</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>4. Reform of the Motor Vehicle Tax</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>5. Support for Mobility Research</td>
<td>0.3</td>
<td>0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>6. Employment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) subsidies for short time work</td>
<td>1.6</td>
<td>1.6</td>
<td>3.1</td>
</tr>
<tr>
<td>b) activation programme</td>
<td>1.3</td>
<td>1.3</td>
<td>2.6</td>
</tr>
<tr>
<td>c) additional personnel for labour market agency</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>d) stabilising the unemployment insurance rate</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
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<tr>
<td>7. Income Tax Cuts</td>
<td>2.9</td>
<td>6.1</td>
<td>9.0</td>
</tr>
<tr>
<td>8. Cuts Social Security Taxes (Health insurance)</td>
<td>3.0</td>
<td>6.0</td>
<td>9.0</td>
</tr>
<tr>
<td>9. Expenditure for Families</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) transfer for children</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>b) higher social benefits for children</td>
<td>0.2</td>
<td>0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Total</td>
<td>20.7</td>
<td>29.2</td>
<td>49.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Additional Measures</th>
<th>2009</th>
<th>2010</th>
<th>2009+2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Re-introduction of Commuter Tax Relief</td>
<td>5.9</td>
<td>2.3</td>
<td>8.2</td>
</tr>
<tr>
<td>Tax Deductability Social Security Contributions</td>
<td>8.1</td>
<td>8.1</td>
<td>8.1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fiscal Packages I + II + Additional Measures</th>
<th>2009</th>
<th>2010</th>
<th>2009+2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>30.7</td>
<td>47.2</td>
<td>78.0</td>
</tr>
</tbody>
</table>

in % of 2008 GDP | 1.2 | 1.9 | 3.1 |

Source: Hein and Truger (2010, p. 209)

Notes: ^1 Without macroeconomic repercussions
Figures 17.7a-c show the budget balance, as well as the output gap as a measure of the cyclical condition of the economy for Germany, the EU-15, and the US respectively. As can be seen, in 2009 the budget balance in the US responded more elastically to the crisis than in Germany or the EU-15. In the US, the budget balance reacted by 0.98 per cent of GDP per one percentage point drop in the output gap. In Germany and the EU-15 the corresponding numbers were 0.5 and 0.78 per cent of GDP respectively. In 2010, however, German fiscal policies accepted a further increase in the budget deficits in the face of an improvement of the output gap and the recovery of the economy, whereas the Euro Area and the US already started reducing the deficit, albeit from a higher level of the deficit-GDP ratio.

Figure 17.7a: Government budget balance (% of GDP) and output gap (% of potential GDP), Germany, 2006 – 2013

![Graph showing government budget balance and output gap for Germany, 2006-2013](source: OECD (2012a))

Notes: OECD projections for 2012 and 2013.

Figure 17.7b: Government budget balance (% of GDP) and output gap (% of potential GDP), Euro Area (EU-15), 2006 – 2013

![Graph showing government budget balance and output gap for the EU-15, 2006-2013](source: OECD (2012a))

Notes: OECD projections for 2012 and 2013.
From the analysis so far it can be concluded that the rapid German recovery in 2009-11 was based on two pillars. On the one hand, the German neo-mercantilist type of development, which was a major cause for global imbalances before the crisis and the severity of the crisis in Germany itself, allowed for a rapid recovery via the net export channel as soon as the world economy recovered from the crisis. As can be seen in Table 17.3, real exports in 2010 almost completely recovered from the collapse in 2009, and the current account surplus remained well above 5 per cent during the crisis and the recovery period. On the other hand, expansionary fiscal policies contributed to the quick recovery of the German economy by means of stabilising domestic demand, which finally induced real capital formation to rise (Table 17.3). Finally, in 2011, private consumption also contributed significantly to real GDP growth.

However, this German type of recovery suffers from two major drawbacks. First, to the extent that it was driven by net exports, it has to rely on the neo-mercantilist type of development that has considerably contributed to world and regional imbalances and to the severity of the crisis in Germany itself. It therefore lays the seeds for further imbalances, fragilities and future vulnerabilities of the German economy, and it contributes significantly to the persistent euro crisis (see Cesaratto and Stirati, 2010; Febrero et al., 2011; Hein, 2012a; Hein et al., 2012). Second, as a political precondition for the German stimulus packages, the so-called ‘debt brake’ was introduced into the German constitution, which will limit the room for manoeuvre for German fiscal policy in the future. From 2016 onwards, the federal budget will only be allowed to run a cyclically adjusted deficit of 0.35 per cent of GDP. The federal states’ (Länder) budgets will have to be structurally balanced from 2020 onwards. As the cyclically adjusted or ‘structural’ deficit will be determined by a variation of the European Commission’s method of calculating structural deficits, it will exhibit the same strong
sensitivity to short term revisions of GDP forecasts, and will therefore prevent the full working of automatic stabilisers. Discretionary fiscal policy will only be allowed under very restrictive conditions. And since this type of fiscal austerity has also been imposed on the Euro Area via a tightened Stability and Growth Pact and a new Fiscal Compact, it will mean restrictive fiscal policies for the Euro Area, too. This can already be seen in Figure 17.7c which presents OECD projections for 2012-13. Although the Euro Area will be in a recession with falling output gaps, government deficits are projected to be reduced nonetheless. Furthermore, on top of fiscal austerity, the euro crisis and related political measures have obliged the other European countries to follow the German type of wage moderation and domestic demand cuts in order to improve competitiveness. Since more than 40 per cent of German exports are still absorbed by Euro Area member countries, this will finally feed back negatively on Germany, too.

17.4. Conclusion

The purpose of this chapter was to outline the transmission of the financial and economic crises to Germany and to sketch the economic policy responses. The German type of development prior to the crisis was characterised as export-led mercantilist, as compared to the debt-led consumption boom or domestic demand-led types of developments in other major countries. This German type of development determined the channels of transmission of the crisis to Germany and the specific severity of the crisis in this country; the foreign trade and the financial market channel were considered to be most important. The foreign trade channel became effective, because the openness of the German economy had rapidly increased since the mid 1990s, and aggregate demand had been driven considerably by net exports. Rising current account surpluses meant an increase in net foreign assets mainly held by commercial banks, which made this sector vulnerable for the financial market channel of transmission. Regarding policy reactions towards the crisis, the immediate bailout of the financial sector detained the financial crisis in Germany and prevented a financial meltdown. Economic recovery was mainly driven by German exports in the course of the recovery of the world economy, and it was strongly supported by expansionary fiscal policies in 2009 and 2010. Finally, it was argued that this German type of recovery suffers from two major drawbacks. First, to the extent that it was driven by net exports, it had to rely on the neo-mercantilist type of development that had contributed considerably to world and regional imbalances and to the severity of the crisis in Germany itself. It therefore lays the seeds for further imbalances, fragilities and vulnerabilities of the German economy, and it has contributed significantly to the persistent euro crisis. There seems to be no indication that Germany will leave this path of export-led mercantilist development. Second, as a political precondition to the German stimulus packages, the so-called ‘debt brake’ was introduced
into the German constitution, which will limit the room for manoeuvre for German fiscal policy in the future. And since this type of fiscal austerity has also been imposed on the Euro Area via a tightened Stability and Growth Pact and a new Fiscal Compact, it will mean restrictive fiscal policies for the Euro Area, too, driving major parts of the Euro Area into deflationary stagnation, and an increasing risk of a collapse of the euro, which would in turn feed back negatively on German exports and growth.
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Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number: 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?
THE PARTNERS IN THE CONSORTIUM ARE:

<table>
<thead>
<tr>
<th>Participant Number</th>
<th>Participant organisation name</th>
<th>Country</th>
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<td>1 (Coordinator)</td>
<td>University of Leeds</td>
<td>UK</td>
</tr>
<tr>
<td>2</td>
<td>University of Siena</td>
<td>Italy</td>
</tr>
<tr>
<td>3</td>
<td>School of Oriental and African Studies</td>
<td>UK</td>
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<td>4</td>
<td>Fondation Nationale des Sciences Politiques</td>
<td>France</td>
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<td>5</td>
<td>Pour la Solidarite, Brussels</td>
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