

# The monetary and fiscal policies of germany



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“ What were Germany’s fiscal policies during the 2007-2010 Global Financial Crisis, and did the common monetary policy adapt sufficiently to the needs of the German economy?”

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Part 2: The monetary and fiscal policies followed during 2008 and 2009 in the context of and in relation to the economic crisis. For the Euro-area countries, the analysis of monetary policy will look at whether the common monetary policy was adapted to the needs of the country

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## **Introduction**

As the economic powerhouse of Europe, The Federal Republic of Germany holds a very special place in the economy of the European Union and of the world; being the globe's second largest exporter. Holding the purse strings, Germany is also the foundation of both the development and the stability of the European Monetary union. This crucial position means that the country has been at the forefront of the European union's strategy to avert meltdown in the financial crisis that really began to hit Europe in 2007. Germany entered a confirmed recession in the second quarter of 2008. There were a number of different effects, including potential bank defaults, rising unemployment and a sharp decline in exports, the consistent growth of which Germany had been heavily reliant.

There were many differences of opinion as to what should be done to avoid economic collapse, but ultimately Germany has turned inwards[1], engaged in a significant stimulus program designed to protect jobs, encourage consumption and avoid systemic bank failures. This paper will, within a theoretical framework, explain the causes, effects and responses to the crisis during 2008 to 2009. Given that Germany is playing a major role in the emerging Greek crisis, I will also touch on this, despite it being beyond the scope of the essay question: the crisis not yet over, and the reaction to the continuing threat of Greek default is relevant in the context of the actions that preceded it. Implicitly, the nature of the Global Financial Crisis affected

(and continues to influence) more than one country. It is thus hard to simply discuss Germany purely in isolation. This essay will consequently occasionally venture onto topics beyond the Bundesrepublik.

## **The Prelude**

It is hard to discuss the development of the crisis and the response thereto without briefly expanding on the earlier events of the crisis. Triggered by sharp interest rate hikes in the US, where interest rates went from 1% in 2004 to 5.25% in 2007[2], a wave of defaults hit the sub-prime housing market, affecting lower-segment home owners[3]. The use of variable rate loans on the basis of the supposed value of the property on which they were based – properties that were essentially worthless anyway – meant that bad loans represented a virtually total loss.

Significant cross-contamination of the balance sheets of global banks meant that whereas debt defaults in the US should have only affected domestic banks, the effect was much wider. The medium of tranching securitised debt issues, which are essentially repackaged non-investment grade ‘junk’ bonds, hid the fact that many international banks had heavily invested in unsuitable financial products. Securitised debt is constructed by collecting mortgages, bundling them, tranching them, assigning a rating and reselling them. Ratings agencies were responsible for labelling the debt as higher-quality than was reasonable, and they played a very real part in the development of the crisis. The clue is in the name, and ‘junk’ bonds are called that for a reason.

Repackaging these Collateralised Debt Obligations or CDOs, meant that the toxic nature of the debt was essentially hidden. Large banks the world over had invested in these – ostensibly not knowing what they really were – and had extended their balance sheets, becoming highly leveraged in the process to cover the investments. When the crisis hit, the defaults affected these banks, and mortgage restructuring was too slow and not to sufficient degree. ‘Rolling over’ became difficult and banks stopped granting loans collateralised on the expected increase in house prices. As CDOs were gradually downgraded, the parent banks of Special Purpose Vehicles, SPVs, – the method through which investment banks or Hedge Funds engaged in CDO trading – had to intervene and bail out their subsidiaries[4]. The sheer size and cost of these rescues eventually had large German banks (who were amongst the first casualties) knocking at the door of the Bundesbank begging for money. IKB[5]and Sachsen LB both needed help, as did Hypo Real Estate, HRE[6]. This was the beginning of the mess.

This very rapidly hit the real economy (as opposed to the ‘fake’ financial economy). The same banks that were involved in sub-prime CDO trading were those that lent to consumers. As lending dried up, the German economy began to suffer from the inside (quite aside from the deterioration of exports to third countries). Deposits also went missing, as in the case of the Oldenburg State Church, which had invested €4. 3 million in securities traded by Lehman Brothers, the failed American Investment Bank[7].

## **Economic Background**

Initially, Germany was in reasonable shape economically when compared to its partner countries within the Eurozone. The debt-to-GDP ratio was around

65%[8], and while the deficit before the crisis had been fluctuating around the 3% maximum mandated by the Eurozone Stability and Growth Pact, (3.8% in 2005) it was actually balanced in 2008, in line with the German Bundesregierung's policy. Indeed it was in a much better position to cope with the crisis than it had been in previous economic cycles, and recent reforms by the Federal government have been fruitful[9].

GDP fell by 0.6% in the second and 0.3% in the third quarter of 2008, which represented the start of technical recession. The situation deteriorated in the fourth quarter of 2008 and the first of 2009 with GDP decreases of 2.4 and 3.5 respectively. The return to growth occurred in the second quarter of 2009, (likely as a delayed result of the fiscal stimulus taking effect), with 0.4% and 0.7% increases in GDP respectively[10].

Unemployment was down markedly in 2008 from only 2005. It was now 3.3 million as opposed to 4.9 million. Total employment was 40 million in the same year, which represented the highest level ever recorded in the Federal Republic; a remarkable feat in its own right. Further, for the first time since November 1992, unemployment in Germany decreased below 3 million. It would appear that the natural rate of unemployment has been coaxed downwards, due to wage reforms by firms, increased competitiveness and government policy. These structural reforms have been particularly successful, as at the time of writing, Germany's unemployment figure is still only 8.7%[11]. This is a change of only 1.2%. In comparison, the change in unemployment in the United States was 3.5%, up to 9.3% in 2009 from 5.8% in 2008. Comparable figures for the UK show a trough-to-peak change of

5. 3% to 7. 9% between October 2007 and October 2009, a change of 2. 6%[12].

The fiscal discipline in balancing of the budget since the middle half of the decade – regardless of the economic argument that doing so is unproductive from a Keynesian perspective – but this allowed it room to engage in fiscal stimuli in line with the needs of the economy. Because Germany had at least some ‘ automatic stabilisers’ and more so than the US[13], the downturn did not cause as much havoc as it might have done.

## **Exports**

Before the crisis, exports represented nearly 50% of the value of the German economy. By volume, Germany exported nearly as much as the United States[14], which is an astonishing figure when one considers the German economy is a quarter of the size of that of the US. Data for 2009 was elusive, but graphs 1 and 2 both illustrate the quite noticeable decline in export value over 2008 to 2009. Nonetheless, Germany’s trade-to-GDP ratio was some 87. 4%, which as a degree of openness indicates that the country is likely to be heavily affected by fluctuations in demand for it’s exports in other countries. Some 86. 2% of its exports were manufactures, particularly heavy machinery and cars, and 63. 7% of its trade was with partner countries within the European Union[15]. In some ways, Germany holds a very similar position to that of China vis à vis the United States: it runs a substantial trade balance surplus to partner countries, issuing debt in return. This is, for instance, the case as regards Greece, Germany being a large investor in Greek debt. The countries that surround Germany, such as Spain and Portugal have operated sizable trade balance and budget deficits,

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importing Germany goods. It is precisely via this method that Germany has maintained its growth over the past decade; exports and the growth thereof offsetting stagnant domestic demand and below-inflation wage increase (i. e. real wage decreases)[16]. Now however, there has been a dire reversal, with the OECD predicting a small net exports deficit for 2009[17]

### German Banking Sector

The German banking system is immensely complicated and characterised by a three pillar structure based upon three distinct types of bank. It is fairly fragmented, and potentially affects the competitiveness of private German banks, such as Commerzbank and Deutsche Bank, in the foreign market. The three pillars include private banks, public-sector banks and Co-operative banks. I will briefly expand on these

The public sector banks operate in two guises, the Landesbanken and the Sparkassen. A Sparkasse is a small banking unit – effectively a building society – with a regional focus. There are 446 Sparkasse operations, running about 16000 branches. The Landesbanke is the higher institution, handling at regional level tasks too great for the Sparkasse[18]. There are eight Landesbanken, representing major areas of German. For instance, Bavaria's Landesbank is called BayernLB. Collectively, the public-sector banks account for 45% of the banking market in Germany. The theory is that because the banks are public-sector guaranteed, they should provide safe, convenient banking services to consumers. While generally the Landesbanken are fairly conservative, a number of them got into dire trouble as a result of the financial crisis and had to be bailed out.



The cooperatives, or Genossenschaftsbanken make up the second pillar and 13% percent of the market. They are organised in a similar way to the public sector banks. DZ bank is the largest such bank.

The third pillar is the private commercial banking sector with 42% of the market. This is made up of banks that operate as publicly traded corporations, structured in a similar way to many other international financial service institutions[19]. However, they differ somewhat in that tighter regulation and capital requirements in theory make them more secure than the equivalent Anglo-Saxon banks[20]. This tighter regulatory framework has lead to a decline of relative importance of German banks, such as Deutsche Bank and Hypo Real Estate, the latter of which has nonetheless had to be bailed out nearly three times.

### Bank Failures and Bailouts

The byzantine structure of the German banking system did not actually help it avoid the turmoil of the banking sector - despite what was said by Bundesbank President Axel Weber in September about the stability of the German financial system[21]- unlike the rest of the German economy which otherwise has performed fairly well, despite the GDP falls and increased budget deficit. Banks both private and in the Landesbank system had to be bailed out after it became clear that they were not solvent or had insufficient liquidity to refinance their debts. A table showing the bailouts and their size can be found in the annex.

One of the major features of the crisis was the loss of confidence within banks. Loans that had turned bad abroad soured lending to perfectly viable

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firms at home in Germany, as banks sought to reign in their highly leveraged balance sheets. The government looked to ensuring citizen's deposits (in order to prevent bank runs) and to restoring the credit link between firms and banks. The ensuring of deposits was total: 100% of deposits were guaranteed, unlike in the Iceland situation, wherein only around 75% of the deposit was secure, or only secure up to a certain amount (£35000). This appeared the a 'comprehensive rescue package', the Financial Market Stabilisation Act. The purpose was, ostensibly, to restore the financial system and rebuild shattered confidence in the sector. It was to ensure stability in transactions between commercial banks[22]. The measures were time-limited, and came with certain strings attached. For instance; banks that receive aid had to clip the bonuses and wages of their senior staff, seeing their salaries capped at a meagre €500000[23].

In October 2008, the German government enacted the Financial Market Stabilisation Act (Finanzmarktstabilisierungsgesetz, FMStG). Within this, it had set aside an astonishing €500 billion Euro Financial Market Stability fund, (SoFFin)[24]. This consisted of €400 billion in loan guarantees, €80 billion in recapitalisation funds for banks in troubled waters, with €20 billion set aside to accommodate bad loans[25]. The sheer size of the SoFFin program represented around 20% of German GDP.

A major case during which this scheme was implemented was the case with Hypo Real Estate, a commercial property lender. A major problem was the debts of Depfa, a Dublin-based subsidiary it had acquired the year before. Depfa had encountered liquidity problems as a result of the financial crisis and was unable to finance its debts[26]. government and local financial

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institutions were forced to offer a credit line of €35 Million euros in September 2008. The announcement triggered a 70% fall in HPE's share price[27]. While in theory the bank was not to require any further capital injection, this amount later went up to €52 million in February 2009, paid for out of the Financial Market Stabilisation Fund (SoFFin). By April 2009, SoFFin tendered an offer to subsume Hypo Real Estate, taking the government ownership to 90%, having spent €102 million. During this time, the German government passed a law forcing the sale of shares by shareholders, even if they refused to sell. On the 5th of October 2009, the entire bank was nationalised[28].

Commerzbank, Germany's second largest private bank also had to ask for help in around September 2008, and was partially nationalised. The government took a 25% stake in the company, bailing it out to the tune of €10 billion for €6 a share. The bank had run into liquidity problems after its purchase of Dresdner bank from Allianz.[29]

Similarly, it emerged in early 2008 that the state-backed BayernLB Landesbank had made significant losses in the sub-prime mortgage crisis of around €2.3 billion in 2007 and €2 billion in the first quarter of 2008, out of a total investment of €24 billion. It was also heavily exposed in the Hungarian and Balkan markets. As an interesting digression; the Bavarian Finance minister Erwin Huber, who as the bank was state-run was also the acting chair of the administrative council was forced to resign over the issue. The bank's losses represented a major issue in the ensuing elections, during which his party, the CSU, suffered their worst election defeat since 1962[30].

## **We're All Crass Keynesians Now**

The German Federal government eventually engaged in up to three fiscal stimuli that consisted of a number of different parts. The first was smaller, the second a larger sum. Angela Merkel, the German Chancellor started pushing for a €23 billion over four year stimulus in late October 2008[31], and the government approved this plan in early November in order to combat the downturn which had, by then, already adversely affected the economy. The stimulus represented 2% of German GDP and included a variety of measures to boost demand, which had faltered since the crisis. Tax reductions on new cars which amounted to a 'tax holiday' on the purchase of a new vehicle in return for scrapping the old one amounting to a €2500 rebate, loans to small and medium enterprises and various public works.

There was concern at the time that the initial amount offered was insufficient to actually have any measurable effect on the German economy.

Notwithstanding the fact that there are significant leakages into the rest of the European Union from Germany, even finance ministry officials at the time complained that the stimulus at it stood in November 2008 was only about half what they reckoned was sufficient to effect useful stimulus (NYTIMES), while most likely being big enough to do significant

It turns out that these officials probably had a point; less than 2 months later another, an even greater push led to the second round of stimuli in January 2009. This time the stimuli represented an additional €50 billion over two years[32]. It took a meeting of over six hours to agree but the measures ultimately included a one-off child support payment of €100, reduced health-

insurance payments, yet more public works investment in infrastructure and public services, and reduction in the lowest bracket of the income tax scale. The most important part of this scheme from an employment perspective, was the plan to avoid mass job-cuts by negotiating with large firms to temporarily place on shorter working weeks or on lower wages. Also included was a plan for a €100 billion loan protection scheme for non-financial enterprises to guarantee lending.

This nonetheless faced criticism for being too small, especially when compared to the United States' stimulus of \$775 billion, 2.8% of US GDP; considerably larger than Germany's. It was said at the time, January 9th 2009, by Dominique Strauss-Kahn, Managing Director of the International Monetary Fund, that Western European governments were still "behind the curve" and "underestimating the needs" of the stimulus. It was estimated that the €82 billion stimulus as it stood would only take effect until mid-to-late 2009. As it turned out growth did return in the latter quarter of 2009, as mentioned above.

Nevertheless, the two previous stimuli were followed by a third nearly a year later with the enactment of the Economic Growth Acceleration Act<sup>[33]</sup> which, while only coming into force on the 1st of January 2010, had been discussed previously (so I shall include it in the essay for completeness). Rather than an outright spending spree, the EGAA is more a collection of measures designed to improve business and living conditions inside the Federal Republic through a series of tax breaks, ostensibly designed to foster demand growth. It takes the form of a 'target tax policy', rather than the aforementioned stimuli which were sold as being 'targeted spending plans'.

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Inheritance tax has been reduced in the Tax II class and the Act also modifies depreciation laws in such a way that low-value immovable assets up to €410 to be immediately marked as depreciated which supplements the previous option which meant that all fixed goods between €150-1000 were compounded and could depreciate over five years. VAT was also slashed by seven percent for short term accommodation, a boon for the tourism industry. The measures also include a system for certain qualifying companies to be allowed a higher tax exemption limit on interest payments. Additionally, interest above this new, lower limit, can be deducted over the next five years.

There are now also deductions on losses and a method for favouring new investments has been instituted. Alongside this, share transfers and company successions have been smooth meaning that within associated firms, the use of tax 'carryforwards' are now permitted within certain criteria. Restructuring a company is now to be exempted from real estate transfer tax. The 'minimum mandatory holding period' has been decreased to five years from seven, as has the minimum wage sum over this time. The various changes, in addition to the healthcare and employment conditions mentioned above stand to improve the lot of businesses and consumers alike, and are likely to keep Germany attractive for investments. They are classic Keynesian cyclical policies to boost spending in bad years and balance the books when in growth.

As an aside to the strict fiscal policy was at least one planned bail out of a large industrial enterprise. Opel, a major component of the American multinational car manufacturer General Motors which found itself in difficulty

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after huge overcapacity (stemming from before the crisis) left it struggling to maintain profitability[34]. As Opel employs over 50000 workers in Germany, the bankruptcy of the company or closure of production plants could have undone much of the benefits of the fiscal policies in these areas. GM offered to sell Opel and asked the German government for state-loans to stay solvent. €4. 5 billion in state aid was offered by Germany - despite protests by competition authorities that the offer was in violation of articles 107 & 108 of the Lisbon treaty[35]- to finance the deal. Ultimately despite agreement in September 2009, the deal fell through when GM changed its mind. I include this as this variety of ' lemon socialism' - propping up unprofitable companies because of the valuable social role they play - is aimed at achieving similar results as direct fiscal interventions.

## **8. ECB Monetary Policy and how it fit Germany**

Germany of course no longer has direct control over its monetary policy, being a major constituent of the Eurozone. However, the European Central Bank ECB, is located in Frankfurt and is based upon the principles of the German Bundesbank. Given the size and importance of the German economy to both the Eurozone and to the European Union as a whole, it is unsurprising that the Governing Council of the ECB might work along the lines that what is good for Germany is good for the rest of the EU. In this sense, the decisions of the ECB are aligned somewhat more closely to the lee of the German economy than they might have been for the Baltic countries - where the interest rate decisions were highly inappropriate for countries such as Latvia trying to defend a narrow peg[36].

Below are found the graphs comparing German GDP between 2004-2010 and the ECB's overnight interest rate between 2000-2010[37]. Graph 3 shows the GDP, inflation-adjusted, and shows both the change on the previous quarter (dark blue line) and the year on year change (light blue columns). Graph 4 shows the evolution of the overnight 'repo' rate of the ECB. From an theoretical economics perspective, if a country operates an independent monetary policy - and assuming their policy makers wish to preserve the long term stability of their economy - then interest rates normally rise during periods of growth in order to counteract inflationary pressures arising from the expansion. Similarly, during periods of recession, central banks generally lower nominal interest rates to foster investment and economic activity. If the question is whether the ECB tailored its rate to the needs of the German economy, then the data has a strong case that it did so.

One needs only a cursory glance at the graphs in the annex to see that (from 2004) when growth was shallow or (or even negative), interest rates were also low, and when growth was higher the rates were higher. When the crisis hits Germany in mid-2008, the ECB interest rate very quickly falls to counteract the crisis. However, The ECB interest rate remains (for now) at 1.00%, with the next meeting of the Governing Council on the 4th of March (the submission date for this paper). It has remained at 1.00% since June 2008, but growth has now returned - albeit to a somewhat meagre degree - so it remains to be seen what the decision of the Governing Council will be.

## **9. Greeced lighting**

Having successfully bailed out its banks, resisted unemployment, engaged in several very significant and highly expensive fiscal stimuli, and exited the

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recession with a deficit well under control[38], Germany has now encountered another problem in the form of Greece. Greece has deep structural problems with highly suspect accountancy practices at governmental level. For instance, quite aside from a debt-to-GDP that is well over 100% (nearly double the maximum supposedly permitted within the Stability & Growth Pact), it emerged in November that the Greeks had essentially lied about their budget deficit and neglected to mention over 5% of government spending. Ignoring for now the moral implications, a deficit of 12.7% in 2009 - over four times the number allowed by the SGP - 'decreasing' to 9.8% in 2010[39], it has emerged that Greece has systematically misled the EU over the scale of its financial mismanagement, even while it was still a candidate country to the Eurozone as far back as 2004[40]. This was all fine and large when growth was strong, but when the financial crisis hit, things went awry. The country now finds itself with double-digit inflation, rioting on the streets and the very real possibility that it could default on its debt.

Germany's position as the largest European economy and its comparatively strong financial position has led to expectation that it should help support Greece deal with its economic difficulties. Given that article 123 forbids the ECB from doing so, attention has turned to the preceding clause, article 122 of Lisbon, which suggests that in times of national crisis and 'in a spirit of solidarity between Member States, [the Commission can decide] upon measures appropriate to the economic situation". The idea arose that Germany should help rescue the Greeks from the mess they made. Germany has interests in doing so - aside from guaranteeing the continued existence

and credibility of the Euro - Germany and German companies have operated as a lender to Greece, investing heavily in Greek debt and because Greece represented a large market for German industrial exports. Were Greece to default, this would be highly costly to Germany in terms of the debt and the evaporation of the export market there.

However, at the time of writing Merkel has told the Greeks that a bailout is off the cards. While private companies have considered buying Greek debt if backed by Berlin, it is not a guarantee that this will necessarily happen[41]. On the 3rd of March 2010 Greece announced further austerity measures of €4.8 billion[42], which pleased Germany, who nonetheless maintained that it was Gree