

Daniel Detzer · Nina Dodig  
Trevor Evans · Eckhard Hein  
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# The German Financial System and the Financial and Economic Crisis

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# The German Financial System and the Financial and Economic Crisis

 Springer

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# Preface

This book is a revised version of a study on the German financial system which was prepared as part of the research project ‘Financialisation, Economy, Society and Sustainable Development (FESSUD)’ (D. Detzer, N. Dodig, T. Evans, E. Hein and H. Herr: *The German Financial System*, FESSUD Studies in Financial Systems, No. 3, 2013, University of Leeds). The project received funding from the European Union Seventh Framework Programme (FP7/2007–2013) under grant agreement n° 266800. This book also draws on a report on financial regulation in Germany (D. Detzer and H. Herr: *Financial Regulation in Germany*, FESSUD Working Paper Series No. 55, 2014, University of Leeds) and on a report on financial regulation in Germany (D. Detzer and H. Herr: *Financial Regulation in Germany*, FESSUD Working Paper Series No. 55, 2014, University of Leeds) and on a study on financialisation and the crisis in Germany (D. Detzer and E. Hein: *Financialisation and the Financial and Economic Crises: The Case of Germany*, FESSUD Studies in Financial Systems No. 18, 2014, University of Leeds), which were completed as parts of the same project.

Most of the data included in this book only go up to 2012, as the original studies were completed in 2013 and 2014. Unfortunately, for several reasons, it has taken until now to prepare the final book for publication. However, we hope that the content of this book will still be of interest for the readers, because this book presents a review of the long-run developments of the German financial system and an analysis of how an increasing dominance of finance (‘financialisation’) has played out in Germany, how Germany was then affected by the financial and economic crisis in 2007–2009 and, finally, how it managed to recover quickly from this crisis.

The results of the studies on which our book is based were presented at annual conferences of the FESSUD project held in Berlin in 2012, in Amsterdam in 2013 and in Warsaw in 2014, and parts were presented at several other conferences, i.e. in Pescara, Bilbao and Berlin in 2014. We are most grateful to the participants, and to the colleagues in the FESSUD project in particular, for their helpful comments. We would also like to thank the student assistants, who have provided invaluable research support at different stages of these studies: Jeffrey Althouse, Natalia Budyldina, Henriette Heinze, Christian Jimenez, Tatjana Kulp, Gayane Oganessian and Barbara Schmitz. Of course, they do not bear any responsibilities for remaining errors and problems in this book for which we alone are responsible.

Berlin, Germany  
February 2017

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# Abbreviations

AG	<i>Aktiengesellschaft</i> (Joint-stock corporation)
BaFin	<i>Bundesanstalt für Finanzdienstleistungsaufsicht</i> (Federal Financial Supervisory Authority)
BAKred	<i>Bundesaufsichtsamt für das Kreditwesen</i> (Federal Supervisory Office for Banking)
BAV	<i>Bundesaufsichtsamt für das Versicherungs- und Bausparwesen</i> (Federal Supervisory Office for Insurance and Home Loans)
BAWe	<i>Bundesaufsichtsamt für den Wertpapierhandel</i> (Federal Securities Supervisory Office)
BIS	Bank for International Settlements
BRRD	Banking Recovery and Resolution Directive
CDU	Christian Democratic Union of Germany
CR	Concentration ratio
CRD	Capital Requirement Directive
DAI	<i>Deutsche Aktieninstitut</i> (German Institute for Stocks)
DAX	<i>Deutscher Aktienindex</i> (German Stock Index)
DBP	<i>Deutsche Bundespost</i> (German Federal Post Office)
DCGK	<i>Deutscher Corporate Governance Kodex</i> (German Corporate Governance Code)
DEA	Data envelope analysis
DFA	Distribution free approach
DM	<i>Deutsche Mark</i> (German mark)
DSGV	<i>Deutscher Sparkassen- und Giroverband</i> (German Savings Banks Association)
DTB	<i>Deutsche Terminbörse</i> (German Derivatives Exchange)
EAA	<i>Erste Abwicklungsanstalt</i> (First Winding-down Agency)
ECB	European Central Bank
ECU	European Currency Unit
EMS	European Monetary System
EU	European Union

FDI	Foreign direct investment
FDP	Free Democratic Party
FESSUD	Financialisation, Economy, Society and Sustainable Development
FMSA	<i>Bundesanstalt für Finanzmarktstabilisierung</i> (Federal Agency for Financial Market Stabilization)
FMStErgG	<i>Finanzmarktstabilisierungsergänzungsgesetz</i> (Supplementary Act to Stabilize the Financial Market)
FMStG	<i>Finanzmarktstabilisierungsgesetz</i> (Financial Market Stabilisation Act)
FMS-WM	<i>FMS Wertmanagement</i>
FSAP	Financial Sector Action Plan
FT	Financial Times
GDP	Gross domestic product
GDR	German Democratic Republic
Gov.	Government
G-REIT	German Real Estate Investment Trust
GSOEP	German Socio Economic Panel
HH	Households
HICP	Harmonised Index of Consumer Prices
HRE	<i>Hypo Real Estate Holding AG</i>
IKB	<i>Deutsche Industriebank AG</i>
IMF	International Monetary Fund
Ins.	Insurance corporations
IPO	Initial Public Offering
KfW	<i>Kreditanstalt für Wiederaufbau</i>
KonTraG	<i>Gesetz zur Kontrolle und Transparenz im Unternehmensbereich</i> (Law on Control and Transparency in Enterprises)
KWG	<i>Kreditwesengesetz</i> (German Banking Act)
LBB	<i>Landesbank Berlin</i>
LBBW	<i>Landesbank Baden-Württemberg</i>
M&A	Mergers and acquisitions
MFI	Monetary financial institution
NASDAQ	National Association of Securities Dealers Automated Quotations
NFC	Non-financial corporation
NUTS	Nomenclature of Units for Territorial Statistics
OECD	Organization for Economic Cooperation and Development
OFI	Other financial institution
REIT	Real Estate Investment Trust
ROW	Rest of the world
RRE	Risk-return efficiency
SAFE	Survey of the Access to Finance of Enterprises
SFA	Stochastic frontier analysis
SMEs	Small and medium-sized enterprises
SoFFin	<i>Sonderfonds Finanzmarktstabilisierung</i> (Financial Market Stabilisation Fund)

SPD	Social Democratic Party of Germany
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SVR	<i>Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung</i> (German Council of Economic Experts)
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer System
TFA	Thick frontier approach
THA	<i>Treuhandanstalt</i>
UMTS	Universal Mobile Telecommunications System
WGZ	<i>Westdeutsche Genossenschafts-Zentrale</i>
WoBauG	<i>Wohnungsbaugesetz</i> (Law for the promotion of housing construction)
WpÜG	<i>Wertpapiererwerbs- und Übernahmegesetz</i> (Securities Acquisition and Takeover Act)

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# Chapter 1

## Introduction

**Abstract** In this book we will provide a long-run perspective on the developments of the German financial system and an analysis of if and how ‘financialisation’ played out in Germany. This will provide the grounds for our analysis of how the German economy was then affected by the financial and economic crisis 2007–2009 and finally managed to quickly recover from this crisis. Our book has four main parts. In the first part, we take a look at the long-run development and structure of the German financial system. The second part deals with the major characteristics of the financial sector in terms of the degree of competition, profitability and efficiency. In the third part we turn to the relationship of the financial sector with the other sectors of the economy. Finally, in the fourth part, we address the effect of the increasing dominance of finance on the macro-economy focussing on the effects on income distribution, the long-run macroeconomic regime, the financial and economic crisis and the recovery from the crisis.

### 1.1 Financialisation in Germany?

The three decades before the recent financial and economic crises, which started as a financial crisis in 2007, became the world-wide Great Recession of 2008/2009 and then the euro crisis starting in 2010, have seen major changes in the financial sectors of developed and developing countries and their relationship with other sectors of the economy. Those changes included: a rapid development of new financial instruments triggered by national and international legal liberalisation and by the development of new communication technologies, an increase in the overall importance of financial factors for distribution, consumption, investment and growth, and an increasing instability potential arising from the increasing relevance and dominance of finance. These changes have been broadly summarised as ‘financialisation’ by several authors. Epstein (2005, p. 3), for example, argued that ‘financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’. As recently reviewed in papers by Sawyer (2013/2014) or

van der Zwan (2014), and documented in books by Guttman (2016), Hein (2012) and Palley (2013), among others, the increasing dominance of finance, or of ‘financialisation’, has been analysed from several perspectives: the deregulation of the financial sector and the rise of shadow banking, the ascendance of shareholder dominance at the microeconomic level, the emergence of several macroeconomic regimes under the dominance of finance, and the ‘financialisation’ of everyday life, among others.

In this book we will provide a long-run perspective on the developments of the German financial system and an analysis of if and how ‘financialisation’ played out in Germany drawing on several of the perspectives mentioned above. This will provide the grounds for our analysis of how the German economy was then affected by the financial and economic crisis 2007–2009 and finally managed to quickly recover from this crisis.

Our book has four main parts: In the first part, we take a look at the long-run development and structure of the German financial system. The second part deals with the major characteristics of the financial sector in terms of the degree of competition, profitability and efficiency. In the third part we turn to the relationship of the financial sector with the other sectors of the economy. Finally, in the fourth part, we turn to the effect of the increasing dominance of finance on the macro-economy focussing on the effects on income distribution, the long-run macroeconomic regime, the financial and economic crisis and the recovery from the crisis. In what follows we will provide brief summaries of the chapters in this book.

## **Part I: Development and Structure of the German Financial System**

### **1.2 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’ (Gerschenkron), 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.

### **1.3 The Growth of Finance and Its Role Since the 1980s—A Quantitative Overview**

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.

There were important changes in ownership and control of the German corporations, which coincided with those trends. 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 share-holdings has been that by foreign investors, whose holdings increased substantially between 1995 and in 2008.

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.

## **1.4 The Institutional 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.

## **1.5 Germany's Integration into International and European 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.

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.

## **1.6 Regulation of the German Financial System**

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 of system. Regulatory changes aimed at strengthening the power of shareholders, and at limiting the influence of banks. This has led to a threefold 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 neo-liberal 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.

## Part II: Competition, Profitability and Efficiency

### 1.7 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 Initial Public Offerings (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.

### 1.8 Profitability of the Financial Sector and Sub-sectors

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.

## **1.9 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.

## **Part III: Finance and the Non-financial Sector**

### **1.10 Sources of Funds for Business Investments: 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 was weak from the mid-1990s following the end of the German re-unification boom, and

particularly in the early 2000s until the Great Recession. 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. Rising relevance of received financial profits (interest and dividends) relative to 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’). And increasing relevance of dividends paid out to shareholders 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 have been 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 has been the major external source of finance in Germany, as well as corporate bond issues, have not been 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. The decline in credit to non-corporate firms since the financial and economic crisis has been mainly caused by lack of demand for the output of these firms, and not by a lack of access to credit.

## **1.11 The Involvement of the Financial Sector in the Restructuring of the Economy**

After the Second World War 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 US 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.

## **1.12 Privatisation and Nationalisation Policies 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 and are now a dominant form of healthcare provision. The process of privatisation has created new markets where financial institutions have been able to expand their activities.

In the course of the crisis several privately-owned financial institutions were either partly (*Commerzbank*) or completely (*Hypo Real Estate Holding AG*) nationalised. On the other hand, the *Deutsche Industriebank, IKB*—up until the crisis in majority ownership of the government—was privatised i.e. sold to a US based private equity company after German government had taken over all of its debts.

## **1.13 The Financial Sector and Private Households**

After a decline in the private saving rate during the 1990s, the average propensity to save out of disposable income increased after 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 in 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 were 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 then 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 have been 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 remained low by international comparison. However, low income households have been increasingly facing serious problems of over-indebtedness in order to maintain their basic standard of living. While the main component of household debt has been housing loans, loans for consumption have been of minor importance in the aggregate.

## **1.14 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 estate 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 a real estate bubble. However, 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.

## **Part IV: Finance, Distribution and Crisis**

### **1.15 Financialisation and Income Distribution**

Germany has seen considerable re-distribution of income since the early 1980s, which accelerated in the early 2000s: a tendency of the labour income share to decline; rising inequality in the personal and household distribution of market and disposable income (although government redistribution has not been weakened), in particular at the expense of very low incomes; and a rise in top income shares, considering the top-10% income share. Examining the three main channels through which financialisation (and neo-liberalism) are supposed to have affected the wage or the labour income share and also inequality of household incomes, there is evidence for the existence of each of these channels in Germany since the mid-1990s, when several institutional changes provided the conditions for an increasing dominance of finance. First, the shift in the sectoral composition of the economy away from the public sector and towards the corporate sector, without favouring the financial corporate sector, however, contributed to the fall in the wage and the labour income share for the economy as a whole. Second, the increase in management salaries as a part of overhead costs together with rising profit claims of the rentiers, in particular rising dividend payments of the non-financial corporate sector, have in sum been associated with a falling wage and labour income share, although management salaries are a part of employee compensation, and thus also form part of the wage share, in the national accounts. The latter implies that the share of direct labour, excluding top management salaries, has fallen even more drastically. Third, financialisation and neo-liberalism have weakened bargaining power of German trade unions through several channels: downsizing the role of the public sector and of government demand management, active policies of deregulation and liberalization of the labour market explicitly and successfully aimed at weakening workers and trade unions, increasing trade and financial openness of the German economy and, finally and in particular, rising shareholder value and short-term profitability orientation of management.

### **1.16 Crisis and Macroeconomic Policies**

The German type of 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. 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 and the respective accumulation of net foreign assets, as well as increasing integration into the world financial markets made the financial sector, and commercial banks in particular, vulnerable for the financial market channel of crisis 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 initially 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 crisis in Germany in the first place, and it thus provides the foundations for future persistent imbalances in the world economy. Second, as a political precondition for the German stimulus packages, the so-called ‘debt brake’ was introduced into the German constitution and enforced on the Euro area member countries, which will limit the room of manoeuvre for German and Euro area fiscal policies in the future. The German type of recovery is thus a highly fragile one—and it cannot and should not be considered as a role model for other countries.

## 1.17 Final Conclusions

Summing up, we conclude that the German financial system has somewhat changed over the last decades towards a more financialised system. But strong attempts by the German government and lobby groups, as well as policies by the European Commission had only limited effects. Financialisation of the German economy has been less pronounced than in the US or the UK, for example. The German macro-economy has witnessed some of the features of financialised economies, for example rising income inequality, falling wage shares and weakened investment in the capital stock. However, what has distinguished Germany from several other countries was the absence of any debt-financed private demand boom, and a private consumption boom in particular, which prevented private household debt from piling up before the crisis. There are several reasons for this more modest ‘financialisation made in Germany’. Institutional inertia of big parts of the German system seem to be important—for example the relevance of local savings banks and cooperative banks, trade unions and the defence of the stakeholder corporate governance system in parts of the economy, or the reluctance of the German population to adopt a stock market and consumption credit culture. This prevented an even more severe financial crisis and it improved the conditions for a rapid recovery from the crisis. However, we hold that unless the German export-led mercantilist regime will not be given up, any such recovery will remain highly fragile, both economically and politically.

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**Part I**  
**Development and Structure**  
**of the German Financial System**

## Chapter 2

# The Historical Development of the German Financial System

**Abstract** 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. Germany required large amounts of capital to industrialise, 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 because 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, could 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 savings banks and cooperative banks contributed significantly to the growth of Germany's very successful small and medium-sized enterprises.

### 2.1 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.

## 2.2 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 1847–1848, 1857–1858 and 1873–1876 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 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. 144–145).

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% 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 Wilhelm Raiffeisen) was set up in 1864 (DGRV 2013). 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 cooperatives to offer current account credits to their members, transforming the cooperatives from loans associations to more formally organised banks (Deeg 1999, pp. 34–36). Between 1851 and 1910 cooperative banks are estimated to have accounted for 8% 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% of the financial system's assets, the savings banks accounted for 32.7%.

## 2.3 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.<sup>1</sup>

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

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<sup>1</sup>This section draws largely on Balderston (1991).

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 1919–1923, 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. 562–563).

Monetary stabilisation in 1923–1924 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 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. 565–569). 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. 582–584). 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% of the share capital owned by the state; 69% of the *Commerz- and Privatbank* and 35% 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 Nazi government. 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. 600–602).

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%, those at the savings banks increased by 68% and those at the cooperative banks also rose by 62%. 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).

## 2.4 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

**Table 2.1** Share of bank business, Germany, 1950–1988 (%)

	1950	1960	1970	1977	1988
<i>Universal banks</i>					
Private banks	36.4	24.4	24.9	24.9	23.6
Big banks	19.1	11.3	10.2	10.4	8.9
Regional banks	12.8	10.4	10.7	10.9	11.4
Foreign banks			1.5	1.9	1.8
Other private banks	4.5	2.7	2.5	1.7	1.5
Savings bank sector	30.8	35.7	38.4	38.5	37.3
Regional associations	10.8	13.5	15.6	16.5	15.6
Savings banks	20.0	22.2	22.9	22.0	21.7
Credit cooperative sector	12.4	8.6	11.5	14.0	16.9
Regional institutions	3.7	2.8	3.8	4.2	4.6
Credit cooperatives	8.7	5.8	7.7	9.8	12.3
<i>Specialised banks</i>					
Mortgage banks	5.9	17.2	13.6	13.0	13.9
Banks with special functions		10.2	8.4	6.5	6.7
Postal banks		2.4	1.9	2.0	1.5

Source Edwards and Fischer (1994, p. 100)

allowed. The *Deutsche Bank* and the *Dresdner Bank* were re-established as unified institutions in 1957 and the *Commerzbank* 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% of each banks' lending was directed at manufacturing industry (Tilly 1996, Fig. 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% 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%, as shown in Table 2.1.

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% of total assets in 1950 to around 25% in the 1960s and 1970s.

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 data from the German central bank (Deutsche Bundesbank)<sup>2</sup> for 1964, banks owned 5% of shares and held the proxy votes for 50.5% of shares, giving them control over 55.5% of shareowners' votes (Edwards and Fischer 1994, 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

<sup>2</sup>In the following also called Bundesbank.

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%) and 119 of the positions as chair of the board (56.4%) (Edwards and Fischer 1994, 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 1976–1977 showed that the big banks acted as leader of the syndicates in 60% of the cases (Edwards and Fischer 1994, 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 2.1. In the case of the savings banks, the primary savings banks maintained their share of bank assets at around 20%. By providing finance for local business they contributed significantly to the success of West Germany's small and medium-sized 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%, 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% in 1950 to 38% 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 1973–1975 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-sized enterprises, but they had less experience in working with this sector, and it was not a success (Deeg 1999, pp. 80–87, 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, pp. 87–88; see also Chap. 6 of this book). 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.

## 2.5 Conclusion

Germany's financial system emerged during the process of industrialisation in the third quarter of the nineteenth century. From the outset, it was primarily based on banks but, unlike many other capitalist countries, in addition to private, profit-making banks there was also a significant sector of public and cooperative banks.

Big private banks played a key role in mobilising finance for larger firms and in the late nineteenth century they also acquired significant shareholdings in companies, usually when these faced difficulties in servicing their debts. The big banks were badly hit by the 1929 crisis and its aftermath and following several failures and mergers three large banks emerged. These three big banks were initially broken up after the Second World War due to their complicity in Nazi war crimes, but in the 1950s they were reconstituted and provided a key source of external finance for big firms in West Germany during the years of the so-called economic miracle.

The savings banks, which expanded rapidly in the nineteenth century, were established by local municipal governments. They operated in their local areas to provide finance for small and medium-sized enterprises that were not served by the private banks. Unlike the private banks, they continued to expand in the interwar years and, after the Second World War, they played a key role in financing the highly successful medium-sized companies which were a hallmark of Germany's successful economic development. Regional associations of the savings banks also played a role in facilitating access to investment banking activities and in providing finance for larger firms.

The somewhat smaller cooperative sector emerged in the mid-19th century and was the result of initiatives by handicraft workers and small farmers. The cooperative banks continued to expand during the inter-war and post war periods, providing banking services to smaller enterprises and, like the savings banks, they are not motivated primarily by making a profit.

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## Chapter 3

# The Growth of Finance and Its Role Since the 1980s—A Quantitative Overview

**Abstract** The value of financial assets in the German economy grew rapidly in the 1990s, both in absolute terms as well as relative to GDP. 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. 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. There were important changes in ownership and control of the German corporations, which coincided with those trends. 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 share-holdings has been that by foreign investors. 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.

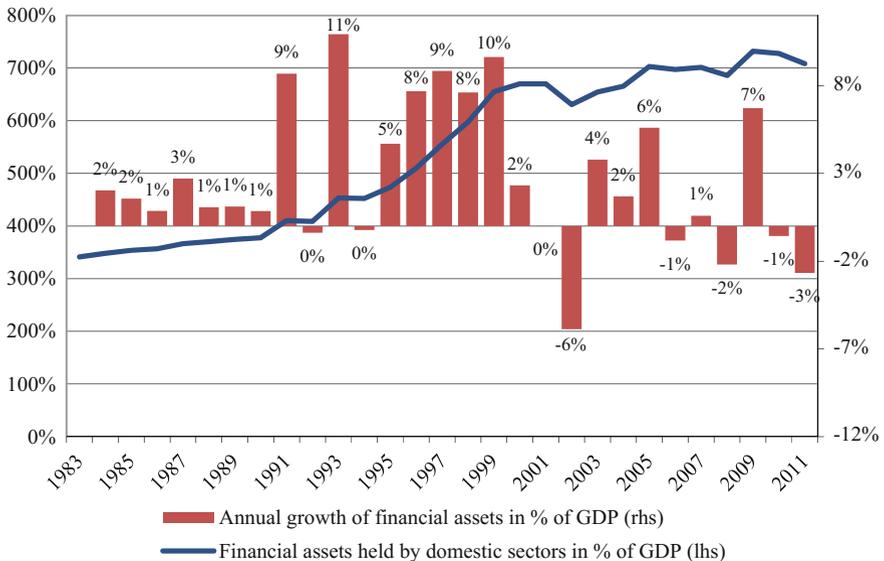
### 3.1 Introduction

This chapter will employ empirical data to assess how, and in which areas the growth of finance has manifested itself in Germany. 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 will be 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 will be reviewed, and, in particular, a closer look at the non-financial corporate sector, will be taken. Finally, the importance of institutional investors in Germany will be assessed. 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 book.

### 3.2 Financial Assets in the German Economy

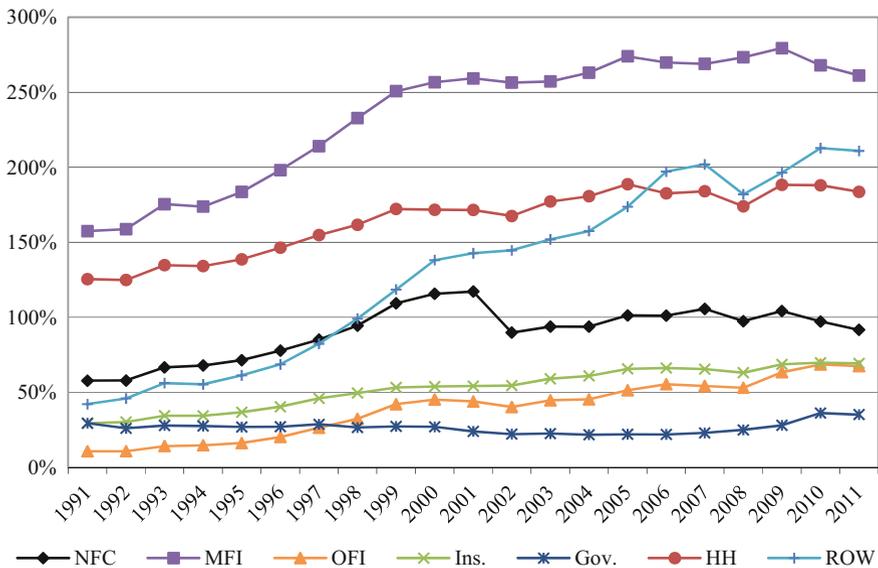
From 1960 until 1980, financial assets in per cent of disposable income grew on average by 2.9% per year (Deutsche Bundesbank 1994). Figure 3.1 presents outstanding financial assets owned by domestic sectors as a percentage of GDP. In the 1980s, growth fell below the average of the previous decades and the ratio of financial assets to GDP grew at 1.6% per year relatively slowly. Starting from 1991 the relatively stable pattern changed. We observe very high growth from 1991 to 2000; financial assets in per cent of GDP grew with an average rate of 6% per year in this period. This was in particular caused by a strong growth in outstanding bank loans (see Fig. 3.8) and from 1995 onwards additionally by a strong increase in



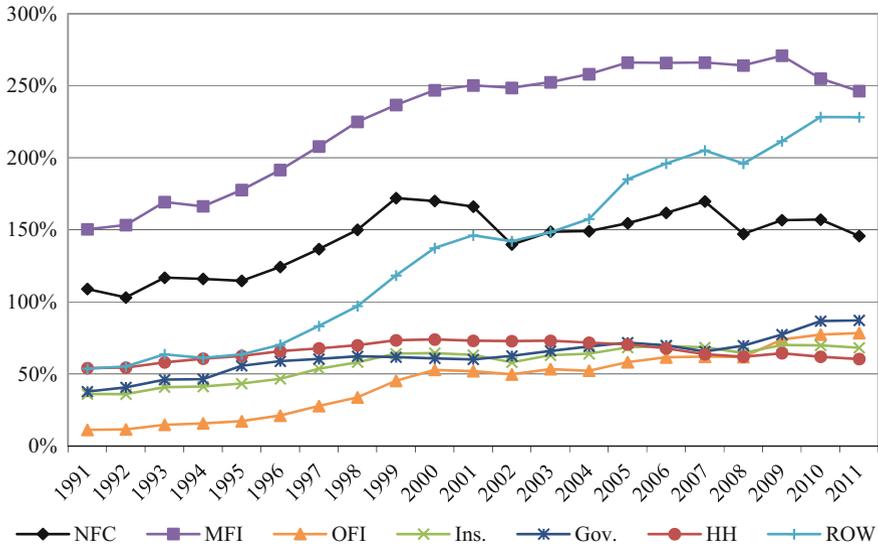
**Fig. 3.1** Financial assets held by domestic sectors, Germany, 1983–2011 (% of GDP). *Source* Deutsche Bundesbank (1994, 2012a), European Commission (2012), own calculations. *Note* Before 1991, only West Germany, data consolidated. Financial assets include monetary gold and special drawing rights, currency and deposits, debt securities, derivatives, loans, shares and other equity claims, investment and money market fund shares, claims against insurance companies and pension funds and other claims

share prices (see Fig. A13.1) 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.

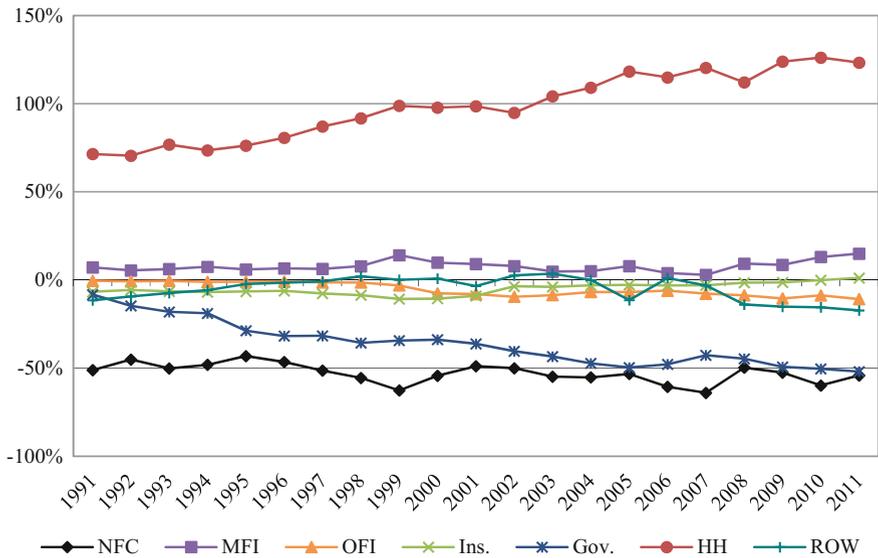
A more detailed picture of those developments is given by Figs. 3.2, 3.3 and 3.4. Banks (referred to as Monetary Financial Institutions (MFIs) in the official European statistics) obviously increased their activity, growing strongly in assets from 1991 to 2000. Also remarkable are the increased financial activities of the non-financial corporations (NFCs). Their liabilities, as well as assets shifted upwards by about 50% 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 was the government sector. The percentage of financial assets held by the government sector was relatively stable, but we can see an increase in financial liabilities from 37% in 1991 to 87% 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 (OFIs) emerged and grew with remarkable speed. In 1991, the size of financial assets held by the sector equalled 10% of GDP. Already by 2011, this figure reached 70% 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.



**Fig. 3.2** Financial assets by sector, Germany, 1991–2011 (% of GDP). *Source* Deutsche Bundesbank (2012a), European Commission (2012), own calculations. *Notes* NFC non-financial corporations, MFI monetary financial institutions, OFI other financial institutions, Ins. Insurance corporations, Gov. general government, HH households and non-profit institutions serving households, ROW rest of the world



**Fig. 3.3** Financial liabilities by sector, Germany, 1991–2011 (% of GDP). *Source* Deutsche Bundesbank (2012a), European Commission (2012), own calculations. *Notes* *NFC* non-financial corporations, *MFI* monetary financial institutions, *OFI* other financial institutions, *Ins.* insurance corporations, *Gov.* general government, *HH* households and non-profit institutions serving households, *ROW* rest of the world

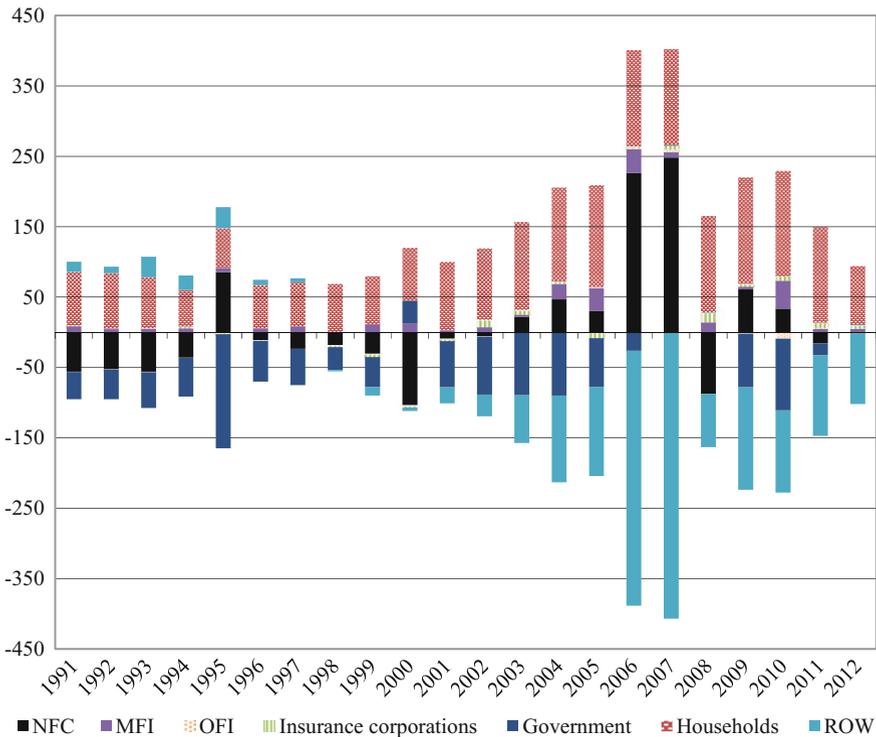


**Fig. 3.4** Net financial wealth, Germany, 1991–2011 (% of GDP). *Source* Deutsche Bundesbank (2012a), European Commission (2012), own calculations. *Notes* *NFC* non-financial corporations, *MFI* monetary financial institutions, *OFI* other financial institutions, *Ins.* insurance corporations, *Gov.* general government, *HH* households and non-profit institutions serving households, *ROW* rest of the world

Financial linkages with the rest of the world have also increased rapidly. While foreign financial claims on the domestic economy were around 50% in 1991, this figure grew to above 200% 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 growth in banks' balance sheets, and in part by the occurrence and the rapid growth of a new type 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 significantly. 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.

Looking at the net financial flows complements this picture, since compared to the stocks, they do not include valuation effects. The net financial flows of the main sectors of the German economy for the period from 1991 to 2012 are shown in

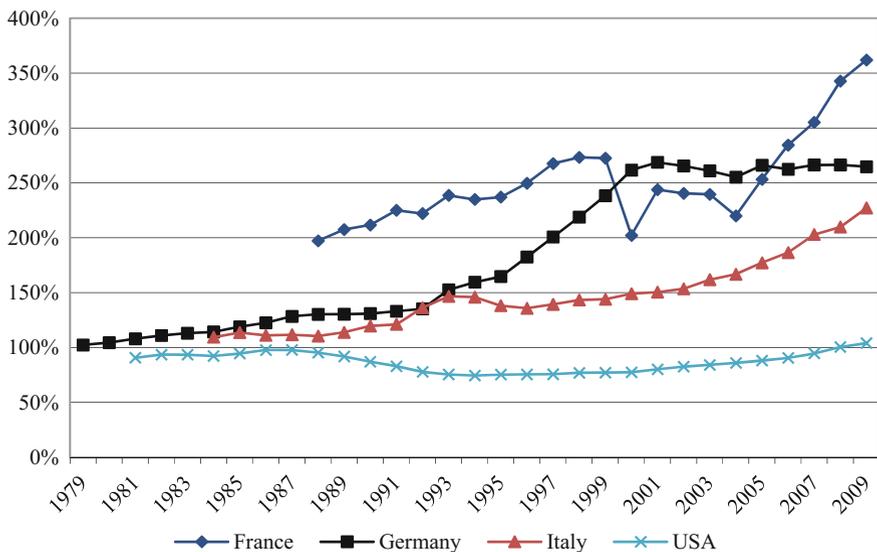


**Fig. 3.5** Sectoral net financial flows, Germany, 1991–2012 (€ billion). *Source* Deutsche Bundesbank (2012a). *Notes* NFC non-financial corporations, MFI monetary financial institutions, OFI other financial institutions, ROW rest of the world

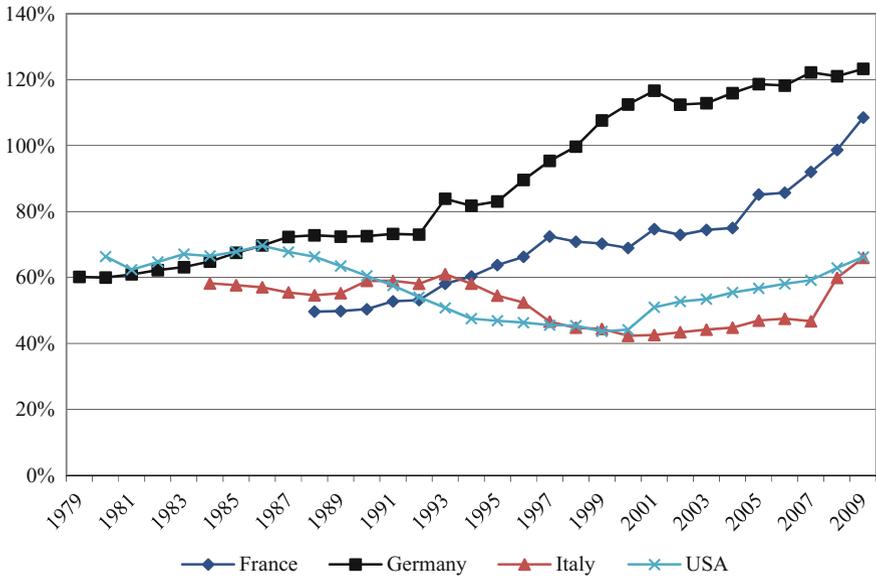
Fig. 3.5. As one would have expected from the stocks, the household sector accumulated financial surpluses over the entire period. These were absorbed until around 2001 mainly by the government and the NFCs. Thereafter, the NFCs switched to a net-saver position. The banks also started accumulating surpluses of financial assets. These surpluses of funds were taken up by the government and to a large extent by the foreign sector.

### 3.3 Size and Activity of Banking and Financial Markets in Germany in International Comparison

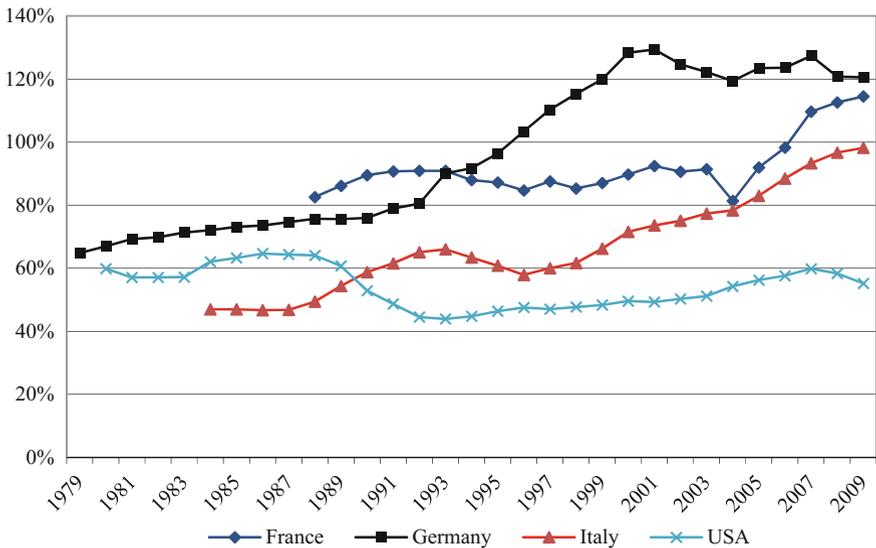
This section uses OECD, World Bank and Bundesbank data to compare the size of different financial markets and actors in Germany to some other developed capitalist economies. Figures 3.6, 3.7, 3.8 and 3.9 look at indicators of the activity and size of the banking sector. Figure 3.6 shows the size of the banking sector's balance sheet to GDP. While this ratio is relatively low for the USA, it is quite high for Germany and France. This ratio highlights the importance of banks as financial intermediaries in those economies.



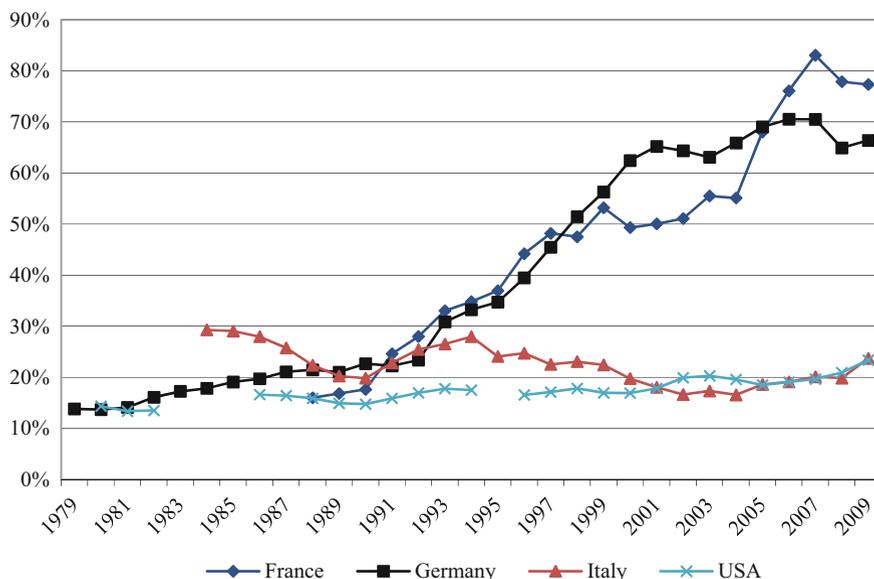
**Fig. 3.6** Balance sheet size of banking sector, France, Germany, Italy, USA, 1979–2009 (% of GDP). *Source* OECD (2012), European Commission (2012), own calculations. *Notes* The data is retrieved from the OECD's bank profitability statistics and tries to include all institutions that conduct ordinary banking business. However, the institutional coverage of banks may not be the same for every country



**Fig. 3.7** Bank deposits, France, Germany, Italy, USA, 1960–2009 (% of GDP). *Source* OECD (2012), European Commission (2012), own calculations



**Fig. 3.8** Bank loans, France, Germany, Italy, USA, 1960–2009 (% of GDP). *Source* OECD (2012), European Commission (2012), own calculations

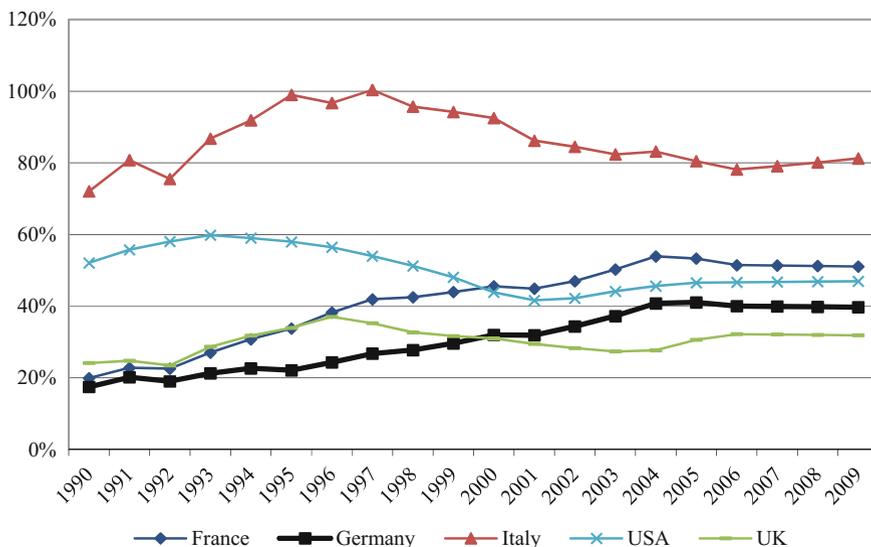


**Fig. 3.9** Securities held by banks, France, Germany, Italy, USA, 1979–2009 (% of GDP). *Source* OECD (2012), European Commission (2012), own calculations. *Notes* Securities include short term debt securities, bonds, shares and participations

Figure 3.7 shows bank deposits in relation to GDP. Deposits grow relatively steadily, in line with credit growth shown in Fig. 3.8. Both ratios grew relatively strong from 1993–2001, and stagnated thereafter. In international comparison, both ratios are high in Germany, especially compared to the USA, which again shows the importance of banks in Germany.

Another interesting feature can be seen in Fig. 3.9. From 1993 to 2001, banks rapidly increased their holding of financial securities in Germany and in France. Hence, besides playing an important role in granting loans and creating deposits, banks also increased their operations in security markets in these two countries.

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. 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.

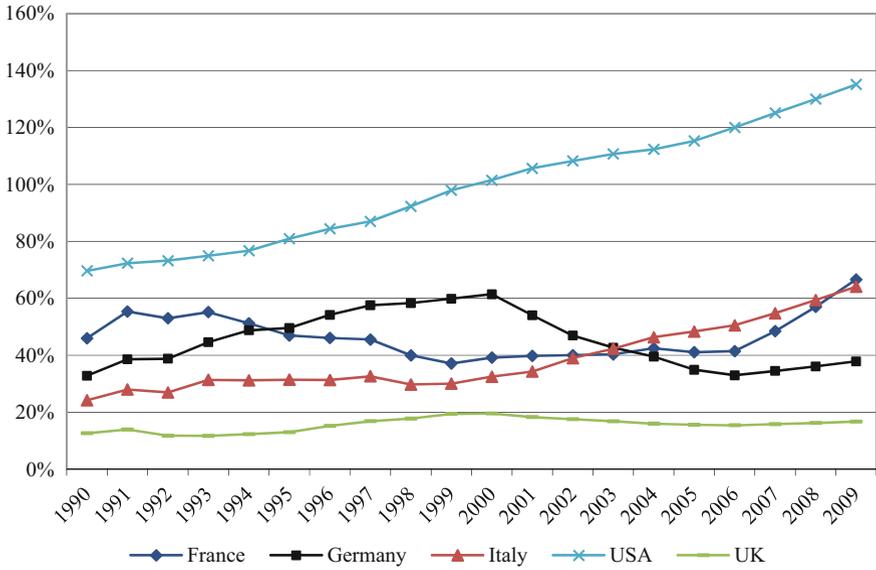


**Fig. 3.10** Domestic public bond market capitalisation, France, Germany, Italy, USA, UK, 1990–2009 (% of GDP). *Source* Beck and Al-Hussainy (2010)

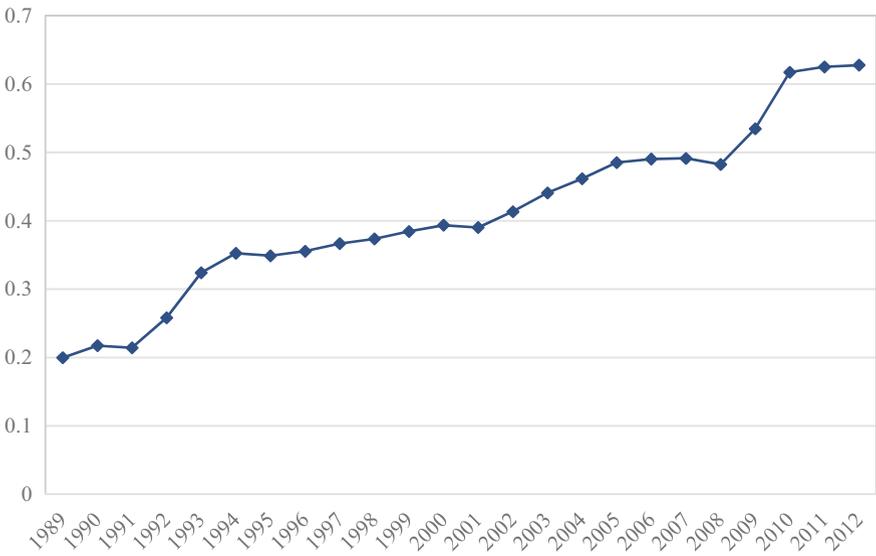
In Figs. 3.10 and 3.11, the sizes of the domestic private and public bond markets<sup>1</sup> are addressed. It can be seen that the German domestic market for government securities became more important in the course of the 1990s and early 2000s. There were two main reasons for this: first, the overall increase in indebtedness of the German public sector; second, the increased reliance of the public sector on this market, instead of bank financing.<sup>2</sup> In addition, if one looks at Fig. 3.12, 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% of GDP. That means all issues of public debt securities were classified by the Bank for International Settlements (BIS) as targeted at local investors. By 2009, the total outstanding amount of public debt securities was equal to about 50% of GDP. The amount of outstanding domestic public debt securities (as defined by the BIS) stood at only 40%. Hence, an increasing part of new public debt issues during this period were targeted at international investors.

<sup>1</sup>Domestic debt securities are defined by the BIS (2016) 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.

<sup>2</sup>At the beginning of 1991, 41% of the outstanding German government debts were loans against domestic banks. This figure decreased to only 21% by July 2011 (Deutsche Bundesbank 2012b).



**Fig. 3.11** Domestic private bond market capitalisation, France, Germany, Italy, USA, UK, 1990–2009 (% of GDP). *Source* Beck and Al-Hussainy (2010)



**Fig. 3.12** Outstanding public debt securities, Germany, 1989–2012 (% of GDP). *Source* Deutsche Bundesbank (2012a), European Commission (2012), own calculations

The domestic market for private debt securities (see Fig. 3.9) 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% of GDP in 1989 to about 65% by 2001 (see Fig. 3.13). 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 Fig. 3.13. Outstanding securities staid roughly at the same level until 2009. The decline of the size of the domestic bond market was largely driven by the fact that more of the issues are classified by the BIS as international.<sup>3</sup>

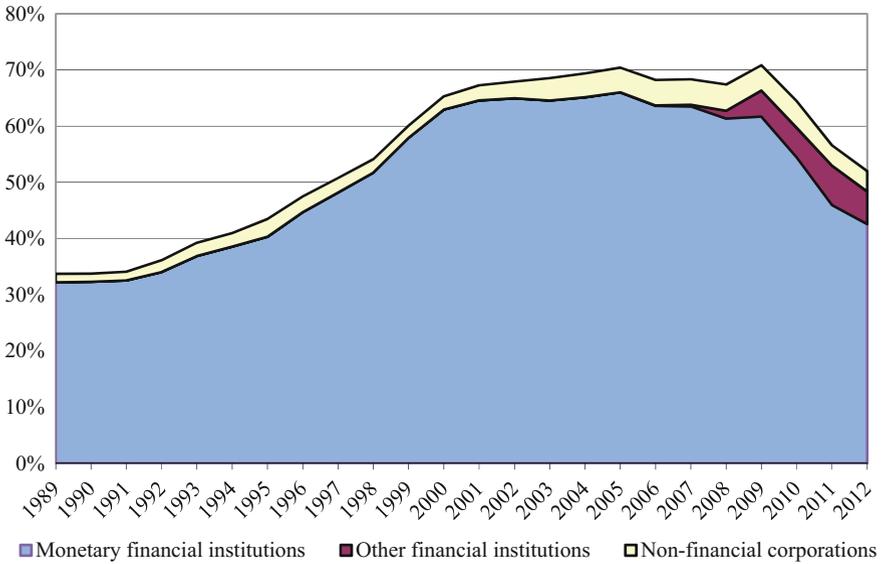
To sum up, the size of the private domestic German bond market increased from 1990 to 2000, mainly driven by rising issues by banks. From 2000 to 2009, the amount of outstanding debt securities was between 65 and 70% of GDP. However, an increased number of new issues were placed internationally, so that the domestic market lost in importance. For non-financial corporations, debt securities remained a negligible source of finance, despite the fact that they tripled their outstanding debt from 1.5% of GDP in 1989 to 4.5% in 2009. It is interesting that other financial institutions increasingly used debt securities to raise funds in the markets from 2006 onwards. While there were no outstanding debt securities in 2005, they amounted to 5.8% of GDP outstanding by 2012.

Figures 3.14, 3.15, 3.16 and 3.17 compare indicators of the size and activity of stock markets for Germany and some other developed capitalist economies. By looking at the number of listed companies (Fig. 3.14) and the stock market capitalisation (Fig. 3.15), 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 increased in the 1990s and 2000s, it remained relatively small. A similar picture can be seen if one looks at the value traded in the stock markets (Fig. 3.16), which remained low for Germany, even though an overall increase of activity can be observed. However, it is interesting to note that the stock market turnover ratio (Fig. 3.17) was the highest for Germany until the mid-1990s, and it was only exceeded by some of the other countries in the years before the financial crisis and the Great Recession.

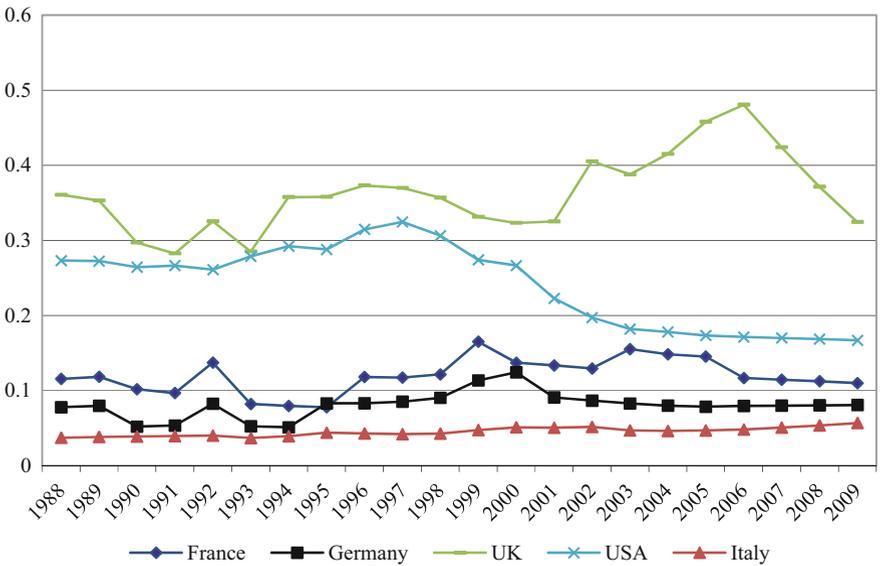
From the international comparison in this section, we can conclude that, compared to other developed countries, the growth in finance and in financial markets in particular has been a relatively recent and more modest phenomenon in Germany. The size and activity in the banking sector in relation to GDP has increased more pronouncedly than in the stock market. Germany can thus still be regarded as a typically bank-based financial system (Levine 2002, p. 399). Banks in Germany are

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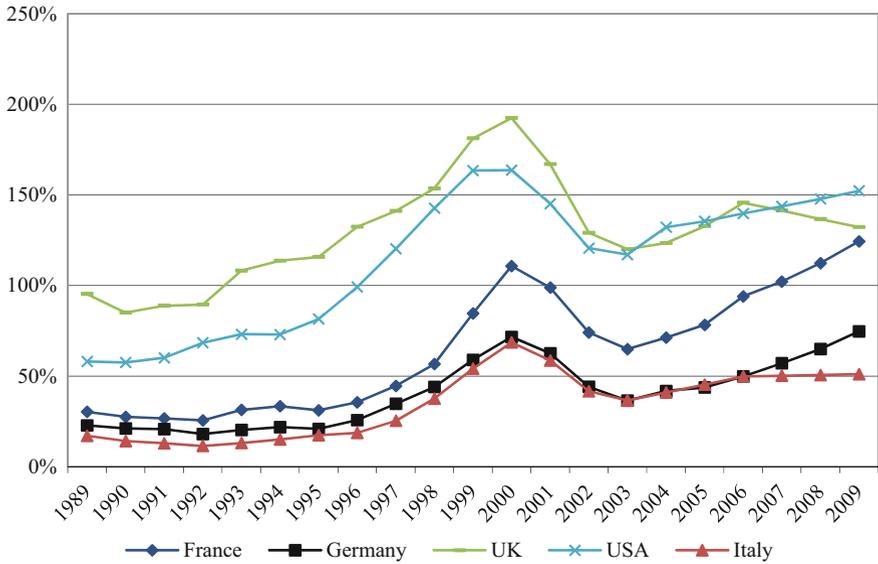
<sup>3</sup>In 1989, international debt securities were equal to 1% in total debt securities outstanding. By 2000, that figure increased to 20%, and by 2009, international debt securities made up 43% of total debt securities outstanding (BIS 2012).



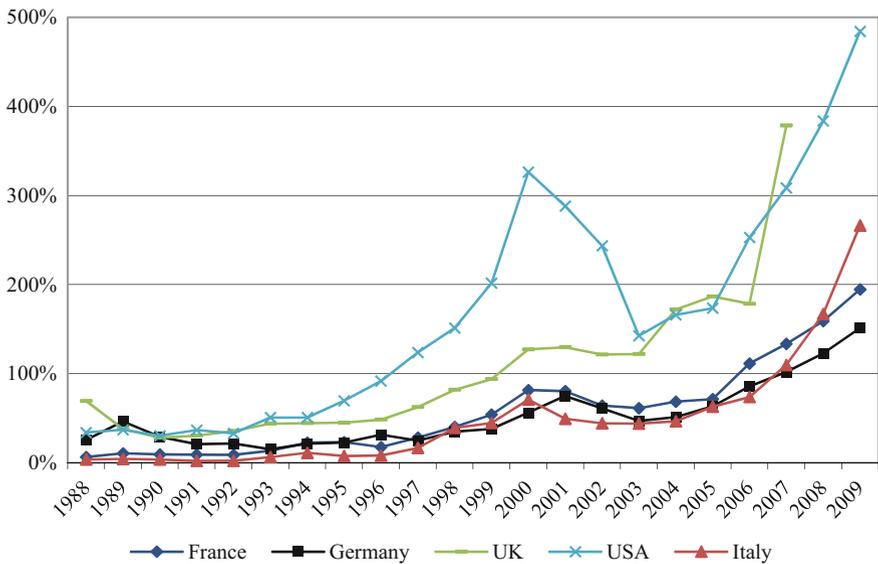
**Fig. 3.13** Outstanding private debt securities, Germany, 1989–2011 (% of GDP). *Source* Deutsche Bundesbank (2012a), European Commission (2012), own calculations



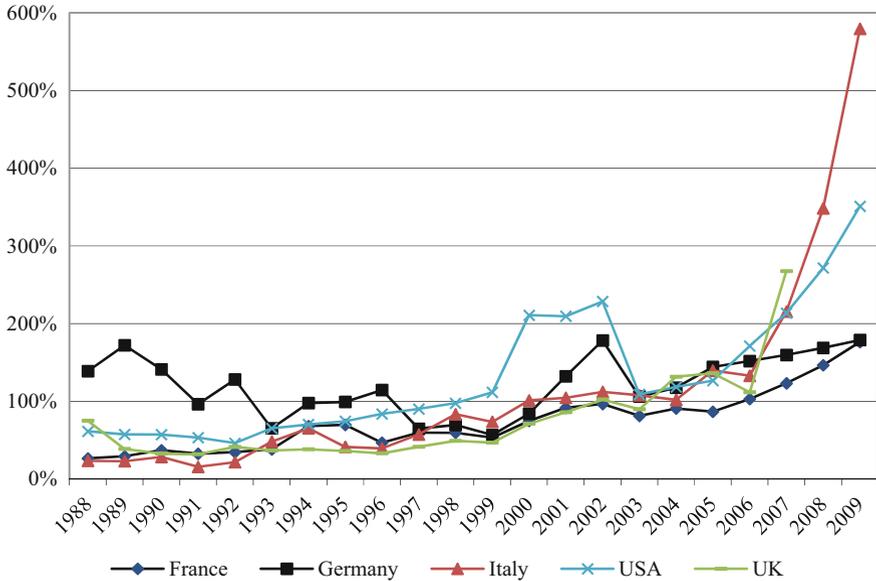
**Fig. 3.14** Number of listed companies per 10,000 population, France, Germany, Italy, USA, UK, 1988–2009. *Source* Beck and Al-Hussainy (2010)



**Fig. 3.15** Stock market capitalisation, France, Germany, Italy, USA, UK, 1989–2009 (% of GDP). *Source* Beck and Al-Hussainy (2010)



**Fig. 3.16** Stock market total value trade, France, Germany, Italy, USA, UK, 1988–2009 (% of GDP). *Source* Beck and Al-Hussainy (2010)

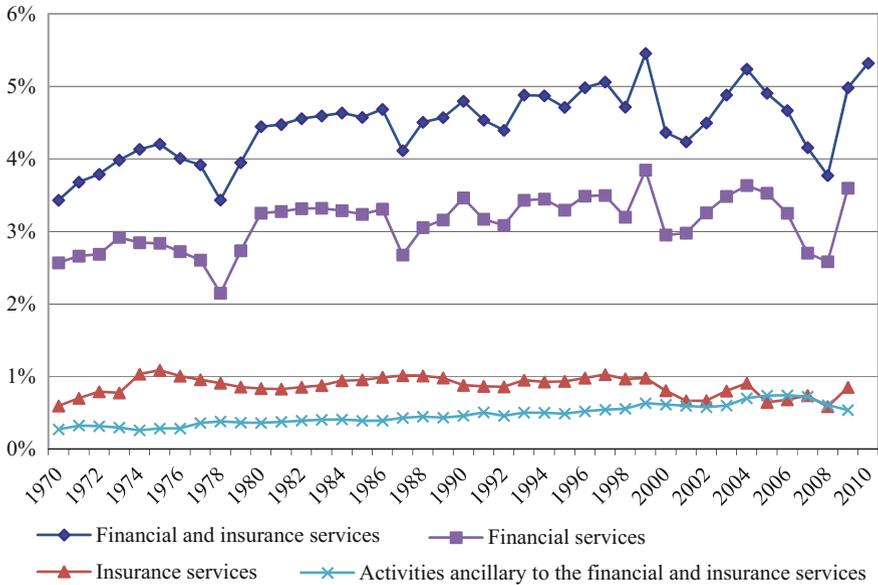


**Fig. 3.17** Stock market turnover ratio, France, Germany, Italy, USA, UK, 1988–2009 (%).  
*Source* Beck and Al-Hussainy (2010)

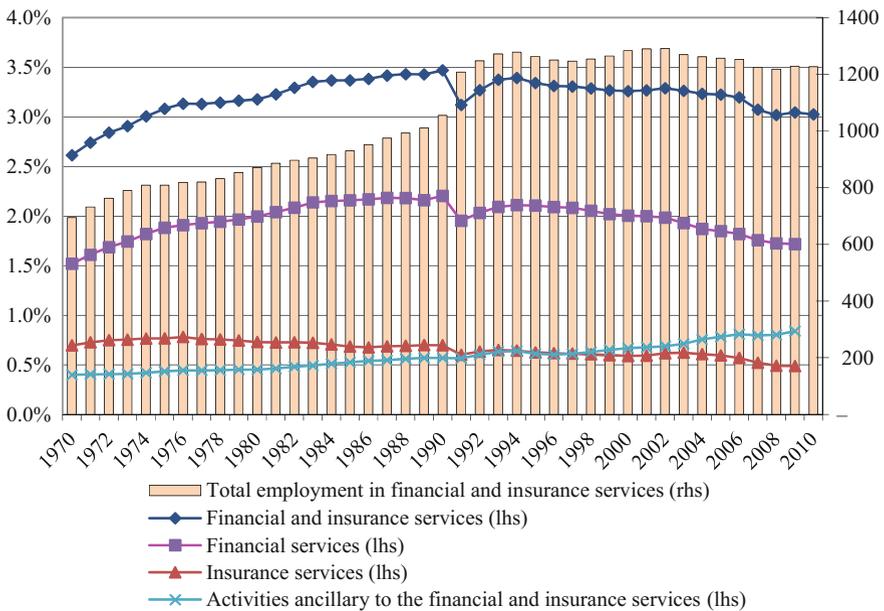
relatively active, and they play an important role as intermediaries, in particular in comparison to the USA. At the same time, financial markets play a minor role in Germany. Despite their growth in recent years, stock markets, in particular, are still relatively underdeveloped in international comparison. 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.

### 3.4 Increased Financial Activity in the German Financial and Non-financial Corporate Business

As already shown by the international comparison, finance has increased its role in Germany, but comparatively slowly. This is confirmed by Figs. 3.18 and 3.19 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% in 1970, the contribution of the financial sector increased to 4.5% by 1980. Thereafter, a further long-run structural shift is not apparent, even though the financial sector's contribution increased to about 5.5% during the years of the stock market boom.



**Fig. 3.18** Gross value added of the financial sector, Germany, 1970–2010 (% of total gross value added). *Source* Statistisches Bundesamt (2006, 2012), own calculations. *Notes* Redefinition of categories 1991



**Fig. 3.19** Employment in the financial sector, Germany, 1970–2010 (% of total employment (lhs) and 1,000 persons employed (rhs)). *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 in financial services increased from about 2.6 to almost 3.5% 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 was 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 employment figures do not indicate an increase, but rather a relative decrease in the importance of the financial sector in the German economy.

However, even though the German financial sector itself does not show a particularly 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 US non-financial firms' profits accrued from financial activities.

A similar trend is apparent for German non-financial corporations. Figure 3.20 shows the composition of NFCs balance sheets from 1992 to 2009. NFCs in Germany have increased their financial holdings from about 32% of total assets in 1992 to almost 44% in 2009. The ratio of financial assets to tangible assets shows that, while holdings of financial assets were about 55% of tangible assets in 1992, they peaked at 110% by 2002. From there, the ratio fell when share prices collapsed.

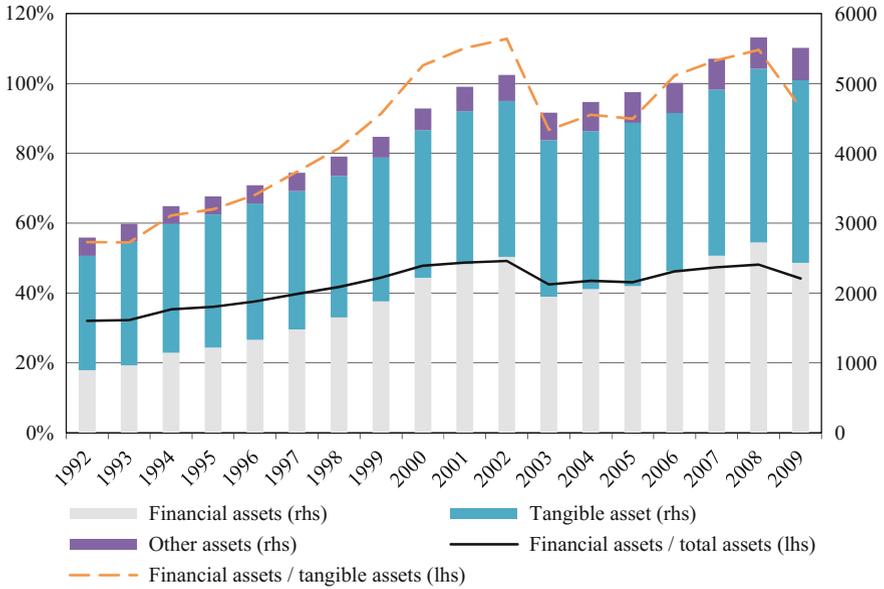
Those figures, however, most likely understate the increased financial investment by German NFCs. Germany was characterised by large cross-shareholdings between companies for reasons other than financial investment. This network was partially dissolved during the late 1990s and 2000s (see Chap. 4). The 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.

This is reflected in the portfolio incomes of non-financial corporations. Figure 3.21 shows 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%, only to rise remarkably in the 2000s up to about a third of total profits.

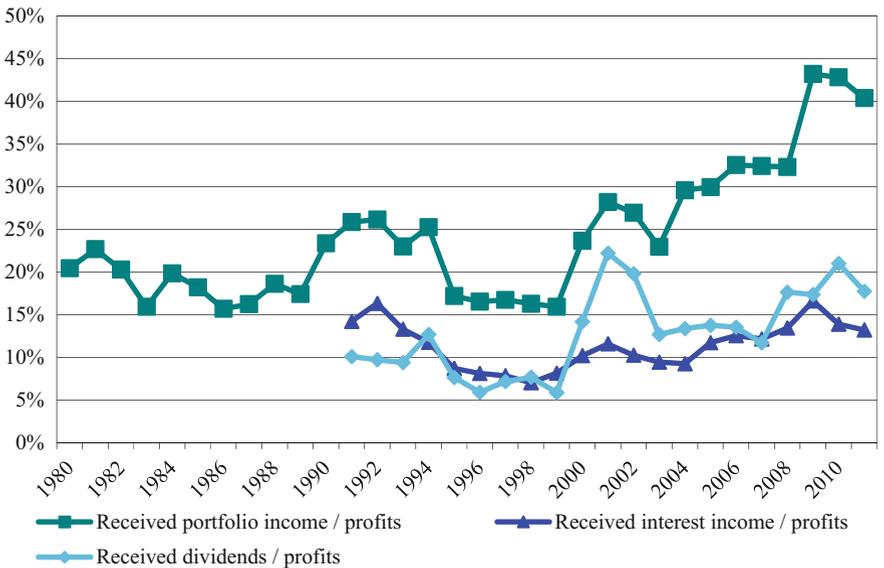
Figure 3.22 shows the gross financial payments made by the firms as a share of their cash flows.<sup>4</sup> The gross payout-ratio was relatively high in 1980, fell thereafter,

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<sup>4</sup>Cash flow = operating surplus + depreciation.



**Fig. 3.20** Asset composition of non-financial corporations, Germany, 1992–2009 (% , € billion). *Source* Deutsche Bundesbank and Statistisches Bundesamt (2010)



**Fig. 3.21** Portfolio income of non-financial corporations, Germany, 1980–2011 (% of total profits). *Source* Statistisches Bundesamt (2006, 2012), own calculations

and showed an upward trend starting around 1990. The downward trend from 1980 to 1990 was mainly due to declining interest payments in this period, as well as falling dividends and profit withdrawals.<sup>5</sup> The upward trend after 1990 can be explained only by increasing dividends and profit withdrawals. Interest payments registered a downward trend. The spread and acceptance of the shareholder value doctrine in Germany could be a possible explanation for this development. As one can see from Fig. 3.22, 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.

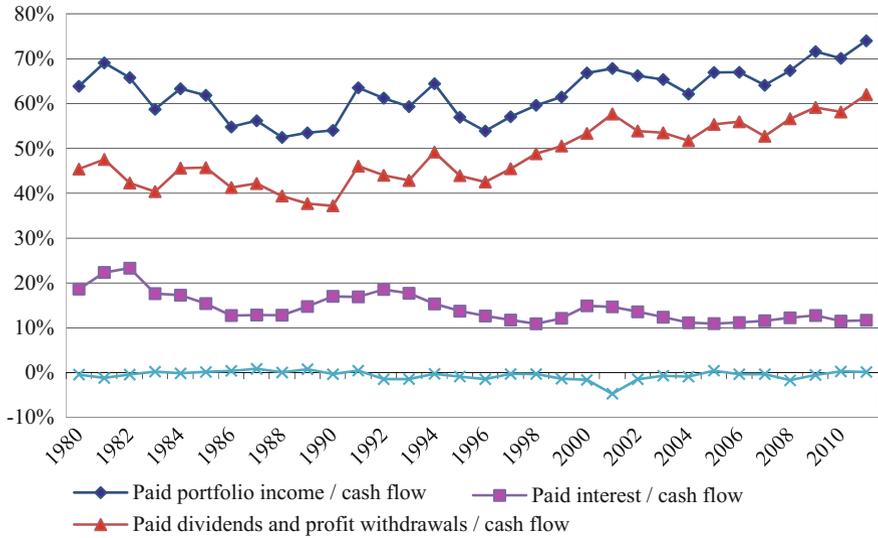
Figure 3.23 shows the net financial payments of German NFCs. Looking at those net-figures reveals that net financial payments have not increased. However, this overall trend is caused by three very different developments. One still can see that the amount of internally generated funds paid out to the owners began to grow in 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, superimposed the increasing payments that firms had to make to their owners, so that overall payments to financial investors was relatively stable around 50% of cash flows.

To sum up so far, 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 towards holding a larger amount of financial assets. This is reflected in their profit and loss accounts. NFCs have received 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 have compensated for this by increasing their own financial incomes.

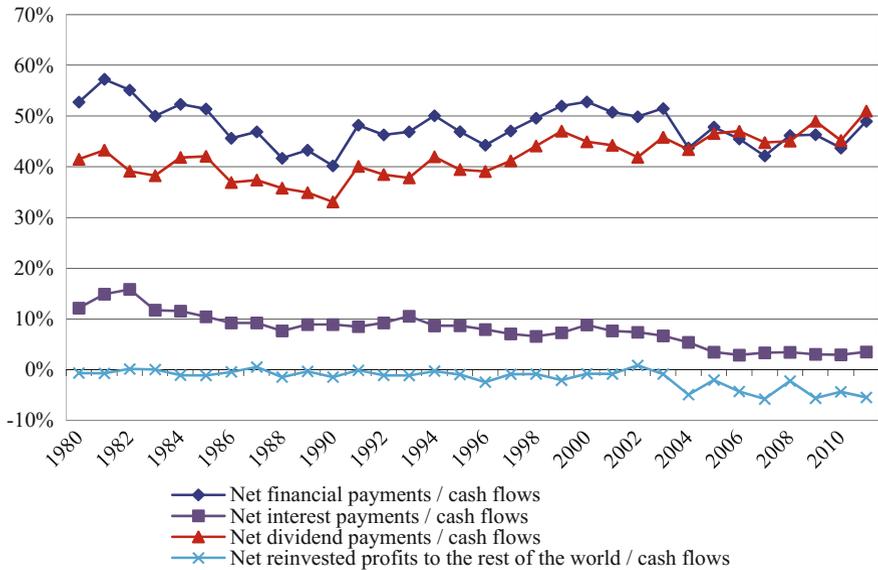
Looking for the reasons of this shift in firms' behaviour, the ownership structure of the Germany corporate sector might give some first clues. The holdings of different sectors of domestic companies' outstanding shares by market value are shown in Fig. 3.24. In 1991 the most important shareholders were non-financial corporations. However, their share declined constantly until 2006. The second most important shareholders were households, which held about 20% of the outstanding shares, but also with a declining trend, so that by 2012 they only held 10% 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 holdings of shares in favour of indirect holdings in the form of investment funds. Banks also decreased their holdings of shares slowly from 1997 onwards. The most remarkable trend,

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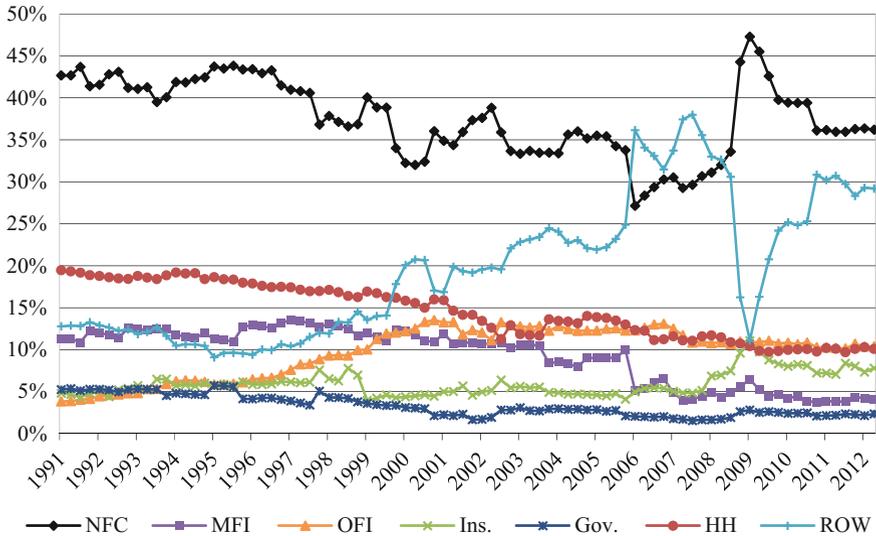
<sup>5</sup>Profit withdrawals refer to the payout of profits to owners of corporations that are not joint stock companies, e.g. limited liability companies, partnerships, etc.



**Fig. 3.22** Gross financial payments of non-financial corporations, Germany, 1980–2011 (% of cash flow). *Source* Statistisches Bundesamt (2006, 2012), own calculations



**Fig. 3.23** Net financial payments of non-financial corporations, Germany, 1980–2011 (% of cash flow). *Source* Statistisches Bundesamt (2006, 2012), own calculations



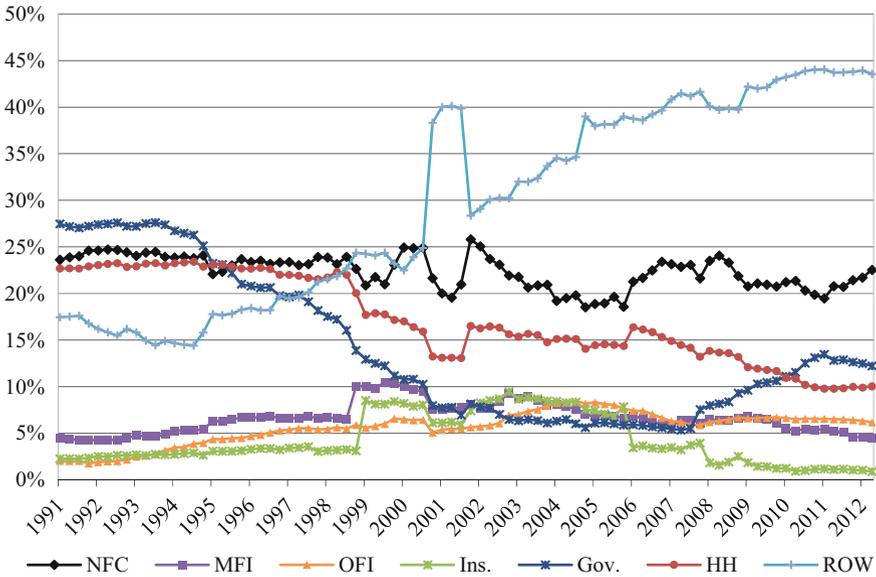
**Fig. 3.24** Ownership of domestic joint stock corporations, Germany, 1991–2012 (% of total shares (at market value) outstanding). *Source* Deutsche Bundesbank (2012a), own calculations. *Notes* For the construction of the figure we assumed that all domestic sectors hold the same share of foreign companies in their portfolio. *NFC* non-financial corporations, *MFI* monetary financial institutions, *OFI* other financial institutions, *Ins.* insurance corporations, *Gov.* general government, *HH* households and non-profit institutions serving households, *ROW* rest of the world

however, is the increase of foreign shareholdings. While in terms of market value foreigners only held 10% of the value of German stock companies in 1995 they increased their holdings to 38% 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 Fig. 3.25. The largest share (27%) of equity was held by the government in 1991. However, the government's share then declined and ranged between 5 and 10% 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% over the period. Households decreased their holdings from around 23 to 10% between 1999 and 2012. Insurance companies and banks had relatively low shares of 2 and 4% 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% 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% 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



**Fig. 3.25** Ownership of domestic non-stock corporate enterprises by sector, Germany, 1991–2012 (% of total equity (at market value) outstanding). *Source* Deutsche Bundesbank (2012a), own calculations. *Notes* For the construction of the figure we assumed that all domestic sectors hold the same share of foreign companies in their portfolio. *NFC* non-financial corporations, *MFI* monetary financial institutions, *OFI* other financial institutions, *Ins.* insurance corporations, *Gov.* general government, *HH* households and non-profit institutions serving households, *ROW* rest of the world

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 kept 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 (Monopolkommission 2012). While in 1996 there were 40 cases among the big non-financial corporations this had decreased to 9 in 2010. 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 rather than a strategic investment. As will be discussed in Chap. 4, 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 shareholdings over the observed period as well.

### 3.5 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 managements of 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 another indicator for the financialisation of an economy.

In Germany investment funds are classified as open-<sup>6</sup> and closed-end.<sup>7</sup> By the end of 2011 there were about 3,250 of closed-end funds. They had a total volume of 198.6 billion euros and managed equity of 98.6 billion euros. Their main investment segments were real estate with a total volume of 72.1 billion euros, 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 can be distinguished further into special funds (*Spezialfonds*) and investment funds (*Publikumsfonds*). 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 euros. They can be distinguished by their investment focus. The most relevant categories are funds focused on equity (238 billion euros) 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 euros were managed in special funds for other institutions by the end of 2010 (BVI 2012b). Of those, 125 billion euros 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 2011). According to the BVI (2012b) for insurance companies this was about 26% of their entire actuarial reserves and for pension corporations it was about 41% of their funds.

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<sup>6</sup>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.

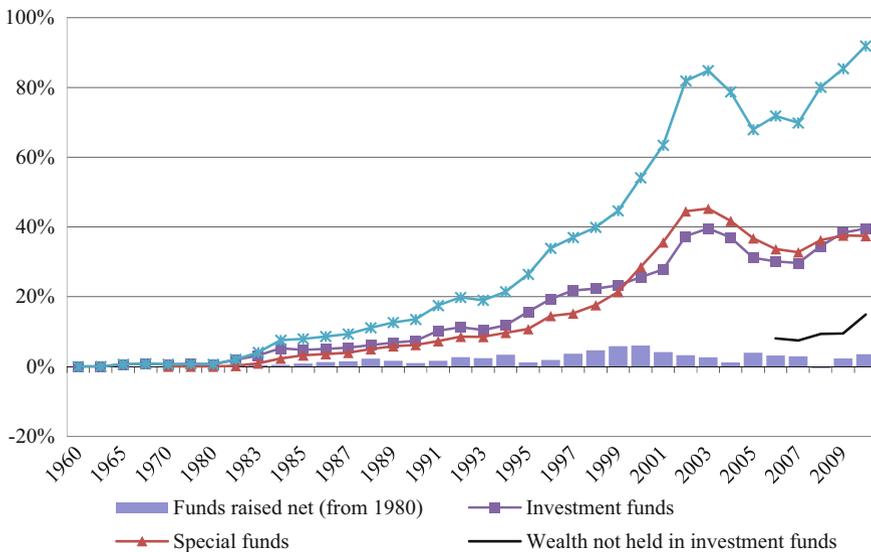
<sup>7</sup>Closed-end investment funds are normally set up for a specific project and for a specific time. If they have collected the targeted amount of funds for the respective project they are normally closed and no further investment is possible. The funds are mostly organised as *GmbH & Co. KGs* (comparable to limited liability companies) and are not obliged to pay out the share of an investor on demand.

Looking at the development of the fund industry, one can see that it 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. By 2010 there were about 6650 investment funds and 3890 special funds (BVI 2012a).

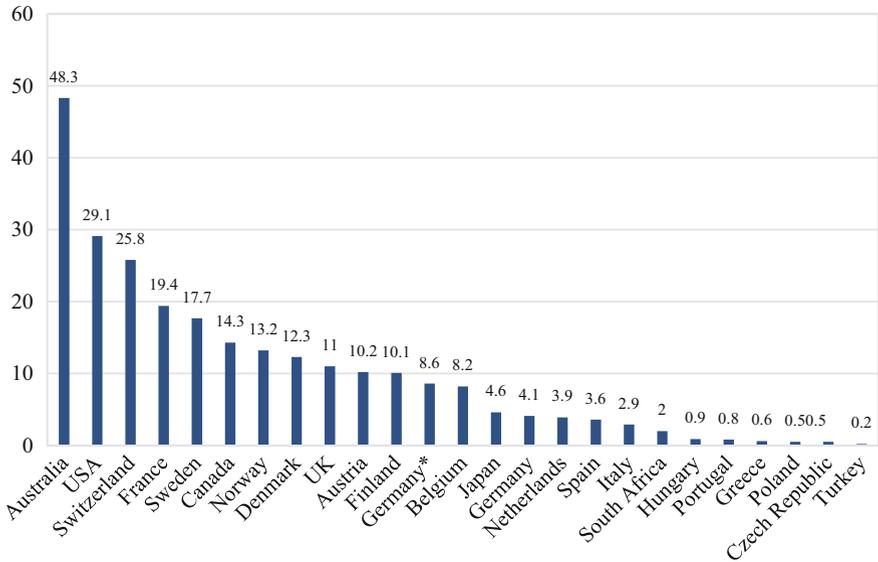
Figure 3.26 shows assets under management by open end funds as per cent of GDP. While in 1980 total assets were below 1%, they grew to about 13% in 1990. After 1994, the growth of assets under management increased rapidly once again. In the earlier phase, the increase was largely driven by an increase 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 USA (Fig. 3.27). However, the comparison only includes investment fund shares directly held and does not include life insurance contracts through which they indirectly invest in special funds, and which are quite popular in Germany.



**Fig. 3.26** Assets under management by open end funds, Germany, 1960–2010 (% of GDP). Source BVI (2012a)



**Fig. 3.27** Wealth held in investment funds per capita, different countries, 2010 (€ 1,000). *Source* BVI (2012a). *Notes* \* All investment funds available for sale in Germany. The graph depicts only investment funds, not special funds

### 3.6 Conclusion

This chapter has provided a first overview over some common indicators for financialisation in the German economy. Many of the points raised here will be analysed in more detail in the following chapters, so that the interpretations of the data have been kept relatively short.

We have 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 has been found in the banking sector.

Looking at the different parts of the German financial system, we have found 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 have found that financial markets are relatively underdeveloped despite their long-run growth, while banks continue to account for most of the financial intermediation. This confirms the general view about Germany being a predominantly bank based system—and has remained so in the period of financialisation.

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

For non-financial firms we have found 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 has been 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 have stayed stable. However, this has been driven by two different trends. On the one hand, we have seen lower interest payments; on the other hand, payments to shareholders have gone up. Hence, we have an indication of increased financial activity by non-financial corporations and, possibly, some indication of an increased shareholder value orientation of management.

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 has remained relatively low.

Over all, the data we have 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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## Chapter 4

# The Institutional Structure of the German Financial System

**Abstract** 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. 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.

### 4.1 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.

## 4.2 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% of banking assets in 2012; a publically-owned savings bank sector, with 29.4% of banking assets; and a cooperative banking sector with 11.8% of banking assets (see Table 4.1). 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% of banking assets in 2012, and which include both private and publicly owned institutions. 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).

### 4.2.1 *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 4.1). 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% in the 1980s and most of the 1990s, but then increased to 18% in 1999 and to 25% 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 euros, almost three times as large as the

**Table 4.1** Banks by banking group, Germany, 1980–2012

	1980		2000		2007		2012	
	Number	% assets						
Total	3,359	100.0	2,987	100.0	2,038	100.0	1,988	100.0
Private banks	162	23.5	290	27.1	254	29.4	284	38.3
Big banks	6	9.8	4	15.4	5	18.6	4	25.3
Regional banks	100	10.5	199	9.8	157	8.9	168	9.4
Branches of foreign banks	56	1.7	87	2.0	92	2.0	110	3.6
Savings bank sector	611	38.6	580	35.3	461	33.9	436	29.4
Landesbanken	12	16.5	13	19.8	12	20.2	10	16.7
Primary savings banks	599	22.1	567	15.5	449	13.7	426	12.7
Cooperative sector	2,304	14.8	2,039	12.5	1,259	11.7	1,123	11.8
Regional institutions	10	4.0	4	3.6	2	3.4	2	3.4
Primary cooperative banks	2,294	10.7	2,035	8.8	1,257	8.3	1,121	8.4
Special banks								
Mortgage banks	39	13.6	32	14.6	22	11.5	18	6.9
Building and loan associations		0.0	32	2.5	26	2.6	23	2.3
Special purpose banks	17	6.4	14	7.9	16	10.9	17	11.2
Memo item								
Foreign banks			148	4.1	138	11.4	150	12.1
of which majority owned foreign banks			61	2.1	46	9.4	40	8.5

Source Deutsche Bundesbank (2012b)

next largest German bank (see Table 4.2). Prior to the onset of the crisis, the bank famously strove for a rate of return on equity of 25%. 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

**Table 4.2** The 50 largest banks, Germany, 2010

Rank	Bank	Assets in billion euros	Branches	Employees	Sector
1	Deutsche Bank AG, Frankfurt/M. <sup>a</sup>	1,905.6	3,083	102,062	Private
2	Commerzbank AG, Frankfurt/M.	754.3	2,170	59,101	Private
3	KfW Bankengruppe, Frankfurt/M.	445.5	70	3,543	Public
4	DZ Bank Frankfurt/M.	383.5	19	26,800	Cooperative
5	Landesbank Baden-Württemberg, Stuttgart	374.4	1	13,061	Public
6	Unicredit Bank AG, München	371.9	927	19,146	Private
7	Bayerische Landesbank, München	316.4	1	10,853	Public
8	Eurohypo AG, Frankfurt/M.	229.0	16	1,278	Private
9	Norddeutsche Landesbank Girozentrale, Hannover	228.6	18	4,211	Public
10	Postbank AG, Bonn <sup>b</sup>	214.7	1,100	20,672	Private
11	WestLB AG, Düsseldorf	191.5	20	4,473	Public
12	Deutsche Pfandbriefbank AG, Unterschleißheim	186.8	7	919	Private
13	Landesbank Hessen-Thüringen Girozentrale, Frankfurt/M.	166.2	13	6,010	Public
14	NRW.Bank, Düsseldorf	156.8	2	1,224	Public
15	HSH Nordbank AG, Hamburg/Kiel	150.9	18	3,852	Public
16	Deka Bank Deutsche Girozentrale, Frankfurt/M.	130.3	6	3,683	Public
17	Landesbank Berlin Holding AG, Berlin	129.9	1	5,985	Public
18	ING-DiBa AG, Frankfurt/M.	96.3	1	2,696	Private
19	WGZ Bank AG Westdeutsche Genossenschafts-Zentralbank, Düsseldorf	94.1	3	1,573	Cooperative
20	Landwirtschaftliche Rentenbank AG, Frankfurt/M.	83.8	1	229	Public
21	DG Hyp Deutsche Genossenschafts-Hypothekenbank AG, Hamburg	63.4	6	454	Cooperative
22	Landeskreditbank Baden-Württemberg - Förderbank (L-Bank), Karlsruhe	61.0	2	1,222	Public
23	DKB Deutsche Kreditbank AG, Berlin	55.2	17	1,134	Public
24	SEB AG, Frankfurt/M.	49.1	174	3,284	Private
25	Dexia Kommunalbank Deutschland AG, Berlin	48.7	1	84	Private
26	BHW Bausparkasse AG, Hameln	44.9	1	1,545	Private
27	Aareal Bank AG, Wiesbaden	44.9	1	991	Private

(continued)

**Table 4.2** (continued)

Rank	Bank	Assets in billion euros	Branches	Employees	Sector
28	WL Bank AG Westfälische Landschaft Bodenkreditbank, Münster	43.9	4	293	Cooperative
29	Bausparkasse Schwäbisch Hall AG, Schwäbisch Hall	41.4	1	764	Cooperative
30	Berlin-Hannoversche Hypothekenbank AG, Berlin	40.7	5	441	Private
31	Deutsche Apotheker- und Ärztebank eG, Düsseldorf	38.8	75	2,419	Cooperative
32	Hamburger Sparkasse AG, Hamburg	38.2	180	5,622	Independent
33	Deutsche Hypothekenbank (Actien-Gesellschaft), Hannover/Berlin	36.0	9	368	Private
34	IKB Deutsche Industriebank AG, Düsseldorf/Berlin	35.7	12	1,613	Private
35	Münchener Hypothekenbank eG, München	35.2	1	366	Cooperative
36	Bremer Landesbank Kreditanstalt Oldenburg - Girozentrale, Bremen	34.8	2	1,028	Public
37	Volkswagen Bank GmbH, Braunschweig	32.8	1	631	Private
38	Santander Consumer Bank AG, Mönchengladbach	31.5	176	1,802	Private
39	Sparkasse Köln Bonn, Köln	29.3	112	4,905	Public
40	Westdeutsche Immobilien Bank AG, Mainz	25.9	13	477	Public
41	Kreissparkasse Köln, Köln	24.5	216	3,829	Public
42	Wüstenrot Bausparkasse AG, Ludwigsburg	23.9	500	2,132	Private
43	Düsseldorfer Hypothekenbank AG, Düsseldorf	20.6	1	50	Private
44	LfA Förderbank Bayern, München	20.5	1	311	Public
45	IBB Investitionsbank Berlin, Berlin	19.9	1	670	Public
46	DVB Bank SE, Frankfurt/M.	19.3	13	579	Private
47	Landesbank Saar, Saarbrücken	19.0	5	516	Public
48	BHF-Bank AG, Frankfurt/M.9)	18.7	14	1,500	Private
49	HSBC Trinkaus & Burkhardt AG, Düsseldorf	18.6	9	2,440	Private
50	Mercedes-Benz Bank AG, Stuttgart	18.2	9	1,353	Private

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

<sup>a</sup>Consolidated with Postbank, parts of ABN Amro and Sal. Oppenheim/BHF Bank

<sup>b</sup>Without 4,500 affiliates of Deutsche Post

cases.<sup>1</sup> 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 (FT 2012).

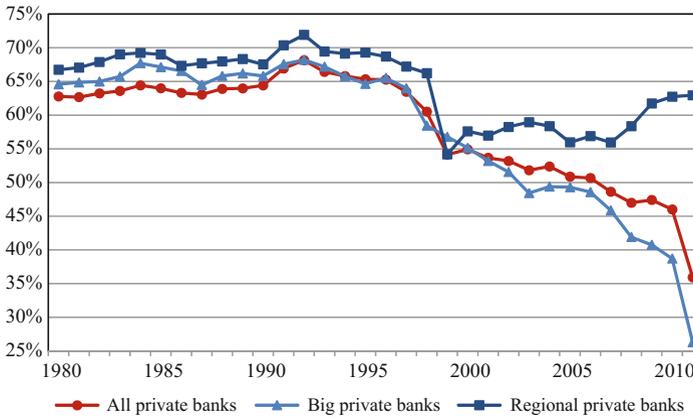
The *Commerzbank* is the second largest big bank, with assets in 2010 of 754 billion euros. In 2009 it took over the *Dresdner Bank*, which had been the second largest bank but which suffered large losses. The *Unicredit Bank*, which was formed from the merger of two medium sized Bavarian banks in 1998, is the third largest of the big banks, with assets of 372 billion euros in 2010. The Deutsche 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 euros in 2010. However, the *Deutsche Bank*, which first purchased shares in the *Post Bank* in 2008, raised its holding to 93.7% in 2012, so it cannot really be regarded as a separate institution.

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% of big banks' assets in the 1960s, has declined sharply in importance. In the 1980s and early 1990s it stood at around 65% of assets, but then fell strongly, declining to some 45% of assets in 2007, when the financial crisis began, and a mere 25% of assets in 2011 (Fig. 4.1).

The big banks initially reacted to the decline in their traditional business by seeking to expand lending to small and medium-sized enterprises but this proved rather unsuccessful due to the strong established relationship between the local savings banks and cooperative banks with small and medium-sized 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

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<sup>1</sup>In May 2012 *Deutsche Bank* agreed to pay 202 million dollars 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 dollars by the Department of Justice for tax-oriented transactions for clients between 1996 and 2002 (Financial Times, 21 December 2010); 7.5 million dollars 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 (Financial Times, 22 February 2011); and 887,000 dollars by the Korean Financial Services Commission for manipulating the country's stock market (BBC, 25 February 2010).



**Fig. 4.1** Lending by private banks to non-banks, Germany, 1980–2011 (% of banks' assets). Source Deutsche Bundesbank (2012b)

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% in the early 1980s to under 60% in 2000, although it then increased again to almost 70% in 2008 and 2009 (Deutsche Bundesbank 2011).

The shift towards investment banking activity meant that the close link with specific industrial and commercial firms through the ownership of shares and seats on company supervisory boards became a disadvantage in gaining business from other companies with which they were not related. 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% 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 is shown very clearly in the network diagrams for 1996 and 2004 in Höpner and Lothar (2006, pp. 2, 5).

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%. The group includes two significant foreign owned banks, the Dutch-owned *ING-DiBa* (rank 18 among banks in Germany with 96 billion euros assets in 2010) and the Spanish-owned *Santander Consumer Bank* (rank 38 with 31 billion euros assets). It also includes several banks set up by industrial companies,

notably the *Volkswagen Bank* (rank 37 with 33 billion euros assets) and the *Mercedes-Benz Bank* (rank 50 with 18 billion euros 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% in 2012.

## 4.2.2 *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.<sup>2</sup> 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-sized 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.<sup>3</sup> Each *Sparkasse* operates in a 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% in 1980 to 12.7% 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% of assets throughout the period since 1980, as shown in Fig. 4.2. The close relation between *Sparkassen* and small and medium-sized 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-sized enterprises, the *Sparkassen* were far less affected by the financial crisis in 2008–2009 and, whereas private banks curtailed lending in response to large losses, lending by the *Sparkassen* remained relatively stable.

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<sup>2</sup>There are independent savings banks in Hamburg, Frankfurt, Bremen and Dresden which are self controlled, and which were not covered by state guarantees, but which otherwise fit in this sector (Hackethal 2004, p. 79).

<sup>3</sup>At the height of the financial crisis in late 2008, the BBC reported that concerned citizens were withdrawing their deposits from the big private banks and opening accounts at the *Sparkasse* in central Berlin's Friedrichstraße.

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.<sup>4</sup> 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 clearing banks for the *Sparkassen* in their region. However, they have also 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% of their assets throughout the 1980s and 90s, but then fell to just over 50% in the mid-2000s (Fig. 4.2).

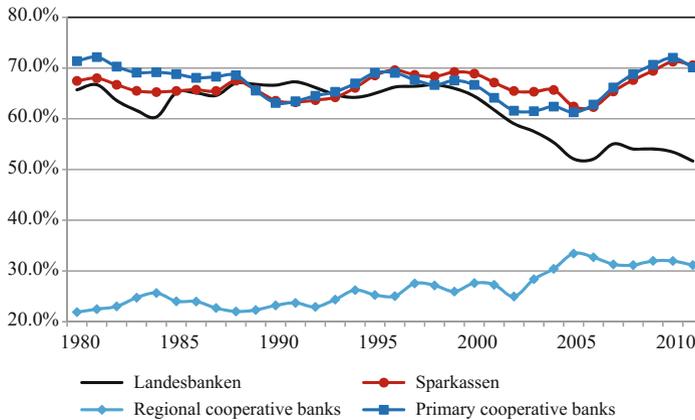
The *Landesbanken* formerly benefited from a guarantee from the regional states, and this enabled them to raise capital through selling bonds at a slightly lower interest rate than the private banks. The private banks had long considered this as unfair competition and, following a successful appeal to 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% of bank assets in 1980 and this increased to 19.8% in 2000 although, following the losses at the *Landesbanken*, this fell back to 16.7% 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.

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<sup>4</sup>There is also some cross-ownership between the *Landesbanken*. For details of the ownership structure see IMF (2012, p. 6).



**Fig. 4.2** Lending by savings and cooperative banks to non-banks, Germany, 1980–2011 (% of banks' assets). *Source* Deutsche Bundesbank (2012b)

### 4.2.3 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% of their assets (Fig. 4.2) 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% in 1980 to 8.4% in 2012.

The cooperative sector includes two regional institutions which act as clearing banks for the primary credit banks. The *Deutsche Zentral-Genossenschaftsbank (DZ Bank)*, which was formed by a merger in 2001, has around 900 members. The *Westdeutsche Genossenschafts-Zentrale (WGZ Bank)* 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% of assets. The two regional cooperative institutions' share of total bank assets has declined slightly, from 4.0% in 1980 to 3.4% in 2012.

### 4.2.4 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 was *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 eighth largest banking institution in 2010 (Table 4.2).<sup>5</sup> The mortgage banks share of total bank assets fell from 13.6% in 1980 to 6.9% 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% 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 *Kreditanstalt für Wiederaufbau (KfW)*, the third biggest German bank, 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, for example in the field of development aid. The group also includes the *Deutsche Industrie Bank (IKB)*, whose purpose is to provide financing for small and medium-sized 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 Chap. 12). In 2012, the special purpose banks accounted for 11.2% of total bank assets.

## 4.3 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* ('Germany as a financial center'), 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; see also Chap. 6

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<sup>5</sup>However, the legal status of *Eurohypo* (renamed to *Hypothekenbank Frankfurt AG* in 2012) was transformed into a non-bank firm and rebranded to *LSF Loan Solutions Frankfurt GmbH* in 2016.

of this book). 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 Chap. 6 for details).

The main securities market in Germany is in Frankfurt, although there are also five smaller exchanges in other cities.<sup>6</sup> 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 to *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%) with smaller holdings by the regional exchanges (10.1%) and traders (5.3%), although the banks have been reducing their holdings since 2001 and *Deutsche Bank* sold its 9.3% 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 from DTB profits (Reszat 2003). The DTB merged with the Swiss Options and Financial Futures Exchange to form *Eurex* in 1998. In 2007, *Eurex* took over the International Securities Exchange in Chicago for 2.7 billion dollars. For *Eurex* cross-ownership in 2012 see *Eurex* (2012).

The growth of the stock market received an important impetus with the privatisation of a number of major state-owned enterprises in the 1990s, including *Lufthansa* (partial privatisation in 1994, full privatisation in 1997) and *Deutsche Telekom* (1996) (see Chap. 12). 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

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<sup>6</sup>Hamburg and Hannover, Berlin and Bremen, Dusseldorf, Munich, and Stuttgart.

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% of GDP as compared with 6–7% in the US and Britain. The pension reform was launched in response to various perceived problems, including an aging population, increasing early retirement, an increasing number of jobs which did not pay pension contributions 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% of previous net income, and to provide tax incentives for employees to invest up to 4% 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 euros, while the value of outstanding bank loans was 1,474 billion euros (Deutsche Bundesbank 2012a). Stock market activity had increased, but market capitalisation in 2010 was equal to 43% of GDP, even lower than the EU average of 67%, and considerably below the US figure of 119% (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 during the new economy boom in the second half of the 1990s but, following the collapse of the stock market bubble, the number had fallen again to previous levels (see Chap. 12). 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% of households have holdings at least through pension funds. 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 also Chap. 13 for details).

## 4.4 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 (Bakk-Simon et al. 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 (2012a) 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

(Deutsche Bundesbank 2012a, p. 69).<sup>7</sup> The total size of these funds is equal to around 15% 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% of the assets of the country's regulated banking sector.

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 euros and 5.4 billion euros respectively in September 2012).<sup>8</sup> 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% of the holdings of these funds were in foreign issued securities, thereby exposing investors in these funds to possible losses suffered abroad (see Deutsche Bundesbank 2012a, Table 6.1 for details).

Although the shadow banking system in Germany is rather small, banks in Germany are connected extensively with the global shadow banking system (Deutsche Bundesbank 2012a, 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 4.3 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 *Landesbanken* were also heavily involved. The vehicles set up by the publicly-owned *IKB* and the *Landesbank Sachsen* 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.

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 2012a, 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 euros 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.

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<sup>7</sup>Our own attempts to replicate the European Central Bank's estimates of the size of the shadow banking sector indicated that for Germany the figure was around 500 billion euros in 2010 and 2011, which is even smaller than the Bundesbank figure.

<sup>8</sup>The figure for money market funds had stood at 33 billion euros 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.

**Table 4.3** German banks' special purpose vehicles in offshore centres, June 2007

Bank	Vehicle	Location	\$ billion
Bankgesellschaft Berlin	Check point Charlie	Delaware, US	2.1
Bayern Landesbank	Giro lion funding	St. Helier, New Jersey	7.4
Commerzbank	Kaiserplatz funding	Delaware, US	9.4
Deutsche bank	Bills securitisation (closed 9/2007)	St. Helier, Jersey	0.0
Deutsche bank	Rheingold securitisation	St. Helier, Jersey	7.2
Deutsche bank	Rhein-main securitisation	St. Helier, Jersey	7.5
Dresdner bank	Silver tower funding	George Town, Cayman Islands	8.0
DZ bank	Coral capital	London	4.0
Helaba	Opusalpha funding	Dublin, Ireland	1.9
HSH Nordbank	Poseidon funding	St. Helier, New Jersey	6.9
Hypo-Vereinsbank	Arabella funding	St. Helier, New Jersey	2.3
Hypo-Vereinsbank	Salome funding	Dublin, Ireland	1.7
IKB	Rhineland funding capital (closed 1/2008)	Delaware, US	18.6
LBBW	Lake constance funding	Bangore, Ireland	9.1
Sachsen Landesbank	Ormond quay (closed 03/2008)	Dublin, Ireland	17.9
West Landesbank	Compass securitisation	Dublin, Ireland	8.4

Source DZ Bank (2008)

## 4.5 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-sized 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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## Chapter 5

# Germany's Integration into International and European Financial Markets

**Abstract** 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.

### 5.1 Introduction

In Germany, as in other Western countries, international capital flows largely collapsed following the breakdown of the international gold standard in 1931. Following the Second World War, international capital flows were strictly regulated under the terms of the Bretton Woods system and, while current account convertibility was re-established in 1958, capital flows remained small. West Germany had large current account surpluses and, in the absence of capital outflows, faced upward pressure on its currency.

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 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. The Deutsche Bundesbank intervened on an increasing scale to prevent an appreciation of the mark but, as the US authorities made no attempt to reduce continuing capital outflows, in 1971 the German authorities stopped intervening and the mark appreciated sharply. A short-lived attempt to re-establish fixed exchange rates broke down in 1973, marking the definitive end of the Bretton Woods system. In late 1973 Germany began to relax its controls on international capital flows, and the controls were fully abolished in 1981.

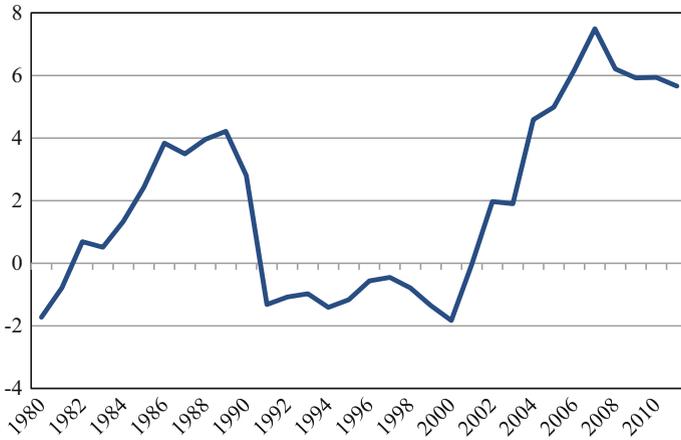
Germany's international financial integration increased steadily, but from a low base, in the 1980s. It then deepened rapidly during the business expansion in the second half of the 1990s and, following a temporary weakening during the 2001–2002 recession, again increased very strongly up to 2007. Following 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.

Until the 1990s, Germany's international bank lending was mainly to countries outside Europe. From the second half of the 1990s, however, bank transactions with EU countries grew strongly, especially with Euro area countries. Following the onset of the Euro crisis in 2010, while German bank lending to core Euro area countries was sustained around existing levels, lending to peripheral Euro area countries was sharply reduced.

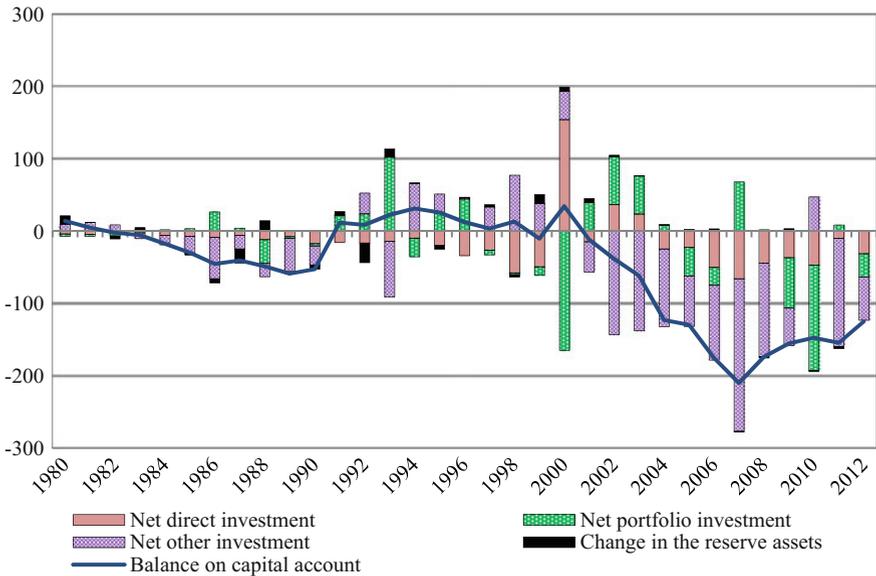
## 5.2 International Payment Flows

From the early 1950s until the 1970s Germany consistently registered a surplus on its trade balance and, in most years, also on its current account balance. A key challenge for the Bundesbank was to limit capital inflows and ensure sufficient capital outflows to accommodate the current account surpluses. This led to a strong rise in Germany's foreign exchange reserves and also served to encourage Germany to expand its development aid.

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 surplus which rose to a peak in 1989 of 4.2% of GDP, as shown in Fig. 5.1. 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% of GDP. 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% of GDP, or 181 billion euros. Following the onset of the crisis, the current account surplus declined slightly but, at around 6% of GDP or 150 billion euros a year, it remained very high after 2008.

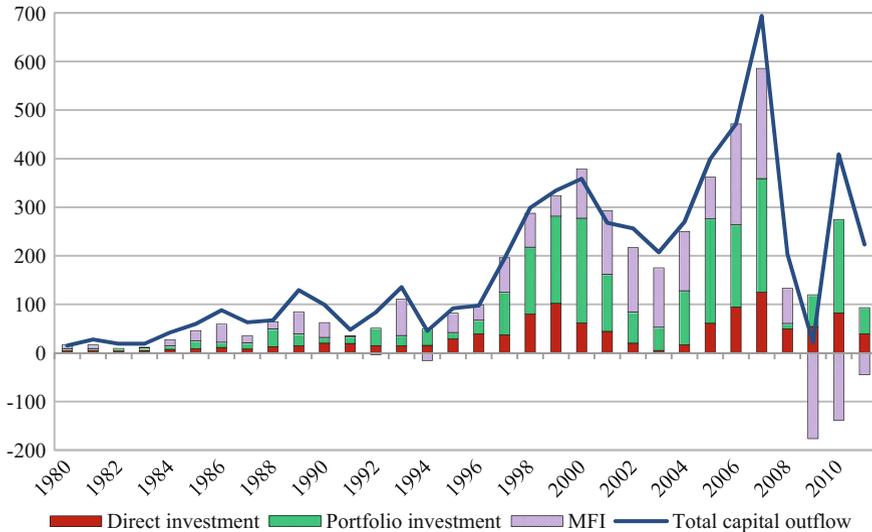


**Fig. 5.1** Current account balance, Germany, 1980–2011 (% GDP). *Source* Deutsche Bundesbank (2012)



**Fig. 5.2** Net capital inflows, Germany, 1980–2012 (in billion euros). *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, which were mainly bank transactions, as shown in Fig. 5.2. In the 1990s, the small current account deficit was matched by a small capital



**Fig. 5.3** Gross capital outflows, Germany, 1980–2011 (in billion euros). *Source* Deutsche Bundesbank (2012). *Notes* MFI Monetary Financial Institutions

account surplus, but it is striking that the scale of the different types of 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 net capital inflows which were due principally to net portfolio inflows and, especially net other investment, which is mainly attributable to bank transactions.<sup>1</sup>

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 (Trans-European Automated Real Time Gross Settlement Express Transfer System) clearance system (see below), as private claims against peripheral Euro area countries were replaced by central bank claims in 2010 and 2011.

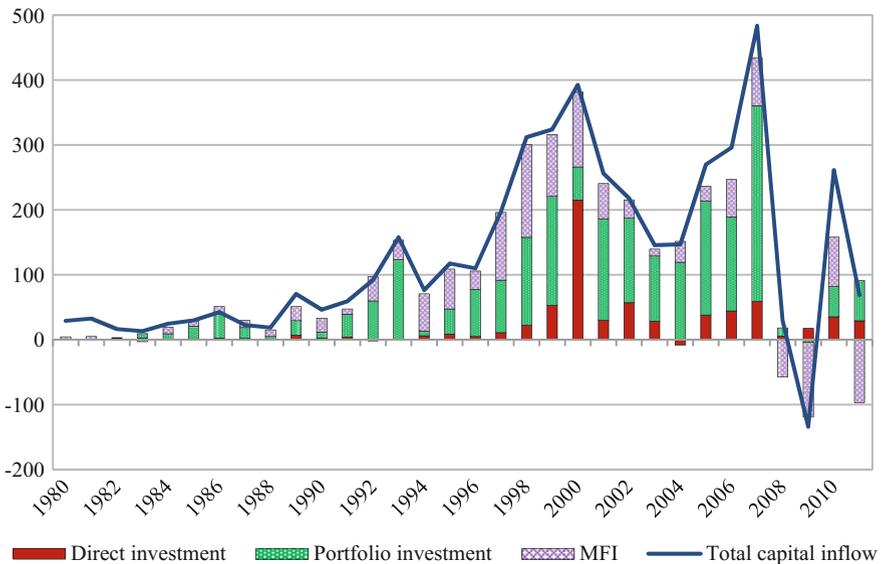
The composition of Germany's gross capital outflows is shown in more detail in Fig. 5.3. The annual outflow increased in the 1980s, rising from 27.8 billion euros in 1980 to 129.2 billion euros in 1989. The largest outflows were registered by

<sup>1</sup>The large net inflow of direct investment in 2000 was principally due to the hostile takeover of *Mannesmann* by *Vodafone* (see Chap. 11 for details).

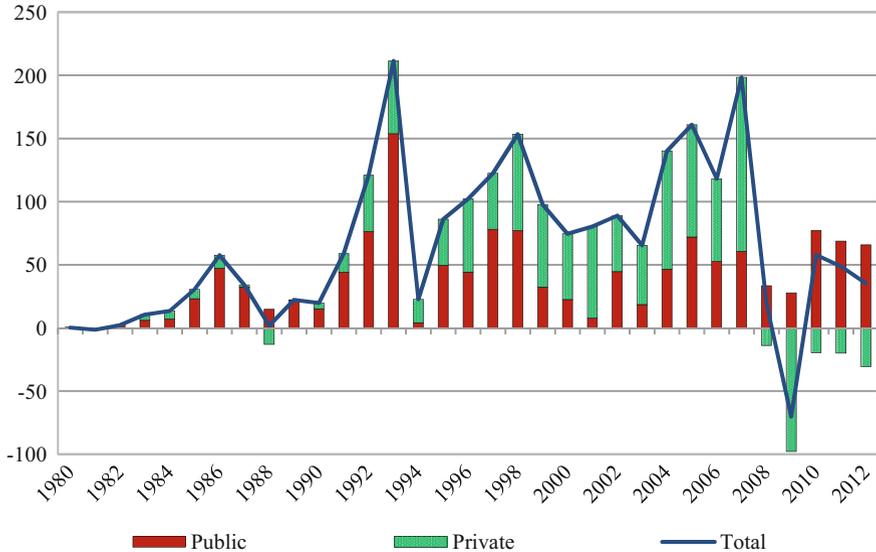
Monetary Financial Institutions (meaning bank transactions), followed by portfolio investment and then direct investment. Outflows declined slightly in the first half of the 1990s, but in the second half of the decade they rose strongly, to reach 358.4 billion euros in 2000. The largest outflow was recorded by portfolio investment, followed by bank outflows (MFI) and then direct investment. Following a short decline during the recession at the start of the 2000s, annual outflows then again increased very strongly from 2004, more than trebling, to reach 693.8 billion euros 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 euros, primarily because outflows of portfolio investment and direct investment were largely offset as German banks repatriated 176.6 billion euros of funds from abroad. 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.

The inflow of capital to Germany is shown in Fig. 5.4. Total inflows were low in the 1980s (generally under 45 billion euros), and consisted predominantly of portfolio investment. Inflows increased in the 1990s, especially in the second half of the decade, and reached 392.6 billion euros in 2000. Inflows from bank transactions 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



**Fig. 5.4** Gross capital inflows, Germany, 1980–2011 (in billion euros). *Source* Deutsche Bundesbank (2012). *Notes* MFI Monetary Financial Institutions



**Fig. 5.5** Inflows of foreign capital into public and private bonds, Germany, 1980–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)

increased strongly to reach a peak of 483.7 billion euros 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 euros in 2009. This was a result of a collapse in portfolio investment in the country and, more particularly, a significant withdrawal of bank deposits.

The inflow of portfolio investment was predominantly into debt securities. In the 1980s this was mainly into government bonds, as shown in Fig. 5.5. During the 1990s, foreign investors also began to purchase private bonds, 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 euros of private German bonds. By contrast, during the same period, foreign investors increased their holdings of German government bonds in every year.

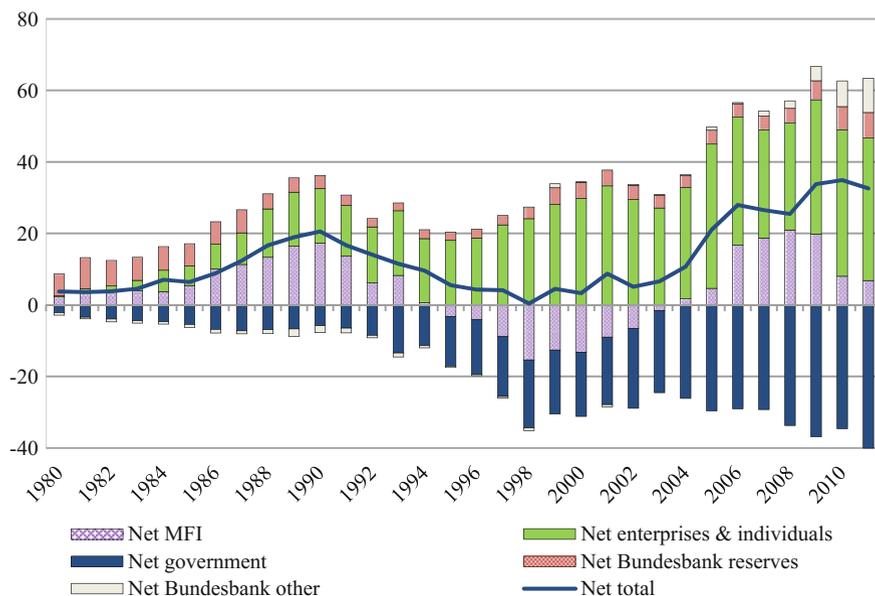
### 5.3 International Investment Position and Bank Lending

The cumulative impact of a country's current account development is reflected in its international investment position. Germany's net international investment position strengthened between 1980 and 1990, rising from 30 billion euros (3.7% of GDP)

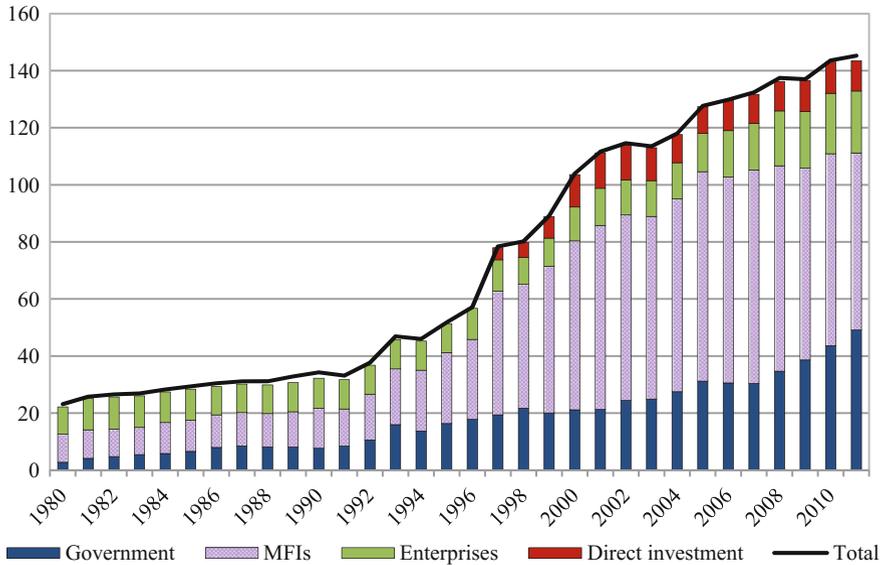
to 269 billion euros (20.5% of GDP) (see Fig. 5.6). During this period, it was primarily banks and companies that built up a positive net international position, but this was partly offset by a rise in foreign holdings of German government bonds. However, between 1991 and 1998, Germany's positive net 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 euros (26.5% of GDP), and it continued to rise, so that by 2011 it stood at 845 billion euros (32.6% 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).

While the net international investment position of Germany has been positive since the 1980s, various sectors of the German economy have been borrowing abroad and this has been reflected in a rising stock of external liabilities. Germany's gross external indebtedness increased from 213 billion euros (23.2% of GDP) in 1980, to 449 billion euros in 1990 (34.3% of GDP) (Fig. 5.7). It then rose very



**Fig. 5.6** Net international investment position, Germany, 1980–2011 (% GDP). *Source* Deutsche Bundesbank (2012). *Notes* MFI Monetary Financial Institutions. Data is for December each year



**Fig. 5.7** Gross external indebtedness, Germany, 1980–2011 (% GDP). *Source* Deutsche Bundesbank (2012). *Notes* Direct investment refers to foreign borrowing by German owned firms abroad; *MFI* Monetary Financial Institutions

strongly in the 1990s, to reach 2,128 billion euros (90.7% of GDP) in 2000, and it continued to rise, reaching 3,766 billion euros (151% 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 euros (74.8% of GDP) and that of the government at 737 billion euros (30.4% of GDP). The figure for foreign borrowing by enterprises in Germany was equal to 399 billion euros (16.4% of GDP) while that for foreign borrowing by German owned firms abroad was equal to 247 billion euros (10.2% of GDP).<sup>2</sup>

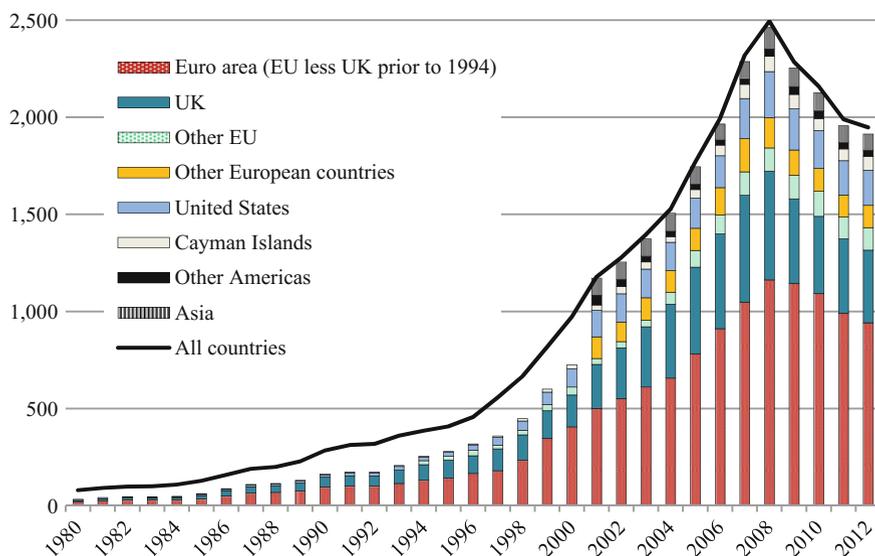
Following the onset of the crisis, Germany's gross foreign borrowing declined slightly in 2009, but it then increased again in the following two years. The decline was principally due to banks, which reduced their international indebtedness between 2007 and 2011 by some 200 billion euros to 1,608 billion euros. However, during the same period, the German government increased its foreign indebtedness

<sup>2</sup>Due to a lack of disaggregated time series data, this figure 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.

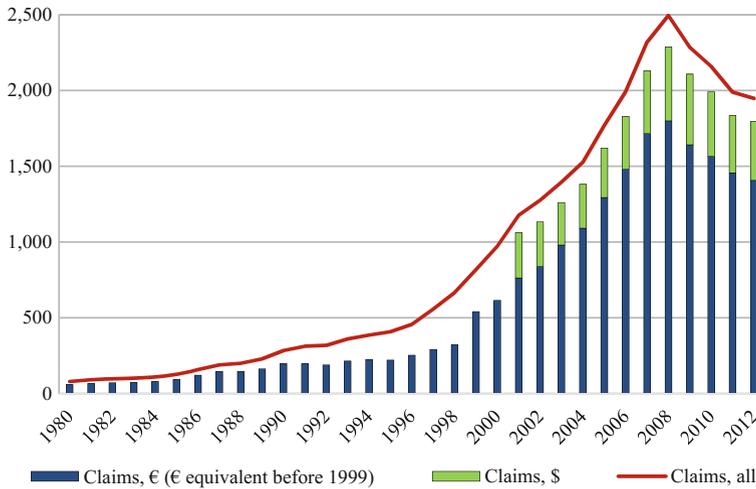
by over 500 billion euros to reach 1,273 billion euros, largely as a result of foreign investors purchasing government bonds.

International lending by banks located in Germany increased steadily from the equivalent of 90 billion euros in 1980 to 456 billion euros in 1996 (Fig. 5.8). It then increased much more markedly from the mid-1990s until 2008, when it reached a peak of 2,495 billion euros. In the aftermath of the crisis it then began to decline, and had fallen to 1,948 billion euros by mid-2012.

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% of lending was to countries within Europe. In 2008, the year when lending peaked, 1,162 billion euros (46.8% of the total) was to countries in the Euro area; 560 billion euros (22.5%) was to the UK; 119 billion euros (4.8%) was to other EU countries; and 155 billion euros (6.2%) was to European countries outside the EU (of which Switzerland accounted for around half). In the same year, lending to the US by banks based in Germany amounted to 238 billion euros (9.6%). Most of the remaining amount in 2008 was made up of lending to the Cayman Islands (79 billion euros), other countries in the Americas (38 billion euros), and Asian countries (109 billion euros). 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 euros of the Euro area figure in 2008) and the Cayman Islands.



**Fig. 5.8** International bank lending, Germany, 1980–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)



**Fig. 5.9** International bank lending by currency, Germany, 1980–2012 (billion). *Source* Deutsche Bundesbank (2012)

Whereas lending to European countries 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.<sup>3</sup>

Prior to 1999, approximately 50% of international lending by banks based in Germany was denominated in Germany's own currency, as shown in Fig. 5.9. However, not surprisingly, the share of lending denominated in euros increased rapidly after 1999. At the peak in 2008, 72% of international lending was denominated in euros and 19.5% in US-dollars, with a small amount in other currencies.

## 5.4 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 1974/1975. This led to several major bank failures, including that of the *Herstatt Bank* in Germany in 1974. In the

<sup>3</sup>The peak lending by German banks in the US was in October 2008. Total consolidated lending amounted to 600 billion euros of which 257 billion euros originated from banks in Germany.

face of widening exchange rate fluctuations between members of the European Communities, 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% 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 Communities based on the principle of 'home country control', which means that financial products which are approved in one country are also permitted in other member states.<sup>4</sup> These proposals were reflected in the Single European Act of 1986, which led to the directive on the free movement of capital and came into force in 1990; the Second Banking Directive of 1989 (see Chap. 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 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 German 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% against the central ECU rate but the process of monetary unification was reaffirmed, and in 1994 the European Monetary Institute, the forerunner of the 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).<sup>5</sup> This was followed in 2001 by a set of proposals by a Committee of Wise Men chaired by Alexandre Lamfalussy

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<sup>4</sup>The following details draw on ECB (2012).

<sup>5</sup>For a more critical account of the Financial Services Action Plan see Frangakis (2009).

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, an issue which assumed great importance following the onset of the financial crisis (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 in 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.

Lending by banks in Germany to EU countries accounted for only 2.5% of banks' assets in 1980. This was not merely rather small; it was equal to only a little more than one third of German banks' international lending. However, lending to EU countries then increased strongly, rising to 5.8% of assets in 1990, 10.8% in 2000 and a peak of 23.9% in 2008, before declining somewhat to 16.2% in 2012 (see Table 5.1).

Since the establishment of the European Monetary Union in 1999, lending by banks in Germany to Euro area countries has accounted for about two-thirds of lending to EU countries. 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 reached a peak of 2.1% of banks' assets in 2008 (6.9% of GDP), but had declined to 1.4% by 2012. Of this, around one third is accounted for by lending to Switzerland.

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, sometimes referred to as the Euro area core, and a group which includes a number of countries in Southern Europe plus Ireland, or Euro area periphery.

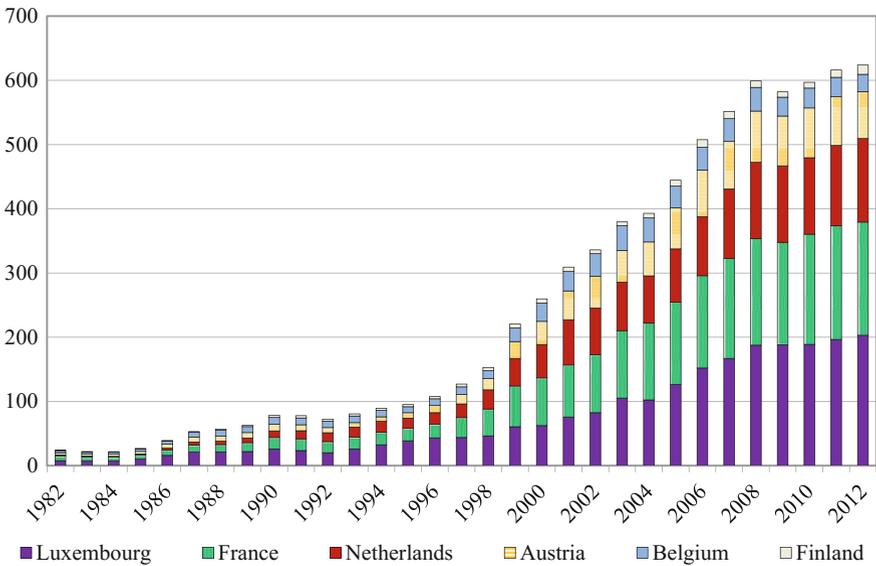
Lending by banks in Germany to Euro area core countries, shown in Fig. 5.10, increased strongly from the mid-1990s, when the transition to monetary union began, until 2008, when the financial crisis deepened. Total lending to this group of countries rose from 95 billion euros in 1995 to 599 billion euros in 2008, and it then remained around 600 billion euros in the following four years. The country with the largest outstanding loans was Luxemburg (187 billion euros in 2008), reflecting its position as a banking centre. This was followed by France (166 billion euros in 2008), the Netherlands (119 billion euros) and Austria (80 billion euros).

**Table 5.1** Lending by banks in Germany to Europe, stocks, 1980–2012

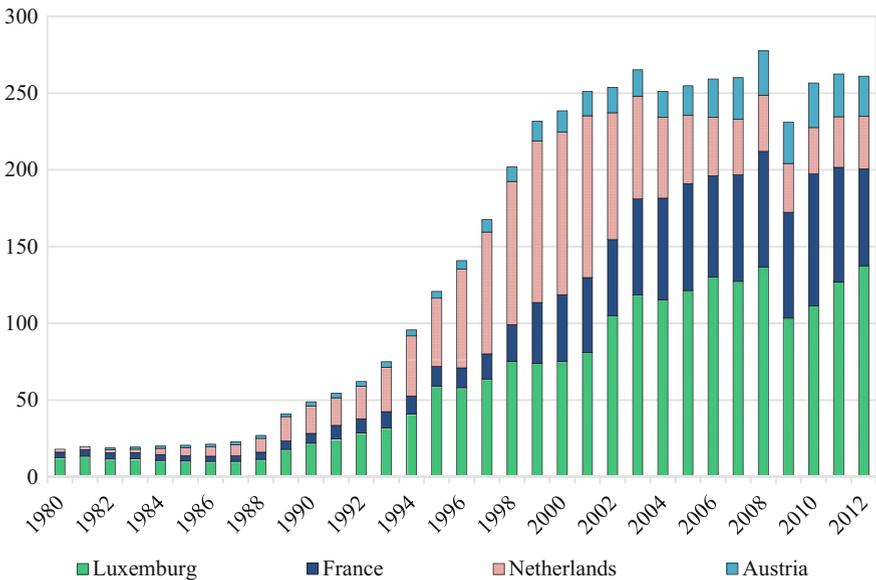
	Dec-1980	Dec-1990	Dec-2000	Oct-2008	Jul-2012
<i>Billions of euro (or euro equivalent)</i>					
Banks' balance sheet	1,273.7	2,775.6	6,083.9	8,030.2	8,726.8
Foreign lending	87.2	311.2	1,048.3	2,645.1	1,937.5
Lending to Europe	NA	NA	907.4*	2,089.3	1,532.2
Lending to EU	32.4	162.0	656.5	1,919.3	1,409.8
Lending to Euro area	NA	NA	436.1	1,192.6	933.1
Lending to other EU	NA	NA	220.4	726.7	476.7
Britain	7.3	55.1	177.1	597.9	358.6
Other	NA	NA	43.3	128.8	118.1
Lending to other Europe	NA	NA	111.1	170.0	122.4
Switzerland	1.7	7.5	37.6	63.8	50.2
Other	NA	NA	73.5	106.2	72.2
<i>% of total bank balance</i>					
Banks' balance sheet	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 <sup>a</sup>	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
<i>% of GDP</i>					
Banks' balance sheet	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

Source Deutsche Bundesbank (2012) (lending), Statistisches Bundesamt (2012) (GDP)

<sup>a</sup>2001



**Fig. 5.10** Lending by banks based in Germany to core Euro area countries, 1982–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)

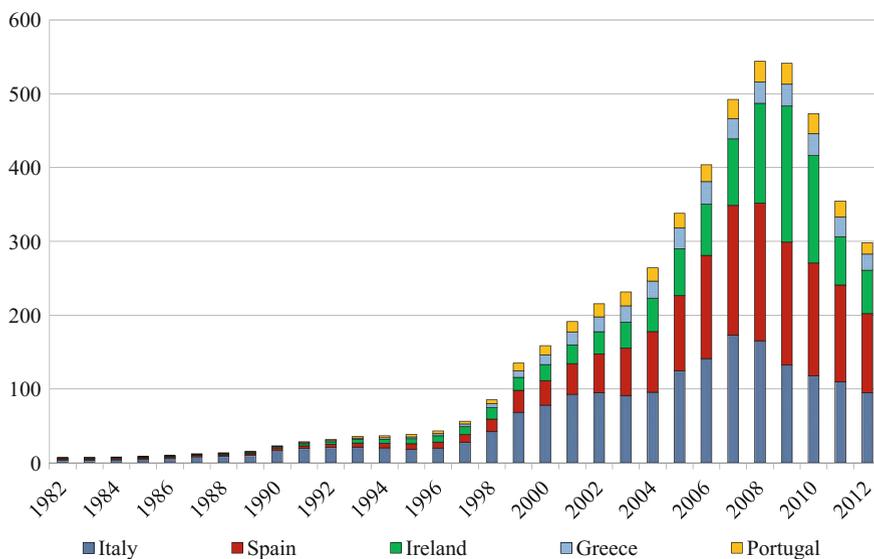


**Fig. 5.11** Liabilities of banks based in Germany to core Euro area countries, 1980–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)

The liabilities of banks based in Germany to Euro area core countries also increased, as shown in Fig. 5.11. 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 euros, although they ceased to rise significantly after around 2000, remaining around 250 billion euros until 2012. The largest amounts again involved Luxemburg (136 billion euros in 2008), followed by France (75 billion euros) and the Netherlands (36 billion euros).

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—when Germany had a small current account deficit—lending was exceeded slightly 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 euros.

Lending by banks in Germany to countries in the Euro area periphery followed a rather different path, as shown in Fig. 5.12. It began to increase in the second half of the 1990s, as it had in the case of lending to Euro area core countries, although the amount involved was initially much smaller. In 1995, outstanding loans to the Euro area periphery amounted to 38 billion euros, but the figure then increased very strongly: in 2000 it had risen to 159 billion euros and by 2008 it had reached 544 billion euros. In marked contrast to the case of the Euro area core 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



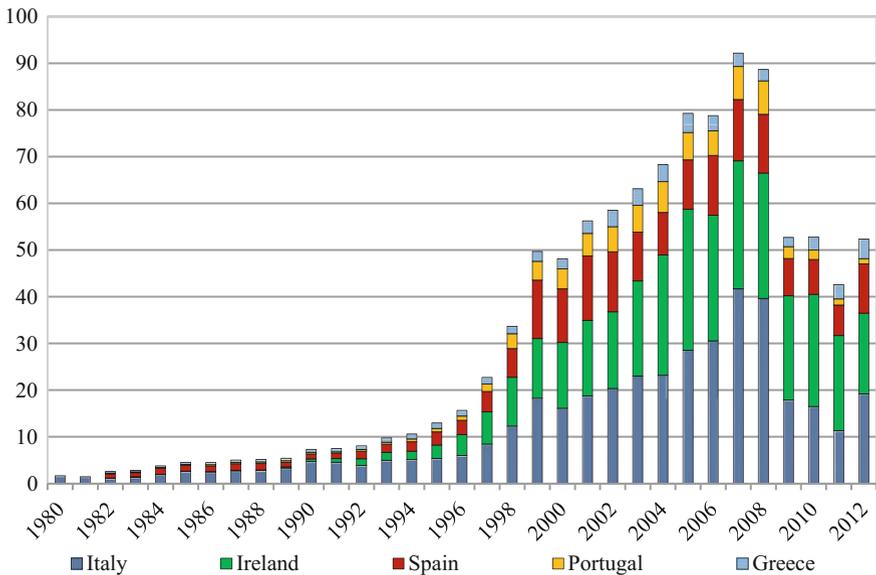
**Fig. 5.12** Lending by banks based in Germany to peripheral Euro area countries, 1982–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)

half, to 298 billion euros. Lending to Italy fell from 165 billion euros to 95 billion euros; to Spain from 186 billion euros to 107 billion euros; and to Ireland from 135 billion euros to 59 billion euros. Over the same period lending to Greece fell from 30 billion euros to 22 billion euros, and to Portugal from 28 billion euros to 15 billion euros.

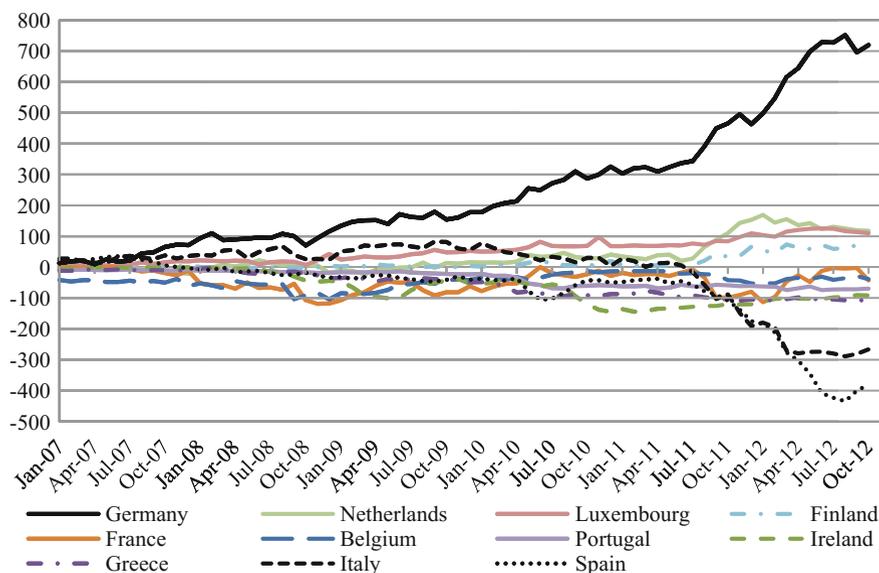
The liabilities of German banks to Euro area periphery countries also increased from the mid-1990s, but from a very low base (Fig. 5.13). From 10 billion euros in 1995 they increased to 35 billion euros in 2000 and to a peak of 81 billion euros in 2007. They then fell sharply, reaching 43 billion euros in 2012.

A comparison of German 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 euros in 2000 to 465 billion euros in 2008, and then declining to 255 billion euros in 2012. This demonstrates a classic example of a boom-bust cycle. A credit boom financed an economic expansion, including real estate bubbles, in peripheral Euro area countries following the introduction of the euros until 2007. There then ensued the bust, as lending by banks in Germany to the peripheral Euro area was sharply curtailed. (Lane 2013).

At the time of European monetary unification in 1999, the ECB 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,



**Fig. 5.13** Liabilities of banks in Germany to peripheral Euro area countries, 1980–2012 (in billion euros). *Source* Deutsche Bundesbank (2012)



**Fig. 5.14** Net balances of national central banks with the Eurosystem—TARGET (in billion euros). *Source* Euro Crisis Monitor (2012)

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, following the onset of the financial crisis, and in particular the deepening of the crisis in the Euro area in 2011, the national central banks of the Euro area states built up substantial claims and liabilities with the TARGET system (see Fig. 5.14). Germany, the Netherlands, Luxemburg and Finland built up claims against the system, while Portugal, Ireland, Greece and above all Italy and Spain built up liabilities.<sup>6</sup>

Sinn and Wollmershäuser (2011) argue that, since Germany has by far the largest claims against the TARGET system, it is in effect financing via the Eurosystem 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. 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.

<sup>6</sup>Claims and liabilities against the TARGET system are subject to the same interest rates as deposits and loans with the ECB.

Sinn and Wollmershäuser's analysis has been strongly disputed by De Grauwe and 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 Bundesbank, 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. 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.<sup>7</sup> 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 Grauwe and Ji (2012, p. 11): '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'.

## 5.5 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

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<sup>7</sup>According to De Grauwe and Ji (2012) in 2011, the ratio of TARGET claims to GDP was 24% for Germany, 25% for the Netherlands, 40% for Finland and 278% for Luxemburg.

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 also a large inflow of funds into German government bonds, even though returns here were low or even zero. While Germany has built up large claims on the ECB's TARGET 2 system, these claims do not appear to reflect unconditional financing of peripheral countries' current account deficits, as some have argued, but rather speculative capital flows to Germany prompted by fear and panic.

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# Chapter 6

## Regulation of the German Financial System

**Abstract** The regulatory regime in Germany from the 1930s 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 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 threefold 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 neo-liberal 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.

### 6.1 Introduction

This chapter gives an overview of the regulations and supervisory institutions governing the financial sector in Germany.<sup>1</sup> The following section describes the supervisory institutions in Germany and their developments. Thereafter, the key characteristics of the regulation of the financial system, which was put in place after the Second World War and remained relatively unchanged until around the mid-1980s, will be outlined. This then enables the description of the main drivers of

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<sup>1</sup>This chapter is partly based on Detzer and Herr (2014, 2016).

change of the system until the outbreak of the financial crisis in 2007. The discussed drivers include the domestic initiatives to vitalise German financial markets, the changing role of the German central bank, and later also the role of international and European initiatives to harmonise regulation. Eventually, a brief look at the financial crisis and its effect on regulation will be taken. While the regulatory changes are quite numerous, we only outline the broad changes here.

## 6.2 Supervisory Institutions in Germany

In Germany, financial supervision was split among different institutions until 2002. There were supervisory institutions for each of the three main fields of finance—insurance, securities trading, and banking. A single supervisory authority was founded in 2002 to oversee all three fields. In banking supervision, besides the supervisory authority, the Deutsche Bundesbank has always had an important role. In 2013, the Financial Stability Committee was established to cover macro-prudential supervision. Besides those bodies on the federal level, there are state-level and special purposes supervisors. The remainder of this section will give a short overview of the developments of the actors and the institutional structure of financial supervision in Germany.

Out of the three fields, the supervision of the insurance sector has the longest history in Germany. Already in 1902 the Imperial Supervisory Office for Private Insurance<sup>2</sup> was established. After a couple of changes during the Weimar Republic and during the subsequent Nazi period, insurance supervision broke down at the end of the Second World War. Only in 1951 a Federal Supervisory Office for Insurance and Home Loans<sup>3</sup> (BAV) was established again. In 1973 the supervision of building and loan associations was transferred to the Federal Supervisory Office for Banking, so that the BAV was only responsible for insurance business.

In the case of banking a comprehensive supervision was only established in Germany after the banking crisis in 1931. Before, only individual groups of institutions (e.g. public savings banks or mortgage banks) or certain types of business (e.g. stock exchanges) had been supervised. An observing banking authority was first established in 1931 by emergency decree. More encompassing supervision was established in 1934, with the Banking Act of the German Reich,<sup>4</sup> which marked the starting point for general codified banking supervision.

After the end of the Second World War, banking supervision was decentralised in the Western occupation zones. However, with the Banking Act,<sup>5</sup> which came

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<sup>2</sup>*Kaiserliches Aufsichtsamt für Privatversicherung.*

<sup>3</sup>*Bundesaufsichtsamt für das Versicherungs- und Bausparwesen.*

<sup>4</sup>*Reichsgesetz über das Kreditwesen.*

<sup>5</sup>*Kreditwesengesetz (KWG).*

into force in 1962, it was centralised again in the Federal Supervisory Office for Banking<sup>6</sup> (BAKred) (BaFin 2014).

This office was entrusted with the supervision of banks, and was tasked with counteracting abuse in the banking system, which endangered the safety of the assets entrusted to credit institutions, interfered with the orderly conduct of banking business, or would have substantial disadvantages for the economy as a whole. For these goals, it was allowed to enact regulative standards for the conduct of banking business. The Banking Act gave the Bundesbank an important role in the supervision of banks. This included certain participation rights when new laws or regulations were established (Deutsche Bundesbank 1961). In practice, the Bundesbank was always highly involved in all areas of banking supervision. With its network of state central bank branches<sup>7</sup> it took over most of the day-to-day supervision and reporting (Krupp 2001). In the following decades the powers and rights of the BAKred were extended. This included the extension to the types of institutions falling under its supervision as well as the strengthening of its powers of investigation and intervention (BaFin 2014).

New rules were established under close cooperation between the concerned ministries, the Bundesbank, market participants (often represented by the head organisations of banks), and sometimes special committees and commissions of experts and interest groups. After the establishment of standards and rules, it was often left to market participants to ensure compliance to the rules through their respective associations. This practice of delegating, on the one hand allowed the BAKred to fulfil its tasks with relatively limited financial resources and manpower, while on the other hand led to a relatively high distance between the BAKred and the regulated institutions. Since the end of the 1970s, when international and especially European influence on German banking regulation increased, there was a trend towards more differentiated supervision, which the banking associations were less able to perform. Therefore, the BAKred assumed an increasing range of supervisory tasks. At the same time, BAKred became a representative in international and European bodies. Therefore, the banking associations lost their importance, while governmental supervision became more relevant (Frach 2008).

Supervision of the securities sector was only established on a federal level in 1995 with the Second Financial Market Promotion Act.<sup>8</sup> It, for the first time, assigned supervisory powers of German securities markets to a Federal Agency—the Federal Securities Supervisory Office<sup>9</sup> (BAWe). It was supposed to ensure the integrity and transparency of capital markets. This included combating and preventing insider trading, monitoring ad hoc disclosure, and other disclosure duties.

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<sup>6</sup>*Bundesaufsichtsamt für das Kreditwesen.*

<sup>7</sup>*Landeszentralbanken.*

<sup>8</sup>*Zweites Finanzmarktförderungsgesetz.*

<sup>9</sup>*Bundesaufsichtsamt für den Wertpapierhandel.*

Later on, it also became responsible for the supervision of takeovers, market manipulations, and director's dealing (BaFin 2014).<sup>10</sup>

Reform of the supervisory structure came under discussion at the end of the 1990s, since the current framework was regarded as weak. This was partially because the agencies were badly equipped in terms of financial and human resources, but also because of a lack of cooperation between the agencies. After lengthy disputes between the Bundesbank, the existing supervisory agencies, and the concerned ministries, a single supervisory authority was established in 2002: the Federal Financial Supervisory Authority<sup>11</sup> (BaFin). This new authority was structured along the three former fields of supervision. Cross-departments were supposed to ensure cooperation and coordination between the different fields. The Bundesbank's important position within the supervisory process was kept, and enhanced, by codifying it into law (Frach 2008).

In response to the financial crisis, additional bodies were added to the institutional structure. The Federal Agency for Financial Market Stabilisation (FMSA)<sup>12</sup> was established in October 2008 to organise the bailout of problematic banks, and to restore trust in financial markets. It was established under the supervision of the Ministry of Finance and has been responsible for the Financial Markets Stabilisation Fund,<sup>13</sup> for the later established Restructuring Fund,<sup>14</sup> and for the establishment and supervision of bad banks (Becker and Peppmeier 2015). Additionally, the Committee for Financial Stability<sup>15</sup> was established at the Ministry of Finance in 2013, to provide national macro-prudential regulation and serve as a link to the European Systemic Risk Board (Deutsche Bundesbank 2013).

All in all, the supervisory structure in Germany has changed from a system that depended more on self-regulation to one that puts more emphasis on state regulation. Additionally, Germany followed the general trend towards an integrated single supervisory authority. Finally, the strong involvement of the central bank in the supervision of banks is an important characteristic of the German supervisory system.

As a response to the euro crisis, the general structure of financial supervision and regulation in the Euro area was challenged. As an answer to the problems associated with banking failures and sovereign debt problems, discussions on a banking union became prevalent in 2012. The European banking union consists of three main components: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), closely related to the Banking Recovery and Resolution Directive (BRRD) and a common deposit insurance system. However,

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<sup>10</sup>This has to be distinguished from the supervision of individual stock and securities exchanges, which is still in the responsibility of the German states.

<sup>11</sup>*Bundesanstalt für Finanzdienstleistungsaufsicht.*

<sup>12</sup>*Bundesanstalt für Finanzmarktstabilisierung.*

<sup>13</sup>*Finanzmarktstabilisierungsfonds.*

<sup>14</sup>*Restrukturierungsfonds.*

<sup>15</sup>*Ausschuss für Finanzstabilität.*

while the first two of those elements have been put in place, discussions on a common deposit guarantee scheme are still ongoing. With the SSM the European Central Bank (ECB) took over direct supervision of the large systemically important banks, and indirect supervision for all banks in the Euro area. The BRRD set the framework for dealing with troubled banks in the areas of prevention, early intervention, and resolution for all EU member states. With the SRM, a central mechanism has been established that is applied when a bank under the direct supervision of the ECB is endangered. Additionally, a resolution fund will be established, with the purpose of covering the costs of a resolution process.

The start of the banking union was originally envisaged for 2013, and has been considerably delayed. The ECB could only assume its role in November 2014, due to concerns and opposition of some member states, among them Germany. The rules of the SRM apply since January 2016.

Concerns in Germany included the issues of the legal validity of the SSM and the SRM without a change of the EU Treaties, as well as practical concerns about potential conflicts of interest arising from the combination of monetary policy and supervision within the ECB. The legal structure of the SRM leads to relatively complex decision making mechanisms, which has raised doubts about its speed and effectiveness during a crisis (Deutsche Bundesbank 2014; Hartmann-Wendels 2013; Schäuble 2014; SVR 2013). Additionally, as a likely net contributor to the support and resolution mechanisms established with the SRM, there were worries about moral hazard, from both member states as well as financial institutions (Howarth and Quaglia 2014). In the policy discussions, there were worries about costs that occur due to past supervisory failure, often referred to as legacy assets, in particular, which would be shifted to the new institutions. (Deutsche Bundesbank 2014; Schäuble 2013a; Bundesverband Deutscher Banken 2013).

However, one of the main issues was the scope of supervision of the ECB and the SRM. Germany was in favour of assigning real investigative and supervisory powers to the ECB, but only regarding the biggest banks. Savings and cooperative banks, mostly small and medium-sized institutions, were concerned that centralised supervision may be designed for large, systemically important banks while smaller banks might be overburdened with inappropriate regulation, and may have to pay for the risks incurred by those big banks. Therefore, they advocated national supervision for the non-systemic banks, which can take into consideration the specific structure of the German financial system. They were supported in this regard by the Ministry of Finance and the Bundesbank. Part of the opposition also stemmed from the impression that European regulation is geared largely towards capital market based finance, and that this might damage or substantially change the successful and robust German bank based system (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, Deutscher Sparkassen und Giroverband 2014). During the negotiations, Germany followed this line of argument and advocated a relatively high threshold regarding which banks to include under the ECB direct supervision. Eventually, the threshold was set at 30 billion euro of bank assets. This will put the public *Landesbanken* under direct ECB supervision, which Germany originally tried to prevent. However, as a compromise, it has been agreed that the

supervision will be ‘differentiated’ and carried out in ‘close cooperation’ with the national supervisors (Howarth and Quaglia 2013b). For the SRM, Germany also succeeded at advocating a solution in which the supervision of smaller local banks remained the responsibility of the national authorities. Only those banks under direct supervision of the ECB, or in cases where the resolution fund should be tapped, fall under the responsibility of the SRM.

## 6.3 The Development of the German System of Financial Regulation Until 2007

### 6.3.1 *The Regulatory Framework After the Second World War*

In Germany, banking regulation was established relatively late during the banking crisis in 1931 when Chancellor Heinrich Brüning established it by emergency decree. In 1934 the ‘Banking Act of the German Reich’ was implemented, whereby all credit institutions were put under supervision. The Banking Act<sup>16</sup> established in 1961, which is still the central law governing banking today, was based on this law (Lütz 2002, pp. 116–133). A central tenet of German banking regulation was that it was restricted to set certain standards, like liquidity or capital requirements, but that direct intervention into banks’ business decisions remained limited. Limits on banking activities, rules about portfolio composition, interest rate regulations, or branching restrictions were not important in Germany or were abolished much earlier than in other countries.

However, the Banking Act used a very broad definition of banking, so that many financial service activities that are not regarded as banking in many other countries can only be conducted by banks. This limits the development of non-bank financial actors to certain restricted areas (such as mortgages, insurance, securities industries) that are governed by special laws. Due to their restrictions on assets and liabilities, those actors do not compete with the main business areas of banks. This wide-ranging regulatory framework of banking activities limited regulatory arbitrage and the development of a parallel banking system in Germany (Vitols 1995).

After the Second World War, security exchanges were organised regionally and were largely self-regulating. While the German federal state governments were the formal supervisory authority of their respective stock exchanges, they pursued a policy of non-interference in capital markets (Lütz 2002, pp. 79–89). The regulatory framework was characterised by a lack of transparency and accountability, low protection of minority shareholders and no binding rules against insider trading. Additionally, German accounting rules were geared towards creditor protection.

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<sup>16</sup>*Gesetz über das Kreditwesen.*

Capital markets were dominated by the few big private banks, which had a strong position in most of the self-regulating bodies of the German exchanges (Lütz 2002, pp. 79–89).

Prior to the 1990s, the regulatory framework for securities and securities markets remained relatively stable, which was supported by the big banks and the Bundesbank. The other sectors of the German financial system, public banks and cooperative banks, also had no incentive to push for changes. Each banking group had its field of business (Lambsdorff 1989; see also Chap. 2 of this book). Until the mid-eighties German banks did not show much interest in financial innovation. However, one has to distinguish between technology-driven innovations (payment systems, ATMs) and modality driven innovations (derivatives, securitization, etc.), where the former are mostly useful, while the latter at least when used wrongly and with wrong incentives can be harmful or benefit the financial institutions at the expense of other societal groups (see Shirakawa 2011). Germany was rather lagging behind on the latter type of innovation, while one of the strengths of the German system was its ability to offer cost-efficient, safe and fast payment and security transaction services (Franke 1998). The prevailing universal banking principle could be one of the reasons why banks were reluctant towards modality driven innovation. In dual banking systems investment banks try to take over business of commercial banks by issuing new products such as securitised loans. Such a pressure for financial innovation does not exist in universal banking systems. Furthermore, the Bundesbank, as mentioned, resisted liberalisation and destabilising innovations.

### **6.3.2 *Adaptions of the Regulatory Framework Due to Banking Crises***

While there were continuous small changes in the Banking Act, substantial revisions only occurred after banking crises unveiled serious weaknesses. Here in particular one should mention the bank failure of *Herstatt-Bank*<sup>17</sup> due to foreign exchange speculation in 1974, and the near default of *SMH-Bank*<sup>18</sup> due to large loan losses in 1983. After the breakdown of Bretton Woods and the accompanying currency fluctuations, *Herstatt-Bank* was increasingly active in currency speculation, an area which was barely regulated at the time. After large losses, the bank had to declare insolvency and its banking license was withdrawn. As a regulatory response to this, currency positions of banks were limited and the intervention rights of the supervisory authorities were bolstered. In addition, the crisis increased the pressure on private banks to improve their privately organised deposit insurance scheme. The crisis also had an international dimension—the counterparties in the currency trades, mostly other international banks, had to bear heavy losses.

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<sup>17</sup>*I.D. Herstatt KGaA.*

<sup>18</sup>*Schröder, Münchmeyer, Hengst & Co..*

The crisis at the German *Herstatt-Bank* and the simultaneous collapse of the Franklin National Bank of New York led to the setup of a committee, which later became the Basel Committee (Basel Committee on Banking Supervision 2013).

The near default of *SMH-Bank* was related to enormous loans, exceeding 800% of the banks own equity, to one debtor, the *Esch-group*, which dealt mainly in construction machines. The bank circumvented the large loan regulations, which were in place at that time, by extending loans through its Luxembourg subsidiary (Der Spiegel 1983) and by extending them to different only indirectly connected firms within the *Esch-group*. The collapse of the bank was only prevented by concerted action of the private banks, the Federal Supervisory Office for Banking, the private deposit insurance scheme and the Bundesbank (Die Zeit 1986). As a consequence, the Banking Act was amended in 1985, reforming, among other changes, the consolidation rules for borrower units.

### 6.3.3 Facilitators of Changes from the 1980s on

**The push for a bigger role of financial markets** In the 1990s and the early 2000s the German corporate governance system and with it the regulation of securities markets, had undergone major changes, which did not result from outside pressure but were largely the product of ‘deliberate governmental policy and [...] sustained party and interest groups politics’ (Cioffi 2006, p. 549). This substantial transformation, according to Cioffi (2006), reflects a shift of policy preferences in favour of financial markets that dates back to the years of the conservative-liberal CDU/FDP<sup>19</sup> governments of the 1980s.

As described in Chaps. 2 and 11, traditionally the big German banks had tight relations with the big German industrial firms. The banks provided the firms with long-term loans, held large amounts of their shares, and were represented at their supervisory boards. This way, the banks formed the core of what is commonly referred to as Corporation Germany (*Deutschland AG*). This favourable position secured the banks a stable but moderately profitable field of business. However, the firms’ need for external finance declined in the 1970s, and they increasingly used international markets to raise external finance. Additionally, international banks as well as the *Landesbanken* started competing for business with the big German private banks. With this, the big banks’ business in this area declined. Initially they tried to compensate by increasing business with small and medium-sized enterprises. However, this strategy failed due to the strong position of the savings and cooperative banks in this area. Finally, the big private banks decided to go global and get a share of the international investment-banking business, which was regarded as highly profitable. They started to extend their activities in this area, mainly through acquisitions of existing international investment banks. With this

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<sup>19</sup>Cristian Democratic Union (CDU), Free Democratic Party (FDP).

strategic reorientation, the banks loosened their ties with non-financial firms, and at the same time pushed the idea of establishing Germany as an international financial centre. Their efforts took the form of the initiative *Finanzplatz Deutschland* ('Germany as a financial centre') which was founded in 2003. This initiative was active until 2011, and was supported by the lobby organisation of the financial system, the German Ministry of Finance, and the Deutsche Bundesbank. Large German firms also supported the strengthening of financial markets, since they saw it as a welcoming opportunity to increase their financial flexibility. Besides these private initiatives, politicians and political parties were also pushing for a change of the financial system. The Kohl government (in particular the FDP and pro-EU parts of the CDU) was willing to reform financial markets as the price to be paid for European unity and the Single Market Program. But there was also support from parts of the trade unions and the regional governments. However, the Social Democratic Party (SPD) in particular put the restructuring of financial markets and corporate governance reforms on its agenda. In the 1990s this put pressure on the conservative-liberal government, which was displayed as the defender of traditional German managerial elites and an increasingly dysfunctional economic order in the eyes of the supporters of a new wave of globalisation. Whilst in opposition, the SPD was able to pressure the Kohl government to adopt relatively far reaching reforms, which were also demanded by the European Commission. However, reforms gained speed when the coalition of the SPD and the Greens<sup>20</sup> came to power under Chancellor Gerhard Schröder in 1998 (see Cioffi 2006). The most important changes will be outlined here.

Starting already in 1984, the Deutsche Bundesbank, and later the government, passed a variety of deregulatory measures, which abolished hurdles for foreign engagements in the German financial system (e.g. certain tax laws), and allowed for more financial innovation (Domanski 2003). However, the more substantial reforms were passed in the 1990s and early 2000s. Three areas of reform were seen as necessary for establishing a—what was regarded at the time—modern (i.e. market based) financial system: (1) regulation of securities and the securities market, (2) company law and corporate governance, and (3) taxation and Corporation Germany. Four 'Financial Market Promotion Acts' were passed. The first two in particular aimed at improving accountability and transparency at the level of markets. The third act aimed to do the same at the level of the firm. Lastly, changes in taxation made in 2000 aimed to unwind Corporation Germany (Cioffi 2006).

Starting with the First Financial Market Promotion Act<sup>21</sup> in 1990, a range of legislative steps was taken to modernize financial markets to become more similar to their US and UK counterparts. The core was formed by the Prospectus Act,<sup>22</sup> which governed requirements for the prospectus of securities' initial public offering. It was the first legislative act that had the protection of investors in German capital

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<sup>20</sup>*Bündnis 90/Die Grünen.*

<sup>21</sup>*Erstes Finanzmarktförderungsgesetz.*

<sup>22</sup>*Verkaufsprospektgesetz.*

markets as its primary goal, but it also abolished a range of tax hindrances to securities trading, such as the stock market transaction tax (Deeg 1999).

According to Vitols (2004), the Second Financial Market Promotion Act, which came into effect in 1995, introduced the most significant changes in regards to securities markets. With it, a range of US practices in financial market regulation were adopted and some EU directives were implemented. It established, for the first time, a federal agency (see above) responsible for the regulation of securities markets, similar to the US Securities and Exchange Commission. This moved the German system away from its focus on self-regulation of the securities markets and exchanges. Other main issues were the banning of insider trading, and more stringent information requirements for issuers of securities and traders, in particular ad hoc news announcements. The anti-insider trading legislation met severe opposition prior to 1994. After Germany failed to comply with the European Commission Directive by the original deadline, 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 Communities 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 the 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 European Commission, the enactment of anti-insider trading legislation was key to fostering international competitiveness of German financial markets, and to opening those markets further for international investors (Pfeil 1996). Besides this, a major change was the admission of money market funds in Germany in 1994, which had for a long time been resisted by the Bundesbank (Fischer and Pfeil 2004).

The Third Financial Market Promotion Act, including the Control and Transparency in Business Law<sup>23</sup> was passed in 1998. These acts can be seen as complementing the prior reforms of the securities market regulations with changes in corporate governance regulation and a weakening of Corporation Germany. The reforms aimed at far reaching reductions of banks' power and their role in corporate governance. The original SPD proposal mandated the reduction of banks' equity holdings in corporations, limited board seats, and totally prohibited bank's proxy voting. However, many of these changes were quickly abandoned after intensive pressure from the financial industry (Deeg 1999; Cioffi 2006). For example, banks demanded far reaching tax exemptions if they had to divest their equity shares and announced that they would retreat from providing proxy voting services. Eventually, these issues were dropped from the reform agenda. It is interesting to note here that, eventually, the banks got the demanded tax exemptions in 2001, without having to accept limits on their cross-shareholdings. Also, the final law included only some

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<sup>23</sup>*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich.*

limitations on proxy voting and board seats.<sup>24</sup> More importantly, the law strengthened the position of the supervisory board against the management board, and introduced additional requirements for transparency and auditing. A third important area in which the law made changes was in the protection and empowerment of minority shareholders. These changes served to weaken insider control and to increase liquidity in securities markets, by abandoning voting caps and instituting a one-share-one-vote rule. The Law also prohibited the voting of cross-shareholding stakes in board elections. These were seen as a defence against hostile takeovers, and their abandonment as a way of furthering the development of a market for corporate control. Finally, the new law allowed stock repurchases and the use of stock options as management compensation—practices typically found in Anglo-Saxon countries and associated with concepts of shareholder value.

In 2000 the Tax Reduction Act,<sup>25</sup> among other changes, eliminated the corporate capital gains tax, which up until then had been 50%. This tax was seen as an important barrier to firms and financial institutions being able to liquidate their interlocking cross-shareholdings. Therefore, on the one hand, the Act aimed to increase the threat of hostile takeovers and create an effective market for corporate control, and on the other hand to increase the liquidity and free float in German stock markets. Shortly after it came into effect in 2002 it set off a wave of corporate restructuring, and a further reduction of the interlocking cross-shareholdings. With this, for the first time, hostile takeovers became a realistic threat for many German firms (Cioffi 2002; Deeg 1999).

A further important change was the Securities Acquisition and Takeover Act,<sup>26</sup> which came into force in 2001, and formally regulated mergers and acquisitions. This act limited the defence capabilities of firms against hostile takeover attempts (Bradley and Sundaram 2003), a particularly controversial issue. Just a week before its passing, an EU directive on this topic was blocked due to German resistance. This has to be seen in the light of the previous pro-takeover reforms, and the hostile *Vodafone-Mannesmann* (see Chap. 11) takeover, which happened in 2000 and revealed the newly created vulnerability of German firms to hostile takeovers. This highly debated takeover was an eye-opener for many former reform supporters, as *Mannesmann* was one of the traditional big German firms, and had no economic problems when it was taken over and split apart by *Vodafone*. In the light of this takeover support for further liberalization measures decreased.

One particular issue was that with the reduction of cross-shareholdings and the abandonment of golden shares, voting caps etc. German firms had given up a range of barriers to takeovers, which were still in place in most other EU countries. German companies feared that when the Directive would be passed, they would be

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<sup>24</sup>Banks have to choose between their own voting rights, if they hold an equity share above 5%, or if they want to vote the proxy votes of shares deposited with them. The law also includes some information duties for the banks.

<sup>25</sup>*Steuersenkungsgesetz*.

<sup>26</sup>*Wertpapiererwerbs- und Übernahmegesetz*.

asymmetrically exposed to foreign takeovers. The mobilisation against the takeover Directive at the EU level was paralleled by mobilisation against the national law. Due to this resistance, a range of measures that provided defence against hostile takeovers remained. Still, the German takeover rules today are among the most liberal ones (Cioffi 2006).

The Fourth Financial Market Promotion Act, which also came into force in 2002, enlarged the investment opportunities for institutional investors, and allowed new financial investors (e.g. hedge funds) to become active in Germany in 2004. In addition, it aimed to implement the 1997 Basel Core Principles for Effective Banking Supervision. The Act further enhanced investor protection, increased market integrity and transparency, and had a profound effect on rules governing prudential supervisory legislation. Lastly, another major change that took place in 2002 was the establishment of the Federal Financial Supervisory Authority (see above).

**The role of the Deutsche Bundesbank** As mentioned earlier, for a long time Germany was regarded as a laggard with regards to modality driven financial innovation. In parts, this was due to the Bundesbank, which resisted liberalisation and the introduction of many financial innovations due to concerns about the effectiveness of monetary policy, minimum reserve requirements, and a spread of short-termism. For example, for a long time and with the partial help of gentlemen's agreements, the Bundesbank limited the use of foreign DM-bonds<sup>27</sup>, certificates of deposits, zero-coupon bonds, and variable interest rate loans, and resisted the introduction of new financial actors such as money market funds. However, starting in the 1980s, the Bundesbank partially lost its capacity and willingness to slow down financial innovations, and secure high standards in banking regulation. Many of the transactions the Bundesbank wanted to inhibit in Germany were conducted abroad by subsidiaries and daughters of German banks, and restrictions in Germany led investors to pursue their business in financial centres like London or Luxembourg. In addition, restrictions inhibited foreign banks entering the German market, and allowed German banks to secure lucrative business for themselves at home. The Bundesbank was aware of these problems, but traditionally prioritised its target of monetary stability. It only changed its stance around the mid-1980s. The first signs of a change can be found in 1984, when the Bundesbank supported the abolishment of the coupon tax. After a 1985 Bundesbank internal paper stated that German banks were sheltered from the 'draught' of international competition by prevailing regulation, a major change took place. The paper criticised the Bundesbank for supporting monopoly rents for the banking industry and argued that the prevention of financial innovations in Germany drove residents to use foreign financial markets. Thereafter, the Bundesbank supported the strengthening of foreign banks in Germany, the abolishment of the stock exchange tax, and the liberalisation of bond issues. Overall, the Bundesbank concluded that new financial

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<sup>27</sup>A bond denominated in Deutsche Mark issued by a non-German entity.

innovations, such as derivatives and securitisations, did not inhibit its monetary policy to a large degree.

The Bundesbank was traditionally rather conservative in the area of banking supervision, where it advocated stricter rules. However, in the 1990s its influence on legislation in this area diminished, in favour of the EU and other international committees. Since then it could less often pursue its agenda to defend rather strict regulations (Franke 1998).

**The increasing influence of EU and international regulations** Starting in 1977, directives were introduced to gradually harmonise regulatory frameworks among EU member states and to create a single market for financial services. The First Banking Co-ordination Directive (77/780/EEC) set minimum licensing requirements and established the principle of home country control. In the following years, further advances were undermined by the inability to agree on a common set of regulations, and only minor changes in the areas of consolidation and accounting followed. A major leap in the harmonization of financial regulation followed the publication of the ‘Completing the Internal Market’ White Paper in 1985. The White Paper based the further integration of banking on three premises: single banking license, home country control, and mutual recognition. These premises were transformed into European law by the Second Banking Directive of 1989. This directive introduced the European Passport for banks. It allowed a bank licensed in one member state to conduct business in any of the other member states, while supervision remained the responsibility of the home country. This required further harmonisation in other areas, and as such in parallel capital requirements were harmonised on the basis of Basel I.

A further major step in the establishment of the internal market was the full liberalisation of capital movement, which was established by a directive in 1988 and had to be introduced in 1990. With the passage of a directive on deposit insurance another important and controversial area of regulation was addressed in 1994.

In 1999 the ‘Financial Sector Action Plan’ (FSAP), similar to the White Paper, listed a range of measures which were seen as essential to accomplishing the full integration of the EU capital and banking markets: a single EU wholesale market, open and secure retail banking and insurance markets, the development of state-of-the-art prudential rules and supervision, and optimal conditions, essentially fiscal rules, for an optimal single financial market (Dermine 2003).

The last step was taken by the White Paper on Financial Services Policy (2005–2010) published by the European Commission in 2005. The most important measures in this paper are the implementation and enforcing of existing rules stemming from the Financial Sector Action Plan, and the fostering of competition between financial service providers, in particular in retail markets (Paul and Uhde 2010). During the integration of EU-financial service markets many directives were passed in a range of areas, such as large exposure rules, investment services, deposit insurance, financial conglomerates, and crisis management, and only a few fields in banking and financial market regulation remained purely national (Heinrich and Hirte 2009).

In some areas EU legislation had no impact at all, since Germany already conformed to the demanded regulations. This was true for the directive on freedom of international capital movement, where Germany had already removed controls before the directive was passed. Similarly, when the first Banking Directive on minimum licensing requirements was passed, German regulation was already in line with it. In the areas of consolidation, financial conglomerates, and crisis management schemes, international regulation determined many of the introduced national rules, since there was no established system of regulation in place in Germany. In the area of consolidation legislative steps were only taken in Germany after a European Communities directive was enacted. Before, there were only agreements between supervisors and banks to voluntarily submit information. Consolidation requirements for financial conglomerates were also only established in Germany after a directive was passed at the European Communities level. The picture is different in the area of crisis management schemes. While at the EU-level a directive was prepared, Germany passed a national law before the directive was completed. However, the national law was already oriented along the expected directive. According to Wolfgang Schäuble, Minister of Finance at that time, this new approach, to pass national regulation already before international agreement is reached, is used to speed up the international processes and to set standards that trigger international regulations (Schäuble 2013b).

The effect of international and especially EU level regulations in areas where long standing national rules and regulations existed in Germany differed by the area of regulation. For example, in the area of deposit insurance, Germany had specific schemes for different groups of banks in place, and was reluctant to change those. Eventually it adapted the schemes to conform to the directive without making any substantial changes.

In the area of capital requirements there was also an established system of regulation in Germany. Here the influence of directives was quite substantial. This can be seen in particular in the issue of eligibility criteria for capital. Despite pressure from some groups of the finance industry on the national level to soften those criteria, the legislator was reluctant to do so, and the Bundesbank was strictly against it. However, a major change took place with the implementation of the 'Solvency and the Own Funds Directives' from 1992. Despite concerns of some national actors, introducing stricter national rules than the respective international agreement demanded was largely prevented due to concerns about the international competitiveness of German banks. While for many countries those new rules were stricter than what prevailed originally, harmonisation in this field meant a softening of standards for Germany. That the trend to soften equity criteria was misleading became clear when during the financial crisis in 2008 and the following years the problematically low level of capital in many banks was a major problem. With the new Capital Requirements Regulation from 2013 the directive has been reversed and only capital of higher quality can fulfil regulatory requirements. However, this lesson came at high cost to the public purse and economic development in general.

To sum up, the effect of EU legislation on the German regulatory framework was quite diverse. Sometimes there were no effects, and sometimes the EU legislation

added important elements to the national regulatory framework. However, sometimes the EU legislation led to a misguided softening of the national standards. In the last case, Germany reduced its resistance more and used national freedom for stricter rules less and less (Detzer and Herr 2014; Detzer 2014).

### 6.3.4 *The Effects of the Financial Crisis After 2007*

The 2007 financial crisis and the crisis in the Euro area have led to far reaching changes in financial regulation and supervision in the EU, and therefore in Germany. We will not attempt to detail all the numerous changes here, but will rather give an overview of the most important ones and discuss some of Germany's concerns and preoccupations with the new regulations.<sup>28</sup> As a direct response to the financial crisis, substantial revisions to banking and securities market regulations were made. Among others, regulations concerning capital requirements, deposit insurance, large exposures, consolidation, corporate governance, credit rating agencies, investment funds and accounting were affected. A novelty in this process was the aim to establish a single rulebook for the EU as a whole. In practice this meant that some key regulations were not passed in form of a directive, which would leave substantial national discretion (e.g. the Capital Requirement Directive (CRD) III had more than 100 national options), but in the form of EU regulation, which is directly applicable.

An area that received particular attention in public discourse was the reform of capital requirements, which were first changed by the CRD II (2009) and then by CRD III (2010). Eventually, substantial amendments were made by the CRD IV in 2013, which introduced the internationally agreed Basel III regulations. As a major change to previous EU regulation it substantially increased the eligibility criteria for regulatory capital, and increased the total amount of risk-weighted capital banks need to hold. Additionally, it made some minor amendments regarding the use of internal risk models (Detzer 2014; Masera 2014).

As shown above, there are large numbers of public and cooperative banks active alongside the private sector in Germany. Public and cooperative banks are integrated in specific group networks and are central to the German economic model, providing bank finance to a large part of non-financial corporations. However, these banks are in parts highly leveraged and local governments and cooperative members may have difficulties with increasing the equity of public and cooperative banks quickly. Also, private German banks are relatively high leveraged in international comparison.

According to Howarth and Quaglia (2013a) these specific features made Germany an advocate of softening the Basel III rules when they were implemented as CRD IV. In addition, the high leverage ratio of its banks led Germany to oppose

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<sup>28</sup>For a detailed discussion of the changes by policy area see Detzer and Herr (2014).

the introduction of a binding un-weighted leverage ratio, which in the end was not included in the CRD IV. This opposition was also based on the importance of trade credit for German companies, which is high in volume but regarded as low risk.

A further problem occurred since Basel III was developed with large listed commercial banks in mind. The German banking sector includes a huge number of non-listed public and cooperative banks. For these banks, alternative forms of capital, such as silent participation, play a major role. Germany pushed for amendments, so as not to put these banks at a disadvantage. In particular, the classing of silent participation as tier-1 capital was a key concern. Originally, as a hybrid form of capital it was excluded from the first tier in the Basel framework. Finally, the generally higher importance of bank credit for German firms, in particular small and medium ones, led to a heightened opposition to too strict equity measures, as these would be more severe in Germany than in more market-based financial systems. Overall, Germany succeeded in getting exceptions into the CRD IV that considered the specifics of the German banking system.

## 6.4 Conclusion

Germany has been the prototype of a bank based financial system. The banking system became strictly regulated after the Second World War. Capital markets played an unimportant role and were largely controlled by a system of self-regulation. Until the 1980s the Bundesbank as well as the German government played an important stabilising role, preserving the existing system. Financial innovations, which could make the financial system less stable, and new types of financial institutions, like money market funds and hedge funds, were not allowed. This changed moderately in the 1980s and more strongly from the 1990s onwards.

The wave of deregulations in the banking industry, more capital market friendly regulations, and the support of financial innovations as well as the aim of making Germany an internationally important financial centre reflected a change in German government policy. Especially after 1998, under the red-green coalition, the deregulation of financial markets and labour markets became an economic and political project, which was supported by the finance industry and the Bundesbank. The big private banks lost part of their business when big companies started to refinance themselves increasingly in capital markets and abroad. Probably more important, the big German banks wanted to go global and take part in the high profits earned in booming financial markets with myriads of innovations. Some of the *Landesbanken* also wanted to get a part of the seemingly big cake of financial markets. The Bundesbank no longer resisted the deregulation of financial markets and, as many other central banks in the world, may have started to believe in the doctrine of efficient financial markets which became mainstream in that time. From the 1980s on, the international competitiveness of German financial institutions also became a topic, and led to laxer and market friendly regulations. At the same time, the regulatory system in Germany became more and more influenced by EU

regulation, which was almost entirely in the spirit of the belief in efficient financial markets, and the belief that deregulation of markets would increase efficiency and growth. Germany was reluctant to take over such rules at first, but gave up most of its resistance from the 1990s on.

In spite of the large and positive role of the bank based financial system in the ‘German miracle’ after the Second World War, a more market based system was tried to be established in the 1990s and 2000s. While EU legislation had some influence on these changes, the pressure for reform came largely from within. Banks, large firms, social democrats and conservatives all pushed for these changes. Only when the effects became clear with the *Vodafone-Mannesmann* deal, did tides turn and did further adoption of Anglo-American practices into the German system come to a halt. Nevertheless, the German system has undergone substantial changes and many elements, typically associated with market-based Anglo-Saxon financial systems, have been at least formally adopted. The German capital market has become more transparent and more easily accessible for foreign investors. The German corporate network has been partly untangled, outsider control has increased, and the market for corporate control has been strengthened.

Overall, from a legal perspective the German regulatory framework changed and provides the floor for a bigger role of financial markets. The big private banks and some of the *Landesbanken* used this new freedom, mainly for business abroad, and were also heavily affected by the sub-prime financial crisis. The domestic financial system, however, only changed moderately. Savings and cooperative banks play a big and important role, and did not change their business models. Private wealth owners only temporarily showed more interest in stock markets during the new economy bubble of the 1990s. Cross-holding of shares between financial institutions and bank companies decreased, and markets for corporate governance were established, but due to strong co-determination rights almost all big firms still follow more of a stakeholder corporate governance model than a shareholder approach (see also Vitols 2004; Cioffi 2006).

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**Part II**  
**Competition, Profitability and Efficiency**

## Chapter 7

# The Nature and Degree of Competition

**Abstract** 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 have been 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. 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.

### 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.<sup>1</sup> 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 Chap. 4). Hence, the large number of credit institutions in Germany does not necessarily indicate a large degree of competition.

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 Indices for

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<sup>1</sup>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 (Krahen 2005, VII).

**Table 7.1** Herfindahl Indices, 1997–2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Germany	114	133	140	151	158	163	173	178	174	178	183	191	206
France	449	485	509	587	606	551	597	623	727	726	679	681	605
Italy	201	210	220	190	260	270	240	230	230	220	328	344	353
UK	208	221	250	264	282	307	347	376	399	394	449	412	467
EU 25/27 unw. average					1185	1198	1186	1171	1135	1106	1106	1120	1102
EA 12/16 unw. average	383	429	468	508	885	904	947	966	1052	1022	1032	1091	1076

Source ECB (2002, 2005, 2010)

**Table 7.2** CR5, 1997–2009 (%)

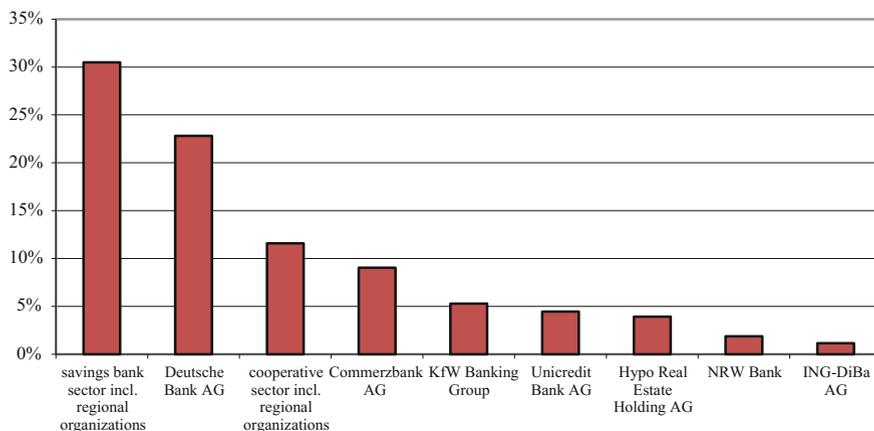
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Germany	17.0	19.0	19.0	20.0	20.2	20.5	21.6	22.1	21.6	22.0	22.0	22.7	25.0
France	40.0	41.0	43.0	47.0	47.0	44.6	46.7	44.7	51.9	52.3	51.8	51.2	47.2
Italy	25.0	25.0	25.0	23.0	28.8	30.6	27.0	26.0	26.8	26.2	33.1	33.0	34.0
UK	24.0	25.0	28.0	28.0	28.6	29.6	32.8	34.5	36.3	35.9	40.7	36.5	40.8
EU 25/27 unw. average					59.5	59.8	59.5	59.0	59.3	59.0	59.5	59.6	59.5
EA 12/16 unw. average	45.0	47.0	49.0	51.0	51.9	52.8	53.2	52.9	56.7	56.4	56.7	57.0	57.0

Source ECB (2002, 2005, 2010)

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.

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% 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 or 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% and a CR5 of 46% for Germany. The five largest institutions are *Deutsche Bank AG*,



**Fig. 7.1** Balance sheet size of banks, Germany, 2010 (% of total sector balance sheet). *Source* Deutsche Bundesbank (2012), Frankfurter Allgemeine Zeitung (2011), own calculations

*Commerzbank AG*, *KfW Banking Group*, *DZ Bank AG* and *Landesbank Baden-Württemberg (LBBW)* (see Chap. 4, Table 4.2). These ratios are already considerably higher than those the ECB has calculated.

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 (Süchting and Paul 1998, p. 32). Taking this into account, we plot Fig. 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% and a CR5 of 79%. Moreover, the Herfindahl Index would be above 1800, which would mean a high degree of concentration. In addition, one has to note that Fig. 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.<sup>2</sup>

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)<sup>3</sup>, 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 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

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<sup>2</sup>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 complement 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).

<sup>3</sup>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*.

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's 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%. The average CR2 is at 55% and the CR3 at 65%. 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% of the local branch network, while the local savings banks operate 40% of local branches and cooperative banks run 22% 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

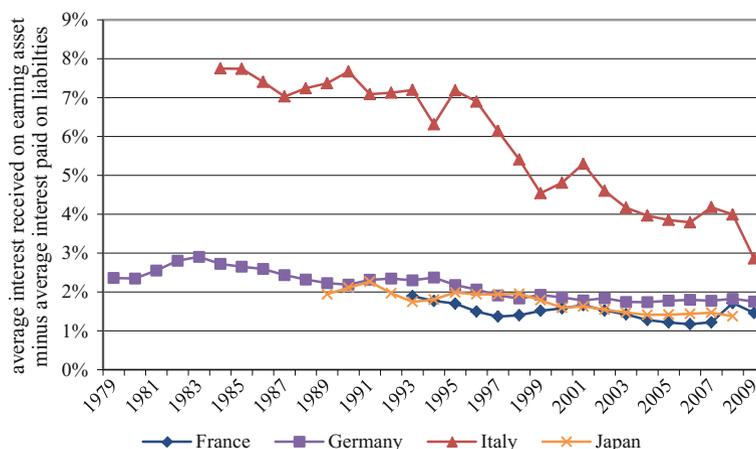
OECD data on bank profitability, bank balance sheets and short-term interest rates were used to calculate a range of figures that can give an indication of the competition among banks (for more details on profitability see also Chap. 8). The banks' interest spread can be seen as an overall indicator for competition<sup>4</sup> 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 Fig. 7.2.

For Germany, the interest spread fell from 1984 to 1999; before this period, it increased from 2.4 to 2.9%. Since 1999, the spread has remained relatively stable at around 1.8%. Since the year 2000, the comparative figures for Japan and France have been consistently 0.25–0.50% 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,

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<sup>4</sup>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.



**Fig. 7.2** Interest rate spreads, France, Germany, Italy, Japan, 1979–2009. *Source* OECD (2012), own calculations

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

	1980–1984	1985–1989	1990–1994	1995–1999	2000–2004	2005–2009
Excess of the average interest return over the short-term interest rate	0.03	1.70	−0.21	2.49	2.13	2.07
Excess of the short-term interest rate over average rate paid on liabilities	2.64	0.75	2.52	−0.51	−0.34	−0.28
Average short-term interest rate <sup>a</sup>	8.46	5.11	7.98	3.53	3.28	3.08
Average spread	2.67	2.44	2.30	1.98	1.79	1.79

*Source* OECD (2012), own calculations

<sup>a</sup> 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

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 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% 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% 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.

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 (*Deutsche Bank, Dresdner Bank, Commerzbank*) dominated the market. The only public bank that competed in

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

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

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 book runner for one single issue. A book runner is the main underwriter in equity or debt issuance

<sup>a</sup>The Herfindhal Index here runs between 1 and 0 instead of 10,000 and 0

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.

In Table 7.5 we extend the period of consideration to October 2012, but include only IPOs above 50 million euros. 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%. 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.

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

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

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

Source Deutsche Bank (2012), own calculations

Notes IPOs of German companies with minimum issue volume of 50 million euros, 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

<sup>a</sup>The Herfindhal Index here runs between 1 and 0 instead of 10,000 and 0

*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.

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 the business was conducted by the big US-investment banks (Fischer and Pfeil 2004, pp. 314–315).<sup>5</sup>

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.

<sup>5</sup>For further details see Chap. 11.

**Table 7.6** Market structure of euro-denominated bond underwriting, Germany, 2001

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

Source Fischer and Pfeil (2004, p. 315)

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 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 and 60% 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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## Chapter 8

# Profitability of the Financial Sector and Sub-sectors

**Abstract** 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 has converged and private banks have gained 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 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. 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.

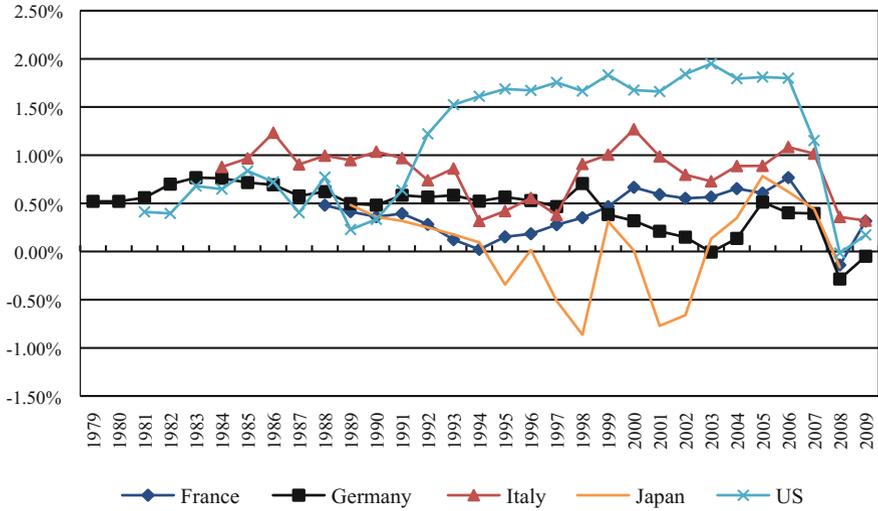
### 8.1 Introduction

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 subsectors 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.

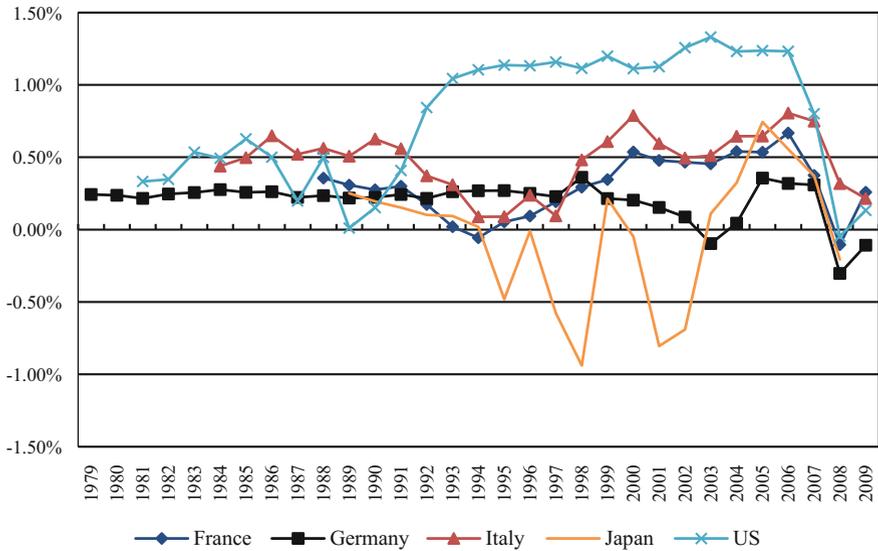
## 8.2 Profitability of the German Banking Sector in International Comparison

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 Chap. 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 ‘(al)though 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.

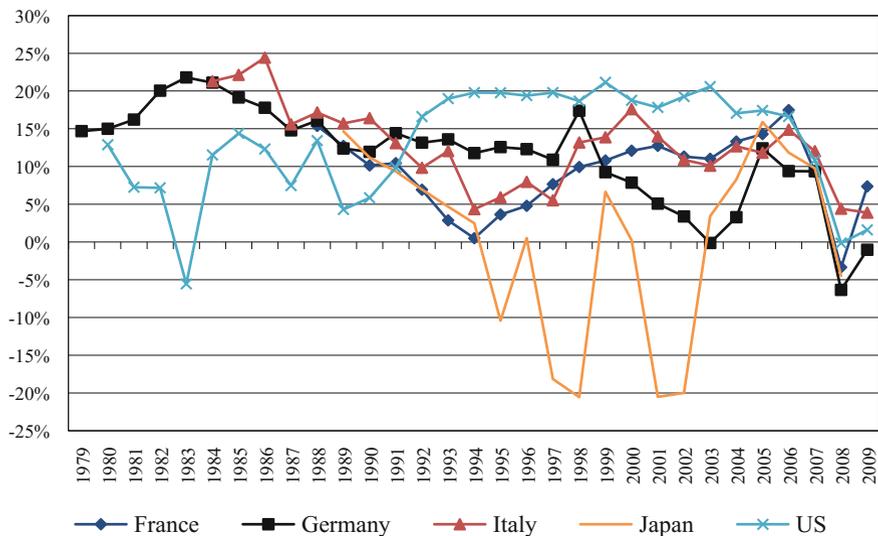
Extending the analysis by Hackethal (2004) till 2009 with data from OECD (2012), we find that the German banking sector as a whole since the early 2000s did not manage to improve the return on equity and the return on assets significantly. The rates of return on assets and on equity have shown a tendency 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 (Figs. 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 (Figs. 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 [...] 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.



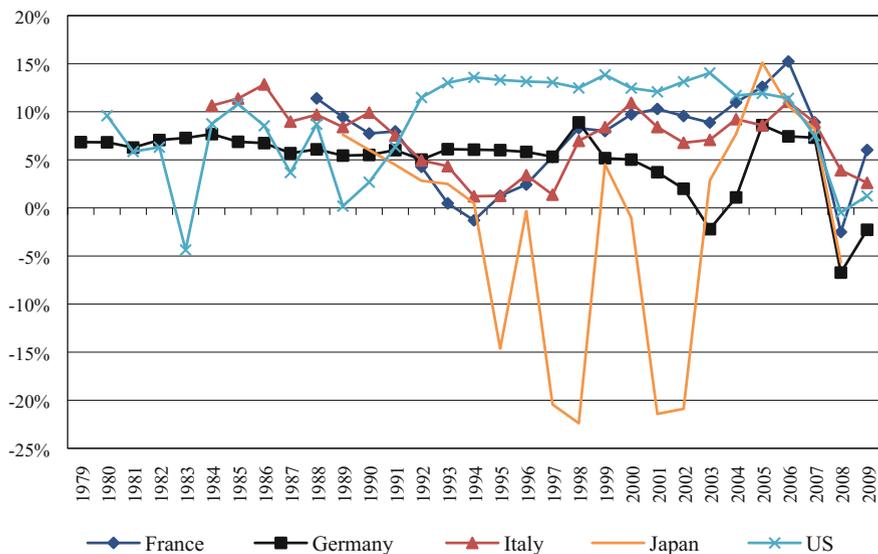
**Fig. 8.1** Return on assets (before tax) of the banking sector, France, Germany, Italy, Japan, US, 1979–2009 (%). *Source* OECD (2012)



**Fig. 8.2** Return on assets (after tax) of the banking sector, France, Germany, Italy, Japan, US, 1979–2009 (%). *Source* OECD (2012)



**Fig. 8.3** Return on equity (before tax) of the banking sector, France, Germany, Italy, Japan, US, 1979–2009 (%). *Source* OECD (2012)



**Fig. 8.4** Return on equity (after tax) of the banking sector, France, Germany, Italy, Japan, US, 1979–2009 (%). *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% of all banks are not strictly profit maximising; around 20% belong to the public savings bank sector, which in 2012 accounted for close to 30% of total banks' assets and close to 60% are part of the cooperative banking sector, which in 2012 accounted for close to 12% of total banks' assets (see Chap. 4, Table 4.1).

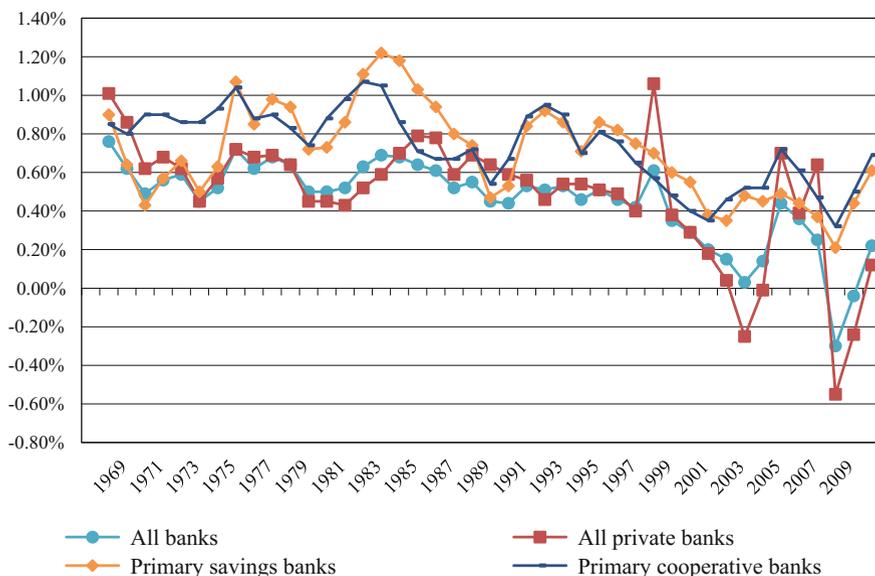
It is striking that the returns on assets before taxes of the public savings banks (without *Landesbanken*, the regional institutions of the public savings bank sector) and the cooperative banks (without regional cooperative banks) have exceeded the rate of return of the private banks almost consistently since the early 1970s; the latter's rates of return have also been fluctuating more violently (Fig. 8.5).<sup>1</sup> Only when taxation is taken into account do the rates of return of the different subsectors converge (Fig. 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 (Fig. 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 (Fig. 8.8). Although taxation reduces the rates of return in each sector, it relatively favours the private banking sector.

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 (Figs. 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 (Figs. 8.10 and 8.12).

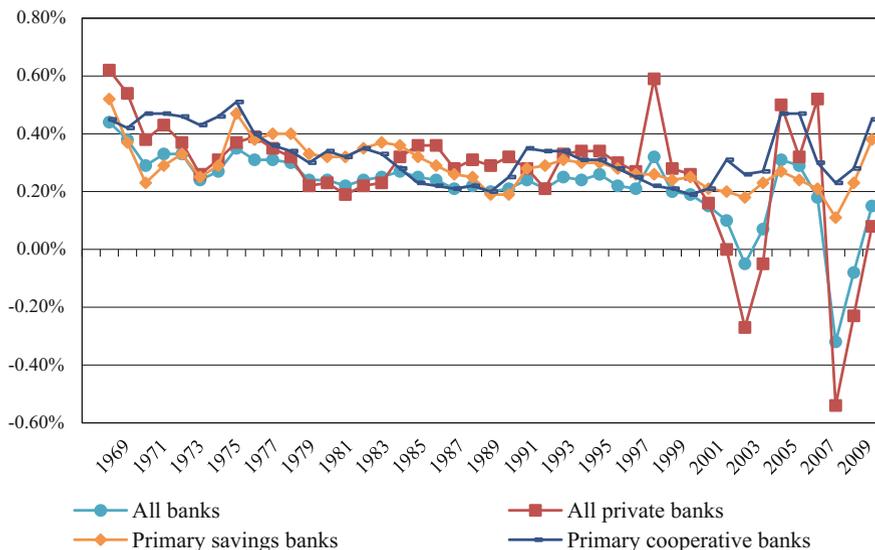
This change in profitability ranking is due to the particularly low profitability of the *Landesbanken*. This also becomes obvious when looking at the profitability of the big banks in each sector and applying the same criteria as above. Regarding the rates of return on assets before taxes we find that 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 (Fig. 8.13). The regional cooperative banks perform close to average. A similar

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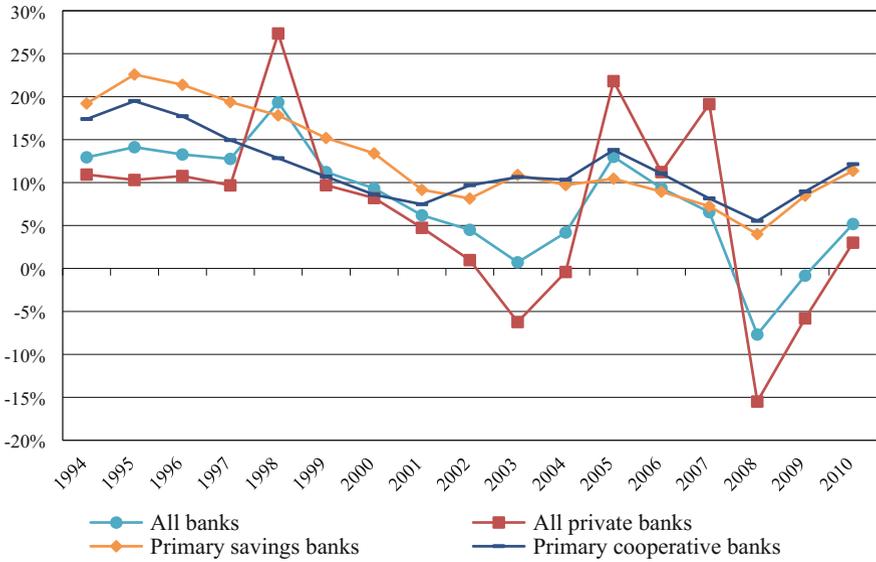
<sup>1</sup>This observation is hard to reconcile with the IMF's (2011, pp. 14–21) finding that German public savings banks, on the one hand, face a higher than average cost-income ratio, and on the other hand provide implicit subsidies to their customers through lending at lower than market rates.



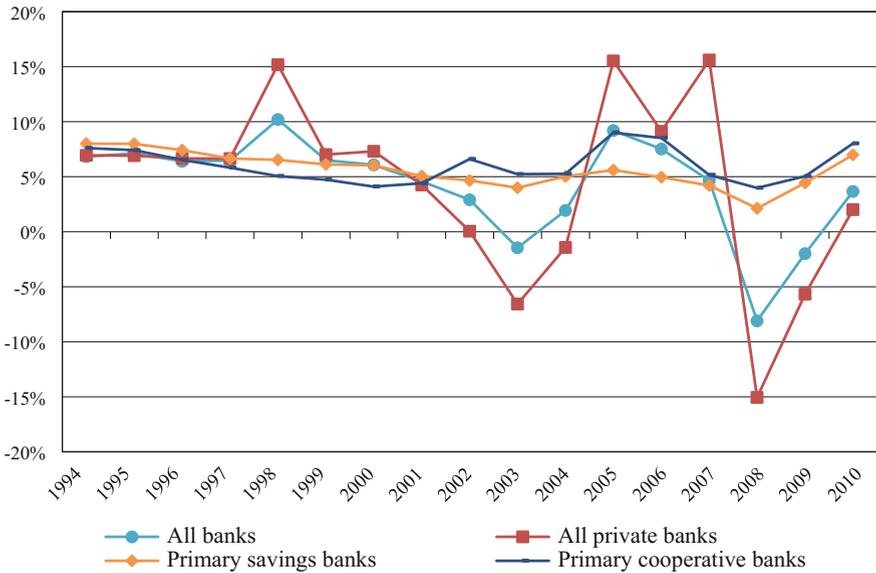
**Fig. 8.5** Return on assets (before taxes) by banking group, Germany, 1968–2010 (%). *Source* Deutsche Bundesbank (2011)



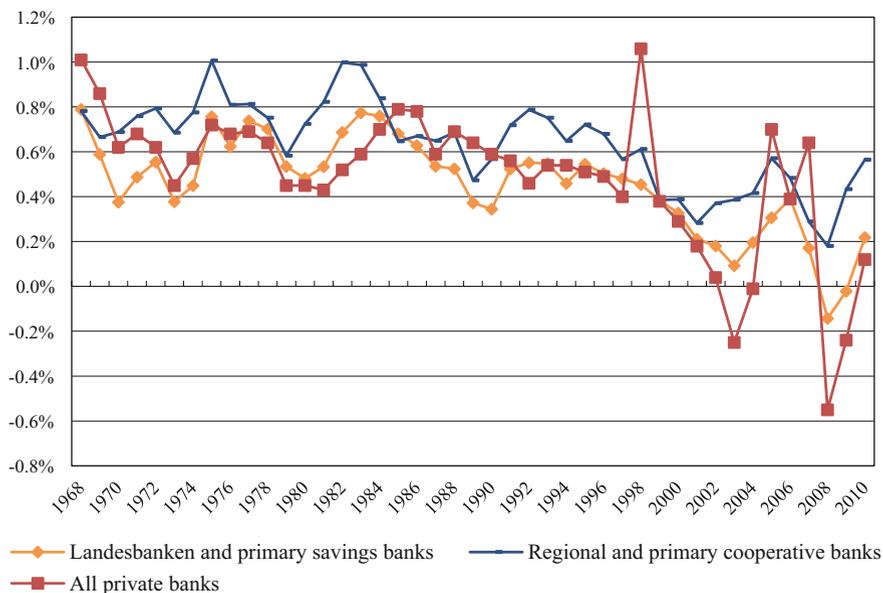
**Fig. 8.6** Return on assets (after taxes) by banking group, Germany, 1968–2010 (%). *Source* Deutsche Bundesbank (2011)



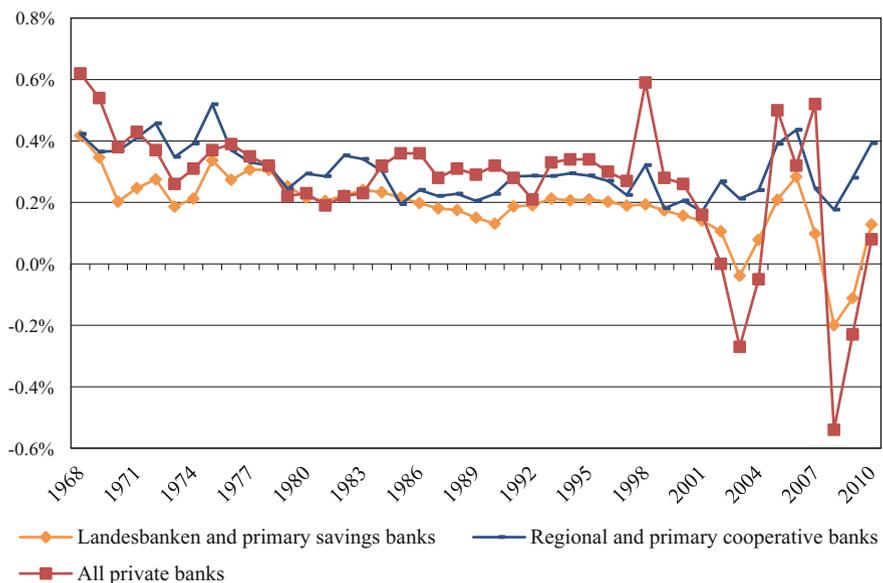
**Fig. 8.7** Return on equity (before taxes) by banking group, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)



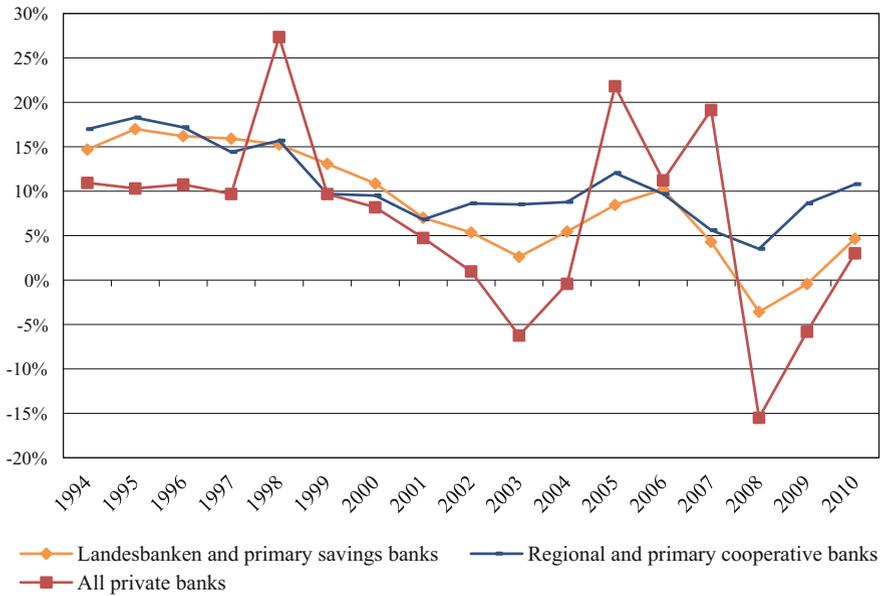
**Fig. 8.8** Return on equity (after taxes) by banking group, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)



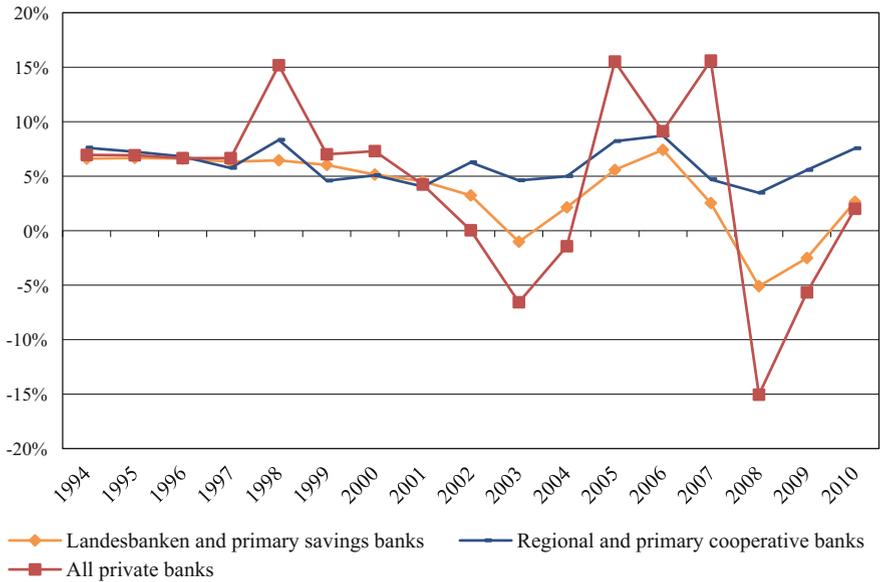
**Fig. 8.9** Return on assets (before taxes) by banking group, Germany, 1968–2010 (%). *Source* Deutsche Bundesbank (2011)



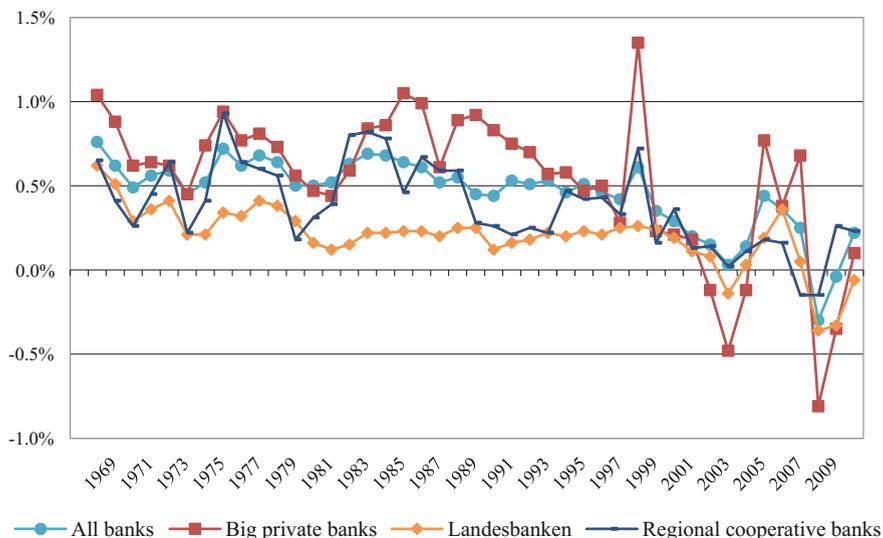
**Fig. 8.10** Return on assets (after taxes) by banking group, Germany, 1968–2010 (%). *Source* Deutsche Bundesbank (2011)



**Fig. 8.11** Return on equity (before taxes) by banking group, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)



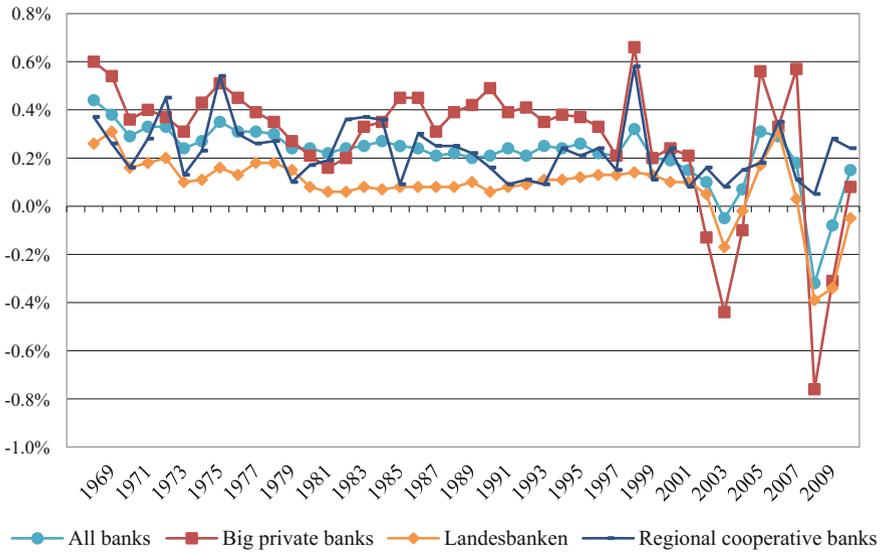
**Fig. 8.12** Return on equity (after taxes) by banking group, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)



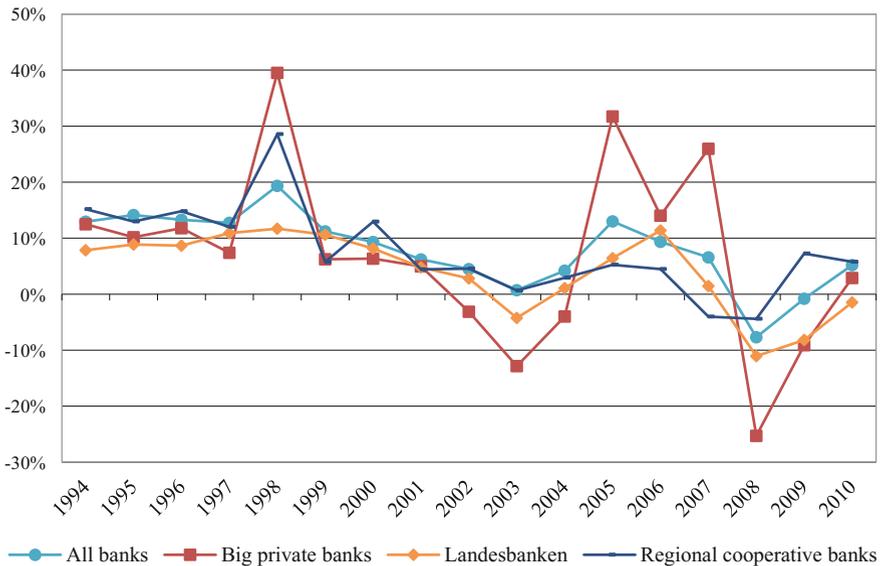
**Fig. 8.13** Return on assets (before taxes) for big banks, Germany, 1968–2010 (%). Source Deutsche Bundesbank (2011)

pattern emerges for the rate of return on assets after taxes (Fig. 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 (Figs. 8.15 and 8.16).

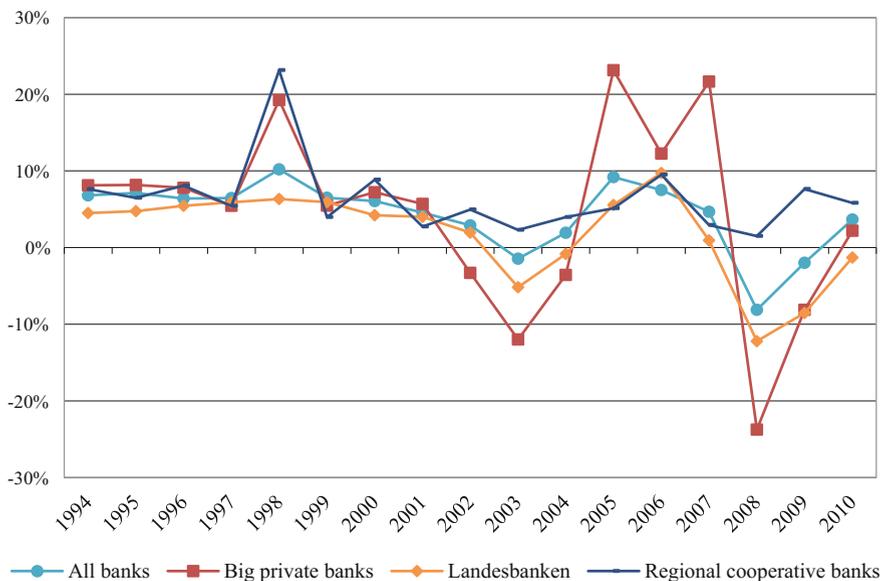
Summing up so far, the profitability of German banks in international comparison has been below average since the early 1980s; pre-tax profitability has shown a tendency to fall from the early 1980s till the recent crisis, whereas after-tax profitability has not; pre-tax profitability of the public savings banks, excluding the *Landesbanken*, and the cooperative banks, 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 converges 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.



**Fig. 8.14** Return on assets (after taxes) for big banks, Germany, 1968–2010 (%). *Source* Deutsche Bundesbank (2011)



**Fig. 8.15** Return on equity (before taxes) for big banks, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)

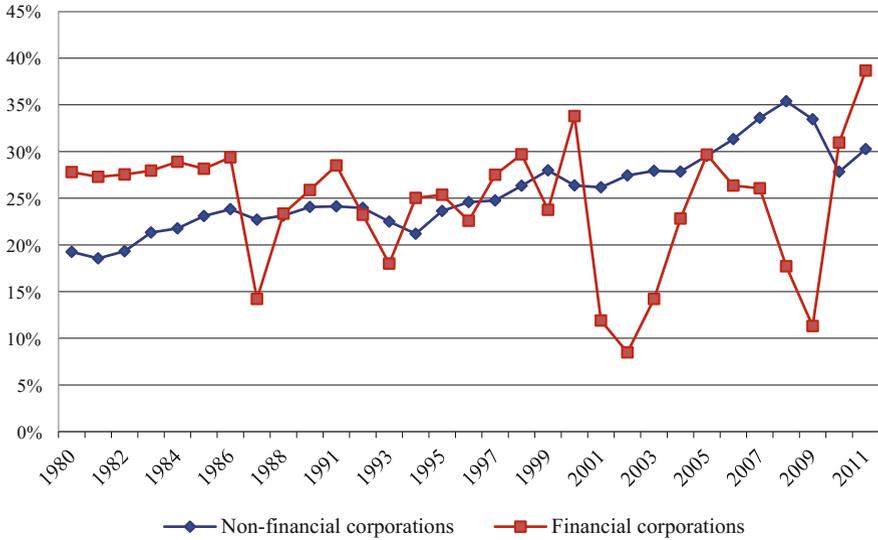


**Fig. 8.16** Return on equity (after taxes) for big banks, Germany, 1994–2010 (%). *Source* Deutsche Bundesbank (2011)

## 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 Chap. 3 of this book, the 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.

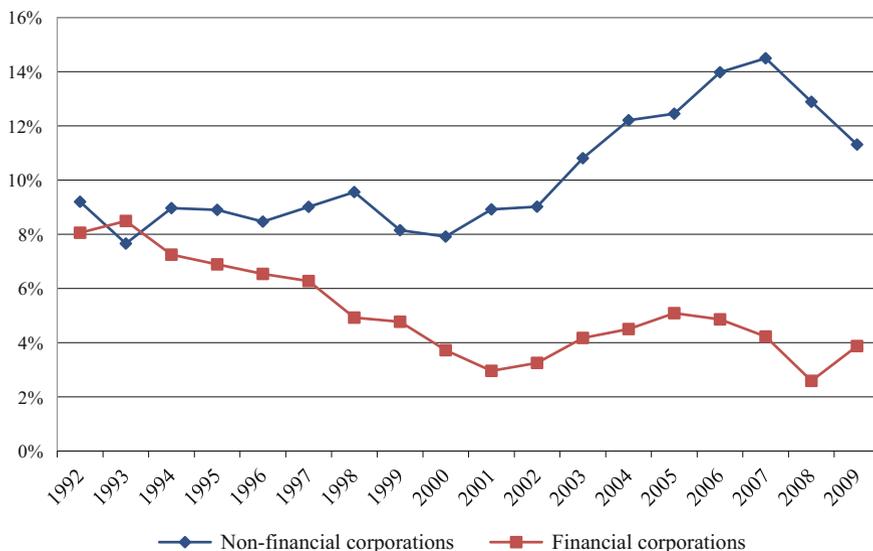
The sectoral profit share relates the sectoral operating surplus to the sectoral value added and provides some information about distribution of net value added produced in each sector between capital and labour. In an earlier study on the US and Germany, Dünhaupt (2012) found for Germany that since the early 1980s the wage share in the financial corporate sector has been fluctuating around 70%



**Fig. 8.17** Sectoral net operating surplus, Germany, 1980–2011 (% of sectoral net value added). Source Statistisches Bundesamt (2012)

without any long-run downward or upward tendency, whereas the wage share in the non-financial corporate sector having been around 75% 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 confirms this finding (Fig. 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.

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 Fig. 8.18, the pattern for the financial corporate sector broadly replicates the falling trend for the banking 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



**Fig. 8.18** Sectoral returns on equity, Germany, 1992–2009 (%). *Source* Statistisches Bundesamt (2012)

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.

## 8.5 Conclusion

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 converges 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.

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## Chapter 9

# Efficiency of the Financial Sector

**Abstract** The evidence regarding the efficiency of the German banking 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. 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. 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. Suboptimal size of German banks is not a significant factor either. 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.

### 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%, the respective bank could reduce its cost by 10% 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 are 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<sup>1</sup>) 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

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<sup>1</sup>'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.

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 and Pastor (1997). They use 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 built a common frontier from all banks and regarded the differences in efficiency as attributable to bank managerial decisions, Lozano and Pastor (1997) included variables that account for country specific environmental factors. The environmental factors considered 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 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% 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%, 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% for Portugal and 52.5% for Luxembourg. Germany ranks fourth with an average efficiency of 39.9%, 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%. The models suggest that about 20% 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% they find average EU-values for cost efficiency of 90.7–91.4% depending on the estimation method. Germany scores between 86.5 and 87.3% and ranks ninth regarding cost efficiency. Looking at profit efficiency the estimated EU-average is between 82.6 and 84.3%. Germany scores between 82.7 and 86.8% and ranks fourth or fifth.

Sheldon (2000) used DEA and a production approach to examine cost- and profit efficiency for different countries for the period 1993–1997. 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% of the measured inefficiency is related to suboptimal size, and the rest is related to X-inefficiency.

Casu and Molyneux (2000) use 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%. 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 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%, which is slightly better than the EU average. Regarding X-inefficiency, German savings banks reach a level of 21.2% 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%. 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% (seventh rank, average 79.8%). However, profit efficiency for German commercial banks is very low. Germany ranks last with an efficiency score of 43.3% (average 58.4%).

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 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

This section looks at studies that focus on Germany 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 three studies dealt with Germany. Here efficiency scores for Germany of 77–81, 93 and 54–61% were found in studies published in 1995 and 1996.

Lang and Welzel (1999) 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% of the German banking sector. With their approach, they can distinguish different cost factors. They find that positive economies of scale effects are only achieved up to an average balance sheet size of 1–2.5 billion euros. 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 SFA and the 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 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%, while Austrian is at 42%. Looking at the scale efficiency he finds that medium sized banks (balance sheet size of 10–100 billion euros) are most efficient, followed by small banks (less than 10 billion euros) and with large banks being least efficient (more than 100 billion euros). 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,<sup>2</sup> 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 must 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 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%. Koetter (2005a) finds also that banks located in Eastern Germany perform consistently worse regarding cost efficiency. Besides this he groups the banks into four categories: local private banks, local cooperative banks, local savings banks and as a fourth group nationally

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<sup>2</sup>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.

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%, and with alternative input prices of 64.3%. 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.<sup>3</sup>

Koetter (2006) uses 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% would, for example, mean that returns could be 10% 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% and profit efficiency to 55%. Those values are in a normal range. The measured RRE is higher at 83.8%. 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 cooperatives, local private commercial and, finally, nationally active banks.<sup>4</sup> Additionally, he finds increasingly worse risk return efficiency with size. The negative effect starts from a mean balance sheet size of 339 million euros—far smaller than many banks in Germany.

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<sup>3</sup>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.

<sup>4</sup>Includes *Commerzbank*, *Deutsche Bank*, *Dresdner Bank*, *Hypovereinsbank*, *Postbank*, regional cooperative institutions and the *Landesbanken*.

## 9.5 The Effect of Mergers on the 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 1989–1997. All together they examine 283 mergers. They are able to distinguish between size- and X-efficiency. As an average value for efficiency, they find X-efficiency of 92% 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% in costs if no branch of the acquired bank is closed to -2.1% 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.

## 9.6 Conclusion

The international evidence regarding the efficiency of the German banking 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 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<sup>5</sup> 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 euros (Lang and Welzel 1998) and 10–100 billion euros (Hauner 2004). Regarding the optimal risk return choices, a negative effect was measured above an average size of 339 million euros (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 euros, about 28% of the savings banks could increase their scale efficiency through mergers, as could about 90% of the cooperative banks (DSGV 2011; 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 enterprises, which are an important part of the German economy. Additionally, some of the scale effects may already be achieved by cooperatives and savings

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<sup>5</sup>Additionally, Hauner (2004) first finds lower efficiency levels for larger banks, but positive economies of scale in all size classes.

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 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.

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**Part III**  
**Finance and the Non-financial Sector**

# Chapter 10

## Sources of Funds for Business

### Investments: Non-financial Corporate Sector and Small and Medium-sized Enterprises (SMEs)

**Abstract** The profitability of the non-financial business sector increased considerably from the early 1990s until the Great Recession, but investment in capital stock was weak. 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. Increasing received financial profits (interest and dividends) indicate 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’). And increasing dividends paid out to shareholders indicate 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 have been 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, as well as corporate bond issues, have not been 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. Periods of high investment are associated with increasing credit and increasing debt-capital ratios. The decline in credit to non-corporate firms since the financial and economic crisis has been mainly caused by a lack of demand for the output of these firms, and not by a lack of access to credit.

## 10.1 Introduction

In the literature analysing the macroeconomic effects of financialisation, it has been argued that, apart from the redistributive effects to be discussed in Chap. 15 of this book and the effects on consumption and saving of private households to be analysed in Chap. 13, financialisation has affected investment in capital stock negatively (Hein 2012, Chap. 3). 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 has mainly focussed on the US. In an earlier study, Stockhammer (2004) 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 Chap. 6 of this book.

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.

Orhazan 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 stocks) on investment is negative for the whole panel.

Tori and Onaran (2016) have estimated the effects of financialisation on physical investment in the UK (1985–2013) using panel data for publicly listed non-financial companies. They find robust adverse effects of financial payments (interests and dividends), as well as financial incomes on the rate of accumulation. The negative impacts of financial incomes from interests and dividends were particularly strong for the pre-crisis period.

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 sector, profitability, and investment in capital stock in Sect. 10.2. Section 10.3 will focus on the sources and the uses of profits (gross operating surplus) of the non-financial corporate sector. Section 10.4 will then deal with investment and capital stock finance of the non-financial corporations, and Sect. 10.5 will present some evidence on this issue for non-corporate business and small- and medium-sized enterprises (SMEs). Section 10.6 will summarise and conclude.

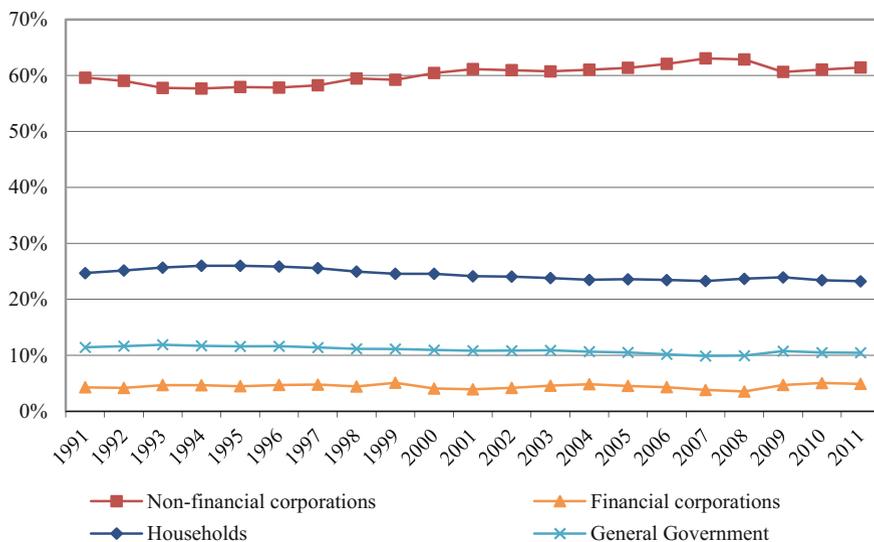
## 10.2 Sectoral Composition, Profit Shares and Real Investment

As was already mentioned in Chap. 3 of this book, 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 2008/2009, it were 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 (Figs. 10.1 and 10.2).

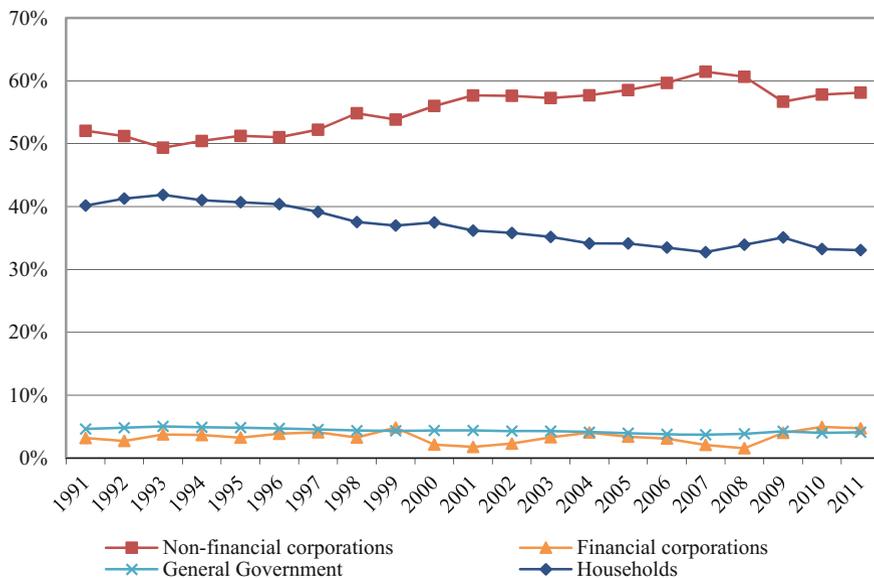
The profitability of the non-financial corporate sector, indicated by the share of gross operating surplus in gross value added of the sector, showed a strong tendency to increase from the early 1990s until the Great Recession, whereas the financial corporate sector was rather characterised by a highly fluctuating profit share without a pronounced trend till then (Fig. 10.3).<sup>1</sup> It was only during the

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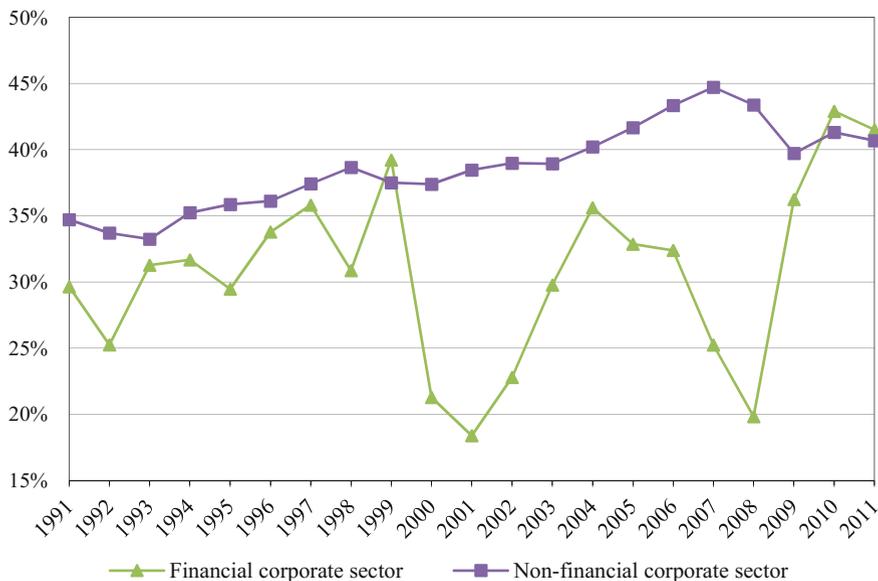
<sup>1</sup>See also Chap. 8 this book for more details on the profitability in the financial sector.



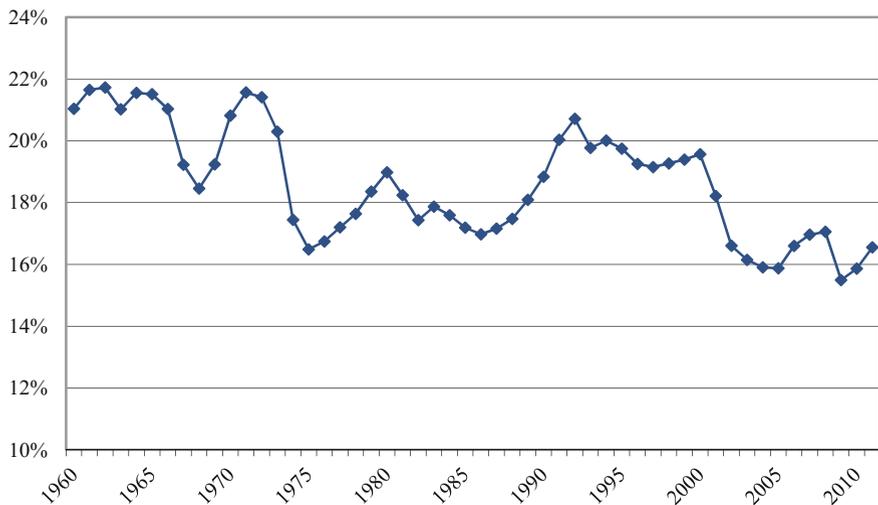
**Fig. 10.1** Sectoral shares in nominal gross value added, Germany, 1991–2011 (% of total). *Source* Statistisches Bundesamt (2012), own calculations



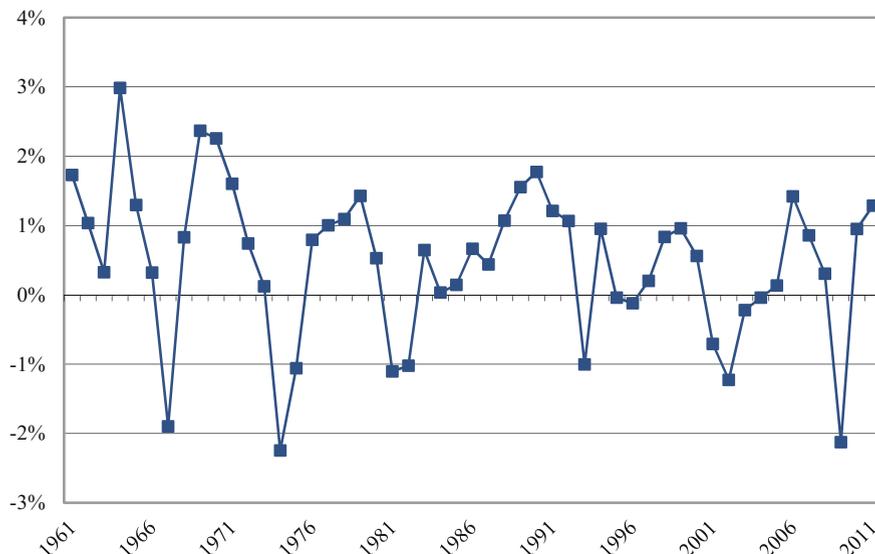
**Fig. 10.2** Sectoral shares in nominal gross operating surplus and mixed income, Germany, 1991–2011 (% of total). *Source* Statistisches Bundesamt (2012), own calculations. *Notes* Mixed income is the surplus or deficit accruing from production by unincorporated enterprises owned by households; it implicitly contains an element of remuneration for work done by the owner, or other members of the household, that cannot be separately identified from the return to the owner as entrepreneur but it excludes the operating surplus coming from owner-occupied dwellings (UN SNA 2012)



**Fig. 10.3** Sector gross operating surplus, Germany, 1991–2011 (% of sector gross value added).  
 Source Statistisches Bundesamt (2012), own calculations



**Fig. 10.4** Gross fixed capital formation of the private sector, Germany, 1960–2011 (% of GDP).  
 Source European Commission (2012), own calculations



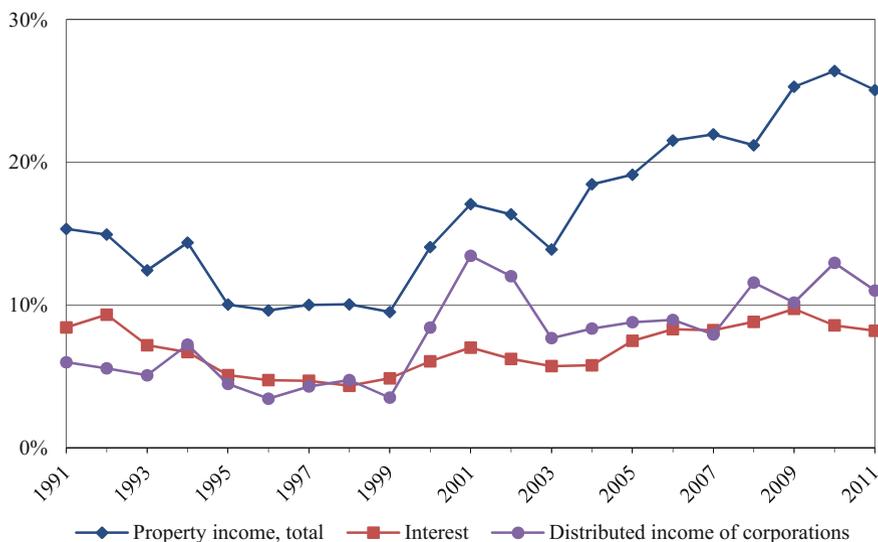
**Fig. 10.5** Real GDP growth contribution of gross fixed capital formation, Germany, 1961–2011 (percentage points). *Source* European Commission (2012)

recovery from the Great Recession in 2010 and 2011 that the profit share of financial corporations managed to catch up with non-financial corporations.

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 the German unification boom in the early 1990s (Fig. 10.4). 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 (Fig. 10.5). Therefore, a closer look at sources and uses of profits of the non-financial corporate sector will be taken in the following section.

### 10.3 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



**Fig. 10.6** Received property income of non-financial corporations, Germany, 1991–2011 (% of sector gross operating surplus). *Source* Statistisches Bundesamt (2012), own calculations

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 Fig. 10.6 shows, this is exactly what can be found for German non-financial corporations since the early 2000s. Property income received, consisting of interest, distributed income of corporations (i.e. dividends, property income attributed to insurance policy holders and rents) increased significantly relative to the 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 the real capital stock of non-financial business.<sup>2</sup>

Another indicator for the effects of an increasing shareholder value orientation of management on investment in the capital stock is the share of profits distributed to shareholders. Retained profits are an important determinant of investment in the capital stock, because they lift the finance constraints firms are facing in incom-

<sup>2</sup>See also Chap. 3 of this book where the change in the composition of the stock of assets held by non-financial corporations is shown.

pletely competitive financial markets.<sup>3</sup> 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 10.7 shows that such a phenomenon can be observed for German non-financial corporations. Distributed property income relative to the gross operating surplus tended to rise starting in 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 profits 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.

## 10.4 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.<sup>4</sup> Here, this type of analysis is extended to the most recent data available until 2010.<sup>5</sup> The method of calculation for the different sources of financing of gross investment is described in Table 10.1.

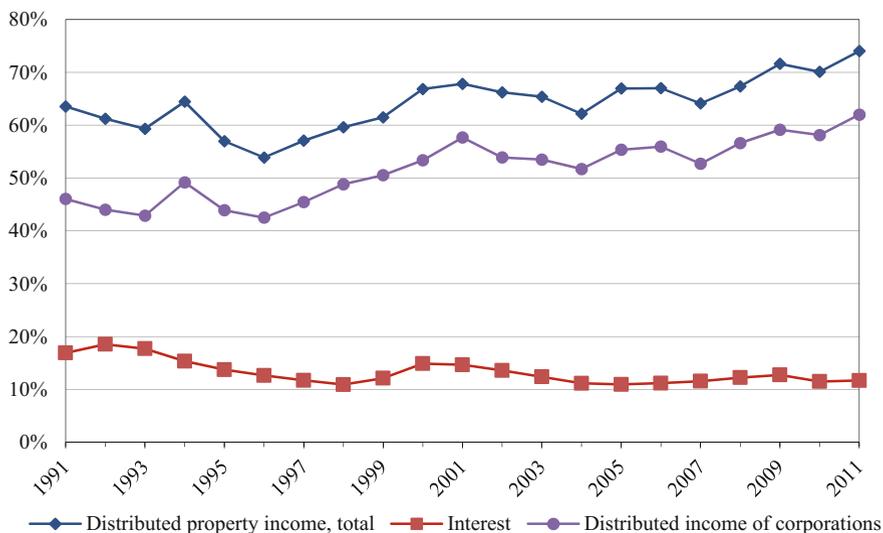
As Van Treeck et al. (2007) have shown, in the period from 1960 to 1989 in West Germany the most important part of finance of gross investment for the non-financial corporate sector as a whole was internal means of finance, i.e. corporate savings plus capital consumption allowances. Between 70 and 90% of gross investment finance was provided by these sources. External finance was mainly

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<sup>3</sup>See Kalecki(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), among several others.

<sup>4</sup>See also Van Treeck (2009).

<sup>5</sup>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.



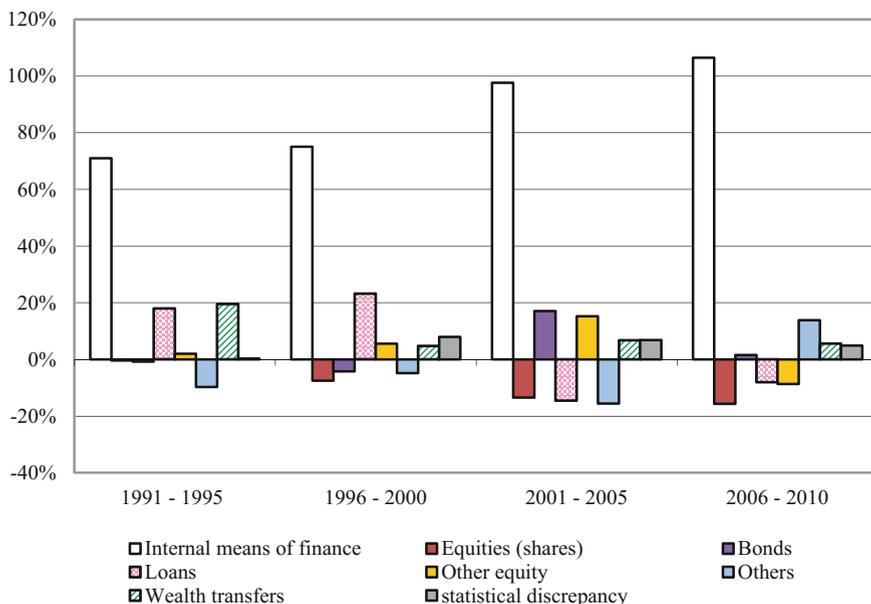
**Fig. 10.7** Distributed property income of non-financial corporations, Germany, 1991–2011 (% of sector gross operating surplus). *Source* Statistisches Bundesamt (2012), own calculations

**Table 10.1** Distribution of profits and financing of gross investment of non-financial corporations (*Source* own illustration based on Van Treeck (2009, p. 921))

From net operating surplus to internal means of finance	The financing of capital investment
Net operating surplus - Net interest payments = Corporate profits before taxes - Corporate taxes - Net social contributions - Net current transfers - Net dividend payments = Corporate savings (incl. pension reserves) + Capital consumption allowances = Internal means of finance	Internal means of finance + Net external finance raised [ = Net increase in bank credit + Net issuance of equities + Net issuance of bonds + Net increase in other liabilities ] - Net financial investment - Gross capital investment = 0

bank credit, which amounted to 10–20% of gross investment finance. Equities and corporate bonds played only a negligible role; in some periods, the contribution of corporate bonds was even negative.

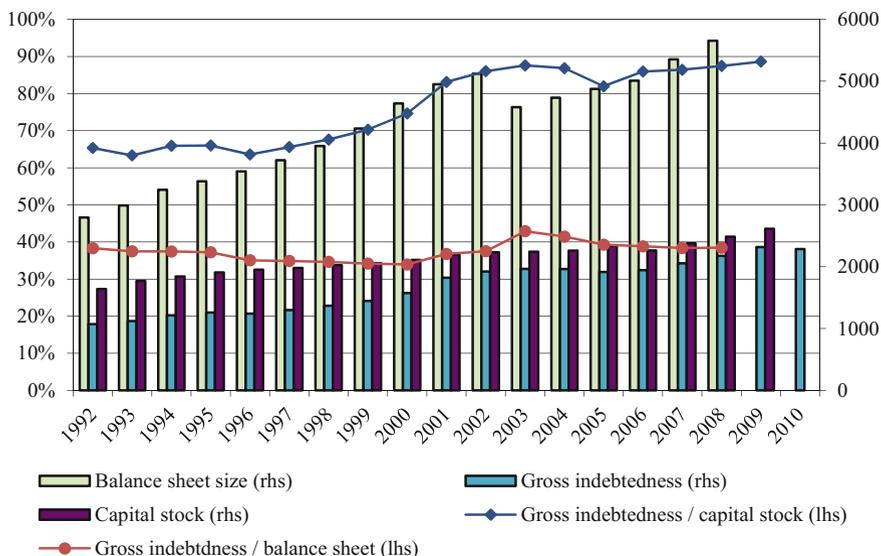
As can be seen in Fig. 10.8, the dominance of internal means of finance continued for non-financial corporations in united Germany from 1991–2010, with an even rising trend. In the last 5-year period considered, 2006–2010, internal means of finance even exceeded gross investment and were partly used to reduce the stock



**Fig. 10.8** Finance of investment in gross capital stock of non-financial corporations, Germany, 1991–2010 (5-year averages, %). *Source* Deutsche Bundesbank (2012), Statistisches Bundesamt (2011), own calculations (with corrections). *Notes* In 1995 the deficit of the *Treuhandanstalt* was shifted from the corporate to the government sector which meant a wealth transfer from the government to the non-financial corporate sector. The position ‘others’ sums up investment in investment certificates, insurance or derivatives, and the position other receivables and liabilities, which are positions occurring mainly as by-product of other economic activities (e.g. trade credit)

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% 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 Fig. 10.9. 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% in the early 1990s to close to 90% in 2009. The major part of this increase took place in the second half of the 1990s during the new economy boom. With respect



**Fig. 10.9** Gross indebtedness of non-financial corporate sector, Germany, 1992–2008/2009/2010 (% (lhs), € billion (rhs)). *Source* Deutsche Bundesbank and Statistisches Bundesamt (2010), own calculations

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%. 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 Chap. 3 of this book.

### 10.5 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)*.<sup>6</sup> Out of around 3.8 million SMEs (annual sales below

<sup>6</sup>For details see KfW-Research (2012). For a more detailed discussion of investment and capital stock finance of the German *Mittelstand* see KfW-Research (2011) and Hommel and Schneider (2003).

500 million euros) in Germany, the representative annual panels have covered 9000 to 15,000 firms.

According to investment finance data provided by the *KfW Mittelstandspanel* in Table 10.2, the main source of finance for German SMEs between 2005–2010 was own sources, which are mainly retained earnings, and to a negligible degree financial sources provided by the owner(s) of the firm (KfW-Research 2011). The share of own sources in investment finance varied between 43 and 51% 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%. Furthermore, subsidies were an important contribution to investment finance, varying between 11 and 15%. In particular, medium-sized SMEs (5–49 employees) benefited from this public assistance.

**Table 10.2** Sources of investment finance of SMEs by number of employees, Germany, 2003–2010 (% of total investment finance)

	2003	2004	2005	2006	2007	2008	2009	2010
<b>Subsidies</b>								
Less than 5	12.0	12.5	7.5	17.4	8.4	7.8	5.4	9.0
5 to 9	7.0	10.1	9.2	18.5	11.1	14.5	13.8	19.9
10 to 49	15.0	11.5	15.4	15.5	13.6	17.7	15.8	15.5
50 and more	20.0	10.0	11.6	11.1	13.2	10.5	16.3	13.9
Total	19.0	11.1	11.1	14.9	11.8	11.8	13.4	13.0
<b>Own funds</b>								
Less than 5	33.0	49.5	50.6	42.7	44.3	54.6	56.8	46.7
5 to 9	32.0	40.5	39.7	39.2	42.1	37.5	47.7	35.5
10 to 49	43.0	38.2	39.9	36.6	36.9	39.8	43.8	41.7
50 and more	40.0	42.3	58.7	48.5	47.4	50.8	51.6	55.0
Total	30.0	43.6	51.1	43.1	43.7	48.0	50.5	47.8
<b>Bank loans<sup>1</sup></b>								
Less than 5	42.0	22.9	27.7	26.4	41.6	33.1	32.2	37.8
5 to 9	53.0	31.3	41.5	33.9	35.6	39.2	33.3	38.5
10 to 49	35.0	34.7	33.0	37.6	38.8	33.9	35.2	33.5
50 and more	30.0	34.6	22.2	30.1	31.2	28.4	26.1	21.8
Total	35.0	30.7	27.5	30.9	36.1	32.0	30.5	31.0
<b>Other funds</b>								
Less than 5	13.0	15.2	14.2	13.4	5.6	4.7	5.8	6.5
5 to 9	7.0	18.1	9.6	8.5	11.2	6.2	5.2	6.2
10 to 49	7.0	15.4	11.7	10.3	10.7	8.6	5.2	9.4
50 and more	10.0	13.0	7.5	10.2	8.2	10.2	5.9	9.3
Total	10.0	14.5	10.3	11.1	8.4	8.0	5.7	8.1

Source KfW-Research (2004, 2008, 2011)

Notes<sup>1</sup> for 2003—external funds

**Table 10.3** Average equity ratio of medium-sized companies by number of employees, Germany, 2003–2010 (%)

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

Source KfW-Research (2008, 2011)

**Table 10.4** Equity ratios of medium-sized companies (sales: 10–50 million euros) in manufacturing industry in international comparison, 2001 and 2008 (%)

	Germany	Spain	France	Italy
2001	28.0	44.7	35.8	27.5
2008	36.2	46.8	39.8	33.0

Source KfW-Research (2011)

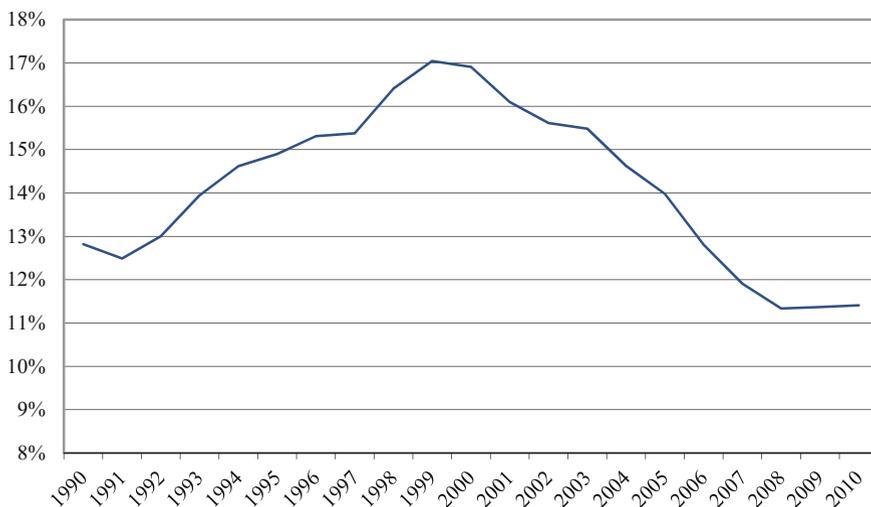
What can be observed for the few years in this data is that in an economic upswing (2006, 2007), the share of bank credit in investment finance goes up and the share of own sources goes down, whereas in an economic downswing and recession (2008, 2009) these developments are reversed.

Looking at the financing structure of the capital stock, the equity ratio of SMEs has continuously increased from 2005 until 2010 (Table 10.3). 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.

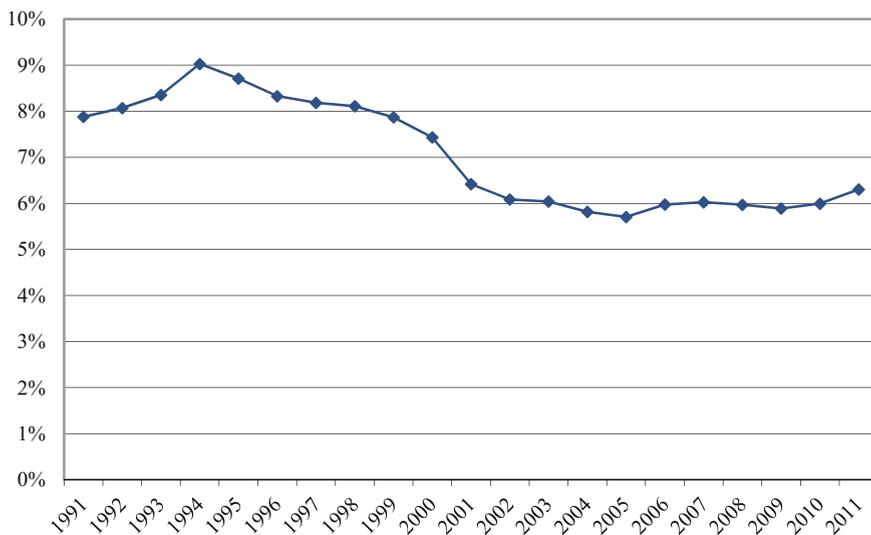
In international comparison, German medium-sized enterprises (annual sales between 10 and 50 million euros) managed to increase their equity ratio considerably from the early 2000s until 2008 before the Great Recession, albeit from lower basic values in 2001 (Table 10.4).<sup>7</sup>

Since 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 2000/2001, and then decreased again until the Great Recession 2008/2009 (Fig. 10.10). This pattern is broadly in line with gross investment of non-corporate business as a share of GDP (Fig. 10.11). In the 1990s this value was considerably higher (8–9%) than in the early 2000s until the Great Recession (around 6%). Periods of high investment are associated with rising indebtedness, because non-corporate business increases

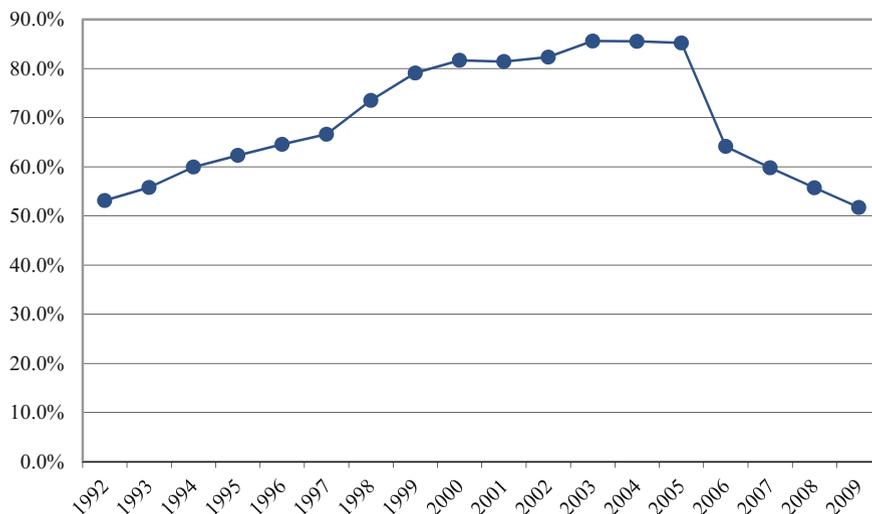
<sup>7</sup>It should be noticed, however, that the database for Table 10.4 is not the same as in the KfW *Mittelstandspanel*. Table 10.4 includes SMEs with sales of 10–50 million euros per year, whereas in the KfW *Mittelstandspanel*, SMEs with sales below 500 million euros per year are included.



**Fig. 10.10** 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



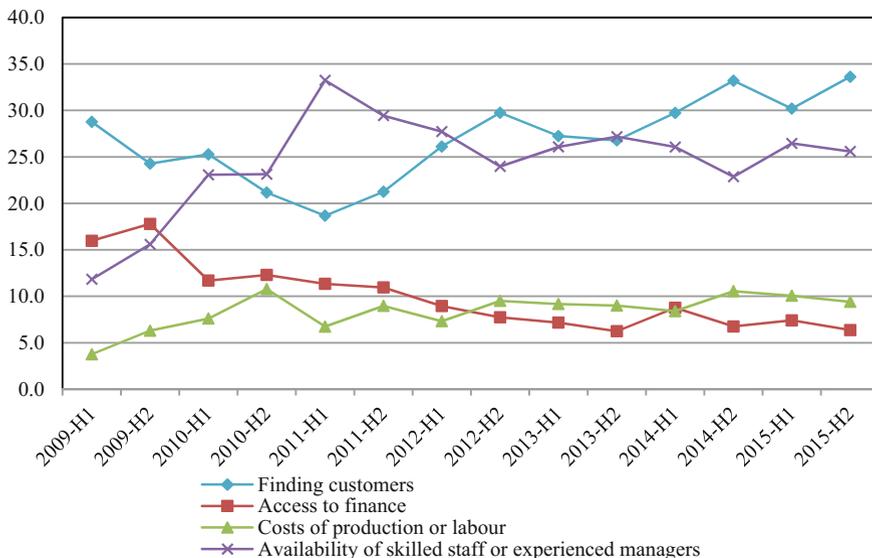
**Fig. 10.11** Gross investment of non-corporate business, Germany, 1991–2011 (% of GDP). *Source* Statistisches Bundesamt (2011), European Commission (2012), own calculations



**Fig. 10.12** 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

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 (Fig. 10.12).

Figure 10.12 clearly shows the impact of the financial crisis on the debt-capital ratio of non-corporate business, with the ratio already steeply falling in 2006 and steadily declining from then on. In order to discuss whether limited access to finance or a lack of demand was the key problem for German SMEs during the crisis and in subsequent years we make use of the Survey of the Access to Finance of Enterprises (SAFE) of the European Central Bank. Figure 10.13 shows the perceived relative importance of different problems faced by German SMEs. In the recession year 2009 the percentage share of surveyed SMEs that perceived the access to finance as their single most important problem was 16% in June and 17.8% in December. After a sharp drop to 11.7% in June 2010 this share declined almost continuously with the latest value being as low as 6.4% at the end of 2015. At the same time, the share of SMEs, which perceived finding customers as their biggest problem, was 28.8% in June 2009 and subsequently declined to its lowest level in the sample period (18.8%) in June 2011. This decline roughly matches the duration of the second German stimulus program (*Konjunkturpaket II*). With the beginning of the euro crisis and the reversal of global economic stimulus programs, the share of SMEs perceiving demand problems as most important showed a rising trend, reaching its highest level in the sample in December 2015 (33.6%). These developments show that for a majority of German SMEs the availability of finance was perceived as being a smaller problem than the lack of demand for their products. While it seems that at the time of the financial crisis access to finance was



**Fig. 10.13** Most important problems faced by SMEs, Germany (% of surveyed SMEs). *Source* ECB (2016). *Note* H1 (H2) refers to the first (second) half of the respective year corresponding to the survey date in June (December)

the major problem for more SMEs than in subsequent years, the number of SMEs that saw a lack of customers as their most pressing problem was much higher throughout the sample period. This supports the view that the recession of 2008/2009 as well as the period of austerity in Europe, starting in 2011, affected most German SMEs by a lack of customers due to insufficient aggregate demand rather than by a ‘credit crunch’.

## 10.6 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 from the mid-1990s, after the German reunification boom, and then 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 the 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, have not been necessary for real investment finance but have been 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. The decline in credit to non-corporate firms since the financial and economic crisis has been mainly caused by lack of demand for the output of these firms, and not by a lack of access to credit.

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# Chapter 11

## The Involvement of the Financial Sector in the Restructuring of the Economy

**Abstract** 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 US or the UK. 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 managed type, involving a compromise between all the stakeholders. The German M&A regime can be judged as 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.

### 11.1 Introduction

This chapter will first give a brief overview of legal reforms that have shaped the control and ownership structures of German companies since the 1990s and enabled the emergence of a 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 (M&A) activities in the non-financial corporate sector. Data will be presented on the development of M&A activity in Germany after the German unification and the character of M&As in Germany, i.e. the presence or absence of hostile takeovers. Finally the role of financial institutions in M&A activities will be discussed, with the focus on their involvement in the cases of hostile takeovers.

## 11.2 Changes in German Corporate Governance since the 1990s

The German Stock Corporation Act<sup>1</sup> 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 the German corporate sector which was characterised by a partly formal and partly informal network of big companies and big private banks. However, beginning in the 1990s, government policy, alongside some of the big companies and financial institutions, aimed to change this traditional structure of the ‘*Corporation Germany*’<sup>2</sup> (Ahrens et al. 2013; Streeck 2009). Between 1990 and 2002 four laws were passed by the federal legislature promoting financial markets (Schmid and Wahrenburg 2004). 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 relevant law for this topic was passed in 2002; the Securities Acquisition and Takeover Act (WpÜG).<sup>3</sup> This takeover regulation—in particular mandatory bid rules,<sup>4</sup> board neutrality and the possibility of mounting defences against takeovers—is especially important in setting the environment for hostile takeovers. The Securities Acquisition and Takeover Act’s most controversial issue was 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<sup>5</sup>—is allowed prior to the publication of the decision to make a public offer (Rieckers and Spindler 2004).

Furthermore, the German Corporate Governance Code<sup>6</sup> was adopted in February 2002, expanding on the 1998 Law on Control and Transparency in Enterprises,<sup>7</sup> with the particular aim of amending, as it was seen, the inadequate focus on shareholder interests and the inadequate transparency of German corporate governance. Multiple voting rights and maximum voting rights of the 1998 Act, which

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<sup>1</sup>*Aktiengesetz*.

<sup>2</sup>*Deutschland AG*.

<sup>3</sup>*Wertpapiererwerbs- und Übernahmegesetz* (WpÜG).

<sup>4</sup>Once a shareholder acquires at least 30% of the company shares, he or she is obliged to make an offer to purchase the remaining shares of that company at a fair price.

<sup>5</sup>This ‘flip-in’ strategy consists of offering the existing shareholders (but not the acquirer) to buy shares on a discount price.

<sup>6</sup>*Deutscher Corporate Governance Kodex* (DCGK).

<sup>7</sup>*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (KonTraG).

had existed primarily to serve as protection against foreign control and hostile takeovers, were now prohibited. In addition, it was made much easier to buy back own shares by companies. Finally, the use of stock options was extended including stock options for remuneration of management.

The Securities Acquisition 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 takeovers easier. The background of the changes was the belief that such policies would make the German financial market more efficient and thus trigger growth. In addition, external pressures had existed since the mid-1990s to redirect the traditional German system of corporate governance towards a more market-based US or UK type of governance. In particular, the pressure came from the European Commission which demanded a wide range of law adjustments in Germany. Looking back, the most relevant changes were a better investor protection (increased protection of small/minority investors) thus strengthening the interest of shareholders and a more explicit framework for transparency and monitoring of management. Although this has not made Germany institutionally comparable to the United States, it led to a ‘hybridisation’ of the German institutional and corporate governance system (Höpner and Jackson 2006; Beyer and Höpner 2003; Höpner 2012).

The stock market traditionally played a limited role in Germany until the 1990s. In the 1980s there were less than 500 listed companies in Germany (Schaeede 2000) and fund raising through the stock market was exercised only by a few of the largest firms. The German corporate governance system as well as the financing of listed companies was deeply influenced by the banking system. Schaeede (2000, p. 9), for instance, reports that in 1992, ‘of the 30 companies included in the German Stock Market Index (*Deutscher Aktien Index*, DAX), eleven supervisory board chairmen and 25% of all supervisory board members were bankers’. Traditionally the mutual corporate ownership or cross-shareholding was a common feature of the German corporate governance system. Banks and insurance companies, furthermore, had a substantial influence on large companies (see Chap. 1), not only through direct ownership but also extensively through the exercise of proxy voting,<sup>8</sup> 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 had been stable, with the loans from the ‘house bank’ being the major creditor for German firms. As mentioned above, this pattern began to change in the 1990s. This

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<sup>8</sup>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.’ (Schaeede 2000, p. 8).

was due primarily to the reorientation of German big banks toward investment banking which before more or less did not exist in Germany and their increasing unwillingness to continue being the providers of cheap credit and to maintain close relationships with 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 was the increasing role of global banking triggered by the deregulation wave of financial systems in the 1980s 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 and low return retail banking. This new and more profitable business model implied a diminishing involvement in the corporate governance of German big firms (Schaede 2000). In addition, advisory activity in merger and/or acquisition deals has become an important aspect of investment banking. This business is incompatible with banks having insider relations with firms which could become targets of hostile takeovers. For example, there were sharp public criticism and protests after several episodes of ‘conflict of interests’ occurred (see below). Moreover, close ties with domestic industrial companies are in conflict with the aim to increase the international role of the German financial market (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 with close links to banks became riskier. Shareholders’ loans are considered ‘equity replacing’ if they are provided when, or held after, the company undergoes financial difficulties. This stems from the belief that a company in difficulty would get loans from a bank which holds shares in the company whereas financing from a neutral third party would be difficult to get. During eventual insolvency procedure, such loans are treated as subordinate to other loans.<sup>9</sup> Further changes that reduced the presence of German universal banks on supervisory boards of companies are related to changes in depositary voting rights. Proxy voting, based on the Law on Control and Transparency in Enterprises of 1998 and on the Act on Registered Shares and the Exercise of Voting Rights Act<sup>10</sup> of 2000, was made more difficult. In addition to multiple voting rights and maximum voting rights which existed before and strengthened the power of domestic banks it was made easier for shareholders to vote and to issue instructions to banks on how to vote.

In sum, 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.

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<sup>9</sup>See *Aktiengesetz* §221, n.31 et seq., quoted in Rieckers and Spindler (2004).

<sup>10</sup>*Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung (Namensaktiengesetz)*.

**Table 11.1** Share ownership in Germany, 1991–2011 (% of total)

	1991	1995	1999	2003	2007	2011
Non-financial firms	42.3	44.0	35.6	36.6	34.8	41.2
Banks	12.5	12.9	13.0	9.2	5.1	4.5
Insurance firms	4.9	6.3	4.5	5.4	5.8	9.2
Government	5.4	4.2	3.5	3.2	1.9	2.6
Investment firms and other financial institutions	4.2	6.2	12.6	13.4	12.4	12.0
Individuals	19.3	18.2	16.9	14.9	13.1	11.3
Foreign <sup>a</sup>	11.3	8.2	13.9	17.3	26.9	19.3

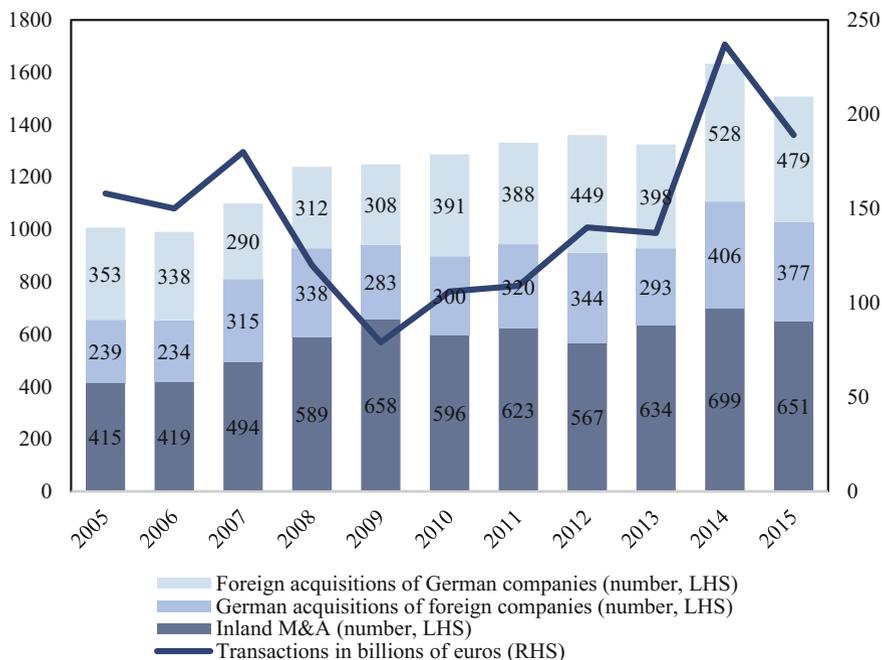
Source Deutsche Bundesbank (2012), own calculations

<sup>a</sup>Foreign investment is not included in the other groups

Table 11.1 shows the changes of share ownership in the two decades following the unification. The role of banks and of the government decreased, cross-firm-ownership decreased until 2007 but had then risen again, and the share of insurance companies and other non-bank financial institutions, as well as of foreign investors, increased.

Relative to other European countries, M&As were rare in Germany up until the early 1990s. Following the unification in 1990, a wave of mergers started between the eastern and western parts of Germany and continued throughout the decade (Höpner and Jackson 2006). Between 1991 and 1997, there were 1,479 deals in Germany annually in value corresponding to about 1.4% of GDP (Detzer 2014). 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 a, as it was called, regional strategy (Andreani 2003). Then in the year 2000 the German banking group *Hypovereinsbank* and the Austrian group *Bank Austria Creditanstalt* agreed on one of the biggest mergers in the European banking system.

Also cross-border M&As involving Germany companies—either as buyers or sellers—increased sharply in the 1990s. Starting at a level of 200 cross-border deals in 1990 with a volume of around 50 billion US-dollars the number increased to around 1100 deals until the end of the 1990s with a volume of around 175 billion US-dollars. Until the mid-2000s the volume of cross-border deals remained at this level. An exception was the year 2000 when *Vodafone* took over *Mannesmann* (see below). Except the year of the *Vodafone-Mannesmann* deal German companies took over on average more foreign companies than vice-versa (UNCTAD 2016). Figure 11.1 shows the total of M&A deals with German participation over the last decade. All type of deals increased moderately. Inland M&As are the predominant form of deals. The volume of German acquisition of foreign companies is around the same as the foreign acquisition of German companies.

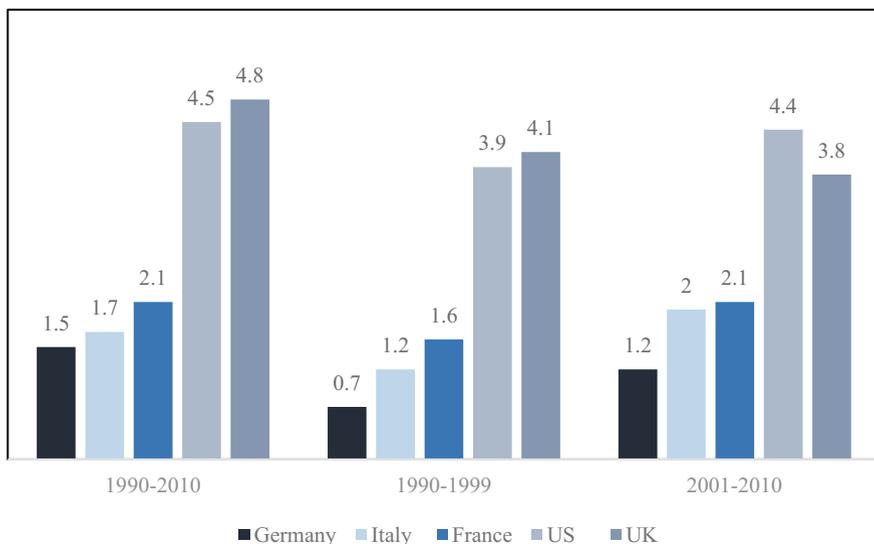


**Fig. 11.1** Number (LHS) and volume (in billion euros, RHS) of M&As with German participation, 2005–2015. *Source* Angermann M&A International (2016)

German M&A activity measured in number and value has been slightly below the European average in the 2000s. Figure 11.2 further shows that, relative to GDP, M&As were lower in Germany than in Italy and France and much lower than in the US and the UK which both showed M&A activity around twice as high as in continental European countries (Jackson and Miyajima 2007). Schröder et al. (2011) argue that Germany had a relatively low M&A activity in comparison to the rest of Europe and especially the US and the UK during the 1990s because of tax disadvantages which suppressed M&As. After the changes in the Tax Reduction Act<sup>11</sup> in 2000 and the repeal of the corporate capital gains tax in 2002, M&As in Germany increased moderately. The general increase of M&A activities, according to Schröder et al. (2011), is also due to the processes of globalisation, the rise in commodity prices, the availability of low-interest financing as well as in the growth of hedge fund and private equity funds.

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

<sup>11</sup>*Steuererleichterungsgesetz.*



**Fig. 11.2** M&As as a percentage of GDP, Germany, Italy, France, the US and the UK, 1990–2010. *Source* Schröder et al. (2011)

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) argue that in general a beneficial environment for M&As consists of high 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, (few legal obstacles with regard to the imminent lay-off of workers). Rieckers and Spindler (2004) have described as one of the characteristic features of the traditional German corporate governance that shareholders with smaller holdings are relatively unprotected since during the general meeting of shareholders the formation of a blocking minority requires more than 25% 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 such voting rights restrictions. It was 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. 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 due to the voting rights restrictions mentioned above, takeovers happened rarely and hostile takeovers were nearly impossible in Germany (Schaeede 2000).

However, the shift towards shareholder value orientation became more apparent since the mid-1990s. From the mid-1990s onwards foreign institutional investors, particularly investment funds from the US, began investing in German companies. According to the Dresdner Kleinwort (2007) report, the share of US-investors increased from 3 to 18% in total share ownership of German companies in the period 1998–2006. The presence of such players has increased the pressure on the management of non-financial firms to align with shareholder interests. At the same time, the presence of blockholders decreased. From 1991 to 2008, shareholders with a block above 25% in German stock companies went down from 85 to 56% (Fichtner 2009).

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 corporate governance systems as their guiding principle. This was supported by the changes in the legislation regarding stock corporations. The Law on Control and Transparency in Enterprises from 1998 introduced the ‘one share, one vote’ principle which gave more rights to minority shareholders, but also meant higher ownership dispersion. But probably the most important barrier to the market for corporate control and potential hostile takeovers came down during the process of dissolution of ties between banks and corporations. Overall German companies became more vulnerable in the market for corporate control. It is important to note here that managers have an incentive to keep the share prices high if the market for corporate control exists, because it shields them to some extent from hostile takeovers. Depending on how active or aggressive the market for corporate control is, management will choose between the conflicting targets of long-term growth and shareholders’ interests. There might even be a conflict between short-term and long-term profit maximisation which, according to the incentive system of shareholder value corporate governance, is decided in favour of short-term profit maximisation (Detzer 2014).

However, as M&As usually imply corporate restructuring which includes—sometimes substantial—lay-offs, Germany’s traditionally high employee participation in the form of co-determination and trade union involvement and relatively strict employment protection laws have been acting as inhibitors to takeovers, especially when hostile. Table 11.2 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. One can conclude that despite the weakening of the institutional barriers to M&As during the 1990s and 2000, Germany still shows characteristics of a predominantly coordinated market economy. The relatively low degree of hostile takeovers—

**Table 11.2** Attempts of hostile takeovers, selected countries, 1991–2005

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

Source Jackson and Miyajima (2007)

especially considering the size of the economies—indicates that Germany has experienced mostly a consensus-type of M&A deals (Jackson and Miyajima 2007).

In the following 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. Investment banks can also play a role in financing M&A deals.

Schröder et al. (2011) present the results of a survey undertaken with 115 German 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. The survey results indicate that the advisory activities of investment banks related to M&As have been evaluated as ‘very important’ or ‘important’ by approximately 50% of the companies asked. The report also states that larger companies which have their own internal M&As 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.

Table 11.3 shows data on the top financial advisors to the M&A sector in Germany in the years 2014 and 2015. 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 most important player in the German M&A sector. However, the table also shows that German institutions play an overall small role in M&As even in Germany and international institutions dominate the M&A sector.

However, 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&As 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% stake in *Hoesch*; or the merger between *Krupp AG* and *Thyssen* in 1998, where *Deutsche Bank* advised

**Table 11.3** Top 10 investment banks in Germany according to the value of the supervised M&A deals, 2014–2015

Ranking		Institution	Volume (in millions of USD)		Number	
2015	2014		2015	2014	2015	2014
1	1	Deutsche Bank	50.995	102.791	31	46
2	2	JP Morgan	49.293	71.770	18	21
3	5	Bank of America Marrill Lynch	40.689	46.656	12	13
4	8	Rotschild	39.500	36.405	35	35
5	3	Morgan Stanley	37.244	71.216	20	19
6	4	Goldman Sachs	34.232	61.706	13	23
7	6	Citi	28.692	41.000	18	23
8	12	Credit Suisse	27.141	18.674	7	11
9	9	Lazard	21.618	36.254	15	20
10	10	UBS	21.511	21.975	6	13
		Total volume	350.915	508.447	175	224

Source Dusterhoff and Wolffson (2016)

*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 deal was one of the largest in the world with the transaction value of 204.8 billion euros (Institute for Mergers, Acquisitions and Alliances 2012). *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 the strong trade union in the sector, the *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% 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% rise of the share price in a 6-month period. The former CEO of *Mannesmann*, Klaus Esser, retired with an additional 30 million euros 'golden handshake'.

German public opinion strongly opposed this takeover and many German interest groups, politicians, journalists, etc. voiced loudly that they did not want an Anglo-American-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 had increased, but that the development of hostile takeovers as in the US or the UK would lead to wide resistance in Germany.

### 11.3 Conclusion

M&A activity increased in Germany from the 1990s on. In the first decade this was mainly associated with German unification. M&A deals have then continued to rise moderately in the 2000s in absolute terms but not in per cent of GDP. The increase was a little smaller than in Europe as a whole, and much smaller than in the US or the 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&As. Investment banks in Germany operate similarly to those in other countries in the field of M&As: 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&As.

The institutional environment in Germany favourable to M&As 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 a market for corporate control occurred in a specific political environment. In the late 1990s the Social Democratic–Green coalition (1998–2005) moved Germany towards a more market driven system of corporate governance by substantially changing the legal framework including tax laws in a way to facilitate M&As. The idea was, following a neo-liberal philosophy, to increase efficiency and growth in Germany which, in that period, was low in international comparison.

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&As 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. Also the relation between CEO's salaries and median wages is in Germany substantially lower than for example in the US (Piketty 2014). 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 and hostile way. The German M&A regime can be judged as a hybrid one, on the one side combining elements of a market approach and, on the other side, strong non-market stakeholder orientation.

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## Chapter 12

# Privatisation and Nationalisation Policies and the Financial Sector

**Abstract** 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. 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 healthcare sector was never a state monopoly, but public hospitals have been increasingly privatised since the early 1990s and private hospitals are now a dominant form of healthcare provision. In the course of the crisis several privately-owned financial institutions were either partly (Commerzbank) or completely (Hypo Real Estate Holding AG) nationalised. On the other hand, the German Industriebank, IKB—up until the crisis in majority ownership of the government—was privatised after German government had taken over all of its debts.

### 12.1 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. However, when Germany later enacted privatisation programmes in most of its public utilities sectors, the involvement of the financial sector was more significant. Against the neo-liberal trend towards

privatisation of the time, also nationalisations took place. During the financial crisis of 2007/2008 and the Great Recession that followed, part of the German financial system got into difficulties. Bailout policies by the German government including nationalisation saved financial institutions in trouble.

Table 12.1 gives an overview of privatisation activities in Germany from 1987 until 2013. Privatisations took place in different sectors, especially in public utilities and the manufacturing-construction-transportation sectors. Also, the privatisation of state property of the German Democratic Republic mainly in the first half of the 1990s is included in the table. At first sight it is astonishing that privatisation revenues in this period were not especially high.

In this chapter, after outlining the developments in privatisation within the financial sector in Germany since the 1980s, other relevant cases of privatisation are discussed. The post-unification wave of privatisation in East Germany is briefly described, and we provide an analysis of the privatisation of some national champions, especially in the telecommunications, transport, and healthcare sector. As mentioned, the global financial crisis took its toll on Germany as well: the government needed to intervene and rescue several financial institutions, which also led to the nationalisation of one entire banking group. The extent of government interventions during and after the financial crisis, with the focus on the cases of privatisation, liquidation and nationalisation of financial institutions, will be the completing theme of the present chapter.

## 12.2 Privatisation Before the Financial Crisis in 2007/2008

After the Second World War most of the major Western European countries (the UK being the exception) were characterised by a high degree of publicly owned banks and insurance companies. For some of these countries, this began to change gradually during the 1980s with the increasing dominance of neo-liberal economic policies, and culminated at the end of the 1990s when public banks were under great economic, political and ideological pressures. However, Germany with its three-pillar banking system largely avoided the fundamental liberalisation that was pursued in many other countries during the 1990s (Krahen 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% of the overall value of privatisations in the country in this period. When considering all banking sector privatisations in the EU15 countries for the same period, Germany's share was only 6.2% in terms of number and 8.2% in terms of value of privatisations (PRESOM 2008, p. 1).

The publicly owned savings bank sector, as well as collectively owned banks, have continued to be an important part of the German banking sector during the 1990s and the 2000s. While big German private banks have tried to push for the privatisation of the public savings banks, 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.

**Table 12.1** Privatisations in Germany, in million US-dollars, 1987–2013

Year	Finance and real estate	Utilities	Manufacturing, construction and transportation	Services	Telecommunication	Natural resources and agriculture	Trade	Total
1987	0	275.6	0	0	0	0	0	275.6
1988	11.1	129.7	675.8	0	0	0	0	1492.4
1989	206.4	0	1544.6	0	0	0	0	3295.6
1990	202.83	0	104.038	0	0	0	0	410.906
1991	1603.24	8.109	979.209	32.569	0	54.417	199.937	3856.69
1992	1.378	89.76	257.588	64.018	0	0	150.989	821.321
1993	492.9	0	70.721	0	0	0	0	634.342
1994	2080.8	801.452	792.04	0	0	1232.7	0	5699.032
1995	174.783	517.853	610.345	0	0	0	0	1913.326
1996	60.922	145.552	0	0	13787	0	0	13993.474
1997	1930.97	1621.69	2712.22	19.533	0	0	0	8996.633
1998	817.65	358.565	964.742	17.118	0	0	1124.62	4247.437
1999	16.903	2805.708	383.305	8.155	10142.7	0	0	13740.076
2000	0	860.712	5670.173	0	12842.4	0	0	25043.458
2001	3326.26	588.179	656.9	0	0	0	0	5228.239
2002	0	420.977	0	0	0	0	0	420.977
2003	0	101.116	1221.4	0	0	0	0	2543.916
2004	6477.308	26.351	2434.076	298.173	4442.48	0	1731.978	17844.442
2005	0	0	925.208	0	0	0	0	1850.416
2006	5451.704	0	1652.2	131.542	3311.29	0	0	12198.936
2007	4001.825	0	4734.26	0	426.97	0	0	13897.315
2008	4726	212.423	3744.189	152.06	1343	0	0	13921.861

(continued)

Table 12.1 (continued)

Year	Finance and real estate	Utilities	Manufacturing, construction and transportation	Services	Telecommunication	Natural resources and agriculture	Trade	Total
2009	6811	0	0	3,526	0	0	0	6814,526
2010	0	0	5512	31,788	0	0	0	11055,788
2011	0	0	0	0	0	0	0	0
2012	1058,781	1,191	1229,5	113,703	62,743	0	0	3695,418
2013	3898,57	5,41	169,7	0	0	0	0	4243,38

Source: Privatisation Barometer (2016)

Compared to the financial sector, the development of privatisation in the non-financial sector was different. After Second World War Germany has resisted to enact privatisation programmes for quite a long time relative to other major industrialised countries. However, at the beginning of the conservative-liberal government<sup>1</sup> in 1982, leading politicians began committing themselves to privatisation, primarily with regard to state ownership of industrial companies (Beyer and Höpner 2003). Yet, only little privatisation really occurred until the late 1980s when the European Commission and the European Court of Justice pushed for further European market integration and competition reforms including privatisation. The pressures from Europe and finally the unification of Germany made privatisation a central issue on the policy agenda in Germany.

Due to the German unification, 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 an especially established holding company—the *Treuhandanstalt* (THA). The financial sector involvement in this privatisation wave of state-owned property from the former German Democratic Republic (GDR) was very limited.

Most of the Central and Eastern European countries with formerly planned economies which also experienced a big wave of privatisation in the early 1990s to a large extent used voucher schemes.<sup>2</sup> Germany organised the privatisation and restructuring of East German companies through the THA, a public agency which sold East German companies to investors on a case-by-case basis. Already in early 1990, shortly before the unification in October of the same year took place, an agreement was made that the ownership of all bigger state-owned companies would be transferred to a purposely created public agency. Companies employing more than 2,000 people were converted into stock corporations or limited liability companies (Carlin and Mayer 1994). The THA became the major vehicle for restructuring and privatisation, privatising more than 13,800 companies and parts of companies in four and a half years (Müller 2001).

The official strategy of the THA was that not only the sale price but also broader social criteria should be considered in the process of privatisation, especially employment and industrial and/or regional policy. For this purpose, buyers had to present a concept how to deal with the company they wanted to buy. 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 according to its strategy. From 1991 on the process of controlled structural change and privatisation of state-owned companies had set in. The THA

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<sup>1</sup>This government was formed by a coalition between the CDU (Christian Democratic Union) and the FDP (Free Democratic Party).

<sup>2</sup>Vouchers were given for free or almost free to each adult. The vouchers then could be used to become a share owner of one of the companies which were privatised via this method. Besides vouchers, auctions and other instruments were also used, especially for smaller companies. Poland was an exception as voucher privatisation did not play a big role in the country (see Herr et al. 1994).

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 developing vertical and horizontal restructuring processes. Restructuring proposals were then discussed with the THA. Here it is important to understand that the THA aimed at restructuring through privatisation by firstly transferring ownership (i.e. actually privatising), and in the second phase supporting the restructuring process via the new owners. In fact, the THA sought to find proprietors with the long-term interest and capability to implement a sound corporate strategy. In many cases the THA remained involved after the privatisation by taking over 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 especially to West German companies which now could acquire potential East German competitors for a low price and include them into their internal division of labour.

It has to be mentioned here that the conversion rate of roughly one GDR-Mark to one D-Mark not only for wages, rents, etc. but also for monetary wealth and debt implied a substantial real appreciation of around 400% for the GDR-Mark. This conversion rate was mainly chosen to save the already relatively small monetary wealth of the East German population. But it also meant that East German companies had lost its competitiveness overnight. In addition, East German wages started to increase quickly. This was part of a policy to reduce the massive movement of East German workers to West Germany. But due to the conversion rate and adjustment of wages East German companies not only had low competitiveness, but were at the same time massively over-indebted. In the early 1990s potential revenues from privatising East German property was estimated at DM 1,365 billion. Shortly afterwards, the THA's first president Detlev Rohwedder reduced this sum to DM 600 billion. In 1992, the THA expected revenues of DM 81 billion and restructuring and closing costs of DM 215 billion. Finally, when the THA was wound up at the end of 1994 and the remaining assets were transferred to the Federal Institute for Special Tasks Arising from Unification<sup>3</sup> the THA had privatised 3500 out of 14,000 enterprises and accumulated a loss of DM 240 billion which became part of government debt (Cassell 2002, p. 180; Tagesspiegel 2015). It should be mentioned that East Germany became largely de-industrialised as East German companies under the conditions described had only small chances to survive under prevailing market conditions (Müller 2001; Heine et al. 1991).

In the early stages of the THA's activities a large number of companies were re-privatised, namely restored to their previous owners. Yet, this was conditional on the THA's judgement whether the new/former owners would be able to take over the businesses in an effective way.<sup>4</sup> With regard to the forms of privatisation,

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<sup>3</sup>*Bundesanstalt für vereinigungsbedingte Sonderaufgaben.*

<sup>4</sup>Other property, like houses, was unconditionally given back to the offspring of former owners. This created a lot of frustration in the former GDR. In other former centrally-planned economies this type of privatisation did not take place.

horizontal mergers with West German companies were the most common, which caused a 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 small companies and for strengthening the small- and medium-sized firm sector. 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 management buy-ins). For a small number of companies which could not be privatised the THA retained the industrial core activities and eventually took over the restructuring itself, or proceeded with liquidation.

In general, the THA privileged 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 monetary wealth in East Germany, limited attempts by the THA to restructure and run own companies for a longer period of time and too much property restored to former owners.

In addition to the East German privatisation programme, Germany began to divest state ownership also in West Germany. For example, towards the end of the 1980s the Volkswagen AG, the Deutsche Lufthansa AG and the steel factory Salzgitter AG were privatised. Important privatisations took place in state monopoly sectors, notably telecommunications and public utilities. We will focus on the most relevant cases of privatisation in Germany, namely the telecommunications and postal sectors, the transport sector and the healthcare sector.

The privatisation of traditional public sector monopolies and public utilities was promoted by the institutions on the European level through directives and regulations. We first take a look at telecommunication and postal services. The Commission of European Communities<sup>5</sup> (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<sup>6</sup> resulting in the restructuring of the DBP and disentangling the three types of activities which were now exercised by three autonomous units: *Deutsche Post* (postal services), *Deutsche Telekom* (telecommunication services), and *Postbank* (financial services). The regulation of these monopolies was the competence of the Federal Ministry of Post and Telecommunication. The entrepreneurial functions were separated from the ownership and political influences. All three units were still fully in public ownership, yet the aim of the first postal reform was to prepare the ground for the following liberalisation and privatisation (Drews 2006).

The Second Postal Reform<sup>7</sup> was passed in 1995 and the necessary legal amendments were made to privatise the three postal corporations (then transformed

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<sup>5</sup>Renamed in 1993 to 'European Commission'.

<sup>6</sup>*Poststrukturgesetz* or *Postreform I*.

<sup>7</sup>*Postreform II*.

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 the directive 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 Third Postal Reform<sup>8</sup> in early 1998 which established a regulatory authority and obliged the *Deutsche Post* to grant the competitors access to its own networks.

The privatisation process of the *Deutsche Post*, today a stock corporation, began with an initial public offering in November 2000. Prior to that, the *Postbank* had been incorporated and entirely sold to the *Deutsche Post* in 1999 (for the privatisation of all three companies see Beyer and Höpner 2003; Drews 2006). Later the *Postbank* was sold to the *Deutsche Bank* which became the only owner of the bank in 2015.

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 traditionally risk-averse German population. In 1996, a massive advertising campaign was undertaken depicting the shares of the *Deutsche Telekom* as ‘people’s shares’. There was a huge response by the public, and for many German households this was the first time they 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, later the market value of *Telekom* shares dropped from its peak of more than 100 euros in March 2000 to less than 10 euros in mid-2002, and then oscillated between 10 and 18 euros for more than one and a half decade (Investor Verlag 2016). 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 ‘people’s shares’ one can conclude that the public in Germany has become very cautious about the privatisation of state-owned enterprises via the stock market and shares in general. It was already pointed out that the German ‘equity culture’ had at best limited success. The number of people holding shares compared with the late 1980s did, in fact, double around the year 2000, but by the end of the 2000s this number dropped again significantly.

The railway reform<sup>9</sup> of 1994 resulted in the creation of the *Deutsche Bahn AG*, the German national railway company, as a commercial company in complete government ownership (Knieps 2004). The *Deutsche Bahn AG* replaced the two separate West German (*Deutsche Bundesbahn*) and East German (*Deutsche Reichsbahn*) railway companies. The privatisation was agreed upon by both the conservative parties and social democratic party in 2005, yet the political debate intensified in 2007 when the social democrats demanded that the privatisation procedure should include a minimum of 25% of the so-called ‘people’s shares’ - among other, to contain the influence of bigger private investors. Then, in 2008 a

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<sup>8</sup>*Postgesetz* or *Postreform III*.

<sup>9</sup>*Bahnstrukturreform*.

different model was agreed upon, which was supposed to split the *Deutsche Bahn* into two separate corporations, the first one responsible for the infrastructure, which would be 100% publicly owned (and would take on the largest part of the debts), and the second one for transport and logistic activities, which corresponds to around 90% of the business activities. The latter company would have been privatised gradually, with a planned immediate offering of 24.9% of the company shares (Huffschmid 2008). Due to uncertainties related to the financial crisis in 2007/2008, the decision to restructure and privatise the *Deutsche Bahn* was postponed, and debates about privatisation have not been resumed.

The German hospital sector has undergone a long process of restructuring since the 1990s, characterised by a decline in the number of hospitals and hospital beds, on the one hand, and the rise in the number of hospital privatisations, on the other hand (Schulten 2006). Major drivers for this, from the regulatory point of view, were the 1993 change in hospital financing from the full cost coverage system to the 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).

Regarding ownership, there are essentially three types of German hospitals: public (owned by German federal states, regions or municipalities), non-profit (various welfare institutions like the Red Cross and churches), 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. Unlike the cases of telecommunications and postal services discussed above, this shift was not due to specific liberalisation policies in the healthcare sector, 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 healthcare sector. From 1991 to 2015, the share of public hospitals (in terms of number of hospitals) decreased from 46.0 to 29.5%, whereas the share of private ones increased from 14.8 to 35.8%. The share of non-profit hospitals slightly decreased from 39.1 to 34.7% in the same period (Statistisches Bundesamt 2016).

The main reason for ongoing privatisations in the German healthcare sector can 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, there is an incentive for privatisation of public hospitals both for eliminating the responsibility of the public sector for loss making institutions and because of the sale revenue. Increasing presence of private hospitals meant that the healthcare sector in Germany became more important for private capital markets. Indeed, this was claimed to be *one* of the major reasons for privatisation.

### 12.3 Financial Institutions and the Government During the Financial Crisis

At the time of the outbreak of the financial crisis in 2007/2008, the German legal and institutional framework did not provide for any comprehensive mechanism for rescuing or restructuring distressed financial institutions in a systemic financial crisis. Neither the German central bank (Deutsche Bundesbank), nor the German Federal Financial Supervisory Authority<sup>10</sup> (BaFin) had the authority to rescue insolvent commercial banks or other financial institutions. Also, the European Central Bank had no mandate for such operations. The problems in the financial system caused by the financial crisis and the following years led to a whole set of new laws, institutions and interventions in Germany. It should be noted that the troubled institutions did not run into problems because of domestic non-performing loans and/or a domestically caused financial crisis. All of them bought toxic foreign products or were involved in the shadow banking sector abroad. A summary of interventions by the German public sector and supervisors between August 2007 and April 2011 is given in Table 12.2.

In the following, the most important activities to stabilise and restructure crisis institutions will be discussed. In the period from August 2007 until September 2008, the German government and other institutions provided capital injections, credit lines and/or guarantees for three German banks. *Sachsen LB* got 17 billion euros from savings banks and 2.75 billion euros from the state of Saxony. Later in the year *Sachsen LB* was taken over by *LBBW*. The *WestLB* got 5 billion euros from the states owning it. This *Landesbank* also could not be saved and in 2012 was dissolved. *Landesbanken* are jointly owned by one or more German states and regional savings banks, which are owned by local communities. For these banks the state as the owner had to guarantee (see below).

In 2008 the *IKB* got 3.5 billion euros from public banks, mainly the public *KfW*, and private banks (Hüfner 2010). The *IKB* was a medium-sized private bank specialising in the financing of manufacturing, which during the years leading up to the financial crisis 2007 had speculated in the US subprime mortgage sector. This was done by its established special purpose vehicle *Rhineland Funding Capital*. This institution 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. The owners of the *IKB* were, at the time, various private banks and institutional investors, but the largest shareholder (38%) was the German publicly-owned *KfW*. The rescue package of 0 3.5 billion euros was paid 70% by the *KfW*, and of the remaining 30% the bulk was borne by the federal government. Later that year the *KfW* pumped another 1 billion dollars into the *IKB* whereby its ownership of the *IKB* increased to 45%. The *KfW* was desperate to sell the *IKB*, but no buyers could be found. By 2008, the *KfW* had injected additional capital and

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<sup>10</sup>Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

**Table 12.2** Measures in response to financial crisis, Germany, August 2007–April 2011

2007	
August	<i>IKB</i> <sup>a</sup> received €3.5 billion from public and private banks. <i>Landesbank Sachsen (Sachsen LB)</i> receives credit line of €17 billion from savings bank group and €2.75 billion in guarantees from the state of Saxony
December	<i>Landesbank Baden-Württemberg (LBBW)</i> takes over <i>Sachsen LB</i>
2008	
March/April	<i>WestLB</i> receives €5 billion first loss guarantee from its owners
August	German development bank <i>KfW</i> <sup>b</sup> agrees to sell its 90% share of <i>IKB</i> to investor <i>Lone Star</i>
September	German Federal Financial Supervisory Authority <sup>c</sup> (BaFin) prohibits naked short-selling of selected instruments
October	<i>Hypo Real Estate</i> 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. Act to Stabilise Financial Markets <sup>d</sup> is passed creating the Financial Market Stabilization Fund <sup>e</sup> (SoFFin) and providing framework for €480 billion in guarantees, recapitalizations, and asset purchases
November	<i>Commerzbank</i> 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). <i>Bayern LB</i> 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
2009	
January	<i>Commerzbank</i> to receive additional €10 billion from SoFFin, made up of a silent participation amounting to €8.2 billion and a capital increase of 25% of ordinary shares plus one share held by the Federal government against payment of €1.8 billion
February	<i>HSH Nordbank</i> receives €3 billion in capital and €10 billion in guarantees from states Hamburg and Schleswig-Holstein. <i>Hypo Real Estate</i> support reaches total of €52 billion in guarantees from SoFFin
March	<i>HSH Nordbank</i> 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 <i>Hypo Real Estate</i> worth €60 million
April	Supplementary Act to Stabilize the Financial Market <sup>f</sup> is passed, including an option for public takeover of banks as a last resort. SoFFin buys shares in <i>Hypo Real Estate</i> worth €124 million. <i>LBBW</i> receives €5 billion in capital and €12.7 billion in guarantees from state Baden-Württemberg
May	BaFin extends prohibition of naked short-selling
June	SoFFin to provide €2.96 billion in capital to <i>Hypo Real Estate</i>
July	'Bad-Bank Act' is passed allowing the establishment of winding-up institutions
October/November	<i>Hypo Real Estate</i> 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

(continued)

**Table 12.2** (continued)

December	Winding-up institution created for <i>WestLB</i> to take on up to €85 billion portfolio of assets and liabilities. <i>WestLB</i> core bank to receive €3 billion in capital support from SoFFin
<i>2010</i>	
April	<i>WestLB</i> split into core bank and a residual €77 billion portfolio is transferred to the winding-up institution EAA <sup>g</sup>
July	Winding-up institution created for <i>Hypo Real Estate</i> to take on up to €210 billion portfolio of assets and liabilities
October	<i>Hypo Real Estate</i> is split and a €176 billion portfolio is transferred to the winding-up institution FMS <sup>h</sup>
December	Availability of new financial stability measures supported by SoFFin expires at end-2010
<i>2011</i>	
January	New bank restructuring law in force that allows for special resolution measures and establishes a restructuring fund
February	Revised restructuring plan for <i>WestLB</i> with different options, including possibility to increase the size of the portfolio transferred to the winding-up institution EAA
April	Further details of restructuring plan for <i>WestLB</i> submitted to the European Commission

Source IMF (2011, p. 11)

<sup>a</sup>*Deutsche Industriebank*

<sup>b</sup>*Kreditanstalt für Wiederaufbau*

<sup>c</sup>*Bundesanstalt für Finanzdienstleistungsaufsicht*

<sup>d</sup>*Finanzmarktstabilisierungsgesetz*

<sup>e</sup>*Sonderfonds Finanzmarktstabilisierung*

<sup>f</sup>*Finanzmarktstabilisierungsergänzungsgesetz (FMStErgG)*

<sup>g</sup>*Erste Abwicklungsanstalt*

<sup>h</sup>*FMS Wertmanagement*

owned 90.8% of the *IKB*. In August 2008, this majority stake was sold to *Lone Star*, a private equity investor from 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* (Huffschmid 2008).

The collapse of Lehman Brothers in September 2008 in the US signalled an intensification of the world financial crisis. This affected Germany as well. In the same month, the private *Hypo Real Estate Holding*, a big private bank and one of the biggest real estate financing institutions in Europe, ran into serious trouble. It got support from government and financial institutions, first 35 billion euros and later 50 billion euros. Trust by the public in the stability of the banking system eroded. The danger of bank runs was also present in Germany. 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.

In October 2008, the Act to Stabilise Financial Markets<sup>11</sup> allowed the establishment of the Federal Agency for Financial Market Stabilisation (FMSA)<sup>12</sup> which is a public institution with the purpose of managing financial crises. The FMSA was thought of as a temporary institution which would operate until the imminent danger of a financial market collapse had passed. It is closely linked to, yet independent from, the German central bank, the Deutsche Bundesbank. In the same month, alongside the FMSA, the Financial Market Stabilisation Fund (SoFFin)<sup>13</sup> was set up to interact directly with the financial institutions which apply for a rescue. The three main instruments of the SoFFin, managed by FMSA, consisted in: guarantees of up to 400 billion euros with the aim of overcoming short-term liquidity bottlenecks; recapitalisation of up to 80 billion euros in form of equity or silent participation; and the assumption of risk positions with the fund taking on some of the troubled banks' risky claims and securities (Pleister 2011). Theoretically, the SoFFin was also able to give guarantees for institutions like Special Purpose Vehicles but in practice this never occurred. In April 2009, the Supplementary Act to Stabilize the Financial Market (FMStErgG)<sup>14</sup> allowed FMSA to buy, under certain conditions, risky assets from financial institutions in stress and even to take over banks as a last resort. In July 2009, the Further Development of the Financial Market Stabilisation Act<sup>15</sup> supplemented the 2008 Financial Market Stabilisation Fund Act and enabled banks to relieve their balance sheets by transferring risk positions to external units, called 'bad banks'.

In November 2008, the *Commerzbank*, one of the biggest German private commercial banks, got into serious difficulties. It needed help from the FMSA (15 billion euros guarantees and a silent participation by SoFFin of 8.2 billion euros). In January 2009, *Commerzbank* needed further help by SoFFin (10 billion euros) and was partly nationalised. In late 2008 also *Bayern LB* reported problems and the state of Bavaria increased the capital of the bank by 10 billion euros. In addition, guarantees were given to the bank.

In February and March 2009, *HSH Nordbank*, another *Landesbank*, came into problems. The states of Hamburg and Schleswig-Holstein (with 3 billion euros capital and 10 billion euros guarantees) and SoFFin (with 30 billion euros guarantees) bailed out the bank. In April 2009, *LBBW* got 5 billion euros new capital and 12.7 billion euros guaranteed from the state of Baden-Württemberg. In the same period and later in June *Hypo Real Estate* needed more help from SoFFin (around 3 billion euros). Finally, in November of the same year, *Hypo Real Estates* was completely nationalised (IMF 2011).<sup>16</sup>

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<sup>11</sup>*Finanzmarktstabilisierungsgesetz.*

<sup>12</sup>*Bundesanstalt für Finanzmarktstabilisierung.*

<sup>13</sup>*Sonderfonds Finanzmarktstabilisierung.*

<sup>14</sup>*Finanzmarktstabilisierungsergänzungsgesetz (FMStErgG).*

<sup>15</sup>*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung.*

<sup>16</sup>This was the first bank nationalisation in Germany in the post-war period.

The introduction of the FMSA and of the SoFFin represent the immediate rescue phase of dealing with the financial crisis in Germany. Once the threat of bank failures and bank runs was contained the priority of SoFFin shifted towards identifying and removing bad assets thus addressing the balance sheet problems of the banking sector (Hüfner 2010). The restructuring phase following the rescue phase consisted in changing the legal framework and establishing permanent mechanisms for dealing with systemic bank crises. In January 2011, the Restructuring Act<sup>17</sup> 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,<sup>18</sup> made the FMSA a permanent feature of the German financial system architecture. All the potential future measures established by the Restructuring Act are planned to be funded by a bank levy, which is to be collected annually from all German banks. The target restructuring fund amounts to 70 billion euros (FMSA 2012). However, this fund is considered to be too small for a systemic financial crisis. In the framework of the Restructuring Act the establishment of bad banks as a restructuring mechanism under the control of the FMSA was also established. Two bad banks had been set up before the law came into force and were managed by the FMSA. After the law came into force, no new bad bank had to be established.

Over the course of the financial crisis the SoFFin injected capital in financial institutions, gave partly large guarantees and took over risks. Table 12.3 shows the massive government interventions. 168 billion euros were actually used as guarantees, almost 29.4 billion euros in capital injections were needed and 5.9 billion euros in risk assumption. Naturally, most SoFFin interventions were concentrated during the peak of the crisis starting in 2008 and then faded out. From Tables 12.2 and 12.3 it can be seen that *Hypo Real Estate Holding* received the bulk of SoFFin support. Total recapitalisation amounted to 9.8 billion euros, and the value of guarantees had been of 124 billion euros (Bundesfinanzministerium 2013).

Of great importance in the crisis were the *Landesbanken*. The savings banks and the *Landesbanken* are publicly owned and therefore traditionally benefited from state guarantees in the case of default. This arrangement was important for these banks due to their market refinancing, but was much opposed by private banks which claimed unfair competition. After pressure from the European Commission, state guarantees by the federal governments for savings banks and *Landesbanken* were abolished in February 2002. However, existing liabilities were still covered and a phasing-out period until July 2005 was granted. Savings banks remained very stable also during the financial crisis. But higher refinancing costs together with bad management created the wrong incentives for the *Landesbanken*, which started to invest in risky securities abroad. In this period, complex financial products, in particular based on the US mortgage market, and other risky credits promised significantly higher returns than investments in Germany. Whereas most private

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<sup>17</sup>*Restrukturierungsgesetz.*

<sup>18</sup>*Kreditwesengesetz (KWG).*

**Table 12.3** SoFFin activities (in billion euros)

Capital injections	Maximal volume used	Used volume at specific dates									
		12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	
<i>Institutes</i>		0	0.5	0.4	0.3	0.3	0.3	0	0	0	
<i>Aareal Bank</i>	0.5										
<i>Commerzbank</i>	18.2	8.2	18.2	18.2	6.7	5.1	5.1	5.1	5.1	5.1	
<i>HRE<sup>a</sup></i>	9.8	0	6.3	7.7	9.8	9.8	9.8	9.8	9.8	7.6	
<i>Portigon<sup>b</sup></i>	3	0	0.7	3	3	2	2	2	2	2	
<i>All</i>	29.4	8.2	25.7	29.3	19.8	18.8	17.1	16.8	15.8	14.6	
<i>Guarantees</i>		Used volume at specific dates									
<i>Institutes</i>		12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	
<i>HRE<sup>a</sup>/FMS</i>	124	16.9	95	15	0	0	0	0	0	0	
<i>HSH Norbank</i>	24	7	17	9	6	0	0	0	0	0	
<i>IKB</i>	10	0	7	9.7	7.3	0	0	0	0	0	
<i>SdB</i>	6.7	0	6.7	5.4	4.4	2.2	0	0	0	0	
<i>BayernLB</i>	5	0	5	4.7	2.8	0	0	0	0	0	
<i>Commerzbank</i>	5	0	5	5	5	0	0	0	0	0	
<i>Aareal Bank</i>	4	0	2	4	1.2	0	0	0	0	0	
<i>DüsseldorfHyp</i>	2.5	0	2.5	2.4	1.5	0	0	0	0	0	
<i>CorealCredit</i>	0.5	0	0.5	0.4	0	0	0	0	0	0	
<i>All</i>	168	23.9	140.7	55.6	28.2	3.7	0	0	0	0	
<i>Risk assumption</i>		Used volume at specific dates									
<i>Institutes</i>		12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	
<i>Portigon<sup>b</sup></i>	5.9		5.9	0	0	0	0	0	0	0	

Source FMSA 2016, our translation

<sup>a</sup>Hypo Real Estate Holding<sup>b</sup>Previously WestLB

German banks started divesting themselves of risky 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* also frequently paid higher dividends than profits earned or even distributed dividends to the public sector when they realised losses. This is clearly shown in Table 12.4. Obviously public owners used them in a dysfunctional way to reduce budget deficits. Most of the *Landesbanken* ran into trouble and had to be bailed out by their respective federal governments on the one hand, and by the SoFFin on the other hand.

The FMSA and the SoFFin manage two bad banks, the *FMS Wertmanagement* (nominal value of 174.3 billion euros at the end of 2010) from the *Hypo Real Estate* and the First Winding-down Agency (EAA)<sup>19</sup> (nominal value of 143.3 billion euros end 2012) from the *WestLB*. Both bad banks reduced their volume substantially in the following years (FMSA 2016). Both bad banks operate as public bodies. The *WestLB* was owned jointly by the federal state of North-Rhine Westphalia and two regional savings banks' associations. The attempted rescue and restructuring of the *WestLB* by the German government consisted of setting up a bad bank, the EAA, at the end of 2009, and transferring 77 billion euros worth of assets and liabilities (mostly securities and structured loans, priced at book value) from the *WestLB* to the EAA in 2010 (IMF 2011). Finally, however, in July 2012 the *WestLB* became the first German *Landesbank* which was dissolved as a result of the financial crisis. The other bad bank, *FMS Wertmanagement*, was established in July 2010 to take over toxic assets from the *Hypo Real Estate Holding*. Finally, in October 2009, the banking group was nationalised by the German government by compensating the remaining private shareholders (IMF 2011; European Commission 2011).

The biggest German bank, the private *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 of the crisis (Huffschmid 2008). Additionally, the *Deutsche Bank* came under serious attack for avoiding to register losses incurred during the crisis, which would have amounted to 12 billion US-dollars (FT 2012). Bank traders did not record mark-to-market and were therefore misvaluing derivatives. Had it accounted for its positions correctly, the *Deutsche Bank* would have needed to ask for a government bailout.

To sum up, bank runs and the collapse of the financial system in Germany could be avoided and household's deposits saved, as promised by the German government in October 2007. However, the policies meant a significant increase in government debt. Far reaching government interventions - including nationalisations - were needed to save the financial system. 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 this respect the stabilisation of the German financial system was successful.

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<sup>19</sup>*Erste Abwicklungsanstalt*.

**Table 12.4** Earnings and dividends of Landesbanken, Germany, 2007–2009 (in million euros)

No.	Bank	2007			2008			2009		
		Earnings before taxes	Dividends							
1	Bayern LB	255.0	122.0	-5,166.0	126.0	-2,756.0	0.0			
2	Helaba (Landesbank Hessen-Thüringen)	402.0	34.0	-53.0	-44.0	343.0	14.0			
3	HSH Nordbank	148.0	241.0	-2,794.0	0.0	-1,261.0	0.0			
4	LBB (Berlin)	306.0	60.0	9.0	100.0	339.0	0.0			
5	LBBW (Baden-Württemberg)	355.0	89.0	-2,569.0	93.0	-1,214.0	90.0			
6	WestLB	-1,498.0	0.0	26.0	33.0	-503.0	0.0			
7	Nord LB	503.0	167.0	22.0	210.0	-92.0	122.0			
8	Saar LB	7.3	8.4	-79.8	8.4	10.9	0.0			

Source Schäfer (2010, p. 119)

## 12.4 Conclusion

From the Second World War until this day 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 numbers, 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 German Democratic Republic. The privatisation of public ownership in the field of manufacturing or of public utilities was more in line with developments in other Western developed countries. This was in part due to ideological motives, partly pushed by the European Commission and partly caused by the desire to raise public revenues or sell loss-making units.

The privatisation of public ownership of former companies in the German Democratic Republic was organised by the federal agency *Treuhandanstalt* with the aim to save as much as possible of East German industry and employment. In practice this amounted to supporting West German capital via privileging West German firms. Mainly due to the creation of the German monetary union and the conversion of East German monetary wealth in West German D-Marks a substantial deindustrialisation in Eastern Germany and big employment losses could not be avoided, despite high transfers from West to East Germany. The role of financial institutions in this process was small.

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. This has created new markets also for 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 stocks 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.

Ownership changes did not only occur from the state to private agents, there were also substantial and - before the financial crisis not expected - nationalisations. These were the result of the financial crisis starting in 2007 and not caused by an attempt to increase the government role in the financial system. Most of the banks that needed intervention were *Landesbanken*. The crisis resulted in the dissolution of one of these publicly owned banks, the *WestLB*, after several failed attempts at privatisation. Others merged or were taken over by sister *Landesbanken*. On the other hand, the *Deutsche 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. There was a partial nationalisation in the case of *Commerzbank*, and a complete nationalisation of the *Hypo Real Estate Holding*, one of the biggest private banks in Germany at that time. As in most countries affected by the financial crisis, the stabilisation of financial markets was mainly paid by the tax payer (Herr et al. 2016). A strategy, for example recommended by Joseph Stiglitz (2010), to let financial institutions fail and then save household's deposits, was not followed or even discussed. Shareholders and big creditors to financial institutions suffered only to a limited extent. The very rich wealth owners were privileged at the cost of the general public.

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# Chapter 13

## The Financial Sector and Private Households

**Abstract** After a decline in the German private saving rate during the 1990s, the average propensity to save increased after 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 in the early 2000s in the face of weak growth, high unemployment and ‘reform policies’ aimed at the deregulation of the labour market and a reduction of social benefits; and third the absence of wealth effects on consumption. The savings of private households were 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 then 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 1990s, as has the relationship of real estate wealth to GDP. However, financial and real estate wealth have been 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 until the Great Recession, and remained low by international comparison.

### 13.1 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 chapter is to single out the country-specific effects of financialisation on the private household sector,

which in general is said to have contributed to re-distribution at the expense of wage incomes, on the one hand, and to provide, in principle, the conditions for increasing debt-financed private household expenditures, 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.

### **13.2 The Development of Income Distribution and the Components of Private Household Sector Income**

As will be shown in detail in Chap. 15 of this book, 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, b; Stockhammer et al. 2011). 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) (Fig. 13.1). The Federal Statistical Office<sup>1</sup> 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.

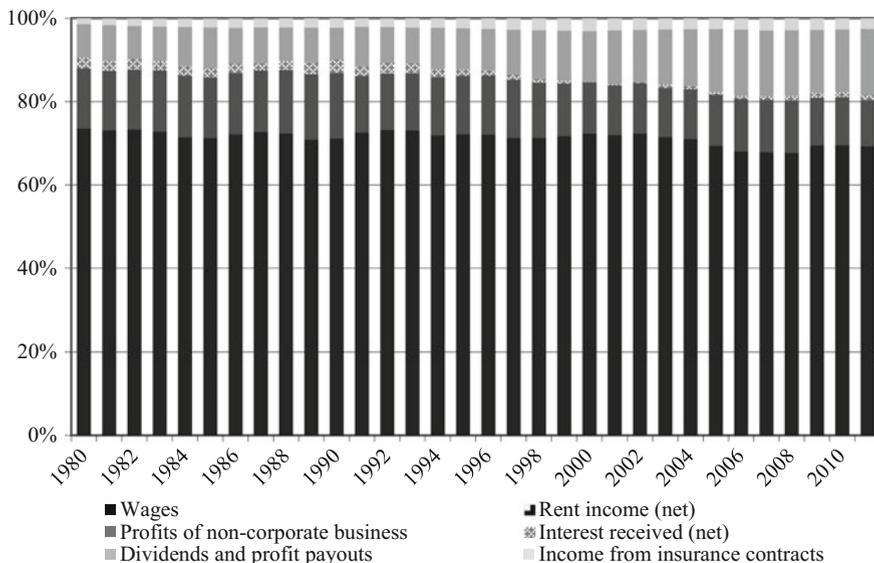
The main source of gross income of the private household sector is wages, albeit at a declining tendency. The share of wages in total gross private household income has come down from around 72% in the mid-1990s, to below 68% in 2006, and has only recovered slightly since then. The share of dividends and profits paid out has increased from close to 10% in the mid-1990s to close to 16% in 2006, and has remained at that level. 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.

### **13.3 Consumption and Saving of Private Households**

Before German unification, the net saving rate of West German households out of disposable income was around 13% (Fig. 13.2), which was significantly above the saving rate in the US and the UK and also France, but below that of Japan and Italy.

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<sup>1</sup>‘Statistisches Bundesamt’ or ‘Destatis’.

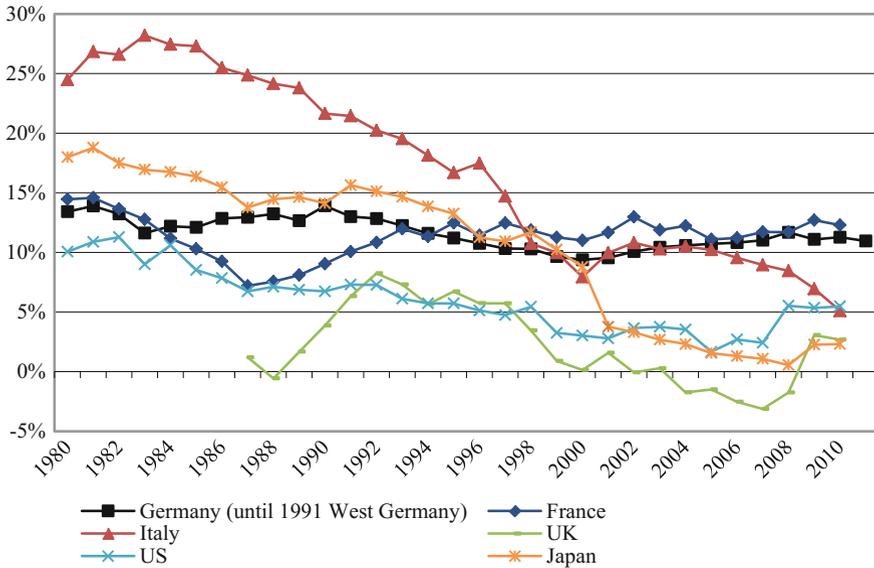


**Fig. 13.1** Primary gross income of the household sector by type, Germany, 1980–2011 (% of total). *Source* Statistisches Bundesamt (2011), own calculations

After unification, the saving rate for united Germany saw a tendency to decline in the course of the 1990s and by 2000 it had fallen below 10%. However, when the new economy crisis hit in 2000/2001, this tendency was reversed and the saving rate increased well above 11%.<sup>2</sup> 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 with a lower propensity to save; 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 market and a reduction of social benefits (*Agenda 2010*, *Hartz-Laws*); and 3. the absence of wealth effects on consumption, which would have lowered the propensity to save out of current 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

<sup>2</sup>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.

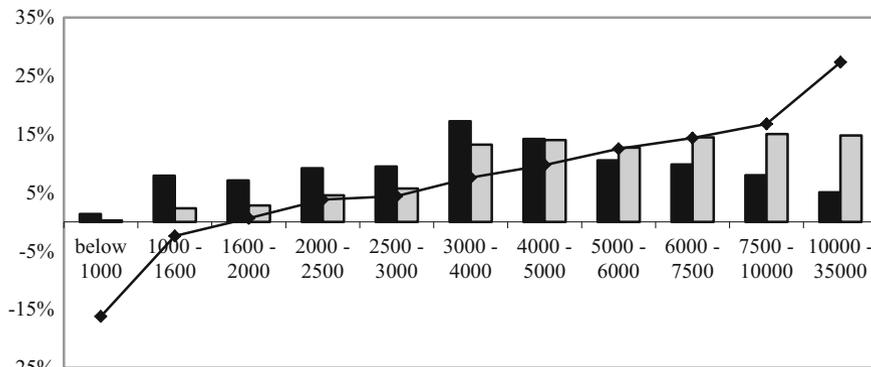


**Fig. 13.2** Net saving of the household sector, France, Germany, Italy, Japan, US, UK, 1980–2011 (% of net disposable income). *Source* European Commission (2012)

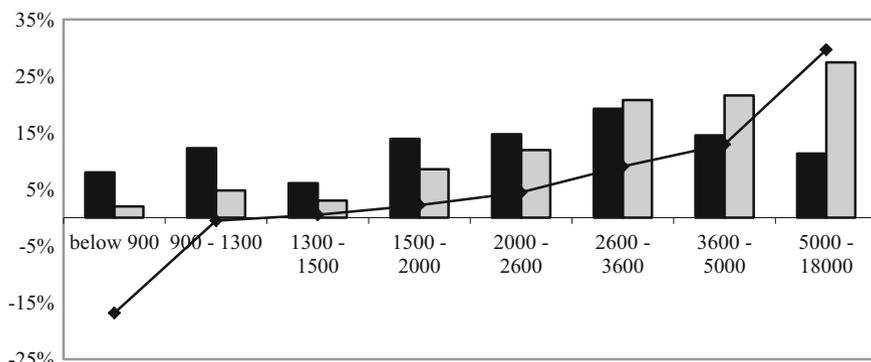
individual household income, irrespective of the source of income, as Fig. 13.3 suggests. Brenke (2011), covering more recent data from the German Socio Economic Panel (GSOEP), reports that households in the bottom half of the distribution have slightly reduced their saving rates after 2000, whereas 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.<sup>3</sup>

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. However, as Fig. 13.3 suggests, and the study by Brenke confirms, the lowest income groups were not able to increase their

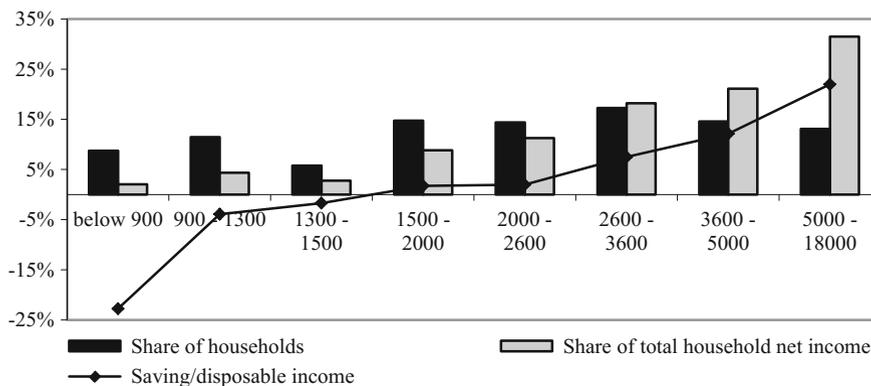
<sup>3</sup>Van Treeck and Sturm (2012) preliminarily conclude from this evidence that the relative income model, according to which consumption expenditure is affected by relative income (‘keeping up with the Joneses’), has little explanatory power for Germany.



(a) 1993 (in DM)

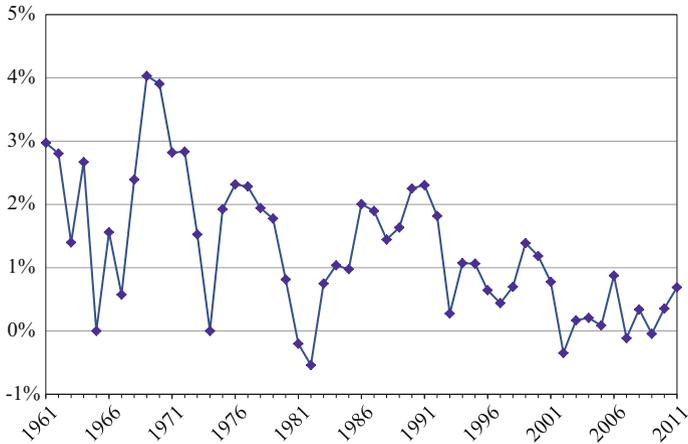


(b) 2003 (in euros)



(c) 2008 (in euros)

**Fig. 13.3** Propensity to save out of monthly disposable income by income group, Germany, 1993/2003/2008. *Source* van Treeck et al. (2007, p. 76), Statistisches Bundesamt (2008), own calculations



**Fig. 13.4** Real GDP growth contribution of private consumption, Germany, 1961–2011 (percentage points). *Source* European Commission (2012)

saving rate, even though they were likely to be most strongly affected by rising inequality and income insecurity. On the contrary, the already low or even negative saving rates of the (very) low income households declined even further. Exploiting the more recent data of the FESSUD Finance and Well-Being Survey, Betzelt et al. (2016) find that the likelihood to have taken a loan with the purpose of covering current living expenses and/or an unexpected expense during 2009–2014 is higher for the bottom and the second income quintile than for higher income quintiles in Germany. They also relate these findings to recent developments in the German labour market, which increased the polarization of working conditions and wage dispersion, particularly in the low-wage sector, and to the high number of ‘hidden poor’, which do not participate in jobseekers’ assistance schemes because of a lack of information or fear of stigmatisation and/or state intervention into their private life. They suggest that these developments have increased the need of low-wage workers and ‘hidden poor’ to partly take on debt to cover basic and unexpected expenditures. This might explain to some extent why saving rates of low income groups stayed negative even in the face of an increasing desire for precautionary savings. 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 was 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 before the crisis. Furthermore, German households’ wealth increases were fairly moderate from the mid-1990s until the crisis, and German house prices did

not see any significant tendency to rise in the same period.<sup>4</sup> We will examine the development of financial wealth in more detail in the next section.

Because of the increasing propensity to save out of disposable income, consumption demand in Germany remained weak, particularly, after the new economy crisis of 2000/2001. 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 (Fig. 13.4).

## 13.4 Household Wealth and Indebtedness

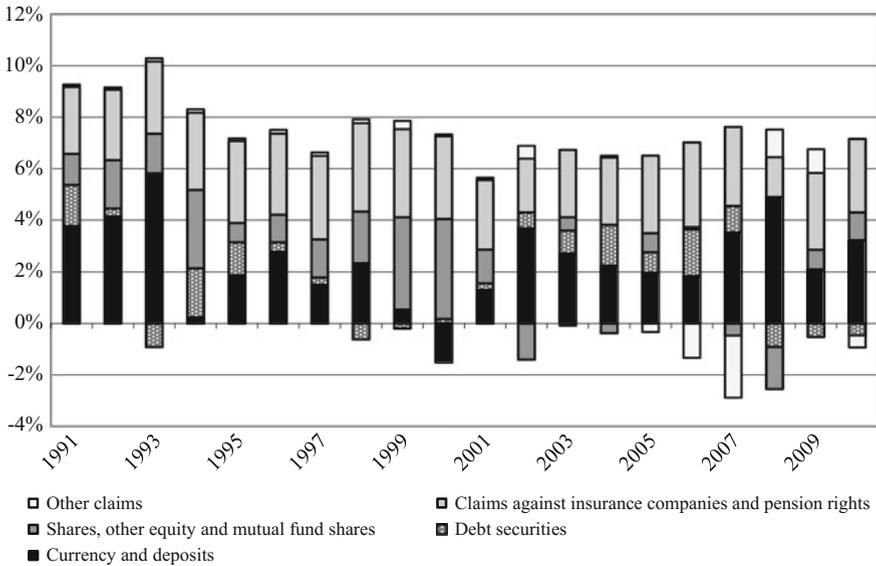
Figure 13.5 shows the composition of the annual flows of saving of the private household sector (here again including non-corporate business and non-profit organisations) from 1991 to 2010 (as a percentage of nominal GDP). As can be seen, contributions to insurance and pension funds were almost constant 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 Chap. 12.<sup>5</sup> 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.

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 Fig. 13.6. 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

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<sup>4</sup>See also Klär and Slacalek (2006) and Hein (2011b).

<sup>5</sup>This is confirmed by data of the *Deutsche Aktieninstitut* (German Institute for Stocks). The number of holders of shares or investment fund shares that were 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 were 10.2 Million direct or indirect shareholders. 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 (Deutsches Aktieninstitut 2012). See also Chap. 3 of this book.

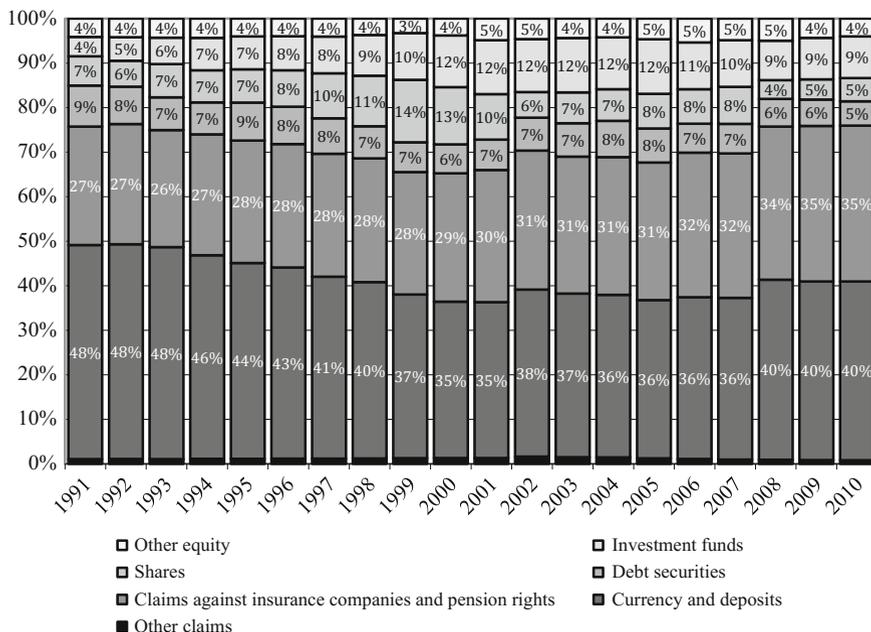


**Fig. 13.5** Net acquisition of financial assets by the household sector, Germany, 1991–2010 (% of GDP). *Source* Deutsche Bundesbank (2012), European Commission (2012), own calculations. *Notes* Debt securities in Figs. 13.5 and 13.6 include money market paper, long-term debt securities and financial derivatives

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, but 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.

Next, real assets and distributional issues will be included in the overview of the composition of household wealth. Furthermore, the development of financial liabilities of this sector will be addressed. Real and financial net wealth (including real estate, net financial assets, claims against private insurance companies,<sup>6</sup> shares and ownership of firms, gold, jewellery, art objects, etc.) is extremely unequally distributed among households and individuals in Germany, and the degree of

<sup>6</sup>Claims against the public pay-as-you-go pension system are not included.

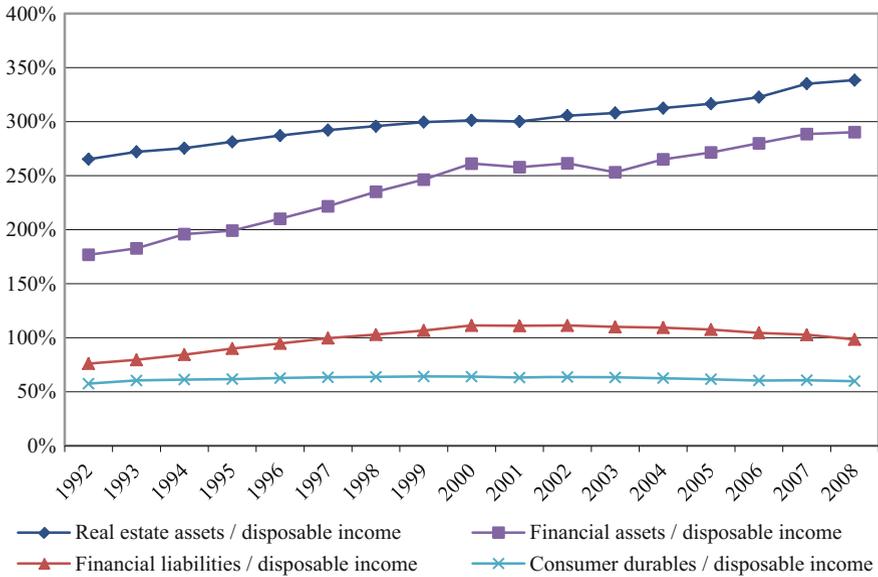


**Fig. 13.6** Financial assets of private households (including non-corporate business and non-profit organisations), Germany, 1991–2010 (% of total). *Source* Deutsche Bundesbank (2012), own calculations

inequality had actually increased prior to the Great Recession, as a 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 euros in 2002 and at 15,288 euros in 2007, while the medium value was at 80,055 euros in 2002 and at 88,034 euros in 2007. 27% of the adults did not have any wealth at all or were even in debt, whereas the upper 10% had an average net wealth of 220,000 euros per person. The wealthiest 10% held 61.1% of net wealth in 2007 (57.9% in 2002), while the bottom 50% had hardly any wealth (1.3% of total net wealth in 2002, 1.2% in 2007). Net wealth of the poorest decile was negative: -1.2% in 2002 and -1.6% in 2007.

As can be seen in Fig. 13.7, households’ financial assets increased in relation to disposable income from the early 1990s up to the new economy crisis 2000/2001. This increase was mainly driven by private saving invested in financial assets, and, particularly in the second half of the 1990s, by the increase in the prices of shares.<sup>7</sup> 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.

<sup>7</sup>Figure A13.1 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.

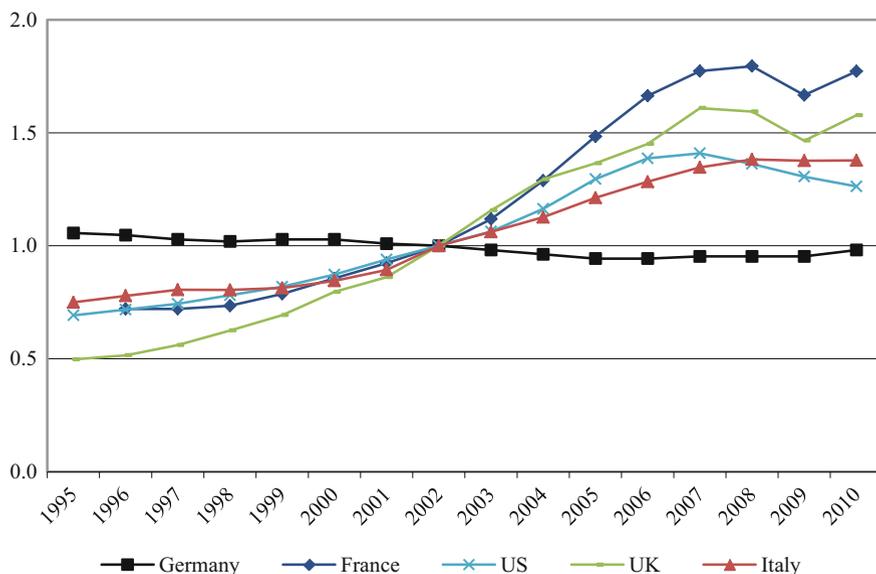


**Fig. 13.7** Assets and liabilities of households, Germany, 1992–2008 (% of disposable income). *Source* Deutsche Bundesbank and Statistisches Bundesamt (2010), Deutsche Bundesbank (2012), own calculations

The most important assets held by private households are real estate assets (Fig. 13.7). 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 until the Great Recession (Fig. 13.8).<sup>8</sup> 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 then stagnated (Table 13.1). For more details on the real estate sector see Chap. 14 of this book.

Financial liabilities in relation to disposable income slightly increased from the early 1990s until the crisis in 2000/2001, and have shown a declining tendency since then (Fig. 13.7). This contrasts with many other countries, where private household gross debt continued to increase relative to disposable income in the early 2000s (Table 13.2). In international comparison, German private household

<sup>8</sup>Note however that after the Great Recession property prices have strongly increased in Germany (see Chap. 14, Fig. 14.8).



**Fig. 13.8** Residential property prices, France, Germany, Italy, UK, US, 1995–2010 (Index 2002 = 1). *Source* BIS (2012a), own calculations

gross debt-disposable income ratios were still relatively low prior to the Great Recession (Table A13.1).<sup>9</sup>

However, (potential) over-indebtedness was a problem for the very poor households in Germany (see Table A13.2 in the appendix). Betzelt et al. (2016) find that when asked whether a household ‘had to work harder’ in 2009–2014 the likelihood of answering with ‘yes’ was significantly lower for the fourth and the fifth income quintile than for the bottom income quintile in Germany, while at the same time being exposed to personal loans<sup>10</sup> increased the likelihood to answer with ‘yes’. Since the distribution of the percentage share of German households with personal loans seems to be relatively even across different income quintiles, this suggests that (over-)indebtedness problems worsened the already precarious situation of low income households in Germany.

Finally, this section will look 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 Fig. 13.9, the most important component is housing loans. In relationship to nominal GDP, housing loans increased from 1990 until the early 2000s, and then have been decreasing. Consumption credit is of minor importance. Relative to GDP, this type of credit slightly increased during the 1990s until the crisis in 2000/2001, and since then has shown a falling tendency.

<sup>9</sup>See also Debelle (2004).

<sup>10</sup>Personal loans include consumer loans, credit lines, accounts with overdraft facility and instalment loans.

**Table 13.1** Housing status of households, Germany, 1993–2008 (%)

Year Reference day: 1 January	Germany		Former territory of the Federal Republic		New eastern Länder and East Berlin	
	Tenant	Owner	Tenant	Owner	Tenant	Owner
	in %					
1993	61.0	39.0	55.0	45.0	81.0	19.0
1998	59.7	40.3	56.4	43.6	74.1	25.9
2003	57.0	43.0	54.4	45.6	68.3	31.7
2008	56.8	43.2	54.3	45.7	67.5	32.5

Source Statistisches Bundesamt (2012)

**Table 13.2** Household gross debt and net wealth, selected countries, 1995–2005 (% of annual disposable income)

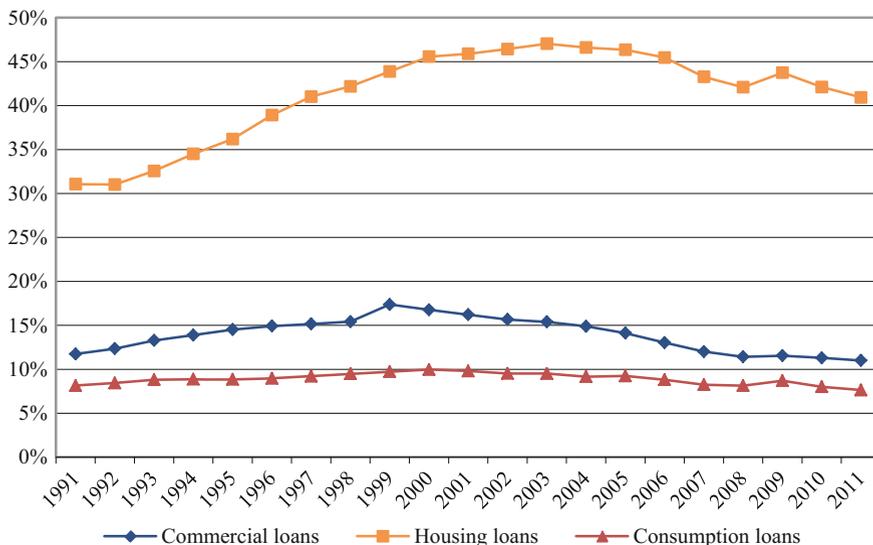
	Gross debt			Net wealth		
	1995	2000	2005	1995	2000	2005
US	93	107	135	510	575	573
Japan	130	136	132 <sup>a</sup>	736	750	725 <sup>a</sup>
Germany	97	111	107	541	575	578
France	66	78	89	461	547	752
Italy	32	46	59	702	820	936 <sup>a</sup>
UK	106	118	159	569	750	790
Canada	103	114	126	370	527	640
Australia	83	120	173	514	567	734
Denmark	188	236	260 <sup>a</sup>	357	524	562 <sup>a</sup>
Finland	64	66	89	202	302	319
Ireland		81	141		618	775
Netherlands	113	175	246	369	528	515
New Zealand	96	125	181	472	445	670
Spain	59	83	107 <sup>a</sup>	540	646	935 <sup>a</sup>
Sweden	90	107	134	262	387	436

Source André et al. (2006, p. 9)

Notes Debt refers to total liabilities outstanding at the end of the period. Net wealth is defined as non-financial and financial assets minus liabilities

<sup>a</sup>For year 2004 instead of 2005

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 A13.1 in the Appendix, the number of credit cards issued has increased continuously since the mid-1990s. However, 97.5% of credit cards only have a payment function.



**Fig. 13.9** Loans to households by type, Germany, 1990–2011 (% of GDP). *Source* Deutsche Bundesbank (2012), European Commission (2012), own calculations

## 13.5 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 a reduction of 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 culture’ in Germany were, therefore, very short-lived. 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 did not increase, the relationship of real estate wealth to

GDP or to disposable income continuously increased from the early 1990s onwards. However, financial and real estate wealth are extremely unequally distributed in Germany, and inequality actually increased in the early 2000s.

Financial liabilities-disposable income ratios slightly increased during 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 euros 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. Therefore, (potential) over-indebtedness has been a problem for the very poor households in Germany.

## Appendix

(Figure A13.1, Tables A13.1, A13.2).



**Fig. A13.1** DAX, Germany, 1988–2012 (December 1987 = 1000). *Source* Deutsche Bundesbank (2012)

**Table A13.1** Payment cards issued by function, Germany, 1996–2010 (end of year, in 1000)

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Cards issued in the country (thousands) <sup>1</sup>															
Cards with a cash function	80,454	84,960	91,324	99,250	106,323	125,508	119,392	116,355	114,836	113,311	104,217	123,558	125,714	129,595	130,223
Cards with a debit function	71,814	7,5760	81,145	9,0210	99,177	93,234	93,658	90,015	88,502	91,577	89,709	100,740	100,667	101,762	102,197
Cards with a delayed debit function <sup>2</sup>	13,540	14,200	15,179	17,040	17,747	17,969	19,694	20,203	20,432	21,141	18,260	18,792	18,991	20,522	21,613
Cards with a credit function	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,452	3,221	3,704	3,728
Cards with an e-money function	22,000	35,000	60,700	60,700	60,700	67,333	62,597	62,817	63,372	64,575	65,906	77,774	79,889	86,006	95,280
of which: cards with an e-money function which have been loaded at least once <sup>3</sup>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,428	4,453	4,863	5,185
Total number of cards (irrespective of the number of functions on the card)	85,354	89,960	96,324	107,250	116,923	125,624	121,019	118,395	117,840	123,390	118,770	132,258	133,586	139,137	139,021
of which: cards with a combined debit, cash and e-money function	n.a.	n.a.	60,700	60,700	60,700	58,885	61,525	62,574	62,398	65,441	64,168	66,099	76,783	81,263	85,149
Memo															
Retailer cards <sup>4</sup>	4,900	5,000	5,000	8,000	10,600	7,400	7,700	8,500	9,300	9,300	10,500	12,600	11,400	10,100	n.a.

Source BIS (2002, 2007, 2012b)

<sup>1</sup>Partly estimated for reference period 2007. Different methodology and data collection method since reporting year 2007 entail breaks in series when comparing 2007 with previous years' data<sup>2</sup>Includes cards with a credit function up to 2006<sup>3</sup>Cards with an e-money function which are credit balanced at the end of the period<sup>4</sup>Part of delayed debit function (charge cards). The German word *Kreditkarte* is used for both credit and charge cards

**Table A13.2** Over-indebtedness of private households, Germany, 1989–2006

Year	Over indebted households in million <sup>1</sup>	Over indebted households due to outstanding loans only in million
1989	1.2 <sup>2,3</sup>	–
1994	2 <sup>3</sup>	–
1997	2.68 <sup>3</sup>	–
1999	2.77 <sup>3</sup>	–
2002	3.13 <sup>4</sup>	2.4 <sup>5</sup>
2003	–	2.9 <sup>5</sup>
2004	–	2.88 <sup>5</sup>
2005	–	1.9 <sup>5</sup>
2006	–	1.6 <sup>5,6</sup>

Source Deutsche Bundesregierung (2008, p. 185)

<sup>1</sup>Over a longer period of time, despite a reduction in living standards, income and wealth are not sufficient to settle existing liabilities

<sup>2</sup>West Germany

<sup>3</sup>Source Korczak, D., GP-Forschungsgruppe: Überschuldung in Deutschland zwischen 1988 und 1999, Gutachten erstellt im Auftrag der Bundesregierung im September 2000

<sup>4</sup>Source Korczak, D.: Überschuldungssituation in Deutschland im Jahr 2002, München 2004

<sup>5</sup>Source Zimmermann, G. E.: Ermittlung der Anzahl überschuldeter Privathaushalte in Deutschland sowie weitere Kennzahlen zum Ausmaß privater Überschuldung auf der Basis der SOEP 2006, Gutachten im Auftrag des Bundesministeriums für Familie, Senioren, Frauen und Jugend, Karlsruhe 2007

<sup>6</sup>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

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## Chapter 14

# The Real Estate Sector and Its Relation to the Financial Sector

**Abstract** 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.

### 14.1 Introduction

Unlike many 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 after the end of the subprime crisis in the US in 2007. We argue here that the relative stability of the German real estate market is mainly 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 structures that were established after the Second World War still prevail to a certain extent and stabilised the market. In the 2000s 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 contributed 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 asked for sufficient own capital before they financed 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. However, after 2011 real estate prices started to increase substantially and there are discussions about the development of local real estate bubbles.

For an in-depth analysis of the real estate market this chapter will outline the most important features of the German real estate sector and draw conclusions. With this objective in mind, 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.

## 14.2 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%. 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).<sup>1</sup> The development of

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<sup>1</sup>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 and 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 in these countries were weakened by high inflation levels in combination with restrictive rent controls. A significant social rental sector has 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 and Strubenhoff 2003, pp. 20–21).

this particular model in Germany has historical roots which will be shortly discussed.

Until the First World War, residential property in Germany 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 19<sup>th</sup> 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 20<sup>th</sup> century was 75.9. The comparable figure for 1990 is 10.3 (Gondring 2009). 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 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 the First World War, 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 or public good. 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<sup>2</sup> was passed.<sup>3</sup> 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 the Second World War** A large part of the German housing stock in the big cities was destroyed during the Second World War. In addition, the influx of displaced Germans led to a shortage of housing. This meant that after the Second World War there was a lack of about 4.5 Million housing units (Voigtländer 2010). This situation 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 after the Second World War. With the help of rent controls, 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<sup>4</sup> in 1955 rents were allowed to increase gradually. In 1960 the Reduction of Controls in the Housing Market and for a Social Rent- and Housing Law<sup>5</sup> 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 rent) (Gondring 2009, pp. 6–13).

After the Second World War the government limited the commodification of private housing provision. It introduced measures to stimulate private building activity and thus increase the supply of housing (Gondring 2009, pp. 6–13). In 1954 the first Law for the Promotion of Housing Construction (WoBauG)<sup>6</sup> 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.

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<sup>2</sup>*Wohngemeinnützigkeitsgesetz.*

<sup>3</sup>In the Profit Housing Act 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 2008).

<sup>4</sup>*1. Bundesmietengesetz.*

<sup>5</sup>*Gesetz zum Abbau der Wohnungszwangswirtschaft und über ein soziales Miet- und Wohnrecht.*

<sup>6</sup>*1. Wohnungsbaugesetz (WoBauG).*

However, the program in Germany was different in two ways. Firstly, the program was mainly designed to stimulate private rental building activity.<sup>7</sup> 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. A second Law for the Promotion of Housing Construction<sup>8</sup> was passed in 1956 and introduced tax benefits for the construction of individual property. The social housing schemes after the Second World War laid the foundations for Germany's large and diversified rental market (Voigtländer 2010). 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 or her own property. Differently, Germany has a well-developed market for rental housing (between 55 and 60% of the German housing stock is available for rent<sup>9</sup>—see Fig. 14.1). 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 real estate prices and rents (see Fig. 14.8), so that a couple of laws<sup>10</sup> were passed to protect tenants. In particular, it ruled out the possibility of terminations for variations of contract,<sup>11</sup> 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, pp. 6–13).

In 2002, the Law for the Promotion of Housing Construction was replaced by the Residential Support Act.<sup>12</sup> 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

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<sup>7</sup>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.

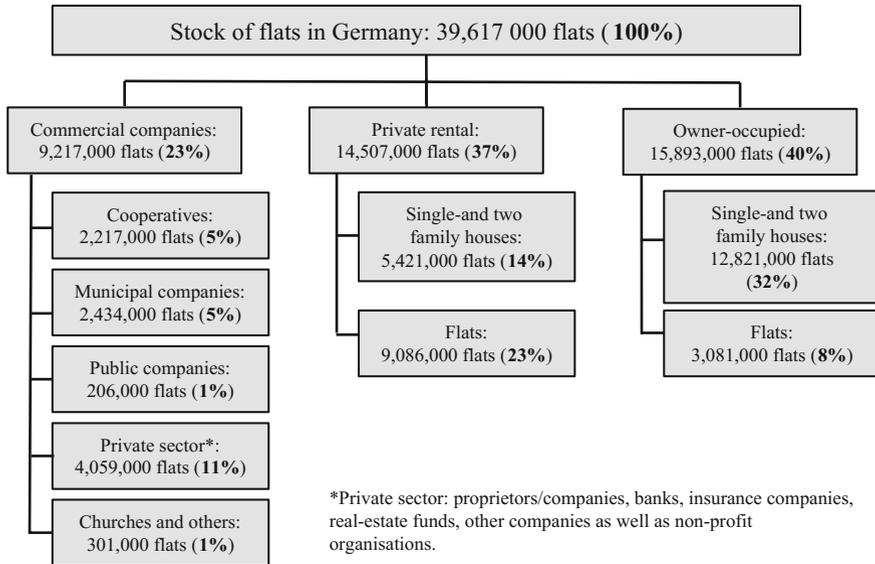
<sup>8</sup>2. *Wohnungsbaugesetz* (WoBauG).

<sup>9</sup>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 2012c).

<sup>10</sup>First and second Act for the Protection against Termination of Lease (*Wohnraumkündigungsschutzgesetz*) and Act on Rental Rates (*Miethöhegesetz*).

<sup>11</sup>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 based on minor modernisations.

<sup>12</sup>*Wohnraumförderungsgesetz*.



**Fig. 14.1** Ownership structure of the housing stock, Germany, 2006. *Source* Stinauer and Stachen (2011, p. 14), our translation

strategy, but kept a statute oriented at the goals of the Limited Profit Housing Act<sup>13</sup> from 1940 (Hain 2008).

**Privatisations of Public Housing Since the 1990s<sup>14</sup>** In 2006, 11% of the housing stock that was available for rent was still owned by municipalities or other public owners (see Fig. 14.1). However, the federal government in particular, but also municipal authorities and the German states, 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<sup>15</sup> 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 in 1997 with the purchase of the non-profit making cooperative *Deutschbau*<sup>16</sup> by daughters of *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 euros in the period 1997 to mid-2012.

<sup>13</sup>*Wohngemeinnützigkeitsgesetz.*

<sup>14</sup>Data in this section was provided by the *Deutsche Mieterbund e.V.* if not indicated otherwise.

<sup>15</sup>*Deutscher Mieterbund e.V.*

<sup>16</sup>*Gemeinnützige Deutsche Wohnungsbaugesellschaft mbH.*

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% of those sales, while 43% 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.<sup>17</sup> 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. Between 1999 and June 2006 they bought 642,000 flats in Germany (and sold 42,000). Other German entities purchased 247,000 flats. The public authorities bought 280,000 flats. However, those were mainly reorganisations of ownerships among public entities. Taken all together, in this period there was a net of 442,000 flats sold from public to private entities. Also industrial companies reduced their holding of flats by 196,000 units. The only large net buyers were foreign investors, which purchased 600,000 flats. Hence, while 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** To understand these developments, one has to consider the specific situation of the housing stock in the former German Democratic Republic (GDR) after German reunification in 1990 (on reunification see Heine et al. 1990). The municipal housing administration in the GDR owned about 3.5 million apartments. Those were transferred into independent real estate associations, most of which were completely 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 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 (Simons et al. 2010). From 1991 to 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<sup>18</sup> 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*,<sup>19</sup> which was solely served by the federal state. However, to be able to do so, the housing associations needed to agree on privatising 15% of their housing stock. Overall, the *Inherited Debt Fund* took over 14 billion euros of old debt and 3.6 billion euros of interest payments. About 12 billion euros of old debt remained with the housing associations (Simons et al. 2010).

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<sup>17</sup>*Bundesversicherungsanstalt für Angestellte*.

<sup>18</sup>*Altschuldenhilfegesetz*.

<sup>19</sup>*Erblastentilgungsfonds*.

With the economic situation worsening in the former GDR and a permanent flow of people to more booming regions in the united Germany the number of unoccupied flats increased to about 16% 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% by 2008, and on average, the housing associations are able to generate positive profits today (Simons et al. 2010).

### 14.3 Size and Composition of the German Real Estate Stock

The stock of real estate is an important part of German national wealth and an important part of households' portfolios. The Federal Statistical Office<sup>20</sup> calculated the value of real estate in Germany at 6,613 billion euros (3,925 residential, 2,688 non-residential) and of building land at 2,118 billion euros in 2008. This is 86% 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 14.1 provides estimations for the value of different forms of real estate in Germany. One can see that measured by value 73% is residential real estate and 27% is commercial real estate. The ownership structure in the housing market can be further subdivided as in Fig. 14.1. It can be seen that a smaller part is owner occupied (40%) and a larger part of the housing stock is available for rent (60%). The latter can be subdivided into commercial companies 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 owned in 2006 about 37% of the total housing stock. About 23% of the housing stock was 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% of the professionally managed housing stock, or 12% of the total housing stock. Their focus is still the provision of housing for low-income households and for particular target groups (such as homeless, pregnant or disabled persons). The group of the private sector commercial companies 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

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<sup>20</sup>Statistisches Bundesamt.

**Table 14.1** Composition of the real estate stock by type, Germany, 2012

Type of use	Calculation	Value in billion euros	Share in %
<b>Dwellings</b>			
Owner occupied	17.5 Mio. apartments $\times$ 250,000 euros	=4,375	73
Available for rent	22.5 Mio. apartments $\times$ 100,000 euros	=2,250	
<b>Commercial</b>			
Office space	410 Mio. m <sup>2</sup> $\times$ 1,700 euros/m <sup>2</sup>	=700	27
Retail	120 Mio. m <sup>2</sup> $\times$ 3,400 euros/m <sup>2</sup>	=410	
Hotel	1.5 Mio. rooms $\times$ 60,000 euros/room	=90	
Commercial or business premise	2.6 billion m <sup>2</sup> $\times$ 430 euros/m <sup>2</sup>	=1,100	
		=8,900	100

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

there are only about 4 million housing units (or 10% of the total housing stock) owned by this group. Whether this will increase is questionable. On the one hand, the financial difficulties of many municipal authorities may lead to further privatisation of the 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 the publicly owned housing stock (Stinauer and Stachen 2011).

## 14.4 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 14.2 gives an overview of the importance of the three activities for the German economy before the Great Recession. We will look at the three areas in turn.

The group of real estate management is the most important regarding gross value added. Overall, it adds 263 billion euros to total gross value added (12.4% 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% of total revenues in 2009), renting or leasing of own real estate (79.5%), real estate brokerage (4.5%) and management of real estate (10%) (Statistisches Bundesamt 2012a, p. 8).

**Table 14.2** Employment and gross value added in the real estate sector, Germany, 2008

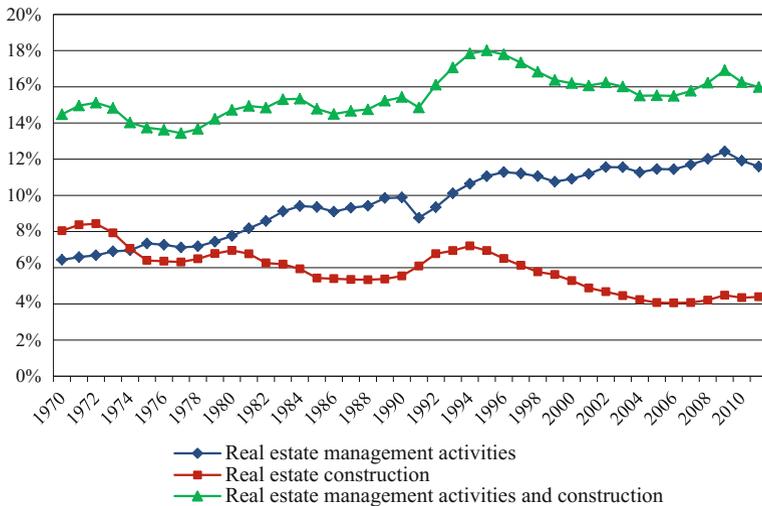
	Unit	Real estate management	Construction	Financial services	Total
Gross value added	Billion euros	263	95	37	395
Share of total gross value added	%	12.4	4.5	1.8	18.7
Employees	In thousand	428	236	339	3132
Share of employees	%	1.1	5.9	0.8	7.8

Source Deutsche Bundesbank (2012), Statistisches Bundesamt (2006, 2012b), own calculations  
 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%). The same method was applied to calculate the employment of the financial sector that is related to real estate financing

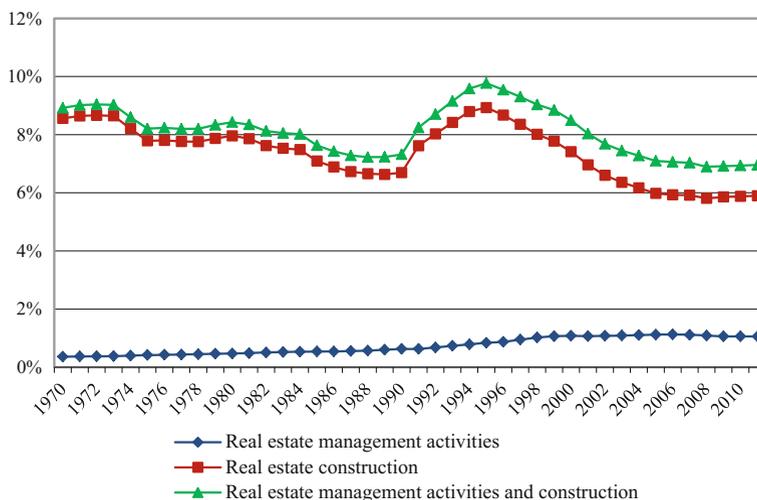
Employment in the sector takes a much lower share. With 428.000 employees, those activities only contribute 1.1% to total employment in Germany.

The picture is reversed for the construction sector. In 2008 it added 95 billion euros or 4.5% 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% of total employment in the economy.

Figures 14.2 and 14.3 show the shares of the construction sector and of real estate management activities since the 1970s. The construction sector declined in



**Fig. 14.2** Gross value added by sector, Germany, 1970–2011 (% of total value added). Source Statistisches Bundesamt (2006, 2012b), own calculations



**Fig. 14.3** Employment by sector, Germany, 1970–2011 (% of total employment). *Source* Statistisches Bundesamt (2006, 2012b), own calculations

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 6.5–12%. Employment developed similarly, increasing its share from 0.4 to 1.1%. Overall, the real estate sector has become more important regarding value added. However, its importance for employment has declined.

For the financial sector the real estate sector is important, because a relevant business line is the provision of loans for real estate investment and purchases. 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. About 49% of all outstanding loans of the banking sector in 2008 were classified as real estate loans (Deutsche Bundesbank 2012). If one regards this as an indicator for the importance of real estate in banks' overall business, the real estate sector is responsible for around 37 billion euros in value added and about 340,000 jobs.<sup>21</sup> Adding all three areas together, the real estate sector is responsible for 18.7% of total gross value added and provided 7.8% of all jobs in the German economy in 2008 (Table 14.2).

<sup>21</sup>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 14.3** Gross value added of real estate related sectors, selected countries, 1991 and 2008 (% of total value added)

	Construction		Real estate management		Total	
	1991	2008	1991	2008	1991	2008
Germany	6.0	4.0	8.9	12.4	14.9	16.4
France	6.6	6.7	10.5	14.4	17.1	21.1
Italy <sup>a</sup>	6.2	6.2	9.4	13.3	15.6	19.5
Netherlands	5.6	5.8	7.1	8.2	12.7	14.0
UK	5.9	6.1	7.6	9.4	13.5	15.5
US	3.8	4.3	11.0	11.8	14.8	16.1
Japan	9.4	5.8	9.3	12.0	18.7	17.8
Austria	7.4	7.1	6.5	9.0	13.9	16.1

Source OECD (2012), own calculations

<sup>a</sup>Real estate management figure for 1992 instead of 1991

**Table 14.4** Employment in real estate related sectors, selected countries, 1991 and 2008 (% of total employment)

	Construction		Real estate management		Total	
	1991	2008	1991	2008	1991	2008
Germany	7.3	4.9	0.6	1.1	7.9	6.0
France	6.9	6.6	1.1	1.1	8.0	7.7
Italy <sup>a</sup>	6.2	6.8	0.3	0.3	6.5	7.1
Netherlands	6.5	5.2	0.8	1.0	7.3	6.2
UK	4.8	4.9	0.8	1.6	5.6	6.5
US	4.2	5.2	1.1	1.1	5.3	6.3
Japan	9.8	7.8	1.2	1.2	11.0	9.0
Austria	7.9	7.2	1.3	1.5	9.2	8.7

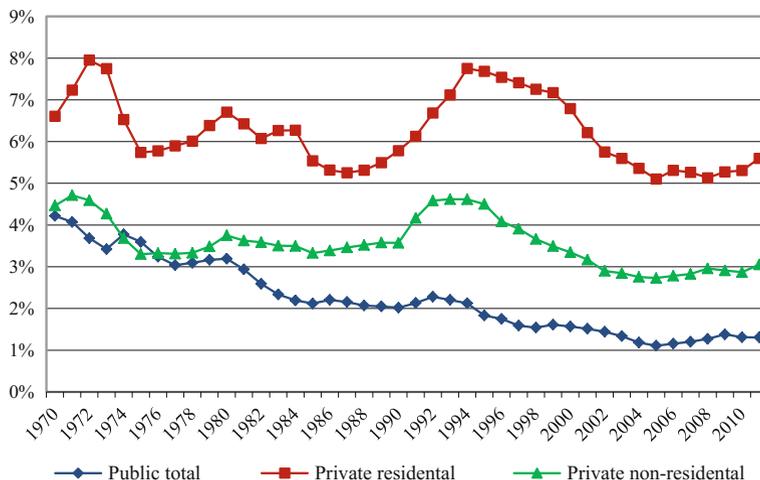
Source OECD (2012), own calculations

<sup>a</sup>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 14.3). In particular, the share of the construction industry is relatively low. The same is true for employment (see Table 14.4). Overall, economic activity in Germany hinges less on real estate management and construction than in other European countries (with exception of the Netherlands).

## 14.5 Investment in Real Estate

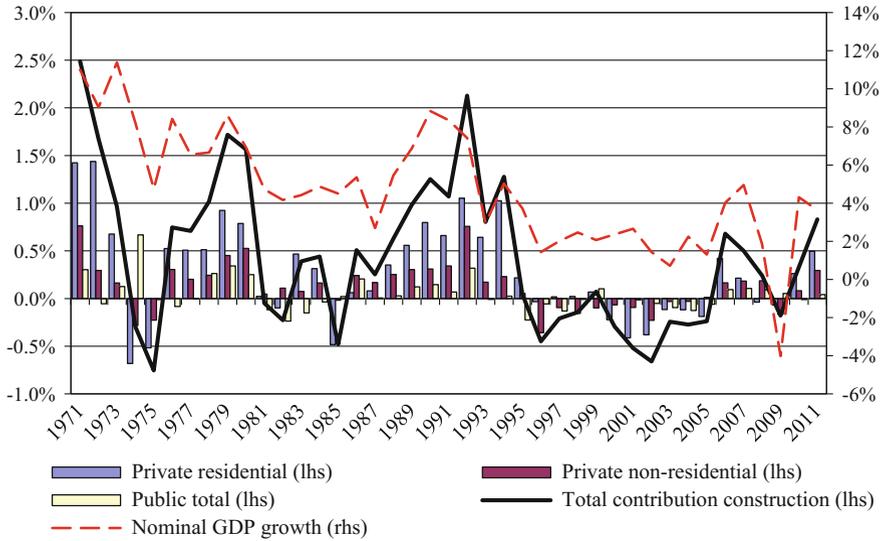
The construction of new residential and non-residential buildings is an important part of investment and therefore of private demand. Figures 14.4 and 14.5 illustrate the share of real estate investment in GDP and the growth contributions to nominal



**Fig. 14.4** Real estate construction, Germany, 1970–2011 (% of GDP). *Source* Statistisches Bundesamt (2012b), European Commission (2012), own calculations, data until 1990 provided by Statistisches Bundesamt. *Notes* Until 1990 West Germany only

GDP by different types of real estate investment. Figure 14.4 shows that in 1970 the combined investment in real estate amounted to almost 15% of GDP (11% private, 4% public). The public sector decreased its investment in real estate constantly, so that its share by 2011 amounts only to 1.3%. Also, the private sector decreased its investment in real estate, so that private real estate investment dropped to only 8.6% of GDP in 2011. Growth contributions of real estate construction activities to GDP are displayed in Fig. 14.5. Two more or less strong boom periods in real estate investment can be identified. One in the 1970s, which was interrupted by the recession in 1974 and 1975, and which is 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 the process of German reunification. After 1995 the growth contributions of private real estate investment were mostly negative. This only changed in 2006 when activity picked up moderately again and contributions became positive.

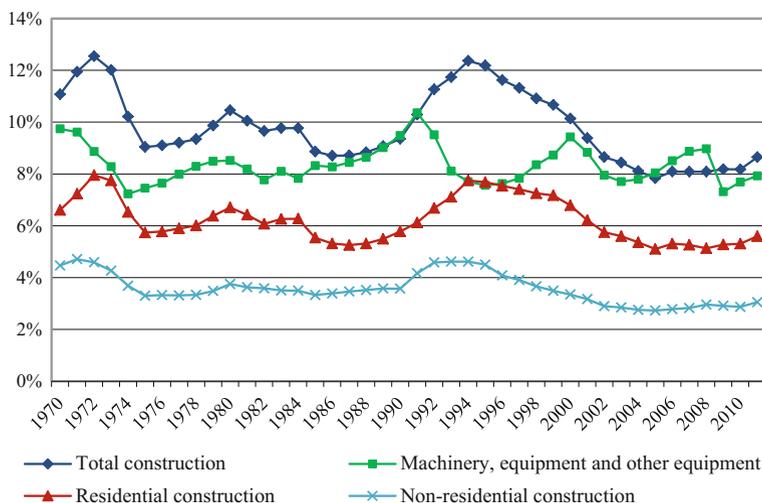
Figure 14.6 shows the ratio of mortgage loans to GDP and total mortgage loans. While during the 1970s mortgage loans grew in line with GDP, the increase in real estate construction activities in the early 1990s were financed by a strong expansion of loans. This has increased the stock of debt relative to GDP in Germany to unseen levels and signals the reunification real estate boom. The build-up of overcapacity in the real estate sector and the increase of indebtedness during the period of strong construction investment in the 1990s (Fig. 14.4) is one of the factors to explain the lasting stagnation of real estate sector investment in the following period and why Germany did not suffer from a real estate bubble in the 2000s.



**Fig. 14.5** Contribution of real estate construction to the growth of nominal GDP, Germany, 1970–2011 (percentage points). *Source* Statistisches Bundesamt (2012b), European Commission (2012), own calculations, data until 1990 provided by Statistisches Bundesamt. *Notes* Until 1991 West Germany only



**Fig. 14.6** Mortgage loans outstanding to domestic enterprises and private households, Germany, 1968–2011 (% of GDP (lhs), in billion euros (rhs)). *Source* Deutsche Bundesbank (2012), European Commission (2012), own calculations



**Fig. 14.7** Total private investment in construction, in machinery and equipment and in other products, Germany, 1970–2011 (% of GDP). *Source* Statistisches Bundesamt (2012b), European Commission (2012), own calculations, data until 1990 provided by Statistisches Bundesamt

Figure 14.7 shows how the different parts of private investment in GDP developed since the 1970s. 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% of GDP. Private investment in construction and machinery and equipment tended to move together until the early 1990s. Then construction investment increased strongly, whereas investment in machinery and equipment declined. Starting in the mid-1990s the share of private construction activity in GDP declined until it stabilised in 2006. The investment in machinery and equipment 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.

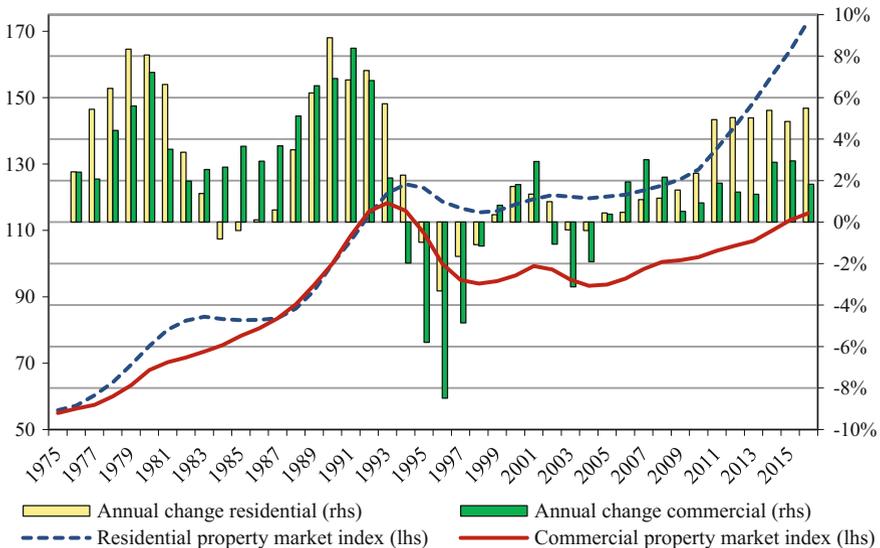
## 14.6 Real Estate Prices and Rents

It is particularly difficult to get a comprehensive picture of rent and real estate price developments in Germany. There is a range of statistics by the Federal Statistical Office. However, the information provided is limited and 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. It provides 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, pp. 21–22).

Figure 14.8 shows the index for real estate prices from 1975 to 2016. It is easy to identify three 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. The second phase lasts from 1995, where we see the collapse in prices after the reunification boom and a long-lasting stagnation of prices thereafter, until around 2011. In this phase the residential property market experienced a slight decrease before stagnating whereas the commercial property market suffered from a substantial fall in prices. Since 2011 real estate prices started to increase again. This new phase continues at the time of writing and it is open to which extent it develops into a real estate bubble. The factors considered causal for the substantial medium-term increases in real estate prices especially in some areas in Germany are the long period of very low interest rates starting shortly after the outbreak of the financial crisis in 2008, increasing foreign investment in the German real estate market which was considered to be undervalued by many investors and shortages of housing in Germany connected to the immigration from Euro area crisis countries and with the influx of refugees after 2013.

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 interesting to note that real estate prices moved opposite to international trends (Gesellschaft für Immobilienwirtschaftliche Forschung 2009). It



**Fig. 14.8** BulwienGesa commercial and residential property market index, Germany, 1975–2016 (Index 1990 = 100 (lhs), % (rhs)). Source BulwienGesa AG (2017), own illustration. Notes Until 1990 only West Germany

is also worthwhile mentioning that the volatility in residential real estate prices in Germany is particularly low. Prices in Germany fluctuated only half as much as those in the Netherlands, the 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.<sup>22</sup> And it can be explained in part by the overall cautious and traditional behaviour in the field of real estate financing and real estate investment. In more deregulated real estate markets interest rate changes have overall much larger effects (Cardarelli et al. 2008).

## 14.7 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 (Herr and Stachuletz 2010). According to Cardarelli et al. (2008) Germany belongs to the most regulated real estate markets. Table 14.5 shows an index which indicates how easy it is for households to get mortgage credits. Values are between 0 and 1 with 1 as the most deregulated market with the easiest access to mortgage credits. In 2008, the US had for example a value of 0.98 France had the lowest value (0.23), followed by Italy (26) and Germany (28). Many of the factors behind the index are not prescribed by law, but have developed due to specific characteristics and culture of the German housing market and the refinancing practices of banks. Demand as well as supply side factors play an important role here.

Generally, in Germany households do not acquire real estate before they have sufficient equity. Also, banks are cautious and, by international comparison, provide only a relatively low ratio of loans to the value of real estate. In 2007, the average loan to value ratio in Germany for a first-time house buyer was around 70% (Euro area average 79% (ECB 2009)). 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 loan to value ratio increased for lower income households (Voigtländer 2010, pp. 58–59). Additionally, the value of the collateral is calculated on the basis of the so-called collateral value<sup>23</sup> of the asset,

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<sup>22</sup>Empirical analyses showed that a 1% point increase in the short-term interest rate leads to a fall in house prices of 6.4% within a 2-year period in the UK. In Germany, prices only fall by 0.2%. 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 than in Germany (Gesellschaft für Immobilienwirtschaftliche Forschung 2009, p. 10).

<sup>23</sup>The collateral value (*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.

while in most other countries it is based on the higher current market value (see also Table 14.5).

Long-term financing and fixed interest rates on housing loans shelter real estate markets from the effect of short-term interest rate fluctuations. However, mortgage loans can have a longer maturity than the interest rate fixation period. In Germany, a fixation period of 5–10 years or even more is common. The share of new variable rate loans accounted for only 15% of all new loans in 2007 (ECB 2009, pp. 25–28). Variable rate loans, where the interest rate is for example indexed to the central bank refinancing 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.

A further feature of the German real estate market is that 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, even though it is possible from a legal point of view. It only amounted to 1–2% 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 14.5). Also, 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.

Financing real estate acquisition and real estate 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% of total bank lending to this customer group in 1970, it had increased to 46.8% by 2010. Overall, there was an amount of outstanding housing loans of 1.1 trillion euros 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. 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<sup>24</sup> enforces that institutions engaged in the lending business (granting money loans or acceptance credit) are credit institutions. Therefore, mortgage lenders are banks by definition and therefore fall under the supervision and regulation of the German Federal Agency for Financial Market Supervision.<sup>25</sup> There are only a few exceptions to this rule. One is the publicly owned development bank *KfW*<sup>26</sup>; another exception within certain limits covers insurance companies (London Economics 2008). However, the importance of

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<sup>24</sup>*Kreditwesengesetz (KWG).*

<sup>25</sup>*Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).*

<sup>26</sup>*Kreditanstalt für Wiederaufbau (KfW).*

**Table 14.5** Institutional differences in national mortgage markets and the mortgage market index

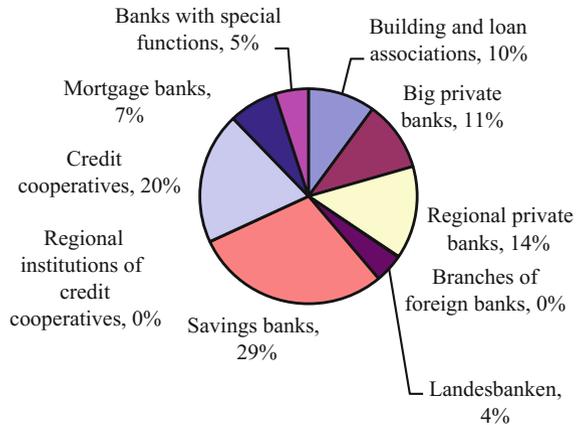
	Mortgage equity withdrawal	Refinancing (free prepayment)	Typical loan-to-value ratio (%)	Average typical term (years)	Covered bond Issues (% of residential loans outstanding)	Mortgage-backed security issues (% of residential loans outstanding)	Mortgage market index <sup>a</sup>
Australia	Yes	Limited	80	25	–	7.9	0.69
Austria	No	No	60	25	2.2	–	0.31
Belgium	No	No	83	20	–	1.9	0.34
Canada	Yes	No	75	25	–	3.6	0.57
Denmark	Yes	Yes	80	30	58.5	0.1	0.82
Finland	Yes	No	75	17	2.6	–	0.49
France	No	No	75	15	1.6	1	0.23
Germany	No	No	70	25	3.6	0.2	0.28
Greece	No	No	75	17	–	6.2	0.35
Ireland	Limited	No	70	20	4	6.6	0.39
Italy	No	No	50	15	–	4.7	0.26
Japan	No	No	80	25	–	4.7	0.39
Netherlands	Yes	Yes	90	30	0.7	4.6	0.71
Norway	Yes	No	70	17	–	–	0.59
Spain	Limited	No	70	20	11.1	5.7	0.4
Sweden	Yes	Yes	80	25	10.1	0.9	0.66
United Kingdom	Yes	Limited	75	25	0.9	6.4	0.58
United States	Yes	Yes	80	30	–	20.1	0.98

*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

<sup>a</sup>The higher the value of the index the more deregulated is the mortgage market. Calculation of the Index: For 'mortgage equity withdrawal' and 'refinancing (free prepayment)', values of 0, 0.5 and 1 are assigned to each country depending on whether mortgage equity withdrawal and free repayment are non-existent, limited, or widespread, respectively. For the other four variables in the Table, each country is assigned a value between 0 and 1, equal to the ratio to the maximum value across all countries

**Fig. 14.9** Housing loans to domestic enterprises and resident individuals from banks, Germany, 2012 (% of total loans). *Source* Deutsche Bundesbank (2012), own calculations



insurance companies in credit markets is rather low. In 2005 insurance companies had only a combined market share of 6% of mortgage loans (Statistisches Bundesamt 2007, p. 110).

In Fig. 14.9 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% are the main providers of this type of housing loans, followed by the group of private banks (big banks and regional banks) with a market share of 25% and the credit cooperatives that provide about 20% of the total loans in this line of business. Mortgage banks only play a minor role and provided 7% of all housing loans in 2012.

Banks with special functions had a strong growth of 95% in their outstanding housing loans between 2000 and 2006. In particular, the public *KfW*, which belongs to this group, was able to increase its market share with a special program for home ownership.

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 mortgaged-backed covered bonds<sup>27</sup> play an important role in Germany. Such a type of securitisation is not comparable with risky mortgage-backed securities widely used in the US before the subprime crisis, but rather with bills of exchange when more than one party guarantees the debt. Mortgaged-backed covered 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 real estate assets in the cover pool. The cover pool eligibility criteria are quite conservative by international standards. Only up to 60% of the collateral value<sup>28</sup> may be taken into account as collateral. This does not mean that banks cannot lend

<sup>27</sup> *Pfandbriefe*.

<sup>28</sup> *Beleihungswert*.

more than 60% of the collateral value. However, any excess cannot be funded via mortgaged-backed covered bonds and so funding in excess of 60% of collateral becomes more expensive for banks (IMF 2011, pp. 5–7). In 2008 mortgaged-backed covered bonds were relatively widespread and normally had a relatively long maturity. The amount of outstanding covered mortgage-backed bonds was 225 billion euros (20% of all real estate loans) and 68% of their maturity was more than 5 years, 30% even more than 10 years. Due to the high safety of covered bonds interest rates paid for them are relatively low, so banks can refinance themselves via mortgaged-backed covered bonds 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 relatively low interest rates without having to take over the maturity risk. This system of refinancing leads to certain incentives that can partly explain the structure of housing finance in Germany. The fact that mortgaged-backed covered bonds can only be used for funding up to 60% of the collateral value 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.<sup>29</sup> This works as an incentive for households to use a higher share of equity (Voigtländer 2010).<sup>30</sup>

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 first need to save a certain amount of money over a certain period. Normally, they earn an interest rate 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 usually 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 mortgaged-backed covered bonds 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 14.5, 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

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<sup>29</sup>For example the bank *ING DiBa* asked for an interest premium for loans above 60% of the collateral value of 0.10% points, above 80% of 0.35% points and above 95% of 1% point (ING 2012).

<sup>30</sup>Before 2005 mortgage banks had the exclusive allowance to issue mortgaged-backed covered bonds, but were in turn limited in the kind of business they were allowed to conduct. In 2005 a legal change, connected to the replacement of the Mortgage Bank Law by the Covered Bond Law, allowed most banks to acquire a license to issue mortgaged-backed covered bonds, without having to restrict their business. Therefore, those special banks lost in importance after 2005.

important role in the real estate sector by providing long-term stable funding and at the same time the real estate sector seems to be a relatively safe and stable business for the banking sector. Additionally, with the mortgaged-backed covered bonds a very safe class of assets is provided to investors in capital markets, coming close to the perceived safety of German government bonds. Overall, the German banks see the financing of residential real estate projects as a safe haven. While since the start of the financial crisis in 2008 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 that banks applied already before the crisis (Voigtländer 2010, p. 51).

The well-developed market for rental housing (up to 60% of the German housing stock, as shown above) is an important argument for the cautious behaviour of German households in the area of real estate investment. Private households only purchase housing when they decide to use it in the longer term and when buying seems to be advantageous. Given the option to rent a flat also in the long-run, 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, even though banks could offer such products from a legal point of view (Voigtländer 2010, p. 55).

## 14.8 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 stock companies, real estate investment trusts (REITs) and private-equity companies. One after the other will be discussed.

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 euros (in 1993 only 49.8 billion). The average equity share (equity in relation to assets held) is around 50% for closed funds according to the Feri EuroRating (Voigtländer 2010). On average the funds raised new equity of about 4.7 billion euros 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 constituted about 35% of the total market volume (Scope Analysis Research 2012a, p. 148), all three of them were closely related to banks.<sup>31</sup>

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 as a separate asset pool. As of 2012 there were 23 asset management companies active in the real estate business in Germany, which managed 46 different open real estate funds (BVI 2012). Legally open real estate funds can finance half of their assets with borrowed funds. In practice, the funds make use of this possibility to a differing degree. Actual debt ratios (debt to total assets) in 2012 ranged from 12.4 to 50.7%. From 2015 onward the maximum regulatory debt ratio was lowered to 30%. This new regulation is mainly supposed to make investment in these funds safer for investors and is in part a reaction to the trouble the funds had had during the financial crisis (Scope Analysis Research 2012b).

Figure 14.10 shows for open real estate funds 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 euros. Additionally, special funds<sup>32</sup> invested in real estate had equity of about 40 billion euros 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 euros (for comparison, the value for the UK was 58 billion euros and for France 60 billion euros). The minor significance of such stock companies becomes even more apparent if one is looking at the free float per person.<sup>33</sup> In Germany it amounted to 55 euros per inhabitant. For Austria, the UK, and the Netherlands the values were more than 10 times higher (Voigtländer 2010).

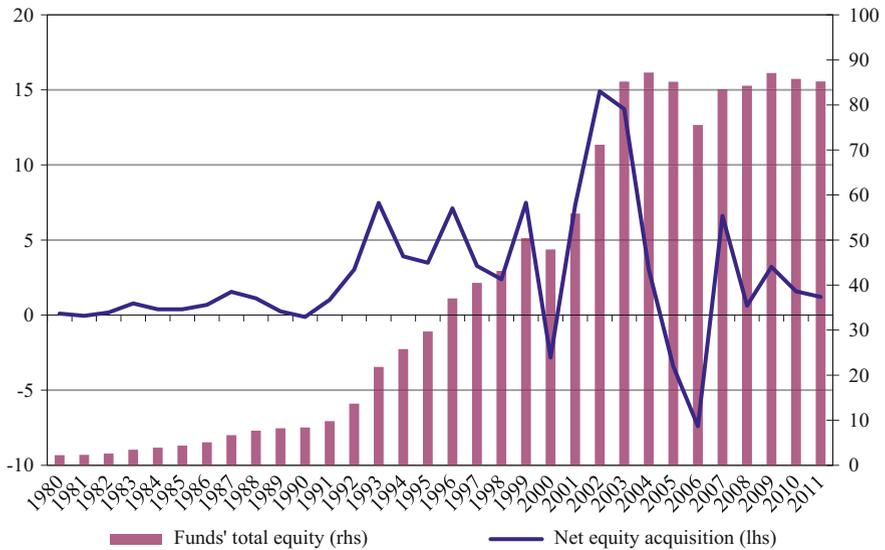
At the beginning of 2007 the so-called G-REIT (German Real Estate Investment Trust) was introduced to attract foreign investment into the German real estate market. These trusts are similar to real estate stock companies; however, they have certain tax advantages which make them particularly attractive to foreign investors (Voigtländer 2010). The overall attractiveness of G-REITs to investors seems to have been low. By 2011 only 4 REITs were registered with 2 in preparation with an overall estimated size of about 6.5 billion euros (REITs Deutschland 2012).

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<sup>31</sup>The three funds and the associated banking groups are: *DWS—Deutsche Bank/Real I.S.—Savings Bank Group/KGAL—Commerzbank, BayernLB, HASPA Finanzholding and Sal. Oppenheim.*

<sup>32</sup>Special funds are funds constituted mostly for institutional investors. They are not open to the general public.

<sup>33</sup>Amount of shares that is held by small investors and that actually is available for trade.



**Fig. 14.10** Total equity and net equity acquisition of open real estate funds, Germany, 1980–2011 (in billion euros). *Source* BVI (2012)

Private-equity companies are a relatively recent phenomenon in the area of real estate. Their acquisition of former publicly owned residential real estate has attracted public debate. After the acquisition of large housing stocks by private-equity investors, media and tenant associations reported a lack of maintenance, as rent increases and a neglect of contractual social obligations. This led to widespread opposition to their acquiring of further public housing stock, which was only partly successful however. Similar to closed real estate funds private-equity companies 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 to invest in the real estate sector. 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 were 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 increased but did not play an important role in Germany until recently (Gesellschaft für Immobilienwirtschaftliche Forschung 2009).

## 14.9 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 rental market acts as a stabiliser for the residential real estate market in Germany. Affordable rents and the 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 accumulate own equity to buy flats or houses and only do so when financing conditions are attractive.

Overall, the German market for real estate financing is relatively conservative. Germany belongs together with Italy and France still to the most regulated real estate markets in Western countries. Generally, households do not, as mentioned, acquire real estate before they have sufficient equity. Banks can offer relatively low interest rates as they refinance themselves through mortgage-backed covered bonds. Loans from building and loan associations can only be obtained after saving a certain amount of money in such institutions. This 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 for real estate loans did not develop. This is not related only to a lack of supply of subprime credits, but also because of a lack in demand. After all, the large residential rental market offers sufficient alternatives for households to entering an expensive and insecure loan contract. Young singles and couples with no or low equity, for example, were not forced to buy real estate and take credits at conditions which were risky. Private renters in the form of small wealth owners renting one or two flats or houses together with non-profit oriented renters dominate the rental market. The most important private profit-oriented financial investors in the real estate market are funds. Foreign investment in the real estate market increased after German unification. Overall, investment in real estate remained relatively unattractive for international investors due to a lack of transparency and taxation.

In the 2000s, unlike other countries, Germany did not suffer from huge real estate bubbles. This can partially be related to the fact that Germany experienced a moderate real estate bubble in the 1990s after German unification. But the main explanation is the relatively conservative German financial system with cautious credit supply in the field of real estate and cautions households which have the option to rent a flat. Foreign inflow of capital in the real estate sector was not sufficiently high to create bubbles. However, tendencies of a real estate bubble developed after the long period of low interest rates after the Great Recession.

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**Part IV**  
**Finance, Distribution and Crisis**

# Chapter 15

## Financialisation and Income Distribution

**Abstract** Germany has seen considerable re-distribution of income since the early 1980s, which accelerated in the early 2000s: a tendency of the labour income share to decline; rising inequality in the personal and household distribution of market and disposable income (although government redistribution has not been weakened), in particular at the expense of very low incomes; and a rise in top income shares, considering the top-10% income share. Examining the three main channels through which financialisation (and neo-liberalism) are supposed to have affected the wage or the labour income share and also inequality of household incomes, there is evidence for the existence of each of these channels in Germany since the mid 1990s, when several institutional changes provided the conditions for an increasing dominance of finance. First, the shift in the sectoral composition of the economy away from the public sector and towards the corporate sector, without favouring the financial corporate sector, however, contributed to the fall in the wage and the labour income share for the economy as a whole. Second, the increase in management salaries as a part of overhead costs together with rising profit claims of the rentiers, in particular rising dividend payments of the non-financial corporate sector, have in sum been associated with a falling wage and labour income share. Third, financialisation and neo-liberalism have weakened bargaining power of German trade unions through several channels.

### 15.1 Introduction

This chapter attempts to assess the effects of financialisation on income distribution in Germany from the 1980s until the financial and economic crises.<sup>1</sup> We will describe the trends of re-distribution of income in Germany for several indicators: the labour income share for functional income distribution, the Gini coefficients and percentile ratios for personal or household distribution, and finally the top income shares and their compositions. In the next step, we will then assess the effects of financialisation on functional income distribution in particular, applying a Kaleckian

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<sup>1</sup>This chapter is partly based on Hein and Detzer (2015).

approach towards the explanation of income shares. In this context, we will check if and to what extent the potential channels for the effects of financialisation on income distribution can be found in the case of Germany. In the final section we will sum up and conclude.

## 15.2 Trends of Re-distribution Since the Early 1980s

Generally, the period of finance-dominated capitalism has been associated with a massive redistribution of income. First, functional income distribution has changed at the expense of labour and in favour of broad capital income in several countries (Table 15.1). The labour income share, as a measure taken from the national accounts and corrected for the changes in the composition of employment regarding employees and self-employed, shows a falling trend in the developed capitalist economies considered here, from the early 1980s until the Great Recession, if we look at cyclical averages in order to eliminate cyclical fluctuations due to the well-known counter-cyclical properties of the labour income share. As can be seen, the fall in the labour income share was considerable in Germany, in particular from the cycle of the 1990s to the cycle of the early 2000s. However, redistribution was even more pronounced in several other countries, as for example Austria, France, Greece, Ireland, Italy, Spain and Japan.

Second, personal income distribution has become more unequal in most of the countries from the mid-1980s until the mid-2000s. Taking the Gini coefficient as an indicator, this is true for the distribution of market income, with the Netherlands being the only exception in the data set (Table 15.2). Germany is amongst those countries showing a considerable increase in inequality, which was only exceeded in Finland, Italy, Portugal the UK and Japan. If re-distribution via taxes and social policies by the state is included and the distribution of disposable income is considered, Belgium, France, Greece, Ireland, and Spain have not seen an increase in their Gini coefficients. In Germany, redistribution via taxes and social transfers has been considerable and not been decreasing over time. However, this did not prevent the Gini coefficient for disposable income from increasing. On the contrary, together with Finland, Italy, Portugal, Sweden and the US the increase in Germany was among the most pronounced. In fact, according to the OECD (2008) applying further indicators for inequality, Germany is one of the countries where the inequality of disposable income increased the most in the early 2000s before the Great Recession. And as can be seen in Table 15.3, this redistribution was mainly at the expense of those with very low incomes. While the P90/P10 ratio for disposable income increased significantly, the P90/P50 ratio hardly increased. The P50/P10 ratio also slightly increased.<sup>2</sup>

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<sup>2</sup>See Anselmann and Krämer (2012), Bach et al. (2009), Grabka and Goebel (2014) and SVR (2011, pp. 334–348) for more detailed studies on personal or household distribution of income in Germany.

**Table 15.1** Labour income share as percentage of GDP at current factor costs, average values over the trade cycle, selected countries, early 1980s–2008

	1. Early 1980s–early 1990s	2. Early 1990s–early 2000s	3. Early 2000s–2008	Change (3.–1.), percentage points
Austria	75.66	70.74	65.20	–10.46
Belgium	70.63	70.74	69.16	–1.47
France	71.44	66.88	65.91	–5.53
Germany <sup>a</sup>	67.11	66.04	63.34	–3.77
Greece <sup>b</sup>	67.26	62.00	60.60	–6.66
Ireland	70.34	60.90	55.72	–14.61
Italy	68.31	63.25	62.37	–5.95
Netherlands	68.74	67.21	65.57	–3.17
Portugal	65.73	70.60	71.10	5.37
Spain	68.32	66.13	62.41	–5.91
Sweden	71.65	67.04	69.16	–2.48
UK	72.79	71.99	70.67	–2.12
US	68.20	67.12	65.79	–2.41
Japan <sup>b</sup>	72.38	70.47	65.75	–6.64

Source Hein (2012, p. 13). Data European Commission (2010a)

Notes The labour income share is given by the compensation per employee divided by GDP at factor costs per person employed. The beginning of a trade cycle is given by a local minimum of annual real GDP growth in the respective country

<sup>a</sup>West Germany until 1990

<sup>b</sup>Adjusted to fit in 3 cycle pattern

Third, as data based on tax reports provided by Alvaredo et al. (2014) have shown, there has been an explosion of the shares of the very top incomes since the early 1980s in the US and the UK, which, prior to the financial crisis and the Great Recession, have again reached levels of the mid-1920s in the US and the mid-1930s in the UK. Although Germany has not yet seen such an increase for the top 1%, top 0.1% or top 0.01% income shares (Fig. 15.1), it should be noted that the share of the top 0.1%, for example, has been substantially higher in Germany than in the US or the UK for longer periods of time and that it was only surpassed by the US and the UK in the mid-1980s and the mid-1990s, respectively (Hein 2015). Furthermore, if we take a look at the top 10% income share, including capital gains, a rising trend from the early 1980s until 2007 can be observed. It reaches the level of the early 1930's, excluding capital gains for the earlier time period.

Taking a look at the composition of top incomes, the increase in the income share of the top 0.1% in the US has mainly been driven by an increase in top salaries (wages and salaries, bonuses, exercised stock-options and pensions) since the 1970s, and, since the mid-1980s also in entrepreneurial income (Alvaredo et al. 2014; Hein 2015). Remuneration of top management ('working rich') has therefore contributed significantly, but not exclusively, to rising inequality in the US in the period of finance-dominated capitalism. Whereas top management salaries have contributed up to more than 50% to the income of the top 0.1% income share in the US, in Germany

**Table 15.2** Gini coefficients for market income and disposable income, selected countries, mid-1980s–mid-2000s

Gini coefficient for households' market income						
Country	Mid-1980s	Around 1990	Mid-1990s	Around 2000	Mid-2000s	Change from mid-1980s/around 1990/mid-1990s until mid-2000s
Austria	..	..	..	..	0.433	..
Belgium	0.449	..	0.472	0.464	0.494	0.045
Finland	0.387	..	0.479	0.478	0.483	0.096
France	..	..	0.473	0.490	0.485	0.012
Germany	0.439	0.429	0.459	0.471	0.499	0.06
Greece	0.426	..	0.446	0.466	0.454	0.028
Ireland	..	..	..	..	..	..
Italy	0.420	0.437	0.508	0.516	0.557	0.137
Netherlands	0.473	0.474	0.484	0.424	0.426	-0.047
Portugal	..	0.436	0.490	0.479	0.542	0.106
Spain	..	..	..	..	..	..
Sweden	0.404	0.408	0.438	0.446	0.432	0.028
UK	0.419	0.439	0.453	0.512	0.500	0.081
US	0.436	0.450	0.477	0.476	0.486	0.05
Japan	0.345	..	0.403	0.432	0.443	0.098
Gini coefficient for households' disposable income						
Country	Mid-1980s	Around 1990	Mid-1990s	Around 2000	Mid-2000s	Change mid-1980s/around 1990 until mid-2000s
Austria	0.236	..	0.238	0.252	0.265	0.029
Belgium	0.274	..	0.287	0.289	0.271	-0.003
Finland	0.209	..	0.218	0.247	0.254	0.045
France	0.300	0.290	0.277	0.287	0.288	-0.012
Germany	0.251	0.256	0.266	0.264	0.285	0.034
Greece	0.336	..	0.336	0.345	0.321	-0.015
Ireland	0.331	..	0.324	0.304	0.314	-0.017
Italy	0.309	0.297	0.348	0.343	0.352	0.043
Netherlands	0.272	0.292	0.297	0.292	0.284	0.012
Portugal	..	0.329	0.359	0.356	0.385	0.056
Spain	0.371	0.337	0.343	0.342	0.319	-0.052
Sweden	0.198	0.209	0.211	0.243	0.234	0.036
UK	0.309	0.354	0.336	0.352	0.331	0.022
US	0.337	0.348	0.361	0.357	0.38	0.043
Japan	0.304	..	0.323	0.337	0.321	0.017

Source OECD (2012b), our calculations

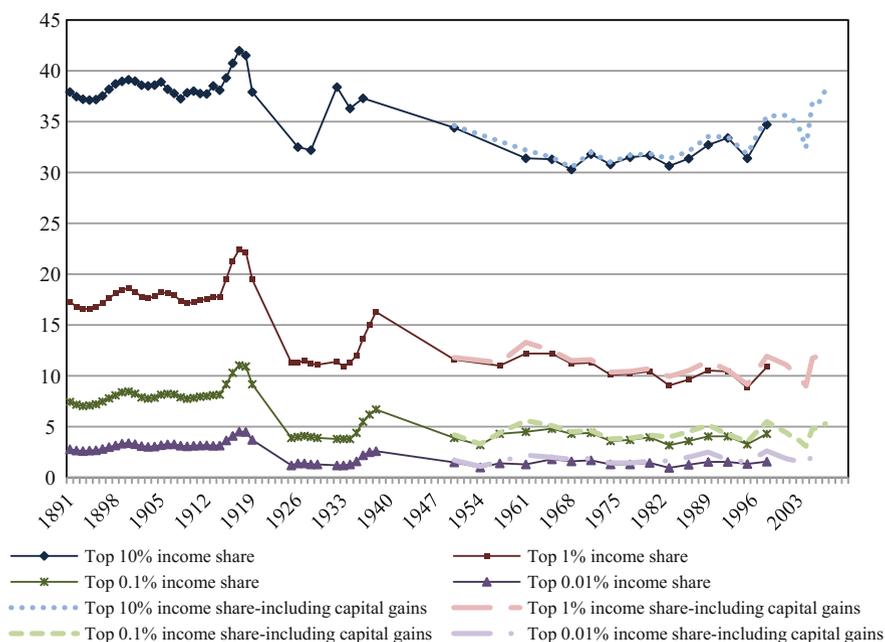
Note Gini coefficient is based on equivalised household income

**Table 15.3** Percentile-ratios for disposable income in Germany, 1985–2008

	1985	1990	1995	2000	2004	2008
P90/P10	3	3	3.3	3.2	3.4	3.5
P90/P50	1.7	1.8	1.8	1.8	1.8	1.8
P50/P10	1.7	1.7	1.8	1.8	1.9	1.9

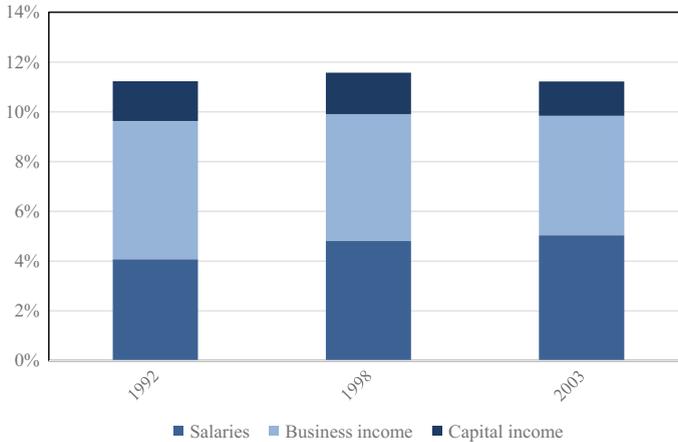
Source OECD (2014)

Notes The P90/P10 ratio is the ratio of the upper bound value of the ninth decile (i.e. the 10% of people with highest income) to that of the upper bound value of the first decile. The P90/P50 ratio is the ratio of the upper bound value of the ninth decile to the median income. The P50/P10 ratio is the ratio of median income to the upper bound value of the first decile



**Fig. 15.1** Top income shares in Germany, 1891–2007 (in per cent of national income). Source Alvaredo et al. (2014), our presentation

top management salaries have so far played a minor role. However, their share increased from 15% in 1992 to 22.4% in 2003 (Bach et al. 2009). Anselmann and Krämer (2012) also 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. Similar results were also found by Dühaupt (2011) when decomposing the gross market income of the top 1% of the income share for Germany (Fig. 15.2). 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



**Fig. 15.2** The top 1% income share in gross market income and its composition, Germany, 1992, 1998 and 2003 (in per cent of national income). *Source* Dünhaupt (2011, p. 27) based on data from Bach et al. (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

business income. The trend towards higher top management salaries is also confirmed by Detzer (2014), considering payments of management boards in the 30 top-listed Germany companies (DAX30). While those salaries increased only moderately from 1987 until 1995, with an average of 5% per year, from then until 2007 they increased strongly, averaging 15% per year.

### 15.3 The Effect of Financialisation on Distribution

To what extent can these tendencies towards redistribution in Germany be related to the increasing dominance of finance? Hein (2015) has reviewed the recent empirical literature on the determinants of income shares against the background of the Kaleckian theory of distribution in order to identify the channels through which financialisation and neo-liberalism have affected functional income distribution (Table 15.4). According to the Kaleckian approach (Kalecki 1954, Part I; Hein 2014, Chap. 5), the gross profit share in national income, which includes retained earnings, dividends, interest and rent payments, as well as overhead costs (thus also top management salaries) has three major determinants.

First, the profit share is affected by firms' pricing in incompletely competitive goods markets, i.e. by the mark-up on unit variable costs. The mark-up itself is determined by: (a) the degree of industrial concentration and by the relevance of price competition relative to other instruments of competition (marketing, product

**Table 15.4** Financialisation and the gross profit share—a Kaleckian perspective

Stylized facts of financialisation (1.–7.) and neo-liberalism (8.–9.)	Determinants of the gross profit share (including (top) management salaries)				
	(1) Mark-up			(2) Price of imported raw materials and semi-finished products	(3) Sector composition of the domestic economy
	1.a) Degree of price competition in the goods market	1.b) Bargaining power and activity of trade union	1.c) Overhead costs and gross profit targets		
1. Increasing shareholder value orientation and short-termism of management	...	+	+	...	...
2. Rising dividend payments	...	...	+	...	...
3. Increasing interest rates or interest payments	...	...	+	...	...
4. Increasing top management salaries	...	...	+	...	...
5. Increasing relevance of financial to non-financial sector (investment)	...	+	...	...	+
6. Mergers and acquisitions	+	...	...	...	...
7. Liberalisation and globalisation of international finance and trade	–	+	...	±	±
8. Deregulation of the labour market	...	+	...	...	...
9. Downsizing of government	...	+	...	...	+

Source Hein (2015, p. 921)

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

differentiation) in the respective industries or sectors, i.e. by the degree of price competition in the goods market; (b) the bargaining power of trade unions, because in a heterogeneous environment with differences in unit wage cost growth between firms, industries or sectors, the firm's or the industry's ability to shift changes in nominal unit wage costs to prices is constrained by competition of other firms or industries, which do not have to face the same increase in unit wage costs; and (c) overhead costs and gross profit targets, because the mark-up has to cover overhead costs and distributed profits.

Second, with mark-up pricing on unit variable costs, i.e. material plus wage costs, the profit share in national income is affected by unit (imported) material costs relative to unit wage costs. With a constant mark-up, an increase in unit material costs will thus increase the profit share in national income.

And third, the aggregate profit share of the economy as a whole is a weighted average of the industry or sector profit shares. Since profit shares differ among industries and sectors, the aggregate profit share is therefore affected by the industry or sectoral composition of the economy.

Integrating some stylized facts of financialisation and neo-liberalism into this approach and reviewing the respective empirical and econometric literature for different sets of developed capitalist economies, Hein (2015) has argued that there is some convincing empirical evidence that financialisation and neo-liberalism have contributed to the rising gross profit share, and hence to the falling labour income share since the early 1980s, through three main channels.<sup>3</sup>

First, the shift in the sectoral composition of the economy, from the public sector and the non-financial corporate sector with higher labour income shares towards the financial corporate sector with a lower labour income share, has contributed to the fall in the labour income share for the economy as a whole in some countries.

Second, the increase in management salaries as a part of overhead costs, together with rising profit claims of the rentiers, i.e. rising interest and dividend payments of the corporate sector, have in sum been associated with a falling labour income share. Since management salaries are part of the compensations of employees in the national accounts and thus of the labour income share, the wage share excluding (top) management salaries has fallen even more pronounced than the wage share taken from the national accounts.

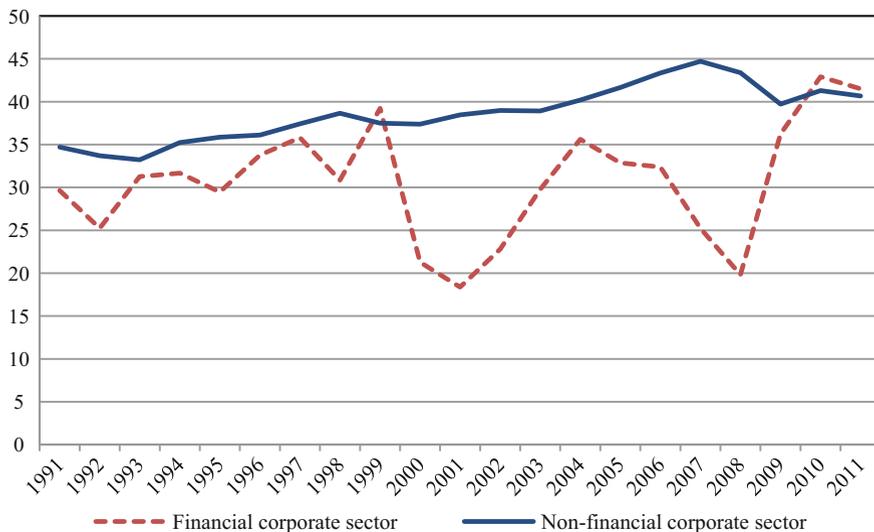
Third, financialisation and neo-liberalism have weakened trade union bargaining power through several channels: increasing shareholder value and short-term profitability orientation of management, sectoral shifts away from the public sector and the non-financial business sector with stronger trade unions in many countries to the financial sector with weaker unions, abandonment of government demand management and full employment policies, deregulation of the labour market, and liberalisation and globalisation of international trade and finance.

These channels should not only have triggered falling labour income shares, but should also have contributed to the observed increases in inequality of personal/household incomes. The major reason for this is the (even more) unequal distribution of wealth, generating capital income, which then feeds back on the household distribution of income when it comes to re-distribution between labour and capital incomes.

Checking the relevance of these channels for the German case, with respect to the first channel we find that neither the profit share of the financial corporate sector

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<sup>3</sup>See in particular the recent panel econometric studies on the determinants of functional income distribution including data for large sets of countries or industries by Dühaupt (2013), Kristal (2010), Stockhammer (2009, 2013a, b) and Tomaskovic-Devey and Lin (2013).

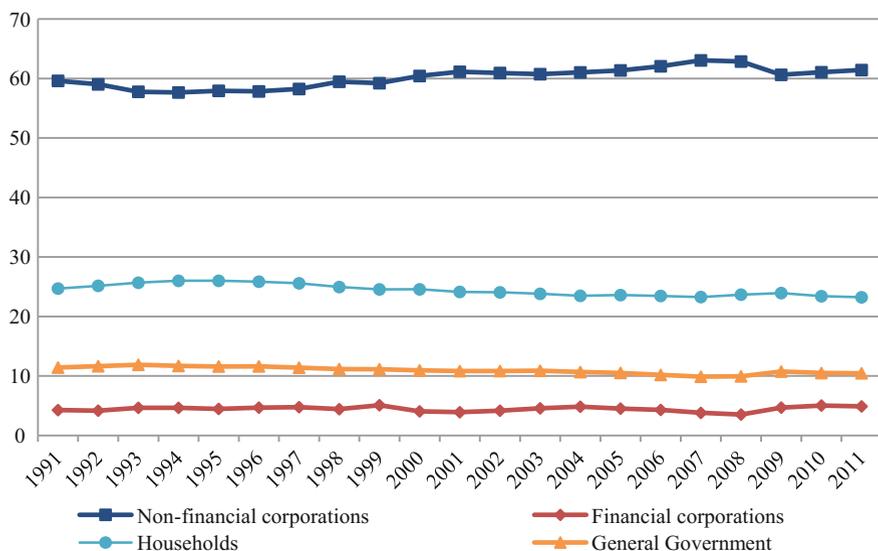


**Fig. 15.3** Sector gross operating surplus, Germany, 1991–2011 (per cent of sector gross value added). *Source* Statistisches Bundesamt (2012), our calculations

was higher than the profit share in the non-financial corporate sector in the period of the increasing dominance of finance starting in the early/mid-1990s (Fig. 15.3), nor was there a shift of the sectoral shares in gross value added towards the financial sector (Fig. 15.4). However, the share of the government sector in value added has seen a tendency to decline, from 12% in the mid-1990s to below 10% in 2007. *Ceteris paribus*, this means a fall in the aggregate wage share and a rise in the aggregate profit share, because the government sector is a non-profit sector in the national accounts.

Regarding the second channel, the increase in top management salaries and higher profit claims of financial wealth holders, there are several indicators supporting the validity of this channel for Germany. Dünhaupt (2011) has corrected the wage share from the national accounts for the labour income of the top 1% by assuming that the latter represent top management salaries, following the examples by Buchele and Christiansen (2007) and Glyn (2009) for the US and Atkinson (2009) for the UK.<sup>4</sup> The resulting wage share for direct labour shows an even steeper downward trend than the wage share from the national accounts: the difference between the two wage shares increased from 4% points in 1992 to 5% points in 2003 (Fig. 15.5). An increase in the share of top management salaries is thus associated with a decline of the share of wages for direct labour in national income.

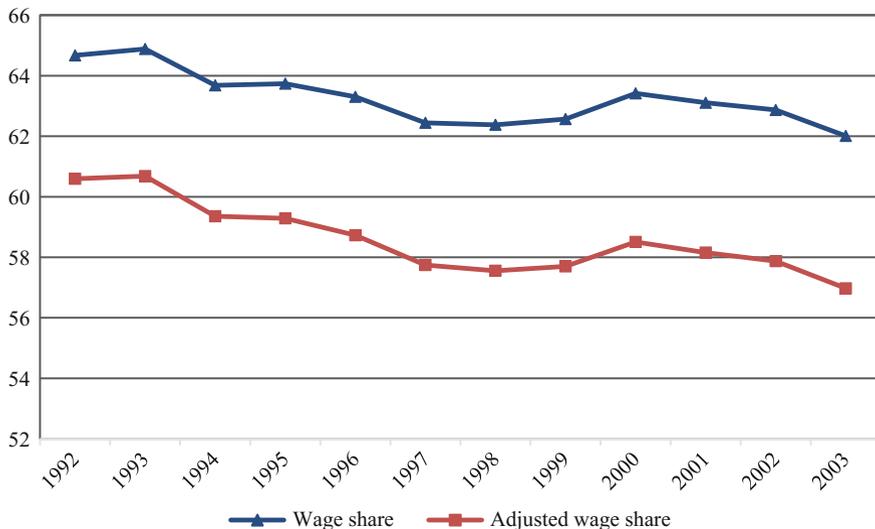
<sup>4</sup>Recently, also the OECD (2012a, Chap. 3) has presented such corrected wage shares for Canada, France, Italy, Japan, the Netherlands and the US.



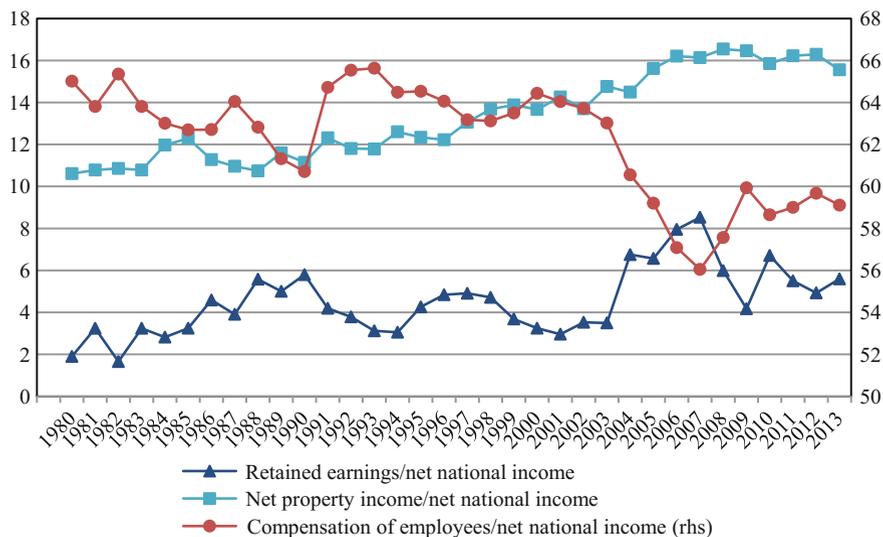
**Fig. 15.4** Sector shares in nominal gross value added, Germany, 1991–2011 (per cent). *Source* Statistisches Bundesamt (2012), our calculations

Extending another analysis provided by Dünhaupt (2012), we also find that, in the long-run perspective, there is substantial evidence that the increase in the profit claims of rentiers came at the expense of the workers' share in national income (Fig. 15.6). In the 1980s, the fall in the wage share (compensation of employees as a share of national income, as retrieved from the national accounts) was accompanied by an increase of both the share of rentiers income (net property income consisting of interest, dividends and rents) and the share of retained earnings of corporations. However, from the 1990s, after German reunification, until the Great Recession, the fall in the wage share benefitted mainly the rentiers' income share. Only during the short upswing before the Great Recession did the share of retained earnings also increase at the expense of the wage share. Decomposing the rentiers' income share (Fig. 15.7), it becomes clear that the increase was almost exclusively driven by a rise in the share of dividends, starting in the mid-1990s, when we observe an increasing relevance of finance and shareholders in the German economy.

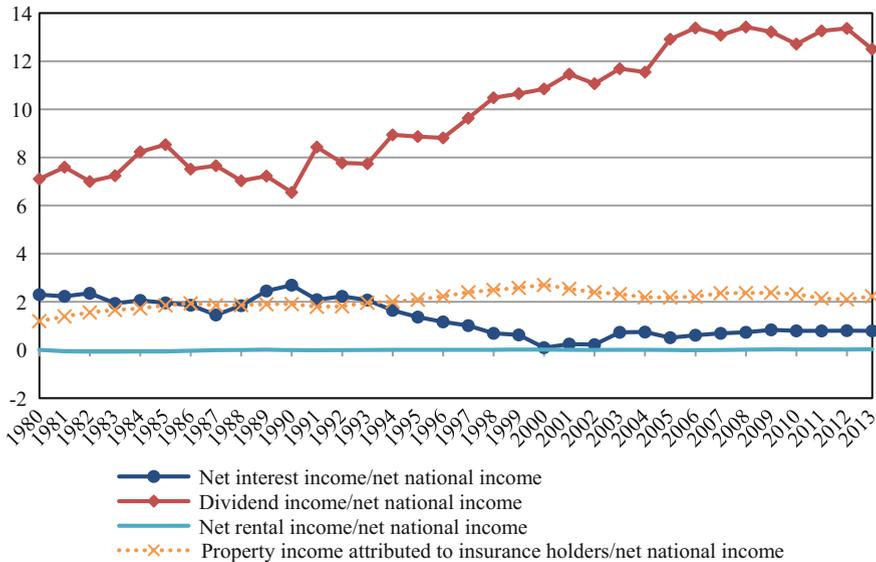
In an econometric study for Germany (1960–2007), Hein and Schoder (2011) find a highly significant and strong effect of the net interest payments-capital stock ratio of the non-financial business sector on the profit share, thus confirming the notion of an interest payments-elastic mark-up affecting the distribution between capital and labour. This means that rising interest rates and costs in the 1980s contributed to the observed fall in the wage share. In the 1990s, however, the decrease in the share of net interest income in net national income would have allowed for a rise in the wage share, which, however, was prevented by the even



**Fig. 15.5** Wage share adjusted for the labour income of top 1%, Germany, 1992–2003 (per cent of net national income). *Source* Dühaupt (2011, p. 27). *Note* The wage share adjusted for the labour income of the top 1% is constructed by taking the three data points. From Fig. 15.2 and interpolating the missing years



**Fig. 15.6** Income shares in net national income, Germany, 1980–2013 (per cent). *Source* Statistisches Bundesamt (2014), our presentation based on data provided by Petra Dühaupt. *Note* West Germany until 1990



**Fig. 15.7** Components of rentiers' income as a share in net national income, Germany, 1980–2013 (per cent). *Source* Statistisches Bundesamt (2014), our presentation based on data provided by Petra Dünhaupt. *Note* West Germany until 1990

more pronounced rise in the share of dividends in net national income, suggesting a dividend-elastic mark-up in firms' pricing, too.

Regarding the third channel, the weakening of trade union bargaining power, we find that several indicators for this apply to the development in Germany from the mid-1990s until the Great Recession. First, starting in the early/mid-1990s, downsizing the government sector, as shown above, and the switch towards restrictive macroeconomic policies focussing exclusively on achieving low inflation and (close to) balanced public budgets meant low growth and rising unemployment, in particular in the stagnation period of the early 2000s, as analysed extensively by Bibow (2003, 2005), Herr and Kazandziska (2011) and Hein and Truger (2005, 2007, 2009), for example.

Second, policies of deregulation and liberalization of the labour market (*Agenda 2010*, *Hartz-laws*) explicitly and successfully aimed at weakening trade union bargaining power through lowering unemployment benefits (replacement ratio and duration), establishing a large low-paid sector, as well as reducing trade union membership, collective wage bargaining coverage and coordination of wage bargaining across sectors and regions (Hein and Truger 2005, 2007). Table 15.5 summarises some supportive data on these developments. As can be seen, as a result of the reforms, unemployment benefits were drastically reduced, so that net as well as gross replacement rates declined considerably in the 2000s, even when other transfers like social assistance and housing benefits are included. While indicators for employment protection show a slight increase in employment protection for

**Table 15.5** Indicators related to trade unions, labour market regulation and unemployment benefits, 1990–2013, Germany

	1990– 1994	1995– 1999	2000– 2004	2005– 2009	2010– 2013
<i>Trade unions</i>					
Union density rate (per cent)	32.7	27.0	23.4	20.1	18.3
Union coverage of workplaces or establishments (per cent)	57.4	49.0		43.0	
Bargaining (or union) coverage, adjusted for occupations and sectors without right for bargaining (per cent)	85.0	74.2	67.9	63.9	61.1
<i>Employment protection</i>					
Strictness of employment protection—individual dismissals (regular contracts) (index)	2.6	2.7	2.7	2.9	2.9
Strictness of employment protection—collective dismissals (additional restrictions) (index)		3.6	3.6	3.6	3.6
Strictness of employment protection—temporary contracts (index)	3.3	2.6	1.7	1.0	1.0
<i>Unemployment benefits</i>					
Gross replacement rate (per cent of average production worker wage <sup>a</sup> )	28.3	26.2	29.2	24.2	
Gross replacement rate (per cent of average wage <sup>b</sup> )			32.3	22.6	20.8
Net replacement rate summary measure of benefit entitlements (excl. social assistance and housing benefits) (per cent)			60.1	45.3	42.2
Net replacement rate summary measure of benefit entitlements (incl. social assistance and housing benefits) (per cent)			63.1	57.6	53.7

Source OECD (2014), Visser (2013), our calculations

Notes Averages were calculated for the 5 year periods indicated. Sometimes data was not available for all years in the 5 year periods

<sup>a</sup>Refers to the average wage in sector D (Manufacturing) of the International Standard Industrial Classification of All Economic Activities (ISIC), Rev. 3

<sup>b</sup>Refers to the average wage in sectors B to N of the ISIC, Rev. 4

regular contracts since 2000, temporary contracts have been heavily deregulated, contributing to the emergence of a dual labour market in Germany. The weakening of trade unions in the 2000s can be seen by the decline in membership, but particularly by the decline in bargaining coverage, which went down from 74% in the late 1990s to only 61% in 2011. While the indicators still show high degrees of coordination of wage bargaining, a trend towards decentralisation of collective bargaining can be observed, too. Krämer (2008) notes that bargaining coverage of branch level agreements has declined. At the same time so-called opening clauses

were used more extensively, which allow firms to diverge from collectively agreed standards under certain circumstances.

Third, trade and financial openness of the German economy increased significantly and put pressure on trade unions through international competition in the goods and services markets and through the threat effect of delocalisation. The foreign trade ratio (exports plus imports as a share of GDP), an indicator for trade openness, increased from 39.1% in the mid-1990s to 71.4% in 2007, just before the Great Recession (Statistisches Bundesamt 2011). The foreign assets/foreign liabilities-GDP ratios, as indicators for financial openness, increased from 56/40% in 1991 to 200/174% in 2007 (Deutsche Bundesbank 2014).

Fourth, shareholder value orientation and short-termism of management rose considerably, thus increasing the pressure on workers and trade unions. According to Detzer (2014), two institutional changes were important in this respect. First, ownership of non-financial corporations changed. The share of stock directly held by private investors halved between 1991 and 2007, while the share held by institutional investors increased significantly. Similarly, strategic investors reduced their ownership share and investors who are more likely to have purely financial interests increased it. Furthermore, fewer strategic block holders, which might shield managers from market pressure, are present on corporate boards. Additionally, activist hedge funds and private equity firms, which directly pressure management to favour shareholder value, have become more active in Germany. Second, the development of a market for corporate control put pressure on managers to pursue shareholder value friendly strategies in order to protect themselves against hostile takeovers. For Germany, data on mergers and acquisitions and hostile takeover attempts show that the activity in this market increased considerably in the 1990s and early 2000s. Important factors facilitating this were legal changes in the 1990s and early 2000 which gradually removed obstacles to takeovers and the gradual dissolution of the German company network. In particular the big banks actively reduced their central role in the network since the 1990s due to their increased preference for investment banking activities. Quantitative indicators for the increase in shareholder value orientation and short-termism of management in German non-financial corporations, as the increase in financial investments and financial profits, on the one hand, and the rise in dividend payments, on the other, have been explored in Chaps. 3 and 10 of this book.

## 15.4 Conclusion

In this chapter we have shown that Germany has seen considerable re-distribution of income since the early 1980s, which accelerated in the early 2000s: a tendency of the labour income share to decline; rising inequality in the personal and household distribution of market and disposable income (although government redistribution has not been weakened), in particular at the expense of very low incomes; and a rise in top income shares, considering the top-10% income share. Examining the three

main channels through which financialisation and neo-liberalism are supposed to have affected the wage or the labour income share, according to the Kaleckian approach, we have provided evidence for the existence of each of these channels in Germany since the mid-1990s, when several institutional changes provided the conditions for an increasing dominance of finance. First, the shift in the sectoral composition of the economy away from the public sector and towards the corporate sector, without favouring the financial corporate sector, however, contributed to the fall in the wage and the labour income share for the economy as a whole. Second, the increase in management salaries as a part of overhead costs together with rising profit claims of the rentiers, in particular rising dividend payments of the non-financial corporate sector, have in sum been associated with a falling wage and labour income share, although management salaries are a part of employee compensation, and thus also form part of the wage share, in the national accounts. The latter implies that the share of direct labour, excluding top management salaries, has fallen even more drastically. Third, financialisation and neo-liberalism have weakened bargaining power of German trade unions through several channels: downsizing the role of the public sector and of government demand management, active policies of deregulation and liberalization of the labour market explicitly and successfully aimed at weakening workers and trade unions, increasing trade and financial openness of the German economy and, finally and in particular, rising shareholder value and short-term profitability orientation of management.

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# Chapter 16

## Crisis and Macroeconomic Policies

**Abstract** The German type of development prior to the crisis can be characterised as export-led mercantilist. This German type of development determined the channels of transmission of the crisis to Germany. 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 and the respective accumulation of net foreign assets, as well as increasing integration into the world financial markets made the financial sector, and commercial banks in particular, vulnerable for the financial market channel of crisis transmission. Regarding policy reactions towards the crisis, the immediate bailout of the financial sector detained the financial crisis in Germany. Economic recovery was initially 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 crisis in Germany in the first place. Second, as a political precondition for the German stimulus packages, the so-called ‘debt brake’ was introduced into the German constitution and enforced on the Euro area member countries, which will limit the room of manoeuvre for German and Euro area fiscal policies in the future.

### 16.1 Introduction

In this chapter we will briefly review the German macroeconomic policy regime in the era of ‘financialisation’ in general, and during the business cycle before the Great Recession 2008/2009 in particular.<sup>1</sup> This will provide the foundations for a discussion of the transmission of the financial crisis to Germany, the bailout of the financial sector, the macroeconomic policy responses, and for an outline of the impact of German economic policy making on the development of the broader euro

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<sup>1</sup>This chapter partly draws on Detzer and Hein (2016a, b).

crisis, which started in 2010. The latter, however, will not be treated here. The final section in this chapter will summarise and conclude.

## **16.2 The German Macroeconomic Policy Regime in the Era of Finance-Dominated Capitalism**

As we have analysed in this book, the most important changes in the German financial sector which contributed to an increasing dominance of finance took place in the course of the 1990s: 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, among others (see Chap. 6). While financialisation is often associated with an increase in the share of the financial sector in value added, employment and profits in the economy, this phenomenon could not be observed in the German economy (see Chap. 3). The increased dominance of finance could however be observed in other quantitative and qualitative indicators. Stock market capitalisation and trading activity have grown, even though they are still moderate compared to Anglo-Saxon, but also to other European countries. The overall amount of financial assets has increased strongly and particularly striking is the strong expansion of bank balance sheets in the course of the 1990s. At the same time, the importance of institutional investors in Germany has increased, but has remained well below other countries. Also, private equity funds and activist hedge funds became more important and active in Germany and have increasingly taken direct influence on non-financial firms' management. Increased financial activity of non-financial firms, another feature associated with financialisation, could also be found in Germany (see Chap. 10). While real investment of non-financial firms has been low, their investment in financial assets and, therefore, the share of financial profits in total profits in those firms increased rapidly in the course of the 2000s. Therefore, while financialisation has been less advanced and less visible in Germany than in other countries, like the US or the UK, there are clear indications for the increasing relevance and even dominance of finance in Germany, too.

This development was accompanied by considerable redistribution of income at the expense of the wage share and of low income households, in particular, as we have shown in the previous chapter. Against this background, severe changes in real GDP growth and its composition, as well as in the trends of the financial balances of the main macroeconomic sectors could be observed. Comparing the development of the two trade cycles from the early 1990s until the Great Recession with the previous trade cycles, we find that average real GDP growth over the cycle slowed down considerably with the increasing dominance of finance and the associated redistribution of income (Table 16.1). Whereas average real GDP growth was between 2.4 and 3.8% in the trade cycles of the late 1960s until the early 1990s, it went down to 1.4% in the cycle of the 1990s and 1.6% in the cycle of the early 2000s. Furthermore, the relevance of the growth contributions of the main

demand aggregates changed significantly. Real GDP growth in the cycles of the 1960s, 1970s and even the 1980s was mainly driven by domestic demand, and the balance of goods of services only contributed up to 0.25% points to real GDP growth which only meant up to 9% of total GDP growth. In the trade cycles of the 1990s and early 2000s, however, the growth contributions of net exports went up to 0.47 and 0.64% points, respectively, which meant 33 and 40% of real GDP growth. In the course of this process the degree of openness of the German economy exploded: the share of exports in GDP increased from 24% in 1995 to 51% in 2013, and the share of imports rose from 23% in 1995 to 44% in 2013 (European Commission 2014).

Growth was thus increasingly driven by net exports and the relevance of domestic demand declined dramatically. This was equally true for private consumption and for investment. The average growth contributions of private consumption were between 1.42 and 2.25% points in the trade cycles of the 1960s, 1970s and 1980s and they went down to 0.72 and 0.28% points on average in the trade cycles of the 1990s and early 2000s. The average growth contributions of investment in capital stock were between 0.38 and 0.69% points in the trade cycles of the 1960s, 1970s and 1980s and they fell to 0.04 and 0.4% points on average in the trade cycles of the 1990s and early 2000s.

The increasing reliance on net exports as the driver of growth since the early/mid-1990s finds its expression in the development of the financial balances of the main macroeconomic sectors (Fig. 16.1). The financial balance of the external sector (RoW), which had turned positive in the 1990s after German reunification when Germany ran trade and current account deficits financed by capital inflows, became negative in the early 2000s and decreased to  $-7.5\%$  of nominal GDP in 2007. German growth was thus relying on current account surpluses—the counterpart of the deficits of the external sector—which had never before been observed in German history. The largest surplus in the current account (and thus deficit of the financial balance of the external sector) had been at 4.5% in 1989, just before German reunification. The financial balances of the German private households have seen a long tradition of being in surplus. But these surpluses even increased in the early 2000s, indicating weak consumption demand, and were accompanied by positive and rising financial balances of the corporate sector in this period, too, which indicates weak investment in capital stock. This meant large and increasing financial surpluses of the private sector as a whole, which were only temporarily and partly compensated by government sector deficits: the public sector was balanced in 2007, just before the Great Recession.

Based on this short description, the German type of development from the early/mid-1990s, and from the early 2000s in particular, until the Great Recession, can be classified as ‘export-led mercantilist’.<sup>2</sup> The export-led mercantilist type of

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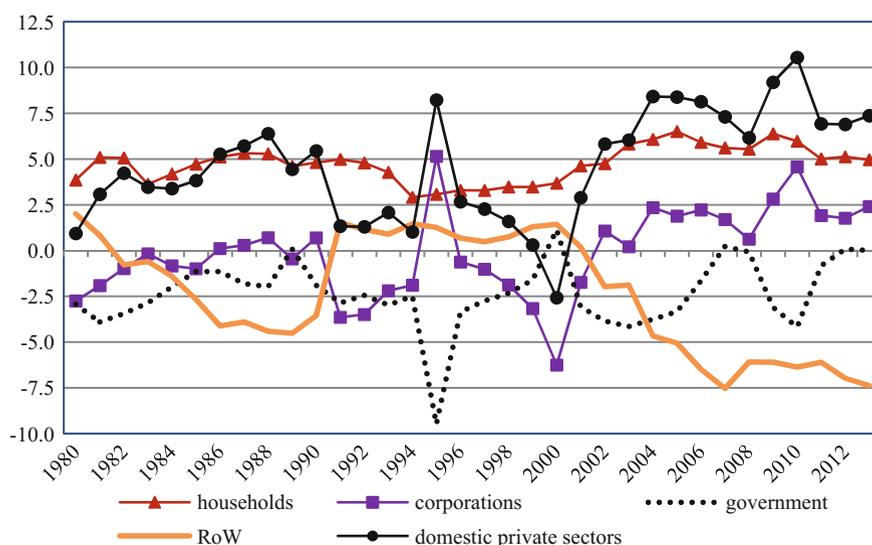
<sup>2</sup>For a classification of ‘export-led mercantilist’, ‘debt-led consumption boom’ and ‘domestic demand-led’ types of development or regimes and its application to different sets of countries, see, for example among others, Hein (2012, Chap. 6), Hein and Mundt (2012, 2013), Stockhammer (2010a, b, 2012a, b), and van Treeck and Sturm (2012, 2013), with slightly different terminologies.

**Table 16.1** Real GDP growth in Germany (in per cent) and growth contributions of the main demand aggregates (in percentage points), 1961–2013, cyclical averages

	1961–1966	1967–1974	1975–1981	1982–1992	1993–2002	2003–2008	2009–2013
Real GDP growth, per cent	4.49	3.82	2.40	2.77	1.40	1.59	0.66
Growth contribution of (percentage points)							
Domestic demand including stocks	4.49	3.59	2.36	2.52	0.93	0.94	0.58
Private consumption	2.47	2.25	1.55	1.42	0.72	0.28	0.60
Public consumption	1.03	0.84	0.70	0.21	0.28	0.17	0.26
Gross fixed capital formation	1.28	0.47	0.38	0.69	0.04	0.40	-0.10
Change in inventories and net acquisition of valuables	-0.29	0.03	-0.28	0.20	-0.11	0.10	-0.19
The balance of goods and services	-0.01	0.23	0.04	0.25	0.47	0.64	0.08

Source European Commission (2014), our calculations

Notes The beginning of a trade cycle is given by a local minimum of annual real GDP growth, 1961–1966 and 2009–2013 are incomplete cycles



**Fig. 16.1** Financial balances, Germany, 1980–2013 (per cent of nominal GDP). Source European Commission (2014), our calculations. Notes West Germany until 1990. In 1995 the deficit of the ‘Treuhandanstalt’ was shifted from the corporate sector to the government sector. In 2000 the payments for UMTS licences from the corporate sector to the government sector are included. RoW is ‘Rest of the World’

development is characterised by positive financial balances of the domestic sectors as a whole, negative financial balances of the external sector, thus current account surpluses based on restrictive wage policies, low inflation and weak domestic demand. This means only small positive growth contributions of domestic demand, but relatively high growth contributions of the balance of goods and services.

It was, therefore, increasing net exports and current account surpluses, which allowed for the decoupling of profits and investment in Germany, since the early 1990s, in particular (Fig. 16.2).<sup>3</sup> From a macroeconomic perspective the following equation, derived from national income accounting, has to hold, as pointed out by Kalecki (1971, p. 82):

$$\begin{aligned}
 \text{Gross profits net of taxes} &= \text{Gross investment} \\
 &+ \text{Export surplus} \\
 &+ \text{Government budget deficit} \\
 &- \text{Workers' saving} \\
 &+ \text{Capitalists' consumption}
 \end{aligned} \tag{1}$$

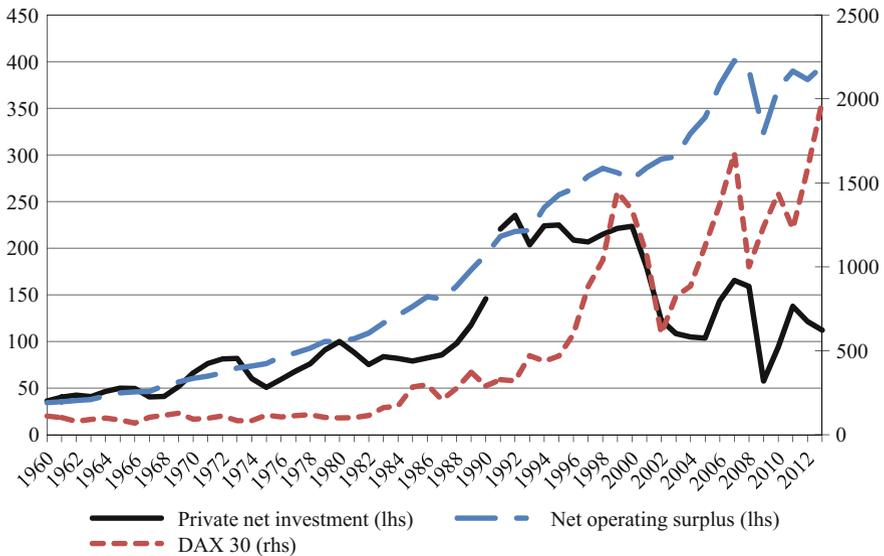
Therefore, with weak investment and consumption, as in the case of Germany, the realisation of profits, and hence a ‘profits without investment’ regime mainly depends on the export surplus and on government budget deficits. As we will analyse in more detail in the following sections, the foundations for rising German net exports were laid, on the one hand, by extreme nominal wage moderation, which increased the price competitiveness of German producers in international markets, and even more so, on the other hand, by low domestic demand, caused by redistribution at the expense of labour and low income households and by restrictive fiscal policies, making imports fall short of rising exports.

Contrary to public and political opinion before the financial and economic crises, this German ‘export-led mercantilist’ model generating a ‘profits without investment regime’ was as fragile as the ‘debt-led consumption boom’ type of development in the US, the UK and other countries. The moderate growth rates were dependent on the dynamic growth of export markets, and hence an expansion of the world economy. A collapse of the latter would therefore have major effects on German growth. 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 2007–2009 crisis, as will be analysed in detail further below.

Let us finish this section by underlining that we do not argue that the German type of export-led mercantilist development before the crisis was exclusively due to the increasing dominance of finance in the German economy. As has been analysed in more detail by Bibow (2003, 2005), Herr and Kazandziska (2011) and Hein and

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<sup>3</sup>It could be argued that this tendency already started in the early 1980s, but was then interrupted by the German reunification boom of the late 1980s/early 1990s.



**Fig. 16.2** Investment, profits, and share prices, Germany, 1960–2013 (Index 1980 = 100). *Source* European Commission (2014), Börse.de (2014), our calculations

Truger (2005, 2007a, 2009), among several others, restrictive macroeconomic policies have contributed significantly to depressed investment and consumption demand, and hence to the mediocre growth and employment performance in Germany starting in the mid-1990s and, in particular, after the recession in the early 2000s. 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-Rente*’, ‘*Rürup-Rente*’), 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 which then also negatively affected investment in the capital stock. 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 monetary policies of the European Central Bank (ECB) in the period from 1999 until the Great Recession. And the attempts of fiscal policies to balance the budget by means of expenditure cuts in periods of weak private demand, in particular in the early 2000s until the Great Recession, reinforced weak domestic demand without directly reaching the consolidation target.

## 16.3 The Transmission of the Crisis to Germany

As can be seen in Table 16.2, the 2008/2009 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 2.8%, the fall in German real GDP was more than 5%, and it was also clearly larger than in the Euro area 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 16.3. 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 16.4). 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 firing workers (see OECD 2010; SVR 2009b; Will 2011). Another striking feature was the fast recovery in Germany. After the large drop of GDP in 2009, growth picked up strongly in 2010 and 2011 and the unemployment rate fell to levels recently experienced only during the reunification boom. The main drivers of the recovery were initially (net) exports and then investment. Real exports had already completely recovered in 2010 from the collapse in 2009. Private consumption only accelerated considerably in 2011. Since 2012 this export-led recovery has made German current account-GDP ratios rise even above the pre-crisis ratios of 7.5% of GDP (Table 16.3).

The German Council of Economic Experts (SVR) has identified three potential channels by which the crisis could have been transmitted into the German economy (SVR 2009a)<sup>4</sup>: 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 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

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<sup>4</sup>See also Horn et al. (2009a, b, c) for detailed analysis of causes and transmission of the crisis to Germany.

**Table 16.2** Real GDP growth, selected countries, 2007–2014 (per cent)

	2007	2008	2009	2010	2011	2012	2013	2014 <sup>a</sup>
Germany	3.4	0.8	-5.1	3.9	3.4	0.9	0.5	1.9
Austria	3.7	0.9	-3.5	1.9	2.9	0.7	0.4	1.5
Belgium	2.9	1.0	-2.8	2.3	1.8	-0.1	0.2	1.5
The Netherlands	3.9	1.8	-3.7	1.5	1.0	-1.3	-0.8	1.0
Greece	3.5	-0.2	-3.1	-4.9	-7.1	-7.0	-3.9	-0.3
Ireland	5.0	-2.2	-6.4	-1.1	2.2	0.2	-0.3	1.9
Spain	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.2	1.0
Portugal	2.4	0.0	-2.9	1.9	-1.3	-3.2	-1.4	1.1
France	2.2	-0.2	-3.1	1.6	2.0	0.0	0.3	0.9
Italy	1.5	-1.2	-5.5	1.7	0.6	-2.4	-1.8	0.5
Euro area	3.0	0.2	-4.4	1.9	1.6	-0.6	-0.4	1.2
UK	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7	3.2
US	1.8	-0.3	-2.8	2.5	1.8	2.8	1.9	2.6
Japan	2.2	-1.0	-5.5	4.7	-0.5	1.4	1.5	1.2
China	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.4

Source OECD (2014)

<sup>a</sup>Forecast by the OECD

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 (Fig. 16.3). While the entire foreign exposure stood at about 2.7 times banks' equity in 1995, it had increased to 7.6 times 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. Especially 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. However, later also private financial institutions were affected by the crisis and had to record heavy losses. The write-offs of large German financial institutions (banks and insurance companies) directly related to the financial crisis amounted to 102 billion euros in the period from 2007 to August 2009 (SVR 2009a).

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 compared to many other economies. This was intensified by global uncertainty

**Table 16.3** Key macroeconomic variables, Germany, 2007–2014 (percentage change if not indicated otherwise)

	2007	2008	2009	2010	2011	2012	2013	2014 <sup>a</sup>
Real gross domestic product	3.4	0.8	-5.1	3.9	3.4	0.9	0.5	1.9
Real private final consumption expenditure	-0.2	0.7	0.3	1.0	2.3	0.7	1.0	1.4
Real government final consumption expenditure	1.4	3.2	3.0	1.3	1.0	1.0	0.7	1.6
Real gross fixed capital formation	5.0	0.6	-11.6	5.2	7.1	-1.3	-0.5	5.7
Real total domestic expenditure	1.9	1.0	-2.2	2.3	2.8	-0.2	0.5	1.6
Real exports of goods and services	8.3	2.3	-13.0	14.8	8.1	3.8	1.0	5.1
Real imports of goods and services	5.6	3.0	-7.8	12.3	7.5	1.8	1.0	4.8
Unemployment rate (per cent of labour force)	8.7	7.5	7.8	7.1	6.0	5.5	5.3	5.0
General government fin. balance (per cent of GDP)	0.2	-0.1	-3.1	-4.2	-0.8	0.1	0.0	-0.2
Short-term interest rate (per cent)	4.3	4.6	1.2	0.8	1.4	0.6	0.2	0.1
Nominal unit labour costs	-0.8	2.3	5.6	-0.9	0.9	3.0	2.2	0.9
Compensation per employee	0.8	2.1	0.1	2.4	3.0	2.6	2.0	2.4
Harmonised consumer price index	2.3	2.8	0.2	1.2	2.5	2.1	1.6	1.1
Current account balance (per cent of GDP)	7.5	6.2	5.9	6.3	6.8	7.5	7.6	7.9

Source OECD (2014), European Commission (2014)

<sup>a</sup>Forecast by the OECD, nominal unit labour costs and compensation per employee by European Commission (2014)

**Table 16.4** Unemployment rate, selected countries, 2007–2013 (per cent of labour force)

	2007	2008	2009	2010	2011	2012	2013	2014 <sup>a</sup>
Germany	8.7	7.5	7.8	7.1	6.0	5.5	5.3	5.0
Austria	4.5	3.9	4.8	4.4	4.2	4.4	5.0	5.0
Belgium	7.5	7.1	7.9	8.3	7.2	7.6	8.4	8.4
The Netherlands	3.5	3.0	3.7	4.4	4.3	5.2	6.6	7.6
Greece	8.3	7.7	9.5	12.5	17.7	24.2	27.3	27.1
Ireland	4.6	6.0	12.0	13.9	14.6	14.7	13.0	11.4
Spain	8.3	11.3	18.0	20.1	21.6	25.0	26.4	25.4
Portugal	8.0	7.6	9.5	10.8	12.7	15.6	16.3	15.1
France	7.7	7.1	8.8	8.9	8.8	9.4	9.9	9.9
Italy	6.1	6.8	7.8	8.4	8.4	10.7	12.2	12.8
Euro area	7.4	7.5	9.4	10.0	10.0	11.2	11.9	11.7
UK	5.4	5.7	7.6	7.9	8.1	7.9	7.6	6.9
US	4.6	5.8	9.3	9.6	8.9	8.1	7.4	6.5
Japan	3.8	4.0	5.0	5.0	4.6	4.3	4.0	3.8

Source OECD (2014)

<sup>a</sup> Forecast by the OECD

associated with the crisis, increasing vulnerability due to integration in production, and the pro-cyclicality of the global financial system.

## 16.4 The Bailout of the Financial Sector<sup>5</sup>

The immediate political responses towards the financial crisis were the Financial Market Stabilisation Act (FMStG),<sup>6</sup> as well as the establishment of the Federal Agency of Financial Market Stabilisation (FMSA)<sup>7</sup> and the Financial Market Stabilisation Fund (SoFFin)<sup>8</sup> as part of the FMSA in October 2008 (SVR 2009b, Chap. 4).<sup>9</sup> The SoFFin was endowed with 480 billion euro in order to re-capitalise banks and to provide them with guarantees. Later on in 2009, the SoFFin was also empowered to establish wind-down agencies, which could be used to transfer assets from banks' balance sheets to those newly created Special Purpose Vehicles (Detzer and Herr 2014). The establishment of wind-down agencies was used by two banks.

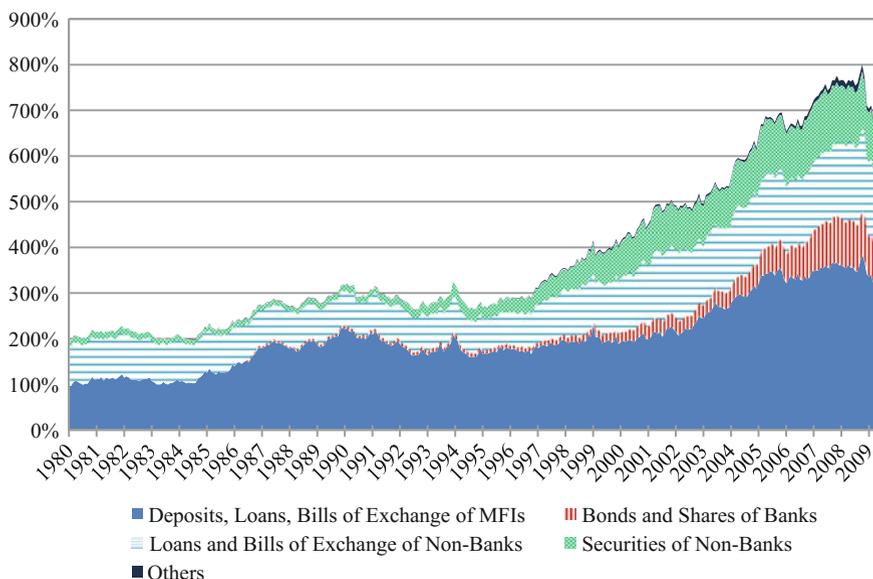
<sup>5</sup>On government interventions and nationalization activities during the financial crisis see also Chap. 12 of this book.

<sup>6</sup>*Finanzmarktstabilisierungsgesetz*.

<sup>7</sup>*Bundesanstalt für Finanzmarktstabilisierung* (FMSA).

<sup>8</sup>*Sonderfonds Finanzmarktstabilisierung* (SoFFin).

<sup>9</sup>For the history and the details of the FMSA see FMSA (2014b) and Detzer and Herr (2014, Chaps. 3 and 12).



**Fig. 16.3** Loans of German banks to foreign banks and non-banks, 1980–2009 (per cent of banks' equity). *Source* SVR (2009a, p. 93)

At the end of 2009 the First Winding-down Agency (EAA)<sup>10</sup> was established to enable the restructuring of the *WestLB*, which first transferred a portfolio of 77.5 billion euro and then later additional assets with a nominal value of about 100 billion euro to the agency (EAA 2014). In 2010 the *FMS Wertmanagement*<sup>11</sup> was established. It took over a portfolio of 175.7 billion euro from the struggling *Hypo Real Estate Group* (FMS-WM 2014). By the end of 2010, the total volume of all these measures peaked at 323 billion euro (FMSA 2014a). Guarantees and risk assumptions had been reduced to zero at the end of 2013 (Table 16.5; see also Table 12.3) and according to an interim report, none of the guarantees was used and the SoFFin received fees of 2 billion euros for providing those guarantees. However, substantial risks from the capital provisions, which stood at 17.1 billion euro in June 2014, still exist, along with risks stemming from bad banks, which still held assets with a nominal value of 233.8 billion euro at the end of 2013. The FMSA estimated that losses on those risks may reach a magnitude of 22 billion euro (FMSA 2013).

All these measures were sufficient to detain the financial crisis and to prevent a financial meltdown in Germany. Despite the stabilisation, there were widespread fears that the damaged financial sector would be curbing loans, thus causing a credit crunch which would affect the real economy. However, the diverse structure of the

<sup>10</sup>*Erste Abwicklungsanstalt*.

<sup>11</sup>*FMS Wertmanagement* (FMS-WM).

**Table 16.5** Stabilisation aid of SoFFin, Germany, 2008–2014 (€ billion)

	Total volume of all measures	Bad banks (nominal asset volume)			Capital injections	Guarantees	Risk assumption
		Total	FMS-WM	EAA			
31.12.2008	32.1				8.2	23.9	
31.12.2009	166.4				25.7	140.7	5.9
31.12.2010	323	238.1	174.3	63.8	29.3	55.6	0
30.06.2011	267.5	217.6	160.5	57.1	17.7	32.2	0
31.12.2011	259.7	211.7	160.7	51	19.8	28.2	0
30.06.2012	227.8	197	151.4	45.6	19.8	11	0
31.12.2012	302.7	280.2	136.9	143.3	18.8	3.7	0
30.06.2013	263	244.8	128.5	116.3	17.1	1.1	0
31.12.2013	233.8	216.7	119.1	97.6	17.1	0	0

Source FMSA (2014a), our translation. Notes FMS-WM—FMS Wertmanagement, EAA—Erste Abwicklungsanstalt

German banking sector in which public, cooperative and private banks as well as regionally, nationally and internationally active banks coexist helped to prevent such a scenario and no widespread credit crunch undermined the recovery (Detzer 2014). However, the drawback of the financial rescue measures was a considerable contribution to the rise in the government gross debt-GDP ratio, which increased from 65.2% in 2007 to a height of 82.5% in 2010<sup>12</sup> and only decreased slowly thereafter (European Commission 2014). This increase was also caused by the expansionary fiscal policies implemented in response to the crisis, which will be discussed in the following section.

## 16.5 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

<sup>12</sup>In particular the establishment of bad banks lead to an increase of gross debt. The SoFFin and the FMS-WM are treated as special budgets and accounted for 11% of total gross government debt. Generally, special budgets of the federal and the federal states’ (*Länder*) governments increased from about 1.1% of gross debt to 16.3% in 2010. Since then it has declined and stood at 15.6% in 2012 (Bundesministerium der Finanzen 2013).

**Table 16.6** Budgetary effects of fiscal packages and additional measures, Germany, 2009–2010 (€ billion)<sup>a</sup>

<i>Fiscal Package I</i>	2009	2010	2009+2010
1. Investment Support	1.32	1.40	2.7
(a) public infrastructure (roads)	1.00	1.00	2.0
(b) support for regions	0.20	0.10	0.3
(c) credit programme for energy-efficient construction	0.04	0.22	0.3
(d) further credit programmes	0.07	0.08	0.1
2. Tax Relief for Private Households	0.38	1.04	1.4
(a) motor vehicle tax exemption	0.38	0.14	0.5
(b) tax incentives for services in private households		0.90	0.9
3. Tax Relief for Businesses	2.18	4.70	6.9
(a) accelerated depreciation allowances (25%)	1.94	4.33	6.3
(b) special depreciation for small and medium-sized enterprises	0.24	0.37	0.6
Sub Total	3.87	7.13	11.0
4. Measures by the Federal Labour Market Agency	0.3	0.5	0.8
Total	4.2	7.6	11.8
<i>Fiscal Package II</i>			
1. Public Investment (local communities)	4.0	12.0	16.0
2. Support for Innovational Research	0.5	0.5	0.9
3. Support for Motor Vehicle Demand	5.0		5.0
4. Reform of the Motor Vehicle Tax	0.1	0.2	0.3
5. Support for Mobility Research	0.3	0.3	0.5
6. Employment			
(a) subsidies for short time work	1.6	1.6	3.1
(b) activation programme	1.3	1.3	2.6
(c) additional personnel for labour market agency	0.1	0.1	0.2
(d) stabilising the unemployment insurance rate		1.0	1.0
7. Income Tax Cuts	2.9	6.1	9.0
8. Cuts Social Security Taxes (Health insurance)	3.0	6.0	9.0
9. Expenditure for Families			
(a) transfer for children	1.8		1.8
(b) higher social benefits for children	0.2	0.3	0.5
Total	20.7	29.2	49.9
<i>Additional Measures</i>			
Re-introduction of Commuter Tax Relief	5.9	2.3	8.2
Tax Deductibility Social Security Contributions		8.1	8.1
<i>Fiscal Packages I + II + Additional Measures</i>			
Total	30.7	47.2	78.0
in % of 2008 GDP	1.2	1.9	3.1

Source Hein and Truger (2010, p. 209). Notes <sup>a</sup>Without macroeconomic repercussions

of the real economy. In what follows, a brief overview of the economic policy responses in Germany will be given, focussing on the years of the crisis and immediately after.

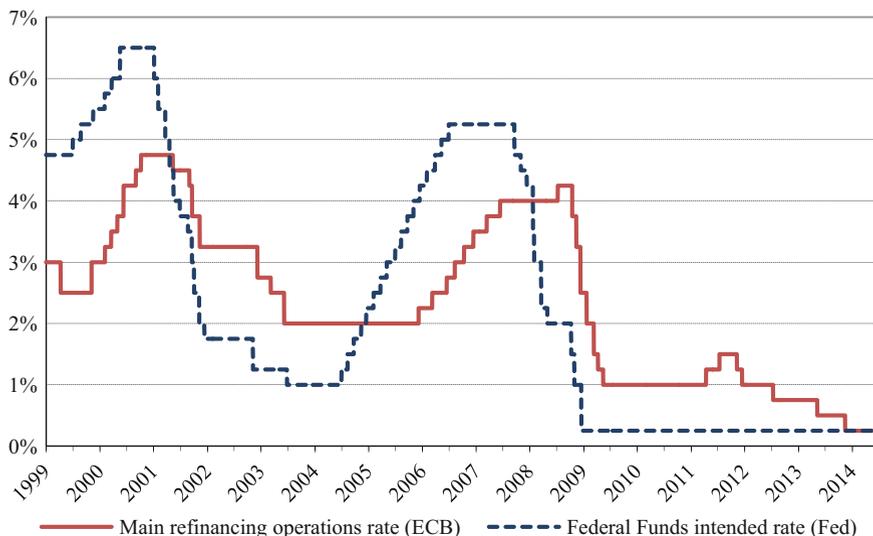
Since the start of the euro in 1999, of course, monetary policy has no longer been a German but a Euro area-wide policy in the hands of the ECB. With respect to its role as a lender of last resort, the ECB acted in a very fast and internationally coordinated manner, thereby saving the financial system 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 (Fig. 16.4). In July 2008, when the dramatic economic slowdown could not be ignored any longer, the ECB even increased the key interest rate, the main refinancing rate, by 25 basis points to 4.25% with recourse to ‘inflationary dangers’. However, as Fig. 16.5 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 head-line 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 inflation—had started to fall. The coming dramatic real economic slowdown was completely ignored initially: interest rate cuts came well after GDP had started to fall strongly, as can be seen in Fig. 16.6. 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 in which economic expansion, driven by net exports, especially towards emerging market economies in Asia and the Americas, resumed quickly.

Wage policies did not actively help to stabilise the German economy during the crisis (Table 16.3). In the crisis year 2009, the compensation per employee only increased by 0.1%. However, a normalisation of compensation growth in the years 2010–2013, compared to the years before the crisis,<sup>13</sup> has contributed to the recovery of private consumption demand. Nominal unit labour cost growth increased in 2008 and 2009 and thus contributed to the rise in German inflation. However, this was due to the usual decrease in labour productivity growth in the course of the crisis, because of labour hoarding in particular, which was actively supported by the government.

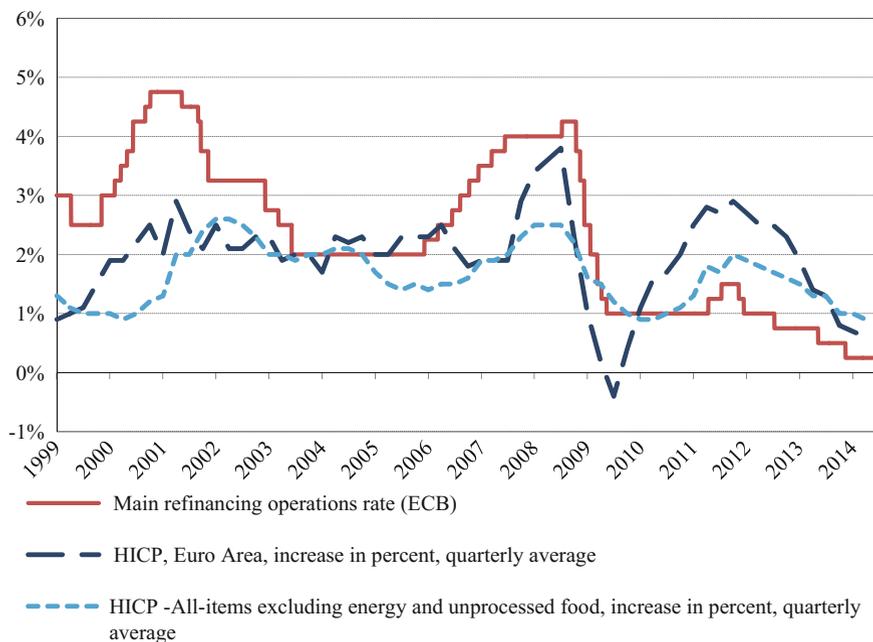
It was therefore fiscal policy which mainly contributed to the quick recovery, reacting in a remarkably counter-cyclical way. Ever since the late 1970s German fiscal policy had built up a more than 25-year-old tradition of pro-cyclical restriction in previous recessions (Hein and Truger 2007a). Yet, this was different in the 2008/2009 crisis. After some hesitation and some merely ‘cosmetic’ measures,

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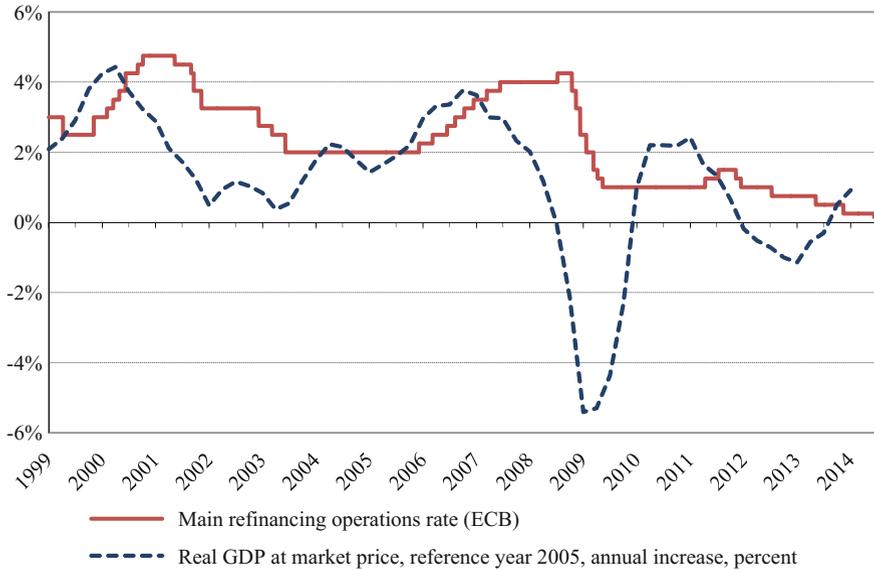
<sup>13</sup>From 2000 to 2007 compensation per employee increased by only 1% on average.



**Fig. 16.4** Key interest rates, ECB vs. Fed, 1999–2014 (per cent). *Source* ECB (2014); Federal Reserve Bank of New York (2014)



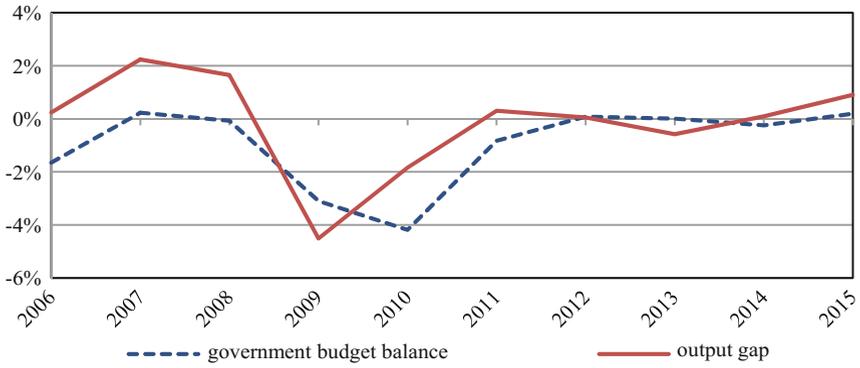
**Fig. 16.5** ECB key interest rate and Euro area inflation, 1999–2014 (per cent). *Source* ECB (2014), own calculations. *Notes* HICP—Harmonised index of consumer prices



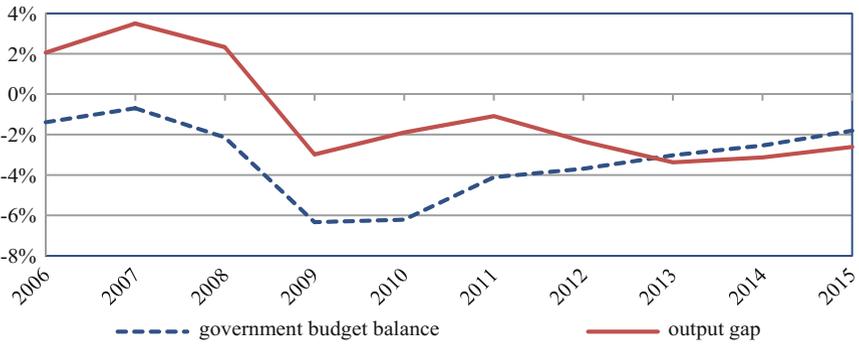
**Fig. 16.6** ECB key interest rate and Euro area real GDP growth, 1999–2014 (per cent). *Source* ECB (2014), own calculations

in the first months of 2009 a substantial stimulus package for 2009 and 2010 was enacted (Table 16.6). 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% 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% of GDP in the period 2008–2010, and was therefore substantially bigger (OECD 2009).

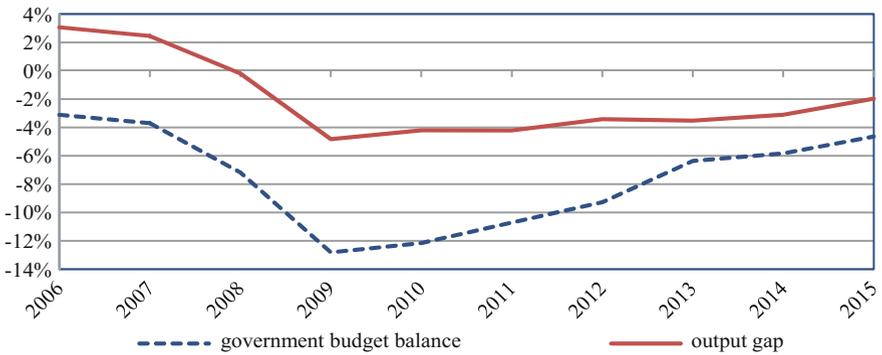
Figure 16.7 shows the budget balance, as well as the output gap as a measure of the cyclical condition of the economy for Germany (Fig. 16.7a), the EU-15 (Fig. 16.7b), and the US (Fig. 16.7c) respectively. As can be seen, in 2009 the budget balance in the US responded more elastically to the crisis than in Germany or in the EU-15. In the US, the budget balance reacted by 1.22% of GDP per one percentage point drop in the output gap. In Germany and the EU-15 the corresponding numbers were 0.49 and 0.79% 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. With the fast recovery in Germany the output gap closed in 2011 and the government reduced its deficit accordingly. In the Euro area, after the output gap started to narrow in 2010 and 2011 it started widening from 2012 on and fell below  $-2.5\%$ . Despite this large deviation of output from its potential, governments in the Euro area acted highly pro-cyclically and introduced austerity



(a) Germany, 2006–2015



(b) Euro area (EU-15), 2006–2015



(c) USA, 2006–2015

**Fig. 16.7** Government budget balance (per cent of GDP) and output gap (per cent of potential GDP), Germany, Euro area (EU-15), USA, 2006–2015, *Source* OECD (2014). *Notes* OECD projections for 2014 and 2015

packages to consolidate their budgets, therewith undermining a timely recovery and generating another recession in 2012/2013.

From the analysis so far it can be concluded that the rapid German recovery after 2009 was based on three main pillars. First, the successful containment of the crisis in the financial sector and the resilience of the three-pillar banking system (public banks, cooperative banks, private banks) prevented a collapse of the financial system and a credit crunch. Second, 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 and growth in emerging market economies of Asia and the Americas picked up, in particular. Third, expansionary fiscal policies contributed to the quick recovery of the German economy by means of stabilising domestic demand, which then also induced real capital formation and private consumption to rise (Table 16.3).

However, this German type of recovery suffers from two major drawbacks. First, to the extent that it is driven by net exports, it has to rely on the export-led neo-mercantilist type of development that considerably contributed to world and regional imbalances and to the severity of the crisis in Germany itself. It therefore contains 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; Uxo et al. 2011; Hein 2013/2014; 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. As of 2016, the federal budget is only allowed to run a cyclically adjusted deficit of 0.35% 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. This type of fiscal austerity has also been imposed on the Euro area via a tightened Stability and Growth Pact and the new Fiscal Compact. All this severely limits the room for manoeuvre for German and European fiscal policies, prevents current account rebalancing in the Euro area and constrains aggregate demand management in the Euro area as a whole (Hein and Truger 2014a, b; Truger and Will 2012).

## 16.6 Conclusions

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 and the respective accumulation of net foreign assets, as well as increasing integration into the world financial markets made the financial sector, and commercial banks in particular, vulnerable for the financial market channel of crisis 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 initially 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 in the first place, and it provides the foundations for future persistent imbalances in the world economy. Second, as a political precondition for the German stimulus packages, the so-called ‘debt brake’ was introduced into the German constitution and enforced on the Euro area member countries, which limits the room for manoeuvre of German and Euro area fiscal policies. The German type of recovery is thus a highly fragile one—and it cannot and should not be considered as a role model for other countries.

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## Chapter 17

# Final Conclusions

**Abstract** Summing up, we conclude that the German financial system has somewhat changed over the last decades towards a more financialised system. But strong attempts by the German government and lobby groups, as well as policies by the European Commission had only limited effects. Financialisation of the German economy has been less pronounced than in the US or the UK, for example. The German macro-economy has witnessed some of the features of financialised economies, for example rising income inequality, falling wage shares and weakened investment in the capital stock. However, what has distinguished Germany from several other countries was the absence of any debt-financed private demand boom, and a private consumption boom in particular, which prevented private household debt from piling up before the crisis. There are several reasons for this more modest ‘financialisation made in Germany’. Institutional inertia of big parts of the German system seem to be important—for example the relevance of local savings banks and cooperative banks, trade unions and the defence of the stakeholder corporate governance system in parts of the economy, or the reluctance of the German population to adopt a stock market and consumption credit culture. This prevented an even more severe financial crisis and it improved the condition for a rapid recovery from the crisis. However, we hold that unless the German export-led mercantilist regime will not be given up, any such recovery will remain highly fragile, both economically and politically.

### 17.1 Introduction

In this final chapter, we will conclude by broadly summarising our main findings on the development of the German financial system and the way financialisation has played out in Germany. We start by providing some background on the global tendency towards financialisation over the last three to four decades. Then, we provide our findings on the main characteristics of the German financial system, before we touch upon the German developments before and in the course of the Great Financial Crisis and the Great Recession from 2007–2009. Finally, we sum up.

## 17.2 The Global Tendency Towards Financialisation

In a longer-term perspective, radical changes in the global financial system started in the 1970s and gained speed in the 1980s. After the deep financial crisis in the late 1920s and early 1930s and the following Great Depression, global financial markets broke down and financial systems were strictly regulated on a national level. In the United States, for example, the Glass-Steagall Act in the early 1930s enforced a segmented financial system. Investment banking which traditionally played a relatively important role in the US was separated from commercial banking. The so-called Regulation Q from the same time period set interest ceilings for deposits in the banking system. Real estate markets were indirectly regulated by the huge state owned mortgage bank Freddie Mac (Federal Home Loan Mortgage Corporation). In Germany and continental Europe investment banking traditionally played an unimportant role. In Germany, after the catastrophic developments in the 1930s, the universal banking system was not touched. However, in Germany in the early 1930s, among other regulations, legally enforced minimum reserve requirements were introduced, which had been introduced in the US long before. After the Second World War the Bretton Woods system with fixed but politically adjustable exchange rates and controls of international capital flows provided a stable international framework for the capitalist world. These nationally and internationally highly regulated financial systems provided the financial conditions for the golden age of modern capitalism after the Second World War: delivering sufficient credit, avoiding major financial crises and reducing the level of uncertainty. Development in Germany after the Second World War can be considered a show case for this general prosperous phase.

In the 1970s, after the golden age period of the post-war era, global capitalism came into crisis. This started with the erosion of the Bretton Woods system in the late 1960s and its final collapse in 1973. Already from the end 1950s onwards international capital flows were slowly liberalised and in the 1970s financial innovations to circumvent regulations were tolerated. For example, financial actors started to circumvent national regulations by increasingly turning to Eurodollar markets and certificates of deposits became more and more popular and weakened Regulation Q. The instability and increasing volume of capital flows from the late 1960s on together with the lack of political willingness to defend a system with stable exchange rates led to a radical regime change in the 1970s. Flexible exchange rates between the leading world currencies were established whereas the majority of countries with less important currencies pegged their currencies to one of the leading world currencies in one or the other way. In the 1970s a big US-dollar-block arose and a much smaller D-mark-block.

The economic crisis in the 1970s in many Western countries including the United States and the United Kingdom led to the election of political leaders which wanted a radical change of the economy and society. Of particular importance were the elections of Margret Thatcher in the United Kingdom in 1979 and Ronald Reagan in 1980 in the US. Both followed a strategy of deregulating domestic and

international financial markets in a radical way. This can be seen as a response to rising distributional conflict and rising inflation, which put pressure on financial wealth holders in particular. The narrative was that such a policy would trigger economic growth and lead to a new phase of prosperity. The neo-liberal policy package in the US and United Kingdom also contained the deregulation of labour markets meaning weakening trade unions, privatizing state owned companies and outsourcing public economic activities to the private sector. This policy approach was not only supported by lobbying groups of the financial system but also by changes in mainstream academic thinking: beliefs in efficient financial markets became ever more popular. Also, regulators followed these ideas and started to adjust regulations accordingly. In the United States, for example, Regulation Q was abolished and the Glass-Steagall Act was step-by-step dismantled. The City of London flourished, since it always had been a place of liberal finance and prone to circumvent national regulations. Related developments took place in the 1980s. For example, the shareholder value principle in corporate governance became more popular and book keeping principles were adjusted to the perceived needs of the financial systems following mark-to-market accounting.

These developments led to a new type of capitalism with financialisation as one of the major dimensions: (a) a bigger role of financial markets including a bigger share of financial markets in % of GDP and profits, (b) a bigger role of financial innovations, in many cases created to reduce transparency and avoid tax payments, (c) more volatile credit expansions and asset bubbles, financial crises and deleveraging periods, (d) an increasing power of financial actors vis-a-vis other stake holders like trade unions and changes in corporate governance, (e) increasing inequality of income and wealth distribution.

Germany in the 1970s and 1980s remained a laggard in all of these areas. The social democratic-liberal coalition under Helmut Schmidt (in office from 1974 until 1982) did not trigger big changes in the German financial system. Also during the long period of the conservative-liberal coalition under Helmut Kohl (in office from 1982 until 1998) reforms in the financial system were limited. In Germany, the big changes in the financial system were introduced under the social democratic-green coalition under Gerhard Schröder (in office from 1998 until 2005). Especially several Financial Market Promotion Acts in the early 2000s led to big changes in the legal framework for the German financial system. The goal of these reforms was to push Germany towards a more capital market-based Anglo-Saxon financial system which was considered to be more efficient and more supportive to growth. As 20 years before, under Margret Thatcher and Ronald Reagan, financial market deregulation and labour market deregulation went hand in hand; in the early 2000s in Germany the so called *Hartz*-reforms profoundly changed the labour market conditions. The changes in the financial sectors were supported by lobby activities. An example of this is the initiative 'Finanzplatz Deutschland' (Germany as a financial centre) which was founded in 2003. This initiative was active until 2011, and was supported by the lobby organisation of the financial system, the German Ministry of Finance, and the Deutsche Bundesbank. Thus, in Germany the radical

neo-liberal policy change only started in the late 1990s, almost 20 years later than in the United Kingdom and the United States.

Several factors explain these changes in the German financial system. The big private banks were the main creditors of the big German companies. From the 1970s onwards this business area was no longer as dynamic as before, because big companies could fund their investment by self-financing and new ways of issuing corporate debt. The big banks initially reacted to the decline in their traditional business by seeking to expand lending to small—and medium-sized enterprises. However, the financing needs of this business had been served by regional and local savings banks and cooperative banks. To develop the domestic securities market in Germany was another strategy to open new business fields. However, due to the traditionally bank based financial system the expansion of domestic securities markets, including managing domestic mergers and acquisitions, was limited.

Finally, the expanding investment banking business especially in Anglo-Saxon countries seemed to be highly profitable. The big private German banks intended to become global players in order to extend their business and their profitability. The Deutsche Bank and Dresdner Bank, for example, bought investment banks in London and New York in the 1990s. In the end, the big German private banks followed the same strategies as the big German companies, which also intensified their strategy to globalise production and business in general. The traditional German corporate governance model, commonly referred to as ‘Corporation Germany’ (*‘Deutschland AG’*), with big German banks holding large packages of shares with big German industrial firms and sitting in supervisory boards of big companies became less attractive. As a result, cross-share-holdings in Germany after the mid-1990s substantially decreased. This development was supported by the abolishment of the 50% capital gains tax on the proceeds from sales of shares in 2002.

The European Commission also intensified its attempts to create a more unified financial system in the EU following the same rules. For Germany, this meant accepting a whole range of legal changes which adjusted financial market rules more towards Anglo-Saxon systems. The biggest changes took place in the regulation of capital markets. EU directives which enforced higher transparency, higher protection for minority shareholders, reducing the voting power of banks in share companies, restricting insider trading, etc. had the aim to change this.

However, investment in shares had not been very attractive for foreigners in Germany, and also the German public had not been much interested to invest in shares or funds. Monetary wealth holdings of German private households were mainly directed to deposit and saving accounts with banks, and to investment in private insurance and pension funds. While the significance of shares and investment funds temporarily increased during the new economy boom in the second half of the 1990s, it later decreased again and remained low in international comparison. The attempts to develop a ‘stock market culture’ in Germany had only limited success. The privatisation of public utilities played a certain role here. For example, the formerly state-owned telecommunication company Deutsche Telekom was privatised in the second half of the 1990s with the aim of making shares more

attractive to the German population. But in 2000 the market value of *Telekom* shares dropped by 90% compared to its peak and only slightly recovered later on.

Another distinguishing aspect of the German system is that corporate governance did not follow the shareholder value logic to the same extent as in other financialised, especially Anglo-Saxon, economies. In big German corporations, trade unions are still sitting on the supervisory board or even have the right to appoint a member of the managing board. Co-determination structures have remained strong and have prevented short-term oriented policies in direct conflict with trade unions on a larger scale. Yet, looking at the relation between CEO salaries and median wages, Germany also followed the shareholder value logic. However, the relation in Germany has remained substantially lower than for example in the US.

A similar picture can be seen in the field of mergers and acquisitions (M&As). Policies in Germany and from the European Commission, as well as changes in the strategies of bigger German banks and enterprises, encouraged M&As from the early 1990s onwards. Yet, these developments were more moderate than in international comparison. Hostile takeovers have been rare in Germany. 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 and hostile way. Thus, the German M&A regime can be assessed as a hybrid one, on the one side combining elements of a market approach and on the other side a still relevant non-market stakeholder orientation.

### **17.3 Main Characteristics of the German Financial System**

The German financial system has two important and distinctive features which are rooted in its development in the 19th century and have existed with modification until today. First, the German banking system is a model case of a bank-based financial system. Enterprises typically have a house-bank as a main creditor with a long-term relationship between the firm and the bank and with intensive knowledge of the bank about the economic and financial situation of the firm. On the one hand, this provides the house-bank with strong levers to influence business decisions within the firm, on the other hand the bank finances investment and innovation of the firm and is helping to maintain business in difficult times. External rating agencies are an alien element in such a system, different from a market-based financial system with anonymous financing structures. Looking at non-bank financial institutions, insurance companies have historically dominated this sector in Germany, first and foremost the *Allianz Group* as one of the biggest insurance companies of the world. In the 1990s investment funds gained importance and became almost as important as insurance companies. Due to the pay-as-you-go

pensions system in Germany, pension funds have been much less relevant. Highly leveraged financial institutions, such as hedge funds and private equity funds, have also had a relatively limited presence in Germany. Overall, what is typically understood as the shadow-financial system (investment funds, hedge funds, private equity funds, financial vehicles, money market funds, etc.) has increased in importance only from the 1990s onwards, but its role for the financing of the German economy has remained a minor one. Also, sophisticated financial products and types of securitisation are not generated widely in the German credit business. There is securitisation in the field of mortgage financing. But here long-established covered bonds are dominating which are considered to be a very safe investment.

The relatively unimportant role of shadow financial institutions in financing the German economy should not hide the fact that segments of the German financial system were massively involved in highly speculative activities. But these activities took place outside Germany and led to massive losses of some of the German financial institutions after the subprime crisis broke out.

The second characteristic of the German banking system is that a large part of it is not privately owned. Currently, the big private universal banks in Germany have a share of around 40% of the total assets of the German banking sector. The publicly-owned savings banks sector has a share of around 30% and the cooperative banks of a bit more than 10%, with the rest being covered by special banks (mortgage banks, development banks, etc.) and by foreign banks. Looking at specialised institutions, the publicly-owned Kreditanstalt für Wiederaufbau (KfW) is one of the biggest banks in Germany. Foreign banks only play a minor role; their share amounts to around 10% of the assets of the German banking sector. Overall, for a long-time and until today, around half of the German banking system has been not profit-oriented.

The number of big private universal banks in Germany has decreased over the years. The biggest of the private banks is the Deutsche Bank which is also the biggest German bank. The savings bank sector has own central institutions, the so called Landesbanken, which take over service functions for the local savings banks including investing funds the local public banks do not need. The Landesbanken are jointly owned by the state governments and the savings banks within the region. The collectively owned banks also created central institutions which play, however, a smaller role.

The big private banks have been the house-banks of the big German firms. The ties between big private banks and big German firms have become somewhat looser from the 1970s onwards. This process has gained speed from the 1990s onwards when cross-shareholding between big banks and big companies has decreased and big firms have increasingly financed their activities with own funds or debt securities. For small—and medium-sized companies the house-bank principle has remained in place. Here the big private banks play no role and this business is dominated by local savings banks and cooperative banks. The house-bank principle in this segment of the financial market is strengthened by the fact that savings and cooperative banks have to restrict their business to the region they are located in.

The success of Germany's small—and medium-sized enterprises is at least partly facilitated by this specific financing structure.

A special role in the German financial system is played by the Landesbanken, the central institutions of the publicly owned savings banks. The eight existing Landesbanken belong to the group of the biggest German banks. Originally, they had acted as the bankers for the regional states and as the central institutions for local savings banks. Their business model also included the financing of big infrastructure projects. All these activities created relatively low returns and were not as attractive as the business of the big private banks. Some of the Landesbanken, also pushed by the regional states, started to follow the same business strategy as the big private banks. However, their foreign investment activities were not very successful. Several Landesbanken, as well as big German private banks, realised severe losses after the outbreak of the subprime crisis and had to be bailed-out by the state. A similar story can be told about the *Deutsche Industriebank AG (IKB)* with the KfW as former main owner. This bank had the purpose to support small—and medium-sized enterprises but before 2007 became engaged in speculative activities abroad and realised high losses which had to be absorbed by the KfW.

Compared with other countries competition in the German banking sector has been relatively high. Since the mid-1990s interest rate margins have even decreased slightly. This indicates an intensification of competition which has been mainly related to the entry of foreign banks and to competition by non-bank financial institutions (e.g. money-market funds) in some segments of the financial market. The efficiency of the German banking system is at a comparable level to other developed countries. Local banks, meaning private, cooperative and public ones, are more efficient than the big nationally active banks. Among local banks, public savings banks and cooperative banks are found to be most efficient. The relatively small size of local publicly and collectively owned banks does not seem to be a problem for efficiency. This is partly due to relatively small economies of scale and scope in banking, and partly due to the integration of publicly and collectively owned banks in national structures of the respective banking group. 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. Profitability of the public savings banks has been relatively low. This has several explanations. First, lending rates of public savings banks are relatively low, secondly the profitability of Landesbanken has been especially low, and, most importantly, it is not the aim of this banking group to maximise profits.

## 17.4 Developments Before and After the Great Financial Crisis and the Great Recession

Before the subprime crisis, the Great Financial Crisis and then the Great Recession in the years 2007–2009, in contrast to many other countries, from the United States over Spain to the United Kingdom, Germany did not see a real estate bubble. In the first phase after the German unification, a moderate increase in real estate prices could be observed, but from the mid-1990s until around 2012 real estate prices in Germany remained stable. This exceptional development in international comparison can be explained by several factors. Firstly, real estate financing in Germany remained overall conservative. Specialised mortgage banks, as well as local savings banks and collectively owned banks as main creditors in the field did not substantially change their business conduct. Secondly, the German real estate market is characterised by a large and diversified rental market. From the total housing stock around 40% is owned and 60% are currently available for rent. The share of rented housing dropped slightly over the last decades, but the fundamental character of the German real estate market did not change. Furthermore, cooperative building-associations which are not profit oriented play an important role in the rental market. Thirdly, before 2007 economic performance in Germany measured in GDP growth and employment creation was below average. Last but not least, the real interest rates in Germany were among the highest in the Euro area due to the comparatively low inflation rate in Germany.

Before 2007 Germany was considered the ‘sick man of Europe’. Rising net exports were the most important demand engine. The current account deficits of the 1990s, which were an exception after the Second World War, turned into increasing current account surpluses in the 2000s. The *Hartz*-reforms in the early 2000s, leading to an increasing sector with precarious work and low wages contributed to more unequal income distribution through different channels. First, wage dispersion increased. Second, the reforms reduced workers’ bargaining power and thus contributed to a fall in the wage share. These developments weakened private consumption demand. Also, cuts in public employment and low public and private investment contributed to weak domestic demand and poor growth. Different from other countries experiencing rising inequality, the German economy did not witness increasing indebtedness of private households due to attempts to maintain or raise consumption expenditures. Instead of a ‘debt-led private demand boom regime’, which could be observed in countries like Spain, Greece, Ireland, the UK and the US, the German economy followed an ‘export-led mercantilist regime’ before the financial and economic crisis, relying on rising net exports and rising current account surpluses as the driver of mediocre growth.

Current account surpluses are only possible with simultaneous net capital exports. For this reason, it cannot come as a surprise that high current account surpluses led to high capital flows from Germany to other countries and a rising net foreign assets position of the German economy. Germany’s international financial integration increased strongly between the late 1990s and 2008. This was characterised

by a marked growth of portfolio investment outflows and in lending abroad by German banks. The lending abroad by German banks was predominantly to Europe, with the largest part going to Euro area countries. German banks also extended their lending to the US during this period. And, in addition to funds from Germany, German banks also drew extensively on funds raised in the US itself. Also large investments by German banks took place in offshore financial centres like Ireland with lax financial market controls.

The lending boom in the early 2000s was followed by the bust in 2008. German private lending in Europe dropped radically in 2008 and German banks started to deleverage. Even the money market in the Euro area stopped working. Only huge financing by the Eurosystem via TARGET2 allowed Southern European countries to overcome the severe liquidity problems created by the sudden stop of lending from Euro area countries like Germany. Losses of German financial institutions from financing European countries which later came into crises were limited, because of the interventions by the European Central Bank (ECB) and the newly established bailout funds at the Euro area level. This was different for German investments in risky US assets related to the subprime crisis. Several Landesbanken, as well as private banks, like Commerzbank and Hypo Real Estate  *Holding*, realised high losses. Also, Deutsche Bank realised high losses but was able to hide them by illegal means. The Special Financial Market Stabilization Fund (SoFFin) had to be created to save banks in trouble. The SoFFin injected capital in financial institutions (almost 30 billion euros), provided large guarantees (almost 170 billion euros) and took over risks. Public households had to spend billions in addition to bail-out or wind-down Landesbanken in trouble. These government interventions were successful in the sense that the financial system became quickly restructured and did not stop granting credits—as in many other countries. However, the main burden was carried by tax payer and not by the owners and big creditors of the private banks.

From this background it becomes clear why the German economy recovered relatively quickly from the deep recession in 2009. In the 2000s Germany did not see a real estate bubble and private households did not accumulate debt as in many other countries. The losses of the financial system were limited as there was no domestic reason for a financial crisis but only an external one. Especially the publicly owned savings banks and the cooperative banks did not suffer any losses and without non-performing-loan problems continued to work normally. Banks which suffered losses were quickly bailed out. In this sense balance sheets were quickly cleaned and the financial system could continue to work. Furthermore, expansionary fiscal policies in 2009 and 2010 helped to stabilise demand when external markets collapsed, and drawing on working time accounts together with heavily subsidised short-term work prevented unemployment from rising significantly. Therefore, when world demand resumed, Germany could successfully continue its mercantilist growth path. German exports to other European countries dropped after 2008, but this could be compensated by increasing exports to countries outside Europe, in particular to emerging market economies. The weak euro supported this German export-led recovery.

The German growth regime suffers from severe problems. Since it is driven by net exports and high current account surpluses, it has to rely on dynamic demand in the rest of the world and on the willingness of the current account deficit countries to accept rising import surpluses and rising net indebtedness. This will prevent global and regional rebalancing and rather continue to contribute to current account imbalances in the world economy, which were at the roots of the severity of the Great Recession. Furthermore, high German current account surpluses might trigger policy measures of deficit countries to reduce imports from Germany and thus undermine the conditions for such an export-led mercantilist regime. Therefore, the German type of recovery is a highly fragile one—and it cannot and should not be considered as a role model for other countries.

## 17.5 Summing up

Overall the German financial system has somewhat changed over the last decades towards a more financialised system. But even strong attempts by the German government and lobby groups, especially in the early 2000s, to push the German economy towards a more contemporary Anglo-Saxon type of financialised system, as well as policies by the European Commission in the same direction, had only limited effects. Financialisation of the German economy has been less pronounced than in the US or the UK, for example. Of course, also the German macro-economy has witnessed some of the features of financialised economies, for example rising income inequality, falling wage shares and weakened investment in the capital stock. However, what has distinguished Germany from several other countries was the absence of any debt-financed private demand boom, and a private consumption boom in particular, which prevented private household debt from piling up before the crisis.

There are several reasons for this more modest ‘financialisation made in Germany’. Institutional inertia of big parts of the German system may be an important one—for example the relevance of local savings banks and cooperative banks, trade unions and the defence of the stakeholder corporate governance system in parts of the economy, or the reluctance of the German population to adopt a stock market and consumption credit culture. This prevented an even more severe financial crisis and it improved the condition for a rapid recovery from the crisis. However, unless the German export-led mercantilist regime will not be given up, any such recovery will remain highly fragile, both economically and politically. Hartz

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