

Germany and the European Sovereign Debt Crisis

In this paper we explore Germany's role in the Euro Crisis. We divide our survey into two sections: First, Germany's domestic economic and political situation; second, Germany's role as a prominent member of the European Union. We consider both long-term and short-term goals for both cases. We finish by examining where Germany's domestic and international goals conflict and how Germany can reconcile their role in the EU with their goals as a sovereign nation.

We begin with a brief summary of Germany's economy:

- Germany has the fourth largest GDP in the world, with 3.6 trillion U.S. dollars in 2011. GDP is divided into 70% service sector, 29% industry and 1% agriculture.
- Currently Germany's gross debt level hits just over 80% of GDP (figure 1).
- Germany's inflation rate, typically under 2%, currently sits at 2.5% (figure 2).
- Unemployment is low, currently at 5.5% (figure 3).
- Real GDP growth peaked at 4.2% in 2009, and currently sits just under 2% (figure 4).

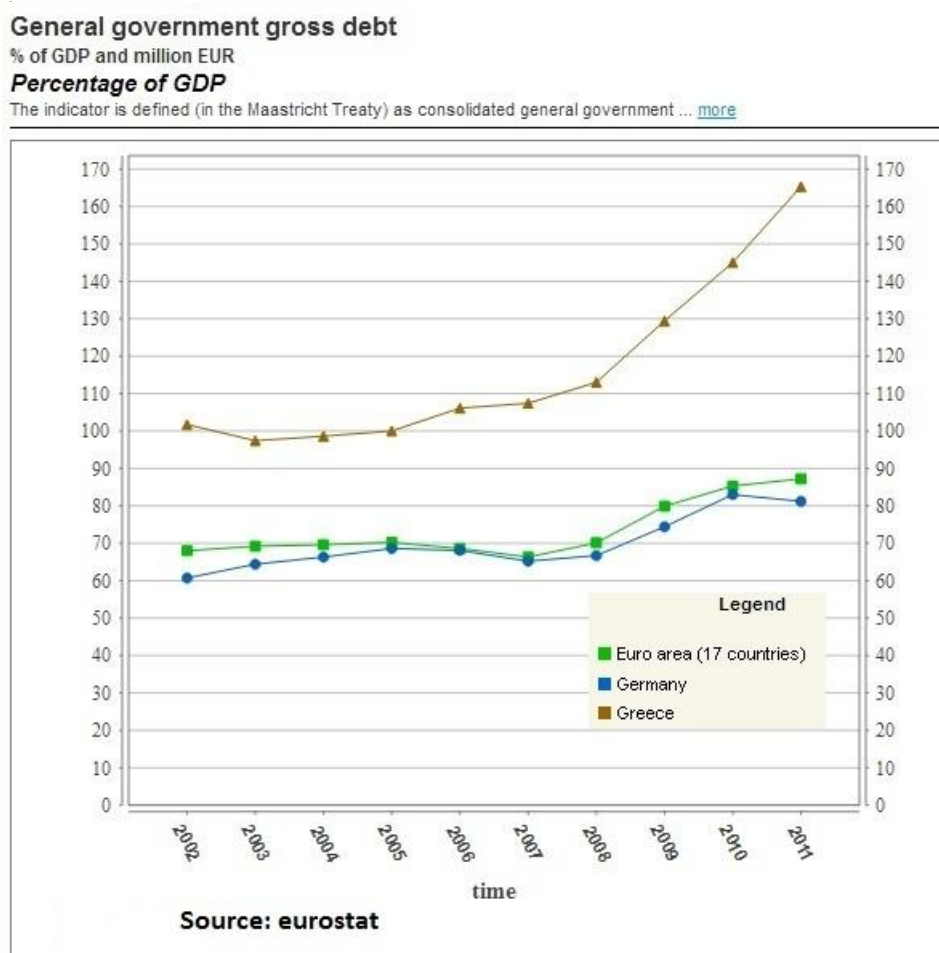
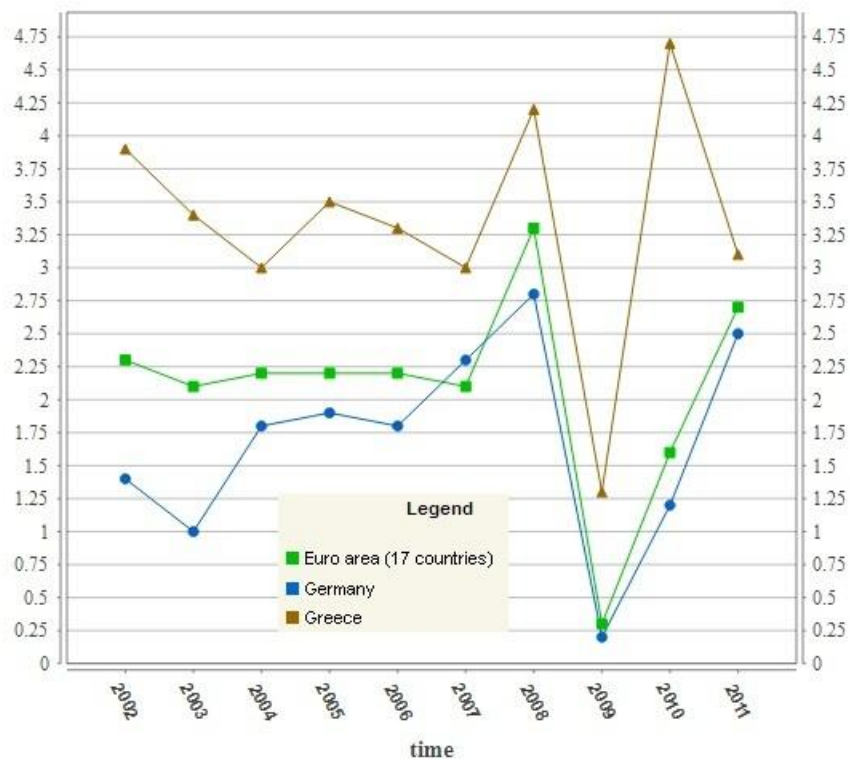


Figure 1

HICP - inflation rate

Annual average rate of change (%)

Harmonised Indices of Consumer Prices (HICPs) are designed for international comparisons ... [more](#)



Source: eurostat

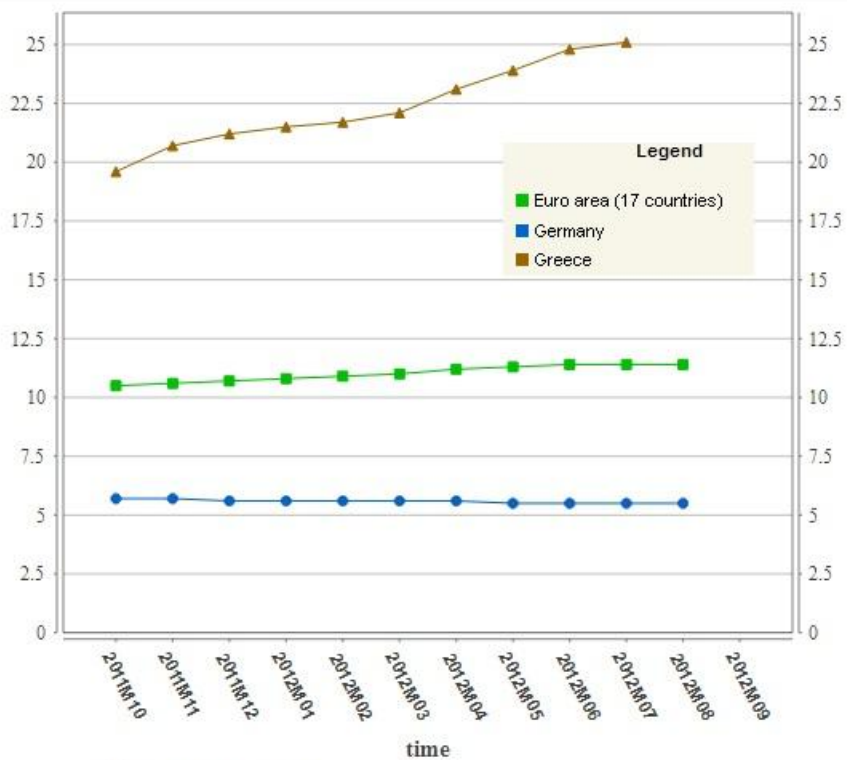
Figure 2

Harmonised unemployment rate by sex

% (seasonally adjusted)

Total

The unemployment rate represents unemployed persons as a percentage of the labour force ... [more](#)



Source: eurostat

Figure 3

Real GDP growth rate - volume

Percentage change on previous year

Gross domestic product (GDP) is a measure of the economic activity, defined as the value ... [more](#)

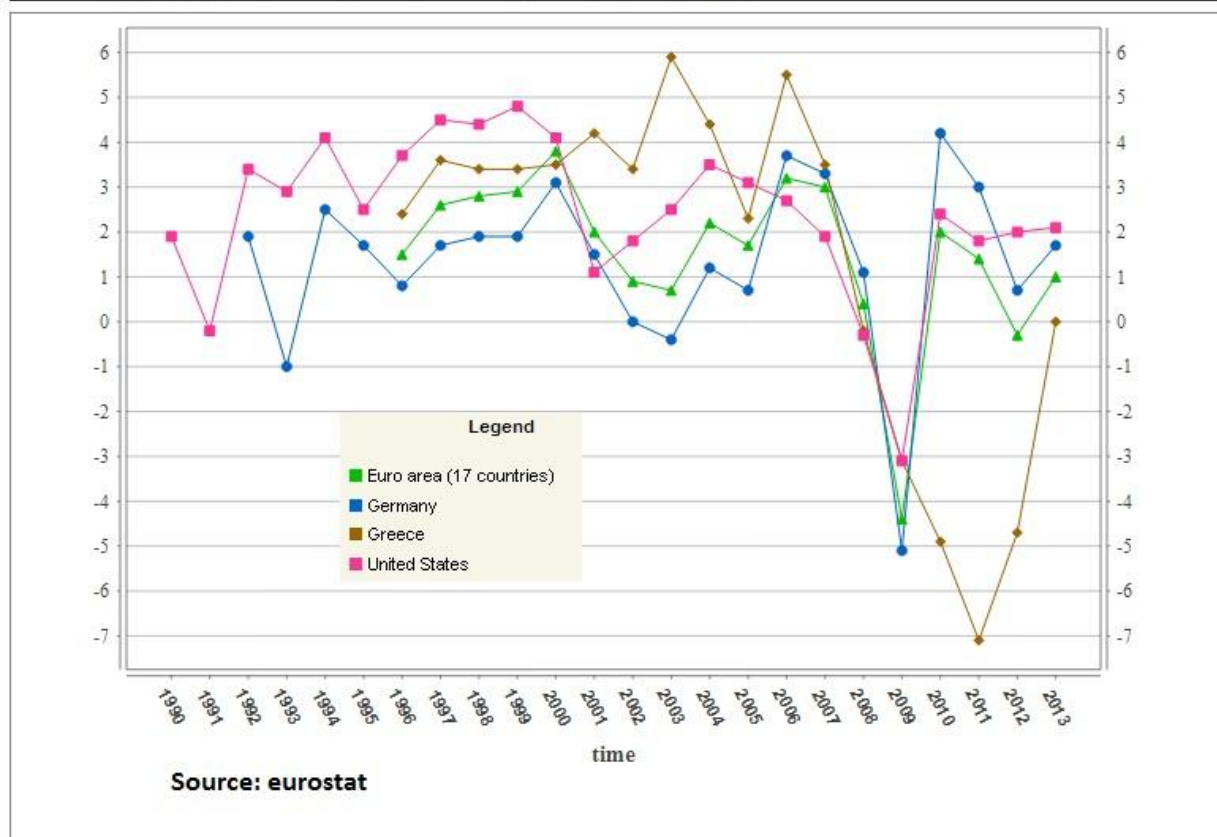


Figure 4

Section 1.1: Germany's banking history and current policies

We will begin this section with a brief overview of Germany's banking system. The central bank of the Federal Republic of Germany is The Deutsche Bundesbank, currently situated in Frankfurt am Main. Revered for its discipline, strength and sheer size it is one of the most respected financial institutions in Europe. It is considered to be the most powerful and influential among the members of the European System of Central Banks (ESCB). Many consider the European Central Bank to be very similar in construction to the Buba (The Deutsches Bundesbank).

Established in 1957 it was the central bank of Germany's previous official currency - the Deutschmark. It was the first central bank to be given full independence and power to carry out discretionary economic policies. Thus the Bundesbank was greatly respected for its control of inflation through the second half of the 20th century. This made the German Mark one of the most respected currencies, and the Bundesbank gained substantial indirect influence in many European countries.

In 2002 Germany adopted the Euro and the responsibilities and duties of the Bank changed. Since the creation of the ESCB the Bundesbank has four areas of activity, which it mostly handles jointly with the ECB:

The Bundesbank as a note-issuing bank

The Bundesbank as the banks' banker (clearing house and bank supervision)

The Bundesbank as the state's banker

The Bundesbank as the manager of currency reserves

Next, we look at the history of the Bundesbank after the fall of the Berlin wall. The Federal Republic of Germany and the German Democratic Republic signed a treaty on 18 May 1990, that created an economic, social and currency union between the two German nations; it came into force on 1 July 1990, and made the Deutsche Mark the sole legal tender in both German states. The Bundesbank was made responsible for money and currency policy within the whole of the currency union. A "Provisional Administration Body" was set up for the purpose of implementing the treaty, and this body continued to operate beyond the official date of reunification until 31 October

1990. The Bundesbank Act was amended to adjust the organizational structure of the Bundesbank to better match changed circumstances following German reunification, and at the same time streamline the organization. The eleven central banks of the 'Länder' and the Provisional Administrative Body were replaced by nine central banks of similar economic size.

The Maastricht Treaty that came into force on 1 November 1993 laid the foundation for the European Economic and Currency Union (EECU). National responsibility for monetary policy was transferred, at the Community level, to the European System of Central Banks (ESCB), comprising the European Central bank (ECB) and the national central banks (NCBs) of the EU states. Until the ECB became fully responsible for currency in 2001, the Bundesbank had three governing bodies. The Central Bank Council (*Zentralbankrat*) was the supreme body of the Bundesbank. It was made up of:

“...the Directorate, which comprised the president, the vice-president and six additional members. These eight people were nominated by the Federal Government (*Bundesregierung*)

The nine presidents of the *Landeszentralbanken*. These were nominated by the *Bundesrat*.”

The Directorate was the executive body of the Bundesbank, while all currency policy decisions were made by the Central Bank Council.

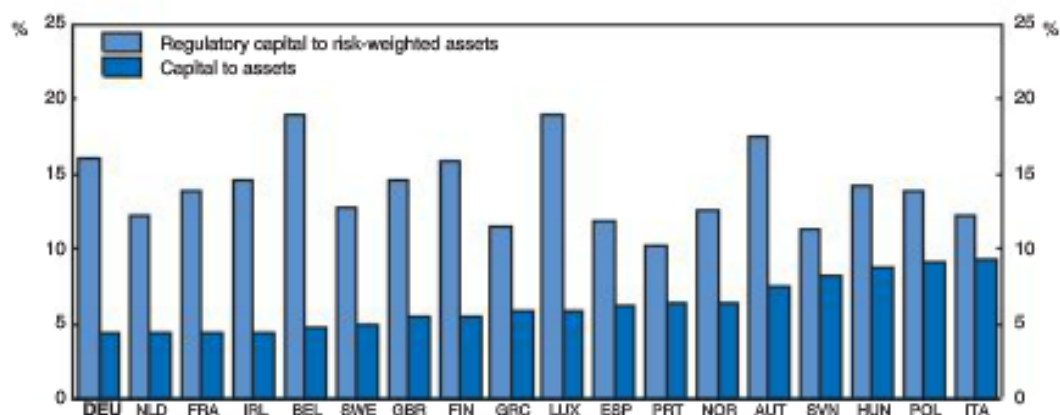
In 2001 the ECB took over full control of currency. The Bundesbank Act was last amended in 2002 by the 7th Law Amending the Law on the Bundesbank of 30 April 2002, which gave the Bundesbank its current structure:

“The Bundesbank has nine Regional Offices located in Berlin, Düsseldorf, Frankfurt am Main, Hamburg, Hanover, Leipzig, Mainz, Munich and Stuttgart. They in turn have 47 branches. Each Regional Office is headed by a President, who is answerable to the Bundesbank's Executive Board.

The Executive Board governs and manages the Bundesbank. It comprises the President, the Deputy President and at four other members. The members of the Executive Board are appointed by the President of the Federal Republic of Germany. The President, the Vice-President and one other member are nominated by the Federal Government; the other three members are nominated by the Bundesrat (the upper house of Parliament representing the Federal States) in agreement with the Federal Government.”

Looking at more recent economic events, Germany was quick and determined in dealing with the sub prime mortgage crisis of 2008-09. Instituting the Federal Agency for Financial Market Stabilisation and redirecting risky investments to bad banks helped increased government debt significantly. This proved to be effective in stabilizing the economy and keeping unemployment surprisingly low. However, the Sovereign Debt Crisis offers different, and in some cases much more serious consequences if left unattended. Looking at the level of capitalization (the lowest of any European country) of German banks we can deduce that they are still highly leveraged. Indicating high vulnerability of the German markets to international (especially European) shocks. The current policy forces banks to increase their capitalization by 50 billion. The government plans to continue supervision and offer help to banks in increasing their capital stock. However, banks offer a lot of challenges. One of the biggest German banks, Landesbanken, has shown persistent low capitalization levels and meager profitability. The government claims to have the situation under control by preparing a restructuring, and in a severe case a bailout.

Figure 3. Capitalisation of European banking systems, 2010



Note: Capital is balance sheet equity (paid-in capital plus reserves).

Source: IMF, Financial Soundness Indicators.

StatLink <http://dx.doi.org/10.1787/888932559619>

The bundesbank has always been strong and respected, however, the creation of the ECB has reduced its power. It comes as no surprise that Jens Weidmann, president of the Deutsche Bundesbank, has issues with the way the ESCB decided to deal with the current Sovereign Debt Crisis in Europe. The Bundesbank wants to maintain its traditions of managing low inflation rates and controlling interest rates, and is prepared to face austerity measures. However, not all members of the ESCB are prepared to--or able to--face such severe measures.

Section 1.2: Germany's domestic policies

This section covers German domestic policy and has little bearing on the eurozone crisis. Feel free to skip ahead to the next section.

Growth in Germany is slowing, which concerns the entire EU. The EU relies on Germany as the European economic engine. According to The Economist, "As long as Europe's biggest economy keeps growing, the argument goes, it can gradually pull others out of the mire."

The primary domestic focus, then, centers on increasing growth. The OECD suggests two avenues Germany should pursue: increasing domestic demand and raising labor input.

Boosting domestic demand provides two benefits: increased growth and a reduction of Germany's structurally high current account surplus (see figure 5). Regulations reform would serve to boost domestic investment, raise productivity in the long run and improve growth potential.

Professional services, which account for 10% of GDP, present an area ripe for reform. Germany ranks 22 out of 27 OECD countries in terms of strictness of professional services regulations. These regulations create barriers to entry and restrict competitiveness. An area of particular note is the licensing and permit system--strict regulations here impede entrepreneurship. Reducing restrictions on licenses and permits would promote competition.

Additionally, Germany would benefit from improved incentives for innovation. Germany currently relies on direct R&D subsidies, rather than tax credits, which have proved successful in several OECD countries. Most importantly, smaller firms, which historically tend to produce radical innovations, do not receive enough attention. To encourage investment in smaller firms, venture capitalists need higher incentives and better exit possibilities. Improving small firms' access to capital markets would boost innovation.

Overall, these--and other--restrictions are stifling German productivity growth. Growth in productivity per employee over the past decade was only around half of the OECD average. Reducing or removing restrictions will improve innovation and productivity in Germany--leading to higher growth.

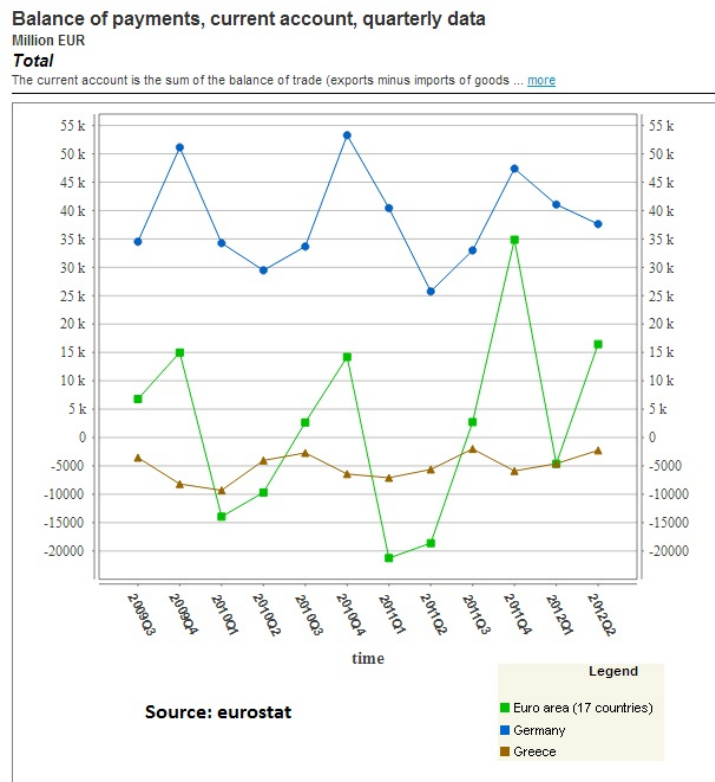
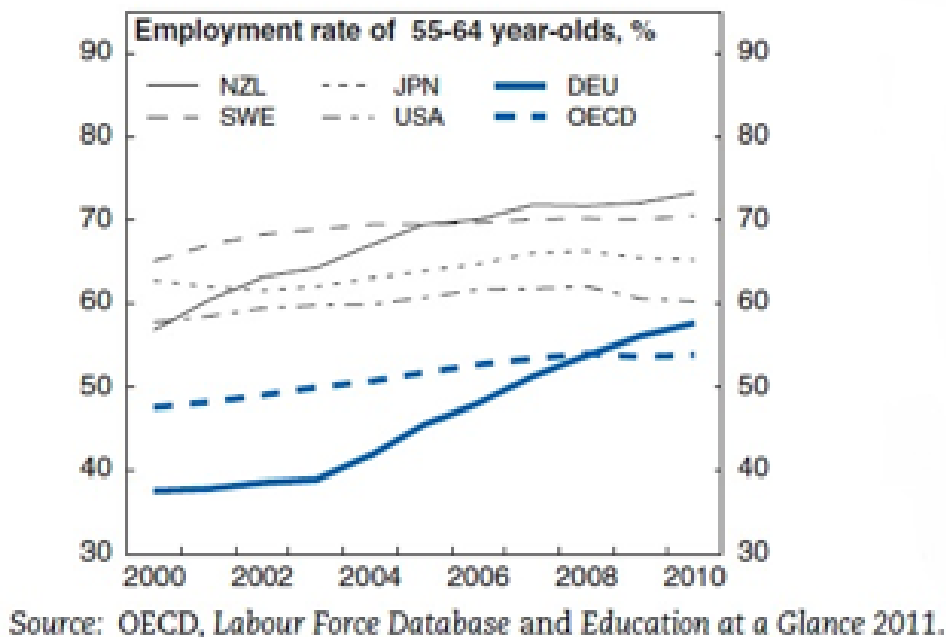


Figure 5

The second set of growth reforms targets labor market policies. Germany faces three main problems on this front: an ageing population, high income taxes, and disincentives for dual-earner families. The first issue concerns Germany's ageing population. Germany must encourage workers to remain in the labor force longer. There are several methods for tackling this issue. First, raise the discount for accessing pensions before the statutory retirement age—this will discourage early retirement. Second, reduce the duration of unemployment benefits for older individuals. Third, move from a seniority pay scale to a performance based pay scale. Currently Germany's wage premium for older workers relative to young ones is one of the highest in the OECD. This high premium discourages the hiring of older workers, who command a higher wage without equivalently higher productivity. Evidence shows that similar reforms have drastically increased the employment rate for older workers in other countries (figure 6).

Figure 6



Germany's taxation system presents another area for reform. Germany taxes 39% of gross wage earnings compared to 24% in the average OECD country. Germany's income taxes are high primarily because of large social security

contributions--these are particularly problematic as they affect low-income earners. High taxes on low-income earners provide a strong disincentive for employment. Additionally, because of high tax rates, Germany faces difficulties attracting highly skilled immigrants. Evidence shows that taxes on non-mobile bases, such as property and consumption—rather than income—are more effective at promoting growth. Germany should lower income tax rates, particularly social security contributions from low-income earners. Lost tax revenue from this policy can be replaced with higher property tax rates.

The next tax issue focuses on dual-earner families. Germany's tax code currently provides numerous disincentives for dual-earners. The result is that one fifth of German women work less than 20 hours a week, twice the OECD average. The first problem is free health insurance for non-working spouses. The second problem stems from a system of joint income taxation, which is most favorable for one-earner couples as the tax schedule is applied to the average income of both spouses. To resolve these issues Germany must enact mandatory health insurance premiums for non-working spouses. Germany must also lower the marginal tax rate for dual-earner families. These policies would serve to encourage women to enter the full-time labor force. This necessitates an obvious additional step—improved childcare services. Currently the childcare enrolment rate for children aged 0-2 years sits at 18% in Germany, only half the OECD average.

The tax and labor reforms outlined here would bring both women and older people into the labor force. This would strengthen domestic demand and reduce the welfare burden on current and future taxpayers.

To conclude, Germany must engage in tax and regulations reform, as well as incentivizing investment and innovation. These policies will boost domestic demand, improve productivity, and increase Germany's growth. Higher growth in Germany will benefit the entire EU.

Section 2: Germany's role in the EU

We now look at Germany's role in the EU. Specifically, we consider the ongoing European Sovereign Debt Crisis, how the crisis impacts Germany, and what Germany can do to help resolve the crisis. We investigate several options going forward, primarily breaking up versus maintaining the Euro. We begin this section with a brief summary of the causes and effects of the Eurozone Crisis.

The Eurozone crisis resulted from several interconnected factors--the most prominent of which was unsustainable capital flows from wealthier European countries to poorer ones (see figure 7). Capital flows from rich to poor were sensible in that poorer countries offered a higher rate of return, the problem stemmed from irresponsible capital investments in receiving countries.

Countries such as Spain and Ireland invested in over-inflated property sectors, fueling a real estate bubble that ultimately collapsed and caused bank illiquidity and insolvency in these countries. Greece mismanaged public finances for over a decade, and then attempted to hide their problem through off-balance sheet transactions and financial derivatives. In all cases periphery countries allowed wages to grow faster than productivity and lost competitiveness.

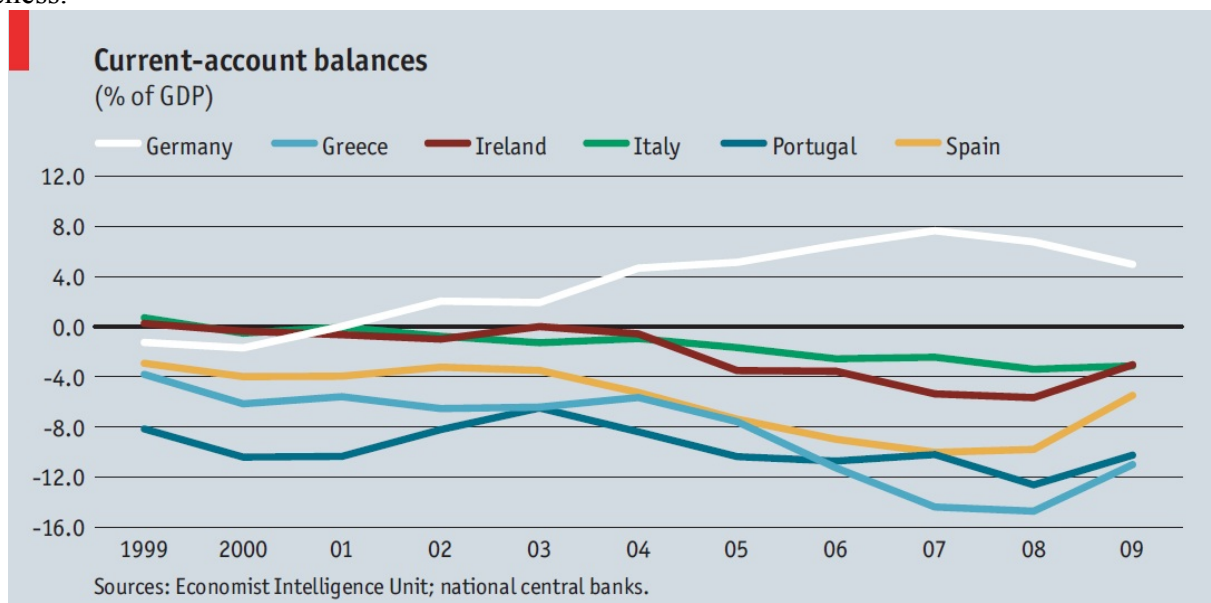


Figure 7

The problem now is that countries that lost competitiveness are stuck with the Euro and cannot engage in independent monetary policy to restore competitiveness. Additionally, highly indebted countries can not default without leaving the Euro. Fear of default further intensified the issue, as investors withdrew large amounts of capital from indebted nations, placing even more stress on already weakened banks.

The crisis affects Germany in that German banks have high exposure to sovereign debt, and face capitalization issues should indebted countries default. Moreover, should periphery countries default, Germany will likely never recover their investments in those countries. Also, Germany strongly believes in the European Monetary Union, both politically and economically. Germany's prosperity is dependent on being part of a large single market. The ability of German companies to plan all business within the euro area on the basis of a fixed exchange rate presents a distinct advantage. The eurozone crisis places this economic vitality at risk.

Germany then faces several options going forward. Option one: Maintain the eurozone. Option two: Germany leaves the Euro. Option three: Kick Greece out of the Euro. Option four: Kick out Greece, Ireland, Spain, Portugal, and Cyprus.

We will now consider each of these options in more depth, looking at the costs and benefits of each. We begin with option four.

Die Rechnung, bitte			
One-off public costs of a euro-area exit			
Latest, €bn			
Costs to euro area	Exit by:		Total
	Greece	PICS*	
Aid package	50	100	150
Disbursement in bail-outs	127	56	183
Government bonds held by ECB†	40	80	120
Target2 debt	106	596	702
Total, assuming no recovery	323	832	1,155
Costs to Germany			
Including aid‡	108	277	385
Bank support§	10	101	111
Total	118	378	496

Sources: Bank for International Settlements; European Commission; Osnabrück University; *The Economist*

*Portugal, Ireland, Cyprus and Spain
†Securities Markets Programme
‡Assuming it pays 1/3 of euro-area exposure
§Assuming no recovery and 50% recourse to state

Figure 8

We see that the cost to Germany from kicking out five of the most indebted countries hits a staggering 500 billion Euros--roughly 14% of Germany's GDP. The benefits of this scenario are several. First, Germany need no longer continue transfer payments to indebted nations, thus eliminating an uncertain future burden on German taxpayers. Second, countries exiting the Euro would immediately regain competitiveness with their new, devalued, currencies. The remaining EMU countries could then enter a stronger monetary union, through both debt mutualization and a banking union. Obviously there are strong political barriers to this scenario, and the immediate cost is high, as outlined in figure 8. Additionally, the high amount of market-wide uncertainty this Euro-surgery would cause could precipitate another global financial crisis.

The next scenario considers only Greece exiting the Euro. Figure 8 shows Germany's immediate cost in this situation--120 billion Euros, about 3.5% of GDP. Another obvious downside is that if Greece leaves, the question arises: who's next? Uncertainty could intensify the crisis further, and force other indebted countries into insolvency and default. As stated in the scenario above, this could cause another global financial crisis. In terms of benefits, Greece would regain competitiveness through a new devalued currency. For Germany, Greece--Europe's most irresponsible country--would no longer leech off of German prosperity. This move would be particularly popular with German tax payers.

In an alternative maneuver, Germany could leave the Euro. The primary argument for Germany leaving the Euro is twofold. First, German funded bail outs of weaker states are wildly unpopular amongst German citizens. Second, a new Deutsche Mark would rapidly appreciate relative to a weaker Germany-free Euro. Countries remaining on the Euro would gain a competitive advantage. The problems with this scenario are both political and economical. Politically, Germany strongly believes the Euro and the EU contribute to democracy and stability in Europe. Additionally, Germany enjoys several economic benefits as a member of the EMU, as outlined above.

The final option is for Europe's political and economic leaders, particularly Germany and France, to ensure the European Monetary Union remains a union. In this case the costs to Germany result from bailing out countries in financial distress. German citizens in particular dislike this strategy, which they view as Germany funding feckless countries living beyond their means. The costs to Germany could be high if countries are bailed out, fail to reform, and then default. In this case Germany would face, potentially, all of the costs outlined in the above scenarios plus the costs incurred attempting to maintain stability. The success of maintaining the Eurozone relies on the ability of debtor and creditor nations to come to terms and uphold any obligations laid out in an agreement. The benefits of maintaining the euro include economic and political stability, potential debt restructuring and eventual repayment, and the general benefits of a currency union, outlined above.

Regardless of which option Europe decides to pursue, every country in the EMU faces tough decisions, each with political and economic costs. In the next section we discuss which scenario the EU is most likely pursue, and the difficulties they will face doing so.

Section 3: Conclusion: What Germany has done so far, where they are heading, and what issues do they face?

Europe will almost certainly seek to maintain the Euro. Major European political leaders have committed to doing so. German Chancellor Angela Merkel and former French President Nicolas Sarkozy have said on numerous occasions that they would not allow the eurozone to disintegrate and have linked the survival of the Euro with that of the entire European Union. In September 2011, EU commissioner Joaquín Almunia shared this view, saying that expelling weaker countries from the euro was not an option. ECB president Mario Draghi has said: "The ECB is ready to do whatever it takes to preserve the euro."

Maintaining the Euro will most likely require moving towards a stronger union. Proposals suggest Euro-wide banking oversight, deposit insurance, and debt mutualization. There are several issues moving forward with these reforms. Germany does not support Eurobonds, which amount to German underwriting of foreign debt. Germany would, however, support Eurobonds issued by a newly created European treasury and legitimated by a properly elected European Parliament—similar to US government bonds issued by the US treasury and legitimated by Congress. This proposal raises another set of issues though. Namely, other countries see a move towards a more federal Europe as German domination, and draw unwelcome parallels to the Austro-Hungarian empire.

In order for the Euro to survive EMU countries need to put aside past differences and objectively consider the best options for future prosperity.

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