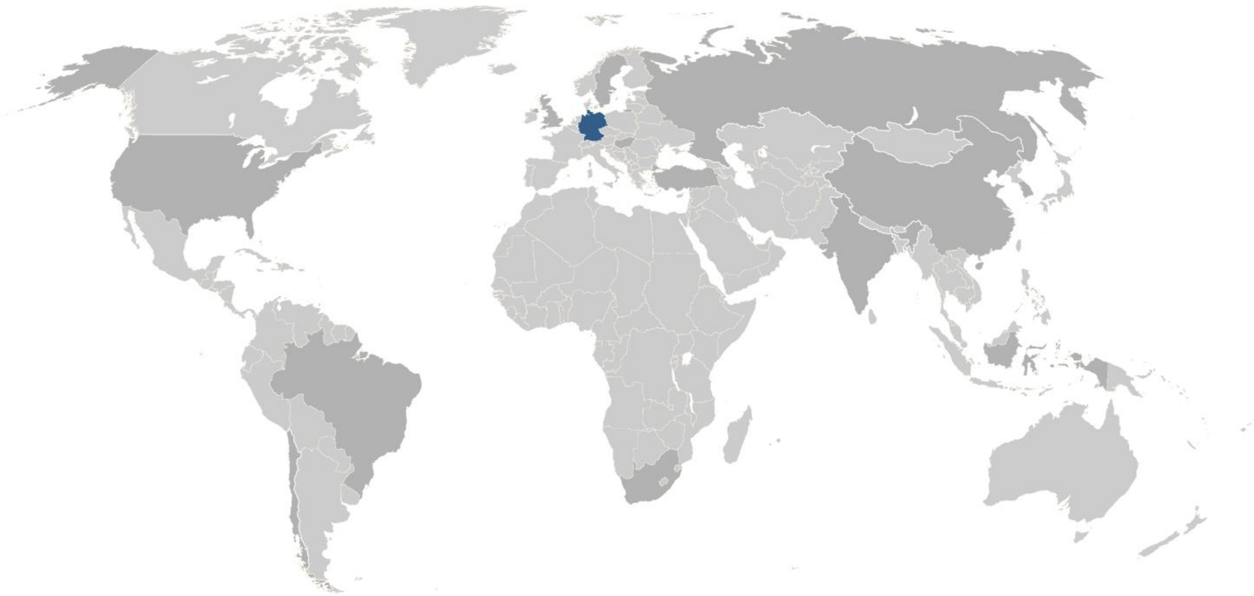
Managing the Crisis |

Germany Country Report

Jeremy Leaman



This report is part of the study *Managing the Crisis* which assesses 14 governments' response to the global economic and financial crisis between September 2008 and September 2009 on the basis of a standardized set of criteria.

Please cite as follows: *Jeremy Leaman*, *Germany Country Report*. In: Bertelsmann Stiftung (ed.), *Managing the Crisis. A Comparative Assessment of Economic Governance in 14 Economies*. Gütersloh: Bertelsmann Stiftung, 2010.

For more information on the study, additional country reports and the comparative article, please visit
www.bertelsmann-transformation-index.de/crisis

BertelsmannStiftung

1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

Germany is the largest economy in Europe, the world's fifth largest on a purchasing power parity basis, and the globe's second-largest exporter. Its longstanding strengths as an industrial trading economy are grounded in the production of research-intensive, skills-intensive manufactured goods, often involving mechanical, electro-technical or chemical engineering processes, supported by stakeholding universal banks and refined industrial services.

In 2007, on the eve of the global crisis, Germany's economy was showing modest real GDP growth of 2.5 percent in a weak business cycle (average growth between 2003 and 2007 was just 1.48%).[1] Demand was asymmetrical, with both private consumption and state consumption showing weak growth (respectively averaging 0.14% and 0.5% in 2003 – 2007). Equipment purchases had recovered well from the 2003 recession, averaging 5.6 percent for the period, but 2007 building investment was still 12 percentage points below 2000 levels. Exports remained the main vehicle of growth, with annual average increases of 7.8 percent; net exports contributed some seven percent to GDP in 2007, which is very high by the standards of other European economies. The overall investment ratio of 18.7 percent was low by Germany's historical standards; however, continuing growth in equipment purchases in 2007 (an increase of 6.9%) indicated strong expectations for future capacity utilization.

Germany's demand asymmetries have been reflected in its external economic conditions; its consistent trade surpluses were temporarily neutralized by current account deficits associated with unification in the 1990s; after 2001, the current account surplus grew to €180 billion by 2007, or 7.5% of GDP, and as such ensured that the aggregate current account balances of the euro zone appeared favorable. Nevertheless, Germany's export dependency rendered it seriously vulnerable to fluctuations in global trade and to global investment flows. Germany remains an attractive location for foreign direct investment (FDI) – predominantly from other OECD countries – but

[1] Figures here from Deutsche Bundesbank, *Monthly Reports* (various) and own calculations.

German stocks of FDI abroad in turn exceed €1 trillion ($1.4 trillion).

Germany's external debt at the end of 2007 was $5.155 trillion (€3.8 trillion), but it enjoys very high levels of gold and currency reserves (€179 billion [$245 billion] at the end of 2007), and is supported by a currency which has been appreciating strongly since 2001. The state's fiscal balances had improved by 2007, with a net public-sector deficit of just 0.2 percent in 2007, and an overall ratio of state debt to GDP of 65 percent.

Germany's financial system was becoming increasingly market-based, with large enterprises deriving less than 10 percent of their funding from banks and around 40 percent from bonds.[2] Germany's capital markets are the third largest in Europe, behind the United Kingdom and France, with total assets of $13 trillion in 2008 (as compared to the UK's $18 trillion).[3] The years of above-average growth (2006 and 2007) saw significant increases in short-term liabilities.

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities prior to crisis

Inasmuch as the growth of Germany's secular economy can be ascribed to government policy, the performance of the German state was patchy. There were significant elements of continuity between the Gerhard Schröder administrations (1998 – 2005) and the Angela Merkel-led grand coalition (2005 – 2009), all of which relied on supply-side reforms to the labor market, taxation and welfare systems.

Marked reductions had taken place in Germany's chronic levels of mass unemployment, resulting in part from the Agenda 2010 reforms, and in particular the four Hartz laws which provided incentives for employment both through positive activation measures aimed at individuals and through reductions in benefits. Overall employment levels rose from 38.7 million individuals in 2003 to 40.2 million individuals in December 2007, in large measure through the expansion of part-time work; total unemployment fell from 4.3 million to 3.4 million individuals in the same period.

A fiscal consolidation process resulted in negative fiscal growth stimuli between 2003 and 2007, resulting in a net public deficit of just 0.2 percent of GDP in 2007.

---

[2] Figures for 2007 from Bundesbank, *Monthly Report*, January 2009.
[3] See IMF, *Global Financial Stability Report 2009*, Statistical Appendix, Table 3; http://www.imf.org/external/pubs/ft/gfsr/2009/01/index.htm (accessed February 25, 2010).

Private consumption was affected negatively by the 3 percentage point increase in the value-added tax (VAT) rate in January 2007, falling in real terms by 0.4 percent in that year.

Consumer price inflation had started to rise in 2007, driven largely by (imported) energy prices but also by the temporary upswing in the business cycle. However, the underlying inflation trend remained benign.

Overall, economic strategy continued to be dominated by supply-side thinking, liberalization and fiscal austerity, the latter supporting the anti-inflationary imperative dictated by euro zone monetary policy and the EU's Stability and Growth Pact (SGP).

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

The grand coalition under Chancellor Merkel had confounded expectations of fragmentation and maintained, despite clear tensions, a strong commitment to fiscal consolidation. The planned federal budget for 2008 envisaged expenditure increases which were markedly lower than the growth forecast in GDP. The coalition reached important compromises on the reform of long-term care, a minimum wage in the postal service and the partial privatization of the railways.

Fiscal conditions thus provided a fairly secure basis for a major countercyclical stimulus, despite the persistence of a state debt ratio which, at 65 percent of GDP, exceeded the prescribed SGP maximum of 60 percent. The outstanding ratings held by German sovereign bonds made the financing of any stimulus package much less problematic than for relatively weaker fiscal regimes.

Monetary policy is now conducted by the European Central Bank, with the Bundesbank serving as Germany's national monetary agency within the European System of Central Banks. Within this system there was clear room for European monetary initiatives; the ECB's repo rate was raised in 25 basis point increments through 2006 and 2007 to reach a cyclical maximum of 4.25 percent in July 2008, while reserve ratios remained very low by historical comparison since the 1990s, standing at two percent for sight and short-term deposits and 1.5 percent for longer-term deposits.[4] Monetary conditions remained favorable for German (and euro area) trade by maintaining a consistently low real exchange rate.

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Exposure to specific market and trade risks

A leaked Federal Financial Supervisory Authority (BAFIN) report from April 2009 calculated the overall exposure of Germany's banks to toxic assets to be potentially as high as €816 billion;[5] this risk was unevenly spread, with heavy exposure on the part of several regional banks, Commerzbank and, in particular, the Hypo Real Estate Group (€268 billion of toxic assets), while Deutsche Bank had a relatively low exposure of only €21 billion.

The stability of the euro provided potentially valuable protection to investors in dollar-denominated securities, compared to investors whose home currencies were more exposed.

Germany's financial sector was and remains an integral and vital part of the country's political economy. Stock, bond and futures markets supplement a three-pillar banking system (private, state and cooperative banks); bank-industry relations have been marked by sizeable, reciprocal stock holdings and reciprocal representation at the supervisory board level, which has ensured a long-term character to corporate strategic planning.

Germany's trade dependency had risen significantly in the years before the crisis. Exports constituted 46.9 percent of GDP in 2007 (as compared to 27.7% in 1982); three-quarters of its exports went to other European countries, including a full 70 percent to other EU member states, while 64 percent of German imports were European in origin.[6]

[4] Bundesbank equivalent rates in 1982 ranged between 4.2% for longer term deposits to 10.15% for large volumes of sight deposits; Bundesbank, *Monthly Report*, October 1982.
[5] *Süddeutsche Zeitung*, April 24, 2009.
[6] The intensification of cross-border intra-firm trade by networked transnational corporations accounts for a significant proportion of the leap in Germany's apparent trade dependency, but does not lessen the increased vulnerability to trade fluctuations.

Germany's property market did not manifest the bubble-like properties characteristic of some Anglo-Saxon economies and Spain in the recent cycle. Indeed, the post-unification construction boom left behind significant over-capacity of both commercial property and housing in some regions.

The position of the banking sector was considered to be comparatively favorable by the Bundesbank on the eve of the crisis.[7] Banks had been able to reduce their provisions for bad debt in 2007,while the position of specialist banks like IKB Deutsche Industriebank, whose exposure to subprime mortgages became known in mid-2007, was seen as the exception that proved the rule of a conservative and risk-averse banking system.[8] The overwhelming majority of German banks appeared to fulfill the 8 percent minimum capital adequacy ratio now demanded by Basel II.

Some observers have considered Germany to be "over-banked" with some 2,400 institutions and 45,000 branches.[9] Retail banking was and remains dominated by local savings banks, while the big private banks (Deutsche Bank, Commerzbank, Hypovereinsbank and Dresdner Bank) derived their most profitable business from commercial banking.

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

Prior to 2008, the Federal Republic had encountered five cyclical crises (1966 – 1967, 1975, 1981 – 1982, 1993, 2003), some of which coincided with financial turbulence, but none of which matched the severity of the 2008 – 2009 recession. The mildest of these five, the recession of the winter of 1966 – 1967, generated a concerted response involving the territorial agencies of the state (central, regional and local government) and the Bundesbank. However, as a Keynesian experiment, it demonstrated the cumbersome nature of a federal state in executing timely cyclical interventions; the resulting pro-cyclical surge of the early 1970s, together with the collapse of the fixed exchange rate regime, was seen to discredit fiscal de-

[7] Bundesbank, *Finanzstabilitätsbericht 2007*, pg. 8 described the risks to the banking sector as "relatively small"; this report was published in April 2008.
[8] Bundesbank, ibid.,78.
[9] M. Koetter, T. Nestmann, S. Stolz and M. Wedow, "Still Overbanked and Unprofitable? Two Decades of German Banking," *Kredit und Kapital* (2006: 4); also Rolf Wagner, "The other German struggle—Germany's political battles may be over, but the war over reform of the country's banking sector has only just begun," *The Banker* (December 2005).

mand management for the next three decades. In contrast, the financial turbulence resulting from exchange rate volatility from the 1970s through to the 1990s was successfully managed by the German central bank in support of macroeconomic objectives founded on a hard currency and export-led growth.

In the absence of any systemic threat to Germany's financial sector, the regulatory system for banking supervision had taken a relatively light-touch approach. The Federal Financial Supervisory Authority (BaFin) deals with international compliance issues relating to EU and other banking provisions, while the Bundesbank is responsible for monitoring and spot-auditing individual banking institutions.

German federalism contains a number of checks and balances on central executive power, which have hindered the timely implementation of countermeasures. This was evident in the 1967– 1969 Keynesian experiment, as well as in the post-unification crisis, in which the federal government's growth imperative was in part thwarted by the Bundesbank's stability imperative.[10]

Contingency powers for crisis management were incorporated in the 1967 Economic Stability and Growth Law, which provided both an institutional framework for cooperation between the state's executive branches and powers to increase resources through "conjunctural reserves" in periods of growth, including the latitude to vary income tax rates by up to 10 percent. These powers have remained dormant since the 1970s, but similar powers were invoked in the wake of German unification with the Solidarity Surcharge on Personal Income and Corporation Tax of 7.5 percent, which has persisted and currently stands at 5.5 percent.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

With its very considerable vulnerability to exogenous shocks from both global trade fluctuations and capital market instability, the German economy has been severely hit in several key areas in the period covered by this study.[11]

After a weakening of growth in the first nine months of 2008, GDP dropped

[10] See here Jeremy Leaman, *The Bundesbank Myth* (London: Palgrave Macmillan, 2001), 242f.
[11] Figures here derived from OECD, *Economic Outlook* 85 (June 2009) and from the Statistisches Bundesamt.

markedly in the fourth quarter (-1.7% year-on-year). The slump accelerated in the first quarter of 2009, with GDP ending 6.6 percentage points lower than the first quarter of 2008; a slight improvement in the second quarter of 2009 (+0.1%) did not prevent GDP levels that were 7.1 percentage points lower than the second quarter of 2008. The OECD has forecast an aggregate GDP decline of 6.1 percent for 2009 and anemic growth (0.2%) in 2010; this is supported by the Bundesbank in its June 2009 forecasts.

Industrial production showed dramatic year-on-year declines in 2009, with the worst represented by April's decline of 27.5 percent. Gross fixed capital formation at the end of the second quarter of 2009 had fallen by 11.4 percent year-on-year, while equipment purchases—a key indicator of future growth expectations—were 24.4 percent lower.

Wholesale trade, excluding motor vehicles, had declined by almost a fifth year-on-year in April 2009, and by August was still 16.1 percent lower than a year before. Retail trade, which had shown weak growth in the last two cycles, was less severely affected but was still down 3.5 percent year-on-year in August 2009.

Exports have fallen sharply since the second half of 2008, and were down 20.1 percent in the second quarter of 2009 year-on-year; imports were marginally less affected, but had still declined by 12.5 percent year-on-year by the second quarter of 2009.

Manufacturing showed the most dramatic decline, reaching a nadir in February 2009 with a 38 percent year-over-year decline. By September, levels remained 20 percent lower than the previous year.

Capacity utilization reached record lows in both the electrical and mechanical engineering sectors by July 2009 (at 72 percent and 69.3 percent respectively, more than 11 points below trend averages). Vehicle manufacturers were the worst hit with utilization levels dipping below 60 percent, echoing developments in global auto markets.[12]

Registered unemployment rose less markedly in Germany than in other European countries in 2009, in part due to short-term arrangements between employers and trade unions. However, the OECD expects it to rise to 8.9 percent in 2010. The outlook for the whole of the OECD group is for aggregate unemployment levels to rise by some 25 million individuals by the end of 2010.[13]

---

[12] Figures from Verband deutscher Maschinen- und Anlagenbau e.V.; Zentralverband Elektrotechnik- und Elektronikindustrie e.V.

[13] OECD, *2009 Employment Outlook: Tackling the Jobs Crisis* (Paris).

In sum, the scale of the economic downturn in Germany has dwarfed all previous episodes in its 60-year history; as such it can be interpreted as part of a long-term structural crisis of the country's political economy, rather than solely a cyclical downturn.

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

The sub-prime crisis of the summer of 2007, involving the salvaging of the IKB

Deutsche Industriebank and the Sachsen Landesbank and the announcement of serious losses for both WestLB and the BayernLB, was seemingly contained by politically brokered deals involving state and private sector guarantees in August of that year. While Jochen Sanio, the president of BaFin, expressed some alarm at that time over the potential scale of the global crisis, a view repeated in his foreword to BaFin's 2008 Annual Report, the Bundesbank's *Financial Stability Report* of April 2008 was more reassuring (see "Exposure to specific market and trade risks"). Similarly, while some statistical indicators suggesting cyclical weakening emerged as early as February 2008,[14] GDP continued to rise in the third quarter, while registered unemployment continued to fall until November 2008.[15] The rise in consumer price inflation in 2008 (a 2.6% average for the year), driven by food prices (an increase of 6.4%) and energy costs (an increase of 9.6%) even caused the European Central Bank to increase the repo rate by 25 basis points to 4.25 percent in July 2008. On August 12, 2008, the federal parliament passed the Law Limiting Risks Associated with Financial Investments, which was directed primarily at regulating the use of collateralized debt obligations

[14] cf. Statistisches Bundesamt. Monthly figures for industrial orders, adjusted by a "trend cycle component," indicate consistent month-on-month falls from February 2008 to May 2009, followed by two flat months and then a further fall in August 2009. The Ifo Institute's business climate survey showed signs of waning confidence in March and April 2008 and then consistent decline through March 2009.
[15] ibid.

(CDO); however, it was not until the Lehman Brothers collapse and the sale of Merrill Lynch to Bank of America on September 15, which triggered a bear run on financial stocks, that concentrated political attention was given to the formulation of a crisis management strategy.

The strategic agenda would evolve as the full depth of the economic crisis emerged, but policy was initially directed overwhelmingly at the financial sector. BaFin temporarily banned short sales of financial stock. The mortgage bank, Hypo Real Estate, was rescued by a joint salvage package that involved the federal government and the banking industry, amounting eventually to some €50 billion, and which was finally concluded on October 5, 2008. On October 8, the federal government issued a guarantee for all private savings accounts and term-deposits. On October 13, it further agreed to a broad, €80 billion support package for banks, with a further €400 billion in liquidity guarantees.

By three weeks after the collapse of Lehman Brothers, all the main executive agencies in the Federal Republic had mobilized to adopt counter-measures, acting in parallel to the cooperative efforts of the globe's major central banks, including the ECB, the Federal Board and the Bank of Japan, to lower refinancing rates and boost liquidity.

German policymakers were only slightly behind their counterparts in the United States and the United Kingdom, who had been worse hit in the initial stages by the collapse of key components of their financial sectors; by early October, German officials were actively engaged in multilateral crisis discussions, through the meeting of EU finance ministers on October 7 and subsequently at a joint meeting of G-7 finance ministers and central bankers on October 10. The federal government's emergency measures, most notably the €400 billion liquidity guarantees, were given legislative approval with the Federal Assembly passage of the Financial Market Stabilization Law on October 17.

The emergency measures enjoyed a wide measure of support within civil society and the media, but at an early stage there was criticism both from domestic actors, including trade unions, and other EU politicians for the federal government's unwillingness to sanction speedier and more expansive counter-cyclical programs. The parliamentary debate on October 15 leading to the Financial Market Stabilization Law reveals a view held both by Chancellor Merkel and her SPD finance minister that the crisis, while severe, was sectoral in nature and that, by implication, the restoration of health to financial markets would normalize other commercial activity.

This dilatoriness (more evident in retrospect) defied the increasing signs of turmoil within the real economy and the collapse of business confidence after mid-September. Sectoral lobbies, in particular those representing employers and industrial workers, became increasingly urgent in their requests for both supply- and demand-side measures to stimulate recovery after the collapse of orders in October.[16]

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

The configuration of the grand coalition, together with the extensive coverage of the crisis in print, broadcast and Internet media, allowed federal government policymakers to consult a wide spectrum of expertise among interest groups, notably employers and trade unions, in addition to the customary consultations with the academic sub-committees of the economics and finance ministries and the Council of Economic Experts.

Ongoing collaboration within the multilateral frameworks of the European Union, notably within the Economic and Financial Affairs Council (Ecofin), was intensified in the wake of the crisis. Crisis talks involving the G-7 and in November the G-20 were attended but not instigated by the German government. Monetary policy necessarily involved international consultations within the European System of Central Banks, but was also a topic addressed in the G-7 crisis talks.

Levels of multilateral coordination associated with the autumn 2008 rescue package were arguably modest, being predominantly confined to guarantee pledges for financial institutions and agreements to tighten bank regulation and remove obstacles to financial market liquidity. By early November, there was a common acknowledgement within the G-7 and core EU member states of the need for fiscal stimulus measures, but these were conducted according to national priorities and preferences. Differences of emphasis were evident

[16] cf. Bundesverband der deutschen Industrie, press statement on October 21, 2008, urging the implementation of a "sustainable conjunctural program"; available at: http://www.bdi.eu/recherchepool.asp C.f. also the call by the Deutscher Gewerkschaftsbund on October 14 for a counter-cyclical investment program; available at: http://www.dgb.de/presse/pressemeldungen/pmdb/pressemeldung_single?pmid=3301. There were marked declines in domestic and foreign demand for investment goods and intermediate goods in October 2008, with overall orders down 21.9% year-on-year; c.f. Bundesbank, *Monatsbericht* (January 2009), 63, Table X.3.

in the German finance minister's criticism of Gordon Brown's "crass Keynesianism" in early December and the refusal to apply the term "conjunctural" (i.e., anti-cyclical) to crisis management programs.[17]

The federal government was not curtailed in its choice of policy measures by any IMF restrictions.

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

The German authorities enacted a series of crisis management measures which reflected the increasing intensity and spread of the crisis. The Financial Market Stabilization Fund (SoFFin) was established by federal law on October 20, 2008, under the supervisory control of the Bundesbank, with a maximum budget of €480 billion. This amounted to some 19 percent of GDP applied over one year.

The federal cabinet agreed to the first active stimulus package—"Securing Employment by Strengthening Growth"—on November 5, 2008. This included a 15-point program of predominantly tax incentive measures stretching over two years (2009 – 2010); the volume of additional fiscal resources was some €12 billion, with a claimed stimulus effect of €50 billion.[18] This represented the equivalent of 0.24 percent or 1 percent of GDP per annum over the two years.

Against the background of an increasingly severe cyclical downturn and criticism of the November package from within both coalition parties, a second emergency stimulus package was approved in mid-January 2009, with a total additional budget of €50 billion over two years.[19] The second stimulus package distinguished itself from the smaller November program by its major focus on public sector infrastructural "investments for the future."

[17] Peer Steinbrück, quoted in *Neue Züricher Zeitung*, December 11, 2008; cf *Der Spiegel*, "Merkel packt ein Rettungspäckchen für die Bürger," October 20, 2008; the second stimulus package, on the other hand, bore the title *Konjunkturpaket 2*, thus retrospectively conceding that the first package did have a counter-cyclical purpose.

[18] Details at: http://www.bundesfinanzministerium.de; the November 5 package supplemented previously approved measures of fiscal relief for households amounting to €20 billion, ibid.

[19] It was passed in both houses of the Federal Parliament by February 20 2009

There have been additional policy measures directed at specific companies (see below), as well as significant injections of liquidity by the ECB in support of European financial markets.

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Targeting and coverage of policy tools

The notional maximum support available to the financial sector (€650 billion or 26.3% of GDP)[20] dwarfs the fiscal stimuli (€62 billion or €100 billion) thus far approved by the federal parliament. Emergency legislation provides for liquidity injections into undercapitalized banks, liquidity guarantees (including 100 percent guarantees for individual savings accounts), and the partial or whole purchase of financial institutions. By the end of July 2009, SoFFin had provided €26 billion in guarantees, while the bailout of Hypo Real Estate, due to be purchased by SoFFin, has already cost the federal state €102 billion.

Special tax-relief measures for businesses—including degressive depreciation on movable asset investments up to 25 percent—were included in the November program. Tax relief for companies and private households totaling €9.4 billion, as well as social insurance contribution reductions worth another €9 billion were approved in February. These were intended to boost both investment and household expenditure.

On the infrastructure front, the combined extra expenditure on state infrastructural projects embodied in the two fiscal stimulus programs is some €22.5 billion, including €13 billion for local authority expenditure on schools and transport infrastructure and €6 billion on federal infrastructural projects. The cost of local investment projects is supposed to be borne in part by the Länder governments, with an additional €3.3 billion.

The car industry was prioritized in the November package in the form of a €2.8 billion “innovation credit” aimed at vehicle retailers; in February a car-scrappage scheme was introduced with an initial budget of €1.5 billion, subsequently raised in April to €5 billion, aimed at replacing older polluting cars with environmentally more benign vehicles. New car purchases in 2009 were

[20] Figures from *Zögerliche Belebung, steigende Staatsschulden*, Joint Report of Economic Institutes, October 2009, 25.

additionally exempt from vehicle license duties; new low-carbon-emission vehicles were exempt from the duty until the end of 2010.

Other measures included €450 million for export innovations, an increase in the ceiling for domestic credit guarantees to industry from €25 billion to €100 billion, and increased expenditure on employment activation policies.

Employment protection as a political (and electoral) imperative was most evident in the extension of eligibility for short-term working benefits by 6 months to 18 months and additional short-term working subsidies to employers of €2.1 billion, to be paid out of the accumulated reserves of the Federal Labor Agency. Unemployment insurance was also provided with a short-term loan subsidy of €1 billion.

Providing an assessment of these measures' adequacy, in terms of targeting and delineation, is problematic at this date, given the predictable time-lags associated with infrastructural projects and the relaxation of planning procedures which were included in the February program. On the positive side, it is indisputable that the rise in unemployment has been cushioned both by state short-term employment support and by parallel agreements between employers and trade unions.

The targeting of the car industry was, on the one hand, appropriate in terms of the centrality of the sector to both the domestic economy and to trade, as well as the current critically low levels of capacity utilization. However, the modalities of the extensive car scrappage scheme are potentially dysfunctional, running the risk of a repeated slump in demand, a diversion in consumer spending and a collapse in second-hand car values.[21] A good number of economists have emphasized the potentially harmful medium-term effects of the scheme.[22]

The specific and controversial rescue plan for Germany's four Opel plants, involving federal loans of some €4.5 billion, has a medium- and long-term logic for Germany's political economy and a short-term fiscal logic in terms of the relatively greater cost (€5 billion) to the sectoral pension insurance scheme represented by Opel's collapse. At the time of writing, there was a strong risk of the planned sale of General Motors' European plants collapsing and two of the four Opel plants being closed.[23]

---

[21] Thus Justus Haucap, chair of the Federal Monopolies Commission, cited in *Süddeutsche Zeitung*, April 8, 2009

[22] Christoph Schmidt, member of the SVR and president of the RWI economics institute, and Klaus Zimmermann, president of the DIW institute, have described the probable effect of the scrappage scheme justifiably as a "bush fire," quoted in: *Die Welt*, March 26, 2009; cf. also Wolfgang Franz, chair of the SVR, *Der Spiegel-Online*, April 8, 2009.

[23] See *Financial Times*, November 4, 2009; *Financial Times Deutschland*, November 10, 2009, http://www.ftd.de/ (accessed February 25, 2010).

While the targeting of local authority investment in schools and transportation infrastructure is sensible, the effectiveness of this approach will only be maximized if projects already in an advanced stage of development are accelerated by cash injections.

The short-term financial support provided to financial institutions was essential, but the medium- to long-term effect of that support will depend crucially on regulatory and ownership frameworks that have yet to be agreed upon by national policymakers and multilateral organizations. The scale of support to the financial sector alone—already amounting to 6.3 percent of GDP—places a significant additional burden on public sector finances.

Development as an objective of stimulus policies

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

The two stimulus packages were and are seen by German policymakers as short-term crisis management measures, rather than significant deviations from the supply-side thrust of German economic policy since the 1980s, which has been pursued by center-right (1982 – 1998, 2009 onward) and center-left (1998 – 2005) administrations as well as the recent grand coalition (2005 – 2009).

The medium-term ambition to achieve balanced state budgets—originally by 2011—remains. This is reflected not only in the ongoing commitment to the EU's Stability and Growth Pact, but also in the specific alteration of the German constitution to require state budgetary consolidation in the medium term and, more seriously, to prevent regional governments from incurring any new debts after 2020. While this so-called debt brake (*Schuldenbremse*) has been justifiably criticized by a number of economists, the measure reflects the conviction among policymakers in all four major parties of the dangers of the state "crowding out" private borrowing from capital markets.[24]

[24] cf. Achim Truger, Henner Will and Jens Köhrsen, "Die Schuldenbremse: Eine schwere Bürde für die Finanzpolitik," Institut für Makroökonomie und Konjunkturforschung, *Policy Brief* (Düsseldorf: September 10, 2009); Both the Free Democrats, who abstained, and the Greens, who voted for the new law, demanded a stricter timetable of consolidation; only the Left party voted against the measure, along with a handful of SPD legislators.

The strong focus on new investment in the country's educational infrastructure is consistent with the EU's Lisbon process and its emphasis on enhancing competitiveness through technological innovation and the nurturing of "human capital." In addition, the German state's strong environmental credentials have been underscored by the prioritization of low-carbon solutions to development, by its favoring of low-emission cars in the scrappage scheme and in vehicle license concessions, and the provision of €3 billion for energy-efficient home improvements.[25] On the other hand, the government's expressed intention of reducing the European Union's 2012 targets for vehicular CO2 emissions arguably sets the supply-side growth imperative over environmental considerations.[26] All in all, there is considerable uncertainty as to the degree to which the stimulus packages can and will be given a green dimension; Menusch Khadjavi et al. estimate a potential green share of 32 percent of total stimulus package expenditure in Germany, but also note the danger of the share being as low as five percent.[27]

There is little evidence of an "opportunity" dimension to Germany's crisis management activity, with the possible exception of a new urgency applied to the issues of tax evasion and the dysfunctional tax competition of low-tax jurisdictions.[28] There is certainly some suggestion that the coincidence of economic crisis and the run-up to the September 2009 federal elections influenced the choice of crisis measures—notably in employment and training subsidies and the new-for-old car trade-in scheme. On the other hand, the relatively low-key character of the elections reflects the greater commitment of the two major parties to domestic and international crisis management.

The second, larger stimulus package lays considerable stress on achieving sustainable growth and sustainable fiscal conditions in the medium term. There is considerable doubt, however, about the adequacy of these goals in addressing longer-term structural deficits, most notably the nation's asymmetries of demand, the related chronic external balances and, at the supranational level, the structural problems of the EU's policy architecture and policy preferences (see below).

---

[25] cf. "Schutzschirm für Arbeitsplätze," Federal Finance Ministry Press Release, November 5, 2008. Point 3 of 15 Point Program.
[26] ibid. Point 11 of 15 Point Program.
[27] Thus Menusch Khadjavi, Sonja Petersen, Sebastian Petrick, Wilfried Rickels, "No Money Left for Climate Protection. Climate Policy after the Crisis," *Kiel Policy Brief* 6 (August 2009), 7.
[28] As early as February 2008, against the background of the Liechtenstein tax affair, CDU General Secretary Ronald Pofalla announced the party's desire to see Europe's tax havens "dried out," quoted in *Handelsblatt* , February 18, 2008. A corresponding Law for Combating Tax Evasion was passed by both houses of the Federal Parliament in July 2009.

- Has the stimulus included “buy national” clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country’s executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

National bias and protectionism

There has been little evidence of measures promoting German products over imported goods; for example, the old-for-new car-scrappage scheme does not discriminate against foreign vehicles. On the other hand, the rescue operation aimed at facilitating the takeover of Europe’s General Motors plants by the Canadian-Austrian company Magna has been highly contested by Germany’s European neighbors, notably the British, Belgians, Spanish and Poles, as it was perceived to favor employees in Germany’s four Opel factories. The EU is set to examine the case and the associated suspicion of unfair state aid.[29] Additionally, measures designed to protect domestic jobs (e.g., short-time subsidies for employers) can be seen to constitute a degree of protectionism.[30]

Neither the Bundesbank nor the ECB have sought to influence the euro’s exchange rate through intervention in foreign markets. Nor, beyond the modest increase of €450 million in the Central Innovations Program for Small and Medium-sized Enterprises (ZIM) relating to exports, have there been any additional measures to enhance Germany’s already refined system of export credit guarantees and trade diplomacy.

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Social protection

Both the November and February programs contain measures promoting employment. These include in-service training, “job-to-job” assistance and extension of eligibility for short-time benefit (November), streamlining short-time benefit applications through the Federal Agency for Labor, employer subsidies for the social insurance of short-time workers, in-service

[29] Neelie Kroes, Speech before the European Parliament on September 14, 2009, European Commission, SPEECH/09/388

[30] The newly formed Global Trade Alert has produced a comprehensive report on crisis-related protectionist measures which suggests that the G-20 countries, including Germany, are all guilty of some discriminatory crisis-management measures. See Simon Evenett, “Broken Promises: A G-20 Summit Report,” (CEPR: September 2009), http://www.voxeu.org/index.php?q=node/3995 (accessed February 25, 20109

training for older and less qualified workers, subsidies for training contract workers and a planned minimum wage for contract workers.

Local authorities are being provided with additional resources for increasing kindergarten provision and improving the fabric of existing school facilities.

Policymakers are seeking to boost household spending both through indirect tax relief measures and direct transfer payments: the starting rate of personal income tax (PIT) has been lowered from 15 percent to 14 percent, with retrospective effect from January 1, 2009; the basic personal allowance has risen by €170 to €8,004; health insurance premiums have been reduced from 15.5 percent to 14.9 percent of taxable income. For each child, households receive a one-off bonus of €100 in 2009; recipients of unemployment assistance (*Arbeitslosengeld II*) will receive a higher benefit for children between six and 13 years of age. In addition, PIT payers will be allowed to double the rate of offset for the cost of artisan work for two years. Finally, the waiving of road license fees for new vehicles for up to two years provides incentives for car purchases.

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

Produced in the context of a strong, active and critical civil society, the government's communication of crisis measures has been extensive and detailed in the period under examination. In particular, the federal government press office, through conventional and online press releases and accessible archives, has communicated an extensive range of materials to the general public along with arguments justifying government measures.[31]

In contrast to other short-term indicators, private consumption in the second quarter of 2009 showed a marked improvement over the first quarter and was 0.5 percent higher year-on-year; this indicates some response to the fiscal measures aimed at stimulating consumption, most notably to the car-buying inducements of the two packages. The uptake of the so-called "wreck premium" has been surprisingly strong. The marked reduction in savings activity – down 55.6 percent year-on-year in the first half of 2009 – indicates

[31] cf. http://www.konjunkturpaket.de/Webs/KP/DE/Homepage/home.html (accessed February 25, 2010)

that households have brought forward larger purchases as a result of such incentives.[32] Gross investments, while also improving over the first quarter of 2009, were still down 10.9 percent year-on-year, while equipment purchases were down 23.4 percent.[33]

Opinion polls surveying the public's perception of the federal government's crisis management efforts have generally shown unfavorable responses. An Emnid survey in December 2008 found only 27 percent of respondents confident that the grand coalition would choose the appropriate measures; 71 percent expressed a lack of confidence.[34] A survey by Infratest two months after the second stimulus package suggested a slight improvement in the government's rating since December, but with 67 percent of respondents still asserting that it "lacked a clear approach to the crisis."[35]

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

The bulk of Germany's crisis measures have been designed to be implemented over two years, 2009 and 2010. While the indirect fiscal stimuli – lower PIT rates, raised allowances, and license-waivers – and direct transfers would seem to have stimulated an improvement in private consumption, the multiplier effects of infrastructural investments are subject to significant time-lags, as demonstrated by previous anti-cyclical investment programs.[36] The effects of the bulk of the €18 billion allocated to infrastructural investments are likely to be seen in the second half of 2010 at the earliest. According to the RWI institute in Essen, projects ready for immediate implementation in January 2009 amounted to only €3 billion.[37] In the same report, the suitability of infrastructural investments as counter-cyclical instruments is placed in some doubt, given the inevitable preparation and planning delays; supply-side tax relief is seen as more appropriate because of

---

[32] cf. Statistisches Bundesamt, "Bruttoinlandsprodukt in der ersten Hälfte 2009," *Wirtschaft und Statistik* 9/2009, 853.
[33] ibid., p.847
[34] N24 Emnid-Umfrage, December 10, 2008; details at http://www.presseportal.de/pm/13399/1318029/n24 (accessed February 25, 2010).
[35] Infratest dimap, ARD Deutschland Trend, at: http://www.infratest-dimap.de/uploads/media/ARD-DeutschlandTREND_April_2009.pdf (accessed February 25, 2010).
[36] J.Leaman, *The Political Economy of West Germany 1945-1985* (London: Palgrave Macmillan, 1988), 187ff.
[37] C.f. RWI (ed.), *Konjunkturbericht. Die wirtschaftliche Entwicklung im Ausland und im Inland zur Jahreswende 2008/2009*, 81

its immediate effect.[38] Some observers also argue that were a more timely deployment of such investments possible, a danger of overstretching capacity and inflation of building costs might arise.[39] A slightly more positive assessment of the immediate cyclical efficacy of infrastructural investments is given by the German Association of Local Authority Peak Federations in their forecast of a 16 percent growth in local investments in 2009, a level which would have modest but not insignificant multiplier effects.[40] In addition, the €9.6 billion allocated to local authorities also allows councils to begin to make good the backlog of state investment, acknowledged by the German Council of Economic Experts (SVR) and other economists.[41] However, by August the German Building Confederation was very concerned that bureaucratic obstacles had prevented most of the earmarked investment funds from being allocated.[42]

The most recent figures, nevertheless, show that building activity has picked up markedly since March 2009, with production levels in July of that year at 124.7 (2005 = 100); construction orders stood at 130, with civil projects doubling from 77.5 in January to 150.3 in June. Public sector orders also doubled in the same period (to 150), but with private contractors also showing strongly (119.2). Private contractor orders for buildings look less dynamic for both housing (110.4) and commercial property (104.7).[43]

After an initial delay, regional and local authorities alike have moved decisively to implement a first tranche of investments, two-thirds of which are targeted at educational infrastructure, as well as to secure the additional €3.3 billion in funding. The increasingly gloomy growth forecasts clearly galvanized all territorial authorities into action in the early summer of 2009, evidenced by the speed and unanimity of Federal Council (Bundesrat) approval of federal crisis legislation.

[38] ibid. p.80f
[39] Thus Roland Döhrn, Rainer Kambek and Christoph Schmidt,“Kritik an Konjunkturpaket,” *Der Spiegel*, January 16, 2009.
[40] Cited in Michael Reidenbach, “Investitionsstau und Investitionsbedarf bei den Kommunen,” *WSI-Mitteilungen*, 5/2009, 259.
[41] Sachverständigenrat für die Begutachtung der gesamtwirtschaftlichen Entwicklung, *Die Finanzkrise meistern – Wachstumskräfte stärken*, Annual Report 2008; see also Reidenbach, op.cit. p.257; Achim Truger, “Die makroökonomische Bedeutung öfferntlicher Investitionen und ihre Finanzierbarkeit,” *WSI-Mitteilungen*, 5/2009, 243-50; Klaus Zimmermann, head of the DIW, in an interview for the “Tagesschau,” January 13, 2009.
[42] cf. *Der Spiegel*, August 11, 2009.
[43] Figures from Bundesbank, *Monthly Report*, September 2009, Statistical Annex X.2, X.4.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

After initial reluctance (within Ecofin, the G-7 and the G-20) to commit Germany to large-scale international cooperation beyond bank bailouts in October and November 2008, German collaboration was more clearly evident in late December and early January 2009, allowing a higher degree of unanimity in the March G-20 meeting in relation to both bank stabilization and fiscal stimuli. Nevertheless, the character of the crisis management shown by the German and other European and G-20 governments has been parallel rather than complementary. Both qualitatively and quantitatively, Germany's response to the crisis has been tailored to its (perceived) national circumstances and its predominant policy preferences. It has therefore been the object of criticism in terms of its dilatoriness, the modest scale of its fiscal stimuli and its ambitions to consolidate state budgets at the earliest opportunity.[44]

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

Both the November and the February programs contained taxation measures designed to stimulate demand in the Germany economy. These included a reduction in the bottom PIT rate from 15 percent to 14 percent, a rise in personal allowance levels, a doubling of the offset value of household repair services up to a maximum of €1200, a one-off payment of €100 per child, and incentives for car purchases. For businesses, small and medium-sized enterprises (SMEs) were offered increased thresholds for purchasing movable assets, and all companies were offered two years of declining-balance

[44] cf. Hearings of the Parliamentary Economic Committee, February 2009, in which representatives of the Federation of German Industry, the German Chambers of Industry and Commerce, Peter Bofinger [member of the SVR] and the Hans Böckler Foundation all stressed the late implementation of the second stimulus package and the dilatoriness of the timetable: http://www.bundestag.de/presse/hib/2009_02/2009_038/01.html. C.f. also parallel hearings of the Budgetary Committee, in particular the submission of Heiner Flassbeck, chief economist of UNCTAD: "Globaler konjunktureller Abschwung – nur noch vergleichbar mit der großen Depression," written submission to Bundestag hearings on the second stimulus package (Konjunkturpaket II) in February 2009, Haushaltsauschuss 16. Wahlperiode, Ausschussdrucksache 5801.

depreciation at an initial rate of 25 percent, beginning January 1, 2009. The primary addressees of these measures have been German households, corporations and unincorporated businesses; the raising of offset values for investments applies to inward investments by foreign companies, reinforcing the location inducements of a standard corporation tax of just 15 percent.

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/ stabilization

Germany's monetary policy is dictated by its membership in the European System of Central Banks. The key repurchase rate (repo rate) is set by the Central Bank Committee of the European Central Bank, of which the Bundesbank is just one among 16 central banks currently represented. Nevertheless, the institutional structure, policy tools and policy preferences of the ECB are virtually identical to those characterizing the Bundesbank up to 1999, and ECB decisions continue to bear the imprint of German monetary policy preferences. The pattern of ECB repo rate cuts has mirrored the historic tendency of the Bundesbank to delay reductions beyond the onset of cyclical downturns, despite acknowledged time-lags of transmission mechanisms of around 12 months. Thus the timing of repo rate cuts has been consistently later than those of the Federal Reserve and the Bank of England, and the increments smaller than those of its counterparts.[45] "Too little, too late" has been a frequent complaint directed at the ECB; Paul Krugman has characterized its indecisiveness as structural weakness, compared to the maneuverability of the Federal Reserve.[46]

Jean-Claude Trichet, president of the ECB, has defended the institution with reference to a convergence of market rates in the United States and the euro zone, despite a currently higher repo rate of 1 percent.[47] And indeed, the ECB's "enhanced credit support" has been received more favorably; above all, the release of large tranches of liquidity into circulation and the reduction in the required quality of securities accepted in exchange for liquidity have been regarded as pragmatic and appropriate measures. Given the weakness of European interbank markets, the new eligibility rules for securities increases the pool to €12.2 trillion. More recently, maturity periods for

[45] The boldest cut in the repo rate was 75 basis points on December 10, 2008 to 2.5%; the Federal Reserve by December 16 had cut its base rate to just 0.25%. Stock markets, which fell in disappointment at the ECB move in December, surged in the United States after December 16.
[46] Thus *The Daily Telegraph* (November 6, 2008)
[47] Paul Krugman, "A Continent Adrift," *The New York Times* (March 16, 2009); See Jean-Claude Trichet, "The ECB's enhanced credit support," Speech at University of Munich, July 13, 2009.

refinancing operations were extended, firstly to six months and in June 2009 to a full year; the June relaxation produced a surge in demand for refinancing, with total additional liquidity for the month reaching €442 billion.

National exchange rate manipulation is not possible; the ECB, like the Bundesbank before it, continues to pursue a policy of currency stabilization both within the euro zone and between the euro and other currencies, sustaining the euro's position as a reserve currency and maintaining a favorable real exchange rate in support of the euro zone's exporters.

Table 1: Changes to taxes, social levies and state expenditure in terms of burdening (-) or relieving (+) budgets (in € billions compared to 2008)

	2009	2010
First Stimulus Package	-4.1	-7.5
Taxation changes	-2.6	-5.7
Extension of short-time working, training expansion	-0.3	-0.5
Supplementary transport investments	-1.0	-1.0
Additional funds for improving regional economic structures	-0.2	-0.3
Second Stimulus Package	-20.4	-25.5
Income tax relief, child bonus	-4.9	-5.6
Changes to vehicle road tax	-0.1	-0.2
0.6 percentage point reduction in health insurance contributions	-3.0	-6.0
Public "investments for the future'	-4.1	-9.4
Promotion of mobility research and innovation	-0.7	-0.7
"Scrappage premium" auto trade-in program	-4.8	-0.2
Increased benefit rate for children of long-term unemployed	-0.2	-0.3
Short-term work grants, training expansion, 5,000 jobs in Fed Empl Agency	-2.6	-3.0
Reintroduction of commuting allowance in PIT*	-5.4	-3.1

Changes to tax allowances for health and long-term care insurance* etc.		-8.3
Other changes to taxation law	-0.1	5.5
Other changes to social insurance contributions	3.0	2.9
Increase in motorway tolls for lorries	0.9	0.9
Extension of labor market measures	-0.9	-0.1
Changes to top-up pensions, higher educational grants, housing and child benefit	-4.3	-5.0
Reduction in homeowner grants	1.2	2.3
Other changes to statutory health and long-term care insurance	-4.5	-4.7
TOTAL	-34.6	-42.6
Fiscal stimuli as a proportion of GDP in %	*1.4*	*1.8*

Source: *Zögerliche Belebung – steigende Staatsschulden: Gemeinschaftsdiagnose 2009*, October 15, 2009

*Enforced changes as a result of rulings by the Federal Constitutional Court

Credibility of funding mechanisms

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

The fiscal position of the German state at the outset of the crisis was, by international standards, very solid.[48] Central, regional and local authorities had reduced the total public budget deficit to just 0.2 percent of GDP in 2007, with an overall state debt ratio of 65.1 percent of GDP. With interest rates at historically low levels, recent state expenditure on interest has been below the levels seen in the 1980s and 1990s, averaging 6.1 percent of total

[48] cf. IMF, “Germany. Staff Report for the 2008 Article IV Consultation,” December 9, 2008.

expenditure between 2002 and 2008, compared to over 10 percent in the late 1980s and most of the 1990s. German sovereign bonds enjoy top ratings in financial markets; 10-year Bunds are a standard benchmark for bond spreads. Together with Japan, Sweden and Switzerland, German sovereign bonds are currently the most sought-after fixed interest securities in world. Financing current liabilities is not a major difficulty, compared to sovereign bond issues in countries with depreciating currencies and worse domestic and external deficits.

A considerable source of uncertainty, however, is the degree to which questionable financial assets in the hands of German banks may turn out to be toxic on maturity. With an estimated €816 billion of such assets outstanding, including credit default swaps, the financial burden on the federal budget, via SoFFin, could be considerable. In its April Financial Stability Report, the IMF suggested that euro zone bank losses are expected to rise to $814 billion (€581 billion) by the end of 2010.[49]

The two stimulus packages are supplements to the normal budgets of federal, regional and local authorities, but are included on these authorities' balance sheets. The special fund for the Stabilization of Financial Markets, SoFFin, remains off the federal government's balance sheet until its planned dissolution on December 21, 2009.

The funding burden of the stimulus packages is borne primarily by the federal government, with regional governments providing €3.3 billion toward projects in their region, and local authorities required to provide matching funds for house-improvement measures. However, more than two-thirds of the expenditure is devolved to the regional and local level; the bulk of the funding is provided by transfers from the central government, financed through the sale of sovereign bonds.

The financial assistance provided or offered to households includes universal, unconditional changes to tax rates and allowances; increased transfer payments; and conditional inducements to purchase goods or invest, with some limitations on the time of eligibility, the particular character of purchases (environmentally friendly vehicles, moveable assets) and the size of enterprise (special allowances for SMEs).

[49] IMF, *Global Financial Stability Report*, op.cit. p.10.

While Chancellor Merkel has acknowledged the likelihood of a protracted downturn and slow recovery and with it the need for expansionary state expenditure, the federal government has made a statutory commitment to consolidate state finances in the medium term. This has taken the extraordinary form of an alteration in the Federal Constitution.

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

The introduction of a second stimulus package in February 2009 was indicative of rapidly altered perceptions of the crisis, from a view of the turmoil as predominantly sectoral and confined to financial services to an acknowledgement of its general recessionary quality. This followed a series of dramatic falls in key indicators in the last quarter of the year —domestic and foreign orders, investments, and business sentiment, among others—and corresponding pressure from trade associations, trade unions and academic advisors to intervene more decisively. The second crisis package in February was based on a set of revised assumptions about the development of GDP, which turned a forecast of 0.2 percent growth for 2009 into a severe recession of 2.25 percent negative growth. After further downward revisions in April 2009 by the OECD, the Bundesbank, the European Commission and Germany’s leading research institutes, the federal government reduced its forecast for the year to reflect a full six percent decline in growth. Apart from extending the car-scrappage scheme, there has been no significant addition to the January anti-cyclical measures. This can be explained in part by the slight improvement in economic conditions during the second quarter of 2009 and in part by the particular circumstances of two coalition partners also playing a role as electoral opponents, each seeking to generate confidence in the run-up to the September elections.

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

By the close of the review period, financial supervision was set to change with the formation of a new federal coalition between the Christian Democratic Union (CDU)/Christian Social Union (CSU) and the market-liberal Free Democratic Party (FDP), as it was a firm policy goal of the latter to locate banking supervision exclusively in the Bundesbank. This has become a firm proposal.[50]

While the September 2009 G-20 meeting produced proposals for limiting bank bonuses, and agreement was reached in outline for tighter capital adequacy rules, no major German legislation on banking re-regulation had emerged as of the time of writing.

After dismissing British and American proposals for establishing so-called bad banks in early 2009, the increasing evidence of large volumes of toxic assets in Germany's banks and their subsidiaries[51] forced Merkel and Finance Minister Peer Steinbrück to produce their own proposal for off-loading such assets into repositories designed to remove them from bank balance sheets. The delay undoubtedly contributed to the downgrading of most of Germany's big state-owned regional banks on Wednesday, May 6, 2009 by the Standard & Poor's credit rating agency. The German solution does not involve a single repository for all problematic assets, in contrast to the US/UK model of a general location for toxic assets with shared liability.

German banks will be able to park all their untradable assets in a purpose-built "mini-bad bank," which will retain specific liability for all associated assets. This bank will refinance the acquisition of these securities through bonds which are guaranteed by SoFFin; the guarantee is provided in exchange for a "guarantee fee" payable by the bank. Assessors will subsequently calculate a realistic market value for the securities plus a risk premium; where there is a difference between the book value and market value, the bank will be obliged to repay SoFFin over a period of 20 years. Any losses still attaching to the securities will be borne by the bank, whereby dividends are diverted to the federal authorities. The only risk to the state attaching to this arrangement arises in the case of the bank's insolvency.

Prior to the passage of the Bad Bank Law in July 2009, the Commerzbank had already established its own repository, taking €15.5 billion of its own toxic assets and €39.9 billion held by Dresdner Bank, which it had just taken over from Allianz. Since the law's passage, only two state-owned banks—WestLB and HSH Nordbank—have announced plans to establish the asset repositories, in order to meet capital adequacy requirements. The IMF has expressed its concern over the lack of "up-front recognition of losses" in Germany.[52]

[50] See Financial Times Deutschland, October 8, 2009.
[51] cf. the leaked report from BaFin which quoted a figure of €816 billion of toxic assets held by German financial institutions.
[52] IMF, *Global Financial Stability Report*, 2009, 15

7. Tentative Economic Impact

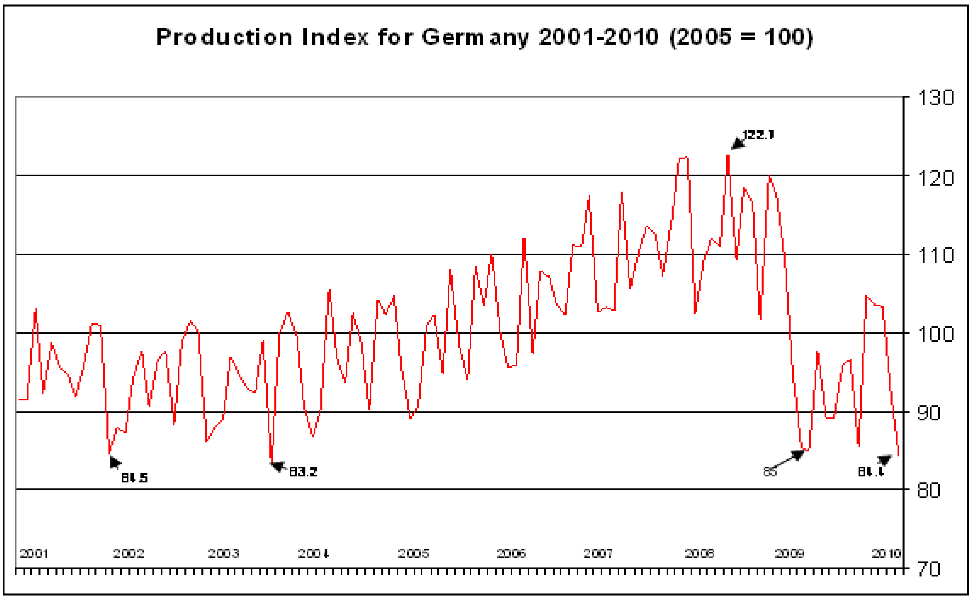
- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

In the absence (as of the time of writing) of even provisional estimates for the German economy's performance in the third quarter of 2009, an assessment of the effectiveness of the state's counter-cyclical programs will at this stage be speculative and approximate. One can nevertheless distinguish between short- and medium-term cyclical effects and between cyclical and structural crisis management.

The current recession is already the sharpest in the history of the Federal Republic. This is manifest in the scale of the decline of key indicators, as with the production index below.

Figure 1: Production index in production industries, original values, 2005 = 100



Source: Statistisches Bundesamt, Short-term indicators portal

July 2009 saw industrial output at just 83 percent of the corresponding July 2008 levels. Investment in machinery and equipment, despite an improvement in the second quarter, was still only 75 percent of second-quarter 2008 levels. GDP in the second quarter of 2009 was likewise up slightly compared to the first quarter, but remained at just 92.3 percent of second-quarter 2008 levels. The most recent prediction for GDP contraction in 2009, in the autumn joint report (AJR) of Germany's major economics research institutes, is for a decline of five percent. The same report forecasts GDP growth of 1.2 percent in 2010. This (optimistic) forecast is based on two risky assumptions: a) that world trade will grow by 5.5 percent in 2010 and b) that the dollar-euro exchange rate will be $1.45.[53] The IMF, in its October 2009 *World Economic Outlook*, is much more cautious, suggesting that world trade will grow by only 1.5 percent. Moreover, even with the US current account deficit set to narrow to 2.4 percent of GDP in 2010, its growing domestic fiscal deficit (currently some 7.7 percent of GDP) will put further downward pressure on the dollar.[54] The current dollar-euro exchange rate of $1.48 matches the year forward-trading rate, both of which could prove too optimistic. The IMF's forecast for a German GDP decline of 5.5 percent in 2009, and of growth of only 0.3 percent for 2010 (a downward revision from its July estimate of 0.9%) looks more realistic. As this chapter goes to print, the production index (figure one above) shows recovery up to September 2009 but then a reversal through to a new low in January 2010, suggesting the likelihood of anemic growth at best and a double-dip recession at worst.

Short-term fiscal measures provided a discernible boost to consumption-led growth, evident in a modest increase in private consumption by the end of the second quarter of 2009. This could be seen in the marked 23 percent increase in new car orders and an associated reduction in net savings of 55 percent in the first half-year. Indeed, the old-for-new vehicle scheme will, according to current estimates, be three times as successful – at least in the short term – as originally anticipated.[55]

As a result of state infrastructural funding, building investment is set to grow by a modest one percent in 2010, according to the research institutes' AJR. However, machinery and equipment investments will continue to fall that year.[56]

---

[53] Gemeinschaftsdiagnose, 38.
[54] cf. OECD, *Economic Outlook* 85, Statistical Annex, Table 51.
[55] An initial allocation of €1.5 billion for 2009 is set to reach €4.5 billion, according to the Gemeinschaftsdiagnose, p.56
[56] For further details of the stimulus effects of infrastructural programs on the economic cycle see: Hans-Ulrich Brautsch, Brigitte Loose and Udo Ludwig, "Investititionen der öffentlichen Hand in die Zukunft: Ja! Die Konjunktur aber retten sie nicht mehr!," *Wirtschaft im Wandel*, 3/2009, 9-18.

Thus, even these optimistic forecasts see a “hesitant recovery” (thus the title of the AJR) in growth, and continued problems with banks’ unwillingness to lend. This hesitancy is mirrored in the very modest September rise in the Ifo Institute for Economic Research’s Business Climate Index to 91.3 (the base level of 100 is represented by the year 2000). More recent October figures from the Mannheim Center for European Economic Research (ZEW) suggest a further fall in business confidence as a result of lower-than-expected exports in August.[57] The AJR thus concedes that recovery could take several years to take hold; this caution has led some commentators to talk about a “washboard-cycle” of short periods of weak growth followed by periods of contraction.[58] The likelihood of a W-shaped cycle, (i.e., with at least one further dip after the mild recovery in the second half of 2009) is arguably increasing, for several reasons:

- The “surprising” month-on-month fall of 1.8 percent in German exports in August does not support the notion of a straightforward V-shaped recovery; the August figures showed a year-on-year contraction of a full 20 percent.
- The short-term fiscal inducements to German households, most notably the old-for-new vehicle scheme, are set to end by early 2010, while the auto license waiver will continue for low-carbon cars until the end of 2010. There is a greater likelihood that such large household purchases, brought forward through fiscal inducement and partially funded by raids on savings, will dip in 2010 as sharply as they rose in 2009, with corresponding negative multipliers. Unless foreign demand for German vehicles increases in 2010, the extremely low levels of capacity utilization in motor manufacturing will continue, reducing incentives for domestic car producers to take advantage of generous short-term depreciation allowances. This is clearly reflected in the AJR estimates of continued falls in equipment purchases.

In sum, the effect of the two fiscal stimulus programs is set to be suboptimal, in part even self-defeating, particularly if a sustainable recovery of all demand factors is not achieved by 2011 and with it a recovery of state revenues. The danger of a Japanese-style L-shaped cycle—a reduction of trend growth and stagnation of growth at low levels—cannot be ruled out, as the most recent production data (Figure 1 above) indicate.

[57] ZEW, cited in *Die Welt*, October 13, 2009.
[58] cf., for example, *Die Zeit*, online, October 14, 2009, www.zeit.de/wirtschaft/2009-10/herbstgutachten-konjunktur (accessed February 25, 2010).

The political logic of crisis management in Germany was in part confounded by the constellation of party forces within the Merkel coalition, at least until September 2009. Co-responsibility for crisis management on the part of electoral rivals may have moderated the interventionist zeal of the German Social Democrats, who were eager not to appear too fiscally profligate, while simultaneously encouraging the CDU/CSU to be more conciliatory towards the interests of organized labor and avoid a strident tax-cutting agenda as a supply-side alternative to demand management. This latter policy preference was thus articulated more strongly by the FDP, the new liberal partners in a center-right coalition, while state-driven demand management was more strongly articulated by the resurgent Left (*Linke*) party. Pre-election opinion polls and the actual election results confirmed the weakening effect of the campaign agendas described above for the CDU and in particular the SPD. By contrast, the more clearly polar positions of supply-side tax cutting and redistributive, interventionist statism respectively produced favorable results for the FDP and the Left Party. Accordingly, recriminations within the SPD have already generated strong moves to remove its centrist leadership and replace it with a more clearly defined social democratic leadership with strong redistributive credentials.

Structural distortions

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

The stimulus policies have as yet shown little sign of generating structural changes within Germany's political economy. The policy preferences of the new federal coalition indicate clearly that the state is seen as an agency to restore equilibrium to the disrupted mechanisms of the hitherto stable system of "Rhenish" organized capitalism. There is little sign that Germany's financial sector, once restored to health, will differ significantly from the status quo ante; indeed, the global financial crisis may reinforce conservative views within the banking sector as to the virtues of prudential, risk-averse, long-term banking behavior.

Above all, the structural weaknesses that characterized Germany's political economy before this global slump persist. The core weakness remains the continuing asymmetry of demand factors and the reduction in the net contribution of private consumption and state consumption to overall GDP growth. There is a grave danger that the legacy costs of bailing out Germany's financial sector could further weaken these demand factors, as state authorities seek to reduce chronic budget deficits through severe expenditure cuts and/or increases in direct and indirect taxes. This would in turn neutralize the limited multiplier effects of Germany’s fiscal stimulus packages, undermining the restoration of the strong growth trends which have historically supported the country’s skills- and R&D-intensive trading economy.

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

BTI Contact

Sabine Donner, Hauke Hartmann
Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
www.bertelsmann-transformation-index.de/en

SGI Contact

Thorsten Hellmann, Andrea Kuhn,
Daniel Schraad-Tischler
Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
33311 Gütersloh
www.sgi-network.de