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Daniel Detzer · Nina Dodig
Trevor Evans · Eckhard Hein
Hansjörg Herr · Franz Josef Prante

The German Financial System and the Financial and Economic Crisis

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Preface

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

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

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

Berlin, Germany
February 2017

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Abbreviations

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

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

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

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Chapter 1
Introduction

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

1.1 Financialisation in Germany?

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

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

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

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

Part I: Development and Structure of the German Financial System

1.2 The Historical Development of the German Financial System

The development of the German financial system has been characterised by two key features, both of which have their origin in the country's pattern of industrialisation in the second half of the nineteenth century. The first is that Germany is a prime example of a bank based financial system. As a so-called 'late developer' (Gerschenkron), Germany required large amounts of capital in order to industrialise rapidly, and this was mobilised primarily by banks. A major role was played by large joint-stock banks which were established in the early 1850s and the early 1870s. The second key feature is that, in addition to profit-oriented commercial banks, the German financial system has also included two other sectors that are not primarily motivated by making a profit, namely the publicly-owned savings banks, and the cooperative banks. By 1913 the German banking system consisted of a private sector, dominated by eight big banks, a large public savings bank sector, and a somewhat smaller cooperative sector. In the 1920s, the big private banks faced

major challenges from inflation and competition from foreign banks, and three big banks emerged as a result of mergers and failures. At the end of the Second World War, the three big private banks were broken up because of their complicity in German war crimes but, following successful lobbying, were allowed to re-establish themselves as unified institutions in the 1950s. The big banks played a major role in financing larger firms during Germany's post-war reconstruction, while the savings banks and the cooperative banks contributed significantly to the growth of Germany's very successful small and medium-sized enterprises.

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

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

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

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

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

1.4 The Institutional Structure of the German Financial System

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

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

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

1.5 Germany's Integration into International and European Financial Markets

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

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

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

1.6 Regulation of the German Financial System

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

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

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