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Europa in der Welt – Von der Finanzkrise zur Reform der Union

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Hans-Werner Sinn

Thank you very much for allowing me to participate in this debate. I think Germany is cooperative as long as the Euro is below \$1.50. Once it goes above \$1.60, we will become nasty. I am very glad that this discussion has been made possible, because cooperation between Germany and France has always been the driving force and the backbone of European integration. I think that in the last few years this cooperation between the two countries could have been better so that there is room for improvement.

However, in the recent past the French president seems also to have changed slightly his position, moving closer towards Germany. I remember, when he spoke about the contact between Germany and France and said that the two countries are like pillars of salt, that are unable to move towards another, despite all the attempts one could possibly make. I don't think this was a fair characterization. Germany and France have had an extremely fruitful cooperation in the post-war period and they are the reason why Europe is such a stable and prosperous continent and we have to continue to build on this cooperation.

Whether we can be so proud of European developments, I am not sure, however we can and should be content with it. So while I agree with your points, I also see some additional problems for Europe and Germany in the future.

This is not an easy period, at least for my country, and you pointed out one of the reasons. In 10 years time, there will be 10 million less Germans and 10 million more French that may compensate for it, but here we do have unresolved problems that are linked to our pension system that relies on young people, which we don't have. So the true problem this country is facing, will be felt in about 15 years time. Around 2025 the baby boomers will go into retirement and there are not enough people to pay for their pensions. And if we at this point will have accumulated huge debts derived from the current crisis, then we will face a serious problem.

This brings me back to the current crisis and what Europe can do about it to get out of it. It is a crisis of similar importance as the Great Depression from 1928 to 1932. President Köhler said, any comparison between the time of the Great Depression and today's crisis is misleading. Well, this is not true. We now have detailed studies by economic historians about the development during this crisis and Barry Eichengreen is particularly famous for his study on this subject. These studies show that the beginnings of the current crisis were very similar to that of the Great Depression in 1929. World trade diminished a lot more now than it did in the first year of the 1929 crisis and industrial production declined by a similar amount.

So this could have become the same sort of catastrophe that we had experienced at the time, but it did not. And why? It did not happen because governments intervened heavily.

After the first year was over, say the period from spring 2008 to spring 2009, things began to develop differently and now we are rescued. The recession is over and we can feel relieved and also hope that we will even have a recovery. So the outlook from now on is more optimistic than last winter. But this is due to gov-

ernment action. And you pointed to the interventions of the Central Banks in the United States and in Europe, as they did a pretty good job in providing the necessary liquidity. But more important was the decision on 11th of October 2008 by the G7 countries in Washington to rescue all systemically relevant banks. The week before had brought us the sharpest decline in stock market prices in more than a hundred years. A week with a similarly strong decline in stock prices did not even happen in 1929. And people had begun to plunder their bank accounts to bring their money into safety. And I know that for some banks the withdrawal of cash on that Friday was as much as usually is withdrawn in two months. So they had difficulties loading trucks with bank notes to bring them to the subsidiaries to make sure that they could hand out the money if people wished so. Well, the promise to rescue all banks calmed the situation. The G7 met the next day. President Sarkozy summoned the heads of the European states in Paris and confirmed a similar policy. Otherwise we would not be sitting here, I tell you. A breakdown of the financial system would have lead to chaos and catastrophe. There is no way to prevent that. If you don't get your income anymore, if you can't withdraw your money from your bank account, if the shops close – then conditions are similar to those in Argentina where people began to loot the shops.

However none of this has happened. In fact, as you said, the crisis is not felt here in Germany anymore. So where is the crisis taking place right now? If you come from America, everyone knows, in Britain there is a crisis. But in Germany – where is the crisis? It is just on the paper, it is nothing that is visible and this is due to the welfare state. 42% of adult Germans live on government support. This is a big problem from a long-term structural perspective but in this crisis, it is a stabilizing element because people continue consuming. If you are a Hartz IV recipient, you don't realize that there is a crisis, the money flows anyway. What could be a weakness under certain conditions is an asset under such circumstances, thereby making Germany the largest shock absorber in this crisis in the whole world.

Everywhere exports and imports declined, but in some countries exports declined more than imports, in others imports more than exports. In the United States the imports declined much, much more than exports, so they reduced their net demand for commodities from the rest of the world. In Germany instead our imports were rather stable due to the stability of the incomes here. People still bought Korean cars or so, but the export declined by 25 % and the result was, that Germany increased its net demand for the rest of the world in an order of a magnitude of 100 billion Euros annualized, more than that. And so it is as if we had made a big demand program for the whole world. Hopefully, we will be able to follow this approach. The crisis is not over yet, although the recession is over and one of the risks, which might occur, is that the beginning of consolidating budgets is started too early, that means before the crisis is over. So some people who say that one should counterfeit finance tax reduction have not understood the problem.

Let me also say a general word on this crisis. The crisis arose from the fact, that the American system of increasing the living standard of their population and fulfilling the American dream that everyone would have a house for himself was financed with borrowed money. In the last few years, the Americans had not been saving anymore. Households saved hardly anything and the deficit of the government and the money, which investors needed, came from abroad. So the Americans had a capital import in the order of \$ 800 billion last year. That meant they sold securities to the rest of the world in order to have revenue. And what did they do with the revenue? They spent it on goods. So they had an excess import on goods over their exports in the order of these 800 billion. Some countries sell goods in order to earn money; the Americans sold securities in order to earn money. This was the big American trick and I say trick, because it now turns out, that these securities are rather valueless. Their value of these types of securities has declined to 30 % of the nominal value during the crisis and it will never retain its original value, which is a big loss for all of those people and institutions in the world holding them. Mortgaged backed security type and CDOs based on mortgages have declined from \$ 1,800 billion annual to just \$ 50 billion. 95% of the market has disappeared and it will probably not return that easily. That is the big problem. The American model, which consisted of selling securities in order to buy goods in the rest of the world, has collapsed. This also has implications for Germany because we are in one sense the mirror economy to the American one. We sold our Porsches in exchange for Lehman Brother certificates. Now, given that these Lehman Brother certificates turned out to be valueless we have a problem in selling our Porsches. The American current account deficit will have to decline via income shrinkage so that the imports decline, by means of a devaluation of the dollar. That will have the consequence that the export surpluses of other countries like Germany and China, and Germany is the second largest exporter of capital in the world, that these surpluses will also collapse. So we will have to stop exporting capital and goods.

Germany is a strange country in that regard. We are having the lowest investment share in GNP among all industrialized countries in the world. This is a country without investment. In the last year we had an aggregate of savings in Germany of € 280 billion, this is the amount of money available for investment and what did we use? We used € 116 billion. The main share of our savings was channelled abroad. This made us number two in terms of capital exporters after China in the whole world. It could have been a nice model, had we bought the right securities for it but it turned out that this was not the case. And this was the reason, why the Landesbanken, the Deutsche Bank and so many other banks have lost such enormous amounts of money in this crisis.

They have lost the money yet they do not show these losses truly in their balance sheets and only a small fraction of it has become known to the public. Look to the last edition of our news magazine, the Spiegel, which has a nice graph of that. Look to the IMF report of one and a half weeks ago. According to that report, the western European banks have just recognized 40 % of the necessary write-offs due to these

toxic assets in their balance sheets and the other 60 % are still coming. Germany has written off € 75 billion and another €110 or so will have to be written off too, what is quite a bit, and these are not my numbers but those of the IMF. So here, we are talking about € 180 billion of equity losses for a banking system, which just has an equity stock of € 300 billion. So more than 50 % of the equity of the German banks will be lost in this crisis. More than 50 %! And what do the banks do? They know that, of course, even though all the numbers have not been shown in the balance sheet, and therefore they shrink. They shrink their operations, because if they don't, they have problems with the supervisory minimum equity requirements. They need so and so much equity and proportion to the landings, which they have and if the equity shrinks they have to reduce the landings. And that is a problem for private businesses so that it is a recipe for a credit crunch in Germany, which is beginning right now and will become more severe in 2010. Politicians are still turning a blind eye on that. But they will have to address that problem as the truth becomes obvious.

So, what do we have to do about it?

We have to distinguish between rules that make the financial system operate better in the future and rules or decisions that help us to get out of the immediate crisis. First, let me talk about these long-term rules.

The rules that we need are basically higher equity requirements in the bank's balance sheets and their operations. This is necessary because only equity is a buffer in case something goes wrong. *If equity is large enough, losses can be avoided by the equity and the bank survives.* Now, so many banks have died in the last year, 83 banks alone worldwide and up to this date this year a number of similar magnitude has been counted. But more importantly high equity is necessary to improve the responsibility of the decision-making in the banks. This is because if you have much to lose, you are more careful in your risk-taking operations. If you have tiny amounts of equity, you don't have very much to lose so you can take the risk. The German banking system on average has just 4 % equity in the balance sheet, 4 % – so you did a business of 100, you invested 100 and your own money was 4. It can easily happen if you invest 100, that you lose 4 or 10. A 10 % loss is possible. But you don't have to bear it. If you have only 4 % equity, someone else bears it. And this someone else is the creditor of the bank or the taxpayer, who bills out these banks. To some extent, the losses of the society at the moment are the result of the profits banks made in good times. *And the business model of banks throughout the world is to play with the aspiration and hope that if something goes wrong someone else will take care of the losses.* But we concentrate on good times, namely 99 years in which everything worked fine, so we build our business models on these 99 years and if in 100 years time, there is a catastrophe then it will be the catastrophe of someone else.

This type of business model has to be stopped and this can only be done with higher equity requirements. So I think in Pittsburgh the G20 countries have shown that

they want to go in this direction. There will be a higher equity ratio, there will be higher risk rates on certain risky investments and it will be prohibited to have offshore operations without showing them in the balance sheets like the German Sachsen Europe LB in Ireland, which was a subsidiary of Sachsen LB. You know, all these activities were completely uncontrolled, they were not showing up in the balance sheet and no equity was provided. And then we need to have an anti-cyclical policy parameter to stop this irrational exuberance of the banking sector in an upswing. In an upswing, all sorts of assets increase in value, they show profits, book profits. Because of the book profits, they borrow; the shareholders want to have money, but there is no money so they borrow it in order to pay the dividends and then the share prices return to normal and the money has gone.

This is what we experienced in the last boom and the same mechanism in reverse is drawing us deeper into the crisis than it would have otherwise been the case. In the boom, when the banks become irrational and want to pursue more risky activities, increase the equity ratio and in the recession, reduce it. This is coming, I believe, because it is in the protocol of the Pittsburgh summit. The Americans would have to change their capital market fundamentally. There we have this non-recourse loans on which everything is build. A house owner is not really liable to re-pay the money, which he borrowed and therefore house owners went much more into risk-taking because they are only liable with their house, rather than his personal income, unlike Europe. This is unheard of in Europe, but the whole Anglo-Saxon system is built on non-recourse loans. They have to revise that.

And then there is also the process of securitization. Because banks knew that there might something be wrong with their claims against house owners they did not keep it in their books but instead sold these claims to the rest of the world, to other banks and the other banks made new packages, selling them again and the buyers made new packages, sold them again and again and again up to 40 times in a row. It was an incredible system without responsibility. Everyone just wanted to make the quick money and imposed the losses on someone else. And this someone else, often enough is going to be the German taxpayer, because in the end it is he or she who will have to finance the losses of the Landesbanken.

So, to me these are the long-term measures necessary for the banking system. But what has to be done in the short term? We now have all these undercapitalized banks, which have reduced their landings. This is risky for the real economy. So what to do about it? The government has decided to set up a fund of € 100 billion in order to finance the firms instead of the banks.

This approach reminds me of the ex-GDR. In 1964, they had the NOSPEL System – das Neue Ökonomische System der Planung und Lenkung der Volkswirtschaft. This meant there was a federal fund of capital and some bureaucrats decided which sectors of the economy should receive this capital.

That is what we have right now in Germany with this € 100 billion program and to me this is the wrong way to fix the problem. Instead we have to re-establish a functional banking sector because the bankers are experts in deciding who is eli-

gible for getting funds and who will be able to repay. Bureaucrats will never be able to do that in a meaningful way.

But how to re-establish a banking system?

It is easier said than done. The banks themselves prefer to just to scale down their operations, to limit the credit, to increase their margin and to wait until the profits have accumulated in order to increase their equity stocks. But this is not without risk.

In my opinion we need to concentrate on bringing the equity capital back into the banks. There are two options:

If the market is willing to buy new shares, which is the first option, fine. If not – well, then banks have to accept government money. The German rescue plan offers another € 100 billion for this purpose. But already € 20 billion of it was needed by the Commerzbank in order to prevent its bankruptcy, while the other banks so far have hesitated to take this money. I think we have to impose this money on the banks. They have to be forced to take it otherwise we don't come up with a real solution.

The Britons did it as they forced their banks to accept public money. The Americans did it too and that turned out to be the way to overcome this situation quickly.

I know that might sound strange with respect to traditional liberal wisdom, but anybody who does not like such an approach has to come up with an alternative.

Germany will have to change after this crisis. The American business model has collapsed, the German one is called into question. I think it made no sense, that we are world commodity exporters selling our machines to the world, being proud of this export record, giving loans to the rest of the world so that the buyers could buy and finance our machines which we delivered to them whilst internally, we have the lowest investment share of all western countries. There is something wrong with this model. In the future, I think, we have to pile up the machines in Germany in order to create work places in Germany and the banks, rather than shuffling the money of the savers abroad, should instead finance investments in Germany. We need more internal growth, a more dynamic economy within the country rather than relying on the rest of the world. I hope, we will be able to solve this problem without imposing too much of a burden on the rest of our European partners.

Thank you very much.