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# Financial Crisis in Germany: A Sneak Peek

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**Abstract**
The German experience of the crisis was very different compared to those of most other countries in Europe. Germany was hit by a very strong shock which was relatively concentrated in the exporting, manufacturing industries. In addition, the German labour market was very resilient during the crisis due to earlier labour market reforms and policy instruments facilitating labour hoarding. As a consequence, public finances were only moderately affected and not many policy reforms had to be enacted.
The German experience of the financial crisis was very different from that of most other European countries. Germany was hit by a very strong shock that was relatively concentrated in the exporting, manufacturing industries. In addition, the German labour market was very resilient during the crisis due to earlier labour market reforms and policy instruments facilitating labour hoarding. As a consequence, the public finances were only moderately affected and not many policy reforms had to be enacted. This paper presents the German experience of the financial crisis
**Keywords:** Germany, crisis management, financial crisis

## Causes of the financial crisis

The collapse of Lehman Brothers in September 2008, sent a wave of fear around world financial markets. Banks virtually stopped lending to each other. Governments have responded with an easing of monetary and fiscal policy that in turn have their own effects on activity and financial and trade flows. The downturn in activity is causing unemployment to rise sharply and, with it, a political response to protect domestic industries through various combinations of domestic subsidies and border protection.

**The financial crisis happened because banks were able to create too much money, too quickly, and used it to push up house prices and speculate on financial markets.**

1. Banks created too much money
   Every time a bank makes a loan, new money is created. In the run up to the financial crisis, banks created huge sums of new money by making loans. In just 7 years, they doubled the amount of money and debt in the economy.
2. This money was used to push up house prices and speculate on financial markets. Very little of the trillion pounds that banks created between 2000-2007 went to businesses outside of the financial sector.
3. Eventually the debts became unpayable
   Lending large sums of money into the property market pushes up the price of houses along with the level of personal debt. Interest has to be paid on all the loans that banks make, and with the debt rising quicker than incomes, eventually some people become unable to keep up with repayments. At this point, they stop repaying their loans, and banks find themselves in danger of going bankrupt.
4. This caused a financial crisis
   This process caused the financial crisis. Straight after the crisis, banks limited their new lending to businesses and households. The slowdown in lending caused prices in these markets to drop, and this means those that have borrowed too much to speculate on rising prices had to sell their assets in order to repay their loans. House prices dropped and the bubble burst. As a result, banks panicked and cut lending even further. A downward spiral thus begins and the economy tips into recession.

5. After the crisis, banks refuse to lend, and the economy shrinks
   Banks lend when they're confident that they will be repaid. So when the economy is doing badly, banks prefer to limit their lending. However, although they reduce the amount of new loans they make, the public still have to keep up repayments on the debts they already have. The problem is that when money is used to repay loans, that money is 'destroyed' and disappears from the economy.

**A Brief Outline of the Crisis**
The origins of the current world financial crisis are now well known. They lie in the worldwide financial excesses of the past few years and even decades; the bursting of the housing and oil price bubbles; excessively low interest rate policies; massive trade surpluses in some countries and trade deficits in others; and savings rates that are too low in some parts of the global economy and too high elsewhere. The cumulative effect is a financial and liquidity crisis that threatens to become a global macroeconomic upheaval, with significantly negative world GDP growth, perhaps for two or three years, sharply increased unemployment, pressures on public revenues and deflation.

**Subprime crisis**
A situation starting in 2008 affecting the mortgage industry due to borrowers being approved for loans they could not afford. As a result, a significant rise in foreclosures led to the collapse of many lending institutions and hedge funds. The financial crisis in the mortgage industry also affected the global credit market resulting in higher interest rates and reduced availability of credit.
The subprime lending is 9% in 1996 but in 2004 it is 21%. Due to securitization, investor appetite for mortgage-backed securities (MBS), and the tendency of rating agencies to assign investment-grade ratings to MBS, loans with a high risk of default could be originated, packaged and the risk readily transferred to others. In addition to considering higher-risk borrowers, lenders have offered increasingly high risk loan options and incentives to them.
Homeowners had been using the increased property value experienced in the housing bubble to refinance their homes with lower interest rates and take out second mortgages against the added value to use the funds for consumer spending. Between 1997 and 2006, American home prices increased by 124%.Easy credit combined with the assumption that housing prices would continue to appreciate also encouraged many subprime borrowers to obtain ARM they could not afford after the initial incentive period. With housing prices now depreciating moderately in many parts of the U.S., refinancing has become difficult, leaving homeowners with higher payments than anticipated.
Loan modification, pumping money into market may slow down the crisis.

- Establish rescue funds for borrowers facing short-term problems caused by illness, layoffs or other one-time events.
- Establish a bond fund to pay for switching borrowers out of unaffordable ARMs.
- Refinance loans for victims of predatory lending. This would involve working with Fannie Mae, the quasi-governmental corporation.

Changing loan terms is a mess, borrower and lender must accept to the terms, lenders may be unwilling to change terms but Fed interference will work out. But lender will accept to change in terms to avoid foreclosures.
Pumping money into markets, reducing bank reserves may temporarily weaken the crisis, but this is twofold operation, pumping money will increase inflation which will results in increase in subprime lending, and reducing bank reserves to small extent is better but as whole destabilize the whole financial system.

**Liquidity crisis**
In financial economics, a liquidity crisis refers to an acute shortage (or "drying up") of liquidity. Liquidity is a catch-all term that may refer to several different yet closely related concepts.[1] Among other definitions, it may refer by market liquidity (the ease with which an

asset can be converted into a liquid medium, e.g. cash), funding liquidity (the ease with which borrowers can obtain external funding), or accounting liquidity (the health of an institution's balance sheet measured in terms of its cash-like assets). Additionally, some economists define a market to be liquid if it can absorb "liquidity trades" (sale of securities by investors to meet sudden needs for cash) without large changes in price. This shortage of liquidity could reflect a fall in asset prices below their long run fundamental price, deterioration in external financing conditions, reduction in the number of market participants, or simply difficulty in trading assets.

**Global Financial Crisis**

The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

On the one hand many people are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns.

**Channels**

The current economic and financial crisis was driven by the reversal of the three positive shocks that developing countries suffered during the boom period: exceptional financing, high commodity prices, large flow of remittances." (Griffith-Jones and Ocampo, 2009) The main channels for the transmission of the crisis were capital flows and the trade channel.

**Capital flow**

The decrease of capital flows was one major channel that brought the crisis from its initiators (developed countries) to the emerging markets. Varied types of flows can be differentiated: private capital flows, foreign direct investment, portfolio flows, international banks, and nonbank lending.

**Trade channel**

The financial crisis was extremely perceptible in each part of the world through fallen trade values and volumes. It primarily affected the trade volumes of the exporters of manufacturing and services, which consequently affected, mostly through this channel, the whole economies of various countries. Falling prices were also important, especially for exporters of goods.

The trade decline began in the third quarter of 2008 and lasted until the second quarter of 2009. It was the deepest drop since the Great Depression of the 1930s. World trade declined steadily, with a precipitous decline of 20% through the early months of 2009. Even China, the most dynamic economy of the years 2007–2010, was hit with negative export-growth, which should be considered in the context of the extreme growth of the previous decade. There is also the influence of trade protection measures, which deepen a trade crisis. Nevertheless, the policy took many measures to stimulate the economy, and with its recovery the volume of trade increased rapidly again.

**Remittances**

Remittances are financial cross-border transfers from nationals to their home countries. Simplified, it is money sent from migrants to their relatives. The International Monetary Fund (IMF, 2008) defines remittances as: "a percentage of household income from foreign economies arising mainly from the temporary or permanent movement of people to those economies." These volumes have risen rapidly in recent years. Remittances are often an important source of capital in developing countries. These transmissions also include non- cash transmissions. In recent years the quantity has grown absolutely and also in relation to other sources of external financing.

**Global impacts of the financial crisis**

Three main shocks capture the onset of the global financial crisis:

The bursting of the housing bubble causing a reallocation of capital and a loss of household wealth and drop in consumption.

A sharp rise in the equity risk premium (the risk premium of equities over bonds) causing the cost of capital to rise, private investment to fall and demand for durable goods to collapse.

1. A reappraisal of risk by households causing them to discount their future labor income and increase savings and decrease consumption.

The current financial crisis started in developed countries, but reduced foreign investment and reduced demand for imports of commodities and labor-intensive products are having profound effects on developing countries.

- Growing protectionism and massive budget deficits in developed countries that threaten to pre-empt much of the world's savings will exacerbate problems for developing countries.
- The many developing countries that lack large foreign-exchange reserves and have balance-of-payments difficulties will be able to implement expansionary fiscal policies only with augmented assistance from the World Bank and the International Monetary Fund and a relaxation of the conditions under which these institutions lend money.
- Continuing lack of demand in developed countries implies that developing countries need to enhance trade and finance linkages among themselves in order to foster economic growth.
- The developed world needs to acknowledge the severity of the effects of the current financial crisis on developing countries, to resist new protectionist measures that would further harm their growth and development, and to maintain and even increase current aid and investment flows.

**The German Financial System and the Financial Crisis**

At the outbreak of the financial crisis in 2007, hardly any- one would have guessed that it would become one of the most serious financial crises since the Great Depression. At the same time, it came as a surprise that after the peak of the crisis in 2009, Germany, which had experienced one of the sharpest declines in GDP during the crisis, was able to recover so quickly. This is particularly surprising in light of the fact that the German banking system was highly exposed to US assets and, correspondingly, was severely affected. Many economists worried that the damage to the financial system could lead to a credit crunch that would aggravate and prolong the crisis.

**Main features of the German financial system**

The German financial system has long been a prime example of a bank-based financial system. Despite some changes, it is still dominated by banks today, while its financial markets are relatively undeveloped. Compared to the US, German firms are financed to a larger extent by bank loans, and households hold a larger share of their financial wealth in the form of bank deposits. Consequently, firms use markets less often to obtain financing, which can be seen by the relatively low number of listed companies and the low stock and bond market capitalization and activity in Germany

**Germany in the economic crisis**

Owing to its strong dependence on exports, Germany was among the economies hit hardest by the financial crisis. But unlike almost all other countries, Germany emerged from the crisis quickly and stronger than before. The commonplace—neoliberal—answer is that Germany's success is the hard-won reward for strict economic management, combining fiscal conservatism and structural reforms of welfare and the labour market. The latter, by reducing labour costs, fostered competitiveness, boosted growth, and increased employment. "Progressive" economists arguing that Germany beggared its Eurozone neighbors by squeezing workers' wages, share a similar view. However, this particular explanation of Germany's resilience is wrong and unhelpful.

Germany's export success cannot be explained in terms of its (labour) cost competitiveness, but is caused by strong non-price competitiveness. This, in turn, is due much more than is normally recognized—by the remaining distinctly non-neoliberal dimensions of Germany's economic model (including a Keynesian crisis response). German and European policymakers preaching austerity and structural labor-market changes as the model for other Eurozone countries, misunderstand Germany's rebound from crisis, with serious costs to Eurozone populations.

**Germany: Balance of Trade**

Germany posted a 25.6 EUR billion in April of 2016, up from 21.8 EUR billion reported a year earlier exports rose 3.8 percent year-on-year to 104.3 EUR billion while imports were nearly unchanged at 78.7 EUR billion. On a seasonally adjusted basis, exports were unchanged while imports fell 0.2 percent. That brought the trade surplus to 24.0 EUR billion. Balance of Trade in Germany averaged 4629.51 EUR Million from 1950 until 2016, reaching an all time high of 26152.74 EUR Million in March of 2016 and a record low of -535.91 EUR Million in April of 1991.

**Impact of the financial crisis**

**National income**

With the exceptions of 1993 and 1996, the 1990s were characterized by stable real GDP growth rates of around 2 per cent per year. Real GDP growth flattened in the early 2000s with close to zero and negative real GDP growth in 2002 and 2003, but became stronger from 2004 onwards with real GDP reaching its pre-crisis peak in 2008. Germany was hit by a severe output shock in 2009 when real GDP fell by more than 5%. This was to a large extent driven by a significant reduction in exports (14%) contributing roughly 6 percentage points to the GDP drop. However, output recovered quickly in the following years and exceeded its pre-crisis peak already in 2011.

**Labour markets**

Share of the unemployed population in Germany increased sharply after reunification with the number of unemployed rising from 2.1 million in 1991 to 3.8 million in 1997. From 1997 to 2000, the unemployment rate decreased in three consecutive years, but continued rising in the early 2000s and reached its peak in 2005 when 4.5 million people were seeking work. Around that time, Germany was often called the 'sick man in Europe'. The surge in unemployment put the center-left coalition of Chancellor Gerhard Schröder under enormous pressure. The government enacted labor market reforms known as the 'Hartz-reforms' from 2003-2005 with the aim to make the German labor market more dynamic and to reduce long-term unemployment. Since then, the unemployment rate has been declining and to the surprise of many observers, it did not soar up in 2009 when real GDP declined by 5.6%. Unemployment increased only very moderately in 2009, but continued falling in recent years. There are different views on which factors contributed to the impressive labor market development since 2005. Some observers argue that the Hartz reforms played an important role in making the labor market more flexible and in strengthening job search incentives while others point to the German system of industrial relations which helped the German industry to improve its competitiveness.

**Conclusions**

The German experience of the crisis was very different compared to most other countries in Europe. Germany was hit by a very strong shock which was luckily relatively concentrated in the exporting, manufacturing industries. In addition, the German labour market was very resilient during the crisis due to earlier labour market reforms and policy instruments facilitating labour hoarding. As a consequence, public finances were only moderately affected. Moreover, Germany had a balanced public sector budget when the crisis broke out, so that enough fiscal space was available to let automatic stabilisers work. Therefore fundamental tax end expenditure reforms, which were driven by fiscal consolidation pressures in other countries, did not take place in Germany.

Germany was heavily affected by the financial crisis due to its "export-led mercantilist" growth model and its high degree of international financial integration. The collapse in international trade hit the German real economy directly and led to a sharp decline in GDP. However, when demand from a range of emerging market economies for German goods increased, the German real economy was able to recover quickly. The German financial sector suffered due to heavy losses on its foreign assets, and heavy government intervention was needed to stabilise the financial system. While it managed to prevent a widespread banking crisis, there were fears that the damaged banking system would undermine a timely recovery by restricting access to credit. In fact, credit growth to the German real economy and to German households slowed and then grew negative in 2009. While the reduction does not seem large enough to speak of an overall credit crunch, as well as small and big banks co-exist, a feature that was prevalent in the banking systems of most European countries until 25 years ago – proved very effective during the financial crisis. This diversity, including the small, regionally oriented, not strictly profit-maximising banks that make up a large segment of it, is an asset to the German economy and it should not be discarded, despite claims to the contrary from international organisations or market liberals, which praise the superiority of privately owned banks. This seems of particular importance when one recognises that these sectors have developed historically and that they cannot easily be re-established by government decision once they have been privatised or dissolved. Therefore, despite the problems with the Landesbanken, which may need reforms, policy makers must ensure that no changes are made that would undermine the highly successful German three-pillar model in the long term.

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