

The Ifo Viewpoints 2008

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What Can be Learned from the Banking Crisis*

Now that the countries of the west have agreed to a three-trillion dollar bailout programme to rescue their banking systems, it is time to look forward and to draw lessons from the crisis. To do this we must understand the causes of the crisis. The claims that the model of American capitalism has self-destructed are just as misguided as putting the blame on the greed of investment bankers and other groups in society. They only touch the surface of the problem.

The core of the crisis lies in the legal provisions of limited liability: creditors of corporations have no claims against the personal assets of the owners (shareholders) of these corporations. These liability constraints lead to a systematic disregard of disaster risks – occurrences with only a slight probability bring about gigantic losses. Investors that opt for high-risk projects with high potential gains and losses instead of safe projects with similar average profits can expect to gain, since they only have to bear a portion of the possible losses. If things go well, investors reap the full profit. If things go badly, at worst their losses would be limited to the stock of equity invested, because claims against private assets have been ruled out. This asymmetric situation encourages bold behaviour and risk-taking.

The conclusion that the limited-liability constraint should be eliminated would be too rash, however, because risk-taking also has its merits. Limited liability was introduced in the nineteenth century in the United States and Europe in order to avoid uncontrollable burdens being placed on equity holders and to enable entrepreneurs to make enterprising economic decisions that they otherwise would not have had the courage to make. It brought about the productive forces that have created the wealth of today's generations.

In times of great economic insecurity, however, limiting liability can become a problem because it induces entrepreneurs to become gamblers. As always it is a matter of weighing up the advantages and disadvantages and finding the proper middle ground. The problem of gambling is particularly serious when corporations are allowed to determine the extent of their liability themselves by choosing the ratio of equity to business volume as they see fit. Then they tend to operate with too little equity and

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distribute to their shareholders too large a fraction of their profits as dividends. The five large US investment banks, of which three have already fallen victim to the crisis, unscrupulously pursued this strategy, their motto being that you can't lose what you don't have. The risks created incentives to minimize the stock of equity kept inside the firms, and the small amount of equity capital in turn created incentives to pursue overly risky operations. The interplay of these incentives is the actual cause of the crisis – and this is where reform must begin.

The privilege of limited liability is not a creation of the market; it was granted by the legislator, and because this is the case, the legislator himself must define his real intention. He cannot allow the beneficiaries themselves to make this definition. If they can, they will define the limitation in such a way that they assume almost no liability, as we have seen. US investment banks, which were not subject to American bank supervision, practised their business with equity-asset ratios in the region of four percent, which is much lower than the rate at which private commercial banks operate. In addition, they carried out very complex credit operations outside of their balance sheets, placing them thus away from investor control.

Some may point out in defence that gambling is prevented by the rating agencies. They argue that rating agencies give poor ratings when risks are excessive, forcing the banks to pay higher interest for the money they themselves have borrowed. In this way, so the argument, the market corrects itself and creates the proper amount of caution. The miserable failure of the rating agencies during the present crisis shows, however, how illusory this reasoning is. The agencies did not give sufficient warning, and their AAA ratings were only withdrawn when there was no other alternative. Since they live on the fees they collect from the financial institutions they rated and were dependent on their good-will, they could not afford to tell the truth. The nearly bankrupt major customers of the rating agencies in America were glamorised while comparably robust but smaller customers in Europe were downgraded. This is also how the credit packages with claims against American homeowners, which were already in risky territory, were offered to the world far above value.

The best proof that the rating agencies and other information channels do not function and are not able to reliably inform purchasers of bank bonds and credit packages about the true circumstances lies in the fact that on the capital market equity capital is always more expensive than debt capital. If the purchasers of bank bonds had been correctly informed about the true repayment probability, they would have demanded adequate risk premiums on interest or sufficient reductions in the prices of these bonds, which would have made these liabilities just as expensive for the banks as equity. Finance theory designates this finding as the Modigliani-Miller theorem, after its

authors. But this theorem fails to match reality. Everyone uses the leverage effects of debt capital up to the limit that the rating agencies establish in order to achieve higher yields from equity capital. Whoever does not do this and instead raises his equity-asset ratio to increase repayment probability is not rewarded for his virtue by the capital market.

Bank bonds and securitised risks are entwined in a cascade of interlinked legal claims at whose end there is somewhere a real investment project. These are products that even specialists cannot properly appraise. The purchasers are almost never able to assess the true repayment probabilities correctly. Only the sellers that assemble the securitised packages have some idea of what they are selling. In the language of economists, these bank products are *lemon goods*, that is goods whose quality can only be partially assessed by the customers at the time of purchase and for this reason are usually offered at inferior quality. The sellers exploit the customers' lack of information by reducing their costs at the expense of quality, knowing that the customers are not able to punish them by refusing to purchase or by demanding price discounts. Quality declines below the quality that would prevail in a market of informed customers. In order to prevent lemon markets, most countries have, for example, food regulators who set the lower limits for quality in food in the form of upper limits for unhealthy ingredients. In the case of pharmaceuticals, quality is safeguarded by the licensing procedures. The loans given to homeowners in the United States – and that ended up as mortgaged-backed securities and collateralized debt obligations – are lemon products. In America higher rates of indebtedness are more common than in Germany. But the banks do not have the same claims to the private assets or income of homeowners than in Germany. If a low-income US homeowner chooses, he can hand over his house keys to the bank and has no repayment obligation. Conscious of this limited liability, US homeowners were much too cavalier in taking on real-estate which they could only afford if housing prices continued to rise. The real-estate bubble that began to burst one and a half years ago and that gave rise to the banking crisis arose this way.

Since the Reagan presidency a quarter century ago, Americans have increasingly become indebted to foreign creditors and have made a good life for themselves. They financed their investments from the capital streaming in from foreign countries and instead of saving relied on the increasing value of their real-estate. The deficit on the current account balance, that is the surplus of imported products and services over exports, reached a peak of 5.5 percent of GDP. This was financed with increasingly more sophisticated investment products that were certified with the stamp of the rating agencies – in the end even the last investment manager of the German state banks noticed what junk was being sold here. The wheeling and dealing has now come to an

end. No European bank escaped the painful experience that the expensive value-at-risk models of the investment bankers were just as worthless as the agency ratings.

Politicians must finally face the task of defining legal liability limitations for corporations by establishing strict minimum standards for equity capital requirement for the various business models of the banks, both in America and in Europe. Stricter rules are not a disadvantage for the economy, since the apparently so much more expensive equity capital, whose use is thus made compulsive, is not economically more expensive than debt capital, as shown by the burdens that the taxpayers must now bear. Furthermore, no scarcity of funds would arise as a result, since the savings of the world just suffices – independently of such rules – to finance the investments.

The necessary steps are as follows:

1. The US must finally participate in international agreements on the harmonisation of banking supervision. These agreements can be based on the Basel-II system, which must be under government control.
2. Europe needs a common system of financial supervision. Every state must pay for the losses of its own banks.
3. Investment banks, hedge funds and private equity firms must be subjected to the same rules as commercial banks.
4. Personal liability limitations for mortgages and other real-estate loans must be lifted in the United States and wherever else they exist.
5. Conduits and other constructs for the shifting of investment banking business from the bank balance sheets should be limited in such a way that the risks that the banks take on are transparent in the bank balance sheets.

Free market advocates that argue against these remedies, without which a market economy cannot survive, confuse the market economy with anarchy. The market economy can only function when it is subjected to traffic regulations. Civil codes in many countries are full of rules that limit private contracts. Only a portion of the contracts that an uncontrolled market economy would develop is allowed, and because of this the system functions. Europe and the world need stricter rules for financial traffic. Such rules do not constitute a systemic break. They are vital for the functioning of the financial capital markets.

Plugging the Leaks: What Caused the Banking Crisis*

With pain and misgiving, the United States Congress bailed out Wall Street in order to prevent a meltdown of America's financial system. But the \$700 billion to be used may flow into a leaky bucket, and so may the billions provided by governments throughout the world.

The US financial institutions that went bankrupt in 2008 – or that would have gone bankrupt without government help – were in trouble because they lacked equity capital. They did not lack that capital because they never had it, but because they paid out too much of their abundant earnings in previous years to shareholders, leveraging their operations excessively with debt capital. If no measures are taken to increase the minimum equity requirements for banks and other financial institutions, financial crises like the current one could recur.

Anglo-Saxon financial institutions are known for their high dividend-payout ratios. From a European perspective, the hunger for dividends and the emphasis on short-term performance goals that characterize these institutions is both amazing and frightening. Investment banks, in particular, are known for their minimalist equity approach. While normal banks need an equity-asset ratio of at least 7 percent, investment banks typically operated on a ratio of only 4 percent.

The lack of equity resulted largely from the concept of “limited liability,” which provided an incentive for excessive leveraging. Earnings left inside a financial institution can easily be lost in turbulent times. Only earnings taken out in time can be secured.

Lack of equity capital, in turn, made risk-averse shareholders hire gamblers to manage their limited-liability investment companies. The managers chose overly risky operations, because they knew that the shareholders would not participate symmetrically in the risks.

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While upside risks would be turned into dividends, downside risks would be limited to the stock of equity invested. Claims against the personal wealth of shareholders would be blocked by the limited liability constraint. The banks' creditors or governments ultimately would bear any losses. The mutual interaction between the incentive to minimize equity capital and the incentive to gamble in order to exploit the upside risks caused America's crisis.

In theory, bank lenders and the government could anticipate the additional risks they encounter when a company chooses a high-leverage strategy. Lenders may charge higher interest rates, and the government may charge higher taxes or fees.

But this theory fails to match reality. Governments do not tax the return on equity less than debt interest, and lenders do not sufficiently honor the benefits of high equity with lower interest rates, owing to a lack of information about the true repayment probability. This is why equity capital held by financial institutions typically is more than twice as expensive as debt capital and why these institutions try to minimize its use.

The provision of limited liability not only turned Wall Street into a casino, but so-called "Main Street" also was induced to gamble, because homeowners enjoyed a limited liability similar to that of the companies. When low-income borrowers took out a loan to buy their homes – often 100 percent of the purchase price – they typically could use the home as collateral without warranting the repayment with additional wealth or even their income. Thus, they were protected against the downside risk of falling house prices and profited by speculating on the upside risk of appreciation.

Such homeowners knew that with rising prices they would be able to realize a gain by either selling their homes or increasing their debt, while in the case of falling prices they could simply hand over the keys to their banks. Given the uncertainty about future house prices, they could reasonably expect gains, which induced them to pay even more in the first place. Gambling by Main Street caused the sub-prime crisis.

The crisis spread because the banking system was not sufficiently risk-averse – and in some cases even seemed to relish risk. Mortgage banks kept some claims on their books, but sold most of them to investment banks as "mortgage-backed securities". The investment banks blended these securities into "asset backed securities" and "collateralized debt obligations" and sold them on to financial institutions throughout the world. These institutions, attracted by the high rates of return that were promised, invariably neglected the downside risks.

The buyers of the CDOs were often misguided by rating agencies that performed badly and did not provide reliable information. As private rating agencies live on the

fees they collect from rated companies, they cannot easily downgrade important clients or the assets they sell. The big American investment banks received excellent ratings up to the last moment, and so did the CDOs with which they betrayed the world.

All of this explains why the US had such a formidable period of growth in recent years, despite the fact that household savings were close to zero, and why foreigners were willing to finance a record US current-account deficit of more than 5 percent of GDP – higher than it has been since 1929. That period is now over.

The US must carry out fundamental reforms of its financial system to plug the equity leaks and recover investors' confidence. But even then it will have a hard time continuing to sell financial assets to the rest of the world. American households will need to learn to accumulate wealth by cutting consumption rather than speculating on real estate. A painful decade of stagnation for America lies ahead.

Nuclear Power: Wrong-way Driver Germany*

Driving along the motorway, Michel is listening to the radio. A speaker interrupts to say: “Attention, a wrong-way driver is coming your way.” Annoyed, Michel proclaims: “Just one? There are lots of them!” Michel is Germany, and the motorway is nuclear power.

Except for Germany no single country is keeping to its nuclear power phase-out plans. In Sweden, which had propagated a nuclear phase-out already in 1980 and in fact closed two nuclear power plants in 1999 and 2005, further closings have been moved into the distant future. The ten still existing plants have been modernized so extensively that a systematic phase-out is virtually impossible. 80 percent of the Swedish population accepts nuclear power. In Belgium it was decided in 2005 to annul the phase-out decision of 1999. The Netherlands also reversed a 1994 phase-out decision in 2005 and four new nuclear power plants are scheduled to be built by 2015. Italy closed down its reactors in 1990 but now wants to build four new ones. Finland, which many often regard as a nuclear-power opponent, is currently building the largest nuclear power plant of all times with a total capacity of 1600 megawatts near Olkiluoto. The UK intends to take four nuclear power plants from the grid but at the same time to build six new ones. China is planning 24, the US 12 and Japan 11 new reactors. Even India wants to build 10 new nuclear power stations. The Czech Republic wants to construct a second reactor right across the German border at Temelin, and Switzerland is also planning a new nuclear reactor on Germany’s southern boundary. Fortunately, we still have the Austrians, our “wrong-way” neighbours in the south. Austria does not want nuclear power. But Austria cannot phase it out because it already did so twenty years ago.

Going the wrong way has never bothered Germany’s idealists. With no common sense and always deeply convinced that the world should follow Germany’s lead, we often run full steam ahead until we fetch a bloody nose for ourselves. The country suffered from the excesses of patriotism and socialism, and now it is suffering from the excesses of Green idealism. We always want to offer the world another opinion, and we are always in the right and all the others are wrong.

28 percent of the world’s wind energy is produced in Germany, 48 percent of photovoltaic energy and 45 percent of biodiesel. In all of these categories Germany is far in the lead over all the other countries of this earth. We are once again showing them the way.

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Green stubbornness is now costing us an enormous amount of money. Photovoltaics has already cost us 26 billion euros in public subsidies and would have cost us 120 billion up to 2015 if the Bundestag hadn't decided to reduce the subsidy rate by ten cents. However, this electricity is still ten times more expensive than normal electricity and many more billions of euros in costs will still be spent. Currently, photovoltaics covers about half a percent of Germany's electricity supply whereas a good quarter of its electricity comes from nuclear reactors. In France the atomic industry supplies about 80 percent of the country's electricity.

Most people have realised in the meantime that bioenergy is a flop. The Greens will never manage to convince the needy of this world that food belongs in the tank instead of on the plate. The political battle has been lost even before it began.

What remains are the wind propellers. Wind energy is getting closer to becoming competitive, but although it only supplies slightly more than a twentieth of Germany's electricity, our landscapes have been sufficiently ruined and the off-shore locations have already been sold to the oil companies. Where are the new ones to be built? Not in my garden, thank you very much, and also not next to the idyllic farmhouses of my boyhood home!

And what about liquefying, under high pressure, the carbon dioxide that arises from burning coal and pumping it into the earth? Fabulous idea! Liquid carbon dioxide needs about 5.4 as much space as the anthracite coal that is burned or 1.35 times as much room as lignite coal, and for the production of liquid carbon dioxide we need about a third more energy. And where should it be sequestered? The empty gas storehouses are already used as temporary storage for natural gas. In order to sequester the fluid carbon dioxide arising annually from a lignite coal power plant with the same net capacity as the one at Biblis, Germany's best known reactor, we would need a storage space of approximately 37 million cubic meters or approximately 11,000 freight trains a year. In order to carry away the spent fuel rods of the Biblis nuclear power plant, one single castor transport with four containers is necessary. And who would want to live above a carbon dioxide storage? Carbon dioxide is heavier than air. Whoever lives above it when it is released might just as well lie down to sleep in a wine cellar.

Illusions and a lack of pragmatism wherever one looks. That is the Green idealist republic of Germany. How about letting the citizens themselves decide on how they want to save the world's climate. Let the power stations sell the different types of CO₂-free electricity at prices that are justified by the costs. My bet is that atomic electricity would easily win the race.

Barbarians or Geniuses at the Gate?*

Europe is currently experiencing a huge wave of migration between its east and west. This movement resembles the Great Migrations (Völkerwanderung) that marked Europe between the fourth to sixth centuries.

Within the first year of Romania's accession to the EU on January 1, 2007, for example, roughly a million Romanians migrated to Italy and Spain. More than 800,000 eastern Europeans have become workers in the United Kingdom over the past four years, most coming from Poland. Indeed, in the last two years alone, 1.5 million Poles emigrated, and overall probably more than two million have done so since Poland's EU accession in 2004. On a smaller scale, the migration of Ukrainians to the Czech Republic, Bulgarians to Turkey, and British citizens to Spain is also noteworthy.

Because Germany still restricts the immigration of dependent workers from eastern EU countries, most of immigrants from these countries come as self-employed or economically inactive people. In Munich, the number of self-employed tilers increased in 2004 and 2005, the first two years after the first eastern enlargement wave, from 119 to 970. But despite restrictions, by 2005 Germany had absorbed 37 percent of all migrants from eastern Europe that had come before and after eastern EU enlargement, whereas Italy had absorbed 22 percent, Greece 11 percent, Switzerland 8 percent and the UK only 3 percent. In the same year, 13 percent of the population living in Germany was foreign born, more than in Britain (10 percent), France (7 percent), Spain (5 percent), or Italy (3 percent).

The immigration waves of the last two years to Britain, Spain and Italy will have significantly changed these figures, but the information needed to update the statistics is not yet available. Nowadays, people move faster than statistical offices can count them.

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Before the EU's eastern enlargement, many studies predicted the likely migration waves. The forecasts of the proportion of eastern Europeans who were expected to move west within a 15 years ranged from 2.5 percent to 6 percent. Given that about 5 percent of the Polish population has now emigrated within a period of only four years, despite immigration restrictions by important target countries, these estimates were much too cautious.

Before enlargement, it was politically incorrect to discuss possible waves of migration to the west, as EU politicians saw this as an obstacle to the enlargement process. Now that enlargement has taken place, it is easier to discuss migration objectively.

This immigration is not an *invasione barbaricha*, as Italians refer to the Völkerwanderung, although the orders of magnitude are comparable. As migrants move between markets with well-defined property rights, immigration in principle is beneficial for both the immigrants and the target country. The immigrant receives a higher wage than at home, and the target country benefits from cheap labour, which creates more value than it costs.

But in practice, immigration is often not as beneficial as it could be, because the target country has a rigid wage structure that prevents the additional jobs needed to employ the immigrants from being created. If, for example, a target country provides minimum wage guarantees and replacement incomes for the domestic unemployed, immigrants simply force domestic residents into the care of the welfare state. This is not a problem of immigration as such but of poorly designed domestic social and labour market institutions.

To be on the safe side, host countries often try to limit immigration to skilled workers, because they join segments of the labour market in which sufficient downward wage flexibility provides immigrants with additional jobs. But countries have so far had mixed success in attracting skilled immigrants. The most successful countries in this regard have been the Anglo-Saxon countries (Canada, Ireland, Australia, the United States and the UK, in that order), as well as Denmark and Norway.

More than one-third of immigrants to these countries have tertiary education, with Canada and Ireland at 45 percent. In the more unsuccessful countries – Italy, Austria, Germany, France, Portugal and the Netherlands – the proportion of immigrants with a tertiary education is below a quarter. In Italy, the share is just 11 percent – the lowest in the available statistics.

The brain drain to the Anglo-Saxon countries, the US in particular, is astounding. The graduating classes of top American universities are packed with foreign students, and 27 percent of physicians practicing in the US today come from abroad. America's postwar growth and dynamism largely resulted from skilled immigrants. Before and after World War II, many skilled people came from Europe, Germany in particular; in recent decades, Asian immigrants dominate, with India, Pakistan, and the Philippines occupying the top ranks.

Today's brain drain is not only from emerging and developing countries to richer countries but also from European countries to the US. In most research disciplines, European-born "superstars" work and teach in the US rather than in Europe, and, according to a study by Gilles Saint-Paul, it is the superstars in particular who generate growth and prosperity for a country.

Of course, people with a decent tertiary education are also important for a country's economy, and here the losses of some European countries are substantial. While only 3 percent of Spanish and 4 percent of French people with tertiary education live abroad, 7 percent of Italians and 9 percent of Germans do. Surprisingly, Ireland and the UK lead in this category, with 34 percent and 17 percent, respectively. This may reflect the high interchange in both directions between the Anglo-Saxon countries, or replacement migration in which skilled people arrive from elsewhere as the domestic skilled migrate to other Anglo-Saxon countries.

The European landscape will change as rapidly in the course of this century as it did at the time of the *Völkerwanderung*. History will have many tales to tell about what this really meant for the Continent. At the moment, though, the casual observer is still rather clueless.

Market Order under Attack: The New Minimum Wages*

Before the construction company Philipp Holzmann AG went under, its employees offered management a wage cut to save their jobs. But they were not allowed to work more cheaply because the employers' associations (HDB and ZDB) to which Holzmann belonged opposed the offer as did the IG Bau trade union. Why were the social partners opposed to the wage cuts? Because they included competitors of Philipp Holzmann who with their opposition were able to ward off low-wage competition. Philipp Holzmann was forced into bankruptcy.

German Reunification was similar. After western German employers and trade unions had set up new wage bargaining associations in eastern Germany, they worked out new collective wage agreements in spring 1991 which were aimed at raising wages in the east to western German levels within five years. Why this? Because the western German competitors of the companies privatized by the Treuhand didn't want low wage competition at their doorstep. They wanted the Japanese, who were interested in the Treuhand workers, to either stay home or at least to pay western German wages if they came. The Japanese chose not to come, investments were scanty and eastern Germans are still waiting for self-sustaining economic growth.

And now the latest absurdity: When Deutsche Post CEO Klaus Zumwinkel realized that he couldn't prevent the postal-carrier monopoly from ending on 1 January 2008, he demanded minimum wages. Why? He wanted to protect himself from competitors who were already waiting in the wings. And he succeeded. In the meantime, 40 of the 90 PIN Group companies, including the holding company, have declared bankruptcy, and almost 8000 employees have been dismissed.

This is German corporatism at its worst. If the competition can't be kept out, it can at least be forced to pay the same wages that the others have to pay. Low-wage competition pays dumping wages, it is argued, a market economy needs quality competition and not wage competition, and appeals are made to the social conscience of the public to protect one's own interests. Philipp Holzmann's competitors proclaimed the noble goal of achieving more fairness in competition. In the case of the Treuhand companies, it was argued that help must be given to "our brothers and sisters" who were

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suffering hardship through no fault of their own. And Klaus Zumwinkel even claimed the Pope was on his side. Politicians have always gone along with this dubious game, drowning out the sabre rattling with the soothing music of social harmony.

By doing so they have compromised the prosperity of the nation. Philipp Holzmann could have survived and the workers could have kept their jobs. The Japanese and many other investors could have touched off a second economy miracle in eastern Germany with their know-how and the highly motivated staff of the Treuhand companies. And PIN could have continued to pay its workers, keeping the postal rates low at the same time.

Now the German government wants to perfect the Zumwinkel strategy by introducing industry-specific minimum wages. Chancellor Merkel is opposed to a comprehensive minimum wage, as she has repeatedly stated in public. But she seems to be willing to swallow the industry-specific minimum wages that her labour minister is demanding.

Today, collective agreements in Germany can be declared generally binding if at least fifty percent of the employees in an industry work for employers that are contractually bound to the wage agreement. This of course does not mean that more than 50 percent of the employees must be union members. If out of one hundred employees, fifty work in companies for which the collective agreements are binding, only about ten of these are typically union members. These ten are then able to determine the wages of the other ninety. That is called the autonomy of collective bargaining.

What happens, however, if the union members have even less power, and the 50 percent needed to make an agreement binding is not reached? Then expert committees, comprised in the decisive phase of equal numbers from the unions and employers' associations, have the task of determining wages for the whole industry. In principle, it is sufficient when there is only one union member out of 100 employees to negotiate minimum wages for the other 99.

It is particularly problematic when several unions are involved. In these cases the Minister of Labour now wants the largest of these unions to have the final say. If half of the employees are in the one and half in the other union, but the one union has 11 percent and the other union only 9 percent of the employees as members, the collective agreement of the smaller union is replaced by that of the larger one. The expert committees are also to have the right to dominate the smaller union if this union subjects less than 50 percent of the employees to the binding agreement. It will be interesting to see how the Federal Constitutional Court will rule in this matter.

What the Ministry of Labour is currently seeking to push through is an attack on the ordering framework that a market economy needs in order to function. It is the best way to force Germany again to its knees, after it had been freed from some of its fetters by the Agenda 2010 reforms. No member of the current government can later exculpate himself if he or she now approves these plans only to save the coalition. The coalition is not worth it.

Poverty Creation from Unrealistic Needs Adjustments*

“One in eight Germans lives in poverty!” was the heading in *Bild am Sonntag* for a recent interview with Federal Minister of Labour Olaf Scholz. The Minister stated that according to the EU poverty definition, a single who earns less than sixty percent of the medium income is poor and that 13 percent fit this definition. The same line is taken by a study of the German Institute for Economic Research (DIW), according to which the share of Germans considered to be middle class declined by 3.8 percentage points between 2002 to 2005. And a study by the Institute for Labour and Qualification at the University of Duisburg-Essen asserts that the percentage of low wage earners in Germany (22 percent) now nearly matches that of the US (25 percent). Is there really a new poverty in Germany and are we losing our middle class?

Maybe. There are indicators that point to more inequality. The share of gross wages in the national income has decreased, and the spread of gross wages has increased in Germany, as in other industrial countries, although the spread is not as large as in Anglo-Saxon countries nor has it grown quite so fast as in most of them. The increasing inequality in market incomes is the result of the low wage competition from the former communist countries of the world. For many years now, I have been calling attention to the threat to social coherence in western Europe and to the necessity to reform the welfare state.

Nevertheless, I consider the cries of alarm that we are currently hearing in the media to be misguided and exaggerated. The public discussion suffers from a confusion of ideas, it ignores the existence of the German welfare state, makes use of outdated numbers and has allowed itself to be misled by a statistical artefact. Let’s look at each one in turn.

First of all, it is simply not true that one in eight Germans are poor. If this were the case, the German welfare state would be failing in its duties, defined in the Constitution and in the twelfth volume of the German Social Security Code, of safeguarding the dignity of its citizens through its social services. And indeed, in the government’s recent poverty report we find no such statement on the amount of poverty. The report refers to the “poverty risk” instead of poverty itself, and this is an important difference. In order

* Shortened version of “Der bedarfsgewichtete Käse und die neue Armut,” *Ifo Schnelldienst* 61(10), 2008, p 14–16; additionally published in *WirtschaftsWoche*, no. 22, May 26, 2008, p. 48–49.

not to stir up emotions, one should keep to the official concepts as defined by the Federal Statistical Office in its report on poverty and conditions of life (Armut und Lebensbedingungen) which is fully compatible with the OECD definitions. Here the “poverty risk” begins at 60 percent of the median, “relative income poverty” at 50 percent and “poverty” at 40 percent. The EU also does not say that one is poor at less than 60 percent but only “at risk of poverty”, as can be read in its reports on the social situation in the EU.

Hardly anyone with a legal residence in Germany is poor. Social welfare and ALG II (fixed welfare for the employable population) ensure, assuming normal housing costs, that income amounts to 54 percent of median earnings. Measured in terms of the relative reduction of the share of people at risk of poverty, Germany, after Scandinavia, is one of the most generous welfare states in Europe if not in the whole world. The percentage of those threatened by poverty – 26 percent – before social transfers (excluding pension payments) is reduced to 13% as a result of state social services in Germany, a decrease of exactly 50 percent. On average for the entire EU-25, state transfer payments have only lowered the portion of the population below the poverty risk line by 38.5 percent (from 26 to 16 percent). To be sure, about 4 percent of the German population is poor according to the official definition. But this has always been the hard core of those who for various reasons do not take advantage of the money offered by the welfare state and need to be helped by other measures.

In 2005, the year on which the government’s latest poverty report is based, the average monthly Hartz-IV benefit claim of a one person household stood at 700 euros, of which 360 euros went for housing and heating costs, according to OECD information. Free health insurance worth some 200 euros has not even been included. The poverty line however in that year was set at 520 euros. This clearly shows that ALG II recipients in Germany are not poor according to the standard international definition. They of course face the risk of poverty, since the corresponding limit was 781 euros. A two-person household and certainly large families are even relatively further above the poverty levels that apply to them because the additional grants that the German welfare state gives to additional persons in a household are larger in percentage terms than the value of their needs that are assumed when calculating the poverty line. Families are also not poor in Germany.

Because Germany has a welfare state, poverty is also not indicated when the portion of low-wage earners in Germany, with an hourly wage of less than two thirds of the median, approximates that in the US, because wages and income are not the same thing. The fact that the spread of gross wages is similarly high in both countries does not surprise economists: This is explained by the factor price equalisation theorem which

can only be circumvented at the expense of mass unemployment. In the case of countries that trade with each other and between which capital can flow freely, wages must adjust for any given qualification level so that wage differences only result from wider gaps in education. But even these differences hardly exist, as the PISA tests confirm for Germany and the US. Both countries rank at the top in terms of the extent of the gaps in education among 15 year-old pupils. The tripartite educational system that has been proven to be a hindrance to social mobility is Germany's real social problem and not poverty in itself. Poverty can be measured only in terms of income, which in Germany is much more evenly distributed, thanks to the welfare state, than in America. Germany's low-wage earners receive ALG II that has been increased to such a great extent that virtually all recipients are well above the poverty line. They are even farther above the poverty line than unemployed ALG II recipients, who as already mentioned are at about 54 percent of median income, because the increases not only go to the ALG-II level but clearly above this. A low-wage earner who in 2005 worked full time for only four euros an hour had, assuming normal housing and heating costs, a net income of about 910 euros and was thus clearly above poverty-risk level of 781 euros. There is thus no cause for alarm on this point either!

However, how is it that according to the DIW analysis the share of the middle class in the German population (defined as between 150–70 percent of the median) decreased by almost four percentage points from 2002 to 2005, and that according to data from the Socioeconomic Panel the portion of those facing the risk of poverty increased by two percentage points? For a period of only three years, these are enormous changes; much more than could be explained by globalisation.

A portion of this increase is due to the special effect that appeared immediately after the Hartz reforms in the year of the report, 2005. The Hartz IV reform meant that about two million Germans were reclassified from unemployment assistance recipients to social welfare recipients and that wage subsidies were paid to low-wage earners in the context of ALG II. Immediately after the introduction of the new welfare system, this led in fact to an increase in the share of those facing a poverty risk because of the high unemployment, which was the highest in the history of the Federal Republic. In the meantime, however, the Hartz IV reforms have taken effect and have brought about a miracle on the German labour market. In western Germany alone, the recent economic upswing has created at least 1.1 million more jobs than could have been expected from an extrapolation based on previous economic upturn patterns. The gain in jobs together with wage subsidies have made considerable contributions to the decline in the risk of poverty and to a stabilising of the middle class – but this is not yet evident in the statistics of 2005. The government's poverty report was already dated before it was

written. Because it takes no account of the labour market successes, it is impossible to use this report as proof of increasing poverty in Germany, deficits in the Hartz IV legislation or even the need for minimum wages. The latter would be especially absurd, since minimum wages force an even larger portion of the lesser qualified into unemployment.

Doubts about the interpretation of the numbers are also justified because the development presented is not based on a factor such as per-capita income but on what statisticians call income based on needs-adjusted equivalence scales. Here it is assumed that a couple that separates is considered to become poorer unless each partner's income increases by a third. This is not implausible but it implies that the redistribution measurement is more an extension of social preferences than economically induced support-shortfalls. The principle that usually applies in statistics of separating facts and value judgements is being violated by the poverty statistics.

Because of the weighting of the equivalence scale, a reduction in household size but with the same per-capita income leads in itself to a reduction in equivalence-scale income – and thus to a larger share of those facing a poverty risk and falling out of the middle class. A decrease in household sizes has indeed taken place to a large extent in Germany: According to the OECD, the share of single parent households grew four times faster in Germany than the OECD average between 1995 and 2005. 80 percent of the growth of the calculated inequality in this time period can be explained by the changed age and household structures. From 2002 to 2005, the period on which the poverty report is based, the number of single-person households grew by a considerable 3.3 percent.

Here, the welfare state provides for the additional needs of the eroded families by granting additional benefits. But it does not do this to the extent that statisticians who devised the equivalent scales would prefer. The German welfare state gives a couple living on ALG-II that decides to separate only an increase in the standard benefit of eleven percent instead of a third more as the equivalence scale would require.

The increase in the (computational) poverty risk thus has little to do with greater inequality in the wage structure or a deficit in the structure of the welfare state. Public opinion gets worked up over the inequities of the market economy – and has been duped by a statistical artefact.

The whole thing becomes a farce if we consider that unemployment benefits and to a much greater extent the current ALG II offer a strong stimulus to couples to live separately. If one partner earns well and the other is long-term unemployed, the unemployed partner can only claim benefits if he/she does not formally cohabit with the

well-earning partner in a “household unit”. If they both form a joint household, the benefits are cancelled. State aid thus becomes a separation bonus, the state only paying on the condition that the couple does not marry or formally cohabit. No wonder that many young people chose not to declare cohabitation or separate if they once did. The result: In the first year of ALG II, the number of single person households increased in Germany by one percent and in the second year by five percent.

Although the additional welfare benefits make it economically possible for people to live alone, the statistics then indicate that there is a higher risk of poverty. If the partners live together, they belong to the middle class and are not regarded as in risk of poverty. If they declare that they have separate households in order to get more money from the state, the unemployed partner is now suddenly considered to be in risk of poverty. (According to a court decision, a separation of table and bed within a home is sufficient for declaring separately.)

It is obvious that when the needs-adjusted equivalence scales are used to calculate redistribution measures, they do not lead to sensible results if this causes families to erode and the state supports this erosion financially, as is the case in Germany. Behavioural changes that people adopt to improve their economic situation are registered as a worsening of their living situation in the statistics and lead politicians to sound the poverty alarm. This is needs-adjusted nonsense, nothing more.

Lemon Banking*

After the 1982 debt crisis, the Savings & Loan crisis in the United States in the late 1980s, and the Asian financial crisis of 1997, the sub-prime mortgage crisis is the fourth major banking crisis since World War II, and by far the biggest. According to the IMF, the total loss in terms of balance sheet write-offs will be nearly \$1 trillion worldwide, of which the lion's share probably will be borne by US financial institutions. Given that the combined equity capital stock of all US financial institutions is roughly \$1.2 trillion, this is a breathtaking sum.

Why do banking crises happen? Are bank managers ignorant? Why do they underwrite risks that drive their banks to the brink of bankruptcy? The answer lies in a combination of a bad accounting system and various moral-hazard effects that were not contained by existing regulatory systems.

The bad accounting system is the International Financial Reporting Standard (IFRS), which is now used by big companies throughout the world. The deficiency of IFRS is that it does not mitigate systemic contagion resulting from asset price movements. When asset prices move, firms that own these assets are forced to revalue them on their balance sheets quarter by quarter. The timely reporting of non-realized capital gains and losses makes the shares of the company that holds them volatile, sending shock waves through the financial system.

An alternative would be a precautionary accounting system, like the one that all German companies used before the transition to IFRS began. In Germany's traditional system, a company's assets were evaluated according to the "lowest value principle": the lower of an asset's historical price and its current market price must be used for accounting purposes. This allowed managers to pursue more long-term goals and

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proved effective in blocking contagion effects. Indeed, it was a major reason for the German financial system's stability,

In the current crisis, three moral-hazard effects are particularly important. First, management pay depends too much on short-term share-price performance, probably owing to the excessive influence of investment banks on commercial banks' policies. Given that investment banks can only attain high rates of return in a world with volatile asset prices and short-term performance goals, companies pressure their managers to follow suit.

Second, banks' assumption of excessive investment risks reflects their expectation that governments will bail them out if necessary. This was the case in the S&L crisis, where the government explicitly served as a deposit insurer. Banks could take on overly risky projects without scaring off investors because the government would step in as the lender of last resort.

In the sub-prime crisis, a similar phenomenon was implicitly at work, with banks speculating that they were too big for governments to let them fail. The fact that the Bank of England bailed out Northern Rock and the US Federal Reserve saved Bear Stearns with \$30 billion suggests that they were right.

The third, and probably most important, moral hazard results from asymmetric information between banks and their lenders. Banks issue securities with attractive nominal interest rates but unknown repayment probability. Often, securities are created that are backed by sophisticated portfolios containing good and bad assets whose true risk cannot easily be assessed. In the current crisis, even the private rating agencies dramatically underestimated the risks involved, which helped lure international financial investors into purchasing mortgage-backed securities at exaggerated prices.

So nothing stopped the banks from selling "lemon" bonds. Like used cars that break down right after they are sold, tomatoes and apples that look good but taste like water, or suits that quickly become threadbare, the seller could reduce the quality of the product and cut costs without the buyer's knowledge. As low-quality products sell at the same price as high-quality products, the latter disappear from the market.

In capital markets, the information asymmetry between buyers and sellers of securities is even more extreme, making it hugely tempting for banks to issue securities that increase their expected profits by reducing the repayment probability below what buyers expect. To do so, they develop complicated legal claim structures that hardly anyone can fully understand and operate with too little equity capital to cover the risks.

This destroys the market for sound financial instruments, undermining the viability of the capitalist system.

To address this problem, stricter banking regulation is needed in order to increase the probability of repayment, and hence the quality of securities. Financial products must be made transparent, off-balance sheet operations must be limited, and, above all, the scope of leveraged operations must be reduced by requiring higher equity-asset ratios. Banks often oppose higher equity-asset ratios, because equity capital is more expensive than debt capital. But this is precisely because of the lemon effect.

The IMF, the G7 or a joint US-European body could be the right forum for determining new rules for financial markets aimed at enhancing the efficiency and stability of the world economy. By contrast, setting rules unilaterally would be a recipe for global disaster, because competition between governments to create advantages for their own banking sectors would merely reproduce the inadequate regulations that resulted in lemon banking in the first place.

The German State Banks: Creative Destruction*

The international banking crisis has caused trouble for many German banks, but the German state banks (Landesbanken = LB) may be hit particularly hard. SachsenLB had to write off €1.8 billion; the State of Saxony prevented its bankruptcy only by providing a guaranty of €2.75 billion. The bank was taken over by Landesbank Baden-Württemberg (LBBW). WestLB may have to write off €2.0 billion and BayernLB reported a write-off of €4.3 billion. For all regional state banks, a total write-off of at least €12 billion is expected, corresponding to 19% of their aggregate equity capital of €63 billion. Comparable figures for private banks are not available, but if the percentage share were of a similar magnitude, their losses would amount to about €45 billion. The figures estimated to date are not nearly that high, however.

The fact that the state banks are affected so strongly by the sub-prime crisis is no accident – it is systemic. They were also especially involved in the Asian crisis of the late 1990s. At the time, WestLB was lucky enough to be able to rely on the special support of the State of North Rhine-Westphalia, which was heavily criticised by the EU. The crisis of the regional bank of Hesse (Helaba) in the mid-1970s or the 2001 crisis of Bankgesellschaft Berlin (LBB), which cost the state dearly, suggest that the business model is not good.

The state banks do little to help small and medium-sized businesses (Mittelstand) or the German economy by providing cheap loans, as one might surmise at first glance, but rather involve themselves in big international loan transactions and invest their money in risky securities. Due to protection by the liability of the guaranty authority and their privileges as state institutions, they nevertheless enjoyed AAA ratings for a long time. Endowed with the best ratings, they were able to develop a business model that basically consisted in refinancing at favourable terms in the international financial markets and then lending the funds at high interest rates and high risk all over the world. They invested in English travel companies, acquired shares in the Hungarian Foreign Trade Bank and in French insurance companies, purchased shipping companies and opened branches worldwide. Hardly a risk seemed too high. The newly developing but still weak Asian countries were their clients as well as the US investment banks that were eager to get rid of their dubious loan packages. The regional banks generated their

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profits from the interest rate differential. In addition, they functioned as central giro institutions and awarded loans to big customers, loans that were too large for smaller institutions.

Surprisingly, despite their privileges, the state banks mostly only earned below-average returns on equity. That they were able to maintain their market share against the private banks and grew as fast as the latter was mainly due to the fact that their state owners were willing to accept low pay-out ratios.

The business model of the state banks has collapsed in the meantime: In 2005 the EU Court of Justice (ECJ) prohibited both the liability of the guaranty authority and the privileges as state institutions, because it considered these as unfair competitive advantages over the private banks. Only a grandfathering rule is providing old securities with state protection during a transition period until 2015. Because of this transition period, the state banks had purchased a lot of risky assets before 2005 and thus raised the level of the potential investment crisis. Their function as the central giro institutions for the savings banks has also outlived its usefulness, because the savings banks are all interlinked now. Some executives tried to counteract with ever more risky investments, but the result was, as one can see, ruinous. Germany's state banks are finished.

They are trying to survive by merger. WestLB is flirting with Helaba, and LBBW has its eye on BayernLB. A merger of state banks does not constitute a new business model, however. A horizontal merger of institutes that are equally affected by the loss of authority guaranties will not generate the necessary return on equity. You can't expect sick people to get better by putting them all in the same room.

A possible business model is presented by the Italian Unicredito, which took over HypoVereinsbank. Unicredito emerged from an association of Italian savings banks. The local communities as owners of the savings banks put their equity into a foundation, and the foundation became the owner of a new big bank, with the former savings banks becoming member branches.

The German savings banks could do something similar with the regional banks. This solution would have the benefit of not joining equals but rather two types of banks, which could be complementary to each other. The savings banks are distributed widely, collect savings and grant loans to small and medium-sized businesses. But for big customers and financial market transactions they are too small. The state banks, however, know this business. The cheap funds raised in international capital markets, which are no longer available now because of the loss of the liability of the guaranty authority, could be replaced by the low-interest funds collected by the savings banks from small savers. And the savings banks could gain access to higher returns on loans

than could be earned from small and medium-sized firms and limited capital market transactions. Both sides could benefit from a vertical merger.

The problem is, however, that the savings banks do not want to lose their independence and therefore vigorously oppose such a model. But this opposition must be overcome in favour of the task at hand. The taxpayer can no longer pump more and more money into the model made obsolete by the ECJ. Perhaps the mayors of the local communities could be consoled with positions on supervisory boards of the foundations that will then own the new big banks. They could do a lot of good in their communities with all the money that will be paid out to the foundations.

The Party is Over*

With the United States teetering into recession, the global economic boom has ended. The boom was unusually long and persistent, with four years of roughly 5 percent growth – a period of sustained economic dynamism not seen since around 1970.

The clearest sign that the boom is ending is the IMF's forecast of 1.5 percent growth for the US in 2008. That may not sound like a recession, but the Fund's marginally positive projection primarily reflects the growth overhang from 2007, with hardly any new contribution in 2008. It is compatible with three consecutive quarters of zero growth in 2008.

Many argue that a US recession will no longer affect the world because China has supplanted America as an engine of the global economy. Wrong. Although China is growing fast, its economic power remains tiny. While the US contributes 28 percent to world GDP, China accounts for only 5 percent. The whole of Asia, from Turkey to China, contributes 24 percent, less than the US alone.

At some stage, the world may no longer catch a cold when the US sneezes, but that is far from being true now. Twenty-one percent of China's exports and 23 percent of the EU's exports to non-member countries go to the US. Thus, the world cannot help but be pulled down by a US slump.

The most recent Ifo World Economic Survey (WES) from 90 countries confirms this. Assessments of the current economic situation and expectations for the next six months have worsened everywhere. In both western and eastern Europe, the index sank more than in Asia or Latin America. The decline in the WES indicator during the last two quarters was the sharpest since 2001, when the stock market bubble burst. In the US, the

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WES indicator is now below the level of September 11, and so is the Michigan index of consumer confidence.

For many years, the US has lived beyond its means: a household saving rate close to zero and investment financed solely with foreign funds. The US current account deficit, which is identical to net capital imports, grew steadily to an annual \$811 billion in 2006, or 6 percent of GDP – by far the largest since the Great Depression. Year after year, the US managed to sell its assets abroad and enjoy the high life at home. No longer. The world has caught on.

Banks everywhere are learning the hard way that the debt with which the US financed its consumption boom will not necessarily be repaid. The mortgage-backed securities that US banks succeeded in selling to the world are not comparable to European assets with similar names.

In Europe, particularly Germany, a mortgage-backed security (Pfandbrief) is an ultra-safe asset, as normally banks finance no more than 60 percent of a house's value. By contrast, such US securities are like a lottery ticket. US banks finance up to 100 percent of a house's value, sometimes even more, and the sub-prime market even includes loans to people without jobs and income. Many European banks may not have understood this, yet they still shied away from revealing these dubious investments on their balance sheets. Instead, they placed them in conduits based in low-tax countries.

Those conduits are now showing gigantic losses that have to be covered by the parent banks, some of which are being driven to the brink of bankruptcy. This spring will show the necessary write-offs in the annual balance sheets, but the full truth will not become known before the 2008 balance sheets are published in the spring of 2009.

As American assets have lost their attractiveness, their prices have dropped. This has meant either a decline in asset prices quoted in dollars or in dollars quoted in other currencies. Indeed, adjusted for inflation differences, the dollar is now nearly as low against the euro as it was against the deutschmark in 1992, when German unification resulted in the breakdown of the European currency system.

The prices of US homes are also declining at an accelerating rate, in many areas by more than 10 percent per year. The prices of traded mortgage-backed securities have followed house prices down. Only US stock market prices have remained relatively stable. But it is only a matter of time until they fall, too. After all, the Standard & Poor's US price-earnings ratio is still above its long-term average – 26.84 in 2007, compared to its long-term average since 1881 of 16.31.

The Party is Over

This asset meltdown is the reason for the likely recession. First, consumers, faced with tighter credit and falling house values, will need to cut spending, slowing the US economy and affecting all countries via world trade. Second, with banks losing substantial amounts of equity capital – estimates now reach \$300 billion and more – the need to maintain minimum equity-debt ratios will force them to curtail business lending, hindering investment demand.

True, the US Federal Reserve has tried to prevent a recession by cutting its interest rates. But the Fed cannot endow the banks with new equity capital and prevent a credit crunch. More promising is the \$150 billion tax cut that the US Congress recently enacted. Equivalent to 1 percent of US GDP, it is large by all accounts. Whether it is enough to compensate homeowners for the wealth losses resulting from declining house prices and to prevent the impending recession remains to be seen. But, whatever happens, the party is over.

Cuius regio eius religio*

At Christmas Germans show their pious side. Many go to church on Christmas Eve even if the rest of the year they're too busy. But in church their divisions come through again: 31 percent of the population is Catholic and 31 percent Protestant. Although the Peace of Augsburg of 1555 is nearly half a millennium old, religion is still primarily a matter of residence. Cuius regio eius religio – whose region, his religion – this dictum still holds true today in terms of empirical regularity.

Apart from the conflict over the “true faith”, Protestants were able for some time to believe that they had the better religion since they were economically more successful. Max Weber's explanation for this is well known. Since Protestants, in particular Calvinists, believed that God's blessing is upon the economically successful, they tried particularly hard to prove this blessing was theirs with their success vis-à-vis their fellow men. In actual fact, even today average earnings of Protestants in Germany are higher than the average earnings of Catholics, and the Protestant regions are still more successful, on average, than the Catholic regions.

Max Weber derived his findings from the empirical studies made by his student, Martin Offenbacher, in Baden. The positive correlation between success and Protestantism he found was unambiguous. But is this theory, which every schoolchild in Germany is taught, in fact true? Is the Protestant ethic the reason for this correlation?

Sascha Becker and Ludger Woessmann have expressed their doubts. They both work at the Ifo Institute and on the economics faculty where Max Weber's chair is still located. In a CESifo Working Paper and in a second dissertation (Habilitation) they have thoroughly re-examined Weber's thesis. They pored over old Prussian data on economic activity, illiteracy and economic performance from the nineteenth century and earlier, digitalising them and examining them for relevant correlations, using the methods of modern econometrics. The differences between the Catholic and Protestant regions of Prussia gave them sufficient empirical material to reach statistically well-based findings.

The result is a new theory on the causality between religious affiliation and economic success that has nothing to do with the Protestant ethic. Instead of the Protestant ethic, it

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is pure and simple the better education in the Protestant areas that explains the greater economic successes.

Luther wanted the Bible that he had translated into German to be read by the people and for this reason he sought to reduce illiteracy. He instructed the principalities that had converted to Protestantism to build school houses next to the churches, where boys and girls could be educated. He regularly sent out his flock of reformers to oversee the teaching methods of these schools, the very first school inspectors. With this he managed to increase the educational level of the Protestant regions dramatically. The much higher level of education that the Protestant regions still had in the nineteenth century is the reason why these regions industrialised more rapidly and attained greater economic prosperity.

However, there was no Protestant ethic at work here. The authors tested their findings by comparing regions with different religious affiliations but with the same amount of illiteracy. There were not many such regions but enough, since some Catholic rulers also placed importance on a good school education. Here religious affiliation had no influence on economic success. Economic success was attributable exclusively to better education and not to differences in religious affiliation.

To be fair to Max Weber it must be noted that in developing his thesis he was not looking specifically at Lutheran Protestantism but at Calvinism and certain Dutch sects that indeed believed that blessings fell to the industrious. The data from Baden that he used included both Lutheran and Reformed Protestants, who adhered to Calvinism. Nevertheless the work of Sascha Becker and Ludger Woessmann raises considerable doubts about Max Weber's thesis, and in any case their work proves that in Prussia the Lutheran regions were more successful than the Catholic regions solely on the basis of their better education.

For Catholics this finding may be nothing new, since they have always been suspicious of Max Weber's thesis. Bavaria, primarily a Catholic state, should be all the more impressed since it has performed particularly well in the PISA tests. Protestants, however, must now take leave of a historical picture that they have taken for granted. Under the Christmas tree both religions are identical, and the differences in the market value of the presents – mere earthly possessions – have more to do with the education of the parents than blessings from the Lord.