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Halle Institute for Economic Research
Member of the Leibniz Association

Press Release 20/2016

Halle (Saale), 9th May 2016

Are lacking structural reforms in the financial sector the underlying reason for the German criticism of the ECB?

The major reason for the intense criticism of the European Central Bank's (ECB's) low-interest-rate policy may be the lack of structural reforms in the German banking system. The resulting persistent fragmentation increases the banking sector's vulnerability to the low-interest-rate environment. Hence, parts of the banking sector, due to their strong ties to politicians, appear to have successfully influenced public opinion against the ECB.

One rational explanation for the adverse German attitude toward the low-interest-rate policy of the ECB may be the specific structure of the German banking system. The German financial sector is equally divided between credit unions ("*Volksbanken*"), private commercial banks and savings banks ("*Sparkassen*"). There are more than 400 savings banks and more than 1 000 cooperative banks, resulting in a degree of fragmentation that is unique in the euro area. In other euro area countries like Italy, Austria, Spain and France, where the banking systems were historically fragmented as well, public banks and institutions, which used to look much like the current German savings banks, were (at least partially) privatized and liberalized and their governance structure was improved. The ensuing consolidation process led to a financial system consisting of fewer and larger financial institutions. These reforms bear fruit in the current low-interest environment: Large banks are less severely affected by extremely low interest rates, because their business model is not limited to collecting retail deposits and extending loans to households and small businesses. Hence, their profitability does not exclusively depend on the margin between deposit and credit rates. In a low-interest environment, this margin shrinks because deposit rates to retail customers cannot fall below zero, as households then have the option to withdraw their money and keep it "under the mattress". This problem is less painful for larger banks, because larger banks also engage in other activities besides collecting deposits and extending loans: They underwrite bonds and shares, for example, and tend to have a larger asset management business. These are fee based activities that are profitable even in the face of low interest rates. Ultimately, larger banks are considerably more resilient to a low-interest environment.

Press contact
Stefanie Müller
Tel +49 345 7753 720
presse@iwh-halle.de

Scientific contact
Reint E. Gropp
Tel +49 345 7753 700
president@iwh-halle.de

Keywords
monetary policy, central bank, savings, financial market reforms

Halle Institute for Economic Research (IWH) – Member of the Leibniz Association
Tel +49 345 7753 60
Fax +49 345 7753 820

Kleine Maerkerstrasse 8
D-06108 Halle (Saale)
Germany

P.O. Box 11 03 61
D-06017 Halle (Saale)
Germany

www.iwh-halle.de

For those banks whose business model is dependent on interest margins, the problems only appear gradually over time: The more credits stemming from the earlier high-interest environment still on banks' books are repaid and replaced by lower rate loans, the more difficult it becomes to remain profitable. Hence, in the low-interest-rate environment, the pressure to reform this fragmented system increases gradually over time. Assuming an average credit period of ten years, low interest margins would fully hit banks only starting in the coming years. German banking associations understand these developments and therefore have started to lobby against the ECB in order obtain an increase in rates before they are fully hit.

When the German Minster of Finance attacks the ECB and its independence, as happened recently at the IMF Annual Meetings, he risks turning himself into the chief lobbyist of the fragmented German financial system that seeks to prevent reforms. This is striking when one recalls that Germany is quick to demand structural reforms in other euro area countries and has criticized the low-interest environment on the grounds that it may reduce the pressure for reforms in these countries. But Germany is affected exactly in the opposite way: The ECB's low-interest-rate policy puts great pressure to implement overdue reforms of the German banking system.

Why were reforms in the banking sector delayed in Germany? One, the link between local governments and parts of the banking system, especially the savings banks sector, traditionally is very close. Local politicians tend to occupy the chairs of supervisory boards in savings banks, for example. Hence, savings banks are very good in representing their interests to politics. The lesson learned from the current situation therefore should be to initiate this overdue reform process now: First, the close ties between local governments and savings banks should be cut. Independent experts should replace local politicians as chairmen of the supervisory boards and credit committees of savings banks. Second, the regional restrictions on the granting of credits should be abolished such that savings banks are allowed to compete with each other, which would initiate a consolidation process. Third, it would be crucial to clarify the complex ownership status of savings banks (*"Gesellschaft öffentlichen Rechts"*), as already done in some cases, such that savings banks can merge with other institutes outside the savings banks sector. In general, legal preconditions have to be created to make it possible for commercial banks and savings banks or also for credit unions and savings banks to merge. It is high time to allow the German banking sector to consolidate, to reduce the number of banks, and to increase the average size of banks in order to increase its resilience. Politics should use the current monetary policy to initiate the overdue process, rather than criticize an institution that tries to do its job in a difficult environment.

Scientific contact
Professor Reint E. Gropp, PhD
Tel +49 345 7753 700
president@iwh-halle.de

Press contact

Stefanie Müller
Tel +49 345 7753 720
presse@iwh-halle.de

IWH List of Experts

The IWH List of Experts gives an overview of the IWH research themes. The institute's press office will be pleased to establish contact to the respective experts.

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