

## THE CREDIT CRUNCH: A COMPARISON OF GERMANY AND JAPAN

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The credit crunch suffered by private enterprises is contributing to the current economic slowdown in Germany. Small firms are affected in particular, while larger firms increasingly substitute other forms of external finance.<sup>1</sup>

The main reason for this development is the increased risk of non-performing loans after the credit-boom of the late 1990s<sup>2</sup>, the stock market decline after the year 2000 and the banks' efforts to strengthen and adjust their balance sheets in the light of Basel II and the possible loss of their "triple A" rating.

In many respects this development is reminiscent of the beginning banking crisis in Japan in the early 1990s. Here, the lending boom of the late 1980s also ended in a stock market crash, while banks aimed to achieve the Basel I accord until 1993. The magnitude of the problem clearly differs, but the causes and the development of macroeconomic variables are remarkably similar in the two countries.

Even though the German banks are in a better condition, and a crisis to the extent of the Japanese banking crisis appears unlikely, the problem of a German credit crunch must be taken seriously. It could still have a substantial impact on the real economy, in particular when complementing other domestic problems in the labour market and an overvalued real exchange rate. Furthermore, the number of stabilisation instruments is smaller in Germany than in Japan. The Maastricht criteria constrain fiscal policy, and the ECB is not likely to reduce interest rates to zero – like the bank of Japan – in order to stimulate investment in Germany (see

Sinn and Reutter 2000). A comparison of the two countries therefore makes sense despite the differences in the magnitude of the problem.

In comparing Germany and Japan, the first analogy is that initially the phenomenon of a credit crunch is denied.<sup>3</sup> Usually, aggregate bank lending or interest rates are chosen as indicators of a credit crunch which may not display a clear picture. In the following we argue that these two indicators alone are not sufficient to verify the existence or absence of a credit crunch and a comparison is made between these and other macro variables in Germany today and in Japan in the early 1990s.

We find a remarkable similarity in the time path of key macro variables. The aggregate credit volume, the development of stock prices and of new equity issues in both countries, before and after the beginning of the credit crunch, are very similar. Japanese as well as German banks hold substantial amounts of equity in other firms. Changes in stock prices – in contrast to other OECD countries – therefore directly translate to the banks' balance sheets. In the Basel I agreement these equity holdings are considered "Tier 2 Capital", relevant for the risk adjusted capital asset ratio. A reduction in its value therefore contributes to the credit crunch in both countries.

We also take a look at substitution effects in the mix of firms' external financing, and at direct surveys. Both indicate a credit crunch in Germany, starting in the first quarter of 2001 and in Japan, starting in the fourth quarter of 1991.

### The usual suspects

#### *Aggregate Credit Volume*

As shown in Figure 1a, the aggregate credit volume has stagnated in Germany since the first quarter of 2001. This is not sufficient to indicate a credit crunch, however, as it is impossible to distinguish the supply of and the demand for credit.<sup>4</sup>

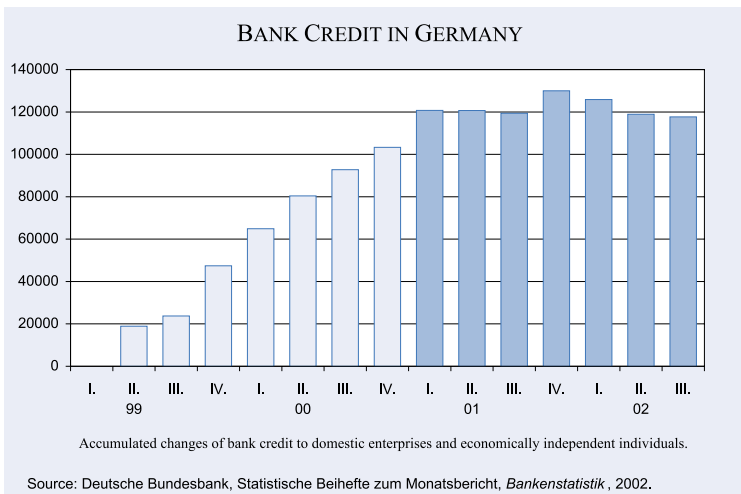
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<sup>1</sup> Since asymmetric information exists between banks and their clients, a situation can arise, where firms cannot obtain credit, even though they are willing to pay the market interest rate. The reason why the interest rate does is not simply increased according to the average risk characteristics of the firms, is that in this case the good risks will stay away from the market – an adverse selection with only the bad risks remaining. This is exactly what the banks try to avoid in the present situation.

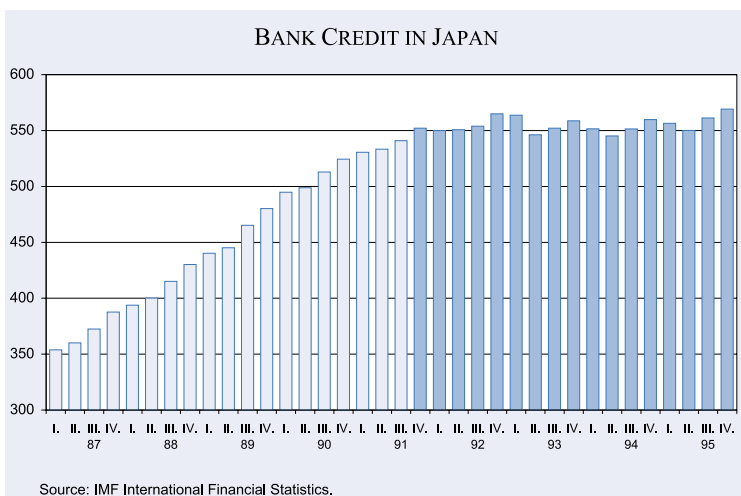
<sup>2</sup> See Hans-Werner Sinn (2002).

<sup>3</sup> The joint economic forecast of the German economic research institutes (Gemeinschaftsdiagnose der Wirtschaftsforschungsinstitute), as well as the Bundesbank and the German Council of Economic Advisors (Sachverständigenrat) reject the hypothesis of a credit crunch in Germany ("All in all the institutes do not see a clear indication that there exists a distortion in credit intermediation in Germany", Gemeinschaftsdiagnose 2002, p. 34).

<sup>4</sup> This is also the case when the development is displayed as a ratio, relative to GDP, as in Figure 4.1. in the Joint Economic Forecast.

**Figure 1a**

Note: The figure shows the accumulated changes of bank credit to domestic enterprises and economically independent individuals.

**Figure 1b**

Nevertheless, this first indicator already displays a striking similarity to the development of credit in Japan at the beginning of the banking crisis: In the first quarter of 2001 in Germany and the fourth quarter of 1991 in Japan, there was a clear structural break in the time path of aggregate credit (see Fig. 1b).

In the case of Japan there seems to be agreement that a credit crunch was present after the banking crisis in 1990. As the German development of aggregate credit looks so similar, it is at least unlikely that the German credit slowdown was entirely demand driven, while that of Japan was mostly the result of a lack of supply.

### Interest rates

The level of interest rates is often quoted as a further indicator of tight credit conditions. High interest rates, so the argument goes, makes credit less affordable,

forcing small firms into bankruptcy. Pointing at the presently quite low level of interest rates, the credit crunch hypothesis for Germany is often rejected.

This indicator, however, is also not sufficient – it is not even necessary. A reduction in credit volume due to high interest rates need not be inefficient. Not every project should receive financing, in particular under risk. As long as only those projects are financed, whose marginal product of capital is higher than the interest rate, there is no distortion in financial intermediation and capital markets are functioning well. A “credit crunch” is only present when firms with profitable projects cannot obtain credit in spite of low interest rates (lower than the expected marginal product), because banks are credit rationing. In Japan, for instance, the credit crunch co-exists with near zero interest rates.<sup>5</sup>

### Stock prices and new stock issues

The second analogy in the experiences of Germany and Japan is the development of stock prices and the issuance of new equity. These indicators are interesting for at least two reasons. Banks in Germany as well as in Japan hold substantial amounts of equity in their portfolios. In the Basel I agreement, Japan negotiated this equity to count as “Tier 2 Capital” making them relevant for fulfilling the risk-adjusted capital asset ratios. While not typical of other OECD countries, in Germany and Japan it means that changes in stock prices directly translate to balance sheet problems of the banking system.<sup>6</sup> Ito

<sup>5</sup> The increase in interest rates relative to government bonds is displayed in Figure 4.2 of the Joint Economic Forecast.

<sup>6</sup> In Germany this was not possible due to a principle of conservative accounting called the “Niederwertprinzip”. According to this principle, stocks are listed on the balance sheets according to their book value at the time they were purchased, not at their present value. Nevertheless, the implicit increases in value surely were taken into account by the rating agencies as additional hidden reserves, even if they were not explicitly shown in the balance sheets. Since 2001, Germany has switched to the US accounting standards, where stocks that are not intended for immediate sale are regularly value-adjusted.

(1996) has argued that this was the main reason for the banking crisis and the subsequent credit crunch in Japan, and also the reason why other countries, like the United States, France or Italy, which also experienced stock market crashes, did not experience such a strong impact on the banking system.

In both countries – Germany and Japan – the structural break in aggregate credit was preceded by a stock market crash, approximately one to two years before the credit crunch. In Germany it happened in January 2000 – about one year before the break in aggregate credit, in Japan in September 1989, two years before its structural break in bank lending (see Fig. 2a and 2b).

Falling stock prices do not only affect the banks directly via their balance sheets, but they also indirectly reduce their ability to meet the Basel I and II agreements. In principle there are two ways to

increase the capital asset ratio, either by raising additional capital or by reducing lending. The indirect effect of the stock market crash is to make the former option more difficult. Figures 3a and 3b show that the new issues of equity are highly correlated with the stock prices themselves. The difficulty of raising new capital in the stock market makes the reduction of lending the only alternative for raising the capital asset ratio.

### Alternative indicators

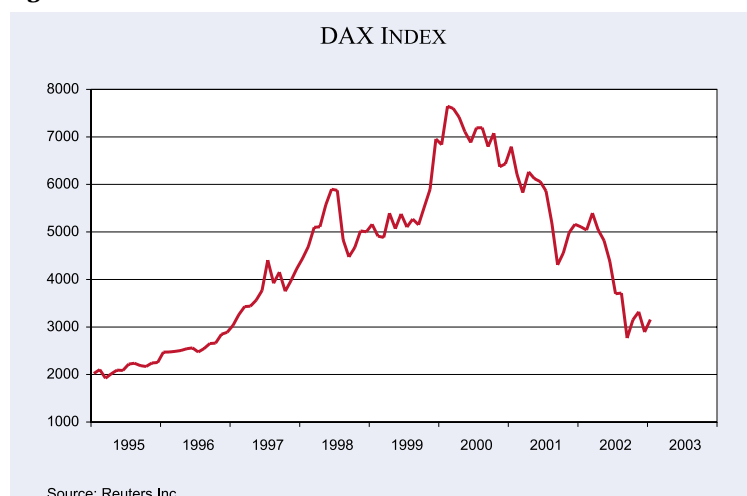
#### *External financing mix*

More informative than the volume of aggregate lending is the development of important substitutes for bank credit: short-term commercial paper. This indicator is used in a paper by Kashyap, Stein und Wilcox (AER 1993) for the United States, who find that after contractionary monetary policy of the Fed, firms substitute commercial paper for bank credit. This is taken as evidence of the credit channel of monetary policy.

Under the assumption that changes in aggregate credit are due to changes in the *demand* for credit, one would expect that all substitutes of bank credit should display a similar behaviour. The amount of commercial paper held and issued by firms should therefore also decline. As Figure 4a shows, this was not the case in Germany after aggregate credit began to stagnate. On the contrary, the beginning of the credit crunch and the structural break in aggregate lending coincide with a boom in alternative sources of financing. This points to the view that there must at least *also* have been a supply side change that affected some firms in a credit crunch situation.

When looking at new net issuance of short-term commercial paper as a share of total external finance (bank credit

**Figure 2a**



**Figure 2b**

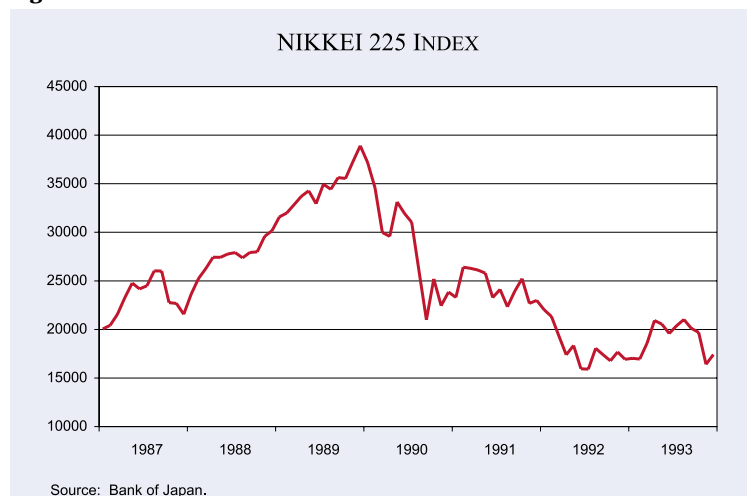
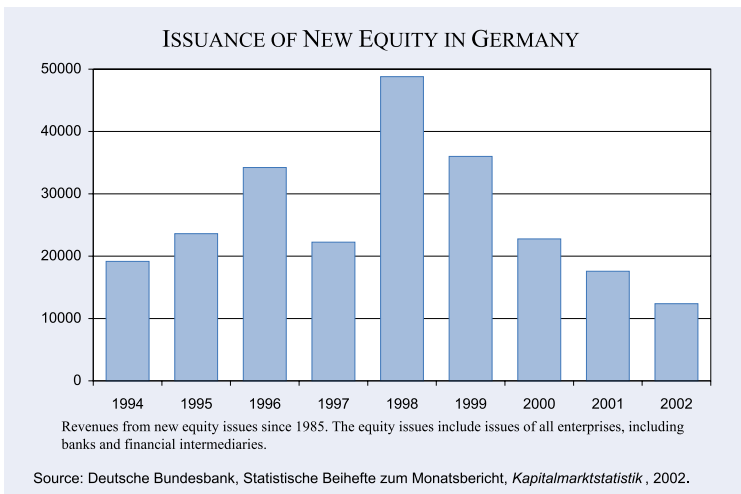
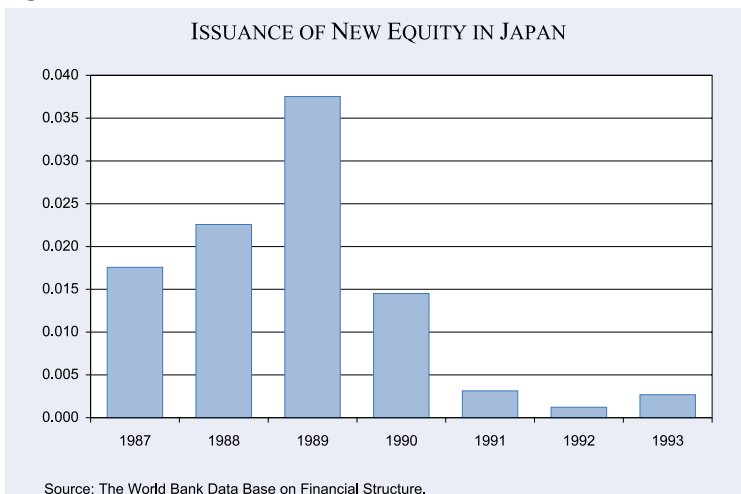


Figure 3a



Note: The figure shows the revenues from new equity issues since 1985. The equity issues include issues of all enterprises, including banks and financial intermediaries.

Figure 3b



Note: The figure shows the issues of new equity relative to GDP.

plus commercial paper), the substitution of bank credit by other forms of external finance becomes very clear. The share of commercial paper accumulated from the beginning of 1999 until mid-2000 is close to zero. After 2001 it rises to 5%. Although the Bundesbank and the Joint Economic Forecast of the research institutes point to this development, they argue that commercial paper is a negligible component of total financing. Even though this is correct when comparing the stocks of bank credit and commercial paper, the relevant indicator is the relative changes in or the new issues of commercial paper and bank credit. Here, the share is much higher.

Alternative explanations of increased use of commercial paper include the slowdown in the issuance

of new equity, as this equally applies to banks and non-banks.<sup>7</sup> However, there are several reasons for not including new equity in the comparison. If the reduction of new equity issue were the reason for the increase in commercial paper issue, then, without a credit crunch, one would expect all substitutes (external financing via commercial paper and bank credit) to increase equally. Furthermore, the decline in the issuance of equity had already started in 1998, almost three years before the beginning of the credit crunch. The substitution by commercial paper exactly coincides with the structural discontinuity in aggregate credit.<sup>8</sup> Also, in a long-run comparison, the funds raised by the issuance of new equity is not very low.

A similar behaviour is also observable in Japan, although the changes in the composition of external finance are less clear than in Germany. Although the net issue of commercial paper is higher in 1991 than in 1988 and 1989, the year of the stock market crash, a longer-run downward trend started in 1990. (see Fig. 4b).

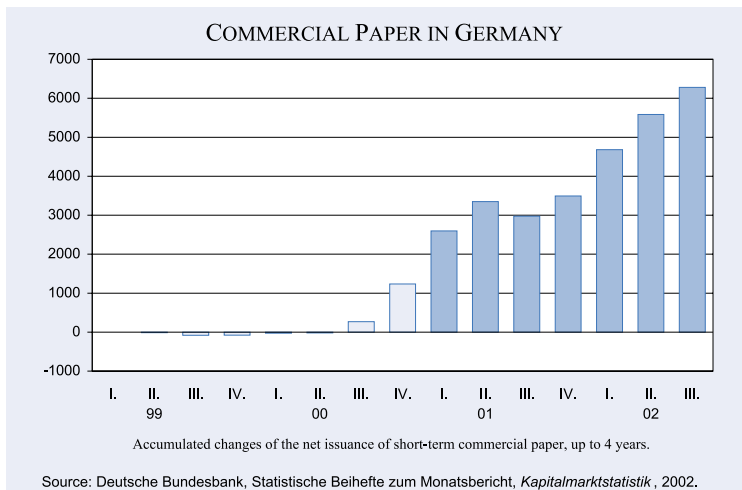
#### Direct surveys

The most direct way to assess the presence of a credit crunch and to distinguish supply-side from demand-side effects is to directly ask the firms about the banks' lending attitude. Figure 5 shows the results of the TANKAN-Survey in Japan, which asks firms about the perceived lending attitude of the banks. This question can be answered

<sup>7</sup> A further reason is the increased efficiency of the bond market following the introduction of the euro. However, even if this were the main reason, it remains an indicator of a continuing demand for external finance.

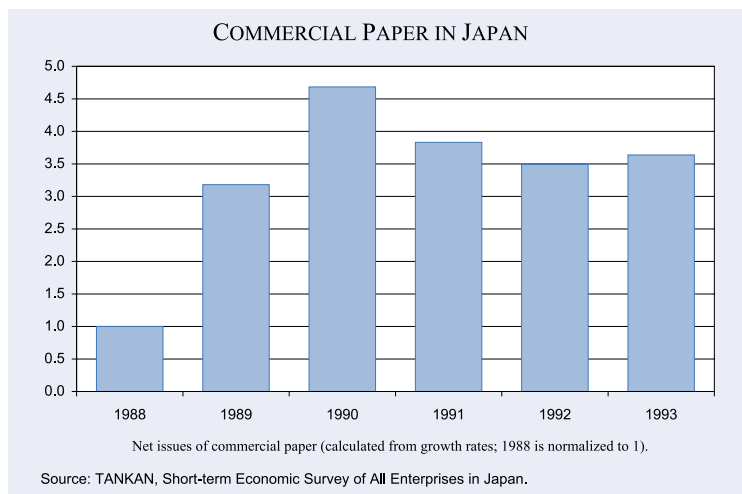
<sup>8</sup> Furthermore, there is a fundamental difference between a firm's decision to use external or internal finance. Bank credit and commercial paper are therefore likely to be closer substitutes than equity issuance.

**Figure 4a**



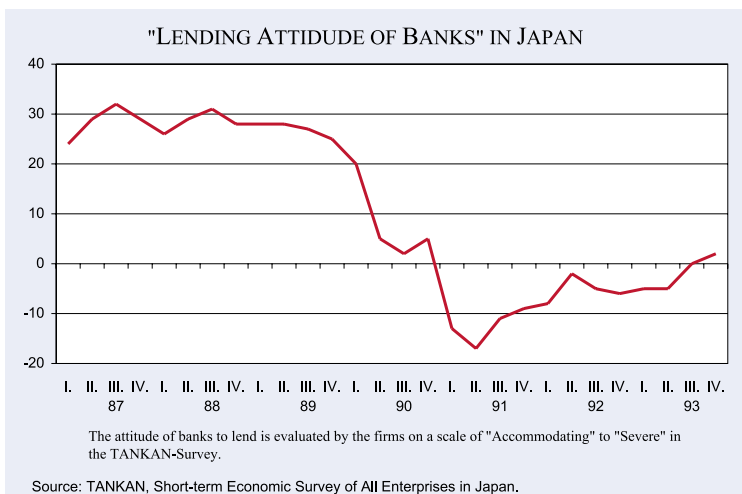
Note: The figure shows the accumulated changes of the net issuance of short-term commercial paper, up to 4 years.

**Figure 4b**



Note: The figure shows the net issue of commercial paper (calculated from growth rates; 1988 is normalized to 1).

**Figure 5**



Note: In the TANKAN Survey, Banks' attitude to lend is evaluated by the firms on a scale of "accommodating" to "severe".

on a scale of 100 (accommodating) to - 100 (severe). Cargill, Hutchison and Ito (2000) as well as Hutchison (2000) use this indicator to point to the fact that Japanese firms are affected strongly by the credit crunch even today. In the third quarter of 2002, the index value still stood at - 2.3. Therefore a demand-side driven reduction in aggregate lending cannot be the full explanation.

Although no comparable indicator exists in Germany at this point, the Ifo Institute, which conducts regular surveys on the business climate in Germany, will start this year asking a question corresponding exactly to the formulation of the one used in the TANKAN-Survey. This will allow monitoring the effects of the Basel II agreements on the lending behaviour of banks and a direct comparison between Germany and Japan.

A telephone survey similar to this was already conducted by the Ifo Institute in 2002 (see Russ 2002). This telephone survey of 1,100 representative enterprises in Germany showed that 38% of the firms that wanted to obtain new credit had to exert greater effort to get the credit authorised. 27% of the firms said that they did not obtain any credit despite their efforts, 11% had to pay higher interest rates and only 22% of the firms that had applied for credit responded that they did not experience any problems. Furthermore, 14% of the firms had existing credit lines cancelled by the banks and a further 10% were just able to prevent such a cancellation.

## Concluding remarks

The credit crunch in Germany and the banking crisis in Japan are not comparable with regard to the extent of the problem. A crisis of this dimension is not likely in Germany. Nevertheless, the development of several variables is remarkably similar and needs to be taken seriously, as even a problem much smaller than that of the Japanese banking sector could mean a substantial impairment of real growth in Germany.

In Japan, the problems in the banking system were recognised too late and were initially not taken seriously. In order to prevent this same mistake, the development of the credit markets in Germany must be closely monitored and analysed further.

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## HAS THE RETAIL BANK INTEREST RATE PASS-THROUGH BEEN ATYPICAL IN 2002?

GABE DE BONDT\*

### Introduction

The adjustment of retail bank interest rates to market interest rate changes in the euro area is a key link in the monetary transmission process. Retail bank interest rates reflect the prices of money and credit, which, in turn, are important for firms and households and therefore for monetary policy. Following the decision of the ECB Governing Council to lower the interest rate on its main refinancing operations by 50 basis points on 5 December 2002, much attention was devoted in the media to the retail bank interest rate pass-through process in Germany. This discussion was triggered by some statements of banking officials, who said that German banks could currently not afford to pass through the ECB interest rate cut, given concerns about German banks' margins and therefore profitability.

Against this background, this article briefly reviews the relevant issues regarding the interest rate pass-through process and examines whether the developments in 2002 have been in line with the adjustment of bank lending and deposit rates to changes in market interest rates as observed for the years 1999–2001. In this respect, the German experience is compared with that of the euro area.

### What do we know from past experience about the interest rate pass-through?

Four main issues emerge from past experience about the interest rate pass-through.

First, a distinction should be made between an immediate or short-term adjustment of retail bank interest rates to changes in official and market interest rates and a final or long-term adjustment.<sup>1</sup> Retail bank interest rates adjust with a delay to

changes in official and market interest rates, that is the immediate, i.e. same month, pass-through tends to be incomplete although typically there is a close to one-to-one pass-through in the long term of changes in market interest rates to retail bank interest rates. Short-term stickiness of retail bank interest rates can, among other factors, be explained by administrative costs of price changes, maintaining bank-customer relationships, risk premia and uncertainty about whether market interest rate changes are temporary or permanent.

The second important issue for the retail bank interest rate pass-through process is that maturity matters.<sup>2</sup> For instance, banks prefer to fund their loans with a comparable maturity to avoid interest rate risk due to a mismatch between their assets and liabilities and offer loans at rates which are competitive to those on non-bank sources of finance. This implies that long-term lending rates are expected to adjust more to changes in government bond yields than to money market interest rate movements.

Third, an important difference between the adjustment of lending compared to deposit rates is that credit risk considerations will play a role in the way the former respond to official interest rate changes (for empirical evidence for Germany see Winker 1999). In addition, the degree and speed of the interest rate pass-through highly differs across different segments of the retail bank market. This reflects, among other factors, differences in the degree of competition and market power of banks. The fourth and final issue is that the retail bank interest rate pass-through may change over time. Several studies provide evidence supporting the fact that the speed at which retail bank interest rates adjust to changes in market interest rates has become quicker since the introduction of the

<sup>1</sup> See B. Mojon, (2000), "Financial structure and the interest rate channel of ECB monetary policy", ECB Working Paper, 40; L.A. Toolema, J.-E. Sturm and J. de Haan, (2001), "Convergence of monetary transmission in EMU: new evidence", CESifo Working Paper, No. 465; F. Heinemann and M. Schüller, (2002), "Integration benefits on EU retail credit markets – evidence from interest rate pass-through", Zentrum für Wirtschaftsforschung; and S. Kleimeier and H. Sander, (2002), "Consumer credit rates in the eurozone: evidence on the emergence of a single retail banking market", European Credit Research Institute Research Report, 2.

<sup>2</sup> Arguments and empirical evidence in favour of this for the euro area is provided in G. de Bondt, (2002), "Retail bank interest rate pass-through: new evidence at the euro area level", ECB Working Paper, 136 and for euro area countries in G. de Bondt, B. Mojon, and N. Valla, (2002), "Interest rate setting by universal banks and the monetary policy transmission mechanism in the euro area", CEPR Conference Paper, Conference entitled "Will universal banking dominate or disappear? Consolidation, restructuring and (re)regulation in the banking industry, Madrid 15 and 16 November.

\* European Central Bank. Comments by Hans-Joachim Klöckers and John Fell are appreciated. All views expressed are those of the author alone and do not necessarily reflect those of the ECB or the Eurosystem.

euro.<sup>3</sup> Furthermore, the speed at which bank lending rates adjust to changes in market rates may depend on time-varying bank-specific characteristics, such as bank profitability and its interplay with bank refinancing conditions (Weth 2000).

### What is a typical response of retail bank interest rates to market interest rate changes?

#### Bank lending rates

Table 1 provides insight into the typical response of bank lending rates in both Germany and the euro area during the first three years of Stage Three of EMU. The immediate (or within one-month) adjustment to a change in corresponding market interest rates was incomplete in all cases and typically amounted to between 40% and 75%. The immediate adjustment of bank interest rates on consumer lending and short-term lending to enterprises varies, however, between 5% and 25%. In contrast, in the long term, a complete adjustment of all bank lending rates to market rates with a comparable maturity is found. The mean adjustment lag at which market interest rates are fully passed through to lending rates is generally up to 4 months. The main exceptions are the slow adjustment speed of the interest rate on short-term lending to enterprises in Germany of 6 months and of

the interest rate on consumer lending in both Germany and the euro area of around 1 year.

#### Bank deposit rates

Table 2 provides insight into the typical response of bank deposits rates in both Germany and the euro area during the first three years of Stage Three of EMU. The immediate (or within one-month) adjustment to a change in corresponding market interest rates has been incomplete in all cases. A typical immediate adjustment of deposit rates varies between 45% and 55%. The immediate adjustment of bank rates on deposits redeemable at notice of up to three months and overnight deposits is, however, found to be less than 20%. The long-term adjustment of deposit rates to a change in market rates with a comparable maturity is found to be up to 85%. In contrast to bank lending rates, all deposit rates adjust in the long term by less than one-to-one to market interest rate developments. The mean adjustment lag at which market interest rates are fully passed through to deposit rates is generally up to 2 months. The exceptions are the slow adjustment speed of the interest rate on deposits redeemable at notice of over three months in Germany and the euro area. The mean speed at which these deposit rates finally adjust to market interest rate developments is found to be around 6 months.

It should be noted that these results, just as those for lending rates, might be affected by the choice of the market rate with the most comparable maturi-

<sup>3</sup> See footnote 2.

**Table 1**

**Overview of adjustment of bank lending rates to market interest rates in Germany and the euro area**  
(100 basis point change in comparable market rate passed through to bank lending rate in basis points)

Bank lending rate	Market interest rates with a comparable maturity	Immediate adjustment <sup>a)</sup>	Final adjustment <sup>b)</sup>	Adjustment speed (in months)
<b>Germany</b>				
Up to 1 year to firms	Twelve months	6	94**	5.7**
Over 1 year to firms	Five-eight years	56**	114**	1.8**
Consumer lending	Three-five years	8*	119**	15.4
House purchase	Three-five years	73**	98**	0.4**
<b>Euro area</b>				
Up to 1 year to firms	Six months	23**	90**	3.0**
Over 1 year to firms	Two years	42**	95**	3.6**
Consumer lending	Two years	7	78**	8.5**
House purchase	Five years	44**	103**	2.4**

Notes: <sup>a)</sup> Adjustment in the first month. <sup>b)</sup> In all cases the final adjustment is not statistically different from 100, i.e. there is a complete long-term adjustment. \*\* and \* denote significance at the 1% and 5% level, respectively. For a model description see ECB Working Paper No. 136.

Sources: Bundesbank, ECB, Reuters, and author's estimations based on sample 1999.01–2001.12.



**Table 2**

**Overview of adjustment of bank deposit rates to market interest rates in Germany and the euro area**  
(100 basis point change in comparable market rate passed through to bank deposit rate in basis points)

Bank deposit rate	Market interest rates with a comparable maturity	Immediate adjustment <sup>a)</sup>	Final adjustment <sup>b)</sup>	Adjustment speed (in months)
<b>Germany</b>				
Up to 3 months notice	Three months	17**	35*	7.3
Over 3 months notice <sup>c)</sup>	Twelve months	45**	83**	1.9**
Maturity of one month	One month	54**	72**	1.0**
Maturity of three months	Three months	50**	83**	0.9**
<b>Euro area</b>				
Overnight	Overnight	7**	61**	1.5**
Up to 3 months notice	Three months	6	30**	5.1**
Maturity up to 2 years	Three months	43**	76**	1.0**
Maturity over 2 years	Two years	43**	64**	1.1**
Notes: <sup>a)</sup> Adjustment in the first month. <sup>b)</sup> In all cases the final adjustment is statistically different from 100, i.e. there is no complete long-term adjustment. <sup>c)</sup> Same results are found for the euro area, since Germany has for the euro area bank rate a country weight of 100%. ** and * denote significance at the 1% and 5% level, respectively. For a model description see ECB Working Paper No. 136.				

Sources: Bundesbank, ECB, Reuters, and author's estimations based on sample 1999.01-2001.12.

ty. For instance, German deposits redeemable at notice of up to three months, cover special savings accounts with specific contractual conditions which usually reflect in their remuneration the movement of longer-term market interest rates.

#### **Has the retail bank interest rate pass-through been atypical in 2002?**

To assess whether the 2002 experience was different compared to that in the period from 1999 to 2001, a sequence of one-month ahead forecasts (red lines in Chart 1) for the retail bank interest rates considered and its 95% confidence interval (dotted lines in Chart 1) are calculated.<sup>4</sup> These forecasts are based on actual values for the lagged retail bank interest rates and on the typical retail bank interest rate pass-through seen in 1999-2001 by estimating a model over this period, as summarised in Table 1 and 2. The yellow lines in Chart 1 are the actual values for the retail bank interest rates.

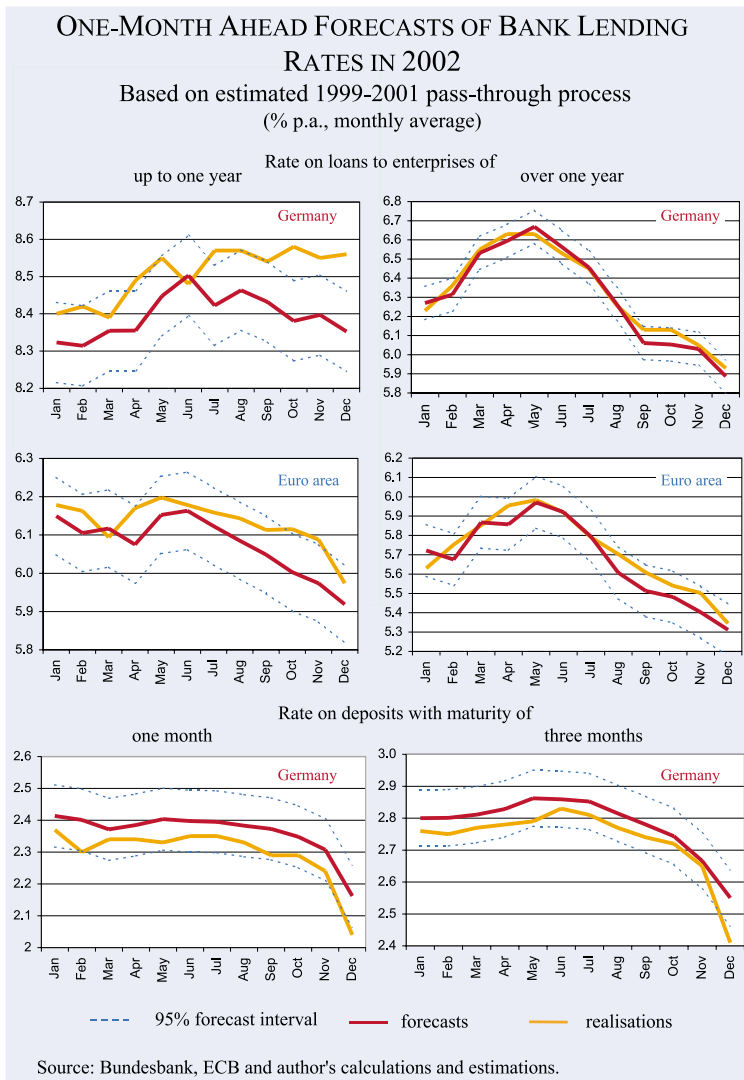
Broadly speaking, retail bank interest rates adjusted in 2002 in a typical way to changes in market interest rates with a comparable maturity. The main exception regarding lending rates is, however, that the interest rates on loans to enter-

prises have been stickier since the summer of 2002 than models may have predicted on the basis of previous experience (see top panel of Chart 1). The latter finding is particularly marked in the case of Germany, where short-term lending rates to enterprises have remained fairly stable since July, while the model would have predicted a slight decline. But also for long-term lending rates to enterprises, the bank rates were higher than predicted by the model, albeit not at a statistically significant level. The main atypical observations found for deposit rates are that the German interest rates on deposits with an agreed maturity of one month and of three months, respectively, adjusted more quickly to falling money market rates in December 2002 than might have been expected from past experience (see bottom panel of Chart 1).

In sum, these findings show that banks in Germany were slower in lowering their corporate lending rates than usual in the second half of 2002, but at the same time much quicker than observed in the past to lower their rates on deposits with an agreed maturity, following the ECB Governing Council decision to lower interest rates by 50 basis points on 5 December 2002. This suggests that the retail bank interest rate pass-through has been asymmetric in December 2002, e.g. deposit rates are quicker to adjust downwards than lending rates in a environment of falling market interest rates.

<sup>4</sup> Chart 1 plots this for the retail bank interest rates which show a striking atypical behaviour. Charts for the other retail bank interest rates are available upon request.

**Chart 1**



**Do credit risk considerations help in explaining the atypical sticky corporate lending rate?**

A likely explanation of the more than usual sluggish behaviour of corporate bank lending rates is credit risk considerations. Corporate bond spreads can provide an indication of the market perceptions of the prevailing degree of corporate credit risk (see Chart 2). In fact, this indicator suggests that credit risk concerns rose considerably in 2002, in particular in the second half of 2002. These concerns can also be seen in the spread between bank lending and market interest rates. Furthermore, it should be kept in mind that corporate bond spreads, based on one particular rating category may be biased if there are substantial numbers of credit rating downgrades from that credit tier as was the case in 2002.

Further evidence in favour of relatively high credit risk concerns in the fourth quarter of 2002 is that the interest rates on long-term corporate loans, as set by German banks, diverged more than usual across borrowers (see Chart 3). This suggests a relatively large difference between bank perception of the credit risk of "bad" and "good" borrowers.

In sum, there can be good reasons to assume that the observed atypical pass-through to loans to enterprises reflected, at least to some extent, credit risk considerations.

**Concluding remarks**

To examine the retail bank interest rate pass-through it is

**Chart 2**

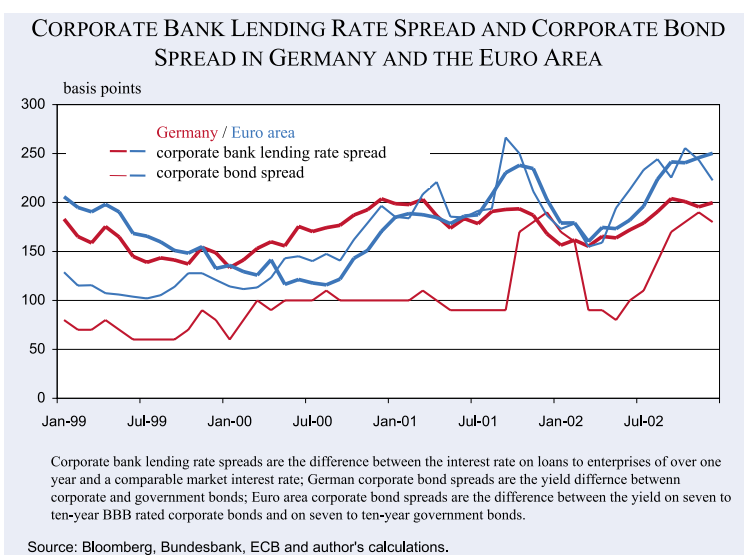
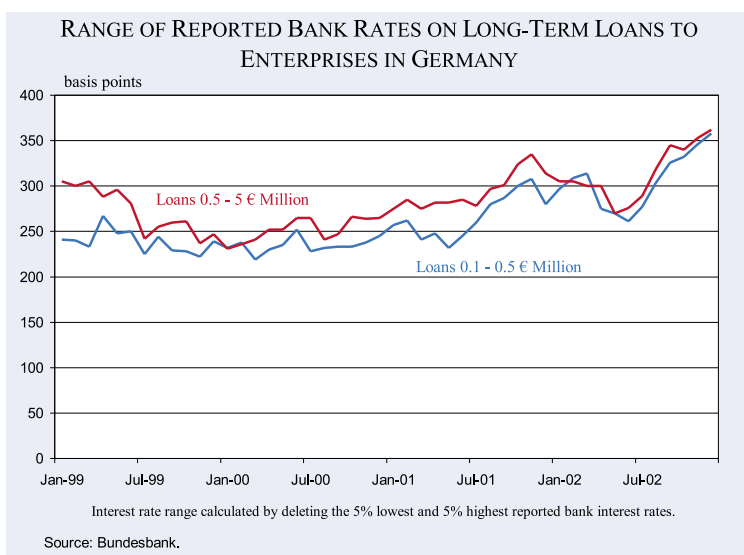


Chart 3



adjusted much more quickly to the decline in money market rates in December 2002 than expected from past experience. This suggests that at least in certain segments of the German retail bank market banks, with high loan-loss provisioning needs and profits under pressure, have been attempting to maximise their margins through an asymmetric interest rate pass-through in late 2002.

important to i) distinguish between an immediate and final adjustment of retail bank interest rates, ii) take into account the maturity of the retail bank rates, iii) take account of credit risk developments regarding bank lending rates, and iv) consider the possibility of time-variation in the retail bank interest rate pass-through process.

Experience of the first three years of Stage Three of EMU suggests that for most bank lending and deposit rates, it may take up to 4, respectively, 2 months before the adjustment process of retail bank rates is completed. The adjustment speed is, however, found to be significantly lower for the interest rate on loans to enterprises of up to one year in Germany (6 months), on consumer lending in Germany and the euro area (12 months) and on deposits redeemable at notice of up to three months in Germany and the euro area (around 6 months).

Turning to developments in 2002, the majority of the responses of retail bank interest rates in Germany and the euro area to changes in market interest rates with a comparable maturity was reasonably consistent with past trends. However, the interest rates on loans to enterprises have, notably in Germany, behaved a bit differently since the summer of 2002 from what might have been expected on the basis of past trends. A likely explanation for this atypical sticky interest rate behaviour is that credit risk considerations played some offsetting role. At the same time, the interest rates on German deposits with an agreed maturity of one month and of three months, respectively,

# A CONSTITUTION FOR EUROPE – COMMENTS AND PROPOSED CORRECTIONS

## TWENTY MEZZOGIORNOS\*

HANS-WERNER SINN\*\*

Europe will soon have a constitution. But if the draft presented by Valéry Giscard d'Estaing is anything to go by, it will be imbued with old ideology. The document ignores free-market economics. There is not a word about the protection of property rights, and no commitment to free enterprise and the division of labour. Instead, it contains dubious secondary objectives like "sustainability" or "balanced economic growth", as if a constitution could ensure that such concepts become reality.

Far too little thought has been given to legal and economic ramifications of these grand constitutional proclamations. Take the proposed creation of European citizenship together with the prohibition of discrimination on the basis of national citizenship. Both were implicit in earlier treaties and are central to the European idea: Europeans have joined together and should not discriminate against each other. But the new draft would give these principles the status of constitutional law. If applied to other "rights" enumerated in the document, such as social cohesion and social protection, they could create social harmonisation by the backdoor. That would have grave consequences for the European economy.

Under the current principle of inclusion, any EU citizen who moves from one EU country to another to work is immediately and fully integrated into the social system of the host country. The EU migrant pays taxes and social insurance contributions and together with his family receives access to all the state benefits available

to domestic employees. A migrant worker with a below-average income profits from the income redistribution of the welfare state just as a national does. According to the calculations of the Ifo Institute, the net benefit that Germany has been granting amounts to €2,300 a year in the first 10 years. By restricting benefits to working migrants the cost may be limited. Those who migrate for reasons other than employment receive no welfare benefits apart from emergency health care. However, the current draft constitution could mean that the inclusion principle would apply to *all* migrants from EU countries. This is not stated explicitly. But the draft includes no restrictions on the rights, so the courts would probably interpret the concept of social inclusion even more generously than they do already.

Current problems with the principle of inclusion will only be amplified. If having work is no longer required before immigrating to a welfare state, the flood-gates will be opened. Masses of poverty refugees would move from eastern European countries to seek their fortune. To prevent this chaos, EU migrants should have to wait for full welfare benefits, such as rent subsidies and public housing, while enjoying access to public services and other benefits they pay for via taxes and social insurance contributions. If differential treatment of this sort is not allowed, governments will be forced to compete to trim welfare benefits so that they are no more attractive as destinations than their neighbours. Traditional welfare states would not survive.

Harmonisation of social standards could prevent a downward spiral. But economic conditions are far too varied for this to work. In all eastern European countries, wages are less than one third of German social welfare assistance, and even in some Spanish, Portuguese and Greek regions, wages are less than half of German social welfare assistance. Harmonising welfare at a level still acceptable to western Europe would lead to the deindustrialisation of whole regions in the south and east.

\* Published as "There is no European Right to a Place in the Sun", *Financial Times*, February 13, 2003, p. 11; see also "Zwanzig Mezzogiornos", *Financial Times Deutschland*, February 13, 2003, p. 30.

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The economic pain would then have to be eased by large fiscal transfers between governments. Theoretically, this is possible. Indeed, the draft constitution provides for such social cohesion. But the results could be disastrous. Look at Germany and Italy. The German government contributed to east Germany's lack of competitiveness by offering western welfare payments which pushed wages above productivity. Similarly, the Italian social system has prevented wages in southern Italy from falling to a competitive level. Consequently, both eastern Germany and the Italian Mezzogiorno suffer from mass unemployment. Productivity is stuck at only 60 percent of the other regions. And they are dependent on vast financial transfers.

It would be unwise to impose the Italian-German model onto Portugal, Spain, Greece, eastern Poland, Slovakia, Romania or Bulgaria, but this is precisely what a European social union would do. There would not be two but twenty Mezzogiornos in Europe if the non-discrimination planned in the draft constitution were applied without restrictions to social benefits for all EU citizens.

## CORRECTIONS TO THE DRAFT TEXT OF THE ARTICLES OF THE TREATY ESTABLISHING A CONSTITUTION FOR EUROPE

This note contains proposed amendments and corrections of the first 16 articles of the constitution as drafted by the Convention on the Future of Europe.

New passages are in bold letters, cancelled passages are crossed out.

### Titel 1

#### Article 3: The Union's objectives

(2) The Union shall work for a Europe of sustainable ~~development~~ **prosperity and stability** based on ~~balanced economic growth~~ **the protection of property rights, economic freedom, the division of labour** and social justice, with a free single market, and economic and monetary union, aiming at full employment and generating high levels of competitiveness and living standards. It shall **remove obstacles to** ~~promote~~ social cohesion and **promote** economic cohesion, equality between men and women, ~~and~~ environmental ~~and social~~ protection and ~~shall develop~~ scientific and technological advance. ~~including the discovery of space.~~ It shall encourage solidarity between generations and between States, and equal opportunities for all.

#### Comments

*Economic growth cannot be guaranteed by anyone, let alone a constitution. The protection of property rights, economic freedom and the division of labour are the cornerstones of a market economy and they need the irrevocable legal support that only a constitution can provide.*

*Social cohesion is desirable, but removing obstacles is all the EU needs to do since market forces by themselves will bring about rapid cohesion. There is an optimal cohesion speed, and government interventions aimed at increasing the speed of social cohesion are more likely to harm than to help the economies involved. East Germany is the striking example. Policy measures to promote economic*

cohesion such as support for local infrastructure can be defended. However, measures to directly promote social cohesion and protection are counter-productive. They are extremely costly, result in mass unemployment and slow down the speed of economic cohesion.

*The discovery of space is too specific for a constitutional goal. This smells after transfers to the European Space Agency in Paris.*

(3) The Union shall constitute an area of freedom, security and justice in which its shared values are developed and the richness of its cultural **and social** diversity is respected.

*Comment*

*In connection with article 16, the amendment reduces the risk of social harmonisation.*

#### **Article 7: Citizenship of the Union**

(2) Citizens of the Union shall enjoy the rights and be subject to the duties provided for in this Constitution. They shall have:

- the right to move and reside freely within the territory of the Member States;
- **the right to use the public infrastructure as well as the security and legal protection in their Member State of residence under the same conditions as nationals of that state;**
- **the right to work and the duty to pay taxes and fees as well as the right to participate in contribution-financed social security systems in their Member State of residence under the same conditions as nationals of that state;**
- the right to vote and to stand as a candidate in elections to the European Parliament and municipal elections in their Member State of residence under the same conditions as nationals of that State;
- ...

*Comment*

*Full social inclusion would be a major problem for Europe triggering off mass migration from the new member countries, imposing high fiscal burdens on the target countries and eventually eroding the European welfare state. Rather than restricting the non-discrimination clause of Article 6, the enumer-*

*ation of migrants' rights makes it possible to exclude the constitutional right to receive tax financed social benefits and be a net recipient of government resources, even if nationals enjoy such a right. The exclusion makes it possible for a state to prevent welfare shopping. Proposals to delay the full inclusion of migrants in the redistributive activities of the state in some initial period after their entry become possible. (See Scientific Council of the German Ministry of Finance, *Freizügigkeit und Soziale Sicherung in Europa (Economic Freedom an Social Security in Europe)*, Bundesministerium der Finanzen, Berlin 2001, as well European Economic Advisory Group at CESifo, *Report on the European Economy, Chapter 3: "Rethinking Subsidiarity in the EU: Economic Principles"*, p. 76-97, Munich 2003.)*

#### **Article 12: Shared competences**

(4) Shared competence applies in the following principal areas:

- internal market
- area of freedom, security and justice
- ~~agriculture and~~ fisheries
- ~~international~~ transport
- trans-European networks
- ~~energy~~
- ~~social policy~~
- economic ~~and social~~ cohesion
- environment
- public health, and
- consumer protection.

*Comments*

*Agriculture certainly is not a policy area with international spill-over effects that could justify EU action, despite the obvious vested interests of some countries.*

*Transport is an EU issue only to the extent that it is international.*

*Energy is of no concern for the EU. Energy is a normal private good which is efficiently allocated via the market process. There is no need to single it out relative to other goods.*

*For the reasons explained above, social policies and social cohesion do not belong to the set of EU policies.*