The *Schäuble* Legacy

By Hans-Joachim Dübel

Politics über alles.

Wolfgang Schäuble, lawyer, lifelong party soldier, and member of the German Bundestag since 1972, was appointed in 2009 at the age of 67 to the post of German finance minister. This was during the financial crisis that started in the United States and exposed the failures in the German banking system. It soon became apparent how involved both leading *Volksparteien*—the CDU/CSU and the SPD—were in the scandals of the public Landesbanks. Their politicians in the German states caused billions in losses through the pervasive neglect of basic governance standards.

In 2001, Schäuble's CDU had collapsed politically in the state of Berlin after the Bankgesellschaft Berlin real estate scandal. In 2009, the situation was different: both the SPD and the CDU had a major hand in the narrowly avoided collapse of Germany's financial system, and in fact in creating the crisis to begin with through inflating America's housing finance system. Schäuble's predecessor at the finance ministry, Peer Steinbrück of the SPD, as governor of the state of North Rhine-Westphalia had overseen double-digit billions in purchases of U.S. mortgage assets, including derivatives, for the Westdeutsche Landesbank, which was eventually shut down. After moving into the role of crisis management, CDU veteran Schäuble adopted the principle that cover-up was in the bipartisan interest. Draconian measures taken to this end included staffing the bank

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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rescue agency SoFFin with former Landesbankers and threatening members of parliament sitting on the SoFFin oversight committee with two years of jail for leaks.

To keep the SPD politically in line with the cover-up strategy as the coalitions changed, Schäuble retained Steinbrück's deputy, Jörg Asmussen, in the ministry as undersecretary. Asmussen had been responsible for the botched nationalization of Hypo Real Estate, and the loss-making Commerzbank rescue investment. With additional lavish bad bank arrangements, such as Hypo Real Estate's transfer of all Greek exposure at par to FMS Wertmanagement, a bad bank set up by the federal government, the government expanded the Landesbanken investor bailouts to investors in private banks. In this way, subordinated creditors and even hybrid capital investors in the entire German banking system were left largely unscathed. These included important campaign sponsors.

Could such a veteran of domestic political tactics be expected to develop into a crisis manager who protected taxpayer interests and acted as forward-looking architect of a new European financial system in the multiple banking and sovereign finance crises that followed in Europe? By design, no.

When Deutsche Bank CEO Josef Ackermann, then head of the top global banking club, the Institute of International Finance, offered the German government a more market-oriented partial private roll-over of Greece's sovereign debt in early spring 2010—a measure that could have significantly reduced the public bill for

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the eurozone—Schäuble let himself be guided by political considerations such as the upcoming state elections in North Rhine-Westphalia and France's fierce insistence on a complete public bailout of its bank investors in Greek debt.

After getting the official sector fully involved, despite Merkel's promise to the contrary to the North Rhine-Westphalia electorate, Schäuble delayed a badly needed haircut for Greece's privately held sovereign debt for another two years. This helped French, German, and other banks to largely transfer their exposures to a number of public shadow budgets, from the European Central Bank via the European Financial Stability Facility to bad banks such as FMS Wertmanagement. To make matters worse, Greek bank investors and the European Central Bank were exempted from the early 2012 sovereign bond haircuts, so Greece, facing a collapsing GDP, remained saddled with unsustainable debt levels, now entirely to public creditors, with German taxpayers the first in line. All threats by Schäuble about Greece being pushed from the eurozone for non-compliance with the draconian austerity measures would henceforth be muted, serving as political exercises to counter the mounting domestic criticism of his handling of the Greek situation.

In mid-2012, with Spain's financial sector crisis breaking out after years of delay and the downfall of the entire eurozone looming, Schäuble's role as Europe's Mr. Bailout finally became entirely untenable even for the strong German fiscal balance sheet. A group of financial sector economists, including the author, publicly demanded bail-in of bank creditors and an end to loss-making public recapitalizations of banks. Schäuble's reaction was to propose a European bail-in regime—for 2016, a full four years in the future. As Cyprus and additional banking crises hit home, and domestic opposition to Schäuble in the form of Alternative für Deutschland grew, his defensive position ultimately was swept away.

However, Schäuble still left European fiscal policymakers a major headache by accepting a *de facto* €100,000 European deposit insurance promise in the 2016 Directive that implemented the bail-in regime, a promise that was made without actuarial pricing and sufficient capital to back it up, but was nevertheless implemented in such diverse places as Bulgaria, Cyprus, and Greece. The Hellenic Financial Stability Fund, the Greek bank rescue fund, with accumulated losses of €36 billion by 2016 and a major contributor to Greece's structural insolvency situation, is a symbol for Schäuble's dual European sovereign and bank investor bailout legacy.

After leaving significant fiscal risks and an inevitable official Greek debt haircut to his successor, is there

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a positive Schäuble legacy for German and European public finance? As the fiercely anti-bailout party FDP threatened to take over the finance ministry, during his very last days in office Schäuble put his weight behind a Bundesbank proposal to implement creditor participation in sovereign finance, according to which the European Stability Mechanism would provide fresh capital for sovereigns excluded from the market only after which existing creditors got extended to be exposed to possible haircuts going forward. While the proposal still falls short of the at-least-partial coverage of (*de facto* sub-) sovereign exposures required to keep the eurozone alive from an investor perspective, assuming an end to the ECB's purchases, it demonstrates a recognition that excessive debt problems have to be dealt with systematically. All relevant European (sub)sovereign bond market reform proposals have been on the table since 2010, and it was typically Schäuble who blocked them with legalistic arguments. Now, a parallel ECB exit from purchases and the introduction of a new bond market regime will not work together well, another headache for his successor.

In fairness, the most powerful financial policymaker in Europe was never alone in taking wrong turns and pursuing dead ends, nor was he entirely free in his decisions, given a strong German chancellery and powerful international financial interests. Still, Schäuble's story remains one of short-term political tactics dominating long-term financial sustainability considerations, at the expense of tremendous fiscal costs for future generations. It is illustrative of one of Germany's central political tragedies—a deeply politicized public finance system that obscures transparency and penalizes the selection of forward-looking financial policy decision-makers. Will the next finance minister be able to fix the system? Or rather, will the political and financial system permit somebody who is able to fix it to be selected? ◆