Heiko Steffens

THE IMPACT OF THE FINANCIAL CRISIS ON CONSUMER PROTECTION

Abstract: *Deep impact of the crisis on the German economy: the macro-economic indicators reveal dramatic contractions in most areas. German government launched two recovery programmes with a total budget of 80 billion Euros before June 2009. The most popular tool was the "environmental premium" (so called "Abwrackprämie"): a subsidy to promote sales of new cars. The crisis also provoked a public debate of the role of economists and the value of economic theories. The classic theories were questioned, while the "Behavioural Economics" were praised. German consumer organisations criticised the financial intermediaries and advisers and called for a legal reform in the system of financial supervision upon each level.*

Key words: *macro-economic situation, German government's recovery programmes, environmental premium, consumer protection, value of economic theories, bad deals, financial intermediaries and advisers, reform of finance supervision, product information, macro prudential social and economic governance*

JEL: B 13, G 0, D 11, E 20, E 32

At the beginning of my presentation I am going to share with you a brief introduction to the present macro-economic situation in Germany.

According to the Federal Statistics Authority's figures in September 2009, the growth rate of the Gross Domestic Product (GDP) has been estimated to reach – ceteris paribus – minus 6 percent at the end of the year. In particular, the development in exports contributed to a high degree to the change for the worse. From January to July alone the figure dropped to around minus 25 percent. Incoming orders from the Eurozone dropped by minus 36 percent. In consequence, production was affected by minus 20%; total federation tax revenue was affected by minus 6 in the first half-year – to just give some examples.

If we would look deeper into the components of the indicators we would find even more dramatic developments, for instance car industry. Later more about the car market!

One of the "pluses" in the contribution of GDP components to stabilisation came from private consumption: +0.3%.

As a matter of fact, in the first half of the year private demand was a strong supporter of macro-economic developments. The driving forces which kept consumption on a high level of performance are as follows, in my opinion:

First of all – until now – a slow motion of the crisis on its way to the labour market. Responsible for that is a mix of several factors, such as legal regulations, expectations for a quick recovery from the crisis, securing jobs on the basis of subsidies from the government, etc.

But there is no doubt even with very optimistic experts that a decline in the employment figures (by today 8% in Germany; 12% in Slovakia) and a dramatic increase in the unemployment rate are very likely to come. If the labour market collapses, of course, it will have a strong negative effect on private consumption via income reductions. Dominique Strauss-Kahn of the International Monetary Fund commented in Berlin a month ago:

"I am concerned about the third phase of this crisis following on the heels of the financial and economic phases – namely high unemployment. We expect unemployment to continue rising through next year. … a jobless recovery remains a risk. Having … many people out of work has significant economic costs, ranging from lower private demand to a decline in potential growth. … The social consequences … are even more worrisome" (Strauss-Kahn, D. 2009).

Second, calm price trends, the inflation rate oscillating around 0% in year-on-year terms. For the first time after twenty years, the inflation rate receded to a level of 0.5%.

Thirdly, starting in autumn 2008 the German government launched two recovery programmes: the first one, under the title "Financial Market Stabilisation", takes steps to reduce tax burdens on private citizens and a monetary mega-infusion into systemic relevant parts of the banking and business sectors by providing 30 billion euros in 2009 and 2010. In spring this year the government adopted the second recovery programme under the title "Pact for Employment and Stability in Germany" based on a budget of about 50 billion euros. The total budget of 80 billion is debt financed. One of the obvious primary results of the government's generosity in deficit-spending, beyond immediate stabilisation effects in the banking sector, was a temporary increase of confidence in the government's willingness and competences to practice good macro-prudential governance.

Fourth, one short-term and very popular tool of the government's recovery programme this year provided an enormous demand push on the car market. This tool, also practiced in Slovakia, officially called "environmental rebate/premium" (scrap money), in public referred to as "Abwrack-Prämie", was designed as a subsidy to promote sales of new cars. The budget of this tool: 5 billion euros.

Individual consumers received a state subsidy of 2,500 euros on the strictly defined rule that they have their 9-year or older car shredded and buy a new car. By 2 September, not even after half a year in force, all 5 billion euros was spent.

Positively speaking, the car market boomed by +26%. About 400,000 new cars were sold: mostly small cars of the low price segment.

Most cars use less fuel and cause less CO_2 emissions! Well, on the other hand some consequences of the “Abwrackprämie” are only too obvious:

A) the “Abwrackprämie” stimulated a run to small cars, a low profit segment of car industry; B) the politically boosted demand very likely satisfied a considerable part of future demand, and this way created difficulties in coping with the underemployment of the production capacities in the future.

If you asked me to express in two sentences the general feeling in Germany about the crisis, I would think a quotation from John Maynard Keynes would be most appropriate. Keynes wrote about the economic world crisis in 1930:

“We are caught in enormous turbulences. We have failed in the control of a most sensitive machine (the financial markets – H.S.), the performance of which we don’t understand. As a result, our potential for creating welfare has been exhausted – maybe for a long time” (Keynes, J. M. 1956, p.194, re-translated by H.St.).

The second part of my paper is dedicated to consumer protection. I would like to start with a brief reflection on the model of “homo oeconomicus” and his twin brother “sovereign consumer” in the frame of an “Abwrackprämie” Scenario.

A car owner drives his 10-year old and well-kept high-class Mercedes to the shredder station. The manager of the station, a fan of antique Mercedes, wants to buy this car and offers his new client 4,000 euros for it. The client refuses, he prefers 2,500 euro from the government, and his car not going second hand, but shredded. If this may be acceptable as an example for the behaviour of “sovereign consumer”, it is in no way an example for the rationality of “homo oeconomicus”.

Anyway, it is a surprising observation for economists to witness that beyond the urgent practical and political problems of managing the financial and economic crisis, there is also going on a debate about the value of economic theory.

The point of departure to this debate is the suspicion of the public opinion that academic economics is blind and lame. Why did the economists not see the crisis coming, why is their analysis of the catastrophe rather vague? Why are their recommendations to what the government could and should do in order to solve the crisis as manifold as the schools they belong to? Economists have to respond to questions asked by politicians and civil society representatives, who question the value of formal mathematical models and abstractions. It seems that “homo oeconomicus” has become the public enemy No.1: first for the acceptance of greed, second for the heroic assumptions on which the financial market equilibrium is built. In consumer policy, for instance, the debate calls for a paradigm shift. A shift away from the consumer as a neoclassical rational actor to the consumers as individuals who make their decisions under a whole variety of preferences, needs and desires, benefits and costs perceptions, information behaviour patterns, subject to influences from marketing and other commercial practices, and last not least a trend to herding.

Herding, i.e. tendency to join self-enforcing waves of optimism and pessimism, which forward the pro-cyclicality of the financial system.

Behavioural economists particularly blame the neo-classical theory for the neglect of “bounded rationality” as a fundamental constraint in the behaviour of real consumers and the problems arising from that.

One set of problems, for instance, relates to ‘bad deals’ (cf. Kuneva), particularly when you trusted a bad bank and collected a lot of toxic or worthless assets in your investment portfolio.

Bad deals reduce consumers’ wealth and welfare. Bad deals result either from deceptive claims or unfair commercial practices or taking advantage of the asymmetric distribution of information, on the supply side. On the other hand, bad deals are also related to consumers’ ill defined preferences, to information overload, to overconfidence, for instance, in the competence of financial advisers, to the misconception of future benefits and risks.

OECD was one of the first prominent agents of Behavioural Economics [cf. OECD 2007, p.8 et passim], others followed. Behavioural economics is very much in line with the concept of “evidence-based consumer policy” in the European Union.

The European Consumer Commissioner, Meglena Kuneva, for example, at a Hearing on the 3rd of September announced in her speech that her directorate had “launched a study to better understand the drivers of consumer choice in financial markets. The study will … draw from the research of behavioural economics, a branch of economics that examines the behavioural and emotional factors in the decision-making process of consumers.

The study will consider the response of consumers to simplified and standardised (financial – H. St.) products” (Kuneva, M. 2009, p.5).

On the micro-economic level, the focus of consumer protection policy includes both financial products and financial services, such as financial advisers, who are in a way the intermediaries between the world of finance transactions and the real economy represented by investors and borrowers.

By the crash of Lehman-Brothers in September 2008, one year ago, about 50,000 German investors (consumers) did lose their entire shares set aside as provisions for old age.

The estimated sum of the loss is about 700 million euros. This case is particularly instructive, because it has brought the competences reliability and trustworthiness of financial advice under scrutiny. The financial advisers of Citibank, German Savings Bank and other banks advised especially aged consumers around 60 to switch their savings from the less profitable but secure accounts to high profitable, but difficult to understand and very risky Lehman certificates. The consumers trusted their financial advisers just as they trust in their doctors, neither understanding the risk information nor being adequately informed about the risks. For a (too) long time in the EU and in Germany, the crucial role of the financial intermediaries was widely ignored and by

ISSN 0323-262X ISSUE 3, ČÍSLO 3/2009

such the financial advice service escaped through the patchy regulatory framework of the EU and most member states. Consumers in most cases are not fully financially literate and, in consequence, over-confident to a familiar person at the bank counter, who invites them to a cup of coffee in order to chat about a re-allocation of their assets.

In Germany research launched by the Minister of Consumer Protection found out that about 20 to 30 billion euros were lost by inadequate or biased financial advice.

This is not a special result of the crisis, but a general observation. German consumers terminate about 50-80% of their long-term investments, for instance life insurances, earlier than contracted. The optimism at the beginning, the enthusiasm of the bank adviser who did not pay enough attention to "bad luck" situations like divorce, unemployment, sickness, and other adverse things that can happen during 25 years.

According to EU Commissioner Kuneva the core problems are:

"First, bank employees and intermediaries themselves often lack a sufficient understanding of the products they sell. Second, advisers often are subject to an inherent conflict of interest which results from their remuneration structures. If an adviser earns the highest fees for selling those products that are very profitable for the bank, one should not be surprised that, in the end, the adviser favours the (short-term revenue – H.S.) interests of the bank (and himself– H.S.) over the (long term security requirements – H.S.) interests of the consumer" [3, p.4].

The German Consumer Organisation, *vzbv* underpinned Kuneva's initiatives on the national level. Recently the executive director of *vzbv*, Gerd Billen, briefed the new government what the consumers waited for.

"From the consumers' perspective, the reform of the financial markets is the most important issue. The new government must ensure that all financial products are put under firm supervision.

There must be no more unregulated product on the relevant market. Consumer protection must be explicitly integrated into the mission of the Federal Finance Supervisory Authority (BaFin) and the National Central Bank (Bundesbank). In addition, the qualifications and competences of financial intermediaries and advisers must be improved. And, for every financial product – from Funds to Savings Bonds – a product – information – which notices as precisely as possible the costs and risks of that product, must be made available. If necessary it should be implemented by law" [1, interview].

At the end of my speech I would like to invite you to a "tour d'horizon", during which some problems the designated government coalition of the Christian Democrats (CDU/CSU) and the Liberals (FDP) is facing, are spotted.

After the enthusiasm of the first days after the election, the public opinion realizes, that the "winner gets it all", gets political power and positions, but also gets the enormous debts, the unsolved problems of the crisis, particularly those endangering the labour markets. The negotiations on the details of the coalition treaty are still going on, today. And yet, some major conflicts are obvious, mostly in the area of internal affairs, volume and timing of the tax reductions promised, reforms on the health-system, etc. The Liberals claim the abolition of minimum wages and the liberalisation of dismissal protection and other issues of employment protection. The Christian Democrats, in contrary, fear to be labelled as "neo-liberal" and provoke resistance of the trade unions, the support of which they badly need.

In crisis management the Liberals are sceptical against the allocations of means from the recovery programmes to big companies, systemic relevant or not, they prefer to support small and medium enterprises.

In EU-policy nothing new: business as usual. This is also true of foreign politics.

Given the fragility of the recovery on the national level, very well aware of the benefits provided by the EU; given the uncertainty of global readjustments and redistribution of market power; given the awareness that the systemic risks of the crisis include financial, economic and political risks (people not voting or voting for radical leftist or rightist political parties).

Given all this and more, I am convinced that the coalition treaty of the designated government is going to define the objectives and precautionary principles and smart instruments of "macro-prudential social and economic governance" that fits into the European Union.

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