

Human Trafficking: Germany Needs to do More to Protect Victims



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Human Trafficking: Germany Only Average When It Comes To Protecting Victims

by Seo-Young Cho

According to the United Nations, over 2.45 million people are victims of human trafficking, and the number of unrecorded cases is also believed to be significant. Therefore, many countries have increased their efforts to combat trafficking and to protect the victims. DIW Berlin recently updated the 3P Anti-Trafficking Policy Index which facilitates an international comparison of government policy efforts in three areas: prosecution, (victim) protection, and prevention. The update of the Index now covers the period from 2000 to 2011. On a worldwide scale, countries have generally shown high commitment towards implementing prosecution policies, and the most significant improvements have been observed in preventive efforts. However, many countries fail to ensure the protection of trafficking victims. By international standards, Germany performs well when it comes to prevention and prosecution. However, it has failed to protect the victims of trafficking and, over the past year, this situation has further deteriorated.

Human trafficking is a serious problem, the true magnitude of which is difficult to gauge as many incidences remain unrecorded. According to UN estimates, 2.45 million people are currently victims of human trafficking, of which 1.2 million are children under the age of 18. Europol believes that several thousand people, particularly women and children, are victims trafficked in(to) the EU every year. According to the International Labour Organization (ILO), traffickers make a total annual profit of approximately 31.6 billion US dollars.¹

Over the last decade, in response to the problems of human trafficking, national governments and international organizations have adopted new legislation, including, for example, Protocol to Prevent, Suppress and Punish Trafficking in Persons passed by the UN in 2000.² Since this Protocol came into force, many governments have adopted the standards it sets out and have increased their policy efforts to combat trafficking in persons.

The updated version of the 3P Index³ for 2011 published by DIW Berlin indicates that, over the last decade, the majority of countries made progress when it comes to the prosecution of the perpetrators and prevention of human trafficking and, in 2011, managed to sustain the standards achieved. However, many countries, including European ones, continued to fall short when it comes to implementing adequate victim protection measures. In Germany, although efforts are being made to prosecute traffickers and prevent the crime of human trafficking, protection for the victims of trafficking remains insufficient (see Box 1).

¹ P. Belser, „Forced Labour and Human Trafficking: Estimating the Profits,” WP42 (Geneva: International Labour Office, 2005).

² Palermo Protocol, „Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children, Supplementing the United Nations Convention Against Transnational Organized Crime” (2003), www.un.org.

³ The 3P Index was originally developed by the University of Göttingen as part of the EU project „Indexing Trafficking in Human Beings.” It is now updated annually by DIW Berlin. See background paper on the Index by S. Cho, A. Dreher, and E. Neumayer, „The Determinants of Anti-Trafficking Policies – Evidence from a New Index,” *Scandinavian Journal of Economics* (forthcoming: 2012).

Box 1

Human Trafficking and Anti-Trafficking Measures in Germany

The United Nations has classified Germany as one of the major destination countries with a very high influx of human trafficking victims.¹ According to the German Federal Criminal Police Office (BKA), between 600 and 1,200 victims are identified every year and between 300 and 500 cases of human trafficking are investigated.² Sexual exploitation in the form of prostitution is by far the most frequently occurring case. Others include, for example, trafficking in persons for labor exploitation in the form of domestic or agricultural work, as well as exploitation in smaller factories, snack bars, or restaurants. According to the BKA, 95 percent of all cases investigated in 2010 were sexual exploitation.³ Over the last decade, Germany has made considerable efforts to combat human trafficking but, recently, its victim protection measures have been lagging behind. Germany received the highest score (5) in the prevention policy area, and it has made similarly distinct policy efforts with regard to prosecution, giving it a score of 4 in this area. However, this year, Germany only received a "modest" score of 3 for victim protection. The reason for this is that victims of human trafficking are often not recognized as such, which, in turn, means that they are not protected, for example, by being granted amnesty as prescribed in the United Nations Protocol. The deterioration in Germany's country assessment since 2010 coincides with the change in government constellation in 2009—from a coalition of the Christian Democratic Union (CDU) and the Social Democratic Party (SPD) to a coalition of the CDU and the Free Democratic Party (FDP). The SPD demonstrated a strong commitment to victim protection during their term of office—particularly by granting the right of residence to victims of human trafficking.⁴ In June

¹ United Nations Office on Drugs and Crime, *Trafficking in Persons: Global Pattern* (Vienna: 2006).

² BKA, *Lagebild Menschenhandel* (Human Trafficking Situation Report, Wiesbaden: 1999 to 2010).

³ BKA, *Lagebild Menschenhandel* (Human Trafficking Situation Report, Wiesbaden: 2010).

⁴ www.bundestag.de/presse/hib/2012_06/2012_319/03.html.

Table

The 3P Evaluation for Germany

Index

	Prosecution ¹	Protection ¹	Prevention ¹	Aggregate 3P Index ²
2000	5	4	4	13
2001	5	5	5	15
2002	5	5	5	15
2003	5	5	5	15
2004	5	5	5	15
2005	5	5	5	15
2006	5	5	5	15
2007	5	5	5	15
2008	5	5	5	15
2009	5	5	5	15
2010	5	3	5	13
2011	4	3	5	12

¹ 1 is the lowest and 5 the highest score; 4: strong, 3: modest, 2: limited efforts.

² Sum of all three components.

Source: Cho, Dreher, and Neumayer, *Determinants of Anti-Trafficking Policies—Evidence from a New Index*, *Scandinavian Journal of Economics* (forthcoming: 2012).

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2012, the German Bundestag (lower house of German parliament) ratified the Council of Europe Convention on Action against Trafficking in Human Beings that was adopted in 2005. Proposals from the SPD and The Left (Die Linke) to improve victim protection, made in the course of the ratification of the Convention, were rejected by a Bundestag majority. Independent experts invited in the run-up to the ratification in March also called for better victim protection.⁵

⁵ Official minutes of the 187th session of the German Bundestag on Thursday 28 June, 2012, www.bundestag.de/dokumente/protokolle/amtlicheprotokolle/2012/ap17187.html.

Box 2

Definition of Human Trafficking

According to the UN Protocol,¹ human trafficking is defined as "the recruitment, transportation, transfer, harbouring or receipt of persons, by means of the threat or use of force or other forms of coercion, of abduction,

¹ Palermo Protocol, "Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children, Supplementing the United Nations Convention Against Transnational Organized Crime," (2003), www.un.org.

of fraud, of deception, of the abuse of power or of a position of vulnerability or of the giving or receiving of payments or benefits to achieve the consent of a person having control over another person, for the purpose of exploitation. Exploitation shall include, at a minimum, the exploitation of the prostitution of others or other forms of sexual exploitation, forced labour or services, slavery or practices similar to slavery, servitude or the removal of organs."

Combating Human Trafficking No Easy Task

To date, the UN Protocol to Prevent, Suppress and Punish Trafficking in Persons is the most important legal instrument in international fight against human trafficking. The Protocol both defines the term "trafficking in persons" and outlines the necessary policy measures (see Box 2). Furthermore, the Protocol identifies three prime policy areas: criminal prosecution of traffickers, prevention of trafficking in persons, and the protection of the victims of human trafficking. These 3P measures (prosecution, protection, and prevention) are designed to reduce the crime of trafficking and protect the human rights of the victims.

However, it must be borne in mind that successful efforts to protect victims may actually result in an increase in human trafficking. If victims of trafficking are granted amnesty and a legal right of residence in the destination country where they would otherwise be regarded as illegal immigrants, this could make human trafficking an attractive option. In other words, protection of victims may be interpreted as a signal for a liberal immigration policy which might, in turn, result in more illegal immigration inflows, increasing the pool of potential victims of human trafficking.⁴

Thus, a conflict in policy objectives emerges.⁵ Countries with more restrictive immigration policies prioritize preventing illegal immigration at the expense of pro-

tecting human trafficking victims and defending their human rights. These countries are reluctant to implement victim protection programs while pursuing strict border security policies and rigorous prosecution of traffickers. Furthermore, the victims are sometimes even prosecuted for crimes—violation of immigration or prostitution laws, for example—resulting directly from the fact that they have been trafficked, although such penalties are prohibited by the UN Protocol.⁶

3P Index Evaluates Anti-Trafficking Policy Performance

In order to assess anti-trafficking policy efforts, the 3P Index is developed to evaluate policy performance in up to 185 countries for the period from 2000 to 2011 in the three main policy dimensions: prosecution, protection, and prevention.

Prosecution is evaluated on the basis of six policy indicators:

1. Adoption of anti-trafficking laws prohibiting trafficking in human beings,
2. Adoption of child trafficking laws,
3. Application of other relevant laws,
4. Level of penalty,
5. Law enforcement, and
6. Collection of crime statistics.

The evaluation focuses on the adoption of relevant anti-trafficking laws as well as the implementation of the-

⁴ S. Cho and K. C. Vadlamannati, "Compliance with the Anti-Trafficking Protocol," *European Journal of Political Economy*, no. 28 (2012): 249-265.

⁵ B. Simmons and P. Lloyd, "Subjective Frames and Rational Choice: Transnational Crime and the Case of Human Trafficking," mimeo, Harvard University (2010).

⁶ U.S. Department of State, *Report on Trafficking in Persons* (Washington D.C.: 2012).

se laws. This means that indicators 1 and 5 carry particular weight in the country assessments.

Victim protection is evaluated on the basis of nine indicators:

1. Amnesty for victims,
2. No self-identification required as a prerequisite for recognition of victim status,
3. Provision of legal assistance for victims,
4. Granting of residence permits,
5. Provision of accommodation,
6. Provision of medical assistance,
7. Provision of job training opportunities,
8. Provision of rehabilitative support, and
9. Provision of assistance for repatriation to the respective countries of origin.

The most important factor here is that victims are not prosecuted.

The evaluation of the final area, preventive policy, is based on seven indicators:

1. Implementation of public campaigns to raise anti-trafficking awareness,

2. Training executive and judicial personnel with providing information on the specific circumstances of human trafficking,
3. Promotion of information exchange among different governmental authorities,
4. Monitoring of borders, train stations, and airports, etc.,
5. Adoption and implementation of national action plans for combatting trafficking in persons,
6. Promotion of cooperation with NGOs and international organizations in the country,
7. Promotion of cooperation with other governments.

All 3P Index indicators selected are in line with the provisions of the UN Protocol.

The coding is based on data from the country reports published by two different organizations: the U.S. Department of State's annual Trafficking in Persons Reports (2001 to 2012) and the Trafficking in Persons: Global Patterns reports published by the United Nations Office on Drugs and Crime (UNODC) for 2006 and 2009. The qualitative information from these reports is converted into a 5-point scale for each policy area, based on the coding standard,⁷ where score 5 represents complete fulfillment of all indicators of each policy area and 1 signifies no efforts made in this area.

As can be seen from the table, between 2000 and 2011 global anti-trafficking efforts have been increasing in all three policy dimensions. The greatest successes were achieved in the prosecution policy area, where the average score increased from 2.89 in 2000 to 3.70 in 2011. For preventive measures, the average score for all countries increased from 2.49 in 2000 to 3.37 in 2011, which means that the greatest progress has been made in this area in absolute and relative terms. The development of victim protection policy, on the other hand, is clearly lagging behind with a slow increase from, on average, 2.25 points in 2000 to 2.73 points in 2011.⁸

Table

Global Anti-Trafficking Measures

Average scores

	Prosecution ¹	Protection ¹	Prevention ¹	Aggregate 3P Index ²	Number of countries evaluated
2000	2.89	2.25	2.49	7.53	81
2001	2.97	2.47	2.79	8.23	90
2002	3.12	2.76	3.24	9.12	119
2003	3.33	2.67	2.98	8.98	136
2004	3.39	2.73	3.12	9.24	154
2005	3.55	2.80	3.19	9.54	159
2006	3.61	2.77	3.14	9.52	164
2007	3.69	2.72	3.06	9.47	171
2008	3.73	2.81	3.22	9.76	176
2009	3.75	2.80	3.28	9.83	177
2010	3.65	2.82	3.40	9.87	184
2011	3.70	2.73	3.37	9.80	185

¹ 1 is the lowest and 5 the highest score; 4: strong, 3: modest, 2: limited efforts.

² Sum of all three components.

Source: Cho, Dreher, and Neumayer, *Determinants of Anti-Trafficking Policies- Evidence from a New Index*, *Scandinavian Journal of Economics* (forthcoming: 2012).

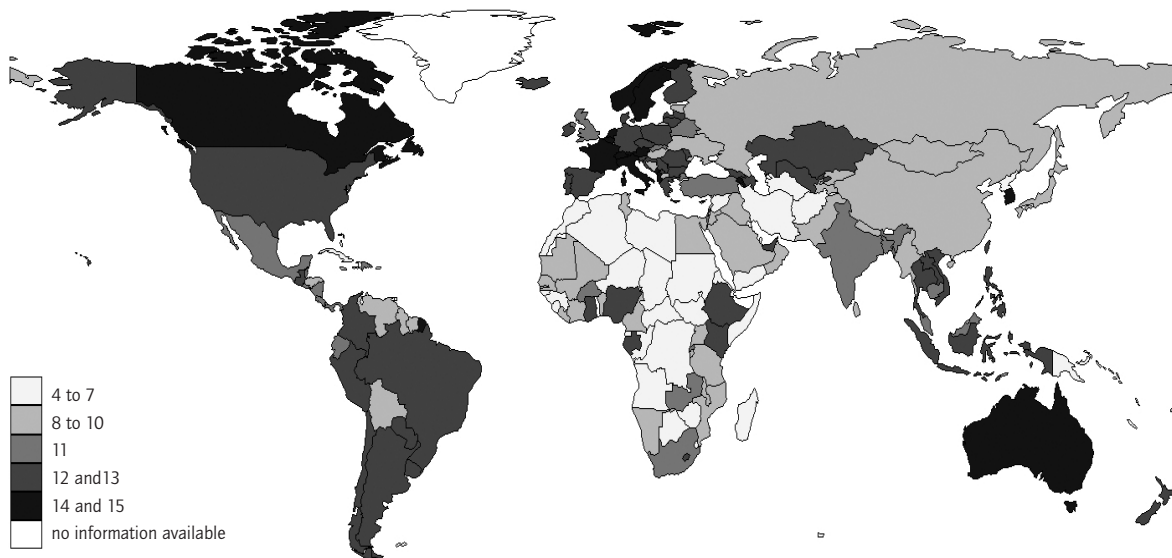
⁷ For a detailed explanation of the Index, see the section headed „3P Index / Coding Guideline“ at www.economics-human-trafficking.org.

⁸ If we examine the developments in all 81 countries that have been evaluated since the Index assessments began in 2000, this trend becomes even more evident. In 2011, the overall score for this group of 81 countries is 4.81 points for prosecution policy and 2.94 for victim protection. The score for prevention is 3.76 points. In the overall assessment, the score improved from 7.58 in 2000 to 10.88 in 2011. This development shows that countries with more effective anti-trafficking policies also have better available data as they were already able to be assessed in 2000 based on this data.

Figure 1

The 3P Index for 2011

Scores of 3 to 15



Source: Cho, Dreher, and Neumayer, *Determinants of Anti-Trafficking Policies. – Evidence from a New Index*, *Scandinavian Journal of Economics* (forthcoming: 2012).

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Canada, Australia, and some European countries are exemplary in combating human trafficking.

Combating Human Trafficking in 2011: Deficits in Victim Protection

There was a slight decline in overall anti-trafficking policy efforts in 2011 as compared to the previous year. A country's overall anti-trafficking performance is based on the aggregate of all three components of the 3P Index. The resulting score is, therefore, between three (no efforts) and 15 (all objectives fully achieved). The global average score of this Index was 9.80 in 2011 and thus lower than in 2010 when the corresponding figure was 9.87. This development is mainly attributable to the declining efforts in victim protection, which offset the successes in prosecution. The development of prevention policy is also slightly negative, but this is considerably less significant than that of victim protection.

Figure 1 shows the global anti-trafficking measures in 2011. It is clear that Europe and the Americas are in the lead (score twelve or higher) (see table in the Appendix), while in many parts of Asia and Africa the scores are significantly lower and policy efforts are inadequate (seven or lower) in some countries. Three countries—Italy, Sweden, and the Netherlands—received the maximum scores for all three policy areas. Not only do these three

countries have strict anti-trafficking policies in place with high numbers of convictions, they are also at the forefront in identifying victims and provide them with the necessary legal and social support, including amnesty. Conversely, eight countries—Libya, Micronesia, Iran, Eritrea, North Korea, Somalia, South Sudan, and Madagascar—received the lowest score (4). All three leading countries are in Europe and they are all major destinations for human trafficking. Consequently, their increased efforts may be interpreted as a policy reaction to the growing influx of trafficking victims. The high score awarded for victim protection here is noteworthy, however, since high victim protection could have a counter-effect on reducing human trafficking inflows as outlined above. The countries at the other end of the spectrum (worst performers) are predominantly states without functioning governments, or with only very weak governments, and those suffering from political unrest which, therefore, do not perceive human trafficking to be a major problem.⁹

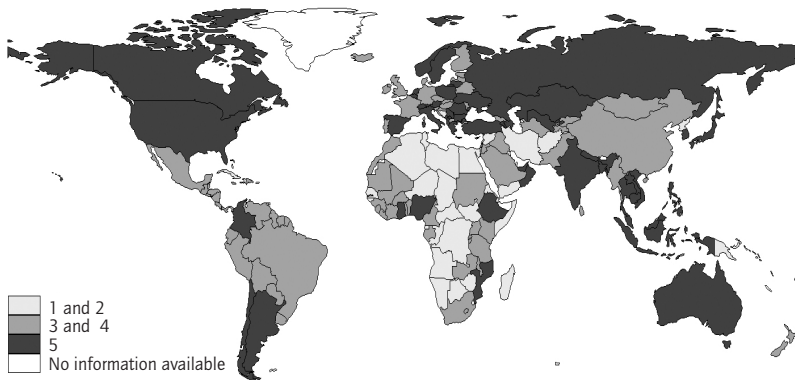
⁹ U.S. Department of State, *Report on Trafficking in Persons* (2012).

Figure 2

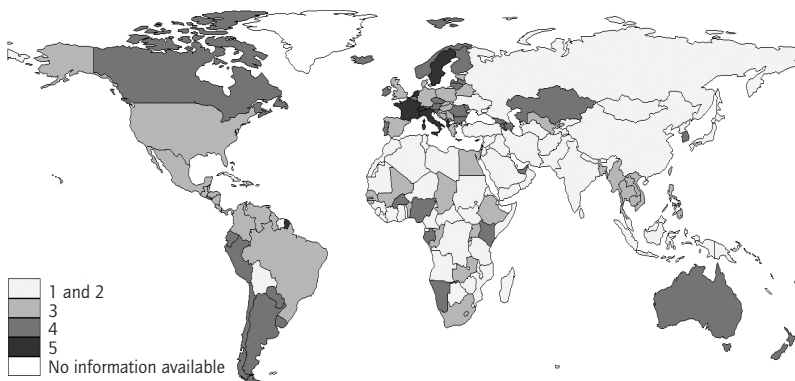
Prosecution, Protection, and Prevention Policies 2011

Scores from 1 to 5

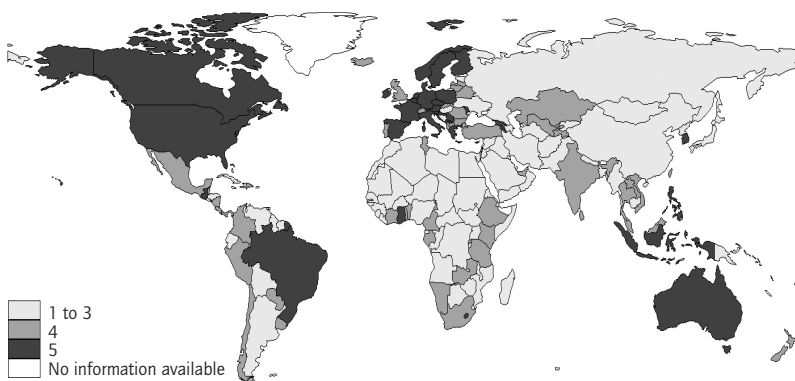
Prosecution



Protection



Prevention



Source: Cho, Dreher, and Neumayer, *Determinants of Anti-Trafficking Policies- Evidence from a New Index*, *Scandinavian Journal of Economics* (forthcoming: 2012).

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Figure 2 shows the developments for 2011 in different regions for each of the three policy areas individually. In most parts of the world, governments are concentrating their efforts on improving prosecution, which is reflected in a respectable average score of 3.70. This is due to the fact that 157 out of 185 countries evaluated have adopted direct or indirect anti-trafficking legislative measures. Enforcement of this legislation remains relatively weak, however. Only in a third (66) of all countries were a substantial number of traffickers charged and convicted, while very few sentences were passed elsewhere. In some countries, such as Germany, for instance, despite a high number of criminal cases, most of these result in a suspended sentence. Therefore, Germany has dropped from score five to four for prosecution this year,¹⁰ while in countries such as Italy or the Netherlands, which received the full five points for this policy area, human traffickers face prison sentences—the average duration of 21 months in the Netherlands and 6.5 years in Italy.

Victim protection receives the least attention worldwide. The average score of 2.73 shows that efforts in this policy dimension generally leave much to be desired and they are extremely limited in some countries. Even in western Europe, where there is otherwise a strong commitment to combating human trafficking, victim protection is lagging behind the other two policy areas. Only five countries in Europe fully comply with all the requirements (France, Italy, the Netherlands, Switzerland, and Sweden), in contrast to some of their neighbors who blatantly penalize victims and were consequently ranked in third place or lower (Denmark, Germany, Greece, Luxembourg, Spain, Poland, and the United Kingdom).

Only 73 countries worldwide ensure that victims are not punished, while in 99 countries victims clearly face penalties—imprisonment, fines, or deportation.¹¹ This is a flagrant violation of victims' rights as guaranteed by the UN Protocol and in many cases also by national anti-trafficking legislation.

The main reason behind convicting victims lies in the difficulty in clearly identifying them as victims of human trafficking. In order to determine whether an illegal immigrant is a victim of human trafficking, it is necessary to use systematic identification criteria which must be in accordance with the standards set out in the UN Protocol. In most countries, however, these criteria are not appropriately exercised and alleged victims are not scrutinized more closely, but simply immediately

With regard to victim protection and prevention, there is room for improvement in many countries.

¹⁰ See the most recent national report for Germany in the annual report on the human trafficking situation, published by the U.S. Department of State, *Report on Trafficking in Persons* (2012).

¹¹ For 19 countries, the situation is unclear or no information is available.

classified as illegal immigrants and consequently deported or detained in custody (if not imprisoned). These situations show that governments often do not meet their obligation to protect human rights of victims, but rather simply view cases of human trafficking as a violation of immigration laws. The general slow progress and recent regression in victim protection—in contrast to continued success in prosecution—suggest that governments have little interest in prioritizing defending human rights of trafficking victims.

Finally, it is worth noting that the development of prevention policies follows a similar pattern to prosecution. Although at 3.37 the average score is slightly lower than that of the previous year, it still indicates a high level of commitment by governments. Countries in Europe and the Americas demonstrate greater efforts here than those in Asia and Africa.

Conclusion

Overall, it can be concluded that global anti-trafficking measures have led to conflicting developments. On the one hand, many countries are making consistent progress in the prosecution policy area, while at the same time showing a low level of commitment to victim protection and stagnating as far as prevention policy is concerned. Global anti-trafficking developments in 2011 indicate that there is still a long way to go until human beings, irrespective of their origin, are protected from inhumane treatment.

Countries such as Germany should therefore step forwards their efforts to protect victims and not only look at human trafficking from the point of view of immigration policy but also ensure that fundamental human rights of victims are respected. Here, it is particularly important to recognize victims of human trafficking as victims so as to be able to protect them accordingly.

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SEVEN QUESTIONS TO SEO-YOUNG CHO

»Germany is one of the major destinations for human trafficking«

Criminal Police Office, approximately 600 to 1,200 victims are identified every year. But that is just the tip of the iceberg. The true magnitude of human trafficking in Germany is still unknown.

1. Dr. Cho, human trafficking is an international problem, and the latest 3P Index on this subject has recently been published. What is the purpose of this Index? Human trafficking is a major global problem. The United Nations adopted the Convention against Transnational Organized Crime and its Protocol to Prevent, Suppress, and Punish Trafficking in Persons, especially Women and Children in 2000, the so-called Anti-Trafficking Protocol. The 3P Index aims to evaluate governmental efforts to tackle human trafficking. The 3Ps stand for prevention, prosecution, and protection, in other words, the three main policy dimensions in combating human trafficking.
2. What is the global extent of human trafficking? The United Nations estimates that there are currently approximately 2.45 million victims of human trafficking worldwide, and about half of them are children under the age of 18.
3. What are the causes of the problem? The countries sending human trafficking victims are mainly developing countries. The countries receiving human trafficking victims are normally developed countries. So basically, this is a problem caused by income disparity between the countries of origin and destination. The countries from which trafficking victims originate are not necessarily the world's poorest. Frequently, they are Eastern European countries, former Soviet states, and also some Asian countries. What they have in common is geographical proximity to developed countries. The reasons behind human trafficking are largely rooted in the income disparities between countries and their geographical proximity.
4. What role does Germany play in human trafficking? The United Nations has categorized Germany as one of the major destination countries with a very high inflow of human trafficking. According to the German Federal
5. What are governments doing to combat the problem? Germany, for example, has anti-trafficking legislation, particularly in connection with sexual and labor exploitation. The perpetrators are investigated and prosecuted. This applies especially to those who recruit people in their home countries and traffic them to Germany. Efforts are also being made to prevent human trafficking. These include border controls, checking travel documents, international exchange of information, and public awareness-raising campaigns.
6. What are the most serious problems in combating human trafficking? Worldwide, and also in Germany, prosecution policies to combat human trafficking have been significantly improved. But the main problem arises with victim protection policy, granting them amnesty for illegal acts they have committed as a direct consequence of the fact that they have been trafficked. Victim protection policy is clearly lagging behind the other efforts to combat human trafficking.
7. Why isn't more being done to protect the victims? Basically, governments see human trafficking as an illegal immigration issue so their main objective is to curtail this illegal movement of people. But victim protection have a different policy objective. It aims to guarantee protection and amnesty and provide humanitarian assistance for those who have been trafficked and are residing in the destination country. In this case, the aim is not necessarily to reduce human trafficking flows into the country. It is rather a matter of providing basic human rights for the victims of human trafficking. Consequently, there is a potential conflict between the two different policy objectives: reduction of illegal migration vs. victim protection.

Interview by Erich Wittenberg.

Need for Reform of EU Banking Regulation: Decoupling the Solvency of Banks and Sovereigns

by Johannes Pockrandt and Sören Radde

Recent developments in Ireland, Greece, and Spain have shown that sovereign debt crises endanger the solvency of domestic banking sectors, while banking crises in turn endanger the solvency of the domestic sovereigns. This diabolic loop between government and bank solvency is exacerbated by the home bias in banks' government bond portfolios, that is, banks' excessive exposure to domestic sovereign debt. Neither current European banking regulation nor plans to implement Basel III in the EU take this interdependence into account. Both treat government bonds of Member States as risk-free, highly liquid assets and exclude them from capital requirements and large exposure regimes. Future EU banking regulation should aim to remedy this. Consequently, EU government bonds could be given risk weights specific to each country. At least in the Euro area, however, a strict limitation of bank investments to cross-border sovereign debt without country-specific risk would be more effective. The advantage of this reform is that it could be integrated into a variety of scenarios for future government refinancing in the Euro area.

On October 20, 2009, less than two weeks after the change of government in Greece, the new finance minister announced a deficit of at least twelve percent for the current fiscal year. The Greek government was thereby seriously infringing on the deficit limit for European Member States. On April 23, 2010, it made an official request for financial aid and loan guarantees from the European Union (EU) and the International Monetary Fund (IMF) totaling 110 billion Euros. On March 9, 2012, the majority of Greece's private creditors agreed to a partial haircut. Subsequently, the four major Greek banks—National Bank, Eurobank, Piraeus, and Alpha—announced losses of over 28 billion Euros. The Greek government had brought the Greek banking sector to the brink of collapse.

On March 31, 2010, Anglo Irish Bank announced the biggest loss in Irish corporate history. The Irish banking sector's former flagship had run aground, despite billions in capital injections from the Irish government. On August 10, 2010, the European Commission approved temporary government aid worth ten billion Euros. By the end of 2010, Anglo Irish Bank had received three times this amount from government, Allied Irish Bank more than ten billion Euros, and Irish Nationwide Building Society over five billion. On November 21, 2010, Ireland asked for assistance from the EU and IMF's Euro rescue fund. Bailing out its domestic banks cost the country a total of almost 64 billion Euros, equivalent to over 40 percent of gross domestic product. The Irish banking sector had brought the Irish government to its knees.

On May 25, 2012, the fourth largest bank in Spain, Bankia, asked its government for 19 billion Euros in financial assistance. So far, Spain has not sought assistance from the European Stability Mechanism. But it does seem increasingly difficult for Spain to break the diabolic loop between banking and sovereign risk.

The Diabolic Loop between Banking and Sovereign Risk

As the aforementioned examples show, the credit risks of sovereign countries and their domestic banking sectors are closely linked and mutually reinforcing. What explains this diabolic loop? The Greek case shows that, banks, as major investors in government bonds, are affected by governments defaulting on their debt through direct losses. Long before an actual default, difficulties in government refinancing already affect the refinancing conditions in the domestic banking sector.¹ Banks use long-term government bonds in particular as collateral for short-term loans with which they cover their liquidity needs. Concerns among investors and rating agencies that governments will not be able to fully pay off their debt lead to declining credit ratings of government bonds. Consequently, a haircut is applied to government bonds in refinancing operations which reduces their collateral value. Haircuts are also applied by the European Central Bank (ECB) when lending to commercial banks as part of their short-term main refinancing operations (MROs) and longer-term refinancing operations (LTROs).² In short, downgrading government bonds reduces the volume of secured loans and, therefore, has an adverse effect on short-term refinancing options for banks. Thus, risks arising from banks' maturity transformation increase sharply. A lower government rating may also result in rating downgrades for domestic banks. First, government guarantees for individual institutions or specific liabilities in the banking sector will lose credibility. Second, a rating downgrade also raises doubts about the ability of a government to save systemic financial institutions from impending insolvency. They no longer benefit from an implicit "bail-out" guarantee. Both effects increase the refinancing costs of unsecured loans. Sovereign debt crises also affect the banking sector through more indirect channels. Rising inflation expectations due to monetization of government debt, the decline in government spending, or tax increases for budgetary consolidation may curb economic activity and reduce the demand for bank-intermediated credit.

Conversely, the risk of bank defaults raises the financing costs of sovereigns. The credit rating of a country is weakened indirectly if the supply of credit falls due to extraordinary strains on the banking sector. A credit crunch, in particular, curbs investment and has a ne-

gative impact on growth, which in turn reduces tax revenue. The fear of a credit supply collapse may even cause governments to directly support their domestic banks through guarantees, capital injections, or by buying up loss-making assets. As the example of Ireland demonstrates, the associated burdens may put a strain on government financing, which in turn increases refinancing costs for the financial sector through the channels described above.

This mutual contagion in the credit risks of banks and sovereigns is reflected in the market for credit default swaps (CDS). In the Euro area, there is a strongly positive correlation between premiums on credit default swaps for five-year bonds issued by banks and their respective countries (see Figure 1). It is worth noting that this correlation exists independently of the country's credit rating—it applies equally to countries particularly affected by the debt crisis on the periphery of the Euro area (Spain, Italy, Portugal, and Greece) and the core countries with high ratings (Germany, Austria, the Netherlands, and France). Although the level of default risk in these two groups of countries—and therefore also in their banking sectors—is decoupled (see Figure 2), government bonds are no safe asset class in either group.

The diabolic loop between banking and sovereign debt crises could have been attenuated had banks diversified their government bond portfolios across Euro area member states. However, banks invest to a large extent in the government bonds of their home countries which increases the interdependence between sovereign and bank risk through the previously described channels.³

Using stress-test data from the European Banking Authority (EBA) from December 2010 we examine this bias towards domestic sovereign debt in greater detail (see Figure 3). The sum of European government bonds held by European banks (EU sovereign debt in the EU banking sector) serves as a reference value. On average, 58 percent of a sovereign's outstanding debt in the EU banking sector were held by the domestic banking sector (home share); in countries such as Germany, the share was even higher (73 percent). However, this measure ignores the fact that large EU countries issue proportionally more debt than small countries. Their share in an EU-wide diversified bond portfolio should correspondingly be larger. Therefore, we adjust the home share by the share of the home country's debt in overall EU sovereign debt held by the European banking sector. The resulting "home bias" measures the bias of the

¹ See M. Davies and Tim Ng, "The Rise of Sovereign Credit Risk: Implications for Financial Stability," BIS Quarterly Review (September 2011).

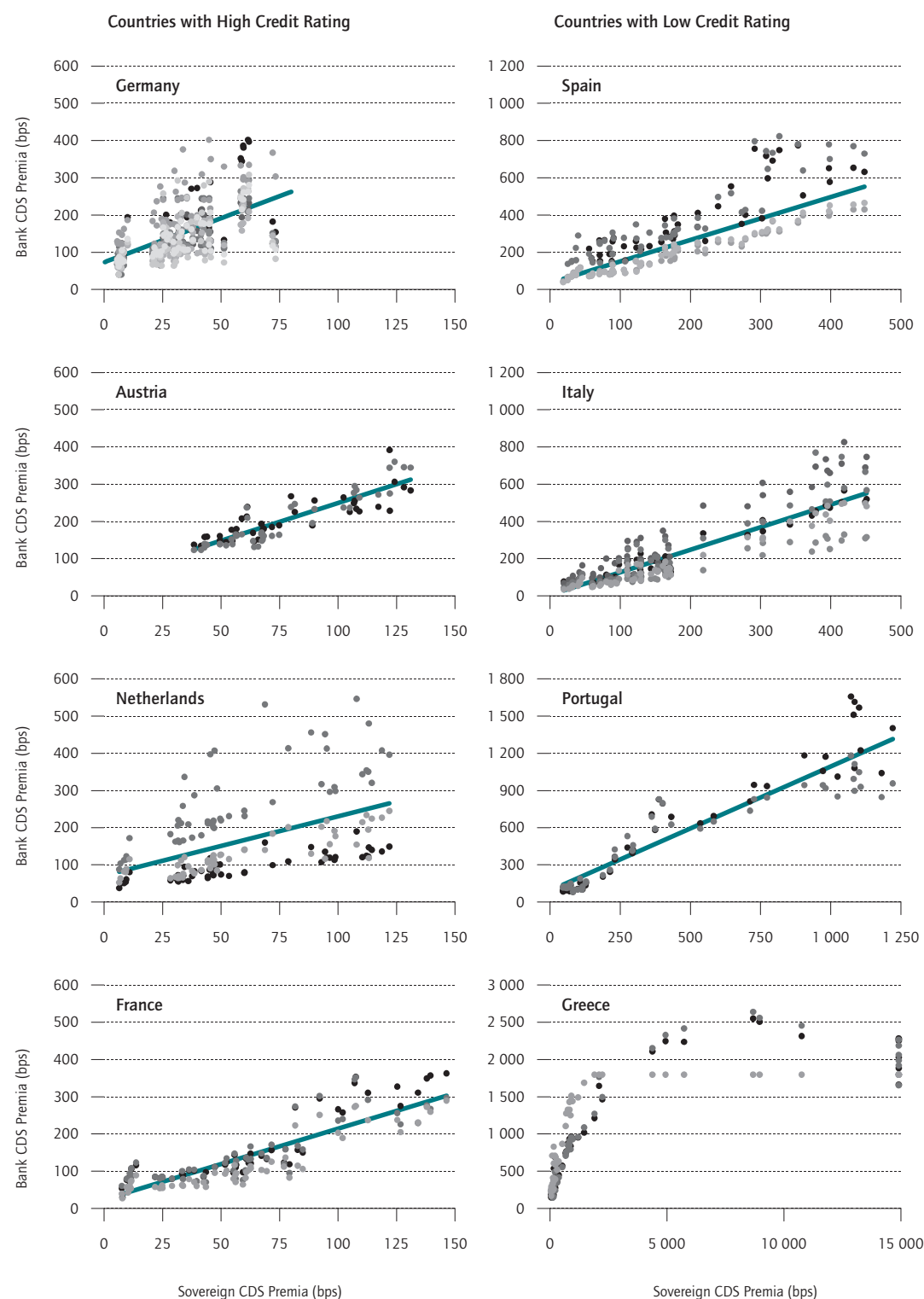
² For more information on ECB haircuts for different asset classes and credit ratings, see http://www.ecb.int/press/pr/date/2010/html/sp090728_1 annex.en.pdf.

³ See S. Merler and Jean Pisany-Ferry, "Hazardous Tango: Sovereign Bank Interdependence and Financial Stability in the Euro Area," Banque de France Financial Stability Review, no. 16 (April 2012).

Figure 1

Correlation between CDS Premia¹ on Sovereign and Bank Bonds

In basis points



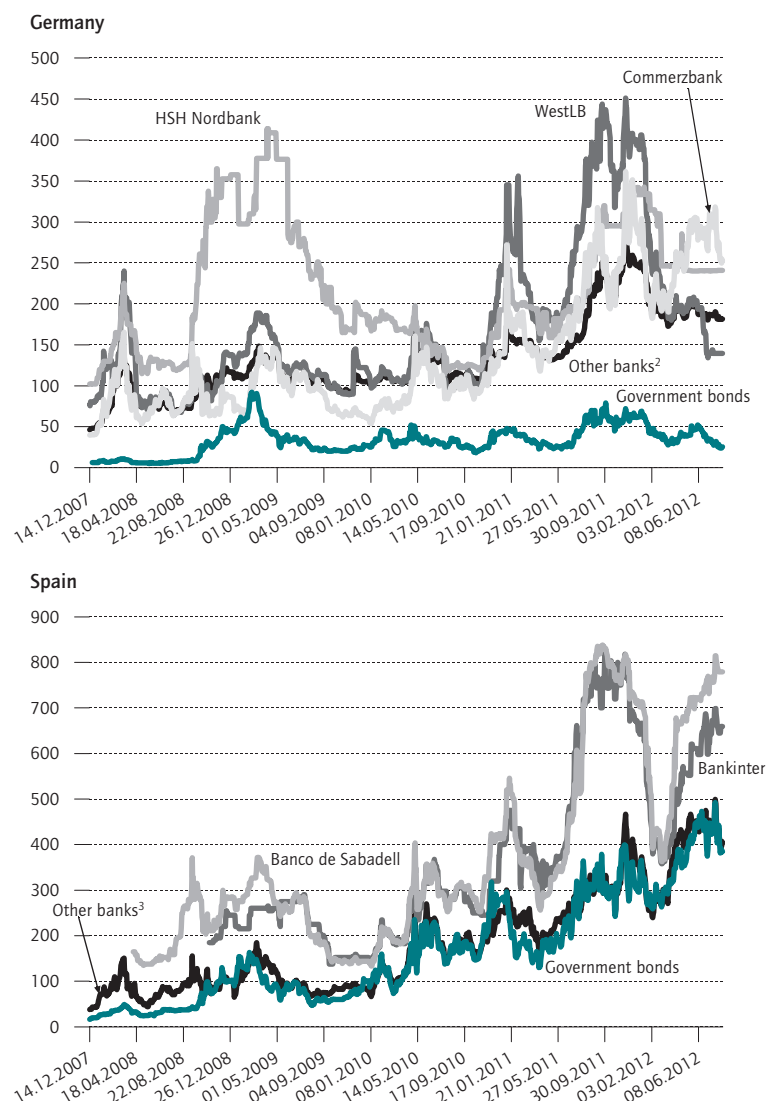
¹ Premia for credit default swaps (CDS) on 5-year bonds of stress-test banks and domestic governments, monthly averages from December 14, 2007 to August 13, 2012.

Source: Datastream; calculations by DIW Berlin.

Figure 2

CDS Premia¹ in Germany and Spain

In basis points



1 Premia for credit default swaps (CDS) on 5-year bonds.

2 Bayerische Landesbank, Deutsche Bank AG, Landesbank Baden-Württemberg, Landesbank Berlin, and Nord LB are combined.

3 BBV Argentaria SA and Banco Santander SA are combined.

Source: Datastream; calculations by DIW Berlin.

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Euro area countries with high and low credit ratings have decoupled in terms of the level of default risks.

European government bond portfolio of a banking sector in favor of its home country. Even this conservative measure puts average excessive domestic government debt in EU banking sectors at 53 percent. In countries with sovereign debt strains such as Greece, Portugal,

Spain, Italy, and Ireland the home bias was significantly above average at over 60 percent; in the core countries, Germany, the Netherlands, France, and Austria, on the other hand, the bias was below average.⁴

Government bond portfolios pose serious risks, particularly for banking sectors that either lack diversification or are poorly capitalized. On average, European banks' exposure to their domestic sovereign amounted to 78 percent of total equity (Tier 1-3).⁵ The exposure-to-equity ratio was highest in Greece with 180 percent (see Figure 4). A haircut of 50 percent at this point would have reduced Greek banks' equity by 90 percent and practically pushed them into insolvency.

The risks incurred due to excessive home bias in government bond portfolios are also reflected in the credit risks, and therefore CDS premia at individual bank-level (see Figure 5).

Sovereign Risk in Banking Regulation

The demonstrable interdependence of government and bank solvency hints at the riskiness of government financing as part of the European financial institutions' business model—particularly in relation to the respective national banking sector. It also points to the need for separating the solvency of central governments from that of domestic banking sectors through adequate regulation, thereby reducing systemic risk, both for the national economy and for the international financial system. Against this background, it is astounding that European government debt is being treated as riskless in both past and currently applicable EU banking regulations, as well as those under negotiation. This is clear in the core areas of European banking regulations for government bonds: capital adequacy rules, the regulation of large exposures, and liquidity requirements.

Capital Requirement Rules

The current EU regulatory framework requires financial institutions to hold a minimum amount of capital for the loans they issue to other financial institutions,

⁴ In the wake of the European sovereign debt crisis, the proportion of foreign government bond buyers decreased in the affected countries. Foreign investors were replaced, in particular, by domestic banks. Political pressure is seen as a major driver of this development. See S. Merler and Jean Pisany-Ferry, "Who's Afraid of Sovereign Bonds?," Bruegel Policy Contribution, issue 2012/02.

⁵ This measure for equity capital is very generous. In the EBA's 2011 bank stress test, only core equity (Tier 1) was recognized as fully loss-bearing. On this basis, exposure to government bonds would have been even greater.

companies, individuals, or governments. An institution should hold enough capital reserves to cope with, inter alia, the financial burden of non-serviced loans or systemic shocks, without directly restricting financing for the real economy. The amount of capital a bank must hold depends on the risk weighting of a loan which is derived from the credit worthiness of the borrower. According to the second EU Capital Requirements Directive (CRD II), eight percent of the loan volume would have to be kept as equity for a risk weighting of 100 percent. However, a risk weight of zero is currently applied to government debt of EU Member States. As a result, European government bonds are considered to be risk-free investment products that require no capital backing.

The capital requirement rules for the European banking sector are based on the Accords of the Basel Committee on Banking Supervision (BCBS) but differ from them in key areas. The Basel II rules allow financial institutions to take two approaches to the risk weighting of government debt. The IRB (internal ratings-based) approach lets financial institutions themselves assess the credit rating of individual governments. There is explicitly no zero weighting in this approach. Rather, the IRB approach requires a meaningful differentiation of risk weights based on the respective credit default risks. However, the standardized approach makes reference to external credit ratings and gives government bonds with high credit ratings a risk weight of zero percent.⁶

The inclusion of Basel II rules into European law was initially implemented in CRD I.⁷ It made a crucial change to the standardized approach to government debt: claims on central governments and the central banks of Member States are, regardless of their rating, assigned a zero risk weight if they are denominated in the local currency and refinanced in that currency.⁸ But large banks generally assess their credit risks according to the IRB approach. Although they too may assign a zero weight to government debt, this is due to another exemption clause: even if exposures to private counterparties are assessed according to the IRB approach, the modified standardized approach may be applied to government bonds. Thus, claims on Member States are systematically privileged in terms of their risk weighting.⁹

⁶ Bonds with AAA to AA- credit ratings are assigned a risk weight of zero percent. A, BBB and BB+ to BB- are given a risk weight of 20, 50, and 100 percent, respectively. Credit ratings below BB- are given a risk weight of 150 percent.

⁷ CRD I is used as a technical term and refers to the recast Banking Directive (2006/48/EC) and the recast Capital Adequacy Directive (2006/49/EC).

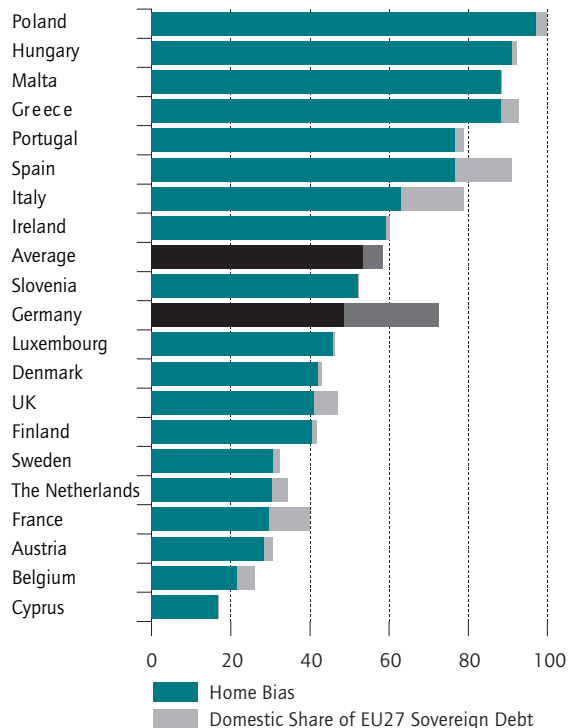
⁸ See Directive 2006/49/EC, Annex I, Paragraph 14 in conjunction with Directive 2006/48/EC, Articles 78-83 and Annex VI, Section 1. 2, Number 4.

⁹ See Directive 2006/48/EC, Article 76.

Figure 3

Home Bias in Government Bond Portfolios

In Home Bias in Government Bond Portfolios



Source: EBA 2011 Stress Test, December 31, 2010; calculations by DIW Berlin.

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Banks invest heavily in domestic government bonds.

In subsequent directives CRD II¹⁰ and CRD III,¹¹ zero weighting remained unaffected, and has also gone unchallenged in ongoing negotiations on the implementation of Basel III rules as part of the CRD IV package.¹² Basel III requires an increase in the capital requirements for banks of up to 10.5 percent of risk-weighted assets. In light of refinancing difficulties in several euro countries on the international bond markets, these stricter requirements are not, however, applicable to government bonds in accordance with implementation proposals by the European Commission, and compromise texts of the European Parliament and the Council of Member States.

¹⁰ See Directive 2009/111/EC.

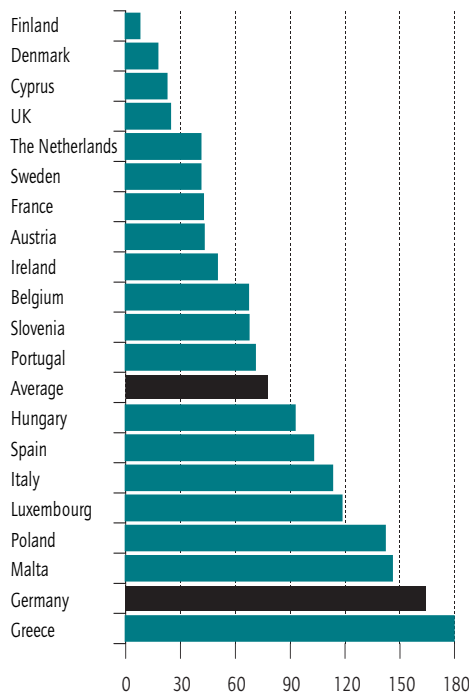
¹¹ See Directive 2010/76/EU.

¹² See COM (2011) 452, Article 109, Paragraph 4.

Figure 4

Exposure¹ to Home Sovereign

In percent



1 Ratio of domestic government bonds to equity. Source: EBA 2011 Stress Test, December 31, 2010; calculations by DIW Berlin.

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Exceptions in large exposure regime allows high exposure to the domestic sovereign.

Large Exposure Regime

The capital requirements for European banks have given them a clear incentive to invest in European government bonds rather than in private securities with similar risk prospects.¹³ This investment behavior is further fuelled by the large exposure regime. Under the existing implementation of Basel II rules in CRD I legislation, a loan from a financial institution to a client or a group of connected clients is considered a large exposure where its value is equal to or exceeds ten percent of the issuing financial institution's own funds.¹⁴ Large exposures are also limited to a maximum of 25 percent of the financial institution's own funds.¹⁵ However, it is at the discretion of Member States to partially or wholly exempt such loans from the large exposure regime, which represent zero-weighted claims on a central go-

vernment or a central bank.¹⁶ Thus, excessive exposure by individual banks to the bonds of individual Member States is allowed. In fact, this is expressed primarily as a significant risk concentration on their home countries, the home bias. Large exposure rules in the Commission's CRD IV proposal have not been changed significantly from CRD I.¹⁷ The exception for zero-weighted government bonds remains.¹⁸ In current negotiations, only the European Parliament has been pushing for the Economic and Monetary Affairs Committee's text to include guidelines that financial institutions should not hold disproportionate amounts of sovereign debt from any specific country. Moreover, the European Banking Authority (EBA) should set guidelines on appropriate levels of exposure.¹⁹ This requirement, however, will be difficult to implement politically. There is clear resistance by various national delegations in the European Parliament as well as in the Council.

Liquidity Rules

The implementation of Basel III rules as part of the CRD IV package will also require European banks to build up short-term liquidity buffers. The Liquidity Coverage Ratio (LCR) was introduced to ensure banks could cover their liquidity needs in a crisis situation by retaining highly liquid assets for more than 30 calendar days. The LCR specifies liquidity required with respect to a stress scenario designed by the Banking Supervisory Authorities and based on systemic and bank-specific shocks. To meet the LCR, assets are divided into two broad categories: highly liquid and less liquid. Government bonds are declared highly liquid and can be included in unlimited amounts in the liquidity buffer. Less liquid assets may only represent up to 40 percent of the buffer. Basically, the Commission's proposal on implementing liquidity requirements calls on financial institutions and investment firms to hold as many different assets as possible to cover their immediate liquidity needs.²⁰ It does, however, not contain specific rules for such differentiation, nor do the compromise texts of Parliament and Council. The introduction of the LCR and, in particular, its specific design at European level is expected to provide a further incentive for European banks to buy and hold European government bonds.

¹³ See D. Schäfer, "Banken: Leverage Ratio ist das bessere Risikomaß," Wochenbericht des DIW Berlin, no. 46 (2011).

¹⁴ See Directive 2006/48/EC, Article 108.

¹⁵ See Directive 2006/48/EC, Article 111, Paragraph 1.

¹⁶ See Directive 2006/48/EC, Article 113, Paragraph 3a.

¹⁷ See COM (2011) 452, Part III, Article 384.

¹⁸ The exception for government bonds also covers the limiting of large exposures to the higher value of either 25 percent of eligible capital or 150 million Euros, as modified in CRD IV. See Directive 2006/48/EC, Article 389, Paragraph 1a.

¹⁹ See: ECON/7/07784, Article 109, Paragraph 4a.

²⁰ COM (2011) 452, Part I, Recital 74.

Breaking the Diabolic Loop

According to the presented evidence, the special regulatory treatment of government debt allows for immense concentrations of risk in the European banking sector. To reduce the likelihood of crises for both banks and governments, a departure from current regulatory practice is urgently needed. In particular, any future reform of EU banking regulations should address the home bias problem.

The systematic downplaying of credit default risk by EU Member States could already be repealed within the Basel regulatory framework. Basel II and III and the IRB approach to assessing credit and market risks already allow for risk weights derived from default risk. These would also directly affect government bonds. Certainly, the exemption rule that allows banks to exclude their government bond portfolios from internal credit ratings and apply a zero risk weighting to them should be removed.²¹ At least in currently over-indebted EU Member States, differentiated risk weights and corresponding capital requirements would create a direct incentive to diversify risks in government bond portfolios.²² At the same time, such measures could send a clear signal: Since government debt within the EU and, in particular, the Euro area would no longer be treated as risk-free, the base for market expectations of an implicit bailout guarantee for these securities would erode.

Skeptics of such risk differentiation argue with good reason that default risk on government liabilities is much more difficult to determine in practice than that of private counterparties.²³ Moreover, it does not represent an effective means of containing home bias in countries with very good credit ratings. An effective complementary measure would be to abolish the special treatment of government debt in the large exposure regime. Limiting government debt exposures to 25 percent of own funds would affect virtually all European banking sectors and include a ceiling for home bias. This would be

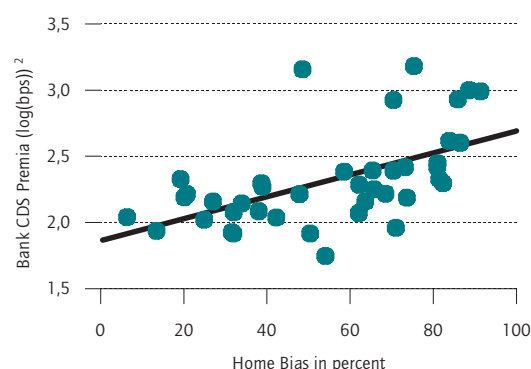
²¹ See H. Hannoun (Deputy General Manager of the Bank for International Settlements), "Sovereign Risk in Bank Regulation and Supervision: Where Do We Stand?," speech held at Financial Stability Institute High-Level Meeting, Abu Dhabi, UAE, October 26, 2011.

²² For a detailed discussion of the impact of different risk weights on the affected economies, see M. Kager, "The Interaction Between Sovereign Debt and Risk Weighting under the CRD as an Incentive to Limit Government Exposures," in *The Interaction Between Sovereign Debt and Risk Weighting Under the Capital Requirements Directive (CRD) – as an Incentive to Limit Government Exposures* (Policy Department Economic and Scientific Policies, European Parliament, 2010).

²³ See B. Frohn, "The Interaction between Sovereign Debt and Risk Weighting Under the Capital Requirements Directive (CRD)," in *The Interaction Between Sovereign Debt and Risk Weighting Under the Capital Requirements Directive (CRD) – as an Incentive to Limit Government Exposures* (Policy Department Economic and Scientific Policies, European Parliament, 2010).

Figure 5

Home Bias and Bank Risk¹



¹ Correlation between premia for credit default swaps (CDS) on 5-year bonds and the home bias of the respective stress-test bank.

² Basis points as logarithmic function.

Sources: EBA 2011 Stress Test, December 31, 2012, Datastream; calculations by DIW Berlin.

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Distortion of government debt portfolios towards the home country increases default risk of individual banks.

more in line with the spirit of the European Parliament's call to limit exposures to individual countries.

Deeper intervention into the government bond portfolios of European banks might successfully separate sovereign and bank risk in the EU. Banks could be forced to regionally diversify their portfolios through direct controls. Thus, the volume of claims on domestic central government and subsidiary administrative levels could be kept specifically below the large exposure regime, keeping home bias in check. A supranational institution such as the EBA should monitor compliance with these requirements to ensure the banks of all Member States are treated equally, which is vital, not least for maintaining the idea of a European internal market. However, such an approach would probably involve considerable bureaucratic effort.

The risk of twin crises in individual single-currency countries could be prevented more effectively if only government bonds without country-specific risk were recognized as low-risk and highly liquid assets. The crucial factor would be that these investments are issued jointly by all Member States. Joint liability would, however, not be a necessary condition. Such commonly issued but not commonly guaranteed bonds would be something like the European Safe Bonds (ESBies).²⁴

²⁴ See Euronomics (September 2012): <http://euro-nomics.com/http://euro-nomics.com/2011/european-safe-bonds/>.

Undoubtedly, commonly guaranteed bonds, such as exposures to the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), Euro Bonds, or Blue Bonds²⁵ would have the advantage of being independent of country-specific risk. However, the benefit of commonly guaranteed bonds would have to be thoroughly weighed up against the costs and possible disincentives of common debt.²⁶ The charm of a regulatory preference for or even a restriction on country-independent bonds in bank portfolios derives mainly from their compatibility with any scenario of public financing in the Euro area which envisages commonly issued government bonds. At the same time, Member States would be deprived of the possibility to push their respective banking sectors towards the financing of current budget deficits.

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JEL: G18, G21, G32

Keywords: Basel III, Sovereign debt, Financial contagion, Diabolic loop

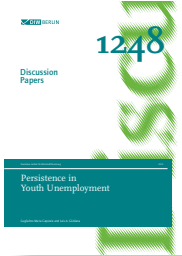
Article first published as "Reformbedarf in der EU-Bankenregulierung: Solvenz von Banken und Staaten entkoppeln", in: DIW Wochenbericht Nr. 42/2012.

²⁵ See Bruegel (May 2010): <http://www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal/>.

²⁶ A detailed discussion of the risks and institutional challenges en route to a debt Community would, however, go beyond the scope of this article.

Discussion Papers Nr. 1248/2012

Guglielmo Maria Caporale ; Luis A. Gil-Alana



Persistence in Youth Unemployment

This paper examines the degree of persistence of youth unemployment (total, male and female) in twenty-four countries by using two alternative measures: the AR coefficient and the fractional differencing parameter, based on short- and longmemory processes respectively. The evidence suggests that persistence is particularly high in Japan and some EU countries such as Spain, Portugal, Ireland and Finland, where appropriate policy actions are of the essence. Specifically, active labour market policies are necessary to prevent short-term unemployment from becoming structural (long-term).

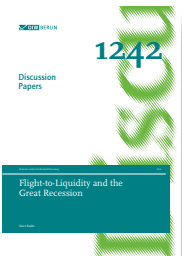
JEL-Classification: C22, J64

Keywords: Youth unemployment, persistence, fractional integration

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Discussion Papers Nr. 1242/2012

Sören Radde



Flight-to-Liquidity and the Great Recession

This paper argues that counter-cyclical liquidity hoarding by financial intermediaries may strongly amplify business cycles. It develops a dynamic stochastic general equilibrium model in which banks operate subject to financial frictions and idiosyncratic funding liquidity risk in their intermediation activity. Importantly, the amount of liquidity reserves held in the financial sector is determined endogenously: Balance sheet constraints force banks to trade off insurance against funding outflows with loan scale. The model shows that an aggregate shock to the collateral value of bank assets triggers a flight to liquidity, which amplifies the initial shock and induces credit crunch dynamics sharing key features with the Great Recession. The paper thus

develops a new balance sheet channel of shock transmission that works through the composition of banks' asset portfolios rather than fluctuations in borrower net worth as in the financial accelerator literature.

JEL-Classification: E22, E32, E44

Keywords: real business cycles, financial frictions, liquidity hoarding, bank capital channel, credit crunch

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Discussion Papers Nr. 1249/2012

Christian Dreger, Hans-Eggert Reimers



Does Euro Area Membership Affect the Relation between GDP Growth and Public Debt?

We analyse the relationship between the debt to GDP ratio and real per capita GDP growth for the euro area members by distinguishing between periods of sustainable and non-sustainable debt. Thresholds are theory-based and depend on the macroeconomic framework. If the interest rate exceeds nominal output growth, primary budget surpluses are required to achieve a sustainable debt ratio. The negative impact of the debt to GDP ratio is particularly strong for non sustainable ratios and especially relevant for the euro area. This suggests that the participation in monetary union might entail an additional risk for its members.

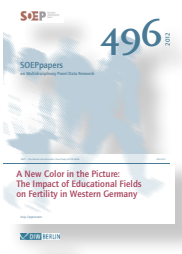
JEL-Classification: F43, O11, C23

Keywords: Euro area debt crisis, debt sustainability

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SOEPpapers Nr. 496/2012

Anja Oppermann



A New Color in the Picture: The Impact of Educational Fields on Fertility in Western Germany

The extensive research on the impact of educational attainment on fertility behavior has been expanded by a new dimension. According to these recent findings, not only the level but also the field of education has to be taken into account. The field of education determines a great deal about labor market options and influences opportunities to combine employment and family life. The question this paper aims to answer is: How does the educational field influence the transition to parenthood of women and men in Western Germany? The German Socio Economic Panel (1984-2010) provides the data. Discrete time event history models are applied

to examine the impact of the field of education on the transition to parenthood, looking at the time after graduation until a first child is born. Educational fields are grouped according to their most salient characteristic with regard to the share of women, the occupational specificity, the share of public-sector employment, and the share of part-time employment among people educated in the field. The models take the educational level into account and control for marital status, episodes of educational enrollment, and migration background. The results show that educational fields matter for the transition to a first birth only for women. For men, the results do not show a significant impact of educational fields on the transition rates to parenthood. However, they point at the importance of the educational level for the probability of men to become fathers. High transition rates are found among women educated in both female-dominated and male-dominated fields. The finding of low transition rates among women educated in public-sector fields come as a surprise, since, given the high workplace security in the public sector, they were expected to be among the women with high transition rates.

JEL-Classification: J12, J13, J16, I24

Keywords: field of education, level of education, fertility, childlessness, Western Germany

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