EXECUTIVE SUMMARY

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Against a backward-looking economic policy

1. 2013 Bundestag election campaign: Redistribution instead of genuine reforms

1. In the 2013 Bundestag election campaign the discussion about what economic policy strategy to adopt for the coming years was largely focused on domestic policy aspects. In contrast to earlier Bundestag election campaigns, this debate was conducted against the backdrop of Germany's **favourable economic situation**. Public budgets and social security systems are financially healthy, while the job market withstood the global economic crisis and the subsequent crisis that hit the euro area. In addition, all current forecasts indicate that we might now see the long anticipated **economic upturn**. This forthcoming improvement is due not least to the Outright Monetary Transactions (OMT) announced by the European Central Bank (ECB), which contributed significantly to relieve the euro area crisis and lower the uncertainty that was affecting the economy.

2. Almost all parties obviously took Germany's strong economic situation for granted rather than seeing it as a result of the many effective reforms undertaken in the past, above all the Agenda 2010. Actually, most parties focused on questioning these reforms in many areas and countering the perceived dramatic rise in the country's income inequality with increased redistribution via tax policy. The minimum wage and the rent price ceiling – issues now being debated – even represent attempts to legally decree a desired market result. As a consequence the currently discussed economic policy measures taken together threaten to ruin the reform progress Germany has achieved in recent years.

The present economic situation and Germany's healthy position compared to the euro area's crisis countries seem to have obstructed many politicians' view of the **major future challenges**. However the longer we wait and the less systematically we address them, the bigger they will become. Many good-willed acts under discussion at this time, such as the mothers' pension (*Mütterrente*), raising low pensions and allowing broad exemptions to the new retirement age of 67 will largely be shouldered by future generations. Future challenges will even be far more difficult to overcome, if the Agenda 2010 reforms become diluted or completely reversed in some areas. The same is true for new measures, like the minimum wage, which hurt growth and job creation.

3. Policymakers should be looking towards the future instead of pursuing this rather backward-looking economic policy. A **future-oriented economic policy** avoids measures that generate even greater pressure to act in the future, safeguards past reform progress and improves economic conditions. All this is necessary to strengthen Germany's economic growth, ensure viability of public budgets and social security systems and make the legal and institutional framework of the German economy serve as crisis-proof architectural model for the euro area in view of future demographic change.

2. Economic forecast

4. The uncertainty regarding the further direction of the euro crisis quickly diminished following the announcement of the OMT programme in September 2012. Moreover, the

global economy stabilised during the course of 2013. The upturn now evident is, however, not yet able to sustain itself, because many advanced economies continue to have high public deficits and a very expansionary monetary policy is providing support. The economic slowdown in emerging market economies persisted this year. Overall, global economic output is likely to rise from 2.2% this year to 3.0% in 2014 (Chart 1).

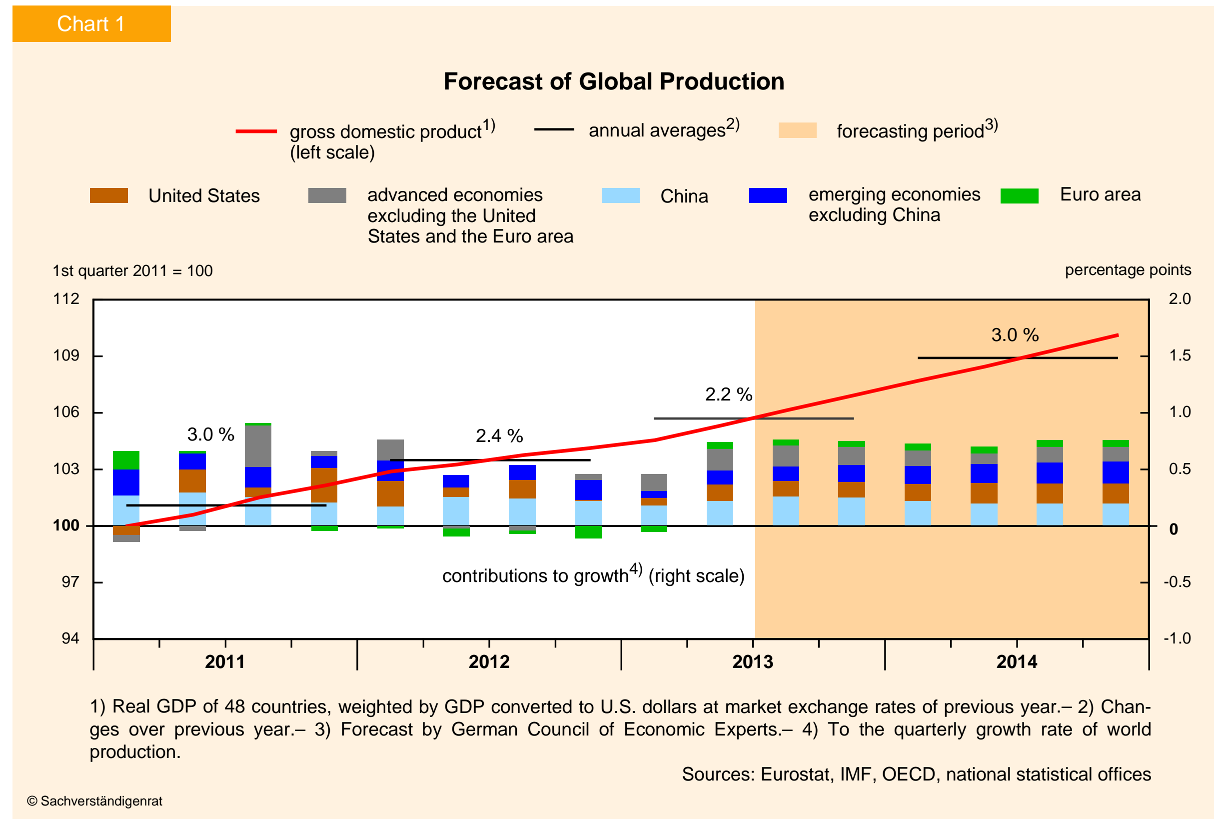

Chart 1

Forecast of Global Production

1) Real GDP of 48 countries, weighted by GDP converted to U.S. dollars at market exchange rates of previous year.– 2) Changes over previous year.– 3) Forecast by German Council of Economic Experts.– 4) To the quarterly growth rate of world production.

Sources: Eurostat, IMF, OECD, national statistical offices

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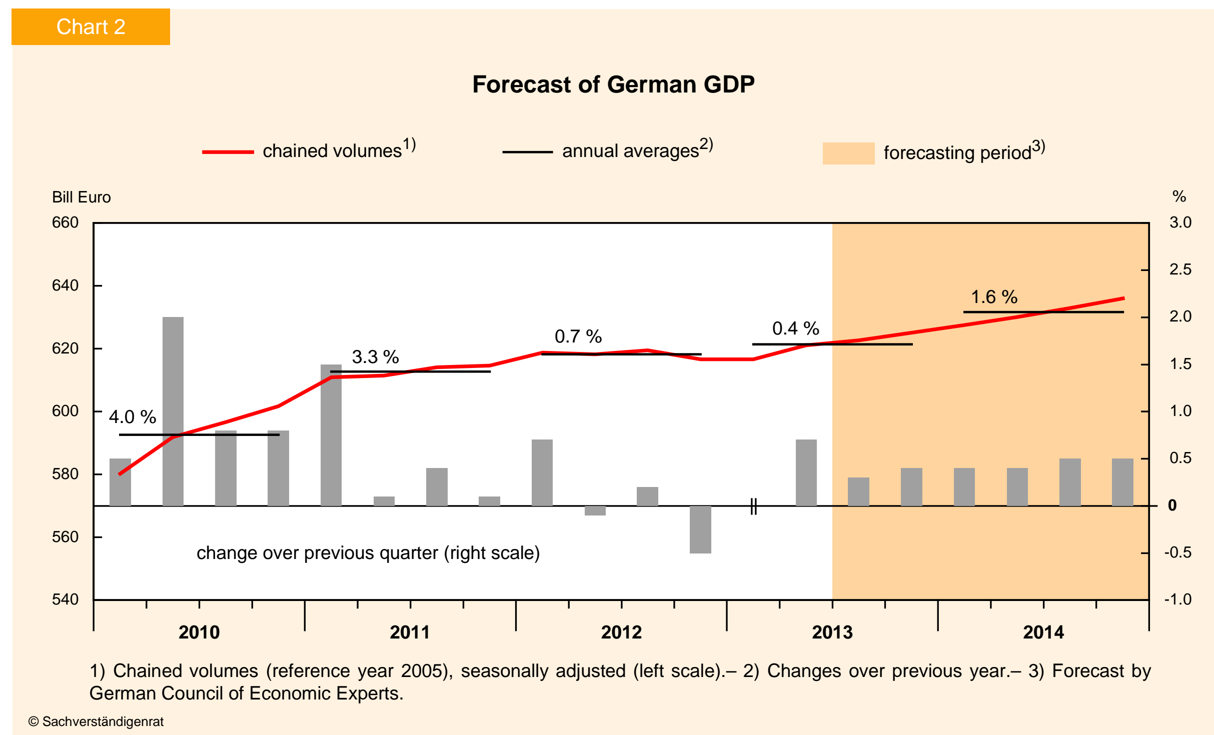
The **euro area** crisis countries improved their competitiveness during the past years and undertook a good portion of necessary adjustments to their respective current accounts. Consequently, despite the need for more adjustments, the recession is probably over in many euro area member states, largely due also to less uncertainty about overcoming the euro area crisis. Due to the year's weak start, the GCEE anticipates a growth rate of -0.4% in euro area GDP for 2013. A rate of 1.1% is expected for 2014.

5. In view of these facts, **Germany's economic situation** is very likely to improve in 2014. With GDP growth of only 0.4% expected for 2013, the GCEE forecasts growth of 1.6% for 2014 (Chart 2). This upturn will be largely driven by domestic demand. For example, as equipment investment reached its low in mid-2013, the GCEE expects that figure to grow by 6.2% in 2014. Net export growth will make a negative contribution as a result of higher anticipated imports. German consumer prices will likely rise more than in the overall euro area in 2014.



3. Economic policy agenda: Avoid, safeguard, improve

6. The German federal government can only convince other European governments to assume national responsibility themselves and conduct the necessary reforms, if it adheres to this advice in its own national area of responsibility. Regardless of Germany's present top economic position in Europe, there are many reform-related problem areas which urgently need to be addressed by national policy to further safeguard welfare and social progress in Germany. A **future-oriented economic policy** should **avoid** backward-looking measures, **safeguard** the reform progress already achieved and **improve** economic conditions.

The demographic change already underway is one of the biggest challenges for German economic policy. Germany should start preparing now for the resultant impacts. This had been the precise aim of many of the reforms implemented in the past, particularly the **Agenda 2010** introduced ten years ago. Reversing or diluting a considerable part of these reforms now will burden future generations and weaken Germany as an investment location, thus decreasing potential growth and public financial viability in the long term. If, in addition to that, the course is wrongly charted by taking backward-looking measures and failing to adopt new reforms, the **need for economic policy action** will be that much greater down the line.

In light of these facts, the GCEE has selected from a large number of policy areas, those which require the most urgent economic action or where reforms already implemented are in danger of being reversed or diluted, in its Annual Economic Report for this year.

Labour market

7. The **labour market institutions** as a whole, and their interaction with other constitutive elements of the legal and institutional framework of an economy, are of key importance to its

long-term growth path as well as its ability to deal with cyclical shocks. The international comparison shows that countries in **system competition** can learn from one another. Especially in a currency union, regulatory obstacles should be corrected as the nominal exchange rate is unavailable as an adjustment mechanism. Wage indexation systems and minimum wage levels are examples of such obstacles, because they function as a catch, reducing employment opportunities in particular for the youth, the long-term unemployed and the low-qualified.

8. In this regard, Germany has chosen the right path in its Agenda 2010. No cause for complacency, however. Instead, the current state of labour market offers a **good starting position** for orienting labour market institutions towards ensuring long-term participation of all people. More regulation on employment relationships would not be conducive to this aim. On the contrary, labour market mobility should not be decreased again. In particular, there is **no need for more regulation** in Germany's labour law. Instead an assessment should be made of how labour law can make the labour market sufficiently flexible in view of the demographic change.

9. An encompassing statutory **minimum wage** must be **rejected** in Germany's network of institutions, as must be the implementation of statutory sector-specific or regional minimum wages. An extension of minimum wage limits agreed by collective bargaining under the Employee Secondment Act (*Arbeitnehmer-Entsendegesetz*) to other sectors must also be rejected. Such measures would thwart the wage flexibility and improved employment opportunities of low qualified individuals achieved via the Agenda 2010.

The facts at hand do not support the frequently raised argument that as a result of having a minimum wage, a large percentage of low-wage earners who receive “Basic Social Security” (*Arbeitslosengeld II*) **top-up benefits** would then get by without government subsidies. These are mainly disbursed to address the financial problems of families, not as a reflection of low individual wage earnings, anyhow: only fewer than 1% of all full-time employees subject to social security contributions receive top-up benefits. An effective social policy does not intervene in the market but directly aids needy individuals and their families as is already the case today.

The **international examples** of a supposedly harmless statutory minimum wage that are cited time and again are not convincing: In Germany a statutory minimum wage would be grafted onto an otherwise comparatively rigid labour market. Negative employment effects would likely be higher than in more **flexible labour markets**. Moreover, statutory minimum wages of other countries are frequently set **low relative** to the general wage structure. Nor can the experience Germany has already made in minimum wages for certain sectors be extrapolated to apply to a general statutory minimum wage. In contrast to a sectoral minimum wage, employees who lose their jobs due to the general minimum wage cannot **switch** to another sector because the same minimum wage rule that exceeds their level of productivity is in place everywhere.

Negative employment effects are concentrated above all in employee groups whose **productivity** is lower than the legal minimum wage. Based on the current wage distribution, the share of those employees who would be affected by a minimum wage of €8.50 per hour is particularly high in eastern Germany, for those working in small businesses, in consumer-related sectors, and above all, for those with a **low level of qualifications**. There is thus a great danger that the low-qualified, the long-term unemployed, many young and disproportionately many workers in eastern Germany would be pushed out of the labour market. A minimum wage aspiring to help low-wage workers will likely create far more problems for them than it can actually solve.

10. The GCEE does indeed see a **need for further reform** in the labour market. With a view to a long-term viable labour market structure, **labour market permeability** needs to be increased. For this reason, labour law should clearly regulate employment protection, to prevent too strong a segmentation of the labour market. Temporary employment and the option of fixed-term contracts remain useful components of a **flexible labour market framework**, enabling employment to be quickly adjusted and safeguarding job opportunities for people with few qualifications. Moreover, such employment relationships are necessary in a rigid labour market in order to create a stepping stone to regular employment for entry-level workers and the unemployed. In general, lower barriers for entering the primary labour market should increase the effectiveness of labour market policy measures.

In the medium to long term, the greatest potential remains in improving the apprenticeship and adult education systems. Germany does enjoy a high employment rate and level of income, however there is room for improvement in **income mobility** across generations when compared internationally. The highest priority should thus be on increasing **equal opportunities**.

Budget consolidation

11. Public budgets have developed very positively over the past few years, however the current healthy picture is only a **snapshot**. A low budget surplus is expected for 2013; the debt-to-GDP ratio will fall to 78.3%. This progress in **consolidation** is indeed urgently necessary with a view to the long-term viability of Germany's public finance. There has been a steady positive trend in the public debt-to-GDP ratio since the 1970s, with the financial and economic crisis exacerbating this situation. In light of these facts, the country's introduction of the constitutional debt rule in 2009 was the correct step to take to ensure **viability** of its government finances. This "debt brake" must be observed.

12. Despite the progress recorded in the past five years in budget consolidation and compliance with the debt brake in this year, there is no denying the fact that the good budget situation is mainly due to economic development and a wide variety of **special factors**. The **healthy labour market situation** has eased the burden on public budgets to a considerable degree, generating a heavy increase in tax revenue, with the result that this figure reached one of the highest levels of recent decades in 2013. Moreover, Germany was the **safe haven for investors** during the euro crisis, which is why the German government currently has extraor-

dinarily low funding costs. Before the demographic change leads to considerable increase in public spending from 2020 onwards, Germany is **currently in a favourable demographic situation**. The number of pensioners is rising only slightly while the number of school-age children is already decreasing significantly, thus relieving the burden on the childcare and education systems.

13. Overall, there is **currently no evidence** of the **necessary consolidation** in terms of public spending. There is considerable need for consolidation in many German states in order for them to meet the budget balance requirements prescribed by constitutional law by 2020. Their demands to the federal government for more funds for education and public investment are inacceptable. The states had the wrong spending priorities in the past by over-emphasizing government consumption. By setting the **right priorities**, increased needs for public investment can be managed with present government revenues. A reform of the financial relationships between the federal government and the states under a Federalism Reform III, which would give the states more fiscal autonomy and thus greater responsibility, would make more sense than shifting federal funds to the states and municipalities. **Tax increases**, in contrast, should be **rejected** in the current situation. The aim instead should be for systematic reduction of debt while simultaneously limiting the tax burden in order to tap new growth potential.

14. As soon as the aforementioned special effects taper off and the economy is no longer in full swing, the **lack of consolidation** will be visible again. This situation is compounded by the fact that crisis-related developments in the euro area or additional aid to banks could burden the German government. In view of the challenges inherent in demographic change, the public budgets have no scope for any structural spending increases. The **long-term viability gap** currently still stands at around 3.1% of GDP. The statutory health insurance system in particular is a cause of concern. As structural increased spending would widen the viability gap, consolidation of public budgets remains the most urgent financial policy challenge of the coming years.

Tax policy

15. The 2013 Bundestag election campaign focused its tax discussion on **reforms to increase revenue**, which are also aimed at further improving the fiscal system's redistribution effect. In this context, SPD and Alliance 90/The Greens presented concrete proposals which would have altered the **income tax system** and which centred on increasing the top income rate from 42% to 49%. Moreover, both parties advocated reinstating the **wealth tax** or introducing a wealth levy.

The GCEE sees **no need for increased revenue** in view of the high rise in the tax-to-GDP ratio of the past three years. Regarding the development of personal income distribution in Germany and how it stands in an international comparison, it is evident that there is **already a strong redistribution** of high to low income in the German fiscal system. The public budgets have sufficient flexibility to finance any potential increased needs for public investment. The GCEE rejects increasing the top income tax rate, reinstatement of the wealth tax and introduction of a wealth levy due to the negative macroeconomic effects to be expected.

16. During the election campaign, various parties also advocated a variety of reforms to the **income splitting for married couples (*Ehegattensplitting*)**- Current tax and social law defines taxes and benefits per household. Income splitting for married couples is a logical consequence of this and cannot be considered a tax break. Whether abandoning the income splitting rule for married couples would be unconstitutional is debatable. Potential reforms would have a limited effect in any case. Restructuring taxation of married couples, for example by moving to **income splitting based on legal maintenance claims (*Realsplitting*)**, could indeed increase the incentive to work and thus contribute to positive economic effects. However these effects are relatively low in the reforms suggested in the discussion. Reforms to improve the incentive to work of secondary earners should focus on reducing the social contributions burden.

17. The GCEE believes that the most urgent **need for action** in fiscal policy is **in other areas**; there continue to be a wide variety of tax relief forms which result in distortion of individual decisions. This is true not least for **value added tax**, simplification of which failed in the past legislative session. **Local government finances** still need to undergo fundamental reform, as do **inheritance tax** and **property tax**. Moreover, tax burdens have increasingly risen in past years as a result of bracket creep and should be balanced as quickly as possible by adjusting tax brackets. In general, an appropriate regular, if not completely automatic, tax system correction would make sense. The aim of financing neutrality in terms of **taxation of corporations** ultimately remains unachieved. The GCEE has already made concrete suggestions in past Annual Economic Reports regarding all of these reforms.

Social policy

18. Analysis of development in **income distribution** in Germany shows – as measured by the Gini coefficient – that the **inequality has only risen moderately** since 1991; the size of the middle class has also changed only negligibly over this period. These findings are in direct contrast to the main buzz words the parties used during this year's Bundestag election campaign to advocate more redistribution, tax rises and reversing parts of the Agenda 2010. Further analyses of **income mobility** in Germany, however, also prove one thing: opportunities for upward income mobility in Germany are relative low by international comparison, especially across generations. For this reason, social policy should primarily aim to **increase equality of opportunities**. To this end, early childhood education makes the biggest contribution.

19. Among the social insurances, the **statutory pension insurance scheme (*Gesetzliche Rentenversicherung*)** particularly shows the successes of Agenda 2010. The reforms implemented will likely have ensured the financial stability of the statutory pension insurance scheme until around 2030. But this will only be the case if, firstly, existing rules, especially retirement at age 67, are adhered to. Secondly, **(contribution-financed) benefit extensions**, such as topping up low pensions or improving the status of mothers in the statutory pension insurance scheme as announced in the Bundestag election campaign, **should be avoided**. In order to safeguard the statutory pension insurance scheme's financial stability, the **statutory retirement age** should be further increased in a rule-based manner **starting in 2029**. The rise

could be based on development of life expectancy data. Moreover, the correction of pension discrepancies between East Germany and West Germany should be included on the new federal government's pension policy agenda.

20. The introduction of a non-income-based financing model for the **statutory health insurance scheme** (*Gesetzliche Krankenkasse*) remains an outstanding issue. The introduction of a **non-income-based employee contribution** would be a step in the direction of a health insurance scheme with a flat-rate contribution system (*Bürgerpauschale*) as preferred by the GCEE. Moreover, the country needs spending reforms that result in **more competition** on the health services market that thus save costs. Such reforms should emphasize the **freedom of contract**. A non-income based form of financing to be introduced through the same institution providing the statutory health insurance is also the best way to fund the public long-term care insurance scheme.

21. **Family policy** is an important and financially crucial component of social policy. It pursues four aims that are to be achieved with as little conflict as possible: balancing family and career, economic stability of families, the well-being of children, and fulfilling couples' reproductive desires. With regard to these four aims, institutionalised childcare has been the most successful. With a view to the demographic change, **expansion of full-day childcare** needs to be driven forward **without compromising quality**. At the same time, measures that counteract the aims should be **terminated**, in particular the **childcare subsidy for home care** (*Betreuungsgeld*). Such funds should then be used for consolidation. This could amount to around €2 billion in 2014.

Energy policy

22. The coalition government consisting of CDU/CSU and FDP called for the **accelerated energy transition** more than two years ago. This major project is currently being undertaken **without any clear overall strategy**. Two questions, in particular, arise in addition to the required grid expansion and conversion. Firstly, how can the costs of building up renewable capacities be minimised? Secondly, how should the future energy market be designed so that capacity expansion and maintenance of traditional power plants can be ensured and subsidy-free pursuit of renewable energies enabled at the same time?

23. Important measures have been undertaken since summer 2011, in the sole area of grid expansion and conversion, enabling existing obstacles to be overcome and acceleration of future expansion. **Next to nothing has been done** in other areas of action, which is disappointing. The costs of subsidising renewable energies have more than trebled since 2010, and now represent one of Germany's largest areas of subsidisation. Thus far, economic policy has only been concerned with the issue of cost allocation instead of the central issue of how to keep the country's economic costs of the energy transition project for the society-at-large to a minimum. However, a waste of some of the country's economic resources naturally means shortages in other areas.

24. For these reasons, above all, urgent efforts must now be undertaken for a **basic reform** of the Renewable Energy Act (*Erneuerbare-Energien-Gesetz* – EEG). In view of the dramatic rise in costs, a **moratorium** on subsidising renewable energies could create the break necessary to develop a systematic long-term energy market design. This kind of concept has been lacking thus far, as has integration of the German energy transition into the conditions of the European energy market.

Instead of Germany's current solo approach, the energy transition must be integrated into a **European climate policy strategy** which addresses the global challenges of climate change. The German energy transition alone will not even be able to alter climate change noticeably. For this reason, the European system of **CO_2 emissions certificate** trading (EU-ETS) should be expanded as the dominant instrument of European climate policy in the future, as well as extended to other sectors, with emission caps being credibly continued beyond 2020. In contrast, no major efforts should be made to pursue additional instruments, some of which are even counterproductive, such as national programmes to subsidise renewable energies.

At international level, conclusion of a global climate protection treaty appears to be at a standstill for the time being. The European trading system for emission certificates should be gradually globalised as an alternative, in order to create a sufficiently large **alliance for a global climate protection treaty**.

Real estate market

25. There have been no signs of undesirable macroeconomic developments on the German real estate market thus far. The real estate market is supported by the generally **favourable fundamentals**, such as the economic situation in Germany and the expected increase in the number of households until the middle of the next decade. One driving factor for the property demand is the unusually low long-term interest rate. However, due to the largely long fixed-rate periods, future interest rate hikes will only have a delayed effect on investors. This means the interest rate risk is borne by the lending banks, which are not always fully hedged against it.

The comparatively high level of **equity financing** among investors is an important stabilising factor for the German financial system. Despite the generally insignificant macroeconomic findings, some cities and individual locations in particular have experienced developments which might be not sustainable.

26. The rising demand for homes in cities poses a socio-political challenge. However, the attempt to solve the problem with **caps** for new leases is **counterproductive** and thus to be rejected. In the short term, this would replace the price with indirect and often discriminatory allocation mechanisms, and in the medium to long term, supply would actually become even more limited.

More generous depreciation rules for investments in residential property construction are difficult to justify. There are already **tax benefits for real estate investments**, such as tax ex-

emption for sales proceeds after a ten-year period, and the existence of both of tax write-offs and the option of recognising maintenance costs as expenses. However, owner-occupied property is currently discriminated against compared with other forms of home ownership. The transition to treatment of such property as capital goods for tax purposes may be a remedy.

A revival of social housing construction is to be rejected. In socio-political terms, it would be preferable to provide assistance to households in the form of housing benefit, rather than funding properties. It would be advisable to make ongoing adjustments to housing benefit rates, which have remained constant since 2009, in particular securing an adequate difference between wages in the case of employment and benefit payments in the case of unemployment.

4. The ECB as crisis manager

27. The ECB contributed to the calming on the government bond and interbank markets with its OMT announcement in the summer of 2012, but at the same time set misguided incentives for economic policy. The mutual dependency between banks and governments has actually increased with a rising proportion of government securities on banks' balance sheets. The market incentives for consequent continuation of fiscal consolidation have also been weakened.

The ECB's low interest policy has thus far been in line with its historical reactions to inflation and growth forecasts. The ECB announced as part of its new “Forward Guidance” communication that it did not expect a key rate increase for “an extended period of time”. Assuming that the ECB will react to inflationary and growth expectations as in the past, this period is unlikely to be longer than three quarters. A **rate increase** could also be justified with the Taylor rule, which provided a useful sign even before the crisis that the key interest rates had been too low for too long. Publication of the minutes of ECB meetings, as planned by the ECB Council, may help with the difficult task of organising a transparent and timely exit from the low interest rate policy.

28. The slight economic recovery evident in the euro area, helped by monetary policy, will be on shaky ground if the national governments do not continue quickly and consequently with the **fiscal consolidation efforts** they have begun. A quantitative analysis of the fiscal consolidation measures planned for the euro area from 2012 to 2014 confirms that they could lead to a **substantial reduction of the debt-to-GDP ratio**. The key requirement for successful consolidation is that improvements to spending and revenue are implemented for the long term. A negative effect on economic growth can be expected in the short term, although spending cuts generally have less of a negative effect than tax increases. The lower debt interest costs will provide scope in the long term which should be used for tax cuts. In this manner, the fiscal consolidation will lead to a long-term increase of potential output and consumption.

29. Moreover, the economic recovery must not belie the fact that monetary and fiscal policy in the euro area remain in crisis mode. The low interest rates, unconventional monetary policy measures and the tense public finance situation are all evidence of this. And above all, the

excessive public and private debt that led to the major economic crisis of recent years has yet to be sufficiently reduced. Private sector debt has in some cases been shifted to public sector balance sheets, either directly through government debt assumption or indirectly via the ECB. These legacy assets are a **major obstacle** to dynamic development of the euro area, which is necessary in order to sustainably grow out of the crisis with increasing economic output.

30. The excessive **public sector debt** makes it difficult for governments to comply with the newly agreed fiscal rules without renouncing their scope for spending policy. For this reason, the GCEE had proposed a **European Redemption Pact** aimed at reducing the debt-to-GDP ratios to an acceptable level and combining the temporary solidarity in the form of joint liability between the countries involved with strict conditionality. The objective of the pact had been to coordinate the fiscal policy players and avert that the ECB would be forced into actions at the limits of its mandate. A pact of this kind could have averted the problematic **confusion between monetary and fiscal policy** and the ensuing potential for fiscal dominance.

It cannot be denied here that the danger of fiscal dominance is diminished by other factors; the rules have been improved through the reforms of the **fiscal surveillance and coordination framework**, such as in the Stability and Growth Pact which were introduced as the "two-pack" and "six-pack". The fiscal compact also introduced obligatory national debt brakes, which provide incentives for solid fiscal policy as long as their binding effect remains strong enough. The redemption pact also provided for such national debt brakes, which were to be permanent, unlike other elements of the pact.

The monetary policy framework saw a key change with the ECB's announcement in the summer of 2012 that it would do "whatever it takes" to preserve the integrity of the euro area, and the subsequent formulation of the OMT programme. With this promise, the ECB is assuming a **guarantee for the integrity of the currency union**, without being able to link it to explicit fiscal conditionality. Although this programme has yet not been activated, it has had a decisive effect on the behaviour of market participants. The evident convergence of interest rates has created some room for manoeuvre in the crisis-hit countries, but also relieves the pressure on governments to follow through with structural reforms.

31. The easing of tension on the government bond markets has put the spotlight on the excessive **private-sector debt**. Banks in many euro area countries are suffering from non-performing assets; they lack the necessary equity to stabilise themselves by own means. However, banks in difficulties cannot contribute to the real economic adjustment processes by reallocating its loans; in fact, they are much more interested in rolling over loans that should actually be written off. The extent of uncertainty surrounding the value of bank assets is correspondingly large.

For this reason, the ECB is planning a comprehensive assessment of bank balance sheets next year, with the aim of identifying the weak points in the European banking sector. An **asset quality review** is planned in association with this, as an important step towards banking union. The ECB will assume its role as supervisor of the major European banks following com-

pletion of the assessment. There are to date only draft documents on the further elements of the banking union – a single European resolution authority and uniform rules on deposit guarantee schemes.

However, the asset quality review again entails the risk that the ECB will be forced into the role of crisis manager in the event of lacking fiscal support, and that monetary policy will be overburdened. It is unclear how the banks' capital gaps are to be filled, and above all, whether the governments are prepared to assume liability for the legacy assets which came about under their responsibility. The governments may actually be hoping not only to transfer formal oversight over banks to the ECB, but also to shift additional risks to European level via a lax asset quality review.

5. National responsibility and role model

32. For the umpteenth time since the European debt crisis began in 2010, monetary policy measures have managed to **buy time**. This must not lead to neglecting fundamental economic and fiscal measures. In fact, it lies with national policymakers to release the ECB from the role of crisis manager. The German government should counter the impression that it expects – or even demands – painful adjustment processes from other countries, but shies away from unpopular measures for Germany. This Annual Economic Report shows numerous starting points for German policy to set an example and thus assume responsibility.

In terms of European policy, the new German government should use two levers for improved economic policy: firstly it should systematically continue with its efforts to establish a **stable architecture for the euro area**, and secondly it should continue to heavily promote **national consolidation and reform efforts**, which benefit primarily the individual member states and enable them to escape from the crisis more quickly.

Maastricht 2.0 as a guide

33. Policymakers should act consistently within the scope of a long-term **euro area architecture**, in order to resolve the shortcomings of the Maastricht Treaty. This would make the euro area more stable and crisis-resistant for the long term. The GCEEs' concept for the long-term institutional framework (**Maastricht 2.0**) follows the basic principle of **aligning liability and control** at the same level in every relevant area of economic policy. This concept consists of three pillars:

- In **fiscal policy,** national responsibility should be preserved as part of a strengthened Stability and Growth Pact and binding fiscal rules. There is currently no sign of a willingness to transfer national sovereign rights to European level. Thus, any long-term form of joint liability, whether through Eurobonds or Eurobills, is lacking democratic legitimation. Against this backdrop, demands for a **fiscal capacity** with the objective of creating a balance for negative shocks through fiscal transfer mechanisms at European level should likewise be **rejected**. In so doing, the GCEE is ultimately advocating a return to the principle of the Maastricht Treaty – since control over fiscal policy will lie at national level in

the foreseeable future, the same should apply to liability. Fiscal misconduct should not be rewarded by a joint assumption of individual risks (**no bailout**).

- Crises cannot be avoided with complete certainty even with strict application of the no-bailout principle. An explicit **rule-based crisis mechanism** is therefore necessary to make this principle credible. Governments can receive liquidity support via the European Stability Mechanism (ESM), to enable a coordinated reaction to crises. However, such aid must be subject to explicit macroeconomic conditionality, as is the case with the current programme countries. Countries whose debt sustainability is constantly in doubt should not be supported by a crisis mechanism. Debt restructuring processes are necessary for such cases, currently set out with the appropriate collective action clauses in new debt contracts with an insolvency regime for countries yet to be established.
- As a third pillar of the Maastricht 2.0 concept, an improved **financial market framework** is to establish European supervision and control over banks. The concept thus evades the principle of national control in a key area of economic policy – financial regulation. Strains on banks in an integrated financial market have effects across borders and can lead to systemic crises. European monetary policy generally constitutes a mechanism for liability at European level, so an effective supervisory mechanism should accompany it. It is important that a comprehensive concept will be implemented, that does not exclude certain elements and leave them at national level.

Need for action in economic policy

34. The road to such long-term institutional framework is currently **blocked** by substantial **legacy assets**. An insolvency regime for countries cannot be introduced due to the much too high debt-to-GDP ratios and the weak banking system; stricter requirements of banks would have a destabilising effect given the high level of banks' investment in government bonds. The difficult task for policymakers is thus to operate crisis management while not forgetting or even contradicting the targeted long-term stable architecture through bad decisions made in crisis mode.

The ECB's decision regarding the OMT programme shows where such decisions can lead – once the promise is made to do “whatever it takes” to stabilise the currency union, it is difficult to take it back. Mechanisms for the permanent collectivisation of risks would have a similar ratchet effect. Moreover, control and liability for legacy assets must go hand in hand. German policymakers can make three specific steps towards this.

35. Firstly, **restructuring and, where necessary, resolution** of ailing banks is paramount for the implementation of a new financial market framework. This is the only way for the banking system to return to its original role of directing capital towards the most promising investment projects. Resolute restructuring of the banks would make a key contribution to reversing the fragmentation of the European financial markets.

German policymakers need to take action to prepare for the banking union; starting with preparation of the **changes to the European treaties** necessary to enable a clearer govern-

ance structure in European supervision as well as clear decision-making structures in the European restructuring authority. **Action is needed in Germany** with particular regard to the treatment of **decentralized banking network structures** (savings and cooperative banking networks) within the implementation of the banking union. The central European supervisor is currently planned to play a major role only for the largest banks. But ultimately, the responsibility for supervision of all banks should lie at European level, also in Germany. There are also a number of questions to be answered about the appropriate treatment of the mutual support schemes of cooperative and savings banks networks in the context of the restructuring and resolution of European banks.

The German government should ultimately create the basis for a **strict asset quality review**. Agreements must be made between the member states involved regarding the allocation of possible restructuring costs of banks engaging in cross-border activities. Governments should keep funds available at national level for this purpose (**fiscal backstops**). If a country is struggling financially after exhausting its national funds to restructure a bank, the ESM can be used to safeguard the national fiscal backstops. However, this must not lead to a direct recapitalisation of the banks, as the governments have a major influence on the banks' situation via their national budget and tax policies. A direct recapitalisation of banks by the ESM, releasing national governments from liability, would provide the wrong incentives.

36. Secondly, it is not only the crisis-hit countries that need to pursue a long-term **consolidation of public-sector finances**, because the crisis has taught us that debt ratios can quickly be seen as no longer viable. The necessary gradual reduction of debt ratios must start with the supply of and demand for government bonds.

Banks play a key role on the demand side. Policymakers' declared objective is to reverse the **amalgamation of risks** of banks and governments through the centralised European supervisor. The decisive regulatory steps have yet to be made in this matter. A separation of risks will not work if stricter regulations on banks' investments in government bonds are not enforced at the same time. The privileges still existing in the form of exceptions to large exposure rules and in terms of capital requirements must be abolished.

On the supply side, stricter rules under the Stability and Growth Pact and **national debt brakes** should prevent a further increase in sovereign debt. While we appreciate that fiscal rules should include scope for special circumstances, these new rules must not be undermined again. As an example, consider the special treatment of government investments when calculating the permissible deficit. Alleged special circumstances can always be found in the political debate. To allow such arguments to prevail would mean that the objective of a stability-oriented financial policy would lose credibility from the word go.

37. Thirdly, **comprehensive structural reforms** are needed on the factor and goods markets to reduce the concentration of some member states on domestic sectors and strengthen the international competitiveness of their companies. This is the only way that these countries will be able to realise a steeper growth path and thereby reduce their debt-to-GDP ratios.

However, adequate scope must remain for **system competition** in Europe. In this respect, it would be dangerous to consider implementing national reforms through contractual regulations and thereby limiting the necessary room for manoeuvre. Reforms at national level should not be the result of contractual agreements between governments, but rather the result of democratic discussion and agreement processes in each country.