EXECUTIVE SUMMARY OF THE ANNUAL REPORT 2016/17

Continued upswing with numerous risks

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This is a translation of the original report published in German, which is the sole authoritative text.

Continued upswing with numerous risks

1. The upturn in Germany and the euro area continues. The German Council of Economic Experts (GCEE) expects real gross domestic product (GDP) in **Germany** to grow by 1.9% in 2016 and 1.3% in 2017, with the decline in growth primarily due to calendar effects. As the underlying growth momentum will remain essentially unchanged, the German economy will move further into overutilisation. The GCEE forecasts real growth for the **euro area** of 1.6% in 2016 and 1.4% in 2017.

2. The **global economy** is growing at a moderate pace. However, further growth is exposed to **numerous** risks, including geopolitical risks and political uncertainty in Europe, not least due to the Brexit referendum. In addition, international financial markets could face turbulence, and China is in the throes of a difficult transformation, which is reflected in weak German exports to China.

3. The expansionary monetary policy around the world indicates a misallocation of tasks; monetary policy cannot generat permanently higher growth. Exceptionally **loose monetary policy** by the European Central Bank (ECB) contributed significantly to the upturn in the euro area, although its extent is no longer appropriate in light of the state of the recovery. Given considerable **structural problems** persist, growth is not self-supporting. Willingness to reform has faded, and some member states lack necessary budget discipline. Monetary policy masks these problems and increasingly threatens financial stability. An exit from the expansionary monetary policy is becoming more and more difficult.

4. Delaying the problems jeopardises the European project. The crisis has already intensified scepticism towards the European Union (EU). The outcome of the Brexit referendum in the UK and the popularity of eurosceptic political parties signal an increasing retreat from Europe. The EU's **long-term economic strength** cannot be ensured without the willingness to undertake fundamental reforms. This could result in further setbacks to European integration.

Reforms for Europe

5. Given increasing centrifugal forces within the EU, the **principle of subsidiarity** must be reinvigorated. Stronger integration is desirable in some areas such as climate and asylum policy and internal security. Fiscal, labour market and social policy, however, should remain the responsibility of the member states.

6. The internal market with the **four fundamental freedoms** – the free movement of goods, services, capital and persons – represents a core element of the EU. These should not be called into question. A delayed integration of EU migrants into social security systems would, however, be appropriate. A strengthening of the single market through improved market access in the services sector is desirable. However, no comprehensive harmonisation and standardisation of entire legal areas should be derived from internal market competence.

7. Trade policy clearly falls into the EU's responsibility. **Protectionist trends should be staved off**. They severely diminish prosperity. The EU should conclude the Comprehensive Economic and Trade Agreement (CETA) with Canada and the Transatlantic Trade and Investment Partnership (TTIP) with the USA.

8. Given the global effect of greenhouse gases, a global approach to **climate policy** is needed, or at least an EU-wide approach. So far, Germany's energy transition has delivered sobering results. The economic costs are high, yet its contribution to reducing climate change is moderate. This experience reveals the drawbacks of a purely national approach to climate policy.

9. As the **euro area** lacks nominal exchange rates as an adjustment mechanism between member states, it is important to ensure that the necessary adjustments are achieved through other mechanisms. For this reason, further structural reforms are needed that facilitate **more flexible wage and price formation** and increase labour mobility.

10. In light of the macroeconomic developments, the extent of the **ECB**'s quantitative easing and the resulting **low interest rates** are neither appropriate for the euro area nor Germany. In their monetary policy decisions, the ECB should take greater account of less volatile price indices, such as the GDP deflator and core inflation. Given the risks monetary policy poses to financial stability and member states' willingness to pursue consolidation and reform, it would be better to **slow down bond purchases** and **end them earlier**.

11. The repeated turbulence in the European financial sector shows that the sector is still not sufficiently resilient to shocks. Many major euro area **banks** in particular are **still not adequately capitalised**. The GCEE considers a leverage ratio of **at least 5%** appropriate.

12. Preconditions for a **common European deposit guarantee scheme** are not currently met. First of all, risks in the banking system need to be reduced, effective European supervision and resolution need to be ensured, and regulatory privileges of sovereign exposures in banking regulation need to be phased out. In the medium term, an **integrated financial supervisor** should be established outside of the ECB.

13. The **European fiscal rules** should finally be enforced. It remains important to strengthen the crisis mechanism, as another flare-up of the euro area crisis cannot be ruled out. This requires a **mechanism for restructuring government debt** in the event of crisis. The GCEE has developed a detailed proposal. It calls for private sector involvement in crisis resolution, which could help to restore the credibility of the no-bailout clause.

Reforms for Germany

14. In the GCEE's view, the Federal Government did not sufficiently take advantage of Germany's favourable economic conditions to conduct reforms. Some of the Federal Government's measures, such as the introduction of the national minimum wage and the pension package, could actually hurt the economy. Over the next few years, economic policy should focus more on the German economy's **competitiveness and future viability**.

15. The development of **income and wealth inequality** is a subject of keen debate in Germany. However, inequality has remained largely unchanged in the past decade. In the long run, a flexible labour market with highly skilled employees is the best way to ensure inclusive growth. Income and wealth mobility should be increased primarily through a targeted **education policy**. Better permeability of the education system and the introduction of a mandatory preschool year could improve **equal opportunities**. A wealth tax, however, should be rejected given its distorting effect on investment.

16. The **labour market** has continued to perform well, yet it remains challenged by entrenched unemployment, low wage mobility and integration of new workers. To tackle these challenges, the **low-wage sector** plays a crucial role. Its absorption capacity should be strengthened, instead of limiting it by even more stringent regulation.

17. The number of **new asylum seekers** has dropped considerably this year. Given the migratory pressure that is likely to persist, policymakers should direct their attention at combating the reasons people flee their home countries. It should also aim for clear European migration rules and effective protection for external borders. Germany is still **able to bear** the additional direct refugee-related **expenses**. The most decisive factor in the long-term costs of refugee migration is labour market integration.

Consequently, the Federal Government should attach a high level of priority to **promoting skills acquisition and education**. Next to language and integration courses, partial vocational qualification courses should be used. Early childhood and school education are also central. A flexible labour market with low entry barriers is essential for integration.

18. The strong economy is currently generating high revenues from taxes and social contributions, generating **fiscal space** in the next few years despite additional refugee migration-related costs and higher public consumption. Additional fiscal stimulus is currently not appropriate. Fiscal policy is already **procyclical**.

Additional public investment can be funded by reducing consumptive spending. The agreement between the Federal Government and the federal states on an infrastructure company for federal motorways and major roads is an appropriate step towards strengthening public investment. The challenges of the future give cause for **further reduction of public debt** so Germany can fulfil its role as an anchor of stability in the euro area.

19. Fiscal leeway could, moreover, be used for reforms to bolster the German economy's competitiveness and exploit efficiency reserves. Such measures include a **corporate tax reform**, which would create funding neutrality through an allowance for corporate equity. Further leeway should be used for a complete correction of income tax bracket creep.

As regards **inheritance tax**, the GCEE abides by its proposal which combines a broad tax base and low tax rates with generous deferral rules. The recent reform, however, makes inheritance tax law more complex and invites tax optimisation. The property tax reform should be completed quickly. The **reform of the financial relationships between the Federal Government and the federal states** pushed through by the state premiers to the detriment of the Federal Government increases the inefficiencies of the fiscal equalisation system.

20. Raising the statutory retirement age even higher is unavoidable if the **statutory pension scheme** is to be made resistant to demographic change. **Linking the retirement age to remaining life expectancy** at age 65 can contribute towards this end. The new rules making the retirement age more flexible are a positive development. Moreover, the GCEE calls for compulsory pension provision for the self-employed, although not necessarily within the statutory pension scheme. For the **unification of pension legislation** between eastern and western Germany, the GCEE has already provided a concrete proposal.

21. The second and third pillars of the pension system play an important role even at times of ultra low interest rates. Obstacles that prevent a greater take-up of occupational and private pension provision need to be eliminated. In particular, improvements should be made for the **provision of occupational pension schemes** in small and medium-sized enterprises and for low earners. Among other measures, the GCEE proposes **abolishing double contribution**, in other words avoiding to levy social and other charges both on contributions and pensions.

An improvement of financial literacy, a general incentive entitlement and more transparency would help strengthen the **Riester pension**. In addition, individuals' contributions to government-incentivised pension schemes should be at least partially exempt from **deduction from the means-tested basic income support**. Also, a non-government standard product could be introduced.

22. Finally, the GCEE reiterates its proposal of a statutory health insurance system funded through a **flat per capita premium (*Bürgerpauschale*)** including a mechanism for social compensation.

Time for reforms

23. The positive economic development offers a chance to conduct efficiency enhancing structural reforms which lay the groundwork for lasting welfare improvements. Now is the **time for reforms** that boost the potential growth of the German economy, help in meeting the challenges of demographic change, globalisation and digitisation, and reinforce stability and economic strength in Europe. Instead of resting on the laurels of past reforms such as the Agenda 2010, or even diluting them, politicians should act decisively to implement necessary reforms.