EXECUTIVE SUMMARY OF THE ANNUAL REPORT 2017/18

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

Major upturn, ideal conditions for reforms

1. The German economy is experiencing a **major upturn**. The German Council of Economic Experts (GCEE) expects gross domestic product (GDP) to grow by 2.0 % in 2017 and 2.2 % in 2018. This puts the rate of expansion ahead of the potential growth rate of around 1.4 % in both years. Production capacities are **overutilised.** In the euro area, the GCEE forecasts GDP growth of 2.3 % in 2017 and 2.1 % in 2018. The global economic upturn has gathered considerable pace since the second half of 2016.

2. The sound economic situation provides an **opportunity to re-adjust economic policy**. This re-adjustment should focus on the challenges of the future from globalisation, demographic change and digitalisation, and no longer on income distribution. In fact, the distribution of net incomes (after taxes and transfers) has remained largely stable since 2005.

3. In addition to a marked drop in interest expenditure, the strong economy and structural changes have contributed to a **significant budget surplus**. Given fiscal risks, such as from demographic change, the consolidation of public finances to ensure sustainability should be a top priority. The favourable budget situation opens up a certain degree of fiscal space which the new government should use **for growth-friendly reforms**. Higher public investment or higher spending on education and research can be financed by shifting priorities in public budgets. This does not require an increase in the public spending ratio. The federal states should take greater responsibility for their municipalities and keep a closer eye on how they manage their budgets.

4. High fiscal revenues reflect not only the solid economic situation, but also the **increasing taxes and contributions imposed**. The progressive income tax rate gives rise to “**bracket creep**” when inflation rates are positive, putting strain on middle-income groups, in particular. A reform of the income tax should be used to return the increase in tax revenue from bracket creep. This has to be coordinated with the **gradual abolition of the solidarity surcharge** so as not to exceed the fiscal space available. The GCEE is against the abolition of the withholding tax on capital income and in favour of more efficient corporate taxation, for example by achieving financing neutrality in taxation by way of an **allowance for corporate equity**. Taxes on wealth should not be increased.

   In addition, the Federal Government should **cut the rate of unemployment insurance contributions**. The GCEE puts the contribution rate after adjustments by cyclical components at 2.5 %, implying that the current contribution rate could be cut by up to 0.5 percentage points.

5. In order to meet the challenges associated with the digital transformation, policymakers should create a **regulatory framework that is open to innovation**. The expansion of broadband digital networks should be driven by private investment. Government support programmes should only be deployed on a

case-by-case basis taking into account European Union (EU) state aid rules. Significant efforts need to be made regarding data security, data protection and safeguarding privacy, without hampering potential efficiency gains through overly strict data protection regulations. The GCEE is in favour of the **establishment of a Digitalisation Commission** to scrutinise regulations hindering innovation and identify need for reform.

6. In its Energy Concept 2010, the Federal Government set itself the target of reducing greenhouse gas emissions by between 80 % and 95 % by 2050. A **uniform CO_2 price** would be a good way of ensuring that the electricity, transport and heating sectors jointly contribute to avoid emissions. The Federal Government should therefore work more strongly towards expanding the EU Emissions Trading System (EU ETS) by including all emitters and sectors of final energy consumption. A price corridor or a reduction in the number of emission allowances in circulation could be used to increase the effectiveness of the EU ETS. A carbon border tax, however, would pose a trade restriction and is problematic with regard to WTO rules and existing free trade agreements.

7. Demographic change will reduce Germany's labour potential. Some areas of the economy already face a **shortage of skilled workers in certain occupations**. It will become increasingly important to better utilise the available labour potential. This could be achieved by measures allowing people to **strike a better balance between family life and work**, for example by further expanding childcare or by an immigration act. The latter should provide specialists with an occupational training background with better **labour migration opportunities**. In addition, policymakers should focus on reducing **long-term unemployment** and **integrating recognised asylum seekers** into the labour market.

8. The digitalisation of the business and society will result in extensive **structural changes** that policymakers should do their best to **facilitate**, for example through innovation-friendly regulation, the systematic digitalisation of government administration and safeguarding a flexible labour market. In addition, measures should be taken to strengthen **education and training** to make it easier for employees to adapt to the new requirements of the digital world, particularly by strengthening basic and non-cognitive skills. Lifelong learning should also be promoted, as should the quality of education and training by increasing **competition between educational institutions**. The Working Time Act (*Arbeitszeitgesetz*) should be loosened.

Changing course in monetary policy, increased risks in the financial system

9. The monetary policy pursued by the European Central Bank (ECB) remains extremely expansionary. The recent extension of the bond purchase programme will increase the degree of expansion even further, although macroeconomic developments call for significant monetary tightening. The ECB should react to increases in growth and inflation rates symmetrically to declines in these rates.

While there are no deflation risks, risks to financial stability have increased. As a result, the ECB should communicate a comprehensive **normalisation strategy for its monetary policy** without delay. This would help alleviate uncertainty among market participants regarding the central bank's future stance.

10. The ECB should **end the bond purchases earlier** than it has announced to date. After the purchase programme has ended, medium and longer-term interest rates may better reflect market participants' views again. An ensuing increase in lending rates would have the positive side effect of curbing banks' interest rate risks. Depending on how inflation and growth develop, this could be followed by hikes of the policy rates. In the long term, the ECB should gradually shrink its balance sheet.

11. Moreover, the Governing Council of the ECB should expand its **forward guidance communication**. Building on its own inflation forecast, it could publish a forecast regarding the development of the bond purchases and policy rates. This is not about making unconditional commitments, but about communicating the **central bank's expectations**. This would make it easier for market participants to form expectations and may enhance the effectiveness of monetary policy. Alternatively, the individual projections of the Council members could be published, or the Eurosystem staff projections that are published at present could be improved by including a policy rate forecast.

12. **Risks in the financial system have increased further** as a result of the low interest rate policy. On the one hand, there is a risk of excessive asset prices, particularly with regard to residential properties and bonds. On the other, the **interest rate risks incurred by banks** have increased considerably as banks are granting loans with longer fixed-interest periods while depending on short-term forms of funding. In case of rapidly increasing interest rates, turbulence in the financial system must be expected, even though credit growth remains relatively moderate at present. At the same time, yields on government bonds and, as a result, funding costs incurred by highly indebted countries could increase considerably. This could put the ECB in a position of **fiscal or financial dominance**, which could deter it from tightening monetary policy as necessary.

13. In communicating its normalisation strategy, the ECB should proactively counteract concerns regarding fiscal or financial dominance by pointing to the existing crisis mechanism and the Banking Union. In addition, **member states** must implement **sustainable economic policies** in order to prepare for rising interest rates in the future. Furthermore, **macroprudential policy** for the banking sector and beyond plays an important role in limiting the risks within the financial system.

Stability for the euro area

14. In the Maastricht Treaty, the member states of the euro area committed themselves to the principle of **national sovereignty in fiscal policy**. Thanks to the economic upturn in the euro area, many member states now meet the 3 % deficit

criterion. In 13 out of the 19 member states, however, debt levels in 2016 were in some cases well in excess of 60 % of GDP. Given its considerable **complexity**, there are justified doubts whether the current framework can exert a sufficient binding effect and guarantee the sustainability of public finances. A simple assessment of whether a member state is meeting all requirements of the fiscal rules is, however, essential in order to ensure that fiscal rules limit incentives of the political economy towards excessive deficits and result in sustainable public finances.

15. One option for simplifying the complex set of rules would be to reduce them to **two benchmarks, complemented by independent supervision**: an expenditure benchmark as an annual operational target and a structural deficit limit as a medium-term target. These fiscal rules could replace the current regulations in the preventive and corrective arms of the Stability and Growth Pact (SGP) and all their exceptions. The current coordination and reporting obligations under the stability and convergence programmes as well as the European Semester would remain in place.

16. **Completion of the Banking and Capital Markets Unions** is essential for a stable and resilient architecture for the euro area. Further risk-sharing should only be considered following risk reduction to prevent legacy debt from the crisis being transferred to the union. In order to achieve this, it is essential for efforts to swiftly reduce **non-performing bank loans** to continue. Banks that are non-viable on their own should exit the market. Gaps in the **European resolution regime** must be closed to ensure that subordinated and senior creditor bail-ins cannot be circumvented. Public funds should only be used to rescue banks in the extreme scenario of a systemic banking crisis. Finally, the **privileges for sovereign exposures** in banking regulation have to be abolished.

17. If member states succeed in appropriately reducing risks, the **completion of the Banking Union** can be considered. This includes creating a common European Deposit Insurance Scheme, common fiscal backstops and, where appropriate, a safe asset in the euro area. Misaligned incentives and implied liability risks would have to be avoided. Measures to strengthen the joint European capital market as part of the **European Capital Markets Union** is desirable. All of these aspects would require greater harmonisation, for example in insolvency and foreclosure law.

18. The euro area features its own permanent crisis mechanism, the European Stability Mechanism (ESM), since 2012. The GCEE considers the **ESM to be a key element of the euro area architecture**. Its further development should under no circumstances turn the ESM into a transfer mechanism. Rather, greater incentives for member states to prevent crises should be provided.

19. To this end, **clear rules for orderly government debt restructuring** in the event of a crisis should be added to the ESM's tool of macroeconomic adjustment programmes. This will ensure that creditors contribute to crisis resolution and that the ESM only grants loans to solvent member states. This reduces

negative incentives of the crisis mechanism for national fiscal policy and strengthens market discipline. The GCEE developed a detailed proposal last year on measures to enable orderly debt restructuring. In addition, the ESM should be given a **crisis prevention mandate** so that it can identify stability risks and monitor member states' fiscal policy in collaboration with other institutions.

20. The creation of common stabilising mechanisms in the form of a fiscal capacity or European unemployment insurance scheme is **not deemed necessary** by the GCEE. Many of these proposals also fail to take sufficient account of varying political preferences and do not ensure the unity of liability and control.

Renewing the European Union

21. There are many areas in which the further development of the EU would make sense. These include the digital internal market, procurement in defence policy, public security, asylum and climate protection. Deepening of European integration should focus on striking a **balance between national responsibility and common action** with the right sequence of reform steps. Germany should constructively promote the acceptance of fundamental principles such as subsidiarity or unity of liability and control.

22. In the area of **foreign trade**, the EU member states should support existing multilateral agreements and forge ahead with the negotiation of further free trade agreements. As for **foreign direct investment**, approaches involving a review or a ban of corporate takeovers by foreign investors harbour the risk of generally restricting the free movement of capital. As a result, any general requirement for approval of foreign investments to protect purely economic interests or economic policy objectives is to be rejected. The GCEE believes that the EU should remain open to foreign investors, even without reciprocity.

23. Within the **Single Market**, there is still potential for reducing non-tariff barriers to trade, for example in the service sector. The GCEE considers the most recent decision to **tighten the rules under the Posting of Workers Directive** to be a protectionist move. This decision goes against the freedom of services of the common market and clearly shows that, despite all the talk about free trade, member states tend to support market barriers when push comes to shove.

24. In the area of **migration and asylum**, many EU member states have a shared interest in more secure external borders. A European approach to tackling the causes of refugee migration as well as international development cooperation could be more effective than national action. The related expenses should be funded by reallocating EU budget funds.

25. Given the immense ramifications of the **United Kingdom's exit** from the EU, the GCEE continues to call for preventingthis scenario. If this is not possible, the objective of the negotiations should be to conclude a follow-up agreement that minimises the damage for both sides. All four freedoms must be respected in any

such agreement, which should not allow for any sort of "cherry picking". It is, however, likely that more time will be needed to negotiate this kind of agreement than the two-year period specified in Article 50 TEU. As a result, the GCEE is in favour of granting a **one-time extension** of this period.

Globalisation

26. The significant expansion of international trade has brought about major increases in efficiency and welfare globally as well as in Germany, and significantly reduced world poverty. Calls for protectionist measures should be firmly rejected. To this end, measures should be taken to **strengthen** the **multilateral rule-based trading system**. Exploiting further potential for trade liberalisation is likely to imply additional increases in welfare. Greater openness in international business relations can also be achieved by removing barriers to the trade of services and digital trade, and by concluding more free trade agreements. Negotiations on the Transatlantic Trade and Investment Partnership (TTIP) should be resumed.

27. In general, the structural change associated with globalisation should be treated in the same way as any other structural changes, such as technological change due to digitalisation. Negative effects at regional or sectoral level are cushioned by existing social security systems and labour market policy instruments. The main aim should, however, be to **better empower workers and businesses** to take advantage of these changes for themselves. Education and training efforts and well-functioning factor and goods markets have the potential to contribute in this regard.