New challenges[1]

1. Two developments dominated politics this year: the **crisis in Greece** and the **dramatic surge in immigration through refugees**. Tackling demographic challenges and creating suitable conditions for an ever-more globalised and digitalised world took a backseat to these pressing concerns. But the focus of German economic policy making should return to making economic processes more efficient, rather than trying to preserve achievements and realise distributive objectives through direct market intervention.

2. Positive **overall macroeconomic developments** will continue in the foreseeable future. Real gross domestic product in Germany is expected to grow by 1.7 % in 2015 and 1.6 % in 2016. For the euro area, the German Council of Economic Experts (GCEE) forecasts real growth of 1.6 % this year and 1.5 % next year.

3. But the two developments have highlighted the need for economic policymaking to **focus on the future viability** of the German economy. Strengthening the euro area architecture is crucial to maintaining competitiveness and stability. At the same time, coping with the surge in immigration will only be possible if appropriate conditions are created to raise Germany's economic potential, especially in view of **low productivity growth**.

Coping with the consequences of refugee inflows

4. A first topic of this report addresses the question how Germany can master the **economic challenges of refugee inflows**. For this purpose, the GCEE carried out a cautious initial empirical evaluation, based on various scenarios. The results are subject to high uncertainty given scant data availability.

5. The scenarios show that the refugee influx will lead to **direct annual additional gross expenses for public budgets** of €5.9 billion to €8.3 billion in 2015 and €9.0 billion to €14.3 billion in 2016, depending on the underlying scenario. Given strong public finances, these costs should be manageable. Lengthy processing times for asylum applications and poor labour-market integration could raise these costs considerably.

6. The effects of the refugee influx on employment and production potential are expected to be moderate in the medium term. In a favourable scenario, hiring of recognised refugees could **increase employment** by up to 500,000 people by 2020. In the unfavourable scenario, employment would increase by only half this number. This rise in employment goes along with about 300,000 to 350,000 recognised refugees expected to sign on as unemployed by 2020.

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

7. Immigration will raise **demand for private housing** in the medium term. As a result, conditions must be created that strengthen **incentives for private investment** in the housing sector. Rent price ceilings (*Mietpreisbremse*) should be rescinded.

8. Given the age and qualification structure of refugees, training and education for recognised refugees will play a decisive role in their **integration into society**. A considerable need for training can be assumed. **Job market integration** is an important aspect of integration into society. Hence, barriers to employment should not be too high. Flexible work arrangements, such as in temporary jobs (*Zeitarbeit*) or contracts for specific projects (*Werkverträge*), must be maintained. Migrants **should not be privileged** over other employees, but should also not be disadvantaged.

9. The **minimum wage** is likely to constitute a high barrier to entry into the job market for many refugees. In view of the increasing labour supply in the low-wage sector, the **minimum wage should certainly not be raised**. Job-seeking recognised refugees should be treated as long-term unemployed from the start. The **exemption from the minimum wage** for long-term unemployed starting a new job should be extended from six to twelve months. Internships should be exempt from the minimum wage for at least twelve months. A minimum wage increasing gradually with age could help lower the barrier to labour market entry for young adults.

The path to more stability in Europe

10. The second focus of this report is **Europe**. To strengthen the architecture of the euro area and its "no bail-out" clause, the GCEE proposes a **sovereign insolvency mechanism**. This should facilitate debt restructuring and creditor bail-in without destabilising the currency union. Debt restructuring procedures should be specified to stabilise the expectations of market participants. This should help strengthen market discipline. Any restructuring of sovereign debt would take place in combination with a strict macroeconomic adjustment programme. As part of the application for an ESM programme, a maturity extension or even a nominal debt reduction vis-à-vis private creditors should take place if debt is considered not sustainable.

11. In addition, the nexus between banks and governments should be severed by **phasing out banking regulations that privilege sovereign exposures**. The GCEE proposes the introduction of risk-adjusted large-exposure limits and risk-adequate capital requirements for such exposures. This will reduce concentration risks in bank balance sheets and raise the ability of banks to absorb losses.

12. A stronger integration of European capital markets through the **European Capital Markets Union** is desirable as it holds the potential to improve cross-border risk sharing. The primary goal should be to reduce frictions in corporate financing.

13. Another important debate centres on the current **low interest rate environment** in the euro area. In January 2015, the European Central Bank (ECB) further eased its already very accommodating monetary policy by introducing a new sovereign bond-buying programme. Recently, it put forth the possibility of further easing. Core inflation has, however, stood near 1 % for months, and has recently risen slightly. Simple interest rate rules, such as the Taylor Rule or a rule that explains past ECB interest rate decisions quite well, suggest that monetary policy should be tightened given the current economic outlook.

14. While the risk of deflation is currently low, there are risks for the development of the economy in the longer term. The ECB's bond buying programme has created favourable financing conditions and provides member states with an incentive to **defer much-needed budget consolidation and structural reforms**. However, further structural reforms to strengthen markets and competitiveness are crucial for a self-sustaining economic recovery. In addition, monetary policy is leading to a build-up of **risks to financial stability** which could pave the way for a new financial crisis. Persistently low interest rates erode the earnings of banks and life insurance companies, and raise the appetite for taking risks. Although there are so far no signs of excessive credit expansion, some sectors, like real estate, are showing some signs of exaggerated prices.

15. Macroprudential policy alone cannot guarantee the stability of the financial system. It is important to avoid delaying an exit from the low interest rate environment for too long. A **timely end to monetary policy accommodation** could effectively prevent the further build-up of risks in the financial system.

16. Considering current economic developments and balancing deflation risks against the risks to longer-term economic developments and financial stability suggest that the **ECB should slow down the expansion of its balance sheet**, or even end it earlier than announced.

Conditions to spur growth in Germany

17. The **future viability of the German economy** is the third focus of this report. It is currently hard to detect any reform spirit enabling Germany to assert its strong economic position in an ever more interdependent and digitised world. **Productivity growth has been slowing** since 2005.

18. Lower productivity growth can be partially explained by the successful integration of less productive workers into the workforce, and is thus the result of successful past labour-market reforms. In addition, the **restructuring of value chains** by businesses worldwide, especially in manufacturing, has come to an end. But within the service sector and in regard to the digital transformation there appear to be obstacles to productivity growth in the German economy. In addition, start-up activity has been low.

19. **Improvements to general economic conditions** rather than public investment programmes can ensure future productivity gains. In the service sector, barriers to competition in areas dominated by former state monopolies are too high, and regulation in professional services is too tight. With regard to the digital transformation, education and training policies play a key role. In addition, over-regulation of product and labour markets could prevent investments in information and communications technologies from realising their productivity-enhancing potential.

20. Given the importance of international trade, **lowering trade barriers and ensuring investment protection** as part of the **TTIP** trade agreement with the United States prove especially important for Germany. In particular, the reduction of non-tariff barriers to trade could yield enormous economic potential. Each government's **sovereign autonomy to regulate** within its borders should not be compromised. However, arbitration panels that improve investor protection would also give German companies more legal certainty when making investments in the United States.

21. **Tax reforms** implemented in Germany since 2000 were steps in the right direction. But the tax system still suffers from major distortions. Withholding tax (*Abgeltungssteuer*) has not been fully integrated into existing rules. As a result, the corporate tax regime does not treat all financing forms in the same way and discriminates against equity financing to the benefit of retained earnings or debt.

22. This problem can be resolved by introducing an **allowance for corporate equity (ACE)** in the sense of a dual income tax, as proposed by the GCEE. Ending tax discrimination against equity financing would help firms that have trouble funding investment, in particular by reducing the tax burden on venture capital. This would benefit in particular investments by young, growth-oriented companies.

23. Education policy should ensure **equal opportunities** and create incentives for individual investments in training. Concentrating public spending on education on the beginning of the educational cycle and mobilising private funding could help to raise economic growth potential.

24. Given demographic and technological trends, the **labour market must be flexible** enough to adjust to new developments, absorb shocks, and create employment opportunities. The challenges of an increasingly digital economy will force employees and employers to accept lifelong learning as a matter of course.

25. Transforming Europe's energy supply is a collaborative project of utmost political importance and the basis for the region's leading role in **global climate protection**. Top priority should be the reduction of greenhouse gas emissions without losing sight of economic efficiency. To transform energy supply in economically efficient ways, a national industrial policy approach like Germany's Renewable Energy Act (*Erneuerbare-Energien-Gesetz, EEG*) is unsuitable. The German government should instead embrace Europe's Emissions Trading System (EU-ETS) as a common tool guiding the region's climate policies. This

would mean applying the scheme to more sectors of the economy and stabilising its price signalling.

Focus on future viability

26. German economic policy must **create the appropriate conditions** to prepare the economy for the challenges of the future - demographic change, globalisation and digitisation. The unprecedented **influx of refugees** means education, integration and labour market policies will have to rise to numerous challenges. Highly diverse social groups will have to be integrated into the education system and the labour market to prevent Germany's unemployment rate from returning to past heights. The German economy has to adapt to a complex and constantly changing world. As a result, economic policy should **focus on the future viability** of the German economy. Just preserving the status quo is not an option.