Towards a forward-looking economic policy

Annual Report – German Council of Economic Experts

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13/14 Against a backward-looking economic policy
14/15 More confidence in market processes
15/16 Focus on future viability
16/17 Time for reforms
17/18 Towards a forward-looking economic policy

Germany and Europe: Outlook, challenges, policies

I. Economic outlook
II. Germany: Re-adjust policies to address long-term challenges
III. Europe: Institutions and policies oriented towards sustainability
I. Economic outlook

Strong upturn – increasing over-utilization in Germany

Continuing recovery in the euro area

Euro area: Investment dynamics indicate broad recovery

Household consumption
Government consumption
Gross fixed investment
Inventories
Net exports
GDP Growth

Gross fixed investment in euro area
Growth contributions
Germany
Spain
France
Italy
Other countries
Stable inflation in the euro area

- GDP-Deflator
- PCE-Deflator
- HICP
- Core-HICP

High demand for German exports continues

- Indicator of export demand
  - United States
  - China and south east asia
  - Italy
  - Other countries
  - Euro area

Wage moderation in Germany ended a while ago

- Nominal wage (gross per hour)
- Inflation
- Labor productivity (GDP per work hour)
- Labor productivity + estimated inflation target

Risks in bank balance sheets: Germany

- New business
  - loan rate
  - deposit rate
- Shares (right scale)
  - Long-term housing loans
  - Short-term refinancing
Expansionary effect of monetary policy continues in major advanced economies

- Change of central bank assets since 2007: Euro-area, Japan, UK, Canada, USA
- Policy rate relative to reference values: weighted policy rates, weighted Taylor rates

Euro-area: monetary policy expansion continues

- Gold & FX
- Bonds
- Purchase programs
- LTRO
- TLTRO
- Other assets
- MRO's

Euro area: Expansionary fiscal stance continues

- Euro area: change in structural primary balance
- Contributions: Germany, France, Spain, Italy, Other countries
II. Germany: Challenges and policies

Challenged by increasing inequality? No! Stable since 2005.

Gini Coefficients

Market incomes

Net incomes post taxes and transfers

German labor market in very good form

- Unemployment rate
- Employed persons (right scale)
- Atypical employment

Challenges

- Increasing overutilization and risk of overheating
- Sustainability in light of aging
- Technological change and digitilization
- Climate change and efficiency of energy policy
- Globalization and migration
**Overheating: Raise potential via tax and other reforms**

- Correct bracket creep
- Phase out solidarity surcharge with tax reform
- Reduction in unemployment contributions
- Finance-neutral corporate taxation
- Growth-friendly expenditure without higher government share
- Tying retirement age to life expectancy

**Digitalization: For a regulation open to innovation**

- Positive experience with automation in industry
- But just average on digitalization
- Expand infrastructure, priority to private investment
- More flexible labor regulation
- Innovation-friendly regulation
- Create digitalization commission

**More market in climate change policies**

- Objective: reduction in greenhouse gases by 80 – 90% until 2050
- Instead of current expensive and inefficient policies:
  - common price for CO₂-emissions
  - strengthen European certificate trading
  - No technology/sector-specific subsidies
  - Coupling of sectors
  - Time path for exit from coal not needed
III. Europe: Institutions and policies oriented towards sustainability

Convergence in euro area: Reforms as national responsibility

- Real effective exchange vs euro area based on unit labor costs
  - Germany
  - Spain
  - Italy
  - France
  - Portugal

Public debt still high, consolidation needs to continue

- Priority for sustainable fiscal policy on national level

  National fiscal policy needs to adjust to member state situation, not be constrained by a prescription for euro area fiscal stance

- Joint fiscal capacity or other transfer mechanisms not needed
  - Structural and cyclical effects not easy to separate, potential for moral hazard
  - National fiscal policy achieves stabilization via intertemporal adjustment, if needed with help of ESM
  - More risk-sharing via capital markets by strengthening capital market union

Germany, Spain, Italy, France

Ireland, Greece, Cyprus, Portugal
Reduce complexity of fiscal rules

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<thead>
<tr>
<th>Current framework</th>
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<td>European Commission supervised by the European Fiscal Board (EFB)</td>
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Risk reduction prior to more risk sharing
1. Swift reduction of non-performing loans
   - Stronger supervisory targets
   - Not publicly-financed bad banks
2. Bank resolution
   - Raise hurdle for exceptions to creditor participation
   - Address differences in national insolvency law
3. State-Bank-Nexus
   - End regulatory privilege for sovereign debt
   - Large-exposure limits

Completion of banking and capital market union

Non-performing loans

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Strengthen ESM, caution regarding SBBS

ESM is a key element of euro architecture
- Add rules for orderly restructuring of sovereign debt in crisis case
- Add mandate for monitoring fiscal policy of member states
- Medium term: Possible fiscal backstop for SRF in systemic crisis

Sovereign-bond-backed securitizations
- Strict conditions avoiding implicit liability risks
- Emission by private actors, abolish regulatory privilege of sovereign debt
- First abolish regulatory bias against securitisation of sovereign bonds

ECB policy characterized by „lower for longer“, purchases should be ended

- An expansionary policy stance will remain appropriate for some time
- But, growth above potential for several years, output gap closing, inflation has risen: Conditions call for removing some accommodation.
- Yet, ECB eases more by expanding balance sheet further.
- „Lower for longer“ compared to empirical reaction function and to Taylor rates even with estimates of medium-term equilibrium rates.
- Net purchases should be ended.
- Side-effect: allows stronger market influence on long-term rates, helps reduce build-up of interest rate risk on bank balance sheets.
ECB: „Lower for longer“ relative to empirical reaction function

ECB: „lower for longer“ relative to Taylor rates

Proposal: A strategy for monetary policy normalization

- Symmetric reaction of the ECB on macroeconomic developments
  - finish monthly asset purchases at an earlier stage
  - then gradually raise key policy rates
  - reduce longer-term asset holdings

- Forward guidance: forecast regarding
  - future development of asset purchases, reinvestments and key policy rates
  - as well as the sequence of these measures

- Comprehensive forecast of the future monetary policy
  - publish quantitative forecast on the expected path of asset purchases and key policy rates
  - alternatively: publish individual council member forecasts similar to the Federal Open Market Committee of the Fed
  - improve Eurosystem staff’s forecast by means of own interest rate forecast

- Expand communication to
  - reduce disruptions on financial markets in the course of monetary policy normalisation and
  - avoid the risk of fiscal and financial dominance

Thank you!

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