EXECUTIVE SUMMARY OF THE ANNUAL ECONOMIC REPORT 2014/2015

Economic outlook 2015

1. **Global economic growth** was below expectations in 2014. Although a slight acceleration in global growth is likely in 2015, the diverging development within the group of industrial countries will continue. The United States and the United Kingdom remain the growth drivers with GDP growth rates of 3.1% and 2.6%, respectively. The euro area is likely to experience a more modest performance. Yet, with expected GDP growth of 1.0% and an inflation rate of 0.7%, a slide into deflation remains unlikely.

2. After a surprisingly strong start to 2014, **the German economy** experienced a **significant setback**. Geopolitical risks and unfavourable developments in the euro area are likely to have played a role here. The energy, labour market and social security reforms introduced by the German government may also have had a negative impact on confidence. The subdued economic development is likely to continue in 2015; the German Council of Economic Experts (GCEE) expects a growth rate for GDP of 1.0%.

Economic policy overtaken by reality

3. The German government has been making extensive use of its economic policy leeway with the introduction of the full pension for those 63 year-olds with a particularly long duration of employment and the extension of pension entitlements to a selected group of mothers. By now, **reality has caught up with economic policy** more quickly than expected. The robust foundations of the German economy would still allow for a realignment of economic policy – but this time geared towards efficiency instead of just redistribution.

4. The new course should tackle **key long-term challenges**. Demographic change will reduce growth prospects from the 2020s onwards, if not before. Cyclical and structural crises can only be overcome if resistant and flexible structures are established in good times and an adequate fiscal buffer is created.

5. The less favourable prospects have triggered a lively public debate on an alleged **investment deficit** in Germany. While focusing on investment as a key determinant of future productive capacity is useful, the current debate is heading in the wrong direction, scrutinising symptoms rather than causes:

   – There are indeed indications that **public investment** is weak. However, instead of questioning the priorities for public budgets, the political discussion leads astray by emphasizing a lack of revenues and demanding either tax increases or greater government borrowing.

– There are no indications at this time of a pathological weakness in **private investment** ("investment gap") that needs to be cured by economic policy. Rather the economic environment for private investment and innovation should be improved to unleash market processes.

6. The therapy considered appropriate by the GCEE is based on the principles of the social market economy, ensuring the efficiency of economic processes and changing distributional results via the tax and transfer system, in line with the societal consensus. Overall, it would be advisable for economic policy to display **more confidence in market processes**. The reform requirements are considerable in view of the challenges. Despite the current attenuated economic outlook, the economic environment is still sufficiently favourable for implementing future-oriented reforms.

7. The efficiency of factor markets in Germany must be ensured in order to offer an attractive environment for private investment:

   – Instead of regulating the **labour market** ever more stringently, existing regulations should be critically examined and corrected. This applies in particular to the general minimum wage to go into effect nationwide from 2015. Correcting this policy would be necessary to enable the country to be resistant and flexible in the face of any future cyclical and structural crises.

   – Demographic change demands **social security systems** that are efficiently and sustainably financed. The current pension policy measures are going in the opposite direction. Instead, the length of working life should be adjusted in line with further rising life expectancy.

   – The **energy transition** should no longer be pursued on a purely national level but incorporated into an international climate protection strategy. Even a purely national plan could be organised more efficiently if the Renewable Energy Act (EEG) were fundamentally reformed.

   Lastly, the efficiency of the German education and innovation system should be improved and a closer integration of the German economy in the international division of labour must be ensured.

8. Enhanced growth prospects could contribute to more German savings flowing into domestic investment and foreign capital being attracted. The GCEE considers measures that increase production potential, such as higher immigration of skilled foreign workers and increasing labour force participation, to be sensible. On the other hand, no economic policy measures should be taken with the sole aim of reducing the German **current account surplus**.

9. No convincing distributional motivation for the recently implemented and still debated policy measures can be found. **Income inequality** has risen compared to the 1990s, not least due to higher employment of low-qualified, older and female workers. Since the reforms under Agenda 2010, however, inequality has not increased any further. There is already a high degree of income redistribution in Germany, in an international comparison.

Germany: Public finances

10. The budget is close to structural balance and the debt-to-GDP ratio will be significantly reduced. The requirements of the Fiscal Compact, the debt brake and the Stability and Growth Pact (SGP) are met. The **consolidation of public budgets** after the economic and financial crisis has been successful thus far.

As the economic environment is deteriorating, and given the structurally balanced budget, the fiscal policy leeway available within the scope of the debt brake may be used. However, important arguments speak against its use; most importantly, the **credibility** of the fiscal rules in the euro area is not yet ensured. Moreover, the favourable budget situation is attributable to bracket creep and temporary **special factors**: low interest rates, increased employment and a demographic respite. At the same time, structural spending has risen considerably.

11. Current projections show that public finances are **not sustainable in the long run** due to demographic change. Hence it is high time for a growth and investment-friendly fiscal policy.

- The scheme for **distributing government revenues** across the federal system could be re-designed in a more growth-friendly fashion by strengthening incentives for pursuing good economic policy at all federal levels. This would require lowering the high marginal transfer rate of the federal states, reducing the exceptions burdening the system and above all strengthening the fiscal autonomy of the German states through higher tax autonomy, in particular the possibility to levy limited tax surcharges on personal and corporate income tax.

- New start-up companies and the growth of young firms continue to be taxed inefficiently, as corporate taxation tends to discriminate equity financing. The GCEE continues to recommend the introduction of an **allowance for corporate equity** in this context.

- The coordination of international corporate taxation under the OECD Base Erosion and Profit Shifting (BEPS) initiative is sensible, but one should carefully avoid the expansion of inefficient anti-abuse rules in the process.

- The hidden increase in taxpayers' burden as a result of **bracket creep** due to inflation should be reduced.

- The existing financing needs for an effective **transport infrastructure** could be covered by shifts in public budgets.

Europe: Structural adjustment processes and monetary policy

12. Macroeconomic **adjustment processes** in the euro area member countries have progressed. They are not only the result of the ECB's announcement that it will undertake large-scale government bond purchases if necessary. The

adjustment also reflects structural reforms and fiscal consolidation, particularly in Ireland, Portugal, Greece and Spain. But the crisis in the euro area is not over yet. Italy, in particular, did not use the easing of financial market tensions for structural reforms and growth-friendly consolidation measures.

13. Euro-area inflation has declined considerably. Therefore, the ECB has cut its key interest rate to almost zero and introduced extensive **quantitative easing** measures. However, this policy holds dangers for long-term economic growth in the euro area. Firstly, low interest rates will tempt the financial sector to assume excessive risks. Secondly, the ECB purchase programs for private and public debt could result in governments curbing their reform and consolidation efforts.

The ECB should avoid massively expanding its balance sheet as long as deflation is neither observed nor forecasted in the euro area. Italy and France can contribute to a lasting improvement in economic performance by means of structural reforms and fiscal consolidation. The German government should advocate such a policy more strongly – and set a good example itself.

Europe: Financial sector regulation

14. The global financial crisis of 2007-2009 and the crisis in the euro area triggered **extensive reforms in the financial market architecture**. The reduction in implicit government bailout guarantees in the banking system can serve as an indication for the success of reforms. However, implicit guarantees remain high, above all for global systemically important banks and for those in countries with a strong fiscal position, such as Germany. Hence, there is still a great need for further policy action.

15. The **European Banking Union** can prevent risks from being shifted from the national to the European level and represents an important step towards a stable financial system. Common banking supervision of significant banks by the ECB has started. As the Comprehensive Assessment revealed only small capital gaps, the resulting capital increase in the European banking sector has been limited; a market shakeout is unlikely. For effective bank resolution it is essential that the **credibility of creditor involvement (bail-in)** is established. This has not been the case to date due to various discretionary loopholes in the bail-in provisions. Policymakers are called upon to further develop the framework for bank resolution at the European and global levels.

The euro area's new **macroprudential supervisory structure** is to be acclaimed. However, it should be shifted outside the ECB in the medium term in order to avoid conflicts of interest with monetary policy. At the national level, political influence is too strong in the German macroprudential authority. The impact of macroprudential instruments is uncertain and limited to the regulated sector, and there is a risk of **excessive fine-tuning**. Increasing banks' equity could already capture a large share of systemic risks in the banking system.