
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

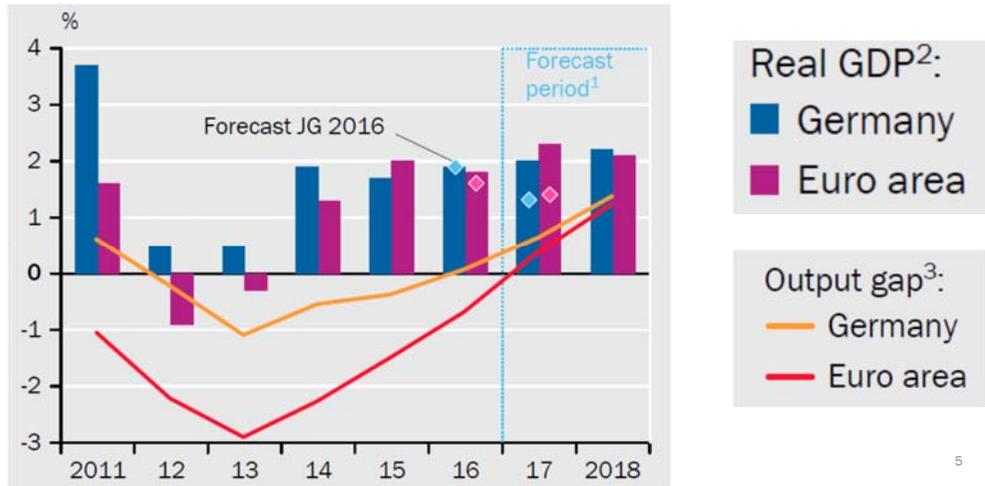


Germany and Europe: Outlook, challenges, policies

- I. Economic outlook
Over-utilization in Germany increases, sustained recovery in euro area
- II. Germany
Need for re-adjusting policies to adress long-term challenges
- III. Europe
Designing institutions and policies oriented towards sustainability

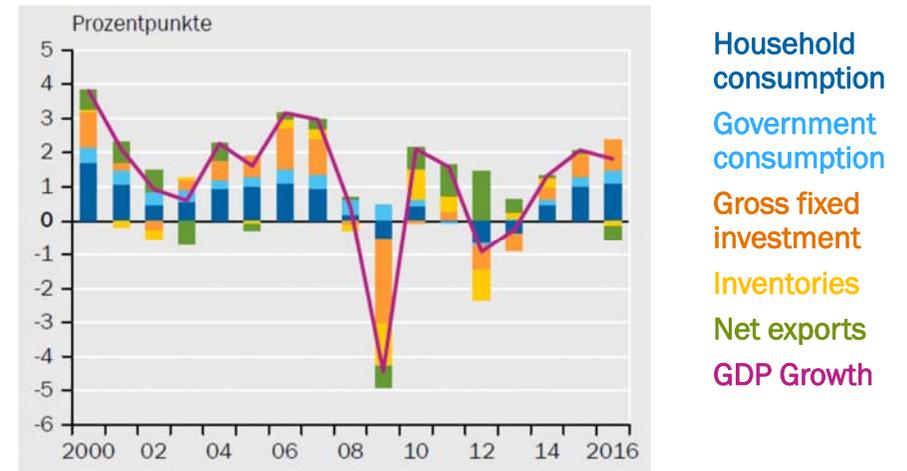
I. Economic outlook

Strong upturn – increasing over-utilization in Germany



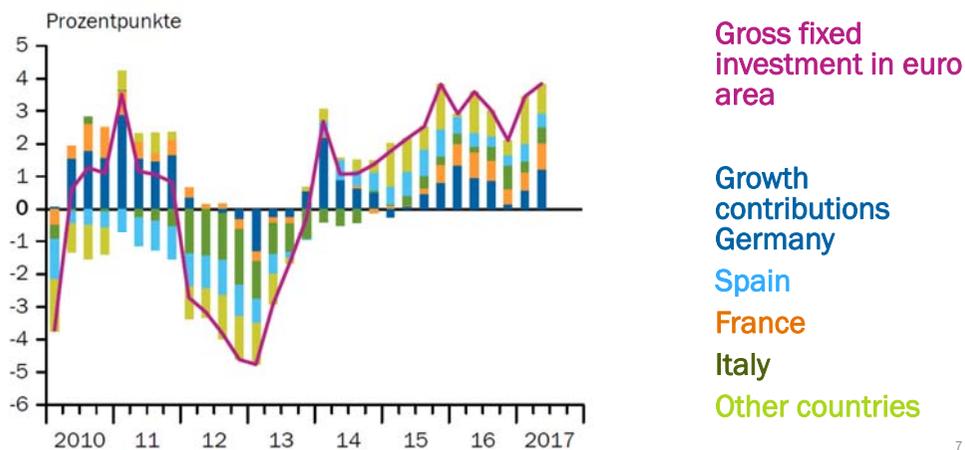
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Continuing recovery in the euro area



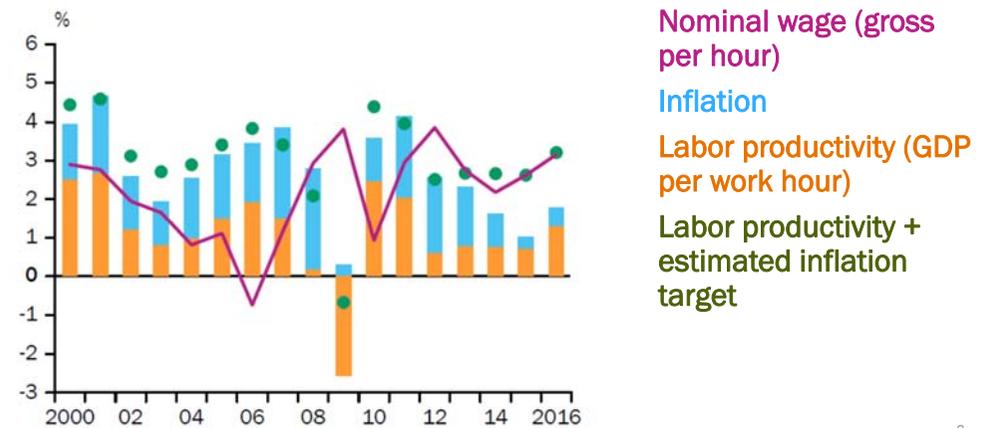
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Euro area: Investment dynamics indicate broad recovery



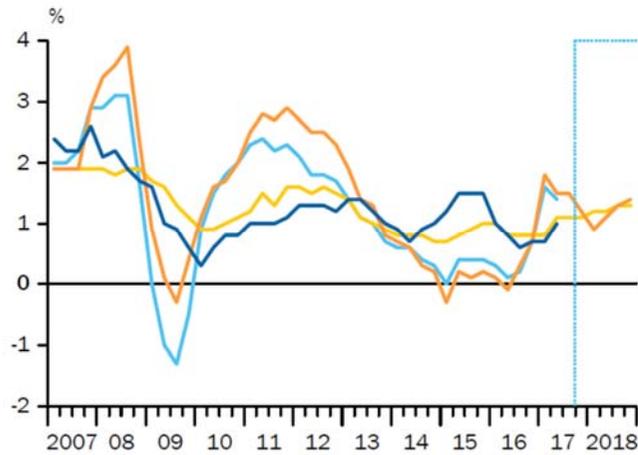
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Wage moderation in Germany ended a while ago



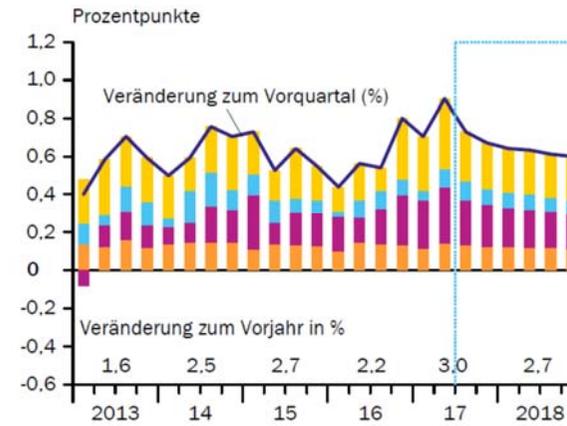
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Stable inflation in the euro area



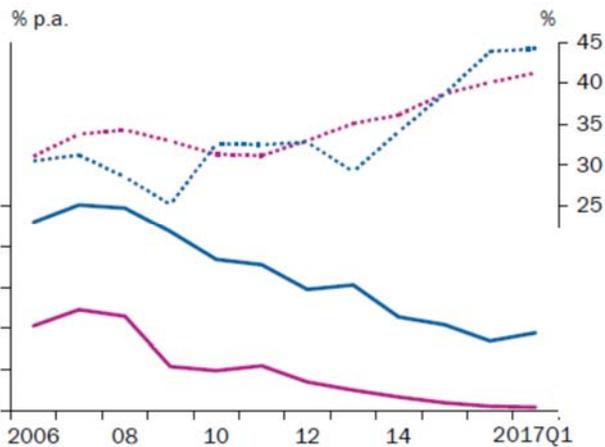
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High demand for German exports continues



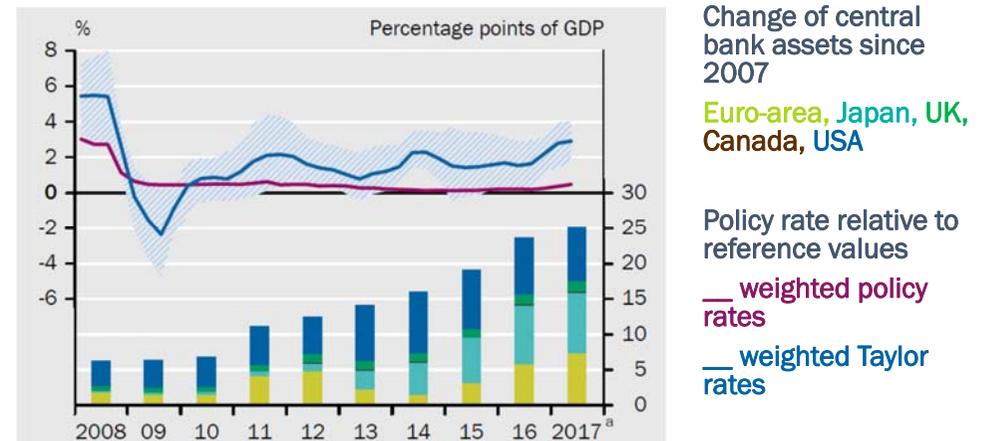
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Risks in bank balance sheets: Germany



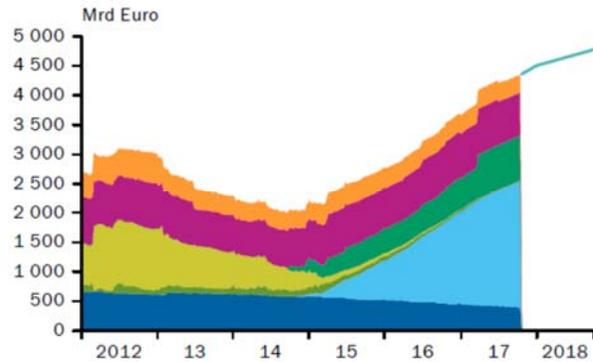
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Expansionary effect of monetary policy continues in major advanced economies



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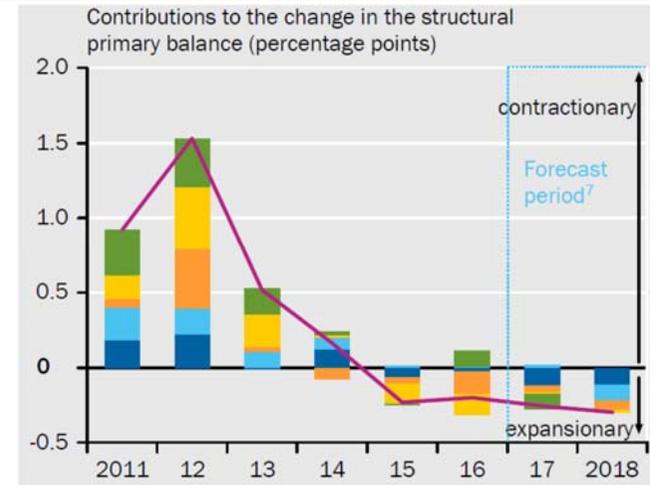
Euro-area: monetary policy expansion continues



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

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Euro area: Expansionary fiscal stance continues



Euro area: change in structural primary balance
Contributions:
Germany
France
Spain
Italy
Other countries

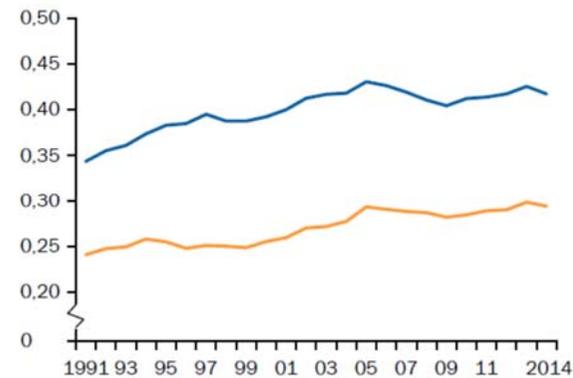
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II. Germany: Re-adjust policies to address long-term challenges

SACHVERSTÄNDIGENRAT
zur Begleitung der
gesamtwirtschaftlichen Entwicklung

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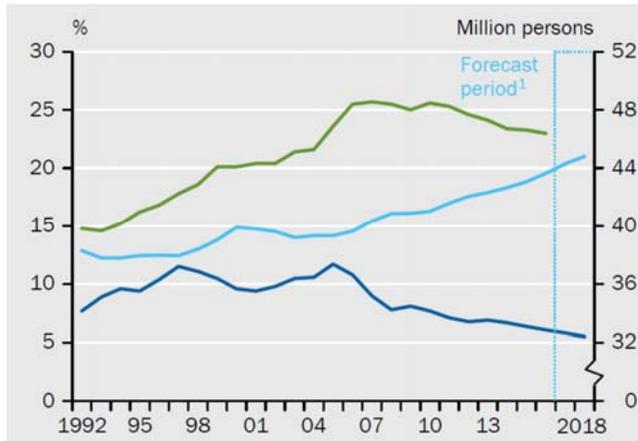
Challenged by increasing inequality? No! Stable since 2005.



Gini Coefficients
Market incomes
Net incomes post taxes and transfers

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German labor market in very good form



Unemployment rate
Employed persons (right scale)
Atypical employment

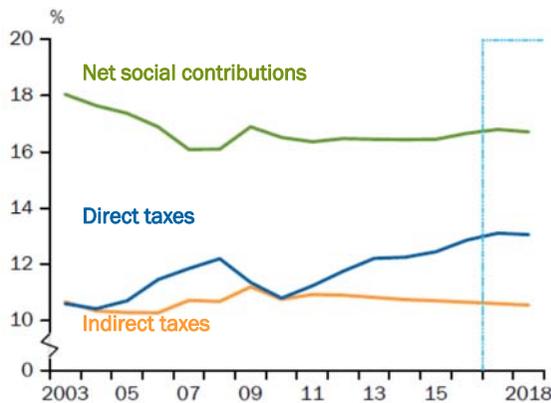
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Challenges

- Increasing overutilization and risk of overheating
- Sustainability in light of aging
- Technological change and digitalization
- Climate change and efficiency of energy policy
- Globalization and migration

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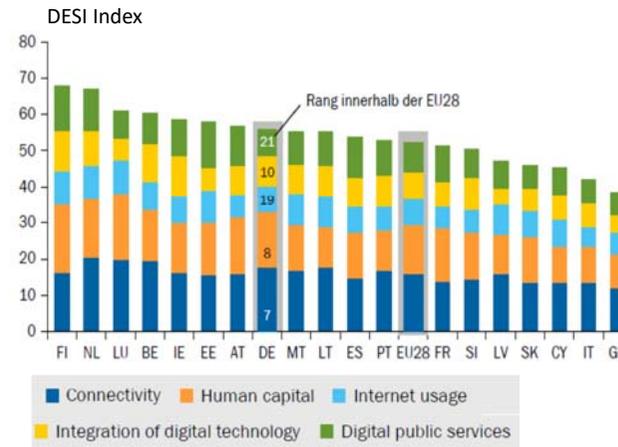
Overutilization: Raise potential via tax and other reforms



- 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

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Digitalization: For a regulation open to innovation



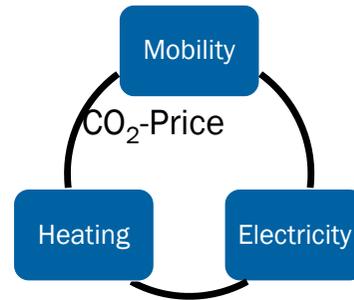
- Positive experience with automation in industry
- But just average on digitalization
- Expand infrastructure, priority to private investment
- More flexible labor regulation
- Innovation-friendly regulation
- Create digitalization commission

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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



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III. Europe: Institutions and policies oriented towards sustainability

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Focus on sustainability

Structural reforms for improving competitiveness and efficiency are national responsibility, need to continue reform process

Deficits have been reduced, but public debt still high, need to continue consolidation, make use of interest savings

Fiscal policy focused on national priorities, not euro area fiscal stance

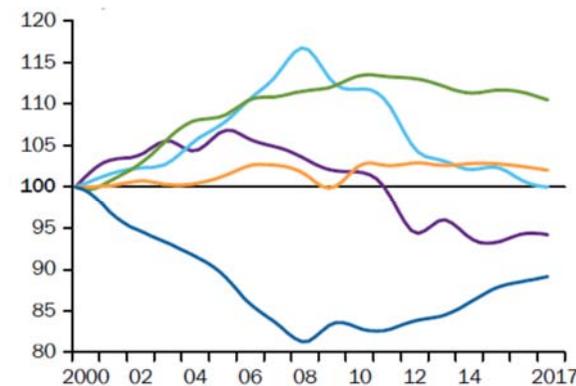
Reduce complexity of fiscal rules, joint fiscal capacity not needed

Expand ESM with role in surveillance and orderly sovereign debt restructuring mechanism

Completing banking and capital market union, risk-reduction prior to further risk sharing, caution regarding SBBS

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Convergence in euro area: Reforms as national responsibility

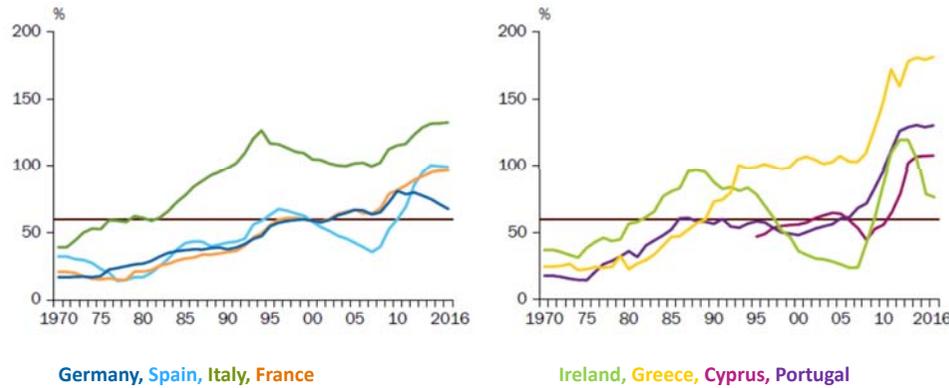


Real effective exchange vs euro area based on unit labor costs

Germany
Spain
Italy
France
Portugal

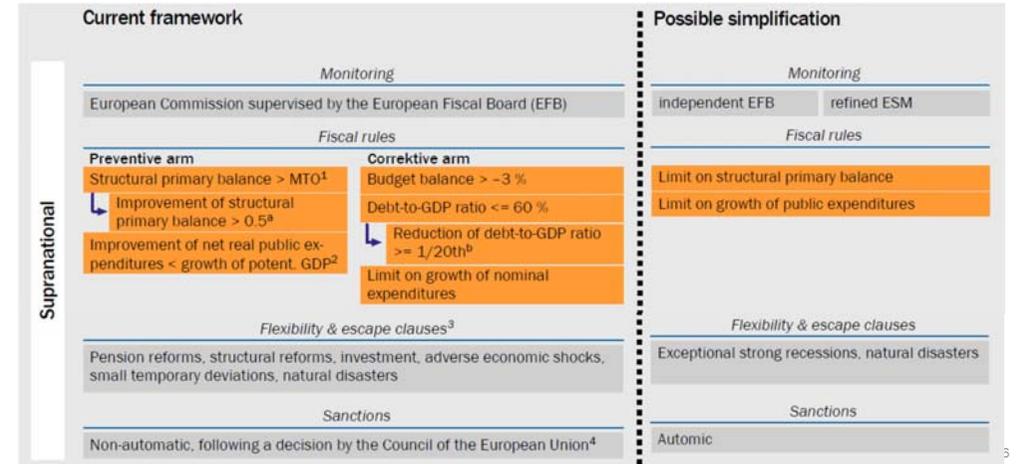
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Public debt still high, consolidation needs to continue



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Reduce complexity of fiscal rules



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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

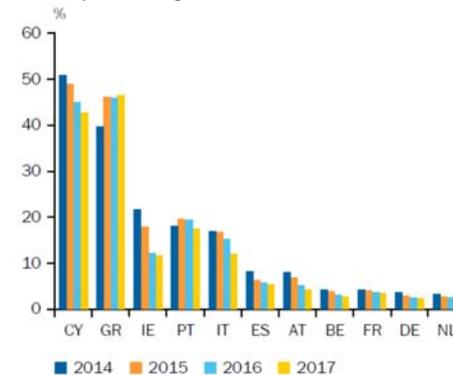
Joint fiscal capacity or other transfer mechanisms not needed

- 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

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Completion of banking and capital market union

Non-performing loans



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

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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 securities

- 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

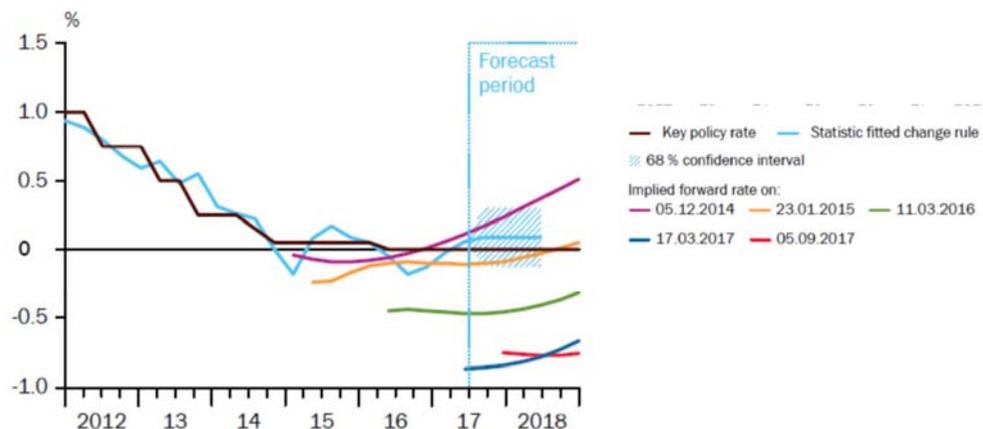
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ECB policy characterized by „lower for longer“, purchases should be ended

- 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.

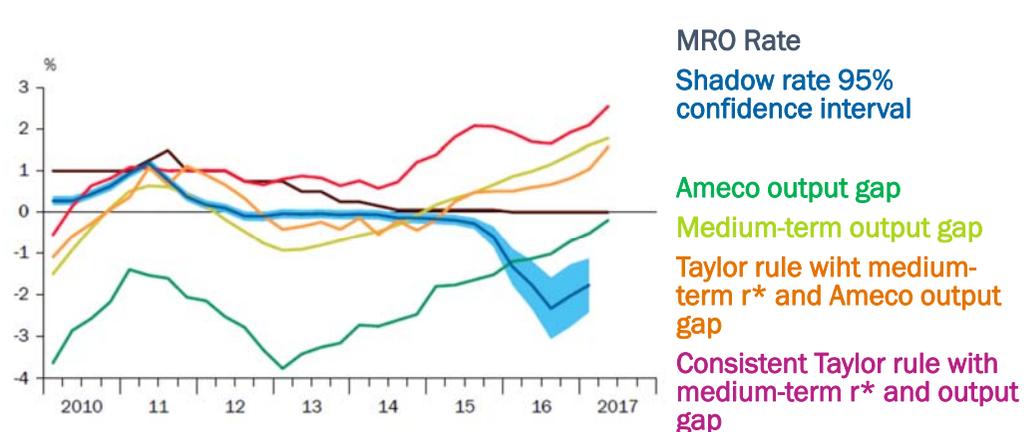
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ECB: „Lower for longer“ relative to empirical reaction function



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ECB: „lower for longer“ relative to Taylor rates



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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

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Thank you!

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