Chances for a stable upturn

Annual Report 2010/11

First Chapter

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Chances for a stable upturn

1. Phoenix rising from the ashes? Less than a decade ago Germany was widely seen as the sick man of Europe, lagging behind more dynamic economies and heaving under the strain of excessive business taxation, an ossified labour market, an overgenerous social security system and, above all, a chronic incapacity to implement radical reforms.

The tune has changed now. Germany's negotiation of the crisis has elicited respect and admiration from all quarters, especially on account of its robust employment trend. Many countries currently look to Germany as a **driver of growth**, and the only thing they find fault with is its international competitiveness, which has produced calls for Germany to halt its export juggernaut and concentrate instead on stimulating domestic demand.

2. As is so often the case, the **truth lies somewhere in between**. In the course of 2010 Germany indeed **shrugged off the crisis** thanks to an exceptionally **strong and rapid recovery**. The pace of growth of German gross domestic product (GDP) in 2010 will amount to 3.7 per cent, due equally to domestic and external stimuli. The official jobless total has fallen steadily and in October 2010 dropped below three million for the first time in 18 years. By contrast, the economic performance of the euro area excluding Germany will be much more modest, with output expanding by just 0.9 per cent and the unemployment rate remaining stuck at around 11 per cent.

But that is only half the story. The recovery must be matched against the **steep slump in 2009** which caused the German economy to shrink by a dramatic and unprecedented -4.7 per cent. Exports were hit particularly hard, tumbling by 14.4 per cent, although this decrease was largely reversed in the course of 2010. This was due partly to the uplift in world trade – which expanded by 12.3 per cent in the first half of 2010 – and partly to the strong competitiveness of Germany's export industry. The economic crisis had chiefly affected the country's **export-related industries** which, however, had become leaner and fitter prior to the crisis through innovation and rationalization. As these industries also employ a disproportionately high share of skilled workers, they also had a strong vested interest in keeping them on the payroll for as long as possible.

Given the recent rollercoaster ride of global trade, the strongly export-led profile of the German economy thus explains the swing in German economic activity – i.e. both the sharp slump in 2009 and the ensuing steep rebound this year. In turn, the large proportion of skilled workers in export-oriented sectors, coupled with a forecast shortage of skilled labour going forward, explains why there was no massive wave of layoffs. While the policy pursued by many firms of coping with shrinking order books primarily by reducing worker hours was significantly underpinned by extended government subsidies, **short-time working** nonetheless cut employee earnings appreciably and also bloated the wage bill. The retention of redundant workers accounted for almost 30 per cent of gross pay costs; in other words, this hoarding of labour temporarily squeezed profits.

3. There are two more aspects to the bigger picture. On the one hand, the **political leaders** in Germany more or less successfully halted the downward slide of the economy by launching several **stimulus programmes** and, after losing the plot for a while – especially in the field of fiscal policy – have now made a start on tackling a raft of **problems**. On the other hand, they are also reaping the rewards of the reform policies put in place by the **preceding governments**, as is illustrated by the following three examples.

First, far-reaching **labour market reforms** were implemented in the middle of the current decade which tilted the relative attractiveness of gainful employment and subsidized idleness back in favour of the former, for instance through the introduction in 2005 of a more stringent welfare benefit regime known as "unemployment benefit II" (*Arbeitslosengeld II*). Together with a generally moderate wage policy course, the labour market reforms helped to lift employment significantly in the years preceding the deep recession to a level which was more or less maintained throughout the economic crisis, thanks largely to the pursuit by the social partners of a strategy geared chiefly to safeguarding jobs. This was bolstered by reforms in the **social security systems**. The main planks of this reform were laid by raising the statutory retirement age to 67 years and introducing several adjustment factors into the formula for calculating pension increases via the Pension Insurance Sustainability Act (*Rentenversicherungsnachhaltigkeitsgesetz*).

Second, a comprehensive reform of **business taxation** was completed in 2008. This finally freed Germany of the embarrassing tag of being one of the highest corporate taxers in the world by bringing corporate tax rates down to an internationally average level which, given Germany's other assets and attractions as a business and investment location, is an acceptable position.

Third, the previous administration passed a fiscalrule capping long-term structural government borrowing, known as the **debt brake** (*Schuldenbremse*), which will enter into force in 2011 and is already on the minds of fiscal policymakers. The debt brake, which has been incorporated as a constitutional cornerstone into Germany's Basic Law (*Grundgesetz*), limits central government structural borrowing as from 2016 to 0.35 per cent of nominal GDP and lays down a deficit reduction path for reaching that goal. Even stricter rules on debt incurrence will apply to the 16 federal states (*Bundesländer*) as from the year 2020.

Although not all the details have yet been ironed out, the debt brake along with the prescribed consolidation path represents a notable fiscal policy achievement. The **consolidation path** starts in 2011 and so should place no great strain on the recovery. On the contrary, if policymakers stick doggedly to the consolidation path, this will greatly boost the credibility of their avowed intent to put public finances on a permanently sound footing.

Germany's comparatively solid public finance position by international standards and the consolidation course laid down by the debt brake have improved the attractiveness of **German government bonds** as a "safe haven" amid the turbulence on the international capital

markets. Given a generally low interest rate environment in many countries, this has pushed down long-term borrowing rates to historically low levels.

4. Notwithstanding the positive nature of the aforementioned reforms, a watchful eye needs to be kept on the danger of **backsliding** in the selfsame policy areas. Thus the provisions relating to unemployment benefit II are still open to political tinkering, as was clearly evidenced by the lobbying that accompanied the changes in 2010 necessitated by a ruling of the Federal Constitutional Court (*Bundesverfassungsgericht*). Various lobby groups attempted in effect to loosen the strings currently attached to the receipt of unemployment welfare benefits. The same applies to the raising of the retirement age to 67, which determined protesters are still attempting to scupper. Parts of the business tax reform are likewise being vociferously called into question, such as the level of, or even justification for, withholding tax (*Abgeltungsteuer*), and calls are being made to raise the top rate of income tax, which would also affect many small and medium-sized enterprises. The consolidation of public budgets is another ongoing tussle whose outcome is still uncertain. Thus while just about everyone backs the idea of trimming public finances, all react with righteous indignation to any suggestion that this might entail tightening their own belt.

5. The unexpectedly positive rebound of German economic activity offers **chances** of attaining a stable, albeit fairly flat growth path. But the potential **risks** cannot be ignored either.

The tentative optimism regarding the chances is grounded on two stimuli.

- The first stimulus concerns the sustained revival of domestic demand in the private sector, meaning consumption and investment. Stronger domestic demand would not only help to offset possible fluctuations on the export front but would also have the added benefit of helping to reduce international imbalances.

- The second stimulus is the still buoyant export momentum fuelled by the high competiveness of German products and a favourable macroeconomic environment, especially in the emerging market countries. Yet it is precisely this external stimulus that is most vulnerable.

If these chances are to be successfully exploited, they must be underpinned by an economic policy stance that lays the necessary groundwork for a higher growth path.

6. The **revival of private domestic demand** – the **first stimulus** driving the chances of attaining a stable growth path – could be achieved in one of two ways. On the one hand, the buoyant labour market trend could boost private consumption. Employees' worries that they might be made redundant are likely to be dispelled by the positive employment climate, while unemployment is likely to fall further in the coming years in light of the projected shortage of skilled workers. Moreover, rising employment will also tend to push up wages.

On the other hand, it seems not unreasonable to expect a growing trend in private **investment**. This expectation is rooted in historically low short and long-term nominal interest rates. In Germany these should additionally be reflected in low **real interest rates** by international standards. In other countries, by contrast, risk premiums due to bloated sovereign debt and concerns about deflation are keeping interest rates higher than in Germany. International investors' risk propensity will remain subdued, not least after burning their fingers in the real estate sector in some euro-area countries or the United States, where many investments have turned out to be far riskier than investors supposed. Given high government debt and sluggish growth in these countries, there is little prospect that these risks will diminish soon.

7. The **second stimulus** for a stable upturn rests on the **high competitiveness of German firms** and on their very dynamic sales markets in some cases. Here, however, the risks are particularly high. A waning export momentum could cancel out or even outweigh a pick-up in domestic demand. Such a **weakening** of export dynamics is by no means an unrealistic scenario and could be triggered by four developments.

- A number of countries might be confronted before long with an economic slowdown, which would inevitably curtail their import demand. This could be caused by high and rising unemployment and by wealth losses on the part of private households in the wake of the financial market crisis.

- The tough austerity programmes that have been initiated in countries such as the United Kingdom and the peripheral euro-area countries (Greece, Ireland, Portugal, Spain) may reduce the demand for German exports directly to these countries and indirectly via third countries. Economic developments within the euro area continue to display substantial imbalances with as yet unknown implications.

- Looking back at the events of the past few years, it cannot be ruled out that financial market turbulence might suddenly erupt again and spill over to the real sector. Banks' balance sheets still carry positions that will likely require sizeable write-downs.

- International exchange rates are subject to growing tensions, and there is already talk of a looming "currency war". One of the prominent accusers is the United States, which claims that the Chinese renminbi is undervalued and threatens to take retaliatory measures. Not only such a tit-for-tat currency war but equally a US monetary policy stance that tolerates significantly higher inflation rates may drive up the euro's external value and hence drive down German exports.

8. The potential for a stable economic upturn needs to be actively supported by appropriate **economic policy initiatives**. These must lay the groundwork for ensuring that the German economy is capable of exploiting growth chances. The objective must be to move forward from the very sluggish rate of expansion vis-à-vis other EU states recorded over the past decade (although this was partly due to the financial strains of German reunification) towards a higher, steeper growth path.

9. In its Annual Report 2009/10 the German Council of Economic Experts – GCEE (*Sachverständigenrat*) outlined an economic strategy geared both to the immediate future and to a medium and long-term perspective. This encompasses, first, the **exit strategies** from the non-standard monetary and fiscal policies and the public support measures for the banking system with a view to reducing the crisis-induced government interventions to a normal measure. Second, the strategy emphasizes the medium and long-term perspective with the aim of lifting Germany onto a higher **growth path**. This requires investment in education and in the country's innovation potential. This growth strategy remains valid and viable, though its implementation will require patience and perseverance. It is therefore time to take stock and examine what progress has been made so far in the field of economic policy, particularly with regard to the exit strategy, and what still needs to be done.

10. The **growth strategy** must couple the defensive aim of countering the persisting danger that the German economy might drift down a low growth path with the offensive goal of improving its chances of attaining a higher growth path (Annual Report 2009 sections 33 ff.). This can be achieved by investing in the country's long-term future through the promotion of educational excellence and innovation.

- An **education offensive** needs to meet two objectives. It must raise the general level of education in Germany, which is currently merely middling by international standards. And it should ensure equal chances of gaining access to higher education, especially for children and youngsters from socially disadvantaged backgrounds. Investment in education should begin at early stages in the learning cycle, for example by funding a mandatory pre-school year, building a nationwide network of all-day schools and making it easier to transfer from one segment of the education system to another. These measures will particularly benefit children from immigrant families. The German government has taken a first step towards improving the educational prospects of children; this must now be followed by further-reaching reforms.

- **Innovation policy** should continue to strengthen the innovation infrastructure, provide suitable incentives for stimulating competing ideas and projects and ensure that state support is scrupulously transparent, of limited duration and conducive to galvanizing entrepreneurial creativity. The government should continue to prioritize the granting of tax incentives for research and development by companies.

11. Five areas where policy initiatives are required can be identified over the short to medium term.

(i) Overcoming the **crisis in the euro area.** The major need is to establish an institutional framework for lasting stability without abandoning key national competencies in the field of fiscal policy. A sustainable framework for the euro area should be based on three pillars:

- **stable public finances.** The Stability and Growth Pact needs to be tightened in such a way that timely and effective sanctions are imposed on countries pursuing an unsound fiscal

policy. This will also necessitate strengthening the European Commission's position vis-à-vis the European Council.

- **stable private financial system.** The euro area needs a tailor-made institutional framework for ensuring the stability of the financial system. A single currency area needs harmonized financial oversight.

- **European crisis mechanism.** This must be designed in such a way that it lends support to member countries in the event of serious disruptions of the capital markets but at the same time ensures that investors cannot bank on the one-way bet that the European Community will invariably bail out a state that pursues a misguided fiscal policy.

(ii) **Reform of the national and international financial market architecture.** This essentially requires defining effective financial market reforms and finding a way of dealing with systemic risks. This breaks down into the following specifics.

- The triple objective of financial market reform should be: to stiffen the financial sector's resilience and reduce procyclicality; to strengthen market stability and reduce systemic importance, for instance by regulating financial products that are currently traded over the counter; and to realign the system of banking supervision.

- At the European level an integrated and viable **financial oversight system** should be established, while in Germany the present twin-peak structure of prudential supervision should be unified without further delay under the aegis of the Deutsche Bundesbank.

- Current **German legislation** aimed at the restructuring and resolution of ailing banks contains many progressive aspects. However, this needs to be embedded within a European mechanism for dealing with cross-border insolvencies.

- There is still no agreed prescription for dealing with **systemically important institutions** – the most arduous legacy of the financial crisis. What is needed is either a levy differentiated according to the degree of systemic risk (Pigovian tax) or a corresponding capital surcharge.

(iii) Implementation of the required **consolidation of public budgets** and **reforms of the tax system.** As the economic recovery gets underway, public budgets should be resolutely consolidated and confidence in the long-term sustainability of public finances reinforced. Fiscal policymakers should focus on two major challenges.

- The new **debt rule** is a key and cogent contribution towards effectively capping government indebtedness. But its practical application provides scope for political engineering and leaves some details unclarified.

- On the taxation front, policymakers have now bowed to reality and shelved plans for unfunded tax hand-outs. But unfinished business remains in the form of the announced restructuring of **municipal finances** and the necessary reform of **the value-added tax**.

(iv) The rigorous implementation of the reforms initiated in the **social security systems** and their complementation.

- With the draft Act on the Sustained and Socially Equitable Funding of the Statutory Health Insurance Scheme (*Gesetz zur nachhaltigen und sozial ausgewogenen Finanzierung der Gesetzlichen Krankenversicherung*) a start has been made on reforming the method of financing the **statutory health insurance scheme** which could pave the way to a funding system that is no longer pegged to labour income. Such a funding system should be targeted as a medium-term objective and complemented by measures to enhance competition among healthcare service providers with a view to extracting efficiency reserves.

- In the **statutory pension insurance scheme** the key need is for policymakers to stand their ground and commence the planned incremental raising of the official retirement age and clawback of the excess pension component.

(v) A forward-looking underpinning of **labour market policy**. Despite the upswing on the labour market, a number of problems are still unresolved. They include

- the need to strengthen incentives for recipients of **unemployment benefit II** to find a job on the primary labour market,

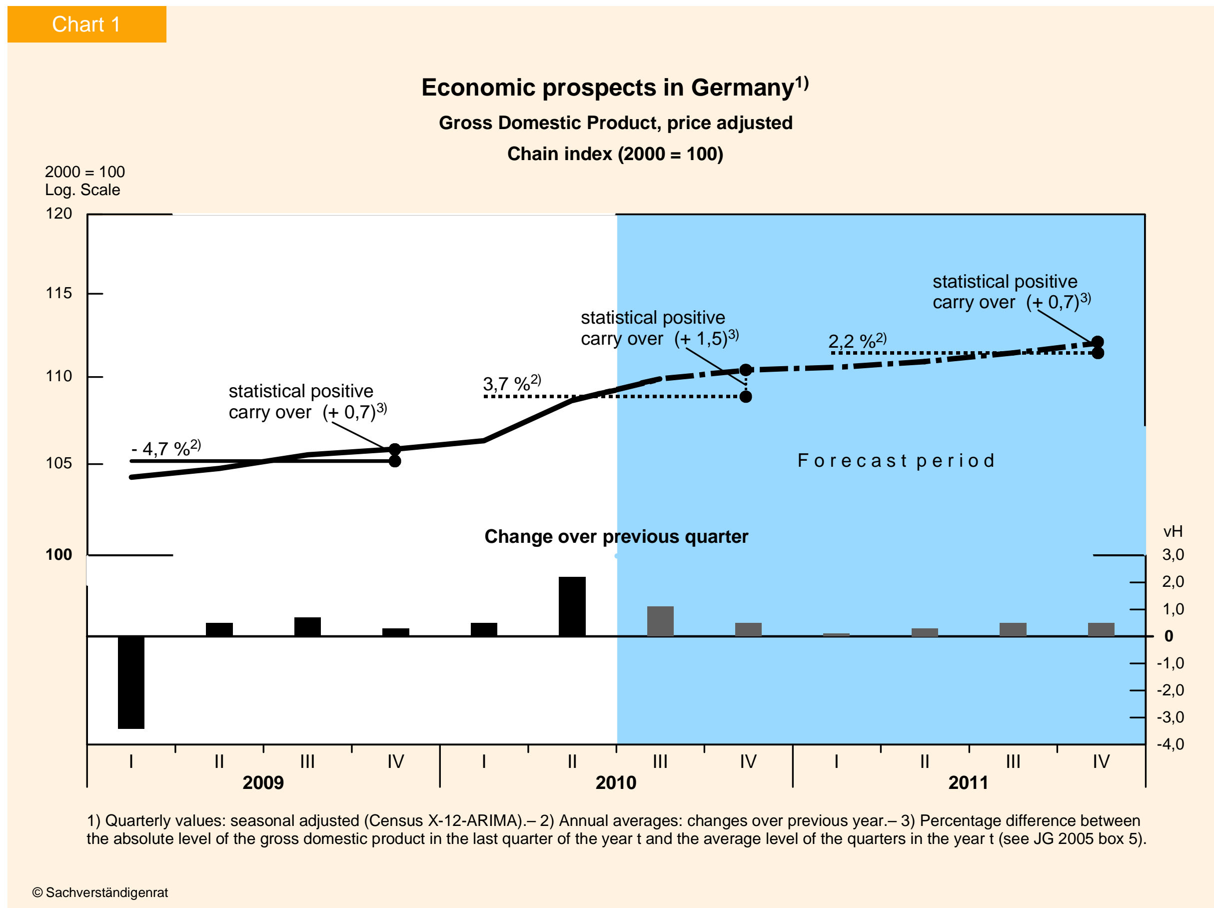
- the need to avoid overhasty or misguided reactions to institutional changes in **collective bargaining legislation** and in the EU's extended rights of **cross-border labour mobility**.

12. The chances of achieving a stable upturn are not bad, although expectations should remain within realistic bounds and not be confused with impossible dreams. Economic policymakers certainly have no reason to take their foot off the reform pedal. The German government has started afresh on tackling key problems, this time taking a more workmanlike approach.

I. The status quo: strong economic recovery losing speed

13. The economic recovery which began in Germany in mid-2009 gathered considerable speed until the second quarter of 2010 before peaking in the spring (Chart 1). The available economic indicators suggest that the upturn will continue, albeit at a slower pace. The positive development of the global economic setting, which up to now has supported the cyclical upswing in Germany through export demand, is likely to slacken. The crisis has blunted or stunted growth in many industrial nations. By contrast, there is a good prospect that the emerging market economies will carry on expanding forcefully.

Chart 1



1) Quarterly values: seasonal adjusted (Census X-12-ARIMA).– 2) Annual averages: changes over previous year.– 3) Percentage difference between the absolute level of the gross domestic product in the last quarter of the year t and the average level of the quarters in the year t (see JG 2005 box 5).

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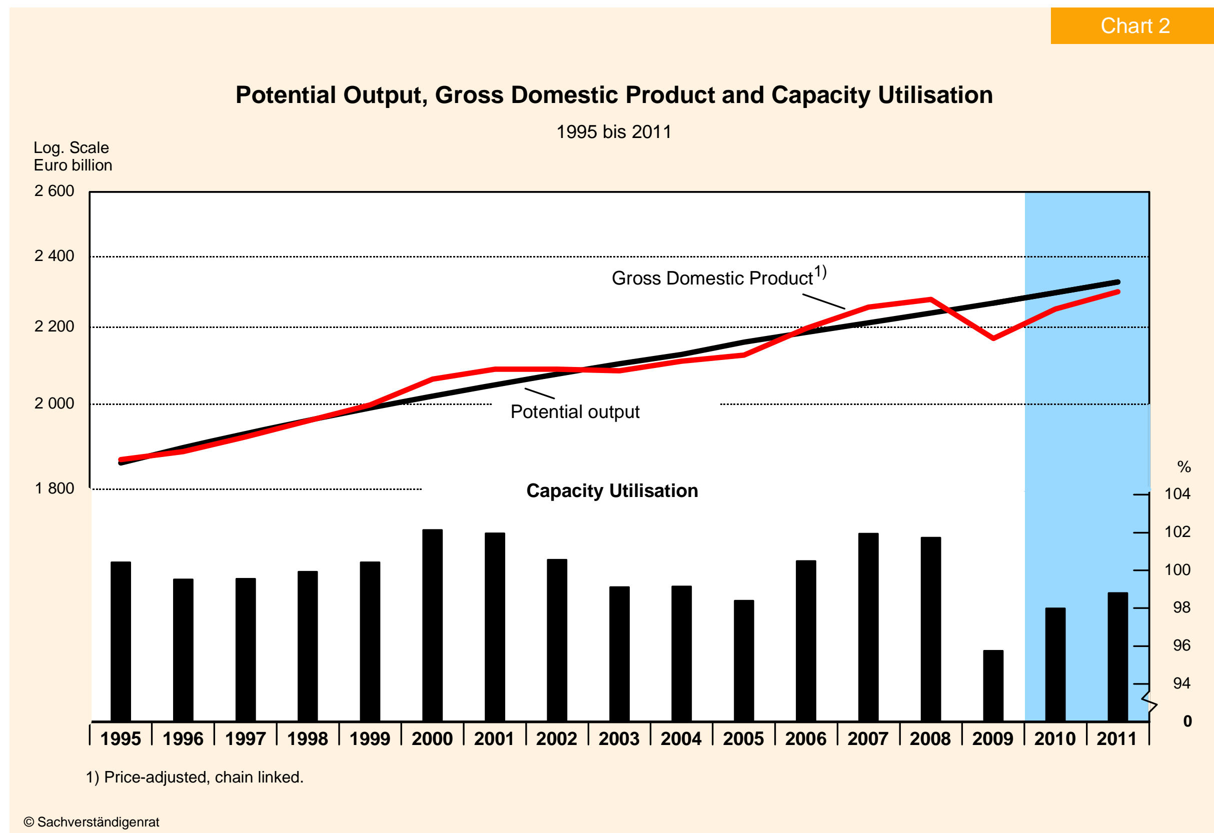
The external stimuli propelling the German economy will weaken as the fiscal interventions launched all around the world to halt the slump expire and many countries set about further consolidating their budgets. The GCEE forecasts that German GDP will grow by 3.7 per cent in 2010 and by 2.2 per cent in 2011. In other words, the upturn in Germany will lose momentum. Inflation is showing signs of stabilizing at a moderate level. Consumer prices will probably rise by 1.1 per cent in 2010 and 1.4 per cent next year (Table 1, page 10).

14. When assessing the dynamic progression of the upturn to date, it should be remembered that the level of GDP reached in mid-2010 merely matched that achieved back at the turn of 2006/2007. The GCEE's projection for Germany indicates that the fall in output caused by the crisis will finally have been cancelled out by the end of 2011. This means that the German economy will have taken around three years to recoup the GDP losses that ensued from the crisis.

Actual output therefore still lies below **potential output**, i.e. the volume of aggregate production that could be generated by normal utilization of all capacities without generating additional inflationary pressure (Chart 2).

Potential output in Germany appears to have been impaired far less than was feared during the crisis. The GCEE gauges the potential growth rate at 1.3 per cent in both 2010 and 2011. This means that the negative aggregate output gap in 2010 can be put at around 2.0 per cent of po-

tential output and could be closed towards the end of 2011 if gross domestic product expands at the anticipated rate.



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15. On the back of the surprisingly strong economic recovery, German firms began **in 2010** to extend working hours again and to hire new staff. The net number of employed persons increased in 2010 by 196,000. The number of persons officially registered as unemployed decreased in the same period by 178,000. This pick-up in the labour market was split more or less equally between western and eastern Germany, after the rise in unemployment in 2009 had affected almost exclusively western Germany. The **simultaneous increase in working hours and employment** shows that the current cyclical revival is not a phase of jobless growth.

16. The measures taken by the German government to stabilize the economy and the financial sector have caused public debt to swell substantially. The state must now roll back its interventionist stance so as to curb government indebtedness and not jeopardize long-term economic growth. The incorporation of the new debt rule into the Basic Law has laid the bedrock for consolidation. The general government **fiscal deficit** will fall by €30 billion in 2011 year on year, thanks largely to the cyclical upswing, but will nonetheless remain at the high

level of €62 billion. Assuming that no further substantial measures have to be taken to stabilize the financial sector, this means that the debt-to-GDP should drop slightly following three years of marked increases. Nevertheless, the need for budget consolidation remains high. The economic upturn should be seized as an opportunity to make significant advances in this direction.

Table 1

Key economic indicators for Germany[1]

	2007	2008	2009	2010[2]	2011[2]
Gross domestic product	*2.7*	*1.0*	*– 4.7*	*3.7*	*2.2*
Private consumption[3]	*– 0.2*	*0.7*	*– 0.2*	*0.1*	*1.6*
Government consumption	*1.6*	*2.3*	*2.9*	*3.0*	*1.0*
Investment in machinery & equipment	*10.7*	*3.5*	*– 22.6*	*9.2*	*6.0*
Buildings	*– 0.5*	*1.2*	*– 1.5*	*4.2*	*1.8*
Other investment	*6.8*	*6.5*	*5.6*	*6.7*	*6.5*
Total domestic demand[4]	*1.2*	*1.2*	*– 1.9*	*2.2*	*1.9*
Exports of goods and services	*7.6*	*2.5*	*– 14.3*	*15.5*	*6.7*
Imports of goods and services	*5.0*	*3.3*	*– 9.4*	*13.3*	*6.8*
Persons employed (domestic)[5]	39.72	40.28	40.27	40.47	40.76
Registered unemployment, stocks[5]	3.78	3.27	3.42	3.25	2.97
Persons employed, covered by social security[5]	26.94	27.51	27.49	27.80	28.17
Unemployment rate[6]	*9.0*	*7.8*	*8.2*	*7.7*	*7.0*
Consumer prices[7]	*2.3*	*2.6*	*0.4*	*1.1*	*1.4*
General government balance[8]	*0.3*	*0.1*	*– 3.0*	*– 3.7*	*– 2.4*

1) Unless otherwise indicated: price-adjusted (changes over previous year); Change over previous year in percent (%).– 2) 2010: own estimate, 2011: forecast.– 3) Including non-profit institutions serving households.– 4) Domestic use.– 5) Thousands persons.– 6) Unemployment rate referred to entire civil sector workforce (employees, self-employed including unpaid family workers). Source: years 2007 to 2009 Federal Labour Office (Bundesagentur für Arbeit).– 7) Consumer price index (2005 = 100), change over previous year in %.– 8) Net lending of the central, state and local governments and the social security system, as % of nominal gross domestic product.

17. The crisis has impeded Germany's economic development less than many people feared a year ago. Key factors in this were the robust rebound of the labour market, the smaller than expected increase in the fiscal deficit and the non-realization of the feared credit crunch. Moreover, the real sector of the German economy was not impaired by the renewed turmoil on the financial markets that followed on the heels of the sovereign debt crisis in the peripheral euro-area countries in spring 2010. Germany's economic performance over the forecast horizon could be harmed by the danger of a currency and trade war, which could have considerable implications for global economic recovery and hence for the upturn in Germany. On balance, the **consequences of the crisis for Germany** to date have been less damaging than in other industrial countries. Consequently, the German economy has a good chance of returning to its pre-crisis growth path.

II. European monetary union in crisis

18. The sharp tensions in the euro area have rekindled underlying doubts about the benefits of a currency union. Notwithstanding the real problems, it is worth remembering that budget deficits and debt ratios have increased not only in the euro area but also no less in the United States, Japan and the United Kingdom. Like those three countries, the member states of the euro zone are suffering from the **consequences of the economic and financial crisis**, which continue to place considerable strains on government budgets. Yet some of the disruptions and dislocations in the euro area are attributable to the **specific conditions of a currency union**.

- The fact that Greece was able to pursue such an unsound budgetary policy for over a decade is at least partially due to the financial markets' ex ante assumption, despite the EU Treaty's clear strictures to the contrary, that, when push came to shove, a state in financial distress would be **bailed out** by the other member countries.

- Owing to the **one-size-fits-all interest rate policy**, the phase of cyclical overheating in Spain, Greece and Ireland persisted for longer than would have been possible in a situation of separate national monetary policies.

- After wages rose much too steeply in the euro-area problem countries over many years, they can no longer resort to nominal **devaluation** to cushion the negative demand effects of budgetary consolidation and rapidly improve their competitiveness without wage cuts.

- The crisis revealed another specific feature of a currency union. In the United States, Japan and the United Kingdom, the central bank purchased vast quantities of government bonds via **quantitative easing** in order to prevent a government financing squeeze. The euro-area countries, by contrast, are basically reliant on capital market funding, which places them at the mercy of the global financial markets. This is the logic behind the massive support intervention programmes that were agreed in May 2010 first for Greece and then for the entire euro area.

19. In view of the enormous adjustment problems facing the stricken euro-area states – above all Greece, Ireland, Portugal and Spain – both now and going forward, it has been suggested that **Germany**, as the largest member state, could or should make an active contribution to stabilizing the euro-area economy. Simulations show, however, that neither pay rises exceeding the increase in productivity nor an expansionary fiscal policy are conducive to noticeably improving the lot of the distressed countries. The simulations also show that a reduction in the imbalances can be achieved through reforms aimed at durably strengthening domestic demand in Germany.

20. In its Annual Report 2009/10 the GCEE outlined its ideas for a stricter fiscal framework in the form of a **consolidation pact**. On 29 October 2010 the European Council endorsed the report of the Van Rompuy task force and called for a fast-track approach in which reforms not requiring an amendment of the Treaty should be implemented by summer 2011. In addition

the Council identified a need for a permanent crisis resolution mechanism which would, however, necessitate modifying the Treaty slightly.

21. If similar crises are to be avoided in the future, the euro monetary union requires an **institutional** framework that addresses the specific problems of such a currency union better than the rules agreed for the euro area in the 1990s. With this aim in mind, the GCEE proposes a **three-pillar model**:

- **stable public finances.** The Stability and Growth Pact is in need of fundamental reform. In particular, this reform must ensure that sanctions are possible also if a country fails to meet its medium-term budget target or if its debt-to-GDP ratio is not constantly diminishing. Beefing up the pact requires strengthening the Commission's role in the excessive deficit procedure vis-à-vis that of the Council such that the initiative for imposing sanctions lies with the Commission and the Council can only reverse this decision by a sufficient overturning vote. The proposals made by the Van Rompuy task force would help to substantially bolster the requirements of a stability-oriented fiscal policy and significantly accelerate the sanction procedure. However, the Economic and Financial Affairs Council (Ecofin) would retain a dominant role in the individual steps of the procedure. This would perpetuate the present situation in which the imposition of sanctions can be blocked for reasons of political expediency. The requisite stronger role for the Commission thus needs to be formally and speedily stipulated in a Treaty amendment.

- **stable private financial system.** Given the substantial costs that all member countries will incur in the wake of the financial and economic crisis, the euro area crucially requires tailor-made mechanisms to safeguard the stability of the financial system. A single currency area requires an integrated financial oversight regime. The new institutions envisaged for the European Union – the European Systemic Risk Board (ESRB), European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) – do not fully fit the bill.

- **mechanism.** When the monetary union was set up, no institutional rules for crisis scenarios were agreed beyond the no-bail-out clause. The result of this was that in May 2010 gigantic rescue shields were set up overnight without having been preceded by and based on a detailed political and scientific debate. In order to obviate such abrupt and arbitrary operations in future, it is vital to put in place a permanent European crisis mechanism to replace the temporary protective shields. This mechanism must provide support to member countries in the event of serious capital market disruptions without giving investors the impression that the Community will always bail out states that pursue a reckless fiscal policy. Where the Commission has proposed the imposition of sanctions on a country under the excessive deficit procedure, it should be ensured that the private sector is always bailed in on a scale commensurate with the sovereign debt ratio. This requirement should be waived for all other countries so as to avoid contagion effects.

22. The three-pillar model we propose deliberately contains no "excessive imbalance" procedure as recommended by the European Commission and the Van Rompuy task force. The problem of a surveillance mechanism for "excessive imbalances" is that macroeconomic disequilibria are attributable to different causal complexes that are largely outside a member state's control. The model we present can directly tackle the roots of the problem in the public or private sector. It does seem sensible, however, to introduce permanent monitoring of competitiveness on the basis of the existing "Surveillance of Intra-Euro-Area Competitiveness and Imbalances".

III. Reform of the financial market architecture

23. Greece's refinancing problems and the resurfacing doubts about the sustainability of sovereign debt in the euro-area peripheral countries Ireland, Spain and Portugal have exposed the **financial system's high vulnerability** to setbacks. In May 2010 this threatened to culminate in a general euro and banking crisis and necessitated renewed substantial interventions by the European Central Bank (ECB) and the euro-area governments. The publication of the results of stress tests for large European banks in July 2010 helped to pacify the markets temporarily. But the markets continue to suspect that bank balance sheets contain severely impaired positions. In the German banking system, especially in the Landesbanken (regional wholesale banks) sector, the process of balance sheet repair and restructuring is progressing at a snail's pace. Advances have been made only in areas in which the European Commission has tied its approval of public rescues to certain conditions in the context of the EU procedure for vetting state aid. The GCEE has stated on several occasions that prudential authorities should intervene more resolutely in order to expedite the clean-up of balance sheets and the adjustment of business models. A banking system with acute balance sheet and structural problems is not only a danger to systemic stability but also an obstacle to the public sector's exit from its explicit and implicit support measures and an impediment to effective reform of the financial system.

24. The **financial system reform landscape** indicates a hive of activity. Numerous national initiatives are underway, a raft of new regulations are being adopted by the Basel Committee on Banking Supervision, and various new European oversight bodies are being set up. Yet this plethora of measures still fall short of the states' avowed intent of ensuring that they will never again be taken hostage by the financial sector. There is still no agreement on the key problem of how to deal in the future with systemically important financial institutions (SIFIs). There is a similar lack of ideas, too, on how to regulate cross-border insolvencies of SIFIs.

25. The GCEE divides its overall assessment of financial system reform into four policy fields. Most advances have been made in the first field, which is aimed at increasing the **resilience of individual financial institutions** and at reducing **procyclicality**. The negotiations leading up to Basel III have produced agreement on the tightening of capital adequacy rules and the introduction of a countercyclical capital cushion, a leverage ratio and liquidity requirements. While these measures are generally on the right track, some of the steps are very small, and their implementation is in many cases still unclear and scheduled for some distant date in the future. Thus a leverage ratio – a robust non-risk-weighted measure of capital cush-

26. In the second field, **enhancing market stability and transparency**, several potentially counterproductive measures are being discussed alongside some promising initiatives such as the regulation of over-the-counter (OTC) products. With the Volcker rule, the US administration has made an unproductive sally towards splitting the banking landscape into investment or depository banks. The prohibition of naked short selling was a highly controversial unilateral move by the German government. A tax on financial transactions, which some people have called for, is an unsuitable crisis prevention tool as it lacks a steering function.

27. In the third field, the **reform of financial market oversight**, the existing structural problems are not being adequately resolved. For example, integration between microprudential supervision at the level of individual institutions and macroprudential oversight, which involves wide-angled surveillance of financial risks spanning institutions, markets and countries, remains insufficient. Moreover, prudential supervisory competencies remain fragmented and are mostly in the hands of national supervisory authorities. Thus microprudential supervision in Europe is split between three institutions, and barely any competencies will be transferred to the new European Systemic Risk Board. In Germany, too, it seems highly likely that the fragmentation of the prudential structure will be perpetuated. What is needed instead is the rapid and full integration of financial oversight under the auspices of the Deutsche Bundesbank.

28. In the fourth field of **crisis management**, the new German Bank Restructuring Act (*Restrukturierungsgesetz*), especially the strengthening of the prudential authorities' intervention rights and duties, offers a ray of hope. In future, supervisors will be able, if necessary without the assent of creditors and shareholders, to introduce prudential measures to restructure and resolve insolvent banks and implement them under their own stewardship. A welcome step forward to better burden-sharing between the private and public sectors has been taken by the creation of a restructuring fund (*Restrukturierungsfonds*), which will be funded by a bank levy and will provide bridging finance in the event of a crisis. The idea is that the cumulative build-up of revenue from the bank levy will relieve taxpayers in future from having to foot the bill of bank bail-outs as the main strain will be borne increasingly by the financial sector itself.

29. Urgent **action is required in key problem areas**. Measures are needed, first, to reduce risks arising from the default of a systemically important institution and, second, to facilitate the restructuring and resolution of SIFIs across borders in a crisis without having to dump the bill on the tax payer. With a view to reducing risks emanating from **systemically important institutions**, the GCEE, like the International Monetary Fund (IMF), favours a levy graduated according to the degree of systemic risk (Pigovian tax). The bank levy provided for in the German Bank Restructuring Act is basically designed as a steering levy, but it is too low to

actually exert a steering influence. An effective steering levy would have to be introduced at an international or at least a European level. The alternative approach of imposing a capital surcharge on systemically important institutions is currently being explored by the Financial Stability Board. No consensus is in sight, however, and there is a danger that the negotiating process will end in a compromise based on the smallest common denominator. If this were to happen, states would be saddled with the role of implicit systemic guarantor indefinitely.

30. Tackling the problem of **cross-border systemic insolvencies** requires an integrated supervision and restructuring regime at European level. The German restructuring fund could serve as a model for a European solution; internationally active institutions would pay into the European restructuring fund instead of the national fund in line with their systemic importance in Europe as a whole. Such a solution is unlikely to be realized in the near future, however, as the willingness to surrender national prudential competencies is rather limited. An interim option would be for the European Systemic Risk Board or the European Banking Authority to try to come up with binding rules to coordinate the separate national restructuring mechanisms with harmonized prudential intervention requirements, resolution procedures and loss-sharing arrangements.

IV. Public finances: reality check

31. **"More take-home pay"** was the central tax policy message in the coalition agreement. While some tax relief projects were indeed implemented in the Act Reducing Citizens' Tax Burden (*Bürgerentlastungsgesetz*) and the Growth Acceleration Act (*Wachstumsbeschleunigungsgesetz*), the promised additional annual tax relief of 24 billion euro within the lifetime of the present parliament seems to have been quietly dropped. The announced changeover of the income tax regime from a linear to a graduated schedule, which certainly would have entailed fairly substantial revenue shortfalls, likewise appears to have been knocked off the current agenda. Both projects died after policymakers at last recognized the reality that the new debt brake forcibly demands rigorous budget consolidation. They ought to have realized that beforehand, however. The discretionary scope for extensive tax breaks, both during and beyond the present legislative period, is very small.

32. The German government is currently working on three major tax policy projects. First, it wants to appreciably **simplify tax law**. That is a sensible idea. However, the measures envisaged so far fall short of the proclaimed goal. The crux of Germany's complex tax laws lies in the lack of neutrality in respect of financing decisions, the choice of legal form and corporate investment decisions. A major shortcoming is the preferential tax treatment of debt financing over equity finance. That needs correcting. Such an objective does not figure on the German government's tax policy agenda, however.

Another planned venture is to **reform value added tax** (VAT). This reform is focused on the reduced rate of VAT. And there is certainly much scope for radically pruning the present range of products and services subject to the lower VAT rate. The government should start by reversing its decision to grant a preferential VAT rate to overnight stays in hotels. In fact, it would be possible to completely abolish the lower VAT rate and then use the resulting extra

income to reduce the standard rate of VAT to around 16.5 per cent. Switching to a single VAT rate would substantially simplify tax administration procedures and would additionally yield moderate efficiency gains. Although it would partially redistribute national income at the expense of lower-income groups, these redistribution effects would be so small that they could be accommodated even without any compensatory measures given the associated benefits in the form of a simpler and more efficient tax system. This assessment relates to average households in the lower income groups for which an income and consumption sample was evaluated in 2008. If it is confirmed in the forthcoming results of a household budget survey broken down by socio-demographic features, there would be a very compelling argument for radically reviewing the reduced rate of VAT. This would represent a **huge step forward** towards simplifying the labyrinthine maize of the VAT system.

The third tax reform project is to **restructure municipal finances** for which purpose a municipal finance committee (*Gemeindefinanzkommission*) has been set up. One model put forward for discussion by the German government would scrap local business tax (*Gewerbesteuer*) and instead give local governments a higher share of VAT revenue plus a portion of the income and corporate tax revenue which they could lever up by a defined municipal factor (*Hebesatz*). This model is widely backed by economists. The alternative model favoured by the representatives of the municipalities envisages retaining local business tax and expanding it by extending the range of liable entities as well as the tax base itself.

A radical cull of the scope of application of the lower VAT rate and a restructuring of municipal finances that abolished local business tax would amount to **tax policy milestones**. If these projects fail, however, the current government's tax policy efforts would merit a poor rating. Its heritage in the tax policy field would then boil down to cutting the VAT rate applicable to hoteliers and boldly proclaiming but then meekly disclaiming a list of ambitious tax reforms.

33. Until the outbreak of the financial and economic crisis the **consolidation of public finances** in Germany as in most other euro-area member countries was progressing well. In 2007 general government budgets in Germany recorded a slight surplus of 0.3 per cent of nominal GDP; the structural fiscal deficit amounted to 0.0 per cent. In the euro area as a whole the deficit ratio in 2007 stood at 0.6 per cent, which is one of the lowest levels since the single currency was launched. In the two crisis years 2009 and 2010 both the government deficit ratios and the debt ratios surged, owing chiefly to the effect of the automatic stabilizers and discretionary stimulus programmes. All in all, the fiscal interventions were useful and successful; they prevented the situation from worsening further and cushioned the slump in macroeconomic activity. This is indicated by calculations regarding the fiscal multiplier effect of the crisis-related policy initiatives.

Not only temporary measures but also permanent expenditure hikes and tax cuts were debt-financed during the crisis years. While this was defensible in the short run, it must not be allowed to lastingly push up government indebtedness. Permanently higher debt-to-GDP ratios impair long-term economic growth. A key objective of a fiscal policy aimed at boosting growth must therefore be to halt the crisis-related rise in public borrowing and lower public

debt ratios. A possible dampening of economic activity in the short turn will be offset by greater growth in the longer term.

34. The **new debt rule** that has been written into the Basic Law ensures that structural public borrowing will be permanently curbed and facilitates a symmetric fiscal policy during upswings and downswings. Even though the debt rule allows a certain operational leeway and its concrete implementation at the level of the state governments has not yet been finalized, it will make a key contribution to strengthening confidence in the long-term sustainability of public finances. Although the provisions of the debt rule have been complied with in the draft Budget Act (*Haushaltsgesetz*) for 2011 and the medium-term financial plan (*Finanzplanung*) up to 2014, this covers only part of the overall consolidation requirement. Additional considerable consolidation efforts are needed in the ensuing years. This applies especially to state governments which, under the terms of the debt rule which apply to them, must achieve structurally balanced budgets as from the year 2020.

V. Social security systems facing reform

35. Looking ahead, the inevitability of **demographic change** together with the likelihood of ongoing **medical progress** spotlights the importance of a highly performing system of healthcare provision in relation to access, funding and quality. The historically evolved German healthcare market, with its systemic split between public and private health insurance and its shielding of healthcare providers from the rigours of competition, is anything but a dynamic springboard for enabling an ageing society to tackle the challenges of the coming decades while simultaneously maintaining a high level of health and quality of life. The present priority must therefore be to **swiftly outline a roadmap for the future** that takes due heed of the ineluctable demographics.

Bearing this in mind, it is disappointing that it took the looming likelihood of another sizeable deficit to spur policymakers into actually making a start on their announced reform of the **statutory health insurance scheme** (*Gesetzliche Krankenversicherung*) by tabling a draft Act on the Sustained and Socially Equitable Funding of the Statutory Health Insurance Scheme. This bill leans heavily on the usual short-term panaceas such as increasing contribution rates and curbing spending growth, although it also contains – at least on paper – a **window of opportunity** for changing over to a method of funding the statutory health insurance scheme that is decoupled from labour income. Given the long-term challenges outlined above, this opportunity should be **grabbed with both hands** and taken as the starting point for introducing a **flat-rate citizens' contribution system** (*Bürgerpauschale*) with a tax-financed social equalization component, such as the GCEE has long advocated.

This must be complemented, however, by eliminating the current dysfunctions in the healthcare market and taking initiatives to strengthen **competition** among healthcare providers in order to free up efficiency reserves. This should include expanding the scope of the health insurance institutions (*Krankenkassen*) to negotiate directly with individual service providers on prices, quantities and quality. This is particularly crucial in the hospital sector. Moreover, competition should be conceived as a **learning curve** for improving quality and cost effi-

ciency by exploring new avenues and approaches. This would encompass, for example, dismantling the Chinese walls between in-patient and out-patient care, exploring commercial and organizational innovations on the part of service providers and enhancing transparency. Furthermore, thought should be given to curbing the healthcare shopping mentality prevalent among many insurees, while maintaining the principle of equal access to healthcare services.

36. The **public long-term care insurance scheme** (*Soziale Pflegeversicherung*) will probably record a small surplus in 2010. But present rapid expenditure growth together with foreseeable further spending rises in the medium term owing to demographic pressures and benefit adjustment dynamics herald a deterioration in the financial situation and thus underline the need for funding reform. This funding reform is a pressing task. As with the organization of the benefits side of acute care nursing, it is equally urgent to strengthen **competition** among service providers so as to ensure improved cost efficiency along with high service quality and enhanced transparency.

37. Especially in the field of the **statutory pension insurance scheme** (*Gesetzliche Rentenversicherung*) it is important that policymakers stand their ground and commence the planned incremental raising of the official retirement age as from 2012. And there must be no more political meddling with the pension adjustment formula in favour of pensioners. Instead, a start must be made as scheduled on clawing back the cumulative excess amount in present pension levels.

38. The **statutory unemployment insurance scheme** (*Arbeitslosenversicherung*) will register a financial deficit at the end of 2010. This is due to crisis-related higher outlays and an insufficient contribution rate. It is likely that the announced increase in the contribution rate to 3 per cent as from 1 January 2011 will be too small to avoid structural deficits in the coming years.

VI. Labour market undergoing institutional changes

39. The labour market recovery in the years 2009 and 2010 caught most analysts by surprise and also attracted international attention. And indeed, contrary to expectations that official German joblessness could again approach the 5 million mark in 2010 (OECD, 2009), it actually fell below 3 million in October 2010 and was thus lower than the average annual level prior to what was the deepest post-war recession. This score was artificially boosted, however, by a statistical effect as, since 2009, unemployed persons involved in labour market policy measures organized by third-party providers are no longer included in the official jobless figures.

Instead of a feared drop in employment below the pre-crisis level, the number of employed persons has hardly changed over the course of the crisis. Since February 2010 the seasonally adjusted number of persons in work has steadily increased. This contrasts with much poorer labour market trends in some other European economies and in the United States, so that some commentators have even begun to speak of a German "jobs miracle".

40. In reality, the explanation is more mundane than miraculous. The robust employment trend is largely due to **the hoarding of labour** on an unexpected scale. This took the form of a massive **drop in hours worked** and widespread use of short-time working, encouraged by generous government subsidies. This led to a steep fall in labour productivity (-2.2 per cent), which picked up again in 2010 (1.4 per cent).

41. Another positive factor was the contribution made by **wage policies**. The social partners not only pursued a moderate pay policy course before the crisis but also prioritized the preservation of jobs during the crisis – which has clearly paid off. Even though workers are understandably clamouring for a piece of the pie now that the economy is expanding again and profits are rising, wage policymakers should not jeopardize what has been achieved to date by granting excessive pay rises, nor should they fully utilize the **aggregate scope for pay growth in each sector**. However, there is nothing to stop individual firms from paying voluntary supplements such as non-recurrent bonuses as long as this is warranted by the company's earnings.

42. Following this effective crisis management, wage policymakers now face three impending **institutional changes** in the labour market architecture: the adjustment of standard unemployment II benefit levels, the abolition of the traditional single plant-level labour agreement and the granting of cross-border labour mobility rights to job-seekers from central and eastern European member states of the European Union.

In the coalition agreement of 26 October 2009 the governing parties promised to improve the permissible amount of top-up casual earnings for recipients of the welfare payment known as **unemployment benefit II** (or "job seeker's basic allowance") in order to boost the incentive to find a full-time job on the primary labour market. They set about addressing this issue in 2010. Separately, the Federal Constitutional Court decreed in a ruling of 9 February 2010 that the method of calculating standard welfare benefits was opaque and arbitrary and that higher rates should apply to ongoing hardship cases. This ruling encouraged political parties and lobby groups to outbid one another in their calls to raise standard benefit rates which included, for example, demands to hike the standard welfare allowance for single persons from 359 euro to at least 400 euro. The German government intends to increase the standard rate of unemployment benefit II marginally and to extend the scope for top-up earnings slightly. In reality, various constraints restrict the **radius of possible reform** in respect of social welfare benefits. That is demonstrated by calculations performed by the GCEE for various reform options regarding unemployment benefit II. First, Germany's Basic Law stipulates a **min-imum level of subsistence** for each person, so that the option of reducing the amount of the job seeker's basic allowance would have to ensure that the recipient could regain the full standard level of benefits by finding work. Second, hard **fiscal constraints** limit the leeway for more generous top-up earnings as this would have to satisfy the requirement of cost neutrality. Yet the German government could have achieved greater labour supply effects in connection with streamlining unemployment benefit II – and without jeopardizing fiscal consolidation. But this would have required setting other **priorities** than

exempting additional sectors from the full rate of VAT or choosing to increase child benefits (*Kindergeld*) and the tax-free allowance for children (*Kinderfreibetrag*).

43. The limitations on **cross-border labour mobility** within the European Union that currently apply to eight acceding countries in central and eastern Europe will expire on 1 May 2011. This forthcoming opening of the border to job-seekers from those countries has aroused concerns that German workers might be displaced as well as fears that this could trigger substantial downward pressure on wages ("wage dumping"), especially among low-skilled workers. However, experience to date as well as empirical studies on the magnitude and consequences of labour migration from central and eastern Europe do not indicate any marked negative labour market effects of such freedom of movement for foreign job-seekers; instead, welfare effects are likely to predominate. The GCEE thus sees **no immediate need for policy measures** in this field.

44. In June 2010 the Federal Labour Court (*Bundesarbeitsgericht*) overturned the principle of the **single plant-level labour agreement** (*Tarifeinheit*) under which traditionally only one labour agreement is applicable in any one company. This ruling provoked animated reactions and calls for corrective legislation. The GCEE cautions against overhasty responses and suggests instead that all concerned should first wait and see how **multiple plant-level labour agreements** pan out in practice.