EXECUTIVE SUMMARY
Stable Architecture for Europe – Need for Action in Germany

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Executive Summary

1. The vicious circle formed by the sovereign debt crisis, the banking crisis and the macroeconomic crisis in the euro area requires the full attention and a strong commitment of Germany's economic policymakers. The efforts being made across Europe are **starting to bear their first fruits**. Current account imbalances in the euro area have narrowed significantly, and elements of a viable long-term framework for the European Monetary Union (EMU) have been put in place with the adoption of the Fiscal Compact and the strengthening of the Stability and Growth Pact. Notwithstanding these positives, it should not be overlooked that it is the European Central Bank (ECB), through its non-standard monetary policy measures, that can claim the main credit for stabilizing the European financial system and ensuring the stability of the banking sector. But in doing so, the ECB has blurred the boundary between monetary policy and fiscal policy in a worrying way, which is why its activities should provide no more than a **temporary fix**. Under no circumstances must the ECB's present policy become a permanent solution.

Preventing such undesirable future economic developments and constructing a **stable architecture for Europe** represent a major challenge. But the road ahead cannot be built without a viable bridge leading out of the current crisis to the long-term framework for the future. Such solutions are needed both for fiscal policy and for financial markets. Fundamental decisions have to be made in both fields. The German Council of Economic Experts (GCEE) therefore proposes to transform the existing European framework to a coherent and cohesive three-pillar conception "**Maastricht 2.0**". This conception consists of three pillars: one for fiscal stability based on national responsibility, one to secure the stability of the financial system via a banking union, and a third pillar for crisis management, including an insolvency regime for member states.

2. The necessary efforts of Germany’s economic policy to contain and overcome the multiple crises in the Euro area have overshadowed the continuing **need for economic policy action in Germany**. Consequently, German policymakers now need to start tackling a backlog of problems at the national level. The change of course in energy policy has to be structured effectively and efficiently, while reforming the healthcare and taxation systems remains a pressing priority. Reforms that have already been implemented or initiated, especially in connection with the labour market and supplementary personal pension provision, should not be retracted.

In energy policy the Renewable Energies Act (*Erneuerbare-Energien-Gesetz*) should be replaced by a more market-based quota model, and the present short-term trouble-shooting approach should be abandoned in favour of devising and erecting a long-term institutional framework for the electricity market. In the statutory health insurance scheme, the German government should further decouple funding from personal income levels. In the field of taxation, the government should take initiatives to strengthen the equity capital base and hence the resilience of both the real and the financial sector. With respect to old-age-security, it is important not to reverse or dilute the reforms that have been already initiated. The same holds for maintaining and extending labour market flexibility. The parliamentary elections due in autumn 2013 present an ideal opportunity for pushing the need for economic policy action in Germany further up the political agenda.

3. The pace of global economic growth has slackened greatly in the wake of the euro crisis; this has affected **economic development** in Germany. Its economy already slowed markedly in 2011, and this slowdown has persisted in 2012. Germany's gross domestic product (GDP) is likely to expand by 0.8 % in 2012 and by the same margin in 2013. The labour market is still holding up well, although it has lost buoyancy, and the previous upward employment and downward unemployment dynamics have recently faltered. The annual unemployment rate is expected to amount to 6.8 % in 2012 and to 6.9 % in 2013.

I. Strengthen Europe's Architecture and Build Bridges to the Future

4. Despite the chinks of light now appearing at the end of the tunnel, the European Monetary Union is locked in a confidence crisis of systemic dimensions. This crisis comprises three interconnected trouble spots. The **sovereign debt crisis** is reflected in spiraling debt ratios and high risk premia on the government bonds of the crisis countries. The **banking crisis** manifests itself in a lingering mistrust in the financial institutions of the problem countries and in a growing fragmentation of banking markets. The **macroeconomic crisis** shows up both in the drift towards recession in a number of member states and in firms' poor international competitiveness, especially in the crisis countries. On the positive side, the structural adjustment measures are beginning to bear fruit, for example in the form of declining current account deficits.

The crisis is compounded by negative feedback effects between the various trouble spots. For instance, the cost of a bank rescue adversely affects public budgetary and debt positions. Falling government bond prices, in turn, triggered by growing sovereign debt weigh on banks' balance sheets and capital base. To take another example, the necessary consolidation of public finances weakens domestic demand in the short run. This leads to a drop in government revenues and rising public transfers. Hence, it is crucial to devise and implement solutions capable of breaking through this vicious circle.

5. The biggest economic policy challenge, thereby, is to carefully deal with short-term problems without undermining the credibility of the **long-term framework**. This framework must avoid the failures that have occurred in the past, notably in respect of public finances and the financial system.

6. In the fiscal field, policymakers have made clear progress by adopting the Fiscal Compact and strengthening the Stability and Growth Pact – leaving aside the necessary criticism of certain details. The long-term challenge of safeguarding fiscal stability in the euro area hinges on establishing a stable architecture for the EMU. With this aim in mind, the GCEE has elaborated its **three-pillar conception** "Maastricht 2.0".

This plan would leave **fiscal and economic policy** largely **under national sovereignty**, in keeping with the governance principles enshrined in the original Maastricht Treaty. It would reform the existing fiscal rules and the financial system architecture in the European Union. Consequently, Maastricht 2.0 relies on national liability and market discipline, supplemented by an insolvency regime for member states. This should be given more credibility by means of a crisis resolution mechanism and accompanying reforms of the financial system.

Introducing, as an alternative approach, elements of joint liability at the European level would require creating **credible powers of intervention** at the European level as well. The GCEE rejects this approach because such powers do not exist at present and, given the political realities, it is highly unlikely that they will be introduced and institutionalized in the foreseeable future. Anyhow, such rights of intervention would be credible only if some central fiscal supervisor – in the form, say, of a European finance minister or a currency commissioner endowed with far-reaching powers – was able to give binding instructions to national parliaments and directly intervene in a top-down hierarchy in member states' finance and tax administrations. Yet this is difficult and practically impossible even at the national level, as is amply testified by real-life experience – not least within Germany's own federal system.

7. Europe's policymakers have made significant progress towards constructing a stable long-term architecture for financial markets. The process of converting the new Basel III capital requirements into European law has been virtually concluded; proposals for better ways of dealing with distressed banks have been made; and first steps have been taken towards creating a **European banking union**. It is vital, however, that the reform process that has now been initiated does not lose momentum. In the GCEE's view, the planned reforms are not far-reaching enough. Two elements are crucial. First, existing privileges with regard to banks' investments into government bonds should be abandoned in the future. In particular, government bonds should be backed by equity capital as well, and exemptions from large exposure rules should be abolished. Second, a leverage ratio of at least 5 % of a bank's total business volume, i.e. on- and off-balance sheet activities as defined by Basel III, should become mandatory.

8. The banking union that is currently under discussion consists of three elements: the transfer of prudential powers to the European level, the establishment of a European recovery and resolution agency, and the creation of a Europe-wide deposit insurance scheme. Concrete legal proposals have been made so far only for setting up a single European banking supervisory authority under the ECB's auspices. At present, cross-border risk transfer cannot be effectively curbed. For this reason, the GCEE is in favour of transferring prudential and resolution competencies to the European level. This is the sole way of ensuring that **liability and control** go together.

9. However, there is still a long and strenuous path to go to a genuine banking union. In particular, assigning banking supervision to the ECB bears substantial risks. Current European legislation does not allow for adequate separation between monetary policy and banking supervision functions; those EU countries that are not members of the euro area would have little possibilities for involvement. These shortcomings alone necessitate a **modification of the European legal framework**. This is the only way to ensure that the European level can intervene effectively, that monetary policy and banking supervision are duly and properly separated, and that liability and control remain together. Besides banking supervision, bank recovery and resolution competencies should be transferred to the European level. A European resolution agency should be funded via a bank levy and the European Stability Mechanism (ESM). If fiscal resources have to be drawn on as well, clear-cut burden-sharing rules should be defined ex-ante. The third element of a banking union – a Europe-wide deposit insurance scheme – is not necessary in the GCEE's view. The introduction of such an insurance scheme would entail considerable risks, because losses would be mutualized ex post.

10. But a banking union cannot solve acute problems in the banking sector. Legacy risks on banks' balance sheets and unresolved legal issues require a **stepwise transition to a banking union**. The GCEE proposes a roadmap consisting of three phases. In Phase I, the necessary legal basis must be laid and the new European institutions set up. Banking supervision functions should be located outside the ECB. Only when Phase I has been concluded banks can qualify progressively for the banking union in Phase II. If any banks needed to be restructured during this phase and if financial resources were required for this, the responsibility would be fully taken by the respective national states, which would also be liable for any use of ESM funds. Banks that, at the end of Phase II, have not met the conditions for obtaining a European banking license would be restructured and, if necessary, liquidated. In Phase III, therefore, only banks that have been granted a European banking license would remain in the market.

Another key requirement is to build a robust **fiscal bridge** leading in a convincing way from today's short-term stabilization measures to tomorrow's Maastricht 2.0 regime. This function can be performed by the GCEE's **plan for a European Redemption Pact**. The European Redemption Pact is designed as a system of mutual obligations for solidarity and solidity, featuring joint liability in the European Redemption Fund – limited both in amount and time – which is interlocked with strong safeguards to the European Redemption Pact.

11. The macroeconomic crisis has a short-term and a long-term dimension as well. This is evident from the pattern of recession and slackening growth in many euro-area states. All past experience suggests that the consolidation of government budgets, i.e. the pursuit of a restrictive fiscal policy, initially slows down the economy and may even pull it into **recession**. Hence it is vital that fiscal retrenchment is carefully structured and calibrated so as to achieve consolidation but avoid a slide into depression. The objective of economic policy in consolidating countries must be to raise potential output in order to attain a higher and steeper growth path in the longer run. Such a **growth policy** will be a long-term task. It takes time for political reforms, for example of the labour market institutions or the tax system, to begin to bear fruit.

As the macroeconomic crisis is affecting the individual countries differently, looking for a one-size-fits-all solution is not appropriate. Besides, it is beyond the GCEE's mandate to make specific economic policy recommendations to the governments of other countries.

II. Challenges for Individual Policy Areas

1. Energy policy: Rely more on market solutions for changing course

12. In the summer of 2011 the German government embarked on a radical change of course in energy policy which is bound to lead to a **complete transformation** of the energy market in the coming decades. Following the decision to accelerate the exit from nuclear power, the amount of electricity generated from nuclear energy dropped sharply. The shortfall has been offset so far by higher output of renewable energies and brown coal as well as higher imports of electricity. It has, however, become much harder for grid operators to guarantee a **secure supply** of electricity.

Substantial costs had already accumulated in the preceding decade from the subsidization of renewable energies. The associated imposition of levies led to an increase of electricity retail prices. Even though that past policy shift is no longer in question, the **dramatic further rise** in household's electricity prices is mainly attributable to the failure to fundamentally rethink the appallingly inefficient promotion of renewable energies introduced by the Renewable Energies Act.

13. The envisaged radical restructuring of the energy supply system poses three key demands on the electricity market: the extension of mostly intermittent capacities for electricity generation from renewable energy sources, the construction of dispatchable backup capacities, particularly in southern Germany, and a substantial expansion of the transportation and distribution networks. These **three major challenges for energy policy** urgently need to be interlocked into a coherent strategy, with a coordinated sequencing of the individual steps. As yet there are no signs of such a strategy emerging. In particular, the promotion of additional generation from renewable energies disregards the supply system's integration limits, and thus fails to reduce the **speed of capacity expansion**.

14. Since an unchanged adherence to the Renewable Energies Act threatens to lead to an uncontrollable increase of the costs of transformation of the energy supply system, it is crucial to map out a concrete long-term expansion path for renewable energies and to base that expansion on **market principles**. Although valuable time has been lost since the policy switch-over, it would still be possible, within the framework of the Act, to **harmonize subsidies** at a moderate level, for instance at the average rate for on-shore wind energy. This one step could put the so far dominant and partly excessive expansion of renewable capacities onto a more calculable path and provide a **much needed policy pause**. This pause is urgently needed in order to establish the long-term institutional framework for the electricity market and develop a coherent strategy for the energy policy switch in which the promotion of renewable energies is aligned in future with the broader European picture.

2. Public finances: Need to reform business taxes, more ambitious consolidation

15. The consolidation of public finances in Germany is advancing. General government is likely to show a surplus in 2012 thanks, above all, to the social security systems, whereas government budgets will again show deficits. This overall positive result is mainly driven by revenue, which will increase this year by 3.4 %. Exceptional factors on the expenditure side have also played a role. Despite a rising government debt ratio, refinancing costs have fallen distinctly owing to Germany's attractiveness as a safe haven in the euro crisis. Additional factors are lower spending by the Federal Employment agency and a comparatively small increase in people entering retirement. By contrast, government consumption has risen at an above-average rate. As neither central nor state government can rely permanently on the help of exceptional factors or a favourable economic development, and, in addition, extra costs will be caused by the ageing population, **more ambitious consolidation efforts** are needed. Plans currently being considered by the government that would increase structural spending, such as an infant care allowance for stay-at-home mothers, top-up pensions for low earners or the abolition of the quarterly consultation fee for visiting the doctor, move in the wrong direction.

16. Structural distortions are evident at the local government level especially. In the aggregate, local governments are actually doing better than federal government and the Länder. The combined local government debt ratio has fallen slightly over the past three decades, whereas the debt ratios of the Länder and of federal government have moved upwards consistently. However, the aggregate figures hide a substantial disparity between the municipalities. Since the late 1990s a number of local governments have resorted increasingly to bridging loans as a permanent funding instrument. In some Länder, especially in Hesse, North Rhine-Westphalia, Rhineland-Palatinate and Saarland, the **financial situation of local government** is now so problematic that these states have had to initiate bail-out arrangements for their local governments. Since the situation of local governments is partly due to high social benefit obligations, federal government has now agreed to take over reintegration costs for disabled persons and welfare payments for needy pensioners and persons with reduced working capacity, which will relieve the local governments. Nevertheless, municipalities also have to make savings themselves on payroll costs and the provision of public facilities so as to avoid running up excessive debts in future. And the Länder need to exercise their responsibility for overseeing local government finances more stringently than they have in the past.

17. In the field of taxation there is an urgent need to revise the business tax system. Despite the advances made by past reforms, the tax distortions relating to corporate investment decisions have not been eliminated. It is particularly the capital structure choice that is distorted, because the option of financing an investment through newly raised equity is still discriminated against funding through retained earnings or debt. This systemic bias encourages firms to reduce their use of equity and avoid raising fresh capital. The GCEE therefore advocates introducing a refinement of the dual income tax system in the form of an **allowance for corporate equity (ACE)** for nominal capital, which would achieve tax neutrality between the different financing options. This proposal could be fairly easily integrated into existing tax legislation without having to abolish the local business tax. The anticipated tax revenue shortfalls of 4.6 billion euro could be completely financed by removing existing tax privileges.

3. Labour market: Consolidate and extend the advances

18. The situation on the labour market remains very positive. In 2012 employment is expected to reach a new high of almost 41.6 million persons in work. The unemployment rate should end the year at 6.8 %, which is the lowest figure since the reunification of Germany in 1990. While the positive labour market dynamics have weakened in the course of 2012 in response to the slackening macroeconomic momentum, the employment situation remains very stable.

These successes owe much to the international competitiveness of German companies, the moderate wage policy pursued in recent years and the reforms undertaken during the past decade. These reforms have made a key contribution to increasing **labour market flexibility –** for both employees and employers. However, the calls now being made for regulatory intervention, e.g. by setting minimum wages, would be counterproductive. Instead of calling the hard-won achievements into question, they now need to be cemented and continued through further institutional reforms of the labour market.

19. The ongoing robust performance of the labour market has prompted a growing debate among the public and politicians alike on the **quality of employment**. This has focused, on the one hand, on the emergence of more fragile types of employment contracts and, on the other, on the development of employee earnings.

The constant growth in employment since the middle of the past decade was accompanied by a steady transformation in job profiles. In particular, part-time working among women has increased significantly. But there has been no disproportionate expansion of more precarious types of employment contract over the past five years.

20. In line with the rising employment and falling unemployment levels, the household income spread has no longer widened since the middle of the last decade. This contrasts with the previous clear rise in income disparities from the early 1990s. The continuous decline in labour's share of national income in Germany since the mid-1970s has sparked a discussion about a supposed **shift in the relative shares of national income** at the expense of workers and employees. However, the functional distribution measure is not a very meaningful measure concerning the level of, and changes in, worker prosperity.

A detailed analysis of the **skills-related wage structure** provides a much clearer picture. It shows that the wage spread has widened at both the top and bottom end during the past few decades. The stronger emergence of a discrete low-wage sector offers low-skilled workers a chance of finding a job and hence of escaping from unemployment. It is critical that low-skilled workers in Germany have limited prospects of advancement. Consequently, efforts need to be focused on creating equal opportunities on the labour market by boosting and improving opportunities for training and further education.

4. Social security: More reform needed despite healthy financial situation

21. Thanks to the robust development of the economy and the positive employment situation, the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*), the statutory health insurance scheme (*Gesetzliche Krankenversicherung*), the public long-term care insurance scheme (*Soziale Pflegeversicherung*) and the statutory unemployment insurance scheme (*Arbeitslosenversicherung*) are all expected to report a **surplus** for 2012 as a whole. In the case of the public long-term care insurance scheme this merely represents a temporary pause in its steady slide into the red, whereas the surpluses of the pension and health insurance funds will be so large that their already sizeable reserves will increase further. In both cases this creates scope for a **substantial cut in the contribution rate**. The German parliament duly decided on 25 October 2012 to lower the contribution rate to the statutory pension insurance scheme to 18.9 % as of 1 January 2013; the GCEE also calls for a cut in the statutory health insurance scheme.

22. However, the current positive financial position hides the **need for more reform** in the social security systems. This applies especially to the public long-term care insurance scheme and the statutory health insurance scheme. In the case of the pension insurance scheme the policy requirement is, above all, sticking to the status quo**.** The GCEE strongly argues against reversing reforms that have been initiated, such as raising the pension age to 67 years or diluting them by granting extra benefits, such as free top-ups for recipients of low pensions which are currently under discussion.

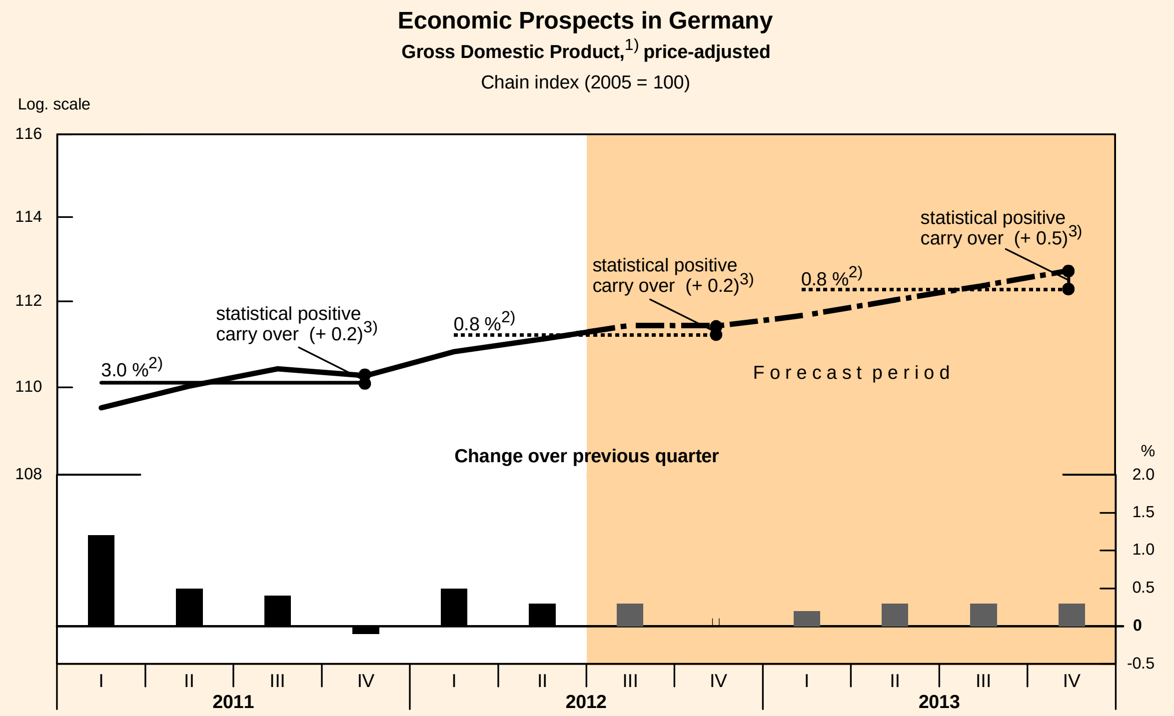
23. In the statutory health insurance scheme the GCEE relies on the widespread introduction of the already legally established top-up contributions which should be developed further in the short-term. The aim should be to **decouple employee contributions from income levels**. This would constitute a step towards a citizens' flat-rate contribution system (*Bürgerpauschale*), which the GCEE has long advocated. It would boost employment and growth and could help to strengthen competition in the healthcare sector. This could be supported by **reforms on the expenditure side**. First, greater use should be made of individual healthcare agreements between providers and users in both out-patient and in-patient care. Second, it would be favourable to switch over from the present dual hospital financing model, which splits responsibility for funding between the health service institutions and the Länder, to a single model of hospital financing by the health service institutions.

III. German economy: No decoupling from the external environment

24. Economic momentum in Germany has progressively slowed in the course of 2012. Domestic demand has developed weakly due to a **sharp fall in investment**. Exports to the euro area declined owing to the intensification of the crisis in the euro zone and the recessions in large member states. This decline was more than offset by foreign trade with non-euro-area countries, despite the deteriorating global economic dynamics and thanks to the euro's depreciation. The export oriented sectors thus made a major contribution to GDP growth (Chart 1).

The **economic indicators** available up to October 2012 suggest that the dynamic of economic activity will slow further to the end of 2012. In particular, domestic industrial demand has recently weakened, and survey data signal a further slowing down of overall economic growth during the final months of the year. The second half of 2012 thus mirrors the recessionary tendencies throughout the euro area, which affect the German economy via the foreign trade and confidence channels and is slowing the pace of economic expansion through declining investment.

Chart 1



1) Seasonally adjusted.– 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).

25. For 2012 the GCEE projects that **GDP will grow by 0.8 %** (Table 1). The slowdown in Germany will probably bottom out in the fourth quarter of 2012. Output is then likely to gradually pick up during 2013. Average GDP growth next year should equal this year's rate of 0.8 %. Investment in machinery and equipment should bottom out at the start of 2013. Domestic demand should become a growth driver in the course of the year. We estimate that output growth will lie below its potential growth rate in both 2012 and 2013. Inflation shows a stable development. In both 2012 and 2013 consumer prices will probably increase by 2.0 %.

The GCEE estimates the German economy's potential growth in 2012 at 1.1 %. This puts the relative macroeconomic output gap, meaning the difference between actual and potential output in relation to potential output, in 2012 and 2013 at around 0.5 % and 0.2 % respectively. This means, the German economy is still slightly exceeding its normal level of production capacity, i.e. actual GDP is still above **potential output** (the output level achievable by the economy at a normal use of all its resources without triggering additional inflationary pressure) (Chart 2).

Table 1

Key economic indicators for Germany[1)]

	2009	2010	2011	2012[2)]	2013[2)]
Gross domestic product	– 5.1	4.2	3.0	0.8	0.8
Private consumption[3)]	0.1	0.9	1.7	0.9	0.8
Government consumption	3.0	1.7	1.0	1.1	1.0
Investment in machinery and equipment	– 22.5	10.3	7.0	– 3.3	0.2
Investment in construction	– 3.2	3.2	5.8	– 0.4	2.1
Other products	– 2.9	3.3	3.9	2.1	2.3
Total domestic demand[4)]	– 2.5	2.6	2.6	0.0	0.8
Net exports[5)]	– 2.9	1.7	0.6	0.8	0.0
Exports	– 12.8	13.7	7.8	3.9	3.8
Imports	– 8.0	11.1	7.4	2.5	4.2
Persons employed (domestic)[6)]	40.37	40.60	41.16	41.57	41.75
Registered unemployment, stocks[6)]	3.42	3.24	2.98	2.90	2.92
Persons employed, covered by social security[6)]	27.49	27.76	28.44	28.95	29.20
Unemployment rate[7)]	8.1	7.7	7.1	6.8	6.9
Consumer prices[8)]	0.4	1.1	2.3	2.0	2.0
General government balance[9)]	– 3.1	– 4.1	– 0.8	0.1	– 0.1

1) Unless otherwise indicated: price-adjusted; change over previous year in percent (%).– 2) 2012: own estimate, 2013: forecast.– 3) Including non-profit institutions serving households.– 4) Domestic use.– 5) In percentage points.– 6) In thousand persons.– 7) Registered unemployed as % of entire civil workforce (employees, self-employed including unpaid family workers). Source: years 2009 to 2011 Federal Employment Agency (Bundesagentur für Arbeit).– 8) Consumer price index (2005 = 100), change over previous year in %.– 9) Net lending of the central, state and local governments and the social security system, as % of nominal gross domestic product.

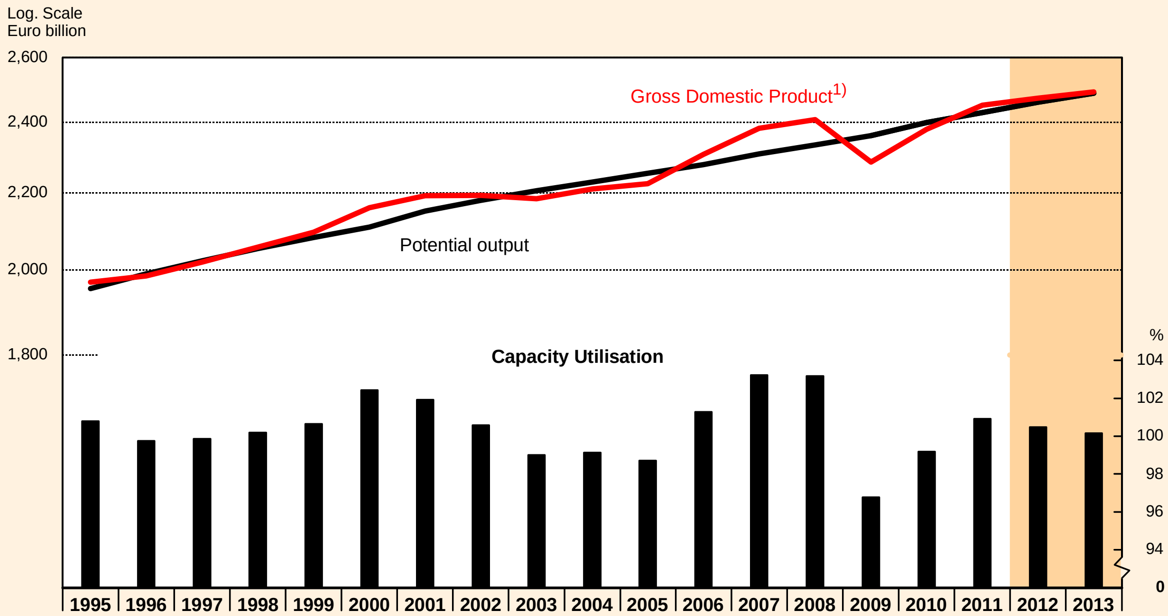
26. The German labour market is still developing positively, even though its dynamics reduced slightly in the course of the year due to the slowdown of economic momentum. **Employment** in 2012 recorded a year-on-year rise of 405,000 persons, while official **unemployment** fell by 77,000. In 2013 the number of people in work should expand by just 176,000 to a total of 41.7 million, while the official number of jobless persons should increase by 18,000 to just above 2.9 million.

27. After showing a small surplus in 2012, the general government fiscal balance is likely to turn slightly negative again in 2013 and record a deficit of 3 billion euro. The deficit ratio would then amount to around 0.1 %. As a result, the debt ratio in 2013 should fall markedly to 80.3 %. This is still well above the reference value defined in the Stability and Growth Pact.

Total government **revenue** is anticipated to expand by just 2.2 % in 2013. Wage tax revenues will grow at a quicker pace since wages will continue to increase considerably and the income tax rates will probably not be adjusted in 2013. General government **expenditure** is expected to increase by 2.6 % in 2013 and thus faster than nominal GDP; the ratio of government spending to national income will therefore increase again after decreasing in 2011 and 2012. By contrast, government interest expenditure is likely to fall once more since it is improbable that the state's funding costs will rise significantly in 2013. This should lead to additional considerable savings in 2013 on the rollover of maturing bonds and loans.

Chart 2

Potential Output, Gross Domestic Product and Capacity Utilisation



1) Price adjusted, chain-linked volumes.