ECONOMIC POLICY: FOCUS ON FUTURE VIABILITY

This is a translation of the original report published in German, which is the sole authoritative text.

I. NEW CHALLENGES

1. Two events have marked the political landscape this year: The **escalation of the crisis in Greece** and the **dramatic increase in the number of refugees** arriving at the European borders. As a result, other pressing issues, particularly demographic change and policies for dealing with an increasingly globalised and digitalised world, faded even further into the background. In light of a stable labour market, economic policy in Germany has largely abstained from focussing on the efficiency of the economy in recent years. Instead it has primarily dealt with securing **the status quo** and realising **distribution objectives** through direct market intervention.

2. For the time being, economic developments are likely to remain favourable. ↘ ITEMS 185 FF. However, the two dominant events have made the necessity of ensuring a well-functioning social market economy even more urgent. Strengthening the **euro-area architecture** is central to its future competitiveness and stability. At the same time, coping with the rise in immigration will only be possible if Germany – particularly with a view to the country's disappointingly **low growth in productivity** – manages to enhance the performance of its economy by creating suitable conditions for private economic activity.

3. Importantly, Germany will be forced to prove that it can meet future challenges in a world that is becoming ever smaller. Global problems – war and displacement, economic crises and absolute poverty – had relatively little bearing on life in Germany until recently. However, **views have shifted this year**, as hundreds of thousands of refugees are now seeking protection and a new future in Europe, changing the socio-political discussion. Moreover, this raises the question of whether Germany will be able to meet the economic challenges arising from this new situation.

4. This issue forms the **first topic** of this Annual Economic Report, based on a cautious empirical assessment of the potential development of the refugee inflow and its components. ↘ ITEMS 18 FF. Naturally, such forecasts are subject to **very high uncertainty**, not least due to the still scant amount of available information. This also applies to the additional costs for administration and transfer payments arising from refugee arrivals.

   These costs should be manageable given the broad potential for efficiency-enhancing policies and Germany's sound fiscal position. Major efforts, however, will be necessary to meet the economic challenges posed by the refugee influx. These are, primarily, accelerating the asylum procedures and providing housing in the short term, and training migrants and integrating them into the workforce in the medium term.

5. Just as with the economic crisis in Greece, the refugee issue demonstrates how important it is for Europe to strengthen its ability to act. Consequently, the **second topic** of this Annual Economic Report is **Europe**. ↘ ITEMS 38 FF. Based on the Council's Special Report on further development of the euro-area architecture (GCEE Special Report 2015, items 65 ff.) published in July 2015, the report

will discuss in more detail how the stability of the euro-area could be enhanced through creation of a **sovereign insolvency mechanism** ↘ ITEMS 44 FF., the **phase-out of regulatory privileges of sovereign exposures by banks** ↘ ITEMS 52 FF. and further integration of European capital markets. ↘ ITEMS 65 FF. These elements promote European integration while also mitigating incentive problems within the monetary union by strengthening the principle of unity of liability and control as well as the no bail-out clause.

Another important discussion concerns **low interest rates in the euro area,** which are likely to prevail for the foreseeable future. A nuanced discussion of monetary and fiscal policy in Europe leads to the conclusion that monetary policy is too expansionary at present and quantitative easing measures should be scaled back. ↘ ITEMS 301 FF. This conclusion is supported by the emergence of financial stability risks from low interest rates, which could pave the way for a new financial crisis. ↘ ITEMS 379 FF.

6. Ultimately, the focus should return to the competitiveness of the German economy. Currently there seems little reform spirit that could enable Germany to assert its economic position in the globalised and digitalised world of the 21st century. Given **lower productivity growth**, the question arises as to how Germany can succeed to create suitable conditions to attract private investment in light of international competition.

This issue constitutes the **third topic** of this Annual Economic Report, based on a careful empirical assessment of the development of overall productivity in Germany. ↘ ITEMS 590 FF. It addresses, in particular, the design of the tax system ↘ ITEMS 714 FF., education and research ↘ ITEMS 556 FF., 668, labour market regulation ↘ ITEMS 566 FF., an economically efficient revolution of energy supply ITEMS 696 FF., and healthcare. ↘ ITEMS 583 FF. In an effort to correct market outcomes for distribution reasons, policymakers should focus on a suitable system for taxation and transfers and avoid setting political prices.

7. In all areas of economic policy, the **future viability** of Germany's economy should again become the focus. Germany will have to **adapt much more quickly** than anticipated to a complex and ever-changing world. Integrating different ethnic groups into the education system and labour market and dealing with the renewed threat of high unemployment now add to the foreseeable challenges of demographic change, globalisation and digitalisation. There will not be a path of return to the former status quo.

II. ECONOMIC RECOVERY, EXPANSIONARY MONETARY POLICY

8. **Economic recovery** in Germany and the euro area continued last year. ↘ CHART 1 In the euro area, this is in part due to the **successful strategy of providing financial assistance conditional on economic reform**. Precisely those former crisis countries that reformed their economic structures

more quickly, and consequently increased their competitiveness, enjoy higher economic growth today. They include, among other, Ireland, Spain and Portugal. Moreover, implementation of the Banking Union and the related comprehensive assessment are likely to result in further improvements to financial conditions, and they may have contributed to the increase in lending.

Economic momentum is also being driven greatly by **special factors**, particularly the **highly expansionary monetary policy**. The resulting depreciation of the euro, along with positive economic developments in the USA and UK, has stimulated exports. The **lower oil price** has given an additional boost to euro-area income and consumption. Moreover, fiscal policy is no longer having a restrictive effect – in Germany it is actually expansionary. Demand from emerging markets, in contrast, has declined.

9. The German Council of Economic Experts (GCEE) forecasts real growth in euro-area GDP of 1.6 % in 2015 and 1.5 % in 2016. ↘ ITEMS 183 F. The forecast for Germany is a real GDP growth rate of 1.7 % in 2015 and 1.6 % in 2016, which exceeds potential growth. ↘ ITEMS 196 FF.

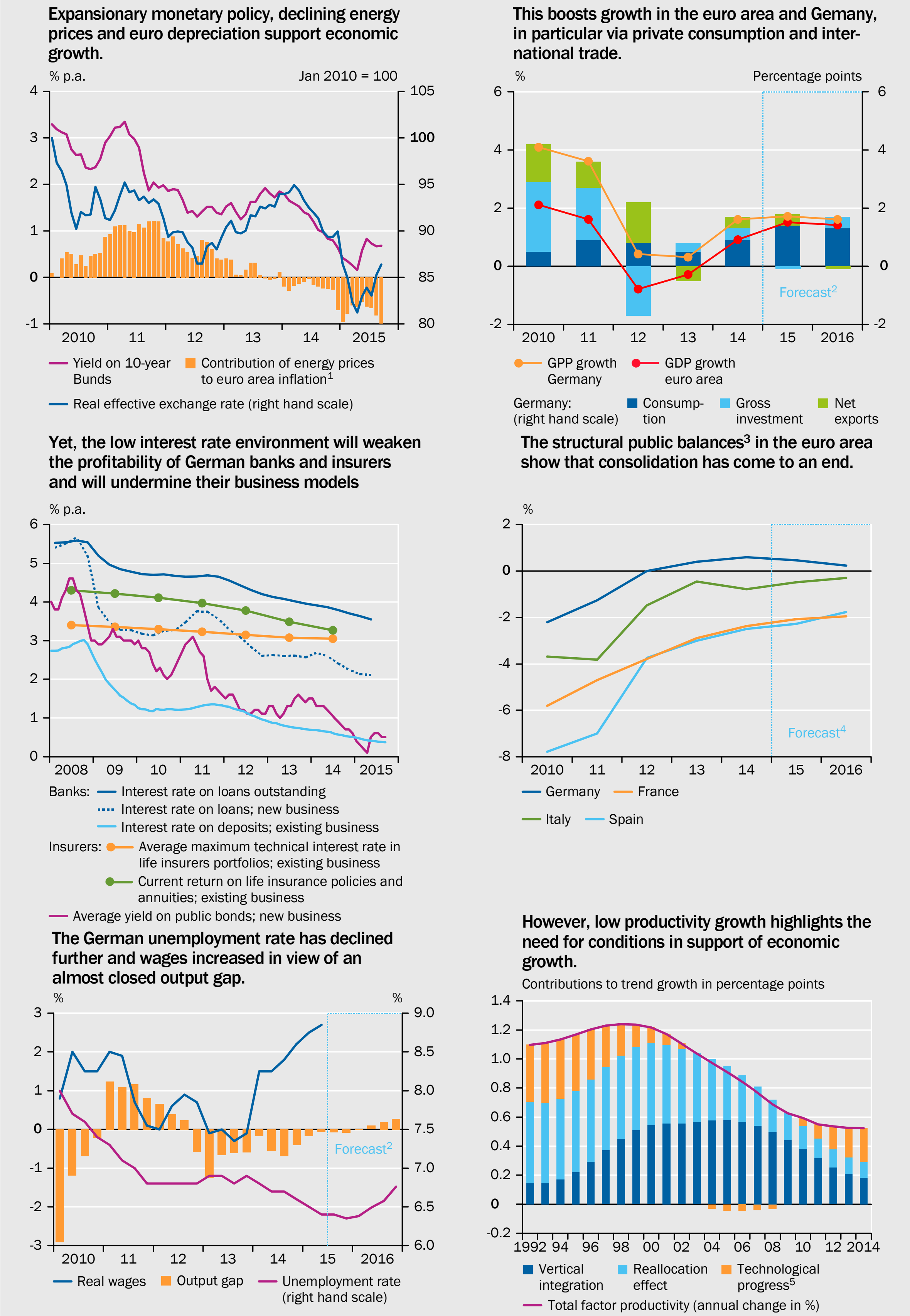
10. At the start of this year, the European Central Bank (ECB) further eased its already highly **expansionary monetary policy** considerably. ↘ ITEMS 282 FF. ECB President Draghi justified the new **government bond purchasing programme** (quantitative easing, QE) at the January press conference by stating that the drop in the price of oil could impact core inflation, and that easing to date was insufficient to prevent the risks of a protracted period of low inflation. Thereafter, medium to longer-term interest rates fell into negative territory and the euro depreciated further. With the bond purchases continuing until at least September 2016, monetary policy is providing an even stronger **stimulus to aggregate demand in the euro area**. Furthermore, in October 2015, ECB President Draghi hinted at expanding or extending the QE programme.

11. **Core inflation**, however, continued to rise slightly over the course of the year, to about 1 % in September 2015. There are no indications of any dangerous self-reinforcing deflation and recession. Basic **interest rate rules** such as the well-known Taylor rule or a rule used by the GCEE that explained the ECB interest rate decisions in the past quite well, suggest a tightening of monetary policy in view of the current economic situation. ↘ ITEMS 301 FF. Moreover, the **risks to the economy in the longer run** must be weighed against the low risk of deflation. Government bond purchases imply favourable financing conditions for member state governments and thus incentivise postponing necessary fiscal consolidation and structural reforms. Right now, however, additional reforms are needed to strengthen aggregate supply, generate expectations of income growth in the future and also stimulate investment.

12. Moreover, considerable **risks to financial stability** are building up as a result of the ECB's monetary policy measures, which could pave the way for a new financial crisis. The low interest period is putting increasing pressure on the earnings of banks and life insurance companies. This creates incentives for excessive **risk taking**, which is reflected, among other things, in a rise in asset prices.

↘ CHART 1

Economic developments and challenges in Germany and the euro area



1 – Consumer price index. Percentage points. 2 – GCEE forecast. 3 – In relation to the production potential. 4 – IMF forecast. 5 –Contribution to total factor productivity net to change in vertical integration and reallocation effect.

Sources: Assekurata, Deutsche Bundesbank, ECB, Eurostat, IMF, own calculations, Statistisches Bundesamt

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While there has been no excessive credit growth to date, there are first signs of asset price exaggerations in individual segments, particularly in the real estate market. ↘ ITEMS 392 FF., 408 FF.

13. **Macroprudential supervision** is intended to counteract the build-up of risks in the financial system (GCEE Annual Economic Report 2014 items 360 ff.). To increase its effectiveness, an expansion of the macroprudential toolbox to include credit-specific instruments and to include the insurance sector is advisable. Yet, macroprudential policy alone can hardly ensure financial stability, as the current monetary stance is aimed at achieving effects that macroprudential policy seeks to limit. For this reason, **a delayed exit from low interest rates** should be avoided. Otherwise, a **rapid increase in interest rates** may be necessary at a later date – which, particularly after a prolonged period of low interest, could jeopardise the solvency of large parts of the banking system, cause asset prices to plummet and threaten the already weakened life insurance sector. ↘ ITEMS 401 FF.

14. Both the current economic situation and the balance between the risk of deflation and risks for financial and longer-term economic stability indicate that a tightening of monetary policy is warranted. In particular, the **ECB should slow the expansion of its balance sheet** or even end it earlier than announced. ↘ ITEMS 301 FF.

15. The varying economic development of member states contradicts the hypothesis that there is a "**secular stagnation**" across the euro area, which would be accompanied by negative long-term equilibrium interest rates. ↘ ITEMS 328 FF. Instead, there are indications that structural reforms, which strengthen markets and competitiveness, are forming the basis to emerge from the crisis. These should pave the way towards an exit from the extremely low interest rate environment in the medium term.

However, this also implies that member states must be aware that the present favourable financing conditions cannot be counted on indefinitely. To ensure long-term debt sustainability, many member states must further consolidate and reduce their **high government debt**. New calls for fiscal stimulus packages should not be heeded. **Responsible fiscal policy** and reforms, in contrast, hold the key to strengthening confidence in the monetary union's future stability, a vital factor for private consumption and investment.

16. Tax revenue has increased due to the favourable economic situation in **Germany**, with low interest expenditures slowing public spending at the same time. In 2014, a **general government surplus** was achieved for the first time since 2007. The **government debt ratio** has fallen by 10.2 percentage points between its high of 2010 and 2015. However, for 2015 and 2016, an expansionary fiscal stance is projected. One-offs have thereby helped to offset additional spending in 2015, yielding a fiscal surplus of €21.2 billion (0.7 % of GDP).

Taking into account planned additional public investment and additional refugee-related expenses lowers the forecasted general government surplus next year to €5.5 billion (0.2 % of GDP). The structural surplus will drop from 0.3 % to

0.1 % of potential GDP. In view of the procyclical fiscal stance, additional increases in expenses are not warranted.

17. Risks to growth in Germany and the euro area arise from **sustained weaker growth in emerging markets**, particularly China und commodity-exporting countries. ↘ ITEMS 114 FF. Moreover, uncertainty regarding monetary policy in the US, which has postponed a necessary interest rate hike for quite some time, is contributing to global financial market volatility. While the danger of the euro area crisis reigniting has declined, medium-term risks to financial stability from loose monetary policy have grown. There is also the danger that some euro area member states will refrain from undertaking urgently needed reforms and consolidation efforts.

III. RESPONDING TO THE REFUGEE INFLUX

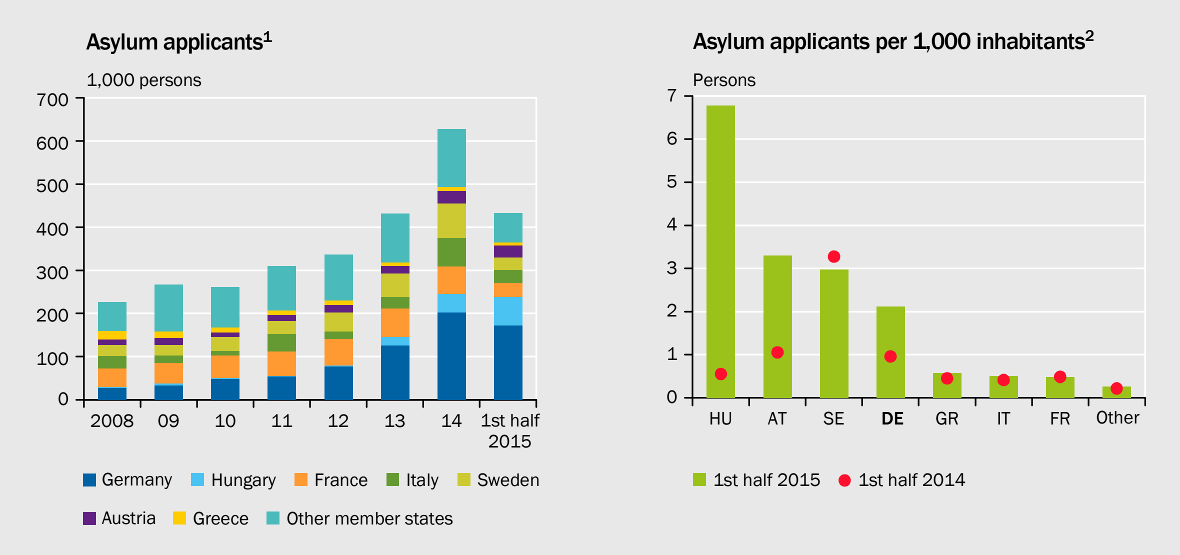
18. The dramatic influx of refugees poses a particular challenge for Europe and, above all, Germany. It is primarily a **humanitarian task.** The key questions are: the extent to which refugees will be permitted to remain in Europe, how they will be distributed within Germany and other parts of Europe, how to provide them with accommodation, food and healthcare, and what procedures will be applied to determine their eligibility for protection. Many decisions on these issues will have **consequences for public budgets**. However, it is far from easy to even estimate the extent of refugee arrivals in the years to come.

19. The scale of the global refugee issue is immense. The **number of refugees, asylum-seekers, and internally displaced people** has been rising since 2010. According to the Office of the High Commissioner for Refugees (UNHCR), the number of refugees and people seeking asylum totalled more than 20 million in 2014. The number of asylum applicants in the European Union (EU) in 2014 was more than double that of 2011 – at 627,000 persons. There were over 400,000 in the first six months of 2015 with preliminary figures for the third quarter 2015 of nearly 350,000 more in the EU. Many refugees want to come to Germany, which in addition to Hungary, Austria and Sweden, accepts the highest number of refugees in relation to its population. ↘ CHART 2

20. The number of asylum seekers in Germany this year is set to significantly exceed the **previous peak** of 438,000 back in 1992. As a result of conflicts in the former Yugoslavia, a total of 1.1 million people sought asylum in Germany between 1991 and 1994. In addition, nearly 900,000 ethnic German immigrants resettled in Germany in this same period (Koller, 1997). It is highly likely that a significant portion of the current asylum seekers will be granted permanent residency in Germany.

21. This poses the question of how integration and labour market policies can successfully harness the **economic potential** of recognised asylum seekers in the best possible manner, minimising the economic costs to Germany, at least in the

↘ CHART 2
Asylum applicants in the member states of the European Union



1 – First time and follow-up applicants. 2 – Total number of asylum applicants in relation to the population on 1 January 2015. HU-Hungary, AT-Austria, SE-Sweden, DE-Germany, GR-Greece, IT Italy, FR-France.

Source: Eurostat

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long term. The present situation is not easily comparable to that of the early 1990s, due to the different composition of refugee groups and fundamental differences in economic conditions.

1. Scenarios for labour force and expenditures

22. This report provides a preliminary assessment of the economic effects of the current and future arrival of refugees. These calculations are subject to **extreme uncertainty** given numerous assumptions must be made, using extremely scant data, to provide a quantitative estimate of the impact, for example, on the labour market and public budgets.

23. Different scenarios were created by varying central assumptions. Each scenario describes the potential **process of integration** after the refugees arrive in Germany. ↘ CHART 3 This process consists of three steps:

– **Application**: It is assumed that due to potential multiple registrations and the waiting period, a portion of the refugees registered upon arrival will not apply for asylum.

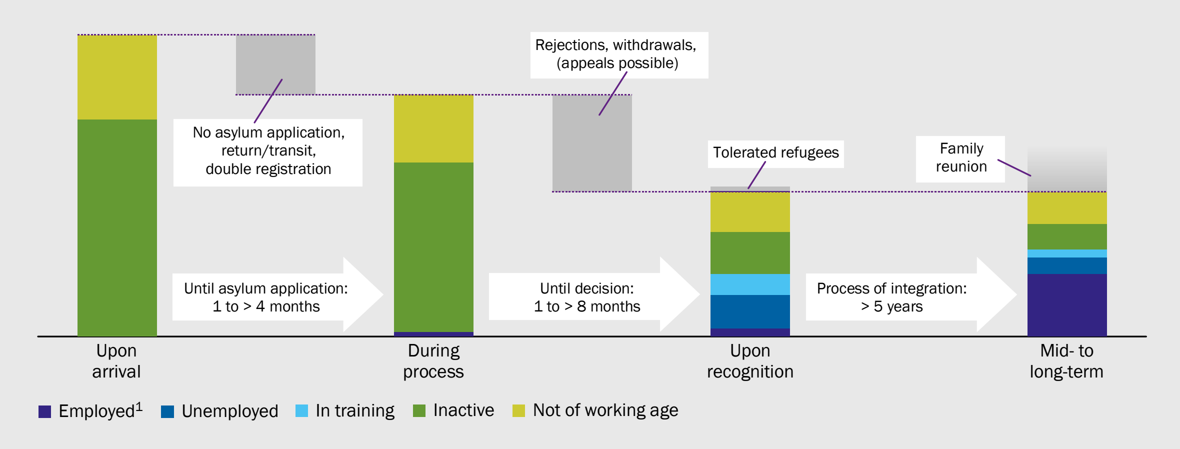
– **Approval**: The percentage of asylum seekers whose applications are approved will likely top historical data, given the large number of refugees from war-torn and crisis regions. Therefore a rise in the overall protection rate, i.e. the percentage of approved applications, from 30 % in 2014 to 60 % in 2016 is assumed.

– **Labour market integration**: The GCEE assumes, on the basis of past experience in recognised refugees' labour market integration as well as their age structure, that labour market participation and employment will rise over time (Brücker, Hauptmann und Vallizadeh 2015). A portion of recognised

↘ CHART 3

Stages of labour market integration of refugees

Illustrative example of the transition of a cohort of arriving refugees



1 – Limited labour market access for asylum applicants during the process and for tolerated refugees.

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refugees will participate in integration and training programmes. A limited number of admittances for family reasons at a later time has also been assumed, although no reliable statements can be made at this time regarding the actual figure. ↘ APPENDIX, TABLE 2

24. These scenarios are linked to assumptions for **direct fiscal expenses**. It is assumed that asylum seekers, tolerated refugees (i.e., migrants with temporary suspension of deportation) and declined applicants will receive benefits in accordance with the Asylum-Seekers Benefits Act (*Asylbewerberleistungsgesetz* - AsylbLG) or social security (*Sozialgesetzbuch XII, Sozialhilfe*). Based on average gross expenses in 2014 plus a premium, an estimate of €800 per month per person entitled to benefits has been assumed for covering accommodation, food and healthcare.

Recognised refugees (i.e., refugees with approved status) are entitled to the same basic social benefits as German citizens. It is assumed that 75 % of recognised refugees will initially receive benefits in accordance with Volume II of the German Social Code (*Sozialgesetzbuch II*). A monthly amount of €550 per person is assumed, which is also based on average benefits in 2014. An annual lump sum of €2,000 per person is estimated for integration programmes, under the assumption that 75 % of the recognised refugees will take up the offer. Asylum seekers whose applications have been denied will continue to receive benefits for a further four months. In addition, lump sum expenses totalling €500 are assumed.

25. The analysis focuses on four **scenarios**, each containing specific combinations of key parameters, to illustrate potential developments: ↘ APPENDIX, TABLE 2

– In the **base scenario**, the influx of refugees will decline from one million people in 2015 to 200,000 in 2020. Given an average asylum application period of eleven months in 2014, a total application period of twelve months, including the period between arrival and application submission, is assumed.

Labour market participation increases in the first five years after arrival from 40 % to 70 %, while the unemployment rate decreases from 80 % to 20 %.

– In the **scenario with a fast-track procedures and quicker integration**, accelerated processing with an average total application period from arrival to asylum decision of six months is assumed for a constant number of refugees. This scenario models faster labour market integration through a more rapidly increasing participation rate to 80 % in the fifth year after arrival, as well as a more rapidly decreasing unemployment rate to 10 %. Such a positive scenario could occur if the refugees' skills set is favourable and integration measures work well.

– In the **scenario with greater refugee inflows, slower procedures, and slower integration**, a 20 % increase in refugee arrivals over the base scenario is assumed. The length of the procedure from arrival to asylum decision averages 18 months. In combination with less effective labour market integration, this results in delayed labour market entry and a higher unemployment rate; a participation rate of 60 % and an unemployment rate of 30 % are assumed for the fifth year after arrival.

– In the **scenario with higher expenses and better integration**, the same refugee figures and application periods are assumed as in the base scenario. The assumption is made, however, that an integration programme which initially generates higher expenses is followed by better medium-term labour market integration. This is reflected in a rise in the participation rate to 80 % and a decline in the unemployment rate to 5 % in the fifth year after arrival in the country.

26. As a scenario analysis always presents several alternatives, it is not meant to serve as a forecast. Instead, it strives to depict different outcomes based on different assumptions. This permits, among other things, the illustration of the **possible consequences of individual policy decisions**. However, developments will depend primarily on factors that are outside the scope of domestic policies, such as the situation in the countries of origin.

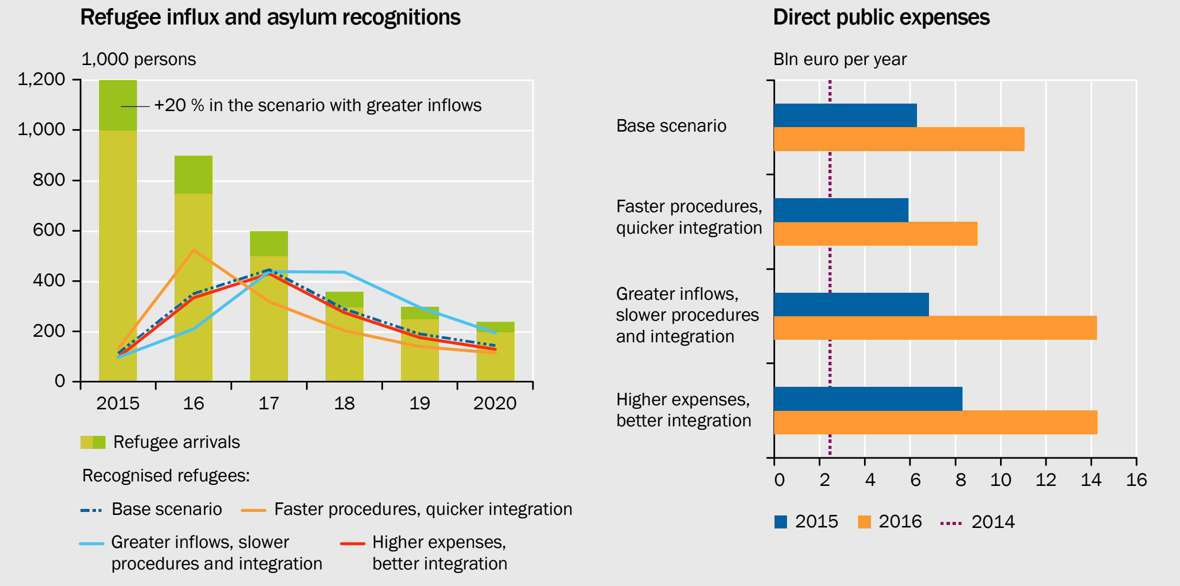
The scenarios assume a relatively quick decrease in the number of refugees migrating to Germany in the next few years. This would require corresponding measures at the political level to limit the number of refugees, or a decrease in migration flows for other reasons. Completely closing off Germany to refugees is not assumed in any scenario.

27. A longer-term view is key to the integration of refugees, as success will only manifest itself over an extended period. The demand for labour will play just as important a role as efforts aimed at enhancing education and qualification.

The scenarios illustrate that the high number of asylum seekers in 2015 initially contrasts with a far lower **number of recognised refugees** – around one tenth of the number arriving in Germany. In the base scenario, the number of recognitions peaks in 2017, or as early as 2016 if a fast-track procedure is introduced. In the case of higher numbers of refugees and slower procedures, a decrease in the number of asylum recognitions should not be expected until 2019.

↘ CHART 4

Projections of the number of recognised refugees and associated expenses in four scenarios[1]



1 – Assumptions, see appendix of this chapter, table 2.

Source: Own calculations

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28. Depending on the scenario, migration, as well as social and integration benefits for asylum seekers and recognised refugees, will result in direct annual **additional gross expenses for public budgets** in the range of €5.9 to €8.3 billion in 2015 and €9.0 to €14.3 billion in 2016. ↘ CHART 4, RIGHT This corresponds to 0.2 % to 0.3 % of GDP in 2015 and 0.3 % to 0.5 % of GDP in 2016. Slower procedures combined with worse labour market integration would likely raise these costs noticeably.

More intensive use of **integration and qualification measures** would increase total expenses in the short term. The extent of additional expenditures of structural nature largely depends, however, on the success of labour market integration. The calculations do not take into account any indirect additional expenses, for example, for administration or public investment.

29. The refugee influx is accompanied by a significant potential for education and skill acquisition. The effects on the labour force potential and thus on production potential are nonetheless likely to be moderate in the medium term. ↘ ITEM 258 In the favourable scenario, **employment will increase** by up to 500,000 people by 2020 due to recognised refugees joining the workforce; in the unfavourable scenario it will only increase by half that amount. At the same time, **unemployment** will rise by about 300,000 to 350,000 people cumulatively by 2020. ↘ ITEMS 526 FF. Thus the number of registered unemployed is likely to pass the three-million mark in the next few years, an annual average figure last exceeded five years ago. The unemployment rate is unlikely to decrease any further.

2. Policy implications for successful integration

30. In addition to an analysis of the economic effects, this report explores the possibilities for effectively distributing the economic burden posed by the refugee influx. This section discusses **migration and integration policies** to harness the economic potential of refugees who remain in Germany for the long term.

31. Coping with the arrival of refugees poses a **challenge to the whole of Europe,** given the EU's open internal borders and the implications of national migration policies for the EU as a whole. The current situation is a test of the union's ability to act. It is therefore paramount to reach agreements that effectively regulate migration to **Europe and Germany**. On one hand, these should involve measures designed to improve the situation in crisis countries and at the EU's external borders, not least to lessen the incentives to migrate. On the other hand, decisions should be made on the adequate **distribution of refugees among the member states**.

To deal with additional spending needs, it is preferable to reallocate funds within the EU budget towards respective **support programmes**. For instance, more money could be channelled into the Asylum, Migration and Integration Fund (AMIF) and the Internal Security Fund (ISF). Invoking the exceptional circumstances clause within the Stability and Growth Pact should be avoided.

32. Germany should swiftly expand the necessary **capacities in public administration**, such as for application processing, integration promotion or repatriation. An acceleration of the asylum procedures is desirable with a view to integrating those granted asylum and as a signal of the government's ability to cope with the current challenges. However, this must not preclude the appropriate assessment of asylum applications, in order to limit appeals and abuses.

The **immediate additional fiscal outlays** related to refugees for this year and next appear manageable. Given the favourable fiscal situation, there is no need for tax hikes or new borrowing at present. ↘ ITEMS 246 FF. The differing expenses for regional and local authorities will largely be offset by federal transfers and fiscal equalisation rules, although reimbursements received at local level vary greatly between the federal states. **Providing in-kind support** to asylum seekers instead of cash payments appears appropriate. Introducing flexibility to building standards through the Refugee Accommodation Measures Act (*Flüchtlingsunterbringungs-Maßnahmengesetz*) in November 2014 is warranted given the urgency of providing sufficient accommodation, particularly during winter.

33. The current high volume of migration increases **the demand for housing** in the medium term. This additional demand meets a housing market that is already tight in some regions (GCEE Annual Economic Report 2013 items 347 ff.). A framework that improves **incentives for private investment** in housing construction will be necessary to enable a sustainable expansion of supply (GCEE Annual Economic Report 2013 items 866 ff.). In particular, it would be advisable to abolish the rent ceiling (*Mietpreisbremse*).

The recently adopted revival of social housing certainly appears attractive in the short term. However, in terms of social policy, public support targeted at households, such as housing benefits (*Wohngeld*), rather than properties would be better suited to prevent segregation and improve integration (GCEE Annual Economic Report 2013 items 873 ff.).

34. Training of recognised refugees is key to **social integration** due to their age and qualification levels. Although reliable data on the refugees' qualifications is scarce as yet, a **considerable need for skill acquisition** can be assumed. In addition to expanding the availability of language and integration courses, there will be an increased need for schooling and training, for which take-up should be encouraged. ↘ ITEM 562

35. **Labour market integration** should be given high priority, as it is an important step for social integration of recognised refugees. The entry hurdles must not be too high and flexible employment opportunities, such as temporary positions (*Zeitarbeit*) and jobs via contracts for work and services (*Werkverträge*) must remain in place. Migrants should **not receive particular privileges** over other labour market participants, but should not suffer worse conditions either.

36. The minimum wage likely presents a high entry barrier for many refugees. Given the increase in labour supply in the low-wage sector, the **minimum wage must certainly not be raised**. Recognised refugees who are seeking employment should be regarded as long-term unemployed from the outset, as the majority will not have had any paid work for an extended period. The **exception from the minimum wage** for the long-term unemployed in the first six months of a new job should generally be extended to twelve months. All internships should be exempt from the minimum wage, at least for a period of up to twelve months, which could facilitate labour market entry for refugees. A phasing-in of the minimum wage according to age would lower the entry hurdle for young adults. ↘ ITEMS 567 F.

37. Refugees arriving for humanitarian reasons must be strictly differentiated from **economic immigrants**. Germany already has a relatively open labour migration policy, which is comparable to the policies of other countries, such as Canada (SVR Migration 2015). Not least due to their skill structure, recognised refugees will not be suited to meet the demand for skilled workers needed in the near future to compensate for the demographic decline of Germany's labour force.

IV. PATHS TO MORE STABILITY IN EUROPE

38. The escalation of the **crisis in Greece** was the second dominant economic policy issues in 2015. Even though a third rescue package for Greece was finally agreed, political turbulence during the negotiations challenged the functioning of the euro area architecture. This led to discussions about the future structure

of the euro area. There are two opposing positions on this matter: The first, as set out in the **Five Presidents' Report**, aims for increased integration of the euro area, which in the long term includes a common fiscal capacity (Juncker et al. 2015). The second, which is held by the German Council of Economic Experts, among others, aims to **reinforce existing rules** while maintaining the unity of liability and control (Deutsche Bundesbank, 2015; GCEE Special Report 2015 items 65ff).

1. Elements lacking in the euro architecture

39. The GCEE's **Special Report** published in July 2015 depicted ways to improve the euro area's institutional framework in order to maintain the union for the long term (GCEE Special Report 2015 items 65ff).

Although the creation of the European Stability Mechanism (ESM) and the European Banking Union were important steps towards making the euro architecture more resilient to crises, more elements are necessary to lend credibility to the **no-bailout clause**. Firstly, a **sovereign insolvency mechanism** should be introduced to enable public debt to be restructured without destabilising the euro area. ↘ ITEMS 44 FF. Secondly, an end must be put to the **privileged status of sovereign exposures** in financial regulation, in order to sever the link between banks and governments (Deutsche Bundesbank, 2015). ↘ ITEMS 52 FF.

Even with these improvements, one member country's fundamental unwillingness to cooperate could create an existential threat to the stability of the monetary union. The GCEE is not arguing for a formalised exit procedure, yet a country's **exit** from the monetary union must be possible as a **last resort**.

40. The **European Banking Union** is a key step towards a more stable financial system in Europe, and should be strengthened further. The GCEE advocates a separation of banking supervision from monetary policy, and thereby the creation of an **independent integrated financial supervisor at EU level** outside the ECB (GCEE Annual Economic Report 2014 item 381). This would eliminate conflicts of interest between monetary policy and banking supervision, such as those that arose during the Greek crisis, and ensure consistent application of European rules for all financial intermediaries in the EU.

Furthermore, the Banking Union should be strengthened through **improvements to the resolution regime** for banks. The scope of discretion for creditor bail-ins should be reduced to raise the credibility of the bail-in rules (GCEE Annual Economic Report 2014 items 338ff). The observed difficulties of creditor bail-ins for the Greek banks emphasise the necessity of credible bail-in rules and high-quality capital.

In contrast, introducing a common deposit guarantee scheme contradicts the principle of unity of liability and control. Despite common supervision, national economic and fiscal policies continue to exercise a major influence on banking sector risks (GCEE Annual Economic Report 2012 item 315), as evidenced by the

Greek crisis, for example. This calls for maintaining **national responsibility for depositor protection**.

41. The procedure for the provision of **emergency liquidity assistance** (ELA) by national central banks also needs to be reviewed. The current rules are based on the idea that information on the use of ELA by a bank has to be kept confidential to prevent bank runs. Yet, ELA loans have now been used in systemic crises, in which the entire banking sectors of certain countries were affected. In such situations, the aggregate volume of ELA should be published. The criteria for granting ELA loans should be harmonised and made more transparent, especially regarding the valuation of collateral as well as the assessment of bank solvency and liquidity, to ensure that only solvent banks receive them. Assessing the solvency of recipient banks should be forward looking, e.g. by means of a stress test, and should be carried out by an independent entity.

42. Cases in which the banks' solvency is closely linked to the solvency of the associated member state should be particularly scrutinised. It must be strictly avoided that emergency assistance is used for **monetary financing of the government**. Therefore, the rollover of emergency loans to Greek banks must be rebuked, as projections had already cast doubts on the solvency of the banks, and a portion of the liquidity assistance was invested in short-term government bonds. ↘ BOX 1

↘ BOX 1

Emergency loans for Greek banks

Emergency liquidity assistance (ELA) allows national central banks – at their own risk – to issue liquidity to domestic banks that are illiquid but solvent (GCEE Annual Economic Report 2012 item 141; GCEE Annual Economic Report 2013 items 205ff). The Governing Council of the ECB can deny such loans with a two-thirds majority.

Since 2012, ELA has been used by three member states in particular: **Greece, Ireland and Cyprus**. While no ELA loans have been drawn in Ireland since February 2013 (GCEE Annual Economic Report 2013 box 9), and those drawn in Cyprus are on the decline, ELA loans granted in Greece have risen sharply since the beginning of 2015. This is primarily due to the ECB's decision of 4 February 2015 to no longer accept bonds issued or guaranteed by the Greek government as collateral for ECB refinancing operations. Because these bonds make up a large portion of Greek banks' collateral, they would have been cut off from the ECB refinancing had the Greek central bank not provided relief by way of ELA loans.

The banks would have experienced a liquidity inflow whenever Greek government bonds became due, and could have used it to repay ELA loans to the national central bank. However at that time, the ECB did not insist on repayments by the Greek banks, but allowed them to use these funds to buy newly issued Greek government bonds.

The volume of ELA loans in Greece had risen to almost €90 billion by June 2015. Without these loans, the major outflows of cash and deposits to other countries would not have been possible. The Governing Council of the ECB placed restrictions on the granting of further ELA loans on 28 June 2015 in view of the impending expiry of the second rescue package on 30 June 2015 without any follow-up package or outcome of negotiations. This led the Greek central bank to order a **bank holiday** lasting several weeks and impose **capital controls**. The restrictions on the ELA loans were not lifted until the Greek government had agreed to discuss a third rescue package and the Greek parliament had approved a package of reform legislations.

43. In contrast to the described reforms needed to strengthen the euro area, the GCEE **warns against hasty moves towards further integration** that will transfer liability risks to the union without also transferring national sovereignty. These could avert acute problems in the short term, but harbour a serious long-term threat to the stability of the euro area (GCEE Special Report 2015 items 94 ff.).

2. Key elements of an insolvency mechanism

44. The introduction of the ESM served to limit the risk of contagion effects in crisis situations. However the availability of crisis lending holds the threat that government creditors will undervalue risks, which is detrimental to the markets' disciplining function. The Treaty on the Functioning of the European Union (TFEU) aims to prevent the taxpayers of EU member states from assuming liability for the excessive debt of a fellow member, by way of the **ban on monetary government financing** and the **no-bailout clause**. This ultimately means that excessive debt has to be tackled through restructuring by means of a **bail-in** (GCEE Special Report 2015 items 83 ff.).

45. An **insolvency mechanism for sovereigns** is intended to enable such restructuring without destabilising the entire monetary union. This is the only way for the no-bailout clause to gain credibility. However, **close ties between banks and states** thus far implied that government debt restructuring threatens the solvency of the banking system and hence causes high crisis costs. The ties between banks and states must therefore also be reduced. ↘ ITEMS 52 FF.

46. The **restructuring of government bonds in Greece** underscored the seriousness of the no-bailout clause. As is evident from the differences between **risk premiums** on government bonds even in this current period of low interest rates, the financial markets no longer assume that all euro-area member states have identical default risks. In the case of a large country such as Italy, it is doubtful anyways whether existing rescue packages would be able to protect it from a serious crisis and restructuring in the event of a major shock (“too big to save”). Concerns that the explicit introduction of an insolvency mechanism would be the very thing to provoke a sovereign debt crisis in Italy are therefore unfounded.

47. At times of great uncertainty, there is a risk of severe, even excessive financial market reactions that create multiple equilibria in a **self-fulfilling prophecy**. An insolvency mechanism for countries stabilises the expectations of market participants, which contains such effects. It also ensures that the restructuring process runs **more orderly and rule-based** in the event of a state insolvency. This in turn reduces the risk of contagion effects and thus strengthens the no-bailout clause. This may explain why there is no empirical evidence of interest

rate spikes in reaction to announcements or introductions of sovereign insolvency rules (Trebesch, 2015).

48. An insolvency mechanism for countries could motivate creditors to take more care in calculating risk premiums on the basis of **sovereign debtors' default probabilities**, and to adjust them more regularly than was the case before the crisis. These risk premiums offer the member states incentives to take on less debt. However, this type of **disciplining effect** could lose impact if the countries are already highly indebted. In such case, highly indebted countries could hope to be able to rid themselves of the debt easily via a sovereign insolvency mechanism, or to delay insolvency for the prospect of recovery (Conesa and Kehoe, 2015).

49. A sovereign insolvency mechanism therefore has to ensure that countries cannot misuse it. To this end, restructuring should be tied to a **strict macroeconomic adjustment programme** that obligates a member state to consolidate its budget and carry out structural reforms in the labour and product markets. This could be implemented through the ESM.

50. Therefore, an insolvency mechanism should be linked to the ESM credit facilities. If a member state applies for an ESM programme, the ESM should only grant access to loans after a **debt sustainability analysis** has been conducted, which includes multiple indicators such as the level of public debt and gross refinancing needs, and also accounts for the country's track record concerning fiscal rules. This reinforces the ex-ante discipline in complying with fiscal rules, as the creditors will have to brace themselves for greater losses in the event of a debt crisis and restructuring. Negotiations with the creditors will be necessary where debt sustainability is in doubt or in the case of excessive debt. The first option to consider is a **maturity extension** for the duration of the ESM programme. In the case of excessive debt, a **nominal debt reduction** of private creditors debt should be conducted before the country re-enters the bond market.

51. In the case of Greece, an analysis of macroeconomic scenarios reveals the extent of uncertainty regarding the long-term sustainability of its public debt. ↘ BOX 2 The possibility of worse than expected developments should therefore always be considered in decisions about ESM programmes. A key aspect that is currently not foreseeable is whether the agreed third aid package will be sufficient to stabilise the government debt ratio beyond 2030, or whether further debt restructuring by public creditors will be necessary after 2019. This could for instance be implemented by way of an additional maturity extension for official loans.

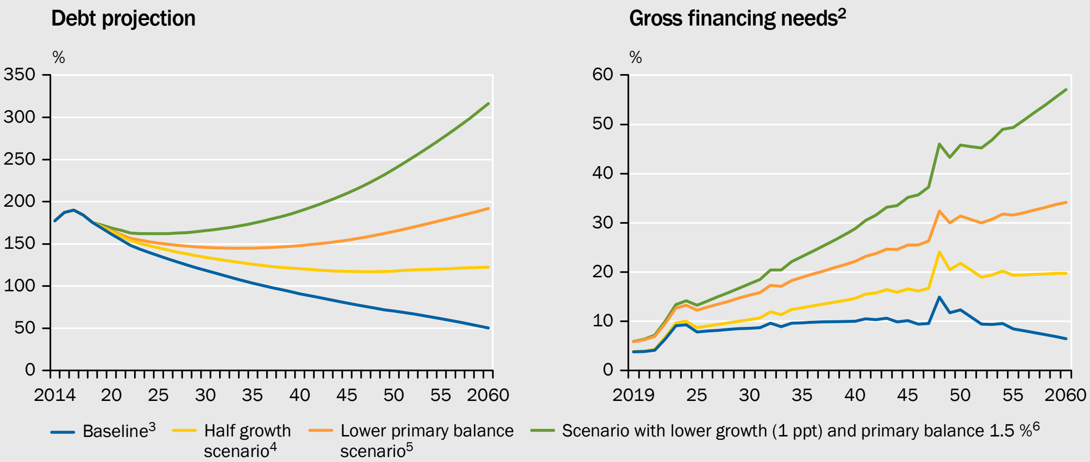
↘ BOX 2

Greece's debt sustainability

An analysis of Greece's debt sustainability must take into account the very favourable terms at which European partners have lent to Greece which will benefit the country for a long time. For this reason, a more accurate assessment of Greece's debt sustainability will only be possible once it has re-entered the capital market. The chart shows that Greece will need to generate a **very high primary**

surplus for an extended period in order to successfully scale back its debt ratio (Scheuering, 2015).
↘ CHART 5 LEFT

↘ CHART 5
Public debt ratio and gross financing needs in Greece[1]



1 – In percent of nominal GDP. 2 – The annual gross refinancing needs are calculated as of amortizations and deficit. The analysis assumes an average maturity of 7.5 years for loans and bonds to private creditors. Refinancing needs until 2019 are assumed to be covered by ESM loans. 3 – For loans and bonds to private creditors an average cost of funds of 6.25 % is assumed (IMF, 2015). This corresponds to the market interest paid by Greece on 5-year bonds prior to the crisis, plus a small premium. 4 – Long-term real growth after 2019: 0.875 %, primary balance after 2019: 3.5 %. 5 – Primary balance after 2019: 1.5 %. 6 – Primary balance after 2019: 1.5 %, long-term growth after 2019: 0.75 %.

Source: Scheuering (2015)

SVR-15-320

The analysis uses scenarios to calculate the debt ratio and the annual gross financing needs, that is, the new credit volume to be issued to fund the repayment obligations and budget deficit. The **baseline scenario** uses the assumptions for economic growth and budget deficit agreed in the third programme (European Commission 2015). Beyond the forecast period, GDP growth of 1.75 % and primary surpluses of 3.5 % of GDP are assumed. In this case, the debt ratio will start to continuously decline from 2017 to around 50 % in relation to GDP at the end of the observation period. The gross financing needs at around 10 % in relation to GDP remains sustainable. ↘ CHART 5 RIGHT The high volume of maturities for ESM loans in the 2040s could be avoided by adjusting ESM loan terms.

However, as **alternative scenarios** show, these developments heavily depend on the assumptions applied. If real growth is assumed to be only half of the value in the baseline scenario from 2019, the debt ratio will rise again slightly from 2048 to around 120 % of GDP. If it is not possible to generate high primary surpluses for an extended period, the debt ratio will rise again in the long term. The picture is similar as concerns gross financing needs. The threshold for the sustainable gross financing needs of 15 % to 20 % of GDP established in practice will be exceeded in the 2030s if primary surpluses are lower.

The assumption of long-term **high primary surpluses** in particular is likely to be problematic. On one hand, high primary surpluses in countries reducing their debt were generally associated with high economic growth in the past. An assessment of such periods in industrialised nations since 1980 shows an average primary surplus of 3.2 % of GDP with average GDP growth of 3.5 % (Abbas et al., 2013). However, in Greece's case, the predicted long-term real growth is a comparatively low 1.75 %. On the other hand, if even weaker economic growth is assumed, the debt ratio will rise more dramatically.

The debt-increasing effect of less favourable economic development will not be felt for another 10 to 20 years, however, when the low-interest debt owed to public creditors will be gradually repaid and replaced by higher-yielding debt to private creditors. For this reason, it remains to be seen what economic shape Greece will be in at that time before conclusively assessing the need for a haircut to ensure debt sustainability. Greece must first create the foundation for more growth through structural reforms, as well as sufficient primary surpluses.

3. Removing privileges for sovereign exposures

52. The close interrelationship between governments and banks, which has strengthened since the global financial crisis (ESRB, 2015), is seen as one reason for the severity of the euro area crisis. **Breaking the sovereign-bank nexus** is therefore one of the central aims of the banking union (European Council, 2012) and a prerequisite for implementing a sovereign insolvency mechanism. ↘ ITEMS 44 FF.

53. The reforms to date, particularly the introduction of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), do in fact lessen the impact of banking crises on banks' home countries (GCEE Annual Economic Report 2014 items 316 ff.). In contrast, reforms are lacking that would limit the impact of a sovereign debt crisis on the domestic banking system. The **removal of a privileged regulatory treatment** of sovereign exposures may lessen a direct transfer of losses to the banking system.

54. The proposed reform is intended to serve three aims:

– to **reduce concentration risks** on bank balance sheets in order to prevent the insolvency of a member state from bringing about the insolvency of a bank;

– to **increase banks' loss absorption capacity** in order to be able to better cope with a sovereign default;

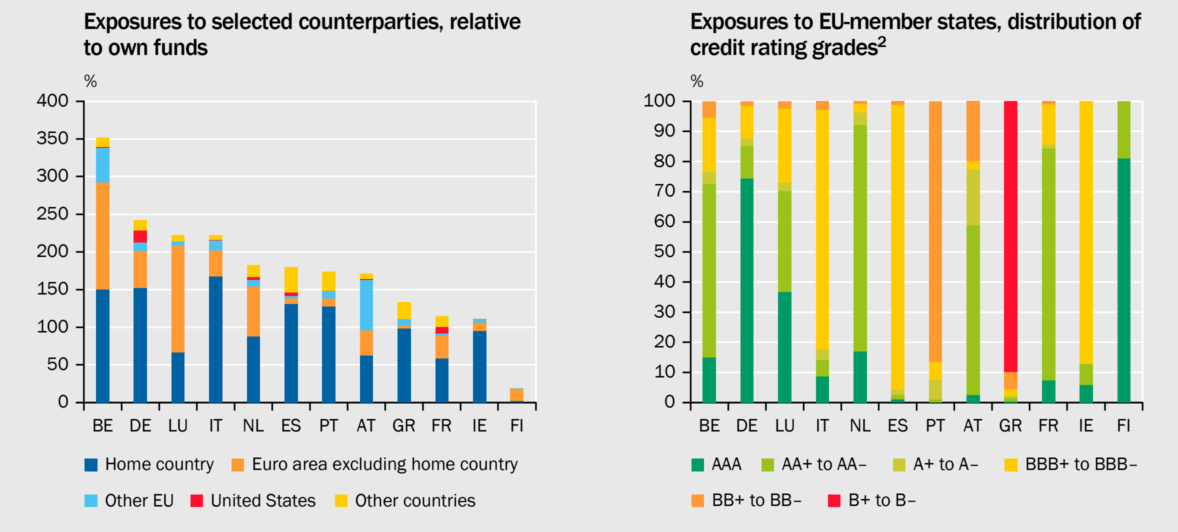
– to **reduce price distortions** in order to reduce incentives for sovereigns to borrow excessively and for banks to lend preferentially to governments.

55. There is currently a large number of rules in European banking regulation that **privilege** sovereign exposures. For example, exposures to private debtors must not exceed 25 % of a bank´s eligible capital; this limit does not apply to sovereign borrowers. In addition, there are no capital requirements for sovereign exposures in domestic currency. Finally, sovereign exposures are considered entirely safe and liquid (Level 1 assets), while non-sovereign, non-high-quality exposures are subject to haircuts and caps under the liquidity coverage ratio.

56. To illustrate the **impact of a reform**, calculations were made based on end-2013 data from the stress test by the European Banking Authority (EBA) conducted in 2014, which includes 95 banks of the euro-12 member states. This sample represents around 77 % of total euro-12 bank assets on the basis of the ECB's consolidated banking statistics. Further details can be found in the appendix to chapter 5. ↘ ITEM 473 FF. The overall picture varies greatly from country to country, and there is a significant home bias, particularly in the southern European countries and in Germany. ↘ CHART 6, LEFT The associated risks, however,

↘ CHART 6

Sovereign exposures of banks in selected euro area member states[1]



1 – Own calculation based on data from the 2014 stress test of the European Banking Authority (EBA); data as of 31 December 2013. For details see Chapter 5, Appendix 2. BE-Belgium, DE-Germany, LU-Luxembourg, IT-Italy, NL-Netherlands, ES-Spain, PT-Portugal, AT-Austria, FR-France, IE-Ireland und FI-Finland. 2 – Credit ratings of Standard & Poor's as of 31 December 2013.

Sources: EBA, Standard & Poor's

SVR-15-430

depend on the issuer's credit standing; the greatest risks are for banks in Greece, Portugal, Spain, Ireland and Italy. ↘ CHART 6, RIGHT

57. The German Council of Economic Experts has developed a proposal for removing privileges for sovereign exposures based on two key elements: **risk-adjusted large exposure limits** and **risk-adequate regulatory capital requirements**. ↘ BOX 3 The large exposure limits are the crucial element of the proposal from the point of view of the GCEE, as they directly reduce the sovereign-bank nexus by limiting concentration risks. In addition, the regulatory capital requirement increases loss absorption capacity and reduces price distortions. It must be taken into account that the Basel III **leverage ratio**, expected in 2019, already implicitly represents a non-risk-weighted regulatory capital requirement.

↘ BOX 3

Proposal for removing regulatory privileges for sovereign exposures

The proposal by the German Council of Economic Experts suggests introducing **large exposure limits for sovereign exposures.** These limits are to **vary with the default risk,** because concentration risks in bank balance sheets primarily represent a threat to financial stability in the event of a significant default risk. An approach that differs from the approach to private borrowers appears advisable due to the great importance of safe and liquid bonds for banking. The default risk could be determined by country ratings or alternative indicators that are not prone to manipulation. Different levels of government should be viewed as a single unit if the default risks are strongly correlated or a separate treatment enables regulatory arbitrage.

For the countries with the lowest credit standing, the GCEE proposes a large exposure limit similar to that for corporate exposures (**25 %** of eligible capital). The limit gradually increases to **up to 100 %** of eligible capital for countries with a better credit standing, using distances between risk categories that are similar to the Basel sovereign exposure risk weights. ↘ TABLE 1 In order to avoid procyclicality, **five-year averages** should be used to determine both the permissible limits and the own funds.

In addition, the German Council of Economic Experts proposes a capital requirements based on the **Basel sovereign risk weights.** ↘ TABLE 1 A **transition period of ten years** could be provided for the large exposure limits, for which an adjustment path is specified (starting, for example, from three times the final limits, which are then gradually reduced). **Grandfathering** could apply to the capital requirements so that only new exposures would be subject to these regulations. The cut-off date would have to be in the past in order to avoid an incentive to stockpile privileged bonds.

↘ TABLE 1

Risk-adjusted large exposure limits and risk weights for sovereign exposures

<table>
<tr><th rowspan="2">Standard & Poor's credit ratings[1]</th><th rowspan="2">Member states[2]</th><th>Basel risk weight for sovereigns</th><th>Large exposure limit[3]</th><th>Basel risk weight for corporations</th></tr>
<tr><th colspan="3">%</th></tr>
<tr><td>AAA</td><td>DE, LU</td><td rowspan="2">0</td><td rowspan="2">100</td><td rowspan="2">20</td></tr>
<tr><td>AA+/AA/AA–</td><td>AT, FI, NL/BE, FR/EE</td></tr>
<tr><td>A+/A/A–</td><td>IE/SK/LT, LV, SI</td><td>20</td><td>90</td><td>50</td></tr>
<tr><td>BBB+/BBB/BBB–</td><td>MT/ES/IT</td><td>50</td><td>75</td><td rowspan="2">100</td></tr>
<tr><td>BB+/BB/BB–</td><td>–/PT/–</td><td rowspan="2">100</td><td rowspan="2">50</td></tr>
<tr><td>B+/B/B–</td><td>CY/–/–</td><td rowspan="2">150</td></tr>
<tr><td>CCC+/CCC/CCC–</td><td>–/–/GR</td><td>150</td><td>25</td></tr>
</table>

1 – As of 1 July 2015. 2 – DE-Germany, LU-Luxembourg, AT-Austria, FI-Finland, NL-Netherlands, BE-Belgium, FR-France, EE-Estonia, IE-Ireland, SK-Slovakia, LT-Lithuania, LV-Latvia, SI-Slovenia, MT-Malta, ES-Spain, IT-Italy, PT-Portugal, CY-Cyprus und GR-Greece. 3 – Own calculation.

Sources: Basel Committee on Banking Supervision, Standard & Poor's

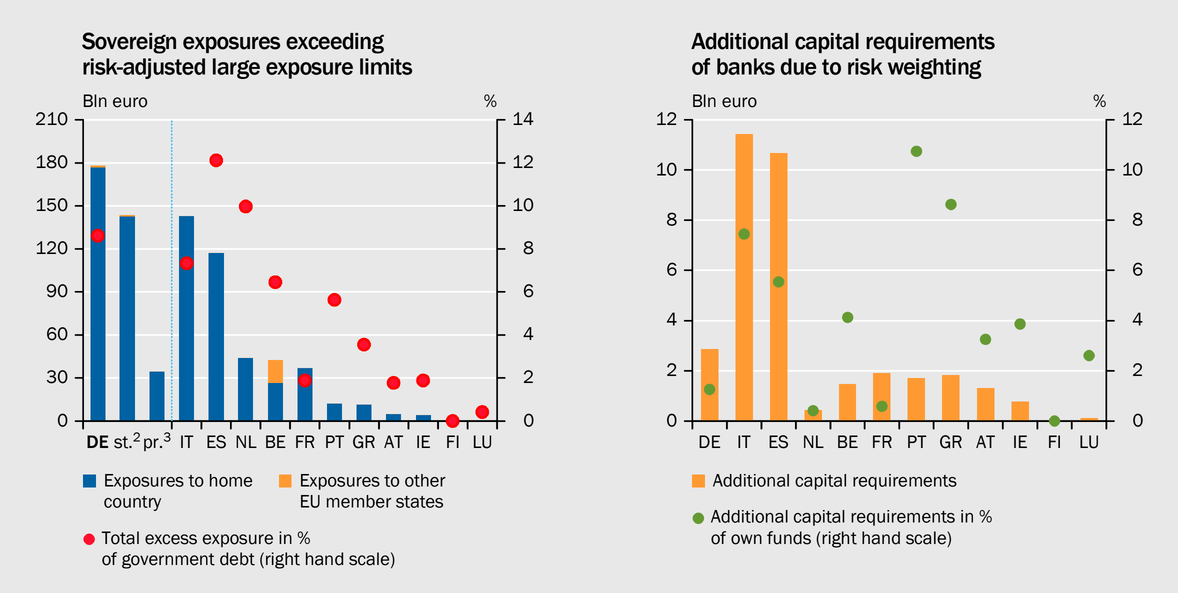
SVR-15-429

58. As a result of the **risk-adjusted large exposure limit**, there is more leeway for holding high-quality government bonds than with a fixed limit. ↘ ITEMS 476 FF. Nevertheless, **considerable reshuffling** is needed, particularly for banks in Germany, Italy and Spain. Based on the bank sample used, the total volume of EU exposures to be divested is €604 billion (as of 2013). In Germany, **state-owned banks** account for the majority of the excess exposures, while private banks are less affected. ↘ CHART 7, LEFT

59. The large exposure limits do not contribute to an increase in loss absorption capacity or to a reduction of price distortions. Therefore, risk-adequate capital requirements should also be introduced. The GCEE proposes removing the exemption from **risk-weighting** for **sovereign exposures** so the Basel rules can take effect. ↘ BOX 3 Basel risk weights for sovereign borrowers are below those for private borrowers.

The **capital requirements** for the bank sample examined would amount to €35 billion, which is approximately 3 % of total own funds. ↘ CHART 7, RIGHT This volume seems **manageable**. For example, in the run-up to the comprehensive assessment alone, €50 billion of core Tier 1 capital (CET1) and €4.6 billion of additional Tier 1 capital (AT1) were raised (ECB, 2014). The low volume implies, however, that only a small amount of **loss absorption capacity** is being created. The additional capital requirements are very unevenly distributed. In abso-

↘ CHART 7
Sovereign exposures exceeding risk-adjusted large exposure limits and additional capital requirements of banks[1]



1 – Own calculation based on data from the 2014 stress test of the European Banking Authority (EBA); data as of 31 December 2013. For details see Box 3 and Chapter 5, Appendix 2. DE-Germany, IT-Italy, ES-Spain, NL-Netherlands, BE-Belgium, FR-France, PT-Portugal, GR-Greece, AT-Austria, IE-Ireland, FI-Finland, LU-Luxembourg. 2 – State-owned banks. 3 – Private banks.

Sources: EBA, Eurostat, Standard & Poor's

SVR-15-431

lute terms they would be highest in Italy and Spain; in relation to own funds, they would be highest in Portugal, Greece and Italy.

60. An important lesson from the past crisis is that regulatory measures must not have a procyclical effect. **Procyclicality** exists when regulation induces adjustment reactions that deepen a crisis. In fact, banks could be forced to divest sovereign exposures due to the large exposure limits if their capital base contracts in a crisis and they have already exhausted their limits. The presumable ensuing rise in governments' funding costs would make additional borrowing more expensive and reduce options for anticyclical fiscal policy if there were little fiscal space. In addition, there could be abrupt credit rating adjustments in a crisis leading to an equally abrupt change in permissible limits.

61. In order to dampen this effect, the use of **multi-year averages** is proposed for own funds and the calculation of limits. This is likely to lead to a significant smoothing of large exposure limits over time. ↘ ITEM 477 Conceptually, risk-weighted capital requirements have the same procyclical effect for sovereign exposures as they do for private ones. This problem should therefore be solved within the framework of the existing **macroprudential toolkit**, i.e. via time-variable buffers.

62. In view of the high levels of reshuffling needed due to the large exposure limits, **generous transition periods** are necessary to cushion the impact on markets and government financing. Phasing-in of the large exposure limits and grandfathering of capital requirements could also increase political acceptance. ↘ BOX 3

63. Uniform regulation of sovereign exposures at a global level (i.e. in the Basel Committee) would be desirable. However, aiming first for an **agreement at the**

EU level would enable its introduction in the near future. As the problem has its roots in the nature of the monetary union, namely the combination of largely sovereign states and a central monetary policy, along with the resulting incentive issues, introducing the regulation in the **euro area** only would also be conceivable. The supposed competitive disadvantages to banks from stricter regulation must be weighed against the advantages from the stabilisation of the euro area.

64. In **Germany**, additional capital requirements are unlikely to meet with great resistance, but criticism can be expected over the large exposure rules. Nevertheless, these in particular must not be left out. In addition, the new rules would help stimulate a rearrangement of the **funding of municipalities and federal states** and facilitate broader diversification across different creditors.

4. More financial integration in Europe

65. A largely shared proposal to deepen European integration is **stronger financial integration** in Europe. The **European Capital Markets Union** has the potential to improve cross-border risk-sharing by strengthening the single market for capital. Risk-sharing was limited during the crisis because capital flows proved to be short-lived and only had limited loss absorption capacity. ↘ ITEMS 446 FF.

66. A one-sided promotion of capital market funding is not appropriate. Instead, frictions that distort the **choice between different forms of financing** should be eliminated. These include primarily the continuing implicit guarantees in the banking system and the preferential tax treatment of debt financing. However, increased capital market funding may make the financing system more resilient through a **greater diversification of funding sources**.

67. The European Capital Markets Union is a long-term project for improving the institutional framework. It is therefore unlikely to substantially help reduce funding obstacles in the euro area caused by companies' still very high debt levels. Without **deleveraging**, the success of the Capital Markets Union is likely to remain limited.

V. PRE-REQUISITES FOR STRONGER GROWTH IN GERMANY

68. The process of securing economic stability in Europe and the immediate challenges of the refugee crisis must not blind us to the **long-term challenges** for the German economy. Demographic change will reduce the labour force in the medium to long term despite currently high net migration. An increase in productivity may offset this **demographic trend** and secure further growth in prosperity. Setting the right conditions to increase flexibility and economic incentives are key to tangible productivity growth.

69. A **slowdown in productivity growth** has, however, been evident in industrialised nations, not least in Germany, for some time. This is often explained by low investment. For Germany, an analysis by the GCEE shows that lower aggregate productivity increases since 2005 are, to a notable extent, due to the successful labour market integration of less-qualified workers. This is not unsettling, but rather part of the success of Germany's labour market policies. ↘ ITEMS 599 FF.

Moreover, in the manufacturing sector in particular, the international **restructuring of value chains**, which had brought considerable productivity advances in the past, seems to have come to an end. There are many possible reasons for this, mostly unrelated to economic policy. Policymakers should, however, take action in cases where protectionism is the cause.

70. An increase in investment activity is welcome if it helps to lift productivity. Investment activity is the result of corporate decisions. The economic conditions to invest and derive profits play a significant role here. They determine whether it is worth working, investing and taking risks. Successfully **harnessing digital change** is also important. Compared to the US, the German economy has not yet effectively translated new information and communication technologies into higher productivity. ↘ ITEMS 652 FF. Particularly in view of digital change, a **visionary economic framework to be developed at the political level** is thus of paramount importance.

71. **Structural reforms** should be given preference over government investment programmes. In the service sector, potential for raising productivity can be assumed due to high **barriers to competition** in the area of former state monopolies and to the **level of regulation** in free professions. ↘ ITEMS 616 FF. In addition, other areas for improving conditions include:

- **trade facilitation and investment protection** as part of the trade agreement with the US;
- **tax reforms** that avoid distortions in financing decisions and do not present hurdles for venture capital;
- **a labour market and education policy** with suitable incentives and an increased equality of opportunities;
- **an energy policy** that efficiently implements the reorientation of the energy sector for climate protection;
- **health policy** that enables hospital reforms, which would achieve important efficiency gains in what is a key sector for the overall economy.

1. TTIP: Trade facilitation and investment protection

72. The US and the EU have been negotiating the **Transatlantic Trade and Investment Partnership (TTIP)** since mid-2013. The agreement promises to reduce welfare-damaging distortions and promote foreign trade by facilitating trade between the US and the EU. Reducing tariffs will be less significant in view

of their already low levels. Instead, the reduction of non-tariff barriers is at the centre of negotiations. These include technical standards and norms, approval procedures as well as rules on consumer, employee and environmental protection.

This makes it more difficult to assess and **evaluate the welfare effects** of TTIP (Egger et al., 2014). The GCEE reported selected estimates in 2014, but at the same time pointed out the associated high level of uncertainty (GCEE Annual Economic Report 2014 item 64 and box 6). Newer, more detailed quantitative analyses confirm the positive effects of earlier studies, but fail to overcome the difficulties in precisely quantifying non-tariff trade barriers (Aichele et al., 2014).

73. Although these estimates are subject to a high level of uncertainty, TTIP is likely to be of great significance from an economic perspective in particular for **Germany as an export nation.** The US are by now Germany's most important trading partner. Re-industrialisation policies in the US are benefitting the German economy in view of the traditional strengths of its manufacturing sector. Harmonisation of industrial norms and standards and simplified approval procedures offer great potential for cost reductions. The digitalisation of the German economy will boost productivity more significantly if trading goods and services with the US is made easier.

In addition, an agreement could **define standards and rules in an exemplary manner** and thus serve as a model for other trading partners (Bungenberg 2014; Mildner et al, 2014). Just like the EU – despite important differences – the US generally set high standards. This can be seen not least in the controversial areas of consumer and environmental protection, as the enforcement of emission norms has recently shown. Balancing the differing political views regarding regulation in a compromise remains the task of the negotiators.

74. Important elements of TTIP are the **rules of investor protection** in the event of investment disputes. The investment protection provisions currently under discussion require, among other things, a duty to pay compensation in the event of direct or indirect expropriation. Furthermore, they include the creation of an arbitration process for investor-state dispute settlement (ISDS) or an international court. Germany has concluded more than 130 investment protection agreements since 1959 and is thus among those that frequently use such investor protection.

75. Due to the thus increased **legal certainty for foreign direct investment**, countries hope to win more foreign investment and promote growth and development. The ISDS closes a protection loophole because there is no general prohibition of discrimination in international law; foreign investors are subject to the laws of the respective sovereign states where they invest. States can change their laws at any time and thus deliberately discriminate against foreign investors. The ISDS thus does not discriminate against the country's citizens by putting foreigners in a better position, but rather ends the discrimination against foreigners. Arbitration proceedings for ISDS are not private, but are based on an international treaty. Moreover, it is by no means the case that private investors

can circumvent national legal systems with ISDS. According to information from the International Centre for Settlement of Investment Disputes (ICSID), a World Bank organisation, the respective government has won in 37 % of the ISDS cases since 1984, and the investor bringing the case has won around a quarter of those; a settlement was reached in 28 % of the cases.

In countries with relatively well-developed legal systems such as the US and the EU member states, the effect of ISDS on legal certainty seems less important (Felbermayr, 2014). Nevertheless, there are significant differences, for example with regard to the **duration and costs of the proceedings**, and judicial independence (Voigt et al., 2015; WEF, 2015). In particular, this holds by accounting for regional differences between the two treaty partners. For example, there are major differences in the standards of legal certainty between the US states just as there are between EU member states. Therefore, **well-developed arbitration tribunals** could even contribute to legal certainty between the US and the EU, and increase foreign direct investment and thus also economic growth.

76. In light of this, the GCEE acknowledges a legitimate interest in an investment protection agreement as part of TTIP. However, the following points should be taken into consideration:

- In order to preserve regulatory autonomy, **state sovereignty for regulation** should not be impaired. In cases that prove particularly difficult in the negotiations, the application of the **country-of-origin principle together with a labeling duty** is to be considered, as it is already provided for in other trade agreements.
- International arbitration proceedings should be improved by introducing an **appeals body**. Moreover, arbitration tribunals should employ independent arbitrators and conduct public hearings. These arbitrators must be free of conflicts of interest. The creation of an **international tribunal at least as an appeals court** is desirable. Such an appeal mechanism should, however, not be deemed a *conditio sine qua non* for the conclusion of an investment protection agreement if it turns out to be unrealistic in the negotiating process.

2. Further tax reforms to combat welfare-reducing distortions

77. The tax reforms since the turn of the millennium have **put the tax system on the right track** with regard to growth and employment. The reforms have reduced the tax burden on production factors and increased the competitiveness of the German economy.

78. The most important remaining distortion is the **differential treatment of debt and equity** in corporate taxation that distorts investment decisions and in particular disadvantages new companies reliant on equity financing. Based on earlier remarks (GCEE Annual Economic Report 2012 items 402ff), the GCEE proposes a **dual income tax with an allowance for corporate equity**

(ACE). Similar models have been successfully introduced in Belgium, Brazil, Italy and Cyprus. In contrast to the Belgian model, which would mean relatively high losses of revenue as it is granted to the entire stock of equity, the GCEE model limits the allowance to the share capital. In view of low interest rates, a switch to this model at the current time would therefore be possible with relatively little loss of revenues.

79. The lack of neutrality between debt and equity finance leads to undesirable side effects from other tax rules. The introduction of a **capital gains tax** for free float shares proposed by the government, which is intended to prevent circumvention of dividend taxation, disadvantages venture capital providers. ↘ ITEMS 793 FF. The implementation of an allowance for corporate equity would in contrast increase the neutrality of the German tax system and at the same time represent tax relief for venture capital providers. Additional tax breaks are then unnecessary.

80. The government has failed to come up with other **tax initiatives** thus far. It has merely achieved compromises for new rules in the following areas:

- **Inheritance tax**: In response to the Federal Constitutional Court's decision, merely the exemption rules have been adjusted. A high price is paid for constitutionality in the form of an administrative burden and a higher burden on companies, without this achieving fairer taxation. The GCEE instead proposes a combination of a broad tax base and low tax rates with generous deferment rules.
- **Bracket creep**: The increase in the basic tax-free allowance and child allowance for 2015 and 2016, together with the increase in the other thresholds of the income tax scale in 2016, results in a tax cut of around €3.3 billion for taxpayers. The GCEE advocates a comprehensive correction retroactive from 2010 that would cut taxes by an estimated additional €5.1 billion. ↘ ITEMS 843 FF.

3. Incentive-driven labour market and education policy

81. Labour market and education policy needs to adjust to the challenges of demographic change, high migration and digitalisation. There is a possibility in the current favourable labour market situation that these challenges could be neglected. In order to harness the **productivity and growth potential** available and to improve participation opportunities, education and skill acquisition efforts should be stepped up and the regulatory hurdles should be reduced. ↘ ITEMS 556 FF.

82. The German labour market is still **highly regulated**. Sufficient flexibility is necessary to adjust to structural changes, to cope with economic shocks, and to facilitate the labour market entry of the long-term unemployed, the low skilled and the refugees. The GCEE therefore urgently cautions against stronger regulation of **temporary employment** (*Zeitarbeit*) **or contracts for work and services** (*Werkverträge*). More flexible solutions for the **entry into retire-**

ment could mitigate the decrease in the labour force resulting from demographic change, and to raising acceptance of the necessary increase in the retirement age.

83. In view of the entrenched long-term unemployment and the expected increase in the labour supply due to the refugee influx, the **minimum wage should not be raised**. In addition to the measures already discussed above to facilitate labour market entry, the exception from the minimum wage for the long-term unemployed should be extended to those receiving basic jobseeker support. ↘ ITEM 36

84. A particularly effective lever for increasing labour volume and productivity, albeit only effective in the long term, is education policy. First and foremost, free access to education and thus **equality of opportunity** should be guaranteed and **incentives for individual investment in education** should be promoted. Focusing public spending more on the early stages of the education life-cycle would help to accomplish this. More private funds could, for example, be mobilised through socially acceptable tuition fees for higher education. In view of the technological changes, employees and employers have to commit to lifelong learning.

4. Economically viable climate protection

85. The restructuring of the energy supply in Europe in view of **global climate protection** is a joint project of high political importance. ↘ ITEMS 696 FF. At the forthcoming climate summit in Paris, the topic of discussion will once again be to reach a global agreement on climate (Cramton et al, 2015), the primary aim of which must be to effectively reduce global emissions of greenhouse gases. From a business standpoint, the implementation of climate goals initially represents a burden on **productivity and the attractiveness as business location** given the high costs of emission reductions. From the point of view of climate protection, significant progress can therefore only be made when a global alliance jointly pursues the goal of emissions reduction (GCEE Annual Economic Report 2011 items 404ff, acatech et al., 2015).

Germany will only be able to take a **pioneering role** in climate protection if the restructuring of the energy sector can be implemented with economic efficiency. The path taken by the **Renewable Energy Act** (*Erneuerbare-Energien-Gesetz – EEG*) of a national industrial policy is the wrong approach. It focuses on technology-based promotion of generation capacity without regard for the system as a whole, and leads to an explosion of costs. The reduction of emissions in Europe should instead follow a common European approach (GCEE Annual Economic Report 2014 item 32). ↘ ITEMS 696 FF.

86. Irrespective of whether volume or price targets are agreed on a global level, there is a conflict of objectives between climate protection and economic efficiency, which is best addressed with market-based instruments. The **Europe-wide Emissions Trading System (EU-ETS)** provides the right mechanism be-

cause it leaves the specific implementation of the measures necessary to avoid emissions to the market players. In order to counteract price erosion for emissions allowances, and to guarantee a minimum price, the **specification of a price range** at auctions or a **one-off reduction** of surplus allowances is likely to be more effective than the "market stability reserve" proposed by the European Commission for a temporary regulation of the auction volumes. In any case, distortions arising as a result of national support programmes such as the Renewable Energy Act (EEG) should be eliminated.

87. If the Federal Government decided to take a consistently European path and to view the EU-ETS as a steering mechanism at European level, the energy transition could be driven forward without repeatedly creating **new subsidies**. One example of this misguided policy is the German electricity sector's additional contribution to emissions reduction discussed in 2015. To this end, older lignite-fired power stations are to initially be kept in reserve at an expected cost of €230 million per year, and later decommissioned. However, it is inconsequential for climate protection how the emissions cuts come about. All that matters is the consistent reduction in emissions.

5. Efficiency increases in the hospital sector

88. The **hospital sector** is a key part of the healthcare system and is becoming increasingly **economically important** due to medical and technical advances and demographic change. ↘ ITEMS 583 FF. Improving the economic efficiency of healthcare is therefore central to the sustainability of public finances (GCEE Special Report 2011). Regarding the **organisation of the hospital sector**, the economic efficiency of facilities must be carefully weighed against nationwide healthcare access.

89. The draft **Hospital Structure Act** (*Krankenhausstrukturgesetz* – KHSG) provides for improving quality transparency and enabling **quality-oriented competition** for patients via remuneration adjustments. The details of the quantitative quality assessment are, however, still undecided. A stronger focus on competition in hospital care may lead to individual departments or whole hospitals having to exit the market for economic reasons. The KHSG is intended to prevent broad healthcare access from being affected by this. For example, extra charges for emergency care and a standardized accessibility indicator are proposed to continue the provision of **appropriate emergency care** in rural areas. ↘ BOX 21, PAGE 271 FF.

90. The KHSG is to be welcomed because overall it leads to **more competition** in the healthcare sector and reduces **distorted incentives**, such as for volume expansion. However, the draft of the KHSG largely ignores the problem of the enduring **lack of investment funding by the German federal states** (GCEE Annual Economic Report 2012 Item 634ff). It can therefore only be a first step towards a more efficient healthcare system.

A differing opinion

91. One member of the German Council of Economic Experts, Peter Bofinger, has a different opinion regarding the views presented in this chapter.

92. The majority of Council members puts this chapter under the heading "Focus on Future Viability". To a large part, economic policies are being proposed that would weaken the role of the government in the economy. In the view of the majority of Council members, future viability appears to imply an economic order with **more market and less government**. However, the experience with the German reunification , the Global Financial Crisis and most recently the refugee crisis shows how fast unexpected, large challenges can emerge which can only be managed by a government that is ready and able to act.

93. The reforms proposed in this report by the majority of Council members would limit the **government's ability to act** considerably:

   – This is especially true for the proposed **sovereign insolvency mechanism** and, related to this, the removal of regulatory privileges of sovereign exposures in bank balance sheets. This would radically limit the financial space and thus the ability of governments to intervene, especially in times of crises.

   – Investor-state dispute settlemente context of **TTIP** would strengthen the position of foreign enterprises in legal disputes vis-à-vis the government. Moreover, regulations in the field of consumer and environmental protection may get untermined by the country-of-origin principle, while economic benefits are uncertain.

   – The proposed tax allowance for corporate equity (ACE) would lead to a considerable loss of tax revenues. This tax rule would have basically the same effect like introducing an asymmetric negative wealth tax while leaving corporate tax rules unchanged. The resulting tax benefit would primarily accrue to wealthy individuals. The already high concentration of private wealth in Germany would thus increase further. The tax disadvantages for equity vis-à-vis debt, which the majority of Council members laments, could be removed without tax revenue loss by substituting the withholding tax on interest incomes by the personal income tax.

94. In addition, the majority calls for a withdrawal of the state from key areas of economic policy, without providing convincing arguments:

   – The scope of the newly introduced **minimum wage** should be restricted, although employment has risen stronger in industries more affected by the minimum wage than in industries which are less affected. ↘ ITEM 36

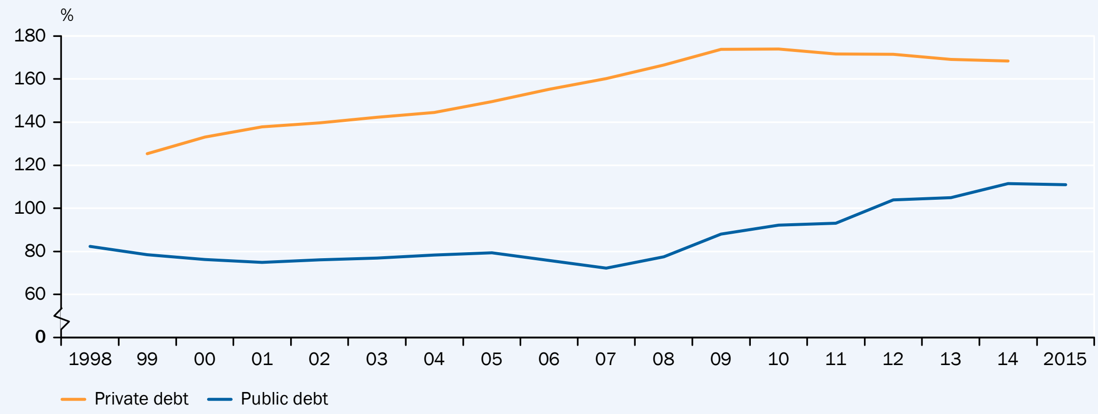
   – The **external flexibility on the labour market** should be strengthened although the German labour market could hardly be doing better - despite high job security indeed.

- Energy policy should phase out **subsidies for renewable energy**, despite the fact that similar schemes are in place in 145 countries. Instead, the majority proposes to strengthen the European emission trading system. ↘ ITEM 86
- The just recently abolished **tuition fees** should be re-introduced. ↘ ITEM 84
- Finally, the policy of the **European Central Bank** (ECB) is considered too expansive. The ECB should slow its government bond purchasing programme or even end it earlier than initially announced. ↘ ITEM 14 Yet, the majority of Council members acknowledges that the ECB contributed to the economic recovery in the euro area.

95. The most far reaching suggestion is the introduction of a **sovereign insolvency mechanism**. In this regard it should be accepted that "the severity of the euro area crisis" ↘ ITEM 52 is first of all a consequence of wrong decisions by private agents, and only partly a consequence of excessive public debt. Until the outbreak of the crisis in 2008, public debt ratios in the euro area had been decreasing whereas the debt levels of corporations and private households had been expanding faster than output. ↘ CHART 8 After the outbreak of the crisis, a notable increase of public debt can be observed. To a large extent, this is due to the fact that, after the excesses of the financial markets, the private economy was stabilised through massive government interventions.

↘ CHART 8

Private and public debt in the euro area
in percent of nominal GDP



Source: ECB

SVR-15-466

96. The majority primarily regards the sovereign insolvency mechanism as a contribution to **strengthen the market discipline** vis-à-vis sovereign countries. ↘ ITEM 48 This approach appears questionable given the crisis was predominantly caused by a misjudgement of markets. The general question to be asked is therefore what qualifies markets for such a far-reaching function (GCEE Special Report items 112 ff). The episode prior to 26 June 2012, the day when Mario Draghi succeeded in stabilising the euro area by giving his famous speech, illustrates that financial markets are not rational and tend to overreact.

97. The majority of the Council members concedes such aberration. In periods of higher uncertainty, they state that there is a **risk of severe**, **in part excessive reactions on the financial markets**, which creates multiple equilibria in the sense of a self-fulfilling prophecy. ↘ ITEM 47 However, the majority then asserts that a sovereign insolvency mechanism would guide expectations of market participants to limit such effects. However, it remains unclear how this works.

98. It is more likely that the insolvency mechanism would destabilise expectations of market participants in times of crisis. An insolvency regime could result in a **bond-run**, where investors fire-sell sovereign bonds to avoid a haircut.

In practice, such an insolvency mechanism implies that more indebted member states would not have the possibility to stabilise the economy in case of severe economic or financial crises.

Because of the insolvency mechanism, these countries are at risk of being hit by a dangerous confidence crisis. Experience of the last ten years has shown how fast a severe crisis can occur which calls for massive state intervention. Countries which can become insolvent would not be able to stabilise the economy in case of crisis. If in case of a severe crisis the macroeconomic stability is not guaranteed, the stability of the banking system would be significantly negatively affected. Due to this, a sovereign insolvency mechanism would be counterproductive.

99. Therefore, a sovereign insolvency mechanism very likely would not stabilise the **architecture** of the monetary union, but rather destabilise it. The euro area's capacity to act in case of a large shock requires that interventions on goods and financial markets can take place in severe crises **without financial restrictions**. This point is proven by the very large public deficits that governments in the US, the UK, and Japan incurred in response to the global economic and financial crisis. The crisis in the euro area in 2010-12 already mirrored the member states' restricted capacity to act due to their membership of the monetary union. In contrast to other highly developed countries, the national debt of the euro area member states is denominated in a currency that the national states cannot issue independently.

100. In the past years, the convincing and pragmatic actions of the **European Central Bank** have ensured that the euro area was stabilised. If the ECB cannot assume this – even for itself – problematic role, policies that can lead to higher instability of the euro area should not be promoted.

Instead, solutions should be pursued that combine necessary fiscal discipline with an unrestricted fiscal policy to act in times of crisis. This necessitates a transfer of fiscal sovereignty from the national to the European level as well as mechanisms for a common liability for government bonds. Without the willingness to engage in further political integration, a stable architecture of the euro area is not in sight. Once the capability to act is ensured at the European level, an insolvency mechanism for individual member states could be discussed again.

101. The **removal of regulatory privileges for sovereign exposures** in bank balance sheets creates a **competitive disadvantage for banks in the euro area** since it should not be expected that other countries introduce similar regulations. The proposed capital requirement for sovereign exposures would increase the funding costs of governments, thus making it more difficult for governments to reduce their debt. Moreover, the proposal would not help banks' profitability. That the "purported competitive disadvantage" is compensated by a more stable euro area ↘ ITEM 63 would only be true if one – as the majority of Council members does – believes in such stabilisation effects. Furthermore, there will not remain any "safe asset" for investment in the euro area any more.

Moreover, the removal of regulatory privileges interferes with bank preferences and would force them to swap current holdings – which are in their view absolutely safe, in particular German Bunds – with bonds of other member states which they view as less safe. At the same time, the proponents of **large exposure limits for sovereign bonds** seem to overlook that an intervention limiting free investment choices limits market discipline.

102. Also in this Annual Economic Report the majority of Council members is in favour of ending subsidies for renewable energy under the Renewable Energy Act (*Erneuerbare-Energien-Gesetz, EEG*). ↘ ITEM 86 It is seen as the wrong way to go.

After all, the fact that 145 countries are currently subsidising renewable energies should be something to think about. These subsidies mostly are part of a model for feed-in tariffs (REN21, 2015). As in Germany, the trend is moving increasingly towards auctions (Bofinger, 2013; Bofinger et al., 2015) which are already in use in 60 countries. In 2014, China, the US, and Japan made the largest investments in renewable energy. To this end, many regard Germany as a useful role model for global climate potection (Wagner und Eitzman, 2015). However, this does not imply that the EEG cannot be improved. Hence the Germany government is intensively working on curbing the „cost explosion" by providing subsidies based on tenders.

103. The promotion of renewable energy does not contradict a **trading system for greenhouse gas emissions** in principle. The target quantities set under such a trading system should take into account that the burden imposed on the economy remains bearable. The price drop caused by the promotion of renewable energy suggests that ambitious targets under the EU Emissions Trading System (EU ETS) are achievable. Without the Renewable Energy Act, the EU-ETS would presumably not have resulted in substantial technological progress since, as acknowledged by the majority, it disappointed expectations in Europe so far. Moreover, given the lack of interest in an international CO_2-trading system to date, no progress on climate change would have been achieved on global level.

104. **A uniform Pigou-tax**, as proposed by Edenhofer and Ockenfels (2015) or by Wagner and Weitzman (2015), appears more promising than quantitative ceilings. For Europe, this would require a price floor in the emissions trading system. Along the same lines, the majority of Council members also favours a **price corridor**. Edenhofer and Ockenfels see an essential advantage of an international price target in its compatibility with national subsidies for renewable en-

ergy. While such measures have only led to a deferral of emissions so far, a price floor would guarantee that additional reductions of emissions could be achieved. In turn, the low-cost availability of renewable energy might increase the willingness of countries to introduce such a global tax.

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APPENDIX

↘ TABLE 2

Scenario assumptions on the impact of the refugee migration

Scenarios / Assumptions	2015	2016	2017	2018	2019	2020
Base scenario						
Refugees						
Arrivals[1]	1,000,000	750,000	500,000	300,000	250,000	200,000
Asylum applicants[2]	80 %					
of working age[3]	72 %					
Total duration[4]	4 months from arrival to application submission, 8 more months until decision					
Protection rate[5]	49 % in 2015, 60 % from 2016 onwards					
Tolerated refugees	5 % of asylum applications denied					
Expenses per refugee						
Benefits for asylum applicants[6]	€800 per month					
Benefits for recog. refugees[7]	€550 per month for 75 % of the recognised refugees					
Lump sum for measures[8]	€2,000 for 75 % of the recognised refugees					
Lump sum upon denial	€500 Euro one-time					
Labor market integration	upon recognition	after 1 year	after 2 years	after 3 years	after 4 years	after 5 years
Participation rate[9]	40 %	50 %	55 %	60 %	65 %	70 %
Unemployment rate[9]	80 %	60 %	45 %	35 %	25 %	20 %
Scenario "Faster procedures, quicker integration"[10]						
Total duration[4]	2 months from arrival to application submission, 4 more months until decision					
Benefits for recog. refugees[7]	€550 per month for 60 % of the recognised refugees					
Lump sum for measures[8]	€2,000 for 60 % of the recognised refugees					
	upon recognition	after 1 year	after 2 years	after 3 years	after 4 years	after 5 years
Participation rate[9]	40 %	60 %	65 %	70 %	75 %	80 %
Unemployment rate[9]	80 %	50 %	35 %	25 %	15 %	10 %
Scenario "Greater inflows, slower procedures, slower integration"[10]						
Arrivals[1]	20 % more arrivals per year than in the base scenario					
Total duration[4]	6 months from arrival to application submission, 12 more months until decision					
Benefits for recog. refugees[7]	€550 per month for 90 % of the recognised refugees					
Lump sum for measures[8]	€2,000 for 90 % of the recognised refugees					
	upon recognition	after 1 year	after 2 years	after 3 years	after 4 years	after 5 years
Participation rate[9]	40 %	40 %	45 %	50 %	55 %	60 %
Unemployment rate[9]	80 %	70 %	55 %	45 %	35 %	30 %
Scenario "Higher expenses, better integration"[10]						
Benefits for asylum applicants[6]	€1,000 per month					
Benefits for recog. refugees[7]	€550 per month for 100 % of the recognised refugees					
Lump sum for measures[8]	€3,000 lump sum for 100 % of the recognised refugees					
Lump sum upon denial	€1,500 one-time					
	upon recognition	after 1 year	after 2 years	after 3 years	after 4 years	after 5 years
Participation rate[9]	40 %	40 %	55 %	70 %	75 %	80 %
Unemployment rate[9]	80 %	45 %	30 %	20 %	10 %	5 %

1 – Calculations assume an additional surplus of 10 % of the recognised refugees of the respective previous year to take into account chain migration (for example family reunion). 2 – It is assumed that the remaining 20 % do not seek asylum due to returns, transits and double registrations. In addition, a portion of pending asylum cases is assumed to be terminated without a decision. 3 – As of the date of application submission. Considering the age structure, it is assumed that the working population will increase annually by 1/18 of the number of recognised refugees since 2015 who were not of working age in the respective previous year. 4 – Applications and decisions are spread equally over the months after arrival or submission in order to achieve the average duration assumed. In order to gradually reduce the number of cases pending in accordance with the assumed processing rate, the number of decisions is increased by (24/duration from application to decision)/100. 5 – As of the date of arrival. 6 – Gross expenses for asylum seekers from arrival until the decision or termination of the application and for tolerated refugees in accordance with the Asylum-Seekers Benefits Act (AsylbLG) or Volume XII of the German Social Code (Sozialgesetzbuch XII). For denied asylum applicants, expenses arise for four more months after denial. 7 – In the first year after recognition in accordance with Volume II of the German Social Code (SGB II). 8 – Qualification and training measures, integration and language courses in the first year after recognition. 9 – Based on the period since recognition. 10 – Only the assumptions changed from the base scenario are listed.

SVR-15-442

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