
Towards a forward-looking economic policy

Annual Report – German Council of Economic Experts

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MGB – November 12, 2017

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- 13/14 Against a backward-looking economic policy
- 14/15 More confidence in market processes
- 15/16 Focus on future viability
- 16/17 Time for reforms
- 17/18 Towards a forward-looking economic policy



Germany and Europe: Outlook, challenges, policies

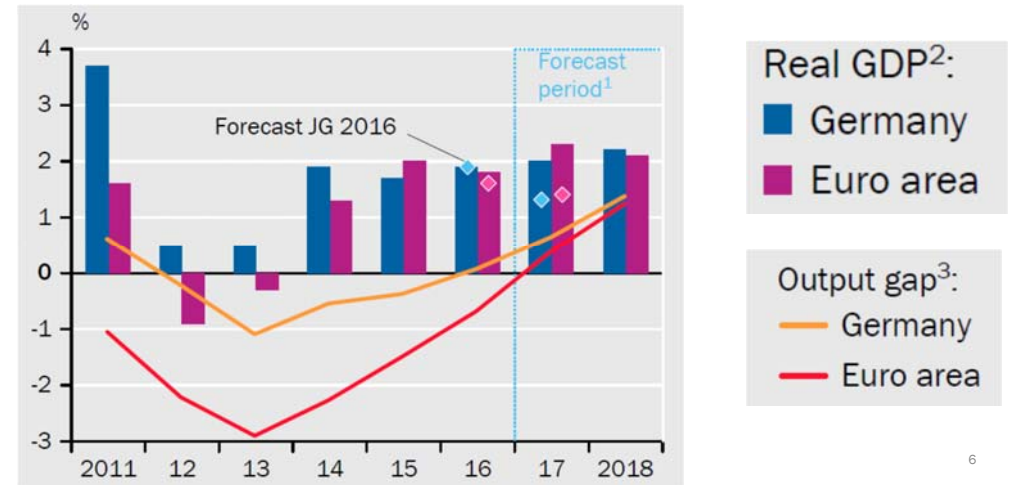
- I. Economic outlook
- II. Germany: Re-adjust policies to address long-term challenges
- III. Europe: Institutions and policies oriented towards sustainability

I. Economic outlook



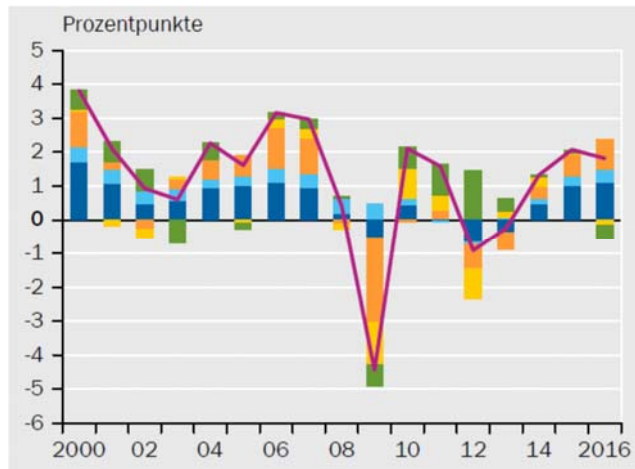
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Strong upturn – increasing over-utilization in Germany



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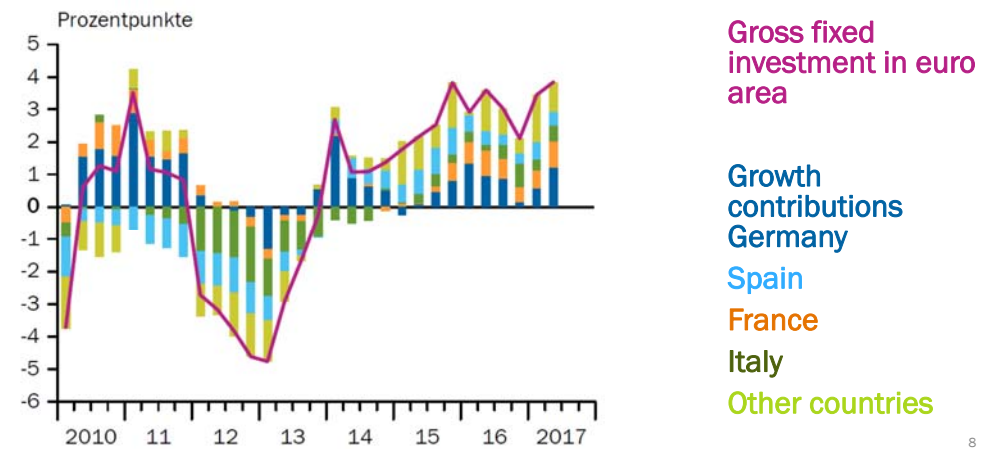
Continuing recovery in the euro area



Household consumption
Government consumption
Gross fixed investment
Inventories
Net exports
GDP Growth

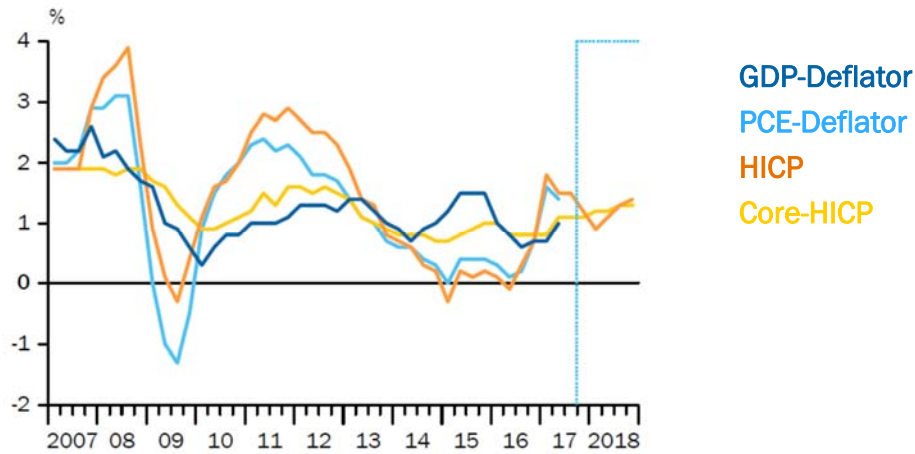
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Euro area: Investment dynamics indicate broad recovery



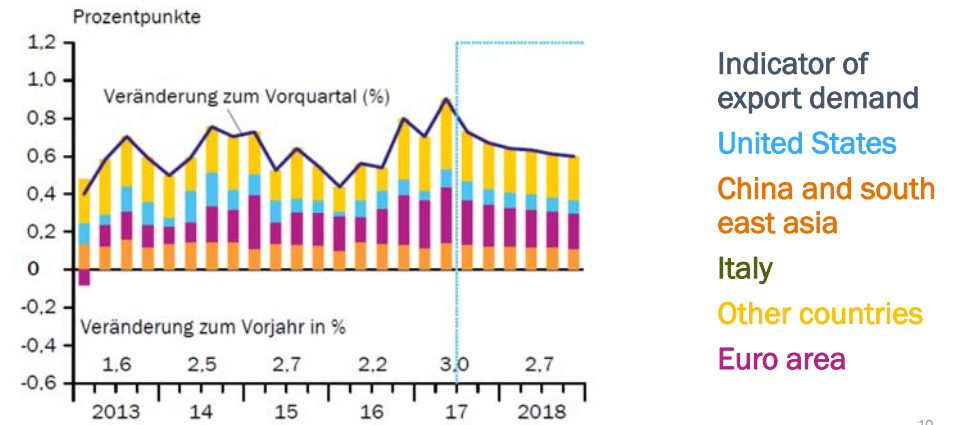
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Stable inflation in the euro area



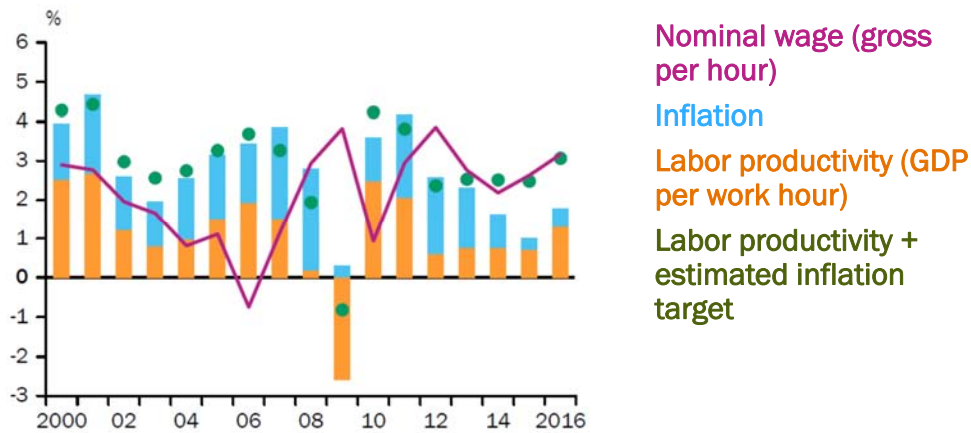
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High demand for German exports continues



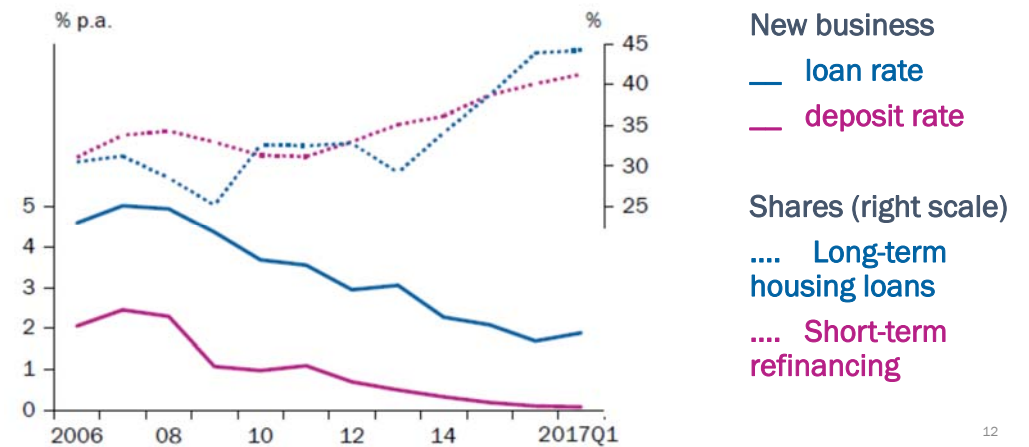
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Wage moderation in Germany ended a while ago



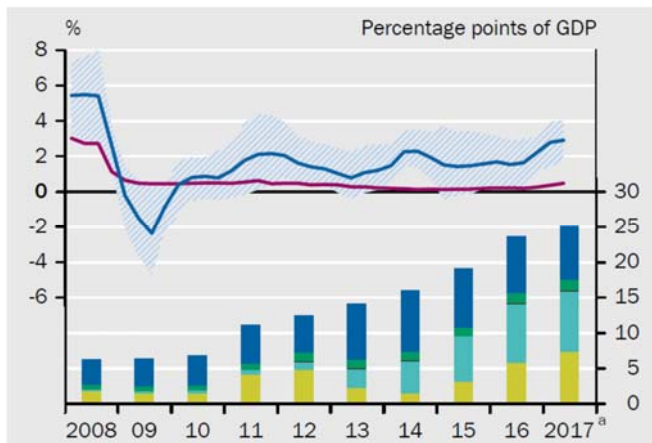
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Risks in bank balance sheets: Germany



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Expansionary effect of monetary policy continues in major advanced economies



Change of central bank assets since 2007

Euro-area, Japan, UK, Canada, USA

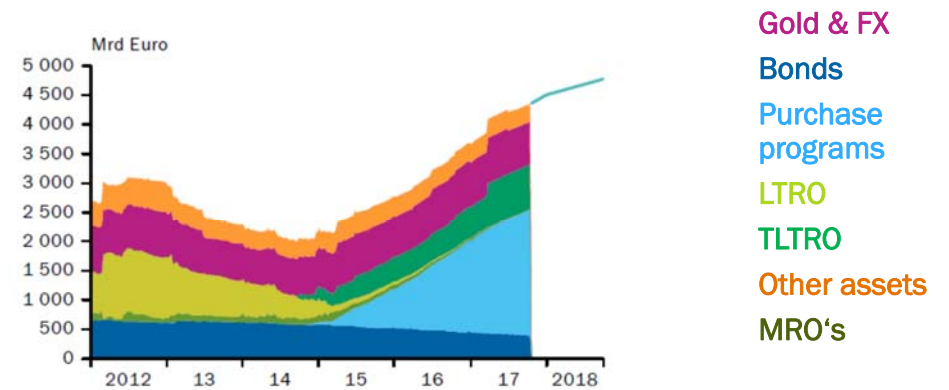
Policy rate relative to reference values

— weighted policy rates

— weighted Taylor rates

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Euro-area: monetary policy expansion continues



Gold & FX

Bonds

Purchase programs

LTRO

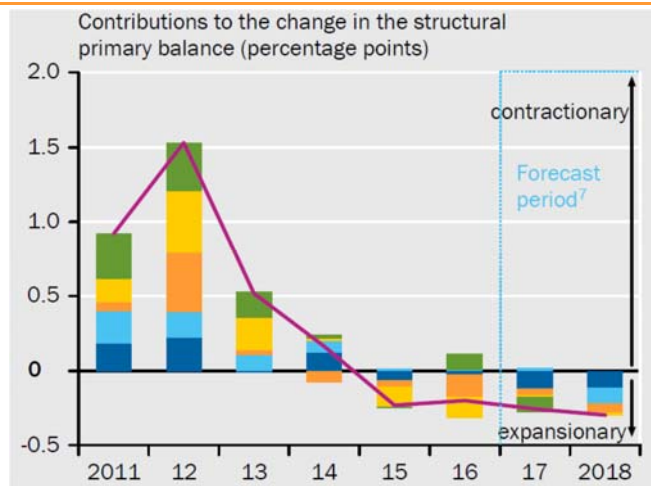
TLTRO

Other assets

MRO's

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Euro area: Expansionary fiscal stance continues



Euro area: change in structural primary balance

Contributions:

Germany

France

Spain

Italy

Other countries

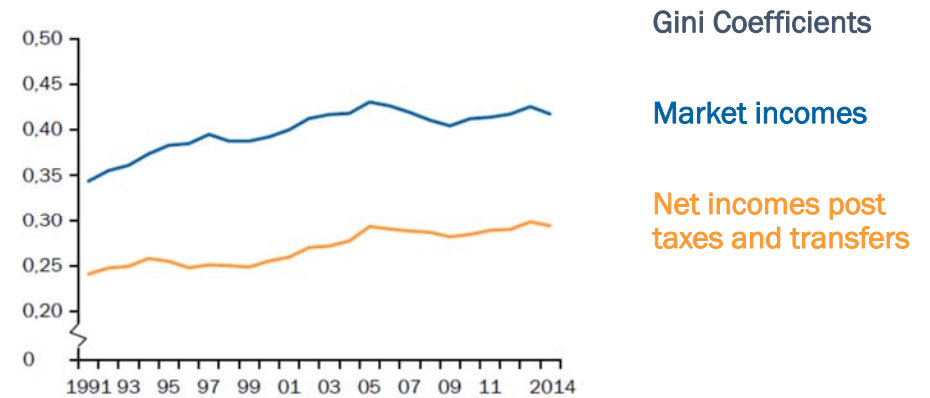
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II. Germany: Challenges and policies

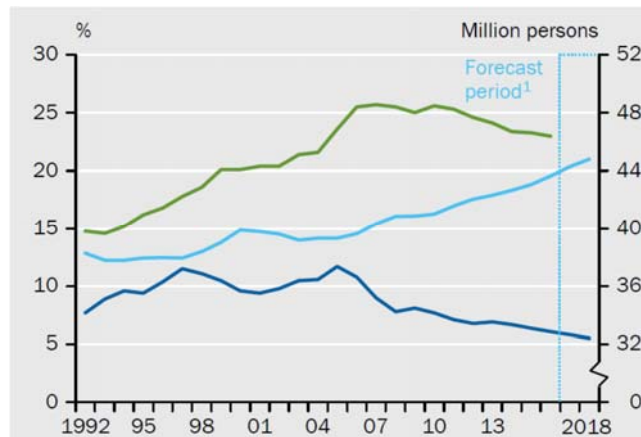
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Challenged by increasing inequality? No! Stable since 2005.



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German labor market in very good form



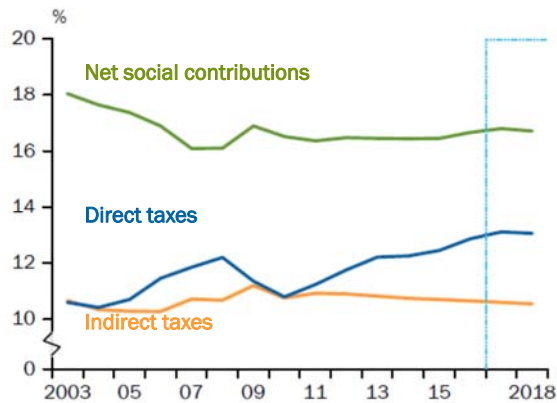
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Challenges

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

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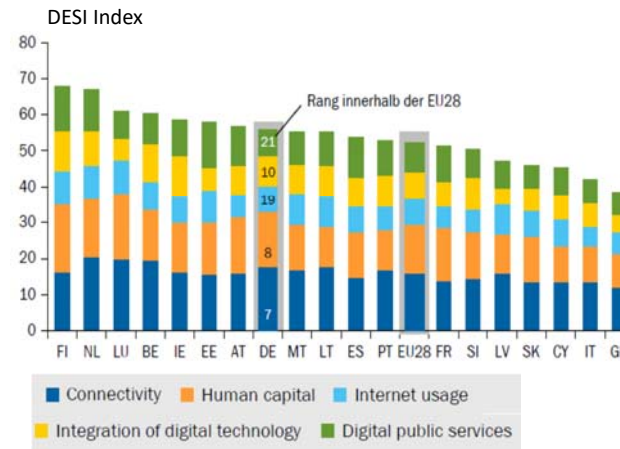
Overheating: Raise potential via tax and other reforms



- Correct bracket creep
- Phase out solidarity surcharge with tax reform
- Reduction in unemployment contributions
- Finance-neutral corporate taxation
- Growth-friendly expenditure without higher government share
- Tying retirement age to life expectancy

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Digitalization: For a regulation open to innovation



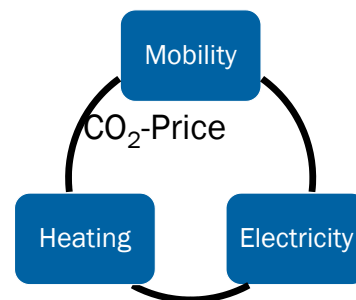
- Positive experience with automation in industry
- But just average on digitalization
- Expand infrastructure, priority to private investment
- More flexible labor regulation
- Innovation-friendly regulation
- Create digitalization commission

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More market in climate change policies

- Objective: reduction in greenhouse gases by 80 – 90 % until 2050
- Instead of current expensive and inefficient policies:

common price for CO₂-emissions
 strengthen European certificate trading
 No technology/sector-specific subsidies
 Coupling of sectors
 Time path for exit from coal not needed



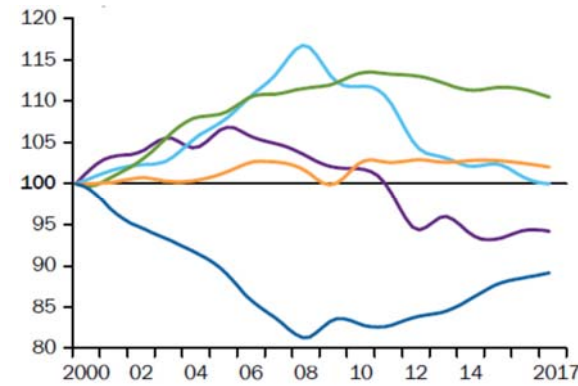
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III. Europe: Institutions and policies oriented towards sustainability

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Convergence in euro area: Reforms as national responsibility

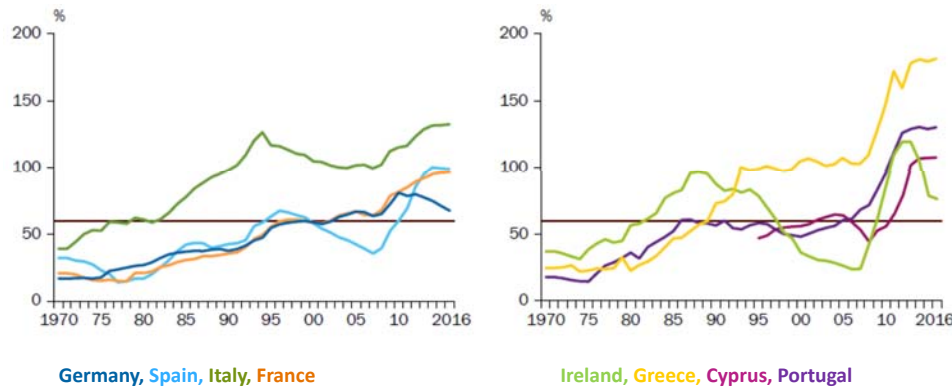


Real effective exchange vs euro area based on unit labor costs

Germany
Spain
Italy
France
Portugal

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Public debt still high, consolidation needs to continue



Germany, Spain, Italy, France

Ireland, Greece, Cyprus, Portugal

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Priority for sustainable fiscal policy on national level

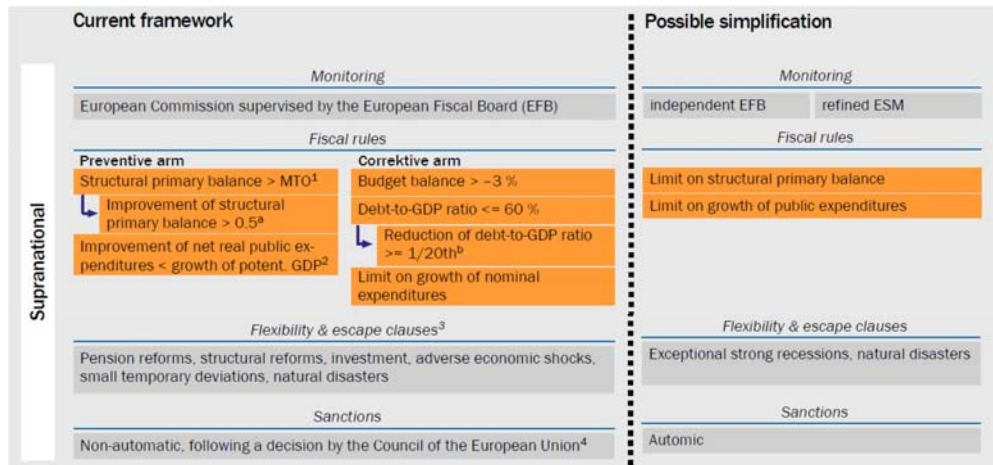
National fiscal policy needs to adjust to member state situation, not be constrained by a prescription for euro area fiscal stance

Joint fiscal capacity or other transfer mechanisms not needed

- Structural and cyclical effects not easy to separate, potential for moral hazard
- National fiscal policy achieves stabilization via intertemporal adjustment, if needed with help of ESM
- More risk-sharing via capital markets by strengthening capital market union

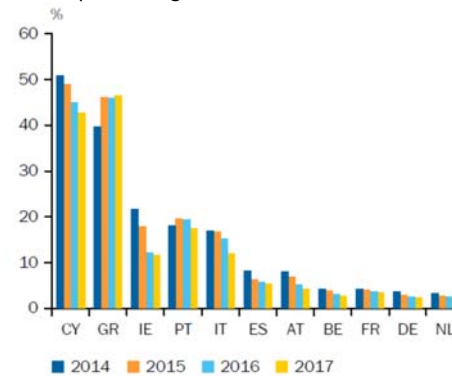
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Reduce complexity of fiscal rules



Completion of banking and capital market union

Non-performing loans



Risk reduction prior to more risk sharing

1. Swift reduction of non-performing loans
 - Stronger supervisory targets
 - Not publicly-financed bad banks
2. Bank resolution
 - Raise hurdle for exceptions to creditor participation
 - Address differences in national insolvency law
3. State-Bank-Nexus
 - End regulatory privilege for sovereign debt
 - Large-exposure limits

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Strengthen ESM, caution regarding SBBS

ESM is a key element of euro architecture

- Add rules for orderly restructuring of sovereign debt in crisis case
- Add mandate for monitoring fiscal policy of member states
- Medium term: Possible fiscal backstop for SRF in systemic crisis

Sovereign-bond-backed securities

- Strict conditions avoiding implicit liability risks
- Emission by private actors, abolish regulatory privilege of sovereign debt
- First abolish regulatory bias against securitisation of sovereign bonds

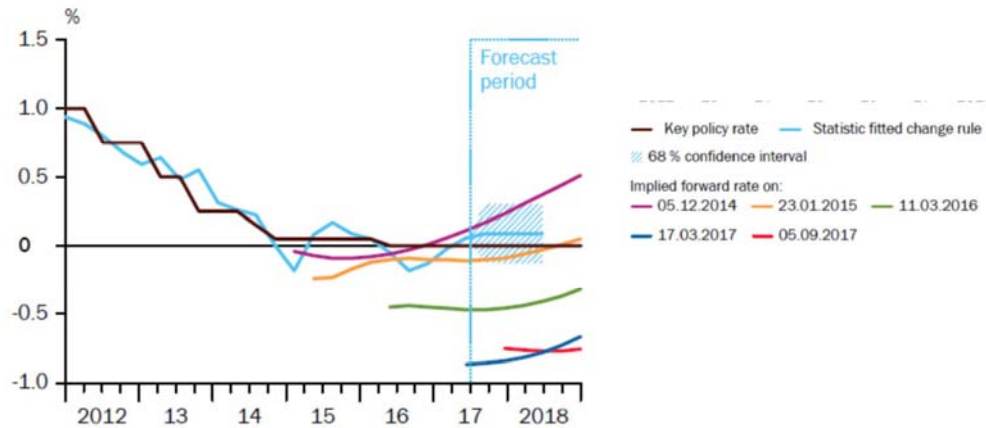
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ECB policy characterized by „lower for longer“, purchases should be ended

- An expansionary policy stance will remain appropriate for some time
- But, growth above potential for several years, output gap closing, inflation has risen: Conditions call for removing some accommodation.
- Yet, ECB eases more by expanding balance sheet further.
- „Lower for longer“ compared to empirical reaction function and to Taylor rates even with estimates of medium-term equilibrium rates.
- Net purchases should be ended.
- Side-effect: allows stronger market influence on long-term rates, helps reduce build-up of interest rate risk on bank balance sheets.

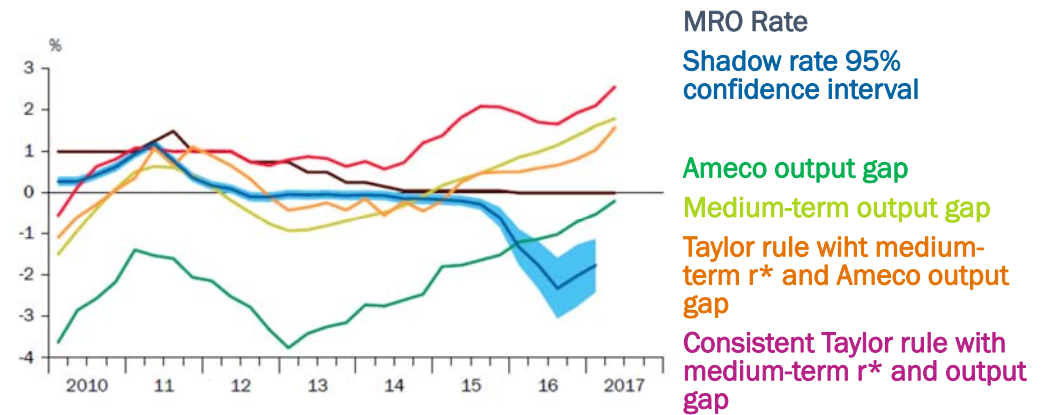
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ECB: „Lower for longer“ relative to empirical reaction function



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ECB: „lower for longer“ relative to Taylor rates



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Proposal: A strategy for monetary policy normalization

Symmetric reaction of the ECB on macroeconomic developments

- finish monthly asset purchases at an earlier stage
- then gradually raise key policy rates
- reduce longer-term asset holdings

Forward guidance: forecast regarding

- future development of asset purchases, reinvestments and key policy rates
- as well as the sequence of these measures

Comprehensive forecast of the future monetary policy

- publish quantitative forecast on the expected path of asset purchases and key policy rates
- alternatively: publish individual council member forecasts similar to the Federal Open Market Committee of the Fed
- improve Eurosystem staff's forecast by means of own interest rate forecast

Expand communication to

- reduce disruptions on financial markets in the course of monetary policy normalisation and
- avoid the risk of fiscal and financial dominance

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