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Challenges for Europe and Germany: a view from the German Council of Economic Experts

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Participants:

Lucrezia Reichlin, Chair of the Scientific Council, Professor of Economics at London Business School
Christoph M. Schmidt, Chair, German Council of Economic Experts
Isabel Schnabel, Member, German Council of Economic Experts

Chair: **Zsolt Darvas,** Senior Fellow, Bruegel

Notes:

The German Council of Economic Experts, as represented by the speakers **Christoph Schmidt** and **Isabel Schnabel**, presented a German view on challenges for Europe and Germany. First, they commented on the economic recovery. They started by pointing out that expansionary monetary policy, falling energy prices, and a weak Euro supported the recovery in Germany. However, investments by German firms remain sluggish and are made abroad rather than at home. They also argue that exports are not the driving force of recovery and growth in Germany anymore; rather, it is domestic consumption. For the rest of the euro area, net exports are still an important driver of the recovery. What is needed is a better energy policy, less regulation of labour markets, and reform of tax systems to give businesses incentives to invest and grow. They argue that a problem with the ECB's QE programme is that it lowers incentives for governments to implement necessary reforms.

Second, they discussed the refugee influx by analysing scenarios differing in number of refugee arrivals and quality of integration. While labour market integration shows a mixed outlook, public expenditure seems arguably sustainable in all scenarios. However, they argue that the growth impact from refugee-related expenditures is expected to be little. Their policy recommendations are lowering barriers to labour markets, e.g. through exceptions from minimum wages and flexibility in temporary work contracts, and policies to facilitate home construction. However, at the same time they see no reason for this situation to be a reason for deviating from fiscal rules.

The third topic was conditions for stronger growth in Germany. While productivity growth has commonly slowed down in advanced economies, in Germany in the last couple of years this was due to the end of the trend towards outsourcing - some two million additional workers have been introduced into low-productivity sectors. What remains more important is the productive use of capital. Their recommendations included reducing regulation on product, service, and labour markets, increasing flexibility regarding work and retirement, and investing more in education and training.

Fourth, they address reform of the euro area architecture, as the crisis in Greece has once more exposed its vulnerabilities. With fiscal rules not being enforced, the no-bail-out clause can only be secured when there is the possibility of sovereign default. For this the euro area needs a sovereign insolvency mechanism that is organised between the spheres of national and European responsibility. This would re-establish market discipline, whose decline is reflected in the convergence of interest rates. However, a further delinking of banks and their sovereigns is needed, which can be supported by introducing risk-adjusted large exposure

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limits and risk-weighted capital requirements. While the first is expected to lead to substantial portfolio reshuffling, in particular in Germany, Spain and Italy, this will be less the case for the latter change. Furthermore, there are severe doubts among the speakers that a common deposit insurance will cut the link between banks and sovereigns. Major incentive problems remain as national governments face less incentives for reform their own system and legacy debt problems pose another issue.

Fifth, they talked about risks to financial stability due to the low-interest-rate environment. As the flattening of the yield curve decreases banks' profit margin from maturity transformation it thus pushes them into a search for more risky assets. It also affects insurance companies as they have sold policies with long-term guarantees. Asset price bubbles are not considered an issue since there is no evidence of a large expansion in credit. As a sharp increase in interest rates poses a major threat they recommend a slow-down in monetary easing now.

Lucrezia Reichlin then discusses a few points raised by the two previous speakers. To the discussion on interest rates and monetary policy she adds that the most relevant factor in banks' profitability is not the level of interest rates but the real cycle. The vulnerability of small and medium-sized enterprises to increasing interest rates is high and non-performing loans remain a major threat. She makes the point that the ECB's QE has actually improved financial stability.

As regards the handling of the refugee influx she deems flexibility in fiscal rules dangerous and advocates a jointly guaranteed vehicle to increase the spending capacity at the euro area level.

With respect to the German experts' proposals to introducing exposure limits and changing capital requirements she mentions an alternative proposal by the European Council of Economic Experts, which is based on the creation of a European safe asset composed of national sovereign bonds with fixed proportions. Its senior tranche would be risk-free asset for the purposes of risk weighting and liquidity coverage ratio calculations and several other advantages, such as governments being able to default without affecting banks, and diversification of banks' portfolios.

Event notes by Bennet Berger, Research Assistant

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