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A CONVERSATION WITH CHRISTOPH SCHMIDT, CHAIRMAN OF THE GERMAN COUNCIL OF ECONOMIC EXPERTS

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P R O C E E D I N G S

MR. DERVIŞ: Good afternoon, everyone. Thank you for joining us this afternoon. We have the honor and the pleasure of hosting Professor Christoph Schmidt, one of the foremost German economists, both academic and policy-oriented. I will quote one of his sentences in a minute. I haven't asked him for permission. And my translation from German may not be perfect, but I'll try.

But he is the Chairman of the Council of Economic Experts in Germany, which is a group appointed by the government, by the major economic ministries. He has been a member since 2009 and the Chairman since 2013. I won't go through -- you have this information. But one thing I want to single out is his PhD from Princeton in 1991, I think -- and many articles, both in German and in English in the scholarly journals.

Now the quote is, "We don't need technocrats or technicians to develop the art of economics for the sake of the art (inaudible) but we need policy-oriented economists. Policy-oriented economics must be as simple as possible," but then there comes another part of the sentence: "but also as complicated as necessary." So, I thought that was a very good quote that I wanted to share with you.

I think all of us at Brookings, in Washington, in the U.S., worldwide, we are very interested in the German economy, in German economic policy. Germany has done extremely well over the last 25 years, when you remember the challenge that it faced, particularly after the reunification.

It is one of the -- considered to be one of the most successful economics in the world now. Now these things tend to change; 10, 15 years ago, it wasn't necessarily so. I wish to Germany that it will continue. And at the same time, however, it is much debated, at least in Washington, in terms of the policy mix. There's certainly a -- how shall I put it -- a Keynesian liberal left critique of German economic policy that is quite strong, and then there is more support from the not-so-Keynesian, let's say, economists. I'm not sure that Keynesian is the right characterization, but let's use it for now.

The other issue which is of great interest, of course, is Europe, as such. Germany is at the center of Europe -- and also of the European crisis management -- the crisis management around the Southern European economies, but now, also, the huge challenge of refugees -- which I think nobody expected quite with these numbers just last year -- or even six months ago.

And then I would maybe like to draw attention to another interesting aspect -- it's my own opinion, my personal opinion. I don't want to speak for anybody else. But Germany has managed to be a quite consensual society for the last few decades. When you compare it to many others, there seems to be less political partisanship and extreme tension. I mean, of course there's political competition and debate, but there's quite a bit of consensus building.

I always give the example of the Grand Coalition -- I mean, the Christian Democrat/Christian Social Union, I think, was missing three seats; in the last elections, were an absolute majority -- and yet it was decided to build the Grand Coalition. And the negotiations lasted a long time. I read the coalition agreement, because I had some hopes that, you know, in my own home country, people would think of Grand Coalitions, but didn't happen.

But it was another reflection of, I think, the consensus orientation, which I at least sense. And when you compare it to the polarization in other parts of the world -- including in the U.S. -- there's quite a contrast, even compared to France, for example. I mean, in Germany, there's a strong conservative center, right? There's a not-so-strong but still strong social Democrats and moderate center left. There's more of a left party.

There's the Liberal Party, Green Party, but you don't see the equivalent of the French National Front, for example, you know, in Germany -- or I could give other examples -- in Austria, for example, there are much more polarized politics.

So, in that sense, also, I would think that in terms of governance and politics, there's a lot to learn from Germany.

And so we'll listen with great interest, and then I will ask a few questions, and then we'll open it to the floor. The podium is yours now. Thanks a lot.

DR. SCHMIDT: Dear Mr. Kemal. Ladies and gentlemen, thank you very much for being interested in my brief introduction to our big report, which we handed over to the German Chancellor a month ago, somewhat -- yeah, on the 11th of November. But first of all, thank you for the invitation to be able to be here amongst you, and to talk about our work.

Before I go more deeply into the content, I would like to structure that along the following lines: I would like to talk about the European economy, the euro area recovery, about the refugee influx, the refugee problem or the migration problem that we'll be facing within the next few years, and then talk about ways to stabilize the European or the euro area architecture. These are the three things I would like to address.

But before I do so, let me just briefly say something or tell you something about us as an institution. We are an independent institution in the sense that the five members of the Board of the Council are appointed by the government. But from then on, we are completely free in what we think is the right thing to say about the state of the German economy and about German economic policy.

Our obligation -- the stipulation by the law is that introduced to us in 1963. As an institution, the law stipulates that we, once a year, have to provide an assessment of the state of the German economy regarding several key variables: growth, price stability, employment situation, and, of course, the current account balance -- and, also, in terms of income and wealth distribution. Yes, these are the things we have to address.

And our objective is to identify problems before they really become obvious, before they become really quite virulent, and to point out ways to solve problems or to address economic policy challenges.

And each year in November, we have to hand over this report, which is our major product. But sometimes -- and this year was such a year -- sometimes, we are obliged or feel obliged to present a special report. This year, the special report was under the impression of the renewal of the crisis in the euro area revolving around Greece. And we wrote a special report on the future of the euro area and its architecture.

And, of course, in the recent contribution in the annual report, many parts of this, also, are rediscovered and refined.

Now the report carries the title "Future Viability and Focus," and it addresses very much German problems -- specific problems to the German economy. Why is it growing so slowly in terms of its productivity growth? Where does the slowdown in productivity come from? How is our energy policy? Should it be redesigned? How is the labor market regulation functioning -- should it be reformed and so forth?

And that reflects our original focus on German issues. But over time, over the last decade or so, European issues have become more and more -- also, a second focus. So, there's always a balance between the two points of emphasis -- domestic and European issues, with the balance shifting from year to year, reflecting the current state of problems. And this year, it's about half and half.

And for our discussion here, I choose to concentrate on the European issues -- because, of course, you also announced -- you have been heard that it will be the future of the European economy that will be mostly discussed.

Now going into the first part of my two-hour lecture, economic recovery and the euro area in recovery, let me just simply point out that in the beginning of the euro crisis, some five years ago, we discovered that our rules and our structure or architecture of the euro area did not really prevent the crisis from happening. And once it erupted, we didn't have the right instruments installed to react very quickly to the crisis. So, it was a step-by-step discovery of possibilities to lead with new challenges as they came along.

And there has been much more progress being made, especially the architecture was enhanced in ways that rather strengthened the original Maastricht idea. For example, through the Fiscal Compact, through the introduction of debt breaks in member-state economies -- but also through joint in situations like the European Banking Union.

So, the architecture is one source of European area or euro area recovery -- has been one source of it, because, of course, all these measures where -- not "of course," but fortunately -- all these measures, taken in their entirety, were able to infuse more confidence regarding the integrity of the euro zone in the future.

The second source of recovery was individual member states actually conducting reforms, actually consolidating their budgets. One particular aspect of that is that it seems to be that it's clearly the problem countries. The countries under an adjustment program -- obliged by this adjustment program -- that we are most successful in reforming their structural setup and consolidating their budget.

And with recent success, you see that, also, the efforts to consolidate budgets is vanishing. So, the structural fiscal balance in many of the euro area countries or member states is, in the moment, close to zero.

But the third source has been equally important -- and the self-sustained recovery of the euro zone wouldn't have seen it if there wasn't extreme or extensive monetary support. And this is, of course, something that generated a specific set of special factors that carried -- especially in the recent past -- carried a lot of the economic recovery.

The euro declined in value. We have seen that the inflation rate by diminishing energy prices has declined, giving European consumers more purchasing power parity. So, there are some especially monetary factors carrying the growth.

In the moment, we see -- especially in the eurozone -- overall, that we have probably -- looking at the growth that is beyond potential -- potential is very low. Due to the accumulated structural problems that we see, we assess it to be 0.8 percent per year, which is not really very -- it's not really satisfying, satisfactory because of -- since we obviously have here member states that should have much more catchup potential than is, in the moment, visible in the potential growth figures -- the estimates of the potential growth figures.

But in the recovery for the euro area as a whole, the foreign trade has become more important. For Germany, it's a special case for Germany. Germany's growth has very much been reliant on its stable labor market. Now there are many factors coming together to generate the stability -- to have generated the stability. But it's really exceptional that you see employment to rise in the years of the crisis, and the structural unemployment rate to shrink.

We have about 3 million more employed in Germany than we had in 2005, and about 2 million less registered unemployed workers, which started at 5 million; is now down to 3 million. So, for Germany, the specific message is that growth is mainly coming from domestic sources, mainly coming from private consumption.

The net export balance is not really playing that much of a role for German growth different and in contrast to what has been the case in the years before -- let's say in 2010 to 2012.

But the consumption is satisfactory. The gross investment is not really playing that big of role. And this is one of the challenges that Germany can make policy should address more in earnest than it has in the past, in our assessment.

Now our current assessment of monetary policy is taking the side of the ECB being too expansionary. We rather think that it should not have extended or announced to extend its quantitative easing program, but rather, step on the brake a little bit, and buy up less volume, and maybe announce to withdraw from this state earlier -- which doesn't say the same thing as we suggest to raise interest rates. That's not what we wrote at all -- but to be a little bit less quick with stepping on the accelerator regarding quantitative easing. That's something that we would have suggested.

And one thing that is obviously not easy to decide is, are we in a phase where structural reforms are even counterproductive? Should there be more fiscal stimulus? We are siding with another perspective, which is saying, well, we should now conduct structural reforms, because the monetary support is as extensive as it can get, and there should be enough leeway, enough legroom for fiscal policymakers to engage into structural reform.

Actually, that's what President Draghi is telling everybody at every occasion possible. And in this regard, we are on his side.

Now there is an additional problem. That would be the second part of my remarks -- an additional problem that has come up, starting, let's say, in the summer or so -- the summer of this year. And that's the huge migrant influx into Europe -- and within Europe, especially into Germany. Now Austria, Germany, Sweden, these are the countries -- Hungary -- that, per capita, take most of the immigrant influx, but especially in Germany, we have seen now roughly 1 million people coming in.

And this has been really the dominant topic of the current policy discussion in Germany, and that's why we also addressed it in our report as one of our points of emphasis. What we did is, we said, well, we used a very stylized model and tried to at least calibrate it to the situation that we have now -- with the asylum procedures, the registration procedures, the cost for providing immigrants with food, with housing, and so forth, the cost of the bureaucracy -- to some extent, at least -- and thereby try to gain some feeling for the order of magnitude of the challenge.

And you have to see that the public discussion -- you were perfectly right to point out that we fortunately have not the Le Pen type of party in the moment, but it's a fragile situation, and, of course, it's very important to provide a very balanced view on the issue, in order to have these very nationalistic, chauvinistic forces not to gain more support. And on the other hand, it's important not to be overly optimistic and naïve, in order not to play down the problem, which might be quite big.

So, what we did is, we used the stylized model to calculate -- at least according to the information we have at hand in the moment -- to calculate how much of a fiscal burden will arise from the current immigration, and how much of a stimulus will arise from the current immigration -- as far as we know it.

But the big unknown, of course, in this is, will European policymakers be able to find a European solution to address the problem of the huge influx potential, the huge reservoir of refugee migration, in order to regulate it and to reduce the number of people coming to Europe to make it sustainable, to make it sustainable from a public policy point of view, from the point of view of integrating the newcomers into the labor market and into society?

Now all of our simulations assume at the outset, as a basic identification assumption that is not challenged afterwards, that European policymakers will be able to do so -- to start from 1 million coming to Germany in five years -- 200,000 -- reduce the influx by investing in helping people at their sources of origin, in the refugee camps, in Lebanon and so on, and investing in a better border protection, better first registration locations in Italy, and Greece, and so forth -- so by a whole menu.

If that's the case, then you see that German government budget is not really strained very much. It's a one-digit billion figure this year that will emerge or will stem from that. And next year, maybe it will be $15 billion or less. So, given the state of the German economy, it's not really an unbearable burden; it's quite sustainable.

And on the other hand, the growth impulse coming from that will be less than 0.1 percentage points of GDP growth. So, it's not really remarkable, given that European policymakers actually will be able to reduce the influx.

And then from that point on, it's, of course, important to invest a lot in lifting the potential, in trying to integrate those who stay on permanently -- which might be about 60 percent or so of those who come into the country -- which would be 20 percentage points more than what we see on average in the last few years. And it's important to invest into these people very much in language courses, vocational training, and so on, in order to integrate them into the labor market.

Nevertheless, we will see unemployment figures rising, as well as employment figures. But unemployment will probably rise within the next few years because of the problem, which is not really worrisome, given that our labor market is in quite a good state -- but we have to be prepared for that.

Now in discussion, I'd like to go more deeply into this. But let me take the third part, because, of course, I was not really given -- and I would not really torture you for two hours.

The third part would be, what does all this mean for Europe? I already indicated for the European architecture, for the euro area architecture, I already indicated that we emphasized the European nature of the problem of regulating the migrant flows. And this reflects very much our view that we have developed, over the last few years, on how the stable architecture for the euro area should look like. Basically, one could go about it in two different ways that are intellectually consistent.

One way would be to have more union, more fiscal union -- joint treasury, political union. For the sake of the argument, if it were possible to convince European member states -- euro area member states -- to give up their sovereignty on key issues of their activities on the fiscal policy, on setting labor markets, and other aspects of economic policy, then this might be a sustainable architecture -- because then liability and control would be aligned at the joint level.

The alternative, of course, is to say, well, let's align control and liability at the member state level -- which, of course, will have to be enforced by the right rules and by adherence to the rules for countries getting into trouble.

Now the worst of all worlds would, of course, be one where you failed to align liability and control at one or the other level, where you have individual control -- let's say about fiscal policy, but joint liability for it. That's a situation that -- and the crises of course coming about -- but it should not be the long-term architecture being pursued.

Now our assessment is that in the near future -- "near future" meaning the next several decades, even -- or within at least the foreseeable years to come -- euro area member states will not be willing to give up this sovereignty. So, it's not really working. The idea, while intellectually sound, is not really working in practice because of these obstacles. So, in our assessment, one should draw the turn the other way and ask yourself, on which fields is joint liability, joint control possible and necessary, and on which field is it not?

And this construct, this rather complex construct is something that we called Maastricht 2.0 -- the idea being that common monetary policy should have a good counterpart in a joint banking union. So, we welcome the banking union; we welcome the ability to jointly decide about restructuring and recapitalizing banks getting into trouble about the joint approach to banking regulation and oversight.

On the other hand, we think that where national sovereignty is not being compromised and are not being handed over -- like, for example, fiscal policy -- we would rather go with individual responsibility, individual liability of individual member states.

And that means that we, in consequence, have been rejecting ideas of a common unemployment insurance to be installed in Europe, of a fiscal capacity -- because it's only a half-baked solution. The intention is good, but the control is then -- it's not obvious that one might really be able to generate it or to design it in a way that this alignment of liability to control is really -- at the joint level, is really realized -- and therefore, will establish a transfer mechanism of one sort or another.

Rather, risk-sharing -- sharing of risk against -- insuring against isometric shocks -- we see more use in fostering cross-border capital, ownership in better migration possibilities, and fostering migration as a safety valve -- and basically, in making the euro area common-market functioning better.

If you look at this Maastricht 2.0 scheme, which is tied together by a crisis mechanism, the ESM -- if you look at this scheme, then, of course, all the tasks, all the policy fields where individual actions of individual actors in the member states or the member states' governments generates large externalities. And this should be a

European issue. And immigration is exactly like that, because you can't really have open borders within Europe, and then the outside of Europe is not decided in a joint approach, but decided upon in national approaches.

So, that's why we are so supportive of the approaches to find a European solution to the migration problem.

Now this Maastricht 2.0 scheme is not as exotic as might sound -- although you will not probably have heard about this under this title. But in a way, what happened in the euro area, in terms of their reforms of the structure, went exactly in these directions -- the fiscal compact, for example, strengthening the individual member-state responsibility, the stability and growth pact strengthening individual membership responsibility, and the banking union strengthening the joint approaches to those issues, those areas where joint approach is the better idea.

But it's incomplete. The banking union is, for example, not quite complete -- not because, as many of you might think, there is not a common insurance scheme -- deposit insurance scheme. That's not what we are concerned about. We are concerned about the close link between monetary policy and banking regulation within one institution. That should be something that will be addressed.

We are also concerned about the still-close link between banks and governments. So, there's a strong home bias in terms of government bonds being held by banks, government bonds of their own countries being held by them, to a large extent.

And while it's now possible through the introduction of this joint restructuring mechanism -- the banking restructuring mechanism -- why it's possible to save a banking system without dragging down governments -- it's not the case that we see it as a very likely outcome that individual governments (inaudible) will be restructured without, at the same time, endangering the national banking system. So, while the link has been severed in one direction, it has not really been effectively severed in another.

And all the ideas of bailing individual creditors and enforcing market discipline by allowing something like a state government and sovereignty mechanism to operate is not really credible as long as this link is in existence. So, in the latest issue in our ideas about the governance of the euro area, we suggest to use base Basel risk rates -- and more importantly, to use large exposure limits to government debt, in order to force a reallocation on the banking side of their investment into government debt, to get rid of this home bias and make the situation in the euro area more stable.

Now I hope that I was able to give you at least a little insight in the way we are thinking about the euro area. I think that it's all very shortly -- briefly -- summarized in the observation that, of course, in a crisis, you need to survive the crisis and overcome the crisis -- and sometimes, it's only possible if you are not, in a Wagnerian way, die in duty, holding to the principles, but by thinking about the survival. But on the other hand, it's also a good idea to always think in the short term when you address a crisis, what will be the incentive structure and the stability of the situation in the long term?

And this delicate issue of trading off short and long-term aspects -- that's something that is in the middle of our discussions. And that's very similar to the sentence that you quoted -- in life, I think the decision is most often a decision on balance. And I'm very adamantly against economic theorizing and econometric work that is just done for its own sake. I think that it's very important to really address the issues at hand, and see how what you have to say as a scientist can fit into real life.

Thank you.

MR. DERVIŞ: Well, thank you, Christoph. I think this was really, really a very, very interesting presentation -- and good, focused time limits, which is very hard.

And let me try to follow up before we open it to the floor.

I think one of the major strong messages you gave is that there are two approaches, really, to the managing the common currency. And I will also ask the question we discussed briefly at lunch -- common currency versus E.U. -- because in your speech -- and, you know, you talked a little about the common currency issues -- but to what extent is it the Europe-wide issue versus a euro zone issue? But that in a minute.

But you said -- and I think very rightly -- intellectually, I totally agree -- that either there has to be greater political union in the euro zone, in which case you can put in place a concordance of responsibilities and needs -- or expenditures, which is balanced -- but that requires a really quite larger degree than existing at this point of what, for shorthand, one can call political integration -- or one has to, in a way, almost renationalize some of the responsibilities within, of course, the European framework -- but really look at what can be done jointly in a setting where the national responsibilities remain quite national.

So, I think this is -- now the question I have is the following: Hans van Assen, who has been very local on the policy front, said that -- has written that, actually, the degree of integration is much more needed in defense, foreign policy, safety, security -- and I think he also added the refugee -- than it is on the purely fiscal side.

My question is, do you think that the dynamics created particularly by the defense and security situation may actually change substantially the chance for more political integration?

I mean, the fact that, you know, the police don't really cooperate sufficiently, the fact that even recently -- I mean, just days ago, the French police, you know -- it was the American intelligence service that had to alert people in Geneva that there was the problem. I mean, there's no European FBI.

What I'm trying to get at is, if on defense and security issues -- and maybe on the refugee issues -- there is more integration, might that change the balance of your opinion on, also, the other, more fiscal side of integration -- or do you think that these things are quite independent?

DR. SCHMIDT: Well, the two avenues to European integration remind me sometimes, in the complexity of not being able to really find an answer that's very easy, of a quote by the former New York Yankee catcher, Yogi Berra, who said, "If you come to a fork in the road, take it."

And I think that you pointed out a very important issue -- namely, that the European integration process has been again and again being accelerated, being fostered by crises. And the refugee crisis, the need to -- or the refugee phenomenon -- the need to find a common strategy might alter the mindset of people. I think over time, we will get there. But in the moment, probably it's a good idea to look field by field, policy field by policy field, and decide whether that's something that should rather be addressed at the common level.

And of course, the migration issue might be a game-changer to some extent. But for the foreseeable future, I don't think we should just hastily then introduce a fiscal capacity that might rather divide people again.

I mean, the problem that we saw in the Greek crisis is, in the end, we were not as European -- the European member states were not bargaining with anonymous creditors in the financial markets; they were just bargaining with one another, and that's exactly what we didn't want to have -- that the Germans are angry about the French and the other way around. We would rather see a situation where the integration process is bringing peace and prosperity at the same time -- and maybe addressing a common problem that's -- obviously, a common problem might help. So, I'm on your side in that.

Obviously, we have very much focused in our areas -- your question, also, at lunch when you mentioned it alerted me to the fact we have very much concentrated on the euro area in our discussions -- and didn't pay so much attention to the larger issue in our arguments and our analysis.

What we, for example did is, in the report, we say, well, all of our forecasts, all of our analyses, are subject, through the qualification, that there will be no big alteration -- like, for example, Britain getting out of Europe. And of course, that's a big statement to rest the rest of 400 pages on. But on the other hand, it shows that we don't really have that much to say on that issue.

In the end, we, of course, want to have an integrated Europe, but maybe we have to take it field by field -- and obvious fields coming first.

MR. DERVIŞ: Maybe just one follow-up -- I've tried to understand during the euro crisis the arguments of the (inaudible) constitutional court. And it seems that one of them -- but, you know, I'm not a lawyer and not a constitutional lawyer -- neither are you, I guess --

DR. SCHMIDT: No, no, no.

MR. DERVIŞ: But, you know, one of the arguments seemed to be that whatever economic measures are taken in common -- or as part of -- they must have democratic legitimacy. I mean, they're guardian of the very strong, democratic principles of Germany.

And I see some problems when -- well, if it's a major kind of renationalization of policies -- but even the steps we're in right now, in terms of the ESM -- is there not a tension between having very pragmatic, technically functional solutions where, you know, governments agree to certain amounts of money, to certain things without having the kind of democratic counterpart? And the Council report seems to argue that, naturally, these measures have to be approved by the national parliaments.

But it does open the door to another type, which is your first integration, in a way -- if there is sufficient political integration, then the European Parliament could provide that legitimacy. Am I interpreting the court according to -- I mean, neither of us are lawyers, but is that part of the duality that you actually stressed on the purely economic side -- you know, the kind of two intellectually consistent positions?

DR. SCHMIDT: Well, there is also a political economy issue with it. When we had the Greek crisis, when it was really -- the heat of discussions was very high -- there was often the argument that the Greek voters just voted for the new government, and, therefore, we had just to respect that they didn't want that same solution that the former government had agreed upon.

And at that time, we very often discussed about the fact about democracies in Europe, and about the fact that it's mainly an intellectual project. So, the German government in particular, when it was pushing for this quid pro quo approach regarding the crisis in the euro area, you get support by the ESM or by the European partners, but there are obligations for structural reforms coming with it.

And I think that should also be understood from all the other partners as being a vehicle, also, to retain the support of the German voters -- which, of course, have not elected a government just to introduce a transfer scheme. And the German Constitutional Court basically, yeah, I think preserves or finds its role in preserving, let's say, this national aspect of having generated a euro area that was not meant to be a permanent transfer but just a stability union.

So, in this sense, it's far away from handing over sovereignty, also, to the European Parliament regarding the transfers. And I think that the German Constitutional

Court is preserving -- or is trying to make the statement that it will be very adamant in maintaining its position about this.

MR. DERVIŞ: Mm-hmm. But it seems to open the door -- like you saying, well, if there was really a political federation -- and if the parliament was elected in a, you know, democratic way and European parliament then we could -- I mean, it wouldn't be a contradiction with the German Constitution for that to happen. But what is the contradiction is making decisions which kind of -- neither the German Parliament nor --

DR. SCHMIDT: Well, in the long term, probably if everything goes well, we might, at some point, decide that there will be a European Constitution that is ratified in all the countries. That's a different story. But that's something that we are far, far away from.

MR. DERVIŞ: I'm partially biased because I spent two years trying to believe that they're not trying to draft as part of the Constitutional Convention. And there was a lot of excitement -- and then, as you know, it was voted down in major ways.

Anyway, another question, and then we'll turn to the audience -- which I'm sure you've heard a lot -- and which one hears a lot in economic debates -- is the German current account surplus. And it's been quite high, between six and eight percent of GDP, now for many years. And in a kind of global imbalances analysis, a surplus in one country detracts from aggregate demand in the world. So, that is one kind of criticism of it. And as you know, the Chinese surplus has been very strongly criticized, in the U.S. particularly, and has periodically generated political waves in Congress.

And the second issue is, you know, is it good for Germany itself? I mean, even if one just took a German perspective -- is running a seven to eight percent surplus year after year something that your group would think is a good thing for

Germany? I mean, I'm putting the question a little bit rhetorically, but to get you to talk a little bit about that point.

DR. SCHMIDT: Actually, this year, it will be on the order of eight percent, even increased from last year; it's true. We have spent -- we wrote a special chapter on this issue last year. This year, we wrote on the very much related special issue of German productivity growth, for obvious reasons -- I think obvious after I have the chance to tell you about last year's chapter.

Now part of this, of course, is an adjustment phenomenon, like demographic changes coming up in Germany. We have in front of us a tremendous aging process. And in some sense, it's quite wise if you have some net foreign assets accumulated before this is really happening.

But, of course, it's also -- and your question already indicated that that necessarily has to be the answer -- not everybody can run a surplus -- not all countries can run a surplus at all times. That's not possible. It's not the recipe for the world. I think that would be not the right way, to suggest that.

But the adjustments of the imbalances, in terms of current accounts in the euro area, have been very much stretched out by the common approach to preserving the euro. If, for example, a country like Greece would have been without this support, the adjustment would have been very quick and painful. And by extending this help, of course -- and especially by having a monetary policy that is giving so much support, leading to a low value of the euro -- then supporting the German exports -- strong exporters, like Germany -- of course, the imbalances -- you cannot have lower imbalances and, at the same time, this monetary support.

So, there are several aspects about the issue that are transitory or that have to be understood within the context of the rescue mission.

But on the other hand, looking at the issue more deeply, the big question is, why are so many of German savings not invested in Germany, but, rather, abroad? And the individual actors, economic actors, in the middle of this discussion are the German companies. German companies actually invest a lot, in terms of FTI, and in other European economies, but they obviously don't find it so attractive to invest in Germany. They would rather help.

The other thing that would really help is if the other economies would develop their expert sectors, at least in the euro area. But let's stick to the German companies.

We identified several fields where a better framework for economic activity, better economic policy would help to make Germany more attractive. One example is labor market regulation. But the even more obvious example is energy policy. We have this energy transition we call the *Energiewende* -- the complete overhaul, the complete change of the supply of energy within the next few decades, in order to get what one might call a decarbonized economy -- so relying very much on renewables as a power source, being highly efficient regarding energy, and trying to avoid energy use -- or to at least slow down energy use growth.

One could do that much more efficiently -- economically efficient -- than we have seen in the past in Germany. Germany is pursuing a very national approach, with higher subsidies for renewables, not aligning the *Energiewende* with its European partners -- which is actually moving us away from an energy union from the common market on energy, which is not really a good thing for Europe, anyway. And it doesn't help the climate at all; it just makes the cost of energy very high, compared, for example, to this country.

So, if you are an aluminum producer, steel producer, a chemical company, you think twice whether you would like to invest in Germany or in the United States in the moment because of the energy cost.

There are several aspects like that that German policymakers could address and make Germany more attractive for investment of the savings that are now going abroad.

One myth that has been discussed -- I think it's a myth -- is that German companies have been very irrational in doing so, because they lost so much money on them. The Bundesbank is providing statistics on foreign direct investment returns of German companies abroad, vis-à-vis foreign companies investing into Germany.

And it seems to be the case that the German investments are quite -- the returns that German companies get for the investment are better than what other companies get from investing in Germany -- which is corroborating our story that it's mainly the lack of attractiveness of Germany as an investment place that is the problem.

MR. DERVIŞ: Thank you very much.

Okay, we'll turn to the audience now. And please raise your hand. I will take a few questions together, and then -- I think you raised your hand first. Please identify yourself, also, and then I'll take two or three, and then we'll go back to Professor Schmidt.

MR. FARMER: Thank you. I'm Nick Farmer.

Can you comment more on productivity, and could you specifically address whether the metrics for productivity developed for manufacturing and service economies are equally valid for digital and internet-based economy?

MR. DERVIŞ: Okay, yeah. Why don't we take you next? It doesn't matter -- the gentleman in the middle first, and then we'll go back.

MR. BJORKSTEN: Hi -- Nils Bjorksten.

I have two questions on the German economy, in particular. First one: Looking up on the productivity, what's the potential growth effect of the net migration?

And the second one is, German inflation -- why is it so low?

MR. DERVIŞ: Yeah, and then here. Back there. No, sorry -- back -- yeah. We'll get to you.

MR. SCARLIS: Basil Scarlis.

I would like you to follow up a bit on your last comments, and tell us -- explain what you're saying. Do you mean that with better labor market regulations and with better energy policies, that would adequately stimulate the German economy? In other words, you wouldn't need to do it through fiscal stimulus to raise aggregate demand -- and specifically, what labor market regulations?

MR. DERVIŞ: There were some in the back that I couldn't see. Okay, we'll take one more -- all the way back -- I don't know -- I only see a hand -- and then we'll come back for --

MR. COBURG: Stanley Coburg.

There was an article in *The Guardian* in May of this year on labor unrest in Germany. It said, this has been one of the most strike-ridden years on record; more than 350,000 workdays have been lost -- this was in May -- compared to 150,000 in all of last year. So, I'm wondering what that portends for Germany.

MR. DERVIŞ: All right. Let's take these four, and then we'll come back to the next round.

DR. SCHMIDT: Yes. About the productivity and the digitalization -- we looked at the development of German aggregate labor productivity over time, which is similar to other developed economies. It has been going down in the long-term trend. But if you look at especially the last 10 years or so, you have to see that the quite strong decline that you see in Germany is partially a reflection of the introduction of many workers that have been out of work and out of the labor market before. Roughly 3 million more people have been employed now than 2005.

Typically, in low-productivity sectors, there's proportionally more in low-productivity sectors -- and probably being themselves rather low-skilled. Their introduction, supported and carried by the labor market performance of the 2000s, also meant that the flipside of the coin is that labor productivity went down.

Now this is a process that is fine, but we need, of course, in terms of demographic change, we need total effective productivity increasing and investment increasing in order to make up for the oncoming decline in labor volume.

MR. DERVIŞ: Can I just ask --

DR. SCHMIDT: Sure.

MR. DERVIŞ: It's the growth of productivity that went down, right, not the productivity itself?

DR. SCHMIDT: Yeah, yeah, yeah.

MR. DERVIŞ: Okay, yeah.

DR. SCHMIDT: And one aspect that might instill some hope is the fact that digitalization is coming about; that the labor world of the future might look quite differently. So, we explored this issue, but we are far from an ultimate answer to this. I'm very much involved in another institution -- the German Academy of Technical Sciences -- where people are very much talking about the factory of the future, about what they call Industry 4.0, the Fourth Industrial Revolution, so to speak, where you think that the Internet of Things, where innate objects, I think is the term, corresponding with one another.

There will be a completely new possibility to have customers reflect on their demand and on their specific preferences in order to shape the development of new product and new business models. But this is all very abstract. What we see in the data, at least in the aggregate data, is, so far, that while everybody's talking about this, at least in the manufacturing field, in the manufacturing area, little of this is discussed in small and medium-size companies in other sectors.

And one of the phenomena that we find puzzling and we don't really have a solution on is, if you look at different sectors of the economy, where is total effect of productivity or labor productivity coming from? Which sectors are the ones contributing most?

Then here, in the United States, we -- as in Germany -- we find ICT-producing sectors are carrying much of it. You see that non-ICT-intensive sectors are carrying something. But in contrast to the United States, in Germany, ICT-intensive sectors -- so banking, insurance, and other sectors where people should really benefit -- or whatever -- companies should really have tremendous productivity increases by using this new technology.

We don't see, in Germany, that these sectors are contributing to productivity growth, and this is really puzzling; could be regulation, could be the wrong education. We are not really sure yet. But that's one of the problems that we have.

But net migration -- or the net effect of migration, as we see it in the moment, is 1 million people coming in as refugees. This will probably not lead to a solution of this problem. What we are trying as a country -- I think very intensely -- is going the way that other classical immigration countries have used for a long time -- trying to convince young people to come into our universities from abroad, either with their skills already -- already with their education finished, or during university or college education time, and to stay in the country.

So, we have, really, a regulation that is quite liberal in terms of trying to attract skilled and talented young people from abroad, but this is a different field of application. What I was talking about before was a humanitarian problem, in first order. And only for those who will be accepted as permanent migrants -- of course it's worthwhile investing into their language education, into their integration into the labor market, into vocational training, and so forth.

But to presume that that will be a net benefit overall for the Germany economy would be too optimistic, I think. These are two separate issues, to be treated separately. And of course it's worthwhile to invest, but it's not the way that we would have gone if we just had thought about it last year. How could we get most migration into Germany, in order to solve the demographic problem? That would not have been the route. Rather, the route that I indicated before -- trying to attract skilled workers and talented young people.

Why is inflation so low? Yes. One of the interesting facts is that the core inflation rate in Germany -- and also in the euro area -- the core inflation rate has been quite stable. But you see that real-wage protests really picked up in Germany quite a bit. The era of wage restraint that we are sometimes criticized for -- Germany is sometimes criticized for -- is long over.

And this is reflected also in the manual labor disputes that we see. We see the labor disputes, especially in sectors where the unions being active there have a strong position, like for the pilots, for example, and in the public service. Verdi is a very aggressive public-sector union in Germany.

So, these are two sides of the same coin. Real-wage growth is quite, quite strong -- stronger than inflation, clearly stronger than (inaudible) the nominal wage growth outstrips inflation by quite a bit. And on the other hand, there are labor disputes, because now, the workers feel that they are in a very good position to fight for higher wage growth.

Last question was about the different fields of providing, let's say, a better framework for economic activity, labor market regulation, energy policy, and so forth, vis-à-vis something that is more taking a discretionary fiscal stimulus type of form.

What we tried in our analysis is to find out in model simulations, what did the different reforms of the early 2000s -- what did it do to the current account balance? For example, what did the Hartz reforms that introduced this low-wage labor market or low-wage sector -- what did it do to the current account balance?

Now at first glance, you would presume, well, it reduced the purchasing power of German workers, so you have less imports. That means you have a higher current account surplus -- which is not really the way it worked, because of two reasons.

First of all, we have generated a low-wage sector, but low wages doesn't mean low disposable income for German workers. We have a poverty relief system in Germany that's not working via mandating higher wages for low-skilled workers via a minimum wage, but rather, we have now introduced a sector where people can get not-too-high wages, but if their family situation -- or given their family situation, their incomes are falling under a certain threshold, incomes will be supplemented. It's something like an earned income tax credit, but very generous for low-wage workers.

And that has led to the situation that disposable income inequality has been quite flat. Contrary to the things that sometimes one reads about Germany, disposable income has not become more unequal. I think you read that in many German newspapers, even, but it's wrong. It's simply wrong, because the principal idea of this system is that if you get work, you should get more income in the end than if you don't have employment.

And here, we come to the second thing -- namely, employment increased, and that increased the income -- and therefore, the purchasing power. That's why we see private consumption being the backbone of German growth. Now if you have a fiscal stimulus program, you won't really add a lot to the situation. The overlap to other economies in the euro area might be quite small. And of course, fiscal stimulus program has to be financed somehow, and you have to always look at the opportunity cost.

The other way or the other alternative that goes into the same direction would be the suggestion, oh, why don't you raise the minimum wage? Again, because of the income support system, that will not really help disposable income situation and purchasing power -- and therefore, private consumption -- and therefore, not the current account balance or imbalance, but, rather, it will be detrimental for employment and then deteriorate the situation instead of helping it.

MR. DERVIŞ: All right. Thank you very much.

We'll take -- yes, you, and then you -- and then you.

MR. ROSE: Herb Rose.

I don't know whether you have ever practiced juggling balls or other objects, but it seems like you have juggled a great number of variables in considering the various models or scenarios. I guess my question is, the interface of politics and economics, provoked by an article on page A-10 of today's *Washington Post*, where Angela Merkel was quoted as saying that multiculturalism hasn't worked in -- I don't know whether it hasn't worked or it hasn't worked in Germany, restating what she said about five years ago.

And so more to my question -- considering that we have an international or a global economy, and/or questions about how China is faring, and what the impact of oil revenues decreasing might have on the economy, and both of you are discussing or alluding to the politics in the rest of Europe, as far as places like France, where Front National has increased their numbers recently -- is it possible, if the economy were to get much worse, that you might have some regrets on the part of Germans, and their thoughts about bringing in a lot of migrants, and how that has affected the economy? And would there be a move further to the right?

MR. DERVIŞ: Okay, okay.

Yes?

DR. GROBE: Hi -- Stefan Grobe, Euronews.

A bit of monetary policy -- how would a news cycle of rate hikes by the Federal Reserve Bank impact Germany and the euro area?

MR. DERVIŞ: All right.

QUESTIONER: Hi. Thank you very much. My name's Dmitri.

I'm just wondering now if you could comment on the effects of the sanction situation with Russia -- if that has affected the German economy, the Europe economy, and what the general feeling is in Europe and Germany about it.

And the other thing is, I saw that they finalized the airport thing in Greece with the German company -- just wondering if you have any thoughts on that.

Thank you.

MR. DERVIŞ: Every question is different.

DR. SCHMIDT: Yep.

QUESTIONER: (inaudible) is my name.

I would like to come back to the Maastricht 2 scheme that you alluded to. While following the debt crisis, these additional measures were put in place. Are you confident that when it comes to the next crisis, that it will actually work? After all, countries tend to forget what happened 10 or 15 years ago. While good progress has been made in structural reforms, can you really hope that governments will not take refuge in the only instrument that is left in the euro zone -- the fiscal policies? So, how confident are you that they will not lead to a similar crisis?

MR. DERVIŞ: All right. We'll take one last question, and then -- yeah.

MR. GAGLIANO: Lou Gagliano.

I would like you to imagine that the year is 2025. How will the E.U. have changed and what governance issues would affect the E.U. -- and specifically, Germany?

MR. DERVIŞ: Well, now you can give another two-hour lecture. But anyway --

DR. SCHMIDT: But these were all quite difficult questions. Let me start with the first one.

Multiculturalism as it was you quoted the Chancellor -- I didn't see the sentence, but I think the question in the end was getting at the following issue: Do we really need economic efficiency and strong economic growth in Germany, also, for providing an environment that makes huge immigration of no-skilled refugee labor more palatable?

The answer we give is yes, we think that, next to all the different challenges that are in front of us, in terms of demographic change and so on, here, we will have to -- the German society will have to change, and we'll have to accept the fact that it's living within a world with a lot of problems. It cannot isolate itself from it, and that's easier to accept and easier to transform into positive energy if the economy is running well. So, we think that economics has a lot to say, also, for these bigger societal issues, because on the back of a strong economy, you can solve these problems even better.

So, yes, we would be worried if the German economy would not grow well, and we still have to face all these problems of integration, just because what you say is right -- it's always a very fragile situation, and you can't really be happy if you give populist politicians too much leeway to find arguments for their chief cause.

Now Federal Reserve interest rates -- we have, of course, as always, some assessment of the situation in the U.S., and we think that it's rather likely that we will see such a change, and this will, of course, emphasize the divide that we see within the industrialized world, between the U.S. and the U.K. on one hand, and the euro area somewhere in the middle, and Japan just the other side of the spectrum of success.

And I think everybody is waiting very much for the communication surrounding this interest rate hike. I don't have much to say about this, because I'm not really an expert, as many of you are much more knowledgeable about the U.S. situation than I will ever be.

But I think that we have to accept the fact that the financial stability risks are something that has to be taken very seriously, leading to a situation where national banks cannot just ignore this issue. In the euro area, there is this additional repercussion of expansionary monetary policy on the willingness to conduct structural reforms that has to be taken into account. But in principle, if there's time to increase interest rates, it should probably be the right way to do it.

The sanctions to Russia have not really affected the German economy very much. I mean, there are some sectors that are obviously more affected. Germany imports a lot of energy from Russia; Russia imports specific things, like machinery and tools from Germany. But overall, that has not really been a problem for Germany. For Russia -- obviously, it's in a deep recession in the moment, but maybe much of the adjustment necessary has already been undertaken there.

The (inaudible) is then just a first step of privatization. I don't know too much about the specifics, but if we would like to see -- or if we will see privatization taking up in earnest, then you need several steps of the same sort and not just one.

Maastricht 2.0 -- well, we have the hope that by severing the link between banks and sovereigns, effectively within the next years, there will be easier ground for enforcing the promises that one makes to one another now.

Of course, if you still are very concerned that by restructuring government debt of one member state in a crisis situation might really be dragging down its banking system, generating new problems, it will never happen. And that's why the changes to the structure of the euro area are so important to be done, to be conducted now.

And about 2025 -- I feel a little bit uncomfortable to go so far in the distance, but I hope you'll excuse me on that one.

MR. DERVIŞ: All right. Well, let me say a few things, and then we'll close the meeting.

You know, I think Willie Haber's question comes back to, in a way, one of the key points you made. In other words, is the second option stable? Given the politics of things and given, perhaps, the need to cooperate more on foreign affairs, and defense, and security, and police, and -- you know -- if a crisis erupts -- now I understand you're trying to take away the causes of what may lead to a crisis.

But I guess many of those who feel that the first option is really the only long-term stable one, also historically -- in a way, we don't have a precedent, right, for monetary sovereignty sharing without political union.

So, just to come back on that -- and, obviously, I'm betraying my own bias a little bit, but that's the prerogative of a panel chair, I guess -- I mean, if you had to compare the kind of likely political/economic stability of the two options, don't you think that the second option may just have inherent instability built into it?

DR. SCHMIDT: Both of them have, actually. And if you could jump into the final arrangement, then we would rather, perhaps, jump into the first one. But on the way to that, we will probably not survive as a euro area.

For that reason, we see the transition being so important in the whole consideration, we think that the second way might have better chances to come to a good end.

MR. DERVIŞ: All right. Well, I think we will have many -- I really, really greatly admire the way you've explained the whole framework and your arguments, and I think we're really grateful.

Maybe in the spirit of this discussion, although it's not directly relevant -- but in terms of politics of globalization, you know -- I was kind of interested to read what Marine Le Pen said yesterday. And she said, you know, politics, left and right, is over; it's now about those who try to preserve national traditions and sovereignty, and those who want to merge everything into a global magma. I'm on the second side of that.

But I think I see it again and again now, that the debate -- in the U.S., too, to a large degree -- is really increasingly kind of falling into these two camps, rather than the old categories. Anyway, that's my last word; now your last word.

DR. SCHMIDT: Well --

MR. DERVIŞ: Not necessarily on this --

DR. SCHMIDT: No, but I think we are very close to one another in the way we see the world. I think that it's about the values that we share, and not about the national and ethnic issues that we should talk about. And I think it's terrible what Le Pen is saying.

MR. DERVIŞ: All right. Well, thank you all for coming. I really enjoyed this, and thank you so much for this, Herr Schmidt -- Christoph -- for really a great afternoon.

DR. SCHMIDT: Thank you very much.

MR. DERVIŞ: And try to enjoy the spring outside.

DR. SCHMIDT: Yes.

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