

BUFF/ED/21/90

July 8, 2021

**Statement by Mr. von Kleist, Mr. Merk, and Mr. Krahnke on Germany
Executive Board Meeting
July 14, 2021**

On behalf of our authorities, we would like to thank staff for the substantive, insightful and constructive discussions, and the well-written and well-balanced report. We appreciate the high-quality analysis, which rightly focuses on the most pressing challenges posed by the COVID-19 crisis and the necessary policies to set the economy on a path to a sustained recovery.

Our authorities largely concur with staff's key findings and recommendations. Continuous efforts to fully overcome the pandemic and to sustainably stabilize the economy remain top priorities. Furthermore, with its recent draft of the 2022 federal budget and the fiscal plan to 2025, the government announces fiscal measures that will continue to provide financial assistance to firms and households, while also promoting a strong, green, and inclusive recovery. Germany is undertaking a broad-based public sector investment initiative focused on education and research, digital infrastructure, transport infrastructure and, overarchingly, the climate-friendly transformation of the economy. The government also continues to be committed to improve inclusiveness, inter alia through a lower labor tax wedge in particular on low-income earners, assistance for job transition as well as further measures to address gender inequities in the labor market.

Renewed surges in infections and, consequently, reimposed mobility and contact restrictions from late last year up until spring this year have taken a toll on economic activity, albeit to a lesser extent than during previous waves. In the first half of 2021, the vaccination rollout has been gaining speed and restrictive measures have successfully brought down new infections, ultimately enabling the gradual lifting of restrictions since May. Against this backdrop, our authorities project a strong economic rebound in the second half of the year, driven by continued strong external demand and rebounding domestic demand. At the same time, the spread of more transmissible variants of the virus continues to pose risks to the recovery.

Crisis Response

Overall, the German economy has weathered the COVID-19 crisis fairly well so far owing to effective government action. The unprecedented policy support has stabilized household income and limited economic scarring by safeguarding viable jobs and companies. The extraordinary fiscal measures comprised higher public health spending, grants as well as easier access to loans and tax relief measures like deferrals to firms, subsidies for the extended *Kurzarbeitergeld*, transfers from Federal to subnational governments, a temporary VAT rate cut, and additional public investment. Due to sound fiscal policy in pre-crisis times the overall debt level is still relatively low compared to other countries or to the peak during the last crisis.

The government is committed to keep up appropriate policy support until the pandemic is fully under control and the economic recovery is firmly underway. At the same time, our authorities continue to monitor the situation carefully and stand ready to employ additional measures if needed. The government is guided by the objectives of protecting Germany's well-diversified and highly competitive economic structures and preserving high-quality jobs. The recently announced draft 2022 budget sets aside EUR 10 billion in precautionary funding to cover unanticipated extra pandemic-induced costs. Another EUR 7 billion is dedicated in 2022 to ensure full financing for business assistance programs and a special fund for cultural events.

A central pillar of the comprehensive policy package that was put in place during the crisis is the enhancement of the short-time work allowance (*Kurzarbeitergeld*). Staff's analysis confirms the effectiveness of this tested tool: The *Kurzarbeitergeld* has not only substantially and significantly contained unemployment but has also stabilized disposable income and, therefore, domestic demand. At the same time, it is worth highlighting that this measure complemented an existing set of well-developed and extensive automatic stabilizers embedded in Germany's tax and social security system, playing an important role in swiftly mitigating the adverse impact of the shock. That being said, our authorities acknowledge that marginal and self-employed workers seem to have been bearing the brunt of job and income losses during the pandemic. Against this background, access to the basic income support for jobseekers and a special program for the self-employed ("Neustarthilfe") was expanded to provide a further safety net for these groups.

In addition to a wide range of fiscal measures, Germany has taken a full set of macroprudential, regulatory and supervisory measures to ensure financial stability and cushion the negative economic effects of the pandemic. These measures have helped to prevent the crisis from spreading to the banking sector and have bolstered financial stability. The occurrence of insolvencies was very low in 2020 due to support measures for companies, exceptional borrower support and fiscal measures, and continues to be limited so far in 2021. However, our authorities agree that these developments warrant close monitoring. At the same time, our authorities view existing facilities for solvency support to firms as likely to be sufficient, with take-up having remained comparatively low.

Beyond tackling the economic fallout from COVID-19 domestically, Germany has also been a strong advocate of advancing global public health by effectively containing the

virus globally. The view that “this pandemic is not going to be over anywhere until it is over everywhere” and that only a strong and decisive multilateral approach will enable the global community to overcome this pandemic, has guided Germany’s national and international response to the current crisis: Germany has significantly expanded health care spending not only domestically but also internationally, to speed up vaccine development and production and to help achieve a fair distribution of vaccines across the world. To this end, Germany is strongly committed to the ACT Accelerator and the COVAX initiative. Germany is currently among the largest donors to these initiatives, with contributions totaling EUR 2.2 billion; in total, Team Europe has contributed USD 4.8 billion so far. The German government is also stepping up to take its share of international responsibility for development cooperation, humanitarian aid and international climate action and has included roughly EUR 2.4 billion in additional funding for these purposes in the draft 2022 budget.

“Policies for a Strong and Sustainable Recovery”

To sustainably emerge from the crisis with full strength, the German government is continuing to pursue decisive fiscal policy action with a view to expand public investment, promote innovation and facilitate a structural transformation of the economy, including digitalization and decarbonization. To this end, the federal draft 2022 budget provides for EUR 51.8 billion in investment spending. The medium-term fiscal plan envisages government investment levels to remain continuously high, at about EUR 51 billion per year until 2025, demonstrating a firm commitment to reinforce Germany’s position as an attractive place to do business. As also outlined by staff in its analysis in Box 1, envisaged additional public investment will have a long-lasting impact on GDP and help to lift Germany’s growth potential by expanding physical and human capital investment (inter alia by crowding-in private investment) and incentivizing innovation.

While this will also be conducive to external rebalancing, our authorities agree with staff’s assessment that the spillover effects of a fiscal expansion in Germany on the rest of the euro area are likely to be limited. In this context, we note that staff assesses Germany’s external position in 2020 to be stronger than the level implied by medium-term fundamentals and desirable policies. Our authorities acknowledge that the current account surplus remains high but emphasize that it is affected by many non-policy variables, including demographic change and non-domestic policy influences, including very strong international demand for German goods and euro area monetary policies. Moreover, the EBA model underlying staff’s assessment continues to perform rather poorly for Germany, with the bulk of the EBA-estimated gap for 2020 reflecting the regression’s residual rather than gaps in the policy variables included in the EBA model.

Decisive climate action is one of the government’s key priorities, which is also reflected in the recent approval of amendments to Germany’s Climate Change Act (CCA) stipulating tighter emission targets and setting the goal of reaching greenhouse gas neutrality already by 2045. Hence, targeted investment in research and infrastructure to accelerate the green transformation, as recommended by staff, constitutes a significant part of the above-mentioned investment initiative. In the past two years, Germany has earmarked

over EUR 80 billion for climate policy measures. A new immediate action program for 2022 was passed alongside the amendments to the CCA and will add roughly another EUR 8 billion to this amount. This will inter alia contribute to strong investment in decarbonizing the housing sector, a comprehensive charging infrastructure for electric vehicles, an extension of (local) public transport, and the promotion of hydrogen research and development as part of the National Hydrogen Strategy.

Our government concurs with staff that achieving emission targets will require multi-pronged policy measures that accompany green investments. Against this background, a market-based mechanism for pricing the CO₂ emissions from fuels is being introduced. The carbon pricing system aims to be socially fair and burden-neutral to the economy. Revenues raised through selling emission rights will be re-distributed to citizens and companies either directly or indirectly to avoid hardships and to further increase incentives for investments in climate-friendly technologies. Potential adjustments to the mechanism will be re-evaluated in the future, with a view to reliably reach the climate targets, also by the development of a specified carbon price path. At the same time, our government holds the view that a carbon price path in line with the climate goals needs to be complemented by supporting sectoral measures, such as stricter regulations and targeted funding measures, as well as public investments. Our authorities take note of staff's recommendation to introduce feebates, however, in practice, these measures might prove to be rather difficult to implement, also due to political economy factors.

Regarding the distributional impact of the crisis, our authorities broadly share staff's assessment that marginally employed workers have been particularly affected, exacerbating risks of rising inequalities. Moreover, staff's analysis rightly highlights that marginally employed workers are predominantly low-income earners. The government will closely monitor these developments and – absent a strong recovery in hiring rates – provide re-integration support if needed. Moreover, the government has expanded access to the basic income support for jobseekers. The rate of social security contributions will be capped at 40 percent in 2021. The government's draft budget 2022 encompasses an additional cap in 2022. It aims to enhance social cohesion and to avoid excessive cost burdens to the insured and their employers.

The government also agrees with staff on the need to support low- and middle-income earners more generally. In this regard, the near-complete lifting of the solidarity surcharge, the increase of child benefits and the increase in individual tax allowances represent a significant tax relief to these households.

Staff rightly accentuates that the pandemic has highlighted the urgency of a digital transformation and the need to further promote innovation, foster private investment, and facilitate structural transformation of the economy. To this end, the government has embarked on a range of supportive measures, including R&D tax incentives, additional financial support for start-ups at the growth stage, as well as legislative measures aimed at supporting the development of key technologies, such as Machine Learning and Artificial Intelligence. Moreover, a number of measures have been undertaken to expand fixed-

broadband and high-speed mobile networks and accelerate the digitalization of schools and public services (“eGovernment”).

Financial Sector

The German financial sector has weathered the COVID shock relatively well so far, benefiting from resilience built up before the crisis, including strong capital and liquidity buffers, lessons-learnt from the previous financial crisis. Also, and in addition to a wide range of fiscal measures, Germany has taken a comprehensive set of macroprudential, regulatory and supervisory measures which helped to ensure financial stability.

During the pandemic, the profitability of German banks has continued to be relatively low, also due to the prolonged period of very low interest rates. However, this also reflects the highly competitive banking market that provides substantial benefits to firms and households. While staff’s view is that smaller banks will likely suffer more losses than large banks owing to their high exposures to SMEs, our authorities note that the effects of the pandemic on bank groups and individual banks is still highly uncertain. To ensure that banks have the capacity to absorb losses and to support the economy through lending, supervisors have been calling on banks to refrain from – or at least limit – dividends and share buy-backs. These measures – in conjunction with the full release of the countercyclical capital buffer – have helped to prevent the crisis from spreading to the banking sector and have moderated the negative economic effects of the pandemic. At the current stage, most banks’ capital and liquidity buffers remain ample, and NPL ratios are still among the lowest in Europe. This notwithstanding, and considering the high degree of uncertainty, it will be of the essence to continue to closely monitor risks to the stability of the banking sector and the financial system as a whole, including risks stemming from an expected increase in insolvencies and an accompanied rise in loan impairments.

While the pandemic has elevated vulnerabilities in the real estate market, our authorities do not see pronounced risks to financial stability from the housing market. Households do not appear to be overly indebted by historical standards and there continues to be no indication of substantially deteriorating lending standards. At the same time, developments in real estate and associated lending activities need to be monitored closely. In this context, our authorities have just initiated a data collection process on residential real estate loans which represents a key step to close existing data gaps. The upcoming FSAP will provide an opportunity to discuss any possible needs for real-estate-specific extensions of the macroprudential toolkit in Germany.

The Wirecard scandal pointed to a need for reforms to Germany’s auditing framework and accounting enforcement. The German parliament thus recently passed a bill to strengthen financial market integrity. The bill legislates reforms to accounting enforcement, reinforces the independence of auditors (in relation to audited companies), and strengthens supervisory activities and powers of the Federal Financial Supervisory Authority (BaFin).