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Statement by Mr. Mozhin and Mr. Tolstikov on Germany
(Preliminary)
Executive Board Meeting
July 18, 2022

We thank staff for the well-written set of reports and Mr. Stephan and Mr. Krahnke for their informative Buff statement. We broadly agree with the staff analysis and recommendations and will make only a few comments.

The recovery of the German economy from the COVID-19 crisis gained momentum by end-2021, and the 2022 GDP growth was expected at 3.8 percent. However, the sanctions campaign against the Russian economy created widespread supply disruptions in the global food and energy markets, and led to much higher fuel prices. The resulting losses in purchasing power and profits, shortages of intermediate inputs, and weaker external demand, including from the collapse of exports to Russia and Belarus, will slow down growth of the German economy to 1.5 percent and lead to further acceleration of inflation to the highest level in decades. The loss of potential output will be permanent, with no recuperation in the subsequent years. Further escalation of sanctions campaign may lead to additional disruptions, which is the main risk for the near future.

We note that for 2022 and 2023, in view of highly uncertain environment, staff recommend *flexible* fiscal policy. One element of this flexibility is the readiness to make budget revisions in case of realization of negative shocks. The risk of a complete gas cut-off is one example, which would justify additional targeted support for vulnerable population groups and critically important industries. Another risk, which is assessed as “low” in the Risk Assessment Matrix, is the faster than anticipated monetary policy normalization by the ECB. In our opinion, on the backdrop of accelerating inflation, growing interest rate differentials between the U.S. and the euro area, as well as the euro depreciation, risks of larger policy rate hike and tighter financial conditions are not negligible. *In case these risks materialize, should Germany provide additional fiscal support to the economy beyond automatic stabilizers or maintain its fiscal stance unchanged?* While it may be mainly the subject of the euro area discussions, we would welcome staff's preliminary opinion on this matter.

Extensive use of the extra-budgetary funds to bypass the constitutional debt-brake fiscal rule is another element of fiscal "flexibility". Although the 2023 draft budget reinstates the debt brake rule, which limits new borrowing to 0.35 percent of GDP, the overall fiscal deficit is projected at 1.5 percent of GDP, as spending could be financed by general reserves and special funds (totaling 6.7 percent of GDP), which are not bound by the debt rule. We agree with staff that this can undermine the credibility of the fiscal framework. In this regard, the authorities are well advised to minimize the use of special funds and/or to postpone the reintroduction of the debt brake rule if downside risks to the economy materialize.

Facing the unravelling of decades-long cooperation in the energy sphere with Russia, Germany has to accelerate green transition, implement energy saving measures, and diversify sources of oil and gas supply. We take note that the so-called "Easter package" of legislative proposals is aimed at speeding up the expansion of renewable energy generation. That may require substantial investments, both public and private. *Could staff provide an estimate of additional budget outlays on the construction of new LNG terminals and the development of solar and wind power generation?*

We take note of the staff assessment that in recent years scaling up public investment has been challenging, as the clear vision of the priority public investment was lacking (as well as the institutional framework to ensure its implementation). The report highlights the need to urgently simplify cumbersome administrative procedures and enhance planning capacity, financing burden sharing, and coordination across different levels of governments. The establishment of the high-level government working group to address these issues is a step in the right direction. We also agree that, in order to achieve green and digital transformation, Germany will need higher investment levels of the private sector, which will also be conducive to external rebalancing. In this regard, the authorities are appropriately encouraged to facilitate investment by reducing red tape, fostering digitalization and financial innovation, and facilitating start-ups' and SMEs' access to private capital markets.

Gradually shrinking labor market is an additional constraint to medium-term growth. We positively note the authorities' efforts to remove the obstacles and disincentives to work in order to boost labor participation, including for women and older workers. It is also important to support job-seeking refugees and facilitate their integration into Germany's workforce.

The FSAP conclusion that the German banking sector is generally well capitalized and resilient to shocks is reassuring. However, the stress tests also identified the shortfalls in capital and liquidity at some banks under severe adverse scenarios. The FSAP stress tests should be complemented by the analysis of the new risks to the financial sector, including exposures to the energy-intensive industries. The authorities are well advised to closely monitor prudential ratios in systemically important banks, establish additional bank-specific buffers for less capitalized banks as needed, and strengthen data collection for less systemically important institutions. Against the backdrop of elevated and rising house prices, it is also important to address remaining data gaps and add income-based measures to the macroprudential toolkit.