



Executive Board Minutes 22/67-3

July 18, 2022–2:30 p.m.

Germany—2022 Article IV Consultation

Documents: SM/22/159 and Cor. 1; SM/22/164, and Cor. 1, and Sup. 1, and Sup. 2, and Sup. 3; SM/22/165 and Cor. 1

Staff: Celasun, EUR; Ananthakrishnan, MCM; Gray, SPR

Length: 1 hour, 23 minutes

ISSUED: June 7, 2023

APPROVAL: June 14, 2023

CEDA OGADA
Secretary

TABLE OF CONTENTS¹

The Acting Chair’s Summing Up	3
Executive Board Attendance	5
Discussion Record	7
Annex	29
○ Gray Statements	
○ European Central Bank Statement	
○ Staff’s Responses to Executive Directors’ Technical Questions	
○ Constituency Codes	

¹ Minutes are the official record of a formal Board meeting in which the Board may adopt decisions and reach understandings related to the business of the Fund. Staff background documents issued before the meeting are the principal basis for the meeting. Preliminary “gray” or “buff” statements by Executive Directors and staff’s responses to Directors’ technical questions are circulated prior to the meeting. Adopted decisions and/or summings up—the Chair’s “sense of the meeting” or policy conclusions/recommendations—are issued after the meeting. The minutes include all these elements, as well as the discussion record (a verbatim transcript of the discussion lightly edited for clarity). Minutes are made public consistent with the IMF’s Open Archives Policy.

THE ACTING CHAIR'S SUMMING UP

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their timely and well-designed response to mitigate the spillovers from Russia's war against Ukraine, including proactively looking at contingency plans in the event of gas supply disruptions. Directors noted that growth is likely to be muted in the coming quarters, and that risks associated with a potential further disruption of natural gas supplies, a gloomy global outlook, and supply bottlenecks loom large. Inflation is also likely to remain elevated in the next two years, mostly reflecting the pass-through of recent increases in natural gas prices.

Directors agreed that the fiscal stance is appropriate for 2022, and the authorities' plan to return to the debt brake rule in 2023 by ending COVID-19 and energy-related relief measures should be manageable. Given the high uncertainty, Directors called for maintaining flexibility and recalibrating near-term fiscal plans as needed if downside risks materialize.

Directors encouraged the authorities to continue to cushion the impact of any further sizable increases in energy prices via targeted and time-bound measures for vulnerable households, and generally recommended allowing the higher international gas prices to pass through to end-users to incentivize energy savings and facilitate the build-up of gas inventories. A few Directors saw merit in the authorities' temporary subsidies for firm's energy bills. Directors recommended allowing automatic stabilizers to operate fully and if needed consider activating the escape clause of the debt brake rule for another year if downside risks materialize. Directors supported the authorities' efforts to ensure energy security, including their plan to introduce financial incentives to encourage further voluntary gas conservation, and close cooperation with other EU countries in planning for potential gas shortages.

Directors welcomed the authorities' ambitious decarbonization plans and their digitalization and transportation infrastructure push. They encouraged the authorities to continue investing in Germany's growth potential and resilience, through further enhancing energy security, digitalization, innovation, labor supply and training, and social protection. Improving economic opportunities for women and migrants will also be important. Boosting green public investment is vital to tackle network externalities and crowd-in private investments in clean technologies, which can also help lower Germany's large external imbalances. Directors urged the authorities to overcome the longstanding obstacles to ramping up public investment rapidly and decisively. To maintain the credibility of Germany's fiscal framework, Directors generally stressed that structural increases in spending for strategic priorities should be integrated into the core budget over time.

Directors welcomed that the financial sector has weathered the challenging circumstances well. They noted the generally positive assessment of the resilience of the German banking system in the FSAP and broadly supported the report's recommendations. Given pockets of vulnerability and structurally low bank profitability, Directors recommended continued close monitoring of the sensitivity of banks' balance sheets to evolving risks and strengthening banks' capital buffers as needed. Directors appreciated the

progress in enhancing the microprudential frameworks for banks and the insurance sector and underscored the need to further strengthen BaFin's operational independence and certain aspects of the overall supervisory framework. Some Directors suggested reviewing the design of the fragmented deposit insurance system. Directors welcomed Germany's recent macroprudential policy tightening and underscored the need to add income-based measures to the macroprudential toolkit and expedite the closure of data gaps. Some Directors also encouraged activation of borrower-based instruments if appropriate. Continued strengthening of the AML/CFT framework will also be important.

It is expected that the next Article IV Consultation with Germany will be held on the standard 12-month cycle.

EXECUTIVE BOARD ATTENDANCE²

G. Gopinath, Acting Chair

Executive Directors	Alternate Executive Directors
I. Mannathoko (AE)	F. Sylla (AF)
S. Chodos (AG)	A. Grant (AP)
A. Bevilaqua (BR)	
Z. Zhang (CC)	
P. Moreno (CE)	
P. Jennings (CO)	
D. Palotai (EC)	
A. Buisse (FF)	
J. Stephan (GR)	
	R. Goyal (IN), Temporary
D. Fanizza (IT)	M. Kashima (JA)
H. Hosseini (MD)	M. Choueiri (MI), Temporary
P. Hilbers (NE)	
M. Poso (NO)	
A. Mozhin (RU)	Z. Abdelrahman (SA), Temporary
R. Lim (ST)	
P. Trabinski (SZ)	
S. Riach (UK)	
E. Shortino (US)	

E. Tsounta, Acting Secretary
 J. Morco, Summing Up Officer
 B. Zhao, Board Operations Officer
 L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Communications Department: W. Amr. European Central Bank: R. Rueffer, S. Tordoir.
 European Department: O. Celasun, T. Lan, A. Mineshima, A. Myrvoda, L. Papi, G. Sher,
 R. van Elkan, J. Zhou. Legal Department: D. McDonnell. Monetary and Capital Markets

² For countries in each constituency, please see the Constituency Codes in the annex.

Department: M. Adams, G. Almekinders, P. Ananthkrishnan, D. Cheng, D. Grolleman, V. Haksar, A. Kahros, M. Khamis, R. Meeks, M. Oliva Armengol, M. Pani, T. Tressel, S. Weber. Office of Executive Directors: S. Riach. Strategy, Policy, and Review Department: W. Gray. Executive Director: A. Andrianarivelo (AF), S. Bhalla (IN), A. BinZarah (SA), C. Huh (AP), M. Mohieldin (MI). Alternate Executive Director: A. Alhosani (MI), M. Alrashed (SA), C. Amarasekara (IN), H. Azal (EC), M. El Qorchi (MD), A. Guerra (CE), C. Just (EC), A. Marcussen (NO), M. Massourakis (IT), F. Mochtar (ST), R. N'Sonde (AF), F. O'Brolchain (CO), O. Parkyn (AP), S. Potapov (RU), C. Roman (FF), J. Romero (CE), B. Saraiva (BR). Senior Advisors to Executive Directors: S. Ahmed (MD), E. Cartagena (CE), J. Garang (AE), V. Grossmann-Wirth (FF), H. Koh (GR), B. Lischinsky (AG), M. Maidi (AE), L. Marek (EC), A. Medearis (US), D. Ong (ST), C. Quagliarini (IT), B. Rankin (CO), J. Rojas (CE), C. Sassanpour (MD), M. Sidi Bouna (AF), S. Spurga (NO), A. Tolstikov (RU), M. Trott (UK), S. Wongwaisiriwat (ST). Advisors to Executive Directors: N. Abu Bakar (ST), F. Al-Kohlany (MI), I. Allika (NO), P. Al-Riffai (MI), D. Andreicut (UK), R. Bah (AF), C. Becker (AP), E. Boukpepsi (AF), L. Cerami (IT), J. Corvalan (AG), R. Fayez (MI), D. Hamzah (MI), T. Krahnke (GR), C. Kuth (SZ), V. Lankester Campos (CE), M. Merhi (MI), D. Milutinovic (NE), R. Moral Betere (CE), I. Ogihara (JA), B. Piasecki (SZ), A. Ribeiro Mateus (IT), I. Valdes Fernandez (NO), C. Westphal (US), Y. Yang (CC), O. Zubareva (RU), F. Lopez (CE).

DISCUSSION RECORD³

The Acting Chair (Ms. Gopinath):

This year, Germany had both an Article IV consultation and a Financial Sector Assessment Program (FSAP), and these took place in the context of the reopening of the economy after the COVID-19 wave in the winter and spillovers from the war in Ukraine. The environment surrounding the German economy remains very fluid. Tensions have escalated in the gas market since the staff report was issued to the Board, and we have seen a further downshift in sentiment indicators. These developments, together with growth slowdowns projected from many of Germany's trading partners, have led staff to revise down its growth projections for Germany, as explained in the supplementary information provided for this meeting. A key economic challenge is to strengthen energy security and build up sufficient gas storage ahead of the winter.

For fiscal policy the question is how to best navigate through the uncertainties, support the strategic goals of the economy, such as enhancing decarbonization and digitalization, and how to alleviate public investment bottlenecks. The FSAP assists the resilience of the banking system to the identified risks to form several points of analysis, including vulnerabilities arising from the real estate markets and persistent low banking profitability, a full assessment of financial market infrastructures, assess the resolution planning and crisis preparedness arrangements, and profiled climate transition risks.

Mr. Stephan:

I would like first to thank the Germany team for the excellent work. I think as in the past, this close communication and cooperation with our office and our authorities has been greatly appreciated. We had a substantive and constructive discussion, and I think everyone enjoyed the first hybrid mission week after the start of the pandemic; and when we recollect what happened, it was a very challenging environment, so when we met first in February, this was a totally different discussion, and this changed then later because the first discussion happened before Russia started its war against Ukraine.

I think the depth and the quality of the analysis of Ms. Celasun's team shows how much effort was put into the report, and I would also like to thank

³ Edited for clarity.

Mr. Prasad and the entire team for the excellent Financial System Stability Assessment (FSSA). I would like to mention this was the last mission of Ms. Celasun as the mission chief for Germany. Let me therefore thank her for the outstanding work. I will respond to the points made in the gray statements and also to the issues that might be raised in the discussion at the end of our today's discussion.

The Deputy Director of the European Department (Ms. Celasun):

I wanted to take the opportunity to talk about one policy issue relating to an appropriate fiscal policy stance if downside risks materialize. Mr. Mozhin in his questions asked about a particular case that of financial tightening in case inflation surprises on the upside. Our view is that in case such risks materialize, many of which involve higher inflation in an already high-inflation environment, fiscal policy needs to be very targeted and provide time-bound measures. In that case, we do not see any conflict with the goal of monetary policy keeping inflation expectations anchored.

Let me elaborate a little more on what we mean by targeted. We think it would be likely that households would need more support in case their cost of living rises further, and since low-income households typically do not make up for a large share of spending in an economy—income is not distributed equally—this would not add that materially to aggregate demand and inflation. We would also advise automatic stabilizers to operate unimpeded. This would include in Germany's case the Kurzarbeit program, which is always in the toolbox but was expanded during the pandemic then partially tightened again. This, together with support to vulnerable households, would essentially limit the contraction in aggregate demand that comes from a negative shock. In that case, monetary policy could stay focused on keeping inflation expectations anchored, and fiscal policy could be directed to where help is most needed.

The staff representative from the Monetary and Capital Markets Department (Mr. Prasad):

I would like to talk about two issues here, one on the vulnerability analysis and the other on macroprudential policies. The FSAP makes several recommendations to address pockets of vulnerabilities in the banking system. Staff's stress test results showed that the overall banking system appears resilient to severe shocks. At the same time, the high degree of uncertainty around the scenarios and the future recovery paths, along with the uncertainties around the war, warrant caution and some policy strengthening

to ensure continued robustness of the financial systems. We recommended that the authorities continue to monitor particularly the large systemically important institutions and establish buffers as needed, also strengthen less significant institutions interest rate risk monitoring, and to increase or to strengthen data sharing between the Bundesbank and the European Central Bank (ECB) for the interconnectedness in the financial system. The authorities also agreed with this, and they also were of the view that the resiliency should not be treated with complacency and especially when the financial system in the world is transforming. They are also very cognizant of these risks.

On macroprudential policy, the countercyclical capital buffers and the systemic risk buffers are appropriate. They are well timed, and well-coordinated, but still more action is warranted because accelerating growth in mortgage lending and house prices, coupled with some overvaluation, they do warrant some measures, but there are some constraints to implement them immediately; so in the meantime, we think that at least some guidance on residential real estate lending standards should be strengthened, especially in respect of practice of lending against real estate transaction costs.

Mr. Poso:

I have issued a gray statement but would like to raise a few points for emphasis.

The firm recovery from the pandemic shock was supported by the solid fundamentals of the German economy. Regrettably, the recovery was interrupted by the Russian invasion of Ukraine, which has resulted in elevated energy and commodity prices, the worsening of supply-side disruptions, high uncertainty, and negative confidence effects. The recovery is expected to continue under the assumption that these headwinds will ease, and the balance of risks is tilted to the downside.

The authorities' timely and appropriate policy response limited the fallout of the COVID-19 shock and is now helping to cope with high energy costs. Therefore, given the current uncertain macroeconomic environment and Germany's ample policy space, policy should remain flexible to continue extending temporary and targeted support if needed. At the same time, it is also critical that authorities continue to devise contingency plans together with their EU partners for a possible shutdown of Russian gas. Germany also needs to continue increasing public investment to secure energy supplies and build resilience. Investment and reforms aimed at boosting labor supply and skills,

simplifying administrative procedures, accelerating digitalization, and enhancing competition are also important to boost potential growth.

The German banking sector has weathered the pandemic well and remains resilient to possible severe shocks, but new challenges have emerged alongside existing ones. In our view, the authorities have reacted adequately to the buildup of risks in the real estate market, but additional macroprudential measures could be considered. A redesign of the deposit currency schemes could also be considered as long as the reform is compatible with a European scheme.

Finally, let me acknowledge the strong commitment of Germany with the Fund's policies and objectives, of which Germany is a key contributor: the 1 billion euro for Ukraine's administrative account that seeks 0.3 billion contribution to the RST and the 100 million PRGT subsidy grant are just the latest examples.

Mr. Chodos:

We issued a gray statement, so I want to focus on a couple of key points.

We find very interesting this debate, or maybe this dilemma, between the subsidy size, the mitigation of the effect of price hikes, especially on companies, versus the incentivizing the gas accumulation. From the experience we have had and throughout history, the thing that we always find the most important is to safeguard the viability of viable companies and especially employment-intensive companies, because if there is a loss, and there are a lot of companies that cease to exist, even if temporary, there is not only the loss of employment, even if there is a safety net—it is not only the social safety net—it is the capital accumulation and the capital knowledge of how to administer that safety net. And wherever that occurs, even if it is a bounce back, and then we have a small depression and then a bounce back, it comes in a more concentrated fashion. Whenever there is this phenomenon of companies crashing because of external conditions not attributable to them and then growth picking up, even if it is a good growth pickup, it comes with a greater concentration, which again has effects for the economy further. We would try from our perspective to look at it from that angle and acknowledging that there are arguments on both sides and the deep challenges of the price hike and all the effects that the war in Ukraine poses.

On the issue of expanding childcare facilities and the issue of gender, we think that this is a very good policy and a very good angle to look at it, and at the end of the day, any gender promotion policy on the economy would depend on the effectiveness of the expanded childcare and reducing the tax for the secondary care. So, at the end of the day, the authorities are well placed to understand that the most important incentive and the clearer it is, the most chances of success and expanding into gender in the economy would have.

Mr. Riach:

Germany sits at the heart of Europe, and the strength of its economy can be seen as a barometer for the economic challenges across Europe, and therefore we welcome the recovery from the COVID-19 shock built on strong fundamentals and the authorities' strong policy response. Moreover, the health of the German economy brings significant spillover effects, both positive and negative, across Europe and the EU in particular. That is why discussions of German fiscal policy always raise such strong emotions here in the Board and why German authorities' strong policy response to the pandemic was so welcome.

Without doubt, Russia's invasion of Ukraine has raised risks across Europe, and we see this very clearly in staff's analysis of the situation in Germany and in particular the downside risks from the war. In this context, the authorities' plan for a broadly neutral fiscal stance in 2022 with more targeted support and a commitment to rebuild fiscal buffers is welcome. We absolutely agree with staff that heightened risks and uncertainty mean that vigilance is needed, and we welcome the flexibility demonstrated by the authorities to date and encourage them to maintain this flexibility going forward.

We welcome staff's detailed analysis of the potential gas shutoff. Staff paint a sobering picture of the GDP impact that a full and permanent gas shutoff could have. We stress the importance of working closely with European partners to prepare contingency plans for gas shortages. We welcome the measures taken by the authorities thus far to limit the likelihood of shortages and to mitigate their economic effect. We agree with staff's advice on the importance of clarifying infrastructure needs and potential rationing plans in different gas cutoff scenarios.

In this challenging environment, we welcome the authorities' continued commitment to the green transition while recognizing the need to manage short-term pressures caused by the current energy crisis. We very

much welcome the authorities' statement in the buff statement that the goal of reducing CO2 emissions in the medium to long term is complementary to current efforts to ensure energy security. We welcome Germany's broader efforts to mitigate climate change and the additional information provided on plans to ensure energy security while being mindful of climate considerations.

Mr. Bevilaqua:

We have issued a comprehensive gray statement, so I will just highlight a few points for emphasis.

Even with the new shock caused by the war in Ukraine, the authorities remain committed to resuming the constitutional debt brake rule next year. The fiscal rule in Germany has worked well and ensures a consolidation path that will bring the debt ratio to below the Maastricht threshold in a few years. However, if new exceptional needs materialize, the use of special funds outside the budget to finance such needs does not seem the best alternative. The authorities understand that technical changes would give sufficient flexibility to the rule without requiring any constitutional changes, while staff seems to favor a more significant overhaul. As in other cases, the balance here is to embed flexibility and enhance transparency without compromising credibility and effectiveness. A move along those lines will be much welcome.

Second, the shortage of energy supply is already a major challenge and also the main short-term risk posed to the German economy. We commend the authorities for working on an energy security contingency plan. That said, we highlight the role of communication to the society, both households and businesses, to help build credibility and support to the measures, possibly furthering a smoother adjustment path by having households providing greater contribution and alleviating the overall economic impact.

Third, inflation rates increased substantially in the last year, and the trend is still upward. In addition, price increases seem widespread, and projections for core inflation are double the targeted inflation rate. Therefore, a possible wage price spiral is a valid concern for the authorities. Indeed, a major problem in this global inflation upsurge has been lenience and belated awareness of the extension and intensity of the process, rather than excessive concerns. Therefore, if anything, it is better to err on the cautious side and act early rather than late. The current context clearly puts the fight against inflation on the top of policy priorities globally, including in the Euro Area.

Fourth, the overall findings from the FSAP are very positive, showing the resilience of Germany's banking sector. We want to underscore our deep sympathy to the authorities' views regarding the financial safety nets. We acknowledge that the peculiarities of the German financial system may call for multiple deposit guarantee schemes approach, even if it looks a bit too complex. Moreover, the very idea that institutional design must follow a one-size-fits-all textbook blueprint is highly misleading. If the authorities' proposed reforms can correct the identified sources of potential distortions, improving the robustness and effectiveness of the system without having to overhaul it, that should always be the preferred approach in our view.

Mr. Jennings:

We issued a gray statement, so I will raise only two points today.

First, it is clear that the main downside risks facing Germany stems from the Russian government and the threat of a prolonged gas shutoff. Mitigating this risk should be a key priority over the near-term. Staff's analysis not only outlines the significant cost of the gas blockade but also underscores the importance of careful rationing. To this end, we applaud the authorities' proactive discussions with EU countries to establish solidarity agreements. However, we also caution the authorities against cuts to fuel taxes and other energy subsidies, which may have the unintended effect of encouraging consumption in this critical period. Instead, we encourage the authorities to consider more targeted relief measures and continue efforts to boost energy security consistent with the government's broader transition to net zero emissions.

Stepping back, I also want to join Ms. Shortino who in her gray statement commends Germany's strong and principled response to Russia's invasion of Ukraine in the face of potentially significant economic disruption and costs. Upholding the UN charter and the rules-based international order that respects the sovereignty of each member comes at a cost, but it is a cost worth paying. In this respect, as Mr. Poso did, I also recognize Germany for its significant contribution to the IMF's administered account to support Ukraine.

Second, I want to thank staff for the response to our written question on gender gaps. The past finding that closing Germany's gender gap would increase output by as much as 7.5 percent underscores just how macrocritical this issue is to a wide range of member countries. I look forward to picking this issue up at the gender strategy discussion later this week and hope we will

begin seeing more regular staff analysis and advice on how to unlock this tremendous growth potential.

Mr. Hilbers:

Up front, like Mr. Fanizza and other Directors, I would like to specifically complement staff for the timely analysis of the spillovers of Russia's invasion of Ukraine and the potential scenario of a Russian gas shutoff. We encourage the continued sharp focus by the Fund on war spillovers in Article IV surveillance, as it is currently essential to guide complex policy decisions. We associate ourselves with Mr. Poso's statement and issued a comprehensive gray statement, so let me just make three remarks today.

First, on fiscal policy, we commend the authorities for the well-balanced policy response to the fallout of the war. We encourage the authorities to continue to uphold the flexible policy stance given the highly uncertain environment currently faced by Germany. This will allow it to best juggle competing policy interests such as alleviating the effects of heightened inflation and protecting energy security while preserving fiscal buffers. In the short-term, securing sufficient energy supply is key, and like Ms. Shortino, we encourage eliminating administrative bottlenecks to allow for a public investment push in energy resilience.

Second, we welcome the elaborate and well-written FSAP. We were encouraged to learn that Germany's financial sector proved to be resilient to severely adverse scenarios, thanks to strong capital buffers and overall low risk. Yet increasing mortgage rates in a context of rapidly rising housing prices will require vigilant monitoring of the housing sector and addressing housing affordability issues. Thus, there should be sufficient room to implement borrower-based measures when needed.

For the next FSAP, like Mr. Trabinski, we would like to suggest staff focus more on Germany's non-banking financial sector considering its increasing relevance in the system, a point also made in recent studies by the Financial Stability Board.

Third, on structural policies, I applaud the authorities for accelerating Germany's transition to renewable energy. Apart from avoiding the worst effects of climate change, establishing energy independence should be yet another compelling reason for us all to speed up the pace of our green transitions. I would also echo Mr. Buisse and Mr. Moreno that cooperation

between EU countries on energy security is crucial. Looking forward, we agree with staff that boosting labor participation, especially through retraining programs, will be crucial to address tight labor markets and allow for more inclusive growth.

Finally, I would like to take this opportunity like Mr. Poso and Mr. Jennings before me, to thank the German authorities for their generous support to Ukraine, including the 1 billion made available through the IMF administered account for Ukraine.

Ms. Kashima:

We commend the authorities for their swift and decisive measures in response to the pandemic and Russia's war against Ukraine, which were well-designed and helped mitigate the economic impact from these shocks. Russia's war against Ukraine is fueling the risks of persistently higher inflation, as well as risks to energy security. As we issued a comprehensive gray statement, I will limit my comments to the following three points.

First, like Mr. Hilbers before me, we welcome staff's comprehensive analysis in the Selected Issues Paper, which clearly highlights how further gas shortages would significantly discourage and reduce economic activities. Building resilience against a gas shutoff scenario is vital, and the immediate priority should be to secure energy supplies in close coordination with the private sector and other EU countries. Targeted investment in climate research and infrastructure would be essential to accelerate the green transition. In this sense, as noted by Mr. Poso and Mr. Hilbers, reducing administrative bottlenecks to public investment will be key to enhance green investments and to secure alternative energy supplies. We encourage the authorities to explore tailored and efficient mitigation measures in a comprehensive and inclusive policy mix in order to enhance cost effectiveness of the climate strategy.

Second, on fiscal policy, like other Directors, we agree that Germany's broadly neutral fiscal stance in 2022 is appropriate to provide well-targeted relief measures in the context of rising inflation. Near-term fiscal policy should be sufficiently flexible to support vulnerable households in coping with higher energy costs. We agree with Mr. Palotai that ample fiscal space may need to be exploited to cushion severe impacts for households and firms but that any extraordinary fiscal support measures should be temporary and well-targeted to ensure that fiscal transfers do not disincentivize passthrough and to support low-income households.

Third, on financial sector policy, we welcome that financial stability was maintained in the face of shocks from the pandemic and Russia's war against Ukraine, but like Ms. Riach, we agree that further analysis in the context of spillovers from the war and the exposure of the financial sector to energy-intensive firms would be useful. The authorities' recent efforts to improve macroprudential policy will help bolster the banking system's resilience. We encourage the authorities to continue close monitoring and follow through on FSAP recommendations, including closing data gaps and removing other legal obstacles for effective implementation of macroprudential policies.

Finally, we thank the authorities for their international contribution, including support towards development cooperation, humanitarian aid, and international climate action.

Mr. Palotai:

We appreciate staff's thorough analysis on both the immediate and medium-term policy challenges for Germany given the substantial degree of persisting economic and geopolitical uncertainty. International cooperation is clearly of essence, and we appreciate that the authorities have approached it with an open mind, including in the context of RePower EU. Staff's analysis of the potential economic losses associated with the gas shutoff, as elaborated in the Selected Issues Paper, is a stark reminder in this regard.

Like Ms. Kashima, we positively note staff's assessment that Germany's public debt is projected to decline to its pre-pandemic level by 2027, while further steps are warranted to improve its transparency, particularly given the potential hidden costs related to contingent liabilities. Banks' buffers and reintroducing a debt brake rule is critical for fiscal credibility going forward.

In the staff responses, we note the lack of granular data limited to depth of the FSAP analysis on the intersectoral linkages among nonbank financial institutions and monetary and financial institutions. In this context, we see merit in following up on nonbanks' related risks in the next Article IV cycle. Like Mr. Fanizza, we are intrigued by the initiative mentioned in the buff on the low for finance in the future to foster private investment, including capital markets. Such policies are instrumental to diversifying funding sources besides the traditional banking sector, not least to support SMEs and green investment. In this context, we welcome that the authorities view the role of

reducing climate-related emissions in the medium- to long-term as complementary to the current efforts to ensure energy security.

Ms. Lim:

I would make three points this afternoon.

First, we commend the authorities for their timely and well-designed policies, which has helped stabilize the economy and cushion spillovers from the pandemic and the war in Ukraine. This includes the quick deployment of temporary measures to help households and firms cope with higher energy prices, which we note will be phased out as planned. The sizeable measures were made possible due to ample fiscal space accumulated from past frugal policies. Therefore, we welcome planned reactivation of the debt brake in 2023, which will help rebuild buffers for future crises and avoid inflation. Should downside risks materialize, I echo Ms. Mohieldin, Ms. Riach, and Mr. Moreno that automatic stabilizers should be allowed to operate fully and well-targeted measures to support the most vulnerable be deployed. As mentioned by several Directors, authorities could also consider postponing the debt brake temporarily to ensure fiscal policy can be flexible and supportive.

Second, Germany's external position remains strong, albeit as authorities noted, is subject to pressures from higher energy prices, aging demographics, and multiple exogenous factors. We welcome that public investments will be kept at high levels across education and research, digital and transport infrastructure, and climate friendly transformation. The increased investments will not only be conducive to Germany's external rebalancing in the medium term but also unleash growth potential.

Third, we positively note that Germany's banking sector remains sound and resilient to severe shocks. On potential vulnerabilities arising from the real estate sector, we welcome authorities' strengthening of macroprudential policies and plans to close data gaps and income-based instruments in the macroprudential toolkit. We note the legal obstacles for the precautionary use of borrower-based measures, including absence of granular lending data. We encourage staff to continue to closely engage with the authorities to explore the feasibility of overcoming these impediments, which should bolster macroprudential tools further.

Ms. Shortino:

Germany's economy was on solid ground in terms of recovering from the COVID shock, and I very much agree with Ms. Riach's point that Germany really is at the heart of Europe, and so that is why it is very concerning the country now regrettably faces significant risks, mostly in response to Russia's invasion of Ukraine. These risks will, of course, hold impacts for the rest of Europe. Just with that framing, we issued a comprehensive gray statement, and I will just underscore a few points today for emphasis.

First, we appreciate staff's detailed but sobering analysis of the potential implications if Russia shuts off gas to Germany, which would be truly devastating to Germany's economy and have knock-on effects both in Europe and globally. We echo the call for the EU to strengthen cross-country coordination mechanisms and design contingency plans under potential gas shutoff scenarios; and given the direct and indirect impacts for European countries, encourage staff to think about deepening their analysis of this risk going forward in other countries as well; and I notice that we will discuss some of this on Thursday during our discussion of the European region, which is very helpful.

Second, with regards to fiscal policy, I just want to support Mr. Poso and Ms. Riach and others in their call for fiscal policy to remain flexible in response to downside risks, particularly given there is ample fiscal space, and encourage the authorities to be prepared to extend targeted fiscal support as needed. In that context, it is important to deepen public investment, which will foster stronger growth over the medium term and help to narrow Germany's large and persistent external imbalances.

We also agree with staff on the need to simplify administrative red tape and strengthen coordination between different levels of government. Such reforms could allow for fiscal policy to be used more effectively to respond to some of these near-term challenges.

Third, we agree with many of the structural reform priorities identified in the staff report and specifically fully agree with staff and the authorities on the importance of promoting green investment. I very much also welcome that achieving the recognition that achieving the country's climate goals will help support goals on energy security.

Lastly, I want to echo Mr. Poso and Mr. Jennings and others for appreciation for Germany's strong support for Ukraine, including through its contribution to the administered account and also and appreciate Germany's other contributions to the RST, PRGT, and other trusts at the Fund.

Mr. Buisse:

I agree with the thrust of staff's analysis and associate myself with Mr. Poso's statement. We issued a detailed gray statement, so I will not repeat it, and I will mainly focus today on fiscal policy as suggested in one question that we asked in our gray statement.

On fiscal policy, we consider, as staff, that the German authorities did a great job at limiting the consequences of the pandemic. Now that new challenges and risks emerge in particular linked to Russia's War in Ukraine, we agree with staff and with the German authorities that the fiscal stance should remain flexible depending on the state of the economy with the option to extend again targeted support if needed, especially in case of a materialization of a negative scenario.

We also agree that independently of an adverse scenario, an increase in public investment is also warranted to accelerate the energy transition and enhance energy security, with a design taking into account raw materials and intermediate goods supplies. This will contribute together with adequate carbon pricing to achieve climate targets. It will also enable a long-term reduction of macroeconomic imbalances and dependency on exports from third countries.

On the gas shutoff scenarios, we thank staff for their response to our question. We are still of the view that the demand side feedback, mostly through the very high oil prices, could be a bit too low in the—gas prices, sorry—could be a bit too low in the model despite the added uncertainty component, but as mentioned in our gray statement, we really welcome the detailed analysis and clarity on the assumptions, which enable comparison with other models and results. I echo colleagues in praising the unwavering financial support that Germany provides to the Fund toolkit. I cannot help but associate myself with Mr. Bevilaqua's point on participation to the Board meeting.

Mr. Sylla:

We have issued a gray statement. I will limit my intervention to two points for emphasis.

First, given the country's available fiscal space, it is critical that the policy in this area remains flexible with more supportive, well-targeted, and time-bound measures in the case downside risks materialize, as stressed by Ms. Celasun in her opening remarks. Postponing the reactivation of the debt brake rule should be considered in that regard.

Second, building energy security and resilience is paramount and key to German economic prospects. We thank staff for the timely and insightful Selected Issues Paper on the economic impact of a potential shutoff of Russian natural gas to Europe and Germany in particular. As energy security is a shared objective, neighboring EU countries, we would like to Ms. Shortino, Mr. Moreno, and Mr. Buisse in commending the authorities for the active discussions with neighboring countries about solidarity agreements in case of potential natural gas supply shortages.

More broadly, the authorities' increased efforts to diversify energy sources are commendable. In this regard, the recent visit of Chancellor Scholz in Senegal and commitments made there were well appreciated by our authorities. I will end by commending the authorities for their continued efforts for various trust funds that our country is benefitting.

Mr. Trabinski:

We commend the authorities for their timely policy measures to address the lingering effects from the pandemic and the spillovers from the war in Ukraine. Let me add three comments to what we have written in our gray statement.

First, going forward, the authorities will have to navigate several critical policy challenges. One challenge will be to balance investments of historically high levels to promote the transformation of the economy with the need to avoid undermining efforts to rein in inflation. Another important challenge will be to manage the tradeoff between measures to ensure short-term energy security and measures needed to achieve the country's long-term climate goals. In this context, we regret the reactivation of previously shuttered coal fire stations, which became necessary as a

consequence of the invasion of Ukraine, and we hope this step can be reversed soon to put the country's green transition back on track.

Second, like Ms. Riach in her gray statement, we wonder about the absence of any assessment of cyber risk in this FSAP even though staff is listing cyber threats as a risk with medium likelihood and high in the RAM. Could staff comment on this apparent contradiction? Consistent with the risk-focused approach to scoping financial stability assessments, a greater focus on cyber risk assessments could be warranted in FSAPs for countries who have systemically important financial sectors.

Finally, like a number of my colleagues, we caution against relying too much on extra-budgetary funds for additional fiscal spending. Germany's strong fiscal framework has served the country well, including by facilitating the buildup of healthy fiscal buffers. The authorities should be careful not to undermine the fiscal framework through repeated bypassing of the debt brake rule.

Mr. Moreno:

Germany, and many have said it, is at the center of the European Union, and so we are looking at it and there are significant spillovers from how Germany is doing for the rest of the world. Let me focus on three issues to emphasize.

First, on the outlook and policy recommendations, the main issue is that the outlook remains very uncertain with risks clearly on the downside. Some positive signals for instance that inflation, second-round effects seem to be contained, but there are two issues. First, we welcome the staff's analysis on the potential shutoff of gas from Russia, but Russia's war in Ukraine and cyber risk, which is also interesting, I would welcome the staff's answer to that question. I think fiscal policy should remain flexible, and Ms. Celasun has explained well at the beginning of the meeting how automatic stabilizers can be used, but I would also add the importance of additional measures to protect companies and the population from the crisis. I look forward to the analysis on the EU area to have a coordinated effort at the European level, including regulatory measures on the energy sector.

Second, on the financial sector, we just highlight the importance of strengthening the macroprudential framework, including income-based measures; and in particular monitoring of the housing market will be important, and like we say in the gray statement, any reforms of the deposit

guarantee scheme should be consistent. I think Mr. Poso has also mentioned it with the European Union.

Finally, let us not forget climate. I think it is now at the second stage because of the urgency of so many issues, but we think it is important to highlight also in the messaging the commitment of the authorities with climate change, including investment and the timely review of carbon pricing also in Germany.

To conclude, just to echo Mr. Poso, I think he was followed by many other colleagues on thanking Germany for their contributions to the IMF, including their generous contribution to the account for Ukraine.

Mr. Zhang:

As we have already issued a gray statement, I will limit my comments on a few points.

First, we appreciate the key role played by Germany in the integration and stability of the euro. Germany is a major manufacturing country and an important part of the global supply chain. We encourage the authorities to keep adhering to multilateralism and accountability to global supply chains stability.

Second, enhancing energy security and building resilience becomes more urgent than ever. Under the current circumstances, we see merit in reintroducing certain nonmarket measures into the energy market, including the reopening of the coal-fired power stations, but we would emphasize that these measures should only be temporary, and market mechanism should remain the cornerstone in underpinning the effective functioning of the energy market.

Third, we welcome Germany's efforts to achieving its climate goals and are encouraged that despite the challenging environment, Germany remains committed to the ambitious climate target. We emphasize that the temporary return to coal should not jeopardize decarbonization efforts and that decarbonization efforts should be accelerated without hesitation or setbacks.

Ms. Mannathoko:

We issued a detailed statement, and I am in broad agreement with the thrust of the assessment and the policy recommendations, and I would just like to offer a few additional comments.

For us the German economy has remained resilient to shocks. This was supported by the authorities' sound but prudent economic management that we saw, timely well-designed response both to the pandemic but also to the shock from the Russian war in Ukraine. We think this is commendable. It helps to shield the EU economy given Germany's central role. Nonetheless, there are downside risks now with rising inflation and gas disruption that require continuous effort to limit impacts. We wanted to associate ourselves with most Directors in this regard on the need for a flexible stance fiscally, a policy that is open to introducing well-calibrated, well-targeted fiscal measures should the need arise.

We also encourage close monitoring of the monetary policy and undertaking effective communication. I appreciated the comment by the mission chief that they are looking at measures where they are careful that these do not generate new domestic inflationary pressures.

Now considering increased financial stability risks, we wanted to just welcome the authorities' commitment to strengthening macroprudential measures for the banking and insurance sector. These include closing important data gaps. These were emphasized by some Directors, I think Ms. Lim, Ms. Grant, and Mr. Hilbers in his statement. Like Ms. Shortino and Ms. Kashima and Mr. Moreno, we want to encourage further efforts to strengthen the AML/CFT framework and its implementation. Like others, we are also interested in whether staff considered a cyber risk assessment.

Finally, like Ms. Riach, Mr. Hosseini, Mr. Chodos, and various other Directors, we wanted to welcome the efforts to mitigate climate change and ensure energy security, including efforts to stimulate green investments and limit the likelihood of gas shortages should there be a cutoff. This is a priority for the authorities, and so in this regard, robust scenarios to fully inform contingency responses, contingency measures in response, this remains key.

Other than that, maybe a bit on labor reforms to boost supply, we are thinking also will be important but also important to close gender gaps in this regard. Like others, we feel this remains critical to support potential growth.

We wanted to commend the authorities' efforts to support and reintegrate job-seeking refugees.

In closing, we too appreciate Germany's resource contributions to IMF's administered account and to other international needs. Like many others, we also wanted to really encourage a solidarity agreement.

Mr. Fanizza:

We issued a gray statement. I support Mr. Poso's insightful comments at the beginning of the meeting. Like my colleagues, I would like to commend Germany for its increasingly active role in support of multilateralism and more in general for their support to development cooperation, humanitarian aid, and climate change.

I have two remarks, one on which I am going to side with the authorities, and the other one on which I am going to side with staff, just to be balanced. We very much welcome all the discussion on carbon pricing, but we need to be clear. In Europe, we are going to do it on a regional basis, if we are going to do it, so I fully support be the authorities' position that it has to be a single carbon price at the European level and also will need also carbon border carbon adjustment. Without that, it is not going to happen.

The other point on which I will side with staff is on the FSSA, which we found very good, and particularly the recommendation to unify the fragmented Germany deposit guarantee schemes. This is very important for us, and the idea of creating a single mandatory deposit scheme with the public backstop is important for us also because we think it is a way to move also toward a regional insurance deposit scheme, so it is quite important.

Mr. Mozhin:

We have issued our written statement.

Let me try to address the big question, and this is whether shipments of gas to Germany through Nord Stream 1 pipeline will be resumed or not. In one word, I mean the answer is that I do not know. At the moment, there are no shipments. And this was preannounced by Gazprom that from July 1 to July 21 there will be no shipments because this will be a regular break for inspection and maintenance. Such breaks have been taking place throughout the whole period of existence of this Nord Stream 1 pipeline. July 21 is the day after tomorrow. We will soon know the answer, and I am expecting

shipments to be resumed. Now, will they be resumed in full or only partially is another matter because maybe some Board members have not heard about the conflict we have had around the turbine which was sent by Gazprom to Siemens, the German company, for repair; and Siemens sent it to its Canadian plant, and after the repair was finished, finalized, the Canadian authorities refused to ship it back to Germany and then to Russia. It was felt that some pressure was necessary under such circumstances, and that is what I believe is behind the reduction of gas shipments that took place even before the break. Now, I understand that this conflict has already been resolved. The turbine is in Germany, and it is expected to arrive in Russia on July 24 so, again, a few days before we know the answer.

The bigger issue really is that as a result of restrictions on our imports, our imports declined by about 40 percent. At the same time, we have seen a significant increase in the value of our exports by almost 40 percent, as a result we now have a record high current account surplus, which is estimated by Fund staff to be at around 12 to 13 percent of GDP, and it may be higher, also depending on the size of our GDP. I mean, of course, what followed was a massive appreciation of the ruble, which appreciated by about 30 percent, and there were periods of even higher level of appreciation. So obviously we cannot maintain, and we do not need this scale of current account surplus, and I wonder what are the means we can use to reduce it. My Finance Minister has recently described dollars and euros as toxic currencies. Clearly, we do not need to accumulate any dollars or euros. Confiscation of our central bank reserves effectively means that for many years Russia had been exporting our stuff, at least partially, for free. This is really behind us. My Central Bank Governor made a statement that external conditions for Russia have changed for long, if not forever, so we will need to reduce our exports.

The staff representative from the Monetary and Capital Markets Department (Mr. Prasad):

I thank Directors for their additional comments and advice during the meeting and note among other things the advice on cyber and NBFIs for the future FSAPs. On cyber risk, it is true that we did not have a separate workstream for this FSAP while we scoped the mission and one of the reasons being data availability, but the Article IV does make a few mentions of the recent FX on wind turbines and oil pipelines.

On the NBFIs, we did not do a separate stress testing on investment companies, but we did an extensive interconnectedness analysis which looked at domestic and cross-border interconnections; and it included the banking

sector, insurance companies, and investment funds, and this interconnected analysis also concluded that financial stability risks appeared to be limited given the conservative investment policies of insurance companies and investment companies. Also, when we were doing the FSAP, the EIOPA was conditioning their own stress tests on the insurance sector in the EU, which included Germany, and the ESMA was also doing a peer review on supervision activities, and the Bundesbank had just completed stress testing on investment companies; so we decided that we would have more general discussions and depend on interconnectedness analysis rather than investment companies stress testing, but we note the Board's advice for the future.

The Deputy Director of the European Department (Ms. Celasun):

A quick answer on the questions we received on the gas shutoff analysis, in particular the demand side. We are using a general equilibrium analysis model, so the supply shocks that we look at also have demand effects that we capture; but it is still, the demand side of the model is not very rich, indeed, so we try to capture the impacts through demand from greater uncertainty, loss of confidence, through separate analysis. But there could, indeed, be more frictions that we do not capture well. Prices could be sticky. Prices and wages. There could be real frictions in moving resources across firms, for example, that we do not capture. Those could to some extent amplify the impacts.

I will also mention that the baseline already captures the impacts on demand through higher prices, including the more Germany-specific rising wholesale prices we have observed in recent weeks that we have captured and that we see in the baseline.

Mr. Stephan:

First let me thank Executive Directors for the very constructive and thoughtful comments. I am very grateful also for the commending Germany for the policy reactions to the various shocks. Let me say up front two points.

First, Germany remains committed to continue its effort to counter the adverse and harmful regional and global impacts of Russia's war against Ukraine; and, second, in spite of the current disruption to our world order caused by this war, Germany will not lose sight of the existential challenges of our time, which is to reduce CO2 emissions. The rising food and energy prices and the major disruptions to the already strained global supply chains have

been weighing on growth and pushed inflation further. This has caused particular hardship for the most vulnerable.

My government has responded to those challenges with various measures which included also income support for vulnerable households, but we acknowledge the concerns regarding specific measures that some of my colleagues have raised, in particular in gray statements; and I would like to emphasize that our government is committed to make possible future measures even more targeted. As many colleagues have stressed today, a key priority remains to safeguard the recovery with ensuring energy security, and let me here emphasize that close cooperation with our European partners will be key in this regard.

There has been a lot of effort in saving gas preemptively, both in the industry and at the household level, also when it comes to electricity production. Also, the government is putting a lot of efforts into developing contingency plans. The aim is basically to have a very broad set of potential instruments available for fighting the challenges of the gas shutoff and to make sure rationing will ultimately hopefully not be required.

I noted various comments of my colleagues in gray statements that wonder whether it would not be preferable to prolong the phaseout of nuclear energy beyond the end of this year. This is a very valid point. My authorities have been evaluating all priorities with a lot of scrutiny and without any preset taboos, carefully weighing all the arguments against each other; and it would go too far now to explain all details, but let me say that our Nuclear Energy Pact from 2011 foresees the completion of Germany's phaseout of nuclear energy by the end of this year, so there are not only legal and security issues to be considered if one deviated from this plan, but there are also very practical things like nuclear fuels, which could not easily get renewed before the next winter. On using coal, I fully share their comments, and I can reassure the Board that this measure should be seen as a very temporary one.

On fiscal policy, a brief point on fiscal stance. My government generally shares staff's assessment, and it agrees that targeted fiscal policy should be tuned to help cushion the economic fallout caused by Russia's war and caused by the pandemic while support should still be given to the green and to the digital transformation.

Now, on the well-known debate on fiscal space, maybe from a philosophical perspective, sometimes I get the impression that we slightly talk at cross purposes, which maybe is not a very effective communication. It

might be a bit of overstatement, but it reminds me of Aristotle when he says, “When things have only a name in common, and the account of being which corresponds to the name is different, they are called homonymous”. I think while using the same expression, fiscal space, there might actually be two different understandings. What explains some of the difference, from my point of view, is that when talking of fiscal space, my authorities see the constitutional setting as a binding constraint. This rule, by the way, helped to put government finances in a favorable starting position prior to the pandemic, and it served, and still serves as a kind of policy anchor also in public communication to ensure sustainable fiscal policies. If we treat the constitution setting as a binding constraint, fiscal space would have to be evaluated differently. Maybe it is more a synonym for policy space in relative terms. This is all not to say that we do not see staff’s argument, and I think the views basically on the appropriate fiscal policy in Germany are basically not too divergent.

On macroprudential policy, we will monitor real estate and housing very closely, but there are some early signs that the situation might change because the mortgage rates have been risen now by 250 basis points, and market intelligence suggests that the mortgage loan dynamic might cool down a bit.

The Acting Chair (Ms. Gopinath):

Germany is an Article VIII member, and no decision is proposed. The 2022 Article IV Consultation with Germany is hereby concluded.

The Acting Chair (Ms. Gopinath) adjourned the discussion.

ANNEX

- Gray Statements
- European Central Bank Statement
- Staff's Responses to Executive Directors' Technical Questions
- Constituency Codes

Statement by Mr. Stephan and Mr. Krahnke on Germany
Executive Board Meeting 22/67
July 18, 2022

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 fallout of Russia's war against Ukraine and the necessary policies to set the economy back on a path to a strong and sustained recovery.

Our authorities largely concur with staff's key findings and recommendations. Continuous efforts to cushion the spillovers from the war, limit scarring effects on potential growth, and to ensure energy security remain top priorities. Looking forward, the federal government recently adopted the draft of the 2023 federal budget and its fiscal plan to 2026. The government aims to gradually exit from the crisis-mode and to re-build risk buffers thereby also avoiding adding to inflationary pressure. At the same time, investments will be kept at historically high levels in order to promote a strong, green, and inclusive economy and to build up defense capacities. Germany is undertaking a broad-based public sector investment initiative focused on (early childhood) education and research, digital infrastructure, transport infrastructure and the climate-friendly transformation of the economy. The government also continues to be committed to preserve and further improve inclusiveness, inter alia through a lower labor tax wedge in particular on low-income earners, investment in social housing, assistance for job transition as well as further measures to address gender inequities in the labor market.

The current environment is characterized by exceptionally high uncertainties and the balance of risks is tilted to the downside. While the greatest immediate threat is a persistent and full shut-off of Russia's gas exports to Germany and Europe more broadly, extended supply disruptions and higher commodity prices would weigh on growth and increase the risks of persistently higher inflation and de-anchoring of inflation expectations. Renewed surges in COVID-19 infections, possibly with more dangerous and highly contagious variants, continue to pose risks to the economic outlook. In the absence of a materialization of these risks, our authorities expect the recovery to regain some momentum by mid-2022, also supported by recent fiscal policy measures. The aforementioned fiscal consolidation envisaged for 2023 is driven by the automatic phasing out of the temporary measures to mitigate the impact of the pandemic and high energy prices and automatic stabilizers. Thus, it has limited impact on growth.

Safeguarding the Recovery

Tackling the fallout from Russia's war against Ukraine has been a major challenge for countries around the world. Rising food and energy prices and major disruptions to already strained global supply chains have been weighing on growth and pushed up inflation further

causing particular hardship for the most vulnerable both in Germany and worldwide. After unprecedented policy support during the pandemic, the German government has responded to the fallout from the war with timely and targeted measures which included various forms of income support for vulnerable households. These measures were designed as an immediate and temporary relief for households amid rapidly rising energy prices. Our government is committed to phase them out as planned. In a similar vein – and while generally concurring with the need to allow price mechanisms to work as much as possible –, the government considers temporary support to firms justifiable. The respective subsidies for firms’ gas and electricity costs would not disincentivize energy saving because of strict eligibility criteria, their temporary nature (last only until September), as well as the fact that they cover only a portion of the increased energy cost and decline over time. While the government aims to return to normality and phase out the extraordinary fiscal responses, our authorities continue to monitor the situation carefully and stand ready to employ additional measures if needed.

A central pillar of the comprehensive policy package that was already put in place during the pandemic is the enhancement of the short-time work allowance (*Kurzarbeitergeld*). Staff’s analysis has repeatedly confirmed 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. More recently, renewed disruptions to supply chains caused by the war led to some shortages in intermediary inputs and negatively affected production in the manufacturing sector. Against this backdrop, the government has decided to prolong the phase-out of the expanded *Kurzarbeit* program until September 2022 to avert layoffs and limit scarring.

A key priority to safeguard the recovery is ensuring energy security. The government is in a continuous process of analyzing the economic impact of a potential Russian gas shutoff and developing contingency plans. In mid-June, the authorities declared the second phase of the three-stage emergency gas plan which triggered measures such as accelerating the filling of storage facilities or reducing the use of gas for power generation. The government is also trying to actively encourage further gas savings by firms and households. In this context, it intends to develop an auction mechanism for industrial gas consumers and to consider ways to promote the exchange of gas heaters for heat pumps (while being mindful of potential capacity constraints in the respective industry).

While the exact GDP loss of a Russian gas shutoff is very difficult to predict, a shutoff can entail substantial costs and could require additional policy support. Our authorities welcome staff’s comprehensive and sophisticated analysis on the potential output loss of a gas shutoff. This analysis adds to a number of studies that try to quantify the economic impact of such an event using very different assumptions. While the reduction in GDP estimated by staff appears reasonable (given their assumptions and the model used) and while agreeing that the economic impact would be sizeable, we generally call for treating point estimates with some caution. The economic models used (e.g. static general equilibrium models) can only capture part of the possible transmission mechanisms and spillovers and the results heavily depend on the underlying assumptions that are subject to high uncertainty.

The financial sector has weathered the COVID-19 crisis and the fallout from the war relatively well owing to comprehensive fiscal policy measures but also a full set of macroprudential, regulatory and supervisory measures taken during the pandemic. So far, financial stability implications of the war seem to be manageable also given the financial sector's limited exposure to Russia and Ukraine as well as to energy-intensive firms. At the same time, further analysis and close monitoring is needed going forward in particular with a view to potential financial stability risks stemming from large energy companies that are directly affected by a plunge of Russian gas supply.

Beyond tackling the economic and humanitarian fallout from Russia's war in Ukraine domestically, Germany is committed to continue its efforts to counter the war's adverse and harmful regional and global impacts, including with a view to helping secure global energy and food security. The German government is stepping up to take its share of international responsibility for development cooperation, humanitarian aid and also international climate action. In the draft 2023 budget, the government has included EUR 22 billion for international development which leaves Germany among the top donor nations worldwide. Moreover, the government stands by its commitment to prospectively increase international climate finance from EUR 4 to 6 billion by 2025 the latest.

“Policies for a more Resilient and Sustainable Economy”

In this challenging environment, Germany will follow a forward-looking fiscal and economic policy that promotes sustainable public finances and boosts potential growth. 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 2023 budget provides for EUR 58.4 billion in investment spending. The medium-term fiscal plan envisages government investment levels to remain continuously high, at about EUR 52 billion per year until 2026. At the same time, the government is committed to exiting the pandemic crisis mode. The goal in this respect is to safeguard against interest rate risks, and a rising fiscal burden from social expenditure and rebuild risk buffers that will enable Germany to address future crises.

In order to be able to confront the huge challenges of our time such as the green and digital transformation of our economy, Germany will need high investment levels, mostly in the private sector. The government aims to foster and crowd-in private investment. To attract private capital, it is essential to ensure a favorable business environment and to create conditions for innovation and entrepreneurship. Against this background, the government is working on a “law for financing the future” (*Zukunftsfinanzierungsgesetz*). This law will aim at reducing red tape, foster digitalization and financial innovation, and facilitate firms' access to private capital markets (in particular for start-ups and SMEs).

Higher public and private investment will be conducive to external rebalancing. In this context, we note that staff assesses Germany's external position in 2021 to be stronger than the level implied by medium-term fundamentals and desirable policies. Our authorities continue to acknowledge that the current account surplus remains high but emphasize that it is affected by demographic change and many exogenous variables, including non-domestic policy influences. Moreover, despite the recent refinements of the EBA methodology, the EBA model underlying staff's assessment continues to perform rather poorly for Germany. The bulk of the EBA-estimated gap for 2021 reflects the regression's residual rather than gaps in the policy variables included in the EBA model. Looking ahead, the current account surplus this year is expected to shrink considerably, given the recent surge in energy prices as well as the huge investment needs to meet all the upcoming challenges in the fields of energy transition and digitalization. Its future evolution, however, is subject to high uncertainty and will also depend on the further evolution of energy prices, supply bottlenecks as well as the further course of the COVID-19 pandemic.

The current disruption to our world order and the foundations of prosperity that are posed by Russia's war against Ukraine should not let us lose sight of the urgent need to address the existential challenges of our time. Our authorities are of the view that in the medium to long term the goal of reducing CO₂ emissions in the fight against climate change is complementary to our current efforts to ensuring energy security, by shifting to renewable energy and decarbonizing our economies.

Decisive climate action thus remains one of the government's key priorities. This is not only reflected in the government's decision to impose tighter emission targets and set the goal of reaching greenhouse gas neutrality already by 2045. This is also visible in Germany's efforts to boost international cooperation on climate, such as the recent endorsement of an international Climate Club. The targeted investment in research and infrastructure to accelerate the green transformation constitutes a significant part of the above-mentioned investment initiative. The government is committed to use the earmarked funds of over EUR 80 billion for climate policy measures to support 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 enhancing the cost-effectiveness of the climate change mitigation strategy and achieving emission targets will require additional measures. Our authorities remain of the view that carbon pricing is the most efficient and effective instrument to reduce emissions and see merit in having a single carbon price in the EU. The national carbon pricing system and a rebating scheme aim to be socially fair and burden-neutral to the economy. Revenues raised through selling emission rights will be re-distributed to citizens and companies 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, while also taking into account the importance of the predictability of carbon pricing. 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.

The yet-to-be announced “summer package” will contain another bundle of decarbonization measures in transport, building, and agriculture. Our authorities also take note of staff’s suggestion to introduce feebates, however reiterate that in practice these measures might prove to be rather difficult to implement, also due to political economy factors.

The government agrees with staff on the need to boost labor force participation and address the demographic challenges that Germany is facing going forward. This will require efforts to promote up- and re-skilling of workers and to provide incentives for labor force participation. As regards the latter, our government is committed to expanding the provision of needs-based and high-quality childcare facilities in order to increase working hours and participation of female workers. To address the high effective marginal tax rate for secondary earners, the government plans to promote the more active use of existing alternatives in the current tax code which enable both earners to face the same marginal tax rate on the first euro earned, thus increasing net income for the secondary earner. In addition, the government is working on further enhancing integration programs for migrants to facilitate their participation in the labor market.

Financial Sector

The German financial sector is overall stable with high capital and liquidity buffers that have strengthened since the last FSAP was conducted. Robust public and private sector balance sheets have thus far supported financial stability in the face of the shocks of the COVID-19 pandemic and Russia’s war against Ukraine. Our authorities take note of the broadly reassuring results of staff’s adverse stress tests that take into account the potential fallout of current detrimental developments. Our authorities welcome the inclusion of emerging policy areas in this year’s FSAP. Our authorities will also continue their ongoing efforts to ensure effective regulation and supervision in the context of climate risks as well as fintech and digitalization.

As also laid out in the staff report, our authorities have been undertaking continuous efforts to further improving macroprudential policy implementation and strengthening the microprudential supervisory framework. Our authorities share staff’s assessment of the dynamics in the residential real estate market to a large extent and are in the process of planning and implementing various initiatives that are in line with staff’s recommendations such as closing important data gaps on lending standards for housing loans to private households and working on adding income-based instruments to the macroprudential toolkit. It should be noted though that any potential activation of all borrower-based measures would require a solid financial stability risk assessment based on available information that generates sufficient evidence that such a step is needed for safeguarding financial stability. The recent tightening of macroprudential policy will also help bolster the banking system’s resilience to adverse developments. Furthermore, our authorities will continue to intensively monitor residential and commercial real estate risks as well as banks’ interest rate risks and analyze implications for the financial system.

Our authorities share staff's assessment that the initiated reforms of the depositor and institutional protection schemes will strengthen the German banking system. However, they are of the view that maintaining the existing multiple deposit guarantee schemes appropriately reflects the three-pillar structure of the German banking system and point out that this structure will not pose a pivotal obstacle to ongoing European discussions on a single European deposit insurance scheme.

Statement by Mr. Mohieldin, Mr. Alhosani, and Ms. Choueiri on Germany
Executive Board Meeting 22/67
July 18, 2022

Statement by Mr. Mohieldin, Mr. Alhosani, and Ms. Choueiri on Germany—
2022 Article IV Consultation
Monday, Jul 18, 2022

1. We thank staff for the excellent set of reports and Messrs. Stephan and Krahnke for their informative Buff statement. The German economy was recovering well from recurring infection waves and associated lockdowns before the war in Ukraine. The latter has created new headwinds, including higher energy prices, scarcity of key intermediate inputs, weaker external demand and confidence, and tighter financial conditions, as noted by staff. The German government is to be commended for its timely and adequate response to the fallout from the war, which generally consisted in income support measures for the vulnerable segments of the population, cuts in fuel taxes, and liquidity support to firms. Nonetheless, growth is expected to slow and inflation to remain high, with risks to the outlook tilted to the downside. We share the authorities' views, as conveyed in the Buff statement, that continuous efforts to cushion the spillovers from the war, limit scarring effects on potential growth, and to ensure energy security remain top priorities. We broadly agree with the thrust of the staff appraisal and would like to offer the following remarks:

2. **Policy discussions appropriately focused on the pressing need to cushion the impact of soaring energy prices and supply disruptions as well as enhance energy security.** The Selected Issues paper examines the potential impacts on the German economy of a shutoff of Russian natural gas supplies to Europe. It estimates the effects on production, the reduced supply of intermediate goods and services to downstream firms, as well as the adverse impact of uncertainty on economic activity to reduce GDP by about 1.5 percent in 2022, 2.7 percent in 2023 and 0.4 percent in 2024. Staff indicates that the economic impacts can be reduced significantly by rationing gas supplies more to more gas-intensive and downstream firms, and by having households share in the burden. While we share staff's call for targeted support to mitigate the impact of high international energy prices, we sympathize with the authorities' views that the need for a quick deployment of relief measures currently warranted certain less targeted measures. This is a reality that several governments across the world are currently facing. We note the difference of views between the authorities and staff on the merit of subsidies for firms' gas and electricity costs. *We would appreciate staff's views on the authorities' argument that such subsidies would not materially disincentivize energy saving because they have strict eligibility criteria, are temporary and would decline over time, and they cover only a portion of the increased energy cost.*

3. The sizable economic impacts of a shutoff of Russian natural gas supplies underscore the need to enhance German energy security, and we welcome the elaboration in the Buff statement and the staff report on Germany's efforts in this regard. The authorities and staff agree that removing obstacles to public investment is essential for a green investment push. In this connection, we welcome the establishment of a working group in the Chancellery to address or at least reduce these obstacles. We also positively welcome the "Easter package" of legislative initiatives aimed to accelerate the expansion of renewable energy.

4. **In the current highly uncertain environment, fiscal policy remains appropriately flexible.** The repeated expansion of Germany's well-established program "Kurzarbeit" and grants to firms were effective in containing the impact on unemployment and support aggregate demand in 2021. The fiscal stance in 2022 is neutral as the COVID-19 relief measures are phased out and rightly aims to support the economy while containing inflationary pressures. While the government plans to tighten policy and return to the debt break rule in 2023, automatic stabilizers should be allowed to operate fully if downside risks materialize. Moreover, if needed, the escape clause of the debt break rule could be activated for another year.

5. We welcome the indication in the Buff statement that investments will be kept at historically high levels in 2023 in order to promote a strong, green, and inclusive economy and to build up defense capacities. To finance increased climate- and defense-related spending, the government has created extrabudgetary funds that are not bound by the debt break rule. We share staff's view that extensive use of extra-budgetary funds can undermine the credibility of the fiscal framework over time. We welcome the indication that the Ministry of Finance already reports annually the consolidated financial positions of public corporations. *Could staff indicate whether such reporting covers the contingent liabilities associated with the quasi-fiscal activities undertaken by state-owned banks and public corporations?*

6. **We welcome the FSAP's finding that the financial sector has weathered the pandemic well, and the impact of the war has so far been limited.** The report also indicates that banks generally remain largely resilient to solvency and liquidity shocks. Moreover, since the last 2016 FSAP, the authorities have strengthened microprudential frameworks for banking and insurance, resolution planning, and crisis preparedness. Staff rightly recommends that the authorities continue to closely monitor prudential ratios for large, systemically important commercial banks, establish additional bank-specific buffers for less capitalized banks as needed, and strengthen data collection at less systemically important institutions.

7. Staff indicates that structural vulnerabilities related to persistent low bank profitability and misalignments in real estate sector prices indicated in the 2016 FSAP remain a concern. With regards to the former, stress tests identify shortfalls of capital and US dollar

liquidity at some individual banks under adverse scenarios. With regards to the latter, staff indicates that house price valuations remain stretched and lending standards appear loose in certain segments. We positively note, however, that macroprudential institutions are well developed, and the authorities have tightened macroprudential policy this year in the face of house price risks. We also welcome the authorities' announcement that important data gaps on lending standards will be closed in 2023 and legislative proposals are being drafted to add income-based instruments to the toolkit.

With these comments, we wish the Germany authorities every success in their endeavors.

Statement by Mr. Hosseini and Mr. Ahmed on Germany
Executive Board Meeting 22/67
July 18, 2022

1. We thank staff for a well-written report and Mr. Stephan and Mr. Krahnke for their helpful Buff statement. Like authorities, we broadly concur with staff's key findings and recommendations.

2. **The spillovers from the war in Ukraine have slowed down the German economy.** With sanctions expected to persist, growth is expected to firm up modestly in 2023. Rising energy costs and supply bottlenecks have pushed inflation to multi-decade highs and high inflation will likely persist into 2023 and moderate afterwards. Ample policy support will partially limit the impact of the pandemic and war on the economy's productive potential. We note that the authorities expect the recovery to regain momentum by mid-2022 when supply bottlenecks and energy prices begin to ease.

3. **We agree that fiscal policy should remain flexible in 2023.** We welcome the German authorities' timely response with well-designed measures to the fallout from the war in Ukraine. Indeed, the immediate priority for the authorities is to secure energy security and build resilience. The fiscal measures seem to be appropriately calibrated and will mitigate the impact of surging energy prices on households and firms. The authorities should consider further relief measures if higher commodity prices and weaker growth prolonged, including possibly extending relief to vulnerable households for coping with higher energy costs. We welcome the government decision to maintain the expanded Kurzarbeit program until September 2022 to forestall layoffs and limit scarring. Given high inflation, continuing with targeted relief measures rather than broad-based fiscal support would be of the essence. In a severe downside scenario, the authorities should consider postponing the reactivation of the debt-brake rule by a year, to ensure that fiscal policy can be sufficiently supportive. We stress the importance of additional measures targeted at groups hard hit by the pandemic and not covered by Kurzarbeit, to prevent widening inequality and deeper labor market scarring.

4. **We support the authorities' structural reform agenda to boost potential growth and support a green and digital transformation.** We welcome Germany's strong commitment to fighting climate change and further enhancing the multi-pronged climate action plan. Germany has made significant progress in reducing greenhouse gas emissions. We note that German authorities concur with staff that enhancing the cost-effectiveness of the climate change mitigation strategy and achieving emission targets will require additional measures. In this regard, we welcome the authorities' plans to transform KfW to a major co-risk capital provider for the private sector, which will augment the Energy and Climate Fund—the federal government's key vehicle for financing green projects. Scaling up public green investment is vital to tackle network externalities and crowd in private investment.

This investment would also help reduce Germany's large external imbalances. The pandemic has also increased the urgency of the long-standing need for a digital transformation and greater innovation. We encourage the government to accelerate the expansion of high-speed broadband networks, increase support for R&D, promote further venture capital, and improve the business environment. Increasing labor force participation is critical to counter population aging, while boosting skills would facilitate structural transformation.

5. We take positive note that the German banking sector was assessed in the 2022 FSAP as generally resilient to shocks although some pockets of vulnerability warrant close monitoring. The German financial sector is overall stable with high capital and liquidity buffers. However, structurally low bank profitability remains a persistent source of vulnerability. The authorities have appropriately tightened macroprudential policy in the face of house price risks. We welcome the authorities' efforts to address remaining data gaps and stress the need for closely monitoring the buildup of financial vulnerabilities in real estate markets.

We wish the German authorities continued success in their endeavors.

**Statement by Mr. Jennings, Mr. O'Brolchain, and Mr. Rankin on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank staff for the comprehensive reports and Mr. Stephan and Mr. Krahnke for their informative Buff statement.

The fallout from Russia's invasion of Ukraine hit the German economy before it had regained its pre-pandemic output. Looking forward, the Russian government remains the key source of downside risk, most notably from a prolonged gas shutoff. Nevertheless, Germany is well placed to weather these risks while continuing longer-term measures to increase growth and resilience. We broadly agree with staff's assessment and offer the following comments for emphasis.

The immediate policy priority is to cushion the spillovers from Russia's invasion of Ukraine and limit scarring on potential growth. We agree with staff that the government's measures to support households and firms in the face of high energy prices have generally been well-designed, especially its one-off income support payments to vulnerable individuals. However, cuts to fuel taxes and energy subsidies for firms should be phased out as they reinforce reliance on fossil energy imports, blunt the incentives to save energy in this critical period, and work against achieving climate targets. Instead, more targeted relief measures should be implemented. As outlined in the helpful Selected Issues Paper, Germany is highly exposed to the risk of a prolonged shutoff of Russian natural gas. Efforts should continue to boost energy security, consistent with the government's broader efforts to transition to net-zero emissions. The uncertain outlook for fossil fuel supplies makes the government's plan to fast track the green transition all the more critical.

Despite recent priority spending, Germany continues to have ample fiscal space. We note that staff project Germany's public debt to resume its downward trajectory from 2023 onwards, declining to its pre-pandemic level by 2027. Notwithstanding Germany's strong fiscal position, we caution the authorities on the extensive use of extra-budgetary funds, which could undermine the credibility of Germany's strong fiscal framework. We note that all such spending is reported in the general government account in accordance with EU standards. We also flag the risk of contingent liabilities stemming from off-balance-sheet bodies, most prominently KfW. We encourage the authorities to consider staff's recommendation to prepare a consolidated report of such fiscal risks, outlining expected costs and maximum potential losses. *Do staff have an estimate of the contingent liabilities stemming from Germany's off-balance sheet bodies?*

The financial sector remains resilient to shocks but pockets of vulnerability warrant action. We welcome findings of the FSAP that overall bank capital is generally sufficient. However, to address vulnerabilities, we encourage the authorities to continue to closely monitor prudential ratios, strengthen data collection, and review the design of the fragmented deposit insurance system. We caution that a shift in market sentiment against some high-debt euro area countries could have knock-on effects on the German financial sector.

We encourage the authorities leverage its fiscal space to increase growth potential and decarbonize. In particular, expanding high-quality childcare and strengthening incentives to work for secondary earners could increase female labor-force participation and promote more inclusive growth. *Can staff estimate the potential economic gains of closing gender gaps in Germany?* At the same time, public investments in digitalization and transport would help further increase growth potential. We welcome the authorities' commitment to emissions mitigation and stress that carbon pricing is the most efficient approach. We encourage Germany to increase its carbon price and broaden its coverage to ensure abatement occurs where marginal costs are lowest.

Note to staff: the Selected Issues Paper has some text errors throughout ("Error! Reference source not found"). Please review before publishing.

**Statement by Mr. Chodos, Mr. Lischinsky, and Mr. Corvalan Mendoza on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank staff for the report, the Financial System Stability Assessment (FSSA), and the Selected Issues Paper (SIP), and Mr. Stephan and Mr. Krahnke for their comprehensive Buff statement.

The authorities successfully managed the side effects from the COVID-19 pandemic and more recently the spike in commodity prices that surged after the war in Ukraine. The priorities to prevent spillovers, limit its effect on potential growth and fight climate change while ensuring energy security targets will prove challenging in the near future and coming years. Thanks to bold and decisive actions to control the spread of COVID-19, the socio-economic situation improved in 2021, with a solid economic growth rebound of 2.9 percent. The positive trend should have continued in 2022 onwards.

The staff's analysis of the economic impacts on Germany of a potential Russian gas shutoff are timely and well-focused. We commend staff for the detailed presentation of different scenarios for the country under these uncertain times. Growth expansion will not be possible, thus affecting job creation and hurting the population with a higher level of inflation. As we understand it, the cumulative GDP loss of 4.8 percent between 2022-24 would occur if the combination of gas shutoff and its second-round effects materialize, in addition to higher uncertainties. However, the return to using coal instead of gas is a very important setback.

Fiscal policy should remain flexible in these uncertain times. We learn from the report that fiscal stance would remain neutral in 2022, after reducing the fiscal deficit to 3.7 percent of GDP in 2021, from 4.3 percent of GDP in 2020 (during the pandemic). Nevertheless, there is an interesting fiscal policy discussion between staff and the authorities regarding subsidies. On the one hand, there is fiscal room to offer subsidies to firms to mitigate the increase of energy costs over the summer, versus not offering subsidies as a way to incentivize gas reserves accumulation for the winter, therefore reducing consumption today. For the former, if subsidies are not offered, firms' balance sheets could be damaged and be pushed to unwanted insolvency situations (otherwise viable firms). For the latter, scarcity of gas for the winter is a potential risk. *We would appreciate staff's elaboration on the SIP baseline scenario that suggests that gas shortage can be avoided, but only narrowly. Does it consider subsidies to firms?*

Automatic stabilizers would be the first line of defense to protect the people and the economy in time of emergency. We concur with the authorities' argument, well proved during the pandemic, that quick deployment of relief measures could come at the cost of less targeted policies in time of urgent needs. In this vein, we also see appropriate the flexibility

set on the fiscal framework that allows important programs not bounded by the debt rule. The Energy and Climate Fund plus the Special Defense Fund add up Euro 240 billion to expenditure, or roughly 6.7 percent of GDP, to act decisively when the time comes. Spending growth was also well justified since the COVID-19 outbreak, and today's uncertain times call for more flexibility of the fiscal policy to support public and private investments, especially for countries like Germany that continue with ample fiscal space for maneuvers and where the external sector should be rebalanced. Flexibility of the fiscal policy could support economic domestic growth, consistent with the idea of public debt reduction, and at the same time, an important increase in imports, other than energy, could support growth in the rest of the world.

We concur with the authorities and staff on the need to address the demographic tasks the country is facing. The plan to reduce labor market mismatches, including the combination of training programs with job-search mechanism to raise competitiveness, and the need to boost labor force participation, aims in the right direction, while ensuring that growth dividends are equitably distributed. In this regard, we support the authorities' commitment to increase female participation in the labor market by expanding childcare facilities. Not less important is to reduce the tax rate for secondary earners, thus increasing in this way its net income. We support programs for migrants to help their integration in the labor market but regret to see the visa programs offered in EMDCs to highly qualified scientists, professionals, and skilled workers.

As mentioned, **we find it reassuring that fighting climate change and seeking energy security is a top priority for the authorities**, along with wide range of investment plans to accelerate economic adaptation to greening economy in the coming years. On the one hand, the authorities' policies to enforce tighter emission targets and attaining greenhouse gas neutrality by 2045. On the other hand, in reinforcing international cooperation on climate, by ratifying an international Climate Club. However, as pointed out by Mr. Stephan and Mr. Krahnke in the Buff statement, additional measures will be needed to enhance cost-effectiveness of climate change mitigation and reaching emission targets, some of them difficult to implement.

As reported in the recent FSSA, capital and liquidity ratios were already strong before the pandemic hit the economy. These buffers mitigated the impact of the shock and allowed the authorities to act decisively in the acute phase of the crisis. As in many parts of the world, pockets of risks have arisen, therefore, close monitoring is warranted given that some banks are dependent on wholesale funding and could be affected by interest rate hikes. Macro prudential tools set in place thus far are worked well and could be adjusted if financial conditions turn more restrictive in the coming quarters. We commend the authorities' efforts to continue effective regulation and supervision to deal with climate, fintech, and digitalization risks.

With these comments, we wish the people and authorities of Germany every success in their future endeavors.

**Joint Statement by Ms. Lim, Ms. Grant, Ms. Abu Bakar, and Mr. Becker on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank staff for the comprehensive set of reports and Mr. Stephan and Mr. Krahnke for their insightful Buff statement. We broadly agree with the thrust of the staff's appraisal and offer the following comments for emphasis.

We commend the German authorities for their proactive policy measures, which have helped limit scarring effects from the pandemic and the war in Ukraine. Germany retains strong economic fundamentals and credible economic policies. Nevertheless, we note that the output gap is only expected to close in 2025, and the outlook is subject to considerable uncertainties, including the significant risk of a full and permanent Europe-wide gas shut-off. While many of the risks to the economic outlook and financial stability are from sources external to Germany's economy, we agree with staff that macroeconomic policies should remain nimble and targeted in the near-term in such a highly uncertain environment. Meanwhile, we encourage the authorities to continue the momentum in undertaking structural reforms, including in tackling energy security issues.

Fiscal policy that is flexible and targeted in the near-term, with a broadly neutral overall fiscal stance in 2022, is appropriate. The temporary support measures are generally well designed and help limit economic scarring. Some refinements to temporary tax cuts and subsidies on fossil fuels, and to the renewable energy surcharge, could be considered to further promote energy conservation behavior. We agree that higher energy prices should be allowed to pass through to firms and that assistance could be targeted to allow firms to adjust consumption. With sufficient fiscal space—and we recognize that this flexibility is attributable to a track-record of prudent fiscal policy—we encourage the authorities to continue to invest in the green and digital transformation of the economy. We also welcome the plan outlined by the authorities to undertake technical modifications on the debt-brake rule to create additional policy space and limit the need for extra budgetary funds.

Developments in inflation warrant some policy attention. While the ECB will decide the most appropriate monetary policy path for the euro area as a whole, the authorities could initiate structural labor market reforms to minimize the risks of a wage-price-spiral. We note that the authorities are expecting no real wage gains, but we also note that inflation rates of nearly 10 percent are unprecedented in recent history and the response of workers is likely to be difficult to predict. *Could staff comment on the impact of recorded inflation on consumer confidence and future price expectations? What are the obstacles of this feeding into wage claims?*

Continued transformation of the German economy is the key to lifting growth potential and enhancing resilience. We welcome the measures taken to enhance digital transformation and incentivize innovation, including the planned “law for financing the future” (*Zukunftsfinanzierungsgesetz*) as mentioned in the Buff statement, which will play a catalytic role in crowding in private investment. We also encourage the authorities to

continue their efforts to support workers in the structural transition and boost labor force participation. We welcome measures to reduce gender inequities in the labor market since the last AIV. Furthermore, we note Germany's continued leadership and commitment to the climate agenda, despite setbacks attributable to the war in Ukraine.

We positively note from the Financial Sector Stability Assessment (FSSA) that the financial system is sound overall and resilient to shocks (given its regional and global importance), and broadly agree with the recommendations to enhance macro-financial resilience. We welcome the authorities' strengthened macroprudential framework, resolution planning and crisis preparedness since the 2016 FSAP. Moreover, plans to close data gaps on lending standards in 2023 and amend legislation to include income-based measures into the macroprudential toolkit will also be instrumental to limit further build-up of vulnerabilities in the residential estate sector. To complement macroprudential tools, we see merit in the recommendation by staff to introduce borrower-based measures when appropriate. We also support simplification of deposit insurance and the solvency framework for insurers. Progress on implementation of the 2016 FSAP recommendations is welcome, and we recognize efforts to improve risk management through the publication of the "Mindestanforderungen an das Risikomanagement von Kapitalverwaltungsgesellschaften" (KAMaRisk). The FSSA also highlights structural challenges related to a large, complex, and low profit banking sector, with substantial staff base and dense branch networks cited as factors. *Could staff suggest possible causes for why competition is not driving consolidation of branch and staff numbers? What are some plausible policy implications for the authorities given that many banks are privately owned?*

Statement by Mr. Bevilaqua, Mr. Saraiva, and Ms. Hennings on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the comprehensive reports and Mr. Stephan and Mr. Krahnke for their informative statement. Swift and decisive policies to support households and firms placed Germany's economy on its way to recovery. However, the war in Ukraine disrupted this scenario, causing a slowdown in the global economy and increasing price and supply pressures, including the threat of an interruption in gas supply to Europe and Germany, in particular. In this context, we broadly agree with the thrust of the staff appraisal and would like to offer the following points for emphasis.

The gradual tightening of the fiscal stance needs to be closely monitored and adjusted as warranted. We agree that the broadly neutral fiscal stance in 2022 seems appropriate under the baseline scenario. Indeed, it balances the needs to support the economy while not fueling pressures that could undermine fighting inflation. While we welcome the authorities' intention to resume the constitutional debt brake rule after an exception period, flexibility should be retained in case additional shocks materialize. The existing fiscal space allowed authorities to take sizable measures to support the transitory shocks during the pandemic period and more recently after the beginning of the war in Ukraine. Most measures are targeted, but some blanket subsidies/exemptions to fuel were granted. *In the staff analysis we missed the overall size of each measure to have a better idea of the balance between targeted and untargeted measures.*

We see merit in exploring more permanent changes in the fiscal framework to enhance flexibility and transparency. We encourage the authorities to re-evaluate the approach of using extra-budgetary funds like the Energy and Climate Fund and the Special Defense Fund and explore, instead, embedding them within the general budget envelope, which would favor transparency and better governance in accommodating some new structural needs. We also agree that higher public investment should be aimed at crowding in private investment and could help lower Germany's large external imbalances. That said, we recognize that the German fiscal framework is strong and credible, ensuring convergence to the main objectives. Therefore, even with the spike in public debt after the shock, the projected downward trajectory should resume not only in the baseline scenario, but also in scenarios in which the economy faces additional shocks. *Given the somewhat different perspectives, we would like to hear staff's comments on the authorities' view that some technical changes that are being considered would be sufficient to create additional fiscal space without having to resort to a constitutional change.*

Inflation is still trending upward and the risk of having higher inflation expectations entrenched should not be neglected. Staff's inflation projections for 2022 and 2023—7.5 percent and 4.6 percent—are in line with those of the Bundesbank and the OECD and point to uncomfortably high inflation rates. Furthermore, price increases seem widespread and core inflation is expected to hover at 4 percent these years. In this context, the authorities' concern

with a possible wage-price spiral is sensible, even in the German context where unions are usually cautious with downside risks to economic activity in wage negotiations. While the risk of unmooring inflation expectations in the Euro Area is perceived as low, recurrent inflation surprises could weaken confidence in the existing framework. That said, financial conditions in secondary markets are already tightening, anticipating the need of further monetary policy action. The current context clearly puts the fight against inflation on the top of policy priorities globally.

We take positive note that the German banking sector was found to be resilient to shocks, although some pockets of vulnerability should be monitored. We welcome the 2022 FSAP conclusions on the resilience to solvency and liquidity shocks by German banks, though we note that structural vulnerabilities related to persistent low bank profitability and misalignments in the real sector prices, indicated in the previous report, remain a concern. As the war in Ukraine lasts longer than initially thought, its fallout could weigh on property prices and business performance, with potential impacts on NPL and banks' financial conditions. Also, faster and stronger than anticipated tightening of international or domestic financial conditions could trigger some unexpected developments in the system. This context heightens the importance of macroprudential monitoring and close surveillance of the real estate sector. With respect to the financial safety nets, we are sympathetic to the authorities' views. Although multiple deposit guarantee schemes may seem overly complex and out of sync with prevailing practices globally, we understand that the peculiarities of the German financial system may call for such an approach. Moreover, the very idea that institutional design must follow a single one-size-fits-all textbook blueprint is misleading. If the authorities' proposed reforms can correct the identified sources of potential distortions, improving the robustness and effectiveness of the system without having to overhaul it, that should always be the preferred approach, in our view.

The possibility of a major disruption in the supply of energy in the short and medium term is Germany's main risk. The scenario of a full shut-off of Russian gas should be taken seriously and would have a sizable impact on the German economy, as shown by staff. Therefore, we concur with staff's recommendation and authorities' actions to build an energy security contingency plan, also highlighted in Mr Stephan and Mr Krahnke's statement. We recognize the deleterious impact on prices and on manufacturing production, even considering the benefits of a change to a more greening energy sources matrix. While we commend the measures being considered, we emphasize the role of appropriate communication to the society, which would help build credibility and support, perhaps contributing to a smoother adjustment path, with greater contribution by households, which could help alleviate the overall impact on economic activity. *Could staff elaborate on the expected effectiveness of the solidarity agreements and the financial incentives in encouraging gas savings and mitigating the rationing of energy-intensive business activity?*

Labor market and structural reforms are needed to boost potential growth. We noted staff's forecast of a permanent loss due to the Covid pandemic and the consequences of the war in Ukraine on Germany's productive capacity but also reflecting the aging population

and the lower productivity growth. In this vein, we concur with staff that a comprehensive labor market reform that supports and stimulates female, as well as older workers' participation rate and also better integrates immigrant labor, including by attracting skilled immigrants, should contribute to alleviate the demographic pressure and the tightness of labor supply. Moreover, the success of announced structural reforms to promote a modern, digital and innovative economy will require an updated and skilled labor force. Along those lines, we welcome the broad-based public sector investment initiative, mentioned by Mr. Stephan and Mr. Krahnke, focusing on education and research, digital infrastructure, transport infrastructure and the climate-friendly transformation of the economy. The combination of these policies would address the negative weight of the headwinds on Germany's potential growth, contributing to higher growth rates.

With these remarks we wish the German authorities and society success in their endeavors.

**Statement by Mr. Andrianarivelo, Mr. Sylla, and Mrs. Boukpepsi on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank Staff for the comprehensive reports as well as Mr. Stephan and Mr. Krahnke for their informative Buff statement.

Despite weathering the Covid-19 pandemic well, the German authorities face significant near-term challenges. The economy was strengthening thanks to increased activity in auto production and services sector. Regrettably, spillovers from Russia’s war against Ukraine including surging energy prices, global inflation amid lingering pandemic, are now stalling growth. The outlook is riddled with considerable risks and uncertainties, including a complete shut-off of Russia’s gas exports to Germany and Europe as a whole, that would impact the largest economy on Europe and significantly worsen the macroeconomic situation with higher inflation and further growth slack. In this context, it is paramount that priorities continue to focus on firming energy security and build resilience by diversifying sources of gas supplies and accelerate the development of alternative energy sources, including through the REPowerEU, or solidarity agreements. The gas shutoff scenario presented in the report clearly stresses the importance of addressing this immediate challenge facing the country. *Staff’s update on the authorities’ ongoing assessments of the economic and financial implications of this scenario as well of contingency plans-if any-would be appreciated.* Looking ahead, scaling up targeted public investment to strengthen digitalization, decarbonization and climate infrastructure while tackling the country longstanding challenges remains also important.

Fiscal flexibility should be retained given heightened uncertainties surrounding the outlook. Under the baseline scenario, we note that the broadly neutral fiscal stance in 2022 and the plan to tightening the stance in 2023 and return to the debt brake rule are appropriate. However, we strongly encourage the authorities to stand ready to provide further targeted support. The activation of the escape clause of the debt brake rule for an additional year should also be considered. We welcome the income support and other measures to mitigate the impact of high energy prices on vulnerable households and firms as highlighted in Annex IV and V of the report. Energy diversification away from one source of oil, coal, and gas, is paramount and we welcome the recent announcements made by the authorities on the timeline to do so.

We broadly concur with staff’s assessment and recommendations for the financial sector, which remains resilient to solvency and liquidity shocks, but continued close monitoring of vulnerabilities identified during the FSAP is warranted. In this regard, we see merit in monitoring of prudential ratios for the systemically important commercial banks, establishing when needed further specific buffers for less capitalized banks and improving data collection for less systemically important institutions. *We agree with staff that it would be suitable to conduct additional analysis of the impact of the war, sanctions, and energy prices spike on the German financial stability. Could staff indicated if this has been done*

since the finalization of the report and if yes what are the preliminary conclusions. While the authorities estimate that the macroprudential policy package announced in January 2022 is appropriate, we agree with staff that close monitoring of risks from real estate is critical and further actions are needed notably, considering the overvaluation of the residential real estate in the largest cities.

Increasing green investment in line with the country’s climate and energy-security goals requires further improvement in public investment. We agree with staff that the authorities need to take the necessary steps to swiftly tackle the obstacles to scaling public investment such as heavy administrative procedures, legal complications, and difficult coordination across different levels of government. We take positive note of the establishment of a working group in the Chancellery to address these obstacles. As for the authorities’ climate-change mitigation policy, we welcome the recent “Easter package”, an accelerator for the expansion of renewable energy, the “Summer package” for decarbonization in transport, building, and agriculture. With the national carbon price been considerably lower than EU Emission Trading System (ETS), we take note of the authorities’ view on having a single carbon price in the EU *and would appreciate if staff could elaborate on where other EU countries stand on this.*

Boosting labor market participation and addressing deficiencies in the labor market such as gaps in human capital and skills are of essence. Along with the authorities’ investment program “childcare financing”, we support staff’s proposals to increase labor participation especially the inclusion of women, youth, and migrants. There is also further scope to increase productivity by encouraging innovation, enhancing competition in the ICT market, and improving digital connectivity and training in a post-pandemic era. We particularly welcome the “Hubs for Tomorrow” program that will support companies and employees to transition to a more digitalized economy and look forward to the “law for financing the future” aiming at reducing red tape, fostering digitalization and financial innovation, and facilitate access to private capital markets, notably for start-ups and SMEs as underscored in the Buff statement.

With these remarks, we wish the German authorities all the best in their endeavors.

Statement by Ms. Riach and Ms. Andreicut on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the helpful set of reports and the extremely timely analysis of the impact of a potential Russian gas shut-off on the German economy. We also thank Mr. Stephan and Mr. Krahnke for their informative buff statement.

Notwithstanding Germany's strong recovery from the pandemic, spillovers from the war in Ukraine are taking a toll on the economy. Higher energy prices, the risk of gas shortages, along with inflationary pressures, have weakened the recovery and are casting doubts on the outlook. Against this challenging background, we broadly share staff's recommendations around maintaining fiscal policy flexible, cushioning the impact of spillovers from the war in Ukraine and continuing to boost energy supply, while progressing the green transition.

Fiscal policy, energy challenges and climate change

The current plans for a broadly neutral fiscal stance in 2022 appear appropriate under the baseline assumptions of no further pandemic or energy related pressures, but caution is warranted given elevated downside risks. We agree with staff that the authorities should stand ready to allow automatic stabilizers to operate fully and continue providing targeted support should risks materialize. We welcome the flexibility demonstrated by the authorities in setting fiscal policy against the current uncertain background and encourage them to maintain this flexibility going forward.

We welcome staff's detailed analysis of a potential gas shut-off, a development which recent media reports characterize as increasingly likely. Staff paint a sobering picture of the GDP impact that a full and permanent gas shut-off could have, estimating it in the range of 1 to 3 percent in 2022, 2023 and 2024. We stress the importance of working closely with European partners to prepare contingency plans for gas shortages. We agree with staff's advice on the importance of clarifying infrastructure needs and potential rationing plans in different gas cut-off scenarios. We broadly welcome the measures taken by the authorities thus far to limit the likelihood of gas shortages and mitigate their economic effect, including support for vulnerable households and liquidity assistance to firms.

While the war in Ukraine has further highlighted the need to move away from fossil fuels and towards renewable energy, Germany's reliance on coal in the short-term is nonetheless likely to increase. We encourage the authorities to continue the green transition,

while managing short-term pressures. This is particularly important given that Germany is among the largest GHG emitters. We agree with staff on the importance of considering the relative efficiency of policy measures in response to the current energy crisis, but also appreciate that the authorities need to balance these considerations with the practicalities of delivering relief quickly. We very much welcome the authorities' statement in the buff that the goal of reducing CO2 emissions in the medium to long-term is complementary to current efforts to ensure energy security. We welcome Germany's broader efforts to mitigate climate change, including the recent "Easter package," which aims to accelerate the expansion of renewable energy and the upcoming "summer package," which will set out several decarbonization measures in the transport, building and agriculture sectors. We also welcome the additional information provided in the buff on plans to ensure energy security while being mindful of climate considerations. We particularly note plans to promote the exchange of gas heaters for heat pumps. We thank the German authorities also for their continued support of international climate cooperation.

Financial sector

We welcome staff's detailed assessment in the FSSA, which highlights the overall strength of Germany financial sector and good progress made since the 2016 FSAP.

Germany weathered the stress of the COVID-19 pandemic well, reflecting a robust prudential framework, strong balance sheets, as well as effective government support measures for firms and individuals. Spillovers from the war in Ukraine to the financial sector have been limited thus far, but risks remain as highlighted by the recent tightening in financial conditions and the prospect of a Russian gas shut-off.

The FSAP stress tests echo the resilience of German banks, although some vulnerabilities remain. Banking system capital and liquidity are assessed to be sufficient to withstand adverse stress scenarios. Low bank profitability continues to be a concern however, with German banks recording a lower return on total assets, risk-weighted assets and equity, relative to the EU average. Banks' exposures to real estate may also constitute a pocket of vulnerability in the context of residential real estate price overvaluations. We welcome the FSAP's property-price-at-risk assessment and agree that it would be useful to include such an assessment also in the Bundesbank toolkit. We welcome the Bundesbank's sustained efforts to close data gaps on lending standards, which is key to risk assessment and subsequent policy decisions. We also welcome the authorities' timely decision to raise the countercyclical capital buffer and to introduce a sectoral systemic risk buffer on loans secured by domestic residential real estate.

We thank staff for the detailed coverage of climate transition risks in the FSAP. Such an analysis is essential to understanding the exposure of the financial system to the green transition and for formulating policy responses to maintain financial stability. We hope to see such coverage also in future FSAPs. We note that the transition may entail expected losses for banks, but that these remain small under the scenario considered. We highlight however the heterogeneous impact among different types of banks, with Landesbanken and development banks most impacted in light of their exposure to the power and transport sectors. Regardless of this heterogeneity, the results make a compelling case for supervisory scrutiny of climate-related risks and for ensuring that banks align their practices with supervisory expectations. Efforts by BaFin in this space will provide a helpful complement to ongoing work by the ECB. We agree with staff that further financial stability analysis in the context of spillovers from the war in Ukraine and the exposure of the financial sector to energy-intensive firms would be particularly useful. We welcome the authorities' current plans for analyzing the financial stability implications of gas shut-off scenarios.

We welcome progress made by Germany in strengthening its AML / CFT framework. This followed findings of the 2010 FATF report that AML / CFT measures were generally sound but required improvements in some areas, such as the reporting of suspicious transactions. The authorities have implemented a comprehensive response to these recommendations, including increased supervisory efforts by BaFin, the introduction of a Transparency Register and a public-private partnership to strengthen AML /CFT cooperation. However, some gaps remain, as highlighted by high-profile money laundering cases in recent years. We therefore agree with staff that measures should be enhanced, including through more remedial actions and sanctions to encourage better compliance.

Finally, while we found the FSAP very comprehensive, we would have also welcomed a discussion of cyber risk. This would have been particularly timely given the warnings issued by BaFin of a large risk of cyberattacks against financial institutions in the context of Russia's invasion of Ukraine.

Statement by Mr. Pösö on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank Staff for their clear and insightful reports in the context of Germany's Article IV consultation. We also thank Mr. Stephan and Mr. Krahnke for their informative Buff statement.

The firm recovery of the German economy from the pandemic shock was interrupted by Russia's war against Ukraine, in particular through the worsening of supply-side disruptions, elevated energy and commodity prices, and a negative confidence channel. The resumption of growth is conditional on the easing of these constraints, with the balance of risk tilted to the downside. In this uncertain environment, contingency planning is of the essence and policies should remain flexible. If needed, authorities should continue extending targeted and temporary support, also taking account of the country's ample policy space. At the same time, increasing public investment, including by removing administrative bottlenecks, is crucial to secure energy supplies and build resilience. The German banking sector remains resilient to severe shocks, although an expanded application of the macroprudential toolkit could be warranted in light of existing vulnerabilities, especially those related to the real estate market.

Macroeconomic Developments

We broadly agree with Staff's view that the growth momentum is conditional on the easing of the current headwinds, and that the balance of risks is tilted to the downside. The Russian war against Ukraine has affected the German economy through higher energy costs and the worsening of supply chain disruptions, also resulting in increased uncertainty and lower confidence. Although the projections of the EU Institutions are not fully comparable to those of Staff due to different cut-off dates, we see that the downward revisions to the growth outlook and the upward revisions to the inflation forecast in the Staff Report are appropriate. The pass-through of energy and food prices into core inflation is subject to a high level of uncertainty, although we note that wage pressures remain contained despite the tight labor market. We broadly agree with Staff that the balance of risks is tilted to the downside, and note that an energy crisis paired with intensified supply shortages could negatively affect investment decisions and trade beyond what is incorporated in the Staff's projections. We also agree with Staff's view that the risk of a permanent de-globalization process is gaining prominence, which would have long lasting negative effects. Regarding upside risks, we agree that the expected further waning of the pandemic could provide an additional boost to consumption despite the inflation surprises affecting real disposable income. The analysis of the impacts of a gas shutoff in the Selected Issues Paper is particularly helpful for informing policy. We note, however, that Staff's estimates for a reduction in German GDP vis-a-vis the baseline are relatively contained compared to other studies, and that additional reductions in Russian gas imports beyond what has already been achieved may be more costly to undertake.

Fiscal policies

We broadly agree with Staff’s recommendations on fiscal policy, and highlight the need to continue increasing public investment, while maintaining flexibility to extend targeted support if needed. Timely adoption of fiscal support limited the economic and social fallout of the COVID-19 shock and is now helping vulnerable households and firms cope with high energy costs and potential gas shortages. In view of the country’s ample policy space, we believe that fiscal policy should remain flexible to extend additional targeted support if needed. However, we also note that further attention is warranted on the design of measures to ensure that support is temporary and increasingly adjusted towards targeting the most vulnerable, and promotes energy savings also through behavioral changes. We also share Staff’s recommendation that Germany needs to intensify public investment to enhance energy security and advance energy transition. However, while more public investment is warranted, plans should also take into account the constraints on input supply pertaining to raw materials and intermediate goods, and thus prioritize projects with the highest feasibility rates.

Structural policies

We broadly agree with the structural priorities identified by Staff and concur on the importance of securing energy supplies and building resilience, notably through public investment. We agree with Staff on the need to invest in Germany’s productive potential and resilience, in particular on enhancing energy security, digitalization, life-long learning and boosting labor supply. Moreover, there is a need to simplify public administration procedures and enhance planning capacity, financing, and coordination across different levels of governments, which are crucial to reduce bottlenecks to public investment. In addition, strengthening competition in business services and regulated professions, and improving the housing supply, e.g. by direct investment in social housing, are also important structural issues that need to be addressed. On climate, we also agree that green investment will be essential, together with adequate carbon pricing, to achieve climate goals. In this context, we welcome the adopted measures aimed to accelerate Germany’s energy transition to renewables.

Financial sector policies

We broadly agree with Staff’s assessment of the financial sector, and concur that while the German financial sector remains resilient, further macroprudential tightening could be considered. We agree that the German financial sector has weathered the pandemic well, and welcome the findings of the stress tests that both significant and less significant institutions are fairly resilient to severe shocks. At the same time, new challenges have emerged and risks remain elevated, in a context of rising interest rates, accelerated inflation, heightened volatility in commodity markets, rising overvaluations in real estate and weakening prospects for the German economy. While the banking sector’s capitalization is overall solid, profitability remains structurally low, which impairs capital generation through retained profits. To achieve sustainable profit levels, banks need to intensify their efforts to improve performance and cost structure and

invest in IT infrastructure. We also share Staff's concerns that in light of a more adverse macro scenario and rising interest rates, asset quality may deteriorate, and the duration mismatch of banks' balance sheets may increase. In this context, the continued rise in house prices leading to overvaluation, and a potential underestimation of credit risk pose medium-term vulnerabilities that have the potential to amplify losses and challenge financial stability in adverse scenarios. Therefore, and although we agree that the recently announced increases in the CCyB and the sSyRB appear commensurate to the cyclical vulnerabilities, further measures could be considered, in line with Staff's call for the strengthening and activation of borrower-based measures.

FSSA specific comments

We consider this FSSA report another good example of how euro area and national FSAP exercises can usefully complement each other, and we broadly share its main findings. On the financial sector developments and systemic risk analysis, we underscore that differences between Staff's and EBA/SSM solvency test parameters do not enable meaningful comparisons. As regards banking supervision, we agree with the recommendations aimed at further reinforcing the operational capabilities and independence of BaFin in line with the recent legislation passed to strengthen BaFin's autonomy and supervisory tools, as well as its strategic cooperation with Bundesbank. We also fully agree that Germany's macroprudential policy framework and toolkit are already quite well developed but could be expanded further to allow for a timely activation of borrower-based measures.

Statement by Mr. Bhalla and Mr. Goyal on Germany
Executive Board Meeting 22/67
July 18, 2022

1. We thank Staff for the comprehensive report and Mr. Stephan and Mr. Krahnk for the helpful Buff statement. While we broadly agree with the Staff recommendations, the following are our observations.
2. Given that significant headwinds to growth arise from conflict in Ukraine, the latter's resolution is a key determinant of expected growth recovery. Staff may like to elaborate on the underlying assumptions in this regard that have gone into its projections about the economic outlook.
3. Although a sharp rise in energy prices has added to inflation pressures, as shown in Text Figure 3 (page 8), inflationary expectations have been worsening since the beginning of 2020, and by early 2022, 5-yr and 10-yr inflation expectations were far above the level that prevailed during last one decade. In our opinion, besides supply bottlenecks, demand factors have also played a significant role in pushing inflationary pressures. Can Staff provide insights into the relative role of demand and supply factors?
4. We note that despite a sizeable fiscal deficit and additional borrowings of about 1.7 per cent of GDP in 2022, the rise in debt to GDP ratio remained modest. Similarly, with further proposed borrowings amounting to 2.6 per cent of GDP to finance defense spending in 2023, Staff doesn't expect the debt GDP ratio to rise significantly. As mentioned in the report, these essentially reflect a favourable interest-growth differential. However, going forward, with the rise in interest rates and deceleration in growth momentum, the favourable interest-growth differential may weaken, causing upward pressure on the debt ratio.
5. We observe that the German economy is facing tightness in the labour market, and the participation rate during the post-covid period has not been able to offset the demographic trends. Nevertheless, this has not been reflected in wage pressures which have remained relatively muted and broadly aligned with the rise in GDP deflator and CPI between 2020 and 2022. Staff may like to elaborate.
6. Although the financial sector weathered the pandemic well due to strong balance sheets and high pre-crisis capital maintained by financial institutions, we

support Staff's suggestion to add additional buffers to guard against financial vulnerabilities caused by rapid house price gains.

7. Due to the worsening energy scenario and scarcity of natural gas, Germany has increased its reliance on coal. Have there been any revisions in the climate-related goals?

We wish authorities all success in their future endeavours.

Statement by Mr. Moreno and Mr. Lopez on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for their comprehensive set of reports and Mr. Stephan and Mr. Krahnke for their useful Buff statement. We mainly share staff's appraisal on the German economy and financial system, along with their main policy recommendations. We associate ourselves with Mr. Pösö's statement and would like to offer some additional comments.

Staff's report is rightly focused on the economic and energy policy priorities and challenges derived from the war in Ukraine and related spillovers. We share staff's view that the economic outlook for Germany has rapidly deteriorated given its direct links to Russia and its high exposure to supply-side spillovers. We note that despite the spike in inflation, wage-induced pressures are contained so far. We commend the authorities for the measures adopted to cushion the impact of the energy crisis on the population. After an initial phase of more general measures —including temporary subsidies and tax cuts— we share staff's views that these policies should be phased out as planned, giving more prominence, going forward, to well-targeted measures focused on the most vulnerable groups, in order to mitigate potential distortive effects on the energy market and on the climate change policy objectives. Regulatory measures to improve competition in the wholesale energy market should also be explored, in addition to mechanisms to encourage gas savings by households and firms. We especially welcome staff's scenario analysis of a gas shutoff from Russia, which points to a substantial output loss and the potential need for additional policy support. Contingency plans —including liquidity support for firms— are essential to mitigate a further impact of the crisis and increase energy security. In this regard, we reiterate the need for a coordinated approach at the European level to reduce energy dependency, increase storage capacity and interconnection, and advance the commonly agreed green agenda.

The neutral fiscal policy stance planned for 2022 seems appropriate, although flexibility remains critical. We agree that under the baseline projections, fiscal policy should be oriented towards stability and consolidation. Nevertheless, in the current context of high uncertainty, fiscal authorities should remain flexible and be ready to act if downside risks materialize, allowing automatic stabilizers to operate and deploying temporary well-targeted measures. The authorities should also consider the activation of the escape clause of the debt-brake rule if needed.

We agree with staff that Germany should increase its investment spending in strategic areas such as fostering the green agenda. Although the use of especial extra-budgetary

mechanisms could help to boost spending in critical areas such as decarbonization, defense and digitalization, we agree with staff that ensuring transparency and risks management practices is critical to preserve the credibility of the fiscal framework. Furthermore, the development of the green and digital agendas, and addressing transport infrastructures deficiencies, will require structural reforms in the public investment framework. Improving infrastructure planning and processes, including public procurement, and enhancing cooperation across municipalities, will be instrumental to reduce constraints to infrastructure developments and increase efficiency in the use of public resources, especially in the current context of increasing construction costs. Germany also needs to boost investments in knowledge-based capital, while improving business dynamics and addressing the declining labor-force participation and skill shortages. We praise the authorities for their comprehensive approach to help the climate transition and ensure that energy security goals are met. Delivering the climate change strategy should be a priority, including a timely revision of the national carbon pricing mechanisms to converge to European levels and accurately reflect and deliver the ambitious decarbonization goals.

The boost in investments would also help reduce the high and persistent external imbalance. Despite its projected reduction in the coming years, the external balance is expected to remain stronger than implied by medium-term fundamentals and desirable policy settings, reflecting both excess of savings and subdued investment. The potential effects of a growth-enhancing fiscal stance in Germany, prioritizing investments in critical areas without jeopardizing fiscal sustainability, would help the rebalancing and spread positive international spillovers. The firm commitment of the German authorities to expand public and private investments, as expressed in the Buff, is a very welcome step that will also contribute to increase potential growth.

The financial sector remains resilient, although some pockets of vulnerabilities should be addressed. Capital and liquidity ratios are broadly adequate, and the stress test results point to a banking system resilient to shocks, including those related to rising energy prices, although some institutions may need additional buffers and risks stemming from large energy companies should be closely monitored. Additionally, some structural vulnerabilities in the banking system remain, such as low profitability and data collection gaps. Developments in the housing market are a source of concern, especially those related to overvaluation in urban areas and loosening lending standards. In line with the FSAP recommendations, the authorities should reinforce the macroprudential toolkit with income-based measures and overcome the operational impediments to activate borrower-based tools. We also welcome staff's recommendation to establish a single mandatory deposit guarantee scheme, which should be pushed forward overcoming the resistance of local and regional corporations.

Finally, on governance, despite the progress in recent years, deficiencies remain in the AML/CFT framework. The authorities should continue their efforts to address concerns related to the management and transparency of the control systems of specific financial institutions. Reported cases of money laundering and tax and accounting frauds point out the need to strengthen the regulatory framework, improve data provision and reinforce AML/CFT supervision, including a closer cooperation between competent institutions and limiting the volume of cash transactions.

Statement by Ms. Kashima and Ms. Ogihara on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the informative report and Mr. Stephan and Mr. Krahnke for the insightful buff statement.

The war in Ukraine is hitting the German economy hard through higher energy costs, weaker external demand and confidence, and broader supply disruptions. Inflation has risen to multi-decade highs and is expected to stay elevated, remaining well above the target. We note staff's downgraded growth projection and the upward revision to the inflation outlook. Downside risks are significant, and the authorities should flexibly provide targeted support should risks materialize. We concur with staff that contingency plans for possible gas shortages would also help swiftly deal with future shocks and further risks. We also welcome the authorities' efforts to enhance humanitarian support for refugees. We broadly agree with staff's policy recommendations and offer a few comments for emphasis.

Energy Security

We welcome that the initial impact from the war in Ukraine has been mitigated thanks to the authorities' timely and well-designed actions. However, further gas shortages would significantly discourage economic activities, as highlighted in the Selected Issues Paper, leading to sizable losses in output and employment. We agree with the authorities that point estimates should be treated with caution. Building resilience against a gas shutoff scenario is vital, and the immediate priority should be to secure energy supplies in close coordination with the private sector and other EU countries. Enhancing energy security and developing contingency plans will also reduce uncertainties arising from the war and inflation.

Fiscal Policy

We agree with staff that Germany's broadly neutral fiscal stance in 2022 is appropriate with well-targeted relief measures and not adding too much to inflationary pressures. Near-term fiscal policy should be sufficiently flexible to support vulnerable households in coping with higher energy costs, and targeted relief measures rather than broad-based expenditures is appropriate. In this respect, we welcome the authorities' efforts in developing a comprehensive information system that will allow the government to deliver targeted relief measures to vulnerable households. Postponing the reactivation of the debt-brake rule may be called for given the heightened uncertainty from the war in Ukraine, resurgence of the pandemic and persistent inflation. Extra-budgetary funds should be well-designed and their extensive use avoided, not only for fiscal sustainability but also for fiscal transparency and risk management purposes. Staff's assessment that Germany's public debt is projected to decline to its pre-pandemic level by 2027 is encouraging. Building buffers and reviving the debt-brake rule is essential for fiscal credibility and to address structural needs.

Financial Sector Stability

We welcome that the financial sector has weathered the pandemic well, and immediate financial risks from the war in Ukraine appear manageable. However, vulnerabilities remain, including risks arising from elevated housing prices and U.S. dollar liquidity risks in some individual institutions. Spillovers from the war could further negatively impact structurally low bank profitability. We encourage the authorities to continue close monitoring and follow through on FSAP recommendations, including on LSI regulation/ supervision and further reforms of the authorities' institutional framework. Further efforts to strengthen governance and transparency are also needed, and ongoing initiatives would enhance Germany's AML/CFT systems.

Climate Policy

Concerns on energy security pose risks in achieving the emission target, and we agree with staff that public investment in this area is vital to accelerate the green transition, considering its network externalities. In this regard, removing obstacles to mitigation measures and improving the public investment framework are key for efficient emission reduction. Enhancing the cost-effectiveness of the climate strategy is critical, and we encourage the authorities to explore efficient and tailored mitigation measures and a comprehensive and inclusive policy-mix.

Labor Market Policy

Boosting labor participation is another policy priority to enhance Germany's potential growth. In this sense, training programs to reskill older and lower-skilled workers will help reduce demographic pressures and support a green and digital transition. Further easing immigration rules is welcome to address shortages of skilled workers, and we encourage the authorities' continued efforts to integrate immigrants.

**Statement by Mr. Hilbers and Mr. Milutinovic on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank staff for the set of excellent reports and Mr. Stephan and Mr. Krahnke for the insightful Buff statement. Germany's economic recovery from the pandemic has been disrupted by Russia's war in Ukraine, fueling inflation pressures and supply chain disruptions, and raising energy security challenges. We broadly share staff's assessment and commend the authorities for their swift policy response to address the negative impact from the war spillovers.

We associate ourselves with Mr. Pösö's statement and wish to make the following points for emphasis.

The war in Ukraine has clouded the economic outlook. Although Germany's economy was on the firm recovery path from the pandemic, Russia's war in Ukraine impacted the economic outlook, with the most significant risk stemming from a possible shutdown of Russian gas to Germany and Europe more broadly. In this regard, we appreciate staff's comprehensive analysis of this scenario and other war spillovers which provides clear and timely input for the current policy discussion in the challenging environment. *Staff's update on gas supply developments is welcomed, including on the Nord Stream 1 pipeline shutdown, and on households' and industry's gas-consumption decline as the result of the gas-savings campaign.*

Given the highly uncertain environment, a flexible fiscal policy is warranted. The authorities' timely set of measures strike the right balance between alleviating increasing inflation pressures, achieving energy security, and preserving fiscal buffers. We welcome the authorities' well-designed contingency plans in case of a shutdown of Russian gas and their efforts for more targeted relief measures. We encourage the continuous policy dialogue between staff and the authorities on contingent policy measures. In addition, while public investment in energy security and infrastructure is crucial, current supply constraints require careful investment prioritization and planning.

We welcome the comprehensive FSAP report that confirms a highly resilient financial sector with strong buffers. While the financial sector remains strong, spillovers from the war and rising housing prices call for continued monitoring. The authorities' ongoing analysis of the financial stability implications of a gas shutdown scenario is helpful in this regard. We agree with staff that rapidly increasing housing prices and mortgage loans pose financial stability risks. In this regard, we support the authorities' macroprudential tightening and strengthening of lending guidelines and welcome their work on closing the data gaps and adding income-based instruments. Nevertheless, rising housing prices on top of higher living costs call for addressing housing affordability issues. *How does staff assess the impact of rapidly increasing mortgage rates on the housing market?*

We commend the authorities for accelerating the energy transition to renewables to increase energy resilience. We agree that the immediate policy priority is to secure alternative energy supplies. In this context, we encourage addressing administrative bottlenecks to allow for a green investment push. Furthermore, we broadly support staff's recommendations to increase labor participation to boost potential growth and address the tight labor market.

With these remarks, we wish the best to the German authorities and people in their endeavors in these challenging circumstances.

Statement by Mr. Fanizza, Ms. Quaglierini, and Ms. Cerami on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for a set of insightful reports and Mr. Stephan and Mr. Krahnke for their helpful Buff statement. We associate ourselves to Mr. Poso's gray and welcome the authorities' steadfast policy response to mitigate the economic fallout from Russia's invasion of Ukraine in a context of heightened uncertainty while pursuing key medium-term priorities like the transition to a greener and more digital economy. We agree with staff that, if downside risks materialize, a more supportive fiscal stance in 2022 would be appropriate given Germany's available fiscal space. We also believe stepping up government spending to address both energy security and the energy transition, and filling the digitalization gap would also help lower the external unbalance. We appreciate staff's in-depth analysis of the financial sector in the Financial System Stability Assessment (FSSA) and concur with its main findings and policy recommendations. We wish to offer the following comments.

- **Macroeconomic outlook.** Macroeconomic projections have been revised down for growth and up for inflation considering the deteriorated economic environment, but we note staff's projections are significantly less sanguine than those by several other forecasters. We find, however, that the current difficult juncture and the exceptionally high uncertainty are well reflected in staff's risk analysis, which suggests a balance tilted to the downside for growth and to the upside for inflation.

- **Fiscal Policy.** We commend the authorities for the effective fiscal policy response to counteract both the COVID pandemic and the fallout of the war in Ukraine. Overall, we tend to agree that a neutral fiscal stance in 2022 is appropriate because of rising price pressures, and that a fine-tuning toward more targeted and temporary measures to counteract energy price spikes may be necessary looking forward. At the same time, we recognize that a more tailored design of emergency measures was impractical in the short term. We agree with staff that fiscal policy should become more supportive if downside risks materialize by using the country's ample fiscal space. Thus, we would see reasons for further postponing reinstating the debt-break rule. Nevertheless, we are encouraged by the authorities' pragmatic approach that relies on extrabudgetary funds (outside the debt-break rule) to address the energy and digitalization challenges, which should also help to reduce the external surplus.

- **Russia’s gas shut off.** We find the Selected Issues Paper (SIP) extremely valuable and timely to inform the policy response to a shut off that would hurt not only Germany but also the rest of continental Europe. We appreciate that the German authorities have pursued a risk-mitigating strategy that would also benefit the rest of Europe, by strengthening the energy infrastructure, and increasing renewable production.
- **Structural policies.** We agree with staff on the need to invest in Germany’s productive potential and resilience, including enhancing energy security, digitalization, life-long learning and boosting labor supply. We welcome the measures to improve childcare services and benefits and ensure that the taxation regime for second earners does not translate into disincentives to work given that the COVID pandemic has had a disproportionate impact for some social groups, including women. We also commend the authorities for their ambitious plans on decarbonization and digitalization. We support staff’s recommendations on the simplification of administrative investment procedures and better coordination across different levels of government. We read with interest the initiative mentioned in the Buff on the “law for financing the future” to foster and crowd-in private investment. On nuclear energy, we would be interested in further staff’s elaborations on the assessment behind the government’s decisions to confirm the phasing out of nuclear energy by end-2022.
- **FSAP. We concur with staff’s assessment of the financial sector and with its findings and policy recommendations.** Capitalization and liquidity in the banking sector are overall satisfactory but stubbornly low profitability constitutes a vulnerability that requires a more proactive approach to improve efficiency and identify new viable business models. In this respect, increased competition from neo-banks and other service providers can have a favorable impact. The authorities’ competition and technology-neutral approach to fintech regulation can also help. Rising risks of overvaluation in the real estate sector are another source of vulnerabilities for the highly exposed banking sector. Like staff, we, thus, support the recent tightening of macroprudential policies, as well as their recommendation to consider the activation of borrower-based measures. We also support staff’s recommendations to strengthen the operational independence of BaFin and its cooperation with the Bundesbank. We see merit in the recommendation to streamline the fragmented deposit insurance schemes, which could also facilitate the adoption of a European deposit insurance scheme. We appreciate the coverage of climate transition risks, but we believe it would have been more helpful to consider a scenario where carbon taxes are used to finance green infrastructure as opposed to paying off public debt.

Statement by Mr. Binzarah and Mr. Abdel-Rahman on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the informative set of reports and Mr. Stephan and Mr. Krahnke for their helpful Buff statement. We note that elevated energy prices, supply disruptions, and the fallout from the conflict in Ukraine are impacting the German economy and fueling increasingly broad-based inflationary pressures. Risks to the outlook are significant including the threats to energy security, which if they materialized would have significant implications for growth and inflation. In these circumstances, and in the absence of an independent monetary policy, prudent and agile fiscal, financial, and supply side policies are paramount to maintain macroeconomic stability and promote sustained growth. Against this backdrop, we broadly concur with the thrust of staff's appraisal and would like to underscore the following points.

- **Energy security is critical for Germany's economic prospects.** Here, we take note of staff's estimates of the significant implications of higher energy prices and energy shortages on economic growth and inflation. Therefore, we welcome ongoing efforts to diversify energy sources and enhance energy security. We encourage the authorities to advance these efforts in coordination with other EU countries. We also underscore the importance of maintaining robust contingency plans to handle a scenario of severe gas shortage. Moreover, we sympathize with the need to provide relief measures to help vulnerable households cope with elevated energy costs and encourage the authorities to improve the targeting of these measures. Nonetheless, the merit for subsidizing firms' energy bills is less clear in view of the authorities' energy and climate agenda. *Could staff comment on how these subsidies fit with the authorities' agenda to enhance energy efficiency and to use carbon prices to drive the energy transition?* Further on climate, we note the authorities' view as conveyed in the Buff statement that introducing feebates to help achieve climate goals might be difficult in Germany due to political economy factors. We therefore reiterate our call that the Fund should not promote a "one size fits all" set of measures to address climate issues given that the right policy mix will vary based on country circumstances.
- **We welcome staff's assessment that the banking sector is generally resilient.** As rightly noted in the Buff statement, strong balance sheets have been instrumental in supporting financial stability. Nonetheless, we call for increased vigilance about pockets of financial vulnerabilities as financial conditions tighten. Here, we note that stress tests under the FSAP identified shortfalls of capital and US dollar liquidity at some individual banks

under severe adverse scenarios. We also note that some individual financial institutions could have material exposures to the fallout from geopolitical developments in Europe. Further, while we welcome the macroprudential measures that have been deployed amid the rapid rise in housing prices, we encourage the authorities to continue to closely monitor financial stability risks associated with exposures to real estate and to stand ready to take further actions as warranted. In this context, advancing efforts to close remaining data gaps as recommended by the FSAP would be highly beneficial in supporting risk monitoring and the calibration of macroprudential tools. On a related note, we join staff in encouraging the authorities to continue their efforts to strengthen the AML/CFT framework and its implementation. On the deposit insurance system, we take note of the authorities' view that the existing deposit guarantee schemes appropriately reflects the structure of the German banking system and welcome the authorities' assurance that this structure will not pose a major obstacle to the ongoing European discussions on a single European deposit insurance scheme.

- **We underscore the importance of supply side measures in supporting macroeconomic stability and promoting potential growth.** Here, we note that Germany is confronted with a rapidly diminishing labor force and a growing dependency ratio on the back of its aging population. In these circumstances, we highlight the need to advance ongoing efforts to boost labor force participation and training to address skills mismatches while utilizing immigration to address labor shortages. Further, we concur with staff that expanding coverage of high-speed internet and the 5G mobile network beyond large cities is important to enhance productivity and innovation. We therefore welcome the federal government initiatives to promote the expansion of the digital infrastructure.
- **Maintaining a prudent and agile fiscal framework is paramount.** We concur with the need to maintain flexible budgeting in view of the significant uncertainties surrounding the outlook. That said, we encourage the authorities to remain mindful of staff's valid concern that the extensive use of extra-budgetary funds to bypass the debt-brake rule may undermine the credibility of the fiscal framework. Further, in view of the increased use of special funds and state-owned banks and public corporations to support macroeconomic stability and achieve strategic objectives, we see merit in staff's recommendations to enhance the monitoring of the resulting contingent liabilities and strengthen the management of associated fiscal risks. To this end, we positively note that the finance ministry reports annually on the financial conditions of public corporations. *Did staff discuss with the authorities further mechanisms to enhance the monitoring of contingent liabilities?* Finally, we are encouraged that the authorities are mindful of the need to underpin the scaling up of public investment by advancing efforts to simplify

administrative procedures and enhance planning and coordination across different levels of governments.

With these remarks, we would like to commend the German authorities for their humanitarian aid, and we wish them well in their endeavors.

Statement by Mr. Mozhin and Mr. Tolstikov on Germany
Executive Board Meeting 22/67
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.

**Statement by Ms. Shortino, Ms. Medearis, and Mr. Westphal on Germany
Executive Board Meeting 22/67
July 18, 2022**

We thank staff for this report and Mr. Stephan and Mr. Krahnke for the informative Buff statement. We note that the German economy had largely recovered from the economic shock after the pandemic, but the fallout from Russia's war against Ukraine poses significant risks to the economy. We welcome the authorities' strong and principled approach to sanctions in response to Russia's war against Ukraine, despite the economic cost to Germany and its European partners. **Going forward, we agree that in the face of these headwinds, the authorities should continue to (1) pursue medium-term investment priorities, (2) strengthen the oversight of the financial sector, particularly non-banks and mortgages, and (3) be prepared to respond to further disruptions by Russia in the supply of natural gas, including through additional domestic policy measures as well as contingency plans with EU allies.**

We welcome Germany's shift in its approach to its fiscal priorities in recent years, first in the wake of the pandemic and then in response to Russia's invasion of Ukraine, and we agree with staff that fiscal policy should remain flexible into 2023. Given Germany's substantial fiscal space and excellent performance in staff's debt sustainability analysis, we also agree that the authorities should continue to pursue medium-term investment priorities, including the ambitious climate, digitalization, and infrastructure investments outlined in the coalition agreement. We strongly support staff's recommendation to review the overall fiscal framework so that fiscal policy can continue to respond to structural investment priorities after the various special funds and reserves are exhausted. We echo that the authorities should simplify administrative processes and enhance planning capacity, financing, and coordination across different levels of governments to facilitate increased public investment. We also welcome the authorities' suggestions for technical modifications to the debt brake to create additional fiscal space, and we agree with staff that the government should consider extending the escape clause into 2023 in case downside risks continue to materialize.

We thank staff for the initial discussion of Germany's 2022 FSAP, and we look forward to the full report's publication. The financial sector has weathered recent shocks well thanks to its sizable pre-pandemic buffers. We welcome that the authorities have tightened macroprudential policies in light of potential housing sector risks, including by raising the counter-cyclical capital buffer, but we agree that further actions may be necessary. It is also encouraging that the authorities intend to close data gaps for the housing sector and may add income-based measures to the macroprudential toolkit. We agree that BaFin may need more resources and better coordination mechanisms to strengthen supervision in the non-bank sector. We strongly welcome efforts to analyze the financial stability implications of potential gas shutoff scenarios. We also encourage the authorities to continue to strengthen the AML/CFT framework by enhancing compliance with customer due diligence requirements, reporting suspicious transactions, and using remedial actions and sanctions to deal with non-compliance; continuing to improve the availability of beneficial ownership

information in the Transparency Register; and pursuing money laundering cases independently of the underlying crimes.

We appreciate the authorities' efforts to stabilize European energy markets and preserve the solvency of gas suppliers, particularly after Russia sanctioned Gazprom Germania and reduced gas flows in the Nord Stream 1 pipeline. We thank staff for the insightful selected issues paper on the economic impacts of a potential shutoff of Russian natural gas. This analysis underscores the importance of careful rationing should such a downside scenario materialize. Toward this end, we applaud the authorities' proactive discussions with neighboring EU countries about establishing solidarity agreements regarding potential natural gas supply shortages. We also welcome the temporary legal amendment to facilitate rapid government intervention to stabilize critical companies in the energy sector and the proactive planning for liquidity support and loan guarantee programs for otherwise viable firms if downside risks materialize. More generally, we commend the authorities for their ongoing efforts to diversify and decarbonize energy sources given pressing risks related to Russian natural gas supplies.

Germany's external position remains stronger than the level implied by medium-term fundamentals and desirable policies. While staff projections suggest that the current account surplus will narrow this year, they also anticipate that the current account will return to heightened levels over the projection period. We agree with staff's assessment that policies to promote investment would help narrow Germany's substantial current account gap, as well as support medium-term potential growth and facilitate the transition to a more digital and greener world. Beyond these investment priorities and policies to promote fiscal flexibility, *what else can the authorities do to meaningfully address Germany's external imbalances over the medium term?*

Statement by Mr. Zhang and Ms. Yang on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the well-written report and Mr. Stephan and Mr. Krahnke for the helpful Buff statement. We broadly agree with staff's policy analysis and recommendations and would like to make the following comments.

Germany's economic activity was firming up amid the pandemic, however, the recovery is clouded by risks and uncertainties associated with the geopolitical crisis. We commend the authorities for their COVID-19 relief measures, which effectively mitigated the dire impacts of the pandemic and supported households and businesses. As staff pointed out, the Ukrainian crisis has created new headwinds, including higher energy prices, weaker external demand and confidence, and tighter financial conditions. Surging energy costs are causing broad-based price pressures, and Germany recorded a monthly trade deficit in May for the first time in decades. Germany is a major manufacturing country and an important part of the global supply chain. We encourage the authorities to adhere to multilateralism and make their contribution in promoting global supply chain stability. *Would staff anticipate a prolonged weakening of Germany's external position in light of the significant drop in the Euro against the USD and lingering uncertainties in the supply chain?*

Enhancing energy security and build resilience become more urgent than ever. The sanctions on Russia's energy sector have brought severe impacts on Germany as its heavy dependence on energy imports from Russia and the difficulties in quickly substituting Russian gas made it vulnerable to energy supply disruptions. We commend the authorities' efforts in filling storage facilities and diversifying sources of gas, while underscoring the importance of cooperation with other EU countries to reduce vulnerabilities. *We note that the EU and Germany have agreed to gas supply partnerships with the U.S. and Qatar respectively, could staff comment on the extent to which these partners could help to offset gas shortages, as well as other sources of gas supplies?* To deal with gas shortage, financial incentives could be offered to encourage gas saving behavior. Potential rationing would be necessary in case of a severe adverse scenario. In this regard, the authorities' ongoing efforts to plan the distribution of gas in a potential emergency are welcome, and non-economic considerations like social welfare, environmental and health implications, and technical and legal constraints should be considered in developing the plan. Having households share the burden of quantity rationing would reduce the economic loss. In general, under the current circumstances, we see the merits of re-introducing some non-market measures into the energy market, but would emphasize that these measures should be temporary.

We encourage the authorities to adopt a flexible and targeted fiscal policy and continue investing in strategic priorities. While the urgent need for a quick rollout of supportive

measures warrants certain less targeted policies, cuts to fuel taxes should be phased out as planned. We share staff's recommendation that international energy prices should be allowed to pass through to domestic prices while the vulnerable should be protected with targeted support. Creating a comprehensive information system on households would allow for better targeting. *Could staff provide more details on the type of data that would be collected by the system?* We see merits in scaling up public investment in strategic priorities, and we agree with staff that long-standing challenges in this area should be addressed, which requires efforts to simplify administrative procedures, improve planning capacity and coordination across different levels of governments.

We welcome Germany's efforts to achieve its climate goals and such efforts should be continued, rather than backtracked. Germany has significantly reduced its GHG emissions over the last decade and implemented a national ETS in addition to joining the EU ETS; however, as a major GHG emitter with relatively high per capita carbon emissions, Germany needs additional measures to achieve climate mitigation. Against the backdrop of energy shortage, it was reported that Germany reactivated previously shuttered coal-fired power stations and increased reliance on coal, *could staff comment on its impact on climate mitigation and the envisaged coal phase-out by 2030?* According to Reuters¹, Germany may revise its 2035 climate goal for the energy sector and instead aim to reach the target after coal-fired energy plants are phased out, *staff comments are welcome.*

Improving labor market dynamism and promoting digitalization are critical to boost growth potential. Germany's labor force participation was facing downward pressure partly due to population aging. We take positive note on the measures to boost participation, particularly those promoting female labor-force participation and working hours. We encourage the authorities to integrate immigrants while easing immigration rules. Efforts to upskilling and reskilling workers are essential, and the National Skills Strategy and the "Hubs for Tomorrow" program could play a key role in this regard. Meanwhile, promoting the expansion of digital infrastructures remains critical as internet availability is uneven across the country. To develop a digital and innovative economy, prominence should be attached to effective and fair competition on digital marketplaces.

We welcome staff's assessment that the banking sector is generally resilient to shocks, the stress test has demonstrated that banks are generally liquid and well capitalized. We encourage the authorities to closely monitor prudential ratios for large SIBs and require additional buffers for less capitalized banks. Given continued rising in house prices, we see precautionary use of borrower-based measures as appropriate.

With these remarks, we wish the authorities every success in their policy endeavors.

¹ <https://www.reuters.com/business/energy/draft-law-shows-germany-plans-revise-key-emissions-target-energy-sector-2022-07-05/>

Statement by Mr. Palotai, Mr. Just, and Mr. Marek on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the informative set of reports and Mr. Stephan and Mr. Krahnke for their helpful Buff statement. While Germany navigated the policy response well through the COVID-19 pandemic, it is faced with rapidly evolving macroeconomic challenges, in particular related to energy security, and accelerating inflationary pressures. **We broadly share staff's assessment, and encourage the authorities** to stay abreast of immediate macroeconomic as well as geopolitical risks, and stand ready to adjust their policies accordingly. As energy security is a shared objective with neighboring countries and supranational institutions, we encourage close cooperation and welcome recent steps in this regard. The authorities are also advised not to lose sight of long-term structural challenges, including low profitability in the banking sector as well as labor market weaknesses related to demographic developments and green transition. We associate ourselves with the statement by Mr. Pösö and offer the following comments for emphasis.

The authorities' fiscal stance has been adequate and should remain flexible. While we welcome that the government envisages a reintroduction of the national debt-brake rule in 2023, ample fiscal space may need to be exploited to cushion the most severe impacts of a potential gas crisis for households and firms. At the same time, any extraordinary fiscal support measures should be temporary and well-targeted to ensure that fiscal transfers do not disincentivize pass through and support low-income households. The authorities should avoid tools such as energy price caps and broad-based tax cuts given their potentially market-distortive effects and the significant fiscal costs.

Finetuning expenditure policies is critical to strengthen budgetary transparency. The authorities should limit directing additional fiscal spending through extrabudgetary funds, as it weighs on the credibility of the fiscal framework. We also see merit in producing a consolidated report of fiscal risks and contingent liabilities, underwritten particularly by state-owned banks and public corporations.

While we positively note the financial sector's resilience as per the FSAP findings, the authorities are faced with persisting structural challenges. The banking sector's resilience to capital and liquidity shocks is commendable, although some risks may emerge down the road given the uncertainties related to a potential escalation of sanctions, rising energy prices, and a substantial downgrade of economic growth in Europe as well as an unwinding of the ECB's policy support. *As the banking sector's low profitability is a key longstanding weakness, we would welcome staff's comments if they consider it a regulatory problem or a business operation issue.* At the corporate level, banks need to improve their cost structure and invest in their IT infrastructure, to reap the benefits of digitalization for both front-office and back-office operations.

Developments in the real estate market warrant careful supervisory attention. We share staff's recommendation that legal obstacles for borrower-based macroprudential tools (LTV, DSTI or DTI limits) should be removed as a matter of priority, to include the tools in the

BaFin's macroprudential toolkit. *Staff's comments on the specific legal obstacles for borrower-based macroprudential tools would be welcome.* We also encourage the authorities to swiftly improve data gaps on lending standards, as they also constrain the deployment of borrower-based macroprudential tools.

Labor market weaknesses and demographic developments constitute a medium- to long-term challenge. Enhanced active labor market policies, including measures to promote female labor force participation, are critical to address population ageing. In the same vein, we see merit in further supporting immigration and devising sound rules and policies for the integration of foreign workers in the labor market.

The authorities are faced with a policy challenge related to upholding their climate goals, while strengthening energy security. Against the backdrop of highly elevated macroeconomic uncertainty, it is critical to beefing up public investments to strengthen energy security, and step up efforts to enhance diversification of energy imports, in order to lower energy dependency on Russian providers. At the same time, the authorities should not give up on their commendable climate change mitigation plans but significantly advance the green transition. In this context, we welcome staff's suggestions related to ramping up green investment, addressing regulatory and planning capacity bottlenecks and enhancing the cost-effectiveness of the authorities' climate change mitigation strategy.

Statement by Mr. Trabinski and Mr. Kuth on Germany
Executive Board Meeting 22/67
July 18, 2022

The German economy is increasingly suffering from the consequences of the war in Ukraine. Economic growth is slowing dramatically and inflation is rising to its highest level in several decades as supply disruptions, weaker confidence, surging energy prices, and looming gas shortages take their toll. The upcoming cold season is likely to further exacerbate imbalances in energy markets, posing the risk of further economic woes. New waves of COVID-19 infections—if disruptive—could further impact economic activity in Germany and its trading partners.

The authorities' policy response to limit spillovers from the war on energy markets are justified, but should become better targeted. Given that imbalances in energy markets will likely remain for some time, distortive and costly fuel tax cuts are not a sustainable instrument. Going forward, as better data on vulnerable groups become available, a transition to more targeted support would be desirable. We consider the reactivation of previously shuttered coal-fired power stations as an unfortunate setback for the country's transition to carbon neutrality, which should be reversed as soon as possible.

Contingency measures and longer-term reforms to enhance energy security and build resilience are critical. Initiatives such as the European Commission's REPowerEU should be further enhanced through international energy cooperation among a wider set of like-minded countries. As the scenario of a complete cut-off of Russian gas becomes more realistic, it is important to ensure the operability of energy companies to prevent a collapse of energy markets. To this end, the passing on of price increases to end consumers should be allowed along with additional investments in the energy sector. In addition, cutting red tape must be accelerated to boost investment in clean energy infrastructure, i.e., by simplifying administrative processes and improving planning capacity, financing and coordination across different levels of government. Finally, it will be crucial to facilitate an appropriate structural transformation of the economy by increasing labor supply and reducing skill mismatches.

Fiscal policy should be flexible and possibly recalibrated to growing downside risks. We agree that a neutral fiscal stance is appropriate in a context of rising inflation. Although exceeding the debt brake rule's new borrowing limit of 0.35 percent of GDP with special budget funds may be possible in the coming years, we caution against undermining the credibility of the fiscal framework. Instead, a return to the regular target of the debt brake rule in 2023 would underscore the authorities' determination to ensure fiscal sustainability. However, the authorities should also prepare for more negative scenarios outlined in staff's risk assessment matrix. Most notably, downside risks include the impact of further supply disruptions in international trade and—at least for another year—energy supply challenges.

Automatic stabilizers and flexible, targeted support should be the first “line of defense” against deteriorating economic conditions. In addition, preparations for activating the escape clause of the debt brake rule may be warranted. *Could staff comment on the probability of such a scenario materializing? Could staff also comment on the possibility that the authorities issue more debt, while the debt brake’s escape clause remains activated?*

We welcome the FSAP’s findings but would have expected a greater focus on non-bank financial intermediation. We note that unlike the banking sector, the non-bank financial intermediation sector in Germany has grown steadily over the past decade, reaching about 40 percent of the country’s financial sector by the end of 2020. *How does staff assess the potential systemic risks posed by non-bank financial intermediation in Germany?*

Statement by Mr. Buissé, Mr. Roman, and Mr. Grossmann-Wirth on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for an insightful report, including the very timely Selected Issue paper and supplementary information document. We also thank Mr. Stephan and Mr. Krahnke for their informative Buff. We agree with the thrust of staff's appraisal, and we associate ourselves with Mr. Pösö's statement. We would like to offer the following remarks for emphasis and questions to staff:

We agree with staff that the German economy was firming up before the war against Ukraine but that headwinds are now significant, including in relation to the tightening of gas supply. The German economy, as many other countries in Europe and around the world, is facing higher energy costs, the worsening of supply chain disruptions and increased uncertainty. On energy security, we concur with staff and the German authorities that cooperation with other EU countries, including in the context of the REPowerEU, is key. We welcome the detailed analysis of the potential loss associated with a gas shutoff in the SIP (and the following supplementary information document). While we welcome the clarity on the specifications and assumptions used for the scenarios, caution remains warranted on the quantification of the impact. *Regarding the gas shutoff scenarios, could staff indicate whether they consider that they fully take into account the "demand side" effects of the assumed increase in gas prices (beyond the confidence effect)? Could staff also further detail their view and possible implementation advice on the auction mechanism for industrial gas consumers envisaged by the German government?*

On fiscal policy, we agree with staff's assessment on the need to continue increasing public investment, while maintaining flexibility to extend targeted support if needed. In line with Mr. Pösö's statement, we consider that past fiscal measures were key in limiting the economic and social fallout of the pandemic and are now helping vulnerable households and firms to cope with high energy costs and potential gas shortages. Fiscal policy should remain flexible to extend additional targeted support if needed while promoting energy efficiency. We also share staff's recommendation that Germany needs to intensify public investment to enhance energy security and advance the energy transition, while taking into account raw materials and intermediate goods supply. An increase in investment and domestic demand will also contribute to the longer-term decrease of macroeconomic imbalances and would benefit Germany by allowing it to reduce its dependency on exports from third countries.

On climate more specifically, we fully agree with staff and the authorities that a green investment push will be essential, together with adequate carbon pricing, to achieve climate targets. We note staff's assessment, largely shared by the German authorities, on the role of the increase in public financing to leverage private financing, simplify administration,

and strengthen coordination between different levels of government. *Could staff further present their view on the impact of the energy transition on the German industrial sector, particularly regarding the automotive sector in the face of various changes (decarbonization, electric cars)?*

Regarding structural reforms on the labor market, we agree with staff and the authorities on the need to boost labor force participation and address demographic challenges. As argued in the report and in Mr. Stephan and Mr. Krahnke's Buff, this will require efforts to promote up- and re-skilling of workers and to provide incentives to increase labor force participation, including through high-quality childcare facilities and increased participation of female workers. We also welcome the confirmation that the German government is working on further enhancing integration programs for migrants to facilitate their participation in the labor market.

We share staff's assessment on the overall solid capitalization of the German banking sector, but also on new challenges and remaining risks. We welcome the IMF's stress testing exercise and the finding that SIs and LSIs are resilient to severe shocks. At the same time, German banks' persistent low profitability remains a challenge. We take note of the German authorities' views on the potential activation of borrower-based measures only following a solid financial stability risk assessment. We support the call for a redesign of the Deposit Guarantee Schemes and Institutional Protection Schemes, in line with a European deposit insurance scheme (EDIS), in view of avoiding fragmentation and the weakening of the internal market for banking services.

Statement by Ms. Mannathoko and Ms. Maudi on Germany
Executive Board Meeting 22/67
July 18, 2022

We thank staff for the informative reports and Mr. Stephan and Mr. Krahnke for their insightful Buff statement. Like the authorities, we broadly concur with the staff appraisal and offer a few observations.

Strong economic management has ensured Germany's resilience to past shocks and will continue to play a crucial role as the economy navigates the latest shock from the Russian war in Ukraine. Given pressures on the fiscus, we note the government strategy to gradually exit from crisis support and re-build risk buffers. The government has confirmed that targeted and temporary support measures adopted in response to the fallout from the war, shielding vulnerable households will be phased out, as will energy subsidies moderating firms' gas and electricity costs that are slated to expire late this year. We view this as a continuation of the culture of prudent economic management.

The planned investment drive will be critical for growth. A well-balanced policy mix will be needed, with close monitoring of inflation and possible measured monetary policy responses at the euro area level if necessary to discourage a de-anchoring of inflation expectations. As rising inflation reduces household purchasing power, if not contained, this will further dampen the rebound of private consumption that supported the recovery. We agree that measures to pull back targeted support and rebuild buffers will also help avoid adding to inflationary pressure.

Fiscal policy: The authorities' neutral fiscal stance in 2022 is appropriate. Alongside targeted support, we applaud the authorities' increased social spending to support refugees from Ukraine. With the recovery of the German economy interrupted by the war in Ukraine, we agree that priority should be given to boosting infrastructure investment and accelerating digitalization and the green energy transition to lower dependency on energy imports and support energy security. Addressing supply side constraints will also help to slow inflation. Noting the uncertain and volatile global environment, we agree that it is critical that the authorities focus on an effective forward-looking fiscal and investment policy stance that boosts potential growth, while ensuring the sustainability of public finances. We welcome the government's goal to foster and crowd-in private investment, which will be critical in accelerating the transition to green energy and digital transformation needed to boost productivity and growth in the medium term. We welcome the use of Energy and Climate Fund investment for infrastructure needed to reach the ambitious climate targets. *Could staff comment on recent moves to overhaul the law, allowing government to buy stakes in energy firms that are badly hit by the soaring gas prices? What implications will this have for the fiscal sustainability?*

Energy security: We appreciate the selected issues paper, providing scenarios for gas shortages and associated costs around Germany's vulnerabilities. We welcome the authorities' measures to prepare for such scenarios, including by diversifying sources of gas imports and reducing dependence on gas and adopting measures to increase energy savings. We also welcome the authorities' planned support to ensure the solvency of energy

companies and to further target income support to the vulnerable households should an adverse scenario materialize. *Regarding the country's three-tiered emergency gas plan, could staff comment on whether there are any plans to undertake a formal gas supply stress test to assess how well companies can cope with a sudden supply shortfall and if the Fund can help in this regard?*

Financial sector policies: While financial conditions have tightened recently and risks to the economy and the financial system have increased, the financial sector has remained resilient to shocks. Nevertheless, increased economic risks, with spillovers from the Russia war in Ukraine, present potential financial stability risks that require close monitoring. We concur with the recommendations of the FSAP report on the need to strengthen macroprudential measures for the banking and insurance sector. We also encourage continued review of the design of the fragmented deposit insurance system and consolidation of existing mandatory schemes into a single scheme. Furthermore, we note that closing data gaps to support risk monitoring and calibration of macroprudential tools requires attention. We welcome the introduction of a sectoral systemic risk buffer on loans secured to address domestic residential real estate challenges. That said, we urge the authorities to strengthen this area in 2023 as recommended by staff. We welcome the authorities' commitment to strengthen the AML/CFT system, including by implementing the FATF "Travel Rule in 2021" and the planned update of the National Risk Assessment (NRA) by end-2022.

Structural reforms: We welcome momentum in this area and note that speeding up the digitalization of the economy requires significant investment in digital infrastructure, a more rapid modernization of the state and better coordination of policies across levels of government. Labor market reforms to ensure labor reallocation towards booming sectors will be important and will help contain wage inflation from labor shortages. We agree that it is especially important at this time to shield employment with the short-time work program, in order to limit layoffs and scarring and protect social stability. At the same time, shortages of skilled labor can also be addressed by raising female labor force participation and upskilling of low-skill workers. We welcome the authorities' commitment to advance labor force participation and address demographic challenges, including by enhancing integration programs for migrants as indicated in the Buff statement.

Finally, we applaud the German government's strong international role in development cooperation, humanitarian aid and international climate action, and note the significant allocation for international development in the draft 2023 budget. We wish the government and people of Germany every success in the reform effort.

**Statement by Rasmus Rueffer (ECB Representative) and Sander Tordo (Advisor) on
Germany – 2022 Article IV Consultation
IMF Executive Board Meeting
18 July 2022**

We would like to thank Mr. Stephan and Mr Krahnke for the informative Buff statement, and Staff for their balanced Report. We broadly agree with Staff and share many of the main findings. We associate ourselves with the statement of Mr. Pösö and would also like to highlight the following items for emphasis.

We broadly agree with the Staff's view on the economic outlook for the German economy, although we project slightly higher growth and lower inflation for 2022 and 2023. The German economy was hit severely by the fallout from the war in Ukraine, which interrupted the recovery from Covid-19 before GDP reached its pre-pandemic level. It affected the German economy through higher energy costs, the worsening of supply chain disruptions, and record high inflation developments, also resulting in increased uncertainty and lower confidence. Staff's projected path of GDP growth for 2022 and 2023 is below the June Eurosystem projections. This difference partly reflects the later cut-off date underpinning of the Staff projections as well as their assumption of more persistent negative effects of energy and food supply disruptions.

We broadly agree with Staff's assessment of the risks surrounding the growth outlook and that further downside risks exist in the near term. Those posed by developments related to the war and the subsequent energy crisis paired with intensified supply shortages remain the most relevant for the near term. We anticipate that these factors will negatively affect investment decisions and trade beyond what is entailed in the Staff's projections. Moreover, we agree with the view that the risk of a permanent de-globalization process is gaining prominence, which would have long-lasting negative effects on the German economy due to severe disruptions to supply chains and trade diversion. Regarding upside risks, we agree that the expected further waning of the pandemic would be beneficial for demand against the backdrop of a relatively subdued consumption path in the Staff projections. The upside risk would be associated with a further rebound in consumption over the summer of 2022, despite negative surprises in inflation affecting disposable income.

Overall, Staff's views on the long-term effects of the pandemic and the war on the German economy do not diverge substantially from ours and the scarring effects will be non-negligible. Staff expect a reduced level of potential GDP of 1.5% in 2027 which is broadly consistent with our projections. It is important to highlight that the scarring effects pertain to the level of potential GDP and not to its longer-term growth rate. Long-standing structural challenges, such as digitalization and demographic change, remain relevant for the medium term. The current account surplus has recently narrowed and is expected to remain subdued due to the deterioration in the goods trade balance. This could continue over the medium term amid a gradual realignment of relative price levels and strengthening of domestic demand. Against this background, and broadly consistent with Staff's analysis, ECB modelling analysis indicates that the current account surplus is still larger than warranted by economic fundamentals and desirable policies, although

the reliability of any normative quantitative assessment in this respect is significantly hampered by the impact of the pandemic and the war on external balances and key macroeconomic fundamentals both in the euro area and in its main trading partners. In this respect, we stress that, as in previous years, the current account gap cannot be traced to any domestic policy gaps in Germany.

We share Staff's recommendations on fiscal and structural policies. Germany needs to intensify public investment to improve energy security and further the energy transition. However, while more public investment is warranted, plans might want to consider the severe constraints on input supply pertaining to raw materials and intermediate goods, and thus prioritise projects with the highest feasibility rates. Energy-related measures should be temporary and increasingly adjusted towards targeting the most vulnerable. On the structural side, while reducing bottlenecks to public investment due to administrative inefficiencies and boosting the labor supply are important priorities, we also note that some other important structural issues still need to be addressed.

We agree with Staff's assessment of the German financial sector and their recommendations for both capital and borrower-based measures. In particular, we agree that Germany's banking sector's capitalization is overall solid. However, while German banks profitability rebounded quickly after a pandemic-related decrease, it remains structurally low, implying a relatively low internal bank capital generation capacity through retaining profits. Going forward, the continued rise in house prices leading to overvaluation, and a potential underestimation of credit risk pose medium-term vulnerabilities that have the potential to amplify losses and challenge financial stability in adverse scenarios. In this context, we agree that the recently announced policy mix of a CCyB and sSyRB increase appear commensurate to the cyclical vulnerabilities identified. We also agree that in addition to capital-based measures, an activation of borrower-based measures should be considered to address flow vulnerabilities. While comprehensive data on lending standards will become available only in 2023, making an in-depth assessment at the current juncture somewhat challenging, authorities may nonetheless want to already consider recommending to banks an LTV cap using non-binding measures to act as a backstop. Additionally, the legal basis for income-based measures should be created, as such measures will likely be needed in the near future.

FSSA specific comments

We consider the FSSA report a good example of how euro area and national FSAP exercise can usefully complement each other and how the national exercise can provide additional value added while avoiding unnecessary duplications. The findings of Germany IMF FSAP are broadly in line with the ECB's risk identification and assessment.

A. Financial sector developments and systemic risk analysis

- **For the FSAP solvency stress test, it should be noted that the adverse scenario is very different to that of the 2021 EBA and SSM Stress Tests.** The latter was characterized by a lower-for-longer narrative and did not include inflation risks. This – in conjunction with some methodological differences – hampers direct comparisons between the results of the two exercises and implies that such comparisons should be done only with due caveats. It should also be noted that the IRRBB analysis does not include detailed derivative data and thus, potential effects of hedging and embedded options under the considered scenarios could not be precisely resolved in the calculations.

B. Banking supervision and macroprudential policy

- **As regards banking supervision we agree with IMF FSAP recommendations aimed at reinforcing the operational capabilities and independence of BaFin, as well as its strategic cooperation with Bundesbank.** At the same time, we would like to stress the relevance of ensuring a balanced approach of the resources allocated to the supervision of Less Significant Institutions (LSIs) and Significant Institutions (Sis). We also support the recommendation related to review the minimum engagement level and inspection frequency, in order to avoid an excessive reliance on external auditors for all the matters that require risk quantification, in particular for credit risk. Finally, we also support the recommendation on the alignment of the corporate governance framework in the banking sector with the best international standards, as the incomplete implementation in the national provisions of EBA GL, BCBS principles and in some cases also of CRDIV, is currently hindering the legal basis for more decisive supervisory actions aimed at reinforcing the internal checking and balances of banking governance.
- **We fully agree with the Staff that Germany's macroprudential policy framework and toolkit are already quite well developed but should be expanded further.** Overall, the framework supports a willingness to act by assigning clear macroprudential tasks to the FSC, Bundesbank, and BaFin, and by having well-designed decision-making procedures. However, the framework could be expanded further to allow a timely activation of borrower-based measures.

Germany

Responses to Technical Questions Posed by Executive Directors in Advance of
EBM/22/67—July 18, 2022

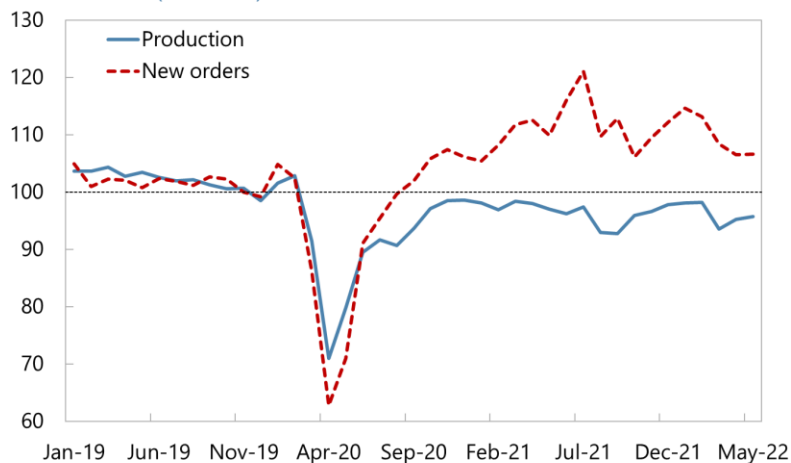
Staff's responses to technical questions are below. Broader policy questions in the areas of fiscal policy under the downside scenario will be addressed in staff's intervention at the Board meeting.

Growth/Inflation

1. **Staff's update on the authorities' ongoing assessments of the economic and financial implications of the gas shut-off scenario as well of contingency plans—if any—would be appreciated.**
 - In their [June monthly report](#), published on June 21, Bundesbank staff updated the assessment of the economic implications of a complete and permanent stoppage of all Russian energy exports to EU and elevated energy and food commodity prices. In this adverse scenario, the real GDP growth rate would be 1.4 and 5.6 percentage points below baseline in 2022 and 2023, respectively. HICP inflation would be 0.5 and 1.6 percentage points above baseline in 2022 and 2023, respectively. After the 60 percent curtailment of the Russian gas flows via the Nord Stream 1 (NS1), the simulations by the Federal Network Agency showed that if reduction remains at 60 percent, Germany can narrowly avoid gas shortages in the coming winter if gas exports can be compressed correspondingly, but a storage level of 90 percent by November would likely not be achieved without additional measures. Staff are not aware of any new contingency plans beyond what is reported in the staff report and the supplementary information.
2. **Given that significant headwinds to growth arise from conflict in Ukraine, the latter's resolution is a key determinant of expected growth recovery. Staff may like to elaborate on the underlying assumptions in this regard that have gone into its projections about the economic outlook.**
 - Incorporating the partial shutoff of NS1 flows, staff continues to estimate that Germany can avoid, albeit narrowly, shortages of gas in the next two winters if Russian gas flows do not decline further, with storage remaining below the authorities targeted levels. Accounting for the erosion of purchasing power and confidence due to rising risks and surging prices in the wholesale gas market, staff estimate the adverse impact to growth triggered by the partial shutoff of NS1 flows at about 0.5 percentage point for 2022 and 2023 (implying a cumulative output impact of slightly more than 1 percent in 2023). This means that staff has shifted 30–40 percent of the output loss for 2022 and 2023 in a full Russian gas shutoff scenario (Selected Issues Paper, Germany 2022 AIV) into the baseline.
3. **Regarding the gas shutoff scenarios, could staff indicate whether they consider that they fully take into account the “demand side” effects of the assumed increase in gas prices (beyond the confidence effect)?**

- Staff's analysis combines a model of the production (or 'supply') side of the economy with another model of uncertainty effects. Implicit in staff's analysis is a rise in gas prices due to shortages. In principle, 'demand' effects should be captured by the model of production because markets clear in equilibrium, so that demand effects equal supply effects. However, uncertainty could affect either demand or supply, and is absent from the production model, which is why staff includes the results from a model of uncertainty as well. As suggested by the question, there could be further imperfections in the economy, like slow-to-adjust prices or wages, or financial frictions, that further amplify the effects and make them larger than estimated by staff. This is one of several sources of uncertainty in the model estimates. For example, in the selected issues paper, staff explains the sensitivity of the gas shortage estimates to factors including infrastructure bottlenecks, gas supplies to neighboring countries, winter temperatures, and burden-sharing by households.
- 4. In our opinion, besides supply bottlenecks, demand factors have also played a significant role in pushing inflationary pressures. Can Staff provide insights into the relative role of demand and supply factors?**
- Staff agree that if demand outstrips supply—either due to supply constraints, or due to higher demand, the result will be higher inflation. Staff ([IMF WP22/31](#)) estimate that supply shocks contributed about 60 percent the increase in manufacturing PPI inflation in Germany between the pre-pandemic years and the second half of 2021, and a sizable share of the increase in core CPI inflation as well. Similarly, as shown by the indicators of production and new orders in manufacturing sector, demand has been above its pre-COVID level since the first COVID wave. Moreover, with the rebound in the demand for services on the back of reduced caution and the elimination of almost all pandemic restrictions, some firms are likely to be raising prices to make up for the losses they incurred during the pandemic.

Germany: Manufacturing Industrial Production and New Orders (2015=100)



5. Could staff comment on the impact of recorded inflation on consumer confidence and future price expectations? What are the obstacles of high inflation expectations feeding into wage claims?

- With rising inflation outturns, both near-term and 5-year household inflation expectations have been rising. Although inflation expectations for the coming five years implied by inflation-linked government bond yields have also drifted up, expectations for the five-year period starting five years from now (a measure of how well and what level expectations are anchored) has softened recently, to around 2 percent, after increasing above 2 percent in early 2022.
- The latest consumer confidence indices (e.g., Growth from Knowledge (GfK)) have fallen to historical lows, on the back of significant changes in multiple factors including uncertainty, prospects of the economy, and inflation. The literature has documented different results in how inflation expectations would affect consumer confidence and spending. For instance, higher prices expected in the future could increase the propensity to consume (as documented in the study by D'Acunto et al., 2016 for the 2007 VAT increase), but high inflation and the associated expected monetary tightening could also hurt households' perceived wealth. Therefore, teasing out the impact of inflation on confidence at this juncture is challenging.
- Wages are expected to catch up in the second half of 2022, as the scheduled minimum wage increase goes into force, and as wage negotiations of larger trade unions start (with demands for compensating for the recent high inflation rates). For instance, in late June, the wage negotiations for the steel industry settled with a 6.5 percent increase for 18 months, their highest wage agreement for 30 years, but about half of the union's initial demand of 8.2 percent for 12 months. So far, unit labor costs have returned to their pre-pandemic trend line. Looking ahead, the mounting downside risks to the economy are likely to dampen wage increases, as unions would tend to prioritize job security in a downturn. Although corporate profits were strong last year, the recent increase in energy prices is likely to squeeze profits and limit the room to accommodate high wage demands.

6. We observe that the German economy is facing tightness in the labour market, and the participation rate during the post-covid period has not been able to offset the demographic trends. Nevertheless, this has not been reflected in wage pressures which have remained relatively muted and broadly aligned with the rise in GDP deflator and CPI between 2020 and 2022. Staff may like to elaborate. What are the obstacles of high inflation expectations feeding into wage claims?

- German labor market has shown signs of tightness, as demonstrated by high vacancy-to-unemployment ratio and the share of firms reporting labor shortage as one of major factors constraining production capacity. However, several factors have contributed to the more muted wage growth so far. First, some labor market weakness remains—for instance, labor force participation and hours worked per worker have not fully recovered, and the number of workers on short-time work scheme is still above pre-pandemic levels. Second, in the first half of 2022, only a few of the larger sectors will be

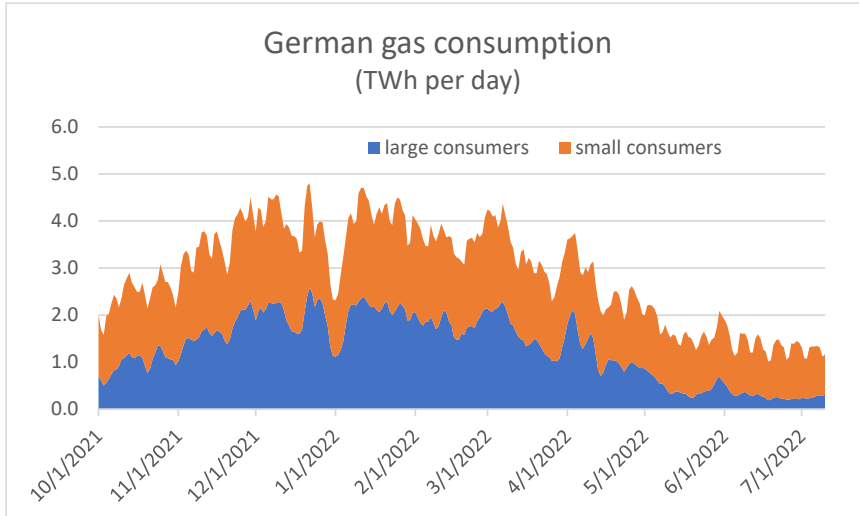
negotiating new collective wage agreements; thus, the influence of the old, low agreements continue to play a predominant role. Third, energy—the driving force of inflation—are largely imported, therefore the current high energy inflation would impair firms profit if the cost can't be fully passed to consumers and thus narrow the scope for satisfying wage demands.

Energy Policy

7. Staff's update on gas supply developments is welcomed, including on the Nord Stream 1 pipeline shutdown, and on households' and industry's gas-consumption decline as the result of the gas-savings campaign.

- As of July 14, gas storage facilities in Germany were filled to 64.5 percent of capacity, which is in line with staff's baseline projections in the Selected Issues Paper. However, since these storage facilities are filled more now than they were on June 1, 2022, which is the data of shutoff analyzed in the Selected Issues Paper, the impact of a shutoff starting now would be smaller than estimated in the paper (starting on June 1). On July 11, the Nord Stream 1 pipeline was shut for maintenance, meaning that no gas is currently flowing through this pipeline into Germany. Maintenance is scheduled to end on July 21. Given the high level of tensions, the risk is high that flows through Nord Stream 1 do not resume on July 21, either for technical or political reasons.
- Daily gas consumption in Germany has fallen by two-thirds since Russia's invasion of Ukraine (see chart below). This drop in consumption reflects some combination of warming temperatures, higher gas prices, a substitution of coal for gas in electricity generation, voluntary energy savings, and the government's energy saving campaign. Staff does not have an estimate that isolates the effect of the latter. However, Ruhnau et al. (2022) find that voluntary energy savings and the government's energy saving campaign together may have contributed to reductions in gas consumption of 6 percent for households and 11 percent for firms.

Ruhnau, Oliver, Clemens Stiewe, Jarusch Muessel, and Lion Hirth, 2022. Gas demand in times of crisis. The response of German households and industry to the 2021/22 energy crisis. ZBW – Leibniz Information Centre for Economics, Kiel, Hamburg.



8. Regarding the country's three-tiered emergency gas plan, could staff comment on whether there are any plans to undertake a formal gas supply stress test to assess how well companies can cope with a sudden supply shortfall and if the Fund can help in this regard?

- As Russian gas supplies to Germany have been curtailed, first to Gazprom Germania and then through Nord Stream 1, German gas utility companies have been forced to substitute these low-cost supplies with more expensive purchases on the spot market. This has raised their costs. At the same time, many gas customers are on fixed-price contracts, meaning that the utility companies cannot immediately pass on their higher costs to customers. As a result, some German gas utility companies are incurring large financial losses. If the remaining Russian gas supplies to Germany are shut off, these financial losses could mount, threatening the solvency of these companies, and potentially exacerbating the gas insecurity situation. Since German customers often receive gas from small distributors, which are supplied by large gas importers, insolvency of a gas importer could lead to further cascading insolvencies at smaller distributors. Furthermore, there is an argument to maintaining the flow of gas, including because safety considerations make it technically challenging and costly to restore the flow of gas through pipelines that have previously been shut-off. For all these reasons, the government is rightly concerned about financial constraints on German gas utility companies exacerbating gas shortages, with potentially large economic effects.
- The legal amendments are part of the government's contingency planning for a further deterioration of the gas security situation. Therefore, the government has announced that they will not immediately be used. Increases in the need for liquidity support for utility companies, if happens, can raise the government's debt or contingent liabilities (e.g., guarantees). Nevertheless, Germany has ample fiscal space, and ensuring the financial soundness of gas utility companies could avoid potentially large economic losses, which could also help the fiscal position.

9. Could staff comment on recent moves to overhaul the law, allowing government to buy stakes in energy firms that are badly hit by the soaring gas prices? What implications will this have for the fiscal sustainability?

- The Federal Network Agency maintains a public dashboard of real-time gas flows into Germany and gas storage levels. The same agency also conducts regular internal scenario analyses to assess the security of gas supply, which would help to identify an emergency in advance. One such scenario analysis was made public on June 22, 2022. Staff have advised that updates to these scenario analyses be published regularly to help encourage energy savings and help planning. The Federal Network Agency has also conducted surveys and interviews to assess the gas usage needs of firms in different economic sectors, with a view to designing a scheme that could be used to ration the available gas supplies, in the event of an emergency, in the least disruptive manner possible. The Bundesbank and the Economy Ministry have been analyzing the effects on different economic sectors of a shutoff of the remaining Russian gas supplies; the Bundesbank published the macroeconomic implications of its analysis in its April and June monthly reports. Finally, the Bundesbank and Bafin have been analyzing the risks to the financial sector of the same scenario. The authorities provided helpful feedback on staff's own analysis of this scenario. Staff stand ready to assist the authorities, including through additional analysis if needed.

10. Could staff elaborate on the expected effectiveness of the solidarity agreements and the financial incentives in encouraging gas savings and mitigating the rationing of energy-intensive business activity? Relatedly, could staff further detail their view and possible implementation advice on the auction mechanism for industrial gas consumers envisaged by the German government?

- In staff's view, financial incentives are a powerful tool for influencing gas consumption, and typically involve allowing price signals to operate. Higher prices need to be paired with targeted income support for vulnerable groups. One possible source of financial incentives is the authorities' new power to allow wholesale gas price fluctuations to be passed on in an emergency to end-users, even if they are on fixed price contracts. This power has not been activated yet.
- Another source of financial incentives is the authorities' announced plan to develop an auction mechanism to encourage gas savings. Such a mechanism has the potential help deliver meaningful gas savings at the lowest possible cost to economic activity. Staff do not have further information on the authorities' plans for the auction mechanism, other than what has been speculated in the news media. The media has reported two possible auction designs, both allowing the protection of consumption by designated groups, which could include households and hospitals, from rationing. One option could be to auction the remaining available gas supplies, and the other could be to auction reductions in consumption relative to last year's level. In staff's view, important questions would have to be answered, including how many firms could practically be included in such an auction scheme, how to differentiate between microenterprises and households, and whether there are technical constraints on the design of such a scheme.

- While solidarity agreements offer little in the way of incentives to save gas, they help to share the burden in a way that avoids very severe outcomes. The ‘trigger’ for a solidarity request is if protected customers (like households or hospitals) in one country cannot be fully supplied with gas.

11. We note the difference of views between the authorities and staff on the merit of subsidies for firms’ gas and electricity costs. We would appreciate staff’s views on the authorities’ argument that such subsidies would not materially disincentivize energy saving because they have strict eligibility criteria, are temporary and would decline over time, and they cover only a portion of the increased energy cost. Could staff also comment on how these subsidies fit with the authorities’ agenda to enhance energy efficiency and to use carbon prices to drive the energy transition?

- In principle, gas subsidies would lower the price that firms effectively pay for gas, which in turn would blunt some of incentive to save gas that is associated with currently high gas prices. However, in this case, the government plans that such support would have strict eligibility criteria, be temporary, decline over time, and cover only a portion of the increased energy cost. This temporary and targeted nature of the subsidies reduces, but does not eliminate, the associated disincentive to save gas. In the weeks since these subsidies were first contemplated, the urgency to save gas ahead of the winter has increased with the rising tensions in gas markets.

12. We would appreciate staff’s elaboration on the SIP baseline scenario that suggests that gas shortage can be avoided, but only narrowly. Does it consider subsidies to firms?

- In the baseline scenario, gas consumption for both households and firms is assumed to evolve each month in line with the average consumption for that month in the previous five years, adjusted down to reflect higher gas prices than in the past. Staff’s analysis does not make explicit allowances for the subsidies because detailed firm-level gas consumption data would be needed to identify which firms are eligible for the subsidy, and such data were not immediately available to staff.

13. We note that the EU and Germany have agreed to gas supply partnerships with the U.S. and Qatar respectively, could staff comment on the extent to which these partners could help to offset gas shortages, as well as other sources of gas supplies?

- The gas shortages that staff estimates in the Selected Issues Paper already account for continued purchases of LNG on the spot market, which include gas from the US and Qatar (in unknown quantities), at their current rate. In its statement on March 25, the United States committed to working towards supplying the EU with additional volumes of 15 billion cubic meters of LNG in 2022. The terms of Germany’s energy security partnership with Qatar are not public information. However, it is staff’s understanding that any gas supply agreements under this partnership would substitute for purchases

that would otherwise take place on the spot market. Therefore, such agreements would be more about price than about new sources of supply.

14. On nuclear energy, we would be interested in further staff’s elaborations on the assessment behind the government’s decisions to confirm the phasing out of nuclear energy by end-2022.

- In staff’s view, all policy options to enhance Germany’s energy security should be considered. The German government examined the question of whether the life of the nuclear power plants should be extended, and published its findings on March 7 (“Examination of the continued operation of nuclear power plants due to the Ukraine war”). This question is complex because the plants would only be able to produce electricity after 2022 if they were able to secure new supplies of uranium rods, and new required safety inspections could delay the production of electricity as well. The government may also have to assume large fiscal risks to keep the plants operational. For these and other reasons, the government concluded that the risks of extending the life of nuclear power plants exceed their benefits in terms of increased electricity generation. IMF staff do not have the expertise needed to evaluate the nuclear energy aspects of this decision.

15. In the staff analysis we missed the overall size of each measure to have a better idea of the balance between targeted and untargeted measures. Creating a comprehensive information system on households would allow for better targeting. Could staff provide more details on the type of data that would be collected by the system?

- Staff estimate that measures to cushion the impact of high energy prices would cost around 1 percent of GDP in 2022. Less targeted measures for households (e.g., lump sum payments for all employees and the self-employed as a salary supplement, discounted cost for public transportation) and measures to limit price pass-through (e.g., fuel tax cuts, abolition of the renewable surcharges) would make up around half of the total cost, suggesting some potential efficiency gains from shifting toward more targeted measures.

Germany: Estimated Fiscal Cost for Measures to Cushion Higher Energy Prices
(Percent of GDP)

Measures to slow price passthrough	0.14
Targeted support for households	0.05
Partially-targeted or uniform support for households	0.40
Support for firms (incl. short-time work benefit)	0.37
Gas Procurement	0.04

Sources: staff estimates based on budget documents and other publicly available information.

- Staff understands that the information system is being worked on and details are yet to be clarified. A key issue for targeting now is that while the government has adequate information on households and individuals who receive social benefits, it does not have

information on the rest of the population that enables the government to assess who are vulnerable to high energy prices. Filling this information gap would help the government deploy better targeted and more effective measures.

Fiscal Policy

16. We welcome the indication that the Ministry of Finance already reports annually the consolidated financial positions of public corporations. Could staff indicate whether such reporting covers the contingent liabilities associated with the quasi-fiscal activities undertaken by state-owned banks and public corporations? Did staff discuss with the authorities further mechanisms to enhance the monitoring of contingent liabilities?

- The German constitution requires that explicit guarantees provided by the government must be specified, quantified, and authorized in a federal law (i.e., the federal Budget Act). In this context, the Ministry of Finance regularly publishes guarantees provided by the federal government, which stood at 14.9 percent of GDP as of end-March 2022. This amount includes government programs that were implemented through KfW and the economic stabilization fund created during the COVID-19 pandemic (WFS). Separately, KfW reports guarantees provided using its own capital, which amounted to 0.12 percent of its total assets at end-2021.
- Quantifying Germany's implicit contingent liabilities is challenging given Germany's large and complex public sector presence in the economy ([Fiscal Monitor 2018](#)). The government discloses its ownership information of public and private corporations and also evaluates the stability and liquidity of the respective companies, as well as their risks, and therefore also indirectly assesses the risks to the federal budget. However, in staff's views, such reporting can be enhanced by quantifying expected cost and maximum probable loss of contingent liabilities.
- To further enhance fiscal transparency and risk management, staffs view (as stated in the staff report) is that the Ministry of Finance could provide a consolidated report of fiscal risks, covering the contingent liabilities associated with the quasi-fiscal activities undertaken by state-owned banks (e.g., KfW) and public corporations, based on analysis by line ministries on the public corporations under their respective span of control. The expected cost and maximum probable loss of contingent liabilities should be quantified in this report.

17. 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?

- Staff will respond to this question during the Board meeting.

18. Given the somewhat different perspectives, we would like to hear staff's comments on the authorities' view that some technical changes that are being considered would be sufficient to create additional fiscal space without having to resort to a constitutional change.

- Staff have not seen detailed reform proposals. That said, staff understood that the technical changes considered by the government are expected to make fiscal policy more counter-cyclical and symmetric around the business cycle. This means that the changes would increase the scope for borrowing when macroeconomic prospects worsen, like the current juncture, but they would not provide additional fiscal space over the entire business cycle.

Climate

19. With the national carbon price been considerably lower than EU Emission Trading System (ETS), we take note of the authorities' view on having a single carbon price in the EU and would appreciate if staff could elaborate on where other EU countries stand on this.

- In the context of the EU's "Fit for 55" package—which comprises 12 legislative proposals that are key to operationalizing the emission reduction targets set out in the EU Climate Law—the EU will introduce an EU ETSII for the road transport and building sectors. The EU ETSII will complement the existing EU ETS, which covers the energy and industry sectors. While the EU ETSII is expected to result in a single carbon price in the EU for the transport and building sectors, carbon prices can differ between the EU ETS and EU ETSII.

20. 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?

- The floating storage and regasification units are expected to cost the government around €3 billion over the next decade. The draft federal budget for 2023 shows that the government allocates €274 million for these units for 2023. Separately, Germany plans to build three on-shore LNG terminals in Brunsbüttel, Wilhelmshaven, and Stade. The terminal in Brunsbüttel will be co-financed by KfW, Gasunie (100 percent owned by the Dutch state), and RWE, and €10.6 million is included in the draft federal budget for 2023. Staff expect other terminals to be also funded jointly by the private sector, but the fiscal cost is yet to be clear.
- As indicated by the authorities in their statement, the government is committed to using the earmarked funds of over €80 billion for climate policy measures to support 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. Staff do not have estimate for the fiscal cost specifically for solar and wind power generation.

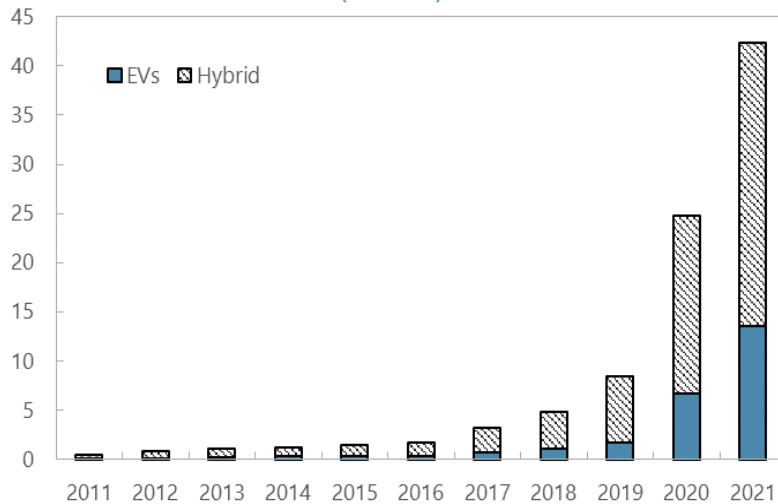
21. Against the backdrop of energy shortage, it was reported that Germany reactivated previously shuttered coal-fired power stations and increased reliance on coal, could staff comment on its impact on climate mitigation and the envisaged coal phase-out by 2030? Due to the worsening energy scenario and scarcity of natural gas, Germany has increased its reliance on coal. Have there been any revisions in the climate-related goals?

- Germany's emissions targets of a 65 percent below 1990 levels by 2030 and net zero emissions by 2045 remain unchanged. The goal of completing the phase-out of coal by 2030 also remains untouched. Staff expect a short-term setback from reactivating previously shuttered coal-fired power stations to be fully offset by a faster emissions reduction in the years to follow on the back of Germany's stepped-up decarbonization efforts.

22. Could staff further present their view on the impact of the energy transition on the German industrial sector, particularly regarding the automotive sector in the face of various changes (decarbonization, electric cars)?

- The government has noted that transforming industrial production processes, including the electrification, is necessary for the industrial sector to become climate-neutral ([BMWK 2022](#)). In addition to the availability of electricity from renewable energies, it requires the use of hydrogen (or its derivatives), especially where direct electrification is not possible, the use of sustainable biomass as a material, and innovative technologies for the efficient use of raw materials (e.g., lightweight construction). The government also indicates that technical negative emissions (e.g., carbon capturing) will also be necessary.
- The automotive sector has been taking steps to promote the green transition. In addition to expanding investment in hybridization, electric mobility, and digitalization, some companies now link the remuneration of members of the board of management to decarbonization progress. Production capacity of batteries in Germany is also to be expanded in the coming years. However, supply shortages of microchips and some raw materials could hamper the production of cars, including EVs.
- Aided by the stepped-up government incentives and high fossil fuel prices, demand for EVs has been rising; the share of EVs and hybrid cars in new car sales rose to 42 percent in 2021 (from 5 percent in 2018). However, expanding further charging stations would be key to sustain this upward trend, which is also critical given the decision of ban the sale of vehicles with combustion engines by 2035 at the EU level.

Germany: Share of EVs and Hybrid in New Registrations
(Percent)



Labor market/structural reforms

23. Can staff estimate the potential economic gains of closing gender gaps in Germany?

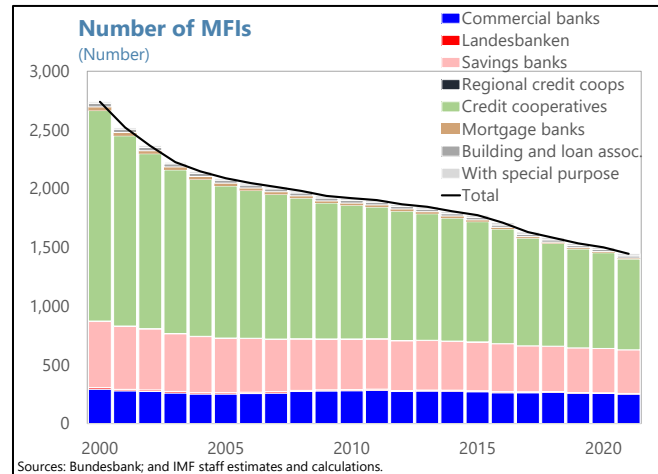
- In the 2015 AIV of Germany and the accompanied Selected Issues Paper, staff estimate that if the difference in average hours worked by men and women were fully closed, potential output would increase by as much as 7.5 percent, and closing both the labor participation rate and average hours worked gaps could increase the total hour worked by 9 to 12 percent. Labor force participation rate gap has reduced from 9.5 percent in 2014 to 8.1 percent in 2021, and average hours worked gap has declined from 9.4 hours in 2014 to 7.8 hours in 2021. Nonetheless, closing the remaining gaps would yield sizable economic gains for Germany.

Financial sector policy

24. Could staff suggest possible causes for why competition is not driving consolidation of branch and staff numbers? What are some plausible policy implications for the authorities given that many banks are privately owned?

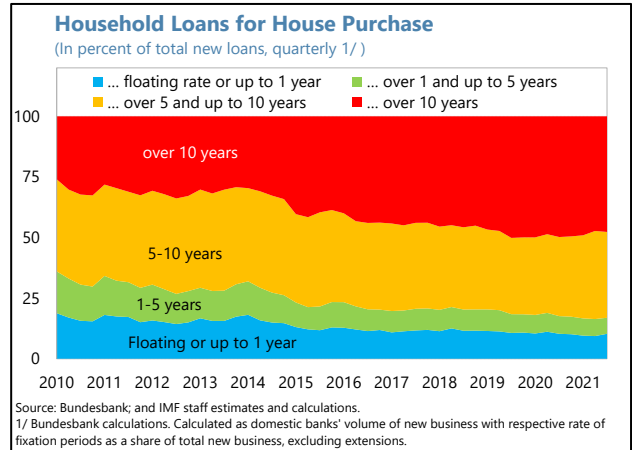
- With some 1,446 banks at end-2021, competition in the German banking sector remains strong, but significant consolidation has taken place over the last few decades. Specifically, both the number of bank branches and bank employees per capita have declined substantially over the past several decades. For instance, the number of banks almost halved during 2000-21, largely driven by consolidation within credit cooperatives and, to a lesser extent, within savings banks (chart). During 2010-20, branch penetration declined from 0.48 to 0.29 branches per thousand inhabitants, while the number of bank employees per capita declined from about 8.3 to 6.9 employees per thousand inhabitants. Given customer preference for the traditional brick-and-mortar bank

business models and conventional products, for years, German banks reportedly continued to display reluctance to cut costs and increase revenues more aggressively in fear of losing customers amid strong bank competition. More recently, however, urbanization and migration increased population growth in larger cities, where customers increasingly prefer cheaper and faster bank services instead of physical branches. Historically low-interest rates on bank savings accounts prompted interest in asset management products, potentially giving rise to greater noninterest fee earnings in the future. The COVID-19 pandemic accelerated this trend toward digital products, facilitating banks' transition to digital platforms. Going forward, continued market-led consolidation, resulting in fewer but more profitable institutions, is crucial for attaining economies of scale, particularly given a large share of private banks.



25. **We agree with staff that it would be suitable to conduct additional analysis of the impact of the war, sanctions, and energy prices spike on the German financial stability. Could staff indicated if this has been done since the finalization of the report and if yes what are the preliminary conclusions.**
- The authorities are closely monitoring events and evaluating the impact of energy price hikes and shortages on the financial sector balance sheets. The FSAP assessments, which were done in March and April, however, relied on very conservative assumptions. The size of the shock to real GDP in the adverse scenario remains significant even under the latest staff update of baseline projections. Under the latest EUR desk projections for real GDP growth (1.2 percent for 2022 and 0.8 percent for 2023), the adverse scenario of the FSAP now broadly corresponds to a 1.9 standard deviation shock to real GDP growth over two years relative to the new baseline. Under the baseline of the solvency stress test as of March 2022, the shock to real GDP growth was three standard deviations relative to the baseline. A shock of 1.9 standard deviation remains close to shocks applied in past FSAPs (two standard deviations) and therefore remains comparatively relevant and significant.
26. **How does staff assess the impact of rapidly increasing mortgage rates on the housing market?**

- For households, rising interest rates could increase the interest burden on borrowers, potentially leading to higher non-performing loans. However, the risk on banks stemming from (mortgage) borrower default is mitigated by a full recourse on residential mortgages and the extended fixed-rate periods on mortgages. Over the last decade, banks' higher-yielding mortgages have been gradually replaced by newly underwritten or refinanced loans with longer fixing interest rate periods and lower interest rates (chart). This suggests that a large share of mortgage borrowers would not experience higher debt service for some time. Rising mortgage rates may lead to lower demand for new mortgages and housing. With lower housing demand, residential real estate price growth would likely decelerate. The extent of such correction is difficult to pinpoint since the house price growth reflects both demand and supply factors. On the demand side, historically, low-interest rates, combined with stable income growth, have supported housing demand over the last decade. On the supply side, housing supply has been inhibited by the construction sector labor shortages, capacity constraints, land scarcity in urban areas, and more recently, supply chain disruption, among others. Also, because mortgage rates are fixed rate, there is no credit risk impact of rising interest rates on the existing stock of mortgages and therefore no stability impact on banks through this channel.



- 27. As the banking sector's low profitability is a key longstanding weakness, we would welcome staff's comments if they consider it a regulatory problem or a business operation issue.**
- To a large extent, German banks' low profitability is the result of the operational environment, macro-financial conditions, and customer preferences. Since the GFC, low bank profitability has been largely driven by low interest rates and flat yield curves, high competition, and customer preference for the traditional brick-and-mortar bank business models and conventional products, among others. There is, however, significant heterogeneity among different types of German banks. Commercial banks, particularly large private banks, have reported low returns since the GFC. Having suffered substantial losses due to risky investments, large private banks have undergone extended periods of costly restructuring, with substantial headcount and branch network reductions, business models' de-risking, and greater costly digitalization. Meanwhile, savings and cooperative banks – which largely fund their operations through customer deposits, rather than the interbank market – continued to report relatively stable profitability with continuous access to funding from retail deposits. This allowed them to increase market share and loan volume growth, which partially helped offset declining interest rates.

28. Staff’s comments on the specific legal obstacles for borrower-based macroprudential tools would be welcome.

- The German Banking Act (KWG, amended 2017) para. 48(u) deals with measures to limit macroprudential risk in lending for construction or purchase of residential real estate in Germany (“tools”); specifically, powers to set minimum loan-to-value ratios on real estate financing; and powers to set maximum repayment periods (for interest-only loans) or minimum loan amortization rates. A tool may be activated “if and to the extent” it is necessary to avert a “threat to financial stability”. In staff’s view, the law does not allow for adequate preparation for the case where the tools should be activated preemptively. So, although it is possible to argue for activation on some other basis, in practice this would appear quite unlikely, especially for the type of precautionary action recommended in the past (IMF 2018, ESRB 2021). And, in practice, the authorities have been quite clear that they currently consider a “threat to financial stability” to be present only if all three factors—rapid price growth, lending growth, and higher LTV ratios—are in play. The latter factor remains particularly hard to establish, as there have been long delays in establishing the necessary framework for collecting granular data on lending standards. A final set of legal obstacles relates precisely to the data gaps. Activation of the tools requires a number of ancillary values to be set, as well as various thresholds (48(u)§3). It also requires an ongoing review process to be undertaken. Such requirements might be challenging to satisfy in the absence of granular lending data, the first wave of which will become available only in mid-2023.

29. How does staff assess the potential systemic risks posed by non-bank financial intermediation in Germany?

- The FSAP interconnectedness exercise looked at domestic and cross-border interconnections (direct financial links between institutions, common exposures) and their evolution over time. It also worked on the characterization of networks among banks and between banks and insurance companies, and investment funds. The analysis identified significant intersectoral linkages among monetary and financial institutions and non-bank financial institutions but risks appeared to be limited given the conservative investment policies in the insurance and investment fund industry. The lack of granular data, however, limited the depth of analysis of these links. At the time of the FSAP, EIOPA was conducting stress testing of the insurance sector in EU, and ESMA was conducting a peer review on supervision of cross-border activities of investment firms, that included Germany.

External

30. What else can the authorities do to meaningfully address Germany’s external imbalances over the medium term?

- In the external sector assessment, staff note that policies for external rebalancing should aim both to increase investment and reduce excess savings. On investment, beyond the decarbonization and digitalization needs identified in the question, structural reforms to

foster innovation, including development of the venture capital market and reducing the administrative steps needed to start a business, would also stimulate investment. On excess savings, these could be reduced through additional tax relief for lower-income households.

31. Would staff anticipate a prolonged weakening of Germany's external position in light of the significant drop in the Euro against the USD and lingering uncertainties in the supply chain?

- Staff expect that fossil fuel prices will remain high over the medium term, representing a prolonged deterioration in Germany's terms of trade, which will weigh on the current account balance. The depreciation of the euro that we have seen in nominal and real terms might buffer this terms-of-trade deterioration somewhat. On the other hand, supply bottlenecks are not expected to weigh on the current account in the medium term because staff currently expect them to be largely resolved by 2024.

CONSTITUENCY CODES

OEDAE

Angola, Botswana, Burundi, Eritrea, Eswatini, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, Tanzania, Uganda, Zambia, and Zimbabwe

OEDAF

Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé & Príncipe, Senegal, Togo

OEDAG

Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay

OEDAP

Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, Nauru, New Zealand, Palau, Papua New Guinea, Samoa, Seychelles, Solomon Islands, Tuvalu, and Vanuatu

OEDBR

Brazil, Cabo Verde, Dominican Republic, Ecuador, Guyana, Haiti, Nicaragua, Panama, Suriname, Timor-Leste, and Trinidad and Tobago

OEDCC

China

OEDCE

Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, and Spain

OEDCO

Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines

OEDEC

Austria, Belarus, Czech Republic, Hungary, Kosovo, Slovak Republic, Slovenia, and Turkey

OEDFF

France

OEDGR

Germany

OEDIN

Bangladesh, Bhutan, India, and Sri Lanka

OEDIT

Albania, Greece, Italy, Malta, Portugal, and San Marino

OEDJA

Japan

OEDMD

Afghanistan, Algeria, Ghana, Islamic Republic of Iran, Libya, Morocco, Pakistan, and Tunisia

OEDMI

Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Maldives, Oman, Qatar, United Arab Emirates, and Yemen

OEDNE

Andorra, Armenia, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Luxembourg, Moldova, Montenegro, Netherlands, Republic of North Macedonia, Romania, and Ukraine

OEDNO

Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden

OEDRU

Russian Federation and Syrian Arab Republic

OEDSA

Saudi Arabia

OEDST

Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Nepal, Philippines, Singapore, Thailand, Tonga, and Vietnam

OEDSZ

Azerbaijan, Kazakhstan, Kyrgyz Republic, Poland, Serbia, Switzerland, Tajikistan, Turkmenistan, and Uzbekistan

OEDUK

United Kingdom

OEDUS

United States