April 28, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/60-1

10:00 a.m., July 8, 2019

1. Germany—2019 Article IV Consultation

Documents: SM/19/166 and Correction 1; and Supplement 1; SM/19/171

Staff: Kozack, EUR; Bayoumi, SPR

Length: 1 hour, 20 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	Alternate Executive Directors
	K. Obiora (AE)
M. Raghani (AF)	
G. Lopetegui (AG)	
N. Ray (AP)	
A. Tombini (BR)	
	Z. Huang (CC), Temporary
L. Villar (CE)	
	A. McKiernan (CO)
	C. Just (EC)
H. de Villeroché (FF)	
S. Meyer (GR)	
S. Gokarn (IN)	
D. Fanizza (IT)	
M. Kaizuka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
A. De Lannoy (NE)	
T. Ostros (NO)	
A. Mozhin (RU)	
	R. Alkhareif (SA)
	K.Tan (ST)
P. Inderbinen (SZ)	
S. Riach (UK)	
M. Rosen (US)	

J. Lin, Secretary
O. Vongthieres, Summing Up Officer
D. Alcantara, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: O. Brekk. Communications Department: C. Andersen. European Central Bank: K. Nikolaou, R. Rueffer. European Department: R. Chen, M. Dao, E. Detragiache, J. Kozack, A. Mineshima, J. Natal, D. Velculescu. Finance Department: O. Unteroberdoerster. Human Resources Department: R. York. Legal Department: F. Fernando. Office of Budget and Planning: D. Citrin. Secretary's Department: J. Lin.

Strategy, Policy, and Review Department: J. Andritzky, T. Bayoumi. Executive Director: L. Levonian (CO). Alternate Executive Director: S. Benk (EC), S. Geadah (MI), A. Guerra (CE), I. Mannathoko (AE), K. Merk (GR), L. Palei (RU), M. Psalidopoulos (IT), H. Razafindramanana (AF), D. Ronicle (UK), B. Saraiva (BR), M. Siriwardana (IN). Senior Advisors to Executive Directors: B. Alhomaly (SA), A. Muslimin (ST), M.Gilliot (FF), P. Harvan (EC), K. Karjanlahti (NO), S. Keshava (SA), M. Maidi (AE), G. Gasasira-Manzi (AE), R. Morales (AG), P. Pollard (US), S. Potapov (RU), J.Weil (CO), C. Williams (CO). Advisors to Executive Directors: F. Al-Kohlany (MI), D. Andreicut (UK), S. Bah (AF), O. Bayar (EC), M. Bernatavicius (NO), S. Buetzer (GR), X. Cai (CC), K. Carvalho da Silveira (AF), D. Cools (NE), D. Crane (US), O. Diakite (AF), I. Fragin (GR), J. Garang (AE), U. Latu (ST), P. Mooney (CO), H. Mori (JA), G. Nadali (MD), A. Nainda (AE), A. Park (AP), B. Parkanyi (NE), F. Rawah (SA), I. Skrivere (NO), D. Susiandri (ST), A. Urbanowska (SZ), S. Yoe (ST), K. Hennings (BR), K. Lok (CC), V. Lucas (GR), J. Montero (CE).

1. GERMANY—2019 ARTICLE IV CONSULTATION

Mr. Meyer submitted the following statement:

On behalf of my authorities, I would like to thank staff for the discussions and the candid, balanced, and at the same time thought-provoking assessment of the German economy. My authorities find their views well documented in the report.

The German economy continues to grow, making this year the tenth successive year of expansion. The labor market continues to perform well. The unemployment rate is expected to drop to historically low levels in 2019, whilst employment rises further. Consequently, personal incomes will again see a substantial increase: the German Federal Government expects that net wages and salaries of employees will grow by 5.1 percent in 2019,[1] a development which is also helped by measures taken by the Federal Government to strengthen income after taxes. In view of rising wages, employment and corporate investment, the domestic economy will remain the driver of economic growth.

Despite the recent growth slowdown and presence of certain external headwinds, output is projected to return to trend. However, and as staff rightly notes, this outlook is subject to significant uncertainty, especially against the backdrop of unresolved trade tensions and risks surrounding the Brexit process that need to be addressed as a matter of priority by all parties involved. Furthermore, heightened geopolitical risks weigh on investor sentiment.

Germany firmly supports an open, fair, and rules-based multilateral trading system which is more important than ever to safeguard the gains that free trade entails for every country while making sure that these are broadly shared. Germany's policies will remain firmly anchored within its responsibilities and commitments to the European Union and the euro area.

On top of this, staff rightly points out that Germany is facing its own multiple challenges of a more structural nature. These challenges include demographic change, digitization of commerce and society, and the energy transition with the phasing-out of production of electricity from nuclear power as well as coal in the context of climate change. At the same time, these

[1] Net wages and salaries per employee are expected to grow by 3.8 percent in 2019.

challenges create the opportunity to enhance domestic sources of growth and well-being.

Fiscal Policy

In line with our commitments at the European and national level, public debt is projected to decline below the debt ceiling of 60 percent of GDP this year. At the same time fiscal policy is projected to be expansionary. Robust social safety nets, progressive income taxation, as well as broad access to education and health systems ensure inclusiveness while supporting potential and productivity growth over the medium term.

Good times were used to rebuild fiscal buffers and to prepare for the significant challenges stemming from an aging society and associated contingent liabilities. The current sound fiscal position increases resilience, also in the context of the above-mentioned external risks that Germany faces. Automatic stabilizers will be able to operate freely in case of slower growth. Moreover, the sound fiscal position will allow decisive counter-cyclical action in case of a severe downturn. In this context, we see the fiscal rules as an important guide post to anchor expectations.

That being said, general government investment has been steadily increasing, both in absolute and relative terms, reaching a multi-year high of € 79.3 billion in 2018. The priorities of a strong and sustained increase of public investment, which is projected to rise further in 2019 and the coming years, lie in areas that are crucial for Germany's future, namely infrastructure, education, universities, research, and digital technology. The federal government strongly sponsors this increase in investment through a number of initiatives, including substantial fiscal support for other levels of government.

Germany is committed to promoting the international reform agenda on corporate taxation, in particular through supporting the establishment of a minimum taxation framework. To this end, we have issued a joint declaration with France on the taxation of digital companies and minimum taxation in December 2018 and look forward to making further progress on this front over the next years.

In this vein, we welcome staff's in-depth analysis of the German corporate tax system and thorough evaluation of reform proposals that aim to address existing shortcomings. Nevertheless, policy makers also face political constraints in undertaking substantial changes to certain features of the existing framework such as the local business tax (LBT) which is levied on the municipal level.

Similarly, we agree in principle with the desirability to reduce adverse incentives of relatively high marginal tax rates including social security contributions for low-, middle-, and secondary income earners. At the same time, staff correctly identifies associated difficulties in alleviating this burden, including constitutional constraints.

The phasing out of the solidarity surcharge for low- and middle-income earners, on which the Federal Government has recently agreed on, will reduce the labor tax wedge in line with staff recommendations, raising disposable incomes by around € 11 billion annually. Thereby, it should have positive effects on incentives to work while boosting domestic demand. Overall, income tax measures taken in the current legislative period will boost disposable incomes of households by around € 25 billion per year.

We also appreciate staff's work on regional fiscal differences which discusses differences in investment needs and financing envelopes on the state and municipal level. However, to some extent these reflect the institutional principles of subsidiarity and self-responsibility, and do not necessarily indicate a general need for policy action, particularly regarding the federal level.

Overall, large fiscal equalization mechanisms exist, and the federal government has embarked on a number of programs that aim to address investment needs at the local level, including through the allocation of additional funds for education, early childhood care, social housing, and public transportation. The Partnerschaft Deutschland initiative, which supports municipalities in accessing federal funds and implementing public investment projects, has garnered much interest from municipalities and we aim to further expand and scale up this initiative. Given the tight labor market and increasingly binding capacity constraints, especially in the construction sector, it should also be noted though that there are limits to expanding infrastructure investment beyond a certain degree at the current juncture.

External Sector and Corporate Savings

My authorities reiterate their view that the current account surplus is mainly a result of private sector decisions in international trade and investment, and not of domestic policy choices. My authorities expect that the current account surplus will continue to decline in the years to come as more people retire and real wages continue to rise, supporting the external rebalancing.

Given the exceptionally high model and estimation uncertainties for Germany in the IMF model, especially regarding unexplained residuals, we suggest classifying Germany's competitiveness position as overall neutral, in contrast to staff's assessment. Indicators such as Germany's real effective exchange rate based on the deflator of total sales against 19 trading partners or recent estimates based on the "productivity approach" with a very broad coverage of trading partners suggest that the German economy currently only has a rather small competitive advantage.

We take note of staff's finding that the build-up of corporate profits and gross savings has contributed to rising wealth inequality in a mutually reinforcing manner. Corporate savings in turn have been a big driver of Germany's current account surplus. Foreign direct investment of German companies, which is statistically reported as corporate savings, is of particular relevance in this context. We believe more granular analysis is needed to identify potential policy distortions behind these trends that have contributed to rising corporate profits and that might incentivize retaining earnings rather than disbursing them.

At the same time, we would like to highlight that the fall in the labor share has been reversed, thanks in large part to higher wage agreements against the backdrop of a tighter labor market over the past years.

Moreover, family-owned firms, to which a large part of corporate savings accrue, constitute an integral part of the German economy and its success story.

Structural Reforms

The planned introduction of R&D tax credits will provide strong incentives for targeted investment in growth-enhancing R&D activities. Tax credits are capped at a base of € 2 million per firm and will therefore primarily benefit small and medium sized enterprises, thus complementing well-tried direct funding for research and development in a reasonable manner.

We fully agree with staff that ensuring favorable conditions for the expansion of the labor supply and allowing workers to obtain and enhance the required skills are indispensable to safeguard strong and sustainable growth over the medium term. Given the projected decline in working age population, my authorities will further work towards promoting a higher labor force participation of women and the elderly, better training and integration of refugees into the labor market, as well as modernizing immigration laws.

Educational outcomes are being strengthened through an increased supply of all-day childcare and all-day schools which also promote the equality of opportunity.

We recognize the importance of providing high-speed internet access, both broadband and mobile, across the country, not least to aid the adoption and development of new technologies. To this end, besides encouraging private investments through investment-friendly regulation, we have set out a clear strategy and will provide substantial funding to support a nationwide fiber-based gigabit network.

The energy transition in Germany is well underway. In April 2019, the Federal Government set up a “Climate Cabinet” in order to coordinate policies and establish a legal framework to reach the overall climate goals for 2030. The “Climate Cabinet” will also discuss on how to ensure the transition to climate-neutrality by 2050. The energy supply is stable and ample with Germany being a net exporter of electricity for the foreseeable future. The costs of producing energy from renewables is projected to decline further and below that of producing energy from fossil fuels. This trend would additionally be supported by increasing CO_2 prices.

We are therefore less concerned than staff that uncertainty surrounding the energy transition will somehow impede economic growth going forward. In Germany, a broad public debate is currently taking place on measures that could be taken to counteract climate change. In this context, measures like carbon pricing or an aviation tax are also being discussed. The introduction of higher taxes on fossil fuels, which is currently under discussion, could further aid the process towards a more energy-efficient economy. However, no concrete decisions have yet been made.

We agree that greater competition in product and services markets as well as in network industries can in principle be beneficial to consumers and create employment opportunities. However, we would be more cautious than staff regarding reforms to liberalize regulated professions. We consider many of the existing regulations to be justified by legitimate concerns surrounding the potential deterioration of quality and consumer protection standards. Notwithstanding that, we are open to the emergence of new services, especially in the sharing economy, but believe that adequate regulations and compensatory mechanisms for the transition period need to be in place.

Financial Sector and Housing Market

We share the view that macro-financial vulnerabilities are on the rise. Our analyses show that during the long phase of economic growth and low interest rates of the past years, cyclical systemic risks have built up in the German financial system. These comprise a potential underestimation of credit risk and a potential overvaluation of assets when real estate is used as collateral. These vulnerabilities could be further amplified by the build-up of interest rate risks. German banks have significantly topped up their capital since the global financial crisis and capital buffers are generally deemed comfortable. Nevertheless, given the gradual build-up of macro-financial vulnerabilities, the Financial Stability Committee recommended the activation of the countercyclical capital buffer (CCyB) to preventively strengthen financial sector resilience in May. Our supervisory agency Bafin has issued a general decree on June 28th, 2019, to set the CCyB at 0.25 percent effective July 1st, 2019, with banks having 12 months to meet the new requirement.

We agree with staff's assessments both on the relatively low level of profitability and its drivers in the German banking sector. Nonetheless, we consider it to be primarily the task of individual banks themselves to have viable profitability levels. This being said, we would like to point out that low profitability does not necessarily reflect high financial stability risks and could rather be the result of prudent risk-taking behavior for instance. Although profitability is generally low, the German banking sector is well-capitalized and resilient. Restructuring and consolidation within the banking sector are ongoing.

Housing prices have continued to rise, in particular in large German cities. My authorities are monitoring housing market developments closely. While the activation of the CCyB will inter alia address potential risks stemming from the stock of loans, my authorities do not see a substantial increase in risks to financial stability stemming from the flow of new housing loans based on the indicators and information available at this point. The growth rate of housing loans to private households does not appear exceptionally high, overall there is no indication of a substantial easing of credit standards, and the aggregate indebtedness of private households is fairly low by historical and international standards. However, in order to address issues of affordability, my authorities are contemplating measures to expand the housing supply and prevent excessive hikes in rental prices.

My authorities concur with staff that addressing gaps in the data regarding real estate lending would allow for a more complete picture of potential emerging financial stability risks. In this respect, the currently ongoing ad hoc survey on real estate lending and corporate credit underwriting standards is expected to provide some valuable information on possible financial risks in specific segments of the economy.

Supply-side of Corruption

Germany welcomes the opportunity to take part in the voluntary assessment under the IMF's Enhanced Engagement on Governance Framework on the supply-side of corruption. My authorities are strongly committed to fighting corruption as also recognized by the OECD Working Group on Bribery that acknowledged Germany as one of the "highest enforcers" of the OECD'S Anti Bribery Convention. At the same time, Germany is working towards further improving the effectiveness of the AML/CFT supervisory framework, including by higher staffing at the relevant supervisory body (BaFin). An in-depth assessment will be provided in conjuncture with the FATF 4th Round of Mutual Evaluations, which is projected to be discussed in June 2021.

Mr. Obiora, Ms. Maidi and Mr. Garang submitted the following statement:

We broadly agree with the thrust of the staff appraisal and policy recommendations. Germany's strong fundamentals have underpinned the economy's performance over the years, reflected in low inflation, low unemployment and sound public finances. Notwithstanding this impressive performance, the medium-term outlook remains subject to downside risks, including unfavorable external environment, low productivity growth, uncertainty over energy transition, adverse demographics, and rising inequality. We are, however, comforted by Mr. Meyer's exhaustive buff Statement indicating that the authorities largely share staff's assessment on these matters, and are committed to needed reforms to boost growth, invest in infrastructure, bolster labor supply, incentivize innovation, and support the economy's rebalancing.

The report seems to have given insufficient attention to critical underlying contexts and risks in the financial sector. We think that staff's focus on low profitability in the financial sector resulted in paying somewhat perfunctory attention to other critical problems in the banking sector. Perhaps, it could have been more useful to look at the country-specific contexts within which the banks operate, and the underlying causes of their low margins. For example, the top 5 banks in Germany have a much smaller market share (about 29 percent) than their European peers (over 45 percent in France and 43 percent in Italy). This suggests that the country's banking landscape is much more competitive and fragmented, with many small banks content with razor-thin profit margins. More also, we would have liked to see a deeper analysis of costs in the sector. Partly reflecting outmoded IT systems as well as expenditure on fines, compliance and regulation, the cost-income ratio for German banks is much higher (over 76 percent) than the European average (just over 63 percent). We welcome staff comments on whether or not these issues could have been better analyzed and discussed in the report.

We are surprised about, and concerned with, the lack of current data on Germany's financial sector. As evident in Tables 6 and 7, most of the data needed to make informed assessments and judgments on the state of the financial sector are either not current or missing. For a surveillance mission that ended in the third week of May, and for a financial sector whose vulnerabilities are on the rise, as staff aptly encapsulates, one would have expected data running up to 2019Q1. This is critical because a more current and complete dataset across the sector will allow for better monitoring of risks. We note that the 2017 Article IV report also had the same issues of inadequate financial sector data. In light of Germany's status as an advanced economy, this persisting problem may not reflect a lack of capacity or availability. To that end, we would welcome staff comments on the reasons for this outcome and its effect on surveillance of the sector. We would also be interested in knowing what, if any, the authorities are doing to correct this anomaly.

The expansionary fiscal stance to boost growth is timely and welcome. In particular, we see merit in using socially equitable tax system to boost disposable income of low and middle-income households. We also commend the authorities for incorporating corrective measures in the 2019 budget, including supporting public investment, income tax relief and innovation. Stimulating domestic demand by making tax system more friendly, incentivizing R&D, and addressing infrastructure gap while seeking solution to international tax issues will help advance the country's growth objectives. We welcome the authorities' motivation to address supply-side constraints through modernizing immigration laws and attracting labor outside the EU, and we urge them to do more to augment human capital and address the fiscal challenges from an ageing population.

Key structural reforms remain decisive to preserve competitiveness, boost productivity and engender inclusive growth. Urgently promoting innovation, lessening the uncertainty around energy transition, reducing administrative red tape, upgrading nationwide digital infrastructure, and targeted investment in education and lifelong learning would be a significant fillip to Germany's medium- to long-term growth. To this end, we commend the authorities for ongoing efforts to boost innovation and facilitate venture capital, through the implementation of the High-Tech Strategy 2025.

Mr. Geadah and Ms. Choueiri submitted the following statement:

Following several years of strong growth, the German economy slowed in the second half of 2018, reflecting a slowdown in global demand and temporary disruptions affecting the auto and chemical industries. Nonetheless, unemployment hit a new record low, pushing wage growth up, investment remained strong and inflation pressures remained subdued. The fiscal position strengthened further and the current account surplus continued to edge down, reflecting a narrowing trade balance. The short-term outlook is favorable, although clouded by weakening foreign demand. Medium-term challenges include unfavorable demographics, productivity trends, digitization of commerce and society, and the energy transition.

The authorities' fiscal priorities, reflected in the government coalition agreement, are to boost productivity and growth potential through investment in infrastructure, education, and research. In this connection, fiscal policy is expected to be expansionary in 2019–21. The impulse usefully includes measures to increase family support and public investment as well as income tax relief. On the basis of the package of fiscal measures agreed when the government coalition was formed last year, staff projects the structural surplus to decrease from 1.2 percent of GDP in 2018 to about 0.5 percent of GDP in 2021–22.

Staff sees scope for additional tax relief for low-income households, a lower effective marginal tax rate for secondary earners (Selected Issues Paper), a larger envelope for tax credits for R&D, and higher infrastructure spending, particularly at the local government level. In his informative buff statement, Mr. Meyer indicates that the authorities consider that large fiscal equalization mechanisms exist, and that the federal government has embarked on a number of programs to address investment needs at the local level. There is a difference in views between the authorities and staff on property or inheritance taxes reform to finance such measures. Moreover, the authorities note that their tax revenue projections are much lower than staff's. Can staff explain the reasons for this difference? We would also appreciate staff's views on the authorities' argument that further reducing the labor tax wedge would be challenging given the increasing aging-related fiscal costs as well as government measures regarding the social security schemes.

The authorities and staff agree that risks to financial stability are building up against the background of prolonged favorable economic conditions and a low-for-long interest rate environment. In this context, the Financial Stability Committee has appropriately tightened macroprudential policies to enhance resilience in the banking system. Addressing data gaps would enable a fuller assessment of possible financial stability risks, and we welcome in this regard the ongoing bank survey on real estate lending and corporate credit underwriting standards. We see merit in staff's recommendation to collect granular data regularly to support macroprudential policy-making. We note the difference in views between the authorities and staff on borrower-based measures (cap on the loan-to-value ratio and amortization requirements) on residential mortgage lending. Can staff further explain the difference between their assessment of financial stability risks stemming from the flow of new housing loans and that of the authorities? We would also appreciate staff's elaboration on their recommendation to introduce income-based instruments (e.g., cap on debt-service-to- income, cap on debt-to-income) in the macropurdential toolkit, given the low household debt to GDP ratio and low and declining household debt service and principal payments to income ratio (Table 7).

We note the difference of views between the authorities and staff regarding the external sector assessment, particularly Germany's competitiveness position, and are sympathetic to the authorities' views on the large uncertainties in the model and estimations. Staff's work indicates that the build-up of corporate profits and gross savings has contributed to rising wealth inequality in a mutually reinforcing manner. We welcome the authorities' openness to more granular analysis to identify potential policy distortions behind the trends that have contributed to rising corporate profits, as conveyed in the buff.

Ms. Riach and Ms. Andreicut submitted the following statement:

We thank staff for an insightful report and Mr. Meyer for his informative buff statement. We agree with the thrust of staff's analysis. We commend Germany's strong economic performance, its sound fundamentals and record low unemployment rate. Nonetheless, we acknowledge that external factors and structural challenges are starting to weigh on growth and sympathize with staff concerns that the expansion has been unequal, with income growth more pronounced at the top of the distribution. Looking ahead, we agree with staff that Germany's key economic challenge involves raising its long-term growth potential while rebalancing its economy. We associate ourselves with the statement of Mr. De Lannoy on behalf of EURIMF and would like to add the following comments.

External imbalances: household purchasing power and digital agenda

Staff identify sizeable corporate net lending, fiscal consolidation and the widening top income inequality as a key source of Germany's rising current account surplus. Staff acknowledge that some of the imbalances have started to unwind but stress that the economy needs to continue the rebalancing process.

In particular, we note staff concerns that that household disposable income relative to GDP has declined by 6.2 percentage points since 2005 and that this decline is concentrated in the lower half of the income distribution, where the propensity to consume is highest. We thank staff for the helpful selected issues paper considering this in more detail. We also welcome staff's recommendations for policies to address the underlying causes of these imbalances and foster more inclusive growth, namely faster wage growth, particularly among middle- and low-income households, and possible increases in the minimum wage.

We note however staff views that bringing the household disposable income to GDP ratio back to its 2005 level through wage growth alone would require nominal wage growth to exceed annual nominal GDP growth by 1.5 percentage points over a decade. In light of this challenge, do staff have complementary policy tools in mind?

More broadly, in the context of tackling external imbalances, we acknowledge staff concerns about Germany's slow progress in adapting to the technological and digital revolution, and the fact that this could undermine the economy's position as an innovation leader. We welcome staff calls for the authorities to upgrade digital infrastructure and push ahead with the e-Government project, as a way of raising productivity and domestic investment while supporting external rebalancing.

Fiscal policy and growth

We welcome the switch to an overall expansionary fiscal policy in 2019, which will be made possible by an increase in family support and public investment as well as income tax relief. Nonetheless, we recognize that there is still room within EU fiscal rules for further expansion.

In this respect, we agree with staff that Germany's fiscal space should be used to support potential growth and rebalancing. We particularly welcome staff's emphasis on investment in digital infrastructure and view this as a higher order priority.

We also agree that the authorities should stand ready to use the available space in the event of a more protracted economic downturn. We welcome the authorities' commitment to stand ready to use 'most' of the space. In any case, the authorities' policy reaction would also depend on the characteristics of the downturn.

Financial sector challenges: low profitability and rising house prices

We note staff concerns about bank profitability in the low interest rate environment and acknowledge that this is a broader concern for the common currency area, as highlighted also by the euro area Article IV report. One particular challenge is the fact that low profitability could erode banks' ability to generate capital organically and put them at risk in case of an adverse earnings shock.

While the low interest rate environment impacts all euro area member states, it appears that the German banking sector has had a weaker performance than some of its euro area peers. This suggests that there may be additional factors at play, potentially including overcapacity in the banking system, high operating costs and outdated IT systems. We would be interested in staff views on potential solutions to the profitability problem. Would cross-border bank mergers, leading to cost savings and improvement in private sector risk sharing within the monetary union, help address the persistent weakness in the banking sector?

Turning to the housing market, we take note of the rapid increases in house prices in major cities and welcome government efforts to increase the supply of affordable housing. We take comfort from the fact that price increases have not yet been accompanied by strong credit growth. Nonetheless, this does not mean that the German housing market is immune from emerging risks. A correction in house prices could put pressure on mortgage borrowers, increase the possibility of defaults, with spillover effects on bank balance sheets. We therefore support staff recommendations for the authorities to expand their macroprudential toolkit.

Mr. De Lannoy submitted the following statement:

We thank staff for their informative report and Selected Issues paper in the context of Germany's Article IV consultation and Mr. Meyer for his informative buff statement.

Germany has experienced solid economic performance in the past decade. The temporary slowdown in growth in the second half of 2018 somewhat overshadowed the positive signs of the economy, such as a historically low unemployment rate and the recent solid wage growth. Germany faces a number of long-term challenges; namely, an ageing population, low productivity growth, a challenging energy transition and a growing wealth inequality. While we acknowledge that addressing such general challenges will require both private and public sector action, we agree with staff that the public sector is in a good position to be a driver of the changes that are necessary in preparing the economy for these challenges while reducing existing imbalances, including the high and persistent current account surplus. In particular, more could be done to use fiscal and structural policies to achieve a sustained upward trend in private and public investment, notably at regional and municipal level.

Macroeconomic developments

Following a temporary slowdown in growth, the German economy is expected to rebound in the second half of 2019, supported by continued strong labor market conditions and fiscal measures. Investment in construction, both residential and commercial, is expected to continue to be strong reflecting housing demand and infrastructure needs and wages will continue to rise given an unprecedented decline in the unemployment rate. Nevertheless, cyclical conditions are estimated to be weaker than in 2017 and 2018.

The current account surplus is expected to continue narrowing but to remain large over the medium term. Indeed, net exports continue trending downwards, underpinned by solid domestic demand and a gradual realignment of price competitiveness. However, absent further policies to enhance investment and reduce excess saving, it will remain large. We find staff's analysis regarding the connection between NFC net savings and the current account surplus interesting and would encourage further analysis to eventually identify relevant policy recommendations

Fiscal policies

We largely concur with staff recommendation on using available fiscal space to strengthen Germany's growth potential and support its rebalancing. We encourage the authorities to continue expanding public investments to create conditions for higher potential growth. We see merit in a tax reform, in particular for middle and lower-income earners, that could contribute to higher purchasing power and better work incentives. Germany's fiscal position further strengthened in 2018, reaching a surplus of 1.7 percent of GDP, mostly due to revenue over-performance and underspending that could be linked to the delay in forming the coalition government. At the same time, staff estimate a moderately expansionary fiscal stance for 2019 (0.6 percentage point of GDP), involving also a welcome further increase in public investments. We welcome this development and would encourage the authorities to continue clearing the public investment backlog that persists, especially at municipal level, as in the past fiscal consolidation was prioritized at the expense of capital spending. In fact, budget surpluses in recent years allowed central government and state governments to build up financial reserves. The government debt ratio is expected to continue declining rapidly over the projection period to below 45 percent of GDP by 2024. While we agree with the authorities, that these buffers are important to prepare for challenges relating to an aging society and associated contingent liabilities, they can also be used to finance additional expenditures in the coming years and leave some leeway before the "national debt brake" becomes binding. We welcome the authorities' view that these rebuilt fiscal buffers will allow the use of automatic stabilizers to operate in case of slower growth or a more decisive use of fiscal instruments in case of a severe downturn.

Financial market policies

While German banks hold adequate capital, low profitability and increasing house prices suggest rising vulnerabilities. We broadly concur with staff's assessment that financial vulnerabilities have risen with credit growth accelerating, real estate pricing rising, profitability remaining challenging for banks and life insurance companies, and provisioning and risk weights declining. We therefore welcome the recent activation of the countercyclical capital buffer (CCyB) and agree that additional macroprudential action in the real estate sector is called for. Moreover, authorities should increase efforts to address data gaps, consider expanding the macroprudential toolkit and activating the existing borrower-based measures as well.

Structural policies

Germany faces medium-term challenges that could be alleviated by structural reforms. We take note of the various initiatives started by the authorities in this regard as elaborated in Mr. Meyer's buff statement. Reforms are required to mitigate longer-term risks stemming from demographic developments, low labor productivity growth, and a challenging energy transition. We encourage further efforts to increase the labor supply and, in particular, female labor force participation. Moreover, high regulatory barriers remain in the business services sector and regulated professions. We agree with the staff recommendation to explicitly link the statutory retirement age to life expectancy, which could be a viable alternative to policies that promote savings for old age. We also agree that increasing investment in education and life-long learning can help ensure that Germany's labor force is equipped with the necessary skills in the face of rapid technological change and we welcome the additional funding in the 2019 and future budgets towards this aim. Initiatives to simplify tax administration and provide tax incentives for R&D to small- and medium-size enterprises are welcome and could usefully be augmented by potentially more effective policies to boost innovation; such as public funding for universities, public research institutes or grants for business R&D. Finally, as regards further investment needs, in addition to staff's focus on digital infrastructure and improving the electricity network we would suggest that the authorities also put emphasis on sustainable transport infrastructure and affordable housing in order to meet climate, energy and environmental targets. We commend the authorities for their commitment to an open and rules-based multilateral trading system and their implementation of the Paris Agreement.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for this excellent report. We also thank Mr. Meyer for his very helpful buff's statement. After years of strong growth performance and the rapid decrease of unemployment, the recent economic deceleration appears partly cyclical and due to temporary factors. Indeed, as a very open economy facing an uncertain external environment, further proactive policies appear warranted to create the conditions of an external rebalancing. As one of the main economies of the Euro Area, the outlook in Germany has major implications and spillovers for the rest of the currency union. In this regard we found particularly insightful the work done on the drivers of Germany's internal and external imbalances, in particular to address the build-up of corporate profits and gross savings that contributed to rising wealth inequality in a mutually reinforcing manner as well described in the Selected Issues

Paper. We share the thrust of staff’s analysis, associate ourselves with Mr. De Lannoy’s statement and wish to add the following points for consideration:

Outlook and risks

After years of solid growth, the uncertainty surrounding the outlook has increased in relation with trade tensions and the escalation of protectionism, Brexit, concerns over trading partners economic prospects and the weakening of business confidence. Growth has decelerated in 2018 and 2019 reflecting mainly temporary factors but also structural imbalances and capacity constraints that may limit growth over the medium term. Admittedly, encouraging signs of recovery in domestic demand and gross fixed investment in 2019 will be supported by strong labor market conditions, fiscal measures and wage growth but German industry, which is one the primary engine of the Euro Area economic growth, continues to face both domestic and external headwinds. Most of them are indeed linked to the significant dependency on external demand and Germany’s high integration in the global value chains, which represents a strength in times of global expansion but weigh on the outlook when global trade decelerates. As regards domestic demand, while it rebounded at end-2018 and is projected to contribute positively to growth in 2019 and 2020, it might take long time for such increase to compensate the sustained dipping in household consumption and disposable income since the great financial crisis in 2008. Our understanding is that domestic demand has been weak in 2019 Q2 – could staff confirm and indicate what might the drivers of such a weakness in a context of rising wages?

Germany’s Bundesbank’s recent downgrade of its growth forecasts for this year – from 1,6 percent to 0,6 percent in unadjusted and calendar adjusted terms – may be predictive of a more persistent slowdown. Accordingly, and in line with staff’s recommendations, raising potential growth and productivity growth while rebalancing the economy in favor of a higher disposable income for middle and low-income households, stronger domestic demand and investment spending should be key priorities.

External imbalances and wage growth

The recent decrease in Germany’ still excessive current account surplus is welcome and efforts to speed up external rebalancing should be pursued. As indicated in the External Sector Assessment, the remaining surplus still reflects large saving-investment surpluses from non-financial corporations (NFCs). More specifically, we found particularly insightful and convincing the selected issues paper demonstrating the link between the increase of the wealth at the end of income distribution, the savings accumulated within firms and persistent excessive external surpluses. In this regard, preferential tax treatments encouraging private corporate savings over distribution of dividends seem to deserve a particular attention. Beyond its impact on external account, the magnitude of the rise in wealth and income inequality, and in particular the decrease of the real revenues at the bottom of the distribution ladder, raise questions. Staff advocates convincingly for an inheritance tax as well as a possible increase in property tax. Going forward, we would encourage staff to further explore those recommendations with the authorities.

Faster wage growth would certainly contribute to boost household disposable income and private consumption, helping reduce the current account surplus and realigning price competitiveness within the monetary union. In line with our usual messages on IMF’s surveillance and the need to deliver more precise recommendations, we really appreciated staff’s effort to quantify the level of the nominal wage growth exceeding annual nominal GDP growth that would be required to bring household disposable income to GDP ratio back to its 2005 by the end of the next decade. While this appears as a relevant reference, a more rapid pace might also have been chosen. More broadly speaking, we would be interested to see such attempt for other Euro Area members’ article IV consultations. We agree with the proposed additional measures aimed at fostering entrepreneurship, increasing minimum wage and alleviating the income tax burden on low-income households to reduce excess saving, stimulate investment. However, more attention should have been drawn on the necessity to upgrade controls over the effective implementation of the minimum wage and to promote the extension of collective bargaining agreements to a larger share of the employees. We understand that some discussions are ongoing on the suppression of existing obstacles to the extension of bargaining agreements – could staff indicate the nature of those discussions?

Fiscal Policy

The expansionary trend of the fiscal policy spells good news for public investment and private consumption. We particularly welcome the willingness of the authorities to make a greater use of the existing fiscal space. This will require proactive actions since the budget execution was once again below projections in 2018. Despite a decrease in structural surplus projected in 2019 and reflecting the supportive fiscal measures towards families and public investment, fiscal space under SGP’s rules remains substantial and should be used to foster potential growth and rebalancing through further tax relief for low-income households and other tax incentives to boost women's labor force participation. The substantial fiscal space could also be leveraged to enhance investment in infrastructures. Infrastructure gaps along with insufficient Länder's planning capacity and coordination across levels of the government should be coped with as demonstrated in Annex VI of the report. Priority given by local governments to fiscal consolidation to meet the Debt Brake rule at the expense of public investment have translated into significant gaps and regional discrepancies which now need to be addressed to enhance preparedness to technological changes, overcome capacity constraints in the construction industry and facilitate the overall execution of public investment.

Fiscal policy has also a critical role to play to counter the effects of an adverse economic outlook. The authorities should stand ready to let automatic stabilizers fully operate and fully use the fiscal space in case of severe downturn. Under such scenario, we cannot but agree with staff's approach of a coordinated fiscal expansion at the European level.

Finally, we salute the authorities' pledge to seek collaborative solutions to international tax issues and encourage them to go further in this direction regarding controlled foreign corporations. In this respect, we thank staff for their useful analysis presented in the Selected Issues Paper underscoring the benefits of the recent Franco-German proposal to introduce inbound and outbound minimum taxes with mechanisms to avoid double taxation while noting that some difficulties remain in relation to the local business tax (LBT) being taken into account. We note that profit-shifting and tax evasion might play a major role in explaining the "puzzle" of the relatively low CIT revenues in Germany and encourage staff to further explore that important issue.

Structural policies

While the fundamentals are strong, structural headwinds warrant further policy action to raise long-term growth potential. Staff highlights that unfavorable demographics along with low productivity growth and uncertainty about the energy transition weigh on the outlook. We salute the structural reforms planned by the authorities and mentioned by Mr Meyer in his gray and the on-going efforts of the authorities to promote innovation and boost venture capital and cross-border investment in the context of the EU-wide Capital Markets Union. The introduction of tax incentives on R&D would indeed support entrepreneurship and innovation. The setting up of the "High-Tech Strategy 2025" and the promotion of innovation of SMEs through tax credit stand for encouraging responses in this respect. There is room to improve further the coverage of high-speed fiber-optic internet at the national level and the implementation of the 5G. This approach should likewise encompass the design of a specific strategy to address taxation of the digital economy. Staff argues that the absence of ad hoc taxes to the sector to avoid over-taxation of profits and economic distortions has been welcome but temporary local taxing initiatives or alternative solutions should not be deterred given the growing “economic presence” of such activities. Staff’s comments would be welcome.

We concur with staff’s recommendations on the necessity to increase competition in business services and regulated profession as well as expand the quality and quantity of labor supply to remove supply-side constraints. Increasing investment in education to reduce skill mismatches in the face of rapid technological changes would be consistent with this objective as well as complementary actions to enhance women’s and old-age labor force participation through respectively taxation (reduction of the high effective marginal tax rate for second earners) and adjustment of the pensionable age with life expectancy (by two thirds of the increase in like expectancy without reducing pensions levels). Lastly, we command the efforts to accelerate energy transition and expect the forthcoming National Energy and Climate Plan for 2021-2030 to include concrete measures to achieve the 2030 target on reducing greenhouse gas output.

Financial system

In the face of low-for-long interest rate environment and increased credit risks, efforts should continue to ensure the implementation of restructuring plans in both banking and insurance sectors. In particular, boosting profitability and avoiding situations where the provisions of state aid (from Länder) and public bail-out programs to recapitalize urgently an entity are warranted. In this respect, we would have been interested by stock-taking of the implementation of the European Bank recovery and resolution directive. To mitigate risks related to the real estate sector against the continued house prices rises and the decline in banks-loan loss provisioning, we fully support the recent activation of the counter-cyclical capital buffer and staff’s recommendations for additional action to address data gaps, foster early implementation of the existing borrower-based measures and expand the macroprudential toolkit by introducing income-base instruments.

Mr. Jin and Mr. Huang submitted the following statement:

We thank staff for the insightful report and Mr. Meyer for his helpful and candid buff statement. Despite the growth slowdown in the second half of 2018, the German economic fundamentals remain sound. The tight labor market brings unemployment rate to a record low and pushes wage growth substantially. Going forward, the authorities are encouraged to raise the long-term growth potential while increasing the economic resilience to external uncertainties. We broadly agree with staff's appraisal and would like to limit our comments to the following for emphasis.

We strongly commend the authorities' firm support for the multilateral trading system, and welcome staff's analysis of the impact of potential US auto tariffs on Germany. The result shows that a rise in global protectionism is likely to affect a broader group of countries which are highly integrated in the value chain.

External Sector

We take note of staff's view that the current account surplus is mainly driven by sizable corporate net lending. We call for more in-depth analysis of the reasons why corporates prefer saving to investing. The family ownership and related tax treatment could explain the corporates' preference of retaining earnings over paying dividends, but could hardly explain the trend of underinvestment. We also do not view the relative low growth prospect, as indicated in the Annex VII, as a very solid reason, given the high corporate profit and low interest rate environment in Germany, i.e., much higher return on investment than on holding liquid assets. Nevertheless, we concur with staff that raising disposable income, particularly among middle- and low-income households, would help to boost consumption and thus narrow the current account surplus. In this regard, we take positive note of recent strong wage growth and welcome the authorities' fiscal measures to support low incomes, including increasing family support and income tax relief. We reiterate our cautious view on the application of the EBA evaluation outcomes especially when there are large unexplained residuals.

Fiscal Policy

The fiscal surplus in 2018 reached a record high, which actually made the fiscal stance contractionary. In this regard, a fiscal expansion in 2019 is welcome. We encourage the authorities to increase public investment in infrastructure, particularly at the state and municipal level. Increasing budget support and technical assistance from the federal government could help local governments to overcome current capacity constraints. We noticed from

Mr. Meyer's buff statement that reforms in both corporate and personal income tax are facing political constraints. We encourage the authorities to keep engaging with the Fund to find more feasible solutions to reduce the high effective marginal tax rate for second earners. The authorities' commitment to seek collaborative solutions to international tax issues is commendable. We take note of the different views on the additional fiscal space. Could staff elaborate more on the major divergences between the authorities and staff?

Financial Sector

The banking sector is well-capitalized and resilient, but low profitability remains a concern. Considering that the low interest rate environment might be continuing, we encourage the authorities to closely monitor the interest rate-related financial vulnerabilities. The restructuring in both the banking and insurance sectors should be implemented in a timely manner. Promoting digitalization in the banking sector can help to not only cut costs, but also find alternative sources of income. We noticed that the rapidly increasing real estate prices have not yet been accompanied by an increase in risks to financial stabilities. However, the rising housing prices could crowd out household consumption and widen income inequality, especially in a country like Germany where the share of homeownership is low. In this regard, we welcome the authorities' recent move to raise the counter-cyclical capital buffer and see merit in staff's suggestion of considering additional macro-prudential policies if necessary.

Structural Reforms

The declining productivity growth calls for steadfast structural reforms. The authorities' strategy to upgrade nationwide digital infrastructure is welcome. The recent heatwave in Europe underscores the importance to counteract climate change. We commend the authorities' continuous efforts in promoting energy transition and emission reduction. Regarding the competition in regulated professions, we take note of the authorities' concerns about the potential deterioration of service quality and consumer protections. However, a level playing field for all participants, no matter domestic or foreign, existing or new entrant, is important. Finally, we welcome the authorities' strong commitment to fighting corruption, particularly against legal persons involved in foreign bribery cases.

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

Mr. Tan and Ms. Susiandri submitted the following statement:

We thank staff for the informative set of reports and Mr. Meyer for his insightful buff statement.

The German economy has experienced robust economic and employment growth in the past decade, with wage increases gaining pace more recently. While sound fundamentals remain in place with an expected return of output to trend, this belies a mixture of external and structural challenges that pose significant downside risks going forward. For one, macro-financial vulnerabilities and weakening global demand may undermine the near-term outlook. Further, the longer-term growth potential is under threat from ageing population, low productivity, technological change, and energy transition. Much uncertainties are also associated with unresolved trade tensions and a disorderly Brexit. Against this backdrop, policy priorities should be directed at turning the structural challenges into opportunities for long-term inclusive growth, while the country navigates through these uncertain times with an eye focused on preserving macroeconomic and financial stability at the same time. We offer the following comments for emphasis.

The declining current account (CA) surplus, which is expected to fall further, and NFC net lending position are encouraging developments. We commend the authorities for the fiscal measures to support disposable incomes and household consumption for the lower-income group. The recent increases in wage growth are also steps in the right direction in supporting external rebalancing and promoting more inclusive growth. Notwithstanding a projected modest narrowing in the medium run based on a gradual realignment of price competitiveness and continued solid domestic demand, we hear the authorities' feedback on the high model and estimation uncertainties in the IMF model. In the same vein, we see merit in better understanding and considering their view that the CA surplus is mainly a result of private sector decisions in international trade and investment, and not of domestic policy choices. Staff's comments are welcome, including the authorities' suggestion to classify Germany's competitiveness as overall neutral, while staff has assessed the 2018 REER to have been undervalued in the range of 8-18 percent.

We welcome the expansionary fiscal policy stance and the authorities' readiness for additional fiscal stimulus in the event of severe economic downturn. We agree with the judicious use of fiscal instruments to boost productivity and expand the potential output in order to support long-term economic growth. In this light, we support the authorities' priorities in utilizing fiscal space to uplift physical and human capital investments as well as R&D. The public investment outlook is expected to be more sanguine, backed by improved fiscal position of the Lander and most municipalities and the revised Basic Law allowing financial assistance to key investment areas. That said, we recognize the shared concern of staff and the authorities on the speed of public investment execution given capacity constraints, particularly in the construction sector. We welcome staff's elaboration on plans to expand the capacity of this sector.

Enhancing productivity and private investment is the right way forward given increasingly binding supply-side constraints on the growth outlook. Staff's policy recommendations have laid out a comprehensive strategy for the authorities to move closer to implementing the digital agenda, transitioning to renewal energy, and supporting innovation and venture capital. The report and buff statement also provided a clear view of some of the challenges entailed in this endeavor. To this end, we encourage the authorities to take a strategic long-term view in persisting with their reform efforts expediently. The structural agenda is very much a work in progress and we support, among others, the authorities' strategy and resources to upgrade the digital infrastructure through a nationwide fiber-based gigabit network, as well as the government initiatives to accelerate energy transition. We also welcome the authorities' initiative with the National e-Government Strategy that seeks to lessen the administrative burden once implemented, and the "High-Tech Strategy 2025" that sets out the priority areas for innovation and venture capital.

The authorities should continue to closely monitor the upward trend in financial sector risks and stand ready to take further action if need be. Low profitability, particularly in the banking sector, is a fundamental problem that has to be nipped in the bud. In this regard, we are glad that the authorities see opportunity for restructuring and consolidation within the banking sector. We would like staff's further comments on the underlying impediments and credible options to address the prolonged weak profitability of the banking sector. Given the macro-financial vulnerabilities from rising housing prices and falling banks' loan loss provisioning, we welcome the authorities' timely activation of the counter-cyclical capital buffer to strengthen bank resiliency. Staff's assessment on imbalances in the real estate sector is well taken and we are pleased to learn that the authorities are proactively reviewing their macroprudential toolkit, including the need to introduce household income-based instruments. Effective execution on this front will see Germany benefiting from these ongoing efforts to remain vigilant to emerging financial sector developments and be prepared for additional policy measures to safeguard the financial stability.

We welcome the visible progress made in addressing the supply-side of corruption. The authorities' efforts to detect foreign bribery, which culminated in Germany being one of the highest enforcers of the OECD's Anti-Bribery Convention, is very much appreciated. In particular, we commend the authorities for volunteering to be part of the IMF's assessment on corruption issues. While more can be done on foreign bribery cases, the overall assessment is a positive validation of Germany's continuing commitment toward anti-bribery enforcement actions.

With these remarks, we wish Germany and its people every success in their future endeavors.

Mr. Just and Mr. Stradal submitted the following statement:

Germany has enjoyed solid growth in the past years, which provided a significant growth impetus to many of its EU trading partners, both within and outside of the euro area. The unemployment has reached multi-decade lows and public debt is on a sustainable downward path, providing ample space to react if the downside risks were to materialize. The near-term risks are indeed tilted to the downside, as the German economy is exposed to slowing global economic growth momentum. In addition, Germany faces long-term challenges that require boosting the potential growth by increased public and private investments, which would also contribute to rebalancing the strong external position. Faster wage growth, which would strengthen household purchasing power, particularly in the low- to medium-income brackets, is also desirable in this regard. We thank staff for their comprehensive set of papers and Mr. Meyer for his helpful buff statement. We associate ourselves with Mr. De Lannoy's statement and add the following comments for emphasis.

We deem the moderately expansionary fiscal stance appropriate given the recent slowdown and the outlook. We support the continued strengthening of public investments to address the pent-up needs in physical and digital infrastructure, education, research, and development. In conjunction with further efforts to reduce the labor tax wedge, deregulate services, and modernize the state administration, the authorities should improve the anemic productivity in the non-tradable sectors and enhance the labor force participation. While acknowledging the constraints of vested interests and the long implementation lags, we underscore the importance of such a comprehensive reform package for addressing the long-term demographic challenges, as well as for rebalancing Germany's external position. We welcome Annex VI, highlighting the importance of effective coordination among the national and regional governments for improving the efficiency of public investments.

We commend staff for the informative and interesting analysis of wealth inequality and private savings in one of the Selected Issues papers. It is an analytically robust contribution to future policy discussions in Germany and we encourage staff to continue to dig deeper before formulating strong policy recommendations. In principle, Germany has, with the social market economy, already a conceptual framework to prevent excessive inequality. Over the recent past, however, growth has been accompanied by an increasing number of low-paying jobs. We caution against throwing the proverbial baby out with the bathwater, as the Mittelstand – mid-sized, often family-run, specialized, highly innovative, and nimble companies – have provided invaluable flexibility to the German economy and have been an important part of its long-term economic success.

We concur with staff that strengthening the macroprudential toolkit is warranted. House prices continue to rise and appear overvalued in major German cities, calling for continued close monitoring. We are concerned by the lack of hard data on loan-to-value ratios and ensuing reliance on survey-based data. We fully endorse staff's call for urgent action to address the macroprudential data gaps. Against the backdrop of hitherto moderate mortgage volume growth, existing high credit standards, and overall strong household balance sheets, we do not see imminent risks to financial stability. However, we encourage the authorities to consider introducing income-based instruments in the context of the upcoming policy review.

Low banking sector profitability is a long-term challenge that requires continued supervisory attention. We welcome the recent activation of the countercyclical capital buffer and note that the full adoption of Basel III is expected to substantially increase German banks' minimum capital requirement. While acknowledging the resilience and adequate capitalization of the German banks, higher retained profits will thus be needed to facilitate recapitalization needs in the future. Finally, we call on the authorities to step up the efforts to establish a core set of readily available, consistent data for banks and non-banks aimed at improving the quality of oversight and financial stability analysis, as recommended by the 2016 Financial Sector Assessment Program.

Mr. Rosen, Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the informative papers and Mr. Meyer for the helpful buff statement. The German economy has performed solidly in terms of growth and employment but continues to rely excessively on external demand. We appreciate that the IMF policy discussions were focused around the key imperatives of rebalancing the economy and boosting potential growth. We concur with the staff appraisal, but staff's advice would have been more compelling if they had included an active policy scenario, demonstrating how a more decisive fiscal and structural policy package would feed into higher and more balanced growth.

Rebalancing. The staff paper makes clear that despite the gradual narrowing, the current account surplus would remain large over the medium-term absent further policy action. Staff's analysis of corporate savings and wealth inequality sheds light on the dynamics that have contributed to persistent current account surpluses, and points to the need to boost lower- and middle-income wages and purchasing power. The Selected Issues Paper describes a reinforcing cycle of national income increasingly channeled into corporate savings benefitting wealthier households (where corporate ownership is concentrated) and thus depressing consumption. Recent wage growth at the lower end is an encouraging sign, and we concur with staff that public communication encouraging stronger wage growth could be helpful. A reduction in the labor tax wedge could also be aimed at lower and middle earners with higher propensity to consume. Can staff comment on whether wages are now growing commensurate with what would be expected given the tight labor markets? We also wonder whether the increase in wages is in line with staff's forecast that German inflation will exceed the ECB's inflation objective by 2022, thus helping to lift overall inflation in the euro area.

Fiscal Policy. We urge the authorities to use ample fiscal space to boost investment in innovation and infrastructure, as well as support policies that can bolster purchasing power of households. We note that the fiscal surplus has hit new records every year since 2014, including over the past year as growth hit a rough patch in H2 2018. The 2019 budget moves in the right direction but could be bolder, as staff's policy recommendations point towards fully using available fiscal space (around 1 percent of GDP) over the next few years. Staff helpfully provide a range of options for how fiscal space could be used, including growth-friendly tax reform (e.g., reducing the labor tax wedge, reducing the high effective marginal rate for second earners), a generous R&D tax credit, and facilitating execution of public investment. We would add defense as an area where spending could be increased. We underscore staff's finding that local governments have been prioritizing fiscal consolidation at the expense of public investment, and that capacity constraints in the construction industry are a new hurdle. Could staff comment on how the authorities could best navigate around these new constraints to ensure more robust public investment? Based on the IMF's Fiscal Space policy, we call on staff to make an initial assessment without considering the fiscal rule, and then use the rule to inform whether Germany should use the space.

Supply-Side Constraints. We support staff's recommendations on reducing supply-side constraints. Stronger efforts to reduce regulatory burdens and improve the business environment could help revitalize private investment, solidify domestically driven growth, and make the economy less vulnerable to external demand. Steps to increase the labor supply by increasing labor participation of older workers would also be welcome. A comprehensive policy package of reducing the tax burden, incentivizing R&D, upgrading infrastructure, and streamlining regulations could do much to make growth durably stronger and more balanced.

Financial Sector. We support staff's recommendations to accelerate restructuring of banks and insurance companies to boost their profitability. Consolidation could help reduce the high operating costs that have contributed to German banks' underperformance in a challenging low-interest-rate environment. However, with higher levels of public capital in the German banking system, publicly owned German banks tolerate higher costs and lower returns, making it difficult for commercial banks to compete. We welcome staff's attention to macroprudential risk, and the authorities' effort to increase the counter-cyclical capital buffer. Yet, German real estate prices are appreciating at a rapid rate and we welcome the authorities' views that they will be considering additional macroprudential tools. Lastly, we would welcome more detail on staff's analysis of how Basel III implementation would affect regulatory capital via floors on internal risk models.

Mr. Inderbinen, Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for their candid set of reports and Mr. Meyer for his insightful buff statement. We broadly share staff's assessment of the economic outlook and the balance of risks, and we would like to offer the following comments.

The German economy continues its solid performance, though downside risks have increased. Germany's prudent and sound economic policies have allowed nearly a decade of solid growth, and the unemployment rate has reached its lowest level since reunification. At the same time, we note that external and domestic downside risks to growth have risen. Germany's open economy is particularly exposed to weak global demand, including in the context of the current trade tensions. In the medium-term, the aging population, low productivity, and lackluster investment could weigh on growth.

Germany's strong fiscal position has helped increase resilience. We see merit in preserving fiscal buffers, particularly in light of the significant external uncertainty and demographic challenges. Moreover, the rebuilt buffers would allow automatic stabilizers to operate fully in case of a downturn. We take good note that public infrastructure spending accelerated in 2018 and continues to be a priority for the authorities. To address the infrastructure gaps, coordination across all levels of government is particularly critical to ensure investment efficiency over the entire infrastructure life cycle. Given the level of income inequality, the authorities are rightly prioritizing investment in education. In addition, we support staff's call for reducing the taxation of labor, which will ultimately contribute to boosting income of the low- and middle-income households.

We appreciate staff's analysis of the linkages between private savings and wealth inequality, as illustrated in the SIP. The staff's narrative involves micro-level evidence of rising income inequality with a macroeconomic approach. We agree with Mr. Meyer that further analysis is needed, with the use of more granular data, to identify relevant policy recommendations.

Higher wages should go hand in hand with measures to increase productivity growth. In the context of low unemployment and a declining working-age population, real wages have grown faster than productivity. While further wage increases would help support household purchasing power and reduce income inequality, they would need to be compensated by improved productivity. In this regard, continued structural reform efforts to support education, research, and innovation are key. We also agree with staff that reducing administrative red tape would be beneficial. In this context, the National E-Government Strategy is a promising step. Regarding staff's proposal to increase the minimum wage, a prudent approach would be to first assess the impact of the minimum wage, including regarding potential distortionary effects on informal employment. Could staff comment on experience with the minimum wage in Germany so far?

The response to rising financial vulnerabilities appears broadly adequate. Risks in the financial sector are increasing in the context of favorable economic conditions and the low interest rate environment. Risks stemming from the housing sector appear manageable for the time being. While we agree that more granular loan data would be valuable, the authorities' preference to first gather information and assess the results of the ongoing survey on real estate lending appears reasonable. The activation of the counter-cyclical capital buffer is a welcome step to enhance financial sector resilience. Could staff comment on how binding the CCyB will be, given that banks' capital buffers are "deemed comfortable" as stated in Mr. Meyer's buff. Also, we would be interested in staff's view on risks stemming from banks' exposure to export sectors, e.g. the auto industry. We note staff's finding that the full adoption of Basel III would substantially increase banks' minimum capital requirements, including of the highly-leveraged G-SIB and some Landesbanken.

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its report and informative paper, as well as Mr. Meyer for his candid buff statement. We associate ourselves with Mr. De Lannoy's statement and would like to add the following comments for emphasis:

The German economy continues to exhibit strong performance but needs to foster its potential and inclusive growth. Germany has been enjoying strong economic performance in recent years, building on strengthened domestic demand and exports. However, several factors, particularly the decline in labor force, low growth and weak investment growth, will weigh on potential output. Moreover, the relative inclusiveness of growth continues to pose challenges. While the number of people at risk of poverty or social exclusion has fallen since its peak in 2014, challenges in equality of opportunities remain. Moreover, even if wealth inequality has slightly declined, the median level of household wealth in Germany is among the lowest in the Euro area, as highlighted by staff in its very interesting Selected Issues Papers. We concur with Mr. Meyer's buff statement that multiple challenges create the opportunity to enhance domestic sources of growth and well-being.

External imbalances in Germany remain large and need to be tackled by authorities. Germany is experiencing macroeconomic imbalances due to its large and persistent current account surplus, which reflects, both excess of savings and subdued investment. Notwithstanding that the current account surplus has fallen recently, it remains stronger than implied by medium-term fundamentals and desirable policy settings, as noted by staff in its report. Moreover, the Net International Investment Position (NIIP) climbed to 60.6 percent of GDP at end-2018. We welcome staff's innovative analysis on the central role that wealth inequality plays for macroeconomic adjustments and imbalances. According to staff, not only does wealth inequality affect the distribution of returns to capital and labor at the micro level, but it is a powerful force shaping the macroeconomic adjustment to external shocks/secular trends. Additionally, widening top income inequality may also help explain high private savings and the rising current account surplus. Interestingly, policies that boost disposable incomes particularly among middle- and low-income households could not only foster a more inclusive growth, but also help speed up external rebalancing. We see merit on staff's proposals for a stronger increase in the minimum wage as well as a tax reform to support the purchasing power of middle and lower-income earners. Could staff elaborate on how an increase in the minimum wage could sustain over time the recent wage growth?

We agree with staff on the need to continue using the space within the fiscal rules to bolster long-term growth, as well as to encourage inclusive growth. Investment to GDP has increased recently, a welcome development. However, it remains below the European area average and the investment backlog is significant. Private investment remains subdued despite a level of capacity utilization that remains above historical average. Moreover, risks stemming from the external sector and the deceleration of economic activity could adversely affect private investment. Therefore, the ample fiscal space could be used to raise public investment to enhance potential growth and favor crowding-in effects on private investment. Public investment has grown around 4.5 percent in real terms in the last four years, but net government investment only turned positive in 2017 and 2018 and it did so unevenly across levels of government. There is room to remove regulatory constraints to public investment by municipalities. Staff rightly points on the need to strengthen the economy by promoting innovation, expanding labor supply to counter population aging, and continuing to fill infrastructure gaps. We also consider important to invest in education and training and support active inclusion to improve competitiveness and inclusive growth.

Structural reforms are also needed to foster a sustainable and inclusive growth model in Germany. It is important to eliminate barriers to foster private investment, particularly by addressing tax distortions to labor supply, labor market shortages, the lack of network infrastructures or the limited competition in certain sectors. Staff makes several useful proposals in terms of promoting innovation and productivity growth, cutting administrative red tape. Additionally, we also consider that pension and labor market reforms are needed to make it attractive to extend working lives and enhancing female labor participation. We commend the authorities for the measures already introduced and we see merit in staff's proposal to reduce the high effective marginal tax rate for second earners, as it can promote full-time female labor force participation. We also commend authorities for undertaking a review of regulations in professional services, with the goal of reforming the Professional Law in this area. Could staff elaborate if further reforms are needed to ensure competition in product markets, notably in network industries? On housing gap and affordability, we welcome authorities' effort to increase housing supply. If needed, further measures may be considered, such as accelerating the construction of social housing, improving transport options, or reforming land-use and building regulation. We welcome the forthcoming National Energy and Climate Plan for 2021–30 that will include concrete measures to attain the 2030 target for reducing greenhouse gas output. We agree with staff that a carbon tax could be a useful part of a comprehensive strategy and the importance to reduce policy uncertainty around the energy transition.

We encourage authorities to speed up closing data gaps as regular collection of granular data is needed for effective macroprudential policymaking. Although the banking sector has relatively good capital and liquidity levels, it faces several challenges, namely low profitability, high costs and low efficiency compared to other European banks. Squeezed revenues from the low interest rate environment, costs incurred through digitalization, regulatory requirements and the emergence of new competitors are intensifying the challenges faced by banks. Authorities shared the view that risks to financial stability are building up and agreed on the urgency of closing data gaps to enable a full assessment of possible financial stability risks. Could staff elaborate on how authorities are planning to close the data gaps?

Mr. Tombini, Mr. Fachada and Mr. Fuentes submitted the following statement:

We thank staff for the reports and Mr. Meyer for his insightful statement. After a strong growth performance over the last decade, Germany's export-oriented economy decelerated in 2018 amid protectionist threats and weakening world trade. The weak underlying cyclical trend was exacerbated by key one-off factors related to the automobile and chemical industries that has disrupted dynamism in industrial production. Yet, tight labor markets and strong wage growth have buttressed private consumption and are expected to help pick up economic activity going forward. Notwithstanding Germany's solid fundamentals and sound policy management, the combination of external headwinds and lingering structural issues could weaken the growth outlook and exacerbate some macroeconomic imbalances.

Global trade tensions and Brexit uncertainty will continue to weigh on exports. Germany's open economy and export-led growth model are increasingly challenged by deteriorating external conditions and worsening terms-of-trade. We note that the decline in net exports of goods and services has been broad-based across trading partners, but more pronounced among non-EU countries. The difficult foreign trade environment magnifies the importance of domestic demand as the driver of growth in 2019-20, supported by high employment, strong wage growth, low borrowing costs and moderately expansionary fiscal policy.

The protracted low interest rate environment brings risks for the German financial system. As the current slowdown in the euro area requires continued accommodative monetary policy, low profitability will continue to weigh on banks and insurance companies, limiting banks' ability to generate capital. We take note of the recommendation of the Financial Stability Committee to raise the counter-cyclical capital buffer to contain stability risks. That said, this supplementary requirement should be carefully monitored to avoid excessive burden on financial institutions vis-à-vis their European peers. In any case, banks and life insurance companies need to accelerate their operational restructuring to boost profitability and cost-efficiency.

Germany remains in prime position to avoid the impact of international tax competition. Like many advanced economies and emerging markets, corporate taxation in Germany is under pressure due to digitalization and the risks associated with tax base erosion and profit shifting. Consistent with the country's leadership in anti-avoidance provisions and in maintaining an efficient tax system, German authorities have acknowledged the need of corporate tax reform to remain competitive and ensure a level playing field for all businesses. Against this background, we agree with Mr. Meyer that the joint declaration with France in December 2018 on the taxation of digital companies and minimum taxation is a step in the right direction to face the challenges of digitalization.

Increasing inequality may require additional adjustments in the tax system. We welcome the attention paid to inequality in the Selected Issues Paper and the assessment of its structural nature. While income inequality in Germany is not as high as in other advanced economies, the wealth and income gap between rich and poor families and regions has widened gradually. Private home ownership remains small among low- and middle-income households, which exacerbates the concentration of wealth at the top of the distribution. We take note of the differences between staff and the authorities regarding the sources and relevance of wealth inequality in the current context. We encourage the German authorities to continue using the tax system and the social benefit structure to moderate inequality.

Demographic trends are hampering potential growth. Positive labor market developments continued in 2018 with the unemployment rate reaching historic lows under high labor force participation. Nonetheless, the progressive ageing of the population is expected to restrict employment growth and contribute to increase labor market shortages over the medium term. Moreover, like other advanced economies, productivity growth has been declining over the last two decades. The current demographic trend could also affect fiscal sustainability as age-related spending increases. In this context, the authorities should continue to promote the prompt integration of migrants in the labor market, and foster innovation and the diffusion of new technologies, particularly among small and medium enterprises.

Mr. Ostros and Ms. Karjanlahti submitted the following statement:

We thank staff for the very interesting set of reports and Mr. Meyer for his informative buff statement. Over the past decade, the German economy, guided by strong polices, has provided a stable source of growth for the entire euro area. Despite the recent growth slowdown, the economic fundamentals are solid with healthy public and private balance sheets, a historically strong labor market, and signs of wage growth picking up. Nevertheless, challenges are arising. Uncertainties related to the external environment, trade tensions in particular, are dampening the prospects for Germany’s export dependent growth model. Furthermore, longer-term structural challenges are weighing on growth potential. Thus, we encourage the authorities to continue policies to boost growth potential and address continued savings and investment imbalances through increasing public and private investment, increasing labor supply, improving financial stability, taking up productivity enhancing structural reforms, and addressing growing income and wealth inequalities. We associate ourselves with Mr. De Lannoy´s gray statement, and generally concur with staff’s appraisal while adding the following for emphasis.

We note the moderation of the current account surplus but agree with staff assessment that it remains substantially stronger than implied by fundamentals. The gradual decline of the current account surplus has continued. The adjustment was aided by weakening external demand and reduced net lending by the non-financial corporations (NFC), but was bolstered by the large fiscal surplus leaving CA surplus elevated at 7.3 percent of GDP in 2018. While there are signs of moderation, the persistent weakness in investment, particularly in the NFC sector, is a key driver of the surplus. Considering continued low levels of investments and gaps in key infrastructure, we encourage the authorities to continue and scale up efforts to boost domestic public and private investment. This would improve potential growth and support rebalancing. We find staff's analysis on the links between income and wealth inequality, strong growth in net savings by NFCs and CA surplus accumulation over the past decades very interesting. While we acknowledge the central role of the Mittelstand firms in the German economy, the findings of accumulating income and wealth inequalities and possibilities for mitigating policies warrant further attention. In particular, we agree with staff that polices to boost disposable incomes among the middle and low-income earners, such as improving minimum wages, would support both rebalancing of the external sector as well as improve equity.

Fiscal space should be used to boost investment in physical and human capital and strengthen labor supply. We commend the authorities for their solid fiscal performance, buildup of significant buffers for future challenges, and reduction of debt levels to below the 60 percent debt/GDP ceiling. However, forecasts for longer-term potential growth are low and shortages of both labor and capital supply are already hindering growth. We strongly agree with staff on the importance of using fiscal space to improve investment in physical capital and increase labor supply. The slightly expansionary fiscal stance and planned increases in investments for 2019 are a step to this direction. We would further encourage the authorities to step up efforts to close the infrastructure gap and, in particular, reinstate investment at the local government level, where the back log is partly due to past fiscal consolidation crowding out public investment. Increasing labor supply in the face of an aging population is an obvious priority. Reducing the tax wedge by providing tax relief for low-income households would not only improve labor supply but also support domestic demand. Thus, we welcome the authorities plans to phase out the solidarity surcharge for low- and middle-income earners. Further, we strongly encourage the authorities to reduce the high marginal effective tax rate of the second earner in the family to improve the incentives for female labor for participation.

Low bank profitability and rapid rise in real estate prices point to financial vulnerabilities. Low profitability continues to weigh on the German banking and insurance sector while house and commercial real estate prices have continued to rise rapidly. In the face of rising macro-financial vulnerabilities, we welcome the activation of the counter cyclical capital buffer. Further, we support staff's advice on strengthening macroprudential measures to contain real estate sector vulnerabilities. We note that despite house prices increasing fast, particularly in large cities, credit growth has been muted, at least at the aggregate level. The lack of granular data clearly prohibits more detailed analysis. We are encouraged of the on-going ad hock survey to fill in some of the data gaps and would suggest regular collection of more detailed debt data. Further, we encourage the authorities to consider activating the existing borrower-based macroprudential measures as well upgrading the macroprudential toolkit with income-based instruments for both residential and commercial real estate lending.

Structural policies are crucial to tackle long-term challenges of the economy. The aging population and low productivity growth shed a shadow on the economy's future prospect. Staff's analysis points that concerns of future growth, red tape, and lack of skilled workers are hindering private investment. Directing the increases in investment to upgrade both the digital and energy transmission infrastructure, as well as increased investment in human capital to improve skilled labor supply, will be important priorities. Efforts to increase innovation such as the increase tax incentives for R&D and promoting venture capital are encouraging. Improving competition in product and service markets and reducing red tape would improve the business environment. However, we agree with the authorities that caution in liberalizing regulated professions is warranted, where consumer protection needs should be weighed against increases in flexibility.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the well written reports and Mr. Meyer for his comprehensive buff statement. Economic fundamentals remain solid in Germany with strong fiscal and external positions, and a sound and resilient banking sector. Benefiting from decade-long solid growth, unemployment is at its lowest level since reunification, pushing wage growth up. The impressive growth achieved in the last decade is continuing despite the considerable slowdown from 2.5 percent in 2017 to 1.5 percent in 2018, reflecting weak external demand. Growth is projected to slow down further in 2019 to 0.7 percent, before recovering to 1.3 percent in 2020, mainly driven by domestic demand, and remain at around the trend thereafter. Inflation is likely to stay below the target rate of 2 percent over the medium-term. The staff report highlights several uncertainties and downside risks. The economy's export dependence could be affected by protectionism, a hard

Brexit, renewed stress in Euro area, anti-globalization sentiments, an un-resolved bank legacy and profitability problems. Domestically, unfavorable demographics and weak productivity growth could weigh on the long-term growth potential. We broadly share the thrust of the staff's assessment and policy recommendations and would like to make following remarks for emphasis.

The appropriate use of the substantial fiscal space is important. Given the lowest investment rate among the advanced economies, we support the staff's view on using the remaining fiscal space to enhance infrastructure and human capital, innovation and labor supply within EU fiscal rules to boost potential growth. While implementing growth- friendly tax reforms, the provision of further tax relief for low income households will help increase their disposable income, which has declined significantly over the years, while supporting domestic demand. That said, we would welcome staff's comments on the 2018 Article IV recommendation to fully use fiscal space (Annex IV).

Germany's external position remains strong with large current account surpluses due to high domestic savings, low investments and declining household consumption. We note that the build-up of corporate profits, which is a big driver of the current account surplus, and gross savings have contributed to rising wealth inequality in a mutually reinforcing manner, and the authorities' view that more granular analysis is needed to identify potential policy distortions behind these trends, as elaborated in the buff statement. The high wealth inequality also reflects that the fruits of strong economic performance have not been better shared. Hence, the proposed multi-pronged policies are important in economic rebalancing and improving distribution of growth benefits. We also welcome the authorities' commitment to an open, multilateral rules-based trading system.

The banks are adequately capitalized and NPLs are declining. However, given the weak profitability, we encourage faster restructuring, cost-cutting, and continued development of fee-based income to boost profitability, reduce risks and solidify financial stability. Attention is also needed to the rising macro-financial vulnerabilities. In this regard, we welcome the recent measures by the Financial Stability Committee to preventively strengthen the financial sector. Like staff, we also encourage the authorities to consider expanding the macroprudential toolkit. Given the continued rise in housing prices, particularly in large cities, close monitoring of the housing market is essential. It is encouraging to note that authorities are taking measures to address gaps in the data regarding real estate lending, which are essential for effectively monitoring risks to the financial sector.

Continued policy action is needed to safeguard growth and effectively face population ageing, given the increasingly binding supply-side constraints. Hence, incentivizing R&D through tax incentives and increasing quality and quantity of labor supply through investment in education and life-long learning to provide skills are important to foster productivity growth, private investments and employment. We stress the need for appropriate tax, pension, and labor market reforms to boost employment of women, elderly and migrants, given the demographic outlook. The progress in integrating refugees into the labor force is encouraging. Could staff comment on the size and the quality of the refugee labor supply in Germany in comparison to other European economies? We welcome the government's plans to embrace competition enhancing structural reforms and continuing a co-investment strategy to crowd-in investment to further support venture capital.

Digitalization and innovation are becoming increasingly important drivers of growth, requiring adaptation to technological change. We note that productivity in the non-financial non-ICT sector has been low, which needs enhanced attention. The ongoing preparation of a master plan to expand mobile coverage and deploy 5G is welcome. In this regard, while welcoming the government's digitalization strategy, staff's comments are welcome on its role in transforming the lagging digital infrastructure and leading the way in modern technology, including artificial intelligence, in Germany by both public and private sectors.

We commend Germany's progress in energy transition. At the same time, we welcome the "Climate Cabinet" that has been established in April 2019 to coordinate policies and establish overall climate goals for 2030, as revealed in the buff statement. Could staff comment on the initial views on imposing measures for specific economic sectors in the context of Germany's current debate on counteracting climate change?

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

Ms. Levonian, Ms. McKiernan and Mr. Hart submitted the following statement:

We thank staff for a good set of reports and Mr. Meyer for his clarifying buff statement. We generally share staff's assessment and will limit ourselves to a few specific remarks.

Germany's economy is strong but long-term structural challenges remain. The German authorities deserve credit for policies that have supported solid growth and labor market performance over the past decade. The economy is now in a very strong fiscal position with ample buffers. Wages are increasing while inflation risks appear to be contained. Still, with its open economy and export-driven model, Germany is exposed to trade tensions, disorderly slowdowns in key trading partners, and other geopolitical risks. Macro-financial risks are also increasing in a “low-for-long” interest rate environment. In addition, Germany is facing longer-term challenges related to population aging, weak productivity, rapid technological change, and a changing energy supply.

Germany’s excessive current account surplus is narrowing slowly but this trend should be supported by more proactive policies. We appreciated staff’s granular analysis of elevated non-financial corporate savings, which have contributed to income inequality and a persistent excessive current account surplus. This analysis supports our view that more should be done to unlock these savings to support demand and raise potential growth.

Therefore, we welcome the authorities’ recent measures to support demand by raising disposable incomes for lower- and middle-income earners, as well as the planned introduction of tax incentives for more R&D spending. In addition, staff’s tax reform suggestions are worthy of careful consideration, as are reforms to expand childcare and encourage more opportunities to promote robust female labor force participation. Overall, a more balanced income distribution would enhance Germany’s resilience.

Relatedly, German authorities could better leverage their fiscal space to raise potential growth by investing in physical and human capital and the quality and quantity of the labor force. Germany’s infrastructure deficit has been exacerbated by a bias towards fiscal consolidation at the local government level. As noted by staff, significant investment gaps have been identified in the areas of education, transportation, energy, and digital infrastructure. We welcome indications in the buff that government investment is increasing. The authorities should further expand their support for quality investment that addresses identified structural challenges. Can staff elaborate on the capacity constraints to infrastructure investment and any approaches being undertaken to address them? We also agree that increasing investment in education and life-long learning can help ensure that Germany’s labor force is equipped with the necessary skills in the face of rapid technological change.

The rise of macro-financial vulnerabilities warrants careful monitoring. Staff identify as the main risks the increase in credit growth, rising real estate prices, and low profitability for Germany's financial institutions. We note that the authorities share these concerns and welcome the recent activation of the countercyclical capital buffer. We agree with staff that the authorities should consider enhancing their macroprudential toolkit and address data gaps, and welcome indications that the authorities will consider these recommendations carefully. Addressing supply-side constraints (particularly affordable housing) would further mitigate risks in the real estate market.

We welcome Germany's firm commitment to an open, fair, and rules-based multilateral trading system. We also welcome Germany's voluntary participation in an assessment of the supply side of corruption and their efforts to enhance the effectiveness of their anti-corruption and AML/CFT regimes.

Mr. Ray and Ms. Park submitted the following statement:

We thank staff for a comprehensive report and Mr. Meyer for his informative buff statement. The German economy has been performing strongly, and following a decade of solid growth, sustained balance sheet repair and improvement in public finances, German unemployment has declined to the lowest level since reunification and public and private debt have fallen sharply. Nonetheless, slower global growth is weighing on the German economy, and the near-term outlook is clouded by unresolved trade tensions and uncertainty around Brexit. Medium-term challenges include aging pressures, low productivity growth and the need to adapt to technological change and manage the planned energy transition. In this context, we agree with the focus on measures to boost productivity and potential growth. Strengthening the resilience of the financial system also remains a priority.

Fiscal tools are appropriately focused on boosting productivity and potential growth through investment in physical and human capital, supporting innovation and bolstering labor supply. Planned measures to upgrade digital infrastructure, support innovation and venture capital are welcome, and there could be value in additional measures to address high effective marginal tax rates on low- and middle-income households and secondary income earners. Expanding the provision of childcare will also support labor force participation. As a broader point, space should always be made for quality investment, and we would caution against too tightly linking the assessment that there is fiscal space with the recommendation that it should be used. There is a case to strike a balance between growth-enhancing investment that is also supportive of external adjustment and maintaining some buffer against downside risks. We note the authorities' view that capacity constraints are becoming more binding, so there may be limits to the ability to expand infrastructure investment. More broadly, this stage of the cycle seems an appropriate time to recharge Germany's fiscal buffers.

We note staff's argument that measures to support disposable incomes are needed to accelerate external rebalancing and foster more inclusive growth. While we share staff's concerns about the risks associated with excess imbalances on a global level, we are also of the view that policy recommendations to deal with external excess imbalances must also have compelling domestic rationale to gain traction. Germany's current account surplus has narrowed in recent years (relative to GDP) and is forecast to narrow further, and we tend to share the authorities' view that relatively high surpluses in the medium term would be consistent with demographic trends.

Strengthening the resilience of the financial systems remains a priority. Continued supervisory focus on the management of interest rate risk and the implementation of restructuring plans to address medium term sustainability challenges to banks and insurers is welcome. Rapid growth in real estate prices should continue to be monitored and data gaps should be addressed. Understanding the nature of the macro-financial risks will assist in determining the appropriate policy response. The activation of the counter-cyclical capital buffer is welcome, but we would caution against the early activation of sector-specific macroprudential tools in the absence of rapid credit growth or evidence of a significant deterioration in credit standards. While staff recommend the development of macroprudential instruments targeted at commercial real estate (CRE) lending, we tend to agree with the authorities that any borrower-based instruments for commercial real estate lending would need to reflect diverse CRE financing structures. Can staff give examples of macroprudential policy measures directed at CRE that have been used effectively elsewhere?

Mr. Raghani, Mr. Sidi Bouna and Mr. Carvalho da Silveira submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Meyer for his insightful buff statement.

Despite the recent slowdown, Germany's macroeconomic performance remains solid although further progress is needed to rebalance the economy and address key structural challenges. The country's fiscal and external positions are in surplus. The labor market has strengthened, and wages are rising. While growth is expected to pick up in 2019 led by domestic demand, vigilance is warranted to guard against downside risks, including less favorable growth prospects within Germany's key trading partners. Furthermore, low productivity growth and population aging are undermining the country's long-term growth potential. There is also a need to adapt more rapidly to technological change while advancing energy transition. Against this background, we broadly share the staff's policy recommendations and would like to make the following comments for emphasis.

We concur with staff on the use of fiscal policy to raise growth potential and further rebalance the economy. As Germany's fiscal surplus remains large, we welcome the measures contained in the 2019 budget on income tax relief and family support which should have a favorable impact on middle and lower-income household consumption. The tax reforms discussed in the Selected Issues Paper on "Tax Pressures and Reform Options" are also valuable reform options to support the rebalancing of the economy and to increase long-term growth. Regarding the proposal to introduce tax incentivizes to stimulate research and development (R&D), we share the staff's view that the envelop in this regard could be increased. We fully agree that further increasing infrastructure investment, especially at the local level would also help support long-term growth. We note that capacity constraints in the construction industry represent a major obstacle to public investment growth. Could staff elaborate on the authorities' view regarding the need to strengthen coordination across the various government levels to ensure that investment projects are implemented over the long term?

Continued vigilance is warranted to mitigate potential financial stability risks notably from the real estate sector while addressing the low profitability of banks and life insurance companies. A sustained period of low interest rates has undermined the profitability of the banking sector and life insurance companies. Therefore, reducing costs within these sectors through, for example, a reduction in the number of branches and leveraging digitization, is essential. We echo the staff's call for a more rapid implementation of banks and life insurance companies' restructuring plans. As regards the real estate sector, we support the staff's recommendation to swiftly address data gaps in some segments of the mortgage market to enable a more comprehensive assessment of financial stability risks emanating from this sector. More broadly, we welcome the authorities' decision to tighten macroprudential measures and commend them for the recent decision to activate the counter-cyclical capital buffer. We take positive note of Germany's efforts to strengthen AML/CFT supervision and agree that progress in this area should advance, particularly for banks with cross-border operations. The 2016 FSAP recommendation on the development of a coordination mechanism for addressing a systemic crisis should also be considered going forward.

Efforts to support productivity growth and to alleviate the country's labor and capital constraints should continue. The authorities have taken commendable policy actions to address the decline in productivity growth as well as supply-side constraints. However, to raise productivity more decisively and increase domestic investment, they should accelerate the implementation of their strategies and initiatives in these areas particularly on digital infrastructure and energy transition. We welcome the National e-Government Strategy which should go a long way towards reducing the administrative burden of doing business. Measures are also needed to boost labor supply, including by further increasing old-age labor force participation. We have noted the staff's call for urgently adapting labor force skills to the rapidly changing technological environment. Could staff elaborate on the measures envisaged by the authorities in that regard?

Finally, we would like to commend the German authorities for their strong involvement in the fight against bribery in international business transactions.

With these remarks, we wish the German authorities success in their future endeavors.

Mr. Kaizuka, Mr. Saito and Mr. Nagase submitted the following statement:

We thank staff for the comprehensive report and Mr. Meyer for the informative statement. It is welcoming that Germany has enjoyed strong economic growth for the past decade and an unprecedented decline in unemployment, although the economy slowed sharply in the second half of 2018. At the same time, the economy faces significant challenges. For example, the gains of the strong economic performance have not been widely shared. The current account is assessed to remain substantially stronger than its norm. Moreover, population ageing, low productivity growth, and weak investment will weigh on the potential output. Against this backdrop, Germany needs to tackle these challenges in the current relatively favorable economic environment. As we broadly concur with staff's appraisal, we would like to offer some comments for emphasis:

Income Inequality and External Imbalances

Income inequality, together with sizable corporate savings and fiscal consolidation, has contributed to a rising current account surplus. Germany needs to continue working on addressing the excessive external imbalances while we positively note the efforts made by the authorities on this front. We welcome that the staff report focuses on income inequality as a source of external imbalances. The Figure 3 illustrates the trends of income inequality since 2000. Understanding the drivers of those trends would be useful to plan measures to reduce income inequality. During 2000s, distribution of real disposal household income had expanded, meaning that a higher income group gained more while a lower income group lost more. However, since 2012, real disposal household income has been stagnated only for the 1st decile group while having risen for all other groups. Could staff elaborate on what drove these developments of income inequality?

Fiscal Policy

Striking the best balance between building fiscal buffers and ensuring spending to reduce inequality and raise potential growth is essential. On the one hand, we see needs to build fiscal buffers to prepare for negative economic shocks and spending pressures from demographic changes, especially in the current cyclical position. On the other hand, facing low productivity growth, Germany should increase spending to enhance inclusiveness and raise its potential growth. We encourage the authorities to maintain the right balance between these two factors going forward.

In this context, at this current juncture, we encourage the authorities to accelerate their efforts to remove impediments for addressing infrastructure gaps, including capacity constraints, while using its ample fiscal space timely and effectively in economic downturn. In this regard, we support the staff recommendations in the last Article IV report to prioritize the provision of Partnerschaft Deutschland's services and make a comprehensive investment plan to alleviate bottlenecks for public investment at the municipal level. Could staff comment on whether there have been any progresses on these fronts? In addition, staff emphasizes the importance of better coordination across levels of government. Could staff elaborate more on the necessary coordination that staff specifically expects?

On tax reforms, we welcome the authorities' commitment on preserving competitiveness and social equitable tax system. It seems that the views on property and inheritance taxes are somewhat different between the authorities and staff. We encourage staff to further discuss this issue, including other options.

Financial Sector

Profitability of the financial sector needs to be strengthened and prevention of the accumulation of macro-financial vulnerabilities is encouraged. The continued "low-for-long" environment has been putting pressure on profitability of banks and insurance companies. They should accelerate their efforts to enhance revenues and reduce costs. In addition, real estate prices continue to rise rapidly, resulting in their overvaluation. Especially, we note that commercial real estate (CRE) prices have risen even faster than house prices and support the staff's view that the authorities should consider introducing income-based macroprudential instruments. We note that the authorities think that appropriate borrower-based instruments for CRE loans would need to reflect diverse CRE financing structures. We would like to hear staff's views on the appropriate design of borrower-based instruments for CRE loans.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Mr. Meyer for his helpful buff statement.

Sound policies and skillful management have helped Germany enjoy strong growth over the past decade, with unemployment rate at its lowest since reunification. However, growth dividends were not evenly shared, leading to rising external imbalances. Lackluster foreign demand and some domestic factors have lowered growth since the second half of 2018. While there are expectations for a gradual economic recovery to trend in the near term, adverse demographics, low productivity, technological change, and energy transition weigh on growth over the medium term. We concur with the thrust of staff appraisal and, given downside risks to the outlook, including a significant rise in global protectionism and lower global growth amid rising uncertainties, we encourage the authorities to use multi-pronged policies to rebalance the economy, address looming challenges, and lift the long-term potential growth while making it more inclusive.

Greater use of the space within national and European fiscal rules is necessary to support growth potential and external rebalancing. We welcome measures included in the 2019 budget that result in a moderate fiscal expansion. However, fiscal space remains substantial over the medium term and should be used to invest in physical and human capital, incentivize innovation, and bolster labor supply to counter population aging. We see merit in rebuilding planning capacity in local governments and stronger coordination across various government levels to help address infrastructure gaps. Further tax relief for low-income households and reducing the high effective marginal tax rate for secondary earners are also advisable. Could staff elaborate on the constitutional constraints in alleviating high marginal tax burden as well as why the proposal to update property valuations turns out to be revenue neutral? We agree on the need to let automatic stabilizers operate fully if growth disappoints and welcome the authorities' readiness, as reiterated by Mr. Meyer, to take decisive counter-cyclical action in case of a severe downturn. The authorities' commitment to seek collaborative solutions to international tax issues is also praiseworthy.

The financial system is well capitalized and liquid, with low and declining NPLs. However, the low-for-long interest rate environment, high operating costs, provisions for compliance violations, and slow progress with restructuring are putting further pressure on profitability and inducing a search-for-yield behavior. Work should continue to develop fee-based income and further consolidate banks as well as ensure faster life insurers' departure from guaranteed-return products and more diversified investment portfolios. Banks' increased exposure to the real estate sector, with continued rapid rise in prices, is building up macro-financial vulnerabilities. We welcome efforts to expand housing supply and mitigate price pressures. However, safeguarding financial stability and guarding against imbalances in the real estate sector require complementing the recent activation of the counter-cyclical capital buffer with additional actions to close data gaps, make use of existing borrower-based measures, and expand the macro-prudential toolkit.

Structural reforms to expand labor supply, upgrade digital infrastructure, cut administrative red tape, advance energy transition, and increase competition in product markets remain essential in promoting private investment, boosting productivity, and lifting growth potential. While the tight labor market is supporting wage growth and economic rebalancing, we welcome the new immigration law to attract skilled labor from outside the EU as well as expanded training of refugees to help them integrate into the workforce. The ongoing initiative to help SMEs advance their digital processes and plans to build a nationwide fiber-optic network by 2025 bode well for raising productivity and domestic investment. Timely and full implementation of the national e-government strategy promises substantial reduction in administrative burdens that stifle entrepreneurship. We find merit in a clear strategy to curb greenhouse gas emissions and complete energy transition to improve business sentiment. More also needs to be done to enhance competition in network industries and professional services.

Finally, we welcome the authorities' strong anti-bribery enforcement actions, including their voluntary participation in the IMF's assessment of the supply side corruption, and wish them continued success in their endeavors.

Mr. Fanizza and Mr. Di Lorenzo submitted the following statement:

We thank staff for their report and Mr. Meyer for his informative buff statement. We agree with the thrust of the staff appraisal and associate ourselves with Mr. De Lannoy's statement. We would like to offer the following comments for emphasis.

The German economy quickly recovered from the GFC thanks to its earlier courageous labor-market reforms and prompt action to recapitalize its banking sector, laying down the bases for a decade-long favorable growth performance. A stable institutional framework, strong fiscal position, unemployment next to the frictional rate, and a quite competitive manufacturing sector point to the key role that the German economy plays in Europe. However, the growth slowdown in recent quarters, trade tensions and the rise in income and wealth inequalities have highlighted the risk that the export-led growth model based on subdued wage growth may have reached its limits. A gradual rebalancing toward a more important role for domestic demand would help reduce the external imbalances the country has accumulated and reduce vulnerabilities to spillovers in case of a disorderly adjustments. Staff provide a list of structural challenges that need to be tackled both to limit these risks and to boost potential growth. We encourage the authorities to follow staff's advice to use the remaining fiscal space under the existing fiscal rules for these purposes.

The discretionary fiscal measures in the 2019 budget represent a step in the right direction, but more needs to be done to secure sustained long-term growth. The tax-relief measures are rightly targeted towards supporting lower-middle incomes, and additional resources are devoted to public investment. However, despite the high investment needs in infrastructure, the resulting fiscal impulse is only about one-third of the available buffer under EU fiscal rules. The DSA shows fiscal buffers will remain strong also under a combined macro-fiscal shock scenario. This result suggests a more proactive approach would not place the fiscal position under undue risks. Moreover, the fiscal surplus reached a record high in 2018 (with a negative fiscal impulse), despite no growth in the second half of the year; this overperformance points to a downward bias in the official revenue projections that casts doubts on the fact that the targeted fiscal loosening could be achieved in 2019. Have staff discussed with the authorities steps that could help reduce this systematic bias? Moreover, staff's analysis shows that the national fiscal rule (the debt brake) has constrained public investment also at the local level. What is staff's assessment of the German "debt brake"? Do they consider that a more flexible framework could actually strengthen German both short and medium-term resilience by allowing for debt financing of investments?

The financial sector needs to adapt to a quickly changing landscape. Its profitability has remained well below the European one, despite low levels of NPLs and the costly recapitalization following the GFC. Revamping the business and governance models remains essential to restore profitability in both banks and insurance by accelerating consolidation and reducing costs. Data gaps should be filled urgently to provide a clear understanding of the systemic risks linked to real-estate exposures and "Level 2 and Level 3 assets", which do not have a liquid-market price and whose discretionary valuations can lead to significant underestimate of potential exposures in case of market stress. Staff's comments on the possible risks linked to these assets are welcome. Finally, we believe that low and declining provisions of NPLs constitute a vulnerability to monitor carefully, because it masks the underlying profitability and capital position.

We welcome the recent downward trend in the external current-account surplus, but we note that the country's NIIP will continue to increase from an already high level, with a real exchange rate that staff consider undervalued. These imbalances reflect: (a) excess savings fueled by a inequal concentration of wealth; and (b) low private and public investments. Actions are needed on both fronts. Correcting these imbalances will benefit not only the German economy, but also the regional economic outlook. A reduction of private and public net savings will make it easier for monetary policy to achieve its inflation target by not only supporting demand, but also avoiding a flattening of the yield curve. At this very juncture the rebalancing could make less likely that trade tensions emerge between the US and Europe. Finally, smaller German external surpluses would also make more credible adjustment efforts in deficit countries.

A strong and dynamic manufacturing sector remains at the crux of the German economic success. However, rapid technological change has already created challenges in the automotive industry by making even relatively-new diesel engines obsolete. It is imperative that the industry adopt and adheres to new standards for fuel efficiency and opens up to the most advanced technologies, such as self-driving cars. In this sense efforts should focus, on upgrading the telecoms infrastructure – essential to promote technological change – boosting investment in research, and strengthening initiatives to enhance access to finance for innovative firms.

Mr. Lopetegui and Mr. Morales submitted the following statement:

We thank staff for their well-written report and Mr. Meyer for his insightful buff statement.

We welcome Germany's strong economic performance over the last decade, supported by labor market reforms and by improved public finances and balance-sheet repair in the non-financial corporate sector. As a result, unemployment has fallen to unprecedented levels, public and private debt have declined, and personal income has risen. GDP growth is picking up in 2019Q1 driven by strong investment, higher private consumption triggered by better labor market conditions, and the recovery from a temporary disruption in car production that depressed economic activity in the second half of 2018. Looking forward, the authorities are encouraged to use the fiscal buffers built during the "good times", as highlighted by Mr. Meyer in his statement, to address structural challenges associated with adverse demographics, low productivity growth, and increased inequality.

Fiscal space remains substantial in the medium term. We welcome measures in the 2019 budget that would result in a fiscal expansion of about 2/3 percent of GDP, namely increased family support, tax relief provisions, and higher public investment. Still, we note that substantial fiscal space remains in relation to the Stability and Growth Pact's (SGP) medium-term objective. We concur with Mr. Meyer that the sound fiscal position increases the resilience of the German economy, a position that is welcome in the context of external risks. We encourage the authorities to take advantage of the reserves accumulated by central and state governments in recent years thanks to budget surpluses to boost spending further, especially on physical and human capital, innovation, and further tax relief for low-income households. We agree with staff that a generous R&D tax credit could be an effective way to encourage innovation. In addition, well-targeted tax relief would not only improve inequality indicators but would also support domestic demand. Moreover, strong coordination across government levels would be necessary to spur longer-term projects.

We welcome the recent pickup in credit growth that contributes to higher domestic demand. As is to be expected, this entails a dose of risk-taking by commercial banks in lending to households and non-financial corporations, especially after a long period of restraint. However, the authorities should be watchful that the low-interest-rate environment and low supply of government securities are not leading banks to take excessive risks as they pursue higher yields and profitability. We welcome the activation of the counter-cyclical capital buffer by the Financial Stability Committee, but we agree with staff that additional macroprudential action should be considered. We support the staff's views that data gaps should be addressed to assess the use of additional macroprudential tools if necessary, such as LTV ratios.

We note that the decline in unemployment has been accompanied by higher wage growth in recent times. This reflects Germany's still strong cyclical position that has translated into widespread labor shortages. Boosting disposable income further could help translate these recent trends into more inclusive growth. We agree with staff and the authorities that this could be achieved through a combination of tax policies, a higher minimum wage, and increased family benefits. In this regard, it would be useful if staff could provide information on the impact of Germany's tax and benefit system in mitigating income inequality. On a related point, recent gains run the risk of being reversed if downside risks materialize and have a significant impact on growth. In this connection, the authorities' commitment to allow automatic stabilizers to operate freely in the event of a slowdown, as confirmed by Mr. Meyer in his statement, is reassuring. Looking ahead, promoting investment in start-ups and venture capital initiatives, increasing competition in business services, and raising investment in education and life-long learning would further contribute to a faster adaptation to rapid technological change and more sustainable growth.

Germany's external current account surplus has gradually come down, mainly because of a slowing external demand from non-EU trading partners. We take note of staff's assessment that the current account surplus remains substantially stronger than implied by medium-term fundamentals. To further narrow external imbalances, Germany's demand for external goods and services needs to increase as the country continues deepening its integration into global value chains, ideally underpinned by a gradual realignment of relative prices. In the meantime, Germany remains vulnerable to external shocks given the uncertain external environment threatened by a rise in global protectionism, a more pronounced China slowdown and/or a hard Brexit, which could significantly affect Germany's exports and FDI and disrupt supply chains. Looking forward, the adaptation of the German economy to technological change driven by digitalization would help to diminish the country's external vulnerabilities. In this regard, we encourage the authorities to address the investors' concerns that appear to have constrained private investment in Germany below that of peers, which translates into high capacity utilization rates rather higher capital expenditure on new technologies.

We commend the German authorities for being on track to meet their renewable energy target. Germany is leading the way in adapting its economic structures to face climate-change related challenges. We welcome the introduction of a Climate Cabinet in charge of coordinating policies and establishing a legal framework to reach the overall climate goals for 2030 and ensure the transition to climate neutrality for 2050, as indicated by Mr. Meyer in his statement. The immediate climate agenda should include ensuring that the adaptation of the internal electricity transmission capacity in line with the recently enacted Grid Expansion Acceleration Act.

We appreciate that Germany maintains a strong commitment to fighting corruption and keeps a robust AML/CFT framework. Recent efforts to tackle AML/CFT risks in cross-border operations are appropriate, including taking into account recently identified AML/CFT weaknesses across Europe.

With these comments, we wish Germany and its people every success in their endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Alhomaly submitted the following statement:

We thank staff for a set of well-written reports and Mr. Meyer for his insightful buff statement. The German economy continues to grow, with sound fundamentals and continued decline in unemployment, but external and structural challenges are creating uncertainties going forward. Against this background, we are in broad agreement with staff’s analysis and policy recommendations and would like to make the following comments for emphasis.

We take positive note of the projected recovery of growth from 2020 onward, after the expected deceleration this year. However, risks are tilted to the downside and the unfavorable demographics, technological change, and the uncertainties of the energy transition are expected to negatively impact economic activity over the medium-term. To this end, we underline the importance of accelerating structural reforms and steadfast implemention of policies to boost inclusive growth while safeguarding financial stability. Could staff elaborate on the reasons behind the divergent views of the authorities and staff on the estimated growth for the year 2019?

In light of the widening income inequality, we agree with staff on the need to boost the disposable income of middle- and low-income households, for instance through faster wage growth. Indeed, this would also help accelerate the external rebalancing and reinforce inclusive growth. In this regard, we welcome the recent increases in wage growth and consider that the recent fiscal measures to provide tax income relief and support household consumption are steps in the right direction.

Fiscal policy has an important role to play, particularly in case of protracted slowdown. In this respect, we welcome the indication in the staff report and Mr. Meyer's statement that automatic stabilizers will operate freely if such event materializes. Staff has assessed the fiscal space to be substantial over the medium-term and advised using it to support potential growth and rebalancing, including through tax reform and bolstering labor supply. Here, while we see merit in staff's recommendations, we would appreciate staff elaboration on the difference in views between the authorities and staff on projected tax revenue. In addition, we concur with staff that revenue shortfall could be offset by reforming taxes. We also take positive note of the authorities' planned tax incentive for R&D activities to foster productivity and innovation.

Additional measures are needed to further boost productivity and domestic investment. In particular, we agree with staff on the importance of upgrading the digital infrastructure, promoting e-Government services. Here, we welcome the authorities' plan to support fiber-based gigabit network across the country. We also note that venture capital investment has been rising recently, thanks to the government initiatives to promote entrepreneurship and innovation. Staff, however, pointed to the existing constraint facing capital-intensive businesses in scale-up stage, due to the small size of venture capital funds. Since such businesses are less risky than startups to attract funding, additional explanations from staff would be welcome to explain such phenomena. We also welcome the authorities' ongoing efforts to crowd in private investment, particularly institutional investors, through its co-investment strategy. Could staff elaborate on the authorities' co-investment policy and how is it contributing to greater private sector investments across sectors and size of firms? Also, we share staff's concern regarding the uncertainties surrounding the energy transition on growth going forward. Here, while we understand that the authorities are considering introducing higher taxes on fossil fuels and that decision has not yet been made, we would appreciate staff elaboration on the potential impact of such measure on growth and the expected social buy-in at this juncture.

The performance of Banks and life insurance companies is under pressure amid protracted low interest rate environment. In this context, we see merit in staff's recommendation to reduce cost by reducing branches and promoting digitalization. We would consider this in broader context as this is not only relevant to Germany but also to many countries, especially in an environment of "low-for-long" and where financial inclusion could be achieved through greater use of technology rather than expanding the number of branches. Staff's comment would be welcome.

We note the continued increase in real estate prices, particularly in large cities. In this regard, we welcome the authorities' efforts to increase housing supply to improve affordability. However, we note that the long-standing issue of data gaps in the real estate sector has not yet been addressed, but are reassured by the indication in the buff statement that ad-hoc survey on real estate lending and corporate credit underwriting standards is underway and is expected to provide more granular information about possible financial stability risks in specific market segments.

With these comments, we wish the authorities all the success.

Mr. Palei submitted the following statement:

We thank staff for the set of insightful papers on Germany and Mr. Meyer for highlighting the authorities' views. We broadly agree with staff's analysis. We particularly enjoyed reading the SIP chapter, "Wealth Inequality and Private Savings in Germany", as it sheds light on deeply rooted imbalances in the German economy and has direct implications for the analysis of a large and persistent undervaluation of the currency and current account surplus. We encourage staff to expand this line of research to other economies with high current account surpluses.

We agree with staff's assessment that the currency is undervalued by about 8-18 percent and the current account surplus is in excess of the estimated "norm" by about 3.6 to 5.6 percent of GDP (Annex 1). We agree that such estimates, including the ones based on the recently improved methodology, remain notoriously imprecise. However, in our opinion, the presence of an unexplained residual or doubts about accuracy of the estimates should not be a reason to negate the results of the technical exercise. Instead, multilaterally consistent assessments should encourage staff to embark on additional analysis of the external sector and the forces affecting it.

We commend staff and Ms. Mai Dao, the author of the special chapter in the SIP, for an insightful analysis contributing to our understanding of imbalances in the German economy and, perhaps, offering an additional angle to consider the large imbalances in the euro area. The latter played a central role in the euro area crisis. Moreover, the new study should be instrumental in the Fund’s policy advice on structural and other reforms in Germany, which may speed up the still slow post-crisis adjustment in the euro area.

From the staff paper we note that over the past two decades various policy decisions and exogenous factors contributed to wage moderation in Germany. We recall that in several staff reports on the Northern European countries, including the Netherlands, Finland, and Sweden, staff discussed similarly structured wage negotiations between the social partners. We realize that other factors, including technology, international trade, immigration, and the development of the global and regional value chains, also contributed to the declining share of labor in GDP. However, the authorities’ reforms and specific decisions, such as setting property and inheritance taxes at relatively low levels, further augmented the share of the rich in Germany.

Over an extended period, skewed distribution of income led to a peculiar situation with the median wealth in Germany being similar to that in Poland, which has a much lower GDP per capita. Low rate of house ownership in Germany and worsening housing affordability could be manifestations of structural challenges in the German economy. Since 2005 disposable income has decreased by 6.2 percentage points of GDP and even more for the middle class and people with low income. This decline should be seen as a cost of restoring and maintaining external competitiveness of Germany which was paid by a large share of population.

We note that Mr. Meyer in his well-focused BUFF statement raised the question about the respective roles of independent decisions by private sector participants versus the authorities’ policies and policy measures affecting the distribution of income and wealth in Germany. We would appreciate staff’s additional comments on this matter.

Another interesting question is related to the nature and resilience of the export-led growth model in Germany. The recent decline in net exports contribution is largely attributed to a combination of rather specific events, some of which may be temporary factors. The recent pick up in wage growth, however, may well lead to a gradual reduction in existing imbalances in the economy and erosion in the economy’s excessive competitiveness. The speed of this process affects economic outlook for Germany and the euro area. We note staff's illustration that even the wage growth consistently exceeding GDP growth by 1.5 percent would take a long time to eliminate the existing imbalances. At the same time, we agree with our colleagues that other consequences of more rapid wage growth should be considered. For example, high wage growth and eroding competitiveness in Germany may complicate the conduct of monetary policy by the ECB. Staff comments would be appreciated.

With these remarks, we encourage staff to further develop their analysis of the nature of external and domestic imbalances in Germany and in other countries facing similar challenges.

The representative from the European Central Bank submitted the following statement:

We thank staff Mr Meyer for his buff Statement and the Staff for their report and selected issues paper. We associate ourselves with the Statement of Mr De Lannoy and would like to highlight the following issues.

We broadly concur with Staff on the economic outlook and risks surrounding the baseline**.** Germany has experienced solid economic performance in the past decade. The temporary slowdown in growth in the second half of 2018 somewhat overshadowed the otherwise positive signs of the economy. Looking forward, we concur with Staff that structural factors, such as unfavorable demographics and low productivity growth weigh on potential growth beyond the near-term horizon. Adding to that, risks to the outlook are tilted to the downside, mainly stemming from unfavorable external factors, such as rising protectionism and retreat from multilateralism, weaker than expected global growth and the possibility of a disorderly Brexit.

We agree with Staff that Germany's current account surplus moderated but remains substantially stronger than implied by medium-term economic fundamentals and desirable policy settings. The surplus reflects the persistent weakness of investment in Germany, particularly in the NFC sector. Against this background, we see a need to boost investment and reduce excess savings which would support the narrowing of the current account surplus. The gradual realignment of price competitiveness and effect on euro area inflation would also foster the sustainability of the adjustment undergone by countries with high external liabilities.

Along these lines, we broadly agree with the IMF's view that available fiscal space should be used to enhance the growth potential of the economy, notably by further increasing public investment and fostering labor supply, e.g. by reducing the high tax wedge. This policy line also concurs with the country-specific recommendation to be addressed to Germany in the context of the 2019 European Semester. Taking into account cyclical conditions and existing downside risks to the baseline projection, we see merit in allowing some remaining fiscal space to be used more effectively in a counter-cyclical fashion following a possible economic downturn.

We agree with Staff that further policy action on structural measures will be needed to address Germany's medium-term economic challenges. Efforts are particularly required in terms of major reforms to mitigate longer-term risks stemming from demographic developments, low labor productivity growth, and a challenging energy transition. The weak structural reform agenda coupled with unresolved bank legacy and profitability problems may indeed increase risks of a turn in business cycle in the euro area and weigh on future investment in Germany. Against this background, we stress the urgency to revive the structural reform agenda in Germany.

We concur with Staff on the need to implement pension and labor market reforms to lengthen working lives and to reinvigorate competition-enhancing reforms. Pension reforms that explicitly link the statutory retirement age to life expectancy can further increase old-age labor force participation and would help to counter adverse demographics. Moreover, increasing investment in education and life-long learning can help the labor force in the face of rapid technological change. In addition, the ageing society would require that younger immigrants be integrated into the workforce, helping to address specific labor shortages. The new immigration law is a step in the right direction. In relation to reforms in competition, we support reforms in enhancing the environment for entrepreneurship and venture capital. Further reforms are still needed to boost productivity and potential growth in non-traded sectors and protected professions and in the services sector.

We broadly concur with Staff's assessment of vulnerabilities in the financial sector and their policy recommendations. Financial vulnerabilities have risen with credit growth accelerating, real estate pricing rising, profitability remaining challenging for banks and life insurance companies, and provisioning and risk weights declining.

We also agree with Staff on their macroprudential policy assessment and recommendations. We welcome the recent activation of the countercyclical capital buffer (CCyB) and agree that additional macroprudential action in the real estate sector is called for. In particular, we concur with Staff's recommendation to address data gaps, to expand the macroprudential toolkit, and to consider prompt activation of the existing borrower-based measures (LTV cap and amortization requirement).

In line with the ECB's Governing Council statement of December 2016, we strongly support the inclusion of DTI/DSTI limits in the legislative framework to have a comprehensive toolkit of borrower-based macroprudential policy measures available. Regarding the activation of existing borrower-based measures, we would, in the first instance, encourage the authorities to consider communication to banks on the importance of sound lending practices for new loans through a recommendation or other suitable communication channels.

Mr. Meyer made the following statement:

I thank the other chairs for their thoughtful gray statements. It is against this background that I would like to make a few comments.

Despite the recent cooldown, Germany is still in a relatively positive economic situation. Growth is expected to return to trend in the baseline, wages are rising very solidly, and unemployment is at an historically low level. Having said this, let me highlight, in light of the recent mixed economic data—as I also indicated in my buff statement—that my authorities will let automatic stabilizers work in case the current slowdown should become more protracted, and will react more forcefully should we see a severe downturn at some point in time in the future. Next to preparing for challenges like aging, this is exactly why we were so keen to regain fiscal room for maneuver after the global financial crisis.

Moving away from the current conjuncture, we are cognizant of the manifold external and domestic challenges that lie ahead. Unresolved trade tensions and uncertainty surrounding Brexit weigh on investors' sentiment, while domestically, we have to address the issue of an aging society, the integration of a record number of immigrants, technological change, and the energy transition from fossil fuels and nuclear power to renewables.

All of the above—and that is an important point—create uncertainties and concerns for our citizens. My authorities see it against this background as one of the most important priorities to foster acceptance for needed reforms. This is why higher public investment and measures to foster social cohesion go hand-in-hand as the government's top priorities. Let me line out in more detail how we intend to tackle these issues.

I will start with multilateralism. In view of the most pressing issues that we all face at the current juncture as common challenges—be it trade, taxation, climate change—continued international cooperation is of the essence. Especially, we consider it of utmost importance to maintain an open, fair, and rules-based multilateral trading system which is beneficial for every country and which is not a zero-sum game. The European Union (EU) is a good example of how progress and tangible benefits for citizens can be achieved when nations come together to work for the common good. Germany stands firmly by our commitments to Europe and to the international community.

On structural reforms, we take note of many Directors' concerns to reinvigorate the reform agenda in Germany and push ahead with reforms that will raise productivity and potential growth. We agree. But I would highlight one more time that we have to proceed on those important issues with very long-term consequences in a manner that is understood and accepted by our citizens. Convincing local communities to accept energy grids through their neighborhoods is not an easy task, as is the move away from coal as an energy source in a socially acceptable way. But we are making progress. For example, last week a report was published that estimated that in the first half of 2019, the share of renewable energies in Germany and their overall electricity production mix rose to a record 44 percent, reducing CO_2 emissions by 15 percent, compared to the same period in the previous year.

Moving to fiscal, in the context of the structural challenges, public investment is a top priority. It continues to rise and will help to modernize our economy in a socially and ecologically sustainable manner. To this end, we are focusing on investments in climate-friendly infrastructure, research and education, affordable housing, and the expansion of fiber optic networks. For some, the increase in public investment may not be fast and sizable enough, but as is outlined in our buff statement, this process is not easy and takes time.

Many Directors have pointed out the need to alleviate the tax burden on low- and middle-income households. My authorities broadly share this view and have, therefore, embarked on a number of measures aimed to do this, first and foremost, the abolition of the so-called solidarity surcharge for all but the top 10 percent of income earners, as well as higher targeted financial assistance to families.

On the external sector. We would like to highlight that Germany's current account surplus has been declining for the third year in a row now and is projected to decrease further. At the same time, growth in Germany has been driven almost solely by domestic demand for years now, further indicating the ongoing rebalancing of the German economy.

Like other Directors, we found the staff's work on the drivers of Germany's current account surplus and the mutually reinforcing relationship with wealth inequality very interesting. We encourage the staff to further explore this issue, not least regarding potential policy distortions and options to address these. This could also contribute to addressing the still very large unexplained current account gap.

Finally, one word on the financial sector, as regards the financial sector, we agree with staff and many Directors that pockets of vulnerabilities exist and have risen but that overall risks are contained at the current juncture, given the generally comfortable capital buffers and fairly low household debt.

Mr. De Lannoy made the following statement:

I will start by thanking the staff for the informative report and selected issues paper and Mr. Meyer for his helpful buff statement and his introductory remarks.

On behalf of my European colleagues, I would like to highlight a number of points.

Germany experienced solid growth during the past decade. Following a temporary slowdown, the economy is expected to rebound in the second half of 2019. Wages are expected to continue increasing, given the historically low unemployment rate, while housing demand and infrastructure needs translate into strong construction investment. At the same time, the German economy faces long-term challenges related to population aging, low productivity growth, a challenging energy transition, and growing wealth inequality. Efforts by the public sector to address these challenges are important and will also help to reduce the current account surplus.

The persistent current account surplus is expected to continue narrowing, underpinned by solid domestic demand and a gradual realignment of price competitiveness. However, absent further policy measures, the surplus will remain large. We see scope for a further increase in private and public investment, notably, at the regional and municipal levels.

We also find the staff's analysis regarding non-financial corporate net savings and the current account interesting, and we would encourage further analysis in this area to identify relevant policy recommendations.

On fiscal policy, we largely concur with the recommendation to use fiscal policy to strengthen growth potential and support rebalancing. Staff estimates a moderately expansionary fiscal stance for 2019. The 2019 budget contains a welcome increase in public investment, which will encourage the authorities to continue going forward. We also see merit in a tax reform, in particular, for middle- and lower-income earners to support purchasing power and strengthen work incentives. The rebuilt fiscal buffers could be partly used to finance such measures. At the same time, we agree with the authorities that these buffers are important in light of an aging society and associated contingent liabilities, while they will also allow for a fiscal stabilization in the case of a downturn.

On financial market policies, we note that German banks hold adequate capital. However, we concur with staff, that financial vulnerabilities have risen, as evidenced by low profitability, increasing house prices, and accelerating credit growth. We, therefore, welcome the recent activation of the countercyclical capital buffer and agree on the need for additional macroprudential action in the real estate sector.

Finally, structural reforms can alleviate Germany's long-term challenges. Ageing-related risks can be addressed with further measures to increase the labor supply and, in particular, female labor force participation. We also agree with the staff's recommendation to link the statutory retirement age to life expectancy.

Labor productivity growth can be increased by reducing high regulatory barriers in the business services sector and regulated professions. The additional funding in 2019 and future budgets for education and lifelong learning also supports labor force adjustments to rapid technological change.

Meeting the climate, energy, and environmental targets requires investments in sustainable transport infrastructure and affordable housing. We take note of the various initiatives started by the authorities to address these long-term challenges, as elaborated by Mr. Meyer.

Mr. de Villeroché made the following statement:

I thank Mr. Meyer for his buff statement and these helpful remarks. I associate myself with Mr. De Lannoy’s statement and oral remarks.

I will start by saying that the report is framing well the structural challenges that Germany is facing and the question of the rebalancing of the economy, looking at the persistently very high external position.

Germany experienced very strong growth over the last years and now is facing a slowdown of the economy. In this context, we would see the need for fiscal policy to be proactive. We had a slightly contractionary stance in 2018. We hope that this year, the significant available fiscal space could be further mobilized to enhance investment, support the adaptation of the German economy, address inequalities, and support the most vulnerable. We hope that this year, the authorities will be able to deliver on that. Since we have a track record of an under-execution of the budget, we remain a bit cautious. We would be happy to hear from staff if they see this risk going forward again.

Second, on the current account surplus, I welcome the work done on the linkage between wealth inequality and the current account surplus. I found this work very interesting. However, according to the norm, the current account surplus is still very high. We know that without a strong push from domestic demand, public or private, this level will remain too high for too long. It is creating risk at the global level, at the European level as well. And here, we hope that the authorities will be more proactive than they used to be.

I would like to echo staff’s recommendation on the need for more dynamic wages to support domestic demand. We would like to have further work on the role of the minimum wage in Germany and the situation of an extension of collective agreements as well, something which may have created some subdued wage increases in the past because they are a less automatic extension of collective agreements in Germany than in other countries.

All in all—and we will have this discussion on the euro area afterward—we definitely think that Germany needs to be ready to accept a higher inflation level. We will not come back to the 2 percent target on average for the euro area without Germany being above the target. It has to be stated somewhere. Otherwise, we may face a very long period of accommodative monetary policy. Germany is a country where inflation can be driven for the rest of Europe, looking at the situation and the position of relative economies.

Let me end by saying that I welcome the statement of Mr. Meyer on having the automatic stabilizers, which could be used in the event of a more protracted situation that Germany will have to address.

It would be reassuring to hear from the German authorities the same statement publicly. Maybe they did it. I am not fully aware of it. But for the confidence in the euro area and in the world economy, it is important that the authorities signal that they are ready to act, if needed.

Mr. Rosen made the following statement:

I thank Mr. Meyer for his insightful buff statement and his comments, in which he pointed out the remarkable stability and strength of the German economy, as well as all it is doing to encourage wage growth and investment.

We fully agree that Germany's economy is strong and highly competitive, and we are encouraged by the actions that Germany is taking to accelerate growth. However, we do believe, like many other chairs, that there is more that can be done on the current account surplus, though we understand it is the authorities' view that this is due to private sector decisions and international trade, not domestic policy decisions. While that may be the case, we, your friends in the United States, as well as many of your European partners who have mentioned it in their gray statements, believe the surplus is still excessively large. We believe more active policy steps need to be taken to further lower the surplus, which will reduce trade tensions and, more importantly, be very positive for both European and global growth.

First, we encourage the authorities to do more to boost household incomes at the lower end—and we heard a little of that from Mr. Meyer this morning—to better support consumption. Recent wage increases are encouraging. We agree with the staff that supportive public communications on wages, combined with tax relief at lower income levels, including reducing the labor tax wedge, will help. We also agree with the staff and many other chairs that pension reform and incentives to increase the labor participation of women and older workers could reduce the fiscal costs of ageing and make more room for the needed reduction in labor taxes.

On fiscal policy, we reiterate our view again, shared with many chairs, that Germany should use its ample fiscal space more actively. More accurate revenue forecasting by the federal government would help. We urge the authorities not to apply tighter fiscal policies than they intended by being overly conservative in their projections, as Mr. de Villeroché has also pointed out.

On the issue of reducing very substantial retained capital in the corporate sector that, according to the staff's analysis, appears to be a significant factor in causing the current account surplus, we agree with other chairs that tax policies that encourage the distribution of dividends should help. But we are cautious, from staff's suggestions, about generational, estate, and other taxes that undermine the stability of Mittelstand companies that have been the backbone of Germany's success.

We appreciate the authorities' plans to boost spending on infrastructure and R&D. Focusing federal government support to different local governments' investment priorities could incentivize larger and longer investment programs. We hope the authorities can move in this direction.

In next year's Article IV consultation, we encourage the staff to include an active policy scenario to better demonstrate the potential impact of a stronger package of policies. Further steps to reduce the tax burden, incentivize R&D, upgrade infrastructure, and streamline regulations could do much to make growth stronger, more durable, and more balanced.

Finally, on the banking sector, we agree with staff's diagnosis, that addressing low profitability requires bank consolidation which, in turn, requires the political will to allow this transformation of consolidation so that banks can focus on becoming more efficient and increase their profitability.

Ms. McKiernan made the following statement:

I thank the staff for the very good report and Mr. Meyer for his helpful remarks and context setting this morning.

At the outset, I would like to commend Germany for its solid economic performance and sound fundamentals. But as Mr. Rosen put it, we also believe that more could be done to deal with rebalancing and long-term challenges. Our gray statement covered the main points, so I will only focus on one particular issue today, which is the link between Germany's high domestic savings, its current account surplus, and its fiscal stance.

We appreciated staff's deep dive into the non-financial corporate savings and the link with Germany's rising income and wealth inequality and the large current account surplus. That analysis has certainly helped to generate a good discussion. It supports our view that there is a strong case for German policymakers to invest more in boosting domestic demand and raising potential growth.

We found staff's suggestions to restore household purchasing power to be worthwhile, particularly at the lower end of the income distribution. Similarly, we agree that raising potential growth will require a greater investment in human and physical capital, as well as policies to support innovation and bolster the labor supply. In addition to helping reduce excessive imbalances, a greater effort on both these fronts would raise potential growth and support inclusiveness.

We certainly appreciated the comments of Mr. Meyer on the policy moves that have been made in several of those directions. We think that these are worthwhile policy objectives in their own right, but they would also have the added benefit of reducing wider euro area imbalances. As Europe's largest economy, with deep trade interlinkages with its neighboring countries and the euro area, Germany would stand to benefit from second-order effects also.

Finally, we appreciated the consistency of the advice contained in this Article IV with that of the External Sector Report (ESR), which we will be discussing on Wednesday. It is these types of links between multilateral and bilateral surveillance that help to build better policy traction and that we would encourage more of.

Mr. Tan made the following statement:

First, we thank Mr. Meyer for his concise statement and opening remarks and also commend the authorities again for their strong economic performance and sound fundamentals. We also thank the staff for the informative set of papers and their helpful responses to the technical questions. We have three points to add for emphasis following our gray statement.

Let me start with the discussion around the use of fiscal space. While there was a range of views shared in the gray statements, a common theme underlying those views is the consensus on creating the conditions for higher potential growth. We take some positives from this, as well as note that the authorities expect to continue to give priority to enhancing infrastructure, human capital, and innovation. Like Mr. Kaizuka and Mr. Inderbinen, we see the central issue as striking a balance between competing priorities that continue to evolve over time.

Preserving some buffers at this juncture makes good sense, especially given the environment, where there is a market premium on having the ability to act in times of need.

The same can be said about preparing for the long-term challenges relating to demographics, digitalization, energy transition, where the authorities have to keep a forward-looking focus, even as they deal with the short-term needs.

In finding the right balance, we see merit in the note of caution from Ms. Levonian, not to link the assessment that there is fiscal space with the recommendation that it should be used. This is self-explanatory and so is the clarification from staff, that steps are needed to support more persistent and sustainable increases in public investments and mitigate capacity constraints in the short term.

My second point is on the external sector assessment. Here, it is worth noting that policy actions to foster more inclusive growth, raise productivity, and revitalize private investment are not mutually exclusive from those that support external rebalancing. In fact, they can be complementary and reinforce one another. We appreciate that this is not lost on the authorities, while moving in the same direction with the narrowing capital account surplus, as emphasized by Mr. Meyer.

An informed policy discussion is predicated on a proper understanding of the underlying drivers and policy gaps. Hence, we also welcome staff's analysis, particularly in the selected issues paper. We see this as a good starting point for further work and would encourage staff to dive deeper and draw out more clearly the economic implications and spillover effects of any distortions identified.

Until then, the high model uncertainties and large unexplained residuals, which are not unique to the German context, place a premium on right-sizing Fund advice, which both staff and the authorities should be mindful of. At the end of the day, external rebalancing is not an end in itself. To have an enduring effect, it should not be pursued in isolation. To gain good traction, it should not distract the authorities from the immediate challenges that they must deal with more decisively.

Our last comment relates to the bank legacy and profitability issues. The staff's responses to the technical questions are much appreciated and have further demonstrated how daunting and deep-rooted the problems are. We agree with the authorities that the financial institutions need to take the primary responsibility for their own business strategy and viability, but we would caution against placing too much faith on them getting it right on their own. Hence, we would call on the authorities to continue to work with and push industry to take more decisive steps and make further progress on their restructuring plans, even as we acknowledge some of the structural challenges at both the national and broader euro area level.

On that note, we wish German authorities well for their future.

Mr. Alkhareif made the following statement:

I would like to begin by thanking staff for their work, including for their excellent selected issues paper about wealth inequality and private savings. I also thank Mr. Meyer for his informative introductory remarks and buff statement.

Indeed, the German authorities deserve to be commended for their prudent economic policies. The GDP has been solid over the past 10 years. The unemployment rate has been very low. But like some other countries, the German economy is faced with multiple challenges, including weak productivity, unfavorable demographics, and rising income and wealth inequality. Against this backdrop, we broadly support staff's analysis and recommendations.

On the fiscal side, my colleagues have discussed this extensively. I will be brief. We note that the German economy recorded its largest fiscal surplus since their unification. Fiscal space is assessed to be substantial over the medium term. In this context, I agree with Mr. De Lannoy, Mr. de Villeroché, Mr. Rosen, and others, that Germany could use some of its fiscal space to boost potential GDP growth and rebalance the economy, including through a higher investment in human capital, and improve the labor supply.

We also take positive note of the authorities' planned tax incentives for R&D to foster productivity and innovation. We encourage the authorities to consider further tax relief for low-income households to boost their disposable income and support domestic demand.

On the external side, we note that Germany has large imbalances. Indeed, rising corporate profits have contributed to growing wealth inequality. Like Mr. Rosen, we agree that policies to boost disposable income among the middle- and low-income earners, such as improving minimum wages, would support both the rebalancing of the external sector as well as improve equality.

With regard to the financial sector, the low interest rate environment is putting further pressure on the banking and financial sectors' profitability. In this context, supervisors should continue monitoring interest rate risks and implementing a restructuring plan in both the banking and insurance sectors. In addition, we agree with the staff on the need to address data gaps to better assess financial stability risks, including the real estate market. We also take positive note of the authorities' efforts to strengthen Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) supervision. Indeed, progress in this area should continue going forward.

Let me conclude my remarks on a personal note to Mr. Meyer. I believe this is his last Article IV consultation here at the Fund. I would like to wish you continued success. You have served Germany very well here at the Board, and I wish you all the best.

Mr. Saito made the following statement:

We thank staff for the comprehensive report and Mr. Meyer for the informative buff statement and also for his opening remarks this morning.

As we have issued a gray statement, I would like to offer two comments for emphasis.

First, on fiscal policy, we are of the view that the authorities need to strike the right balance between building fiscal buffers for aging-related expenditures in the future and to also increase spending to areas which help to reduce inequality and raise potential growth. At this juncture, we encourage the authorities to accelerate their efforts to remove impediments in the local government for promoting infrastructure investment. Such efforts would help the authorities to use their ample fiscal space timely and effectively in the face of an economic downturn in the future.

Second, on the financial sector, real estate prices continue to rise rapidly. In these circumstances, we support the staff's view that the authorities should consider introducing income-based macroprudential measures. In addition, given the high risk of commercial real estate, we agree with staff, that the more stringent prudential measures in areas such as covenants and guarantees are also required.

Finally, the continued low-for-long environment has been exacerbating the profitability challenge of the banks and the insurance companies. They should accelerate their efforts to enhance revenues and reduce costs.

On the revenue side, staff mentioned that the banks should continue to develop fee-based income. Since this is a global challenge, including for Japanese banks, we would like to hear staff's comments on what types of income-based income would be promising for banks, especially for the savings and corporate banks in Germany.

Mr. Just made the following statement:

We appreciate Mr. Meyer's introductory remarks and associate ourselves with Mr. De Lannoy's oral remarks.

We would like to expand our views on fiscal policy and Germany's economic model. Most countries of this chair historically have had and continue to have very strong economic ties with Germany, and we are benefitting from and contributing to the German global value chain. Some of the countries of this chair even share the German authorities' preferences for strong macroeconomic policy management, sound fundamentals, and robust policy frameworks. Indeed, Germany's fiscal performance is quite remarkable, also when put into a European context. Fiscal consolidation is possible in good times, and when faced with headwinds, fiscal policy can appropriately shift gears to support growth, as is currently the case in Germany.

However, we are also increasingly concerned by Germany's fiscal consolidation efforts, which seem to become an end in itself and appear, to a certain extent, obsessive. This obsession with fiscal adjustment is starting to undermine Germany's future economic growth and prosperity and may also weigh on the euro area.

We fully agree that Germany has a mounting investment backlog, and we are concerned that, without a significant increase in public investments, in digitalization, connectivity, physical infrastructure, energy, or decarbonization, Germany's competitiveness will be eroded.

The German economy is confronted with substantial risks from trade wars, automation, and faster decarbonization, which would justify stepped-up public investments to support the German economy over the coming years. While this should, first and foremost, be in Germany's own interests, the German supply chains in the euro area and the EU at large will likely benefit from higher-quality German domestic investment and an increase in German competitiveness.

Germany may be obsessed with fiscal adjustments. Equally, the Fund, in tandem with some of its members, are seemingly obsessed with Germany's current account surplus. Over the years, the staff has presented a wealth of interesting analyses on this topic. This year, we benefit from a selected issues paper on wealth inequality and private savings. We agree that the selected issues paper offers some interesting angles but are concerned that we may draw some premature policy conclusions with unintended consequences. Allow me to elaborate.

One particular strength of Germany's economic model is its Mittelstand. The selected issues paper offers an innovative take on its observed high corporate savings, but this may not be the entire story. The high corporate savings of the Mittelstand may reflect the low fragmentation of Germany's banking system and that municipalities rely on local banks for their financing, often at lower rates than available to the local corporates, which crowds out private investments in geographically fragmented banking markets but also contributes to the buildup of corporate savings for investments.

Mr. Meyer also makes the important observation that German foreign direct investment (FDI) is recorded as corporate savings and, thus, staff may operate with somewhat inflated figures. Nevertheless, the savings behavior of the Mittelstand is a highly important policy question and it would be warranted to have a better understanding of the factors that hold domestic investment back.

Another traditional strength of Germany has been the social partnership between employers and unions and the strong welfare states or the social market economy. The enormous expansion of the low wage sector following the Hartz IV reforms contributed to a weakening of the social partnership, as Germany failed to implement these reforms that would have resulted in a more virtuous circle, at least for the growing cohorts of low-wage earners.

Germany is now facing a mounting inequality problem, which is also increasingly reflected in its public policy discourse. Taxation and investment in human capital are obvious candidates. However, we wonder whether a higher public investment in social housing would be a bit more appropriate than squarely focusing on housing wealth, as the staff does in the selected issues paper.

To conclude, Germany's economic model is characterized by the openness of the economy, a high degree of sectoral and geographic specialization, which would be even more important for income growth, solid public finances, and stability in the future, as the population ages and other countries catch up. However, we should not fall into the trap of seeing this economic model as the problem, but it clearly needs to be renewed to address legitimate concerns about rising regional inequality and social polarization. Fiscal policy will definitely need to play a more supportive role, with public investment focused on increasing Germany's economic potential while safeguarding fiscal stability.

The continued success of Germany's economy and its social model is crucial for a stronger Europe but, in turn, will also increasingly hinge on such a strong Europe. We would see that as a more positive surveillance agenda for the Fund and Germany.

Mr. Inderbinen made the following statement:

We thank the staff for the good documents and their responses to the questions for today and also Mr. Meyer for his helpful buff statement.

In our gray statement, we welcomed the solid performance of the German economy and the sound policies, although downside risks have lately increased. We emphasized, in particular, the strong fiscal position, which has increased resilience. And we note from Mr. Meyer's buff statement the importance of the fiscal rule in anchoring expectations and, thus, providing credibility to macroeconomic policy. As Mr. Meyer reminded us in his earlier remarks this morning, rebuilding fiscal buffers is essential to have space to react in case of a downturn.

Like others, we took good note of the staff's selected issues paper on the high corporate net savings and the buildup of the current account surplus in Germany. We found this work very interesting.

Overall, on the nexus of income and wealth inequality and Germany's external balance, the aggregate saving and investment balance would seem the most important aspect to us.

What should trouble policymakers most is that small- and medium-sized enterprises (SMEs), which are one of the defining features of the industrial organization in Germany, are not investing or innovating as much as they might be.

One reason for retaining earnings may be tax, but as Mr. Jin and Mr. Huang put it in their gray statement, tax can hardly explain underinvestment conclusively. Indeed, from a flow perspective, tax would seem neutral, since the staff explain—albeit in a footnote of the report—that the top personal income tax rate is equal to the combined corporate income and dividend tax rates. So potential policy responses should focus more on structural reform to foster entrepreneurship and innovation, which staff, indeed, include in their external sector assessment, and less on tax reform and wage developments.

On a more formal note, on the external sector assessment, we would have welcomed a bit more material on this in the main body of the report, including a representation of the authorities' views, given the differences with staff. <ore generally, we would also like to emphasize, once again, that it is critical to accommodate for country-specific factors when analyzing external imbalances.

One note on the financial sector that we did not make in our gray statement that I would like to make here, is that we are in agreement with staff on the continued low-for-long interest rate environment and the risks to profitability that this poses to German banks and insurance companies and life insurers, in particular. This would seem of particular importance if some of the companies are relying on transition measures to reach the required solvency ratio.

Here, we would like to note the importance of avoiding a cliff edge effect upon completion of the transition period. We take note of the staff's advice for life insurers to diversify their investment portfolios. But here, we would caution that market repricing remains one of the key risks.

Mr. Tombini made the following statement:

We thank Mr. Meyer for his helpful buff statement and for his intervention.

I commend the German authorities for their strong growth performance and macroeconomic fundamentals and prudent policy management over the past decade. Global trade tensions and Brexit uncertainty, like Mr. Meyer said, are posing a significant challenge for Germany’s external demand and growth outlook. In addition, the structural issues, headlined by lower productivity growth and population ageing, are weighing on potential growth. Against this background, nevertheless, we believe the German authorities are well positioned to safeguard macroeconomic stability and foster growth back to its long-term trend.

A constant theme in the analysis of the German economy during the post-global financial crisis period is the issue of rebalancing domestic vis-à-vis external demand, as we have seen in the discussion this morning.

We see merit in staff’s assessment of the main drivers of the current account surplus and their recommendation to use domestic policies to support demand through increasing real wages, home ownership, and access to financial markets for low- and middle-income households. Furthermore, available fiscal space can be strategically used within the fiscal rule to elevate the country’s potential output and productivity growth. This may be critical in the medium term, considering the progressive impact or the adverse demographics on the labor supply, which could restrict potential output further.

Policy options provided by the staff, including reducing the labor tax wedge, increasing the R&D tax credit, and integrating immigrants into the labor market, would be effective ways to support growth without diverging from the Medium-Term Fiscal Framework.

Regarding the financial sector, the low-for-long interest rate environment has exerted extended pressures on banks’ profitability. While the German banking sector is well capitalized and resilient, their prudent risk-taking behavior could be playing a role in diminished profitability, as suggested by Mr. Meyer in his buff statement. That said, we encourage banks and insurance companies to complete their restructuring process in order to improve cost efficiency.

I want staff to comment on the news we got this morning about the main restructuring initiative from the largest bank in Germany, if this is along the lines that we have thought about, consolidation and restructuring in the financial system.

Finally, like Mr. Alkhareif, I would like to acknowledge Mr. Meyer's contributions to the work of the Board and to the Fund. I wish you well in your future endeavors.

Mr. Fanizza made the following statement:

We thank Mr. Meyer for his buff statement and his quite encouraging opening remarks. I associate myself with Mr. De Lannoy's statement and remarks.

This is an excellent staff report. I find myself in agreement with almost everything. I strongly support the staff's position and the staff appraisal.

Ironically, the sputtering external demand in this soft patch of the German economy at this juncture provides an incredible opportunity for Germany, for the region, and for Europe, where at this juncture the main way to offset the slowdown in external demand is to increase domestic absorption. Staff puts great emphasis on wage growth. It also does an excellent job in quantifying the amount needed. But it is clear that wage growth cannot do the whole job. We also need something else. We need public investment to reduce the net savings of the public sector. Germany has found itself in a fantastic position, where it can actually finance itself at negative rates. The 10-year bond is at minus 0.4 percent. It is mind-boggling; why do not you do it? Let us do it.

Also, it is not only because the rate of interest is low, which helps—and certainly, you could accept many projects that are above that level—but also because fiscal policy needs to do its part in order to facilitate the achievement of the inflation target and—we will discuss later, as Mr. de Villeroché was saying before—the issue is that monetary policy cannot do everything we need. Being more active on the investment side, issuing more and more long-term bonds would help to increase interest rates. That would also increase what I think is an important vulnerability of the German economy, the conditions of the financial sector, which is in trouble because of the low interest rates. We need to get out of this situation. It is a win-win situation in which everybody would benefit, also in the region, by reducing imbalances.

The financial sector remains a vulnerability. The financial sector has been hit by low interest rates but also by underspending, on which we would like some more information on the presence of level two and level three credits.

Mr. Ostros made the following statement:

I thank the staff for the excellent set of reports. I associate myself with the gray statement of Mr. De Lannoy and his oral intervention. I thank Mr. Meyer for his buff statement and his intervention.

Let me start by saying that we often discuss the fine-tuning of fiscal policy in the short term, but overall and on balance, it is an asset for the European economy and the global economy that a major economy as Germany has plenty of policy space in a period of time that is highly uncertain in terms of where we are actually going in the economic development. I would like to commend the authorities for steering the boat so steadily, for being in such a position that is good for all of us.

I found, like Mr. de Villeroché and others, that the focus on wealth inequality and private savings and the link to the current account surplus was very interesting. It is a type of work that makes you understand a little bit more how the German economy works. It adds a new dimension to the discussion on the German current account surplus and the high savings ratio.

The changes in wealth and income distribution over the past two decades and the role of buildups of corporate savings have played a central role in this macroeconomic adjustment process for Germany. The wealth and income inequality loop seem to be also somewhat reinforcing, adding more and more savings to the top income households. I agree with many of the Directors that this is a field that I would encourage staff to go further in to understanding. After listening to Mr. Inderbinen's thoughtful intervention and listening to the alternative explanation by Mr. Just on why the Mittelstand sector saves—because of some of the distortion in the financial sector—there is a scope to more fully understand what is going on. Overall, the tax and benefits system should encourage investment, as well as labor supply. The German authorities have some scope to act on those fields.

My second point relates to the global slowdown in manufacturing and the role of the auto sector. I appreciate the staff's analysis on the potential auto tariffs' effects on the German economy, but I would like us to go deeper to understand what is really happening in the manufacturing sector in Europe.

It seems to be hard to disentangle what is a structural challenge in the auto sector. Maybe there are structural things going on that have more long-term effects than we believe is possible. What is the effect of the slowdown of investment in China? What are the confidence effects stemming from the trade tensions that we are in? I understand that the WEO will look closer into this. But we tend to underestimate the auto sector’s importance in manufacturing because of its complicated value chains and also its very strong driving force for the services sector connected to the auto industry. I would encourage more work on that also.

Mr. Ray made the following statement:

I do not usually intervene on an individual European Article IV report, but I found this set of papers particularly fascinating. Therefore, I cannot help myself. The reason I do not intervene is partly because I cannot get my head around why I would worry about the current account balance of an individual member in the euro area.

It strikes me that some of the questions that come to my mind in Germany are some of the questions that we have discussed in other situations, such as: Has the non-accelerating inflation rate of unemployment (NAIRU) in Germany come down? And if so, why? What can the rest of us learn from it? On this question of fiscal space, we need to be a bit cautious. As we have said in this chair many times, just because you have fiscal space does not mean you should use it. It is not clear to me that it is always the best time to be, for example, ramping up infrastructure spending when you are running a budget surplus because it could be that you are running a budget surplus because you are at that stage of the cycle. I noticed in both the staff report and in Mr. Meyer’s useful buff statement that there are capacity constraints in the infrastructure sector. You would not want to use taxpayers’ money just to ramp up prices. I just wondered how you square that circle.

Second, it is not surprising that German companies are choosing to invest outside of Germany, given the demographics that they are facing. Is there a difference between how large companies think and small companies think? Is that affecting savings?

Like others, the analysis of the link between wealth inequality and the current account balance seems innovative and interesting, but I would come at it as a deficit country, and I would not want to recommend to Asia that the way to fix the current account deficit is to be less equal in the distribution of wealth. I am hoping that this is a German-specific case and that when this is communicated, it is seen as a German-specific case. But generally, I would encourage the staff to keep working on this because it clearly is of interest.

I worry about glib recommendations to lift the pension age. As Martin Baily said to me recently: I used to think this was a good idea until I started to think about the distributional implications of it. It is politically very challenging. Is it, actually, the best thing to do? It is not clear to me it is as simple as some people think.

On R&D, this may be just our perspective, generally, most innovation is either done by large companies or brand-new startups. The large companies do not need an incentive to do it, and it does not seem to me to be a particularly good use of taxpayers' funds. Startups do not pay tax. I do worry a bit about recommendations around using R&D tax credits, and it may be that a much more complicated set of policies is needed because the link between R&D and productivity is established, but how you get more R&D is a bit harder, and I would encourage the staff to think about that a bit more deeply.

Mr. Palei made the following statement:

I wanted to add a few words to my gray statement after listening to Mr. Meyer and also to many colleagues. I would like to support others in encouraging staff to do more work on the role of the institutional setup in depressing wage growth or in wage moderation in Germany, and also to look into some of the cross-country evidence we have. It could be a Germany-specific institutional setup or it could be a broader phenomenon which we did see in some of the other countries. In fact, in my gray statement, I have mentioned some of these countries where I recalled from Article IV consultations, we had very interesting discussions on the wage moderation policies and the wage negotiation process. The link between wage negotiation, the wage bargaining process, and the external position is very important in Germany, and I believe that it is important for other countries as well.

In fact, we are not talking about just current account surplus economies. Last year, there was a working paper on Italy. The title was, "Competitiveness and Wage Bargaining Reform in Italy." It could work both ways. Wage moderation or wage stickiness can also be evident when there is a downward adjustment of wages. We believe that this is a broader phenomenon. By now, the staff has accumulated a lot of evidence in this area, so it would be very useful to put it altogether. Maybe we will have a very useful angle on external imbalances within the euro area. I just wanted to congratulate the staff for this selected issues paper, particularly Chapter 1.

Mr. Huang made the following statement:

I would also like to add points on the external sector. We appreciate the staff's analysis of the high corporate net lending in Germany, which contributes to the current account surplus. In the meantime, we also noticed from Mr. Meyer's buff statement that FDI is important as investment from the perspective of firms' balance sheets but also as savings from the perspective of a country's national accounts. If a country with a current account surplus but most of the surplus is foreign backed under the current account by means of direct investment, do we still need to worry about the large current account surplus or the so-called over-saving?

As more multinational companies are investing abroad, how can we better measure the current account balance in debt circumstances? Thinking about that may be our next priority.

The Deputy Director of the European Department (Ms. Kozack), in response to questions and comments from Executive Directors, made the following statement:[2]

I thank Directors for their careful reading of the reports and for their questions and comments. We have responded to many questions in our written answers. I just wanted to say a few words about the external sector and the financial sector. Then, I will answer the questions that were raised orally.

On the external sector, we appreciate Directors' acknowledgement of the team's work on the drivers of the current account. When we embarked on this work, we started with a very open mind about what we would find. What we had observed was that consumption had declined quite dramatically as a share of GDP in Germany. We also observed that household disposable income had declined quite substantially as a share of GDP. We also observed that the correlation between household disposable income and consumption was stronger in Germany than in many other advanced economies, suggesting that at least on average, German households did not seem to smooth consumption to the same degree as households in other countries. We wondered what this set of observations meant and how it might interact with the observed increase in corporate net lending or corporate savings, which we observe as one of the counterparts to the rise in the current account surplus. Our work, which is presented in the selected issues paper, yielded a number of interesting conclusions. You have discussed them today. They are clearly

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

elaborated in the staff report. But one of the things that several of you have raised today is what does this mean for other countries? Can we draw any conclusions for other countries?

First, several countries have high wealth inequality. Some have current account surpluses, and some have current account deficits. Many countries have also experienced a rise in corporate net lending. Some have current account surpluses and others have current account deficits. The impact of other policies and other sectors of the economy also clearly matter greatly for the evolution of the current account. One needs to put it all together to get the complete picture. My point here is that there are many country-specific factors also that may be at play, and those factors may interact with each other. Let me just mention a few that are applicable in Germany, which may or may not be relevant for some other countries.

The first is the wealth inequality. Starting with an initial condition of high wealth inequality can magnify and reinforce the effects of shifts in income from labor to non-labor sources. Non-labor sources of income, like dividends and profit, tend to accrue to wealthier households which tend to spend less and, therefore, accumulate even more wealth. This tends to increase both the wealth of the wealthier households but also it increases overall household saving. Or in the case where some of this saving is done inside closely held firms, it increases overall private savings. The distinction between what saving is done in the household and what is done in the firm becomes a bit blurred.

A second factor is high private business wealth—wealth in closely held firms—amid rising profits. The concentration of business wealth in private firms like the Mittelstand companies in Germany tends to reduce the opportunity for profits to be distributed more widely in the population. The average citizen cannot buy an equity stake in some of the Mittelstand companies since they are not listed on the stock exchange. That is not to say that the Mittelstand are not extremely important and vital for Germany's economy. It is just an observation, that it is harder for profits to be shared more widely when you have this type of institutional setup for firms. In an extreme case, the main way in which the profits or the proceeds that are generated by this very competitive sector of the economy to be shared more widely is through wages.

The third factor is the issue of consumption smoothing. Some countries that have experienced either high wealth inequality or stagnation of household disposable income have not experienced the same type of stagnation in consumption or a decline in consumption as a share of GDP as Germany. One of the issues that we have considered is whether low median wealth may play a role. In Germany, it is not just that wealth is unequally distributed, but the level of median wealth is also relatively low. This may cause two things. One is that households may not benefit from a wealth effect when asset prices rise because households may have fewer collateralizable assets with which to borrow against to smooth their consumption.

These are just some of the factors that we have looked into in the report and that we are considering. There are many other factors and many other interactions that are in play. Economies are very complicated, but we just wanted to emphasize these few factors, which may or may not be salient for many other economies. These are issues that the team is going to consider and think about more deeply going forward.

The other sector that I wanted to touch on a bit is the financial sector. Many of you discussed the profitability challenges in Germany's financial sector. It has been an issue and a challenge for Germany's financial sector for quite some time. The concern is that—and this is especially true in the systemically important institutions—progress in improving profitability has been too slow and that this may make it difficult for institutions to raise capital or to adapt in the face of potentially new shocks.

Yesterday, Germany's largest financial institution, which is also systemically important both in Germany and globally, announced some significant steps to begin to tackle its profitability problems. These include substantial cost cutting and a carving out of hard-to-value assets into what is essentially a type of bad bank or asset management company or separate entity. Behind the cost cutting is a strategy for the bank to try to refocus on what it would consider its core businesses— corporate and retail banking—and effectively re-orient its business back toward Europe. Newspaper articles this morning suggested that the cost cutting has already begun today in several major cities. It is widely accepted that this type of very ambitious and radical restructuring strategy is needed for this particular institution, given the numerous challenges that it faces, including on level two and level three assets. This particular institution seems to have quite a lot of these difficult and hard-to-value assets. The issue was discussed in the External Balance Assessment (EBA) stress tests. These are the types of assets that will be put into a separate entity to be unwound and to help clean up that part of the bank's balance sheet.

For the other institutions in Germany, the low-for-long interest rate environment continues to pose profitability challenges. The main way we think these institutions will need to deal with this challenge is through consolidation and cost cutting. The opportunities to raise fee-based income are relatively meager. We are talking about ATM fees, fees on deposit accounts, maybe some fees associated with using the payment system, some additional commission income on mortgage lending. But these institutions will also need to think about cost cutting. That will have to entail consolidation but also potentially a shift to mobile banking and internet banking, to become more efficient.

There were a few other questions raised by Directors. One was on our views on budget execution risks. It is the case that fiscal policy has continued to overperform in Germany. As staff, we have, over time, been raising our revenue projections to try to avoid having this positive surprise on the revenue side. For example, this year, our projection for revenue-to-GDP is virtually unchanged, relative to last year, despite the fact that growth is much lower. We are hopeful that we are guarding against these upside surprises on the revenue side for 2019. We are therefore a bit more optimistic that there will be some fiscal expansion this year.

There was also a question on capacity constraints in the construction sector and whether the timing is right for public investment. Our view is that Germany does not need a fiscal expansion for cyclical reasons. We still assess, despite slower growth, that the output gap is positive, but we do think that there are these long-term structural needs in Germany and that Germany should use its fiscal space to begin addressing these much longer-term needs. Some of those needs are on infrastructure, which will require some spending on construction, but we are mindful that there are increasingly tight conditions in the construction sector. For that reason, we also recommend a number of other measures on the fiscal side, including on education, on the tax side, on social spending to help incentivize women to enter the labor force, which would not put such a strain on the construction sector.

There was also a question on whether the behavior of small versus large companies is different with respect to corporate saving and profitability. We do see some differences, but a lot of the rise in corporate savings seems to have taken place in family and closely-held firms. That said, the rise in corporate saving in general has been throughout the corporate sector.

The Deputy Director of the Strategy, Policy (Mr. Bayoumi), in response to questions and comments from Executive Directors, made the following statement:

There was a question on the relationship between FDI and external assessments. I would note that although it is called "foreign direct investment," that investment is generally a buying of an existing corporation, rather than a green field investment. Therefore, it does not necessarily involve an investment on a national accounts basis.

What I think is more interesting is the nexus between those bought companies and then subsequent investment, which may be financed from the home country through bonds or other means. I do think there is a fairly complicated relationship between the current account and global value chain-type relationships. But I do not think FDI is necessarily a good way of measuring that.

Mr. Meyer made the following concluding statement:

I have just a few comments. First, the current account discussion, after all these years, frustrates me a bit. We have a gap of 5.1 percent for Germany; 4 percent of that is not explained. The domestic policy gap is 0.5 percent of GDP in the fiscal. This is the frustration that I have, that this is not really taken into account in the discussion, that we are jumping to conclusions, instead of doing further work to better understand it—which we would support. There were many interesting points on that.

The second frustration is that the rebalancing of the German economy is ongoing. If you look backward a couple of years, there are no net contributions from exports to growth. Going forward, in the projection horizon, it is the same thing. This has to do with a strong labor market, plus wage growth now being quite solid. So those two elements are a part of the discussions, to my frustration, because they seem to be ignored by some.

I would not agree with the Italian chair, that with sputtering exports now should be a golden opportunity to make changes. In Germany, at least, we are trying to have a very long view on the rebalancing and on the challenges.

If I may, I would just reject the idea, as Mr. Rosen has put it, that we should act more proactively on the current account because that would reduce trade tensions. I have to say, if country A is starting bilateral tensions, to ask country B to do something about it so that country A feels better about it is not a solid way forward. I want to be very clear on this one.

I have one comment on the low median wealth. I just wanted to indicate, when comparing countries, that the fact of the social safety net in Germany would have to be taken into account, the pension system, et cetera.

Finally, on the financial markets, I just wanted to point out again, it is right. We have high costs. There are IT gaps, et cetera. But to some extent, low profits in the banking sector do not necessarily reflect high financial stability risks but could also be the result of prudent risk taking, as mentioned, and a competitive banking market in Germany.

On the data gaps, I just wanted to make the point, and we agree, that closing those data gaps is not so easy for the federalism in which we are living in Germany. But we are doing a survey. We might do that survey again. Plus, on the micro level, supervisors have all the information about the single banks. That goes a long way to containing financial stability risks as well.

With this, I would like to thank Directors for their comments. We will convey those to our authorities.

Let me thank the Germany team, comprising Ms. Mineshima, Mr. Natal, Ms. Chen, and Ms. Mai Dao, under the leadership of Ms. Kozack and also Ms. Detragiache, for their excellent work. We would also like to thank the FAD team, under the leadership of Ms. Perry, which has contributed a very relevant analysis on options for tax reform in Germany. As in the past, their close communication and cooperation with our office and our authorities has been much appreciated.

Finally, I thank Julie Kozack, in particular, for the excellent service working on Germany, as she will be moving on from the German desk. We would like to wish her the very best in her new role and are looking forward to working with her successor in an equally outstanding manner.

The Acting Chair (Mr. Lipton) noted that Germany is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the German authorities for their skillful economic management, which has underpinned growth, strengthened the fiscal position, and reduced unemployment to a historically low level. Directors noted the recent economic slowdown and downside risks that weigh on growth prospects. They highlighted long-term challenges from unfavorable demographics and weak productivity growth, as well as external risks surrounding trade tensions and the Brexit process. Addressing these challenges and external imbalances would be a priority going forward.

Directors observed that, while external imbalances are starting to unwind amid faster wage growth, Germany’s large current account surplus partly reflects high corporate savings, widening top income inequality, and compressed household consumption. Directors thus saw a need for forceful policy measures to ensure that the benefits of strong economic performance are broadly shared. Continued faster wage growth and boosting disposable income through the tax and benefit system would be helpful in this regard.

Directors welcomed the moderate fiscal expansion this year. While acknowledging the importance of maintaining adequate buffers to prepare for aging population and potential contingent liabilities, most Directors encouraged the authorities to continue to use the available fiscal space to bolster potential growth and facilitate rebalancing. To this end, they recommended investments in infrastructure, tax measures to raise disposable income for low-and middle-income households, incentives to promote labor force participation by female and elderly workers, and tax credit for further research and development. Directors welcomed the authorities’ readiness to consider additional fiscal stimulus in the event of a severe economic downturn. They also commended the authorities for their commitment to promote fair and competitive corporate taxation and seek collaborative solutions to international tax issues.

Noting weak labor productivity growth and supply-side constraints in both labor and capital, Directors stressed the importance of expediting structural reforms to promote innovation, investment, and competition, also in business services and regulated professions. They encouraged upgrading Germany’s digital infrastructure, implementing the e-government strategy, and improving access to venture capital. Directors observed that Germany is on track to meet its renewable energy target and welcomed the authorities’ consideration of a carbon tax and carbon pricing as part of their strategy for curbing greenhouse gas emissions.

Directors welcomed the progress in implementing the FSAP recommendations. They noted low profitability in both the bank and life insurance sectors, elevated macro-financial vulnerabilities, and rapidly rising real estate prices in dynamic cities. Directors underscored the need to monitor interest rate risk and accelerate restructuring efforts to durably enhance financial sector resilience. They welcomed the activation of the counter-cyclical capital buffer and encouraged further steps to address data gaps that would enable a fuller assessment of potential financial stability risks. They also supported expanding the macroprudential toolkit, including tools for the commercial real estate market.

Directors appreciated Germany's voluntary participation in the Fund's enhanced governance framework on the supply and facilitation of corruption. They commended the authorities for taking strong anti-bribery enforcement actions and welcomed their commitment to continuing efforts in this area.

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

APPROVAL: May 5, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Wages

1. Our understanding is that domestic demand has been weak in 2019 Q2 – could staff confirm and indicate what might the drivers of such a weakness in a context of rising wages?

- Domestic demand has remained strong on average in the first half of the year, in line with rising wages. The weakness in Q2 (as reflected in dropping retail sales, industrial production, and construction indicators) is the reflection of quarterly volatility as the one-off factors that exceptionally boosted Q1 are waning.

2. *Could staff elaborate on the reasons behind the divergent views of the authorities and staff on the estimated growth for the year 2019?*

- The difference between the authorities and staff is minor (0.1 percent of GDP difference in growth forecast)

3. *Can staff comment* on *whether wages are now growing commensurate with what would be expected given the tight labor markets? We also wonder whether the increase in wages is in line with staff's forecast that German inflation will exceed the ECB's inflation objective by 2022, thus helping to lift overall inflation in the euro area.*

- Wages grew strongly at the end of 2018 and the first half of 2019. Staff forecasted a slightly higher wage growth in the 2019 SR, but the recent growth soft patch has led to a downward revision of both unemployment and output gaps, with dampening effects on the wage and inflation forecasts. However, tight labor market still supports dynamic wage developments.
- We documented in the 2017 SR the relationship between wages and inflation in Germany. The correspondence at the annual level is not one for one as increases in unit labor costs are not fully passed through to price inflation in the short run. But over the medium run, and conditioned on our baseline scenario for the global economy, we still expect strong wage growth to gradually affect price inflation and inflation expectations in a self-reinforcing manner.
- There is no objective for domestic inflation in a monetary union and given Germany's advanced position in the cycle, it is to be expected that inflation will be higher than 2 percent in Germany if the ECB is to fulfill its price stability mandate.

4. ***However, more attention should have been drawn on the necessity to upgrade controls over the effective implementation of the minimum wage and to promote the extension of collective bargaining agreements to a larger share of the employees. We understand that some discussions are ongoing on the suppression of existing obstacles to the extension of bargaining agreements – could staff indicate the nature of those discussions?***

- In Germany, extensions to collective agreements are very uncommon as they have to be requested by both parties and have to be approved by a bipartite committee (its consent is necessary, but not sufficient, the Government is not obliged to issue the extension). Extension would then be issued by the Federal or regional governments. Extensions under the Posted Workers Act are limited to minimum wage and other minimum conditions. Until 2015, a necessary condition was that the agreement had to cover >50 percent of employees in the sector. Since 2015, the criterion has changed, in an attempt to increase the flexibility to grant extensions. The collective agreement must now be deemed of **public interest**, which is defined as:

i) being of "predominant importance", meaning that not only the formal but the actual coverage should be taken into account, which includes companies which take over the agreement as an orientation mechanism without being formally covered,

ii) the extension is necessary to prevent an undesirable economic development, or

iii) the extension is needed to secure joint social funds at sectoral level

- In practice, nothing has changed since the extension still has to be requested by the bi-partite commission and employers have resisted and even appealed recent decisions for extensions. Overall, union coverage has been on a declining trend for 2 decades now.
- More recently, Unions have been asking for further revisions to the German Collective Bargaining Law in order to clarify the circumstances in which an extension is in the "public interest". They emphasize, in particular, that the current provision on the "predominant importance" of the collective agreement should no longer be used as a bargaining coverage threshold and that other criteria, such as the provision of equitable working conditions and stability of the bargaining system, should be of equal importance. In this they are supported by legal experts, who argue that an effective extension system need not use any quantitative criteria for the representativeness of the collective agreement (Preis and Peramato, 2017). Second, the unions are demanding the abolition of the veto power of the Collective Bargaining Committees (Körzell and Nassibi, 2017). For this, they propose amending the decision procedure, so that an application for extension can be rejected only by a majority of the votes within the Committee. Discussion is ongoing.

5. ***Could staff comment on experience with the minimum wage in Germany so far?***

- Analysis of the effect of minimum wages on the labor market are always difficult as conclusions would depend on the methodology to build counterfactual controls. Staff did not conduct its own analysis, but our reading of the available empirical evidence is that the introduction of the minimum wage did not have adverse effects on employment so far, including in the low-wage sector.

6. We see merit on staff's proposals for a stronger increase in the minimum wage as well as a tax reform to support the purchasing power of middle and lower-income earners. Could staff elaborate on how an increase in the minimum wage could sustain over time the recent wage growth?

- An important determinant of future wage growth will be robust labor demand and continued tightness on the labor market, a natural consequence of sustained aggregate demand. To the extent that increases in minimum wages are targeted to a segment of the population whose marginal propensity to consume out of income is close to unity, higher minimum wages – if they do not lead to lower employment, a key requirement – could play a significant role in boosting purchasing power and consumption, which in turn would support labor demand and overall wages.

7. For example, high wage growth and eroding competitiveness in Germany may complicate the conduct of monetary policy by the ECB. Staff comments would be appreciated.

- The ECB, by construction, sets monetary policy for the euro area as a whole, and is thus neither able nor expected to adjust its settings based on economic conditions in individual euro area countries. It pursues a medium-term objective of inflation below, but close to, 2 percent—and this is an average: there will be countries where inflation is higher.
- With euro area inflation still well below the objective at this time, the gradual pick up in wage growth is seen as an encouraging sign, and not one that staff would view as complicating the conduct of monetary policy. Staff's advice is for the ECB to maintain strong monetary accommodation until inflation is convincingly converging to target, and for vigilance to be maintained with regard to any adverse spillovers to financial stability, including in Germany, with the targeted use of macroprudential tools as needed.

External Imbalances and Inequality

8. In the same vein, we see merit in better understanding and considering their view that the CA surplus is mainly a result of private sector decisions in international trade and investment, and not of domestic policy choices. Staff's comments are welcome, including the authorities' suggestion to classify Germany's

competitiveness as overall neutral, while staff has assessed the 2018 REER to have been undervalued in the range of 8-18 percent.

- As analyzed in the staff report and accompanying SIP, the CA surplus could also be an outcome of Germany's unequal wealth distribution and resulting income inequality, for which policies may play a role.
- Staff's methodological approach to assess the equilibrium REER differs considerably from that of the Bundesbank. As explained in the ESR page, staff relies on two approaches, the EBA REER level regressions and an estimate of the REER adjustment needed to close the assessed current account misalignment, based on standard trade elasticities. The Bundesbank assessment is based on indicators of past trends in price competitiveness and productivity of the German economy relative to trade partners.

9. Could staff elaborate on what drove these developments of income inequality?

- Starting 2013, real disposable income started increasing more evenly, with most groups experiencing an improvement except for the lowest decile. The strong economic performance and continued fall in unemployment is believed to contribute to this favorable development, and likely did the introduction of the minimum wage in 2015. That said, for many households, this has still not reversed the stagnation of real disposable income compared to before 2000. One factor behind the continued fall in real disposable incomes of the lowest decile is the rise in immigration and their relatively poor labor market prospects.

10. We note however staff views that bringing the household disposable income to GDP ratio back to its 2005 level through wage growth alone would require nominal wage growth to exceed annual nominal GDP growth by 1.5 percentage points over a decade. In light of this challenge, do staff have complementary policy tools in mind?

- As such wage growth may prove difficult to sustain, staff is recommending additional tax relief for lower-income households, who often face relatively high marginal tax rates, to boost disposable income of lower-income households and promote labor supply at the same time (see paragraph 22).

11. We note that Mr. Meyer in his well-focused BUFF statement raised the question about the respective roles of independent decisions by private sector participants versus the authorities' policies and policy measures affecting the distribution of income and wealth in Germany. We would appreciate staff's additional comments on this matter.

- Any decision by private sector participants, including those affecting the distribution of income and wealth, are undertaken conditional on existing policies and institutions. While it is too early to conclude which concrete policies are most relevant for the high inequality of wealth in Germany, staff analysis (as well as evidence in the academic literature) suggest that property and inheritance taxation may play a role.

Fiscal

12. Here, while we see merit in staff's recommendations, we would appreciate staff elaboration on the difference in views between the authorities and staff on projected tax revenue.

- See below

13. ***We take note of the different views on the additional fiscal space. Could staff elaborate more on the major divergences between the authorities and staff?***

- See below

14. The authorities note that their tax revenue projections are much lower than staff's. Can staff explain the reasons for this difference? We would also appreciate staff's views on the authorities' argument that further reducing the labor tax wedge would be challenging given the increasing aging-related fiscal costs as well as government measures regarding the social security schemes.

- Despite lower growth, staff did not revise down revenue projection mostly due to the strong labor market and rising wage growth. Staff's view is that economic growth is supported by domestic demand, which in turn should allow for favorable tax revenue collections.
- Staff has recommended that pension reforms to provide incentives for working longer and disincentives for early retirement, together with life-long learning, would boost labor participation of elder workers and reduce aging-related fiscal costs.

15. The overperformance points to a downward bias in the official revenue projections that casts doubts on the fact that the targeted fiscal loosening could be achieved in 2019. Have staff discussed with the authorities steps that could help reduce this systematic bias?

- Staff discussed revenue forecast in detail with the authorities during past consultations, including the persistent bias (see 2017 Article IV staff report). In light of this bias, staff revamped its own revenue forecast methodology.

16. ***What is staff's assessment of the German "debt brake"? Do they consider that a more flexible framework could actually strengthen German both short and medium-term resilience by allowing for debt financing of investments****?*

- At current conjuncture, staff's assessment is that the debt brake is not constraining the use of fiscal space.

17. Staff argues that the absence of ad hoc taxes to the sector to avoid over-taxation of profits and economic distortions has been welcome but temporary local taxing initiatives or alternative solutions should not be deterred given the growing "economic presence" of such activities. Staff's comments would be welcome.

- Staff's view is that—while it is clearly important to arrive at a solution in regard to taxation of "digital activities"— unilateral adoption of tax measures in regard to these runs significant risk of (as noted in the SIP) economic distortions, but also of not proving to be "temporary" once adopted. Such taxes may, too, have additional unintended consequences in reducing the mutual impetus to arrive at consensual multi-lateral solutions to these issues.

18. ***We would welcome staff's comments on the 2018 Article IV recommendation to fully use fiscal space (Annex IV).***

- Staff welcomes the use of fiscal space. The authorities' 2019 budget will use part of Germany's fiscal space, but not all of it. This includes measures to increase family support and public investment as well as income tax relief, resulting in a moderate fiscal expansion of about ⅔ percent of GDP.

19. ***It would be useful if staff could provide information on the impact of Germany's tax and benefit system in mitigating income inequality.***

- Germany has progressive personal income tax (PIT) rates. The marginal rate rises steadily from 14 to 42 between €9,168 and €55,960. Thereafter it remains flat, with one step rise to 45 percent at €265,326.
- Housing benefits provide additional support mostly to low- and middle-income households, and social benefits are targeted at low-income households.

20. That said, we recognize the shared concern of staff and the authorities on the speed of public investment execution given capacity constraints, particularly in the construction sector. We welcome staff's elaboration on plans to expand the capacity of this sector.

- See below

21. ***We underscore staff's finding that local governments have been prioritizing fiscal consolidation at the expense of public investment, and that capacity constraints in the construction industry are a new hurdle. Could staff comment on how the authorities could best navigate around these new constraints to ensure more robust public investment?***

- See below

22. ***Can staff elaborate on the capacity constraints to infrastructure investment and any approaches being undertaken to address them?***

- See below

23. ***We note that capacity constraints in the construction industry represent a major obstacle to public investment growth. Could staff elaborate on the authorities' view regarding the need to strengthen coordination across the various government levels to ensure that investment projects are implemented over the long term?***

- See below

24. ***In this regard, we support the staff recommendations in the last Article IV report to prioritize the provision of Partnerschaft Deutschland's services and make a comprehensive investment plan to alleviate bottlenecks for public investment at the municipal level. Could staff comment on whether there have been any progresses on these fronts? In addition, staff emphasizes the importance of better coordination across levels of government. Could staff elaborate more on the necessary coordination that staff specifically expects?***

- With the improved fiscal positions in most localities, local governments are refocusing on public investment. As shown in the latest KfW Municipal Panel (2019), the public investment backlog is now estimated at €138 billion, compared with €159 billion in the 2018 Municipal Panel.
- Financial relief and investment promotion by the federal and Länder governments (for example, the Municipal Investment Fund) have been supporting municipal investment. In addition, the amendment to the Basic Law in April 2019 will allow federal government to provide financial assistance to Länder in key investment areas, such as educational infrastructure, social housing, and public rail transport.
- Partnerschaft Deutschland (PD) have been facilitating the execution of public investment at the municipal level. The number of projects that PD provided consulting services increased very rapidly over the past two years. PD also increased their projects on public investment priorities, such as social housing and digital infrastructure.

- Staff recommends enhanced coordination across levels of government to ensure that larger and longer-term projects are implemented. Tailoring the federal government's support to different local government's investment priorities could encourage local governments to plan and take on more large and long-term projects. This would also support more persistent and sustainable increases in public investment and mitigate capacity constrains in the construction sector in the short term.

25. Could staff elaborate on the constitutional constraints in alleviating high marginal tax burden as well as why the proposal to update property valuations turns out to be revenue neutral?

- According to Ministry of Finance officials, the additional tax allowance or tax credit for couples would not be feasible given the constitutional constraints. As they explained, a married couple should not be treated less favorable than two individuals.
- The priority of the authorities' current property tax reform is to update and simplify the outdated property tax system; therefore, they do not plan to raise revenue through this reform.

Structural Reforms

26. ***Could staff elaborate if further reforms are needed to ensure competition in product markets, notably in network industries?***

- Indeed, staff sees need for further reforms to increase competition in regulated professions and network industry. Liberalizing these sectors can reduce the cost of doing business using these business services as inputs. In 2019, the government plans to undertake a review of regulations in professional services, with the goal of reforming the Professional Law in this area. Other professions, such as accountants, architects, and engineers are also in need of reform. Competition in the railway sector is increasing in freight and regional passenger trains, but the market share of new entrants for long distance passenger train services remains low due to high track-access charges. To promote further competition, the government plans to evaluate the Railway Regulation Act.

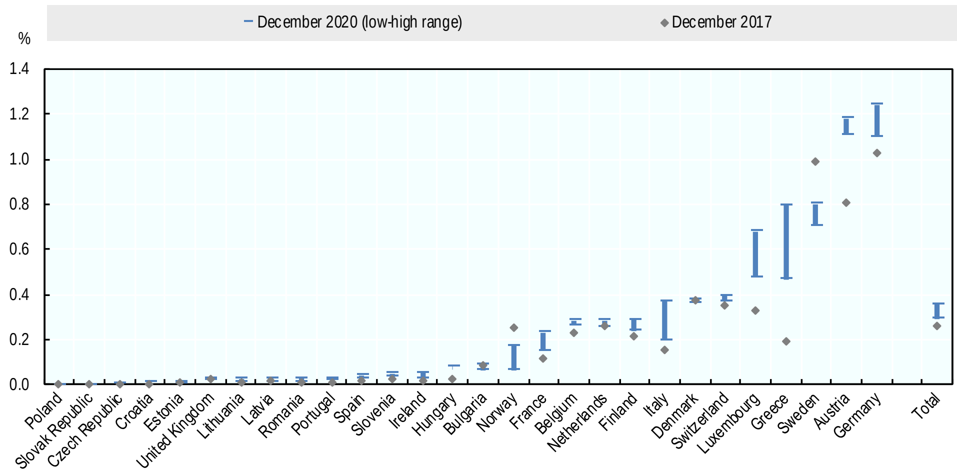
27. ***Could staff comment on the size and the quality of the refugee labor supply in Germany in comparison to other European economies?***

- According to the recent OECD estimate, inflows of asylum seekers during 2014-17 raised Germany's working-age population by around 1 percent (cumulative), which is the largest impact in Europe.
- Education levels of asylum seekers to Germany vary. However, the same OECD study also shows that Germany experienced the largest increase in the population of

low-educated men aged 18-34 among Europe due to inflows of asylum seekers during 2014-17. A recent study by the European Parliament also shows that Germany has received a larger share of people with no education (35 percent) or lower secondary education (26 percent) than Austria or Sweden.

Relative change in working-age population due to increased inflows of asylum seekers between 2014 and 2017 in Europe*

Cumulative change estimated in December 2017 and December 2020



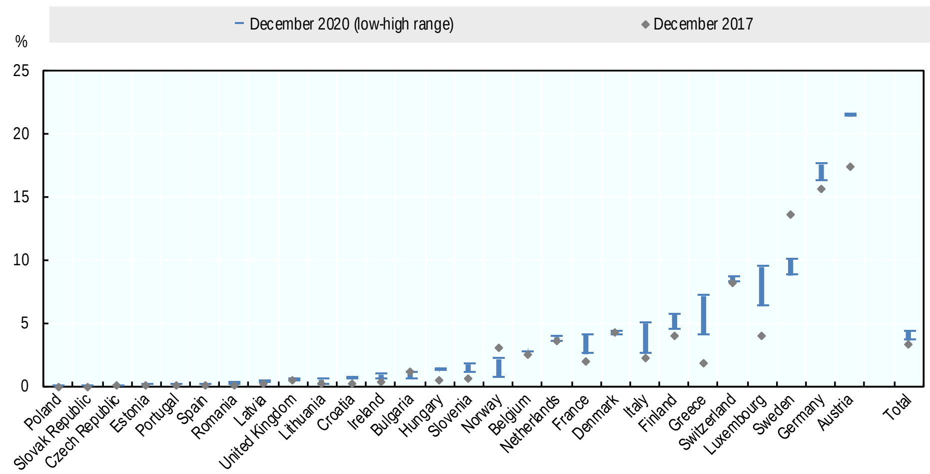
*: EU-28 countries, Norway and Switzerland.

Note: The relative change in working-age population is the difference between the estimated refugee working-age population accounting for increased inflows since January 2014 and the counterfactual refugee working-age population (i.e. assuming that asylum applications in 2014-20 remain equal to the 2011-13 average), divided by the total working-age population in December 2013. Up to December 2017, observed data on asylum applications and decisions are used; for 2018-20, it is assumed that asylum applications are either equal to the 2011-13 average or to the 2017

Source: Eurostat: asylum statistics, labour force statistics; OECD estimates.

Relative change in the population of low-educated men aged 18-34 due to increased inflows of asylum-seekers between 2014 and 2017 in Europe*

Cumulative change estimated in December 2017 and December 2020



*: EU-28 countries, Norway and Switzerland.

Note: The relative change in working-age population is the difference between the estimated refugee working-age population accounting for increased inflows since January 2014 and the counterfactual refugee working-age population (i.e. assuming that asylum applications in 2014-20 remain equal to the 2011-13 average), divided by the total working-age population in December 2013. Up to December 2017, observed data on asylum applications and decisions are used; for 2018-20, it is assumed that asylum applications are either equal to the 2011-13 average or to the 2017 average, generating the December 2020 low-high range.

Source: Eurostat asylum statistics, labour force statistics; OECD estimates.

28. Staff, however, pointed to the existing constraint facing capital-intensive businesses in scale-up stage, due to the small size of venture capital funds. Since such businesses are less risky than startups to attract funding, additional explanations from staff would be welcome to explain such phenomena. We also welcome the authorities' ongoing efforts to crowd in private investment, particularly institutional investors, through its co-investment strategy. Could staff elaborate on the authorities' co-investment policy and how is it contributing to greater private sector investments across sectors and size of firms?

- Germany's venture capital has been rather concentrated in early-stage financing, while the availability of later rounds of financing at the scale-up phase—where firms' financial position can turn to break-even or to profitable, yet requires larger capital/equity to grow—remains relatively subdued. Such a situation is considered a constraint on the growth of domestic start-ups, and the scarcity of sufficiently large venture capital funds appears to be one of the key issues behind it.
- To overcome the above issue, the German government has been providing various support to jointly with the European Investment Fund and KfW (the German Development Bank). Recently, the government has created a new arm in KfW (KfW Capital) to co-invest in venture capital and venture debt funds, aiming to support innovative companies across all sectors.

29. ***While welcoming the government's digitalization strategy, staff's comments are welcome on its role in transforming the lagging digital infrastructure and leading the way in modern technology, including artificial intelligence, in Germany by both public and private sectors.***

- Germany's digital strategy is aiming to enhance digital competence (educating citizens about digitalization); expand digital infrastructure (including nationwide high-speed internet by 2025); promote innovation and digital transformation (implementing AI and digitization ate workplace, known as "Industry 4.0."); facilitate society's digital transition (protecting jobs, and ethics in a digital society); and reduce administrative burden (e-Government).

30. ***We have noted the staff's call for urgently adapting labor force skills to the rapidly changing technological environment. Could staff elaborate on the measures envisaged by the authorities in that regard?***

- We recommend the government to further increase investment in education and lifelong learning. Addressing teacher shortages, especially in vocational education and training and primary education, is therefore urgent.
- The government has recently amended the Basic Law to allow the federal government to provide financial assistance to Länder in key investment areas, including in education.
- The Skills Development Opportunities law also came into force in January 2019, aiming to improve access to vocational education and training for workers whose professional activities can be replaced by technology or affected by structural reforms, or those who seek training in occupations affected by skill shortages.

31. ***Could staff comment on the initial views on imposing measures for specific economic sectors in the context of Germany's current debate on counteracting climate change?***

- Economy wide approaches which provide the same incremental reward for reducing emissions across different sectors are generally the most efficient mitigation policies. In the case of Germany however, emissions from the power sector and large industry are covered under the EU Emissions Trading System, while national policies are needed to implement emission targets for other sectors like transportation and households. National measures imposed on top of the ETS, such as efficiency standards for electricity-using capital would not reduce emissions at the EU level if these remain fixed by the cap (however recently introduced mechanisms now allow some adjustment of the cap in response to pressures in the allowance market). Non-ETS emissions would ideally be priced through a carbon tax (as, for example, in

France, Ireland and Sweden) with the tax aligned with the national emissions target for these emissions. A less-efficient, but perhaps politically easier, approach would involve fiscal or other incentives to promote energy efficiency and clean fuels in the transport and household sectors.

32. ***While we understand that the authorities are considering introducing higher taxes on fossil fuels and that decision has not yet been made, we would appreciate staff elaboration on the potential impact of such measure on growth and the expected social buy-in at this juncture.***

- Political debate on introducing carbon tax in Germany is at an early stage, and thus staff does not have sufficient information to assess its potential growth impact. However, in line with a recent FAD policy paper,staff generally supports carbon tax as it can help Germany meet the CO_2 emission target, while, at the same time, the revenue gains can be used to reduce distortionary taxes. Carbon taxation, however, can be politically difficult. To gain social buy-in, carbon taxes can be introduced gradually, with targeted assistance for low-income households, trade-dependent industries, and vulnerable workers.

Financial

33. ***We note the difference in views between the authorities and staff on borrower-based measures (cap on the loan-to-value ratio and amortization requirements) on residential mortgage lending. Can staff further explain the difference between their assessment of financial stability risks stemming from the flow of new housing loans and that of the authorities? We would also appreciate staff's elaboration on their recommendation to introduce income-based instruments (e.g., cap on debt-service-to income, cap on debt-to income) in the macroprudential toolkit, given the low household debt to GDP ratio and low and declining household debt service and principal payments to income ratio (Table 7).***

- Staff's views on financial stability risks arising from the residential real estate markets are generally in line with the authorities' views; a rapid house price increase has not been accompanied by fast credit growth, and credit-to-GDP ratio remains low from a historical perspective and compared with other advanced economies. However, the lack of granular data prevents fuller assessment of financial stability risks, especially in major cities where housing prices have been rising rapidly. Staff, therefore, is a view that precautionary activation of borrower-based tools is beneficial. The activation may also politically easier before the tools become more binding. However, the authorities are of a view that the law does not allow for such a precautionary activation.

- On the income-based instruments, our recommendation is to create a legal basis for such instruments to expand available toolkits, not necessarily to activate them.

34. Authorities shared the view that risks to financial stability are building up and agreed on the urgency of closing data gaps to enable a full assessment of possible financial stability risks. Could staff elaborate on how authorities are planning to close the data gaps?

- The authorities are currently undertaking ad hoc survey on real estate lending and corporate credit underwriting standards, which is expected to provide valuable information on possible financial risks in specific segments of the economy. The authorities are exploring options to regularize such a survey.

35. Can staff give examples of macroprudential policy measures directed at CRE that have been used effectively elsewhere?

- According to the IMF's Annual Macroprudential Policy Survey, borrower-based measures are relatively less utilized for CRE credit; cap on LTV ratios for CRE (including commercial residential real estate) credit was used in 12 jurisdictions in 2017.

36. We would like to hear staff's views on the appropriate design of borrower-based instruments for CRE loans.

- Staff Guidance Note on Macroprudential Policy—Detailed Guidance on Instrument (2014) indicates that in addition to risk weights and exposure caps, excessive CRE lending can be addressed by macroprudential tools that affect lending conditions. The CRE credit market is characterized by similar collateral where investors are involved in similar business activities, and often with substantial use of leverage. Moreover, risks from CRE markets are similar to those arising in residential real estate markets. Therefore, tools that are used to deal with risks from real estate markets can be extended to address risks in CRE markets. However, Given the higher risks of CRE in comparison to the residential market, more stringent loan covenants, guarantees and some pre-selling proportion of the project are often required on CRE exposures. In addition, policymakers should be mindful of the potential for leakage of corporate sectoral tools; corporate borrowers substitute domestic bank credit with borrowing from unregulated financial institutions or in capital markets (domestic leakages) or borrowing from abroad (cross-border leakages).

37. *Could staff comment on how binding the CCyB will be, given that banks' capital buffers are "deemed comfortable" as stated in Mr. Meyer's buff. Also, we would be*

interested in staff's view on risks stemming from banks' exposure to export sectors, e.g. the auto industry.

- We view the 0.25 percent increase in the CCyB as relatively small, which is expected to have limited impact on credit supply. Regarding potential financial stability risks stemming from the automotive sector, Bundesbank's Financial Stability Review indicates that the introduction of a 25 percent tariff on cars by the US would reduce the profits of automotive corporations, but probably would not pose a threat to their solvency. However, if the heightened trade tensions are translated into confidence, fall in investment, and broader GDP losses, the impact can be larger.

38. Data gaps should be filled urgently to provide a clear understanding of the systemic risks linked to real-estate exposures and "Level 2 and Level 3 assets", which do not have a liquid-market price and whose discretionary valuations can lead to significant underestimate of potential exposures in case of market stress. Staff's comments on the possible risks linked to these assets are welcome.

- Staff does not have information on the share of Level 2 and Level 3 assets in German banks' total assets. However, the poor performance of some German banks at the 2018 EBA stress tests was driven in part by the stress scenario on Level 2 and 3 assets, suggesting possible risks linked to these assets.

39. Low profitability, particularly in the banking sector, is a fundamental problem that has to be nipped in the bud. In this regard, we are glad that the authorities see opportunity for restructuring and consolidation within the banking sector. We would like staff's further comments on the underlying impediments and credible options to address the prolonged weak profitability of the banking sector.

- Germany's fragmented banking system (so-called a "three-pillar" system) complicates consolidation across pillars. For example, as described in the 2016 FSAP, public-sector banks (e.g., Landesbank, savings banks) are owned by state or local governments, and their primary objective is to support the economic development in the city, town, or district. In addition, there are limited financial professionals in management boards of public-sector banks. Consolidation, therefore, requires political will to relax the regional principle. In addition, fragmented deposit insurance schemes also seem to be complicating consolidation across pillars.

40. *We would be interested in staff* views *on potential solutions to the profitability problem. Would cross-border bank mergers, leading to cost savings and improvement in private sector risk sharing within the monetary union, help address the persistent weakness in the banking sector?*

- To boost profitability, more decisive cost cuts—for example, by reducing branches and promoting digitization—are necessary. Consolidation, which has been ongoing gradually within the German banking system, should also continue. Cross-border consolidation can help improve the efficiency and resilience of banks to shocks; for example, a recent study (Duijm and Schoenmaker 2017) finds that cross-border mergers reduce credit risk, although it does not find that cross-border mergers lead to higher returns. Ultimately, however, it is up to individual banks to decide on what tie-ups to pursue.
  Duijm, P and D Schoenmaker (2017), "European Banks Straddling Borders: Risky or Rewarding?", CEPR Discussion Paper DP12159

41. ***The performance of banks and life insurance companies is under pressure amid protracted low interest rate environment. In this context, we see merit in staff's recommendation to reduce cost by reducing branches and promoting digitalization. We would consider this in broader context as this is not only relevant to Germany but also to many countries, especially in an environment of "low-for-long" and where financial inclusion could be achieved through greater use of technology rather than expanding the number of branches. Staff's comment would be welcome.***

- Indeed, many European peers are also facing challenges associated with the "low-for-long" interest rate environment. For the case of the German banking system, its underlying weakness in profitability—which reflects high cost structures, outdated IT systems, and strong competition—was exacerbated by the "low-for-long" interest environment. Without addressing the underlying profitability issues, German banks would continue to trail peers. Cost-cutting and financial inclusion are indeed not necessarily mutually exclusive. The quality and access to financial services can be improved, even when banks are reducing the number of physical branched, by a better use of technologies.

42. ***This suggests that the country's banking landscape is much more competitive and fragmented, with many small banks content with razor-thin profit margins. More also, we would have liked to see a deeper analysis of costs in the sector. Partly reflecting outmoded IT systems as well as expenditure on fines, compliance and regulation, the cost-income ratio for German banks is much higher (over 76 percent) than the European average (just over 63 percent). We welcome staff comments on whether or not these issues could have been better analyzed and discussed in the report.***

- Indeed, as we discussed in the 2018 Staff Report and 2016 FSAP, strong competition in a highly fragmented market has been weighing on net interest margins, especially of savings and credit cooperatives (although their net interest margins are generally higher than those of larger banks). The net interest margins of key German banks, where outdated IT systems and other issues are more prominent, are regularly reported (Figure 15 of the 2019 Staff Report). The figure suggests generally lower net interest margins for German banks compared to peers.

43. We would welcome more detail on staff's analysis of how Basel III implementation would affect regulatory capital via floors on internal risk models.

- Under Basel III's output floor, banks' risk-weighted assets must be calculated as the higher of: (i) total risk-weighted assets calculated using the approaches that the bank has supervisory approval to use in accordance with the Basel capital framework (including both standardized and internal model-based approaches); and (ii) 72.5 percent of the total risk-weighted assets calculated using only the standardized approaches.
- According to the latest Basel III monitoring, the output floor remains the main drive behind an increase in the capital requirement. According the monitoring report, aggregate minimum capital requirements for German banks (including the output floor of 72.5 percent) increase by 23.6 percent. Once fully implemented, the output floor represents the binding capital requirement for around one-fifth of the participating institutions.

44. We are surprised about, and concerned with, the lack of current data on Germany's financial sector. As evident in Tables 6 and 7, most of the data needed to make informed assessments and judgments on the state of the financial sector are either not current or missing. For a surveillance mission that ended in the third week of May, and for a financial sector whose vulnerabilities are on the rise, as staff aptly encapsulates, one would have expected data running up to 2019Q1. This is critical because a more current and complete dataset across the sector will allow for better monitoring of risks. We note that the 2017 Article IV report also had the same issues of inadequate financial sector data. In light of Germany's status as an advanced economy, this persisting problem may not reflect a lack of capacity or availability. To that end, we would welcome staff comments on the reasons for this outcome and its effect on surveillance of the sector. We would also be interested in knowing what, if any, the authorities are doing to correct this anomaly.

- We find the overall coverage and timeliness of the reporting of FSI indicators generally satisfactory. FSI indicators had been reported with a one to two quarter delay through end-2018. Starting in 2019, the authorities report the indicators with a quarter delay, which is in line with the practices taken by most advanced economies. The authorities have also recently informed our Statistics Department that a change to quarterly transmission for all indicators will be feasible in the course of this year.