

SUR/09/5

January 15, 2009

**The Acting Chair's Summing Up
Germany—2008 Article IV Consultation
Executive Board Meeting 09/4
January 14, 2009**

Executive Directors agreed with the thrust of the staff appraisal. They noted that, in the past three months, Germany has come under heightened pressure from the global economic and financial turmoil, reflecting the economy's high degree of openness and integration with the world economy. With the sharp drop in world trade and continuing weakness in domestic demand, Germany faces the prospect of a sizeable, and possibly extended, economic downturn. Corporate and financial sector stresses in the German economy—thus far relatively dissociated from each other—risk becoming more intertwined in the period ahead. Against this background, Directors welcomed the recent initiatives by the German authorities to strengthen significantly the financial safety net and to give valuable economic stimulus. They recognized that the fundamentals of the German economy remain strong, and applauded the sustained fiscal prudence of the last few years that has created the needed room for a sizeable fiscal boost to the economy.

Directors welcomed the German authorities' continuing priority to maintaining financial stability and stabilizing the real economy. Global policy actions and measures to contain the risk of a costly global self-reinforcing slump should preferably be coordinated regionally and internationally for maximum effect. Germany has a special leadership role to play in this process, given the size of its economy and the substantial spillovers into and from Germany.

Directors noted that the global financial crisis has highlighted important vulnerabilities of the German financial system, which could be intensified by the economic slowdown in Germany. They welcomed the authorities' decisive response, noting in particular the creation of the Financial Market Stabilization Fund (FMSF) as vital to shielding the financial sector. A number of guarantees have been issued, which will help banks meet their short-term funding needs. Directors also welcomed the efforts to buttress capital positions. Given the low level of capital in several banks, further recapitalization may be desirable in view of expected asset quality deterioration. Directors also recommended that the agency administering the FMSF use its authority more broadly for enhancing the soundness of the financial sector. In particular, Directors called for a proactive restructuring and downsizing of the Landesbanken, which are a continuing drain on public finances and a threat to financial stability.

Directors called for strengthened deposit insurance, a critical element of the financial safety net, given the risks associated with the existing multiple protection schemes that have typically relied on ex post burden-sharing. A base layer of mandatory deposit insurance—ex ante funded by contributions from all banks—would provide unified terms of protection for depositors and reduce incentives to shift deposits among the existing schemes. The evolving European Union rules should provide guidance on coverage limits.

Directors observed that the case for a tighter bank regulatory and supervisory process has become more compelling. To respond promptly to problem situations, the authorities were encouraged to place greater reliance on timely supervisory assessments independently of the banks' annual external audit cycle, and to link prudential regulation and supervision to a system of macro-surveillance and stability analysis. In this context, greater consolidation of regulatory and supervisory resources could yield significant benefits.

Directors welcomed the authorities' conjunctural fiscal stimulus packages in the past four months aimed at supporting domestic demand and guarding against cumulating the drop in consumer and business confidence. They considered these packages timely. Directors welcomed in particular the significant impetus offered by the latest package. Among the components of the package, they noted that the accelerated reduction in social security contributions and the step up of spending on infrastructure projects are well-targeted and likely to provide both short-term stimulus and lasting benefits. Directors acknowledged the complexity of judging precisely the degree of optimal fiscal impulse when the global situation is in rapid flux, often in unexpected ways. In view of the sizeable recent deterioration in economic prospects and given Germany's fundamentally strong fiscal position, a number of Directors would have favored an even more proactive stimulus. A number of others, however, supported the authorities' considered approach of maintaining equal emphasis on discretionary measures to spur the economy and adhering to fiscal prudence. All Directors welcomed the authorities' reiteration of their commitment to medium-term fiscal sustainability, which will be crucial for ensuring the long-term credibility of public finances in accordance with the Stability and Growth Pact.

Directors noted that trends in healthcare costs and debt accumulation by the states remain a concern. Further rationalization of pharmaceutical expenditures and strengthened efficiency-enhancing competition remain attractive avenues for containing healthcare costs. Directors noted the possible benefits from more state tax autonomy and a redesign of supplementary federal grants to improve states' incentives for fiscal discipline. They welcomed the proposed fiscal rule limiting the structural budget balance to close to zero, and recommended that it be applied also to the states.

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