

**EXECUTIVE
BOARD
MEETING**

SM/16/149
Correction 1

June 23, 2016

To: Members of the Executive Board

From: The Secretary

Subject: **Germany—Staff Report for the 2016 Article IV Consultation**

Board Action: The attached corrections to SM/16/149 (6/10/16) have been provided by the staff:

**Mischaracterizations
of the Views of the
Authorities**

Page 16 (para. 33)

Evident Ambiguity

Pages 4 and 14

**Factual Errors Not
Affecting the
Presentation of Staff's
Analysis or Views**

Pages 6, 7 (text table, line 8), 19, 20

Typographical Errors

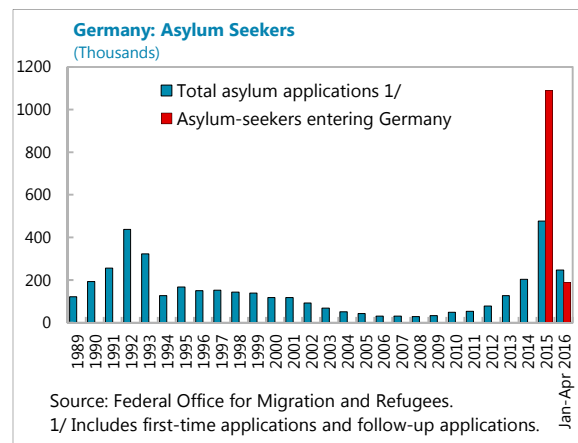
Pages 7 (text table, title) and 16 (para. 31)

Questions:

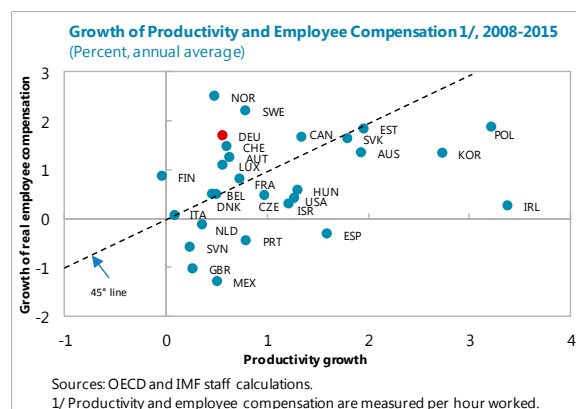
Ms. Detragiache, EUR (ext. 36376)
Mr. Vandenbussche, EUR (ext. 36676)
Ms. Pereira, EUR (ext. 39452)
Mr. Natal, EUR (ext. 35983)
Mr. Xie, EUR (ext. 38366)

CONTEXT

1. **The growth momentum remains steady as strong domestic demand is offsetting weak foreign demand (Figure 1).** Private consumption growth reached a 15-year high last year (Figure 1), while public consumption surged to accommodate higher social benefit spending and provide support to a record number of asylum-seekers. The recovery of investment in machinery and equipment continued as capacity utilization remained above historical averages. Buoyant domestic final demand, however, was partly countered by a slowdown in import demand from trading partners, which translated into stagnating exports in the second half of last year.



2. **In spite of a tight labor market, prices have been nearly flat over the past year, due to falling energy prices.** Core inflation remained low and stable around 1 percent, while the GDP deflator rose by 2.1 percent in 2015. Real wages remain dynamic and keep outpacing labor productivity (Figure 2). Employment growth has been supported by persistently high economic immigration and has remained robust in spite of the implementation of an early retirement scheme. The unemployment rate, at 4.2 percent, reached a new post-reunification low in March. So far, the introduction of a statutory minimum wage on January 1, 2015 has not had a visible impact on average wage growth or the aggregate employment trend (Box 1).



3. **External imbalances are widening reflecting new shocks.** The current account surplus continued to widen significantly in 2015, reaching 8.5 percent of GDP, reflecting lower commodity prices and currency effects (Figure 3). It is now the second largest in the world behind China's when measured in U.S. dollars. The narrowing of the oil and gas trade deficit accounted for 62 percent of the trade surplus increase. In addition, lower oil prices (together with lower lending rates) have stimulated global demand for automobiles, benefiting German exports (Box 2). On a regional basis, the surplus vis-à-vis the rest of the euro area widened by 0.7 percent of GDP, as the energy deficit with the Netherlands shrank. Exports to Asia, on the contrary, decelerated reflecting the ongoing rebalancing in China. From a saving-investment balances perspective, the surpluses of non-financial corporations and the general government, at 4.0 percent and 0.7 percent of GDP respectively, reached their highest levels since 2000. By end of 2015, the CPI-based real effective exchange rate had depreciated by 5.3 percent from its 2014 average primarily as a result of nominal depreciation vis-à-vis the dollar and the renminbi.

OUTLOOK, EXTERNAL ASSESSMENT, AND RISKS

The economy is projected to slowly rebalance, with domestic demand supported by the tight labor market, accommodative monetary conditions, and, in 2016, a fiscal expansion. Declining medium-term growth prospects, however, continue to hold back domestic investment and push up savings, preventing faster rebalancing.

8. **Domestic demand is expected to keep underpinning the moderate growth momentum.** A sizable fiscal expansion (see below), further ECB monetary stimulus since March, and lower energy prices should continue to offset the weakness in key advanced and emerging countries. Private consumption should remain dynamic as real disposable income, while residential investment should pick up further to respond to growing needs (see below). All in all, GDP is projected to grow by 1.7 percent this year and 1.5 percent next year, with a small positive output gap opening up. Continued large net immigration and the gradual absorption of the refugees into the labor market over the short-to-medium term will help meet growing labor demand, though the unemployment rate is likely to bottom out as refugees will face obstacles in finding employment. Headline inflation will rise as a result of the recent ECB policy actions as well as the small positive output gap, but will do so only gradually, and will reach two percent only over the medium-term. In light of the relative cyclical positions and rebalancing needs within the monetary union, inflation in Germany should remain above the euro area average over the medium-term.

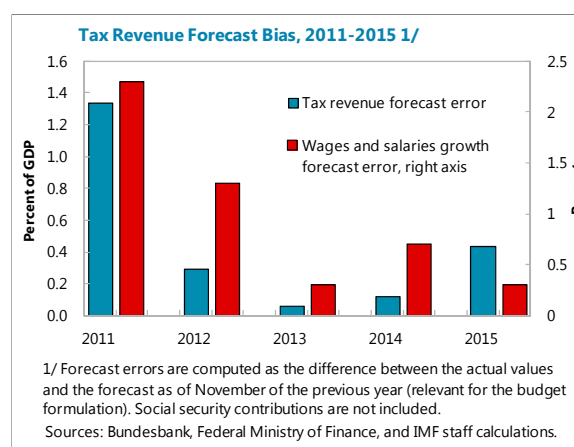
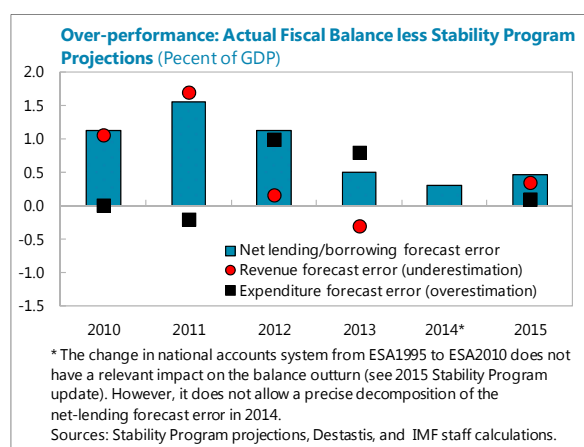
9. **A foreseen fiscal expansion of 1 percent of GDP in 2016 comes at an opportune time, as, if it materializes, it will cushion the effect of slowing foreign demand, though revenues might again surprise on the upside.** The expansion reflects higher planned social transfers, refugee-related spending, and, to a lesser extent, higher public investment and income tax relief. Altogether the structural balance is expected to fall to $-1/4$ percent of GDP in 2016 and remain constant in 2017, slightly above the lower bounds imposed by the fiscal rules (Germany's Medium Term Objective under the Stability and Growth Pact (MTO) and the national "debt brake"). However, over recent years, tax revenues have systematically overperformed forecasts due to better-than-expected labor market developments (though over the longer run there has been no systematic bias).¹ Refugee-related spending should reach $1/2$ percent of GDP per year in 2016 and 2017, although there is uncertainty around this estimate. At the federal level, despite a small deficit expected in 2016, the government should be able to fulfill its "no net new borrowing" political commitment by spending reserves accumulated in 2015. The debt sustainability analysis (DSA) shows that fiscal risks should be manageable, with no severe adverse effects on public debt dynamics (Annex I).

¹ The projections are prepared by the Working Party for Tax Revenue Estimates, a body including representatives from the federal and regional governments, [academia research institutes](#), and the Bundesbank. Decisions are made by consensus. Although methodologies differ, the macroeconomic scenario used by all members is the same. Thus, forecast errors in the macroeconomic assumptions would be reflected in all the estimates.

Germany: General Government Operations (percent of GDP)

	2013	2014	2015	2016 Proj.	2017 Proj.
Net Lending/Borrowing	-0.1	0.3	0.6	-0.1	0.1
Structural Balance	0.1	0.7	0.7	-0.3	-0.3
<i>of which</i> , Structural Balance of the Central Government	-0.1	0.6	0.3	-0.1	-0.2
Change in structural balance	0.3	0.6	0.0	-1.0	0.0
SGP Medium Term Objective (General Government)	-0.5	-0.5	-0.5	-0.5	-0.5
Debt Brake Floor (Central Government)	-1.28	-0.97	-0.66	-0.35	-0.35
Public gross debt (Maastricht definition)	77.2	74.7	71.2	68.5	66.2

Sources: Ministry of Finance, Bundesbank, Federal Statistical Office, and IMF staff estimates and projections.



10. **In 2015, the external position continued to be substantially stronger than implied by medium-term fundamentals and desirable policy settings.** The cyclically-adjusted current account balance stood at 8.8 percent of GDP in 2015, 3–6 percentage points of GDP above the assessed norm of 2.5–5.5 of GDP (Annex II). The wide interval reflects the high sensitivity of the norm to uncertain demographic factors, including future immigration. The REER in 2015 is assessed as undervalued by 10–20 percent, up from 5–15 percent in 2014. In 2016, the oil and gas trade balance should narrow further as energy prices remain lower on average than in 2015, while the lagged effects of the past real effective exchange rate depreciation will counterbalance the slowdown in external demand. Continued strong wage growth and the fiscal expansion, on the other hand, should push up imports.

11. **Over the medium-term, the surplus is expected to slowly decline.** The rebalancing process will unfold as the terms of trade windfall is spent, energy prices partially recover, the output gap becomes positive, and increasing unit labor costs relative to euro area trading partners realign price competitiveness. However, at 6.8 percent in 2021, the current account surplus is projected to remain outside the assessed norm, while the (NIIP) will continue to grow rapidly, reaching over 80 percent of GDP by 2021. Based on the EBA model estimation results, in 2015 if fiscal gaps in Germany and its trading partners were closed, Germany's current account surplus would have been

possible and design more flexible forms of vocational training, with language training and a stronger on-the-job component relative to standard formal schooling, should be given priority. While all these initiatives may require some additional fiscal outlays in the short-term, they would have a potentially large payoff down the road through better employment prospects and less reliance on social welfare. They may also help successfully absorb future non-refugee immigrants.

Incentivizing more active female labor force participation

26. **More active participation of women in the labor market would not only increase labor supply but also enhance productivity.**¹⁰ While female labor force participation is relatively high in Germany, close to half of employed women work only part time. Thus, women work on average 30.5 hours per week, 9 hours less than men do. Limiting constraints to full-time work by women would boost labor supply. It would also strengthen incentives for on-the-job training provision and make firms more likely to have women in senior management positions, which can improve corporate profitability. To this end, the supply of full time schooling services should be expanded further. Distortions that increase the marginal tax burden for secondary earners should also be reduced, specifically by moving towards a system in which health insurance contributions depend on the number of household members covered, with targeted support for poorer households. Greater provision of childcare services and after-school programs would have the further benefit of facilitating the social integration of immigrant children. Also in this case, fiscal resources deployed now—about ¼ percent of GDP if, for example, Germany were to raise spending in this area to the OECD average—would have potentially important medium-term payoffs through higher potential GDP.

Extending working lives

27. **Germany's unfavorable demographic trends are weighing on the outlook.** A recent government report¹¹ estimates that age-related government spending is set to rise between 2 and 4½ percentage points of GDP by 2040 under current policies. Without further reforms, already-high social security contributions would have to rise further or already-declining replacement rates would have to fall further. Past reforms will push the statutory retirement age from the current 65 years to 67 years by 2030 (when pension outlays are expected to accelerate), but no further increases are foreseen, and workers with more than 45 contributory years ~~some workers~~ can still retire at the age of 63. Although participation rates in the 55–64 age group is high in Germany compared to other OECD countries, the opposite is true for those older than 64. While conditions to extend employment contracts beyond the statutory retirement age have been relaxed, there is a loss of pension wealth for those who remain employed.

¹⁰ See Christiansen and others (2016), "Unlocking Female Employment Potential in Europe: Drivers and Benefits", IMF Departmental Paper, and "Women in the Labor Market and the Demographic Challenge", Selected Issues Paper for the 2015 Article IV Consultation.

¹¹ "Fourth Report on the Sustainability of Public Finances" (2016), German Federal Ministry of Finance.

C. Stimulating Competition in the Services Sector

31. **Competition-enhancing reforms in the services sector should be pursued more vigorously.** Slow productivity growth in the services sector is holding back overall growth, and reforms to enhance competition in parts of the sector where it is lacking could trigger a shift toward greater efficiency and innovation.¹³ However, progress on this front has been slow as special interest groups appear well organized, and has mainly reflected pressure from the European Commission (EC). In the context of the EC-driven mutual evaluation on access to and practice of regulated professions, the federal and state governments reviewed the extent and nature of professional regulations, and submitted an action plan in January, which the EC has recently qualified as lacking ambition. In the area of professional services, the loosening of a few requirements are contemplated. ~~Ongoing-~~ Infringement procedures by the EC are ongoing regarding the minimum compulsory tariffs of architects and engineers, while an agreement has recently been found with tax advisors to make these tariffs indicative instead of compulsory. In the retail sector, the government recently gave its green light to a merger proposal between two supermarket chains that had received a negative opinion by the competition authority and the monopolies commission, prompting the chairman of the latter to resign.

32. **Incumbents' dominant position in railways and postal services is still largely unchanged.** A new version of the long-awaited Act to Strengthen Competition in the Railway Sector was approved by the federal cabinet in January 2016 but is facing a deluge of amendments in the parliamentary process. If passed, it would strengthen the powers of the regulator, and would enhance incentives to boost efficiency, while improving the conditions for the development of a single European railway market. Meanwhile, the market share of new entrants in the long-distance rail passenger market segment has remained below 1 percent. In the area of postal services, the competition authority accused the incumbent operator of abusing its dominant position, while the monopolies commission called last year for a reform of the legal and regulatory framework so as to address impediments to effective competition, to no avail.

Authorities' Views

33. **The authorities agreed that faster progress in reforming regulation in parts of the services sector would stimulate competition and growth, ~~but argued that the political process was extremely difficult.~~** In the area of professional services, they saw scope to review conduct regulation, including price regulation, restrictions on inter-professional cooperation, exclusive rights, and shareholding restrictions. By contrast, they thought entry regulation to be truly instrumental in promoting consumer protection and quality and unlikely to have adverse economic effects. They saw the digitization of the economy as an opportunity to rethink and, if necessary, redesign rules and regulations in order to foster innovation and the transformation of existing markets, while

¹³ For model simulations of the macroeconomic effects of services sector reforms in Germany and related spillovers, see "Germany: Selected Issues", IMF Country Report 14/217, Chapter III.

Authorities' Views

39. **The authorities concurred with staff that a housing bubble was not an immediate concern.** Based on its internal valuation models, the Bundesbank's did not see recent price increases or mortgage credit developments as alarming, but was closely monitoring the situation. Authorities agreed with the importance of broadening the macroprudential toolkit, but pointed that privacy concerns related to data access were complicating the legislative process. There was broad agreement that housing supply needed to catch up with demand. The authorities noted that their action plan in this regard was fulfilling one of the commitments made in the government coalition agreement. They also explained that some measures had already been enacted, and that the action plan's success would hinge on continued cooperation across all levels of government as housing policy is very decentralized.

E. Banking and Insurance: Managing Many Transitions

40. **Low interest rates may be a persistent feature of the global economy looking forward.** Monetary policy is not the only factor pushing interest rates down in Germany and globally. Despite record low interest rates since the global financial crisis, inflation has remained subdued, a sign that the natural (or equilibrium) real interest rate—the rate that ensures low inflation at normal capacity utilization—has dropped to levels well below those prevailing in the past. An aging population and slower productivity growth are key factors explaining the secular downward trend in real interest rates since the 1980s (see Box 4). If such factors persist, then nominal and real interest rates may remain below their pre-crisis levels even after inflation returns to target and monetary policy normalizes, with important implications for the financial sector.

41. **Multiple challenges require the banking sector to accelerate restructuring to shore up profitability and safeguard internal capital-generating capacity.** Risk-based bank solvency indicators have improved since the 2014 SSM's comprehensive assessment and seem comfortable, but leverage ratios are low in international comparison. Low profitability reflects a bank-specific combination of remaining crisis legacy problems (especially for banks exposed to the shipping industry), provisions for compliance violations (in the two largest banks), the need to adjust business models to the post-crisis regulatory environment (in all large banks), as well as low interest margins and high operating costs (especially in retail banking). These challenges may have contributed to make large German private banks more sensitive to market turbulence earlier this year relative to peers, with uncertainties on the quality of Additional Tier 1 Tier 2 capital a likely amplifying factor. For large banks, implementing ongoing restructuring plans that involve across-the-board cost-cutting, refocusing on core activities and withdrawing from non-profitable and capital intensive activities and locations, and improving IT systems are priorities. Smaller banks should pursue efforts to further reduce costs, accelerate the development of digital banking solutions, and increase fee-based activities to offset shrinking interest rate margins. Given abundant lending capacity in the sector, meeting these challenges is not expected to lead to a meaningful reduction in the availability of credit to the economy.

42. **Adjustments in banks' strategies, partly in response to regulatory changes, may entail negative spillovers to the rest of the world, as major German banks are withdrawing from correspondent relationships in a number of countries.** In a context of tighter capital and liquidity requirements, stronger AML/CFT and tax transparency rules, as well as economic and trade sanctions in some countries, German global banks have been reviewing their customer base and business lines and have terminated accounts with certain customers and locations, though the phenomenon remains difficult to quantify. To prevent excessive curtailment of financial activities and important growth disruptions in emerging and developing countries, the authorities should encourage the relevant German banks to better manage the risks around these relationships. They should also strengthen the dialogue and cooperation among national supervisors, including to harmonize regulatory frameworks and facilitate cross-border information sharing on customer due diligence.

43. **The FSAP conducted a full assessment of Basel Core Principles for Effective Banking Supervision (BCP) and concluded that the regulatory and supervisory structure was sound, albeit with some gaps.** The assessment was based on a new international methodology, which emphasized corporate governance and generally raised the bar for both banks and supervisors. The assessment founds that the establishment of the SSM had a positive impact on supervision, which moved from a qualitative to a more quantitative approach. However, important shortcomings were highlighted, among which the need to strengthen the role of bank supervisory boards, to provide guidance on supervisory expectations for compliance with risk management and other supervisory requirements, and to improve the coverage and granularity of supervisory data. In particular, the lack of comprehensive, consistent and granular data affects all aspects of financial supervision, risk monitoring, and macroprudential policy. A rapid solution to this problem is essential, and a first step in this direction would be to amend the Federal Data Protection Law, to allow judicious use of data already produced for other purposes, while maintaining adequate privacy protection.

44. **Completing the agenda on the new bank recovery and resolution framework should be a high priority as Germany is home to highly interconnected systemic institutions.** The new architecture is complex and still in its infancy. The Single Resolution Mechanism (SRM) became operational at the beginning of the year. The Bank Resolution and Recovery Directive (BRRD) was transposed into German law, while in January 2016 the Single Resolution Board (SRB) assumed direct responsibility for resolution planning and implementation (in conjunction with the European Commission) for (the largest) banks directly supervised by the ECB. However, resolution planning is still work in progress ~~as-although~~ manuals and instructions for the use of resolution tools are ~~still being drafted-already implemented~~ by the SRB. In addition, the FSAP highlighted that the decision-making process for recovery and resolution is extremely complex as it involves several layers of domestic and European institutions whose ability to coordinate in crisis time remains to be tested. Moreover, the arrangements for handling a potential system-wide crisis remain unclear, in particular when it comes to the coordination between the SRB, the ECB and the German Ministry of Finance. Given the large size of the banking sector relative to the economy and the strong interconnectedness of the system, the authorities should accelerate contingency planning, including by testing the plans