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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 16/58-1

2:45 p.m., June 24, 2016

1. Germany—2016 Article IV Consultation

Documents: SM/16/149 and Correction 1, and Correction 2, and Supplement 1, and Supplement 1, Correction 1, and Supplement 1, Correction 2; SM/16/150; SM/16/153 and Correction 1

Staff: Detragiache, EUR; Erbenova, MCM; Haksar, SPR

Length: 1 hour, 26 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	N. Tshazibana (AE)
	S. Bah (AF), Temporary
	R. Vicuna (AG), Temporary
B. Sterland (AP)	
	M. Cavallari (BR)
	J. Chen (CC), Temporary
F. Jimenez Latorre (CE)	
	R. Young (CO), Temporary
	S. Benk (EC)
H. de Villeroché (FF)	
S. Meyer (GR)	
S. Gokarn (IN)	
	A. Bassanetti (IT), Temporary
	T. Hiroshima (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	W. Kiekens (NE)
T. Ostros (NO)	
	L. Palei (RU)
	S. Rouai (SA), Temporary
M. Omar (ST)	
D. Heller (SZ)	
S. Field (UK)	
	M. Sobel (US), Temporary

J. Lin, Secretary
O. Vongthieres, Summing Up Officer
I. Sian, Board Operations Officer

Also Present
Asia and Pacific Department: C. Rhee. Communications Department: A. Adriano. European Department: E. Detragiache, J. Goncalves Pereira, J. Natal, J. Vandenbussche, P. Xie. Finance Department: D. Andrews, A. Tweedie. Institute for Capacity Development: S. Coorey. Legal Department: W. Bergthaler, C. Joseph Marian, R. Lalonde, H. Pham. Middle East and Central Asia Department: A. Husain. Monetary and Capital Markets Department: M. Erbenova, U. Erickson von Allmen, J. Morsink, J. Scarlata, N. Sugimoto,

T. Xu. Risk Management Unit: X. Li. Strategy, Policy, and Review Department: V. Haksar. Executive Director: A. Mozhin (RU). Alternate Executive Director: M. Arbelaez (CE), S. Badirou-Gafari (FF), K. Choi (AP), O. Hendrick (AG), O. Petryk (NE). Senior Advisors to Executive Directors: R. Bartkus (NO), J. Cova (CE), F. Dlamini-Kunene (AE), M. Haarsager (US), E. Hagara (EC), A. Hubic (NE), H. Joshi (IN), B. Lischinsky (AG), R. Ngugi (AE), H. Nguyen (ST), G. Nkhata (AE), O. Odonye (AE), I. Park (AP), V. Ramcharan (BR), M.Sanchez (FF), E. Sishi (AE), T. Sitima-wina (AE), A. Tolstikov (RU), G. Zuniga-Villasenor (CE). Advisors to Executive Directors: M. Chen(UK), M. Hillebrand (GR), A. Jekabsone (NO), A. Lieber (GR), A. Medearis (US), B. Parkanyi (FF), S. Potapov (RU), D. Vasilyev (RU), T. Yamuremye (AE), H. Zavarce (CE), F. Lopez (CE).

1. GERMANY—2016 ARTICLE IV CONSULTATION

Mr. Meyer submitted the following statement:

I would like to convey my authorities' gratitude for comprehensive, detailed and insightful discussions during this Article IV and Financial Sector Assessment cycle. My authorities find their views well-documented in the set of reports. They found the staff assessment candid and balanced. With regard to the FSAP they will use the findings to critically reflect current structures and practices in Germany's financial sector.

Overview

The German economy is performing well with steady growth supported by solid private consumption based on a strong labor market and higher wages and a recovery of investment. The rebalancing of the German economy is underway (net exports do not contribute to growth) despite a current account surplus that has increased because of temporary developments (commodity prices). Public and private balance sheets are and remain healthy.

As indicated in recent years, the German government plans to prudently build on these favorable developments, emphasizing the medium- and long-term orientation of its policies. This will ensure a reliable economic policy framework as a central precondition for stronger private investment and consumption. In addition, and very importantly, this will support the sustainability of public finances in the face of known and predictable challenges (demographics) on the one hand and provide resilience to unknown and unforeseen developments on the other hand. One example for such unforeseen developments is increased refugee-related expenditures. The approach of fostering confidence and resilience has served the German economy well and contributed to stability in Europe and globally. Looking ahead, my authorities fully agree with staff that the key task will be to strengthen the growth potential of the German economy.

Outlook and Risks

The projection of real GDP growth of 1.7 percent this year and 1.5 percent next year is in line with the assessment of my authorities. They share the view that strong domestic demand is offsetting currently weak exports especially in 2016. Domestic demand is expected to remain strong also in the following years on the back of large employment gains and will additionally be boosted by an expansionary fiscal and monetary policy as well as lower oil prices. Emerging bottlenecks on the labor market are expected to be dampened by high immigration. In this context it seems important to distinguish between refugees and labor-market oriented migrants with the latter typically integrating faster and easier into the labor market.

While my authorities largely agree with the expected path of headline inflation, the decisive role of import prices could have been emphasized more clearly compared to the impact of the output gap and monetary policy measures.

Concerning risks, my authorities largely agree with staff assessment. However, investment could turn out stronger than anticipated by staff contributing to a more balanced view on risks to GDP growth. Concerning the nominal side downside risks to wages seem to outweigh upside risks in the near future. An additional risk relates to the development of refugee influx.

External Assessment

My authorities appreciate the in-depth analysis on Germany's external balance and agree with staff that the assessment of the German current account surplus cannot be reduced to mono-causal explanations. Temporary factors as the favorable exchange rate and commodity prices are responsible for a significant part of the recent surplus. Moreover, my authorities share the view that a large proportion of the surplus can be attributed to fundamental factors with demographics and the associated high savings rate being the most prominent drivers. These fundamental factors are slowly ceasing by nature. Therefore, it is likely that the current account will decrease only gradually. However, this should be a market driven process as the surplus reflects mainly the international competitiveness of German firms and individual decisions by consumers and companies rather than economic policy. Even sizeable increases in public capital spending would only have modest effects on the external balance and spill-over effects on partner countries would be fairly limited – this even more as final demand in Germany is not the main determinant of exports to Germany for many European neighbors as staff analysis has shown in the past (supply chain nature of trade integration).

As mentioned in the staff report, the Deutsche Bundesbank assesses the undervaluation of Germany's real effective exchange rate (REER) to be far smaller than staff. The corresponding differences between staff and the Deutsche Bundesbank are partly related to the uncertainty surrounding the determination of a fundamental equilibrium value of the REER.

Fiscal Policy and Public Investment

Despite the favorable fiscal outcome and cautious planning for the coming years, German fiscal policy faces important challenges. First, authorities at all government levels are currently tackling the urgent task of providing humanitarian assistance to refugees and engage in efforts to support integration into the society and the labor market. Second, as in other countries, public budgets benefit from windfall savings resulting from exceptional circumstances on financial markets. A normalization in interest rates over the medium term needs to be factored in today's budget planning. Third, population ageing will put pressure on public finances through the pension, health and long-term care system.

Given these challenges, the German government aims to maintain a balanced-budget target over the entire projection period until 2020. It will avoid pushing the fiscal deficit to the numerical limits allowed by national and European fiscal rules, and rather strives for safety margins to ensure that fiscal rules are observed at all times.

My authorities agree with staff that fiscal policy is expansionary in particular due to refugee-related spending as well as tax relief notably for families, single parents and low-income earners. At the same time, public investment continues to expand faster than total public spending; a special focus is put on infrastructure, education, research and development. Against this background, my authorities do not agree with staff that "a more ambitious investment program is needed." While "increasing public investment" is high on the government's agenda the overall quality of public infrastructure in Germany is considered to be very good also in international comparisons. The challenge is to preserve infrastructure quality in an efficient manner.

For this reason, my authorities intend to establish a federal transportation entity with the aim to unbundle the mixed responsibilities of the federal level and the German states, the "Länder," to increase overall efficiency. This entity will be organized on the basis of private-sector principles. It will be responsible for planning, construction, operation, maintenance and financing of the federal highway infrastructure based on the life cycle model. To ensure sustainable and predictable financial resources for the transport infrastructure the federal transportation entity will be financed mainly by user fees. Private investors will be given the opportunity to finance projects related to transport infrastructure depending on economic viability.

In addition, my government intends to remove administrative and regulatory constraints to public investment by municipalities and thereby follows up on recommendations of the IMF. Germany's PPP advisory agency Partnership Deutschland will be transformed into a public agency. This new center of excellence provides advisory service to municipalities in Germany throughout all project phases and irrespective of the selected procurement method.

Structural Reforms and Potential Output

In view of unfavorable demographics, my authorities agree that reforms need to be implemented to strengthen potential output and to increase productivity. Prioritizing investment, boosting labor supply, and more competition in the services sector are certainly key reform areas as pointed out by staff. A further target of the federal government is to attract qualified workers from abroad.

Private Investment

Next to the initiatives to promote efficient private and public investment at all levels of government mentioned above (paragraphs 12 and 13) my authorities are undertaking several measures to create a more attractive environment for private investment. Thus, they press vigorously ahead with the energy transition and combine it with an intelligent innovation policy. They also firmly support the expansion of digital infrastructure and provide targeted incentives for small and medium-sized enterprises to invest in the digital transformation. They are improving the environment for "young" companies and venture capital.

Boosting Labor Supply in an Ageing Society

The staff's suggestions to boost labor supply will be an important input for ongoing discussions in Germany. I would highlight the following points with regard to the three areas emphasized by staff:

My authorities agree that extending working lives would improve fiscal sustainability and increase old-age income. Initiatives to create incentives to work beyond the statutory retirement age, e.g. by implementing actuarially neutral schemes, are important to increase retirement age effectively. Indexing the statutory retirement age to life expectancy, as proposed by staff, is one option. To improve the resilience of the social system against adverse demographic developments, it is important to strengthen the second pillar as well, in particular by substantially broadening the coverage of occupational schemes.

The refugee influx in Germany represents a tremendous challenge to all levels of government, to business and society as a whole. My authorities agree with staff that the long term task is to help refugees integrate into the labor market and obtain the necessary qualifications. The German government has taken extensive measures such as accelerating asylum procedures, providing language skills, and improving skill recognition. Further measures are planned by the upcoming integration law. My authorities agree that continuing adjustments are necessary. With regard to the staff's recommendation to vigorously use active labor market policies such as temporary wage subsidies, I would like to point out that in 2016 extensive funds of additional €575 million are provided for active labor market programs for recognized refugees including job search assistance, on the job training, subsidized public sector employment as well as wage subsidies. In addition, for asylum seekers the budget for active labor market policies has been raised by €350 million in 2016. However, measures such as wage subsidies can only be effective, if necessary requirements for employment (e.g. language skills) are met.

In the past ten years the female employment rate in Germany has significantly increased from 65.0 percent in 2006 to 73.6 percent in 2015. Still, my authorities broadly agree with staff on the importance to further incentivize female labor market participation, especially to increase hours worked. My authorities' efforts in this regard are primarily focused on improving the reconciliation of work and family life (while they do not exclude discussions of the tax and social security system). Accordingly, high priority is given to the expansion of child care facilities in terms of quantity and quality. From 2008 until 2019 Germany will have invested €12.4 billion in child care facilities.

Stimulating Competition in the Service Sector

My authorities recognize that there is low productivity growth in some parts of the services sector in Germany and that less regulation could stimulate competition and growth. Against this background, regulations must be clearly justified on grounds of consumer protection, for security reasons, or to preserve the quality of vocational training. My authorities highlight that some progress was achieved with regard to professional regulations and services (veterinarians, tax advisors). However, going forward they agree to carefully examine which regulation is necessary for consumer protection, health or quality of services and weigh it against positive economic effects.

Although the market share of competitors to the incumbent operator in the long-distance rail passenger market segment has remained below 1 percent, the competition in the area of regional rail passenger transport and rail freight transport has increased steadily in recent years. The German government is convinced that the new "Act to Strengthen Competition in the Railway Sector" will have a positive impact on the competition in the railway market.

Housing: Relieving Price Pressure by Stimulating Supply

My authorities broadly agree with staff's assessment of house price developments in Germany. While there are currently no signs of a substantial broad-based house price misalignment, residential property might be overvalued to some extent in a number of cities. They also concur that the expansion of housing supply is currently not sufficient to dampen house price inflation, and that the constrained supply of building land is an important factor for the scarcity of affordable housing. However, my authorities acknowledge that the scope for boosting building land supply in the metropolitan areas might be limited. As noted by staff, they have developed a comprehensive 10-point-plan to address supply constraints and will monitor the success of this program closely.

FSAP and Financial Sector

My authorities agree that the German financial sector is overall stable and robust to shocks. They agree that the persistently low interest rate environment is significantly putting pressure on the profitability of banks including Less Significant Institutions (LSIs). Because LSIs constitute the majority of German banks, German authorities will continue to carry out surveys on the low interest rate environment in order to better monitor interest rate risks. My authorities agree that banks would broadly be able to withstand market and funding liquidity shocks.

My authorities share most of the conclusions of the stress testing results. As they have emphasized during the FSAP in 2011, solvency of insurers still remains adequate. With transitional measures, insurers' capital levels appear generally sufficient. My authorities know that without the transitional measures, a significant number of life insurers would have difficulties in meeting the Solvency II Capital Requirement.

With regard to the Insurances Solvency Stress Testing, my authorities are aware that "low profitability of life insurers hampers their ability to pay guaranteed yields to policyholders." As Germany's insurance sector is dominated by guaranteed return life products my authorities know that they need to be cautious when insurers adopt risky search-for-yield strategies against the backdrop of low profitability and persistent structural weakness.

My authorities agree that systemic risks and spillovers are important issues that should be monitored by authorities. However, they note that only limited conclusions can be drawn from the IMF staff's analysis regarding "domestic interconnectedness among publicly traded German banks and insurers." Although it is true that the German financial system is interconnected, the degree of interconnectedness is hard to be assessed because a comparison to other countries and industries is missing.

My authorities concur with staff on the key messages with respect to the German macroprudential policy framework: while broadly appropriate, some scope for improvement is highlighted. They agree that macroprudential analysis is highly data-dependent. An appropriate set of readily available, comprehensive, and reliable data is a precondition to monitor developments, to identify possible risks to financial stability, to choose and calibrate the adequate instruments and assess their effects afterwards. This argument is of particular relevance for the real estate sector. My authorities are currently working on a legal act implementing a recommendation of the German Financial Stability Committee (FSC). The German FSC has recommended to create additional macro-prudential tools as regards residential real estate as well as a sufficient and proportionate legal basis for the collection of data to the extent and at all the level of detail necessary for the calibration and application of the macro-prudential tools.

The assessment shows Germany's high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs) in general and in particular as Germany has been assessed not only against the essential but the additional criteria. Furthermore, the BCPs have been revised substantially in 2012. In addition, Germany is the first country that has been assessed under the new European banking supervision regime—Single Supervisory Mechanism (SSM)—which conferred specific tasks relating to the prudential supervision of credit institutions upon the ECB. Regarding the assessment of the core principles my authorities think that the compliance with a number of principles is assessed somewhat too negative and that the current regime effectively fulfils the IMF's requirements. In most cases the results are driven by the fact that assessors are not satisfied with the role of the supervisory board within the context of the rules of the German company law. In my authorities' view this critical assessment of the supervisory board and its role within the corporate governance framework in Germany are contradictory to the statement of the Basel Committee of Banking Supervision, which states that both concepts—one-tier and two-tier systems—are both equivalent although the role of the board in its supervisory function in a one-tier-system is broader than in a two-tier-system.

My authorities share the assessment that the transposition of the EU Bank Recovery and Resolution Directive (BRRD) into German law has significantly strengthened the bank recovery and resolution regime as well as crisis management in Germany. Germany has made significant progress in recovery and resolution planning. Resolution of Significant Institutions (SIs) and transnationally active LSIs is taken to a European level and my authorities agree that decision-making processes are complex. Identified operational challenges are being addressed and my authorities are working on making arrangements to ensure that resolution instruments can be timely implemented in order to avoid potential negative market sentiments.

In addition, the harmonized EU directive on deposit guarantee schemes, which entered into force in 2014, establishes a legally binding deposit guarantee for Europe of up to €100.000 per depositor and therefore addresses prior concerns by the IMF. In certain circumstances this limit can be extended. The German Act transposing the Deposit Guarantee Scheme Directive (DGSD) entered into force in July 2015. Since then also mutual protection schemes introduced a legal claim for reimbursement of €100.000.

The assessment with regard to Eurex Clearing AG shows Germany's high level of compliance with the CPSS /IOSCO Principles for Financial Market Infrastructures (PFMI). The German authorities are convinced that Eurex Clearing AG's arrangements fully observe the regulatory requirements laid down in the PFMI including those on operational risk management.

Mr. de Villeroché submitted the following statement:

We thank staff for their comprehensive and detailed reports and Mr. Meyer for his elaborate and informative buff statement.

We commend Germany for an economy that can be characterized by steady growth, strong public finances and high employment. However, the large current account surplus, an ageing population and modest medium-term growth prospects raise policy challenges. While prudent fiscal policy has to be maintained, increased public and private investment as well as structural measures to raise potential output should contribute to closing the savings-investment gap, which would support the rebalancing process not only in Germany but in the euro area as a whole.

Macroeconomic Developments

The ongoing internal rebalancing in the German economy is welcome and needs to be speeded up, with more contributions from investment. Given sound economic fundamentals, domestic demand is set to remain the main growth driver. A modest recovery in business investment is expected, while housing investment is likely to moderate only gradually. Public investment, which has been low for an extended period also in an EU comparison, saw a slight expansion in 2015 and is set to continue increasing.

Wage growth has picked up in the last years. While compensation of employees has grown beyond productivity in recent years, it remained somewhat below productivity plus the ECB's inflation objective. Going forward, wages are forecast by staff to evolve along this trend. So far, core inflation remained low and stable suggesting a muted pass-through from wages to price inflation, which may turn out to be stronger in the future.

The German current account surplus is expected to decline in the medium-term, but only slowly. Temporary factors, such as oil price and exchange rate effects, contributed to the rising current account surplus which stood at 8.8 percent of GDP in 2015. The staff's estimation of an underlying current account norm (2½–5½ percent of GDP) suggests that the external position remains substantially stronger than implied by medium-term fundamentals and desirable policy settings. The staff's forecasts a slow decline only over the medium-term. In this context, seeking out policies that would speed up this process seems to be warranted from both a domestic and European perspective. We therefore support staff's emphasis on the importance of structural policies to close the savings-investment gap and agree that there is a need to boost public investment.

Fiscal Policy

Within the limits of fiscal rules, budgetary policy should be geared more towards investments. Germany is expected to achieve with a buffer both the requirements under the Stability and Growth Pact and the national balanced-budget rule ('debt brake') for the federal budget, while the debt-to-GDP ratio is projected to remain on a firm downward path beyond the requirement of the European debt rule. We take note of staff's projection of a fiscal expansion of 1 percent of GDP in 2016. We commend the authorities for devoting considerable resources to humanitarian assistance and support to the refugees. We note that Germany has also made some progress in boosting public investment and have valuable plans to improve the efficiency of delivering new transportation infrastructure. However, policies to address the investment backlog and boost labor market participation should be pursued more forcefully, by using available fiscal space and by prioritizing expenditure while staying within fiscal rules. Furthermore, we concur with staff that further progress is needed in removing administrative constraints to public investment by municipalities.

Structural Policies

Raising potential GDP is highly important to address the effects of the unfavorable demographic trends. The challenges of population ageing and expected skill shortages call for further measures to enlarge the labor force, by extending working lives, activating and integrating immigrants and encouraging higher participation of women in the work force, to promote investment and to increase competition in the services sector. In addition, we see room for improving the business environment and thus to increase the incentive for the private investment in particular as regards R&D. We take note of staff's assessment that these structural reforms could also have a short-term impact, helping also the reduction of the savings-investment gap.

Integration of low-skilled migrants in the labor market will have long term effects on potential output. The efforts of the German authorities to accommodate the large inflow of refugee are admirable. The 2016 budget augmented spending on active labor market policies targeted at refugees and asylum seekers by a significant amount. In this context, we welcome staff's recommendation to further extend integration measures to help refugees accessing higher-quality jobs as well as to decrease remaining restrictions on work also during asylum procedures.

We concur with staff that there is room to improve competition in sheltered service sectors, in particular professional services and network industries. While some progress has been made in the past, further efforts to liberalize the service sector and retail trade could increase competition and productivity in these sectors and would have a positive economy-wide impact. A stronger and more productive services sector would make the German economy less reliant on manufacturing and export and thus less vulnerable to external demand shocks.

Financial Sector Policies

The German financial sector is resilient but the low interest rate environment is challenging. We share staff's assessment that the current low interest rate environment places pressures on insurers as well as on segments of the banking system which suffer from low profitability, reflecting also specificities of their business models and other structural factors. In this context, a number of banks need to adapt their business models and cost structures. We also agree with staff that a persisting low interest rate environment could lead to increased vulnerabilities in the real estate sector. Nevertheless, there are no indications of economy-wide unsustainable trends in the German housing markets right now. In line with government action, equally important is also to ensure the effectiveness of measures that address housing supply constraints. In this context, a close monitoring of the situation and the preparation of legislative proposals for appropriate macro-prudential instruments are warranted.

We overall share staff's views regarding bank supervision in Germany. The new supervisory framework constitutes a significant improvement as it allows Significant Institutions in Germany to be effectively benchmarked against their peers in the euro area. We also agree with the need for improving the comprehensiveness and granularity of supervisory data, for the introduction of prior supervisory approval for significant transfer of ownership, and for a comprehensive and effective framework to monitor and supervise related-party risk in Germany.

Mr. Alshathri and Mr. Rouai submitted the following statement:

We thank staff for a comprehensive set of reports on Germany's 2016 Article IV consultation and Financial System Stability Assessment (FSSA) and Mr. Meyer for his informative buff statement. We broadly share staff conclusions and policy recommendations and would like to make the following points.

The German economy continues to perform well. While growth, underpinned by strong domestic demand and a recovery in investment in construction, is moderate, unemployment is at its lowest level since reunification, the fiscal position remains healthy, and the banking sector continues to be sound and resilient. On the other hand, the current account surplus increased to 8.5 percent of GDP in 2015, in particular due to the narrowing of the oil and gas trade deficit, although it is expected to moderate somewhat to 6.8 percent of GDP in 2021.

We note staff assessment that risks to the outlook are to the downside. In addition to the risks associated with volatility in global financial markets and slower external demand, the risk of a Brexit could be elevated, as the United Kingdom is Germany's third largest export destination. We agree with staff that in the event of a large downside risk materializing, a fiscal expansion would be warranted.

We commend the authorities for their cautious fiscal policy, but we agree with staff on the importance of using available room under the fiscal rules to boost public investment. We welcome the new 2016-30 plan for transportation infrastructure investments although we note that the plan is not binding. We encourage the authorities to expedite the reduction of the public investment backlog and to accelerate the removal of the administrative and regulatory constraints to public investments by municipalities and we welcome, in this regard, the planned establishment of a federal transportation agency that could help improve planning and reduce delays in highway construction. Still on fiscal policy, we would appreciate staff clarifications on the issue of tax revenue forecasts, which seems to be consistently underestimated compared to actual performance. Is there a risk that this trend may unduly exacerbate the already cautious fiscal policy? In any event, we support staff recommendation to review structural changes in macroeconomic variables underlying revenue projected and encourage also the authorities to develop contingency plans for the use of unexpected windfalls.

We welcome the FSSA and are comforted by its conclusions regarding the strength and resilience of the financial sector. The implementation of the EU-wide reforms is contributing to improving supervision and bank resolution and we encourage the authorities to finalize the agenda of reforms while paying due consideration to the FSAP key recommendations to strengthen the oversight of the banking, insurance, and asset management sectors and improve crisis management and resolution. We note, in particular, the low profitability of banks and life insurance companies exacerbated by the low interest rate environment and we encourage supervisors to remain vigilant.

We support staff recommendations to implement policies and structural reforms to strengthen potential growth, thus generating positive spillovers to the rest of the euro area and contributing to lowering the current account surplus and thus to global rebalancing. This could be achieved through enhancing competition in the services sector, and increasing labor market participation and the integration of refugees and other immigrants.

Finally, we note the length of the staff appraisal section and encourage staff to present a more focused message to help improve the traction of IMF surveillance.

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

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

We thank staff for the comprehensive set of papers and Mr. Meyer for his insightful statement.

The German economy has continued to deliver sustained, albeit moderate, growth on the back of fiscal expansion, accommodative monetary policy, a strong labor market, and low energy prices, in a context of low inflation, adequate fiscal buffers, and growing current account surpluses. Going forward, the authorities face a number of challenges, including the need to raise medium-term potential growth through higher productivity growth and investment in infrastructure and increased labor market participation; make further inroads in growth rebalancing toward domestic sources; and complete the financial sector’s transition to a new regulatory and supervisory framework. We are in broad agreement with the staff appraisal and limit our comments to a few issues.

The economy has shown a remarkable flexibility in responding to new developments. Last year, the adverse effect of weak external demand on growth was offset by increased private and public consumption, together with continued investment in machinery and equipment; the record high number of refugees was managed with limited budgetary impact; and the continued gradual fiscal and monetary stimulus, together with tight labor markets, did not push up core inflation. We commend the authorities for these achievements, which attest to skillful stewardship of the economy. We concur with the risks to the medium-term outlook, and we feel that there are risks on the upside, which the report could have also highlighted. The staff may wish to comment.

The external position remains strong, but gradual rebalancing is under way. At 8.8 percent of GDP in 2015, the cyclically adjusted current account surplus is assessed by staff to be 3-6 percent points of GDP above the norm. However, the surplus is stemming mainly from low commodity prices while the contribution of net exports to growth is expected to turn negative in 2016 and over the medium term, thereby reducing the current account surplus. This said, there is room for stronger rebalancing without endangering the long-term need for buffers to deal with unfavorable demographic trends or unforeseen shocks. The set of reforms outlined in the report offers a range of options to this effect and deserves consideration. Could staff comment on the possible combined spillovers of these measures on Germany's partners?

Sound fiscal policy has served Germany well, and provides space for increasing public investment under the fiscal rule to promote long-term growth. We support staff call for higher public investment, and welcome the authorities' newly released 15-year plan for increased investment in transportation infrastructure. Addressing capacity and regulatory constraints at the local level would also boost private sector activity and growth. We welcome the plans to broaden the mandate of the PPP agency to cover infrastructure programs financed through normal procurement, and create a federal transportation agency to help strengthen implementation of transport infrastructure investment.

We welcome ongoing efforts to increase productivity and encourage private sector investment. We concur with the need to strengthen competition in the services sector, streamline regulations, and encourage investment in digital infrastructure to help bridge the gap with most of Germany's peers in this area. Increasing labor supply would also raise medium-term potential output and address the labor shortage associated with population ageing, including by providing greater incentives for full-time work for women, encouraging longer working lives through pension reform, and by integrating the refugees.

The authorities' decision to address a global humanitarian situation by absorbing a large number of refugees is a historical hallmark for Germany, in addition to its positive side effect on labor supply. We commend the authorities for the efficient delivery of the needed vocational training and for easing a number of working restrictions to facilitate the integration of refugees in the labor force as highlighted in Box1. We concur that sustained efforts will be needed to enhance the qualification of refugees to ensure that they are not trapped in low-skill jobs.

The financial sector is strong and resilient, but faces the challenge of adjusting to an evolving regulatory and supervisory environment. Against the background of strong household and corporate balance sheets, the FSSA reveals that banks have adequate capital buffers, low NPLs, and have made significant progress in deleveraging and cost reduction. Nonetheless, weak profitability in a low interest rate environment is a risk for banks and insurance companies, which the authorities intend to monitor, as indicated by Mr. Meyer. We welcome the indication that the establishment of the Single Supervisory Mechanism had a positive effect on supervision, and concur with the need to address the many challenges posed by the transition to the new EU bank recovery and resolution framework. Given the global role of Germany's financial system, we support staff recommendations in this area, and take a positive note of the authorities' intention to effectively address these challenges.

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

Mr. Canuto, Mr. Cavallari and Mrs. Ramcharan submitted the following statement:

We thank staff for the detailed reports and Mr. Meyer for his informative statement. Germany continues to maintain a strong fiscal position and GDP growth is expected to further strengthen to 1.7 percent in 2016, underpinned by increasing domestic demand. Private consumption growth has accelerated, reaching a 15 year high in 2015, supported by a strong labor market and low energy prices. In contrast, public investment has been falling and remains below the euro area average despite the large public investment backlog.[1] Consequently, the country's long-standing current account imbalance, weak public investment policies and specific financial sector exposures pose downside risks to potential growth and potential adverse global spillovers.

The current account imbalance will continue to be sizable unless the authorities take decisive actions. Germany's current account surplus (CAS) has averaged 6.1 percent over the last decade and expanded further in 2015 to 8.5 percent of GDP. Under the baseline scenario the CAS is expected to decline to just 6.8 percent by 2021, indicating a considerably subdued pace of adjustment, and remains well above the assessed norm of 2.5–5.5 percent. Moreover, the persistent output gap differential between Germany and its trade partners is estimated to have lowered the CAS by 0.3–0.6 percentage points, implying that it could expand further and exceed 9 percent of GDP when cyclical conditions in these countries improve. Therefore, while we take note of the authorities' position that large CAS is not a reflection of policy related macroeconomic imbalances, this does not deny the need to take

[1] European Commission: Country Report Germany 2016

appropriate action to address factors that contribute to this imbalance, including the removal of administrative and regulatory constraints to public investment.

There is scope to increase the level of public investment without endangering buffers under the European Union fiscal framework. The authorities have step up public investment by a cumulative 0.7 percent of GDP over 2016–18, despite having the capacity to finance an increase in public investment by 2 percent of GDP over four years—without breaching the structural deficit rule of 0.5 percent of GDP under the Stability and Growth Pact, Medium-Term Objective (MTO). Moreover, in 2015, Germany recorded a headline budget surplus of 0.6 percent of GDP and a structural surplus of 0.7 percent of GDP, thereby remaining well above the MTO. In addition, Germany's Draft Budgetary Plan for 2016 aims to overachieve the MTO during 2016-2019 with a margin of 0.5 to 1 percent of GDP. Therefore, given the significant investment backlog in infrastructure, education and research, it may be prudent for the authorities to resist imposing deliberate limitations and adopt a more flexible fiscal stance.

Pro-investment policies could raise economic output and generate meaningful regional spillovers. We take note of the authorities' position that regulatory constraints inhibit further expansion of public investment and their commitment to the "black zero" as a cornerstone of fiscal policy. However, investment spending is a variable that influences aggregate imbalances which is directly controlled by the authorities. In addition, less than 14 percent of the EUR 3.5 billion Municipal Investment Fund, which was constituted by the federal government in mid-2015 to provide financial support to local governments, has been utilized. Therefore, we find it disconcerting that the authorities consider the current level of public investment to be adequate, while net public investment continues to be negative. Given its central position in the euro area, Germany is a source of potential spillovers to other member states and could contribute to achieving stronger regional growth, mitigating regional macroeconomic risks. This is of relevance, as is not feasible for most countries to use the "black zero" policy, while the demand management policies of these countries have allowed Germany to utilize the "black zero" as a cornerstone to its own fiscal policy.

Regulatory frameworks need to be reinforced to limit potential systemic risk to the financial sector. Based on the FSAP report, the German consolidated banking sector is resilient, well capitalized and highly liquid. However, challenges remain due to prolonged low profitability and long-standing structural challenges, while there has been limited progress in adjusting business models to the post-crisis regulatory environment. Negative interest rates continued to erode profits, while banks' cost-to-income ratio—over 70 percent—is significantly higher than the euro area average. Could staff briefly elaborate on the possible relation between both very low risk-weighted assets to total assets ratio and the price-to-book ratio in the German financial sector?

We encourage the authorities to take decisive action to address the specific issues identified in the FSSA report—including to facilitate banking consolidation and recurrently highlighted data deficiencies. Outward and inward financial spillovers are potentially significant given the quantitatively important financial linkages and banking sector exposures between Germany and other countries. In this vein, we welcome authorities' continued efforts to enhance cooperation regarding the impacts on third-party countries from the banking resolution framework. Pertaining to correspondent banking relationships, we strongly agree with staff that the authorities should encourage the relevant German banks to better manage the risks around these activities to prevent excessive curtailment of financial services with emerging and developing economies.

Progress has been made on labor market reforms, but more needs to be done. Germany has made considerable progress on reforms promoting female, old-age and low-skilled labor participation[2]. However, even under the most optimistic scenarios the working age population is projected to decline sharply from 2020, while the authorities are relying on the current high level of immigration to dampen emerging bottlenecks in the labor market. Accordingly, we concur with staff that reinvigorated efforts are needed to boost labor supply. More needs to be done to facilitate the productive integration of new immigrants—especially the refugees—into the labor market, as prolonged migrant inactivity could postpone the materialization of important economic benefits, including those related to demographics and the persistent current account surplus.

A concerted effort is needed to increase productivity in the services sector in order to boost competitiveness. Progress has been limited in this area, and more ambitious measures to stimulate competition in the services sector is necessary, especially in relation to eliminating unwarranted restrictions in professional services. Similarly, the long-awaited Act to Strengthen Competition in the Railway Sector has been under discussion for over three years. Simulations from the European Commission demonstrate

[2] Fiscal Policy and Long-Term Growth—Case Studies (SM15/92)

significant macroeconomic benefits from reducing the restrictiveness of professional services regulations. Therefore, given the potential benefits of competition-enhancing reforms in the services sector, we agree with staff that more vigorous efforts are desirable.

Mr. Cottarelli and Mr. Bassanetti submitted the following statement:

We thank staff for a well-focused set of papers and Mr. Meyer for his informative buff. We broadly share the staff appraisal and recommendations. We associate ourselves with Mr. de Villeroché's gray and would like to offer the following comments.

The ongoing rebalancing of the drivers of the German economic growth in favor of a stronger domestic demand is a welcome development and should continue to be pursued. As we stated in previous occasions, it contributes to further strengthening Germany's already sound fundamentals and enhances significantly the country's resilience to external shocks. In a way, Germany's continued good economic performance despite the currently weaker external environment—including the deceleration in some of its main trading partners—is a testament to such a view.

The robust consumption growth spurred by dynamic real wages and a healthy labor market, the initial investment recovery on the back of higher-than-average capacity utilization, and the easing of the fiscal stance for 2016—yet fully obeying by fiscal rules—are all good news and set the country on a stronger footing to address the remaining challenges.

Persistently large current account surpluses—even after accounting for some specific factors that played out in 2015—and declining medium-term economic prospects (and potential growth) are, in our view, intertwined issues which call for a similar set of policy actions. We broadly concur with staff recommendations.

The ample gap between savings and investments deserves continued investigation: it largely pre-dates the global financial crisis and it keeps widening. Favoring the conditions for higher returns for domestic investment remains important. By setting incentives right, well-designed structural reforms can go a long way in this direction. As highlighted by staff over the course of recent years, efforts in Germany should be stepped up especially in the service sector, particularly in the areas of regulated professions, retail trade, and network systems.

Similarly, a more ambitious and well-specified plan for public investment addressing some backlog and infrastructural needs can foster both actual and—through stronger capital and TFP—potential growth. We appreciate the envisaged increase in public investment for 2016-18; at the same time, we continue to see merit in staff recommendations in this area, in terms of both timing and size. Germany is probably better positioned than other countries to overcome the planning and execution capacity constraints that are holding back a more vigorous approach to public investment.

Against this background, we agree with staff that the use of the available room under the fiscal rules—i.e. a fiscal position closer to the Medium Term Objective—would be appropriate at this stage and in the medium term. It would be intended to support growth-friendly structural reforms and additional public investment, without compromising the soundness of the German public finances and the declining trend of the debt-to-GDP ratio. It would contribute to a warranted narrowing of the large current account surplus while preserving—and even strengthening—Germany's hardly won high competitiveness.

Regarding long-term fiscal developments, we also see merit in staff proposals on ways to address the challenges posed by population aging.

We welcome the results of the FSSA pointing to the strengthening of private balance sheets (households and corporates), a relatively well capitalized banking system, low levels of NPLs, and a broadly sound regulatory and supervisory framework. Continued efforts to tackle the remaining structural vulnerabilities along the lines suggested by staff would further enhance the resilience of the system. Sustaining consolidation and restructuring plans, adjusting a cost-intensive business model, addressing some bank-specific issues would improve the banking sector efficiency and increase profitability from the currently low levels. The secular downward trend in real interest rates and the transition to the new regulatory framework places pressures on insurers. At the same time, we take positive note of some points of strength in the sector, particularly among large and small companies. We agree with staff on the need for close supervision and—like the authorities—we are confident in a smooth adjustment.

Mr. Omar, Mr. Nguyen and Mr. Chung submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Meyer for his insightful buff statement. Germany's economy is expected to remain on a moderate growth path with domestic demand underpinning the growth momentum. The authorities' planned fiscal expansion of 1 percent of GDP in 2016 is timely and appropriate. Further efforts to remove constraints to public investment at the municipal level, mitigate the effects of an aging population and enhance competition of the services sector will help boost productivity and lift Germany's medium-term prospects. Major financial sector reforms have helped to bolster the resilience of the German financial sector but key reforms should be completed to address remaining gaps. We offer the following comments for emphasis.

We commend the authorities for a strong track record of prudent fiscal management and are encouraged by staff's estimate of a fiscal expansion of 1 percent of GDP in 2016. As highlighted in the buff, the disciplined observance of fiscal rules has served Germany well and will continue to remain an important anchor as it confronts demographic challenges and increasing social spending needs. Against the backdrop of accommodative monetary policy, and a closed and potentially positive output gap, the authorities' fiscal policy stance seems appropriate. Having said that, we concur with staff that Germany has fiscal resources available within the envelope of the fiscal rules to provide additional fiscal stimulus should downside risks materialize. At the current juncture, we welcome the authorities' ongoing efforts to increase public investment on infrastructure, education, and research and development, as well as plans to strengthen the efficiency of public investment implementation. Given existing public investment constraints faced by municipalities, we welcome the authorities' commitment to streamline and remove the administrative and regulatory obstacles that have thus far limited the planned disbursement of investment funds or delayed investment projects.

Reforms will be needed to boost labor supply and to help mitigate the adverse impact of rapid aging on the workforce and economic activity. We welcome the authorities' ongoing efforts to integrate the large number of refugees and note that further measures to enable informal skills recognition and more flexible forms of vocational training, such as provision of language training, are under consideration or being introduced. While having an already high female labor force participation rate, the authorities could still consider measures to assist female workers who are currently in part-time roles transition to more full-time employment, including by providing more affordable childcare services and after-school programs. With an aging population, there are also merits for the authorities to foster conditions that would help older workers who may wish to work beyond the statutory retirement age to find meaningful employment. Like the authorities, we see advantages in staff's recommendation to have future retirement ages indexed to life expectancy. We note that some of these measures may require additional fiscal outlay in the short term but agree with staff that they would have a potentially large payoff in the longer term. We note that staff recommends that the authorities reprioritize spending within their existing budget in the short term to accommodate the small increase in fiscal costs. Could staff elaborate on areas where public spending could be deprioritized?

We welcome staff assessment that the resilience of the German financial sector has been bolstered by major financial sector reforms that are now nearing completion. We share staff's assessment that the Single Supervisory Mechanism and Single Resolution Mechanism have had a positive impact on the German financial sector, with strengthened supervision and more a more coherent regulatory framework across the EU. Nonetheless, we support the key FSAP recommendations that will help the authorities to address remaining gaps in the regulatory and supervisory structure. In particular, we agree that the authorities should as a priority, provide clearer guidance on supervisory expectations for compliance and improve the coverage and granularity of supervisory data. Further, we welcome the significant progress that has been made in implementing the new bank recovery and resolution framework but agree with staff that the authorities should develop a systemic crisis coordination mechanism among the relevant German and European authorities given the multiple agencies and layers in the new architecture. Given the large size of the German banking sector and the number of globally systemically important German financial institutions, we welcome the authorities' commitment to accelerate their efforts to ensure operational readiness of the resolution framework. We also strongly support staff's recommendation for the authorities to encourage the relevant German global banks to better manage risks and strengthen dialogue with other national supervisors in order to prevent excessive and unnecessary withdrawal of financial services and customer relationships in emerging and developing countries.

The authorities should continue to pursue structural reforms to enhance competition in the services sector and address housing supply constraints. Structural reforms to promote competition in a few key service sectors can help to boost greater efficiency and innovation, including in professional, railway and postal services. We agree with the authorities that the trend toward digitization of the economy could provide a good window of opportunity to redesign rules and regulations in some of these sectors and look forward to the authorities' plans in the near future. While concerns about a housing bubble seem premature, we welcome the authorities' commitment to monitor developments closely and plans to broaden their macroprudential toolkit. In this regard, the authorities' action plan to boost housing supply would also be crucial and constant monitoring of its effectiveness and readiness to recalibrate its specific measures would be required.

We note Germany's strong external sector position relative to medium-term fundamentals and staff's expectations for the current account surplus to gradually decline over time. As stated in the report, the rebalancing process will unfold as the terms of trade windfall is spent, energy prices partially recover and the output gap becomes positive as the recent surplus is largely attributable to these temporary factors. Over the longer term horizon, Germany's aging population and structural policies to address the demographic challenges should also contribute to the narrowing of the saving-investment gap in the economy.

Mr. Snel and Ms. Hubic submitted the following statement:

We thank staff for their well-written reports and Mr. Meyer for his informative buff statement. Germany continues to be an anchor of stability in Europe, with a steady economic growth, overall sound public finances and a robust labor market. However, a declining growth potential, an ageing population and a large current account surplus raise some challenges. The FSSA results indicate that the financial sector is resilient but the low interest rate is cause for concern and should be closely monitored as its consequences can have an impact on financial stability. We associate ourselves with the statement issued by Mr. de Villeroché and would like to add the following comments for emphasis.

The introduction of the minimum wage reduced the marginal employment (the so-called mini-jobs). We welcome the staff's analysis in Box 1 on the impact of the introduction of minimum wage of EUR 8.8 per hour as of January 1, 2015. It seems that the minimum wage has had little or no effect on aggregate wages and employment so far, but a sizable downward effect on marginal employment. Some studies indicate that the marginal employment has led to an increase in poverty and inequality in Germany. Do staff have any early evidence that the significant reduction of marginal employment has had an impact on poverty and inequality? Can they provide an early estimate of the Gini-coefficient? Once more data becomes available, it would be useful to have a SIP on this important issue.

With public finances remaining strong and recording a surplus, there is some scope to further increase public investments. The projected overall general government balance as well as the structural balance are expected to record a surplus this and next year, while the debt-to-GDP ratio is projected to remain on a firm downward path. We welcome this rapid decline of gross public debt which helps increase buffers against the rapidly ageing population and unforeseen shocks. However, we share staff's view that there is still some available fiscal space—with higher than foreseen revenues and prioritization of expenditures—that could be used to increase public infrastructure investments. This would support potential growth and reduce external imbalances at a time when financing costs are historically low. However, a positive cost-benefit analysis is an essential precondition for any additional investment project. Also, better coordination between local authorities could enhance the efficiency of investment spending by reducing the fragmentation of the planning. In this regard, we welcome the authorities' decision to transform Germany's PPP advisory agency Partnership Deutschland into a public agency with an aim to remove the administrative and regulatory constraints to public investment by municipalities. We also strongly support the idea of an establishment of a federal transportation entity with an objective to unbundle the mixed responsibilities of the federal level and the German states regarding the highway infrastructure. This would allow the less economically developed German states to have a better and more efficient access to financing.

Mr. Palei and Mr. Vasilyev submitted the following statement:

We thank staff for a set of well-written papers and Mr. Meyer for his informative buff statement. Germany's fundamentals, such as the fiscal and external positions, remain fairly strong. Given weaker external demand, the German economy needs to rely more on domestic demand to support growth. Very strong external position warrants some rebalancing towards domestic demand. However, this rebalancing should not jeopardize fiscal sustainability, given the fiscal challenges, which we discuss below. We welcome the efforts to increase competition in the services sector, as they should unlock growth in the nontradable sector and help rebalance the economy from overreliance on the tradable sector. We also welcome the authorities' attention to the challenges in the financial sector.

The German economy continues to grow on par with median growth for the euro area. In 2015, with output gap almost closed the economy grew by 1.4 percent. As private consumption reached 15-year high in 2015 and investment in machinery and equipment recovered, domestic demand became the main driver for growth. With the unemployment ratio at 4.2 percent, tight labor market conditions continued to drive wages up with no substantial pass-through effects to inflation.

Germany continues to maintain a very strong external position. The staff noted that cyclically adjusted current account surplus at 8.8 percent of GDP was bigger than estimated norm by 3-6 percentage points. However, fiscal gaps in Germany and its trading partners explained only 1.5 percentage points out of this gap with most of the gap likely reflecting lower fuel prices and limited nominal exchange rate adjustment. The staff noted that aging and projected decline of potential output growth explained high savings and low investment and, as a result, higher current account balance. According to staff, structural reforms aimed at improving productivity, such as increasing female labor participation, continuing pension reforms, and encouraging corporate investment over time should reduce current account surplus.

We commend the German authorities for maintaining prudent fiscal policy. The general government surplus increased to 0.6 percent of GDP, while public debt declined to 71 percent of GDP. We note that fiscal space is not seen as very large, if we take into account the risks of rising costs associated with refugee inflows and population aging. According to the 2016 Fiscal monitor, net present value of pension spending change and health spending change in 2015-2050 was 40 and 36.8 percent of GDP. We note that the authorities are discussing various options of improving pension system sustainability, including staff’s suggestion to prolong working lives in accordance with higher life expectancy.

As yields on long-term government bonds are below zero, bank lending rates are also at the historical lows. Credit growth started picking up and reached 3 percent growth y-o-y in early 2016. Although companies continue to finance their investment using retained earnings and cash reserves, their demand for loans has also increased. At the same time, mortgages explain about half of the total credit growth.

The staff links the current increase in housing prices to low mortgage interest rates in addition to supply constraints. In paragraph 40 of the report, staff noted that the neutral interest rate may be lower than in the past. Could staff provide approximate estimates of the contribution to higher housing prices from lower neutral interest rate?

As the staff report noted, lower equity prices and higher CDS spreads of the largest German banks during the episode of intensified volatility at the beginning of the year may have indicated market concerns about banks’ future profitability. The German banks still need to address legacy problems, refocus on core activities, cut inefficient costs, and adjust their business models to a new regulatory environment. The FSAP noted that the new bank recovery and resolution framework is not yet completed. And the authorities still need to clarify the coordination among the domestic and European institutions, as well as to finalize the instructions for the use of resolution tools.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Meyer for a helpful buff statement. The German economy is in good shape and continues to perform very well. The growth momentum is on a steady uptrend with strong domestic demand as private consumption growth reached a 15-year high. Real wage growth is among the highest, but core inflation remains low reflecting falling oil prices. Unemployment is markedly low, while employment has been supported by a surge in economic immigration. The current account surplus widened further in 2015, reflecting a high level of savings of the private nonfinancial and government sectors, and strengthening the already solid net international investment position. We broadly support the focus of staff discussions on structural reforms to raise the declining growth potential, including through higher investment and continued implementation of financial sector reforms.

The fiscal expansion this year is appropriate, and Germany should continue to use available fiscal space under the fiscal rules to finance growth-friendly policies. A broad increase in tax revenue and decline in interest payments have helped improve the fiscal position, with surpluses achieved in 2014 and 2015, and further reduced debt. After this year's fiscal expansion, surpluses are expected over the medium-term, which will reduce public debt to below 90 percent of GDP by 2020, but also tend to support larger current account surpluses. The reforms recommended to raise labor market participation and modify the pension scheme to promote longer working lives would contribute to boosting incomes and domestic consumption to help reduce these surpluses. We agree with staff on the need for stronger efforts to more efficiently address public infrastructure needs.

Low interest rates are one of the factors behind low profitability of banks which reinforces the need to accelerate the restructuring of the banking sector. Credit growth to corporates is finally picking up, partly supported by relaxed lending standards, and possibly a search for yield. Although the FSAP has concluded that the regulatory and supervisory structure was broadly sound, important gaps were identified that need to be addressed. In particular, we underscore the need to proceed on developing a new bank recovery and resolution framework given the existence of highly interconnected systemic institutions. In this regard, we note that the perceived riskiness of the two largest banks has recently spiked. Bank profitability remains low for German banks overall, reflecting the low interest rate environment, and suggesting a need to adjust the banks' business models. In this regard, we welcome staff's analysis of the structural factors behind low interest rates, which suggests that this is a historical trend that is not driven by monetary policy and is likely to continue even after policy interest rates rise. Besides changing the business model and restructuring those banks that need it, are there other policy implications from these new results? We are encouraged by the authorities' re-focus of supervisory priorities on life insurance firms whose ability to meet life insurers' future commitments has been eroded.

We appreciate staff's mention of the withdrawal of correspondent bank relationships by major German banks in paragraph 42 of the staff report and paragraph 39 of the FSSA. However, we would have liked to see more granularity (on the extent of the withdrawal and the driving forces) in the information provided and would like to know about further work in this area. We join staff in calling on the authorities to encourage the relevant German banks to better manage the risks around these relationships and to strengthen the dialogue and cooperation among national supervisors. We also more broadly call for further enhancements to the Single Supervisory Mechanism, including by addressing the need for more comprehensive and granular supervisory data gaps.

Boosting housing supply is a clear priority. House prices keep rising at a rapid rate, particularly in the cities and partly reflecting a spike in demand from immigrants. We welcome the government's policy package to help housing supply adjust to higher demand, including by facilitating greater availability of building land. The staff expects residential investment to respond faster than in the recent past to surging housing demand. We would appreciate staff elaboration on the possible pace of achieving an adequate supply response? What was the authorities' reaction to staff's proposal to adjust the efficiency of real estate taxation by increasing property taxes through an update of property values and reducing real estate transfer tax rate to help incentivize new construction? While noting that there are no immediate across-the-board concerns in the mortgage market outlook, we join staff in calling on the authorities to address the legislative limitations to improved collection of mortgage data.

Strong immigration to Germany counters the negative natural demographic trends and helps to address a global humanitarian emergency. If net immigration flows subside, the working age population would shrink after 2020. Germany's labor market has benefited from the surge in immigrants in 2015. What are the growth implications of the decline in the number of monthly asylum seekers from a peak of 200,000 in November 2015 to 16,000 in April 2016? We applaud the authorities for the rapid introduction of labor market measures to aid in the integration of immigrants, including active labor market policies.

Mr. Benk and Mr. Hagara submitted the following statement:

We thank staff for an interesting set of reports and Mr. Meyer for his informative buff statement. We agree with the thrust of the staff's assessment and broadly associate ourselves with the statement by Mr. de Villeroché.

Germany continues to demonstrate its strong macroeconomic fundamentals with the economy remaining on a steady growth path as domestic demand offsets the slowdown in foreign demand. The ongoing growth of the German economy is also stimulating the economic activity of its trading partners. Strong labor market developments brought unemployment to a new record low and wage growth remains above productivity. Nevertheless, despite some signs of labor market tightness, underlying inflation remains low. We would appreciate staff's comments on what the reasons of a weak pass-through from wages to inflation are.

We agree with staff's emphasis that the authorities should strengthen Germany's potential output and address the declining medium-term growth prospects. Facing challenges from an aging population, further measures are needed to raise labor market participation of women, older workers and immigrants. In addition, efforts to increase competition in the professional services sector and network industries should be accelerated. We welcome the authorities' steps to increase public investment, focusing on infrastructure, education and research and development areas, and to remove constraints to public investment by municipalities. Nevertheless, we are not convinced that more ambitious investment spending is needed. Without an exact estimate of the optimal public capital stock it is difficult to quantify the investment gap, and since Germany's output gap is turning positive we would suggest putting more emphasis on efficiency and prioritization.

We welcome the conclusion of the FSAP analysis that the German financial system as a whole is resilient. Nevertheless, the low interest rate environment with shrinking interest margins adds to challenges. The high costs, together with crisis legacy problems and the needed adjustment to a new regulatory environment, feed into low profitability of banks, which points to the further need of adjustment and consolidation of the banking sector. Low interest rates also pose a challenge to life insurances' ability to meet guaranteed commitments and highlight the need for close monitoring through the transition to Solvency II.

Mr. Field and Miss Chen submitted the following statement:

We thank staff for an interesting and highly relevant set of reports and Mr. Meyer for his informative buff statement. We broadly agree with the policy recommendations made by staff. It is encouraging to observe domestic sources accounting for much of Germany's growth in recent years and forecasts suggesting that this will continue to be the case over the forecast horizon. We further welcome the resilience of the German economy in the face of a slowdown in emerging markets. We associate ourselves with Mr. de Villeroché's statement and would like to raise a few additional points for emphasis.

We note staff's continued recommendation for a more ambitious public investment program (mainly in transport infrastructure) and Mr. Meyer's view that Germany's quality of public infrastructure is considered to be high by international standards. We agree that investment in transport infrastructure could improve long term growth prospects, if this investment is channeled into good projects. Long-term planning, good governance arrangements, action to reduce regulatory and other constraints, and stronger procurement skills can all play an important role, and in this context we welcome Germany's decision to establish a 15-year plan for transport infrastructure. However, the recommendation that additional public investment should be financed by "possible revenue overperformance," the size of which may vary from year to year, feels slightly at odds with the practicalities of planning and implementing good, value-for-money, growth-enhancing projects. Similarly, we would be interested to understand better the additional investment implied by the recommendation to make "full use of the room available under the fiscal rules." The chart in figure 4 suggests this is quite small. Can staff please clarify, under its projections, how much room for additional investment is available within the fiscal rules?

We recognize the challenges that record levels of refugee inflows are placing on the German authorities, and agree with staff that initiatives for more flexible forms of vocational training could provide faster integration of refugees. We also note Fund analysis elsewhere, which has suggested that flexible labor markets are better able to absorb refugee inflows. Effective integration of refugee will help to slow down the rate of labor supply decline, in addition we welcome staff’s recommendations to introduce policies to increase female participation and extend working lives, which should also help to raise medium term growth potential.

On services, we note that the Fund’s recommendations in this area are longstanding and in line with analysis provided by the European Commission, the OECD and wider academic literature. Germany’s potential growth and investment levels could benefit from increased service sector liberalization. The OECD’s recent EU economic survey has highlighted the potential benefits of fully implementing the EU services directive.

We note with interest the topics discussed by staff in their selected issues paper. On housing, we welcome the evidence, which suggests that recent house price rises in Germany are no cause for immediate concern. However, the analysis indicated that the price elasticity of housing supply has nearly halved over the past few years. Can staff elaborate on the underlying causes that would account for such a marked change in the responsiveness of construction to house price changes? We note that staff make reference to rent controls having had a detrimental effect on residential investment and would welcome further analysis on this.

We welcome the FSSA report this year, and take some comfort in its finding that the financial system as a whole appears to be resilient. However, although with RWA density amongst the lowest in Europe, leverage in some banks remains high. Low interest rates have exacerbated the problem of the low profitability in many AE banks. Some German banks business models may need to be revised and authorities should remain vigilant to banks tempted to adopt risky search for yields activities. In this context staff’s views on whether we should be concerned about the loosening of bank lending standards (as noted in the staff’s report paragraph 6) would be welcomed.

Mr. Torres and Mr. Vicuna submitted the following statement:

We praise Germany’s sound economic performance and broadly agree with the staff’s macroeconomic outlook. In 2016, GDP growth is projected at 1.7 percent and will benefit from strong domestic demand, countering weaker exports derived from lower trading partners’ performance. Private consumption should continue benefitting from strong labor market conditions, while residential investment should respond to surging housing demand. Notably, this year’s fiscal expansion, equivalent to 1 percent of GDP, is also envisaged to support domestic demand. Notwithstanding more stringent goods and labor market conditions, inflation remains low and is expected to approach the 2 percent target only in the medium- term. According to the recent financial system stability assessment (FSSA), as a whole, the system appears stable and resilient to main risks.

Rebalancing of the current account remains an important challenge. On the external sector, the staff concludes that Germany's position in 2015 was substantially stronger than implied by medium-term fundamentals and desirable policy settings. The current account surplus reached 8.5 percent of GDP in 2015, mostly reflecting large saving-investment surpluses of non-financial corporations and households. In turn, the net international investment position continues to improve, reaching 49 percent of GDP by the end of 2015. Given the size and observed trends of the external accounts, a gradual rebalancing process seems warranted and may be enhanced by economic policies to boost domestic investment and medium-term growth in Germany. Moreover, in our view, a gradual rebalancing supported by higher medium-term growth expectations should not only benefit Germany but also constitute an antidote against the integration fatigue in the EU area.

Is Germany's fiscal rule preventing the government from borrowing at negative interest rates? The staff argues that, within full respect of the current fiscal rules, Germany could afford a more expansionary fiscal policy and use it to increase public investment and finance growth enhancing policies (#49). Moreover, the staff also notes that given the current extremely favorable financing conditions this approach would allow for growing fiscal surpluses as of 2016 (graph in page 34 of the report). The authorities, in contrast, seem unconvinced on the existence of such space and argue that fiscal policy is already expansionary (#21). We are a bit perplex. As investors are ready to pay for the privilege of lending money to the sovereign (see page 34), public borrowing, far from having a fiscal cost, would provide a fiscal revenue to the government. Is Germany's fiscal rule constraining the government from increasing its fiscal revenues by stepping up borrowing? We would welcome it if the staff could provide the available estimates of fiscal space for Germany and comments on the associated fiscal policy implications.

Medium-term growth prospects need to be carefully addressed. We note in Mr. Meyer's informative buff that his authorities agree that reforms need to be implemented to strengthen potential output. We concur on the need to strengthen the sources of medium-term growth, in particular, through reforms to boost labor supply and enhance productivity. On labor supply, we welcome the reforms proposed for securing a successful integration of immigrants into the labor market, increasing female labor participation, and the extension of working lives. Regarding the recent refugee surge, we highly appreciate the more detailed information presented by the staff in Box 3 (page 29), which provides very interesting information on policies oriented to facilitate integration to the labor market. We commend these policies both from a humanitarian and an economic perspective and encourage continuing progress in this area. Regarding productivity, we encourage the authorities to continue facilitating the efficient provision of public infrastructure investment and programs to further improving education and research, as they represent crucial sources of potential growth.

We learned from the report about development of legislation to monitor potential risks at the real estate sector. Legislation is being drafted to provide the legal basis for new macro prudential tools to monitor the real estate sector, including loan-to value caps, debt-service-to income limits, debt-to-income ceilings, and minimum amortization requirements. As recognized by the authorities, securing access to the micro data for supervision purposes represents a main challenge for the legislative process. In this regard, we would like to hear from the staff on how do data protection standards in Germany compare to those of other similar countries. What is the experience at the EU level to cope with data protection issues in the context of financial stability purposes?

The last FSSA confirms the resilience of the German financial sector. As noted in the staff report and the buff statement, the sector as a whole appears resilient to a major external shocks. In particular, households and corporate balance-sheets appear strong, banks present adequate capital buffers and low levels of non-performing loans, while insurance companies retain significant loss absorption capacity. Notwithstanding, we specially encourage the authorities to further strengthen the oversight of the banking and vulnerable life insurers, given the risks posed by the current conjuncture of unprecedented low interest rates.

With these comments, we thank the staff for the set of papers, Mr. Meyer for his helpful buff statement, and wish the German authorities and their people success in their future endeavors.

Mr. Sobel and Ms. Medearis submitted the following statement:

We commend the German authorities for their sound domestic economic management over many decades that has delivered sustained macroeconomic stability and low unemployment. We also join staff in the observation that Germany’s willingness to accept a large number of refugees has provided an important global public good. Recently, the gradual recovery in the German economy has been marked by a welcome strengthening in domestic demand, underpinned by stronger growth in nominal wages, which has increased the labor share of income, and low oil prices. Despite these recent encouraging developments, the German economy continues to face significant external and internal imbalances, a lackluster medium-term outlook, and a demography-driven decline in potential growth. Achieving the necessary adjustment will require a combination of greater use of fiscal space and structural reforms to boost both near-term and longer-term growth.

External

As has been the case for many years, the size of Germany’s current account surplus remains massive. In nominal dollar terms, it is the world’s second largest, only slightly lower than China’s, even though the Chinese economy is three times larger than Germany’s. This massive surplus excessively absorbs demand from the rest of the world and hinders the adjustment in euro area deficit countries. For adjustment of global imbalances to occur, domestic demand growth in large surplus countries must significantly and sustainably exceed GDP growth, a point which should—but does not—go to the heart of the Fund’s WEO/WEMDs and work on the IMS. In contrast, staff’s medium-term projections show flat net exports and that Germany’s excessive current account surplus declines scantly to around 7 percent of GDP by 2021.

According to the latest External Balance Assessment, Germany’s external position continues to be substantially stronger than implied by medium-term fundamentals and desirable policy settings. Even taking the high end of the range of staff’s estimate for the current account norm of 2½ to 5½ percent of GDP, Germany’s current account surplus remains well above the norm through the projection period. In this regard, the use of such a wide range for the norm appears in many respects to weaken the utility of the ESR analysis, and the upper end of the German norm seems so high on the face of it as to stretch credulity. Further, to the extent that staff argues that the high norm can be explained by aging, other nations are aging too and it is implausible to think that every aging nation can run a massive current account surplus, nor should aging mask excessive saving.

Fiscal

We found the staff’s discussion of fiscal issues on the whole wanting. The staff report frames the issue of fiscal policy in terms of more progress being needed on public investment, a point with which we agree (see below), and recommends a slightly looser medium-term fiscal position closer to the medium-term objective of the SGP. But beyond that, a more rigorous staff discussion of fiscal issues is lacking. We appreciated the willingness of the authorities to offer clear views, as outlined in paragraph 21. However, a staple of any Article IV is an assessment of the fiscal stance, yet we missed staff's assessment of its view on the "schwarze Null" and, for example, commentary on the structure of revenue and spending (beyond public investment) and its implications for boosting the economy. The staff's comments on these topics would be appreciated.

Further, in the context of recent Board discussions, our chair has noted that the issue of tackling whether adequate fiscal space exists involves perhaps answering three questions: first, does the country have fiscal space in the professional economic judgment of Fund staff; second, should that space be used, a judgment that would necessarily entail some assessment of country-specific conditions, including the macro situation and whether fiscal rules are present; and third, how to use any space. We regret that staff did not provide a firm economic assessment of whether Germany has additional fiscal space. Rather, staff seemingly limit their assessment of whether fiscal space exists within the confines of European and German fiscal rules. Could staff tell the Board how it would answer the first question?

Increasing Investment

The German authorities intend to increase public investment by a cumulative 0.7 percent of GDP over 2016-18, falling well short of the Fund's previous recommendation of a two percent increase over four years. As widely documented, higher public investment would not only stimulate domestic demand in the near term and reduce Germany's current account surplus, but would also raise long-term output and generate beneficial regional spillovers. The expansionary effects of higher public investment are substantially strengthened with an accommodative monetary policy stance, and the current low-interest rate environment presents a window of opportunity to finance higher public investment at historically favorable rates. Noting that tax revenues have systematically over-performed forecasts, we agree that the German authorities should apply any additional revenues to increasing public investment expenditure.

In his buff statement, Mr. Meyer notes that the German authorities do not agree with staff that Germany needs a more ambitious investment program. We side with staff on this issue, and we also support the efforts the German authorities are making, as outlined by Mr. Meyer, to increase efficiency in transportation infrastructure investment and to reduce barriers to public investment by municipalities. We encourage further efforts to increase investment at all levels of government and by private entities as well. Could staff comment on measures the authorities could take to incentivize private investment, in particular, as Mr. Meyer mentions, to help achieve the "Energiewende" and boost innovation?

Structural Reforms

We strongly support staff's recommendations for increasing labor participation of women, older workers and immigrants given Germany's demographic challenges and inflow of refugees. With respect to encouraging greater female labor force participation, we would have appreciated stronger staff emphasis on the need to reduce the high tax wedge on dual-income households that discourages full-time employment of second wage earners. More broadly, we would have appreciated staff views on ways to reduce the overall burden on labor income and its implications for economic growth. Could staff provide an estimate or range for the cumulative impact of the recommended structural labor market reform measures modelled in the selected issues paper on Germany's current account over the medium term, relative to the baseline estimate?

Financial Sector/FSAP

The Financial System Stability Assessment (FSSA) cites low profitability and the ongoing transition to the new supervisory and resolution architecture as the main risks to Germany's financial sector. We concur with staff that there are risks associated with the transition, particularly in the context of an incomplete European banking union, but we also strongly support the new architecture and see great benefits from and progress with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Looking forward, we consider the common European Deposit Insurance Scheme to be a crucial component to further bolster the financial stability benefits of the euro area's banking union, and we urge the German authorities to support this important initiative. Did staff speak with the SSM in its work on the German Article IV and FSAP, and what views did the SSM offer on the German banking system and its health?

Regarding bank profitability, we concur with staff's analysis that a range of factors, including legacy problems, large bank business models, low interest margins and high operating costs have been playing a role in suppressing returns. We also note that German bank profitability is one of the lowest in Europe, including during periods of economic growth and higher interest rates. Could staff comment on how the structure of the German banking system—with the distribution of assets among private, saving and cooperative banks—contributes to the German banking system's relatively low profitability?

The staff report and the FSSA note Germany's strong capital adequacy ratio relative to G7 and euro area peers. However, assessments of the CAR depend on risk weighting and the denominator to an important extent, as alluded to in paragraph 7 of the FSSA document. Could staff expand upon its assessment of the quality of the risk weighting applied by German banks to their assets? Also, could staff comment on the relatively higher leverage among German banks and why the price/book ratios for the large German commercial banks appear weaker than their peers?

Finally, we welcome Germany's publication of the FSSA, Detailed Assessment Reports and background technical documents. We urge staff and all members to publish these documents and to ensure that these documents are sent to the Board much earlier.

Mr. Ostros and Mr. Bartkus submitted the following statement:

We thank staff for the report and Mr. Meyer for his helpful buff statement. We associate ourselves with the views expressed by Mr. de Villeroché and provide the following remarks for emphasis.

Germany remains a powerhouse of the euro area economy, maintains high competitiveness, a healthy labor market, and strong public finances. Its adherence to the EU fiscal rules and strong leadership in dealing with the refugee influx helps to preserve confidence in the European project under difficult circumstances. Nonetheless, the authorities also face challenges that require further action to reduce structural impediments in the economy, raise growth potential, address outstanding issues in the financial sector, and a stronger role in the euro area rebalancing.

It is difficult to disagree with staff that a more dynamic Germany would also benefit the fragile recovery in the euro area. As noted in the report, this year's economic growth is driven by strong domestic demand that is offsetting the weak external outlook. An increase in the current account surplus is largely explained by temporary factors, such as changes in commodity prices and exchange rates. It also reflects Germany's strong international competitiveness and structural factors, including demographics and the savings-investment imbalance. We take note of staff's assessment that an increase in unit labor costs is expected to contribute to the euro area rebalancing.

We agree with staff that weak investment might be partly explained by the regulatory barriers and tax issues, though we missed in the report emphasis on the efficiency of investment, giving credit to Germany's prudent public investment planning. Even though capacity utilization might be above historical average, there seems to be spare capacity in the manufacturing sector, whereas further business investment is likely to be held back by prevailing uncertainty. We would appreciate a more nuanced assessment of the efficiency of public investment and factors holding back private investment.

We welcome the set of measures taken by the German authorities to encourage public and private investment. In particular, plans to establish a more efficient framework for managing the federal highway infrastructure, removing administrative constrains for public investment by municipalities, a 10-point action program to address supply-demand imbalance in the residential real estate sector, and broader initiatives to support business investment in innovation, energy, and digitalization.

We support staff's emphasis on the need to extend working lives, provide conditions for higher labor market participation by women, and the challenge of refugee integration. We encourage the authorities to consider the proposed changes in the pension system. We note that the tax wedge for low wage earners in Germany remains among the highest in the EU. The point on high marginal taxation of second earners is made quite forcefully in the report and is also noted in the 2016 country report by the EC. We are sympathetic to argumentation on the health insurance contributions, but would like to better understand staff's advice on the income taxation, whether they generally consider joined income tax splitting as a constrain on labor market participation?

We are to be convinced by staff's proposal to exempt the refugees from the minimum wage. We understand that similar exemptions are applied to long-term unemployed, but would like to hear further argumentation in support of staff's proposal, whether the same objectives could not be achieved through other measures?

The FSSA assessment provides an accurate characterization of the financial sector challenges and provides well-thought policy advice. The financial sector as a whole is resilient, though the banking sector suffers from low profitability, there is some further scope for increasing cost-efficiency, downsizing, and consolidation. The low interest rate environment poses difficult challenges for both, insurance and banking. Some banks need to adjust to this difficult environment by amending their business models, whereas supervisors should carefully monitor risks in the insurance sector.

We support the authorities' plans to adopt the macroprudential instruments that could be used to address potential imbalances in the housing market and the legal provisions to improve data availability for the macroprudential analysis.

There is a need to better understand the underlying forces behind the recent trends in correspondent banking relations by global banks and we very much welcome that this issue was brought under the scope of the FSSA assessment. These trends seem to be affected by business considerations and issues of regulatory compliance. Though, we would appreciate further clarification, whether access to these relations was more restrained for certain operations, for example clearing payments in U.S. dollars?

Mr. Yambaye and Mr. Bah submitted the following statement:

We thank staff for their comprehensive set of papers and Mr. Meyer for his informative buff statement on recent economic developments in Germany.

The German authorities should be commended for their continued good economic performance despite the difficult external environment. Appropriate policies have helped to maintain the growth momentum which has been helped by falling energy prices. Inflation remains low and stable while the unemployment rate has reached a new low level. Moreover, the persistent current account surplus has boosted the net international investment position (NIIP). We welcome the staff's assessment that Germany will remain in a moderate growth path in 2016, with strong domestic demand offsetting weak foreign demand.

Nevertheless, in spite of this good achievement, we note that risks facing the economy are on the downside. Indeed, trade linkages between Germany and her trading partners, whose growth rates remain low, could adversely affect the growth momentum. Moreover, volatile global financial conditions could adversely affect the German economy's outlook.

In the circumstances, the rebalancing of the economy which is underway may need to be accelerated with stronger emphasis on stimulating competition in the services sector and further efforts on structural reforms, including increased outlays on public infrastructure. Mr. Meyer’s buff statement is very encouraging in this regard as he reminds us of the German government plans to build prudently on favorable economic developments over the medium- and long-term. A more dynamic German economy would also benefit the recovery in the euro area.

As regards fiscal policy, we welcome the authorities’ commitment to a balanced federal budget with a view to preserve the fiscal discipline notably in a context of strong and growing spending pressures from an aging-population. Moreover, given that further progress is needed to address the public infrastructure needs, we see merit in using the available room under the fiscal rules to finance public investment and growth-friendly structural reforms. This will also help the authorities in their efforts to lift the economy’s long-term growth and narrow the current account surplus. We also agree with the authorities that reducing the overall burden on labor income by lowering taxes and contributions is a useful measure to further boost the output.

We commend the German authorities for hosting a large number of refugees. This effort has helped to prevent a global humanitarian crisis. The policy measures put in place including the removal of certain restrictions on employment and training will be helpful in the authorities’ efforts to promote a successful labor market integration of the refugees. Although the cost of these measures is likely to be small, could staff provide further elaboration on this issue? With regard to the projected decline in the labor force due to the rapid aging, we agree on the need for additional measures to further integrate the refugees into the labor market, and broaden opportunities for full time employment of women and extend working lives.

With regard to the banking sector, further efforts are needed to accelerate its restructuring with a view to strengthening profitability and addressing the multiple challenges facing the sector in a context of a prolonged low interest rates. In this regard, we welcome the FSAP that concluded that the regulatory and supervisory structure was sound. However, there is a need to finalize the new bank recovery and resolution framework due to Germany’s highly interconnected systemic institutions. In this regard, the authorities’ strong commitment to the new EU bank resolution framework is reassuring. Moreover, we encourage them to strengthen the dialogue and cooperation among national supervisors and facilitate cross-border information sharing.

The withdrawal of large global banks from correspondent relationships in a number of countries is a source of concern, and we share staff's recommendations that the authorities should encourage the relevant German banks to better manage risks around these activities, and strengthen cooperation with national supervisors and facilitate cross-border information sharing.

We welcome the comprehensive package of measures developed by the authorities in their efforts to address the supply constraints and increase the availability of affordable housing. We agree that lowering the effective real estate transfer tax rate on new construction will help boost the housing supply response, and we encourage the authorities to further broaden the availability of building land as this appears to be the main constraint to a greater housing supply.

Mr. Hiroshima and Mr. Takeuchi submitted the following statement:

We thank staff for a well-written set of papers and Mr. Meyer for his helpful buff statement. The German economy continues to perform well supported by a fiscal expansion, favorable monetary condition and lower energy prices. Going forward, the authorities need to address some challenges, including low productivity in some sectors and unfavorable demographic trends. As we broadly concur with the thrust of the staff appraisal, we will limit our comments to the following points:

Fiscal Policy

The authorities' sound fiscal management is commendable. Regarding public investments, improving efficiency and ensuring infrastructure quality are key issues given increasing public investment, capacity constraint and strict regulation at the national and European level. In light of these, we welcome the establishment of a federal transportation entity and the transformation of Germany's PPP advisory agency Partnership Deutschland from private to public to enhance its functions. In this regard, could the staff comment on the desirable additional actions to further improve efficiency and effectiveness of public investments?

Financial Sector

The authorities need to carefully monitor effects of prolonged period of low interest rates. We welcome that the FSAP showed that the German financial sector is stable and robust to shocks on the whole. However, we take note that large German private banks may be more sensitive to market turbulence owing to low profitability. In addition, protracted low interest rates would hamper life insurers' ability to pay guaranteed return life products. In this regard, we encourage the authorities to monitor them and stand ready to take actions preventing these risks from materializing if necessary.

Structural Reform

We encourage the authorities to implement structural reforms to boost productivity and address demographic issues, including an aging population and an increase in immigrants and refugees. To enhance productivity, we agree that competition-enhancing reforms in the services sector should be implemented more vigorously with consumer protection ensured.

In terms of an aging problem, the authorities need to make efforts to progress the necessary reforms, including pension reforms to promote longer working lives and an enhancement of labor supply by further incentivizing female labor market participation and helping refugees and migrants integrate into the labor market. In addition, reforms of health-care and social welfare system could contribute to reducing public expenditures related to aging population.

As for the integration of refugees and migrants, granular supports are needed, and in this regard, we agree that the authorities distinguish between refugees and labor-market oriented migrants and provide different supports to them respectively.

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

We thank staff for an informative report and Mr. Meyer for his helpful buff statement.

The resilience of the German economy is reflected by steadfast growth backed by buoyant domestic demand, low prices and unemployment, balanced public debt which is resilient to stress, surpluses in both current and fiscal accounts and a positive NIIP. Low interest rates are supportive of credit demand and growth.

The staff expects growth to reach 1.7 percent this year and 1.5 percent next year based on growing labor demand. The staff foresees fiscal expansion of one percent of GDP in 2016 which is growth positive and a sustainable debt level with minimal fiscal risks. The external balance is positive, buoyed by undervalued REER which counterbalances weak external demand. Going forward, the large CA balance is expected to shrink with readjustments in relative fiscal gaps and labor costs in line with euro area trading partners. We concur with staff that external sector rebalancing could be predicated on improving labor supply, prolonging working lives including growth enhancing fiscal policy that would release savings, and strengthen investment and growth. The authorities, however, contend that external surplus would ease only gradually, as the associated factors relate to demographics and higher savings rate, and so cannot be rebalanced by increasing public spending. We invite comments from staff on the differing perceptions about the issue of rebalancing of the external account.

However, ongoing wage pressures and monetary and fiscal expansions could push inflation higher towards the ECB target faster than expected, requiring careful balancing of policy choices. Growth momentum may suffer given the weak outlook for EU partners and China, and the risk of financial turmoil caused by the slowdown in advanced economies and EMEs including the Brexit which may discourage investments and exports and adversely affect Germany's globally interconnected financial sector. Could the staff comment on the likely effects of proposed rebalancing on growth and inflation?

We agree with staff that despite the commitment to sound fiscal policy, fiscal expansion focused on public investment may be warranted to improve potential growth. We welcome the authorities' plan to step up public investment over 2016-18, and their intention to push forward a sizeable 15-year transport investment plan with significant demand positive spillovers in the entire euro area. Could the staff comment on the scheduling of the transport investment plan and the possibility of bringing budgetary allocations forward to have a tangible short term fiscal impact? As noted in the buff statement, we appreciate the authorities' intention to remove constraints on investments by municipalities and the proposal to set up a center of excellence to offer advisory service to them.

The large and globally systemic interconnected financial sector of Germany contributes to financial stability in the European Union. Financial sector reforms have bolstered the resilience of the financial sector with robust solvency standards and recovery and resolution mechanisms, establishment of macro prudential tools and risk based approach to supervision and IT security. Banks have substantial capital buffers and low asset impairments, although their profit margins remain compressed due to low interest rates. In this regard, we welcome the surveys by authorities to track interest rate risk of

LSIs under low interest rate interest environment. We encourage the authorities to incentivize banks to recast business models and reduce costs, and to prevent the adoption of risky lending practices in search of profits. While insurers generally own strong loss absorption capacities and are subject to risk based supervision and solvency requirements, asset managers adhere to liquidity risk management and asset valuation guidelines. Given the incipient real estate risks, the FSC recommendations for additional macroprudential tools is timely. Nevertheless, Germany's financial sector faces risk in the event of large global financial shock that could translate into significant domestic financial risks and cause global spillovers through second round effects.

We agree with staff that there is need to improve monitoring of financial stability risks and cross-border spillovers by collecting granular data and finalizing the macro prudential framework. In the housing market, the rapid rise in prices in large urban areas warrants closer monitoring of banks' exposures to mortgages. In this respect, while we welcome the authorities' plan to develop macro prudential policy instruments for the real estate sector, we also appreciate the wide ranging measures taken by the authorities to enhance housing supply.

Germany faces the risk of falling labor supply due to an ageing society, but this is expected to be eased by high immigration going forward. We encourage the authorities to improve employability by skilling immigrants, increasing female participation in labor force and extending working lives. We subscribe to staff view that while the small fiscal outlays in doing so would have large payoffs, the demand spillovers would also be positive for euro area increasing consumption and investment. In this respect, the allocation of substantive budgetary resources for labor market programs for 2016 by authorities is welcome. We encourage the authorities to implement reforms in the services sector and those slated for railways and postal services to enhance efficiency and productivity. While we welcome the authorities' willingness to review regulations in the services sector, we encourage them to ease entry regulation in the services sector to foster competitiveness.

We wish the authorities success in their endeavors.

Mr. Haley, Mr. McGrath and Ms. Young submitted the following statement:

We thank staff for the comprehensive reports and Mr. Meyer for an informative buff statement. We broadly agree with the analysis.

Germany enjoys a stable but modest economic growth path. Growth is expected at 1.7 and 1.5 percent of GDP in 2016 and 2017 respectively, underpinned by strong private consumption at a 15-year high as a result of strong labor markets, fiscal expansion, monetary stimulus, and low oil prices. Strong auto sector performance, aided in part by prolonged low oil prices, has helped counter a decline in exports vis-à-vis waning global growth. This shift towards stronger domestic demand is welcomed, and hopefully reflects the beginnings of a longer-term, more durable structural shift in Germany's growth model. That said, growth potential remains mediocre over the medium term and warrants decisive action.

Germany's current account balance remains persistently high despite stronger domestic demand. Fueled by an expanding trade balance, the current account balance reached a record high 8.5 percent of GDP in 2015. We note that staff expect it to decline only over the medium term. To what extent will the projected pace of decline aid in global and regional rebalancing?

Fiscal Policy

Fiscal policy is an important lever to strengthen growth, while also buttressing on-going rebalancing. Important considerations include not only the quantum, but also the prioritization of expenditures, the quality and efficiency of expenditures, the potential for synergies with other simultaneous reforms, and on the trade-offs between prudence and potential. We commend the authorities' recent actions with respect to prioritization of expenditures. They have taken decisive action in allocating significant resources to refugee settlement and will continue to do so in the coming years. The authorities' commitment to increase public investment by a cumulative 0.7 percent of GDP over the next two years is also a welcomed step in the right direction after a decade of underinvestment. The expansionary fiscal position for 2016 has enabled such important measures.

Germany is also taking important steps to improve the efficiency and effectiveness of public investment. This includes efforts to reduce administrative and regulatory constraints faced by municipalities and notable reforms of the PPP advisory agency Partnership Deutschland. We also commend the focus on alternative financing sources to support the creation of a federal transportation agency and the recent initiatives to stimulate private investment in e-infrastructure. Such measures can greatly leverage limited fiscal resources if deployed effectively. We agree with the authorities' views as expressed in the buff that a challenge is to preserve infrastructure quality in an efficient manner. We note that the highest returns may not necessarily come from greenfield investment but in the upgrading of existing infrastructure.

The joint execution of key structural reforms could support Germany's fiscal position in the near and medium term, while also magnifying beneficial spillover effects. We welcome commitments by the authorities to boost labor supply including through enhanced female labor participation, greater refugee workforce integration, and incentives for extended working lives. We note these are largely in line with the objectives of staff's recommendations even if the policy paths differ in some cases. The staff helpfully identify the short-term demand boost that such measures could provide to the economy if executed effectively. We support staff's calls for more vigorous pursuit of competition-enhancing reforms where progress has been slow on several fronts.

That said, we believe Germany has additional fiscal space that could be deployed to strengthen growth prospects through enhanced public investment without compromising market confidence, taking into consideration its sustainable debt position and low borrowing costs. The authorities indicate their intent to maintain prudent fiscal buffers given Germany's aging population and modest growth prospects in the medium and longer term. We see this logic could also support an argument to invest decisively in future growth. We would welcome further comment by staff on the expected growth differential from staff recommendations versus the authorities' planned spending, including possible inter-generational effects.

Financial Sector Policy

Germany's financial sector appears resilient, albeit with on-going transitions and adjustments ahead. We welcome FSAP findings that post-crisis deleveraging has progressed steadily, household and corporate balance sheets are strong, banks hold substantial capital buffers, and non-performing loans are low and declining. The authorities appear to have taken onboard many of the recommendations from the 2011 FSAP. We also commend euro area (EA) efforts to strengthen financial sector supervision and regulation including through the establishment of the Single Supervisory Mechanism (SSM) and the EU Bank Recovery and Resolution Directive (BRRD). We note the 'untested' nature of the latter, but we expect continued strides towards full operationalization at the EA level will reduce the transitional uncertainty noted by staff over time and welcome the authorities' strong commitment to this end.

We note that a more significant challenge will be the adjustment to a low interest—low profitability environment, particularly for medium-sized banks and insurance companies. We note the importance of transitional measures for the insurance sector with respect to EU Solvency II framework, and support careful communications around its execution. We also note that staff expects further consolidation among banks as part of the transition, and we welcome the authorities' appropriate vigilance, particularly given the largely bank-specific factors that account for low profitability. The Fund's forthcoming work on the medium-term impacts of unconventional monetary policy should be informative to—and informed by—the German banking sector experience with its strong interlinkages within the euro area as well as internationally.

We welcome staff's analysis on de-risking among German banks. The analysis suggests that German banks are withdrawing from correspondent banking relations from a number of countries. The German case, in particular, underscores the complexity of the issue as the reasons likely reflect necessary adjustments in response to lower profitability, as well as in response to regulatory landscapes. We would appreciate greater clarity on staff's advice "to encourage German banks to better manage risks around these relationships" as a means to preventing excessive curtailment of activities.

Other

Germany has demonstrated strong leadership in light of the refugee crisis. It has set a good example by committing to accept a large number of refugees and by pressing for an EU-wide solution. We encourage Germany to remain firm in its resolve to advance on both of these fronts in the face of fiscal, political and social challenges. We agree with staff's emphasis on the importance of swiftly integrating immigrants, in particular asylum-seekers, into German society. Measures to accelerate their integration into the labor force would help avoid unexpectedly high fiscal costs, and offset demographic challenges over the medium term. We are encouraged by the authorities' efforts to prioritize actions, including added emphasis on language training, in a manner consistent with effective and timely integration.

Mr. Jimenez Latorre and Ms. Sanchez Rodriguez submitted the following statement:

We thank staff for the insightful report, including the Financial Sector Assessment. We associate ourselves with Mr. de Villeroché's gray statement and would like to add the following comments for emphasis:

Many aspects point to positive trends in the German economy that should help European rebalancing. As figure 2 conveys, wage growth continues to outpace productivity, and competitiveness gains from the early 2000s are being unwound. This is a welcome development that goes in the right direction of needed internal revaluation.

At the same time, we are somehow puzzled by the small impact these developments are having on the current account surplus. To be sure, the behavior of oil prices and the exchange rate are supporting the current account surplus, even amidst lower external demand from some trading partners. The staff also points towards unspent terms-of-trade windfall. Could staff provide a breakdown of the impact these factors play in the current account surplus? Could staff explain why we are not seeing any impact from the ULC deterioration on the current account? How does ULC deterioration add up with an estimated undervaluation of the REER of 10-20 percent?

Wage growth and strong employment numbers are supporting private consumption—growing at its highest of 15 years (2 percent)—also a development in the right direction. Having said this, the private investment-savings gap remains sizable and points towards factors that may be holding back consumption and investment. Like staff, we see merit in promoting structural reforms that will boost potential growth. We are particularly keen on measures directed towards addressing aging of the workforce: extending working lives, integrating refugees and promoting active female labor force participation could stimulate private consumption and investment in the short term, and thus help with European rebalancing. The recognition of the positive short-term effects of structural reforms is in line with other countries' recent experiences and will help to advance the structural reform agenda. We also concur with staff on the need to accelerate competition enhancing reforms in the services sector, where slow productivity growth is holding back overall growth.

On the fiscal front, recent efforts to increase public investment go in the right direction. We encourage the German authorities to make full use of the room available under fiscal rules—possibly using revenue over performance—to increase domestic spending, including by considering tax incentives for private domestic investment and consumption, as well as increases in public infrastructure spending. We are cognizant of progress made and welcome the sizable increase in investment envisaged on the 15-year plan for transportation infrastructure investment. over 2016-2030. At the same time, we note that staff points at negative net public investment in 2015.

The removal of barriers to new housing and competition reforms should also help raise domestic absorption.

The German financial sector is resilient and well supervised. Given its centrality in the global economy and the low profitability of current business models in a context of low interest rates, we concur with staff on the recommendations to strengthen banking, insurance and asset management oversight, and carefully monitor developments.

Ms. Tshazibana and Mr. Sishi submitted the following statement:

We thank staff for the detailed staff report and the comprehensive information contained in the supplemental and background papers. We also express our appreciation to Mr. Meyer for the insightful buff. We broadly agree with the staff appraisal and make the following points for emphasis.

We commend authorities for their commitment to long-term macroeconomic stability and prudent fiscal policy management. However, policies to support domestic demand have become more important to boost actual and potential growth. We therefore welcome the fiscal stimulus of 1 percent of GDP, as well as efforts by the authorities to promote domestic demand further through raising the minimum wage and reducing labor market taxes. This will offset weak external demand and could have positive spillovers to the rest of the region. In light of the prevailing global and regional risks, we agree that further fiscal expansion would be warranted should significant downside risks materialize. At the same time, we note the authorities' caution towards fiscal expansion given risks posed by the aging population, humanitarian assistance and the rising cost of debt following monetary normalization. We urge the authorities to consider options for supporting the economy through non-recurrent spending, including the upgrading of old infrastructure. We strongly support the authorities' efforts to reduce constraints to public investment on municipal governments.

In addition to fiscal measures, implementation of structural reforms to boost labor supply, increase productivity and increase competition will sustain growth beyond the medium term. We found the analysis on the relationship between the external balance, interest rates and the demographic trends useful. We broadly support the recommendations for a three-pronged approach to alleviating labor supply constraints (greater participation of women in the labor force, refugee integration, and raising the retirement age), while also welcoming the authorities' efforts to spend more on training and skills development. Like staff, we see scope for more competition for professional services and in network industries. We welcome the introduction of new legislation to strengthen competition in the rail sector.

We welcome the progress made by the authorities since the 2011 FSAP, and we commend the authorities for enacting reforms to bolster the resilience of their financial institutions, including the bank resolution framework that has been adopted. We also share the authorities' view that there is a significant role to be played by supervisory boards and this should be strengthened. We concur with staff's assessment that further enhancements to compliance controls for AML/CFT provisions are needed, as well as the effectiveness of data collection. We further share staff's assessment of the impact of low interest rates on bank profitability and on the insurance industry, and welcome the stated commitment of the authorities to monitor interest rate risks.

Mr. Heller and Mr. Cavaliere submitted the following statement:

We welcome the continued strong performance of the German economy. We note, in particular, that domestic demand remains strong lead by solid private consumption growth and a rebound in investment. These developments have played a key role in boosting employment and reducing the unemployment rate to a new post-reunification low. Moreover, they have allowed to rebalance the German economy and offset the negative impact of fluctuations in global demand. We also note that public and private balance sheets remain healthy, also thanks to strong revenues in 2015.

The prudent fiscal policy envisaged by the authorities is warranted. We agree with staff that the authorities' continued fiscal discipline has served Germany well. In our view, this discipline has played a key role in ensuring that the macroeconomic policy mix is quite balanced as well as in ensuring relatively sound economic fundamentals. The commitment to a balanced federal budget until 2020 shows that the authorities intend to continue to pursue a prudent fiscal policy. Such a policy is warranted in light of the challenges ahead highlighted in the buff statement of Mr. Meyer, especially to prepare for the pressure on public finances that will result from population aging, which will impact the pension, health and long-term care system. Moreover, a prudent fiscal policy will be essential to advance the reduction of in the public debt-to-GDP ratio that remains above the DSA threshold for high scrutiny, taking advantage of the current favorable interest rate-growth differential.

The envisaged investment in public infrastructure should be made in an efficient manner. As the overall quality of public infrastructure in Germany is adequate, investments should aim at preserving its quality and addressing areas where there is scope for improvement such as in the digital infrastructure. We welcome that the authorities plan to (i) enhance transportation infrastructure investment in the period 2016-2030, (ii) remove administrative and regulatory barriers to public investment by municipalities and (iii) invest in broadband infrastructure. In implementing these measures it will be important to focus on efficient investment and avoid misallocations. In particular, it will be important to carefully select investment projects in order to maximize their growth impact and avoid that spending beyond the absorptive capacities in local administrations. Increasing public investment in an efficient manner, together with growth-friendly structural policies, would also help address declining medium-term growth prospects.

More needs to be done to stimulate female labor supply, especially to increase work hours. The staff's analysis in the selected issues paper shows that enhancing women's participation has sizeable positive effects on the German economy, both in the short and the long term. We welcome that the authorities have important efforts in the recent years to expand child care facilities. However, we are of the view that more efforts are needed to remove the constraints to full-time women' work. In this context, we see strong merits in increasing the overall availability of affordable childcare, further expanding full-time schooling services, and improving the provision of high-quality after-school care. Reducing distortions that increase the marginal tax burden for secondary earners would also help incentivize more active participation of women in the labor market.

Lastly, remaining gaps in the regulatory and supervisor framework need to be addressed. The FSAP shows that both the financial sector and the regulatory and supervisory framework are sound. However, the FSAP also come to the conclusion that some shortcomings remain to addressed. In this context, we agree that high priority should be given to the finalization of the agenda on the new bank recovery and resolution framework, in close collaboration with European partners. In particular, it will be essential to address operational challenges and ensure that the new resolution instruments will be effective, also in the case of large banks with cross-border operations. We also see merits in improving the coverage and granularity of data for banking supervision and macroprudential policy.

Mr. Jin, Mr. Chen and Mr. Teng submitted the following statement:

We thank staff for the well-written papers and Mr. Meyer for the informative buff statement. We agree with the thrust of staff's analysis, and limit our comments to the following.

Growth remains steady on the back of strong domestic demand as private consumption holds firm against the backdrop of a weak global economy. While the healthy balance sheets and the robust labor market are expected to support continued expansion of domestic demand, a stronger outlook will depend on the progress in addressing some important challenges facing the economy, including the need to boost investment, address vulnerabilities in the financial sector in a persistently low interest rate environment, and advance key structural reforms to raise growth potential and promote rebalancing.

We welcome the authorities' commitment to fiscal sustainability in the face of long-run demographic developments, as well as fiscal resilience against unknown shocks. We share staff's assessment that, given the strong fiscal position, making full use of the available room under the fiscal rules to support growth once demand risks materialize and, more importantly, to finance growth-enhancing reforms seems appropriate, which will not only promote growth prospects but also facilitate external adjustment. In this vein, more public investment would be desirable, noting the need for infrastructure upgrading and the scope for higher net public investment. The staff suggests reprioritizing spending items within the budget envelope as a way to support public investment when the fiscal space becomes lower. Could staff comment on the potential space of such resource reallocation?

We would encourage more analysis on the effectiveness of the persistently accommodative monetary policy as, in the case of Germany, growth of investment and credit to the nonfinancial corporations remains moderate. An extended period of very low interest rates is also raising financial stability concerns. Although it is encouraging that the financial system in Germany generally appears resilient, extraordinarily low interest rates have caused notable pressure on banks' profitability and complicated their lending behaviors. Given their systemic importance, we call for particular attention to the large global banks which have been exposed to sharp share price falls recently. Moreover, we agree with staff that German banks should better manage their derisking process to minimize negative spillovers as they withdraw from correspondent banking businesses. Like staff, we encourage the authorities to make further progress in completing the bank recovery and resolution framework as a high priority.

We note the rapid rise of housing prices that has outstripped disposable income growth, and consequently the pickup in mortgage loans. Although prices are assessed to be broadly in line with long-term averages, emerging vulnerabilities from price hikes in some large cities warrant close monitoring. The staff points to the supply and demand mismatch as an important driver, which concentrates on the affordable housing segment, mainly reflecting the new flows of immigrants. Could staff comment on the share of this segment and its impact on the overall housing prices, particularly in large cities? In view of the potential risks in the housing markets, we welcome the ongoing efforts to enhance the macroprudential toolkit to ensure the soundness of the banking sector.

We appreciate the focus on the need for stronger efforts to implement key structural reforms to raise growth potential and facilitate external adjustment. We encourage the authorities to strengthen their efforts to promote private investment, including in digital infrastructure, as well as easing housing supply constraints. Stronger support for public investment at the local level by addressing some of the capacity and regulatory impediments is also important. Boosting labor supply is essential in the context of a rapidly aging population, and we welcome the ongoing efforts in this area, including promoting more efficient and effective integration of immigrants into the labor market.

Lastly, we note that Germany continues to record large current account surplus and also recognize that Germany is part of a currency union which, as a whole, has a rather moderate current account surplus at around 3 percent of GDP. How to assess the external balance of a part of a currency union and its implications for economies outside the currency union deserves further exploration. Moreover, Germany’s current account surplus has boosted its NIIP and overseas investments, which could benefit the recipient countries as well. In this sense, how do staff view the trade-offs of Germany investing its savings domestically versus overseas in terms of the contribution to the global demand and, hence, growth and employment? These may provide some new perspectives that would help to deepen our understanding of current account balance and global rebalancing. We encourage staff to do further work in this direction.

Mr. Sterland and Mr. Stewart submitted the following statement:

We thank staff for their comprehensive and well researched reports, and Mr. Meyer for his detailed buff statement. We welcome Germany's relatively strong short-term outlook, with robust domestic demand and a strong labor market, reflecting a strong record of policy reform and increasingly supportive macroeconomic policies. We agree with staff that the main priorities are to raise potential growth and underpin strong demand via a lift in quality infrastructure investment and structural reform, which will also assist in reducing external imbalances. On fiscal policy we agree that settings should remain supportive of strong growth in the context of asymmetric risks. While financial stability arrangements are generally sound, further improvements in crisis coordination are a priority, while attention to improving the structural impediments to bank profitability would assist growth and rebalancing. We make the following points for emphasis.

Low interest rates and supportive fiscal policy have assisted in substantially improving the outlook for domestic demand, significantly addressing an area of previous concern in the German economic recovery, and the proposed policy focus on structural reforms would further underpin growth and rebalancing. We congratulate the authorities for their generous approach to absorbing refugees, and welcome their willingness to use the flexibility inherent in a strong fiscal position to facilitate this absorption—this has also proved useful in the current conjuncture. We also note positively the renewed growth in loans to non-financial corporates, as balance sheets are repaired, capacity utilization continues to improve, and firms begin to react to the low cost of credit driven by the ECB's policy approaches. Given the risks around the outlook, we agree on the focus on stepping up structural reforms, supported by continued supportive macroeconomic policies. We note staff's analysis that a portion of the current account surplus is a result of country-specific factors rather than policy gaps: nevertheless, we also note that the policy package proposed would both strengthen growth and facilitate external rebalancing. We also note that higher wage and price growth than in the baseline would further facilitate such rebalancing, and consider such outcomes should be tolerated for a time if they were to eventuate.

We agree Germany should run fiscal policy close to the limits allowed for under the European rules. This represents a reasonable balance between the needs of the economy at full capacity, the range of domestic and international risks and spillovers, and the benefits of prudent anchors to safeguard long- term sustainability. Hence, we agree that policy should remain broadly supportive, and be loosened if downside risks materialize. We agree that lifting high-quality infrastructure investment is a priority, though this shouldn't be closely tied to point estimates of identified fiscal space—room should be made for high-quality investment within any fiscal envelope, and the emphasis should be on sound long-term infrastructure planning. We welcome the recent increase in infrastructure investment, and the steps being taken to improve national planning processes and institutions, and urge action to address capacity constraints in the planning processes and coordination at the local level, which has been raised in previous surveillance.

We agree that improving labor market participation and service sector competition are critical to underpinning longer term growth and fiscal sustainability. Regarding the labor market, efforts to improve incentives for longer working lives and female participation are particularly relevant in Germany. With respect to refugees we welcome the approach of providing active labor market support and subsidies, along with the authorities' emphasis on providing appropriate skills training. Competition policy consistently shows high returns to growth and strong spillovers. In this context, we urge the authorities to closely examine the policy rationale for various protective and apparently anti-competitive regulation.

We agree that there are not major imminent financial stability concerns, though consider the low returns across the banking system an important medium term stability and growth issue that needs to be resolved. While the ECB's stimulatory policy settings, and deleveraging process in the wider economy, have helped to improve the demand for credit, German banks face a number of structural impediments to improved profitability. These appear not so much in the more familiar issues of high NPLs that are a feature of some other European banking systems, but rather result from uncompetitive cost structures. As such, the focus should be on eliminating barriers to industry consolidation and reform. Finally, we would encourage authorities to facilitate good information flows with other jurisdictions to reduce the risks that larger German banks engage in wholesale withdrawal of correspondent banking relationships. Continued engagement by the authorities with international efforts on this topic is also welcome.

We welcome the generally sound financial stability oversight structures, though urge further tightening of crisis response arrangements. Of particular importance is the need to clarify the co-ordination arrangements between the Single Resolution Mechanism, the European Central Bank and the German authorities in a crisis situation. We agree that the day-to-day supervision by the SSM should be as streamlined as possible. We would also place particular emphasis on the regulators having access to timely and comprehensive data to ensure that risks do not build to an unsustainable point.

The representative from the European Central Bank (Mr. Pineau) submitted the following statement:

We thank staff for the report and Mr. Meyer for his comprehensive and insightful buff statement. We fully associate ourselves with the gray issued by Mr. de Villeroché and would like to briefly elaborate on a few aspects.

We broadly agree with staff's assessment of the outlook for economic activity. We broadly share staff's expectations as regards price developments. At the current juncture, stronger wage growth in Germany, adjusted for productivity developments, than in the euro area as a whole would usefully contribute to economic rebalancing in Germany and, more generally, in the euro area. In that context, we expect a stronger link between wage growth and price developments than staff does, and thus we also project a stronger impact on relative price competitiveness from a given adjustment in wages. In general, however, we expect wage growth to be somewhat more moderate compared to staff's projections.

We support staff's emphasis on the importance of structural policies to close the savings-investment gap and agree that there is a need to boost investment. The latter would trigger an increase in aggregate demand and, as a by-product, would contribute to a narrowing of the large current account surplus. The demographic challenges ahead call for further measures to enlarge the labour force. While we share the assessment that in the current favourable economic conditions the employment impact of the minimum wage seems negligible, it could become a binding constraint in more adverse cyclical conditions and may inhibit the employment of refugees. The authorities should monitor this closely and, if necessary, take appropriate measures, possibly along the lines suggested by staff.

We concur with staff that there is large room to improve competition in sheltered service sectors, in particular professional services and network industries. We also encourage the authorities to improve the business environment and increase private investment in particular as regards R&D. In addition, a more efficient system of corporate taxation, further reducing the administrative burden for SMEs, and increasing availability of online public services could increase investment incentives.

We broadly share the staff’s view as regards fiscal policies. The existing public investment gap in Germany should be addressed by using available fiscal space while remaining within the limits of national and European fiscal rules, which remain important in view of the relatively large ageing-related fiscal burden projected for the medium and long term.

We agree that the financial sector is resilient and share the view that the low interest rate environment entails risks in particular for those institutions characterized by traditional business models and low efficiency. In this context, we agree that a number of banks need to revise their business models and cost structures to address their low profitability. As regards potential vulnerabilities in the real estate sector, a close monitoring of the situation and the on-going legislative preparations for appropriate macroprudential instruments are warranted.

We overall share staff’s assessment of banking supervision. We agree with staff that the new supervisory framework constitutes a significant improvement. We also agree with the need for improving supervisory data, for prior supervisory approval for significant transfer of ownership, and for a better framework to monitor and supervise related-party risk in Germany. We however feel that a more positive rating as regards the supervision of operational risk might have been appropriate.

Mr. Meyer made the following statement:

I thank Directors for the thoughtful statements. I also thank Directors for commenting so positively on Germany’s role in taking in refugees. As these challenges are well understood, I will not go into further detail in my remarks. But I want to highlight that my authorities greatly appreciate Directors’ acknowledgement.

I was a bit concerned that this Article IV cycle could be a repetition of past discussions. I am happy that this is not the case. To the contrary, after studying the gray statements carefully, I see a significant amount of common understanding on where the German economy stands, what the challenges are, and how my authorities plan to deal with these challenges.

It goes without saying that I appreciate Directors highlighting the strength of the German economy—steady growth, robust private consumption based on a strong labor market, healthy public and private balance sheets, and overall stable financial sector that is robust to shocks.

My authorities want to build on these strengths, taking a medium- and long-term perspective. They want to create a reliable environment for consumers and investors but then let the market process work.

My authorities are also in broad agreement with Directors on the central challenge for Germany—the need to raise potential growth while maintaining the stability of our financial sector and the housing market.

What is helpful is the fact that almost all Directors highlight that the rebalancing of the German economy is ongoing. This issue was always contentious, as Directors were concerned that Germany is too heavily dependent on exports. Since 2013, growth has come almost entirely from domestic demand. This allowed Germany to grow steadily even in a difficult external environment.

This rebalancing process is expected to continue. The staff does not expect any positive contribution to growth from net exports. Wages are expected to grow solidly and faster than productivity. This, together with the reform effort of our partners, especially in the EU and the euro area, will allow further rebalancing.

Germany's current account surplus is still high and even increased further, but most Directors acknowledge that this is mainly related to temporary factors. Directors agree with the staff's analysis that the surplus is expected to go down over time.

The question is, does the surplus decrease fast enough and what can and should policies do? This leads the staff and basically all Directors to two main elements: the first is using structural reforms to raise potential output. We fully agree. Importantly, this includes measures to facilitate more private investment. On this basis, we see the development of the current account as a market-driven process. The second element is the role of fiscal policy and investment. Most Directors praise Germany's solid public finances. At the same time, many Directors argue that we should use remaining room toward our fiscal rules for more investment.

My authorities have a nuanced view here. Fiscal policy is facing several challenges. Therefore, it is prudent to have buffers that we can use in the future. While we do not believe it is the optimal advice in a situation where fiscal policy is already expansionary, to use even the last bit of room under fiscal rules, those rules are not a target but a limit. It is also prudent to have buffers for unforeseen events, as the ongoing refugee crisis clearly shows.

Next, public investment is high on my authorities' agenda, but public investment should be efficient. Therefore, it is of the highest priority to make progress in this regard on all levels of government. The objective is to increase administrative capacity and to improve processes and thereby sustain and increase investment in a durable manner.

Third, the staff's policy advice in this regard is well taken. However, this is a medium- and long-term task. We see higher and more efficient public investment spending as a structural issue. We would not like to do what would impede efficient spending. What we would not like to do is micromanage public investment in the very short term. Several Directors also looked at this topic this way, for example Mr. Sterland and Mr. Field among others, and their reasoning was convincing. This might be a reason to look at this issue, maybe even over and above the German Article IV consultation.

I would like to add three remarks on the more critical aspects of the Financial Sector Assessment Program (FSAP). First, we have a significant amount of agreement. The German financial sector is overall stable and robust to shocks. At the same time, the persistently low interest rate environment is putting significant pressure on the profitability of our banks and insurers. Therefore, my authorities will remain vigilant and continue to carry out service on the low interest rate environment in order to better monitor interest rate risks.

Second, my authorities concur with the staff on the key messages with respect to the German macroprudential policy framework. While broadly appropriate, some scope for improvement is highlighted. I would like to underscore that my authorities are acting on this and are currently working on a legal act implementing recommendations from our Financial Stability Committee to create additional macroprudential tools as regards residential real estate.

Third, the FSAP assessment shows Germany's high level of compliance with the basic core principles for effective banking supervision. Still, my authorities believe that the compliance with a number of the principles are assessed somewhat too negatively. I will try to explain that element one more time.

The role of the Supervisory Board is central. Germany has a two-tier system where responsibilities are divided between the Management Board and the Supervisory Board. The staff criticizes the role of the Supervisory Board as too passive and not focusing enough on risk management and risk culture.

My authorities hold the view that this criticism is contradictory to the statement of the Basel Committee, which explicitly does not advocate a specific board structure and states that both concepts, one-tier and two-tier systems, are equivalent.

Mr. de Villeroché made the following statement:

To complement what I said in my gray statement, I would emphasize that Germany has steady growth, low unemployment, strong public finances. It is clearly a robust economy, and it is playing a key role as a stability anchor for the euro area. Having a strong economy and being a stability anchor is important in light of these current events.

I also commend the authorities for how they have managed the inflow of refugees, in particular the expansion of important fiscal resources to humanitarian assistance and to the integration of the refugees.

To give my intervention some perspective, I would like to stress that individual policies in Germany are critical for Germany itself; but due to its size and pivotal role, the German economy is important for the euro area at large as well.

I would like to come to the point of the current account surplus remaining quite high. It is of concern for both Germany and the euro era. We concur with Mr. Meyer that there is an ongoing rebalancing, which is welcome. It should be recognized. We have an increase in public investment, which has been observed in 2015, and which should continue and is going in the right direction.

Private consumption is increasing as well. We note that wages are picking up in Germany. They have been growing at a slower pace than productivity, inflation targets in recent years, and now it is forecast to evolve along this trend in the next years.

Having said this, the projected trend of the current account adjustment is not analyzed by the staff as being in line with desirable policies. This is why we consider that the ongoing rebalancing policies should be accelerated for the benefit of Germany and the euro era as a whole.

Regarding fiscal policies, we take note of the projected fiscal expansion of 1 percent in 2016. Most of this is due to the efforts made to accommodate refugees, and we commend the authorities for that. We also believe that beyond this point, the available fiscal space should be used more forcefully to boost investment. It would participate in a more comprehensive strategy to raise potential GDP in Germany.

Regarding structural policies and taking into account demographic trends, we welcome initiatives announced by the authorities to boost investment—the removal of the administrative burden, the 15-year plan to increase infrastructure investment, and the reform of public-private partnerships (PPPs). At the same time, we support the staff's recommendations concerning the large available workforce and the liberalization of the service sector and retail trade.

Lastly, regarding the financial sector, we are comforted by the resilience of the financial sector in Germany. As is the case for many other countries, the current low interest rate environment is challenging for the sector. Nevertheless, the low profitability of some segments of the banking sector also reflects some specificities of the business models and other structural factors.

Moreover, we are also comforted by the positive assessment of a new supervisory framework that constitutes a significant improvement for the European banking sector as a whole.

Mr. Heller made the following statement:

In one of my first gray statements written three years ago, I referred to Germany as the stellar performer in the euro area. While this may have been a slight exaggeration, I am pleased to note that the German economy is still performing well. Domestic demand is strong, unemployment has been trending down for many years and is now as low as it was at the time of reunification a quarter of a century ago. Exports are also weakening, and as Mr. Mojarrad pointed out in his gray statement, rebalancing is on the way.

Finally, fiscal policy continues to be prudent. The commitment of the authorities to a blank zero in the federal budget is appropriate given that the economy is at full capacity right now.

I would like to turn to one point in the Financial Sector Stability Assessment (FSSA), and it is related to capitalization in the banking sector. It is striking to see that leverage in the banking sector is still high, not so much compared to the peer banks in the euro area or non-U.S. G7 countries. Risk-weighted capital ratios are high, but unrisk-weighted leverage is very high. We would call on the authorities to put more emphasis on reducing leverage in the banking sector, and by doing so, increasing the resilience in the sector.

Mr. Sterland made the following statement:

I compliment the staff, and I think the way that the German authorities and chair have interacted with this is good.

I wanted to react to a few of the discussion points raised in the gray statements rather than reiterate the points in our gray statement. I would like to address three issues.

The first is how we think about the fiscal stance and fiscal space. The second is how we link infrastructure demands and priorities with that fiscal task. The third is on external balance.

On the first issue, I agree with Mr. Sobel that the Article IV surveillance process should focus on economics and it should not be overly driven by institutional constraints. The Fund should come in, should give advice based on analysis.

In addition to the three helpful questions in the U.S. gray statement, perhaps it is implicit in one of them, the fourth question is also how one uses space safely and sustainably. That is part of the economic decision. That brings me back to anchoring, which matters for that decision.

The three questions are hugely valid. There is one implicit or a separate question, which is how one uses that space, and then unwinds it if one uses it in a discretionary way or uses it consistently through time.

On that basis, when I add that element to the mix, that leads me to think that the staff gets this one right, that there is some discomfort for our German authorities, but it is respecting the bottom-line anchor of the system as a reasonable one that keeps discipline in the system.

I can see the argument that the economy is at full capacity, that in those circumstances one might run a tighter fiscal policy over time. But when I read the report as a whole and think about the risks facing Germany and the multilateral and regional context and the fact that anchors are still respected, where the staff has turned up is a good balance between those considerations, and I am happy to support that.

I think the staff implicitly did address the economics. However, I can agree with Mr. Sobel, and perhaps we will find better language to do this after our discussion next week. Perhaps that needs to be drawn out a bit so that it does not look arbitrary or overly influenced just by country factors. That is where I get to on the fiscal side.

On infrastructure, it is a related point. Sometimes I have seen a tendency—and Mr. Field raises this point—that we have a relatively small difference in the fiscal outlook, the recommendation versus the authorities. Then it is proposed that we fill that little wedge up with infrastructure. As someone who comes from working in budget systems, that is what I am hearing from Mr. Meyer and even other Directors—that that feels like it is using quite a slow-moving and important efficiency element to fine-tune year-by-year outcomes. That feels wrong.

I do not believe the advice is in the wrong place. I agree with the advice to increase infrastructure. But the way it is linked in an operational sense makes one feel like the staff is tuning something up and down while at the same time advocating that it be based on long-term planning, so I would put it the other way. I would say infrastructure is needed, whatever that fiscal outlook is. If one was on the limit, one would make space for it hard; if one had a bit of room, one might make space for it less hard. One might implement other growth-enhancing elements to use up the space. But the mixing of the infrastructure advice with the fine-tuning of fiscal policy might be what is tripping some people up. It would trip my system up, even though I agree with where one might end up on that.

I even agree that using any overperformance of revenue to fund infrastructure—I believe that's what Mr. Field was referring to—feels wrong if one has been a person that is involved in a serious budget process. It is not the way one makes decisions about third airports or major roads by looking at a new estimate of revenue and then putting a new project on the agenda

But the fundamental point is still right. Australia made mistakes for five years. We overestimated revenue, we kept not doing something serious and pro-growth with that so it was frittered away in inefficient year-by-year fiscal measures that a political system produced.

So I agree with the sentiment there and there could be value in that, but I would not link it so tightly to the infrastructure recommendation because that feels like it is inappropriate fine-tuning with the instrument that is not good to fine-tune with.

Finally, on external balance, we welcome the analysis of the country's specific characteristics. We are supportive of that and looking forward to continuing to define that approach. In this case, there is still a gap. It is hard. The overall current account surplus is high. The amount of the gap is uncertain.

But in that context, the staff has struck the right balance. The staff used it to look harder for no-regrets policies like productivity enhancement. Mr. Cottarelli said it well, that there is a large current account surplus and poor growth, which are intertwined issues, and they need a similar set of policy actions.

I believe it is the right approach to use the current account imbalances to look for underlying imbalances and then really target them hard. That is a way of both getting traction with authorities and dealing with the substantive issues.

Mr. Rouai remarked that tax revenue forecasts seemed to underestimate the actual performance. There was a risk that it could unduly exacerbate the already cautious fiscal policy, and he encouraged the authorities to address that data issue. He also encouraged the staff to present a more focused message to help improve the traction of Fund surveillance. He noted that the staff's appraisal was four pages long and could have been more focused.

Mr. Kiekens made the following statement:

The FSAP for Germany is a landmark achievement, and I would like to warmly congratulate the entire staff for what they have produced in discussions with the authorities and in the reports, including the technical notes which are, for everyone who is interested in the technicalities, very worthwhile to read.

The financial sector in Germany is a large one in Europe. It has been fragmented, with a large number of small institutions where the governments need to be improved. I fully endorse the recommendations of the staff in this respect.

The most concerning information we received is the graph on page 10 of the staff's written responses, which shows that the price or market-to-book value of the two large German banks—Deutsche Bank and Commerzbank—is extremely low, 30 percent. Something is inconsistent. Either the market is valuing these large banks way below their real value, or the accounts are overstating the true value of the bank.

The staff makes an effort to explain this divergence. There are low valuations of the banks, which are larger than the peers in Europe. It is to be explained "by investors' concerns about the low profitability associated with challenged bank business models, structurally high operating costs, potential for further litigation costs, and the likely increase in the funding costs."

These are all elements of fragility, and so it needs to be taken into account. I believe the market, at least to a large extent, expresses that in the valuation.

But today Mr. Heller says that the banks are overleveraged and that one of the objectives of the bank managers and shareholders—he spoke also about the authorities—would be to reduce that leverage. That is easily said but extremely difficult when one has a market valuation that is only 30 percent of book value, unless the shareholders are willing to give up quite a lot and have to recognize the valuation of increasing capital—if that is the avenue they are going to follow—the book value is only 30 percent, rather than the real book value. The other way around is to shed a significant amount of assets. But the market needs to be able to absorb these assets, also.

If there is any more comment on that, I would welcome that. But in any case, these low valuations are a serious indication that the strength of the financial sector is probably not as strong as it appears on the balance sheet.

My second comment is on the current account. The staff projects that by 2020, the net international investment position of Germany will approach 90 percent of GDP. At the same time, in their projections for the balance of payment, the financial income for Germany with probably Europe's largest net international investment position, is only 2.3 percent.

The first question that raises is why are Germans so eager to build up current account surpluses and save if all these savings are projected to generate such a meager income?

We understand that a low-interest rate environment is to persist, at least to some extent. At the same time, this low-interest rate environment stimulates non-consumption not directly. But savings may be paradoxically and perversely savings. I read this morning a report by an expert on the pensions in Germany arguing that it is now much more expensive for young people to build up a pension than before—three times, four times more expensive—and therefore, if they want to save for old age, they have to work longer. This is something that the German authorities are promoting, and also, to save more.

So the current account surplus, which generates this important savings abroad, generates some additional income, but very low levels of income. I would welcome the staff's comment on the interaction between low interest rates, low growth, and high savings, and what could be done about it, if anything.

Mr. Field made the following statement:

I wanted to comment on what Mr. Sterland said, because that was basically my point and the question I was asking in my gray statement. We need to be clear about the way we are framing our fiscal policy advice. It did feel like we were conflating a number of different issues in the advice for Germany. As Mr. Sterland noted, potentially it looked like we were trying to fine-tune the fiscal path through infrastructure spending. That feels like a bad way to formulate policy.

We need to be clear—and maybe this will become more clear when we have our discussion on fiscal space and define what we mean better—where we are talking about adjustments to the fiscal stance and where we are talking about the separate issue of how much infrastructure investment should take place.

The way the advice is formulated here feels like using revenue surprises to fund more infrastructure. Seems back to front, particularly for a country like Germany. What a country should do is assess its infrastructure needs and look at those carefully, think about where it could augment infrastructure spending, where that augmentation would have the biggest bang for the buck, where it could have a particular effect on potential and growth.

Then one designs the investment program accordingly. The way we formulate the advice in the report, it feels like we are conflating these things.

To reiterate what Mr. Sterland was saying, we need to think about how we are formulating those things so there is clarity.

Mr. Kiekens asked why the authorities should not borrow for an investment if the environment was such that borrowing was almost free of any charge, and one could identify investments with a real rate of return that would more than offset the cost of borrowing and amortization. He asked why the authorities should not make investments with a higher rate of return than the cost of financing, particularly if there was ample space in the investment savings balance.

Mr. Sobel made the following statement:

I want to begin by underscoring the point made in our gray statement—that we have enormous respect for Germany's longstanding commitment to stability and sound macroeconomic policies, which has delivered huge economic successes for the German people. We also heartily commend Germany for embracing refugees.

I thank the staff for its answers to our questions, especially on the banking system. I agree with much of what Mr. Heller had to say about the financial system.

On one other financial sector-related issue—and I never know what goes in the euro bucket and what goes in a country bucket—the United States has been a strong and consistent supporter of European efforts to forge banking union. We have seen banking union as part of an essential firewall for a strengthened European economic and financial system. We especially welcome the creation of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM), and we agree with the staff that the German financial system is stronger as a result.

The creation of the SSM and the SRM already presupposes some degree of European risk sharing. In that spirt, we see the creation of a European-level deposit insurance system as a necessary building block for banking union.

It could be argued that deposit insurance can create moral hazard, which needs to be mitigated through strong supervision and regulation. But having supervision and regulation, for all intents and purposes, at the

European level and deposit insurance at the national level creates a potential gap in the architecture of Europe and a misalignment of incentives.

Furthermore, to the extent that turbulence from one country in Europe can destabilize another country, a system based on national deposit insurance cannot internalize intra-European spillovers and provides little comfort that it can serve as a line of defense against those spillovers.

Strong supervision and regulation, including consideration of the risk weighting of sovereign debt, is an important risk mitigant in the face of moral hazard. This is something the Basel Committee should appropriately take up. But steps for creating a more perfect banking union should proceed now.

On Germany's massive current account surplus, our gray statement articulates themes that Board members, including Mr. Meyer, have often heard from our chair—so often maybe they do not want to hear it again—and that the U.S. authorities have put forward consistently for many years. We concluded the U.S. Article IV meetings this week, and Secretary Lew articulated those same themes about the lopsided distribution of global demand and its deleterious impact on the world economy earlier this week to Madame Lagarde.

Regardless, the German surplus remains large and the outlook is for more of the same. The Board is familiar with this chair saying that we do not feel that the Fund, as an institution, accords the global pattern of external imbalances and its implications—an issue that extends well beyond Germany—anywhere near the proper attention this issue deserves.

We also do not believe that explanations that rely heavily on a saving investment gap argument—which is an accounting identity but not a behavioral relationship—get to the heart of the issue. Nor are we at all persuaded by the emphasis the staff assigns to demographics, the speed of aging, for example, in explaining huge current account norms. As Mr. Kiekens suggested, the notion of excess savings also merits attention and consideration.

Mr. Meyer posited in his opening remarks—which were good, helpful, and thoughtful—that rebalancing is happening. We welcome the strengthening in German domestic demand, a point we made in our gray statement and made as well last year. However, we were struck by Table 3 on medium-term projections. For 2017 through 2021, the staff's medium-term projections basically show a foreign balance of minus 0.2 percent per annum. This is a very modest number.

We welcome the strengthening in German domestic demand. But Germany is not contributing to global rebalancing in the sense that domestic demand is strongly and sustainably staying above GDP growth.

On fiscal policy, I would just say that the German Article IV and the gray statements, plus Mr. Sterland's and Mr. Field's interventions, underscore why it is critical that the Fund pursue its long overdue dive into fiscal space with alacrity. Mr. Sterland's anchoring questions were subsumed under my number two. But that is a minor trivial point. Again, we praise Germany for its strong performance.

Mr. Sterland made the following statement:

I just wanted to clarify my point on infrastructure. While it is absolutely critical that the infrastructure is carefully assessed and is value for money, I am all for the Fund, with other institutions, keeping our feet to the fire to ramp it up to make it more rampant. I do not want to suggest that we should therefore be passive about infrastructure investment, but that our processes can be clunky, our interdepartmental coordination can push it all in the direction of delays.

It is right for us to push hard on this. I do not want my comments to be misread as advocating that we should be passive with whatever careful process it produces. We should push our agencies; we should break through coordination problems. But we should not fine-tune it beyond that. We might need to accelerate it, but we need to be careful not to look like we are turning it up and down in relation to vagaries. It is just more to support both the urgency we give that, but just watch how we frame it from a fiscal management perspective year to year.

The staff representative from the European Department (Ms. Detragiache), in response to questions and comments from Executive Directors, made the following statement:[3]

I will start with a small point about the results of the U.K. referendum to leave the European Union and their implications for Germany. I want to

[3] 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.

point out that the macroeconomic baseline forecast in the staff report does not reflect the materialization of this risk, which the staff report characterizes as a downside risk for Germany.

The United Kingdom is an important trading partner for Germany. It accounts for 7½ percent of its exports. German banks have sizable exposures to the United Kingdom, and in some cases sizable operations in the United Kingdom.

Any significant change in the economic relationship between the two countries would have important repercussions on the German economy, which would materialize gradually over time as this new relationship will be defined.

There may also be effects in the short term through the ramifications of market turbulence, higher uncertainty, and also political risk from rising anti-European sentiment.

The staff is preparing a new updated euro area forecast. In that context, we will prepare a new forecast for Germany as well, which will be multilaterally consistent and will reflect our views of how these factors will play out.

I want to address the issues of the fiscal space and our fiscal advice to Germany. But first of all, the Directors know that there will be a discussion of fiscal space next week, and I will defer to the discussion.

But as far as Germany is concerned, it is clear from the Debt Sustainability Analysis (DSA) that is in the report that Germany's fiscal position is strong and the public debt is currently on a rapidly-declining path toward the 60 percent threshold.

We believe that fiscal rules have played an important role in achieving this strong fiscal position. I would like to emphasize that we do not see fiscal rules as purely an institutional factor somehow divorced from economic considerations. To the contrary, I would say that economic considerations lead countries to adopt fiscal rules and have led institutions like the Fund to recommend countries to rely on fiscal rules as a way to manage their fiscal policy.

These considerations have to do with deficit biases and political business cycles and pressures coming from the political economy factors that tend to push up deficits, as we have seen in many countries. We support the

German fiscal rules and their observance, while acknowledging that these rules do constrain the room available for discretionary fiscal policy.

In the current case, we would view it as appropriate to use the room under the fiscal rules to finance growth-friendly policies. With public investment, there is an ongoing debate on whether public investment is a good instrument to use for discretionary fiscal policy. On the one hand, it is well-recognized that spending on public investment has large multipliers. From that point of view, it is a good instrument to support aggregate demand. On the other hand, are the considerations that Directors have mentioned about the need for long-planning processes, avoiding waste, and the inability to ramp up the spending in response to cyclical needs.

In the case of Germany, there has been a need for more public investment. We recognize in the report that this could also be carried out by reprioritizing spending—not necessarily just to the extent that there is space, but also perhaps reprioritizing spending.

Some of this investment is to perform maintenance and upgrades. There is probably some flexibility as to the timing with which this spending is carried out. To this extent, it can perhaps be profiled over time in a convenient way.

I would generally agree with the point that it is important to have a process to identify the necessary public investment projects, identify projects that have high social rates of return, and have a process that allows one to put these projects in place quickly and efficiently.

In terms of whether should we finance all projects that have positive rates of return, there is a question of whether we want a fiscal rule of the golden rule type that exempts public investments and so gives the flexibility to ramp up public investment without considerations for deficit ceilings. There are pros and cons to having golden-rule-type fiscal rules in place.

On the question of savings and population aging and the effects of lower interest rates on savings, it is a concern that building retirement income through savings may become more difficult in an environment of low interest rates. The predicament of the life insurance industry in Germany is a case in point.

It is an interesting discussion that we perhaps could pursue further in future consultations—the extent to which Germany's tendency of saving using fixed-income instruments is actually making this problem more severe and whether some policy interventions may be warranted to encourage more investment in equity and other types of instruments.

In terms of the net investment income position and the meager return on foreign assets, the question is: would the return on investing domestically in Germany be any higher? That probably is not the case, because returns on safe fixed-income instruments in Germany are probably negative nowadays.

The staff representative of the Monetary and Capital Markets Department (Ms. Erbenova), in response to questions and comments from Executive Directors, made the following statement:

I would like to comment on a few aspects related to the FSAP, in particular the context of the FSAP and what data was available to the team, the impact of the U.K. referendum, and then react to the discussion by Directors.

Germany's FSAP was the first amongst euro area country FSAPs after the new architecture was put in place for supervision and crisis management and bank resolution in Europe. That is why it was an uncharted territory in terms of process and collaboration amongst country-level and euro area-level authorities within the new mandates and responsibilities. This required pragmatism and good will and a significant amount of engagement and resources from all participating agencies, and we would like to acknowledge that we had excellent cooperation and engagement from our counterparts. We have also learned a lot from this assessment and are applying these lessons in other ongoing and planned euro area FSAPs.

We also did not have a baseline for this assessment because key elements of the oversight and crisis management framework are completely new and fundamentally different from the previous FSAP.

We have made this assessment within the ongoing transition to a new framework. In that sense, it is a point-in-time judgment call, albeit by an experienced team of assessors, and the track record of all of these institutions is so far short.

With that, we had many discussions with the relevant authorities on the policy choices and tradeoffs involved in the design of these new institutions, which hopefully enriched our analysis.

Our assessment benefited from extensive access to data. Throughout the FSAP, our vulnerability analysis utilized individual institution-level data provided both by German authorities and the European Central Bank (ECB) in a manner that ensured confidentiality.

We also had excellent access to staff at all levels, and crucially a full engagement in policy discussions from senior officials in Germany and the ECB to perform our assessment of the SSM.

In terms of our comments about the need to improve existing data and data collection, those are not comments reflecting upon the cooperation by authorities but upon the need to improve availability of this data for financial stability and macroprudential policy by authorities.

In terms of Brexit, in the FSAP we have identified the outcome of the U.K. referendum, which has eventually materialized, as a potential contributor to a growth slow-down risk scenario and increase in market strains. Similar to the U.K. FSAP, and fundamentally for the same reasons which were discussed last week, we did not have a stress-testing exercise with a particular Brexit scenario, but we considered this outcome as a potential source of volatility in the existing extreme downturn scenario analyzed in the stress testing exercise.

We have also quantified potential valuation losses for sovereign exposures in the FSAP documentation. While a number of German banks do remain exposed to vulnerable sovereigns, the existing regulatory treatment would largely shield banks from immediate losses in an event of a short-lived pressure on sovereign debt.

Furthermore, it is likely that German government bonds, which are the largest portion of bank sovereign exposures, will continue retaining their safe haven status. That will importantly limit losses from exposure to sovereign debt.

The bottom line so far has been a profound market reaction but no market seizure, also in reflection of the decisive communication by many central banks. We do expect that the large uncertainty will remain, particularly for banks, and weigh on economic outlook. We see much more limited impact on insurance.

In reaction to the discussion in the Board, we agree that completing banking union, including through a common permanent backstop for the Single Resolution Fund discussed in the documentation and through European Deposit Insurance Scheme, remains an important priority and would serve to reinforce the existing firewall in the euro area. This analysis would go beyond the scope of the national German FSAP. Therefore, we did not engage in depth in this discussion in the FSAP documentation. But it has been a longstanding staff position that this would constitute the missing piece of completing banking union in Europe.

In terms of a discussion about bank leverage and how to reduce it, fundamentally these are business decisions by banks, which need to be made in an enabling regulatory and supervisory environment. But those should be bank decisions.

We believe that strengthening management oversight by supervisory boards and greater engagement of supervisory boards in strategic and risk appetite discussions would serve as an additional incentive. For these decisions to be made, we also believe that strengthening risk management, particularly operational risk management where a number of additional costs have contributed to low profitability of the largest banks, would be an additional important contributor to this.

Ultimately, banks need to strengthen their capital positions to improve profitability and deficiency. They need to embrace IT investments surrounding the discussion about infrastructure and a more decisive rationalization of the existing structure, particularly of the extensive branch structure and head count that would be necessary to improve efficiency of the banking sector.

Mr. Kiekens made the following statement:

On fiscal rules, I agree with the staff that fiscal rules should be structured according to sound economic analysis and insights, and primarily, a fiscal rule must set a constraint on developments of primary spending for consumption reasons, at least to what can be financed by sound income from taxation.

We have a tendency in many of our analyses to place an excessive consideration on gross debt, and we do not look enough at the public balance sheet of a country. We have amply discussed fiscal rules and fiscal policies in

Germany. Unless I am mistaken, the papers contain no fiscal balance sheet. If a country has a debt of 50, 60, 70 percent of GDP and poor infrastructure built up by deficits to finance consumption and transfers and spending, that is a worrisome situation.

However, if the same country has a balance sheet that is positive or not very negative, and that is a reflection of highly profitable and productive investment in public infrastructure, that should be an important part of the consideration.

There was a disarming recognition at the end of the intervention of the mission chief: Investing in Germany would not result in any return. That shows the dire situation of the European economy and of one of the best performing economies in the world.

Now investing abroad is better than investing in Germany. That was the staff's message. Still, my view is that 2 percent on a net investment position of 90 percent is excessively low. In a few minutes, we will discuss the Czech Republic. I have the table here with me. The Czech Republic has a negative net investment position. The cost for the Czech Republic to finance that negative position—so to pay interest and dividends and remunerations to foreign investors, many of them being Germans—is 9.4 percent of GDP.

The return on investments in the Czech Republic are way over 10 percent. Why are the Germans, who invest so much in Central Europe, not able to generate on a 90 percent net investment position, only a meager 2 percent?

There is one lesson we have learned and that everybody in other surplus countries—be that the Netherlands, Belgium, Switzerland—should learn. There is a big risk, if one invests abroad, that indeed one will lose. Who were the big losers of the financial crisis in 2007, 2008, 2009? Many European countries, banks in European countries, with substantial investments abroad as a reflection of the current account of the country losing trillions of dollars elsewhere. We need to reflect on all these things.

Mr. Sobel made the following statement:

In addition to Mr. Kiekens's points on looking at balance sheets, the Fund appropriately looks at gross debt but also should look with more emphasis on net debt. In the gray statement, where we posited our three questions on fiscal space, the first question was what is the staff's independent view as professional economists? The second question was, even if there is fiscal space, does it make sense to use it, taking into account country circumstances, taking into account fiscal rules and the like?

I heard the staff's answer. And if I heard it incorrectly, I apologize. But the staff is basically arguing that fiscal rules are important for credibility. That is a point I broadly agree with. They should use the space within the rules.

But I still believe it is possible to disentangle the two questions. Let us not talk about Germany. Let us talk about a country like Germany. If a country like Germany, hypothetically speaking, were to run a 1 percentage point of GDP deficit right now, would the staff be worried about its debt loads and commitments to strong and sound fiscal policy in any way, shape, or form? The staff may then say because the present rules and credibility, ergo, we do not want to go there. But I do believe it is possible to answer that question separately from saying, well, there is a rule and that is the way it is.

More generally—and again, this is not a question about Germany, it is a more hypothetical question—if the Fund thought that the application of a fiscal rule was too tight, would the staff, in its advice, take that rule as a given?

The staff representative from the European Department (Ms. Detragiache), in response to further questions and comments from Executive Directors, made the following additional statement:

I would like to clarify that when I referred to the returns on investing in Germany, I meant the returns in investing in safe, riskless, or fixed-income assets in Germany. Those returns are, at the moment, quite low and even negative. Clearly there are other types of investments in Germany that are more profitable than that.

Let me turn to the question of fiscal rules. There is a discussion that can be relevant, can be addressed, about how the rules are calibrated and whether they may be too tightly calibrated, which would warrant a revision of the rule itself and its calibration.

In the current European situation, there are these medium-term objectives. One could ask whether these objectives could be re-discussed in light of the very low interest rates, the new world of low interest rates, also perhaps in the new world of lower medium-term growth rates.

It is a perfectly legitimate question to ask. In the case of Germany, one could ask the question of whether that break is appropriately calibrated. In this consultation, we have not raised this issue, but it is a valid question.

In terms of whether we can think about fiscal space abstracting from fiscal rules, I find it hard to think about what the German fiscal position would be in our outlook in a world where the fiscal rules were not there or in which Germany decided to ignore the fiscal rules or repeal them or make exceptions to them in a deliberate way. It would be a somewhat different world, and I find it hard to answer the question in the abstract.

The staff representative from the Strategy, Policy, and Review Department (Mr. Haksar), in response to further questions and comments from Executive Directors, made the following additional statement:

I would make two observations for Directors' consideration. One is that the Fund's staff do, in the context of surveillance, engage with authorities to discuss the design of frameworks. There is a significant amount of technical assistance that is provided as well. We do express views about some of the design features, some of the planned amortizations. This is something about which there is a large body of literature and much discussion.

One of the features that one finds in these discussions is that there is discussion of the design frameworks, but there is also a question of the authorities' perceptions of the nature of risks that the country faces and the risks that they are seeking to manage in the context of the design of their fiscal framework. In many emerging market frameworks, one will find that there is a lot of focus on the occurrence of contingent liabilities, which is also an advanced economy issue as well. It is a topic that was raised in a recent Fiscal Affairs Department Board paper as well.

I would say that this is a topic that does get a significant amount of attention and maybe it should get more attention. That is something worth considering.

I would also point Directors to the comment that my colleague made earlier, that there would be a discussion next week on the paper that we have circulated on initial considerations on consistent approaches to fiscal space. That might be an opportunity to reflect on some of these issues as well.

Mr. Kiekens made the following statement:

The reason why the return on the foreign investment position is so low in Germany is because it is an extremely conservative investment strategy. Of the 7 percent current account surplus, only one-tenth of that is invested in foreign direct investment. The rest is portfolio investment with a very low return, which is somewhat surprising for a country with so much financial assets or financial strength, that they are seemingly—unless we care about the private sector—so conservative in their investment strategy.

I cited the case of Czech Republic and the returns that the Czech Republic has to pay on the foreign investments. In Germany, 6 percent is invested in portfolio. It is a pity that we do not have the ventilation between shares and between fixed income, and the analysis should be helpful.

But for future analysis, that could be helpful to look at. The numbers that I see on direct investment are the net amounts. Germany invests 3.7 percent gross. But there is also foreign investment coming into Germany. On a net basis, it is 0.7 percent.

Mr. Meyer made the following concluding statement:

I have comments on Mr. Kiekens's point and savings in Germany. I would like to highlight that the savings by private households has been stable over years, not changing. What is really going on is that corporations are saving much more. Then we are into the question of private investment and if this would be foreign investment or investment in Germany.

As Ms. Detragiache has indicated, there is discussion ongoing around the low interest rate environment that will stay for some time to expand the investment opportunities in the second pillar of our pension system, the occupational pension system, to hopefully get higher returns.

My second comment is on the discussion on fiscal policy. I was pleased with the way it is presented in the U.S. gray statement with the three questions. Because my concern is that a discussion only on fiscal space, however we define that, is not really the right discussion. But asking those three questions was appropriate. If there are three questions on whether adequate fiscal space exists, it is actually not a discussion about fiscal space but it is about adequate fiscal policy advice. It is a much broader discussion.

Having said that, I thank Directors for the gray statements. We will convey them to our authorities. I thank the Board for the rich discussion today.

I would like to thank the whole Germany team for the Article IV consultation, Ms. Detragiache as mission chief, and Mr. Vandenbussche, Ms. Pereira, Mr. Natal, and Mr. Xie. It shows that the core of this team has been working together with Germany for some time as we had comprehensive discussions, but my authorities always felt that the exchange of views was candid and fair and that my authorities' views were always taken into account in a fair manner.

For the FSAP, I thank the mission chief Ms. Erbenova and the deputy mission chief Ms. Scarlata and 10 more team members. There were two missions last November and again in February, March. I would like to highlight, as Ms. Erbenova already has done, that the process was a special challenge, as this was the first time that we had an FSAP in the context of the new supervisory framework in the EU. I would also like to emphasize that the coordination was excellent, and overall a success.

The Acting Chair (Mr. Furusawa) 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 welcomed the increased contribution to growth from domestic demand, supported by lower energy prices, rising real wages, declining unemployment, and accommodative fiscal and monetary policies. These developments will continue to underpin growth in the period ahead. Directors noted that risks to the outlook are tilted to the downside, including weaker growth in Germany's trading partners and heightened uncertainty following the outcome of the referendum on the U.K. membership in the European Union. Meanwhile, the large current account surplus persists, and an aging population and refugee inflows continue to pose challenges.

Against this backdrop, Directors agreed that policies should focus on raising potential growth and reinforcing rebalancing, which will also support the fragile recovery in the euro area. To this end, Directors broadly concurred that, to the extent that there are fiscal resources available within the fiscal rules, they should be used to boost high-quality public investment and finance growth-enhancing reforms. They welcomed the authorities' ongoing efforts to enhance the overall efficiency of public investment and plans to address administrative and regulatory constraints to investment. Directors also commended the German government for shouldering the burden of absorbing a large inflow of refugees.

Directors underscored that faster progress on structural reforms is essential for boosting medium-term growth in a rapidly aging society. They called for well-targeted measures to increase labor supply by promoting labor force participation of women, older workers, and immigrants; and reforming taxation, the pension system, and health insurance contributions. Directors also encouraged decisive steps to enhance competition and productivity in the services sector.

Directors welcomed recent actions to ease supply constraints in the housing sector. They supported reforming the real estate transaction tax and improving the macroprudential toolkit targeted at the real estate sector and the supervisory database. Continued close monitoring of house price developments and mortgage credit is also warranted.

Directors observed that the overall banking sector remains strong, resilient, and well-capitalized. Nevertheless, given prolonged low interest rates, high operating costs, and technological and regulatory changes, it is important that banks accelerate their efforts to adjust to these challenges and improve risk management. Directors recommended that the authorities monitor the insurance sector closely, require action plans from troubled firms, and keep safety nets under review.

Directors welcomed the progress made in implementing the recommendations of the 2011 Financial Sector Assessment Program. They considered it a high priority for Germany to complete the agenda on the new bank recovery and resolution framework, consolidating the positive effects of the European Single Supervisory Mechanism and Single Resolution Mechanism. Further efforts are needed to improve the coverage and granularity of supervisory data, complete resolution planning for large international banks, and broaden crisis management coordination arrangements with European authorities.

Directors noted the globally systemic importance of large German banks and the potential spillover effects of their withdrawal from correspondent relationships. They encouraged the authorities to promote better risk management by these banks, strengthen cooperation with other national supervisors to harmonize regulatory frameworks, and facilitate cross-border information sharing.

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

APPROVAL: March 17, 2017

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/Risks

1. ***Could staff provide details on potential upside risks?***

- The report acknowledges a number of upside risks to the outlook. It explains (paragraph 13) that "given the considerable monetary and fiscal stimulus in the pipeline, upside risk could arise from a stronger-than-expected response of the economy" and that "inflation could also reach the ECB inflation target faster should wage pressures intensify, which would also accelerate the projected external rebalancing." However, staff believes that the balance of risks at this point in time is titled to the downside.

Fiscal Policy

2. ***On fiscal policy, could staff clarify the issue of tax revenue forecasts, which seems to be consistently underestimated compared to actual performance. Is there a risk that this trend may unduly exacerbate the already cautious fiscal policy?***

- The persistent downward bias in tax revenue estimates since the trough of the global crisis is mostly explained by consistently positive surprises regarding the performance of the labor market (relative to government forecasts, which form the basis for the revenue projections). The latest estimates for unemployment and wage growth are in line with staff's macro framework. Should these indicators again surprise on the upside, and to avoid the risk of an unduly tight fiscal position, staff advises that the windfall is used to finance growth friendly policies.

3. ***A staple of any Article IV is an assessment of the fiscal stance, yet this is missing in staff's assessment of its view on the "schwarze Null" and, for example, commentary on the structure of revenue and spending (beyond public investment) and its implications for boosting the economy—could staff comment on this?***

Noting that staff recommends that the authorities reprioritize spending within their existing budget in the short term to accommodate the small increase in fiscal costs, could staff elaborate on areas where public spending could be deprioritized?

- The authorities' current financial plan is anchored on a balanced budget position at the federal government level ('black zero'). This is not a fiscal rule but a political commitment. In the current circumstances, it implies a tighter fiscal position than full use of the available space under the national Debt Brake rule would generate (between 0.2 and 0.3 percent of GDP in 2016–17; see also text table "Germany: General Government Operations" on page 7 of the report). The staff's advice is for the full use of such space to finance long-term growth friendly policies, primarily public investment in the short-run, which entails the largest fiscal multipliers.

- We would encourage the authorities to consider reprioritizing spending within the social benefits category. As indicated in past consultations, recent pension measures which result in shorter working lives for certain workers could be revisited. In addition, current untargeted child benefits which are not tied to incentives for parents (particularly mothers) to return to employment could be phased out in exchange for larger investment in childcare.

4. ***The staff suggests reprioritizing spending items within the budget envelope as a way to support public investment when the fiscal space becomes lower—could staff comment on the potential space of such resource reallocation?***

Could staff comment on the additional investment implied by the recommendation to make "full use of the room available under the fiscal rules"? The chart in figure 4 suggests this is quite small—can staff please clarify, under its projections, how much room for additional investment is available within the fiscal rules?

- In 2016–17 the difference between the general government's structural balance and the limit imposed by the MTO is ¼ percent of GDP. This difference rises to 0.4 percent of GDP in 2018. To fund the remainder of the public investment program (1.3 percent of GDP) over 2016–18 a reallocation of some 0.1 percent of GDP per year should be sufficient. We think this is feasible.

Public and Private Investment

5. ***The staff's comments on a more nuanced assessment of the efficiency of public investment and factors holding back private investment?***

Could the staff comment on the desirable additional actions to further improve efficiency and effectiveness of public investments?

- Public investment efficiency is relatively strong in Germany (PIE-X score of 0.96 compared with an advanced economy average of 0.87). However, there are important differences across levels of government, with municipalities in particular having lower planning and administrative capacity. The PPP framework, very strong at the federal government level, could also be improved at the municipal level (for details, see selected issues paper for the 2015 Article IV staff report on Germany). The federal government is taking steps to contribute in this direction, including through the revamping of its PPP advisory agency, Partnership Deutschland, change its ownership structure towards government ownership (rendering it more attractive for small municipalities to recur to its services) and extending the scope of advice to all investment projections (regardless of procurement or financing methods).

- Concerning factors holding back private investment growth, declining potential growth as well as still considerable downward risks are the most relevant factors.

6. ***Could the staff comment on the scheduling of the transport investment plan and the possibility of bringing budgetary allocations forward to have a tangible short term fiscal impact?***

- The 15-year transport investment plan put forth by the government is expected to be somewhat back-loaded. As an illustration, although the average investment amount would be over 17 billion per year, the current plan envisages investments of about 13 billion euro for 2016–18 (increasing from EUR 12.2 billion in 2016 to 13.3 billion in 2018). Some of the investment could be brought forward, using the space available under the fiscal rules. However, due to capacity constraints, it is unlikely that investment increases within a single year could exceed 0.5 percent of GDP.

7. ***Could staff comment on measures the authorities could take to incentivize private investment, in particular, as Mr. Meyer mentions, to help achieve the "Energiewende" and boost innovation?***

- The policies recommended by staff (public investment, structural reforms to expand labor supply, competition-enhancing reforms in the services sector) would all lead to stronger private investment. In addition, as stated in #20 of the report, staff welcomes the authorities' initiative to facilitate private investment in the digital infrastructure. Concerning the Energy Transition, in past consultation staff raised concerns that the high cost of electricity and regulatory uncertainty might be factors holding back private investment in some sectors. The authorities are moving to contain costs. A key recent measure has been the decision to auction off access to the grid by renewable producers. It is not yet known if this measure will be effective.

8. ***Could staff comment on the expected growth differential from staff recommendations versus the authorities' planned spending on investment, including possible inter-generational effects?***

- To address public infrastructure investment needs, staff has called in 2014 for additional investment of 2 percent of GDP over four years. Additional government commitments since then amount to about 0.7 percent of GDP. Further hiking public investment by the remaining 1.3 percent of GDP is estimated to increase real output positively by 1.6 percent (calculations based on the fiscal multipliers estimations discussed in the selected issues paper of the 2014 Article IV staff report on Germany). Investing in public infrastructure contributes to Germany's potential output in the long run, benefitting future generations.

External Sector

9. ***Noting the behavior of oil prices and the exchange rate are supporting the current account surplus, even amidst lower external demand from some trading partners;***

staff also points towards unspent terms-of-trade windfall—could staff provide a breakdown of the impact these factors play in the current account surplus? Could staff explain why we are not seeing any impact from the ULC deterioration on the current account? How does ULC deterioration add up with an estimated undervaluation of the REER of 10–20 percent?

- To precisely pin down the effects of different factors on the current account is very difficult. A shorthand answer to the question of unspent terms-of-trade windfall—which assumes everything else constant—is to compute the difference between the oil and gas trade balance in 2014 and 2015. This amounts to 0.6 percent of GDP.

- In our baseline scenario higher ULC eventually leads to higher REER and a lower current account surplus, but pass-through is typically long as firms first absorb higher wages in profit margins.

- ULC have been rising steadily over the last five years, but they come from a very low level and there is therefore no contradiction between a rising ULC and still sizable REER undervaluation. Also, in 2015, the CPI based real exchange rate depreciated in effective terms by 5.3 percent from its 2014 average primarily because of nominal bilateral depreciations vis-à-vis the U.S. dollar and the RMB.

10. ***Comments from staff on the differing perceptions about the issue of rebalancing of the external account?***

- The authorities expect a slow rebalancing through market forces and view it as satisfactory, while staff thinks that policies can speed up the rebalancing, while also helping to increase German potential growth.

11. ***Noting that staff expect the current account surplus to decline only over the medium term, to what extent will the projected pace of decline aid in global and regional rebalancing?***

12. ***Could staff provide an estimate or range for the cumulative impact of the recommended structural labor market reform measures modeled in the selected issues paper on Germany's current account over the medium term, relative to the baseline estimate?***

Could staff comment on the possible combined spillovers of the set of reforms outlined in the report measures on Germany's partners?

- The recommended structural labor market reforms have positive but small trade spillovers to the rest of the world, which are commensurate to the effect of each policy on Germany's domestic demand and the importance of trade linkages. Combining the three policies under the assumption that the ECB's monetary policy remains at the zero lower bound during three years—as is done in the SIP—gives rise to significant positive feedback loops as inflation and inflation expectations rise in the rest of the euro area, pushing down the real interest rate. At a 3 years' horizon, GDP is higher by 0.2 percent in the rest of the euro area and the German current account declines by 0.5 percent of GDP.

- The current account surplus is projected to decline to 6.8 percent by 2021 from 8.5 percent in 2015. It is difficult to assess what is the precise effect of this decline on regional and global imbalances, because forecasts of the evolution of these imbalances reflect a variety of factors. However, model simulations of policies that reduce the German surplus (for instance higher public investment, or reforms to expand labor supply) show that such policies lead to an improvement in the current account of the rest of the euro area.

13. ***How do staff view the trade-offs of Germany investing its savings domestically versus overseas in terms of the contribution to the global demand and, hence, growth and employment?***

- Concerns with large current account surplus arise primarily from the possibility that such surpluses finance unsustainable deficits, exacerbating imbalances in other countries.

Wage Growth and Inflation

14. ***Could the staff comment on the likely effects of proposed rebalancing on growth and inflation?***

- The three labor supply policies proposed by staff (the macroeconomic effects of which are presented in detail in Chapter 1 of the selected issues paper) and the recommended increase in public investment (the macroeconomic effects of which are presented in Chapter 3 of the 2014 selected issues paper, and in IMF WP 14/227) would reduce the current account and boost growth in the short to medium term. The net short term effect on inflation would be positive but muted as the policy measures not only stimulate demand but also boost potential output.

15. ***The staff's comments on the reasons of a weak pass-through from wages to inflation.***

- The decline of import prices has enabled firms to offset increases in the compensation of employees over the past several quarters. The Bundesbank has argued that, in addition, strong competition in the retail sector has helped contain price pressures in that sector. Finally, the residential rent component of the CPI (which has a weight of 20 percent) has a high degree of inertia.

Housing Sector

16. ***Could staff provide approximate estimates of the contribution to higher housing prices from lower neutral interest rate?***

- Estimating the neutral interest rate is a challenging task, especially for an open economy like Germany, and staff did not attempt such an estimation for this consultation.

- Recent studies have estimated the relationship between housing prices and interest rates in Germany. In particular, a recent ECB working paper (WP No 1904 / May 2016) has found that the elasticity of real housing prices to the nominal mortgage rate is about -0.12. Given that nominal mortgage interest rates have halved since mid-2009, this result would suggest that changes in nominal mortgage rates have boosted real housing prices by 8–9 percent since mid-2009.

17. ***The staff expects residential investment to respond faster than in the recent past to surging housing demand—could staff elaborate on the possible pace of achieving an adequate supply response? What was the authorities' reaction to staff's proposal to adjust the efficiency of real estate taxation by increasing property taxes through an update of property values and reducing real estate transfer tax rate to help incentivize new construction?***

- The government expects its 10-point action plan to have visible positive effects on residential construction volumes from 2017 onward. The success of this action plan will crucially depend on actions taken by sub-national levels of government, so the federal government has been reluctant to communicate on specific volume targets.

- The federal government indicated that negotiations with Länder about a reform for the valuation of properties were ongoing and but that no time schedule had been set. The Ministry for the Environment (and Construction) viewed a reduction in the real estate transfer tax favorably, but explained that Länder (who set the tax rate) did not.

18. ***Can staff elaborate on the underlying causes that would account for such a marked change in the responsiveness of construction to house price changes?***

- The selected issues paper puts forward a number of likely reasons for this phenomenon. One key reason is the decreasing availability of building land in high demand areas. Other reasons include a decreased acceptance by the public of new construction projects in inner cities, inadequate staffing at planning and building authorities (as the recent changes in demographic patterns were unexpected a few years ago), greater regulatory uncertainty (e.g. with respect to rent control), and higher real estate transaction tax rates.

19. ***Could staff comment on the share of the affordable housing segment and its impact on the overall housing prices, particularly in large cities?***

- The staff has not conducted an analysis at this level of granularity for lack of publicly available data. A September 2015 study by a German think tank (the Pestel Institute) analyzed the gap between actual construction and construction needs by type of dwelling and found that all of the gap (about 150,000 dwelling units per year for the next 5 years, against 250,000 new dwellings actually constructed in 2015) is accounted for by the categories of social housing and affordable rental housing.

Banking and Financial Sector

20. ***Could staff comment on how the structure of the German banking system—with the distribution of assets among private, saving and cooperative banks—contributes to the German banking system's relatively low profitability?***

- The structure of the German banking system is discussed in more detail in the TN on stress testing. Specifically, about 40 percent of banking sector assets concentrate in commercial banks (including the big banks), and about 40 percent in public savings banks and cooperative banks combined (please see table below). The savings and cooperative banks have relatively conservative business models that focus on maturity transformation and rely on net interest margins. According to the FSSA, the relatively large share of the savings and cooperative banks have in part contributed to the low profitability in the German banking system, in the current low interest rate environment. The sensitivity analysis for less significant institutions (largely composed of savings and cooperative banks) in the FSAP also shows that the persistently low interest rates weigh significantly on their profitability. The euro yield curve is much flatter than the U.S treasury yield curve, with 30Y-1m term spreads at 1.5pp and 2.4pp, respectively, which weighs heavily on German banks' net interest income.

Germany: Banking Sector Structure in 2010 and 2015

	2015			2010		
	No. of institutions	**Total Assets** (euro bn)	**% of total (assets)**	**No. of institutions**	**Total Assets** (euro bn)	**% of total (assets)**
All categories of banks	**1803**	**8053.5**	**100.0**	**1919**	**8354.1**	**100.0**
Commercial banks	273	3175	39.4	280	3023.5	36.2
Big banks	4	2025.2	25.1	4	2084.8	25.0
Regional banks and other commercial banks	162	878.9	10.9	168	735.1	8.8
Branches of foreign banks	107	270.9	3.4	108	203.7	2.4
Public savings banks	425	2189.1	27.2	439	2546.4	30.5
Landesbanken	9	1060.3	13.2	10	1463.5	17.5
Savings banks	416	1128.8	14.0	429	1082.9	13.0
Cooperative banks	1048	1084.4	13.5	1140	967.5	11.6
Regional institutions of credit cooperatives	2	291	3.6	2	262.5	3.1
Credit cooperatives	1046	793.4	9.9	1138	705	8.4
Other banks	57	1605	19.9	60	1816.6	21.7
Mortage banks	17	384.7	4.8	18	719.5	8.6
Building and loan associations	21	213.4	2.6	24	198.9	2.4
Special purpose banks	19	1006.9	12.5	18	898.2	10.8
Memo: Foreign banks	141	950.7	11.8	150	888.1	10.6
of which: Banks majority-owned by foreign banks	34	679.8	8.4	42	684.4	8.2

Sources: Deutsche Bundesbank. Latest available data: May 2015.

21. ***Noting that bank profitability remains low for German banks overall, reflecting the low interest rate environment, and suggesting a need to adjust the banks' business models, besides changing the business model and restructuring those banks that need it, are there other policy implications from these new results?***

- The implications of low equilibrium interest rates are wide-ranging. The WEO Chapter "Perspectives on Global Real Interest Rates, April 2014, for instance, points out that low equilibrium rates may induce all financial institutions, and especially the ones that propose guaranteed return products (e.g., pension funds, life insurance), to adopt riskier behaviors to increase returns. Appropriate micro- and macro-prudential oversight will therefore be critical to avoid the building up of systemic risks. Low equilibrium interest rates also complicate the task of monetary authorities as the zero lower bound on interest rates will bind more often and may hamper efforts by central banks to get the right amount of accommodation in downturns. On the other hand, lower real interest rates help fiscal sustainability by lowering the cost of financing public debt.

22. ***The staff views on whether one should be concerned about the loosening of bank lending standards (as noted in the staff's report paragraph 6)?***

- Paragraph 6 of the FSSA highlighted the risk associated with the low interest rate environment which could potentially lead to "search for yield" by banks and insurers. However, it does not make statement/inference on the loosening of bank lending standards. Based on the April results of the Bank Lending Survey (BLS) in Germany published by the Bundesbank, the credit standards for loans to enterprises were eased marginally, but credit standards on mortgage loans were tightened after the implementation of the Act Implementing the Mortgage Credit Directive and Amending Commercial Rules (Gesetz zur Umsetzung der Wohnimmobilienkreditrichtlinie und zur Änderung handelsrechtlicher Vorschriften). In addition, credit standards in the consumer credit segment remained virtually unchanged on balance.[4]

23. ***Could staff expand upon its assessment of the quality of the risk weighting applied by German banks to their assets? Also, could staff comment on the relatively higher leverage among German banks and why the price/book ratios for the large German commercial banks appear weaker than their peers?***

- RWA density of German banks is about 30 percent, on average. While lower compared with the U.S. banks, German banks' average risk-weights are not too different from EA peers average and other G7 countries average (about 40 percent):

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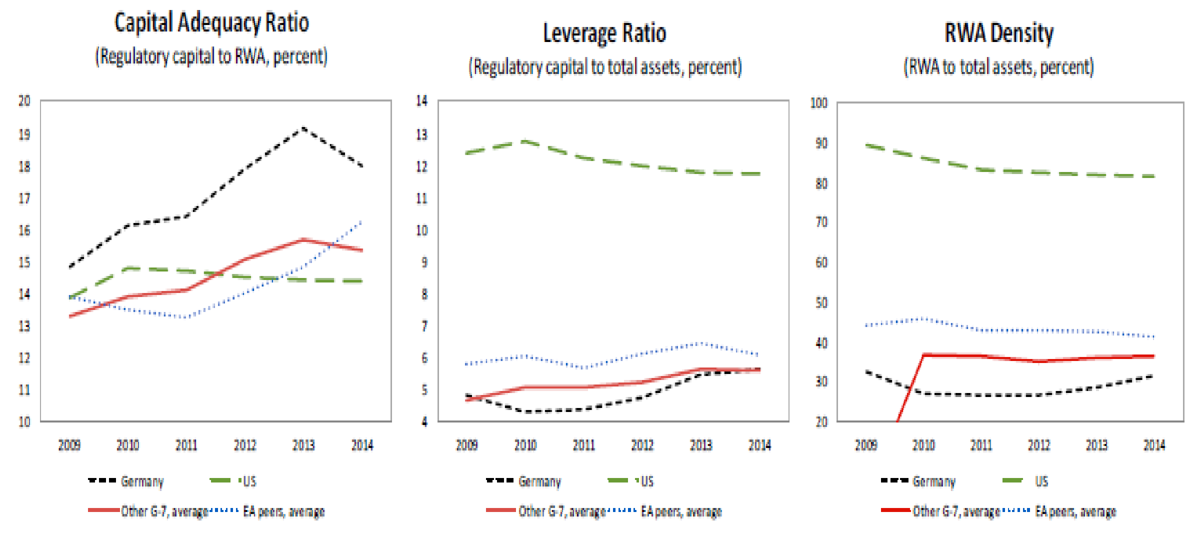
[4]https://www.bundesbank.de/Redaktion/EN/Pressemitteilungen/BBK/2016/2016_04_19_bank_lending_survey.html



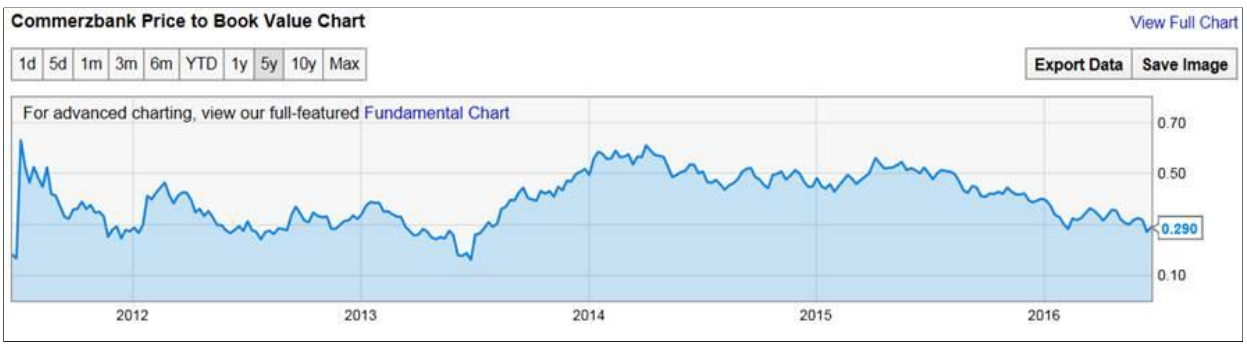
Source: IMF, EBA, ECB. IMF staff calculations.

- Several factors can explain the low density: Mortgages make up the lion's share of exposures, and generally have low risk-weights owing to low probabilities of default and collateralization. Similarly, sovereign debt instruments on banks' books largely enjoy a zero risk-weight treatment. Furthermore, many large German banks use internal models for calculating capital requirements, which typically reduces RWA density. In 2015, 64 percent of the Significant Institutions' (SI) exposure was under the Internal Ratings Based (IRB) approach, which is exactly the average of European SIs directly supervised by the ECB. The German SI's share of assets with modelled risk weights is below the French (66 percent), Dutch (85 percent), and British (72 percent).

- High leverage (or low ratio of capital to assets) could certainly be a concern. While the capital to assets ratio for Germany (5 percent) is much lower compared with U.S. banks (12 percent), it is comparable to that of EA peers (6 percent) and other G7 countries' average (5 percent). Furthermore, almost all banks' risk-weighted capital ratios are very well above regulatory minima, providing substantial buffers against potential losses on a risk-adjusted basis. Stress tests showed that the largest banks are sensitive to shocks but that in most banks capital buffers are sufficient to absorb scenario losses. As limits to leverage become binding going forward, we expect leverage to come down.

- The low RWA density and low P/B ratios are related to banks' business models, in that, the low RWA density partly reflects banks' reliance on the traditional maturity transformation business models together with sizable mortgage exposures (but little investment banking and trading activities). This traditional business model has proven challenging for bank profits in the current low interest rate environment with highly compressed interest rate spreads. The concern on part of the investors have been reflected in the equity prices of the large German banks and contributed to the low P/B ratios.

- Price-to-book (P/B) ratios for the largest German banks have indeed declined sharply since 2014. For Deutsche Bank, the P/B ratio fell from about 0.76 in January 2014 to 0.3 in June 2016, and for Commerzbank from about 0.58 in January 2014 to 0.29 in June 2016. While major banks have generally experienced a decline in their P/B ratios, the current levels for the largest German banks are much lower compared with U.S. banks (Goldman Sachs at 0.81, Morgan Stanley at 0.74) and moderately lower compared with European peers (BNP Paribas at 0.58 and Credit Suisse at 0.55). The low level of P/B ratios of German banks in part reflects investors' concerns about low profitability associated with challenged bank business models, structurally high operating costs, potential further litigation costs, and a likely increase in funding costs as requirements for bail-inable debt become effective.



24. ***On withdrawal of correspondent bank relationships by major German banks, could staff comment on further works in this area in particular providing more granularity (on the extent of the withdrawal and the driving forces)?***

- The forthcoming SDN on the withdrawal of correspondent banking relationships (CBRs) provides a factual account of the trends in termination of CBRs by global banks. While citing a lot of survey evidence as well as specific country details, the SDN does not cover the quantitative impact assessment of a loss of CBRs. To the best of staff's knowledge, countries have yet to collect sufficiently granular information to be able to undertake a quantitative exercise regarding the drivers or impact. Furthermore, the short time series of available information (given the recent emergence of the problem) further limited a quantitative analysis.

- Informal discussions with the SDN LEG/MCM team have guided area departments' in their surveillance engagement with country authorities on this matter on a voluntary basis. This work is still in a nascent stage. MCM and LEG hope to include a quantitative assessment—drawing on specific country evidence collected by area departments—into the forthcoming Board paper to be finalized in early 2017.

25. ***On underlying forces behind the recent trends in correspondent banking relations by global banks, could staff clarify whether access to these relations was more restrained for certain operations, for example clearing payments in U.S. dollars?***

- Discussions of the FSAP team with German banks and supervisors underscored the multiplicity of drivers behind the withdrawal of correspondent banking relationships. Ongoing review of business strategy by the largest German banks may have played a role alongside cost-benefit considerations and regulatory compliance concerns. These discussions did not indicate a particular currency bias. However, other staff work and available survey evidence (for example the World Bank surveys) indicate that the payments denominated in U.S. dollar have been particularly affected, possibly owing to the U.S. dollar's central role in correspondent banking relationships given the predominance of the U.S. dollar in global trade and financial activity.

26. ***Could staff clarity its advice "to encourage German banks to better manage risks around these relationships" as a means to preventing excessive curtailment of activities?***

- The staff urged authorities to encourage banks to assess the risks that they face in specific situations using the risk-based approach required under the 2012 Financial Action Taskforce (FATF) standard and to apply risk mitigation tailored to the risks of a specific customer or product, with a view to preventing unnecessary curtailment of legitimate financial activities. The risk-based approach is intended to assist in the prioritization and efficient allocation of resources in the long-term, by allowing greater flexibility in adopting mitigating measures commensurate with the ML/TF risks identified by the bank. In practice, this translates into the implementation of additional preventive measures to mitigate higher risks (e.g., enhanced due diligence), while allowing for simplified preventive measures where the risk is proven to be low. Proper implementation of the risk-based approach may lead to instances of withdrawal of correspondent banking relationship on a case-by-case basis, where a correspondent bank is unable to conduct the required level of customer due diligence to mitigate the risks identified, or where it has reason to believe that the respondent bank is involved in ML/TF activity. However, it in principle should not result in wholesale curtailment of these activities with entire categories of customers or countries.

27. ***Could staff comment on how do data protection standards in Germany compare to those of other similar countries? What is the experience at the EU level to cope with data protection issues in the context of financial stability purposes?***

- The issue of data protection was raised by the German authorities during the FSAP discussions. Unlike the authorities in a number of other EU countries, the German authorities do not have access to the granular data (e.g., loan-by-loan and collateral data) required to calibrate real estate-related macroprudential policy tools, like loan-to-value ratio or debt-to-income ratio limits. The authorities pointed to Germany's stringent data protection law as an important constraint in obtaining access to such data.

- Germany's data protection standards strictly limit the use of data collected for one purpose to be used for another purpose. In the context of the FSAP, the team recommended amending the Federal Data Protection Law to allow judicious use of granular data already collected from banks for other purposes (related to consumer protection, bank supervision, etc.) also to be used in the macroprudential context, while maintaining adequate privacy protection and complying with the data subjects' rights.

28. ***Did staff speak with the SSM in its work on the German Article IV and FSAP, and what views did the SSM offer on the German banking system and its health?***

- The FSAP team spoke with all entities responsible for the supervision of German banks, including BaFin, the Bundesbank and the ECB. The ECB, as supervisor of significant institutions in the euro area, was involved in the discussions on supervision, as expressed in the ROSC and in the DAR, as well as in stress testing and vulnerabilities exercises, as reflected in the TN. All authorities involved provided excellent collaboration and access to aggregate and individual bank supervisory information, which has been the basis of the team's assessment of the German banking system, as well as excellent engagement in policy discussions. In particular, the ECB supervisors and financial stability staff concurred with staff's overall risk assessment and emphasis. Discussions focused inter alia on solvency stress test results, implications of latest trends in the shipping industry, liquidity and conditions on the funding market.

Labor Force and Structural Reforms

29. ***Does staff have any early evidence that the significant reduction of marginal employment (so-called mini-jobs) has had an impact on poverty and inequality? Can they provide an early estimate of the Gini-coefficient?***

- This is a complex question. Not all workers in mini-jobs are poor or low income (many mini-jobs are second jobs, and many mini-job workers are in double-income families). Second, the net wage may not rise as a mini-job is converted to regular job following the minimum wage introduction, because in the regular job the worker has to pay the employee share of social security contributions and the minimum wage is gross of these contributions. It is not known to what extent this has happened. In addition, for workers receiving supplemental social assistance, a wage increase typically brings about some withdrawal of social assistance benefits, so that the effect on poverty may be somewhat muted.

30. ***The staff's comments on the advice on the income taxation, whether they generally consider joined income tax splitting as a constraint on labor market participation?***

- In the context of a progressive income tax system, the joined income tax filling (a result, in the case of Germany, of the constitutional provision for income splitting within married couples) leads to an especially large marginal income tax rate for secondary earners. This acts as an important constraint to labor market participation or the increase in number of hours worked for the second earners. A significant reform of the system would require changing the constitution.

31. ***The staff's comments on their proposal to exempt the refugees from the minimum wage? Noting that similar exemptions are applied to long-term unemployed, could staff comments further on the argument in support of staff's proposal, whether the same objectives could not be achieved through other measures?***

- Indeed, similar effects could be achieved through temporary wage subsidies for employers, also mentioned in #24 as a specific example of an active labor market policy. Such a policy, as mentioned in Box 3, has been found to be successful in other countries. However, subsidies would have a budgetary cost.

32. ***The policy measures put in place including the removal of certain restrictions on employment and training will be helpful in the authorities' efforts to promote a successful labor market integration of the refugees, although the cost of these measures is likely to be small, could staff provide further elaboration on this issue?***

- According to Eurostat, the per student public spending on vocational (post-secondary non-tertiary) education was EUR 5.5 thousand in 2013. Assuming a per student cost of the additional training of a similar magnitude, the cost to the government would be under 0.15 percent of GDP (per each year of training) for the 2015–16 refugee wave.

Other Issues

33. ***What are the growth implications of the decline in the number of monthly asylum seekers from a peak of 200,000 in November 2015 to 16,000 in April 2016?***

- This decline is built into staff's growth projections for the staff report. Stronger flows in 2016 would have implied an even larger fiscal expansion in 2016 and slightly higher growth in 2016–17.