January 29, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/60-3

2:30 p.m., June 29, 2018

3. Germany—2018 Article IV Consultation

Documents: SM/18/156 and Correction 1; and Supplement 1

Staff: Kozack, EUR; Kaufman, SPR

Length: 1 hour, 16 minutes

Executive Board Attendance

C. Lagarde, Chairman

Executive Directors	Alternate Executive Directors
M. Mkwezalamba (AE)	
D. Sembene (AF)	
A. Armas (AG)	
H. Jang (AP)	
A. Tombini (BR)	
Z. Jin (CC)	
C. Hurtado (CE)	
N. Horsman (CO)	
	C. Just (EC)
H. de Villeroché (FF)	
	K. Merk (GR)
	H. Joshi (IN), Temporary
A. Leipold (IT)	
	Y. Saito (JA)
J. Mojarrad (MD)	
H. Beblawi (MI)	
	N. Jost (NE), Temporary
T. Ostros (NO)	
A. Mozhin (RU)	
	R. Alkhareif (SA)
J. Agung (ST)	
	P. Inderbinen (SZ)
S. Riach (UK)	
M. Claver-Carone (US)	

C. McDonald, Acting Secretary
J. Morco, Summing Up Officer
R. Smith Yee, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: A. Modi. European Central Bank: A. Meyler. European Department: R. Chen, E. Detragiache, J. Kozack, A. Mineshima, A. Musayev, J. Natal. Institute for Capacity Development: R. Young. Research Department: M. Dao. Strategy, Policy, and Review Department: M. Kaufman, M. Takebe. Statistics Department: L. Kemoe. Western Hemisphere Department: J. Goncalves Pereira.

Executive Director: D. Mahlinza (AE), S. Meyer (GR), M. Raghani (AF). Alternate Executive Director: P. Fachada (BR), A. McKiernan (CO), L. Palei (RU), H. Razafindramanana (AF). Senior Advisors to Executive Directors: W. Abdelati (MI), M. Choueiri (MI), C. Collura (IT), W. Kuhles (GR), T. Ozaki (JA), G. Preston (AP), M. Sidi Bouna (AF), T. Sitima-wina (AE), A. Tivane (AE). Advisors to Executive Directors: A. Abdullahi (AE), A. Arevalo Arroyo (CE), K. Carvalho da Silveira (AF), L. Cerami (IT), D. Crane (US), J. Garang (AE), G. Kim (AP), N. Komura (JA), M. Merhi (MI), G. Nadali (MD), A. Nainda (AE), L. Nankunda (AF), A. Park (AP), B. Parkanyi (NE), M. Svenstrup (US), K. Lok (CC), J. Montero (CE).

3. GERMANY—2018 ARTICLE IV CONSULTATION

Mr. Merk submitted the following statement:

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

The German economy has been performing well and its performance continues to be strong, sustainable, balanced, job-rich and inclusive. Driven by domestic demand the upswing is ongoing, while increasing supply-side bottlenecks are reflected in strong wage growth and in higher domestic inflation. Employment is continuing to increase and unemployment is expected to fall to a new record low in 2019. In line with our commitments at the European and national level, public government debt is decreasing towards the debt ceiling of 60 percent of GDP. Reliable social safety nets are securing the inclusiveness of growth.

We broadly agree with staff's views on the near-term outlook and the challenges in the medium term. We emphasize that potential growth is set to slow down over the medium term. Like staff we see the main risks and challenges to the outlook stemming from external factors and from Germany's demographic profile. The aging of the society is one of the major obstacles for stronger potential growth. However, further increases in labor participation especially of women and the elderly, a reduction in long-term unemployment as well as qualified immigration may mitigate the negative economic and fiscal impact of the decline in working age population to some extent.

Fiscal Policies remain forward looking, prudent, and growth friendly. The fiscal stance in Germany is mildly expansionary, in spite of an increasingly positive output gap. Public investment in physical and human capital will be increased further. The new government is committed to tackle still existing capacity constraints for public investment at the municipal level and to simplify tax administration to improve business climate. The phasing out of the solidarity surcharge will reduce the labor tax wedge.

Having said this, we do not agree with the assessment that there remains ample fiscal space after implementation of current government plans. Against the backdrop of the significant challenges stemming from an aging society, we see a strong case for using the opportunity to build buffers for the time to come. We see a balanced federal budget as an important guide post to anchor expectations which can serve as an anchor of stability not only for

Germany but also for the euro area. Preserving fiscal sustainability in the face of demographic challenges and rebuilding buffers for unforeseen but probable events, like a future economic downturn, is of utmost importance. Moreover, all levels of government must be prepared for a normalization of interest rates.

My authorities reiterate their view that the German current account surplus is a result of private sector decisions in international trade as well as in domestic saving and investment and not of domestic policy distortions. To a considerable degree the current account surplus is explained by the rapidly aging population. Therefore, we expect that the current account surplus will decline in the years to come, especially when the baby boomers will retire. Also, differences in expected GDP growth domestically and abroad and trading partners' policies help explain the surplus. It is not fully clear whether these factors are adequately reflected in the models used by the staff to evaluate current account balances. Therefore, we would like to stress that a cautious interpretation of EBA "norms" is warranted, given the high model and estimation uncertainty. The same is true for the REER estimates: In contrast with the IMF assessment, the Bundesbank currently does not consider the REER as significantly undervalued, and instead assesses German price competitiveness to be neutral within reasonable error bounds. Methodically, we would reiterate the view that on a global scale—since Germany is a member of the European Monetary Union—the euro area balance should be the primary reference for assessing the significance of current account developments.

We agree with staff's assessment that more analysis on the rise of corporate savings is needed. We also see a need for a more multilateral scope of analysis and reporting on current account developments, encompassing trading partners' macroeconomic policies as well as the role of monetary policy, exchange rate developments and other external factors.

The ongoing more robust wage growth will further strengthen domestic sources of growth. However, we highlight that wage increases cannot be set politically. Wage setting is left to social partners. This decentralized process for wage bargaining is highly valued in Germany and communication by officials has often been seen as politicizing social partners' negotiations.

We agree with staff that higher domestic investment is desirable. In the past years Germany has already implemented various measures to promote domestic investment, and there is a commitment to do more in the new coalition agreement, including investment in education, e.g. increased supply of all-day childcare and all-day schools; expansion of training for refugees, which will help to integrate refugees in the workforce; investments in the expansion of high speed internet and 5G network, while public investment must not crowd out private investment.

Germany launched various initiatives that will strengthen potential growth and incentivize private investment in a sustainable, forward-looking, and cost-efficient way:

The new government will support digital transformation through investments in digital infrastructure and an improving supply of skilled labor. The Federal Government aims at rolling out comprehensive gigabit networks. Additional public investment will predominantly be aimed at rural areas, where private investments could not be expected in the near future.

The new government will continue the transition to renewable energy sources while reducing uncertainty in the energy sector for private investors.

Labor supply will be strengthened and the new government will make it more attractive to extend labor market participation. Furthermore, there are plans to further support vocational training and life-long-learning, invest in the integration of refugees, promote the reconciliation of work and family life for all, and safeguard the fairness of labor markets.

Support of R&D to small and medium sized enterprises as well as measures to improve the framework conditions for venture capital will help to stimulate investment and innovation.

We agree that greater competition in product markets are warranted but are not convinced about staff's recommendations regarding reforms in the professional services. We consider many of the existing regulations to be justified by legitimate concerns guarding against potential deterioration of quality and consumer protection standards.

We broadly agree with staff on their assessment of the housing market and the financial sector. The housing sector has, in recent years, been characterized by rising prices, in particular in the major German cities. Our authorities are monitoring the housing market closely and do not see any immediate risks to financial stability stemming from this market. In this context a lack of substantial credit growth or deterioration of credit standards, and households' strong balance-sheets are reassuring. At the present juncture, they do not consider the activation of borrower-based macroprudential tools to be warranted. The financial sector as such is resilient, capital buffers in the banking and live insurance sectors are deemed comfortable, and restructuring is ongoing, albeit slowly. At the same time, the low interest rate environment and strong competition remain challenging for the financial sector.

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

We thank staff for their interesting report which highlights Germany's continued strong economic performance in 2017, underpinned by solid domestic demand and a rebound in exports. Inflation and wage growth picked up somewhat, reflecting an even tighter labor market and unemployment below most estimates of natural rate. The fiscal position strengthened further and the current account surplus declined as both the trade and income balances deteriorated. While the short-term growth outlook is favorable, unfavorable demographics and productivity trends will weigh on potential growth and put pressure on public finances. Commendable efforts continue to prioritize domestic investment in physical and human capital, while also addressing poverty risk among some groups to prepare for the future, and we thank Mr. Merk for the update on these policies in his informative buff statement. Risks to the outlook are tilted to the downside, with Germany being vulnerable to increased protectionism and rising anti-EU or anti-globalization sentiment.

The current account surplus declined in 2017, although it remained high at 8 percent of GDP. We note the authorities' view that the current account is the result of private sector decisions and not of domestic policy distortions, although they concurred with staff on the desirability of promoting higher domestic investment. We see the importance of demographic factors in explaining Germany's high savings rates and join the authorities in stressing that a cautious interpretation of EBA "norms" and REER estimates is warranted, given the high uncertainty in the model and estimations.

Germany's fiscal policies have been an anchor of stability in the euro area. The fiscal position continued to strengthen in 2017 and the public debt ratio is declining, creating fiscal space. The measures outlined in the new government's coalition agreement are, therefore, welcome as they would lead to a moderate fiscal stimulus in the medium term. The authorities and staff concur on the priorities for fiscal policy, namely, the need for further increases in public investment and the importance of addressing investment bottlenecks at the municipal level. The authorities, however, disagreed with the assessment that there remains ample fiscal space after implementation of current government plans. Preserving fiscal sustainability in the face of demographic challenges and rebuilding buffers for a future economic downturn are of utmost importance for them, as conveyed by Mr. Merk. We would appreciate staff's comments on the authorities' views on the lack of space at the federal government level due to both the "black zero" (an informal fiscal guidepost aimed at no new debt at the Federal level) and Germany's national fiscal rule.

Tax reforms, including the reduction in the solidarity surcharge and the unemployment contributions, would reduce the tax wedge, and we take positive note of the additional measures considered, namely the reduction in bracket creep. We see merit in staff's suggestions regarding the pension and labor market reforms, investing in digital infrastructure, and introducing greater competition in products' markets.

We commend steps taken so far to encourage the banking and life insurance sectors' restructuring and improve their profitability, although additional efforts will be needed to improve cost efficiency and address remaining legacy issues. The staff's analysis in Annex IX indicates that house prices are estimated to be more than 20 percent above their fundament level on average in major German cities. In this connection, we see merit in staff's recommendation to lower the effective burden of tax on new construction and reexamine zoning restrictions, in particular where demand is not likely to abate. With the absence of regional credit statistics and granular loan information preventing a full assessment of potential financial stability risks in specific market segments, we welcome the concurrence between the authorities and staff on the need to address data gaps in the housing sector. The staff consider that, in addition to the loan to value (LTV) caps and amortization requirements, which were introduced in 2017, income-based instruments, such as the debt-to-income ratio and the debt-service-to-income ratio, should be added to the legislation and considered for early activation. The authorities assess financial stability risks corresponding to real estate markets to be low and do not concur with staff's latter recommendation. Can staff comment on the authorities' arguments that macroprudential tools would face legal obstacles and that microprudential tools are available and can be effectively used to address bank-specific concerns?

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

We thank staff for the report and Mr. Merk for his informative buff statement.

Supported by previous structural reforms and robust domestic and external demand, Germany has maintained solid growth momentum in recent years. However, the rising tempo of growth has tightened labor market conditions and pressurized wages; inflation rose to 1.5 percent in end 2017 compared to 0.4 percent in 2016. However, going forward, inflation is likely to stay below the target rate of 2 percent in the medium term due to a gradual slowdown in growth owing to demographic transition and weak productivity growth. On the negative side, the outlook for Germany is clouded by downside risks from protectionism, a hard Brexit, anti-euro/EU sentiments, policy uncertainty, stalling of reforms, entrenched bank legacy problems, which could be aggravated by the withdrawal of monetary stimulus by the United States. All these have the potential to renew financial stress with implications for exports and investments.

The fiscal sector is marked by the accumulation of general government surpluses which reached 1.2 percent of GDP in 2017 and will climb to 1.4 percent in 2019, before declining in the medium term reflecting a moderately expansionary stance in the coming years. While the current fiscal position indicates the availability of substantial fiscal space under the European fiscal rule, Germany's investment rate continues to lag and remains among the lowest in advanced economies. We would like to encourage the authorities to use this fiscal space for productive investments especially in infrastructure and human capital. These initiatives will help correct external imbalances and create positive spillovers for Germany's trading partners. In this context, we are encouraged to note the new government's willingness to increase investment in physical and human capital. We welcome the new government's budget proposals that include additional spending and tax/surcharge cuts aimed at addressing poverty risks. Could staff provide an estimate by which the CA would rebalance if the general government surpluses were to be fully utilized for supporting enhanced investments?

Further, high domestic savings, low investments and declining household consumption have resulted in large CA surpluses lending considerable strength to Germany's external position which stands better compared to the Fund yardstick of medium term fundamentals. We echo the staff view that rebalancing of the external sector based on further increase in wages would not only increase domestic demand but also facilitate the normalization of monetary policy going forward. Could staff comment on the authorities' disagreement with the reported apportionments of a part of CA gap attributed to domestic policy distortions?

Although banks are adequately capitalized and NPLs are declining, their ability to generate capital is weighed down by poor operating efficiency and profitability. Banks need to adapt their business models to reduce operating costs to enhance profitability. Improving operational/cost efficiency of banks would enable competitive pricing of credit and encourage investments to facilitate economic growth and rebalancing. Pushing further consolidation among small and mid-sized banks is pertinent for improving overall efficiency. Could staff suggest how consolidation among small and mid-sized banks could be further incentivized? On the other hand, larger banks should consider the implications of the implementation of Basel III regulations on risk weight/'output floor' and related costs of compliance. Although increasing long-term yields since 2016 have improved the solvency ratio of German life insurance industry, the sluggish pace of transition from guaranteed to flexible return products is of concern. Does staff agree with the comfort taken by the authorities from long transitional period available for compliance with Solvency II against the prospective outlook on interest rate/yield movements? We encourage the authorities to implement a comprehensive package to enable faster restructuring, restoration of profits and reduction of interest rate risks in the banking and life insurance sectors to solidify financial stability.

Measures aimed at boosting investments and productivity would serve to unlock Germany's economic potential. The ample fiscal space available at the general government level needs to be harnessed for use in infrastructure projects and for investing in education and skill building to foster productivity growth, private investments and employment. We encourage the authorities to support this endeavor by addressing capacity constraints and by promoting municipal level investments. In this connection we support staff advise on prioritization of Partnerschaft Deutschland (PD) promotional services to municipalities where public investments are delayed. Given the demographic outlook, implementation of suitable tax, pension, and labor market reforms are warranted to incentivize and boost employment of women, elderly and migrants to reduce poverty risks. We welcome the authorities' commitment on rapid integration of refugees into the labor force. Embracing competition enhancing structural reforms such as promoting entrepreneurship and venture capital investments would serve to foster private investment. Among other priorities, advancing digital and energy transformation and augmenting competition in the services sector would ease business costs and spur innovations and efficiency. Could staff comment on the authorities' emphatic arguments against their suggestion regarding reforms in the professional services?

We wish the authorities the very best in future endeavors.

Mr. Ostros submitted the following statement:

We thank staff for their insightful report in the context of Germany's Article IV consultation. We also thank Mr. Merk for his informative buff statement.

Despite the softening of growth at the beginning of the year, the German economy is performing well, providing an opportune time for policy measures aimed at raising its long-term growth potential. While solid domestic demand is expected to marginally ease the sizable current account surplus, the saving vs investment imbalance remains. These developments point to the need to increase investments in Germany that would raise productivity. This would also help the desirable rebalancing within the euro area. Addressing demographic challenges will also require active labor market policies and further pension reforms that can increase labor market participation.

Macroeconomic Developments

Following a soft patch in early 2018, the German economy is expected to continue its strong performance; at the same time, incentivizing investments should be made a priority. Solid growth in recent years has brought the unemployment rate to record lows, opened a positive output gap and pushed capacity utilization to above its long-term average. Under these tight market conditions inflation and wage growth have picked up and are expected to increase further. Nonetheless, inflation will remain below but close to 2 percent in 2018-19. In this context, it is somewhat surprising that investments as a share of GDP have stayed below the level that characterized past decades. Future business opportunities may be dimmed by slow productivity growth and the negative effect of an ageing population on labor supply, holding back private investments. In addition to a gradual moderation towards its potential, substantial downside risks weigh on growth linked to a possible escalation of trade tensions and a potentially more damaging Brexit scenario.

We agree with staff's assessment that the current account is higher than what fundamentals and desirable policies would imply and that the real effective exchange rate is undervalued. The current account surplus has declined slightly from its peak in 2015 but remained elevated at 8 percent of GDP in 2017. We note the fact that while the overall surplus has not changed significantly, staff reported an increase in the surplus vis-à-vis other euro area members (i.e., in relations where the nominal exchange rate did not play a role) implying that Germany's surplus with the rest-of-the-world has declined. We feel that more detail about how the analysis took this into account would have been useful. Moreover, we consider, like staff, that only a small part of the current account gap can be attributed to domestic policy distortions, notably to fiscal policy, and that the persistent weakness of investment is a key issue, which requires policy action. While an increasing number of people reaching retirement age would certainly help moderate the current account surplus in the medium- to long term, a sustained rise in wages and higher investment would constitute a more direct and earlier correction. The ensuing positive effects on growth and euro area inflation would not only be beneficial for Germany (improved terms of trade; higher potential output) but also foster the sustainability of the adjustment undergone by countries with high external liabilities. Finally, we take note of the differences between the REER misalignment estimates of staff and the Bundesbank and recall that the results of the European Commission's models fall closer to those of Fund staff.

Fiscal Policies

We largely concur with staff recommendations on using available fiscal space to strengthen Germany's growth potential and support its rebalancing. The headline budget balance further strengthened in 2017, mostly due to cyclical factors; whereas the fiscal stance is assessed as broadly neutral with the structural balance remaining flat at 1 percent of GDP. Taking into account the planned measures of the government's coalition agreement, fiscal policy is expected to be moderately expansionary in the coming years; although fiscal space in relation to the EU fiscal rules would remain substantial. However, in the context of a positive output gap and in view of risks related to domestic and international factors, the challenge for the authorities is to use fiscal policy space prudently to enhance the sustainable economic potential.

We found the assessment by staff, which identified that fiscal space would primarily exist at the regional and municipal government levels, useful. We also welcome the authorities' commitment, as mentioned in the buff statement, to tackle capacity constraints at the municipal level that constrain investments. Nonetheless, we would call on the authorities to devise a comprehensive investment plan that comprises all levels of the government and which could also catalyze or complement additional investments by the private sector.

Financial Market Policies

Sustaining profitability remains the biggest challenge for German banks. Banks have increased their regulatory capital ratio but suffer from low profitability. Banks should therefore tackle their high cost-to-income ratios by working on income sources and improving their technical infrastructure. There is also the need to adapt business models by continuing to refocus activities to improve their readiness should financial market tensions arise.

While current real estate developments may not be a source of immediate concern, strengthening the macro-prudential toolkit would be an important preparatory measure. While, at the aggregate level, house price developments, the pace of credit growth and household indebtedness do not show worrying signs, there seem to be a few housing market hot spots developing in bigger cities that warrant the continuous attention of the authorities. For this reason, we concur with staff that a pre-emptive strengthening of the macroprudential toolkit (e.g. through the introduction of income-based limits) and closing the existing real estate data gaps would be essential.

Structural Policies

To counter challenges associated with an ageing population, Germany must boost its productivity growth and increase labor market participation. Notwithstanding positive overall impact of past structural reforms, additional reforms are needed to mitigate longer-term risks stemming from demographic developments and slow total factor productivity growth. In this regard, we welcome the commitments in the coalition agreement and encourage the authorities to implement these structural reforms to boost the labor supply of women (e.g. improving child-care facilities), older workers (e.g. upgrading their skills and lengthening working lives) and migrants (further improving their language education and training) which would attenuate the impact demography will have on the labor force. We note in this regard that some pension reforms in recent years unfortunately may have increased such risks, by shifting additional burden on younger and active generations. The other strand of reforms must concentrate on raising productivity growth through, for instance, updating the country’s physical and digital infrastructure; we are encouraged by the commitments to invest in digital infrastructure in the coalition agreement. Furthermore, it is important to remove the high regulatory barriers in the business services sector and regulated professions; and reinvigorate entrepreneurship by improving access to venture capital. Government initiatives to simplify tax administration and provide tax incentives for R&D to small- and medium-size enterprises are steps in the right direction.

Mr. De Lannoy and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Merk for his informative buff statement. We take positive note of Germany's strong economic performance and the underlying prudent economic and fiscal governance of recent years. While we disagree with staff that Germany should use up its entire fiscal space—given non-negligible internal and external risks—we do agree that the economic upswing should be used to prepare the German economy for future challenges, including those linked to digitalization. We welcome the positive trends regarding wage developments. We associate ourselves with Mr Ostros and would like to make the following points for emphasis.

We remain to be convinced about staff's approach to assess the availability of fiscal space, and the appropriateness of its use. In effect, staff lists a number of external and internal downside risks to the continuation of Germany's economic success, including risks from an uncontrolled exit of the United Kingdom from the European Union, the rise of protectionism in Europe, and strained international trade relations, which are critical for Germany's export-oriented industry. Regarding internal risks, developments related to the integration of refugees and an ageing population seem to warrant close monitoring and careful policy deliberations, potentially weighing on both federal and local government budgets. We agree with staff that Germany has a sound fiscal track record which gives favorable conditions to access the market with limited risk to debt sustainability. At the same time, we find the availability of budgetary room for maneuver towards European and national fiscal rules relevant, not only, but also for Germany, allowing to deal with uncertainties and potential future adverse developments. For that reason, and considering the positive output gap, we do not share staff's assessment that Germany should "use its entire fiscal space," irrespective of reference value. Similarly, we note that debt levels are still above the Stability and Growth Pact (SGP) benchmark of 60 percent of GDP. We can retrace the government's desire to adjust these levels in times of economic upswing. Such a prudent policy stance appears to be in line with the 2018 WEO recommendations. Finally, we do support staff's call for pension reform.

That said, we agree with staff that it is expedient to promote and prioritize cost-effective public investment. Preparing the German economy to rapidly transforming industries, and digitalization in general, will require important investment efforts. We welcome the announcements and steps taken by the government to that effect. Regarding infrastructure investment, we take note of the stagnating public capital stock and the bottlenecks that exist at the local level. We welcome the efforts at the federal level to alleviate Länder und Kommunen both financially and logistically. We believe that public resources can play an important role in this context and do not necessarily agree with the authorities that public investment crowds out private investment. Targeted public spending can, under the right circumstances, lead the way and help attract private investors and incentivize entrepreneurs. This holds in particular in times of technological change. Here, ICT infrastructure or e-government are examples where efforts remain necessary. While they are challenges faced by the entire membership, automatization and digitalization will require particular attention in Germany given i.a. the high level of job automatability. We therefore support staff's call for continued investment in human capital and other intangibles, including R&D, and welcome the authorities' acknowledgement of the challenges that lie ahead.

Regarding financial market policies, we agree with staff that supervisory attention remains warranted. We encourage the authorities to close data gaps and strengthen the macroprudential toolkit to be able to adequately assess and address risks in the real estate market. The implications of low profitability of German Banks vis-à-vis its peers should also be monitored. We welcome the continued reduction of NPLs.

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

We thank staff for the report and Mr. Merk for his thorough statement. The German economy continues to experience a broad-based upswing, buttressed by solid fundamentals and sound macroeconomic policies. Private consumption has benefitted from thriving labor market conditions, while strong external demand has been supporting exports. While the changes in the political landscape do not envisage drastic policy deviations, growth is expected to gradually converge to potential, as the country faces sizeable structural challenges that could affect its long-term dynamism.

Steadfast commitment to fiscal discipline continues to translate into rapid decline in the public debt ratio, creating significant fiscal space. The national fiscal rule and the "black zero" federal guideline have effectively anchored fiscal policy and strengthened public finances, contributing to rise fiscal surplus to 1.2 percent of GDP in 2017. The combination of strong growth and contained current and capital spending are expected to lead to an even higher fiscal surplus in 2018-19. Consequently, the debt-to-GDP ratio is projected to decline further, falling to around 56 percent of GDP at end 2019. The favorable budget position should allow for a more accommodative stance to support growth in the near term, as recommended by staff.

Progress in external rebalancing is key for Germany and the rest of the world. The current account surplus remained high in 2017, despite narrowing from record highs in 2015-16. According to staff's external sector assessment, Germany's external position remains substantially stronger than implied by medium term fundamentals and desirable policy settings, and the real effective exchange rate (REER) is estimated to be 10-20 percent undervalued. The combination of sustained fiscal surpluses, modest wage growth, and low investment vis-à-vis high saving rates driven by the country's aging population, continues to fuel Germany's competitiveness, contributing to robust trade surpluses. We associate ourselves with staff's views regarding the desirability of fostering an increase in public and private investment to reverse this trend. We take note that the Bundesbank considers the REER to be close to equilibrium.

Household indebtedness ratios have been slightly trending down, but housing prices have risen across major cities. Leverage and debt-service-to-income ratios among German households remain low relative to OECD peers, and have been declining in recent years. Nevertheless, the housing market is facing pressure in major urban areas, causing residential prices and rents to rise faster than income. While financial authorities are effectively monitoring market developments, we see merit in staff's recommendation to consider activation of macroprudential tools given house prices uprising trend and the data gaps that hinder a full risk assessment.

The banking sector remains resilient, but profitability is still low. The compound effect of structural factors and low interest rates continues to cause a substantial drop in profits among traditional financial intermediaries. In particular, some systemic institutions continue to underperform given their high operational costs and legacy issues, including regulatory violations. Accelerating cost restructuring across the banking sector is critical to restore profitability and reduce stability risks.

Despite recent strong performance, the German economy is on a long-term trend to lower potential growth. An unfavorable demographic outlook and the associated drop in the labor force are not expected to be offset by immigration. In addition, productivity growth has been slow in recent years, particularly in the services sector. Concerted reform efforts at the federal and subnational levels to boost labor force participation of women and older workers, as well as to elevate the human capital investment, especially among low-skilled workers and refugees, are warranted to boost potential growth.

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

We thank staff for a well-written report and Mr. Merk for his informative buff statement. The German economy continues to perform well, registering robust growth, low unemployment, strong fiscal and external positions, while the banking sector continues to be sound and resilient. We commend the authorities for these achievements, which confirm that prudent policies and comprehensive structural reforms pay off over time. We broadly share staff's risk assessment, policy conclusions, and recommendations and we would like to focus our comments on the following issues.

We welcome the indication that fiscal policy will be moderately expansionary in the coming years benefiting from the new government's fiscal measures of 1½ percent of GDP to support long-term growth and increase social spending, including on the integration of refugees. We note, however, that staff considers that fiscal space would remain substantial, specifically at the state and municipal government levels, and suggests additional public investment in physical and human capital. The authorities disagree with staff assessment on fiscal space while agreeing with the priorities for fiscal policy. On balance, and considering the declining trend in public debt ratio, we encourage the authorities to be proactive and use any available space within the fiscal rules to further boost public investment, which would also help external rebalancing. Efforts are also needed to alleviate administrative bottlenecks to investment at the municipal level.

On the housing market, we agree with staff on the importance of monitoring developments in those major cities where house prices are overvalued. Like staff, we encourage the authorities to address data gaps to help assess risks to financial stability. We note, however, that this is a long-standing recommendation, now judged as urgent by staff, and we would appreciate some clarifications on why progress has not been achieved in this important area.

We welcome the further progress in the implementation of the 2016 FSAP recommendations, detailed in Annex V, and note that the banking system is adequately capitalized, although profitability remains low, particularly for large banks. We therefore agree with staff on the need for accelerating restructuring in the banking and life insurance sectors and for continued supervisory attention to progress in implementation.

We support staff policy recommendations to reinforce structural reforms to boost productivity growth and private investment, noting from the staff report that "new business creation in Germany has been on a declining trend for a decade." This latter observation seems to be confirmed by Germany's low ranking in the category "Starting a Business" of Doing Business 2018. However, we are surprised by the ranking itself (113 over 190). To what extent this ranking is consistent with staff's own analysis? The staff's elaborations would be welcome. In any case, this reinforces our view on the importance of caution in using TPIs, particularly when ranking is involved.

Finally, we would have preferred more outward spillover analysis in the staff report in view of the importance of the German economy both regionally and globally. We also encourage staff to include in the staff report only summaries of the SIPs and not the whole text.

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

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

Underpinned by sound policies and skillful management, the German economy has performed very well in recent years. After surprising on the upside in 2017, growth is projected to remain robust even if somewhat lower in 2018; the widening positive output gap is putting upward pressure on inflation; and the unemployment rate has reached record lows. The fiscal surplus continues to increase; the current account surplus remains very large; and the public debt-to-GDP ratio is rapidly declining and is expected to reach 45 percent in 2023. Progress on structural reforms, however, has been slow and uneven. While the economy is expected to continue to grow strongly in the near term, unfavorable demographics and weak productivity growth weigh on potential output over the medium to long term. We concur with the thrust of staff appraisal and, given downside risks to the outlook, including a significant rise in global protectionism, encourage the authorities to use the current cyclical upswing to decisively address looming challenges and help raise long-term growth potential.

The ample fiscal space within the fiscal rules, primarily available at the state and municipal government levels, should be used to increase investment in physical and human capital and boost the labor supply of women, older workers, and migrants. We welcome the new government's budget proposal that envisages 1.5 percent of GDP in additional spending and tax cuts, spread over the next four years. However, further measures are needed to address bottlenecks to public investment at the municipal level, increase education spending, expand childcare and after-school programs, reduce the labor tax wedge on low-income households and secondary earners, explore incentives for lifelong learning, and enhance opportunities for refugee integration. We are pleased to learn from Mr. Merk's helpful and concise buff statement that the authorities have taken several measures in these areas, including expanding training for refugees to help them integrate into the workforce. Pension reform should also be considered to help lower the public pension bill, extend working lives, mitigate risk of old-age poverty, reduce the need for precautionary savings, stimulate investment, and facilitate external rebalancing.

The financial system is well capitalized and liquid, with low and declining NPLs. However, low net interest margins, high cost structure, and provisions for compliance violations weigh on banks' profitability and erode their ability to generate capital. They need to de-risk portfolios and adapt business models, reduce interest rate risk, and restore profitability by accelerating the implementation of restructuring plans, developing more fee-based revenues, and further consolidation. Life insurers should continue shifting away from guaranteed return products to more flexible ones, reducing duration gaps, and consolidating. We underscore the need for continued supervisory attention to financial risks and restructuring plans in both sectors.

Rapidly rising and overvalued house prices in some major cities together with data gaps that prevent a full assessment of risks in the housing sector require close attention and early action. We welcome government's renewed support for social housing, and see merit in reexamining zoning restrictions and lowering the effective tax burden on new construction to help expand supply and mitigate price pressures. Consideration should also be given to strengthening the macroprudential toolkit by including income-based instruments and activating existing tools at an early stage. Could staff elaborate on legal obstacles to early activation of borrower-based macroprudential tools?

Structural reforms to support entrepreneurship and venture capital, complete digital transformation, advance energy transition, and increase competition in product markets remain essential in promoting private investment, enhancing productivity, and boosting growth potential. Support for early-stage financing for start-ups should be complemented by provision of scale-up capital and expansion of e-government services. We welcome plans to increase public investment in digital infrastructure and agree on the need for supportive regulations and adequate funding to attract private sector investment. Promoting public transportation, supporting the use of e-vehicles, and phasing-out coal-fired power production could be elements of a credible strategy to reduce greenhouse gas emissions. We appreciate staff indication of the government's goals in this area, and how likely they are to be reached. More also needs to be done to enhance competition in network industries and professional services.

We wish the authorities continued success.

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

We thank staff for their comprehensive report and Mr. Merk for his insightful buff statement. We associate ourselves with Mr Ostros' gray and will mainly focus our comments on the wage dynamic, the fiscal stance and structural reforms and their contribution to raising potential growth while reducing external imbalances.

Being the largest economy in the euro area, Germany's economic developments and policies naturally need to be considered in this broader context. We praise the German authorities for sustained and robust economic performances, which are reflected in its growth rate and a record low unemployment. We also salute the authorities for their involvement in renewing the EU deepening, with the recent Meseberg declaration illustrating the common European ambition shared by our two countries. Going forward, we concur with staff that the economic outlook for Germany will be heavily impacted by external developments and political decisions related to trade relationships with its principal partners. In addition, as in most other advanced economies, unfavorable demographics and low productivity weigh on potential growth.

In view of the large positive output gap assessed by staff, in contrast with the European Commission assessment, we would like to have their view on the main drivers behind the desynchronization of European economic cycles.

Against this background, policies supporting public and private investment along with an intensification of wage dynamism would help boost potential growth while supporting the desirable reduction of the current account surplus and rebalancing in the euro area.

We welcome the recent wage increases, that are more in line with productivity and inflation expectations, and encourage the authorities to sustain this dynamism. We appreciate the analytical work conducted by staff on the drivers of wages moderation as well as their efforts to forecast the pace of wage dynamism going forward. The record low unemployment and the recent negotiated agreements should ensure more sustained wages and prices increases going forward, therefore facilitating the normalization of the monetary policy. Having said that, in view of Germany's external position, that remains substantially stronger than implied by medium-term fundamentals and policies, a more forceful action in raising wages is needed. At the current pace, the realignment of price competitiveness within the euro area would be excessively gradual. While we support staff recommendation to emphasize the benefits of wage dynamism acceleration in the authorities' public communication, we see other avenues for policy action. In particular, we invite the authorities to consider raising the minimum wage further, strengthen the public wages and increasing their role in wage bargaining.

The current economic environment provides favorable conditions to prepare for the future via increased productive investment. The annex on government investment in Germany presents useful information and cross-country comparison on the level and efficiency of public and total investment. In view of the low level of public investment compared to other advanced countries and the erosion of the net capital stock of infrastructure and education since the early 2000's, there is scope for improvement in these areas. While the substantial fiscal space created by fiscal consolidation can support public investment in physical and human capital, private investment and increased labor force participation should also be enabled. Increased investment would also support the rebalancing.

The new government's coalition budget features welcome measures but the fiscal expansion remains limited. The substantial fiscal space under the European rules should be used more forcefully, including through measures sustaining investment. Indeed, staff projects a stability of public investment in 2018 and a marginal increase in 2019 (+0.1 percent of GDP). Although the fiscal space is ample, it is mainly located at the regional and municipal levels due to the national debt brake. Yet, bottlenecks and capacity constraints at the subnational levels might hinder investments. We are less optimistic than staff regarding the capacity of the Partnershaft Deutschland agency to promote municipalities' investment significantly and call for a comprehensive investment plan covering all levels of government. Boosting investment in human capital, including through all-day school and lifelong learning, notably for long term job seekers, is a priority to effectively tackle the ageing challenge and we take note of the authorities' commitment in these areas.

While a series of measures will support the business environment, there is room for fostering private-led investment and growth. We were particularly interesting in staff's analysis of the rise of corporate savings and encourage staff to deepen tits analysis. Considering the high level of NFC's savings, in particular in SMEs, it is worth examining the factors incentivizing firms to increase retained earnings. It seems that the 2000 and 2008 tax reforms fueled, at least partly, it by introducing a favorable tax treatment of retained earnings and reducing corporate tax rates. Would staff recommend a change in this framework in order to boost investment? We would also appreciate if staff could work on the relationship between business creation, entrepreneurship, innovation and potential growth, including through cross-countries analysis.

We welcome the government's plan to make Germany a lead market for 5G application by 2025 and to enhance the promotion of digitalization and ICT competences in SMEs. Moreover, increased competition in network industries and professional services is warranted, although this shouldn't be done at the expense of quality and consumer protection standards. Finally, we agree that a greater labor force participation would help alleviate supply-side pressures in the labor market but also pressures on the pension system. Some tax measures will support it but more should be done, notably regarding childcare. Besides, can staff elaborate on concrete incentives to extend working lives? We also take note that no new action has been taken to tackle poverty, notably among the elderly. The staff's comments are welcome.

Mr. Hurtado and Ms. Sanchez Rodriguez submitted the following statement:

We thank staff for its report and Mr. Merk for his candid buff statement. We associate ourselves with Mr. Ostros' statement and would like to add the following comments for emphasis:

The German economy continues to exhibit strong performance, with robust growth and record low unemployment. Over the cycle Germany has managed to accumulate sizable buffers through savings, both private and public, with the latter leading to ample fiscal space.

Some could argue that an economy in the cyclical position of Germany should refrain from using its fiscal space in a procyclical fashion. We are of the view, though, that there are structural reasons supporting the use of its fiscal space. Rather than to fine tune the economy, we would call on the authorities to invest in their future, tackling low productivity, unfavorable demographics, and infrastructure decline.

We welcome the narrowing of the current account; still, at 8 percent and well above historic levels, it remains too high. Excessive savings have both public and private underpinnings. Using fiscal space could help address the public side of the equation and rebalance the economy. On the private side, the issue of excessive private savings seems more complex. We find staff's analysis on the increase of Non-Financial Corporations savings very insightful; could staff elaborate on why tax reforms, precautionary savings, or the need to build cash buffers for R&D are leading to a decline in dividend payout rates? What is happening in the German economy amidst buoyant exports, robust growth and record low unemployment that small and medium-sized companies still feel the need to set aside precautionary savings? More importantly, the German authorities see the current account surplus as a result of private saving decisions; how can the authorities affect such private decisions through policy action? The staff's comments are welcome.

The flip side of this corporate behavior seems to have been a reduction in households' disposable income. Indeed, the share of consumption over GDP has dropped by four percentage points from its 1995–2005 levels. The staff's calculation stating that were consumption levels to return to the previous norm, the current account surplus would decrease by about 1.4 percentage points, seems very compelling.

On policy recommendations, we commend the German authorities for their various initiatives directed towards the right objectives: strengthening potential growth and incentivizing private investment. Supporting the digital transformation through physical and human capital or extending and enlarging labor market participation are necessary and welcome steps. More specifically, we call on them to invest in early childcare and early childhood education to support female labor participation as well as to reduce the labor tax wedge on low-income households and secondary earners. Also, we fail to see a conflict between consumer protection and further increasing competition in network industries and professional services.

On the housing market, we note that the authorities are monitoring price developments carefully; also, as mitigating factors, we note that credit growth is subdued, there seems to be no deterioration of lending standards and households' debt is low. We are somehow concerned that staff has found some data gaps that prevent it from fully assessing macro prudential risks and urge the authorities to address them.

Finally, the financial sector is generally resilient, with low interest rates and strong competition weighing on margins. Given the exposure to abrupt normalization of interest rates, continued supervisory attention to interest rate risks is warranted.

Mr. Saito and Mr. Komura submitted the following statement:

We thank staff for the comprehensive report and Mr. Merk for the informative statement. The German economy has been performing well. The growth rate marked 2.5 percent in 2017. Also, the unemployment rate has reached post-reunification lows, resulting in a moderate rise in wage growth. Looking ahead, wage growth is expected to accelerate and exceed 3.5 percent in 2019 based on the staff's analysis on the Phillips curve. However, the growth rate is expected to revert toward its potential, around 1.3 percent, which unfavorable demographics, low productivity growth, and a lack of skilled labor weigh on. By utilizing a window of opportunity, Germany needs to raise its potential growth, while building fiscal buffers, to achieve strong and sustainable growth. In addition, the staff report indicates several downside risks, such as global protectionism, a reassessment of sovereign risk in the euro area, and unsolved bank legacy and low profitability. As it is open and integrated, the German economy would be vulnerable to external shocks like protectionism measures. At the same time, German economic developments have outward spillovers given the size of its economy. We therefore look forward Germany to achieving steady economic growth by well preparing and dealing with those risks, and thereby supporting the global and reginal economic activities.

Potential Growth and Fiscal Policy

Germany needs to boost its potential growth. The German economy has similar challenges to other AEs. For example, workforce is expected to begin shrinking in 2020 even after accounting for the recent bold immigration policies. Also, productivity growth has been lackluster. To raise the potential growth, we agree with staff that key priorities include raising public investment, conducting pension and labor market reform, fostering entrepreneurship and venture capital, and investing in digital infrastructure. In this regard, we commend the authorities for recent efforts, such as an increase in supply of all-day child care and all-day schools, expansion of training for refugees, measures to improve framework conditions for venture capital, and expansion of high-speed internet and 5G network.

For fiscal policy, striking the best balance between building fiscal buffers and ensuring spending to raise potential growth is essential. On the one hand, we see needs to build fiscal buffers to prepare negative economic shocks and spending pressures from demographic changes, especially in the current cyclical position. On the other hand, facing stagnated productivity growth, Germany should increase spending in areas to raise its potential growth to keep achieving strong and sustainable growth going forward. Striking the right balance between these two factors is critical for fiscal policy management in Germany. The staff assesses that there is substantial fiscal space under the European fiscal rule, while seeing that fiscal space primarily exists at the local government level rather than the central government level under the Germany's national fiscal rule. Also, staff and the authorities point out that local governments are under capacity constraints regarding both funding and planning. In this context, we would like to ask three questions. First, in which level does staff recommend Germany to primarily increase expenditures, the local government level or the central government level? Second, what specific spending does staff consider it appropriate to increase in the local government level? Third, could staff elaborate on capacity constraint of local governments in more detail? In reality, we consider that if the capacity constraint chiefly means a lack of ability to identify "effective projects," rather than a lack of man power, it would be challenging to have enough capacity in the short-term. Regarding more expansionary fiscal policy, staff considers that such a policy would facilitate external rebalancing. We note that staff estimates show the CA Gap is 3¼ - 6¼ percent of GDP. As a general remark, results arising from the EBA should be cautiously taken. Related to this point, staff made the adjustment on CA norm reflecting uncertainty of demographic outlook and the impact of the recent large-scale immigration on national savings. While the updated EBA methodology better captures the impact from demographics, could staff elaborate more on the justification of incorporating the uncertainty of demographic outlook? Specifically, it appears to us that other countries also face the uncertainty of demographic outlook as well. Could staff comment on this adjustment from the view point of evenhandedness?.

Housing Market

Close monitoring of housing market is needed. At the aggregated level, housing prices are rising moderately broadly in line with economic fundamentals. In contrast, at the city level, housing prices in Germany's major cities are estimated to be overvalued by more than 20 percent above their fundamental level on average. The Bundesbank obtains similar overvaluation estimates. In assessing financial stability risks stemming from extended housing prices, staff and the authorities seem to have different views. In particular, the authorities see overvaluation concerns as localized. Could staff comment on the view? We encourage staff and the authorities to carefully monitor housing market developments and keep discussing their implication for the financial stability risks..

Financial Sector

Accelerating restructuring, improving profitability, and reducing interest rate risks are main challenges for the banking and life insurance sector. The high cost structure and low interest rates continue to weigh on profitability of the banking sector. In addition, while risk-weighted capital stood at comfortable levels and is improving for all categories except large banks, the staff report mentions that the completion of Basel III may have important implications for large German banks. Furthermore, maturity transformation has helped banks and life insurance firms sustain profit margins but exposes them to interest rate risk. We share staff's view that continued supervisory attention to the progress in implementing restructuring plans while upgrading the business model and interest rate risks of the banking and life insurance sectors is critically important.

Mr. Agung and Mr. Sumawong submitted the following statement:

We thank staff for the comprehensive report and Mr. Merk for his insightful buff statement. The German economy continued to grow robustly in 2017, underpinned by domestic demand, with a positive output gap and record low unemployment. The near-term economic outlook remains positive, but Germany is vulnerable to external shocks similar to other open economies. In addition, rising house prices could pose vulnerabilities to financial stability. More importantly, medium-term growth prospects are constrained by demographic pressures and low productivity growth. Against this background, the authorities should address long-term economic challenges together with efforts to safeguard resilience of the financial sector. We offer the following comments for emphasis.

We agree that the policy priorities should focus on raising growth potential through increasing labor supply and improving productivity.

We commend the authorities' strong adherence to fiscal prudence as reflected in a downward trajectory of public debt. We are of the view that fiscal policy could help support long-term growth, particularly given the relatively low level of public investment. We therefore note positively the authorities' plans to increase public investment and address capacity constraints at the municipal level, and encourage the authorities to consider a comprehensive investment plan, as recommended by staff, to help prioritize investment. Further, we are encouraged by the authorities' efforts in integrating refugees into the labor market, but understand that even after accounting for immigration fully, the labor force will still begin shrinking in 2020.

Having said that, we welcome the new government's budget proposal containing growth-enhancing measures, including additional spending on enhancing human capital and infrastructure, and boosting labor supply as highlighted in the buff statement, which are in line with the key priorities in staff's policy advice. Nevertheless, we note that staff recommend the authorities to fully use the entire fiscal space within fiscal rules. In contrast, the authorities disagree on the availability of fiscal space given the "black zero" and the national fiscal rule and the need to build buffers. In this connection, we invite staff to comment on the differing views on fiscal space. Similarly, we note with reservation staff's suggestion for the authorities to utilize the escape clause under the national debt rule in Annex II should risks materialize, and invite staff to provide further explanation on the feasibility of such recommendation.

Structural reforms are essential to promote higher growth over the long term. We see merit in staff's recommendation on expanding e-government services to further support entrepreneurship in addition to the authorities' ongoing initiatives. While progress has been made in the digital agenda including planned additional investment in digital infrastructure, the authorities recognize the shortage of skilled labor as one of the main impediments to faster technological adoption. As such, we agree with staff on the importance of lifelong learning provision to better prepare workers for the future of work. We also agree that enhanced competition in the services sector, particularly in railway, postal, and professional services, can help boost productivity, investment and long-term growth but underscore that this should not come at the expense of quality or consumer protection standards.

We encourage the authorities to continue safeguarding financial stability. We note that the authorities and staff share similar views on the overvaluation of house prices in major cities, despite differing views on the timing of deploying macroprudential tools. On this note, we emphasize that the activation of macroprudential policies needs to be well-calibrated, well-targeted and data dependent. Thus, we encourage the authorities to address data gaps that might hamper the ability to fully assess financial stability risks from housing markets while continuing to closely monitor real estate market developments. Further, we support the inclusion of income-based instruments in the legislation, which is also in line with the 2016 FSAP's and the Financial Stability Committee's recommendation, to have a more comprehensive set of macroprudential tools available. In doing so, we invite staff to comment on how best to address the communication challenge as current conditions, i.e., low and declining debt-service-to-income ratio and low household indebtedness, do not warrant the inclusion of the new policy instruments and in light of the more urgent need to improve housing affordability. At the same time, the German financial sector continues to face challenges from a low interest rate environment and new regulatory initiatives. We therefore agree with staff on the need to accelerate restructuring in the banking and insurance sectors to boost profitability.

We note that the Germany's current account surplus is expected to continue to gradually decline over time as wage increases and population ages. We acknowledge the authorities' reservations over the assessment of German's external position in the buff statement and understand from Annex I that a large part of the current account gap cannot be fully explained by the models. Hence, we join the German authorities in calling for careful interpretation of model-based estimates. We also reiterate our view that staff adjustments remain essential to ensure that the assessments and policy recommendations have sufficiently taken into account country specificities.

Mr. Armas and Mr. Lischinsky submitted the following statement:

We thank staff for the set of reports and Mr. Merk for his helpful buff statement.

The performance of the German economy was qualified as "impressive" in the staff report. There are reasons for that; in 2017 the growth rate was 2.5 percent, job creation also grew strongly, thus unemployment fell to the lowest rate since German reunification, and in turn, nominal wages were pushed up and as was inflation (although still below 2 percent). The social safety net guarantees decent living standards for the population and inclusive growth. The fiscal surplus increased by 0.2 percentage points compared to 2016, the public debt is projected to be reduced and this year the country will achieve the debt ceiling of 60 percent of GDP agreed in Maastricht.

The trade balance, broadened since 2001, continued in 2017 with a surplus over 8 percent, as in the past two years. These figures are well above the interval assessed by staff as being consistent with economic fundamentals and desirable policies. The real effective exchange rate (REER) is estimated by staff to be undervalued by 10-20 percent, which is consistent with the current account (CC) surplus (8 percent of GDP). This view is not shared by the Bundesbank which considers that the REER is not significantly undervalued and the price competitiveness is neutral. In this regard, we would appreciate it if staff could elaborate on the impact of the subsidies and the import tariffs on the current account surplus and REER in Germany. On the other hand, how is the assessment about REER misalignment in Germany compatible with the high financial integration within the euro area, where the CC surplus is lower (about 3.5 percent of GDP)? Should composition of internal savings (households or Firms) be considered in the CC assessment? The staff’s comments are welcome.

We note that policy discussions with staff were centered on addressing medium and long-term challenges to increase growth potential, while rebalancing the economy to increase public investments and reduce the trade surplus. The aging population is seen as one of the major impediments for enhancing potential growth. Solutions could be brought through measures to increase labor participation of women and the elderly, immigration, and the reduction of long-term unemployment. We commend the authorities for the important progress made on refugee integration.

Although fiscal policies are prudent, growth friendly, and an anchor for expectations and stability, there is ample fiscal space, as mentioned in the staff report. On the one hand, the country prefers not only to rebuild buffers for probable events, such as an economic downturn or the normalization of interest rates, but also to deal with demographic challenges. On the other hand, fiscal space could be used, as long as the public debt ratio is on a declining path, to take measures to increase public investments where needed, particularly at the local level. Other investment possibilities are advancing in digital infrastructure, education, childcare facilities, and training for refugees, and several initiatives were launched to strengthen potential growth and reinvigorate competition.

The growth of the aging population, which in the near future will impact public finance, inclines policies to pension and labor reforms that must be balanced with product markets reforms. These reforms would encourage longer working lives, reduce poverty risks, which in turn, could support long-term growth and help external rebalancing.

Risks in the real estate market should be monitored, particularly over-valued house prices in major cities, including loan-to-value caps and amortization requirements. Although the authorities are monitoring the housing market and do not see risks to financial stability, staff calls to urgently address data gaps and the early activation of macro-prudential tools to safeguard financial stability; additionally, surveys in these cities could be conducted to collect information on granular data. Furthermore, the recently approved legislation has not included income-based instruments to avoid an excessive increase of household debt and adding these tools would be warranted. It is just as important to enhance surveillance on banking and life insurance sectors as accelerating their restructuring to increase profitability and reduce rate risks.

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

Mr. Leipold and Ms. Collura submitted the following statement:

We thank staff for their report and Mr. Merk for his buff. We share the staff appraisal, associate ourselves with Mr. Ostros' statement and offer the following comments.

Germany's robust growth provides a window of opportunity to set up the necessary policies to lift potential output and prepare the country for future challenges. Supported by domestic demand and exports, the German economy has been growing at a steady pace, registering rising employment and a record low unemployment rate. Potential output, however, is limited by lackluster productivity growth and adverse demographics. Growth-friendly policies would help mitigate the factors which are restraining investment and encouraging excessive savings, and as such move also toward a reduction of the very high current account surplus. Furthermore, these policies would realize positive spillovers for the rest of the European Union.

Policy action is needed to promote the external rebalancing. Germany's external position remains substantially stronger than implied by fundamentals and desirable policies, and the real effective exchange rate is estimated to be undervalued. We note that only a limited part of the current account (CA) gap is currently attributed to domestic policy distortions (i.e.

domestic fiscal policy and low credit-to-GDP ratio). That confirms the case for envisaging wide-range policies to enhance investment, productivity growth and labor supply to help offset the effects of population aging. In welcoming the authorities' plans to invest in digital infrastructure, we concur with staff's reforms multi-pronged strategy, first on removing all the obstacles to private investment and competition. We note however that fiscal policies to increase fertility appear not to have been discussed with the authorities and would encourage staff to do so in light of the positive experience in other countries (e.g. Sweden).

In the meantime, more sustained wage growth and price inflation are needed to drive REER appreciation and help rebalancing; we encourage the authorities to communicate the desirability of stronger wage growth, while respecting the autonomy of social partners. The recent news about the governments' plans to increase the minimum wage is a positive step. Can staff provide a preliminary assessment on the size of the increase and its impact? The European Commission (European Commission's Country Report, Germany 2018) considers rising income inequality among the factors that explain the CA surplus; this element does not seem captured in staff assessment. The staff's comments are welcome.

The moderate expansion of fiscal policy starting in 2019 is welcome. It comes after several years of fiscal consolidation, which has resulted in a steady debt reduction (according to staff, debt is projected to reach 45 percent of GDP by 2023) but has also contributed to the rise of Germany's external surplus and the decline of disposable income. However, according to staff more incisive action would be needed. While safeguarding the soundness of the fiscal accounts, an appropriate use of fiscal space would help address increasing supply-side bottlenecks, which are also recognized in the buff. The authorities' fiscal plans will not exhaust fiscal space under the European framework, but would almost do so under domestic fiscal rules at the central government level. Fiscal space would remain available at the regional and municipal level where the accumulated investment backlog remains large. To which extent are the policy actions identified by staff under the remits of these levels of government? Have staff met their representatives during the mission? What is the traction of the Fund's advice toward these other levels of government? That said, we join Mr. Ostros in his call on the authorities to devise a comprehensive investment plan that comprises all levels of the government.

Increasing profitability is challenging for the German banking and life insurance sectors as in many other European countries. It requires addressing the high cost-to-income ratio and structural inefficiencies as well as revamping the banking business model. We concur on the need for a pre-emptive further strengthening of the macroprudential toolkit so as to avoid the build-up of vulnerabilities and be able to effectively tackle possible future excesses in the housing sector. In this respect, it is of utmost importance to remedy the lack of regional credit statistics and granular loan information which are necessary to fully assess potential financial stability risks in specific market segments.

Ms. Horsman and Mr. Hart submitted the following statement:

Germany's economy is currently performing strongly, but with a more uncertain medium-term outlook. Growth is robust, employment figures are strong, core inflation is projected to gradually rise from a low level, public debt is falling rapidly, and there are significant fiscal buffers. However, looking further ahead, Germany's growth rate is expected to decline to a modest 1.3 percent due to demographics and weak productivity growth. We thank staff for their frank assessment of the outlook and risks, and Mr. Merk for clearly outlining his authorities' views. We note there is general agreement about the nature of the challenges facing the Germany economy, albeit with a divergence of views on the appropriate pace and composition of the policy response. Since we broadly share staff's assessment, we will limit ourselves to the following remarks.

Germany should take further steps to reduce its external imbalances in an orderly manner. Persistent excessive global imbalances exacerbate the risks of a retreat from economic integration. A disorderly unwinding of these imbalances is in no one's interest. We urge all members to candidly and urgently assess their own role and to ensure they are contributing to unwinding excessive global imbalances to support stronger, more sustainable, and equitable growth for all. While the new German government has taken positive steps in this regard, we agree with staff on the need for a stronger policy response to boost productivity and raise potential growth while preparing to address medium-term demographic challenges. More generally, we support staff in their efforts to undertake a more rigorous, transparent, and consistent approach to assessing the root causes of excessive imbalances.

With significant buffers in place, we agree that part of Germany's ample fiscal space can be usefully directed towards promoting growth-enhancing public investment. The quality of Germany's public capital stock has been declining since the 1990s. Further budgetary measures to promote public investment should be a priority, particularly those aimed at addressing capacity constraints at the municipal level. Efforts being taken by the new government to improve Germany's digital infrastructure are very welcome. These could be supplemented by additional incentives for private sector investment in digital infrastructure.

We agree that Germany should increase incentives for domestic private investment and entrepreneurship. High non-financial corporate (NFC) savings are the main driver of Germany's savings-investment imbalance, but we underscore that NFC investment decisions do not take place in a vacuum: the economic and policy environment in which they operate matters. We encourage the German authorities to further promote a favorable climate for domestic private investment, including through tax incentives for research and development, expanding support for venture capital, and promoting greater competition in network and professional industries. We also support staff undertaking a more granular analysis of the NFC savings issue in future reports.

Stronger wage growth would also help with external rebalancing. The German household share of GDP has steadily decreased over time as their purchasing power has eroded. We note positively that there are signs that wages are starting to accelerate, which should support stronger private consumption and inflation in the euro area. But the trend towards higher wages could also be undermined by the current climate of uncertainty around global trade.

Finally, the combination of Germany's low productivity and adverse demographics suggests the need to invest in higher human capital and increase the labor supply. Labor force participation has made strong gains in the last decade – particularly among women. However, with 65 percent of women with young children working part-time, we support staff's recommendation to further expand childcare programs to provide greater opportunities for women to pursue full-time employment. Pension and labor market reforms that make it more attractive to extend working lives would also strengthen Germany's long-term growth potential. Further, we support staff's recommendations on improving the quality and funding of education and life-long learning (recognizing that that education policy is the remit of the Länder). We also concur with staff on the importance of refugee integration to further anti-poverty efforts and encourage authorities to keep up their efforts in this regard, which may help alleviate demographic pressures.

Mr. Inderbinen and Mr. Weber submitted the following statement:

Continuation of the solid economic expansion is welcome. The stronger-than-expected and broad-based economic growth shows that prudent and sound macroeconomic policies play an important role and continue to benefit Germany. Consumption, investment, and exports—the three main drivers of growth—show no significant weakness. We note, however, that downside risks, in particular those stemming from trade tensions as well as sovereign risks and a lack of structural reforms in the euro area have increased. We thank staff for the good documentation and Mr. Merk for his clear buff statement.

Fiscal space should be used in a prudent manner. The budgetary overperformance essentially results from the economic upswing. In the current situation, proceeds that are of a cyclical nature would best be used to increase fiscal buffers and contribute to an anti-cyclical stance, particularly in view of Germany's unfavorable demographics and the increased uncertainty. Regarding fiscal priorities, we note that government investment spending has been increased in recent years, which will continue. We also see merits in the authorities' plans to address bottlenecks at the municipal level and to use fiscal resources to increase (female) labor supply and improve digital infrastructure.

We welcome the intentions to continue with structural reforms. Germany has a solid record of undertaking structural reforms, and we welcome that the authorities remain committed to this approach. We share staff's recommendation to address adverse effects of looming changes in Germany's demographic composition by increasing labor market participation. We see particular merit in measures aimed at increasing older persons' and women's participation in the labor market, including the tailored tax measures, better day care, and investment in lifelong education. Continued transformation of 'Minijobs' into standard employment relationships would likely also be beneficial. We also suggest removing regulatory burden and to enhance competition in the service sector in order to raise lackluster productivity growth.

Accelerated restructuring in the financial sector would help to enhance resilience. We note that limited progress has been made since last year's Article IV. The banking sector continues to suffer from weak profitability. We concur with staff that accelerating the restructuring process and better exploiting economies of scale would be helpful to strengthen the banking sector's resilience. Given the intensive use of internal risk models, particularly in the large banks, we would have appreciated more analysis by staff on the impact of the ‘output floor’ under Basel III. Also, we note the vulnerabilities of export companies to adverse external developments, including a hard Brexit and trade disputes, which would increase credit risks for German banks. As staff assessment also shows, low interest rates have weakened conditions of life insurance companies. Could staff elaborate on this development, in particular on the exposure of life insurance companies to liquidity and market risks?

Supply side and macroprudential measures would help address housing market vulnerabilities. As the demand side is mainly driven by structural factors that are difficult to address, rising prices would require further measures on the supply and macroprudential side. On the supply side, one possibility could be reducing stringent zoning restrictions and increasing construction capacity. On the macroprudential side, considerations might be given to income-based instruments that take debt sustainability into account. We also see merit in closing existing data gaps to allow a full assessment of stability risks and ensure a tailor-made approach to handle potential house price overvaluations.

Ms. Barron and Ms. Park submitted the following statement:

We thank staff for a comprehensive report and Mr. Merk for his informative buff statement. The positive near-term outlook for Germany is welcome. We agree with the focus on measures to boost potential growth through public investment and structural reforms. It is less clear cut, however, that this requires German authorities to ‘fully use’ the available fiscal space, as recommended by staff. Strengthening the resilience of the financial system remains a priority, given structural pressures on the profitability of banks and insurers.

We do not agree with the assessment that Germany should ‘fully use’ assessed fiscal space. A mildly expansionary stance strikes a reasonable balance between growth-enhancing investment (that is also supportive of external adjustment) and sustaining credible national fiscal anchors, building buffers against downside risks, and avoiding excessively pro-cyclical policy as the economy approaches full capacity.

Public investment in physical and human capital is key to boosting medium term growth. Prioritizing public investment in physical and human capital should not, however, be tied too tightly to fiscal space; room should always be made for high quality investment. Planned investment in education and training and in the expansion of high speed internet and the 5G network is welcome, as are efforts to address capacity constraints for public investment at the municipal level.

We encourage progress with structural reforms to increase labor supply and boost productivity growth and private investment. Measures to address high effective marginal tax rates on low-income households and secondary earners are welcome, as are measures that increase incentives to work for older workers. Structural reforms are also needed to enhance productivity growth and investment, which includes ensuring that regulatory settings support the ongoing shift to digitalization and encourage the provision of scale-up capital to entrepreneurs.

Many of the proposed spending measures and reforms need to be enacted at the state and municipal level. What is staff's view on the appetite for these reforms at the sub-national level? Do the reforms require coordinated action or would there be benefits if the sub-national governments went it alone? Representatives of sub-national governments are not included in the list consulted by the staff team. Is that something that would be done in a future Article IV consultation?

We also see value in monitoring of housing market risks and efforts to strengthen the resilience of the financial system. Signs of localized pressures in housing markets suggest the need for ongoing monitoring, and further work to address data gaps. However, a stronger case needs to be made for the early activation of macroprudential tools in the absence of rapid credit growth or evidence of a significant deterioration in credit standards. Understanding the nature of the macro-financial risks will assist in determining the appropriate policy response. For example, measures that expand the supply of land or encourage construction could have a more lasting impact on property prices. Continued supervisory focus on the implementation of restructuring plans to address medium term sustainability challenges to banks and insurers is also needed.

Finally, we think that it is best practice for the Board to consider European Union level surveillance before the surveillance on individual European Union members. What is the impact of the weaker medium-term outlook for the rest of the EU?

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

We thank staff for the comprehensive report and Mr. Merk for the informative buff statement. We congratulate the German authorities for the impressive economic performance in 2017, including the highest fiscal position and lowest unemployment rate since unification, as well as the progress in public debt reduction. We agree with the thrust of the staff's analysis and would limit our comments to the following.

Rational utilization of fiscal space might help address long-term challenges, while more prudent assessment of fiscal space is warranted. We commend the authorities' expansionary fiscal stance to address the stagnant public investment, and encourage a better coordination between the federal government and local government.

Continuous efforts in promoting external sector rebalance are still warranted. We commend the spending measures proposed by the new government's budget as well as their investment promotion measures, and encourage the authorities to increase their investment and support for other EU countries, especially those countries in stress. Meanwhile, we welcome staff's introduction on the German capital and financial account, which enables us to evaluate the external sector in a more balanced manner. However, we noticed an increase of the policy gap in the German external sector assessment, which is partly due to the methodology shift. We call for a prudent application of the EBA evaluation outcome in surveillance and policy recommendation.

We commend the staff's proposal on strengthening investment on physical asset and human capital, as well as supporting entrepreneurship. Germany carried out the "new 2020 High-tech Strategy" in 2013 and digital economy is one of the six priority tasks, especially the "industry 4.0." We welcome staff's elaboration on the main progress of such strategies and how the government implemented them in the past.

Demographic challenges need to be settled with comprehensive policies. In the short run, we agree to use fiscal space to increase additional labor supply in young women by strengthening the child-care system, reducing the tax wedge on low-income families, and cutting effective marginal tax rate for secondary earners. We also agree with the authorities that structural reform should be ready to foster the hiring of the elderly. In the medium and long run, we noticed that fiscal pressure would increase in maintaining the contribution rate under 20 percent and the replacement rate above 48 percent after 2025, but no reform actions were taken after the 2017 Article IV consultation. We welcome staff's elaboration on what the obstacles are in such reforms.

We commend the resilience of the German banking sector. However, we noticed that large German banks continue to underperform in comparison to its European peers in performance indicators, and the restructuring process remains slow. We welcome staff's elaboration on the reasons why the restructuring process remains slow. With the increased interest rate risk exposure caused by search-for-yield in the banking and insurance sectors, we welcome staff's elaboration on how to contain possible risks of asset revaluation caused by interest rate normalization. We wonder whether the low interest rate is still fit for the whole euro area under the current upward economic cycle, and look forward to discussing it in the upcoming policy report of the euro area in July.

Mr. Mahlinza and Mr. Sishi submitted the following statement:

We thank staff for the comprehensive and well-articulated assessment of the German economy, and Mr. Merk for his informative buff statement. We wish to especially express our thanks to staff for the deeper analysis of the financial account of the balance of payments in Box 1. In addition, having raised the issue of private sector savings in a previous statement, we express our appreciation for the exploration of corporate savings and public investment that is contained in the annexes.

Germany's economic performance continues to impress, with upwardly revised growth rates portending a strong medium-term outlook for debt reduction, sustained full employment and upward price pressures. Nevertheless, the economy continues to face significant challenges due to an aging population and a complex external environment, including within the euro area. In this regard, we encourage the authorities to proceed swiftly with structural reforms to lift potential growth and encourage greater private sector dynamism. We broadly agree with staff's appraisal and wish to make the following points for emphasis.

We would agree with the authorities that the current fiscal stance is consistent with a positive output gap. Nevertheless, demand-pull factors appear evident, including within the labor and housing markets. Accordingly, with the fiscal position broadly stable and government revenues remaining robust at around 45 percent of GDP through to 2021, stronger action is warranted to alleviate the supply constraints. In this regard, we welcome the commitments indicated in the buff statement to address the limited investment by municipalities and to simplify the tax system. We would urge that more concrete progress on these and other initiatives designed to raise productivity and potential output is reported in upcoming Article IV reports. More broadly, the report and buff statement further highlight that the determination of fiscal space and its use remains a sensitive and non-exact science. We would welcome comments from staff on how the Fund proposes to bridge the gap with the authorities on this matter.

We remain sympathetic to the authorities' concerns regarding the EBA norms and estimates of REER valuation in the EBA model. Nevertheless, we are of the view that the country's relatively low investment rate does suggest an REER that is somewhat undervalued. This should be a source of concern for the authorities as it relates to the external balance, given that estimates of the current account surplus over the medium-term continue to rise when compared with those in previous Article IV reports, and that the imbalances are increasing viz a viz other members of the euro area. We also note with interest the observation in Annex VII that corporate tax policy may have played a role in the decision by firms to accumulate cash and avoid additional investments. We would appreciate staff's comments on how the authorities have reacted to this analysis on the tax system and the conclusions thereof.

We welcome the initiatives that are being implemented by the coalition government, including on digital infrastructure investment, boosting employment opportunities for women, and reducing the labor tax wedge, among other things. In addition, in view of the statement regarding household savings in the buff, we wonder whether staff have included estimates of higher spending by retirees in the current baseline scenario and to what extent this affects the levels of projected domestic expenditure and external imbalance.

We broadly welcome the initiatives that are being implemented by the coalition government, including on digital infrastructure investment, boosting employment opportunities for women, and reducing the labor tax wedge, among other things. In addition, in view of the statement regarding household savings in the buff, we wonder whether staff have included estimates of higher spending by retirees in the current baseline scenario and to what extent this affects the levels of projected domestic expenditure and correction external imbalance within this scenario.

Finally, we support calls for improvements in monitoring the housing sector, as well as measures to address data gaps that prevent more granular assessment of financial stability risks. At the same time, it is surprising that banks and non-banks have not pursued cost-reduction and other restructuring measures more aggressively, given low profits within a low interest rate environment. In this regard, we wonder whether enough competition exists in the sector, and whether the additional consolidation referred to in the staff appraisal may not further harm competitiveness and dynamism, even if it creates a more stable system. The staff's comments are welcome.

We wish the authorities well in their future endeavors.

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

We thank staff for the well-written set of reports and Mr. Merk for his informative buff statement.

The German authorities are to be commended for another year of strong economic performance on the back of robust domestic demand, foreign trade and investment. Inflation and wage growth remain moderate, and employment gains have pushed the unemployment rate to a new post-reunification low. While the outlook is for continued expansion, downside risks could stem from rising geopolitical tension, protectionism and limited progress in restructuring major banks. Against this background, we encourage the authorities to steadfastly implement their reform agenda aimed at boosting long term growth prospects and reducing external imbalances, while keeping the public debt on a downward trend.

We agree that one of Germany's key economic challenges is to raise the country's long-term growth potential to help stimulate investment and reduce the current account surplus. Continued policies that increase investment and reduce saving should be helpful in accelerating the necessary adjustment. In this context, we welcome the gains achieved through the Municipal Investment Promotion Program and the Partnerschaft Deutschland (PD) investment promotion measures. To further increase public investment, we agree that efforts need to focus on addressing bottlenecks at the municipal level, expanding school programs to support women, and lowering tax wedges. Furthermore, we encourage the authorities to continue to work on the investment plan, covering all levels of government, in order to help improve investment prioritization. While we note that the tightening labor market has led to an increase in wage growth, thereby contributing to external rebalancing, we wonder to what extent Germany's demographic factors, including migration, would affect the country's external rebalancing over the medium-term, notably through their dampening effect on wage growth? The staff's comments are welcome.

It is encouraging that the fiscal measures envisaged under the new government's budget are prone to promote long-term growth and inclusiveness. In particular, we welcome the additional spending investment in childcare and school programs, housing support, vocational training for refugees, as well as tax cuts for low and middle-income households. However, we share the staff's views that the authorities should take advantage of the substantial fiscal space and the cyclical upswing to further boost potential growth by increasing public investment, labor supply and productivity.

We concur with the staff's assessment that reforms to the pension and labor market are essential to increase labor participation, and reduce excessive saving for retirement. In this regard, we take good note of the progress made toward refugee integration and full-time employment for women. The authorities rightly underscore the political challenges associated with increasing the already high retirement age. In this light, we would appreciate it if staff could indicate what other avenues could be explored by the authorities to boost labor participation?

We welcome the progress made in advancing the German Digital Agenda and fostering entrepreneurship and venture capital investment. Notwithstanding these positive developments, we note that reforms in network industries and professional services have been somehow sluggish. Looking ahead, efforts should be aimed at accelerating regulatory reforms with a view of avoiding discrimination against smaller competitors and new entrants. This will be helpful in raising productivity and fostering private investment.

House price developments, particularly at the city level, should continue to be monitored closely by the authorities. We welcome the introduction of the macroprudential toolkit in 2017 and the steps taken by the authorities to address supply shortage and improve house affordability. Nonetheless, prices continue to rise rapidly at major cities and the absence of data prevents fuller assessment of financial stability risks. As recommended by staff, we urge the authorities to address data gaps and strengthen the macroprudential toolkit with income-based instruments, while standing ready to activate the existing macroprudential tools to preserve financial stability if necessary. Noting that the authorities share the staff's concern over the data gaps, we would be interested in staff's comments on the types of initiatives that are being considered by the authorities to address the existing data gaps?

The financial sector continues to be a concern, as low and flatter yield curves as well as recent regulatory reforms take a toll on profitability. Going forward, we encourage the authorities to expedite restructuring plans in order to improve structural inefficiencies in the banking and life insurance sectors, while monitoring potential interest rate risks. Could staff provide an update on the progress made towards implementing previous FSAP recommendations, including (i) developing a formal coordination mechanism for addressing systemic crises, and (ii) reinforcing contingency planning for the management of a systemic crisis?

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

Mr. Claver-Carone and Ms. Crane submitted the following statement:

We thank staff for the useful paper, including a number of helpful annexes on selected issues, and Mr. Merk for the informative buff statement. We welcome the solid growth record of the German economy. We agree with staff's proposed fiscal and structural policy actions to promote domestic investment, boost labor supply, raise productivity and real median incomes, and accelerate external rebalancing. Prioritizing such measures is a critical component of durably strengthening domestic demand in Germany and achieving stronger and more balanced growth across the euro area. We agree with the thrust of the staff appraisal and would like to highlight a number of points.

Fiscal Policy

We strongly concur with staff's advice that Germany should use some of its ample fiscal space to take more decisive action to raise investment and boost potential growth, beyond what has been announced in the latest budget proposal. We welcome the positive steps included in the new government collation agreement, including high-speed internet expansion, encouraging full-time female employment, and phase out of the solidarity tax. Nonetheless, we urge the authorities to further increase public investment, while working to improve budget execution at the local level. Germany has a substantial fiscal buffer over the medium term in relation to EU rules, even after accounting for the planned fiscal stimulus package. We hope that the staff's analysis showing that German public investment (even accounting for different investment modalities) lags many other advanced economies will prove persuasive. Addressing municipal bottlenecks will be crucial given the increasing role localities are meant to play in public investment under the 2016 reorganization of central-local financial relations. The staff also makes a good case for further reducing the labor tax on low income and secondary earners.

External Sector

We agree with staff that Germany's external position remains substantially stronger than merited by fundamentals and desirable policies, and that Germany needs to take more forceful policy action to contribute to regional and global rebalancing. The large current account surplus will persist over the medium term under current policies. Regarding staff's description of recent developments with the current account, the change in Germany's terms of trade in 2017 rather than being "unfavorable," actually contributed to reducing imbalances. The annex on the Rise of German Corporate Savings describes the link between non-financial corporate deleveraging, which government tax policies have encouraged, and the compression of wages. This shows that both public and private decisions have contributed to excess savings in the German economy. A key challenge is discerning which reforms can most effectively catalyze stronger business investment. We agree with staff that education spending and tax incentives to address shortages in skilled labor could help. Can staff comment on other high priority reforms in this area? We would also note that even a relatively open economy like Germany has room for further trade openness, as the IMF's Working Paper on A Multidimensional Approach to Trade Policy Indicators demonstrates. For example, Germany ranks in the middle of the pack among advanced G-20 economies on average applied MFN tariff and trade-distorting agricultural supports.

Inflation and Wages

Achieving a faster and more durable return of euro area inflation towards its target will require that the euro area economies in the strongest cyclical position—particularly Germany—undergo a period of stronger-than-average inflation dynamics to offset necessary weaker dynamics elsewhere and firmly entrench inflation expectations around the target. Wage growth has an important role to play in supporting inflation dynamics and facilitating Germany's rebalancing. While staff point to positive wage developments in 2018, wage suppression still appears to be weighing on inflation. In this context, we appreciate staff's analysis on the impact of immigration on wages in the annex on Puzzling Wage Developments in Germany, which highlights demand-pull factors. While it is mentioned briefly, could staff elaborate on the possible role of the threat of offshoring on German wage developments?

Banking Sector

We concur with staff advice that large banks should accelerate restructuring plans that include aggressive cost cutting and developing fee-based revenue. We continue to believe that Germany's banks' underperformance relative to peers is partly due to the dominance of public and cooperative ownership, which continues to create a difficult operating environment for private banks.

Housing Sector

We encourage the authorities to closely monitor housing developments in local markets where price pressures are high. Addressing data gaps, as recommended by staff, would help in this regard. We agree with the authorities that micro-prudential policies have an important role to play in containing financial stability risks, but if more granular data reveals pockets of rising housing-related risks then there could be a complementary role for additional macroprudential policy tools.

Structural Reforms

We agree with staff that structural reforms, including tax simplification, tax incentives for research and development for small and medium-size enterprises, and e-government services could help reduce the burden for new businesses. Reforms in this area, combined with reforms that enhance the ability of Federal, regional and local authorities to utilize available funds for investment in human and physical capital, can help boost productivity growth and spur additional private investment, laying the groundwork for longer-term growth.

Ms. Riach and Miss Chen submitted the following statement:

We thank staff for an insightful report, and Mr. Merk for his informative buff statement. We agree with the thrust of staff's analysis and recommendations. The German economy continues to perform well, with unemployment at its lowest rate post-reunification, and wage growth picking up. However, inflation has remained low and the external position continues to be substantially stronger than implied by medium-term fundamentals. While the short-term outlook is robust, Germany's long-term prospects are impacted by its unfavorable demographic trend. We therefore agree with staff that now is the time for the authorities to focus on the future. We associate ourselves with the statement of Mr. Ostros and would like to add the following comments.

Fiscal Policy

We agree that raising long-term growth potential is a key economic challenge for Germany. Increasing the public spend in physical and human capital is one key avenue to raise potential growth, and support external rebalancing. Germany's strong fiscal position means that the authorities face fewer tradeoffs in their policy choices. We note staff's recommendation to "use the entire fiscal space." If Germany's fiscal space is indeed as substantial as staff's view, under the circumstances of a positive output gap with tightening labor market, it is not clear a very large procyclical fiscal stimulus would be prudent.

Addressing Long-Term Challenges

We appreciate the annex on government investments, which is a helpful comparative exercise that provides evidence based recommendation on where the authorities could focus their efforts. There are also lessons to be learnt for others, especially with respect to the high level of spending efficiency demonstrated by Germany. We particularly welcome the authorities' plans to support digital transformations, and believe this could be even more beneficial if it was paired with the recommendation to reduce regulatory barriers for new enterprises especially startups.

The staff point out that productivity growth has been especially lackluster in the service sector. While we agree that introducing greater competition in professional services is important, more analysis by staff on the size of the benefits from liberalizing service sector trade may make the recommendation more persuasive.

Financial Sector

We welcome the rise in regulatory capital ratios but note that leverage remains high. There appears to be little progress from last year's Article IV with respect to addressing the low profitability issues in both the banking and insurance sector. Could staff say more about their view of progress in implementing restructuring plans, and whether greater attention may be necessary?

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

We thank staff for a well-focused report on Germany and Mr. Merk for providing additional details on the authorities' views. We note that the authorities largely agree with staff on the evaluation of current developments and long-term challenges, as well as policy recommendations. We offer a few comments for emphasis.

The German economy continues to grow at a brisk pace, with most estimates pointing to a positive output gap. Unemployment rate is very low, and employment growth is strong. The baseline scenario shows gradual slowdown of real GDP growth from 2.5 percent in 2017 to about 1.1 percent in 2023. Such a projection is based on the expectations of continuing low productivity growth and further ageing of the population, even after taking into account net immigration. In Figure 4 staff compared real GDP growth in Germany with the rest of the euro area. We believe that proper comparisons should reflect the role of the demographics, and ask staff to provide comparisons of GDP per capita growth as well as GDP per working person growth.

The German economy is fiscally fit. Last year the overall fiscal surplus reached 1.2 percent of GDP and it is projected to be even larger in 2018-2019. To some extent, this performance is due to low interest rates. However, even with eventual normalization of monetary policy in the euro area, the German economy will continue to demonstrate fiscal resilience to a variety of possible shocks. We note that the public debt is on a declining path and, by the end of this year, it is expected to return to 60 percent of GDP. The authorities and staff agree that the current fiscal policy stance is mildly expansionary, which is appropriate considering the desirability of somewhat higher inflation in Germany compared to the average for the euro area.

The latter follows from staff's analysis of Germany's external position. Current account surplus remains above 8 percent. All estimates provided in the staff report point to the current account being well above the norm. This is a sign of persistent imbalances in the euro area. While we understand that the German authorities have reservations about the methodology used by staff, we believe that the signs of significant real exchange rate misalignment are present. Accordingly, wage growth and higher inflation in Germany and in other euro area countries in a similar external position would lead to desirable rebalancing within the euro area.

In the discussion of wage growth in paragraph 17, staff advised the authorities to emphasize the need for higher wage growth in their public communications, “while respecting the autonomy of the social partners.” In response to this call, Mr. Merk in his informative BUFF statement emphasized that the German current account surplus was the result of private sector decisions, not the domestic policy distortions. According to the literature on wage moderation, in Germany the government supposedly played a prominent role in wage negotiations leading to restoration of competitiveness in the 2000s. Could staff elaborate on the differences between their views and recommendation to become more vocal in public calls for wage increases, on the one hand, and the position of the authorities, on the other hand?

With these remarks, we wish the German authorities further success.

Ms. Erbenova, Mr. Just and Mr. Hagara submitted the following statement:

We thank staff for an interesting set of reports and Mr. Merk for his informative buff statement. We broadly associate ourselves with the points made by Mr. Ostros and would like to provide the following comments for emphasis.

Germany’s economic performance strengthened further in 2017, supported by both domestic and external demand. The labor share has returned to levels from the early 2000s, while the growth continues to generate jobs, bringing the unemployment rate to new post-unification lows. The tighter labor market has started to feed into higher wages. Wage inflation is expected to accelerate further with the increasingly positive output gap. We welcome staff’s continued focus on the wage/inflation developments, indicating that the traditional Phillips curve works well for Germany with the expected magnitude. Against that backdrop, the decentralized wage bargaining process in Germany doesn’t seem to be creating distortions that would require any form of government intervention. While the analysis shows no significant impact of immigration flows on wage dynamics in Germany, staff’s views on the impact of the minimum wage on the employability of migrants are welcome. We also note that staff usually considers the impact of Germany’s policy actions on large European countries and/or the euro area as a whole. Spillovers to Germany’s supply chain partners, but also to other Central and Southeastern European countries, deserve attention as well.

Germany’s fiscal performance has remained strong, while the fiscal policy stance is expected to be moderately expansionary in the coming years on the back of the new government’s package. The positive fiscal balance is expected to bring the public debt-to-GDP ratio to 60 percent this year and is expected to decline further in the coming years. Against the increasingly positive output gap, an aging population and the multiple risks mentioned by staff, including rising global protectionism, the non-negligible risk of a hard Brexit and unresolved crisis legacies, we consider the prudent fiscal policy stance with a focus on rebuilding fiscal buffers to be appropriate. We do not agree with staff's assessment and advice that the fiscal space should be fully used. We are also not convinced that the risks mentioned in the staff report, as well as the cyclical position of Germany, were taken into account appropriately. Generally, a more neutral interpretation of fiscal space as a buffer that the authorities should try to maintain for bad times would be better suited to adapt to the changes in economic cycles in our view. Having said that, this chair has always been advocating changes towards a more growth-friendly fiscal mix and measures to improve spending efficiency. In this vein, the government package seems to be going into the right direction. Nevertheless, while the recent pick-up in investment activity at the municipal level is welcome, the remaining investment bottlenecks at the regional level need to be addressed.

Germany's key economic challenge is to raise its long-term growth potential. We agree with staff on the need for structural reforms, including enhancing competition in network industries and professional services as well as reforms to make the insolvency regime more flexible. The potential benefits of such reforms would justify possible short-term reform costs and we would have welcomed more emphasis on those reforms in the staff report. We encourage the authorities to take bolder actions so that Germany's strong economic and social outcomes are sustained in the future. At the same time, the gaps in digital services should be addressed, including by promoting competition in the mobile market.

House prices are rising moderately at the aggregate level, but appear overvalued in major German cities. Nevertheless, with respect to only moderate mortgage growth so far, high credit underwriting standards and strong household balance sheets in general, we do not see an immediate need to activate macroprudential tools at this stage. For a full assessment of potential risks, data gaps should be addressed in accordance with staff's recommendation. We welcome the strengthening of the macroprudential toolkit but encourage the authorities to expand it by introducing legally-binding income-based instruments (DTI, DSTI). From a longer-term perspective, sustaining the profitability of German banks remains the main challenge against the backdrop of high operating costs.

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

We would like to thank Mr. Merk for his buff statement and staff for their reports. We associate ourselves with the statement by Mr. Ostros.

The near term economic outlook is for continued solid expansion, but over the medium term unfavorable demographics and weak productivity growth are expected to weigh on output and potential growth. We agree with staff that the German economy has performed very well in recent years, supported by prudent economic management and past structural reforms. Beyond the near-term horizon, supply-side constraints may materialize and we share staff's view that unfavorable demographics and low productivity growth will weigh on potential growth. In the staff projections, the positive stock contributions in 2018 and 2019 are striking and it would be interesting to hear the reasons behind this, as stock contributions are typically kept ex ante neutral over the forecast horizon and we note that in the April 2018 WEO the forecast for Germany did not feature such contributions. We share staff's view that the risks to the outlook are tilted to the downside. A significant rise in global protectionism or a hard Brexit would hurt Germany's exports and FDI and deter domestic investment.

On the nominal side, we share staff's forecast for an increase in underlying inflation and wage growth. We welcome staff's analyses of wage developments and the influence of slack. We would note however that estimation of the Phillips Curve relationship in Germany is surrounded by a very high degree of uncertainty stemming from factors staff mention (like wage moderation after the start of EMU and the Hartz reforms) but also the internal adjustment processes following German reunification. With respect to the role of immigration on wage growth, the approach of staff to try to disentangle compositional from competition effects and to use micro data is well founded. However, the conclusion that immigration has played no role for wage growth in Germany may be too strong, especially against the background of the already-noted high uncertainty surrounding the German Phillips Curve relationship.

We agree with staff's assessment that the current account is substantially higher than fundamentals and desirable policies would imply and that the real effective exchange rate is undervalued. Like staff, we consider that only a small part of the current account gap can be attributed to domestic, notably fiscal, policies and that the persistent weakness of investment is a key issue. This is particularly the case in the non-financial corporate sector notwithstanding some first signs of a gradual reduction of net lending by this sector. An investment boost would trigger an increase in aggregate demand and, as a by-product, real appreciation through a temporary pick-up in inflation as well as a narrowing of the current account surplus. This would have a positive effect on euro area inflation, be beneficial for the German economy (improved terms of trade; higher medium-term potential output) and also foster the sustainability of the adjustment undergone by countries with high external liabilities. We also concur with the staff assessment of a somewhat undervalued real exchange rate. The staff assesses Germany's real effective exchange rate to be undervalued by between 10 and 20 percent. This range of estimate is broadly plausible as estimates may vary depending on the underlying premise of the framework used (e.g. relating the real exchange rate to a set of macroeconomic fundamentals or using external balance models that focus on current account adjustment needs).

Fiscal space should be used to support potential growth and labor supply avoiding—given the current favorable economic situation—a major pro-cyclical fiscal loosening. We broadly agree with staff's view that available fiscal space should be used to enhance the growth potential of the economy, notably by further increasing public investment and fostering labor supply, e.g. by reducing the high tax wedge. At the same time, it is necessary to consider cyclical conditions. If the full degree of available space were to be utilized in the near-term, this would impart a substantial stimulus on the economy. Given that staff estimate that the output gap closed substantially further in 2017, this would be a highly pro-cyclical impulse. Furthermore, in view of the risks related to domestic and international factors, fiscal buffers may be required in the event of an economic downturn so that fiscal policy could be used more effectively in a countercyclical fashion. In this context, the challenge for the authorities is to use fiscal policy space in a prudent and targeted manner to enhance the sustainable economic potential.

In the area of structural reforms, we fully agree with staff that decisive and ambitious policy actions are needed to increase the level of potential output and to address medium-term challenges. Given that staff estimate output to be substantially above potential, we would stress the urgency to reinvigorate the reform agenda in Germany. As some pension reforms in recent years may have increased risks and shifted additional burden on younger and active generations, we concur with staff on the need for pension and labor market reforms to lengthen working lives and counter adverse demographics. Product market reforms and fostering the framework conditions for entrepreneurship can also contribute to increasing potential and attenuating imbalances. We welcome staff's call for reinvigorating competition-enhancing reforms in network industries and professional services. Improved framework conditions enhancing the environment for entrepreneurship, venture capital and also the digital infrastructure, could strengthen private investment incentives.

Sustaining profitability remains the biggest challenge for German banks. Banks have increased their regulatory capital ratio but suffer from low profitability. Banks should therefore tackle their high cost-to-income ratios by working on income sources and improving their technical infrastructure. There is also the need to adapt business models by continuing to refocus activities to improve their readiness should financial market tensions arise.

While current real estate developments may not yet call for the early activation of existing macroprudential tools there is a strong need for the pre-emptive strengthening of the macroprudential toolkit and the closing of data gaps. The staff's analysis suggests that house prices have risen faster than can be explained by fundamentals in Germany's major cities. Their estimates of overvaluations in excess of 20 percent are of a similar magnitude to the 15-30 percent overvaluations in major cities recently reported by the Bundesbank. On the other hand, mortgage growth at the aggregate level has been moderate so far and more or less in line with nominal GDP growth. Furthermore, German households in aggregate are not highly leveraged and, in an environment of low mortgage lending rates, the overall debt-service-to-income ratio is low and declining. However, should house prices move further out of line or signs of household stress start to emerge, this may alter the overall assessment. In this context, we fully support staff's call for urgently closing real estate data gaps and strengthening the macroprudential toolkit. In both areas, Germany is lagging behind best practices of euro area peers. With respect to data gaps, the absence of regional credit statistics and granular loan information prevents a full assessment of potential financial stability risks in specific market segments. Large data gaps are also present in the area of commercial real estate, and therefore a key policy priority for national authorities should be to implement the 2016 ESRB recommendation on closing real estate data gaps. With respect to the macro-prudential toolkit, income-based macroprudential instruments, such as debt-to-income ratio and debt-service-to-income ratio limits, are not included in the legislation, but would be important complements to the existing tools (LTV limits and amortization requirements).

Mr. Merk made the following statement:

Economic performance in Germany is strong, underpinned by solid domestic demand. Growth is robust. Unemployment is at a record low. Wage growth is accelerating. Domestic inflation is on the rise given the increasingly positive output gap. Furthermore, public debt is on a decreasing path. The outlook for the German economy is favorable, particularly in the near term. That being said, we are aware that potential growth is set to slow down over the medium term. The staff and many Directors point to the domestic challenges—the demographic profile first comes to mind—and they identify substantial international risks to the outlook.

Against this background, we see a strong case for building buffers and using fiscal policy space in a prudent and growth-friendly manner. We pursue a mildly expansionary fiscal stance. We further increase public investment in physical and human capital. We phased out the solidarity tax surcharge, and the government is committed to tackle still-existing capacity constraints for public investment at the municipal level. Our fiscal policy serves as an anchor of stability for the euro area, and we welcome that this view is shared by several Directors.

On the current account discussion, first, we underline that a cautious interpretation of the External Balance Assessment (EBA) norms is warranted given the high model and estimation uncertainty. Second, the current account balance is reflecting foremost countless domestic and international private sector decisions. To a considerable degree it is explained by the rapidly aging population and therefore will decline in the years to come. Trading partners' policy as well contribute. Consequently, the largest part of the current account surplus is explained by fundamentals or remains unexplained. Only a very small part of the current account surplus, 0.4 percent of GDP, is interpreted as a domestic fiscal policy distortion by the staff.

We agree with the staff and with the messages in many gray statements that higher investment levels in Germany are desirable. Various measures to promote domestic investment are implemented, and further public investment and measures to stimulate private investment are foreseen in the coalition agreement, including investment in education, childcare, digital infrastructure, fostering R&D, supporting the transition to renewable energy, and improving framework conditions for venture capital.

On wages, as the staff points out, wages already picked up and are expected to rise further. After 2.6 percent in 2017, the staff expects wages to increase by 3.3 and 3.5 percent in 2018 and 2019, respectively, driven by market forces and based on social partners' autonomous negotiations. Therefore, we doubt that the staff's recommendation on public communication by the authorities in regard to wages makes sense. Rather, there is a risk of a backlash from social partners. In addition, I am convinced that the social partners are well aware of the staff's view.

Lastly, my authorities observe developments in the real estate markets closely and assess corresponding financial stability risks to be low. There is no substantial credit growth or deterioration of credit standards, and households' balance sheets remain strong. Therefore, my authorities do not see the need for the activation of the macroprudential tools at this stage but continue to monitor the situation closely.

An early activation of macroprudential tools in spite of seeing no immediate risk to financial stability would face legal obstacles in Germany. As a legal prerequisite, a threat to financial stability needs to be identified prior to any activation of the macroprudential tools.

Mr. Ostros made the following statement:

I thank the staff for a good set of reports. I have issued a statement, and on behalf of my European colleagues, I would like to reiterate the main points. We welcome Germany's strong economic performance as well as the near-term outlook for continued solid expansion. However, we are mindful of the effects of weak productivity growth and unfavorable demographics on output and potential growth in the medium term. Furthermore, substantial downside risks weighing on growth are associated with a significant rise in global protectionism and a potentially more damaging Brexit scenario.

Germany's current account surplus remains elevated, but only a small part of the gap can be attributed to domestic policy distortions. It is the persistent weakness in investment which is the key issue and requires policy action. We agree that over time, a gradual realignment of price competitiveness within the euro area and solid domestic demand are expected to ease the sizeable current account surplus; but the savings versus investment imbalance remains. The sustained rise in wages and higher investment would constitute a more direct and earlier correction. It would also foster the sustainability of the adjustment in countries with high external liabilities.

We largely concur with the staff's recommendation on using available fiscal space to strengthen Germany's growth potential and support the rebalancing. Nevertheless, in the context of a positive output gap and added risk related to domestic and international factors, the challenge is to enhance sustainable economic potential using prudent fiscal policy. With Germany's fiscal space primarily identified at the local government level, we welcome the authorities' commitment to tackle capacity constraints at municipal governments that constrain investment.

Germany must boost its productivity growth and increase labor market participation to counter challenges associated with an aging population. Additional reforms are needed to mitigate longer-term risks stemming from demographic developments and slow total factor productivity (TFP) growth. Structural reforms that could attenuate the impact demography will have on labor force are encouraged. We also stress the importance of updating the country's physical and digital infrastructure as part of the reforms aimed at raising productivity growth.

Lastly, on the financial sector, German banks suffer from low profitability and should tackle their high cost-to-income ratios by improving infrastructure and working on income sources. While the pace of credit growth and household indebtedness are not of immediate concern, a few market hot spots in bigger cities warrant continued attention. We support the staff's call for a preemptive strengthening of the macroprudential toolkit in closing the real estate data gaps.

Mr. Saito made the following statement:

We thank the staff for the comprehensive report and Mr. Merk for the informative statement and today's remarks. I have issued a gray statement. I would like to offer three comments for emphasis.

First, on the potential growth, the recent economic performance in Germany has been impressive. The growth rate marked 2.5 percent in 2017 with an historically low unemployment rate. Looking ahead, the growth rate is expected to slow down toward its potential growth rate, which is constrained by unfavorable demographics and low productivity. As many Directors indicate, boosting potential growth is the key for German economy. In this regard, we welcome that the authorities have launched several initiatives, including investments in digital infrastructure, expansion of the training for refugees, and measures to improve framework conditions for venture capital. We expect the authorities' continuous effort on this front.

Second, on demographics, we found that the staff's work in this report to be very informative. For example, the staff discussed the impact of immigration on wages. Given the recent large immigration flow in Germany, such analysis is invaluable. We also commend the fact that the staff report includes the discussion on boosting labor supply with women and older workers and mitigating pressures on public finances, including pension expenditures. We look forward to seeing further work on demographics used as a lesson for other advanced economies.

Finally, on fiscal policy, we are of the view that striking the right balance between building fiscal buffers and increasing spending to raise potential growth is essential. On the one hand, we see the need to build fiscal buffers to prepare for negative economic shocks and spending pressures from demographic changes in the near future and also avoid procyclicality in the current favorable economic conditions. On the other hand, Germany should increase spending in areas to raise its potential growth, including public investment and childcare, which would also facilitate reducing external imbalances as a result.

Given the differences of available fiscal space between the central governments and the local governments under the current fiscal rules, we agree with the staff that a comprehensive investment plan covering all levels of government is needed. That being said, we would like to hear the staff's view about how the staff can help to address challenges faced by the local government, such as capacity constraints, or more generally, how the staff can get better traction for the Fund's policy advice among local governments. I stop here.

Mr. Mkwezalamba made the following statement:

I thank the staff for the report on the German economy and for the responses to the technical questions, including the ones that we raised, and we would also want to welcome Mr. Merk's remarks.

We found the analysis on the issues identified in the annexes to be useful and strongly encourage the staff to deepen their analysis on these issues. In particular, this should include German savings and investment trends, the external balance, wage dynamics, and tax policy. We join other Directors in acknowledging the strong growth and resilience of the German economy. We commend the authorities for their focus on maintaining stability and gradually improving policy buffers. We note positively the downward trajectory of public debt and the plans to lift potential output. We issued a gray statement in which we raised a few questions, some of which have been answered, but wish to make some two comments.

First, in addition to the point we raised on fiscal space, we join other Directors in seeking clarity on the savings and investment behavior in the economy. Like Mr. Ostros, we also find it puzzling that in an environment of extremely low interest rates, the investment rate continues to be subdued. This is the main reason we inquired about other factors that could explain this phenomenon. We thank the staff for their response to the question and look forward to further analysis on this issue as indicated in their response.

Second, I would like to convey my authorities' continued appreciation to the German authorities for providing development and technical assistance (TA) support to many of our countries, this includes their work in assisting countries achieve the 2030 Sustainable Development Goals (SDGs) but also in their leadership in the G20 Compact with Africa initiative. We look forward to continued collaboration and cooperation on this and other matters.

Mr. Alkhareif made the following statement:

We join others in thanking the staff for a well-written report and Mr. Merk for his introductory remarks and buff statement. The German economy continues to perform well, registering robust growth, low unemployment, strong fiscal and external positions, while the banking sector continues to be sound and resilient. In our gray statement, we welcomed the indication that fiscal policy will be moderately expansionary in the coming years, and although the authorities disagree with the staff on the availability of fiscal space, on balance and considering the declining trend in public debt ratio, we encourage the authorities to be proactive and use any available space within the fiscal rules to further boost public investment, which would also help the external rebalancing.

We support the staff's policy recommendations to reinforce structural reforms to boost productivity, growth, and private investment. As noted in our gray statement, the case of Germany reinforces our view on the importance of caution in using third-party indicators (TPIs), particularly when ranking is involved. On the housing market, we look forward to the staff's clarifications regarding the traction of their recommendation to address data gaps.

Finally, we would have preferred more outward spillover analysis in the staff report in view of the importance of the German economy both regionally and globally. With these remarks, we wish the authorities all the success.

Mr. Just made the following statement:

We thank the staff for the informative report and answers to the technical questions. I associate myself with Mr. Ostros' intervention and thank Mr. Merk for his introductory remarks. We would like to add a few observations.

Like Mr. Saito, Mr. Inderbinen, Mr. Ostros, Ms. Barron, and Mr. Mahlinza, we agree with the authorities' prudent fiscal policy stance, which balances the need to support potential growth with demographic challenges, and the increasingly positive output gap against the backdrop of a negative risk to the outlook, as mentioned by the staff report. In this context, we were a bit puzzled by the use of qualifiers in the Main Themes in Grays, but trust that the appropriate ones will be used in the summing up.

We do not share the staff's recommendation that Germany should use its entire fiscal space for two reasons. First, this could be in conflict with European national fiscal rules. The EU fiscal government functions only if rules are adhered to, and Germany has probably committed the original sin by being the first large country to break Stability and Growth Pact (SGP) rules. Despite Germany's subsequent policy reversals and its ambition to lead by fiscal policy example, the euro area still has difficulties following the agreed fiscal governance framework. And second, we believe, that a more symmetric approach to assessment of fiscal space of not only allowing its adoption to changing cyclical position but also to describe it as a buffer, would be more appropriate.

The discussions about Germany's economic policies often have a religious fervor to it. In our viewpoint, most aspects of German fiscal policy point in the right direction. The lack of speed reflects societal and cultural preferences. Germany's risk acceptance and risk tolerance are firmly grounded in prudence and solid outcomes.

We have also stressed in the past that we often tend to overlook that the competitiveness of the German economy is the backbone of the German supply chain countries, which also greatly supports the income convergence of central and Eastern European EU members. These countries are basically forgotten in the debate. Equally, many of the countries have concluded that

Germany's economic performance is grounded in fiscal responsibility and have started to implement such policies and focus on resilience.

The economic success of many German supply chain countries is also sidelined in this debate. We would also argue that, on balance, these policies would support the overall objectives of the euro area. Whether the interplay of more life cycles smoothing views with more Keynesian views leads to suboptimal outcomes should be addressed in the euro area Article IV reports.

We are somewhat concerned about the medium-term growth prospects of Germany, but are confident the authorities will, in the end, implement reforms necessary to sustain Germany's strong economic and social outcomes, which in turn are vital for the well being of a large number of countries in the region.

Mr. de Villeroché made the following statement:

I would like to thank the new mission chief for this comprehensive and good report. I would like to thank Mr. Merk for his introductory remarks, and I associate myself with Mr. Ostros' statement.

As noted in my gray statement, we commend the authorities for the continued strong performance of the German economy, notably with very low levels of unemployment. I would like to emphasize a few points, but first, I would like to make a point on process. As we stated on several occasions in the past, we would have preferred that this Board discuss Germany after having discussed the euro area Article IV report. We just received the euro area Article IV report today, and we see this as a missed opportunity to derive targeted domestic actions from the general domestic of the euro area. For example, on the discussion related to internal imbalances, it does not make sense to discuss Germany's Article IV consultation today without having read completely the Article IV report for the euro area.

In this respect, the Fund is lagging the European calendar. We now start with a general assessment, and we believe this should be addressed promptly.

Coming to the German economy and the question of imbalances, we believe that the excessive current account surplus is a sign of persistent insufficient internal demand, both public and private; and it remains a source of concern because it contributes to the internal imbalances of the euro area. In the staff's projections, the decline of the current account surplus would be excessively gradual over the coming years. Although only a limited part of this excessive surplus is explained by domestic policy distortions, using the EBA methodology we believe there is more to be done, especially since wage dynamics are treated as exogenous to policy discussions in this methodology. We welcome the recent wage increases in Germany. They go in the right direction, including the recent rise of the minimum wage.

Having said that, more could be done, and there is room for a more active role of the authorities, something they did in bad times, and they could do it in good times as well. We support the staff's recommendation to have active communication by the authorities on the need to keep higher wages in Germany.

Generally speaking, we believe that a very slow adjustment, which is currently what is happening, will slow down the normalization of the ECB's monetary policy, and more pedagogy is needed to explain in Europe that differentiated inflation rates may be needed to rebalance the economies.

I have a final point on fiscal space. We believe that the current fiscal space is not appropriate. Germany has ample fiscal space, which under existing rules should be used for the structural purpose of preparing the German economy for the challenge of the aging population. Investment in physical and human capital, both direct public investment and supported private investment, are ideal candidates considering the need to enhance productivity to compensate for a declining workforce. Other views should also be examined to promote female labor participation and enhance the social safety nets notably.

Mr. Inderbinen made the following statement:

We join others in thanking the staff for the excellent documentation and also thanking Mr. Merk for his buff statement and introductory remarks. We put out a gray statement in which we welcomed the continued expansion of the German economy, and we emphasized the role of prudent and sound macroeconomic policies in generating this outcome.

On fiscal policy specifically, we emphasize the cyclical character of the current budgetary overperformance. Given the longer-term outlook for public finances, in particular the pressure that Germany's demographics will be having on the fiscal position, we would see merit in building buffers which would also contribute to an anti-cyclical stance. In this sense, we share the skepticism of Mr. De Lannoy, Mr. Jost, Ms. Riach, Ms. Erbenova, and Mr.

Just, on the staff’s views on fiscal space and its use. Also, as Mr. De Lannoy and Mr. Just note in their gray statement, debt levels are still above the SGP benchmark.

At the same time, there is a need for structural reforms to help raise domestic consumption, productivity, and investment. These include increasing female and elderly participation in the labor market, liberalization of product markets, and reforms aimed at improving the environment for private investment and entrepreneurial activity.

Lastly, we would like to underline that faster progress of structural change in the banking sector would be beneficial. While capitalization has increased, costs are high and profitability of the sector is weak. Completion of Basel III will also have an impact on the larger banks, and against this background, we encourage further implementation of the 2016 Financial Sector Assessment Program (FSAP) recommendations.

Mr. Claver-Carone made the following statement:

We thank the staff for this high-quality paper and Mr. Merk for his buff statement. Clearly the core message of the staff report is that Germany should use more of its ample fiscal space to take stronger action to raise investment and boost potential growth. We recognize that the German authorities have a more cautious view of fiscal space, but we would encourage them to consider doing so.

In the buff statement, Mr. Merk highlighted the new government’s commitment to addressing municipal-level bottlenecks for public investment, and we welcome that. We also welcome the plans for investment in digital infrastructure and investment in human capital through vocational education and lifelong learning, and support for R&D focused on small- and medium-sized enterprises (SMEs), and we encourage them to continue on that path.

The staff’s analysis of the external sector shows a persistent current account surplus that is unlikely to decline much under current policies. Much of that is due to business savings, and thus one key to reducing imbalance is public policies that make it more attractive for companies to invest more and perhaps save less. We do not agree with the argument that trends are simply the sum of private decisions. The staff had some good policies, and we would love to hear if the staff suggests any prioritization of those. With that, we wish the German authorities the best.

Mr. Tombini made the following statement:

I also thank the staff for this report and Mr. Merk for his introductory remarks. We issued a gray statement, and I wish to commend the authorities for the healthy cyclical position of the German economy. Looking ahead, the situation offers the authorities an opportunity to address the structural shortcomings, which will help raise the long-term growth potential of the economy.

Additionally, I would like to make three points. First, I concur with the staff's recommendation to use available fiscal space to boost Germany's growth potential and support global rebalancing. Given the size of the German economy and its large current account surplus, Germany has a clear responsibility toward global rebalancing. The fiscal surplus has strengthened in 2017 and is expected to strengthen further this year, while public debt is expected this year to fall below the European SGP limit of 60 percent of GDP. Amid positive output gap, the authorities have the opportunity to use available fiscal space to increase public investment projects and aim at raising the economic growth potential.

Second, given the demographics and population aging, Germany needs to promote further labor market participation and better integrate the recent wave of migrants into the labor market. In this regard, the authorities should be commended for providing professional training and language programs to immigrants, which will help them integrate into the German labor market.

Finally, I welcome the emphasis of the staff's report on policies to foster entrepreneurship in Germany, including facilitating venture capital and investment in R&D, as well as in digital infrastructure.

Germany is a world leader in manufacturing, and there is no reason not to expect the country to also lead in the field of new technologies.

Mr. Leipold made the following statement:

I would like to start by thanking management, the Secretary's department, and the staff for today's bunching of the German and U.S. discussions. Having two large countries with payments imbalances with opposite signs on the same day is very helpful in allowing us to take a broader view on the adjustment of global imbalances, even though it adds to the work.

That being said, I also agree with Mr. de Villeroché that there could be a better sequencing between euro area and individual countries' consultations.

I would like to make a few points on global payments imbalances because they are central to the consultation we are discussing. Whenever the issue of global payments imbalances returns to the forefront, we cannot help but think, "here we go again." It is an age-old issue and one that predates Bretton Woods, and remained unresolved at the conference itself. The crux of the issue is how to secure a symmetric adjustment of global imbalances, how to ensure that the needed correction does not fall exclusively on deficit countries, pushed by market pressures and the loss of reserves, but is correspondingly shared by countries in surplus as well.

The two countries discussed today do not contribute toward the adjustment of global imbalances for two quite distinct reasons. The United States is a deficit country but is not subject to the same adjustment pressures faced by all other deficit countries because of its honored position, as they share the main reserve currency.

Germany is a case where the country's contribution to global payments adjustment remains elusive for quite a different reason. It is not because of any particular German trait, but simply because international pressure has never succeeded in inducing a country to adjust. If one considers in recent times the cases of Japan or China, or at the height of the oil crisis, the case of the OPEC countries, corrections when they happen are driven by exchange rate appreciation if a currency is not manipulated or by domestic realization that a change is in the country's own best interest—not before.

Keynes' preoccupation with trying to solve this problem at Bretton Woods was that if there is no international adjustment mechanism, and as long as surplus countries resist for whatever reason to deploy their greater purchasing power, adjustment inevitably occurs by a contraction and deficit in countries with this deflationary bias in the world economy. Keynes tried to come up with a scheme to address this; but he also realized that it was ideal but perhaps Utopian, and that is how it turned out to be. To date, it is fair to say that the international monetary system, with our institution at the forefront, has not succeeded in ensuring an appropriately evenhanded and symmetric adjustment process for global payments imbalances.

Although difficult, this institution needs to continue to think of how to address this issue. Until then, operations for more investment, for use of fiscal space—prudent, appropriate or whatever adjective or adverb we would like to use—can continue and we repeat them in many gray statements, but with little chance of real impact on traction. However, intractability today should not mean resignation or forbearance. The search for a solution beyond pleading has to continue.

Mr. Jin made the following statement:

I would like to thank the staff for this well-written and informative report and Mr. Merk for his buff statement and remarks.

People tend to assume that monetary policy decisions in the euro area should be designed to serve the area as a whole. However, in practice, we observed that the monetary policy in recent years appeared to effectively favor countries in stress in this area. This might be partly due to the significant difference in the level of economic development and the cycle of economic growth in different countries. We can understand the ECB's approach considering the difficulties in fiscal coordination and the limited fiscal transfer mechanism. But for countries with solid economic performance like Germany, the extraordinarily low interest rate and the weak euro could have been over-expansionary, leading to the higher-than-normal current account surplus and undervalued real effective exchange rate.

Nevertheless, it is not completely meaningful to discuss the external imbalance of a single euro member country without looking at the current account of the euro area as a whole. We believe the current account surplus of euro area as a whole can be further reduced, although it is not very high; but considering the size of the euro economy, it can be reduced further.

To examine the external imbalance of Germany within a single currency zone, we can consider two issues. The first is that the current account surplus should be balanced in the form of capital flows from Germany to other countries in the euro area, preferably to weak countries, and actually this is what is happening. We have noticed that Germany's outward portfolio investment has mainly flowed to other countries in the euro area, so this is quite good. But it is unclear whether this investment has been put into weaker economies in the region.

Second, fiscal space could be partly used to invest in projects in other members in the euro area to facilitate economic integration, such as infrastructure construction or human capital development in the form of foreign assistance or aid. Going forward, with the development of fiscal cooperation within the euro area, such as the central fiscal stability capacity mechanism we discussed recently, monetary policy decisiond could be conducted in a more unbiased manner.

Mr. Hurtado noted that the staff had been very clear about the conditions under which it was advisable to use fiscal space. After closing the output gap, fiscal space should be used to support the economy in the long term by investing in infrastructure, easing demographic pressures, and investing in human capital to address automation and protect productivity.

Mr. Agung made the following statement:

We thank the staff for the report and Mr. Merk for his buff statement and introductory remarks. We understand that the staff will respond orally to our questions on the difference of views between the staff and the authorities on fiscal space, but I would like to add two comments on this issue.

As mentioned in our gray statement, fiscal policy could help support long-term growth. But like many other Directors—Mr. Saito, Mr. Inderbinen, Mr. De Lannoy, Ms. Erbenova—we feel that the fiscal policy needs to strike the right balance between supporting higher growth potential and building fiscal buffers. This is particularly important in the case of Germany, given its downside risks and demographic challenges.

The second issue concerns the External Sector Assessment, we share the authorities' concern that the model did not take into account the country-specific factors, including a fast-aging population. As such, we reiterate our position that caution should continue to be exercised when drawing conclusion from the model-based assessment. Staff judgment remains essential to ensure that the assessment and policy recommendation have sufficiently taken into account country specificities.

Ms. Horsman made the following statement:

We also thank the staff for the report and Mr. Merk for his buff statement and introductory remarks. We generally agree with Mr. Ostros' comments on the savings and investment balance. As I mentioned in my gray statement and also again this morning in the U.S. Article IV discussion, reducing external imbalances in an orderly way is in everyone's interest. We welcome indications that Germany's government is taking steps in this direction, as outlined by Mr. Merk, but believe that more can be done to promote domestic investment, both public and private.

I wanted to pick up on one other point that was raised in other Directors' gray statements. As noted by Mr. Ostros, Mr. de Villeroché, Ms. Erbenova, and others, Germany's economic size and interconnectedness mean that its policies need to be considered in a regional context. In that context, like Mr. Alogeel, we would have liked to see more discussion of outward spillovers of domestic policies. We found this morning's U.S. Article IV Board meeting to be a good model of how Fund surveillance can generate a frank and healthy discussion in that regard.

Mr. Joshi made the following statement:

We thank the staff for the comprehensive report and Mr. Merk for his informative buff statement. We have issued a gray statement which reflects our world views on the economic issues. In addition, we have several points for emphasis.

We welcome the budgets contained in the new government's coalition agreement aimed at supporting long-term growth and reducing poverty. While Germany is well-known for its technical leadership and excellence, we believe that the implementation of high-speed internet connections and the 5G network would help potentially enhance productivity and new investments that come on board. At the same time, a reduction in the labor tax will encourage employment.

We commend the focused initiatives taken that support female employment, such as child care services and schooling. Besides promoting physical, public, and private investments, better vocational training and education services would enhance productivity and potential growth, and therefore including much more substantial support for these efforts would improve the long-term prospects of growth.

We also welcome the measures taken to enhance social benefits, which would come back and reduce child poverty. These well-thought-out and multipronged initiatives by the new government, especially focused on enhancing equality and human capital, would serve to maintain Germany's position as a leading economy in the world. We wish the authorities the best and all success.

Mr. Armas made the following statement:

I thank the staff for a well-written report. I would like to emphasize and clarify a few points raised in our gray statement. One question was about the meaning of a Current Account Assessment when there is a currency union. Usually we assume that a currency union will remain intact for good, even though some member countries may show substantial surpluses while others will be in deficit, because there is supposed to be a high degree of financial integration across the system. Typically, in that case, it is expected that countries with higher marginal productivity of capital, and therefore higher real interest rates, i.e. countries with less capital, will run a current account deficit (the southern part of the euro area), as opposed to countries with a higher stock of capital, which will run current account surpluses. It is my impression that we should focus more on the situation of the current account for the area as a whole. We suggested that in the future it would be useful to hold these meetings together with an assessment of the euro area. The answer we received is that there will be a new meeting on July 16. That was the spirit of my question; but, as Mr. Jin also mentioned, there is a conceptual question about the assessment.

The second point is about how to explain this surplus. According to the staff, the gap is 5 percent; so when we talk about fiscal policy, the fiscal surplus is about 1.2 percent of GDP. When we talk about fiscal tools, we are not dealing with the great gap associated with the private sector; and then we have to explain the main source of the current account surplus; i.e., the corporate sector. The report is clear in this regard. We need to understand the process of how the corporate sector in Germany is saving in many ways and, more crucially, what will happen in the future with that surplus.

My second question, which perhaps was not well understood, concerns the structural part of this current account surplus. We asked a theoretical question about tariffs in Germany. There was no intention to make a policy statement. The question was what would happen if there was a further tariff reduction of tariffs and what would be the resulting impact on the current account. The answer we received is that the gap between savings and investment is what matters instead of an assessment or estimation, if there is one, about the impact of tariffs on the Current Account.

Mr. Mozhin made the following statement:

This Board has been discussing the granular issue of high current account surplus in Germany year after year, and every year we have heard appeals from the staff and some Board members to the German government to use its fiscal space to increase domestic demand in Germany, and by doing so, to assist the euro area deficit countries reduce their respective current account deficits. Of course, the concept of fiscal space is not a precise science, and it is difficult to say how much of that is present in Germany. But whatever fiscal space is available in Germany, it is obviously the result of prudent fiscal policies in Germany for so many years. That is how fiscal space can only be achieved. My understanding from this report is that more recently, perhaps in the last year or a little more, the German authorities moved in the direction of attempting to use fiscal space to increase demand. Now we see that Germany has a positive output gap, and inflation in Germany is higher than the euro area average, so my sense is that the German authorities responded to those pressures to some extent.

The question I have is how much of this will be sufficient to have an impact on the deficit countries in the euro area? How much fiscal deterioration in Germany will be needed to have a visible impact on curing the current account deficits and stimulating growth in the deficit euro area countries? Clearly, there is this tension between how much fiscal deterioration is needed and how much impact it may have on the other countries. We have seen some effort on the part of Germany, but it is seen as insufficient, so the question I have now is how much is sufficient?

The current account surplus has to be matched by a capital account deficit. I have been raising this question every year, and I am grateful to the staff that the report includes Box 1 on the evolution of the balance of payments financial account. Frankly speaking, I am totally confused, because in the footnote to this box, I see that the balance of the capital account is close to zero as a share of GDP. The current account is 8.5 percent of GDP. The capital account is zero, and then there is this definition of financial account which is supposedly the German financing of current accounts in other euro area countries, but I would want some clarification because it is not easy to understand. The first sentence states: “Germany’s financial account balance has trended up since 2001.” Up meaning where? In the direction of further deficit? Because the next of the sentence is: “mirroring the current account surplus.” Then there is this whole discussion about two types of current account, and capital account outflows. Could the staff please clarify?

The representative from the European Department (Ms. Kozack), in response to questions and comments from Executive Directors, made the following statement: [1]

I would like to thank Directors for their careful reading of the report and all of the questions. I will cover three broad areas: fiscal policy, the

[1] 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.

external sector, and macroprudential policies. I will also respond to the questions that were raised orally.

Starting with fiscal policy, there were several questions on fiscal space, on the staff's recommendations for policies at the local government level, and on the difference of view between staff and the authorities on fiscal space.

Starting with fiscal space and the relationship to the fiscal rules, the authorities' view is that fiscal space at the federal government, or central government level, is limited by both their political commitment to the black zero—which is no new debt at the federal level, or essentially a zero budget balance—and also their national fiscal rule, which is embedded in law. The national fiscal rule imposes a structural deficit of 0.35 percent of GDP at the federal government level. In the latest government projections, the government projects that the federal government will have a balanced budget between 2019 and 2021, and therefore, they do not see any fiscal space at the federal level.

From the staff's perspective, we assess fiscal space at the general government level, and we assess fiscal space relative to Germany's European fiscal rules. I want to clarify that we are not suggesting that Germany violate its European fiscal commitment or European fiscal rules. Our assessment of fiscal space is relative to Germany's medium-term objective embedded in the SGP. However, we also do agree with the authorities that at the federal government level, there will be very limited fiscal space in the coming years; so most of this fiscal space that we assess at the general government level will be at the state and local level. This gave rise to a number of questions about what can be done. Can the state and local governments spend more and have a more expansionary policy, and is our policy advice hitting areas that they can affect? Several of our key policy recommendations, including on public investment at the municipal level, more education spending, more spending on child care and after-school programs, and more spending on vocational training and lifelong learning, are all areas that are under the remit of the state and local governments, so there is fiscal space in these areas we are emphasizing.

In addition, there were some questions about how to relieve the bottlenecks to public investment at the municipal level, and we have to give credit to the authorities that they have done a number of things to alleviate some of the financing constraints that had existed earlier, particularly at the municipal level; so financing no longer seems to be a major issue. At present, the issues seem to be that over time there have been reductions in the staffing at the municipal levels, especially in areas needed to plan and implement public investment projects. These capacity constraints have yet to be addressed, but the hope is that with this additional financing, over time these constraints can be addressed.

I would also point out that there may also be regional disparities within Germany in how public investment or fiscal space is spent, is available regionally, and this is something that we will look into in future consultations.

There were also some questions on how to bridge the difference between the staff and the authorities on fiscal policy and fiscal space. As we heard from Mr. Merk, and we know from the authorities' buff statements and past statements, the authorities' emphasis is really on reducing public debt and building fiscal buffers; whereas our emphasis is on using fiscal space to raise potential growth. But I would want to point out that the choice is not binary. Even if Germany uses all of the fiscal space—according to our definition and fully consistent with adherence to its European fiscal rules—public debt will still decline in Germany. Germany can still build buffers by reducing public debt and still take actions on the fiscal side to boost potential growth, to take measures to deal with some of its longer-term challenges. We do not see the choice as binary.

I also want to point out that we firmly believe—and this is partly why the staff report spends a significant amount of time discussing private investment and productivity growth—that fiscal policy alone will not solve the problem of the current account surplus. Having a fiscal expansion will not make the surplus go away or shrink down to a level that is more consistent with fundamentals and desirable policies; so action is also needed on the private sector side, and so we spend some time in the staff report trying to discuss policies that could incentivize those actions.

On the issue of bridging the gap, yes, we disagree with the authorities on the extent of fiscal space and maybe the pace at which it is used, but we do broadly agree with the authorities on the key challenges facing the German economy; and it is also fair to say that we agree on the importance of raising domestic investment, and this common ground does allow us to have a candid and fruitful exchange of views with the authorities.

Turning to the external sector, there were a number of questions on policy distortions and how policies can affect the behavior of private agents. We believe that Germany's policies contribute to the external imbalances; but the contribution of identified policy gaps is quite small relative to the size of the overall current account gap.

We know that the authorities disagree with this finding, so the question is, what do we do? In the staff report, we have tried to focus on other areas, particularly structural reforms and other reforms that can catalyze private investment and reduce the need for saving. Some of our policy advice in terms of extending working lives, providing incentives for older workers to stay in the labor force for longer, can reduce incentives to save. Making it easier for startups to access venture capital, reducing regulations, improving competition in network industries—all of these things can, hopefully, catalyze private investment and boost productivity growth.

I would also say that given the demographic profile, and the fact that many agree that the present looks nice, but that growth can be lower in the future; this in and of itself may be creating a disincentive for investment. Policies that can boost longer-term growth can also then indirectly provide a better environment for private investment by giving investors more confidence that the future is as bright as the present.

Turning to macroprudential policies, there were a number of questions in this area. There was one question on whether we agree with the authorities on the fact that the housing market issues are localized, and the broad answer is yes. We agree with the authorities that at the aggregate level, at the national level, we do not see signs of overheating in the housing market. Where we do see signs of overheating are in these major cities, which we see as hot spots. Nevertheless, we believe that strengthening the macroprudential toolkit now, addressing data gaps now, and considering the early activation of macroprudential tools can prevent a buildup of risks in these hot spots.

On the legal obstacles to early activation, Mr. Merk gave the authorities' reaction, and this is consistent with what they have told us. One of the issues that we see is that for the authorities to be able to activate macroprudential tools, they need to be able to provide some evidence that there is a financial stability concern. When there are data gaps which prevent one from doing this analysis at the regional level, the problem is that one may never be able to have this evidence; so, first, we would like the data gaps to be addressed, and the Bundesbank is in full agreement with this. But if it is going to take time to address the data gaps, we would prefer to be cautious and apply some fairly standard macroprudential tools, like a loan-to-value ratio and an amortization requirement, early to be ensure these risks do not build up, especially since we do not feel we are able to monitor them because of the data gaps.

On microprudential measures, we fully agree that microprudential measures are a very important part of the response, and we welcome the fact that the authorities are monitoring vigilantly what is happening in the housing market and undertaking microprudential and Pillar II measures where needed; but we still believe that macroprudential measures are important for systemic risks and financial stability.

On the issue of data gaps, our understanding is that this is a difficult issue in Germany because Germany has strict regulations on data privacy and personal data protection and some of the data that are required—for example, on household indebtedness, the type of mortgage loan, the wealth and assets of the individual, so we could understand who is taking out what kind of loans—are protected by law, so a political decision is needed to move ahead on the data gaps, and that is part of why it is taking some time.

There was also a question on communication and how to communicate a strengthening of the macroprudential toolkit. There is a role for public communication to explain to the public and to educate the public on the importance of macroprudential tools and to avoid financial stability risks, to avoid housing booms and busts. Some of this public communication can be used to help explain to the public why some of these measures are needed and why they need to be part of the toolkit.

With respect to the questions that were raised orally, there was a question on prioritization of policies. I would say that we view the policies in the staff report as priorities, but we also are aware that some of the policies have a longer fuse. They will take a longer time, and some can be implemented more quickly. Policies like improving education will take a very long time, whereas other policies such as reducing administrative burdens for SMEs can be done more quickly. In the staff report, we tried to only discuss policies that we see as priorities; but we know that they will evolve and take effect over time, so it is not that everything will take effect only at one time.

Finally, on the question of tariffs, we misunderstood the question as it was posed in the gray statement. It is the case that Germany as part of the European Union is governed by tariffs at the European Union level which are relatively low in an international perspective; and this will be covered in the euro area staff report. But we still do see that the fundamental drivers of the current account is not trade policy, but saving and investment balances.

Although there is a lot of discussion now about trade policy, and trade policies can certainly have effects in the short-term, over the longer-term, these balances are ultimately driven by saving and investment. To the extent that tariffs reduce disposable income, that would suppress consumption and potentially investment, and we may not see big effects on trade.

Finally, there was a question on the capital account versus the financial account. The capital account is a statistical term which refers only to capital transfers; whereas the financial account is what used to be called the capital account in the old days. When we talk about the financial account, one can think about it as the old capital account.

Mr. Mozhin made the following statement:

This is really confusing. What is indicated in the footnote is that the balance of the capital account is close to zero as the share of GDP. I cannot understand that. With current account in a huge surplus, what used to be known as the capital account is indicated to be zero. But I was educated as a Marxist. I am not supposed to know all these definitions.

But I want be sure that I did not misunderstand. What we heard from the staff is that there is not much that the German government can do to reduce the current account surplus in the short run. Of course, there are always measures like structural reforms, like improvements in education, although I had not heard about poor education in Germany. But there is a list of measures which are stipulated in the report which can gradually help reduce the current account surplus, but not in the short run, not immediately. In that sense, this will not help provide any immediate help to euro area deficit countries.

Mr. Merk made the following concluding statement:

I would just add to this discussion a clarification with regard to the staff’s answers. My authorities’ emphasis is not only on fiscal buffers, but on a growth-friendly but prudent fiscal policy, so we aim—and some Directors had that wording in their statements—to strike the right balance, and we do that by pursuing a mildly expansionary fiscal course despite a positive output gap.

Second, we thank the staff for the assessment that we cannot reduce the current account surplus by fiscal policy in a substantial manner, and that was my point in the introductory statement. The fiscal policy distortion identified by the staff is very small.

As a third factual point, the national fiscal rule that binds us is strongly embedded in constitutional law.

With that, I thank Directors for their constructive gray statements and comments, which I will convey to our authorities. I would like to thank the staff for the well-written and informative report and the answers in today's Board meeting. In this regard, my special thanks go to the mission chief, Ms. Kozack, and the whole team, with Ms. Pereira, Ms. Chen, Ms. Mineshima, Mr. Natal. They provided insightful, candid, and thought-provoking surveillance work. From my side and on behalf of my authorities, I would like to convey gratitude for the constructive discussions with the team during the mission and for the uncomplicated cooperation after the mission in preparation for today's Board meeting.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended Germany's strong economic performance and welcomed the prospects for continued solid growth in the near term, underpinned by robust domestic demand amid a tight labor market and accelerating wages. They noted, however, that external imbalances remain sizable and important risks are clouding the outlook. Rising protectionist trends, geopolitical uncertainty, or a reassessment of sovereign risk in the euro area could lead to bouts of financial turbulence, negatively affect export prospects, and weigh on investment.

Directors stressed that the positive near-term economic outlook provides an opportunity for Germany to more forcefully address its long-term challenges. Given unfavorable demographic prospects, they agreed that Germany's policies should focus on bolstering potential growth. In this regard, Directors recommended further expanding public investment in physical and human capital, and prioritizing measures that incentivize labor supply and help improve the environment for private investment. Such measures would bolster productivity growth, further lift long-term output, and reduce Germany's large current account surplus.

In this context, Directors welcomed the new government's initiatives to support long-term growth. Many Directors urged using Germany's fiscal space to further raise public investment (while alleviating bottlenecks at the municipal level), expand childcare and after-school programs, reduce the labor tax wedge, and provide additional funding for primary education and life-long learning. A number of Directors, however, emphasized a need to balance spending to raise potential growth with maintaining strong buffers for potential economic risks and upcoming demographic challenges. Directors also stressed that pension and labor market reforms that make it more attractive to extend working lives would lower the public pension bill, raise growth, and reduce the need to save.

Directors noted the slow labor productivity growth and a declining trend in entrepreneurship. They recommended further improving access to venture capital, providing tax incentives for R&D to small- and medium-size enterprises, and reducing administrative burdens. They also urged the authorities to ensure that incentives, regulations, and funding availability are appropriate to complete Germany's digital transformation. Directors also renewed calls for accelerating competition-enhancing reforms in parts of the services sector and network industries.

Directors emphasized that accelerating house prices in Germany's most dynamic cities deserve close monitoring. They noted that the lack of granular data at the city level prevents a full assessment of developments. In this context, they recommended strengthening the macroprudential toolkit and urgently addressing data gaps to guard against the risk that pockets of financial vulnerability might emerge.

Directors noted that profitability in the bank and life insurance sectors remains low and that restructuring efforts must be accelerated to durably strengthen resilience and reduce risks. They stressed the importance of continued supervisory attention to progress in implementing restructuring plans and reducing interest rate risk in banking and insurance.

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

APPROVAL: February 5, 2020

JIANHAI LIN
Secretary

Annex

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

Real Sector Developments and Outlook

1. ***The recent news about the governments' plans to increase the minimum wage is a positive step. Can staff provide a preliminary assessment on the size of the increase and its impact?***

- The minimum wage is set by a multipartite commission with representatives from employers and employees. The planned increase in minimum wage of 4 percent in 2019 is slightly higher than expected wage increases in the rest of the economy and reflects a very tight labor market situation. As a result, we do not expect detrimental effects on employment. The previous bi-annual agreement raised minimum wage by a significant margin above average wage increases without leading to discernable effect on employment.

2. ***The staff's views on the impact of the minimum wage on the employability of migrants are welcome.***

- The minimum wage might in principle be a deterrent to employment for low-skilled labor, migrant and natives alike. However, the experience with previous increases in minimum wage has been positive so far. For example, refugees have been integrating the labor market at a faster pace than previously assumed, and the minimum wage is not mentioned as an impediment for employment in employers' survey. As noted above, the planned minimum wage increase of 4 percent in 2019 is slightly higher than wage increases in the rest of the economy and is consistent with the tight labor market.

3. ***While it is mentioned briefly, could staff elaborate on the possible role of the threat of offshoring on German wage developments?***

- The threat of offshoring potentially played an important role in the wage moderation episode that began in the early 2000s. The importance of this factor is difficult to assess empirically as it is difficult to disentangle the respective roles of the Hartz labor market reforms (which were enacted over 2002-05) and offshoring on wage growth. Lately, however, wages have been growing faster than productivity in Germany, a reflection of increasing labor shortages in many sectors. Therefore, the threat of offshoring does not seem to have played a significant role in recent years as unit labor costs and labor demand rose in tandem.

4. ***According to the literature on wage moderation, in Germany the government supposedly played a prominent role in wage negotiations leading to restoration of competitiveness in the 2000s. Could staff elaborate on the differences between their views and recommendation to become more vocal in public calls for wage increases, on the one hand, and the position of the authorities, on the other hand?***

- We agree with the authorities that wages setting is a decentralized process in Germany and wage setting is better left to social partners. That said, a clear and unequivocal communication by the authorities that higher wages are the natural consequence of a very tight labor market and a healthy development that does not jeopardize the upswing could help inform social partners. It would also facilitate external adjustments in the euro area and speed up the normalization of the ECB's monetary policy.

5. ***The European Commission (European Commission's Country Report, Germany 2018) considers rising income inequality among the factors that explain the CA surplus; this element does not seem captured in staff assessment. The staff's comments are welcome.***

- The staff is aware of empirical work on income inequality and current accounts. However, many conceptual and empirical questions need to be resolved before concluding that such variables should affect the current account norm. That said, staff is exploring related issues, including how expanding global value chains and rising corporate saving, coupled with wealth inequality, can partly contribute to external imbalances.

6. ***We wonder whether staff have included estimates of higher spending by retirees in the current baseline scenario and to what extent this affects the levels of projected domestic expenditure and external imbalance.***

- The current baseline forecast assumes that employment will start to decline at the end of the forecast horizon as a result of population aging. GDP growth and investment would moderate, while consumption would remain more stable (retirees do not produce anymore but continue to consume). As a result, household saving would fall and the current account surplus would decline. However, this has only a marginal effect on the baseline forecast given that these trends are projected to take effect only at the end of the forecast horizon.

7. ***While we note that the tightening labor market has led to an increase in wage growth, thereby contributing to external rebalancing, we wonder to what extent Germany's demographic factors, including migration, would affect the country's***

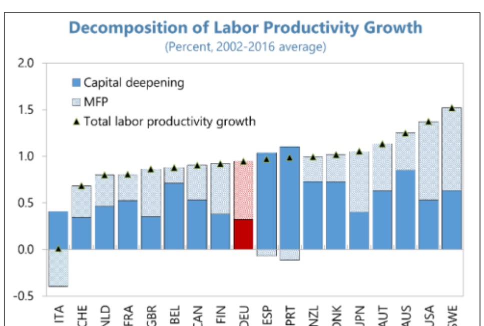
external rebalancing over the medium-term, notably through their dampening effect on wage growth? The staff's comments are welcome.

- The baseline forecast assumes that immigration flows will slow in coming years as economic conditions improve in the rest of the EU. Labor markets have started to tighten in the rest of the EU, particularly in Eastern Europe where wage increases have been very strong in recent years.

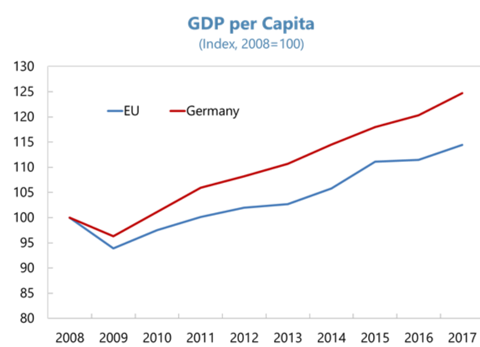
- Empirical analysis by staff and researchers at IAB (the research institute of the German employment agency) do not find a significant impact of the previous large wave of migration (2012-2016) on wages (see Annex VI of the staff report). We therefore do not expect much dampening effect on wages due to lower immigration flows in the baseline.

8. ***In Figure 4 staff compared real GDP growth in Germany with the rest of the euro area. We believe that proper comparisons should reflect the role of the demographics, and ask staff to provide comparisons of GDP per capita growth as well as GDP per working person growth.***

- The staff typically focuses on headline GDP as it is the relevant benchmark to assess fiscal and labor market developments. The staff also routinely computes measures of potential growth and a decomposition along the production factors, which shows that the contribution of employment (boosted by immigration) was particularly large in Germany. The text chart in paragraph 15 of the staff report (copied below) provides a comparison of labor productivity growth (GDP per employed person) for all OECD countries. Germany is close to the median of the distribution. Germany's per capita GDP growth also compares well to the rest of the EU.



Source: OECD, and IMF staff calculations.



Sources: Eurostat, Haver Analytics, and IMF staff calculations.

9. ***In view of the large positive output gap assessed by staff, in contrast with the European Commission assessment, we would like to have their view on the main drivers behind the desynchronization of European economic cycles?***

- While the business cycle in Germany has been in a more advanced stage compared with other euro area countries, we do not see a "desynchronization of the European economic cycles." The euro area as a whole is also on a cyclical upswing, with the aggregate output gap expected to close this year. The dispersion of output gaps among countries has already narrowed considerably and is expected to narrow further.

10. ***What is the impact of the weaker medium-term outlook for the rest of the EU?***

- Given Germany's weight in the euro area economy (about 30 percent), a weak medium-term outlook in Germany will have a substantial impact on the euro area economy. More generally, the euro area's medium-term growth prospects remain modest, reflecting demographic change, weak productivity, and crisis legacies. The staff will provide the updated projections for the euro area in the corresponding Article IV staff report and for the EU more broadly in the July WEO Update.

Fiscal Policy

11. ***We would appreciate staff's comments on the authorities' views on the lack of space at the federal government level due to both the "black zero" (an informal fiscal guidepost aimed at no new debt at the Federal level) and Germany's national fiscal rule?***

- The staff will respond to this question during the Board meeting.

12. ***The authorities disagree on the availability of fiscal space given the "black zero" and the national fiscal rule and the need to build buffers. In this connection, we invite staff to comment on the differing views on fiscal space.***

- The staff will respond to this question during the Board meeting.

13. ***The report and buff statement further highlight that the determination of fiscal space and its use remains a sensitive and non-exact science. We would welcome comments from staff on how the Fund proposes to bridge the gap with the authorities on this matter.***

- The staff will respond to this question during the Board meeting.

14. ***Can staff elaborate on concrete incentives to extend working lives? We also take note that no new action has been taken to tackle poverty, notably among the elderly. The staff's comments are welcome.***

- The staff has recommended in the past that longer working lives can be incentivized by indexing the retirement age to life expectancy, with financial disincentives for (unjustified) early retirement and financial incentives to remain in the labor force even beyond the statutory age when individuals wish to do so, and making the choice to remain in the labor force actuarially neutral, with additional contributions counting towards larger pension benefits.

- To address old-age poverty risk, the coalition agreement includes measures to cap the pension contribution rate at 20 percent and set a floor on replacement rates (under the national definition) at 48 percent until 2025.

15. ***The authorities rightly underscore the political challenges associated with increasing the already high retirement age. In this light, we would appreciate it if staff could indicate what other avenues could be explored by the authorities to boost labor participation?***

- As noted above, pension reforms to provide incentives for working longer and disincentives for early retirement, together with making the choice to remain in the labor force actuarially neutral would boost labor participation of elder workers. Encouraging life-long learning would also enhance the employment opportunities of older workers.

16. ***Fiscal pressure would increase in maintaining the contribution rate under 20 percent and the replacement rate above 48 percent after 2025, but no reform actions were taken after the 2017 Article IV consultation. We welcome staff's elaboration on what the obstacles are in such reforms.***

- The new government proposed to establish a pension commission, which would focus on the future of the state pension after 2025 as well as the other pension pillars. The commission has been tasked with delivering recommendations for a "reliable inter-generational contract." It will submit a report by March 2020, at which time reforms may be considered.

17. ***We agree with staff that education spending and tax incentives to address shortages in skilled labor could help. Can staff comment on other high priority reforms in this area?***

- Other high-priority reforms include investment in life-long learning to ensure that workers are equipped with up-to-date skills and continued expansion of childcare spending to support full-time female labor force participation.

18. ***In which level does staff recommend Germany to primarily increase expenditures, the local government level or the central government level? Second, what specific spending does staff consider it appropriate to increase in the local government level? Third, could staff elaborate on capacity constraint of local governments in more detail?***

- The staff will respond to this question during the Board meeting.

19. ***To which extent are the policy actions identified by staff under the remits of [the subnational] levels of government? Have staff met their representatives during the mission? What is the traction of the Fund's advice toward [subnational] levels of government?***

- The staff will respond to this question during the Board meeting.

20. ***Many of the proposed spending measures and reforms need to be enacted at the state and municipal level. What is staff's view on the appetite for these reforms at the sub-national level? Do the reforms require coordinated action or would there be benefits if the sub-national governments went it alone? Representatives of sub-national governments are not included in the list consulted by the staff team. Is that something that would be done in a future Article IV consultation?***

- An annual survey conducted by KfW (2017) indicates that municipalities' perceived investment backlog stood at €126 bn (3.9 percent of GDP) in 2017, indicating there is strong appetite for public investment at the sub-national level.

- In staff's views, to help prioritize investment, a comprehensive investment plan—covering all levels of government—should be prepared.

- The staff will further analyze public investment at sub-national government levels in future consultations.

21. ***We note with reservation staff's suggestion for the authorities to utilize the escape clause under the national debt rule in Annex II should risks materialize, and invite staff to provide further explanation on the feasibility of such recommendation.***

- The escape clause under the national debt brake rule (as well as the European fiscal rules) is meant to allow for temporary deviations from the standard structural deficit ceilings in exceptional circumstances, when events outside government control have a severe impact on the economy and the fiscal accounts. It is meant to allow scope for adequate countercyclical fiscal policy when needed (such as in situations where risks described in Annex II materialize). A correction mechanism foreseen in the national and European fiscal frameworks would force adjustment of the fiscal path once economic conditions normalize such that long term fiscal sustainability is preserved. The staff's advice on this issue is consistent with that of past staff reports.

External Sector and Corporate Savings

22. ***Could staff provide an estimate by which the CA would rebalance if the general government surpluses were to be fully utilized for supporting enhanced investments?***

- Based on staff's analysis in previous consultations (see 2014 selected issues papers and Box 1 in the 2017 Article IV staff report) as well as the EBA framework, the direct impact of a one percentage point of GDP increase in public investment would be to lower the CA surplus by 0.3 - 0.5 percentage point of GDP. The impact of other policies aimed at fostering private investment could vary substantially depending on their nature; in particular their effects on labor supply and productivity growth over time.

23. ***Could staff comment on the authorities' disagreement with the reported apportionments of a part of CA gap attributed to domestic policy distortions?***

- The staff will respond to this question during the Board meeting.

24. ***While the overall (CA) surplus has not changed significantly, staff reported an increase in the surplus vis-à-vis other euro area members (i.e., in relations where the nominal exchange rate did not play a role) implying that Germany's surplus with the rest-of-the-world has declined. We feel that more detail about how the analysis took this into account would have been useful.***

- The improvement in the CA surplus vis a vis the rest of the euro area over the recent years is concentrated in the Benelux countries, in particular the Netherlands since 2015 (owing to the general decline in energy prices) and Luxemburg more recently (relative to which the primary income balance has been rising). In 2017, the decline in CA surplus vis a vis non-euro area partners is explained both by the euro appreciation and a one-off effect in the secondary income balance.

25. ***While the updated EBA methodology better captures the impact from demographics, could staff elaborate more on the justification of incorporating the uncertainty of demographic outlook? Specifically, it appears to us that other countries also face the uncertainty of demographic outlook as well. Could staff comment on this adjustment from the view point of evenhandedness?***

- While other countries may also face uncertainties in their demographic outlook, staff is of the view that those faced by Germany are indeed much higher. These uncertainties are driven by (i) the large-scale in-migration wave that took place in the aftermath of the crisis, and (ii) the refugee wave, particularly since 2015. As an indicator for the unusual degree of uncertainty, demographic projections by the UN showed that Germany exhibits the largest changes, both in terms of future age composition as well as the prospects for medium-term population growth, in the two most recent vintages (2017 and 2015). This is related to the uncertainties surrounding the sustainability of migration rates, but also to whether the recent pick-up in fertility will be long lasting.

26. ***The German authorities see the current account surplus as a result of private saving decisions; how can the authorities affect such private decisions through policy action? The staff's comments are welcome.***

- The staff will respond to this question during the Board meeting.

27. ***We also note with interest the observation in Annex VII that corporate tax policy may have played a role in the decision by firms to accumulate cash and avoid additional investments. We would appreciate staff's comments on how the authorities have reacted to this analysis on the tax system and the conclusions thereof.***

- It is important to note that staff's analysis on corporate savings has focused on establishing the stylized facts. The staff has not yet identified policy distortions. To this end, staff has noted that the corporate tax reforms of the 2000s *may* have contributed to reducing the debt bias and to retain more earnings in the firm, thereby encouraging higher corporate savings. The staff has not taken the view that these reforms discouraged investment (Annex VII focuses on savings only).

- The authorities agreed with staff on most of the stylized facts of NFC savings, however they did not see the linkage with the tax system. As noted in Mr. Merk's buff, the authorities agree that further analysis of this issue is needed.

28. ***Could staff elaborate on why tax reforms, precautionary savings, or the need to build cash buffers for R&D are leading to a decline in dividend payout rates? What is happening in the German economy amidst buoyant exports, robust growth and record low unemployment that small and medium-sized companies still feel the need to set aside precautionary savings?***

- The staff's discussion of stylized facts of NFC savings is a first step into a deeper analysis of the fundamental drivers of NFC savings in Germany. In Annex VII, staff has listed several possible factors that could be related to the increasing corporate savings, but further empirical analysis will be needed to establish causal links.

29. ***We would appreciate it if staff could elaborate on the impact of the subsidies and the import tariffs on the current account surplus and REER in Germany.***

- The staff sees the current account surplus as driven by savings and investment decisions of German economic agents.

- Concerning steel and aluminum tariffs recently implemented by the U.S. administration, staff estimates the direct impact on the German current account surplus to be limited given the relatively low weight of German exports of these particular goods to the United States

30. ***How is the assessment about REER misalignment in Germany compatible with the high financial integration within the euro area, where the CA surplus is lower (about 3.5 percent of GDP)?***

- The assessment of the consolidated external position of the euro area will be covered in the Article IV staff report for the euro area, scheduled for Board discussion on July 16. The staff's assessment of the current account and REER of the euro area is consistent with the aggregation of the assessments of the euro area member countries.

31. ***Should composition of internal savings (households or Firms) be considered in the CA assessment?***

- An analysis of the composition of private savings can help identifying some of the drivers of the current account surplus, beyond fiscal policy. The precise mechanisms are likely to be country-specific, however.

Structural Reforms, Innovation, and Climate Policy

32. ***Could staff comment on the authorities' emphatic arguments against their suggestion regarding reforms in the professional services?***

- In staff's view, regulation of professional services has implications for the cost of doing business as professional services play an important role as intermediate inputs. Reducing the cost of doing business can provide greater incentives for private investment and boost productivity growth.

- Based on our discussions with the authorities, they are not yet convinced that reforms of professional services would reduce the cost of doing business sufficiently enough to offset the cost of undertaking the reform.

33. ***Would staff recommend a change in [the corporate tax] framework in order to boost investment? We would also appreciate if staff could work on the relationship between business creation, entrepreneurship, innovation and potential growth, including through cross-countries analysis.***

- The staff has not yet analyzed whether changes to the corporate tax framework would be warranted to boost investment. Further analysis of this issue is planned for future Article IVs.

34. ***To what extent [the Doing Business 2018] ranking [for "Starting a Business"] is consistent with staff's own analysis? The staff's elaborations would be welcome.***

- The staff relies on third-party indicators for its analysis of the ease of doing business. The staff, however, is generally cautious about using relative rankings from the Doing Business Indicators. The staff report, therefore, shows a cross-country comparison of the number of procedures to start business in the form of limited liability company to indicate key challenge in doing business in Germany that is often cited by the authorities and the private sector. Similar indicators compiled by the OECD—for example, "communication and simplification or rules and procedures" from the OECD's Product Market Regulation Indicator—also show a similar picture.

35. ***Germany carried out the "new 2020 Hightech Strategy" in 2013 and digital economy is one of the six priority tasks, especially the "industry 4.0." We welcome staff's elaboration on the main progress of such strategies and how the government implemented them in the past.***

- "Industry 4.0" is the German government's ongoing national strategic initiative based on the "High Tech Strategy 2020." It aims to drive digital manufacturing forward by increasing digitization and the interconnection of products, value chains, and business models. It also aims to support research, the networking of industry partners, and standardization. The previous government allocated € 200 mn for the initiative, which is complemented by financial and in-kind contributions from industry. By 2016, the government has funded 10 Industry 4.0 competence centers, with five more to come. A range of measures taken by the government to enhance the adequacy of venture capital has also been supporting investment in intangible assets. The new government is expected to pursue the agenda; it even plans to expedite the expansion of high-performance broadband networks, which is expected to be financed by auctioning 5G licenses.

36. ***Promoting public transportation, supporting the use of e-vehicles, and phasing-out coal-fired power production could be elements of a credible strategy to reduce greenhouse gas emissions. We appreciate staff indication of the government's goals in this area, and how likely they are to be reached.***

- Germany is on track to meet its renewable energy (RE) target. In 2017, Germany produced 33.1 percent of its energy out of renewable, a remarkable achievement which puts the country in good position to reach its 2020 target of 35 percent. However, faster progress in greenhouse gas emission reduction is needed. The Federal government has set ambitious goals to cut greenhouse gas emission by at least 85 percent from 1990 to 2050. It has also laid out ambitious national targets for 2020, going beyond EU requirements, including: reducing carbon emissions by 40 percent relative to their 1990 level and reducing primary energy consumption by 20 percent relative to 2008. According to recent projections (Projektionsbericht 2017), Germany may miss its 2020 target by 4 percentage points.

Housing Market and Macroprudential Policy

37. ***The authorities see overvaluation concerns as localized. Could staff comment on the view?***

- The staff will respond to this question during the Board meeting.

38. ***Can staff comment on the authorities' arguments that macroprudential tools would face legal obstacles and that microprudential tools are available and can be effectively used to address bank-specific concerns?***

- The staff will respond to this question during the Board meeting.

39. ***Could staff elaborate on legal obstacles to early activation of borrower-based macroprudential tools?***

- The staff will respond to this question during the Board meeting.

40. ***Like staff, we encourage the authorities to address data gaps to help assess risks to financial stability. We note, however, that this is a long-standing recommendation, now judged as urgent by staff, and we would appreciate some clarifications on why progress has not been achieved in this important area.***

- The staff will respond to this question during the Board meeting.

41. ***Noting that the authorities share the staff's concern over the data gaps, we would be interested in staff's comments on the types of initiatives that are being considered by the authorities to address the existing data gaps?***

- The staff will respond to this question during the Board meeting.

42. ***We invite staff to comment on how best to address the communication challenge [for inclusion of income-based instruments in the macroprudential legislation] as current conditions, i.e., low and declining debt-service-to-income ratio and low household indebtedness, do not warrant the inclusion of the new policy instruments and in light of the more urgent need to improve housing affordability.***

- The staff will respond to this question during the Board meeting.

Banking and Insurance

43. ***Could staff suggest how consolidation among small and mid-sized banks could be further incentivized?***

- While staff assesses that consolidation among small and medium-sized banks would foster profitability, no specific policies have been identified as desirable to accelerate the process. The consolidation process is ongoing and is expected to continue, given market pressures and consolidation gains in the context of digitalization of the economy as well as new regulatory requirements.

44. ***We welcome staff's elaboration on the reasons why the restructuring process [in the banking sector] remains slow.***

- Restructuring of business models in the banking sector is ongoing and should continue. The pace has been slow in some large banks due to the difficulty in restructuring complex operations. As with consolidation (see answer above), staff expects this progress to be driven by market pressures.

45. ***Could staff say more about their view of progress in implementing restructuring plans, and whether greater attention may be necessary?***

- We refer to the answer to the previous question. The staff notes that at the current juncture Germany banks are generally well capitalized. However, continued supervisory attention to financial stability risks emerging from banks' business models remains essential.

46. ***We wonder whether enough competition exists in the [banking] sector, and whether the additional consolidation referred to in the staff appraisal may not further harm competitiveness and dynamism, even if it creates a more stable system. The staff's comments are welcome.***

- Competition in the German banking sector is high; Germany has a relatively large number of institutions per capita, and the low interest margins are partially a reflection of competition pressures. The staff assesses that there is currently scope for further consolidation without threatening financial stability.

47. ***With the increased interest rate risk exposure caused by search-for-yield in the banking and insurance sectors, we welcome staff's elaboration on how to contain possible risks of asset revaluation caused by interest rate normalization.***

- A steady interest rate normalization would generally benefit the German banking and insurance sectors, while an abrupt rise in interest rates can lead to asset revaluation related losses. The ongoing supervisory attention to interest rate risks—such as the 2017 Interest Risk Survey of the Bundesbank, for small and medium sized banks; implementation of Pillar II requirements for most exposed banks, and requiring action plans from insurance firms in difficulty—is welcome.

- In the banking sector, further consolidation and development fee-based income would support profitability without need to resort as much to expanded maturity transformation. In the insurance sector, improving profitability through assess to international investment portfolios and derivative products would also be helpful.

48. ***Does staff agree with the comfort taken by the authorities from long transitional period available for compliance with Solvency II against the prospective outlook on interest rate/yield movements?***

- The long transitional period provides an opportunity for life insurers to restructure their business models and continue to reduce reliance on guaranteed return products, in line with staff's recommendation. However, this process must be accelerated.

49. ***Low interest rates have weakened conditions of life insurance companies. Could staff elaborate on this development, in particular on the exposure of life insurance companies to liquidity and market risks?***

- In response to the decline in interest rates, life insurers have been expanding the maturity of their asset holdings, increasing exposure to liquidity risks and valuation changes in the event of an abrupt rise in interest rates. Such scenario would lead to a reduction in asset values, at the same time that more policy holders might be lapsing their policies. The Bundesbank 2017 Financial Stability Report assesses the critical interest rate level for life insurers given an upsurge in policy lapses (level beyond which financial stability might be impaired) to have declined from about 5-6 percent in the pre-crisis years to about 3½ percent since 2014.

50. ***Could staff provide an update on the progress made towards implementing previous FSAP recommendations, including (i) developing a formal coordination mechanism for addressing systemic crises, and (ii) reinforcing contingency planning for the management of a systemic crisis?***

- To the best of our knowledge, no specific actions were yet taken on this regard.