January 2006
IMF Country Report No. 06/16

Germany: 2005 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Germany

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 28, 2005, with the officials of Germany on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 19, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a supplement to the staff report, based on follow-up discussions with the new government that ended on December 14, 2005. The supplement was completed on December 28, 2005.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 11, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Germany

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Germany

Approved by Michael Deppler and Adnan Mazarei

September 19, 2005

- Discussions took place in Berlin, Frankfurt, Bonn, and Munich during June 15-28, 2005. Meetings were held with Bundesbank President Weber, State Secretaries Koch-Weser (Ministry of Finance) and Pfaffenbach (Ministry of Economics and Labor), and senior officials at the Chancellery, the Ministries of Finance, Economics and Labor, and Health and Social Security, the Bundesbank, and the Federal Office of Financial Supervision (BaFin). The mission also met with the Finance Ministers of the Länder Governments of Hesse (in the West) and Brandenburg (in the East), federal parliamentary representatives, social partners, associations of financial institutions, and research institutes.

- Following the general elections on September 18, 2005, a second round of discussions is planned for November. A supplement will report on these discussions prior to the Board meeting.

- The team comprised Messrs. Chopra (Head), Traa, Odenius, Braumann, Danninger (all EUR), and Cihak (MFD). Mr. Meissner, Germany's Alternate Executive Director, attended the discussions.

- The authorities released the mission's concluding statement and intend to publish this report. Last year's Article IV staff report was published as IMF Country Report No. 04/341 following the IMF Executive Board meeting on October 25, 2004.

Main Websites for German Data

Data in this Staff Report reflect information received by August 31, 2005. More recent data may be obtained directly from the following internet sources:

German Federal Statistical Office... http://www.destatis.de

Deutsche Bundesbank... http://www.bundesbank.de

Ministry of Finance.. http://www.bundesfinanzministerium.de

Federal Labor Agency.. http://www.arbeitsagentur.de

Information on German economic statistics can be found at the Special Data Dissemination Standard website of the IMF...............http://www.imf.org/external/country/DEU/index.htm

Contents Page

Appendices

Executive Summary

Germany faces serious economic challenges and needs decisive, forward-looking policies to raise employment, investment, and output growth. Germany is wealthy but has a highly regulated economy that is financing a generous welfare state. Rigidities from this structure impose long adjustment periods after shocks such as unification, rapid regional and global economic integration, and pressures from aging. Problems manifest themselves in three interrelated features:

- Low and declining trend growth, and most recently weak domestic demand despite strong exports.
- High and long-lasting unemployment, with high reservation wages and gross labor costs.
- Persistent fiscal pressures, and public finances and welfare programs that are not sustainable under current policies.

Implementing a sound reform strategy with a clear timetable offers the best prospect for building confidence and revitalizing growth. The staff recommends that the strategy encompass the following mutually-reinforcing elements:

- **Fiscal consolidation** to reach structural balance by 2010 and help secure long run fiscal sustainability. Emphasis should be on reducing distortions via cutting subsidies and tax expenditures, recalibrating entitlement benefits, cutting payroll taxes, and raising the retirement age. Institutional reforms to improve incentives for better fiscal management are also important.
- **Labor market reforms** to reduce high unemployment and raise labor utilization, thus limiting the effects of aging on growth and public finances. Reforms need to facilitate job creation and include: allowing wage setting to reflect local labor market imbalances and productivity differentials; switching central wage bargaining to the firm level; and cutting employment protection legislation to boost employment of the most vulnerable workers.
- **Product and services market reforms** to boost the effectiveness of labor market reforms. By increasing competition in product and services markets, wage moderation will be passed on to lower prices, and result in faster output and employment growth. Regulations and administrative hurdles need to be reduced to make the business climate more conducive to job creation, particularly in the service sector.
- **Financial sector reforms** to make the sector more dynamic and place it in a better position to support growth. The banking sector's continued fragmentation limits economies of scale and risk diversification. Abolishing limits on intraregional

competition and opening up public sector banks to private capital would facilitate market driven restructuring, foster returns to scale, and bolster profitability.

I. Introduction

1. **The discussions took place against the backdrop of low trend growth, persistent fiscal pressures, and Chancellor Schröder's call for early elections.** Since the 2004 Article IV consultation, the authorities' main policy initiative has been implementing the far-reaching Hartz IV labor market reforms in January 2005.[1] These were part of Agenda 2010, which provided a forceful start in addressing Germany's deep seated structural problems (Box 1). Implementing Hartz IV, however, has proved more challenging than expected and continued high unemployment has sapped public confidence. Following the ruling coalition's loss in the key state elections of North Rhine-Westphalia in May, just prior to the consultation mission Chancellor Schröder called for federal elections in September, one year early in the government's term, to seek a new mandate for reforms. These surprise elections restricted the depth and specificity of the forward-looking policy discussions. Nevertheless, the authorities welcomed the opportunity to assess economic policy challenges that need to be tackled by any future government, and it was agreed that the discussions would continue in November following the elections. A supplement will report on these follow-up discussions.

II. Background

2. **German exports are flourishing but domestic demand continues to languish, resulting in a tepid and unbalanced recovery.** Weak domestic demand is driven in large part by necessary adjustments as Germany rebuilds its competitiveness through wage moderation and other efforts by companies and government to improve efficiency and lower costs. Considerable progress has been made in this adjustment process, but persistent weak economic performance—despite strong global growth, accommodative interest rates, and a broadly neutral fiscal policy—suggests that Germany's problems are structural rather than cyclical.

3. **Labor market conditions are difficult and sentiment is weak.** The creation of new jobs continues to be stifled by wage rigidities and regulatory hurdles, and the increase in the labor force resulting from the Hartz IV reforms triggered a rise in unemployment to 12 percent (5 million persons, national definition; 9.5 percent on Eurostat definition) in early 2005. This damaged consumer sentiment and muted the government's enthusiasm for additional reforms. High unemployment continues to restrain wage demands, keeping core CPI inflation low at 1 percent, although rising commodity prices have lifted headline inflation to about 2 percent so far this year (Figure 1).

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[1] The Hartz IV reforms merged the long-term unemployment program and social assistance into a single new Unemployment Benefits II (UB-II) program, with lower average benefits and expanded means testing and job search requirements. UB-II is managed jointly by the Federal Labor Office and local governments.

Box 1. Past Fund Policy Recommendations and Implementation

In recent consultations, Directors have welcomed the path breaking reforms of Agenda 2010, which were in line with longstanding Fund recommendations. At the same time, they noted that these initiatives needed to be augmented to help overcome the high costs of unification, cope with globalization, and anticipate the pressures from aging.

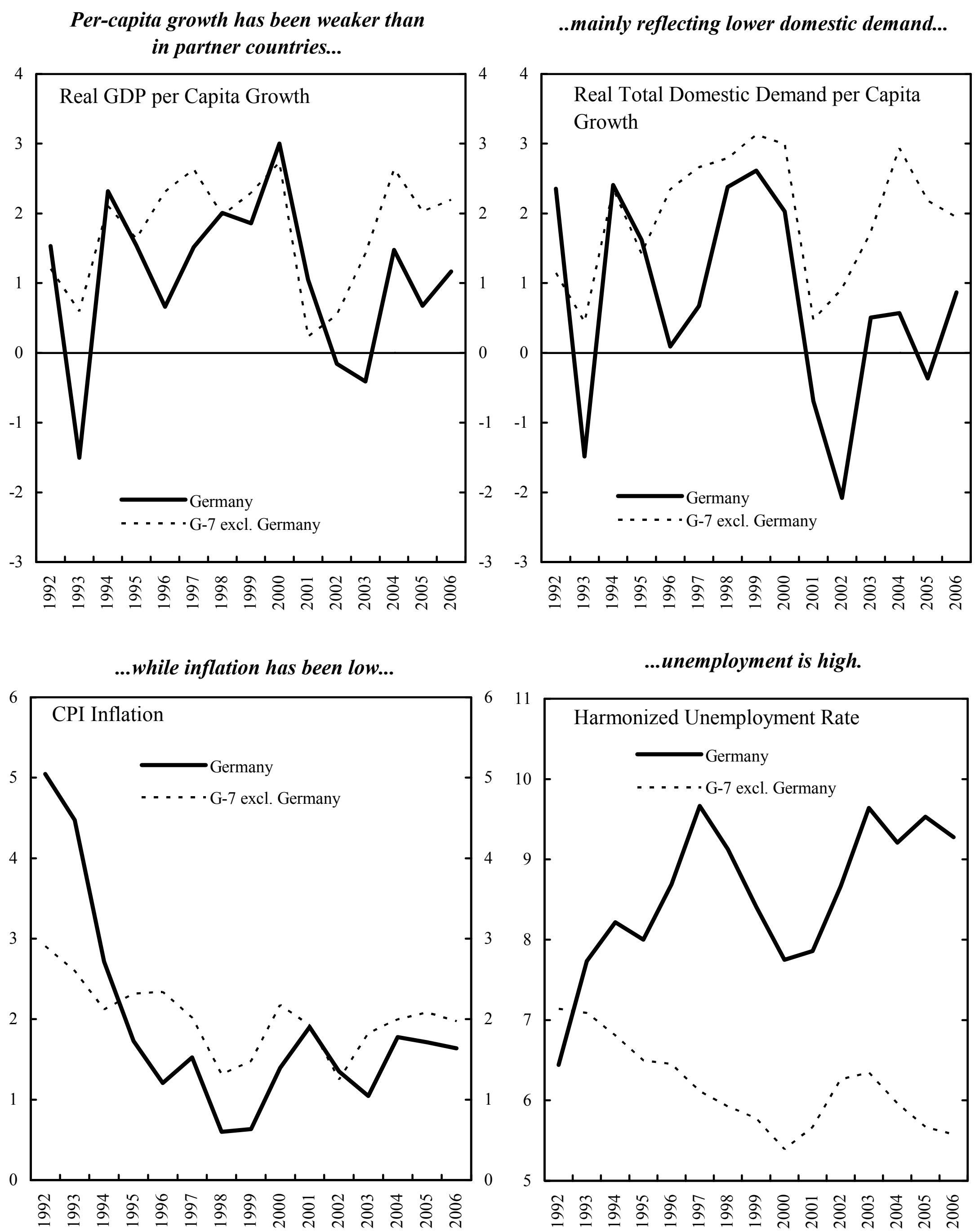
Fiscal consolidation: Directors endorsed the objective to reduce the structural deficit by 1.5 percent of GDP during 2004–06, but the structural deficit is projected to decline only by 0.4 percent of GDP over this period. Efforts to cut tax expenditures and subsidies have met with little success, and discussions by a parliamentary commission to reform Germany's complex federal structure and intergovernmental relations were broken off without agreement.

Labor market reforms: Directors have supported Germany's sustained wage moderation and the successive Hartz (I-III) reforms to help overcome the labor cost shock of unification and strengthen incentives to work. Also, wage determination has become more decentralized de-facto, but there are still constraints on firm-level bargaining. Employment protection legislation, although streamlined, continues to be tight. Most recently, the authorities proceeded with the implementation of the difficult Hartz IV reform. However, political compromises complicated operational aspects of the reform, including overlapping responsibilities between different agencies, incomplete enforcement of eligibility requirements, and some rollback of the reform for elderly workers.

Pension reforms: The introduction of a "sustainability formula" to slow future pension increases was a central feature of Agenda 2010. However, the formula was suspended for 2005, its first year of operation, due to a safeguard clause intended to prevent nominal pension cuts. The recommendation to shift the pensionable age from 65 to 67 has not been followed up.

Financial sector: Supervision is improving in line with the 2003 FSAP recommendations, including by strengthening regulations for reinsurance. Directors also called for reducing impediments to a market driven restructuring of the banking system. Although some Landesbanken have converted into joint-stock companies, overall restructuring is proceeding slowly and the system remains segmented. Good progress is underway in bolstering capital markets, as demonstrated by the fast growth in asset-backed securities.

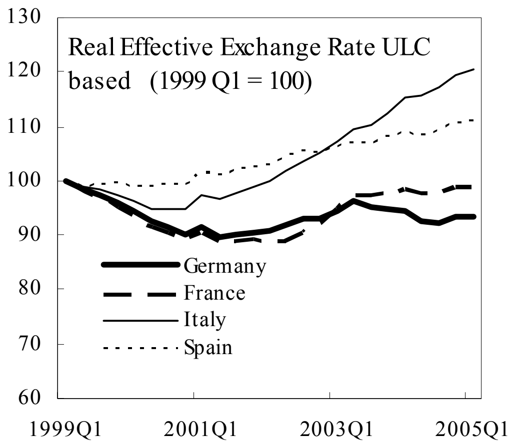
Figure 1. Germany: Economic Performance, 1992-2006
(In Percent)



Source: IMF, World Economic Outlook.

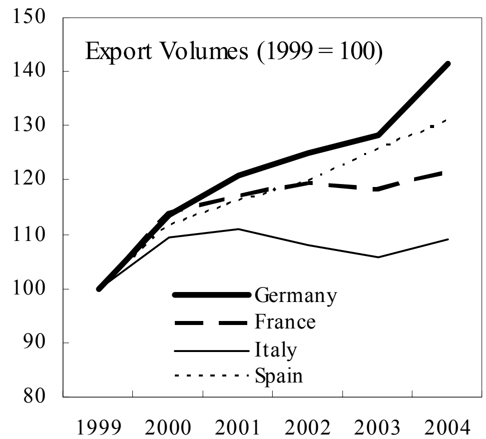
4. **Exports are the bright spot, based on improved competitiveness and a favorable product mix** (Box 2). Business restructuring, cost cutting, sustained wage moderation, and low inflation and unit-labor cost growth have helped rebuild competitiveness after the surge in costs associated with unification. Germany's export mix—dominated by capital goods—has been favored by the global upswing in investment, which has been an additional important factor underlying this success. Moreover, Germany's exports are oriented to fast growing and oil producing countries, and have gained market share both outside and inside the euro area (text charts and Figure 2). The external current account surplus is projected to be over 4 percent of GDP in 2005.

Competitiveness has improved...



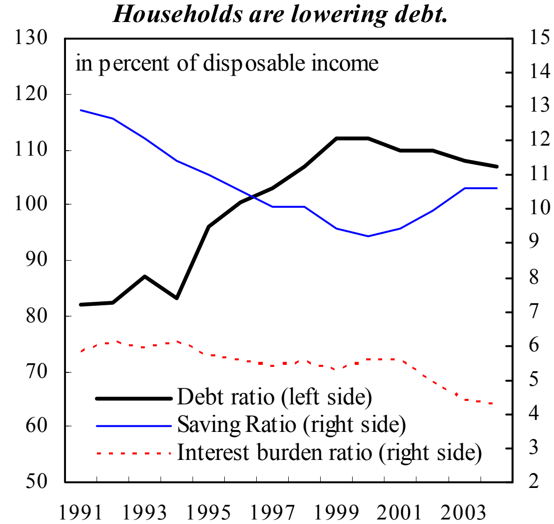
Source: INS and WEO.

...and exports are doing well.



5. **By contrast, household consumption remains weak.** Slow growth in household consumption is consistent with fundamentals as wage moderation contributed to slow disposable household income growth and wealth formation was weak in part due to stagnant real asset prices (Box 3). At the same time, saving has increased as households have been lowering their high debt and scaling down their earnings expectations in view of permanently lower growth and cuts in future entitlement benefits.

Households are lowering debt.



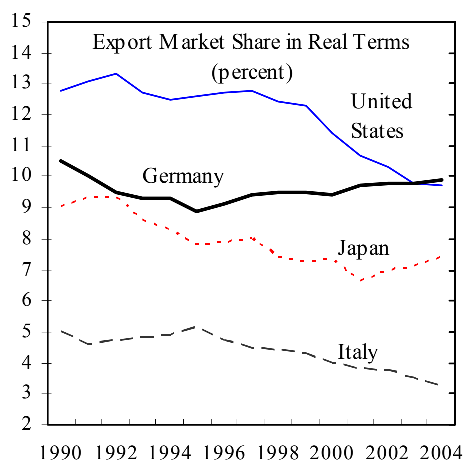
Source: Bundesbank.

Box 2. Competitiveness

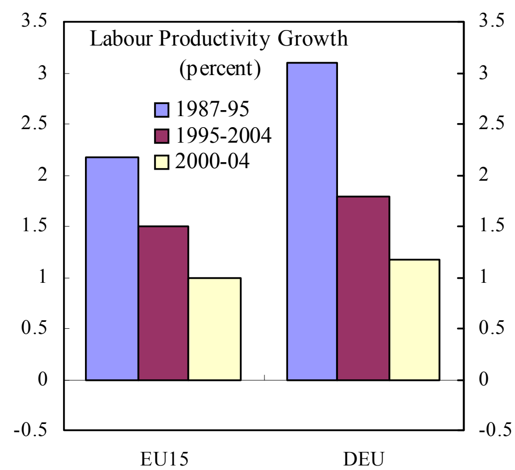
Export strength. Germany became the world's largest exporter in dollar value in 2004, surpassing the U.S. This development is seen as an indication of recovering competitiveness, following the cost pressures incurred in the early 1990s with unification.

Improving labor productivity. Labor productivity in Germany has grown faster than the EU-15 average. Combined with sustained wage moderation, this has resulted in Germany's ULC falling by 8 percent relative to the EU-15 since the start of EMU.

Global demand strength. While adjustment efforts have contributed to slow domestic demand, strong global demand boosted Germany's export volume growth to 9 percent in 2004, substantially higher than the previous year. Econometric estimates suggest that Germany's exports are more elastic to changes in global demand than to price and REER developments.[1]



Source: Bundesbank



Source: US Conference Board

Favorable trade linkages. In addition to the strength in global demand, Germany's ties to fast growing markets were also major factors for Germany's export success. Germany has greater exposure to new EU members, Asia, and the U.S. than most EU partner countries.

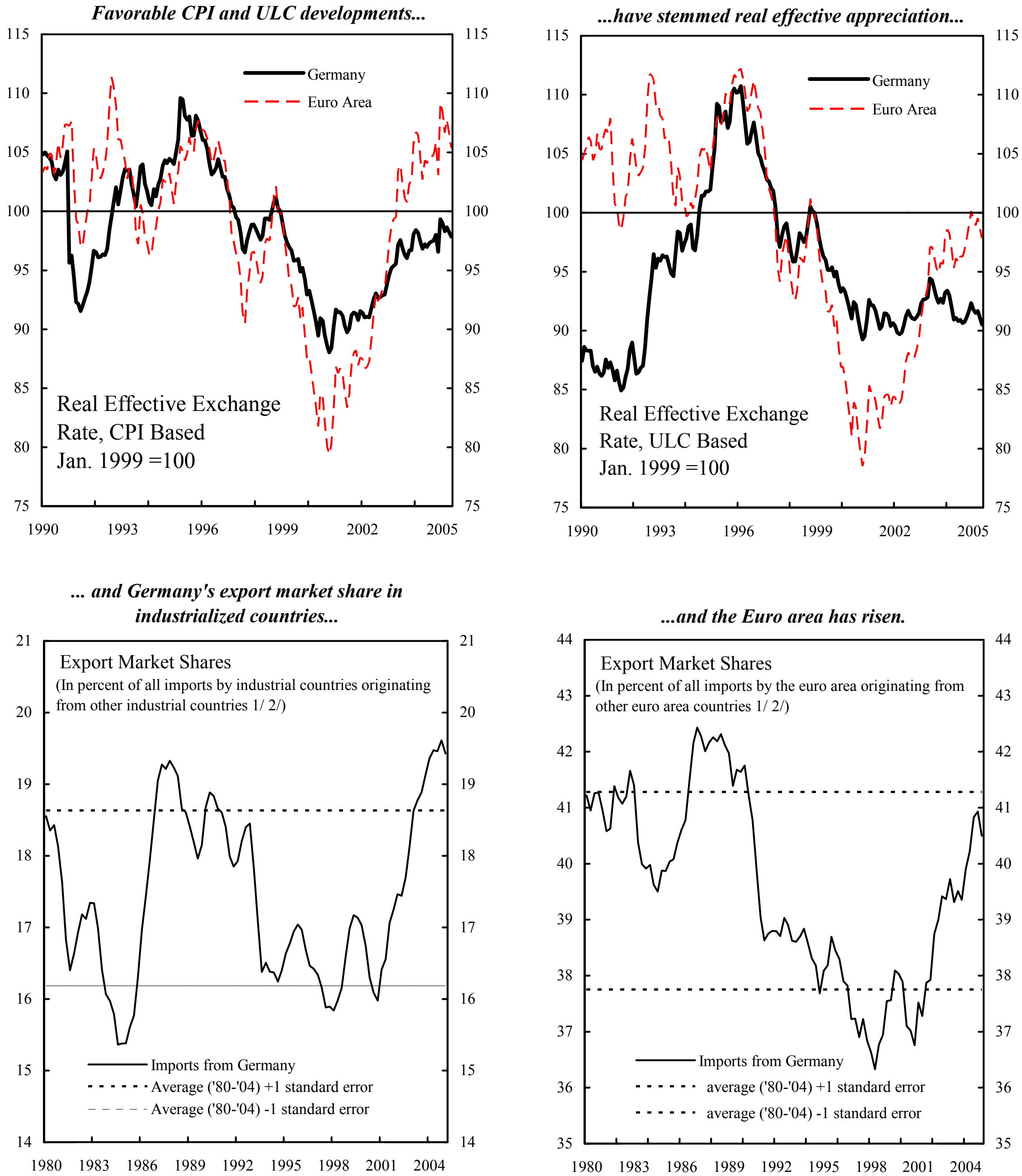
Composition of Exports, 2004
(Shares, in percent)

	France	Germany	Italy	U.K
Exports to new EU members	3.3	8.5	5.4	2.3
Exports to the United Kingdom	9.3	8.2	6.9	...
Exports to the United States	6.7	8.8	8.0	15.0
Exports to Asia excluding Japan	4.9	7.1	5.7	7.4

Source: IFS, IMF.

[1] See "Explaining Differences in External Sector Performance Among Large Euro Area Countries" being issued as a background paper for the France, Germany, Italy, and Spain consultations.

Figure 2. Germany: Competitiveness and Exports 1980-2005



Sources: Direction of Trade Statistics; and IMF staff calculations.
1/ Excludes Belgium and Luxembourg.
2/ Three-quarter moving averages.

Box 3. German Consumption Growth—a Regional Comparison

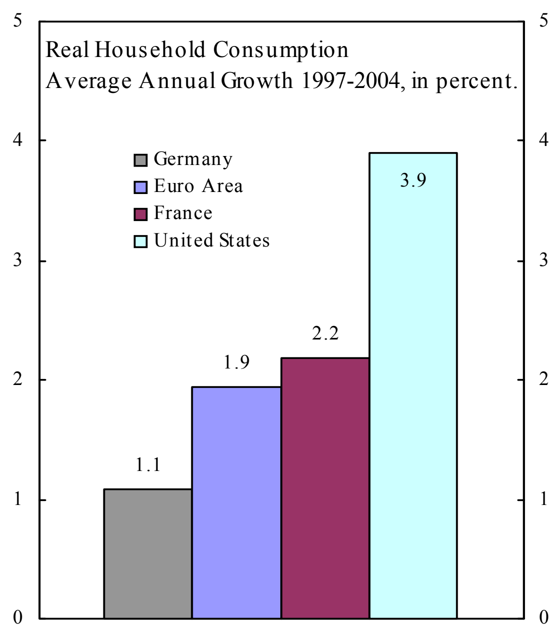
Consumption growth has been slow. In the last three upswings, during a period of six quarters following the trough, German consumption rebounded by more than 4 percentage points. By contrast, in the six quarters since the last trough in the fourth quarter of 2003, consumption has stagnated. Other EU members have had much stronger consumption growth.

Income growth has been weak. During 1996–2004 real disposable household income grew by 0.6 percent a year, reflecting slow employment growth and wage moderation. This underperformed the euro area by 1 percentage point a year.

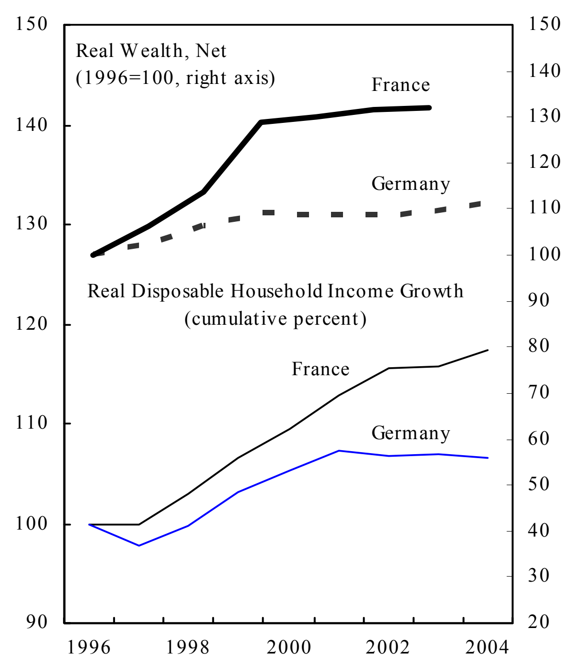
Household saving edged higher. Difficult but necessary cuts in entitlement and unemployment benefits reduced income. Fears about potential job losses may have also led to higher precautionary savings. Household savings rose by 1.4 percentage point to 10.6 percent between 2000 and 2004. The increase in the household saving rate in the EU was about 0.6 percentage points through 2003.

Wealth formation in Germany trailed the international average. Net wealth, mainly comprising housing stock, increased little during 1996–2003, reflecting flat housing prices. In France, Italy, Spain and the U.K., rising home prices boosted wealth.[1]

Germany's household consumption is weak...



...reflecting slow growth in wealth and income.



[1] French net wealth to household disposable income rose by 14 percent during 1996-03, as housing prices rose by 59 percent over this period.

6. **Despite improvements in profitability, companies are still cautious about investing in Germany** (Figure 3). Salient factors are:

- **Profit growth is concentrated in large export companies, which are integrating their operations into global production chains.** This has been illustrated by the steady rise of imports of intermediate inputs for exports. Thus, a growing share of investment is taking place abroad where cost bases are lower[2]—and where demand is expanding faster—thereby dampening the stimulus from exports to domestic demand.

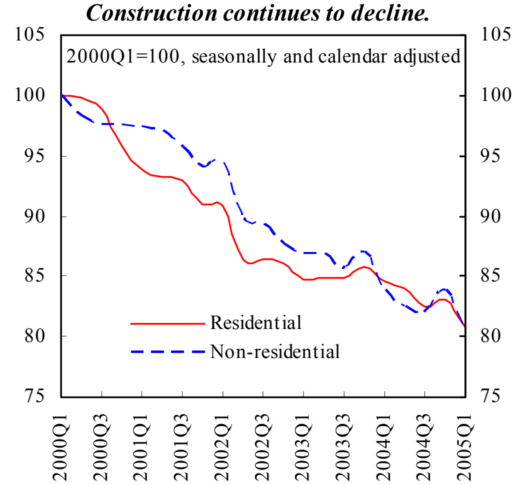
- **Capacity utilization is below average** and domestic cost cutting—rather than demand growth—has been the main factor driving profitability. Against this background, manufacturers continue to reduce domestic employment.

- **Small and medium-sized enterprises (SMEs) have weaker finances and are more oriented toward domestic activity.** SMEs undertake about half of domestic investment. With low equity, they depend heavily on the banking system for their financing, which only recently began relaxing lending standards after a period of tightening with the advent of risk-weighted lending and other structural changes in the financial sector. SME financial ratios under perform those of large enterprises in Germany and fall short in international comparisons.[3] Thus, adjustment in SMEs appears incomplete.

- **Balance sheet repair is unfinished.** The business sector debt-GDP ratio has improved but remains elevated by historical and international standards. Corporate cash flow is still mostly used for debt reduction rather than investment.

- **Finally, construction investment continues to dwindle.** Concerns about household income and job losses, combined with excess capacity in the business sector, continue to depress construction.

Construction continues to decline.



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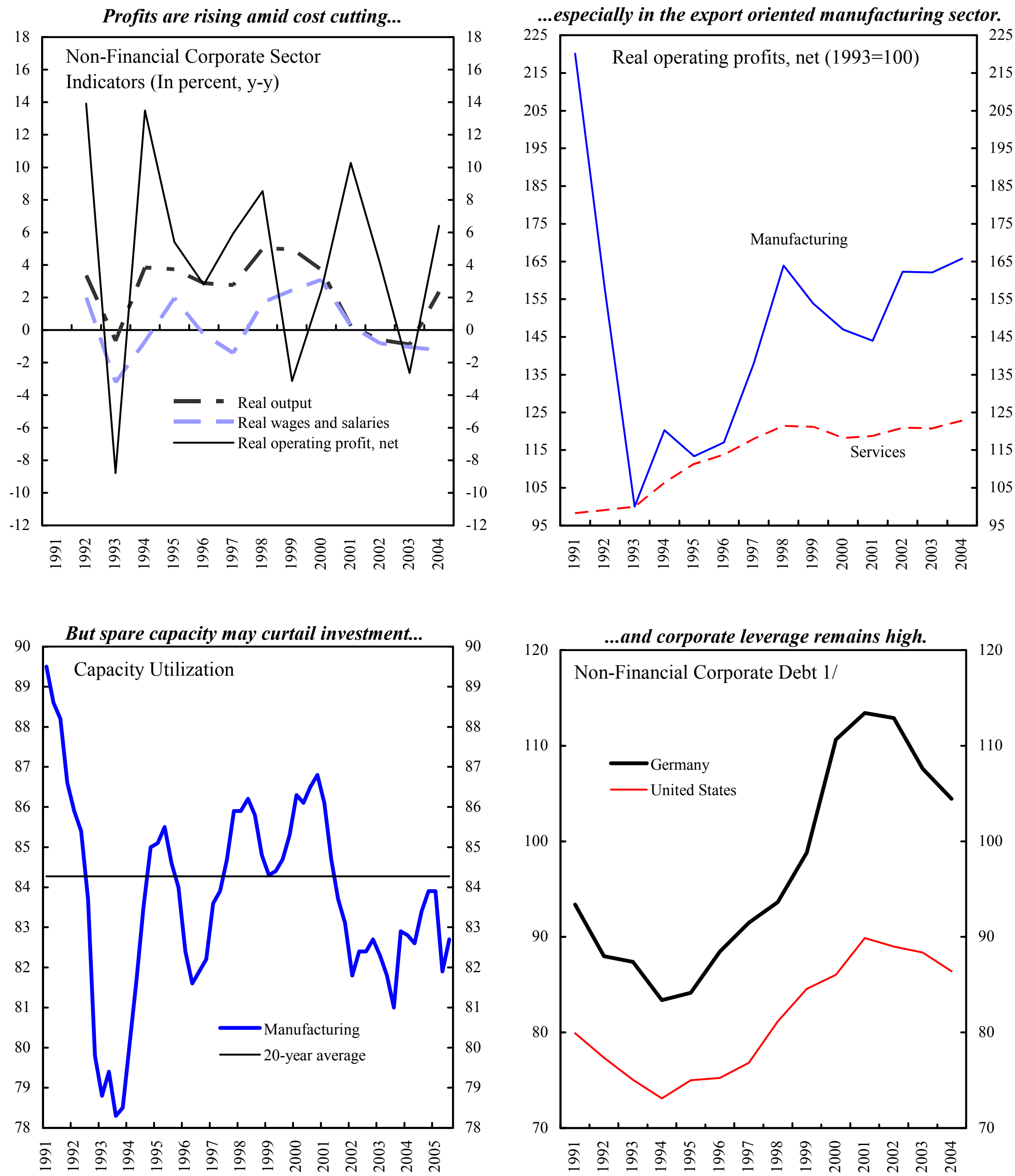
[2] FDI data understate the shift of productive capacity abroad, in part because the large exporting companies operate and obtain financing directly abroad.

[3] See the selected issues paper "The Performance of Germany's Nonfinancial Corporate Sector—An International Perspective."

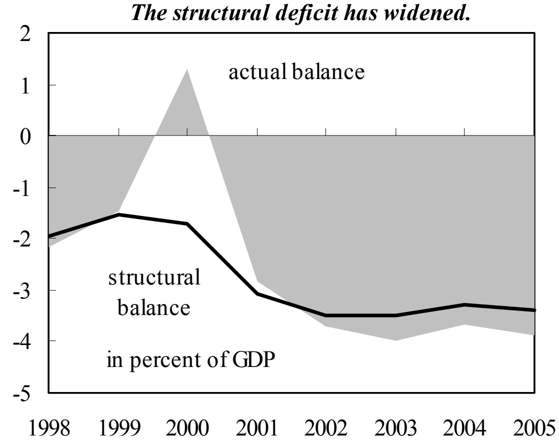
Figure 3. Germany: Profitability, Leverage and Capacity Utilization 1991-2004



Sources: Bundesbank; German Statistical Office; and IMF staff calculations.
1/ In percent of corporate GDP.

7. **Fiscal policy has been complicated by structural shifts in the tax bases and moderate growth.** Automatic stabilizers have been allowed free play and the fiscal stance has been broadly neutral in recent years. Discretionary expenditure was contained as intended to offset the income tax cuts (amounting to 1 percent of GDP) phased in during 2004–05. Nevertheless, the trend decline in Germany's main tax base (labor income) and rising aging-related social security expenditures have put considerable pressure on the structural deficit.

The structural deficit has widened.



8. **Private sector credit has been declining in real terms.** Although monetary conditions are accommodating, survey data suggest that the demand for credit has continued to decline owing to a combination of weak economic activity and the efforts by firms and households to reduce debt. Analysis also suggests that banks with weaker capitalization curtailed the supply of credit in 2003–04, although these constraints are now beginning to ease.[4] More generally, preparation for Basle II has been a force for changed behavior by German banks, especially the greater focus on risk differentiation. Falling demand for credit, combined with a renewed targeting by private sector banks of SMEs, has heightened competition, triggering a narrowing of lending spreads (Figures 4 and 5).

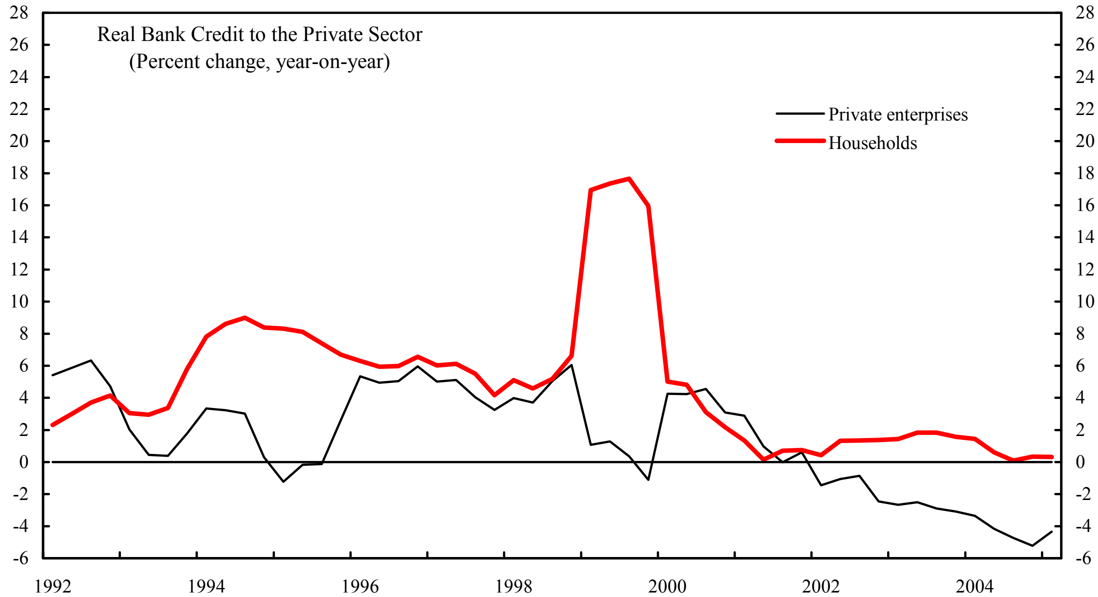
III. Policy Discussions

9. **In the staff's view, a comprehensive forward-looking strategy is needed to raise employment, investment, and output growth.** This strategy needs to be decisive, but implementation could be graduated along a well-specified path, with particular focus on dealing with aging and consolidating public finances and reducing distortions, especially in the labor markets. The call for early federal elections, however, constrained the authorities' ability to outline concrete policy plans for the future. Nevertheless, the authorities agreed that moving beyond the reforms of Agenda 2010 is imperative to confront the challenges of low growth and high unemployment and address strains on the generous welfare system from demographic change, and also to make full use of the opportunities from greater economic integration both in the expanded EU and worldwide. Moreover, given its size and importance for the region, firm policy leadership by Germany to tackle structural constraints on domestic demand would help reinvigorate growth in Europe, contribute to a reduction in global

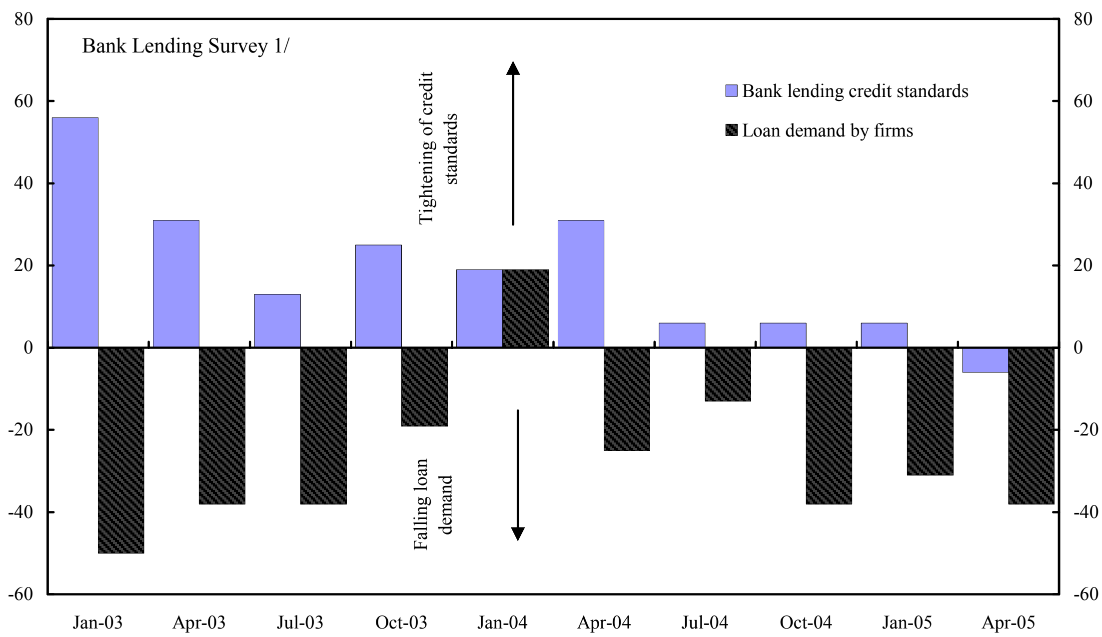
[4] See the selected issues paper "The German Banking Sector: Credit Decline, Soundness, and Efficiency."

Figure 4. Germany: Interest Rates and Credit Developments

Real private sector credit is contracting...

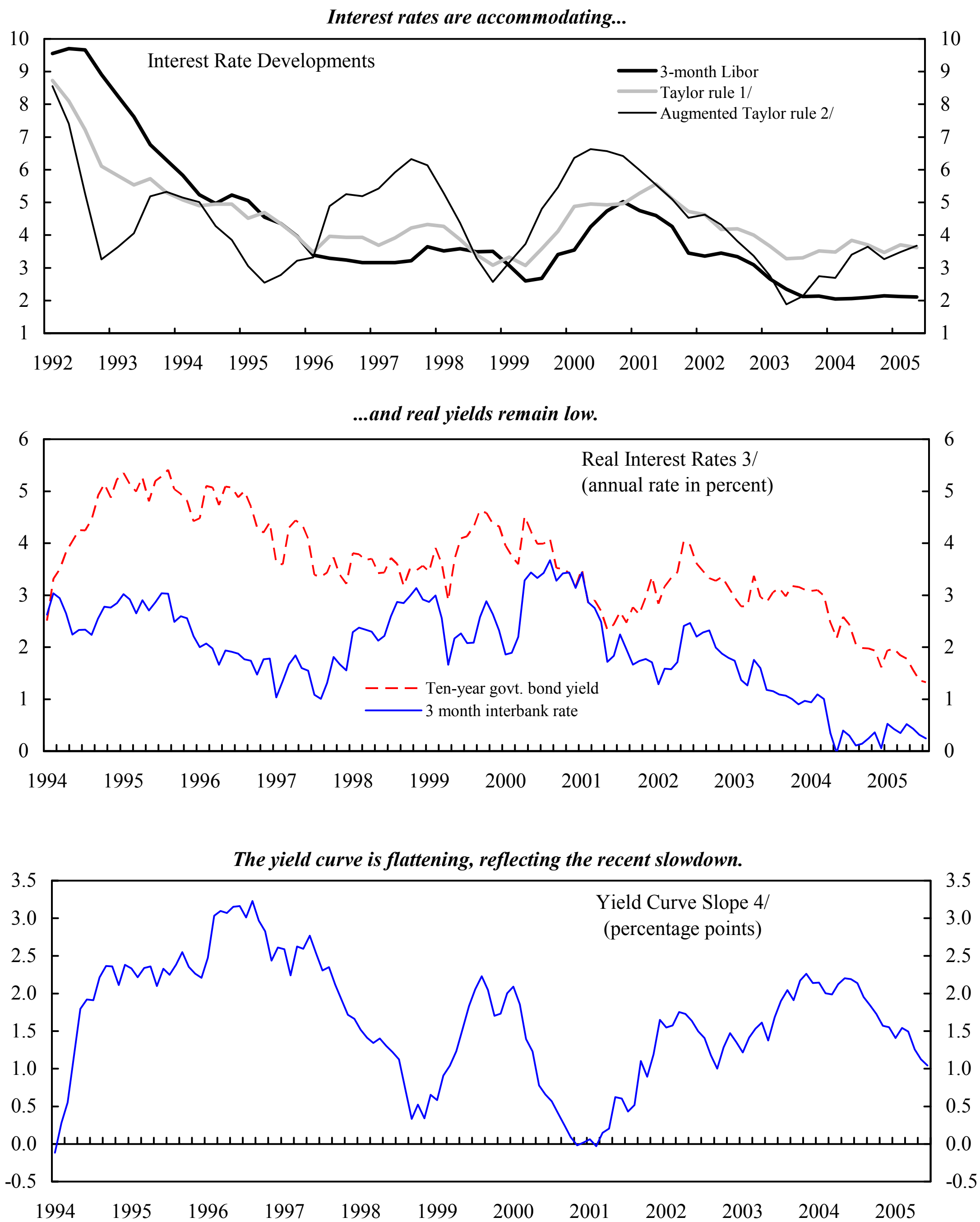


...and firms' loan demand is falling amid tight credit standards.



Sources: Deutsche Bundesbank; and IMF staff calculations.
1/ In percent of responses.

Figure 5. Germany: Financial Indicators



Sources: Deutsche Bundesbank, DataStream; and IMF staff calculations.

1/ Assumes inflation target of 1.75 percent and equilibrium real interest rate of 2.5 percent.

2/ Subtracts percent REER appreciation in the last two quarters relative to the preceding four quarters with a weight of 1/3.

3/ Yields minus consumer price inflation.

4/ Ten-year Bund rate minus 3-month interbank rate.

imbalances, and also encourage reform elsewhere. Against this background, the discussions provided an opportunity to take stock and to discuss the outlines of a possible time-consistent fiscal and structural reform strategy for the post-election period.

A. The Economic Outlook

10. **There was agreement that growth in 2005 would be subdued and the outlook was one of only gradual strengthening into 2006.** Investment in machinery and equipment is slowly turning up and rising employment and progress in balance sheet repair are expected eventually to assist a broader recovery. The staff forecasts growth of 0.8 percent in 2005 and 1.2 percent in 2006 (the authorities project slightly higher growth in both years). Adjusting for differences in working days, this implies a slow recovery as signs of accelerating activity are still tentative.[5] With continued support from the global expansion (albeit at a decelerating pace) and low euro area interest rates, domestic demand is projected to become stronger moving into 2006 (Figures 6 and 7).

Germany: Real GDP Growth, 2003–2006

	2003	2004	2005	2006
Headline real GDP growth, in percent	0.0	1.6	0.8	1.2
Adjusted for working days, in percent	0.0	1.0	0.9	1.4

Sources: Data provided by the authorities; and Fund staff calculations.

[5] High frequency indicators have been firming since mid-year, consistent with the staff's projection of a stronger second half of 2005.

Figure 6. Germany: Quarterly GDP Growth Contributions, 2004-2006
(Calendar and seasonally adjusted, at annualized rates, in percent)

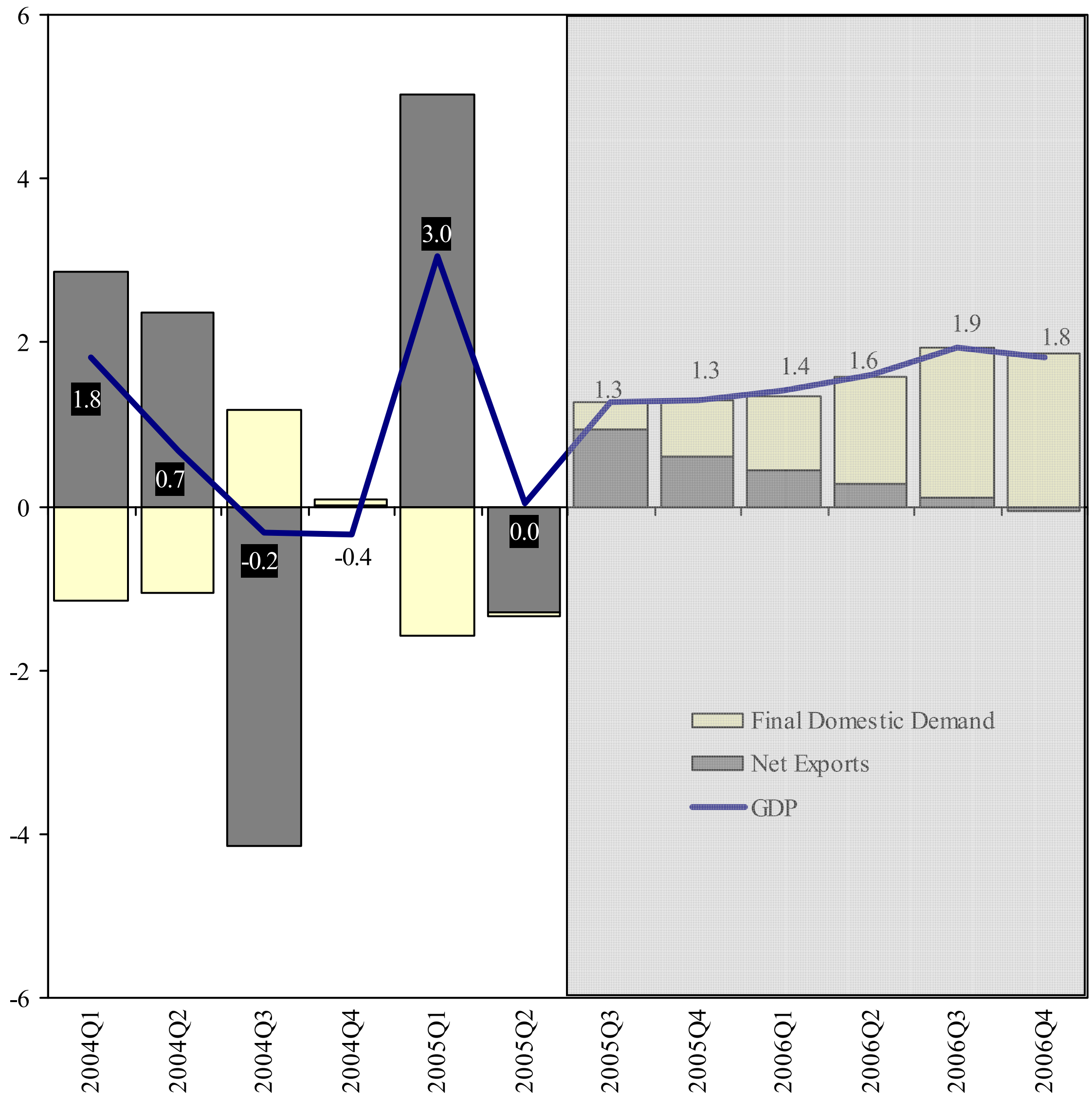
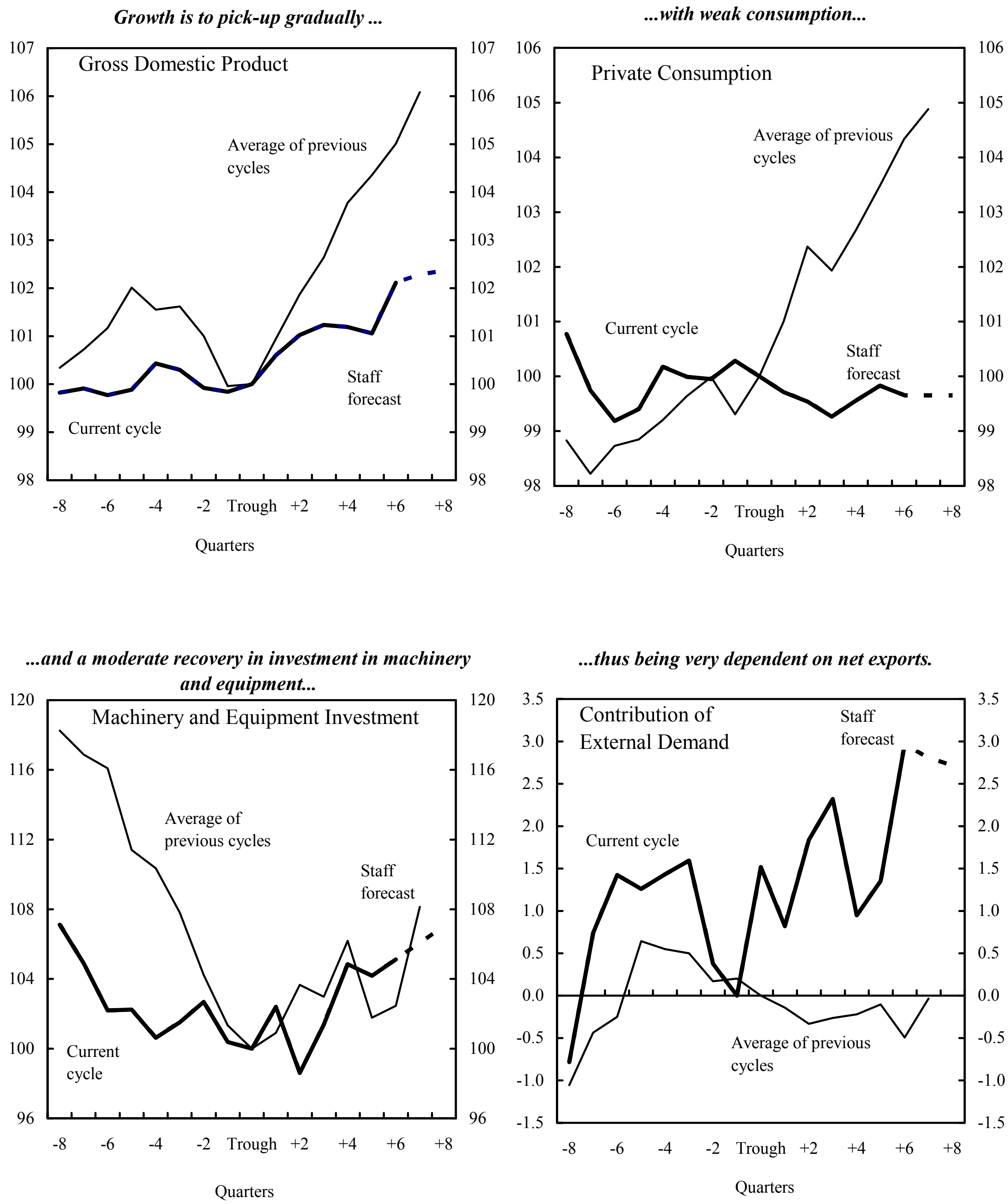


Figure 7. Germany: Comparison of Business Cycles, 1970-2005



Sources: Federal Statistical Office; and IMF staff calculations.
Note: All values are relative to trough equal to 100, except the contribution of external demand, where trough is equal to 0. The average of previous cycles is an unweighted average of troughs occuring in 1975, 1982, and 1994. The trough for the current cycle is assumed to be 2003 Q4.

11. **The risks to the outlook are broadly neutral, but with domestic demand still weak there is considerable uncertainty about the projections.** On the positive side, adjustment efforts are beginning to improve the conditions for a recovery and the downbeat mood might give way to renewed confidence, especially if the elections provide impetus for reform. Exports could yet spark a stronger response in domestic demand and productivity gains spurred by recent reforms may also be greater than assumed. On the downside, the reliance on cyclical exports, combined with the slow response of domestic demand despite strong foreign demand, amplifies Germany's vulnerability to external developments. Firms' wait-and-see stance about new investment may persist. Companies may also wait to see what effect higher oil prices will have on consumer and external demand.[6] Further, despite signs that the labor market is stabilizing, fears about job security and slow wage growth continue to hurt consumer confidence. The authorities were in broad agreement with this assessment and were particularly concerned about the impact of stubbornly high oil prices and a sudden unwinding of global imbalances and associated risks for German exports. They were also apprehensive about the euro appreciating and becoming more volatile, but expected that greater flexibility in Asia's managed exchange rate regimes might alleviate some of the risks for the euro.

12. **For the longer term, the most critical element in the outlook is the impact of aging on potential output growth.** A growth-accounting framework shows that on current policies potential output growth would fall from 1.4 percent a year at present to about 1 percent in the long run, although per capita growth would be more robust at 1-1½ percent a year.[7] This decline is largely due to the forceful headwinds from the aging-related decline in labor supply and hours worked.[8] This is a problem not only of the future but also of the present, because, in contrast to most other European countries, Germany's working age population has already begun to decline.[9] Deeper reforms that boosted participation rates and triggered a sharp decline in unemployment would attenuate the decline in potential output growth. However, such an outcome cannot be realized with current policies and relative factor prices. The mission therefore stressed that it will be important for the next government to build on the Agenda 2010 reforms by improving incentives and fostering higher labor utilization and potential output growth, which would also ease the strain on public finances.

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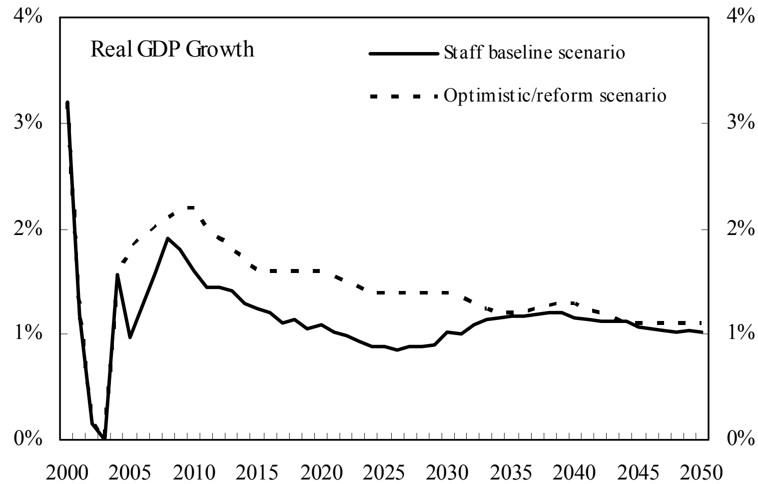
[6] Simulations suggest that a permanent 10 percent increase in oil prices, at constant exchange rates, reduces real GDP by 0.2 percentage points a year for three years. Progress in reducing the economy's oil use intensity since the 1980s and export resilience (including to oil producing countries) so far have cushioned the impact of the recent steep oil price increases on the German economy.

[7] See the selected issues paper "Long-Run Growth in Germany."

[8] The demographic projections are based on the central long run scenario of the Statistical Office, which assumes a net inflow of 200,000 immigrants per year.

[9] The working age population in Germany declined by 1 percent between 1999 and 2004, whereas it increased by over 2 percent in the euro area excluding Germany.

Potential output growth is projected to slow as aging unfolds.



Source: Staff calculations.

1/ The baseline scenario assumes unchanged policies and a long-run unemployment rate of 8 percent. The optimistic/reform scenario assumes the implementation of policies sufficient to obtain an unemployment rate of 3.3 percent.

B. Fiscal Policy

Fiscal consolidation

13. **Germany's high fiscal deficit is largely structural, reflecting adverse trends in the main tax bases and a generous welfare system.** The weakness in labor markets and the need for wage moderation, in the context of an increasingly competitive global environment, have contributed to a secular decline in the labor share of national income. With two-thirds of all revenue derived from wage income, there has been a steady erosion of the fiscal revenue base (Box 4).[10] Moreover, social transfers and unemployment insurance costs have increased sharply in recent years, underscoring the feedback from poor labor utilization to the fiscal position.

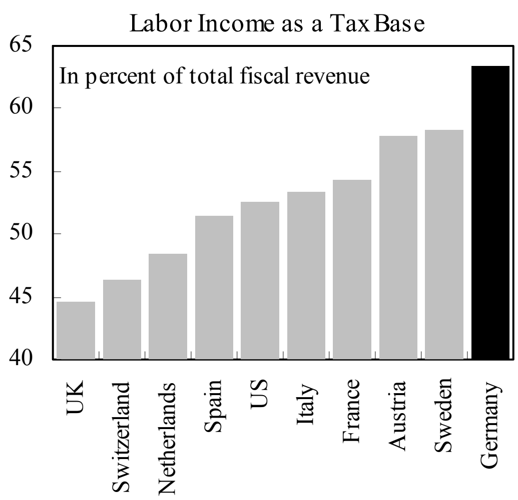
14. **These adverse trends will intensify in the future, making corrective action urgent.** The mission's projections suggest that, on current policies, the structural deficit will widen further in the future because of the acceleration in population aging starting in 2010 and the corresponding slowing of the economy. These widening deficits would lead to long-

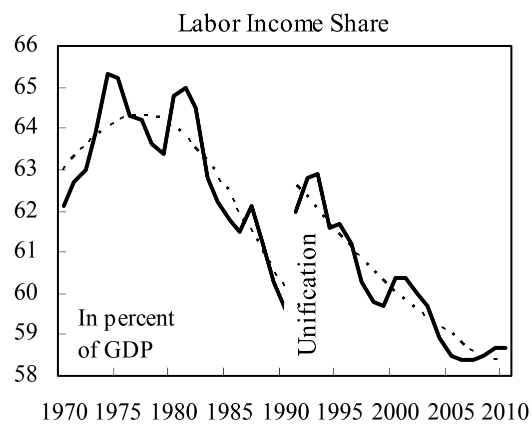
[10] See also the selected issues paper "Decomposing the Fiscal Balance."

Box 4. Why is Germany's Fiscal Deficit so Large?

The recent fiscal deficits of 3½–4 percent of GDP are the largest in the last six decades. They are also larger than in the 1990s during unification. No sudden shocks explain the current deficits, but the persistent pressures from globalization and aging are changing the structure of production and forcing firms to contain wage costs. The procyclical fiscal policies during 1998–2000, when growth was strong, have also contributed to current difficulties.

Changes in Germany's economic structure have gradually eroded the tax base and caused new spending pressures. The main tax base is labor income, which yields about two-thirds of all fiscal revenue. This dependence exceeds even that of the Scandinavian countries. However, the labor income share in GDP has been declining over time, while the cost of unemployment insurance has increased. In response, and under German legislation, payroll tax rates have increased from 26 percent in 1970 to 42 percent at present, putting further pressure on labor markets. Employment gains have shifted to low-wage and part-time jobs, away from full-time/full-benefits jobs. Correspondingly, the number of jobs subject to social security contributions has declined. As a policy implication, shifting some revenue collection toward indirect taxes combined with further entitlement reforms could alleviate the pressure on payroll charges and lower employment costs.





Thus, despite adjustment efforts in 2003–04, the structural deficit remains high. Tight management of public investment, the wage bill, and other discretionary spending, and the unanticipated benefit of low interest rates have helped to offset the revenue losses associated with the income tax cuts. But the additional pressures on the deficit from a changing structure of production and aggregate demand and aging have not yet been overcome. Efforts to address these new pressures have included limits on pensions, health, and unemployment benefits. Nevertheless, the structural fiscal deficit remains over 3 percent of GDP. Without further steps, demographic shifts and rising interest rates are likely to continue to intensify the fiscal headwinds in future.

run debt sustainability problems. Even in more optimistic scenarios with higher growth and lower unemployment, as in the authorities' first *Long-Run Fiscal Sustainability Report,* the fiscal gap would still widen sharply, making it necessary to take action to bring public finances in line with long run sustainability (Figure 8).[11]

15. **A public sector balance sheet showing the government's unsustainable intertemporal position under current policies provides further insight into the size of this fiscal challenge** (Box 5).[12] An illustrative balance sheet estimated by the mission combines information on government assets and liabilities with the net present value (NPV) of future fiscal deficits from the long run fiscal baseline described above. At over 300 percent of GDP, the resulting estimate of the net liability position of the public sector underscores Germany's unsustainable intertemporal fiscal position and the need to address the issue head-on. The long run impact of the measures of Agenda 2010, which are estimated to have reduced the NPV of future deficits by 70 percent of GDP, is large but insufficient to address the threat to fiscal sustainability. Nevertheless, bringing this information to the public, with regular updates, would help to show the long run benefits of such difficult reforms.[13]

16. **The authorities agreed that future deficit pressures are a serious concern and have ruled out expansionary fiscal policies to boost growth, but indicated that the deficit would still remain high in 2005 and 2006.** They noted that substantial discretionary spending cuts had been implemented over the past two years during a period of weak growth to compensate for tax cuts, but they were reluctant to make significant additional cuts in a period of slow recovery. On current policies, the staff projects a general government deficit of 3.9 percent of GDP in 2005 (compared with 3.7 percent projected by the authorities), and little improvement in 2006. Apart from growth being weaker than originally forecast, the authorities explained that unexpected developments had complicated budgetary execution in 2005, resulting in a wide deviation from the original 2005 fiscal deficit objective of 3 percent of GDP:

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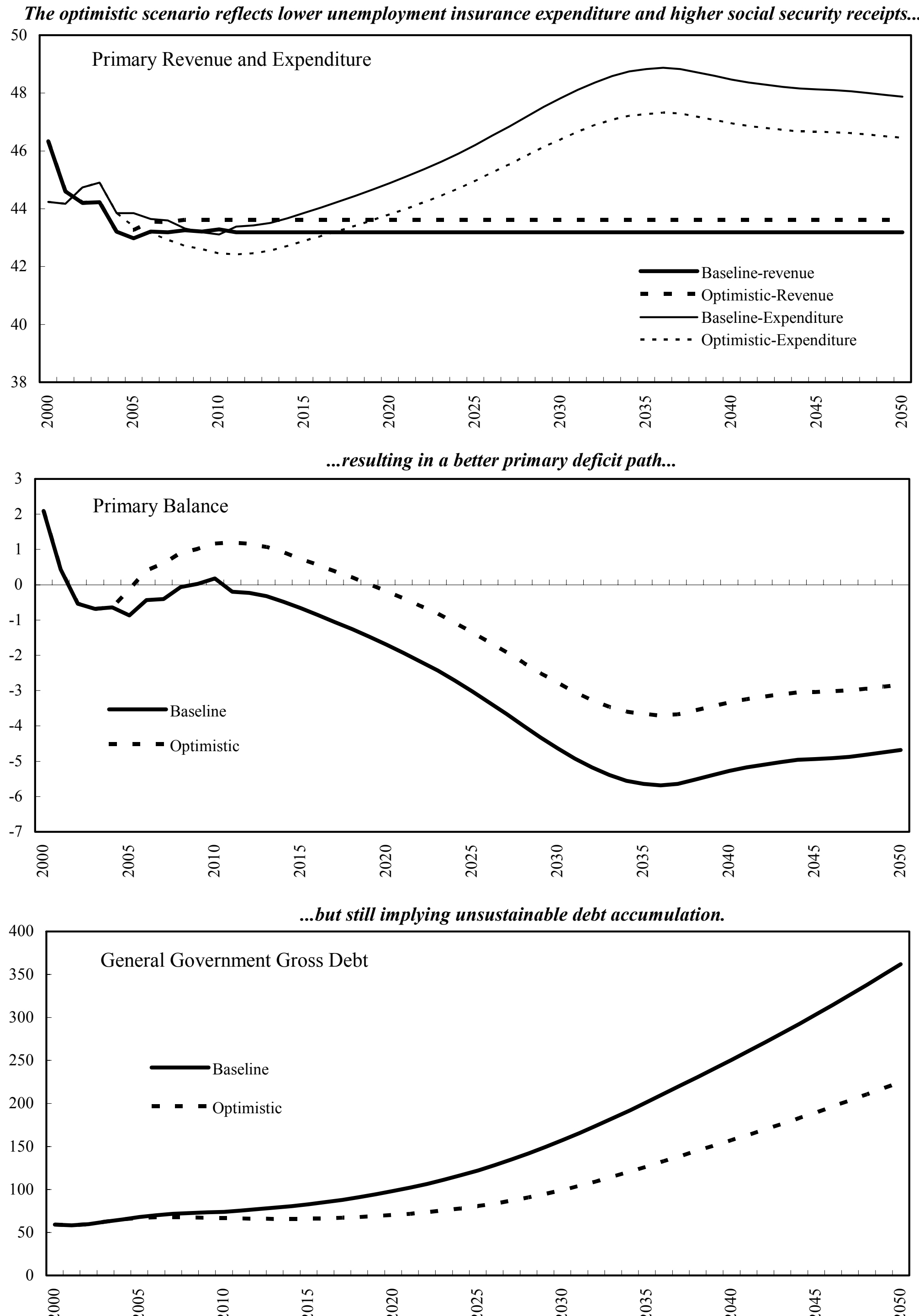
[11] The authorities' scenarios are more optimistic because of higher growth and lower unemployment, and because they assume that the government will achieve its financial plan through 2008 (*Mittelfristiger Finanzplan).* However, this plan is off-track, making the starting position too optimistic. Both the authorities' and staff projections assume that higher future entitlement expenditures are not automatically financed with higher payroll taxes—to avoid negative repercussions on labor supply—even though, under German law, higher entitlement spending eventually tends to trigger higher payroll tax rates to balance the social security system. See the selected issues paper "Germany: A Long-Run Fiscal Scenario Based on Current Policies."

[12] See the selected issues paper "A Preliminary Public Sector Balance Sheet for Germany."

[13] The authorities were beginning to collect more information on stocks of assets and (implicit) liabilities, and officials of the state of Hesse informed the mission that they were preparing a balance sheet for the state, which they expect to have ready by 2008.

Figure 8. Germany: Fiscal Projections, 2000-50
(In percent of GDP)



Source: IMF staff calculations.

Box 5. A Preliminary and Illustrative Public Sector Balance Sheet

A public sector balance sheet can be a useful indicator of intertemporal health of the public finances. The balance sheet is intended to reflect all assets and liabilities of the general government. In addition, the long-run projections of future fiscal balances can be discounted and their net present value can be entered in the balance sheet to capture implicit liabilities.

A preliminary balance sheet for Germany suggests intertemporal fiscal inconsistency. Combining the debt already issued with estimates of the net present value of debt to be issued in the future under current policies provides information on the intertemporal net financial position of the general government. This approach suggests a negative net worth of the public sector of 324 percent of GDP.

The balance sheet can provide guidance to policy options. By systematically quantifying the future impact of fiscal and structural measures, the balance sheet can help to show the costs and benefits of fiscal and structural measures and thus promote transparency.

It can also help to clarify public debate. The public can assess progress toward safeguarding fiscal solvency if policy options are presented within the time-consistent framework of a balance sheet. Without such a framework, the confidence boosting effect of economic policies may be lost, because the benefits would become visible only in the long run. For example the entitlement reforms in Agenda 2010 have yet to gain public recognition for their large improvement (some 70 percentage points of GDP) in net worth between 2003 and 2004.

General Government Balance Sheet (preliminary)

	2003	2004 Est.
(Billions of euros)		
Intertemporal financial position	-9,216	-8,240
Net debt already issued	-1,135	-1,224
NPV of future net debt 1/	-8,081	-7,016
Other, net	104	106
Public sector net capital stock	1,096	1,098
Net worth	**-8,016**	**-7,036**
(In percent of GDP)		
Intertemporal financial position	-433	-379
Other, net	5	5
Public sector net capital stock	51	50
Net worth	**-377**	**-324**

Sources: Bundesbank; Ministry of Finance; and Fund staff calculations.
1/ Staff projections of fiscal balances for a rolling 50-year period (baseline scenario) discounted at the average interest rate on government debt.
Figures for 2004 include the impact of reforms of Agenda 2010.

- **The Hartz IV labor market reforms turned out more expensive than expected.** Instead of lowering costs, additional outlays of about ⅓ percent of GDP are expected. Means-testing had been deficient and income support turned out to be more costly than expected.

- **Weakness in employment subject to social security contributions put pressure on the pension system.** Further, the sustainability formula, designed to decouple growth in pensions from nominal wages as the dependency ratio rises, had been suspended for 2005—its first year of operation. As wages have been flat, applying the pension adjustment formula would have resulted in a reduction in nominal pensions, triggering a safeguard clause in the legislation to prevent such cuts.

- **The 2004 reform had improved health care finances only temporarily.** Current trends suggest a shift back into deficit in the health care programs in the coming years.

Germany: Fiscal Balance under Current Policies
(In percent of GDP)

	2004	2005	2006	2007
Overall balance	**-3.7**	**-3.9**	**-3.7**	**-3.7**
Change in overall balance	**0.3**	**-0.2**	**0.1**	**0.0**
Structural effects	0.2	-0.1	0.4	0.2
(1) Structural shifts 1/	-0.3	-0.2	0.2	0.1
(2) Policy measures	0.5	0.1	0.2	0.1
Tax reform	-0.4	-0.1	0.0	0.0
Health care reform	0.4	0.0	0.0	0.0
Pension reform	0.2	0.3	0.0	0.1
Hartz reforms	0.0	-0.3	0.1	0.0
Subsidy cuts	0.1	0.1	0.1	0.0
Discretionary cuts	0.2	0.0	0.1	-0.1
Temporary effects	0.1	-0.1	-0.3	-0.2
(3) Cyclical	-0.3	-0.2	0.0	0.1
(4) One-off	0.4	0.1	-0.3	-0.3
Bundesbank profits	-0.2	0.0	0.0	0.0
Landesbanken guarantees	0.0	0.1	0.1	-0.2
Postal pensions, floods, other	0.6	0.1	-0.4	-0.1
Memoranda:				
Structural balance 2/	-3.3	-3.4	-3.0	-2.8
GDP growth	1.6	0.8	1.2	1.6

1/ Takes into account trend changes in tax bases relative to GDP.
2/ The change in the structural balance equals the change in the overall balance minus the cyclical and one-off effects.

17. **In view of these pressures, the authorities have resorted to one-time financing measures to meet the constitutionally-mandated golden rule.**[14] In the pension system, the government plans to advance the collection of contributions by half a month in 2006, thus receiving 13 installments next year. In addition, the securitization of future debt service payments on Russian Paris Club debt owed to Germany provided cash-flow relief in 2004 and 2005, and the securitization of pension receipts in the postal system will reduce financing needs in 2005 and 2006. Meanwhile, Länder are benefiting from the reimbursement by the Landesbanken of their interest subsidies, which were prohibited in the context of the abolition of public guarantees for these banks. Even though most Länder will return a similar amount of funds to public banks to avoid their decapitalization, these outlays are registered as an equity injection on market terms below-the-line,[15] resulting in one-off receipts of ¼ percent of GDP over two years.

18. **The mission stressed that such one-off policies should be avoided and replaced by a comprehensive forward-looking fiscal strategy to deal with the structural changes in the economy.** Specifically, the mission recommended early action to bring the structural fiscal position to balance by 2010 when aging accelerates, and to forestall adverse market reactions if structural and fiscal problems remained unaddressed. This goal will require annual structural fiscal measures of at least ½ percent of GDP, a reasonable pace with the rate of growth at or above potential. Further fiscal measures would be needed beyond 2010 to keep the fiscal balance in an appropriate range because expenditure pressures will continue to grow as aging unfolds. Adjustment should focus on high-quality durable expenditure cuts rather than increases in tax rates, and take advantage of the important synergies between fiscal reform, recalibrating entitlements, and reforming the labor market.

Durable adjustment and tax reforms

19. **Future adjustment policies need to put priority on spending cuts and expanding the tax base.** The mission noted that there is room for cuts in all three of the main welfare/entitlement blocs:

- **Households and workers** receive generous benefits including housing and commuter subsidies, tax exemptions for work on Sundays and holidays. These benefits have grown over time to become an integral part of the welfare state.

- **Corporate welfare** is also a burden, with special depreciation rules, loss carryovers, energy and sectoral subsidies (e.g., in agriculture).

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[14] Legislation requires the federal cash deficit to be no more than investment spending.

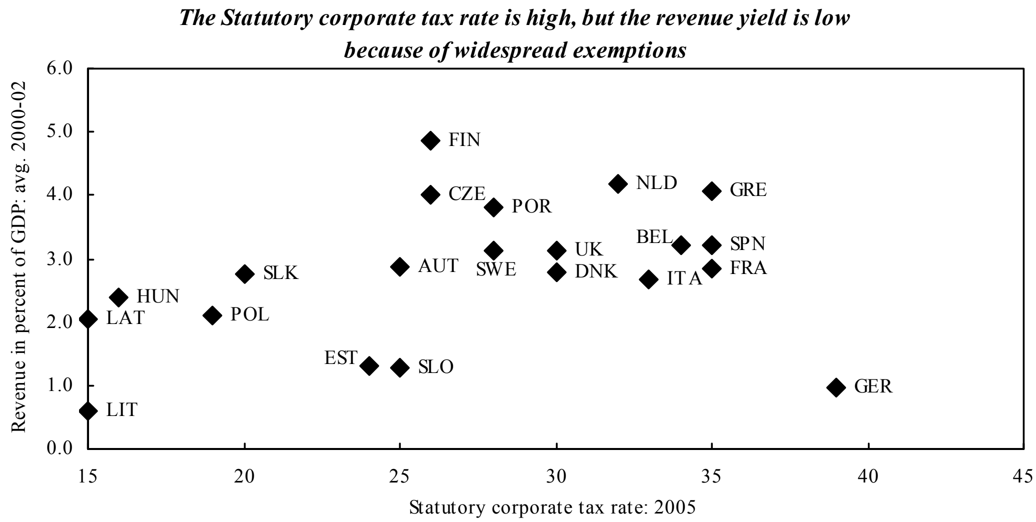
[15] In accordance with Eurostat methodology.

These subsidies and tax expenditures for households, workers, and corporations amount to as much as 6 percent of GDP (as estimated by the Koch-Steinbrück Commission). They need to be cut drastically but have proven politically resilient.

- **General entitlement benefits** also need further cuts. Options here include cuts in long term care insurance, new steps to limit growth in health care spending, lowering the high cost of unemployment benefits, and shifting the pensionable age from 65 to 67 years of age (as had been proposed by the Rürup Commission). Increasing discounts for early retirement and premia for delayed retirement to improve the actuarial balances, as in France, should also be considered. Such steps could help limit the adverse effect on aggregate demand as they would simultaneously improve labor utilization. The authorities noted that the effective retirement age is going up gradually, including by increasing the age at which unemployed workers qualify for early retirement. Raising the statutory retirement age would need to be considered again by the next government.

20. **There was agreement that significant increases in payroll taxes should be avoided to combat the erosion in full time employment and bolster labor utilization.** The authorities, however, noted that there are differences of view across the political spectrum about how this should be achieved. Regarding the funding of healthcare, one proposal is to widen the contribution base by including capital income and contributions from individuals presently in private health care programs (*Bürgerversicherung*). An alternative proposal is to replace the healthcare payroll tax with a lump sum contribution per adult, while using general revenue to compensate those with low earnings (*Gesundheitsprämie*). Draft legislation on any of these proposals will have to wait until after the elections. The election has also generated a debate about the pros and cons of raising the VAT to finance a reduction in the unemployment insurance contribution rate.

21. **Corporate income tax reform has moved higher on the policy agenda.** Earlier this year, the government sought a six percentage points cut in the federal corporate income tax (CIT) rate (bringing the overall rate to 32 percent), financed by reducing corporate deductions and exemptions. However, political parties did not agree on how to distribute the burden of offsetting measures and the proposal was not implemented. Noting that Germany has a high CIT rate but low revenue yield, the mission said that reform would be worthwhile but emphasized that any cut in tax rates should be fully compensated as fiscal consolidation needs to be the top priority. Further, tax reform should be framed in a comprehensive way to avoid further complicating the tax system, with the emphasis on broadening the tax base. The authorities noted that the Council of Economic Experts has been asked to prepare a CIT reform proposal by the end of 2005.



Fiscal institutions

22. **Views differed on whether an independent fiscal council could play a useful role in fostering sound policies.** The mission suggested that an annual review by such a council that reports to parliament could enhance transparency by vetting the government's policies from a long term perspective and also help make the case for reforms. Although the authorities saw merit in these goals, they noted that Germany already enjoys an extensive outside review of policies, including by the Council of Economic Experts and through twice yearly consultations on tax projections with a group of renowned economic research institutes. Therefore, they felt that installing a fiscal council would add to costs while offering small benefits. Instead, the government intended to update periodically the new *Long-Run Fiscal Sustainability Report* to strengthen communication and transparency. The mission noted that as macroeconomic and budgetary forecasts generated by non-partisan entities tend to be more accurate than those produced by governments, they could contribute to the formulation of more realistic budgets and long-range projections. Further, to be effective the proposed fiscal council should have a formal mandate, democratic legitimacy, accountability, and clear channels for policy dialogue and communication.

23. **Amending features of Germany's fiscal federalism will be essential to strengthen fiscal management and overcome reform gridlock.** The authorities concurred that aspects of the system had outlived their usefulness and needed to be modernized. Reform proposals had consistently run into difficulty because of the relative ease with which these can be blocked in the *Bundesrat,* which is controlled by the Länder, who have diverging interests.[16]

[16] German federalism was designed after the War to provide strong political checks and balances. However, with the passing of time, it is now recognized to have led to paralysis and is seen as an impediment to policy reform.

The mission recommended that modernizing the system should be a priority, with emphasis on the following areas: (i) reducing the number of laws that need the approval of both chambers of parliament; (ii) creating some leeway for competition between subnational governments to make tax and expenditure policies more efficient and to encourage fiscal consolidation; (iii) strengthening the Internal Stability Pact by including clear commitments of various levels of government, including individual Länder, to help ensure consistency in the overall policy framework; and (iv) cutting redundancies and aligning better the tasks among different parts of government to improve fiscal management.[17]

C. Labor Market Issues

24. **Higher employment growth holds the key to stronger potential output growth.** Disequilibria in labor markets have been persistent, with significant underutilization of labor (both in persons and hours worked) because of high costs and rigidities. These employment barriers and high reservation wages induced by the generous welfare system especially affect elderly workers, women, and those with lower productivity. Valuable progress has been made to begin tightening unemployment and welfare benefits and improve incentives to work with the Agenda 2010 reforms, and large enterprises have taken the lead to begin expanding the average hours worked per week. The challenge now is to improve structural conditions to boost the creation of jobs and labor demand.

25. **The Hartz IV reforms have boosted labor supply.** The authorities noted that the merger of the open-ended unemployment assistance and social assistance into a new unemployment benefit (UB-II) program in early 2005 had brought former welfare recipients into the labor force. Consequently, labor supply rose by nearly half million persons (1 percent of the labor force), and the unemployment rate jumped by a full percentage point in the national definition in the first few months of the year (Figure 9).

26. **However, the Hartz IV reforms on their own appear insufficient to yield durable improvements in the labor market.** Although the government's perseverance in introducing these reforms is commendable, employment growth has so far been concentrated in temporary work and the self-employed. High labor costs and labor market rigidities still hold back demand for full-time employment. In particular, Germany's tax wedge on labor income remains among the highest in advanced countries.

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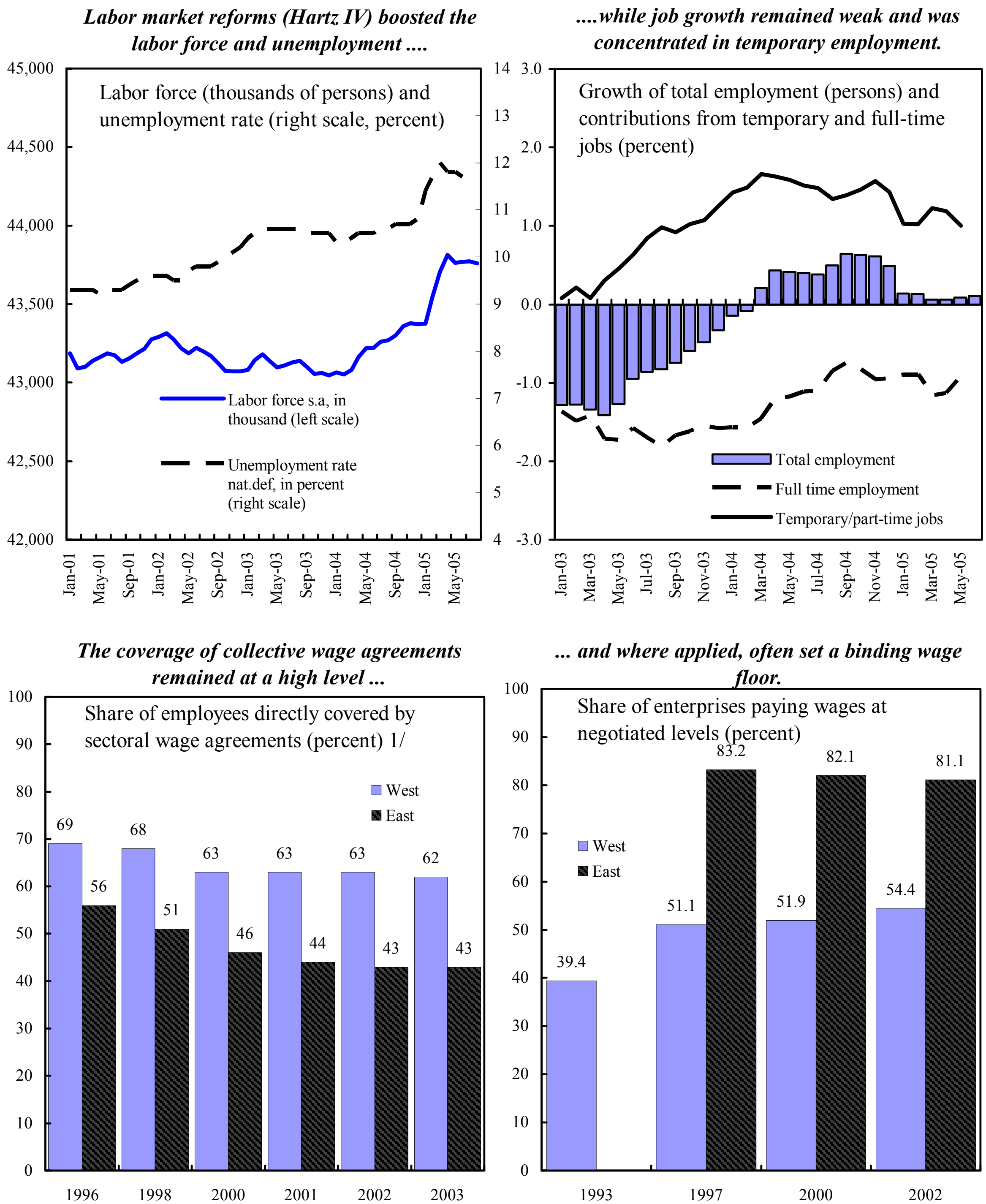
[17] For additional discussion on German fiscal federalism see the selected issues paper "Federalism and the Political Economy of Adjustment" in IMF Country Report No. 04/340.

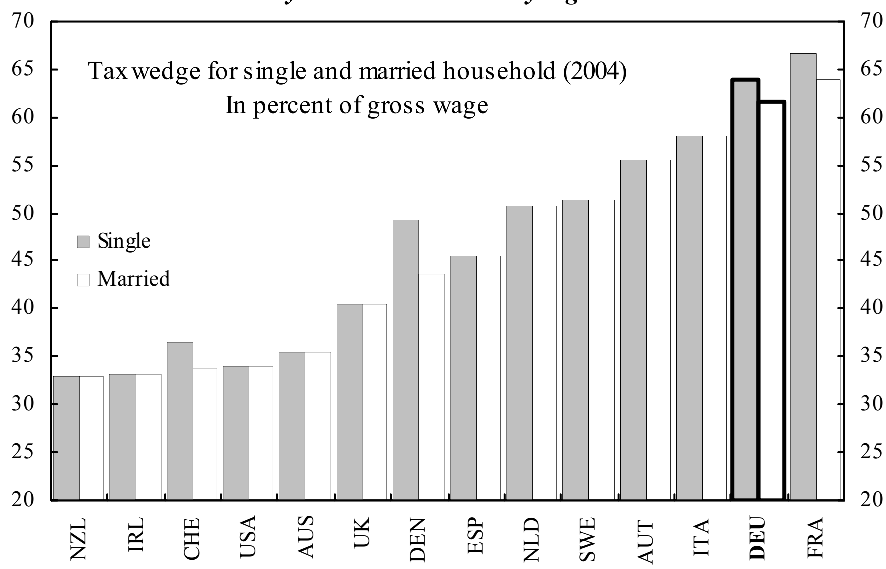
Figure 9. Germany. Employment Growth and Coverage of Collective Wage Agreements



Sources: Federal Agency for Employment; and Institute for Labor Research (IAB).

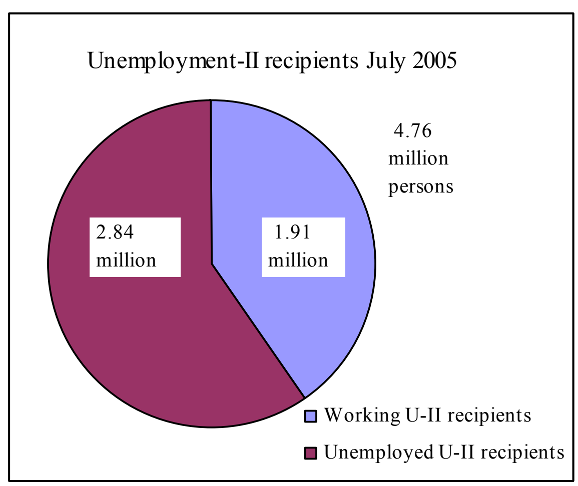
1/ Share of employees directly and indirectly covered by wage agreements in 2003: 85 percent (West) and 77 percent (East).

Payroll taxes remain very high



27. **Further reforms are needed to revitalize labor demand.** The mission called for policy adjustments in two areas. First, formal wage determination is centralized and responds insufficiently to local labor market imbalances and productivity differentials. Second, high reservation wages supported by the generous welfare system for entry level and low skill jobs prevent adequate job creation, considering that most of the long term unemployed have low productivity. Reducing central controls on wage bargaining in favor of more firm level bargaining should therefore be a priority. The mission also recommended loosening employment protection legislation (EPL) to boost employment by lowering job turnover costs and reducing labor court involvement, which has become more prominent over time. In the authorities' view, however, wage bargaining has already become more flexible because of widespread "opening clauses," resulting in large intersectoral pay differentiation. Moreover, they noted that EPL had been relaxed in 2004, but considered it too early to draw firm conclusions about its impact.

28. **The UB-II system created by the Hartz IV reform has the potential to become an effective welfare-to-work program.** The authorities explained that of the 4.8 million participants in UB-II, 40 percent were employed and received "top up benefits" to raise their income to a social minimum. The program thus has some features of a negative income tax and its design now needs to be fine-tuned to improve incentives to work. High marginal income taxes for those that qualify for UB-II are a disincentive to look for work and



need to be reduced. Moreover, it will be important to apply means testing and job search requirements more firmly. The mission recommended against diluting the reform by prolonging the duration of unemployment benefit payments for older workers, as such actions create uncertainty about the government's resolve. Nevertheless, the duration of benefits for elderly workers was subsequently extended to limit social hardship.

D. Product and Service Markets, and Trade Policy

29. **Further deregulation in product and services markets will be essential to facilitate the structural shift from manufacturing to a more service based economy.**[18] Numerous studies have pointed to supportive interactions between product and services market reforms and employment growth. Although Germany's overall regulations rank close to the EU-15 average (Figure 10), a specific breakdown suggests relatively high barriers and impediments in administrative product market regulations, liberal services, and for full time employment.

30. **The authorities reported progress in reforming markets for network industries.** Past difficulties in the energy sector with respect to network access and high electricity prices are being addressed. An agency with an expanded mandate to supervise electricity grids, gas and railway networks is scheduled to become operational in August 2005, and has been charged to devise incentive-compatible pricing mechanisms. Moreover, the postal monopoly on letters of up to 50 grams will expire in 2006.

31. **Further efforts to lower barriers to entry in the services sector would improve the climate for running small businesses and boost job creation.** The mission noted that this is especially important for professional services where the restrictiveness index is substantially higher than the EU-15 average. Opaque rules in administrative regulation, state control, and barriers to entrepreneurship also create unnecessary costs and impede entry. The authorities pointed to progress in the areas of craftsmanship and regulated professions, especially lowering entry barriers and removing master certificate requirements for 53 out of 94 specific activities. They also explained that negotiations on the EU Services Directive were continuing. Preliminary estimates by an expert working group suggest that Germany's highly skilled engineering, construction, and R&D sectors could benefit substantially from the Directive by generating increased access to other EU markets. At the same time, the authorities remained concerned that the country-of-origin principle could lead to a "race to the bottom" for service sector standards. Hence, they were as yet reluctant to endorse this principle and were seeking adequate safeguards for quality standards and exemptions for key sectors such as health care. The mission encouraged the authorities to preserve the country-of-origin principle, while limiting exemptions only to the most sensitive areas and for a transition period.

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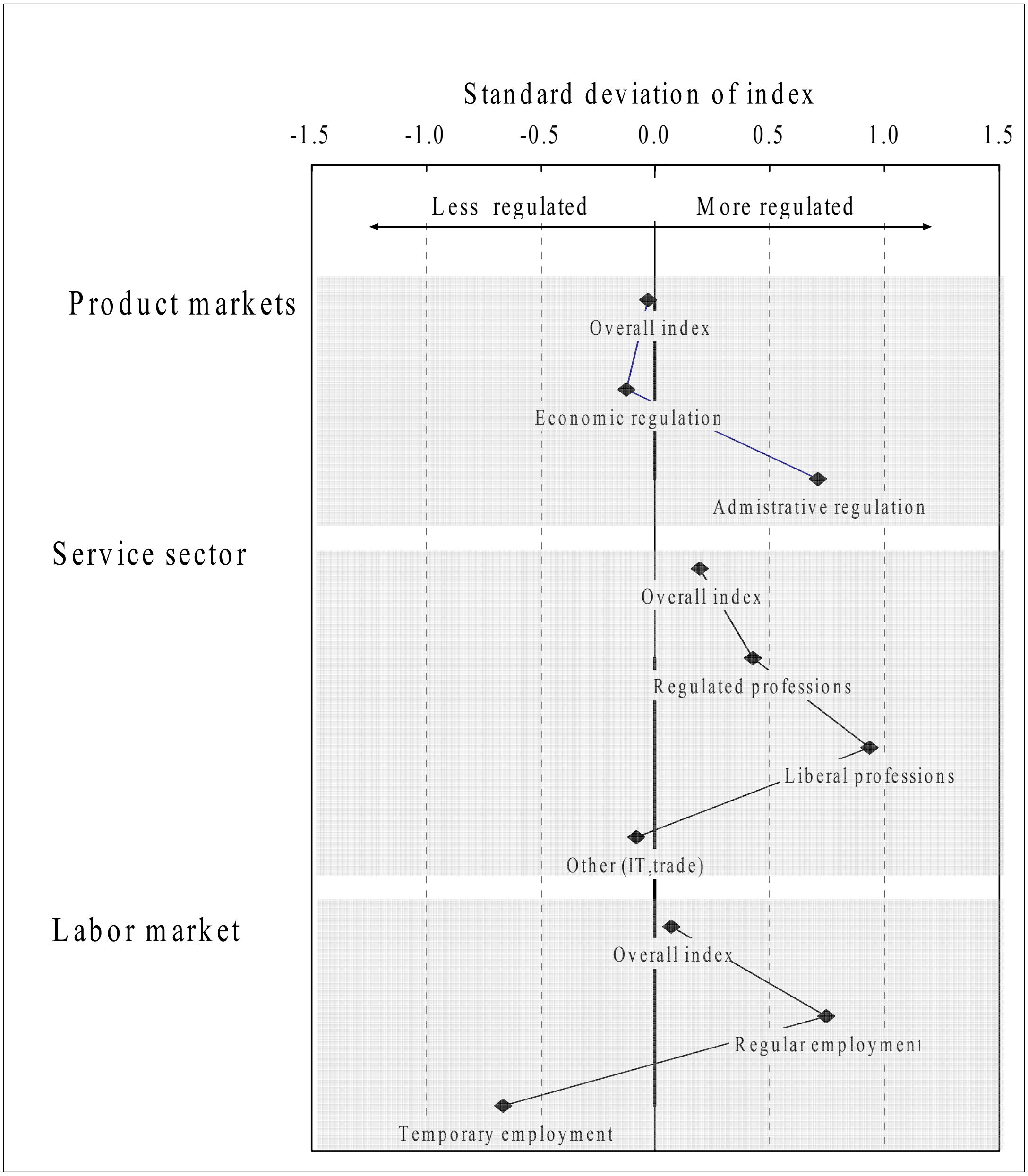
[18] See the selected issues paper "Does Regulation Impede Growth in Germany?"

Figure 10. Germany. Market Regulation Indices Relative to the EU-15 Average: 2003 1/



Sources: OECD; Copenhagen Economics, Institute for Advanced Studies; and IMFstaff calculations.
1/ Observations depict the value of Germany's regulation index relative to the EU-15 average.
A value of zero indicates that the regulation index in Germany is at the EU-15 average,
a positive (negative) value measures higher (lower) levels of regulation.

32. **Regional integration and the lower cost base of the new accession countries have been prominent in the domestic debate.** The authorities said that the public perceives increased competition from trade liberalization and migration as a threat to domestic investment and employment. The mission pointed out that it is insufficiently recognized that integration provides opportunities to exploit comparative advantage to mutual benefit, with gains from integration that accrue to consumers as well as exporters in the region over time. If the focus is on protecting current domestic advantage, the accrual of mutual gains will be thwarted. Meanwhile, Germany has invoked limits on the free migration of labor from the new accession countries for a transition period.

33. **The authorities support multilateral trade liberalization.** In the context of the Doha round, Germany has backed a reduction in tariffs, liberalization of trade in services, and a cut in agricultural subsidies.

E. Financial Sector Developments and Policies

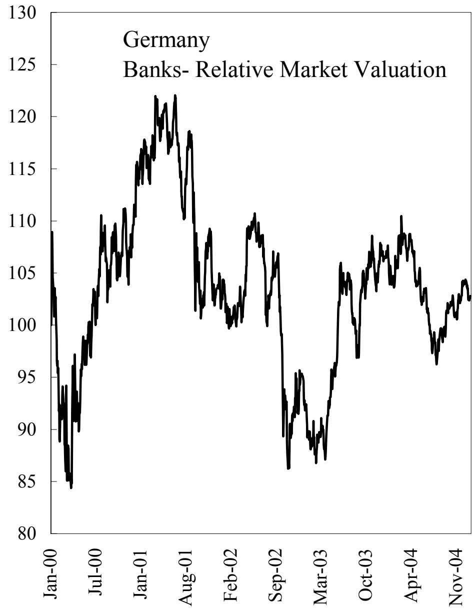
34. **Financial sector performance is improving and there has been some progress in addressing structural weaknesses.** The authorities noted that recovery of banking profitability has continued into 2005, from the trough experienced in 2003 (Figure 11). Cost-income ratios are improving, there has been progress in cost cutting, and buoyant financial markets are boosting income. Bank capitalization is also improving, partly by disposing of impaired assets, and provisioning has tapered off. The purchase of Germany's third largest private bank by an Italian bank is seen as a breakthrough in financial sector restructuring and a welcome sign of the German authorities' openness to such cross-border mergers. The insurance sector is also recording higher earnings and stronger capitalization. The authorities' stress tests—using the FSAP methodology—have been encouraging for banks and insurance companies. Although Germany's moderate growth might trigger some instances of strain within the financial sector, the probability of systemic risks are judged to be small.

35. **The authorities also pointed to the important steps taken by the Landesbanken to prepare for the phase out of state guarantees.** To mitigate the immediate liquidity impact, Landesbanken had stepped up their issuance of long term bonds, which qualify for grandfathering provisions and lock in guarantees until 2015. Moreover, back office and product development cooperation between the Landesbanken and the Sparkassen (savings banks) has been intensifying. The number of Sparkassen and Volksbanken (cooperative banks) is gradually declining. These developments had been recognized by ratings agencies, as most Landesbanken had secured ratings in the single-A range, while Sparkassen tended to be rated somewhat higher.

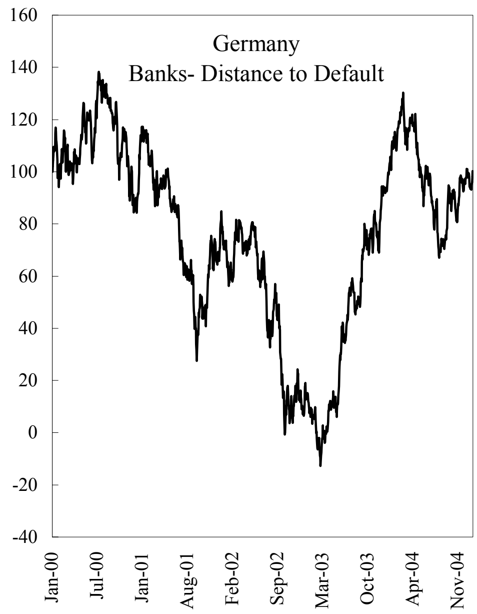
Figure 11. Germany: Relative Market Valuation and Distance to Default 1/

Large banks

Bank's relative valuation has recovered...



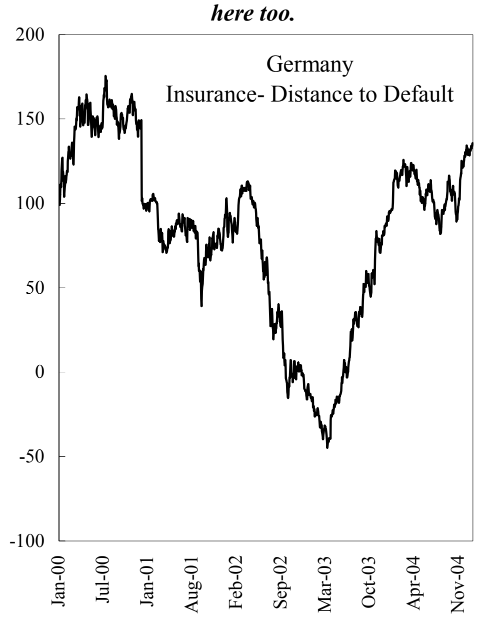
...and their riskiness has diminished



Insurance companies

Insurance companies are still weak...

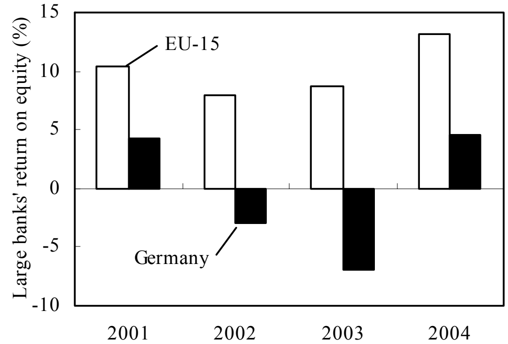
...but concerns about defaults have declined here too.



Sources: DataStream; and IMF staff calculations.
1/ Market valuation relative to the aggregate stock market index. Distance to default approximates financial soundness and is calculated as the sum of the ratio of the estimated current value of assets to debt and the return on the market value assets. The calculations cover the four largest banks and fifteen largest insurance companies (January 3, 2000 = 100).

36. **Notwithstanding these developments, the mission noted that Germany's banking sector performance continues to fall short of international peers.** In particular, the banking sector has been one of the least profitable in the EU. Further, impaired loans are over 5 percent of total loans, while unprovisioned (but typically collateralized) impaired loans remain high at nearly 47 percent of capital in 2004 (see table below and also Table 4). The authorities noted that the secondary market for nonperforming loans has grown rapidly and is facilitating the cleaning of banks' balance sheets.

Bank profitability is below peers.



Germany: Comparative Banking Sector Indicators, 1999–2004

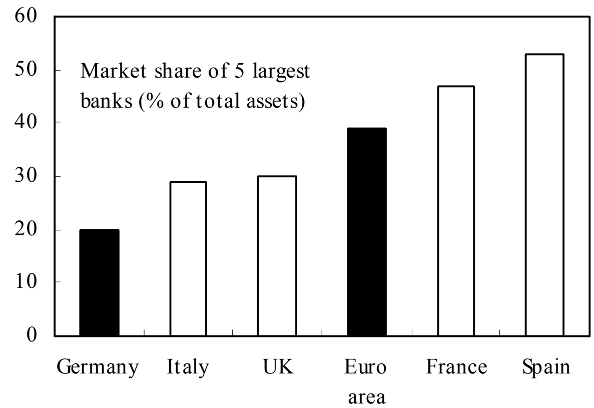
	1999	2000	2001	2002	2003	2004
Regulatory capital to risk-weighted assets						
Germany	11.5	11.7	12.0	12.7	13.4	13.2
EU-15 average	12.0	11.6	11.8	12.1	12.8	12.8
United States	...	12.4	12.9	13.0	13.0	13.2
Capital to assets						
Germany	3.1	3.2	3.2	3.5	3.9	3.7
EU-15 average	6.0	6.1	6.2	6.1	6.0	6.0
United States	...	8.5	9.0	9.2	9.2	10.3
Nonperforming loans to total gross loans						
Germany 1/	4.2	4.7	4.6	5.0	5.3	5.1
EU-15 average	3.5	3.0	2.8	2.8	2.9	2.3
United States	...	1.1	1.3	1.4	1.1	0.8
Nonperforming loans net of provisions to capital						
Germany 1/	39.2	44.7	46.1	47.5	52.1	46.8
EU-15 average	19.2	18.2	15.5	15.0	...	...
After-tax return on average assets						
Germany	0.2	0.2	0.2	0.1	-0.1	0.1
EU-15 average	0.9	0.8	0.7	0.6	0.7	0.9
United States	...	1.1	1.1	1.3	1.4	1.3
After-tax return on average equity						
Germany	6.5	6.1	4.6	2.9	-1.5	1.9
EU-15 average	17.2	16.6	14.0	12.1	14.5	17.5
United States	...	13.5	13.0	14.1	15.0	13.3

Sources: Data provided by the authorities; and Fund staff calculations.

1/ Based on the German definition of nonperforming loans ("loans with a loss provision requirement"), which differs from the definition proposed in the IMF's *Compilation Guide on Financial Soundness Indicators* ("loans with principal and interest payments past due or delayed by 90 days or more"), thus affecting international comparability.

37. **The segmentation associated with Germany's three pillar banking system continues and impedes revenue growth.** Moreover, the regional principle, whereby Sparkassen and Volksbanken are confined to do business in their communities of origin, limits competition and concentrates risks. Further, Landesbanken still face the task of developing viable business models in the absence of state guarantees. In some instances, injections of public funds have shored up capital, and further consolidation seems necessary. The authorities agreed further consolidation is likely, but reiterated that fostering regional competition among public entities was largely a matter of state, rather than federal law.

The banking system is highly segmented.



38. **A more dynamic banking system would be better positioned to support growth.** The mission reiterated the importance of harnessing market signals to guide restructuring, noting that several Länder still need to adopt legal frameworks that facilitate the mobilization of private capital, including by transforming public sector banks into joint stock corporations. Further, dismantling regional barriers to operating public sector banks would help achieve greater scale economies and diversify risk. The authorities noted that regional barriers had begun to soften, as the nascent market for collateralized debt obligations allowed regional banks to diversify credit exposure. Entry of foreign banks in the retail market had also already instilled more dynamism. In addition, the authorities noted that silent partnerships—akin to placing subordinated debt—have facilitated, at least in principle, the entry of private capital into public banks, but agreed with the mission that private funding is still small.

39. **Further steps are needed in the insurance sector, notwithstanding improvements in profitability and solvency.** These improvements are mainly concentrated in the nonlife sectors, while a key issue in the life sector remains how to combine strong competition in a fragmented market with the requirement that at least 90 percent of profits be distributed to policyholders. The mission reiterated that eliminating the mandatory 90:10 profit split would provide flexibility to replenish reserves during times of duress, and consumer protection goals could be achieved through other means, including better disclosure requirements. The authorities elaborated that capitalization in the insurance sector would be sufficient to meet higher requirements, which will come into effect with the introduction of Solvency II. At that time, the mandatory profit split could be rescinded.

40. **The authorities noted that the financial sector regulatory framework had been further enhanced in response to FSAP recommendations.** The number of supervisory staff have been increased and regulation of the reinsurance sector has been enhanced by bringing solvency requirements, licensing, investment rules, and other key regulations on par with direct insurance. The mission welcomed these steps, but noted that financial sector transparency needed to be raised further. Several FSAP recommendations still needed follow up, including publishing more timely financial soundness data, in particular on impaired loans. Adopting minimum quantitative criteria for classifying impaired loans will also be important and the rules for granting and monitoring loans to related parties need to be strengthened. The authorities plan to address these two issues with the implementation of new EU regulations, and have also committed to publishing the full set of core financial soundness indicators by December 2006 building on the good progress in this area in 2005.

41. **There have been noteworthy advances in capital market development.** The authorities explained that the new *Pfandbrief* law of July 2005 has leveled the playing field in the mortgage industry, and is expected to foster a competitive mortgage bond market.[19] The market for other asset-backed securities and impaired loans is growing quickly, offering institutions additional instruments to manage their exposures. The creation of real estate investment trusts has been held up by tax complications, which are being analyzed. Finally, developments in funded pension schemes such as the second pillar (corporate) and third pillar (Riester) pensions are also likely to stimulate the German financial system, as they have done in other countries.

F. Other Issues

42. **AML/CFT legislation has been strengthened**, including with ratification of the UN Convention for the Suppression of Financing of Terrorism (1999). The Third EU AML Directive is expected to become part of German law by mid-2007. The German Financial Supervisory Authority (BaFin) is building up its AML/CFT audit unit.

43. **Germany's statistics are adequate for surveillance.** Collecting national accounts data on inventories and compiling quarterly accounts for the general government would be an important enhancement. The authorities are participating in the IMF's Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs); this exercise should produce the first data and metadata as of end-2005. In July 2005, the authorities received a STA mission, which is now preparing a ROSC on statistical and data issues.

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[19] Pfandbriefe are securitized debt obligations underpinned by mortgages or certain other assets. With the change in the law, all banks are now permitted to issue Pfandbriefe rather than just a limited number of specialized institutions.

44. **Germany aims to increase official development assistance** from 0.3 percent of GDP in 2003 to 0.5 percent by 2010, depending on economic and fiscal conditions.

IV. Staff Appraisal

45. **Germany needs a decisive, forward-looking policy strategy to confront the serious challenges it faces.** Adjustment is making the economy more flexible but substantial policy challenges remain to boost potential growth and secure fiscal sustainability. First, high labor costs and rigidities have contributed to intolerable unemployment, especially for the most vulnerable. Second, Germany is at the cusp of a powerful demographic shift and long run simulation show that public finances and long-standing welfare programs are not sustainable under current policies. Third, globalization and the expanded EU offer valuable opportunities and need to be embraced for Germany's own advantage. Agenda 2010 was a forceful start in reforming entitlement systems and labor markets, and will yield sizeable and lasting benefits. However, the unmet challenges require additional steps that include fiscal consolidation and a reorientation of policies to reduce distortions, especially in the labor markets. The strategy must be decisive, with firm implementation and a clear explanation of the policy steps and their timing. Such an approach offers the best prospect for building confidence and revitalizing growth. And, given Germany's size and influence, it would also set a powerful example for other countries in the region and contribute to a reduction of global imbalances.

46. **Growth is projected to strengthen in the second half of 2005 and in 2006, but it remains unbalanced and is highly dependent on the external environment.** The corporate sector is adapting to a more competitive world by cutting costs and wage moderation has been sustained. As a result, competitiveness has improved and exports have been strong. Yet, exports have been slow to ignite domestic demand as firms and households remain cautious about spending. An abrupt unwinding of global imbalances and rising oil prices may yet frustrate the recovery. Revitalizing demand on a sustained basis will require further progress in addressing Germany's domestic impediments.

47. **The fiscal deficit is largely structural and long run projections suggest that current policies are unsustainable.** There has been a secular decline in the largest tax base, wage income, while high and long lasting unemployment benefits and social transfers exert pressure on expenditure. More fundamentally, the public debt ratio is projected to increase sharply as aging raises expenditure on pensions and health care. Corrective action is therefore urgent. Policies need to be realigned with what a declining population can reasonably deliver, and expectations on output growth and income need to adjust accordingly. Indeed, important synergies exist between public finances and labor market and social security reform.

48. **In light of the increasing pressure from aging, policies should aim to eliminate the structural deficit by 2010.** This goal requires high quality measures of at least half percent of GDP a year, with additional efforts after 2010 as aging unfolds. Resorting to one-off measures such as assets sales or bringing forward future revenue streams to meet the golden rule does not address the fundamental fiscal problem and should be avoided. The

fiscal strategy should combine three elements: durable expenditure cuts, adjusting entitlement outlays, and tax reform:

- **There is ample room to cut subsidies and tax expenditures.** Even moderate but durable cuts can add up to significant savings over a long period.

- **Current entitlements are too costly and will exert growing pressure on payroll taxes if left unaltered**. An equitable recalibration of benefits that includes increasing the retirement age and shifting health care financing away from payrolls can contain nonwage labor costs and other taxes. This will also help raise employment and investment.

- **Tax reform should aim at simplifying the tax code and lowering payroll taxes, possibly with some shift to indirect taxes.** However, as the priority should be fiscal consolidation there is no room for uncompensated tax cuts. Hence, any plans to lower tax rates should be fully financed with base broadening and cuts in tax expenditures and subsidies. Piecemeal adjustments should be avoided as they further complicate the tax system and reduce yield.

49. **Improved transparency and more effective communication about the need for reforms would help garner public support and strengthen confidence.** The government's *Long-Run Fiscal Sustainability Report* is an important innovation but it uses assumptions that render its findings too optimistic. Appointing an independent fiscal council to prepare an annual assessment of the public finances for parliament could provide more realistic forward looking perspectives and better identify policy successes and failures. Also, preparing and publishing a public sector balance sheet, which shows the net present value of the path of future deficits, would increase transparency of the intertemporal fiscal position and help convince the public of the need for reforms and their long run value in strengthening public sector solvency.

50. **Efforts to reform intergovernmental fiscal relations should be revived to provide incentives for better fiscal management.** The current system has become outdated and is hampering consolidation. Reforming federal structures is complex but progress can be made by creating some leeway for competition at the subnational government level to make tax and expenditure policies more efficient and to encourage consolidation; strengthening the internal stability pact by including clear commitments of various levels of government; and cutting redundancies and aligning better the tasks among different parts of government to improve fiscal management.

51. **Raising labor utilization is critical to mitigate demographic pressure on growth and public finances.** The government's perseverance in introducing the difficult Hartz IV reforms is commendable because the new system has improved incentives to work. However, by themselves these reforms are not sufficient for durable employment growth as high labor costs still hold back demand for full time employment. To reap the full benefits of the reform, its implementation needs to be improved by reducing the overlap of functions

between the Labor Office and local governments, and by tightening means testing and the enforcement of job search requirements. Further, the new UB-II program can become a more effective welfare-to-work program by improving incentives for participants to increase labor income while receiving partial benefits.

52. **As more workers are now looking for jobs, greater emphasis needs to be put on reforms that increase labor demand.** Wage determination needs to respond better to labor market imbalances and more closely reflect productivity differentials, including by permitting lower wage floors for entry level and low skill jobs. Lowering the wage wedge and reducing remaining central controls on wage bargaining in favor of more decentralized and firm level bargaining will also be essential. Moreover, cutting employment protection legislation would boost participation and employment, in particular for those with little work experience or skills.

53. **Product and services sector reforms would reinforce labor market reforms by increasing competition and enhancing productivity.** Establishing a business climate that is more favorable to creating and running small businesses, particularly in the service sector, is a priority to boost job creation. This will require a further reduction of service regulations and administrative hurdles in regulated professions and crafts. Germany's support for an EU Services Directive that preserves the country-of-origin principle and limits exemptions to the most sensitive areas for a limited transition period would also serve the country well because its high skilled engineering, construction, and R&D sectors could gain by obtaining easier access to EU countries.

54. **Financial sector profitability is recovering, but a more dynamic banking system would be better able to support growth.** Cost cutting, lower provisioning, and favorable financial market conditions have improved performance. Changes in the public banking pillar, including intensifying cooperation between Landesbanken and Sparkassen, are welcome. Landesbanken have shored up their liquidity by raising long term funding prior to the withdrawal of state guarantees in July 2005, but they still need to develop viable business models. Although there may be isolated instances of strain, the likelihood of systemic difficulties is small. Nevertheless, performance of the German financial system tends to lag EU partners because of the sector's continued fragmentation, which continues to limit economies of scale and growth.

55. **Amending the legal framework to support market-based restructuring of the banking system remains a policy priority.** Consolidation within and across the three pillars of the banking system continues to be hampered by restrictive Länder legislation. Outdated regional barriers limit risk-pooling and may be unnecessary to protect local banks, which enjoy an information advantage with regards to local clients. Moreover, opening up public sector banks to private capital by transforming them into joint-stock companies more decisively than has been done so far would facilitate market driven restructuring, foster synergies and returns to scale, and help direct funds more readily to areas of highest investment needs.

56. **Supervision and regulation have been strengthened, but there is room to enhance transparency.** Supervisory capacity has been reinforced and regulation of the reinsurance sector has been strengthened. It will also be important to abolish the mandatory 90:10 profit split between insurers and policyholders as envisaged when the EU Solvency II comes into effect. The transparency of the system would be aided by publishing more timely financial soundness data, in particular on impaired loans. The liberalization of the *Pfandbrief* law should help further advance capital market development.

57. **Germany's statistics are adequate for surveillance,** and its participation in the IMF's Coordinated Compilation Exercise for FSIs is welcome. Collecting and publishing inventory data would facilitate the monitoring of real sector developments.

58. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Germany: Basic Data

Total area	357,041 square kilometers
Total population (2004)	82.54 million
GDP per capita (2004)	US$ 33,279

	2000	2001	2002	2003	2004	Proj. 2005	Proj. 2006	Proj. 2007	Proj. 2008
	(Percentage change)								
Demand and supply									
Private consumption	2.4	1.9	-0.5	0.1	0.6	-0.3	0.4	1.6	2.0
Public consumption	1.4	0.5	1.4	0.1	-1.6	-0.3	0.3	0.7	1.1
Gross fixed investment	3.0	-3.7	-6.1	-0.8	-0.2	-0.8	2.8	3.5	2.8
Construction	-2.4	-4.6	-5.8	-1.6	-2.3	-5.1	0.5	2.5	1.5
Machinery and equipment	10.7	-3.7	-7.5	-0.2	2.6	3.9	5.1	4.5	4.0
Final domestic demand	2.3	0.4	-1.3	-0.1	0.0	-0.4	0.8	1.8	2.0
Inventory accumulation 1/	-0.1	-0.9	-0.6	0.6	0.5	0.4	0.1	0.0	0.0
Total domestic demand	2.2	-0.5	-1.9	0.6	0.5	0.1	0.9	1.8	2.0
Exports of goods and nonfactor services	13.5	6.4	4.2	2.4	9.3	5.5	5.3	4.5	4.5
Imports of goods and nonfactor services	10.2	1.2	-1.4	5.1	7.0	4.2	5.1	5.5	5.1
Foreign balance 1/	1.0	1.7	1.9	-0.8	1.1	0.7	0.3	-0.2	0.0
GDP	3.1	1.2	0.1	-0.2	1.6	0.8	1.2	1.6	1.9
Output gap (In percent of potential GDP)	1.7	1.5	0.2	-1.3	-1.0	-1.6	-1.7	-1.5	-1.1
	(In millions of persons, unless otherwise indicated)								
Employment and unemployment									
Labor force	42.2	42.4	42.5	42.6	43.3	43.5	43.8	44.0	44.1
Employment	39.1	39.3	39.1	38.7	38.9	38.9	39.3	39.6	39.9
Unemployed 2/	3.1	3.1	3.4	3.8	4.4	4.6	4.5	4.4	4.2
Unemployment rate (in percent) 3/	7.8	7.9	8.7	9.6	9.2	9.5	9.3	9.0	8.7
	(Percentage change)								
Prices and incomes									
GDP deflator	-0.6	1.2	1.4	1.1	0.8	0.4	0.7	1.0	1.4
Consumer price index (harmonized)	1.4	1.9	1.3	1.0	1.8	1.7	1.7	1.5	1.5
Average hourly earnings (total economy)	3.3	2.5	2.5	1.5	1.5	2.0	2.0	2.0	2.0
Unit labor cost (industry)	-1.7	0.5	1.3	-1.7	-4.0	-0.3	0.2	0.2	0.2
Real disposable income 4/	2.1	2.1	0.0	0.6	0.8	-0.6	0.2	0.9	1.6
Personal saving ratio (in percent)	9.2	9.4	9.9	10.3	10.5	10.2	10.0	9.4	9.1

Sources: Deutsche Bundesbank; Federal Statistical Office; IMF, World Economic Outlook; IMF, International Financial Statistics; and staff estimates and projections.

1/ Growth contribution.

2/ National accounts definition

3/ Eurostat definition.

4/ Deflated by the national accounts deflator for private consumption.

Table 1. Germany: Basic Data (concluded)

	2000	2001	2002	2003	2004	Proj. 2005	Proj. 2006	Proj. 2007	Proj. 2008
	(In billions of euros, unless otherwise indicated)								
Public finances 1/ 2/									
General government									
Expenditure	930	1,005	1,031	1,047	1,038	1,049	1,068	1,094	1,124
(In percent of GDP)	45.1	47.6	48.1	48.4	46.9	46.8	46.7	46.7	46.4
Revenue	957	945	951	960	957	962	983	1,006	1,039
(In percent of GDP)	46.4	44.7	44.3	44.4	43.2	42.9	43.0	42.9	42.9
Overall balance	27	-60	-80	-87	-81	-87	-85	-88	-85
(In percent of GDP)	1.3	-2.8	-3.7	-4.0	-3.7	-3.9	-3.7	-3.7	-3.5
Structural balance	-35	-65	-75	-75	-73	-76	-68	-66	-70
(In percent of potential GDP)	-1.7	-3.1	-3.5	-3.5	-3.3	-3.4	-3.0	-2.8	-2.9
Federal government									
Overall balance	28	-27	-36	-40	-51	-46	-48	-50	-50
(In percent of GDP)	1.4	-1.3	-1.7	-1.8	-2.3	-2.1	-2.1	-2.1	-2.1
General government debt	1,211	1,224	1,278	1,358	1,430	1,517	1,602	1,689	1,774
(In percent of GDP)	58.7	57.9	59.6	62.8	64.5	67.6	70.1	72.1	73.3
Balance of payments									
Trade balance 3/	52.0	90.1	126.4	121.6	142.8	159.0	160.1	164.8	175.7
Services balance	-49.0	-49.9	-35.5	-34.0	-31.0	-33.6	-30.7	-33.5	-34.9
Factor income balance	-7.3	-9.5	-14.7	-13.8	0.1	0.7	0.9	1.2	1.6
Net official transfers	-19.1	-16.9	-16.3	-18.7	-17.6	-17.5	-17.8	-18.3	-18.9
Net private transfers	-9.3	-10.5	-11.8	-10.0	-10.9	-11.7	-11.9	-12.2	-12.6
Current account	-32.7	3.3	48.2	45.2	83.5	97.0	100.6	102.1	110.9
(In percent of GDP)	-1.6	0.2	2.2	2.1	3.8	4.3	4.4	4.4	4.6
Foreign exchange reserves (e. o. p.) 4/	53.4	49.5	40.5	32.5	29.3	33.1	...	...	...
	(Percentage changes, end of period)								
Monetary data									
Money and quasi-money (M3) 5/ 6/	-1.0	6.1	...	3.5	2.2	3.9	...	...	...
Credit to private sector 5/	5.8	3.2	0.9	0.0	-0.2	1.0	...	...	...
	(Period averages in percent)								
Interest rates									
Three-month interbank rate 7/	4.4	4.3	3.3	2.3	2.1	2.1	...	...	...
Yield on ten-year government bonds 7/	5.3	4.8	4.8	4.1	4.2	3.1	...	...	...
Exchange rates									
Euro per US$ (annual average) 7/	1.08	1.12	1.06	0.88	0.80	0.79	...	...	...
Nominal effective rate (1990=100) 8/	97.8	98.5	99.5	103.5	104.4	108.5	...	...	...
Real effective rate (1990=100) 8/ 9/	100.8	100.0	100.1	103.1	103.1	98.2	...	...	...

Sources: Deutsche Bundesbank; Federal Statistical Office; IMF, World Economic Outlook; IMF, International Financial Statistics; and staff estimates and projections.

1/ Data for federal government are on an administrative basis. Data for the general government are on a national accounts basis. Debt data are end-of-year data for the general government in accordance with Maastricht definitions.

2/ Government expenditure in 2000 includes, as a negative entry, the proceeds from the sales of mobile phone licenses of euro 50.8 billion (2.5 percent of GDP). The proceeds also affect the financial (but not structural)

3/ Including supplementary trade items.

4/ From 1999 onward data reflect Germany's position in the euro area. Data for 2005 refers to June.

5/ Data for 2005 refer to a change from July 2004 to July 2005.

6/ Data reflect Germany's contribution to M3 of the euro area; data not shown for 2002 because of a series break.

7/ Data for 2005 refer to August. Exchange rate is the average of the year.

8/ Data for 2005 refer to July

9/ Based on relative normalized unit labor cost in manufacturing.

Table 2. Germany: General Government Finances

	2002	2003	2004	Staff Proj. 2005	Staff Proj. 2006	Staff Proj. 2007	Staff Proj. 2008
				(In billions of euros)			
Revenue	**951.2**	**960.3**	**956.8**	**962.3**	**982.5**	**1,006.4**	**1,039.2**
Current	942.7	951.1	947.2	952.5	972.5	996.2	1,028.6
Direct taxes	227.2	225.9	221.1	219.9	224.1	230.7	238.3
Indirect taxes	250.3	255.8	260.2	264.7	270.8	279.2	288.4
Social security contributions	389.2	394.4	395.3	393.0	399.3	409.7	422.9
Other current	76.1	75.1	70.7	74.9	78.5	76.6	79.1
Capital	8.5	9.1	9.7	9.8	10.0	10.2	10.6
Primary expenditure	**967.9**	**982.2**	**975.1**	**984.8**	**1,003.9**	**1,028.8**	**1,056.2**
Current	899.3	914.8	912.0	921.0	938.9	962.2	987.8
Wages	169.1	169.0	168.7	168.5	171.5	175.0	179.9
Goods and services	88.8	89.2	89.5	89.1	92.9	95.1	97.8
Subsidies	31.7	29.9	29.0	23.4	25.7	29.9	30.7
Social benefits	574.1	588.1	586.6	601.2	609.1	621.6	637.5
Other current	35.7	38.6	38.3	38.9	39.7	40.7	41.8
Capital	68.6	67.5	63.2	63.7	65.0	66.6	68.5
Primary balance	**-16.7**	**-22.0**	**-18.3**	**-22.5**	**-21.4**	**-22.4**	**-17.0**
Interest	62.9	64.6	62.9	64.1	63.7	65.2	67.5
Overall balance	**-79.6**	**-86.5**	**-81.2**	**-86.5**	**-85.1**	**-87.6**	**-84.6**
				(In percent of GDP)			
Revenue	**44.3**	**44.4**	**43.2**	**42.9**	**43.0**	**42.9**	**42.9**
Current	43.9	44.0	42.7	42.5	42.6	42.5	42.5
Personal income tax	10.6	10.4	10.0	9.8	9.8	9.8	9.8
Indirect taxes	11.7	11.8	11.7	11.8	11.9	11.9	11.9
Social security contributions	18.1	18.2	17.8	17.5	17.5	17.5	17.5
Other current	3.5	3.5	3.2	3.3	3.4	3.3	3.3
Capital	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Primary expenditure	**45.1**	**45.4**	**44.0**	**43.9**	**43.9**	**43.9**	**43.6**
Current	41.9	42.3	41.2	41.1	41.1	41.1	40.8
Wages	7.9	7.8	7.6	7.5	7.5	7.5	7.4
Goods and services	4.1	4.1	4.0	4.0	4.1	4.1	4.0
Subsidies	1.5	1.4	1.3	1.0	1.1	1.3	1.3
Social benefits	26.8	27.2	26.5	26.8	26.7	26.5	26.3
Other current	1.7	1.8	1.7	1.7	1.7	1.7	1.7
Capital	3.2	3.1	2.9	2.8	2.8	2.8	2.8
Primary balance	**-0.8**	**-1.0**	**-0.8**	**-1.0**	**-0.9**	**-1.0**	**-0.7**
Interest	2.9	3.0	2.8	2.9	2.8	2.8	2.8
Overall balance	**-3.7**	**-4.0**	**-3.7**	**-3.9**	**-3.7**	**-3.7**	**-3.5**
Memorandum item:							
Structural fiscal balance	-3.5	-3.5	-3.3	-3.4	-3.0	-2.8	-2.9

Sources: Ministry of Finance; and Fund staff projections based on continuation of current policies.

Table 3. Germany: Balance of Payments

	2002	2003	2004	Staff Proj. 2005	Staff Proj. 2006	Staff Proj. 2007	Staff Proj. 2008
	(In billions of euros, unless otherwise indicated)						
Current account	**48**	**45**	**84**	**97**	**101**	**102**	**111**
In percent of GDP	2.2	2.1	3.8	4.3	4.4	4.4	4.6
Trade balance	126	122	143	159	160	165	176
Exports	653	665	732	776	823	870	918
Imports	-526	-544	-589	-617	-663	-705	-742
Nonfactor services	-35	-34	-31	-34	-31	-33	-35
Exports	111	111	116	119	127	134	141
Imports	-146	-145	-147	-152	-157	-167	-176
Factor services	-15	-14	0	1	1	1	2
Credit	103	97	107	120	126	134	144
Debit	-118	-111	-107	-119	-125	-133	-142
Current transfers, net	-28	-29	-28	-29	-30	-30	-31
Capital and financial accounts	-74	-43	-99	-97	-101	-102	-111
FDI, net	38	27	-22	-22	-19	-17	-18
Portfolio investment, net	63	65	17	35	36	37	38
Other	-177	-136	-95	-112	-117	-121	-131
Reserve assets	2	0	1	3	0	0	0
Errors and ommissions	26	-2	15	0	0	0	0
Memorandum items:							
US$/EUR, p.a.	$0.94	$1.13	$1.24	...	...	...	...
REER (based on relative CPI)	102.1	106.7	108.1	...	...	...	...
REER (based on relative ULC)	99.2	101.7	100.2	...	...	...	...

Sources: Deutsche Bundesbank; and Fund staff projections (WEO).

Table 4. Germany: The Core Set of Financial Soundness Indicators for Banks, 1998-2004
(In percent)

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04
Capital adequacy							
Regulatory capital to risk-weighted assets	11.4	11.5	11.7	12.0	12.7	13.4	13.2
Commercial banks	11.9	12.4	13.0	13.6	14.4	14.4	13.6
Landesbanken	10.5	10.5	10.7	11.3	12.7	14.5	14.0
Savings banks	10.9	10.9	10.7	10.8	11.2	11.5	12.1
Credit cooperatives	11.0	11.2	11.2	11.1	11.0	11.7	12.1
Regulatory Tier I capital to risk-weighted assets 1/	7.4	7.6	7.7	8.0	8.6	8.8	8.7
Commercial banks	8.0	8.5	8.9	9.6	10.4	10.2	9.4
Landesbanken	6.1	6.2	6.2	6.6	7.9	8.9	8.3
Savings banks	7.0	7.0	7.0	7.1	7.3	7.4	7.7
Credit cooperatives	7.2	7.3	7.4	7.5	7.6	8.1	8.4
Asset composition and quality							
Sectoral distribution of loans to total loans							
Loan to households	33.3	35.9	36.2	36.3	35.6	36.0	35.9
Commercial banks	...	38.2	37.2	37.5	36.2	37.5	38.2
Landesbanken	...	13.5	14.7	15.3	14.4	13.6	13.2
Savings banks	...	65.6	65.4	64.5	63.6	64.7	64.0
Credit cooperatives	...	68.2	69.7	68.5	68.7	69.9	69.9
Loans to non-financial corporations	19.4	17.5	17.6	17.3	16.7	16.2	15.3
Commercial banks	...	22.8	21.1	19.6	17.9	15.9	14.4
Landesbanken	...	18.9	19.6	19.8	18.9	18.6	17.9
Savings banks	...	18.0	18.8	19.2	19.0	18.7	18.3
Credit cooperatives	...	13.2	13.8	13.8	13.5	13.1	12.6
NPLs to gross loans	4.5	4.2	4.7	4.6	5.0	5.3	5.1
Commercial banks	5.1	5.0	5.5	5.1	5.1	5.1	4.7
Landesbanken	2.8	2.5	2.7	2.8	3.7	4.4	4.3
Savings banks	6.1	5.7	5.6	5.9	6.4	6.8	7.0
Credit cooperatives	6.5	6.4	6.9	7.2	8.1	8.1	8.2
NPLs net of provisions to capital	42.2	39.2	44.7	46.1	47.5	52.1	46.8
Commercial banks	38.1	37.2	39.6	49.8	47.6	55.5	45.4
Landesbanken	32.5	26.0	29.6	27.9	31.6	34.9	35.5
Savings banks	56.4	51.6	49.2	52.2	53.6	58.1	55.3
Credit cooperatives	47.8	49.7	51.9	53.7	61.2	58.3	57.1
Earnings and profitability							
Return on average assets (after-tax)	0.3	0.2	0.2	0.2	0.1	-0.1	0.1
Commercial banks	0.6	0.3	0.3	0.2	0.0	-0.3	-0.1
Landesbanken	0.1	0.1	0.1	0.1	0.1	-0.2	0.0
Savings banks	0.3	0.2	0.3	0.2	0.2	0.2	0.2
Credit cooperatives	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Return on average equity (after-tax)	10.2	6.5	6.1	4.6	2.9	-1.5	1.9
Commercial banks	15.2	7.0	7.3	4.2	0.0	-6.6	-1.4
Landesbanken	6.3	5.9	4.2	4.0	1.9	-5.2	-0.8
Savings banks	6.5	6.1	6.1	5.1	4.7	4.0	5.1
Credit cooperatives	5.1	4.7	4.1	4.4	6.6	5.2	5.1
Interest margin to gross income	75.0	73.2	67.8	69.8	73.4	70.2	73.4
Commercial banks	64.7	61.7	52.7	56.2	63.7	56.5	64.8
Landesbanken	72.0	77.6	72.4	75.0	75.8	79.0	79.4
Savings banks	81.9	81.3	80.9	80.8	81.3	80.6	79.6
Credit cooperatives	79.0	77.1	76.5	78.3	79.1	75.4	75.5
Noninterest expenses to gross income	63.6	66.0	68.4	71.4	67.2	66.5	65.5
Commercial banks	67.8	73.9	75.4	80.4	74.2	74.0	73.5
Landesbanken	46.5	54.8	55.9	57.1	56.1	53.1	53.5
Savings banks	66.5	65.7	68.9	69.9	66.5	66.4	64.9
Credit cooperatives	72.4	71.2	74.5	76.7	73.1	69.6	68.7
Liquidity							
Liquid assets to total short-term liabilities 2/	...	...	1.4	1.4	1.4	1.3	1.4
Commercial banks	...	...	1.2	1.2	1.2	1.2	1.2
Landesbanken	...	...	1.3	1.3	1.3	1.3	1.4
Savings banks	...	...	2.3	2.4	2.3	2.3	2.5
Credit cooperatives	...	...	2.0	2.1	2.2	2.2	2.2
Sensitivity to market risk							
Net open positions in FX to capital	5.2	6.6	7.4	10.8	6.1	3.7	3.7
Commercial banks	8.7	6.2	5.2	4.0	2.2	2.6	1.6
Landesbanken	8.4	9.5	11.4	10.8	12.8	4.0	6.2
Savings banks	3.3	4.8	6.0	5.7	5.1	4.5	4.1
Credit cooperatives	1.0	10.5	13.6	12.6	12.2	8.3	7.5

Sources: Deutsche Bundesbank; IFS; and Fund staff estimates.

1/ According to Capital Adequacy Regulation, Principle I.

2/ Prudential supervision liquidity ratio. Data not available before July 1, 2000.

Table 5. Germany: Encouraged and Other Financial Soundness Indicators, 1998-2004
(In percent, unless otherwise indicated)

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04
Corporate sector							
Total debt to equity	88.6	76.2	93.2	101.3	146.6	125.1	114.4
Total debt to corporate GDP	128.5	136.8	152.9	155.3	155.8	152.6	140.9
Return on invested capital	15.4	11.7	12.8	14.4	21.1	18.6	19.6
Earnings to interest and principal expenses	528.1	476.0	396.5	401.2	447.2	495.6	567.4
Number of applications for protection from creditors	17,948	17,888	18,219	20,923	23,595	23,811	22,424
Deposit-taking institutions							
Capital to assets	4.0	4.1	4.2	4.3	4.5	4.5	4.3
Commercial banks	5.7	5.9	5.8	5.7	5.7	5.5	4.8
Landesbanken	3.7	3.7	3.8	4.2	4.7	4.7	4.3
Savings banks	4.1	4.1	4.2	4.3	4.5	4.6	4.8
Credit cooperatives	4.9	4.9	5.1	5.0	5.1	5.4	5.5
Geographical distribution of loans to total loans							
Germany	85.3	85.4	83.6	81.3	80.0	78.6	76.8
EU-member countries	8.4	8.6	9.6	11.6	13.2	14.6	16.9
Others	6.3	6.0	6.8	7.1	6.8	6.8	6.3
FX loans to total loans	9.1	7.8	9.3	10.2	9.6	9.1	9.6
Personnel expenses to noninterest expenses	56.0	54.8	54.1	53.1	53.1	53.8	54.4
Commercial banks	54.1	51.3	50.4	49.2	48.5	49.4	49.8
Landesbanken	52.8	51.0	51.9	49.8	49.6	49.0	50.2
Savings banks	59.9	59.9	60.0	59.3	59.5	60.6	61.3
Credit cooperatives	58.2	58.5	57.8	58.4	59.0	59.0	59.2
Trading and fee income to total income	25.0	26.8	32.2	30.2	26.6	29.8	26.6
Commercial banks	35.3	38.3	47.3	43.8	36.3	43.5	35.2
Landesbanken	28.0	22.4	27.6	25.0	24.2	21.0	20.6
Savings banks	18.1	18.7	19.1	19.2	18.7	19.4	20.4
Credit cooperatives	21.0	22.9	23.5	21.7	20.9	24.6	24.5
Customer deposits to total (non-interbank) loans	...	67.0	67.0	67.5	68.2	69.8	72.5
Commercial banks	...	70.6	70.3	76.5	80.2	84.1	89.6
Landesbanken	...	40.1	42.7	38.2	33.0	35.6	38.2
Savings banks	...	107.2	104.1	103.8	102.7	102.6	103.8
Credit cooperatives	...	116.1	110.6	113.8	113.5	114.4	115.6
Spread between highest and lowest interbank rates 1/	47.0	19.0	20.0	10.0	20.0	…	…
Spread between reference loan and deposit rates 2/	…	…	…	…	…	379	366
Insurance sector							
Solvency ratio, Life	…	…	…	…	170	176	…
Solvency ratio, Non life	…	…	350	350	337	346	…
Return on average equity, Life 3/	11.9	11.4	12.5	7.0	3.4	5.7	…
Return on average equity, Non life 3/	8.1	7.3	8.7	8.9	2.8	4.1	…
Market liquidity							
Average bid-ask spread in the securities market 1/	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Households							
Household debt to GDP	69.5	72.7	73.1	72.4	72.0	72.1	71.0
Household debt service and principal payments to income	5.2	4.9	5.4	5.3	4.9	4.4	4.1
Real estate markets							
Real estate prices 4/							
New dwellings	99	99	100	101	102	101	100
Resale	99	100	100	100	98	97	95
Residential real estate loans to total loans	13.7	16.3	16.6	16.3	16.3	18.2	17.9
Commercial real estate loans to total loans	6.8	6.5	6.4	6.3	6.3	6.6	6.4

Sources: Deutsche Bundesbank; IFS; and Fund staff estimates.

1/ Spread between highest and lowest three month money market rates as reported by Frankfurt banks (basis points).

2/ Spread in basis points, calculated on the base of the German MIR statistics for outstanding amounts.

3/ Taken from balance sheet data: profits after tax / equity.

4/ Residential property (index, yearly average, 2000 = 100). An aggregation of the data for new dwellings and resale is not available.

Table 6. Germany: Financial System Structure, 1998-2004
(In billions of euros and percentage)

	Dec-98			Dec-99			Dec-00			Dec-01			Dec-02			Dec-03			Dec-04		
	Number	Assets Euro	Percent of total	Number	Assets Euro	% of total	Number	Assets Euro	Percent of total	Number	Assets Euro	Percent of total	Number	Assets Euro	Percent of total	Number	Assets Euro	Percent of total	Number	Assets Euro	Percent of total
Private depository institutions	3,246	5,139	79.5	2,966	5,593	76.4	2,709	5,995	76.5	2,492	6,228	76.6	2,337	6,290	76.4	2,199	6,299	76.9	2,120	6,480	...
Commercial banks	328	1,296	20.0	290	1,447	19.8	294	1,704	21.8	279	1,790	22.0	273	1,830	22.2	261	1,804	22.0	252	1,879	...
Of which																					...
Big banks	3	562	8.7	4	825	11.3	4	970	12.4	4	1,027	12.6	4	1,056	12.8	4	1,045	12.8	5	1,218	...
Regional and other banks	241	634	9.8	199	517	7.1	200	613	7.8	195	633	7.8	186	665	8.1	173	671	8.2	163	568	...
Branches of foreign banks	84	100	1.5	87	105	1.4	90	121	1.5	80	130	1.6	83	109	1.3	84	88	1.1	84	93	...
Landesbanken	13	940	14.5	13	1,145	15.6	13	1,223	15.6	13	1,269	15.6	14	1,324	16.1	13	1,346	16.4	12	1,282	...
Savings banks	594	910	14.1	578	925	12.6	562	954	12.2	537	986	12.1	520	998	12.1	491	1,000	12.2	477	1,002	...
Regional institutions of credit cooperatives	4	201	3.1	4	214	2.9	4	227	2.9	2	216	2.7	2	199	2.4	2	187	2.3	2	201	...
Credit cooperatives	2,256	520	8.0	2,035	534	7.3	1,792	534	6.8	1,619	552	6.8	1,489	560	6.8	1,393	566	6.9	1,336	576	...
Mortgage banks	33	795	12.3	32	830	11.3	31	892	11.4	28	922	11.3	25	873	10.6	25	872	10.6	25	866	...
Banks with special functions	18	477	7.4	14	498	6.8	13	461	5.9	14	493	6.1	14	506	6.1	14	524	6.4	16	674	...
Building and loan associations 1/	34	...	...	33	146	2.0	31	154	2.0	29	158	1.9	28	164	2.0	27	173	2.1	27	184	...
Insurance companies 2/	684	750	11.6	683	817	11.2	666	873	11.1	650	943	11.6	705	1,013	12.3	705	999	12.2	...	...	...
Life	123	462	7.1	123	505	6.9	123	540	6.9	120	570	7.0	134	596	7.2	134	587	7.2	...	...	...
Nonlife	271	91	1.4	271	94	1.3	260	96	1.2	254	100	1.2	262	107	1.3	262	105	1.3	...	...	...
Other	290	197	3.1	289	218	3.0	283	237	3.0	276	273	3.4	309	311	3.8	309	307	3.7	...	...	...
Investment funds 3/	805	578	8.9	915	763	10.4	1,019	811	10.4	1,112	802	9.9	1,141	762	9.3	1,170	722	8.8	...	...	...
Money market funds	39	18	0.3	36	22	0.3	39	20	0.3	46	34	0.4	42	40	0.5	38	46	0.6	...	...	...
Pension investment mutual funds	31	0	0.0	43	2	0.0	45	3	0.0	47	3	0.0	49	2	0.0	51	1	0.0	...	...	...
Securities-based funds	718	513	7.9	818	683	9.3	915	733	9.4	997	697	8.6	1,026	635	7.7	1,055	573	7.0	...	...	...
Open-end real estate funds	17	47	0.7	18	56	0.8	20	55	0.7	22	68	0.8	24	85	1.0	26	102	1.2	...	...	...
Total financial system	4,769	6,467	100.0	4,597	7,319	100.0	4,425	7,833	100.0	4,283	8,131	100.0	4,211	8,229	100.0	4,101	8,193	100.0	...	...	...
Memorandum items:																					
Majority foreign-owned banks	72	126	2.0	61	123	1.7	56	130	1.7	53	168	2.1	49	276	3.4	45	293	3.6	42	321	...
Foreign banks	156	225	3.5	148	229	3.1	146	251	3.2	133	297	3.7	132	386	4.7	129	380	4.6	126	414	...
Majority public sector owned banks	625	2,327	36.0	605	2,568	35.1	588	2,638	33.7	564	2,748	33.8	548	2,828	34.4	518	2,870	35.0	505	2,958	...

Sources: BaFin; Deutsche Bundesbank; and Fund staff estimates.

1/ Assets are not included in Bundesbank statistics until 1999.

2/ Number of insurance companies by legal status.

3/ Total assets for pension investment funds, net total assets for all other categories.

Germany: Public Debt Sustainability

Under current policies, Germany's general government debt/GDP ratio is projected to increase sharply in the long run. Population aging within the context of Germany's current entitlement system poses a serious challenge to fiscal sustainability. Aging and its fiscal costs will accelerate starting in 2010. Until then, the gross debt is projected to increase to 74 percent of GDP. Germany's projected increase in the old-age dependency ratio through 2050 is in the upper range of G-7 countries while the entitlement system and labor market policies tend to offer generous benefits at a cost of relatively low labor utilization. Although recent pension, health care, and labor market reforms substantially lowered future implicit liabilities (already included in the projections), they were insufficient to assure fiscal sustainability.

A long-term fiscal sustainability analysis illustrates these points:

- Under a baseline scenario of current policies, the debt/GDP ratio would rise sharply over the projection period 2005-2050. The main factors are a deceleration of GDP growth (denominator effect) due to a shrinking working-age population, and higher expenses—and deficits—for the aging dependent population (numerator effect).

- Alternative scenarios confirm the likelihood of an unsustainable debt trajectory. More optimistic growth assumptions relative to the baseline (assuming lower unemployment in the long run and higher labor utilization) are helpful but not sufficient to contain debt accumulation. Also, a scenario with key variables (growth, interest rates, and the primary balance) at their recent historical levels; and a scenario of a constant primary deficit of 0.9 percent of GDP (its value in 2005)—would both still result in a steadily rising debt ratio.

Thus, under any scenario, structural fiscal adjustment appears necessary to achieve intertemporal fiscal consistency.

The authorities agree that pressures from population aging are a concern, but differ in their assessment of the severity and urgency of the problem. The authorities have published a *Long Run Fiscal Sustainability Report* that assumes strong up-front fiscal adjustment combined with higher growth than in the staff baseline scenario (based on lower unemployment and higher labor utilization). These assumptions imply a lower debt profile and postpone the moment when the debt starts accelerating, but they do not assure long run sustainability. The authorities agree, therefore, that further fiscal measures are necessary to strengthen the public finances over the long run.

Germany: General Government Debt Sustainability Framework, 2004-2050
(In percent of GDP, unless otherwise indicated)

	Actual	Medium-term Projections						Long-term projections 7/			
	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050
Baseline scenario: general government gross debt 1/	64.5	**67.7**	**70.1**	**72.0**	**73.2**	**73.9**	**74.7**	**99.6**	**159.2**	**252.6**	**363.6**
o/w foreign-currency denominated	0.0	0.2	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0
Change in public sector debt	1.8	3.1	2.4	1.9	1.2	0.7	0.8	24.9	59.6	93.4	111.0
Identified debt-creating flows	1.2	2.2	1.8	1.7	1.3	0.9	1.2	3.7	7.9	10.1	12.1
Primary deficit	0.8	1.0	0.9	0.9	0.7	0.5	0.3	2.2	5.4	6.6	6.7
Revenue and grants	43.2	42.9	43.0	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8
Primary (non-interest) expenditure	44.0	44.0	43.9	43.9	43.6	43.3	43.2	45.0	48.2	49.3	49.5
Automatic debt dynamics 2/	0.7	1.2	0.9	0.8	0.6	0.5	0.9	1.5	2.5	3.5	5.4
Contribution from interest rate/growth differential 3/	0.7	1.2	0.9	0.8	0.6	0.5	0.9	1.5	2.5	3.5	5.4
Of which contribution from real interest rate	1.7	1.7	1.8	1.9	1.9	2.0	2.2	2.5	3.9	6.2	8.9
Of which contribution from real GDP growth	-1.0	-0.5	-0.8	-1.1	-1.3	-1.5	-1.3	-1.0	-1.5	-2.7	-3.4
Other identified debt-creating flows	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	0.5	0.8	0.7	0.4	0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0
General government debt-to-revenue ratio	149.5	157.7	163.0	167.8	170.5	172.4	174.3	232.9	372.3	590.8	850.4
Scenario with key variables at their historical averages 4/		**67.7**	**69.6**	**71.4**	**72.9**	**74.4**	**75.8**	**93.1**	**116.5**	**147.8**	**189.7**
Scenario with constant primary deficit of 0.9 percent of GDP in 2005-2050		**67.7**	**70.1**	**72.2**	**73.7**	**74.9**	**76.4**	**97.9**	**126.8**	**157.2**	**193.0**
Scenario with higher economic growth from enhanced labor utilization 5/		**66.8**	**67.6**	**68.0**	**67.7**	**67.3**	**66.8**	**70.3**	**99.3**	**157.2**	**224.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	1.6	0.8	1.3	1.6	1.9	2.1	1.8	1.0	1.0	1.1	1.0
Average nominal interest rate on public debt (in percent) 6/	4.6	4.4	4.4	4.3	4.3	4.3	4.5	4.4	4.4	4.4	4.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.9	2.6	2.7	2.8	2.8	2.8	3.0	2.7	2.7	2.6	2.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.3	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.8	1.7	1.6	1.5	1.5	1.5	1.5	1.8	1.8	1.8	1.8
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.5	-0.6	0.2	1.0	1.1	1.5	1.6	1.6	1.7	1.0	1.1
Primary deficit	0.8	1.0	0.9	0.9	0.7	0.5	0.3	2.2	5.4	6.6	6.7

1/ Long term projections reflect a staff current-policies baseline with the long run NAIRU at 8 percent of the labor force.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2 as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ Real GDP growth at 1.5 percent a year; real interest rate at 5.2 percent; and the primary balance at 0.8 percent of GDP (a surplus).
5/ Optimistic staff scenario reflecting a lower steady-state NAIRU of 3.3 percent, and higher average output growth.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Identified debt creating flows refer to indicated year, not to the decade. Cumulative increases for the decade are indicated in the line "Change in public sector debt".

Staff Analytical Work on Germany, 2001-05

Growth and Competitiveness

- Long-run Growth in Germany. *Forthcoming Selected Issues Paper.*
- Does Regulation Impede Growth in Germany? *Forthcoming Selected Issues Paper.*
- The Performance of Germany's Non-Financial Corporate Sector – An International Perspective. *Forthcoming Selected Issues Paper.*
- External Sector Role in Recent Growth Performance of Large Euro Area Countries. *Forthcoming Selected Issues Paper.*
- Investment Trends in OECD Countries: Long-Term Developments and Future Prospects. *IMF Country Report No. 04/340*.
- Does PPP hold in the Long Run? Germany and Switzerland. *IMF Country Report No. 04/340*.
- Business Investment in the Current Cycle. *IMF Country Report No. 03/342*.
- Growth and Adjustment in Germany. *IMF Country Report No. 02/240*.
- Is Germany Competitive? *IMF Country Report No. 02/240*.
- Job-Rich Growth in Europe. *IMF Country Report No. 01/307*.

Fiscal Policy and Entitlement Programs

- Why is Germany's Deficit so Large? *Forthcoming Selected Issues Paper.*
- A Preliminary Public Sector Balance Sheet for Germany. *Forthcoming Selected Issues Paper.*
- A Long-Run Fiscal Scenario Based on Current Policies. *Forthcoming Selected Issues Paper.*
- Pensions and Growth. *IMF Country Report No. 04/340*.
- Federalism and the Political Economy of Adjustment. *IMF Country Report No. 04/340*.
- The Fiscal Challenge of Aging: What Needs to Be Done. *IMF Country Report No. 02/240*.
- Health Care Reform in Germany. *IMF Country Report No. 02/240*.
- Rules-Based Fiscal Policy and the Fiscal Framework in France, Germany, Italy and Spain. *IMF Country Report No. 01/307*.

Labor Markets

- Employment, Unemployment, and Labor Supply in Germany. *IMF Country Report No. 04/340*.
- The Unbearable Stability of the German Wage Structure: Evidence and Interpretation. *IMF Staff Papers, August 2004*.
- On Sand and Grease in Labor Markets: How Does Germany Compare. *WP/02/164*.

The Financial System

- Credit Decline and the Efficiency of German Banks. *Forthcoming Selected Issues Paper.*
- Germany's Three-Pillar Banking System. *IMF Occasional Paper 233 (2004)*.
- Germany's Financial System: International Linkages and the Transmission of Financial Shocks. *IMF Country Report No. 03/342*.
- The Slowdown in Credit Growth. *IMF Country Report No. 02/240*.

Germany: Fund Relations
(As of July 31, 2005)

I. **Membership Status:**

Germany became a member of the Fund on August 14, 1952. Germany has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II.	**General Resources Account:**	**SDR Million**	**% Quota**
	Quota	13,008.20	100.00
	Fund holdings of currency	10,164.66	78.14
	Reserve position in Fund	2,843.60	21.86
III.	**SDR Department:**	**SDR Million**	**% Allocation**
	Net cumulative allocation	1,210.76	100.0
	Holdings	1,327.05	109.60
IV.	**Outstanding Purchases and Loans:**	None	
V.	**Financial Arrangements:**	None	

VI. **Projected Payments to Fund:**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	--	--	--	--	--
Charges/Interest	0.09	0.09	0.09	0.09	0.09
Total	0.09	0.09	0.09	0.09	0.09

VII. **Exchange Rate Arrangement:**

Since January 1, 1999, Germany has been a member of the European Economic and Monetary Union; the deutsche mark entered EMU at a value of DM 1.95583 per euro.

Germany is an Article VIII member and maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for reasons related to security. In accordance with IMF Executive Board Decision No. 144-(52/51), effective December 2001, the authorities put into effect a series of measures freezing the accounts of and banning payments in favor of the Taliban, listed terrorists, and persons and organizations related to terrorism. Pursuant to UN Security Council resolutions and/or EU regulations, restrictions are imposed on payments and transfers to Iraq, Libya, Zimbabwe, and certain individuals in the Myanmar. EU sanctions are maintained against the assets of 13 persons associated with Serbia and Montenegro.

The restrictions against individuals, organizations, or countries have been modified since the last No. 144-(52/51) notification to the Fund.

VIII. **Article IV Consultations:**

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (IMF Country Report No. 04-341) was discussed at EBM 04/100 (October 25, 2004).

GERMANY: STATISTICAL ISSUES

Germany's economic and financial statistics are adequate for surveillance purposes. Germany has a full range of statistical publications and subscribes to the Fund's Special Data Dissemination Standard (SDDS). The authorities make substantial use of the Internet to facilitate on-line access to data and press information.

Germany adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. In April 2005, revised national accounts statistics were released to comply with EUROSTAT requirements. With this revision, Germany adopted chain-linked pricing, allocated financial intermediation services to the users, and introduced new data (e.g. hedonic pricing). Nonetheless, four significant gaps remain:

- Statistics on inventories are unavailable. In the national accounts, inventory accumulation is derived as a residual and lumped together with the statistical discrepancy.

- Although explanatory documentation exists, the lack of a table bridging the general government data in the ESA95 classification and the general government cash data on an administrative basis is viewed as impairing fiscal analysis.

- Flow-of-funds data for the 1970s and 1980s remain patchy. Also, flow-of-funds data are published on an annual basis only and with a nine-month lag.

- The absence of any pre-1970 ESA95 data complicates time series analysis.

As with other euro-area countries, Germany does not publish quarterly general government revenue, expenditure, and balance on an accrual basis (ESA95). These data, however, are disseminated quarterly on a cash-basis, although Germany no longer reports cash data for publication in the *Government Finance Statistics Yearbook (GFSY)*.

Following the adoption of the ESA95 standard for fiscal reporting by member countries of the European Union, the IMF Statistics Department is collaborating with member states, Eurostat, and the European Central Bank to develop a fiscal data reporting system that accords with the accrual methodologies of the ESA95 and the *Government Finance Statistics Manual 2001*. The *Government Finance Statistics Yearbook* reports annual data for Germany using the framework of the *Government Finance Statistics Manual 2001*: These data refer to the central government, state and local government, and the general government (1999-2001).

The 2003 FSAP mission found that the availability and timeliness of financial soundness indicators were relatively weak. Germany is participating in the Coordinated Compilation Exercise for financial soundness indicators (FSIs) in which Germany commits to compilation of a benchmark set of FSIs that will potentially serve as a basis for regular compilation of FSIs.

A ROSC Data Module mission in July 2005 assessed Germany's data dissemination practices and the quality of the main macroeconomic datasets.

GERMANY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of September 6, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	July 05	8/02/2005	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July	August	M	M	M
Reserve/Base Money	June 05	July 05	M	M	M
Broad Money	June 05	July 05	M	M	M
Central Bank Balance Sheet	June 05	July 05	M	M	M
Consolidated Balance Sheet of the Banking System	June 05	July 05	M	M	M
Interest Rates[2]	June 05	July 05	M	M	M
Consumer Price Index	July	August	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 05	July 05	Semi-annual	Semi-annual	Semi-annual
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	June	July	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June	July	M	M	M
External Current Account Balance	June 05	August 05	M	M	M
Exports and Imports of Goods and Services	June 05	August 05	M	M	M
GDP/GNP	Q2 05	August 05	Q	Q	Q
Gross External Debt	H1 03	June 05	Semi-annual	Semi-annual	Semi-annual

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2005 Article IV Consultation

Supplementary Information

Prepared by the European Department

Approved by Michael Deppler and Adnan Mazarei

December 28, 2005

1. After a close election in September, a "grand coalition" government took office on November 22, 2005. The government comprises the Christian parties (Christian Democratic Union and Christian Social Union) and the Social Democratic Party, and is headed by Mrs. Merkel (CDU). Mr. Müntefering (SPD) is Vice-Chancellor and Minister of Labor and Social Security.

2. As envisaged in the staff report for the 2005 Article IV consultation with Germany (September 20, 2005), a second round of discussions was held with the new authorities and staff at the Bundesbank.[1] This supplement reports on these discussions, which centered around the coalition agreement issued by government partners on November 12, 2005.[2] An updated staff appraisal based on these discussions is included in this supplement.

I. The Coalition Agreement

3. **The coalition agreement sets out the major policy objectives for the government's four-year term**, although in many areas detailed policies and the interlinkages between various aspects still need to be crystallized. The key economic elements of the agreement include:

- **Fiscal consolidation:** reducing the deficit below the Maastricht criterion in 2007, with an increase in the VAT rate from 16 to 19 percent in January 2007 as the main adjustment measure. A package of new expenditure initiatives equivalent to about

[1] The discussions took place on December 12-14, 2005 in Berlin and Frankfurt. Meetings were held with Finance Minister Steinbrück, State Secretary of Finance Mirow, State Secretary of Labor and Social Security Anzinger, senior representatives at the Chancellery, the Ministries of Finance, Economy, and Labor and Social Security, parliamentarians from both major parties, and staff at the Bundesbank. The staff team comprised Mr. Chopra and Mr. Traa. Mr. Bischofberger, Germany's Executive Director, attended the discussions.

[2] In addition, on October 18, 2005, the authorities provided an updated Notification of Restrictions Under Executive Board Decision No. 144-(52/51) concerning certain payments restrictions.

1 percent of GDP distributed over four years (with some backloading) is to provide support for selected activities. (See Box 1 for additional information.)

- **Labor markets:** reducing nonwage labor costs by cutting unemployment insurance contributions (financed in part by one-third of the receipts from the VAT increase) and extending the probationary employment period—i.e., with unrestricted dismissal rights—in new labor contracts from 6 to 24 months.

- **Product and service markets:** implementing further reform in network industries; tightening licensing requirements for some crafts; and renegotiating the EU Services Directive.

- **Entitlement reforms:** increasing the statutory retirement age from 65 to 67 years at a pace of one month a year starting in 2012; freezing pension benefits for the foreseeable future; and increasing the pension contribution rate from 19.5 to 19.9 percent effective January 2007.

- **Federalism reforms:** reducing complexity and improving political and financial governance.

- **Financial sector:** implementing the Basel II capital adequacy accord "in a *Mittelstand* friendly way;" reviewing governance aspects of the Federal Office of Financial Supervision (BaFin), including "reducing supervisory regulation to an appropriate level" to facilitate the extension of credit; and enhancing the role of the National Development Bank (KfW) to support investment and the market for venture capital.

II. Report on the Discussions

4. **As the government took office only recently, converting the coalition agreement into an operational implementation plan is still in its early stages**. The authorities observed that the agreement is the result of difficult negotiations between two parties that had spent 30 years opposing each other in government. Fiscal consolidation is the fundamental goal and the area where the strategy is most fleshed out; accordingly, this was the focus of the staff visit. There is also agreement between the coalition partners that the financing of the health insurance system and corporate income tax regime need major reform, but, given their complexity, decisions on these two reforms have been scheduled for 2006 and 2007, respectively. In other structural reform areas, such as labor, product, and service markets, where the initial plans are modest, the mission's interlocutors noted that the coalition partners would need more time to learn how best to work together and make further progress, and hence the coalition agreement should be viewed as a stepping stone to further initiatives.

A. Fiscal Policy

5. **The coalition agreement articulates specific policies to reduce the fiscal deficit to below 3 percent of GDP in 2007**. The authorities noted that the general government deficit, which is projected to remain around 3¾ percent of GDP in 2005, had been too high for too

long. A new budget for 2006 will be presented in February 2006 and will aim to lower the deficit by about ¼ percent of GDP (in both nominal and structural terms). Moreover, the authorities will prepare the ground for additional durable adjustment measures totaling at least ¾ percent of GDP in 2007, centered around the VAT hike on January 1, 2007. The intention is to continue with further deficit reduction in later years (the precise objectives will be spelled out in an updated Stability Program to be submitted to the European Commission in February 2006), but the detailed policies to achieve this were not available at the time of the discussions. The authorities noted that the grand coalition has broad support in both chambers of parliament and felt that using this opportunity to make a determined effort to reduce the fiscal deficit was already strengthening confidence and improving sentiment.

Germany: Preliminary Staff Estimates of Fiscal Measures in the Coalition Agreement

	2005	2006	2007
(In billions of euros)			
General government balance projected in the staff report 1/	**-86.5**	**-85.1**	**-87.6**
Cumulative measures in the coalition agreement 2/			
VAT increase	...	...	21.1
Reducing tax expenditures and subsidies	...	1.2	7.6
Cost cutting in Hartz IV program	...	5.0	6.0
Increase in pension contribution rate	...	...	3.8
Reduction in the unemployment contribution rate	...	...	-13.0
Support package over four years	...	-2.9	-5.5
Discretionary spending cuts and other	...	1.3	0.2 to 9.9
General government balance after measures 3/	**-86.2**	**-80.5**	**-67.3 to -57.6**
(In percent of GDP)			
General government balance projected in the staff report	**-3.9**	**-3.7**	**-3.7**
Cumulative measures in the coalition agreement	...	0.2	¾ to 1¼
General government balance after measures	**-3.8**	**-3.6**	**-3 to -2½**

Source: Staff estimates based on information provided in the coalition agreement.
1/ The projections in the staff report were premised on policy plans prior to the elections.
2/ Projected cumulative impact in billions of euros, a negative number widens the deficit.
3/ Also reflects small data revisions since issuing the staff report.

6. **The mission welcomed the authorities' commitment to reduce the fiscal deficit, but also expressed reservations about the fiscal consolidation strategy.** Specifically**:**

- **The consolidation effort in 2006 is insufficient** and the mission argued that a small additional effort to achieve structural adjustment of ½ percent of GDP would not pinch off growth (see section D on the updated macroeconomic outlook). This would require adjustment of ¼ percentage points more than planned, which could be achieved by curtailing new expenditures or advancing the VAT increase by three to six months. In addition to showing more distinct progress in 2006, this would also allow a more even consolidation path into 2007. The authorities were mindful of the lumpy adjustment path, but they felt that the expansion was still fragile and that the planned approach would provide "backwind" to the recovery, thus placing the economy in a better position to absorb the large deficit reduction in 2007. They also noted that in any event the new government had been in office too briefly to be able to prepare and get approval for major adjustment measures for 2006.

- **The preannounced VAT increase introduces a time inconsistency risk**. If the recovery is seen as too fragile to tolerate a large VAT increase in 2006, the same could be true in 2007 if the economy does not pick up significantly. Alternatively, if the economy is strong at the end of 2006, consolidation measures will appear less necessary and there will be pressure to scale back the VAT increase. The authorities recognize this risk and intend to contain it by seeking early legislative commitment to the VAT increase in 2007 (possibly in a by-law to the 2006 budget) to strengthen the credibility of the adjustment effort. They felt that the coalition could not afford to reconsider this key measure as the resources were needed in any event to help comply with the constitutionally-mandated golden rule (discussed in ¶17 of the staff report). Further, they view the VAT increase as central to the strategy of putting greater reliance on indirect rather than direct and payroll taxes.

- **The deficit reduction effort puts more emphasis on increases in tax rates as opposed to durable expenditure cuts**. The authorities explained, however, that the fiscal challenge could not be tackled with expenditure cuts alone. This would imply cutting pensions and other entitlements for which there was little political support. Moreover, they pointed out that the adjustment strategy does contain cuts in tax expenditures and subsidies that will cumulate to 0.6 percent of GDP a year by 2009—more in these areas was not politically feasible—and that a sizeable decline in spending on active labor market policies is also underway. The authorities also stressed that substantial spending associated with reunification limits the fiscal room for maneuver.

- **The package of new expenditures offsets the other efforts to cut spending and some elements could become permanent and introduce new distortions**. These distortions include accelerated depreciation for new investment and new subsidies (via the tax system) for spending on household services. The authorities explained that the accelerated depreciation rules would be valid only in 2006 and 2007, after which the planned corporate income tax reform would go into effect and lower overall distortions.

- **The fiscal strategy includes measures that require counterpart efforts that have not yet been fully specified**. For instance, it is assumed that subnational governments will save all proceeds from the higher tax revenue transfers following the VAT hike, without specifying a mechanism to ensure that this takes place. Also, as unemployment insurance contribution rates are being reduced, the labor office will need to find offsetting savings to avoid the need for new subsidies. The authorities deemed the risk of such leakage to be small. Many subnational governments are suffering from excessive deficits themselves and need the additional revenue transfers to bring these down. Further, the coalition partners have broad representation in the Länder, which will strengthen fiscal coordination. Finally, the authorities said that the labor office had been lowering costs already and improving its performance, and they will implement new efficiency measures in 2006 to help offset the revenue cuts.

7. **The authorities recognize that the small deficit reduction planned for 2006 will have implications under the revised Stability and Growth Pact rules**. They pointed, however, to their concrete plan to bring the deficit into compliance with the Maastricht criterion in 2007, which they believe sets them apart from other countries with excessive deficits. At the same time they emphasized that Germany does not want to be seen as the country that does damage to the revised Pact, and they are engaged in a dialogue with the European Commission to reach satisfactory understandings. The mission stressed the importance of accepting the consequences (primarily intensified fiscal surveillance by the Commission) under the SGP, noting that resistance would have grave implications for the credibility of both Germany and the Pact. Instead, Germany could exert much-needed leadership by accepting the consequences of its policy plans, and then overcome these difficulties in 2007 with the already-agreed deficit reduction package.

B. Structural Issues

8. **Although the emphasis is on fiscal matters, the authorities stressed that the coalition agreement also makes important headway on structural issues**. In some areas, they felt that the agreement was farther reaching than appreciated by most observers. In other areas, it sets out principles of understanding, which now needed to be translated into policy plans. The discussions focused on the following issues:

- Increasing the **retirement age** was seen as one of the grand coalition's major achievements. This issue had been taboo, but was now accepted to help bring the pension finances under control and increase labor participation. The mission agreed that it is an important step, but recommended that its implementation be accelerated as the 24-year time span to achieve the two year increase was excessively gradual, especially keeping in mind that the age limit will likely need to be increased further in the future in line with life expectancy.

- Coalition discussions on **labor market reforms** had been particularly difficult. The main accomplishments in this area will be the reduction in the wage wedge by cutting contribution rates for unemployment insurance from 6.5 to 4.5 percent, and the loosening of employment protection legislation by lengthening probation periods for new labor contracts. In addition, the authorities noted that drawing on the experience gained under the Hartz IV reforms, improvements in this important program are underway, notably in the design of the Unemployment Benefit II program.[3] The mission welcomed these initiatives and appreciated that more time may be needed to bring the coalition partners together on other essential aspects of labor market reform, especially to revitalize labor demand (see ¶27 and ¶52 of the staff report).

[3] A technical error in the design of the UB-II program had caused a sharp increase in the marginal tax rate for participants who were transitioning from welfare to work. This distortion had significantly weakened the effectiveness of the program and raised costs as participants did not make the transition. See also ¶28 of the staff report.

- Proposals in **product and services markets reforms** fall short of what is needed and in some aspects go in the wrong direction. Specifically, the mission reiterated the views laid out in the staff report (see ¶29-32 and ¶53), emphasizing the important complementarities between labor market and product and services market reforms.[4] The authorities are still formulating their views on these matters and their immediate priority is to continue with reforms of network industries, where they see scope to partially privatize the national railroad and to reform the postal services when its monopoly status for letter delivery expires in 2007. At the same time, they believe that adequate licensing requirements are necessary to assure workmanship of high quality, and that the EU Services Directive as presently formulated raises concerns about a race to the bottom in labor conditions and quality of service in some areas.

- The planned **federalism reforms** focus on reducing the number of laws that require upper house approval, and clarifying the responsibilities of different levels of government (such as environmental policy for the federal government and education policy for the Länder). The mission welcomed these efforts, but noted that they should be augmented by deeper second stage reforms as outlined in the staff report (see ¶23 and ¶50). In this second stage, the authorities should seek possibilities for small revenue surcharges and independent expenditure decisions at the Länder level, and a strengthening of the Internal Stability Pact (ISP) with quantitative targets for different levels of government and penalties for noncompliance. The authorities responded that there was no support for more competitive federalism at this time, mainly because of the concerns of the poorer Länder. Options to strengthen the ISP, however, are being discussed but are still at an early stage.

- The authorities stressed their commitment to **reform the health insurance system and the corporate income tax regime** even though these are areas where the coalition partners had taken opposing positions in the past. The coalition needed more time to discuss these reforms and develop a common approach. The health care reform will be formulated in the course of 2006, and a CIT reform is envisaged to go into effect in 2008. The mission agreed that these reforms are complex and should not be rushed. It recommended that the health care reform should seek financing models that do not increase the burden on payrolls (see ¶20 in the staff report), and that the CIT reform should endeavor to be revenue neutral with base broadening and a lowering of tax rates (see ¶21).

C. Financial Sector Policies

9. **The mission expressed concern that the financial sector initiatives described in the coalition agreement could be taken to imply a relaxation of supervision**, including possibly a reduction in the independence of BaFin. This would be ill-advised, not least

[4] See also Berger and Danninger (2005), "Labor and Product Market Deregulation: Partial, Sequential, or Simultaneous Reform?" *IMF Working Paper,* WP/05/227, which was prepared as background for the Article IV consultation discussions with Germany.

because of the high level of impaired loans in the banking system, low overall profitability, and some isolated signs of stress as evidenced by the recent difficulties in a large mortgage bank and a real estate investment fund. The authorities explained that it is not their intention to weaken financial sector supervision or regulation. Rather, the intention is to implement the objectives in the coalition agreement in a way that strengthens the financial sector and makes it more efficient. They also reiterated their commitment to the independence and autonomy of BaFin, but wanted to review its governance structure and learn from the experience gained in the three and a half years since the agency was established. On Basel II, they noted that although the potential burden for smaller banks and companies (which in Germany rely on bank financing to a greater extent than in other countries) is of concern, good progress has been made by bank federations to develop centralized risk models and that *Mittelstand* companies need to accept that they will be rated. They also saw the KfW as a useful institution with its own niche in the German capital market, and would explore options to stimulate investment in smaller enterprises, including through the development of a more active venture capital market.

D. The Updated Macroeconomic Outlook

10. **Lack of clarity about the timing and size of some of the coalition's policy measures adds uncertainty to the economic outlook**. The coalition agreement does not provide a macroeconomic framework and many of the economic policies are not quantified. Further, the implementation timetable for some of the policy proposals has not been specified and the impact of the preannounced VAT increase on consumer and business behavior is difficult to quantify precisely. Nevertheless, common views are emerging that the fiscal strategy and structural policy mix will likely be about neutral on growth and inflation in 2006, but will result in a slowing of growth and a temporary uptick in inflation in 2007. (See Box 2 for the experience with large increases with consumption taxes in Japan and the U.K.)

Germany: Revised Macroeconomic Outlook 2005-2007 1/

	2005	2006	2007	2005	2006	2007
	(Percentage change)					
	Staff Report			Supplement		
Real GDP	**0.8**	**1.2**	**1.6**	**1.0**	**1.5**	**1.0** 2/
Final domestic demand	-0.4	0.8	1.8	-0.1	1.2	0.7
Private consumption	-0.3	0.3	0.7	-0.3	0.6	0.1
Gross fixed investment	-0.8	2.8	3.5	0.2	3.7	3.2
Foreign balance 3/	0.7	0.3	-0.2	1.1	0.3	0.4
CPI inflation	**1.7**	**1.7**	**1.5**	**1.9**	**1.9**	**2.5**
Unemployment rate (ILO) 4/	**9.5**	**9.3**	**9.0**	**9.1**	**8.8**	**8.9**

Source: Staff projections.

1/ "Staff report" refers to figures reported in the staff report; "Supplement" presents revised outlook that takes account both the policy package and revisions to the baseline that are unrelated to the package.

2/ Mid-point projection. Depending on the consumer response to the VAT increase and the final package of fiscal measures, the staff projects growth in 2007 to be in a range of ¾ to 1¼ percent.

3/ Contribution to growth.

4/ Also reflects data revisions for 2005 since the staff report was issued.

11. **Economic growth strengthened somewhat in the second half of 2005, and is expected to continue firming in 2006.** However, growth remains unbalanced with the expansion still largely based on external demand. Investment in machinery and equipment is picking up, while construction and consumption have remained weak. Overall, the staff projects output to expand by 1 percent in 2005 and by about 1½ percent in 2006. (These are headline growth figures; the corresponding figures adjusted for working days are approximately 0.1-0.2 percentage points higher.)

12. **The projection for 2007 is subject to more uncertainty**, with some advance of consumer purchases likely at end-2006, in anticipation of the VAT hike, followed by a drop in consumption in the first half of 2007. Spending is expected to begin normalizing in the second half of 2007. The fiscal impulse is projected to be negative by at least ¾ percent of GDP. As a result, output growth is likely to slow, to between ¾-1¼ percent. Consumer price inflation is expected to remain steady at 1¾ percent in 2006, followed by a one-off increase to about 2½ percent in 2007 because of the VAT hike.[5] On these prospects, employment is not expected to strengthen significantly and unemployment is expected to remain comparatively high. The staff's revised outlook is broadly consistent with the views of the authorities and most other analysts.

III. Staff Appraisal

13. **The coalition agreement contains several economic measures and objectives that are featured in the comprehensive strategy advocated in the main staff report**. At the core is the vital commitment to reduce significantly the fiscal deficit in 2007, while reducing the cost of employment and shifting some fiscal revenue from direct to indirect taxes. The planned increase in the statutory pension age and the move toward reforming the federal fiscal structure are also important steps in the right direction. Many of the details in the agreement, however, still need to be worked out. Careful and steadfast implementation of intended policies, in a way that avoids introducing new distortions, will ultimately determine their success. In this connection, the short delay in implementing the difficult but needed reforms in the areas of health care financing and the corporate income tax system is appropriate, and the time should be used to design bold policies that reduce distortions and are revenue neutral.

14. **The objective of fiscal consolidation by 2007 is welcome but the path to get there is too backloaded and there are drawbacks related to the composition of the package**. The consolidation planned for 2006 is insufficient. In addition, the deficit reduction strategy is heavily weighted toward increases in tax rates rather than expenditure cuts, and a deeper and broader-based approach to reducing tax expenditures and subsidies would be preferable. The delayed VAT increase also gives rise to time inconsistency concerns. Further, the new spending initiatives could lead to permanent costs and distortions and are unlikely to be

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[5] The VAT increase is expected to be reflected only partially in headline inflation because categories subject to the reduced 7 percent rate are exempted, and with the wage wedge declining slightly, suppliers do not need to adjust output prices fully with the tax hike.

effective. To meet the previously recommended target of annual structural adjustment of at least ½ percent of GDP, adjustment amounting to ¼ percent of GDP would need to be brought forward from 2007 to 2006. This could be done by curtailing new expenditures and dropping those that may create new distortions, or bringing forward somewhat the VAT increase. Cyclical conditions do not preclude this small additional adjustment in 2006.

15. **More generally, the coalition agreement needs to be used as a stepping stone for much bolder structural reform and continued fiscal consolidation.** The policy measures on labor, product and services reforms are not strong enough to significantly bolster competition in the economy and strengthen employment and long-run growth. This partial approach will limit the full benefits of the policy package in the agreement. Every effort should therefore be made to augment the coalition agreement in these areas to improve efficiency and take advantage of the critical synergies between labor, product, and services market reforms and structural fiscal adjustment. Moreover, the fiscal consolidation package in the agreement should be considered as a first step toward regaining control over public finances, and policies should aim to eliminate the structural deficit by the turn of the decade and reduce the public debt-to-GDP ratio. Various welfare programs also need to be put on a sound intertemporal footing. In the financial sector, the coalition agreement should be implemented in a way that does not infringe on the independence of BaFin or weaken prudential oversight.

16. **In sum, although valuable initiatives have been developed, Germany still has some way to go in framing a cohesive policy strategy to raise economic performance in a durable way.** The staff report offered a vision for such a strategy with mutually-reinforcing elements. The strategy should be decisive, with firm implementation and a clear explanation of the policy steps, their quantification, and timing. A good start has been made in putting together such a framework, but it will need to be augmented and cast in a quantified long-run outlook that takes account of looming demographic changes. The grand coalition government offers a unique opportunity to address these challenges with determination.

Box 1. Key Fiscal Policy Steps of the Coalition Agreement

Many of the measures in the coalition agreement described below have not been fully quantified and also some (small) components may already be in the fiscal baseline and would not affect the deficit path in net terms.

Measures to increase revenue:

- Increase VAT rate in January 2007 from 16 to 19 percent, yielding about 1 percent of GDP.[1]
- Cut tax expenditure and subsidies with savings accumulating to 0.6 percent of GDP by 2009.[2]
- Increase pension contribution rate in January 2007 from 19.5 to 19.9 percent, yielding about 0.2 percent of GDP.
- Increase top marginal income tax from 42 to 45 percent for individuals earning over €250,000 or couples earning over €500,000 a year (small yield from 2007).

Measures that reduce revenue:

- Cut the unemployment contribution rate in January 2007 from 6.5 to 4.5 percent of gross taxable wages, costing about 0.5 percent of GDP.
- Eliminate inheritance tax for qualifying small firms (no yield or timing available).

Measures that increase expenditure:

- Support package to be implemented over four years from 2006 to fund higher R&D spending, transportation infrastructure, accelerated depreciation for investments in machinery and equipment, family assistance, and building renovation and household services, totaling about 1.1 percent of 2005 GDP.

Measures to reduce expenditure:

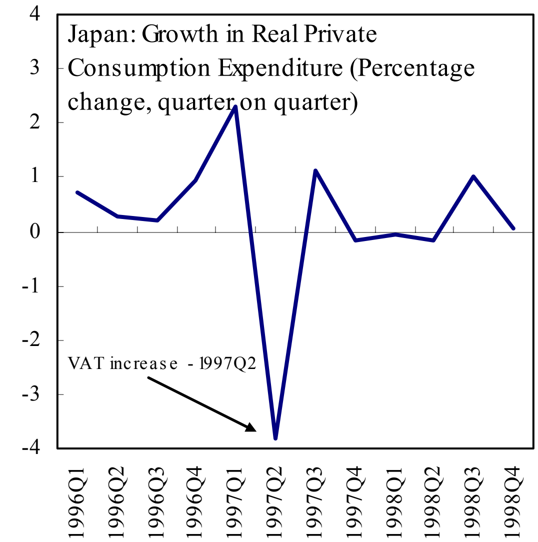
- Rationalize active labor market programs from 2006.
- Cut Hartz IV costs through improved design and administration from 2006.
- Cut pension contributions on behalf of unemployment benefit recipients from 2006.
- Cuts in public administration and other from 2006.
- Cut federal subsidies to health insurance funds from 2007.
- Extend pensionable age from 65 to 67 at a pace of 1 month a year from 2012.

[1] One percentage point of the VAT increase is earmarked to fund the reduction in unemployment contribution rates. A similar amount for this purpose is to be obtained through cost cutting in the Federal Labor Office (cutting active labor market programs and Hartz IV costs).

[2] Cuts in tax expenditure will raise revenue; subsidy cuts (the minor part) will lower expenditure.

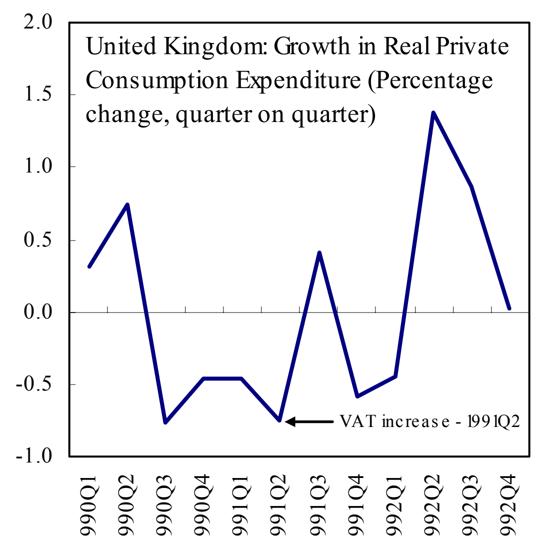
Box 2. Large Increases in Consumption Taxes – The Experience of Japan and the United Kingdom

The April 1997 hike in Japan's consumption tax rate from 3 to 5 percent has been blamed for the subsequent economic downturn, but a number of other factors were also important in triggering the recession. Consumption fell sharply in the second quarter of 1997. Some consumer purchases were brought forward to the first quarter, prior to the increase in the consumption tax, and spending resumed in the third quarter. The weakness in domestic demand in 1997 and 1998, however, was caused primarily by a large contraction in business investment that has been ascribed to domestic financial stress associated with the failure of several large financial institutions. In addition, the Asian crisis contributed to a stall in export growth. Moreover, the consumption tax hike was part of a broader program of fiscal consolidation that included the withdrawal of temporary tax cuts, an increase in medical insurance copayments, and continued cuts in public investment, which together resulted in a structural fiscal contraction of slightly more than 1 percent of GDP in fiscal year 1997. Inflation increased temporarily to 1.7 percent in 1997, falling back to 0.6 percent in 1998 as there were no second-round increases because of slack in the economy.



Source: WEO.

In the United Kingdom, the increase in VAT from 15 to 17½ percent in 1991 was part of a broader reorientation of fiscal policy. The VAT increase helped finance a decrease in the corporate income tax rate and the elimination of the "poll" tax. Other fiscal measures in the budget, together with a privatization program, were designed to balance the budget over the cycle. In addition to the fiscal consolidation, there was significant monetary tightening in 1990 to slow an overheating economy. Thus, while consumption fell, several factors alongside the VAT increase contributed to this result. As in Japan, second-round inflation effects were small.



Source: WEO.

The Japan and U.K. episodes point to some cyclical impact of a VAT increase, but the influence on growth is also determined by accompanying policies and circumstances. Currently, consumer confidence in Germany remains subdued with growth still driven primarily by external demand, and a VAT increase in this environment could slow the momentum of economic recovery. Effects of the VAT increase in Germany may, however, be less severe than either the 1997 increase in Japan or the 1991 increase in the UK because (i) the fiscal shock is smaller than that in Japan in 1997 and it is not accompanied by the same degree of financial sector difficulties as in Japan; (ii) fiscal multipliers in Germany have been estimated to be smaller than in Japan; and (iii) even though the European Central Bank recently raised its policy rate, the extent of ECB cumulative tightening is envisaged to be much lower than the doubling of interest rates in the UK in 1990. As in Japan and the UK, second round effects on inflation in Germany are expected to be small, especially with continued high unemployment.

Selected Economic and Social Indicators

	2002	2003	2004	2005 1/	2006 1/	2007 1/
Real economy (change in percent)						
Real GDP	0.1	-0.2	1.6	1.0	1.5	¾ to 1¼
Total domestic demand	-1.9	0.6	0.5	-0.2	1.3	0.6
CPI (average)	1.3	1.0	1.8	1.9	1.9	2.5
Standardized unemployment rate (in percent)	7.7	8.8	9.2	9.1	8.8	8.9
Gross national saving (percent of GDP)	20.6	19.9	21.2	21.8	22.0	22.2
Gross domestic investment (percent of GDP)	18.3	17.8	17.4	17.1	17.4	17.4
Public finance (percent of GDP)						
General government balance	-3.7	-4.0	-3.7	-3.8	-3.6	-3 to -2½
General government structural balance	-3.5	-3.4	-3.2	-3.4	-3.2	-2¾ to -2¼
General government debt	59.6	62.8	64.5	66.9	68.9	70.9
Money and credit (end of year, percent change) 2/						
Credit to private sector 3/	0.9	0.0	-0.2	2.4	...	...
M3 3/	...	3.5	2.2	4.7	...	...
Interest rates (percent)						
Money market rate 4/	3.3	2.3	2.1	2.5	...	...
Government bond yield 4/	4.8	4.1	4.2	3.4	...	...
Balance of payments (percent of GDP)						
Current account balance	2.2	2.1	3.8	4.7	4.6	4.8
Trade balance	5.9	5.6	6.5	7.3	7.2	7.4
Exports	30.4	30.8	33.0	34.7	36.2	37.4
volume (annual percent change)	3.5	3.0	10.0	7.4	6.5	5.1
Imports	24.5	25.1	26.6	27.4	29.0	30.0
volume (annual percent change)	-0.3	6.6	8.2	5.3	7.1	4.9
Net oil imports (billions of US$)	30.6	32.0	33.0	50.7	59.4	57.6
FDI balance	1.8	1.3	-1.0	-1.0	-0.8	-0.8
Official reserves minus gold (billions of US$) 5/	51.2	50.7	48.8	39.9	...	...
Fund position (as of October 31, 2005)						
Holdings of currency (percent of quota)						78.4
Holdings of SDRs (percent of allocation)						109.5
Quota (millions of SDRs)						13008
Exchange rate						
Exchange rate regime			Participant in euro zone			
Present rate (Dec 14, 2005)			Euro 0.84 per US$			
Nominal effective rate (2000=100) 5/	102.0	107.2	109.0	108.1	...	...
Real effective rate (2000=100) 5/ 6/	99.4	103.4	102.4	98.1	...	...

Social indicators: **GDP per capita** (2004): US$33,279; **income distribution** (ratio of income received by top and bottom quintiles, 2001): 3.7; **at-risk-of-poverty rate 7/** (2003; percent): 10; **life expectancy at birth** (2003; years): 75.5 (male), 81.3 (female).

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; IMF, World Economic Outlook; Eurostat; and staff projections.

1/ Staff estimates and projections, if not otherwise indicated.
2/ From 1999 onward data reflect Germany's contribution to M3 of the euro area. Data not shown for 2002 because of a series break (from January 2002 M3 excludes currency in circulation).
3/ Data for 2005 refer to the change from Oct 2004 to Oct 2005.
4/ Data for 2005 refer to December 14, 2005.
5/ Data for 2005 refer to November 2005.
6/ Based on relative normalized unit labor cost in manufacturing.
7/ At risk of poverty rate: cut-off point: 50% of median equivalised income.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/4
FOR IMMEDIATE RELEASE
January 18, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Germany

On January 11, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

Economic activity in Germany is slowly picking up, and there is scope for some further firming of growth in the course of 2006. The recovery, however, remains unbalanced and strong exports have yet to feed through into higher household spending. Firms invest cautiously, with some uptick in spending on machinery and equipment. However, structural labor market weakness, giving rise to slow employment and wage growth, is inducing cautious consumer spending. While the risks to the outlook are broadly neutral, an unwinding of global imbalances and higher oil prices could yet provide headwinds for the recovery. On balance, headline growth is forecast at 1 percent in 2005 and 1.5 percent in 2006, implying a gradual recovery in working-day-adjusted terms.

On the policy front, the Coalition Agreement that was issued on November 11, 2005, contains several valuable objectives, such as lowering the fiscal deficit to below the Maastricht criterion by 2007, increasing gradually the pensionable age, restarting federalism reforms, and lowering slightly the nonwage labor costs. Nevertheless, domestic markets remain

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the January 11, 2005 Executive Board discussion based on the staff report.

hampered by rigidities, especially the labor, product, and services markets, and the coalition partners need to use the coalition agreement as a stepping stone to make further progress in structural reforms. More attention must be paid to improving the structural conditions for labor demand.

The fiscal deficit is projected to be about 3¾ percent of GDP in 2005, with a small improvement in 2006. Revenues have been held back by a secular decline in wage income, Germany's major tax base, while costs for labor market reforms and pension outlays were turning out higher than expected, and savings from healthcare reform were somewhat lower than expected.

The authorities' stress tests suggest that the likelihood of systemic difficulties in Germany's financial system is small, and confirm that the financial sector is recovering from the weakness experienced in 2003. Nevertheless, there is a continued need for market-driven restructuring and defragmentation of the banking sector, which has underperformed its EU peers.

Executive Board Assessment

Executive Directors commended the new German government's agenda to meet the challenges of globalization and demographic change. The authorities have appropriately placed high priority on fiscal consolidation with the articulation of policies to reduce the fiscal deficit substantially. Directors welcomed the authorities' perseverance in introducing far-reaching and politically difficult labor market reforms in 2005 that have improved incentives to work, and their plans to make further reforms in the labor market and entitlement programs. Successive structural changes in these and other areas are bearing fruit, increasing the economy's competitiveness and flexibility. At the same time, Directors noted that, despite growing signs of economic recovery, substantial challenges lie ahead, as trend growth is low and unemployment remains high. To secure a durable improvement in economic performance, and better position the German economy to help support global growth, Directors urged the authorities to build on the initiatives already announced, and implement a bold, comprehensive, and mutually-reinforcing set of policies to reduce distortions and structural rigidities and achieve fiscal sustainability over the medium term.

Directors welcomed the signs that output growth is gaining momentum in 2006.
They commended the ongoing business restructuring, cost cutting, and sustained wage moderation that have helped rebuild competitiveness and underpin strong export growth. However, the recovery remains overly dependent on external demand. Although there is still insufficient support from domestic demand, Directors were encouraged that investment in machinery and equipment is slowly turning up and labor market trends are improving.
To ensure a broad based and sustained recovery, Directors underlined the importance of following through with a reinforced and clearly communicated medium-term reform strategy.

Directors stressed the importance of actions to address persistent fiscal pressures, and welcomed the authorities' articulation of policies to reduce the fiscal deficit below 3 percent of GDP in 2007. They took note of the authorities' consolidation strategy implying a lowering of the structural deficit by ¼ percent of GDP in 2006, and their plans aiming toward additional durable adjustment equivalent to at least ¾ percent of GDP in 2007. They acknowledged the variety of considerations that have shaped the authorities' objectives, including the importance of securing a political consensus to ensure the achievement of their medium-term fiscal goals, and of avoiding undercutting the still-fragile economic recovery. At the same time, several Directors considered that a more ambitious frontloading of fiscal adjustment could have been contemplated. This is especially so in the current circumstances of an improved economic outlook, as well as the greater popular acceptance of the need to set the public finances on a firmer footing on which the new government's fiscal objectives are founded. A number of Directors, noting the dampening effect of the preannounced VAT increase on consumption growth, urged the authorities to rely more heavily on expenditure cuts.

Directors noted that further deficit reduction, coupled with entitlement reform, will be needed after 2007 to secure sustainable public finances and safeguard the economic basis of the German social model. They urged the authorities to eliminate the structural deficit by the turn of the decade, when the costs of an aging population begin to accelerate. This will require a sustainable deficit reduction strategy focused on expenditure cuts, especially deeper and broader reductions in subsidies and tax expenditures. Directors welcomed the corporate income tax reform planned for 2008, but cautioned that it should be revenue-neutral to avoid compromising fiscal consolidation goals.

Directors underscored that current entitlement programs will exert growing pressure on payroll taxes if left unaltered. They welcomed the steps taken under Agenda 2010 to start reforming the entitlement system, and the authorities' intention to develop plans to strengthen health care financing in 2006. While commending the authorities' recent decision to increase the statutory retirement age by two years, many Directors viewed the planned pace of the increase as too gradual, and called for its acceleration. Directors saw scope for recalibrating entitlement benefits further, and encouraged the authorities to pursue additional steps to limit spending growth on pensions, long-term care insurance, and health care.

Directors supported the planned federal reforms aimed at clarifying the responsibilities of the various entities and streamlining the process of passing new legislation. They encouraged the authorities to build on these by introducing greater leeway for competition between states and strengthening the internal stability pact, thus further facilitating efficiency and fiscal discipline. Directors welcomed the Government's Long-Run Fiscal Sustainability Report, which will help make the public more aware of the need for reform. With regard to the possible role of a fiscal council, Directors felt that such a function was already served by a number of well-regarded institutions in Germany, including the Council of Economic Advisors, the Bundesbank, and research institutes.

Directors emphasized the need to raise the rate of labor utilization to mitigate the impact of a decline in the working-age population on growth and the public finances, and in that light they supported the reforms to boost labor supply. They welcomed several recently announced initiatives—including those to improve the welfare-to-work aspects of the Unemployment Benefits II program, reduce the tax wedge on labor, and loosen employment protection legislation further—and they looked forward to the effective implementation of these proposals. To complement these reforms, Directors called for additional steps to promote greater wage differentiation and thus help increase labor demand, including by reducing centralized wage bargaining in favor of more decentralized and firm-level bargaining.

Directors encouraged the authorities to proceed more vigorously in deregulating product and service markets to foster job creation and reinforce labor market reforms. While good progress has been made in product market reforms over the years, relatively high barriers and impediments persist in certain areas. Directors recommended a further reduction—both domestically and in the EU context—of service regulations and administrative hurdles in regulated professions and crafts.

Directors noted that financial sector soundness continues to improve, with better bank profitability and a reduction in nonperforming loans, and they agreed that the risk of systemic difficulty is small. They welcomed the removal of state guarantees in the banking sector and the intensified cooperation within the public banking pillar. However, the performance of large German financial institutions still lags behind that of many of their foreign peers. To improve banking sector soundness and performance further, Directors recommended amending its legal framework to support market-based restructuring in both the public and private pillars. Directors commended the authorities for increasing supervisory capacity in and strengthening the regulation of the reinsurance sector. They took note of the authorities' commitment to ensure strong prudential oversight going forward.

Directors welcomed Germany's commitment to trade liberalization, and called on Germany to work with European and other partners toward the successful conclusion of the Doha Round. Directors commended Germany's intention to increase its official development aid.

Directors considered that Germany's economic statistics are of high quality. At the same time, they saw scope for further improvements, including with regard to inventory data. Directors welcomed the authorities' commitment to start providing a full set of core financial soundness data.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Germany: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
Economic activity and prices	(Change in percent, unless otherwise noted)				
Real GDP	1.2	0.1	-0.2	1.6	1.0
Net exports 2/	1.7	1.9	-0.8	1.1	1.1
Domestic demand	0.4	-1.3	-0.1	0.0	-0.1
Private consumption	1.9	-0.5	0.1	0.6	-0.3
Gross fixed investment	-3.7	-6.1	-0.8	-0.2	0.2
Construction investment	-4.6	-5.8	-1.6	-2.3	-4.4
Gross national saving (percent of GDP)	19.6	19.4	19.3	21.0	21.7
Gross domestic investment (percent of GDP)	20.0	18.3	17.8	17.4	17.1
Labor force 3/	42.4	42.5	42.6	43.3	43.2
Employment 3/	39.3	39.1	38.7	38.9	38.8
Standardized unemployment rate (in percent)	6.9	7.7	8.8	9.2	9.1
Unit labor costs (whole economy)	0.5	1.3	-1.7	-4.0	-0.3
GDP deflator	1.2	1.4	1.1	0.8	1.4
Harmonized CPI index	1.9	1.3	1.0	1.8	1.9
Public finance	(In percent of GDP)				
General government balance 4/	-2.8	-3.7	-4.0	-3.7	-3.8
Structural government balance	-3.1	-3.5	-3.4	-3.2	-3.4
General government gross debt	57.9	59.6	62.8	64.5	66.9
Money and credit	(Change in percent over 12 months)				
Private sector credit 5/	3.2	0.9	0.0	-0.2	2.4
M3 5/	6.1	...	3.5	2.2	4.7
Interest rates	(In percent)				
Three month money market rate 6/	4.3	3.3	2.3	2.1	2.5
Ten-year government bond yield 6/	4.8	4.8	4.1	4.2	3.4
Balance of payments	(In billions of euros, unless otherwise noted)				
Exports 7/	737.8	763.2	776.6	848.5	907.9
Imports 7/	697.6	672.3	688.9	735.7	772.5
Trade balance (percent of GDP)	4.3	5.9	5.6	6.5	7.3
Current account balance	3.3	48.2	45.2	84.5	106.6
Current account (percent of GDP)	0.2	2.2	2.1	3.8	4.7
Exchange rate	(Period average)				
Euro per US dollar 6/	1.12	1.06	0.88	0.80	0.84
Nominal effective rate (1990=100) 8/	100.5	102.0	107.2	109.0	108.1
Real effective rate (1990=100) 8/ 9/	98.9	99.4	103.4	102.4	98.1

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; IMF, World Economic Outlook; and staff projections.

1/ Staff projections, if not otherwise indicated.

2/ Contribution to GDP growth.

3/ Domestic definition on a national accounts basis; according to new integrated system of economic accounts (ESA95).

4/ On a national accounts basis; according to the new integrated system of economic accounts (ESA95).

5/ Data for 2005 refer to October, 2005. M3 refers to Germany's contribution in the euro area.

6/ Data for 2005 refer to December 14, 2005.

7/ Includes supplementary trade items.

8/ Data for 2005 refer to November, 2005.

9/ Based on relative normalized unit labor cost in manufacturing.

Statement by Karlheinz Bischofberger, Executive Director for Germany
January 11, 2006

Fiscal Consolidation and Economic Growth – The Government's Priorities

1. The new government has put forward an ambitious agenda designed to meet the dual and closely inter-related objectives of fiscal consolidation and stronger economic growth with a strong focus to respond to the challenges of globalization and demographic change. This agenda consolidates, deepens and extends fundamental reforms already implemented under Agenda 2010, generally in line with longstanding Fund recommendations. The implementation of the agenda is now facilitated by solid majorities in both chambers of parliament.

2. The new government's reform agenda includes some major political breakthroughs, such as an agreement on federalism reforms and an increase of the retirement age. The agenda is well-sequenced with a clear timetable. The phasing of fiscal consolidation reflects the need to support the recovery while ensuring medium-term fiscal sustainability. Complex structural reforms such as health care funding and corporate income taxation will be prepared diligently in 2006 and 2007; there will be no "quick fixes". The agenda is comprehensive, stresses the quality of fiscal adjustment, and pays due regard to the complementarities of growth-enhancing and deficit-reducing reforms. The implementation of this agenda will go a long way towards safeguarding and strengthening the economic basis of the German social model.

3. Germany has improved its competitiveness considerably through continued wage moderation. Yet, together with high unemployment and necessary measures to contain growth in entitlement benefits, this has had a dampening effect on real disposable income growth and has held back private consumption. Furthermore, the long-term economic effects of German unification must be borne in mind. The annual fiscal transfers to the *New Länder* are projected at about 4 percent of GDP. These factors add to the complexity of the reform task but will not lead to a slow down of the reform process.

Economic Outlook

4. There is mounting evidence that the economic recovery is taking hold. Exports continue to expand strongly, reflecting Germany's high degree of international competitiveness and brisk foreign demand for its high-quality products. There are also signs that the pattern of economic growth is becoming more balanced with domestic demand beginning to catch up. Private investment has gained significant momentum, the construction

sector is recovering after years of contraction, and there are clear indications that consumer confidence is strengthening. Nevertheless, this process has yet to firmly translate into higher employment and stronger household consumption.

5. My authorities broadly concur with the staff's updated macroeconomic outlook. With the recovery taking hold and the overall fiscal stance turning only slightly tighter in 2006, household spending is expected to strengthen over the course of the year, also supported by some additional expenditures being brought forward in anticipation of the VAT increase planned for 2007. My authorities are confident that the VAT increase will not derail the economic upswing in 2007, as the recovery will be sufficiently rooted by then. At the same time, they believe that a more front-loaded consolidation path, as recommend by the staff, could jeopardize the recovery and, thus, undermine the environment for the fiscal consolidation strategy.

Fiscal Policy

6. The fiscal strategy places considerable emphasis on high-quality expenditure reduction and on broadening the tax base, while acknowledging that tax increases will be unavoidable if meaningful consolidation is to be reached. One half of the overall deficit reduction package (€ 138 billion over the period 2006 to 2009) will consist of expenditure cuts (€ 34 billion) and the abolition of tax exemptions and tax expenditures (€ 33 billion), the remaining resources stemming from tax increases (€ 71 billion). Indeed, if one bears in mind that one percentage point of the VAT increase is earmarked to fund the reduction in unemployment insurance contribution rates, the overall package becomes weighted towards expenditure cuts and measures to broaden the tax base.

- On the expenditure side, the package includes, *inter alia*, reductions in entitlements and stronger means-testing under the new Unemployment Benefit II (UB-II) program, savings from streamlining active labor market policies and the administration of the Federal Labor Office, cuts in the federal subsidy of health insurance funds, in the public sector payroll as well as in funds for regional development and agriculture.
- Measures to broaden the tax base include in particular the abolition of the home owner subsidy (*Eigenheimzulage*) and a significant cut of the commuter tax exemption.
- On the income side, the VAT will be raised by three percentage points to 19 percent (still below EU average) at the beginning of 2007, and the marginal income tax will be increased for high income earners.

Legislation for the VAT increase will be passed well before its implementation in order to remove any uncertainties about the fiscal consolidation path and to bolster confidence. The planned measures conform with the staff recommendations to shift revenue collection towards indirect taxes combined with entitlement reforms in order to alleviate the pressure on payroll taxes.

7. The economic recovery will be supported by a carefully sequenced fiscal consolidation. In addition to confidence-building effects of the reform policies, tax reform and a set of specific growth enhancing measures targeted at priority areas will further strengthen the growth potential:

- A fundamental reform of the corporate income tax regime is planned to go into effect in 2008. The reform will be guided by the objectives of making the tax system more competitive and less prone to allocative distortions and tax avoidance, and reducing the volatility of tax revenues.
- A package amounting to € 25 billion over the next four years includes, *inter alia,* the promotion of research and development in order to maintain and strengthen Germany's leading position in many innovative technologies, and improved depreciation rules to stimulate investment in machinery and equipment (until the corporate income tax reform is introduced in 2008).

Fiscal Framework

8. My authorities remain firmly committed to the Stability and Growth Pact (SGP) and are fully aware of the critical importance to safeguarding its credibility. The government's consolidation strategy is designed to bring the general government deficit below the Maastricht limit of 3 percent of GDP in 2007. Details of this strategy will be published in the update of Germany's Stability Program to be presented next month.

9. The envisaged federalism reforms mark an important political breakthrough. They will enhance efficiency by disentangling competencies of the federal government and the *Länder*. Also, the Internal Stability Pact will be strengthened by clarifying the respective responsibilities of the federal government and the *Länder* governments in the context of the SGP. Equally important, the reform will make it easier to pass new legislation by limiting the number of bills to be approved by the upper house of parliament, where the *Länder* governments are represented. Streamlining the currently complex financial relations within the government sector will be another major area which will be addressed later during the current legislative period.

10. The staff propose a new fiscal council to review fiscal policy. My authorities are skeptical that this would create significant value added in the case of Germany. There are already a number of well-respected non-partisan institutions in Germany, including the Council of Economic Advisors *(Sachverständigenrat),* the Bundesbank, and private research institutes that effectively perform the role of assessing fiscal policy and perspectives.

Labor Market

11. The labor market reforms of recent years have brought about important changes, in particular for labor supply. For labor demand to take off, the most important prerequisite now is stronger economic growth. The policy strategy is threefold: My authorities will make improvements to existing labor market reforms, introduce additional reforms affecting both labor supply and demand, and undertake a wide range of measures to promote the growth potential and to facilitate job creation:

- The UB-II program, which has already led to a considerable increase in labor supply, will be streamlined and optimized, including through more stringent means testing in order to further strengthen incentives to work and to combat misuse. The existing "top up benefits", intended to reduce high marginal income taxes for those who qualify for UB-II, will be streamlined and combined to make them more effective and more akin to a negative income tax.

- Active labor market policies will be cut back significantly and limited to those of proven effectiveness.
- In order to strengthen the competitiveness of labor, the tax wedge will be reduced significantly, in particular by lowering the unemployment insurance contribution rate by 2 percentage points from the beginning of 2007. This measure will overcompensate a small increase of the pension contribution rate by 0.4 percentage points, leading to an overall reduction in non-wage labor costs to below 40 percent.
- Tax deductions for household services and home improvements up to a specific limit will promote job creation in the service sector. At the same time, this will provide an incentive to transform already existing informal activities in this area into regular employment which will be subject to social security contributions.
- Enhanced financial support for families and increased investment in child-care and all-day schools will contribute to higher labor participation, especially among women.

12. As regards employment protection legislation (EPL), a careful balance needs to be struck between enhancing flexibility and avoiding an unwarranted rollback of the social model. Hence, my authorities will continue their gradual approach to reforms in this area. Building on the EPL deregulation undertaken in 2004, the probationary period for new employees will be extended from six months to two years. These measures will also effectively simplify EPL, thereby reducing costly labor court involvement.

13. The present system of wage bargaining has been very effective in delivering wage moderation, but further flexibility is desirable to make room for more wage differentiation. My authorities welcome the increased use of opening clauses and other arrangements agreed by social partners in order to allow firm-level bargaining, thereby promoting more pay differentiation under the present system.

Pensions and Health Care

14. The introduction of a sustainability formula, capping pension growth in line with the rising dependency ratio, has been an important step towards inter-generational equity and long-term sustainability of the pension system. Since 2004, pensions have effectively been declining in real terms. The sustainability formula will now be further strengthened by an arrangement which offsets expenditure overruns in future years. Such overruns may occur in years of overall low wage increases as pensions are related to the general wage development and are not allowed to decline in nominal terms. These measures on the entitlement side will be complemented by steps to raise the retirement age. In particular, the new government will gradually raise the statutory retirement age from 65 to 67 years from 2012 onwards, which is generally in line with staff recommendations.

15. The recent reform of the health insurance system has led to a significant surplus of public health care finances of € 4 billion in 2004. For 2005, another financial surplus is expected. These results have been instrumental in stabilizing health insurance contribution

rates, and thus non-wage labor costs. Yet, renewed financial strains are likely to reemerge, partly because of sunset clauses attached to recent measures. The new government is committed to further promoting competition, individual responsibility, and cost-effectiveness, while preserving the high quality of the German health care system. A fundamental reform of the health care system will be worked out in 2006, drawing on available blueprints and best practices. Furthermore, elements of a funded scheme will be added to the present pay-as-you-go system of long-term care insurance.

Product and Service Markets

16. Reforms of product and service markets clearly contribute to higher employment growth. As noted in earlier Article IV staff reports, Germany has a distinguished track record of steadfast product market liberalization, but further improvements are envisaged:

- A series of measures will be taken, including a "small company act" providing for a comprehensive cutback in administrative regulation of SMEs and start-up businesses, and the general application of simplified and expedited planning processes for construction and infrastructure projects which have already proven their usefulness in the *New Länder*.
- In the energy sector, the Federal Network Agency's mandate was expanded in July 2005 to the electricity and gas sectors with a view to improving the market mechanism and strengthening price incentives.
- As regards the services market in the EU, my authorities are convinced that a well-functioning internal services market is of vital importance. At the same time, they continue to attach great importance to avoiding an erosion of important social and quality standards. They will work towards an EU Services Directive that meets both objectives.

Financial Sector

17. The German financial market has performed well during the past year. The DAX stock market index gained almost 30 percent and profitability in both the banking and insurance sectors have improved further. The measures implemented during the past years to improve the institutional framework governing financial markets have thus started to take effect. The new government will continue this path of swiftly and fully implementing agreed EU regulations while gradually modernizing remaining national financial sector laws and regulations. This will ensure that the German financial system becomes even more efficient, strong and competitive to act as a growth engine for the other sectors of the economy, while maintaining strong and efficient prudential oversight. In this context, three and a half years after its inception the governance and the working methods of the German Federal Financial Supervisory Authority *(BaFin)* will be reviewed to ensure that the agency has the structure, including the necessary independence and autonomy, and the means to optimally fulfil its mission in an evolving environment.

18. The German banking system is generally well-placed to support the economic recovery. Profitability and cost-income ratios have further improved. In particular, the profitability gaps of the big internationally active banks vis-à-vis international competitors have narrowed as a result of cost-cutting and a tapering-off of provisioning. Impaired loans

are on the decline. Regarding international comparisons of impaired loans presented by the staff, my authorities would like to note that these are subject to considerable caveats due to diverging definitions. The definition used in Germany for non-performing loans (NPLs) is relatively broad, resulting in comparatively higher NPL figures.

19. Financial sector transparency has increased further. A number of additional financial indicators has been compiled in September 2005. Germany has also committed itself to providing the IMF with the full set of Core Financial Soundness Indicators for publication in December 2006. My authorities are currently exploring ways for an appropriate dissemination of indicators and metadata in accordance with the IMF Compilation Guide on Financial Soundness Indicators.

20. The further development of capital markets remains high on the policy agenda. As noted by the staff, the market for asset-backed securities is growing quickly. The scope for public-private partnerships will be expanded. The introduction of real estate investment trusts is being seriously considered. The provision of venture capital will be promoted further. The conditions for private equity financing will be improved.

Other Issues

21. My authorities reiterate their firm support for international trade liberalization and welcome the recent agreement reached in Hong Kong as an important intermediate step towards a successful conclusion of the Doha Round. They strongly supported the EU offer to eliminate all forms of agricultural export subsidies and welcome their phasing out by 2013 as part of an overall Doha Agreement. They look forward to more progress in liberalization of industrial goods and services, in particular financial services.

22. While the successful conclusion of the Doha Round and the associated enhanced trade opportunities have the potential to significantly improve the income situation of poor countries, ODA remains important for these countries, too. Germany has agreed to increase its ODA to 0.33 percent of GNI until 2006 and to achieve 0.51 percent of GNI by 2010 as an intermediate step towards reaching the goal of 0.7 percent of GNI by 2015. The new government remains committed to these targets, in particular to support low-income countries in their efforts to reach the Millennium Development Goals. Given the need for fiscal consolidation, Germany has stressed the importance of innovative financial instruments for ODA funding.

23. My authorities appreciate and support the important role of FSAPs and ROSCs in the context of Fund surveillance. With the recent conclusion of a data ROSC, which will be published together with the 2005 Article IV papers, Germany will be one of the few Fund members for which both an FSAP and all Fund-led ROSC modules have been completed and published.