© 2011 International Monetary Fund

July 2011
IMF Country Report No. 11/168

Germany: 2011 Article IV Consultation—Staff Report; 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 2011 Article IV consultation with Germany, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 17, 2011, 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 June 9, 2011. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 6, 2011 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Germany.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2011 Article IV Consultation

Prepared by the Staff Representatives for the 2011 Consultation with Germany

Approved by Antonio Borges and Tamim Bayoumi

June 9, 2011

Executive Summary

Background: Given its large size and international connections, Germany has been called on to assist the global economic recovery. Similarly, a robust German financial system is important both for German and global financial stability. The authorities recognize these linkages and the consequent German responsibilities. They welcomed the focus of this consultation on Germany's international role.

Challenges: The authorities argued, and staff agreed, that short-term stimulative measures—more rapidly raising wages or delaying fiscal consolidation—could compromise German strengths with dubious value for other countries. The real German challenge is to strengthen its areas of weakness and, thus, play a more medium-term international role. The key is to counteract growth constraints in a way that also supports sustainable rebalancing via higher domestic demand growth. Thus, Germany's gain would benefit Europe and the global economy. Also, given the financial system's large size, its international connections, and the nonlinear behavior of these connections at times of stress, the forward-looking development of stronger German systemic shock absorbers is an important goal of the authorities.

Policy Recommendations: Enhancing growth will require focus: tax policy to raise labor force participation and investment, education and innovation policy to raise productivity (especially in the services sector via more widespread use of information technology), and an efficient and stable financial sector (that is also more sensitive to financing start-up ventures). The authorities broadly agreed with this agenda. They also agreed that these measures will help raise the traditionally-anemic consumption growth, and such autonomous demand will boost Germany's role as an international locomotive and narrow its current account surplus. However, they also felt that some rebalancing was already ongoing. On securing financial stability, the authorities recognize the importance of purposeful progress in resolving the legacy of the crisis and greater clarity on the regulatory and supervisory regime to facilitate proactive supervisory practice. They saw some merit in staff's suggestions for streamlining the permanent resolution and deposit insurance mechanisms and changes in the three-pillar banking system to meet new challenges; however, they saw these as more medium-term tasks.

Contents Page

I. Outlook ... 3
A. A Gradual Growth Slowdown ... 4
B. Raising Medium-Term Growth ... 8
C. Modest Inflationary Trends ... 12

II. Spillovers ... 13

III. External Accounts and Competitiveness ... 17
A. Current Account Balance ... 17
B. International Investment Position ... 22

IV. Public Finances ... 23

V. Financial Sector Stability ... 31
A. Status of the Financial System ... 31
B. Managing the After-Effects of the Crisis ... 34
C. Enhancing Preparedness for Future Crises ... 35

VI. Staff Appraisal ... 39

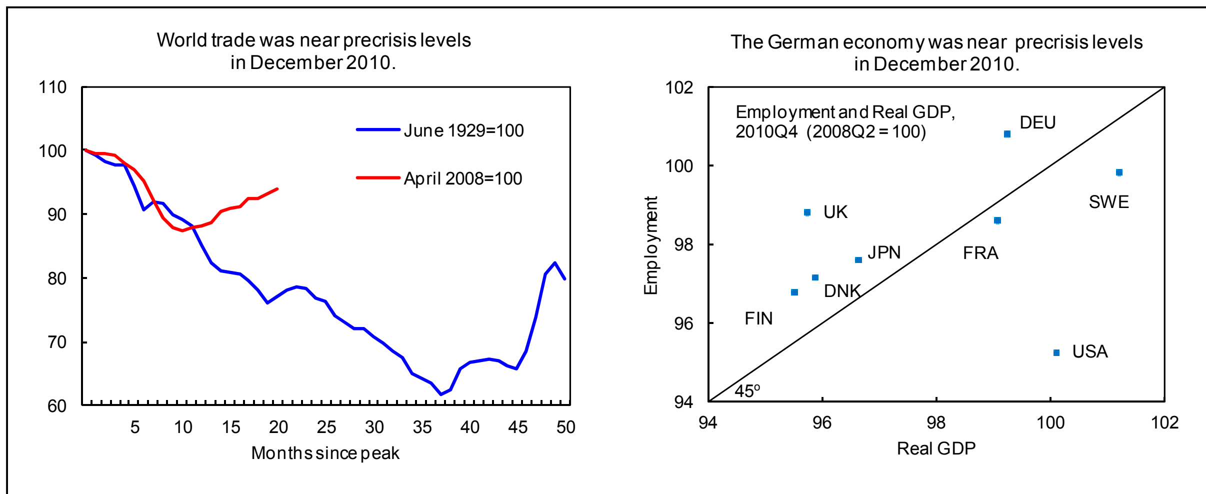
Tables
1. Selected Economic Indicators ... 41
2. Statement of Operations of the General Government ... 43
3. General Government Stock Positions ... 44
4. Core Financial Soundness Indicators for Banks ... 45
5. Additional Financial Soundness Indicators ... 47
6. Medium-Term Balance of Payments, 2006–16 ... 49

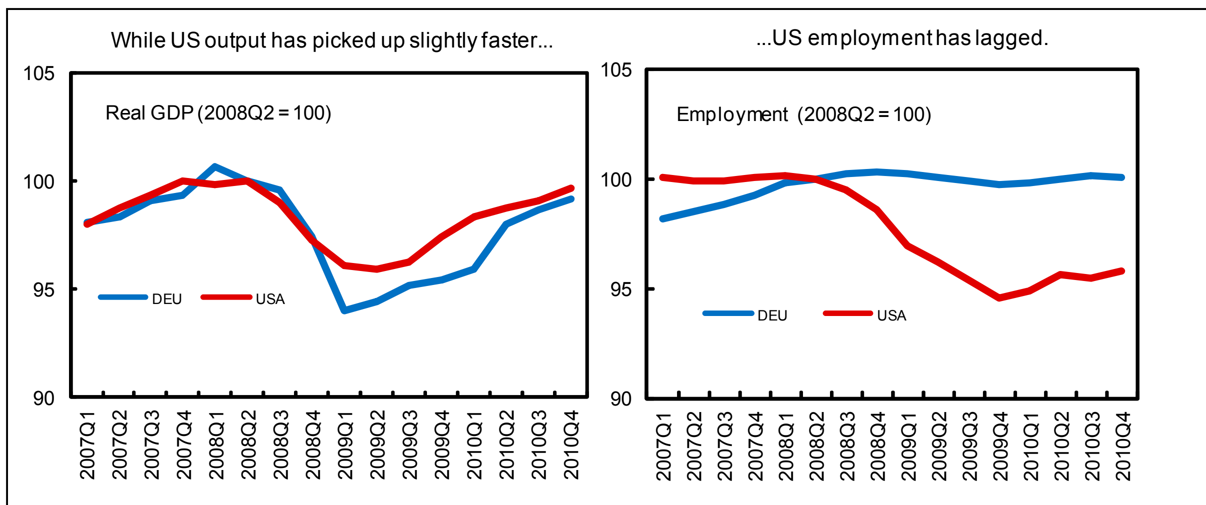
Figures
1. Productivity Trends in the Private Economy, 1985–2007 ... 9
2. Financial Sector Health, 1990–2010 ... 33

Boxes
1. Germany's Growth Potential—Little Damaged but Low ... 5
2. Labor Market Dynamics During the Crisis and Beyond ... 6
3. Structural Factors and the Current Account ... 17
4. Large Fiscal Adjustment are Subject to Risks ... 25
5. Taxation and Labor Supply ... 29
6. Social Spending and the Efficiency of Public Expenditure ... 30
7. Effects of Raising Capital Adequacy Requirements ... 38

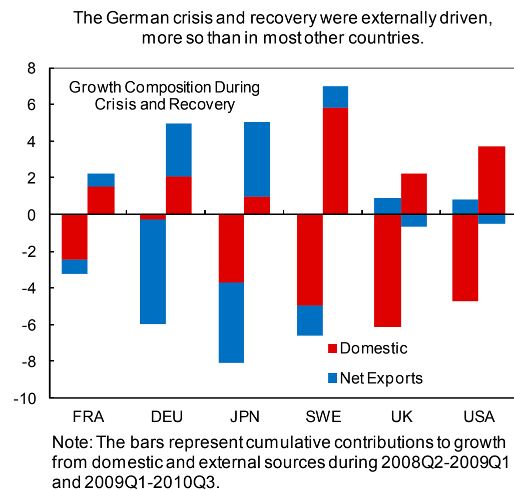
I. Outlook

1. **The recovery has brought German output and employment above pre-crisis levels.** After the world economy's fearsome drop starting in the second quarter of 2008, economic activity in several emerging markets is now above pre-crisis levels while advanced economies are just approaching those levels. In the first quarter of 2011 German GDP surpassed its pre-crisis level following growth of 3½ percent in 2010, and employment is higher than before the crisis. On both these counts only a few advanced economies have done as well. The United States is somewhat ahead in terms of output but significantly lags in employment growth. Consequently, the United States has gained in terms of productivity growth, a reminder that Germany has considerable ground to make up on productivity.





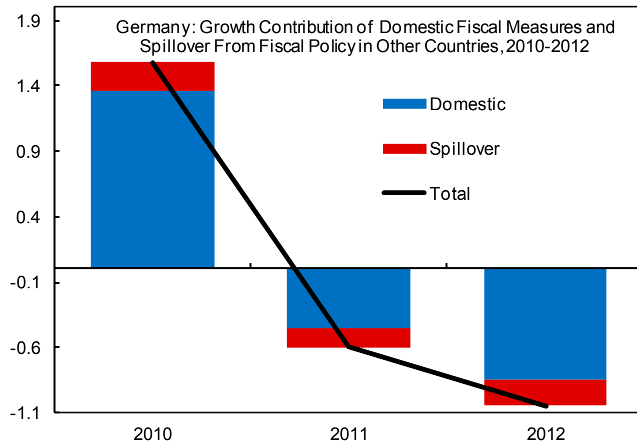
2. **The nature of the German recovery and its growth prospects are explained by the prominent role of external demand.** More so than elsewhere by far, Germany's crisis contraction and the recovery were driven by external demand. Thus firms, viewing the downturn as temporary, had greater incentives than elsewhere to retain workers—and the hourly flexibility in labor contracts and the short-work subsidy scheme (*Kurzarbeit*) were well suited to reinforce those incentives. Also, because the demand shock predominated, potential growth did not fall significantly and the output gap is projected to close later this year (Box 1).



Note: The bars represent cumulative contributions to growth from domestic and external sources during 2008Q2-2009Q1 and 2009Q1-2010Q3.

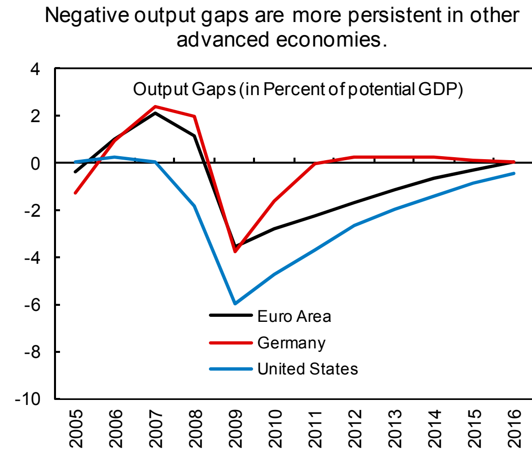
A. A Gradual Growth Slowdown

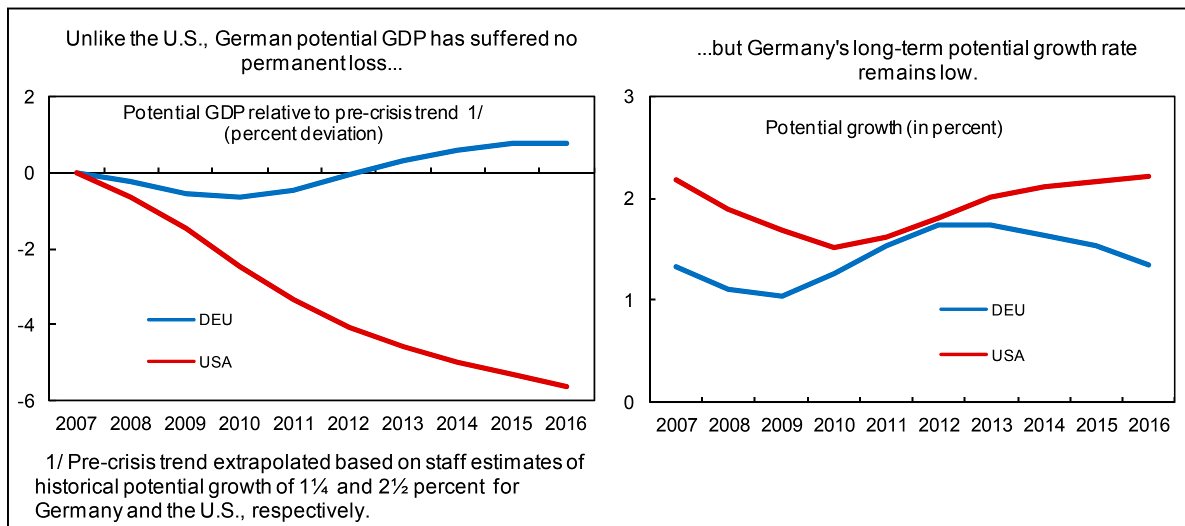
3. **Growth will remain above potential in the short term, but the economy is expected to slow gradually.** Staff's estimate of a small output gap is supported by continued buoyancy of production, confidence, and orders data; the expected improvements in employment reflect convergence to a lower structural unemployment rate (Box 2). Staff projects the economy to expand by a still healthy 3 percent in 2011, in line with the authorities' assessment. This will cause the output gap to close towards the end of the year. Growth will continue to slow as the fiscal consolidation takes hold, the output gap closes, and world trade growth slows after its bounce back. The authorities noted that domestic demand may grow stronger than projected by staff, pointing to the expected increase in the wage bill as well as a pickup in investment activity. Staff viewed such rebalancing as a cyclical response triggered by the export impetus and, thus, not yet a reflection of a structural shift.



Box 1. Germany's Growth Potential—Little Damaged but Low

The impact of the crisis on German potential GDP was relatively mild. Germany experienced a temporary decline in external demand, in contrast to longer-lasting, structural shocks elsewhere. Staff estimates that German potential growth during the crisis has declined only moderately from its pre-crisis rate of about 1¼ percent. As such, German potential GDP will likely suffer limited permanent damage from the crisis in contrast to more persistent losses elsewhere—U.S. potential GDP, for example, is projected to be about 5 percent below its pre-crisis trend in 2015.



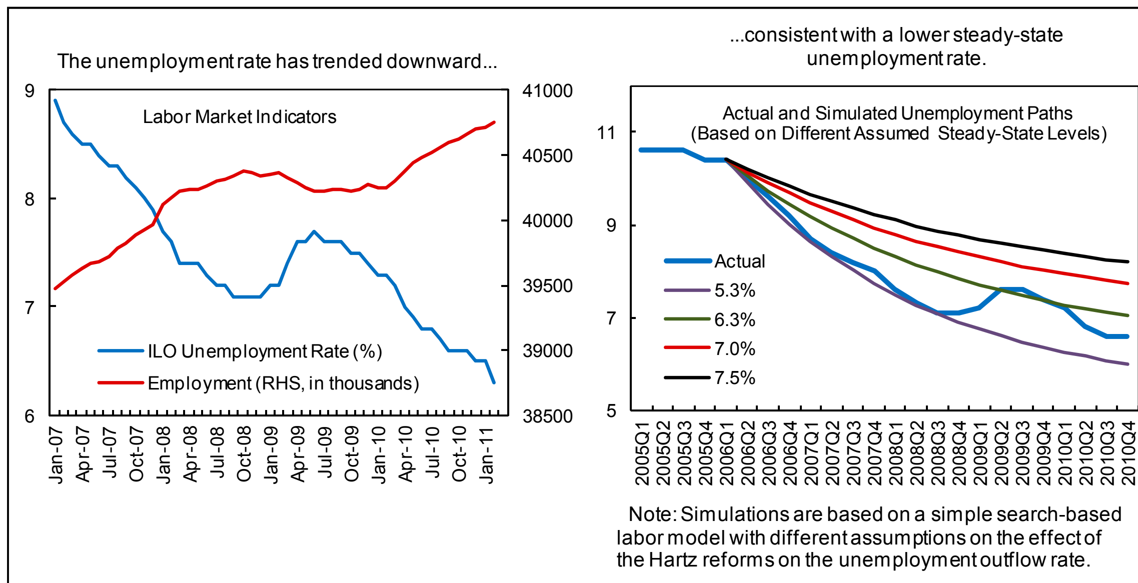


The benign crisis impact does not resolve Germany's long-term problem of low potential growth. While Germany escaped the crisis with little permanent damage, its long-term growth prospects, estimated by staff at about 1¼ percent annually, remain low. This view was shared by the authorities who see potential output growth at between 1¼ and 1½ percent. Thus, although the U.S. has lost ground relative to its pre-crisis trajectory, the growth gap vis-à-vis the U.S. will remain significant.

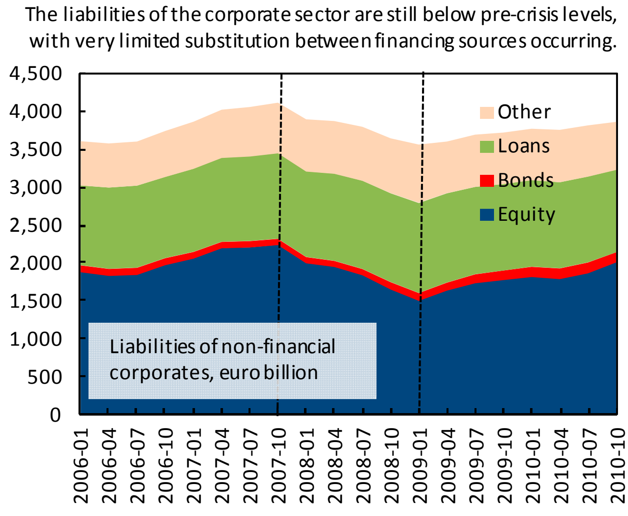
Box 2. Labor Market Dynamics During the Crisis and Beyond

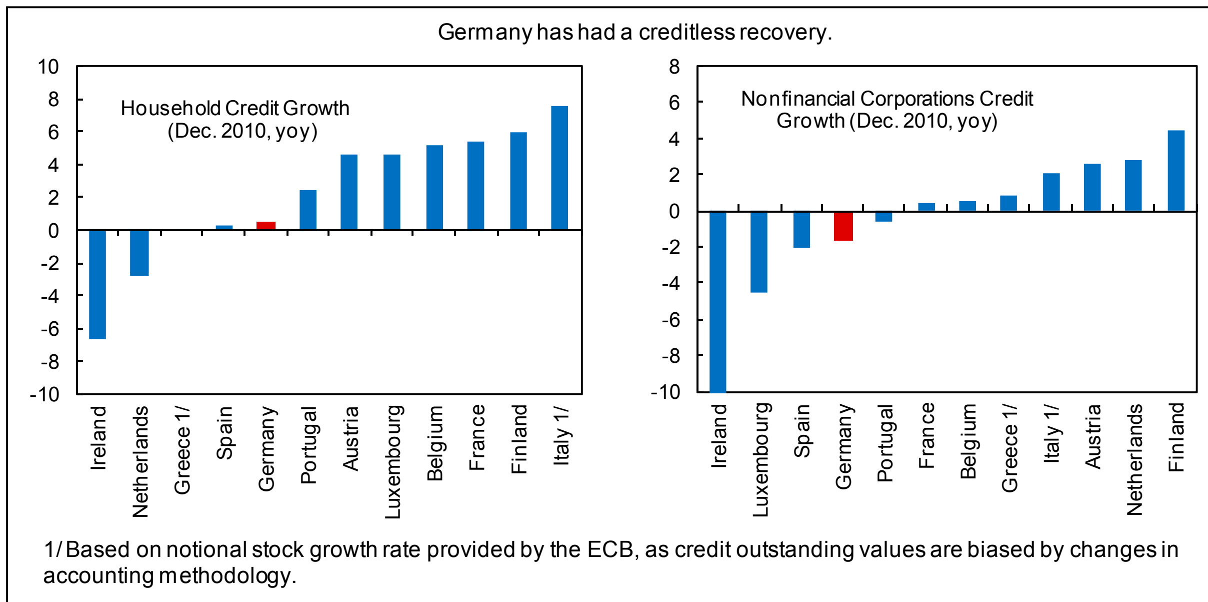
German employment remained remarkably stable during the crisis. The outcome reflects the nature of the shock experienced, the institutional framework, and supporting policies.

- While the shock was severe, firms perceived it as temporary and so had the incentive to hold on to labor and reduce hours worked rather than lay off workers.
- It helped that in recent years, flexible workweeks and work-time accounts had been incorporated into collective agreements. The subsidy for reduced work-time hours (*Kurzarbeit*) was extended and similarly reinforced the incentives to adjust employment through hours.
- The Hartz reforms in the early 2000s redesigned unemployment and welfare benefits, and thereby increased the flow into employment, especially at the low-wage end. This has led to a decline in the steady-state unemployment rate, which is projected to reach about 6¼ percent or less, from over 8 percent historically. This underlying downward trend also explains the moderate unemployment response.



4. **Germany has had a creditless recovery.** This is not a surprise. In recent years, bank credit and indicators of economic activity have been only loosely correlated. Even so, the anemic credit growth in the past year to households and especially to enterprises is remarkable considering the strength of the Germany recovery and also the pace of credit growth elsewhere in Europe. With little substitution to other forms of external financing, German corporates have apparently relied on their own profits to finance the recovery. For a sustained rise in investment rates and rebalancing, stronger credit growth will be important. The authorities noted that in the past, credit has picked up with a lag and they expect that further GDP growth will be supported by the extension of more credit.





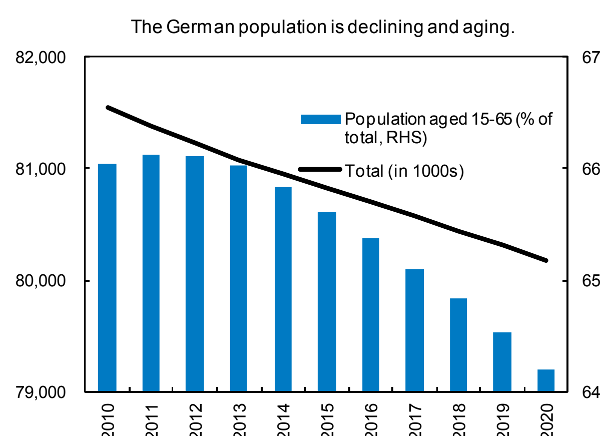
1/ Based on notional stock growth rate provided by the ECB, as credit outstanding values are biased by changes in accounting methodology.

B. Raising Medium-Term Growth

5. **The low potential growth rate reflects a combination of factors.** GDP growth is projected to converge, by 2015, to the long-term potential rate of 1¼ percent. Over the last decade, labor and capital services have made modest contributions; adjusted by hours worked, the contribution of labor has been nil. Total factor productivity (TFP) has responded to cyclical factors, falling sharply in the crisis and then realizing an offsetting gain in the recovery. But the recent flattening is consistent with low long-term average TFP growth. Productivity growth has been strong in Germany's traditional areas of strength, rising but below that of the U.S. in the production of information and communications technology products, and low in services, especially business and trade services.

Decomposing Growth (qoq, Annualized)

	GDP	TFP	Capital	Labor
2000Q1-2005Q4	0.9	0.4	0.5	0.1
2006Q1-2008Q2	4.7	2.2	0.9	1.5
2008Q3-2009Q1	-5.5	-6.0	0.5	0.0
2009Q2-2010Q2	3.9	3.3	0.3	0.3
2010Q3-2010Q4	2.1	1.2	0.4	0.5
Average 1991-2010	1.3	0.5	0.6	0.1

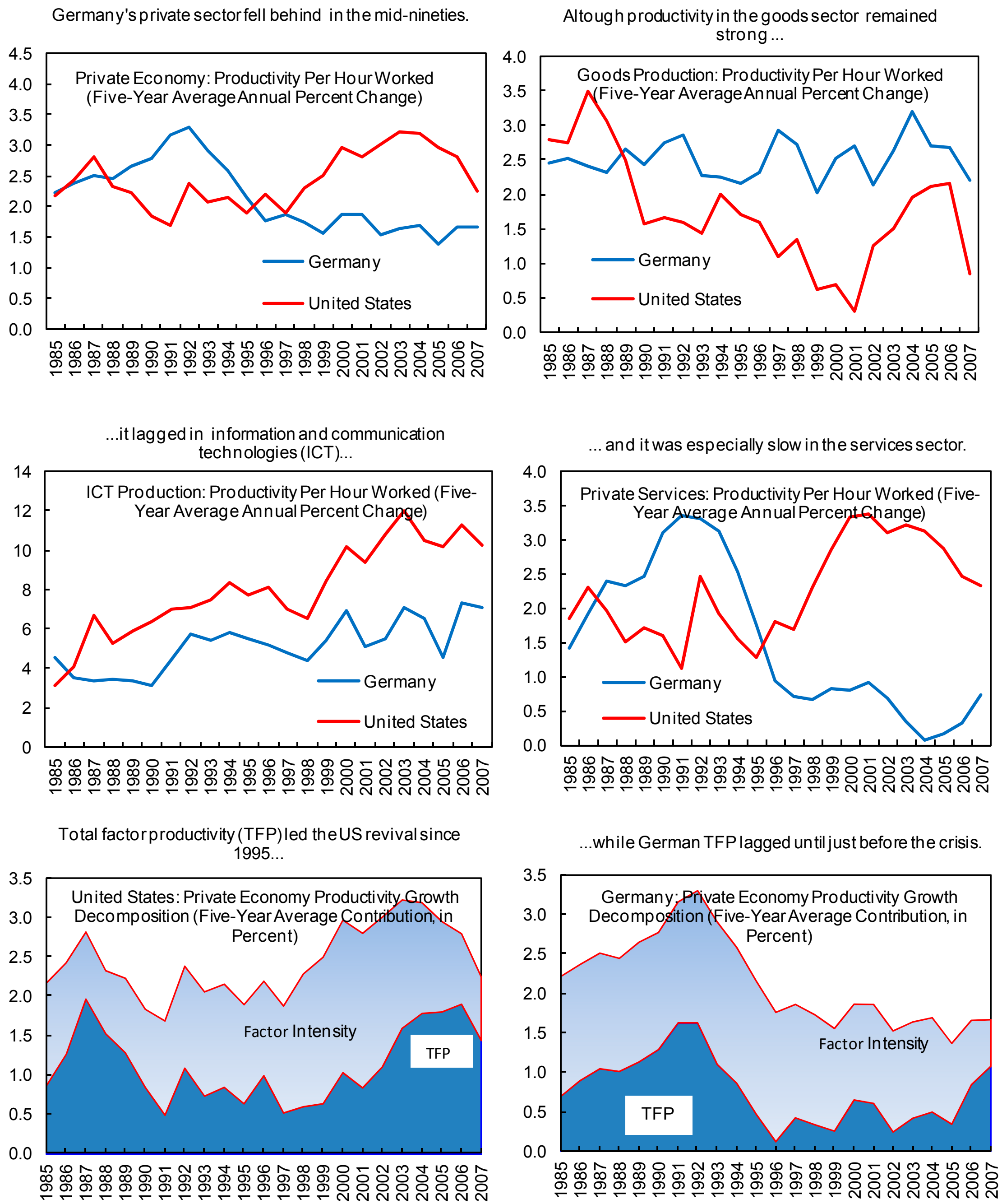


Contributions of Sectors to Average Annual Labor Productivity Growth in Market Services, 2000-07
(in percentage points)

	Germany		United States	
	Share in real value-added 1/	Contribution	Share in real value-added 1/	Contribution
Market services labor productivity	100.0	0.6	100.0	2.5
Distribution services contribution	40.7	0.8	40.8	1.3
from trade	30.0	0.5	34.1	1.1
from transport and storage	10.6	0.3	6.8	0.2
Finance and business services contribution	44.0	-0.3	46.2	1.0
from financial intermediation	11.0	0.1	19.4	0.5
from renting of m&eq and other business services	33.0	-0.3	26.8	0.5
Personal services contribution	15.4	-0.1	13.0	0.2
from hotels and restaurants	3.8	0.0	5.2	0.0
from other community, social, and personal services	11.0	-0.1	7.5	0.2
from private households with employed persons	0.8	0.0	0.3	0.0
Contribution from labor reallocation 2/	…	0.2	…	0.0

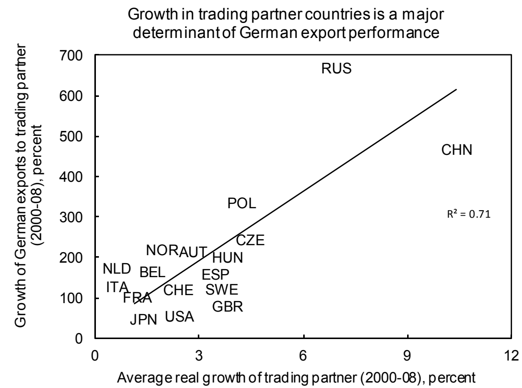
Source: EU KLEMS database, November 2009 release, and IMF staff estimates.
Notes: Numbers may not add up due to rounding.
1/ In 2007.
2/ Impact of changes in the distribution of labor input between industries on labor productivity growth in market services.

Figure 1. Germany: Productivity Trends in the Private Economy, 1985-2007

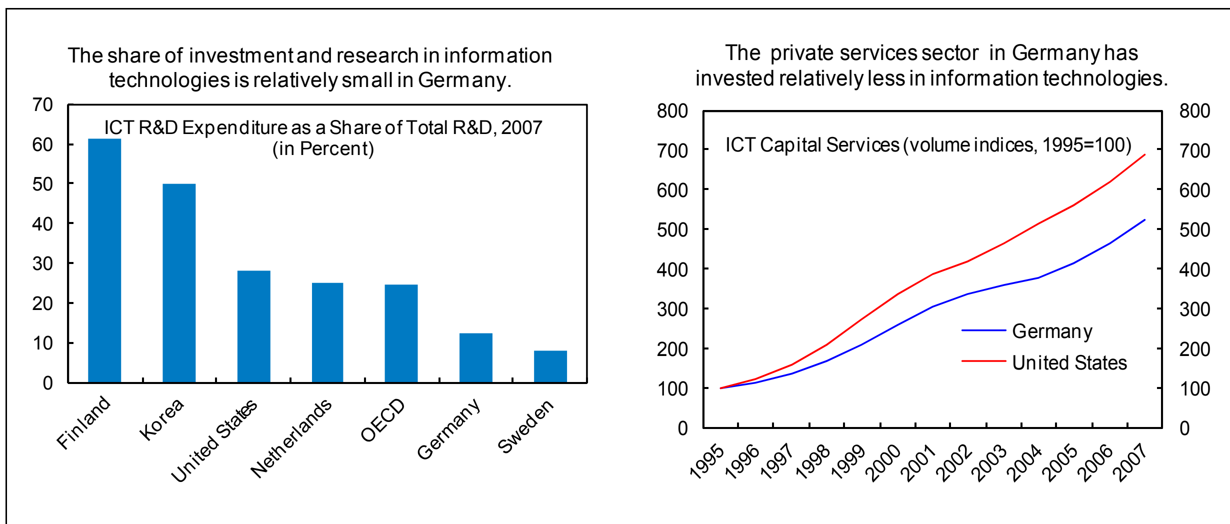


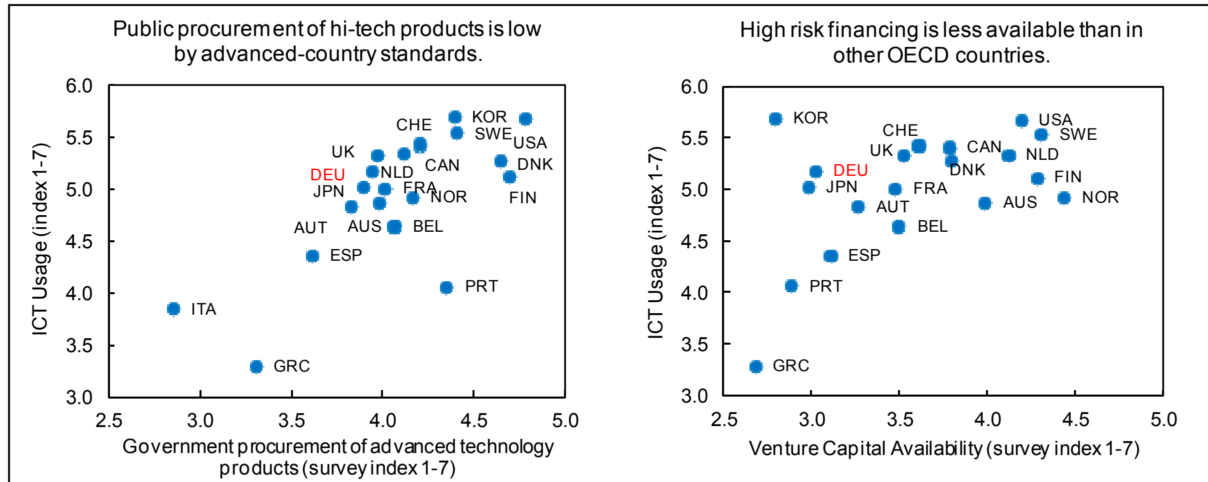
Source: EU KLEMS database and IMF staff estimates.

6. **Export dependence offers some upside growth potential but the downside risks argue for strengthening domestic demand.** Growth in its main trading partners has been a major determinant of German export performance. A one percentage point increase in growth in its main trading partners can lift German growth by up to ½ percent. Arguably, the strong growth prospects in emerging markets offers Germany continued opportunities. However, this dependence also represents a downside risk, and, in particular, will require maintaining its export market shares in the face of growing sophistication of the emerging market producers themselves. Also, the volatile nature of export-dependent growth underscores the necessity to strengthen domestic sources of demand. This view is shared by the authorities in their contribution to the Group of Twenty (G-20) mutual assessment program.



7. **A multi-pronged growth agenda is required.** All three contributors to potential growth, labor, capital, and productivity need attention. First, merely to offset the sharp decline in the working-age population over the next decade would require an about 2½ percentage point increase in labor force participation, a gap unlikely to be filled by additional immigration. Second, the low investment rate needs to be raised. And, finally, higher productivity growth will benefit from investment and innovation, especially in areas outside Germany's traditional strengths. Productivity gaps in the services sector require greater usage of information and communication technology (ICT), where Germany can close the gap with the international frontier. The importance and crosscutting nature of ICT is reflected in Germany's High Tech Strategy, and, more broadly, in Europe's 2020 growth agenda, which also notes the link between ICT usage and services' productivity.





8. **This agenda needs to be supported by specific policy measures.** Based on discussions with the authorities, the measures with the greatest expected leverage to support these objectives are:

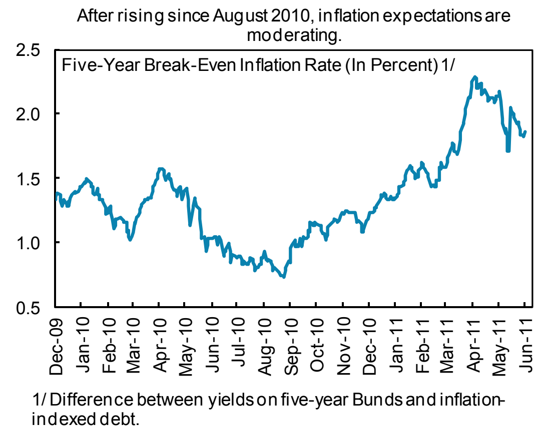
- **Tax policy.** Tax policy to increase incentives for labor participation and investment is discussed in section IV on public finances.

- **Education policy.** While the authorities noted that important education initiatives are already bearing fruit, they recognized the need for more widespread early childhood care and education, reorienting vocational training to emphasize lifelong learning, and further upwards mobility within the education system.

- **Innovation policy.** Promoting the availability of risk capital will help raise incentives to invest in higher-risk, higher-growth sectors. In this regard, removing uncertainties regarding tax treatment, redesigning change-of-ownership rule, which eliminates loss and interest carry-forward, as well as improving the efficiency of the insolvency process (by promoting faster restructuring proceedings, including through legislative initiatives currently underway) would help develop further venture capital and private equity markets. Further efforts in increasing commercial use of intellectual property rights held by universities and research institutions should be considered.

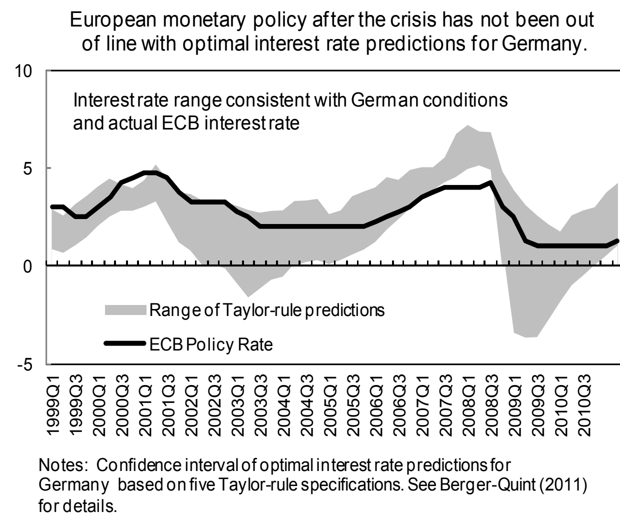
C. Modest Inflationary Trends

9. **Rising commodity prices will temporarily lift German headline inflation in 2011.** Staff and authorities project headline inflation to increase from 1.2 percent in 2010 to 2½ percent in 2011, due largely to energy and food price pressures. With these pressures currently seen as temporary, and inflation expectations already scaling back, headline inflation is projected to drop to about 1½ percent in 2012, and then converge back to an annual rate of about 2 percent in the medium term.

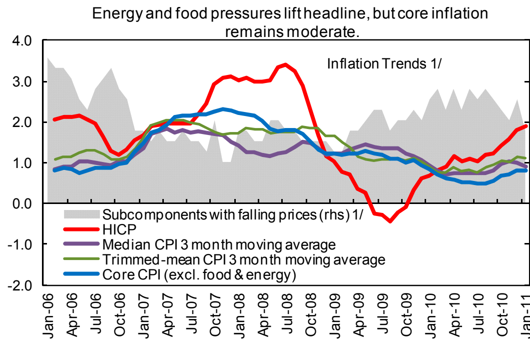


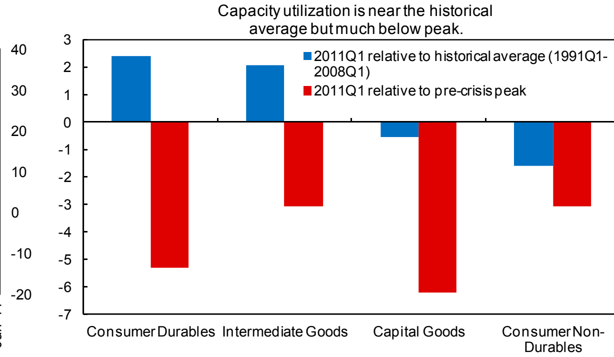
1/ Difference between yields on five-year Bunds and inflation-indexed debt.

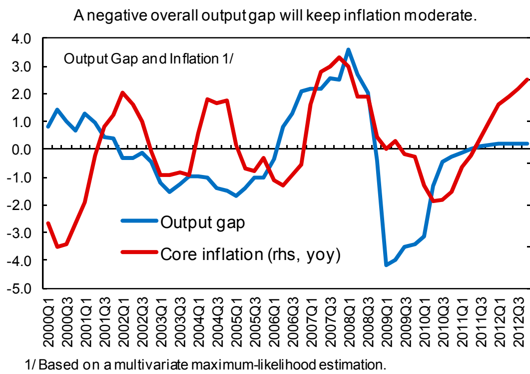
10. **Core inflation is projected to rise only moderately.** For 2011, staff projects core inflation to rise to 1¼ and to about 2 percent in 2012, up from 0.8 percent in 2010. A part of this rise, however, is influenced by prices of imported raw materials, and will subside as the rate of increase of imported prices falls. While a declining output gap will pull up core inflation, slack in most sectors suggest that this increase will remain moderate in 2011. Negotiated wage agreements have been moderate thus far, consistent with a continued decline in the structural unemployment rate. With German inflation slightly below the euro area average but the output gap closing somewhat faster, euro area monetary policy has been broadly appropriate for Germany.



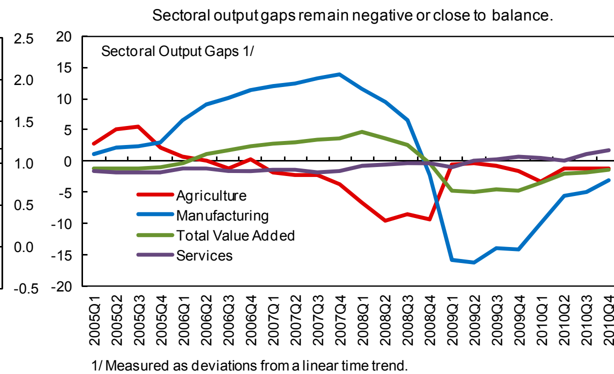
Notes: Confidence interval of optimal interest rate predictions for Germany based on five Taylor-rule specifications. See Berger-Quint (2011) for details.







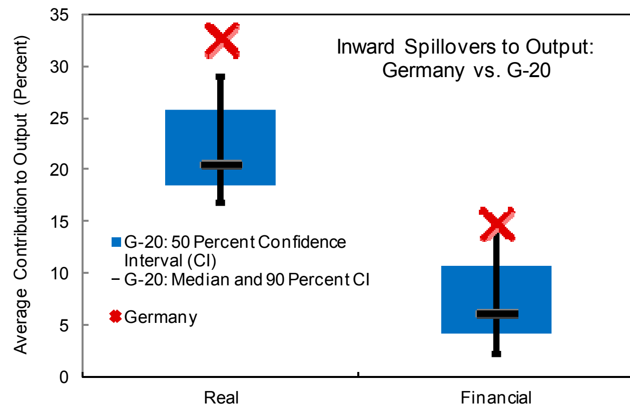
1/ Based on a multivariate maximum-likelihood estimation.

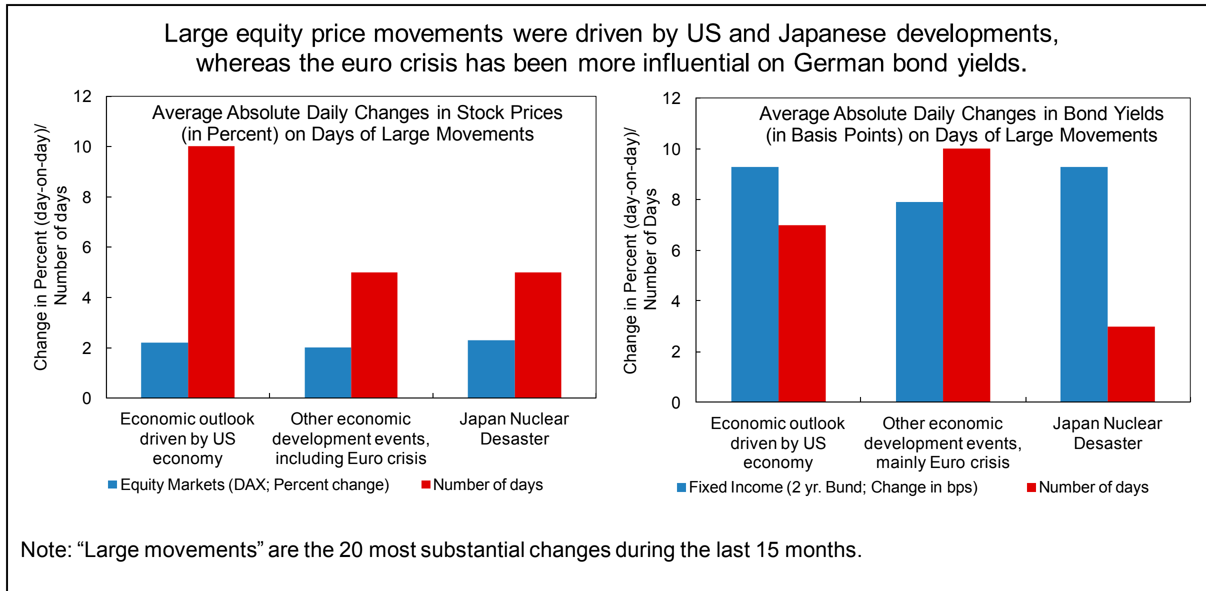


1/ Measured as deviations from a linear time trend.

II. Spillovers

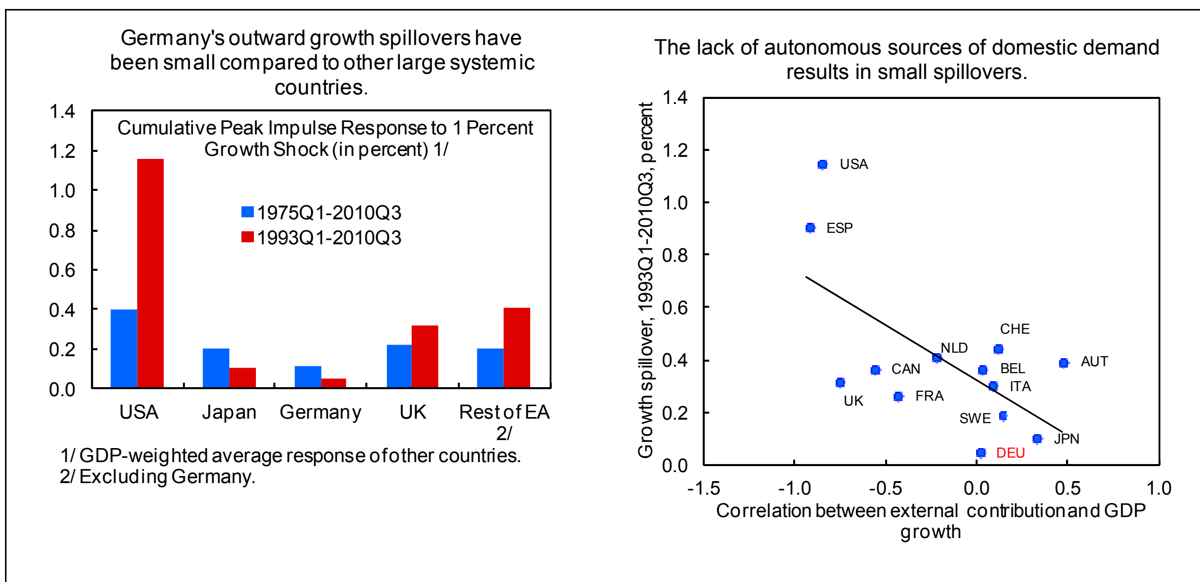
11. **Germany has been a sensitive recipient of external real and financial shocks.** These external shocks have accounted for almost half of business cycle fluctuations in Germany, the highest among the G-20 countries. Recent market data reinforces the conventional analysis of the role of external shocks, showing that the large movements of German stock and bond prices have been driven mainly by developments outside Germany.





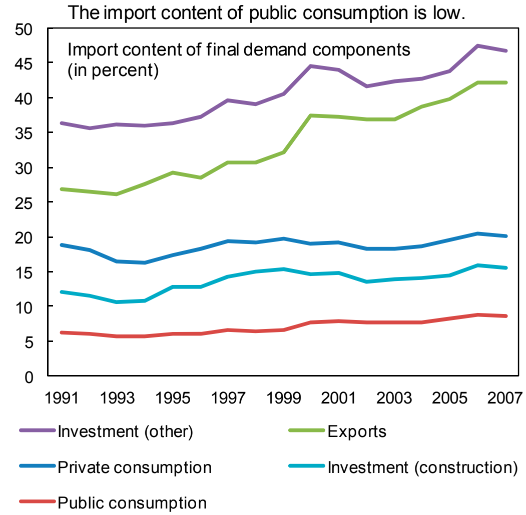
Note: "Large movements" are the 20 most substantial changes during the last 15 months.

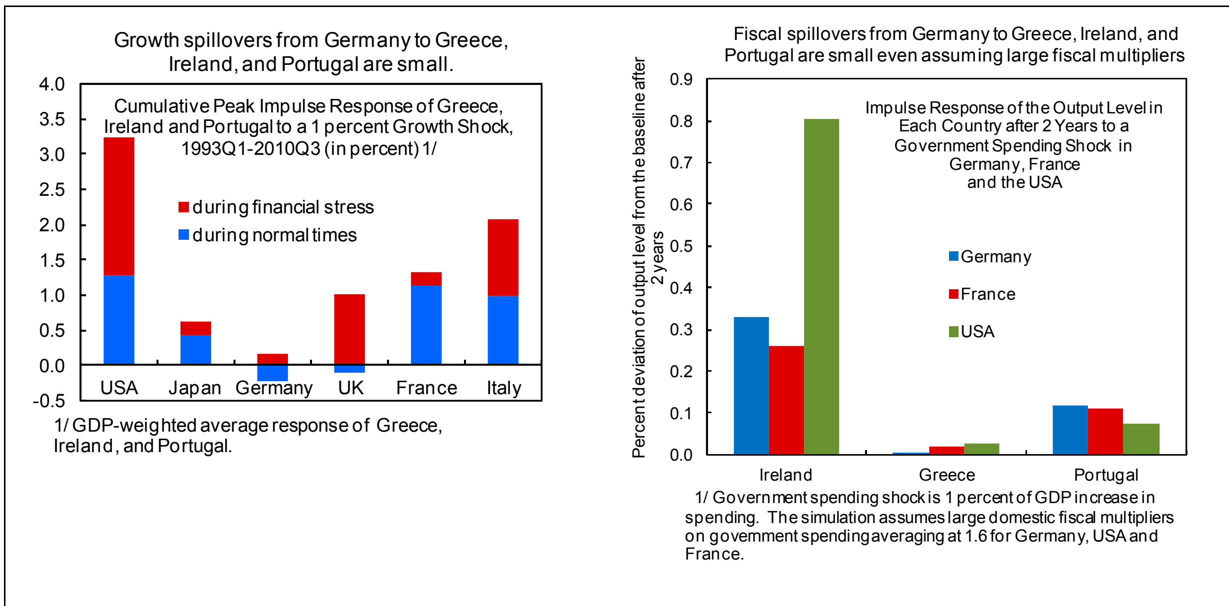
12. **Despite its large economic size, Germany has not been a significant independent source of global growth.** Germany's outward growth spillovers have been small compared to other large countries. The limited outward spillovers from Germany and large inward spillovers are related. Countries with high sensitivity to external shocks generate limited outward spillovers. Germany transmits impulses from the United States and Asia, mainly to European economies with strong trade links. The authorities suggested that Germany's robust recovery could enhance its role as an independent engine of growth. They also noted that those countries that are thought of as locomotives experienced unsustainable residential investment booms and rising current account deficits. And they pointed to beneficial effects from German foreign direct investment on growth in Central and Eastern European countries which have been integrated into Germany's regional supply chain.



1/ GDP-weighted average response of other countries.
2/ Excluding Germany.

13. **Thus, German fiscal policy also has limited consequence for European growth.** Fiscal actions convey across borders through trade, which dilutes the growth impact even where strong trade links exist. With multipliers in a generally-accepted range, the external growth effects of German fiscal policy are small. In particular, for the most stressed economies in the European periphery, high fiscal multipliers would need to operate for relatively modest effects. Similarly, fiscal policy changes in Germany have only a small impact on the trade balance of peripheral countries, and are thus unlikely to contribute to the reduction in intra-European imbalances. The authorities agreed with this analysis, and pointed to the low import content of public consumption. Moreover, they argued that German fiscal consolidation could benefit the periphery by lowering interest rates, which would help especially with risk premia so high.





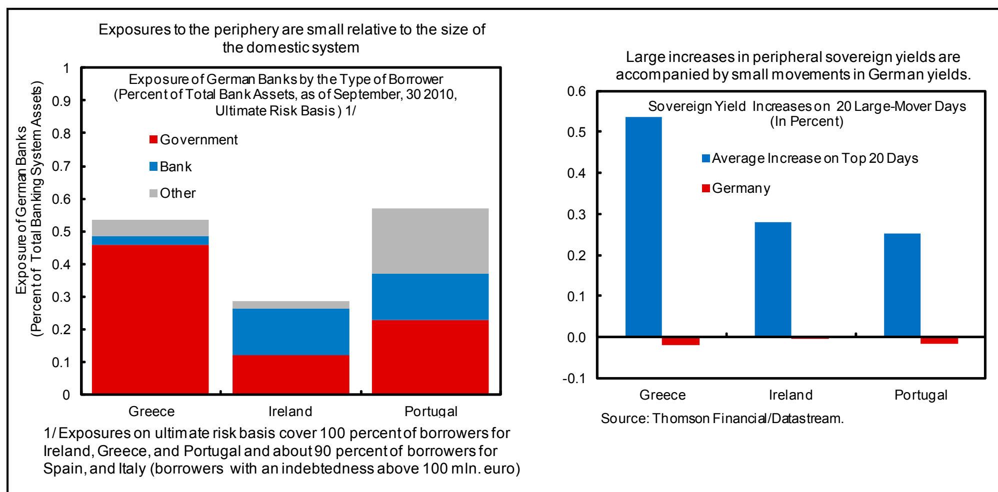
14. **Greater contribution to European and global rebalancing would require more autonomous German sources of domestic demand.** Stepped up efforts to raise potential growth would contribute to that goal if they create wider employment opportunities alongside higher productivity growth, particularly in the non-tradables sector. In addition to creating incentives for greater domestic investment, higher permanent incomes would also sustain higher consumption growth. While the authorities shared this perspective, they also felt that some of the rebalancing was already occurring.

15. **The German financial system could generate outward spillovers—and it is susceptible to shocks from other large financial systems.** The large size of Germany's financial system, its international connections, and the nonlinear behavior of these connections at times of stress, imply that Germany could have a larger cross-border influence through its financial system than through its real economy. For this reason, as the authorities recognize, a robust financial system is important for both German and global financial stability. The risks of financial spillovers into Germany arise mainly from other large financial systems. Broader risks arise from the continuing uncertainty with regard to the debt obligations of euro area sovereigns and banks under stress, which creates an environment where contagion risks are elevated. Staff proposed that these challenges warrant a more comprehensive and consistent European policy response, and the German authorities emphasized the need for a clear framework that paid due regard to moral hazard and private sector involvement.

16. **German exposure to direct risk from the European periphery is limited in terms of banks' assets but more wideranging implications are possible.** Aggregate exposure of German banks to sovereign and bank debt held in peripheral economies is small relative to the size of their assets. But this exposure represents about 30 percent of total bank equity. Moreover, the exposure is concentrated in select banks, which, if placed under stress, could have more widespread knock-on effects. Similarly, stress from the periphery to banks outside Germany could also create stress in Germany. Thus far, these risks have not been viewed as significant by the market: to the contrary, the German sovereign has been a safe haven when the periphery has been under financial stress—in such conditions German bond yields have declined or remained constant.

Exposure of German Banks to Banks and Governments on Ultimate Risk Basis as of September 30, 2010

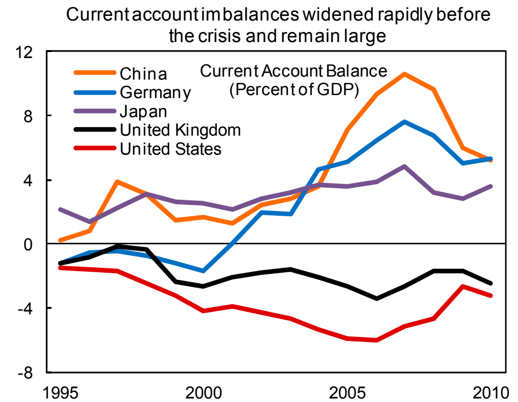
	In percent of			
	Total Bank Assets	Assets of Banks with Large Exposure	Total Bank Equity	Equity of Banks with Large Exposure
Greece	0.5	0.7	12.1	19.5
Ireland	0.3	0.3	6.4	8.6
Portugal	0.4	0.5	9.2	14.4
Total	1.2	1.5	27.7	42.5



III. External Accounts and Competitiveness

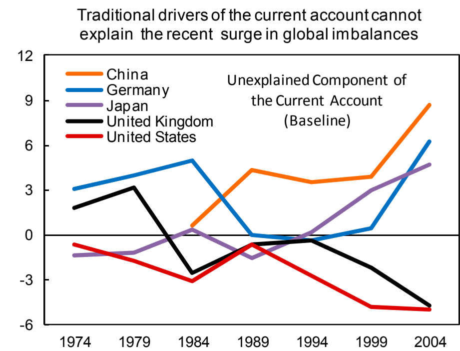
A. Current Account Balance

17. **Riding the wave of global growth in the run-up to the crisis, Germany, amongst others, experienced a large increase in its current account balance.** Germany's current account surplus rose to about 7½ percent of GDP just before the Great Recession. In addition to long-term forces generating precautionary savings in Germany, the peak surplus also reflected a cyclical rise in exports during the boom years (Box 3). In those years, high surpluses also rose in China and Japan, mirroring the rise in the U.S. deficit. The German surplus has since receded to about 5 percent of GDP.



Box 3. Structural Factors and the Current Account

The emergence of global imbalances cannot be explained by current account models. In the long term, current account balances are to a large extent driven by fundamentals such as per capita income level, fiscal policies, demographic factors, oil prices and the initial net foreign assets position. The traditional drivers of the current account, however, cannot explain the recent surge in global imbalances. The residuals from the current account equation largely mirror the imbalances from 2000–09.



Structural factors also cannot explain the emergence of the imbalances, although they may explain the level of a country's balance. The impact of structural factors on the current account is not robust across country samples, with some commonly recommended reforms increasing and some reducing the current account balance. The econometric results suggest, though, that Germany could reduce its surplus through lower taxes on business and labor, further reduction in the gross unemployment replacement rate, and a smaller public share of the banking system.

	Advanced, Emerging and Developing Countries		OECD Sample	
	Impact on the Current Account	Statsictially Significant	Impact on the Current Account	Statsictially Significant
Structural reforms that could reduce the current account balance				
Deregulation of the Credit Market 1/	↓	Yes	↑	No
Reducing taxes (profit, labor and other business taxes) and simplifying procedures for tax payments	↓	Yes	↓	No
Reducing Unemployment Gross Replacement Rate	↓	Yes	↓	No
Deregulation of professional services	NA	NA	↓	No
Product Market Deregulation	NA	NA	↓	No
Deregulation in retail trade	NA	NA	↓	No
Structural reforms that could increase the current account balance				
Reducing the ratio of minimum wage to mean wage	↑	Yes	↑	Yes
Reducing Employment Protection	↑	No	↑	No

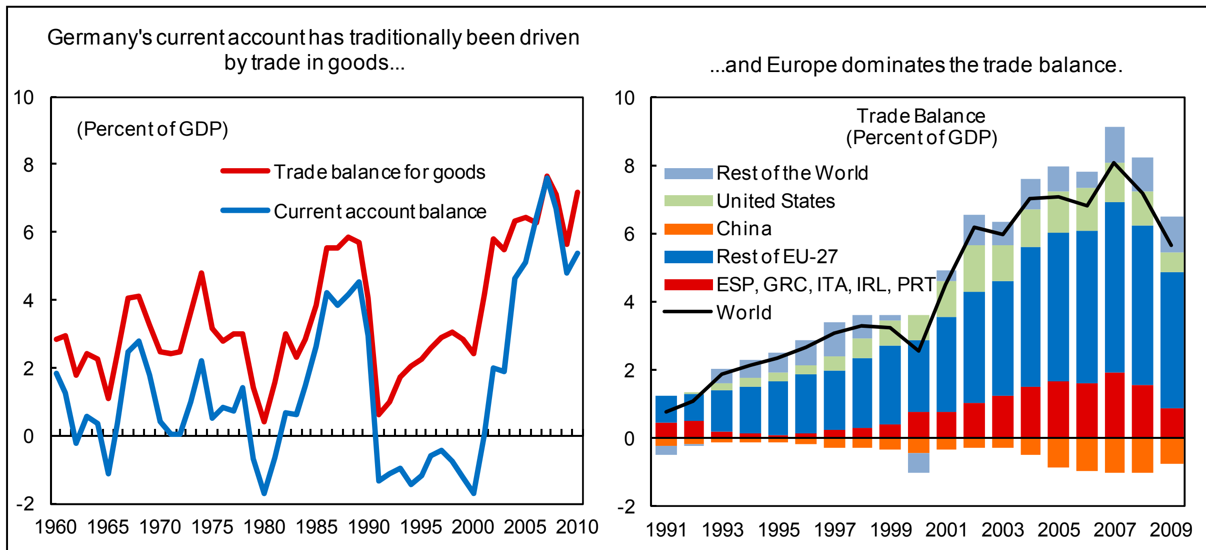
1/ Regulation in the credit market is measured by the index, which includes four components (i) ownership of banks measured by the percentage of deposits held in privately owned banks, (ii) control of interest rates, (iii) percentage of credit extended to private sector and (iv) competition from foreign banks. Germany scores low on this indicator due to the high degree of public ownership in the banking system.

18. **Germany's current account surplus reflects a positive trade balance especially vis-à-vis other European countries.** Trade surpluses for goods have been the main driver of Germany's current account; in fact, Germany has not recorded a trade deficit in goods in the past 50 years. Estimates based on CGER-like methodologies show that Germany enjoys a moderate competitive advantage between 2 and 9 percent. In recent years, the surplus with other European countries has risen, raising the concern with regard to "intra-European" imbalances. The trade balance with China, on the other hand, has been negative and has widened in the last decade. These developments, the authorities agreed, are related.

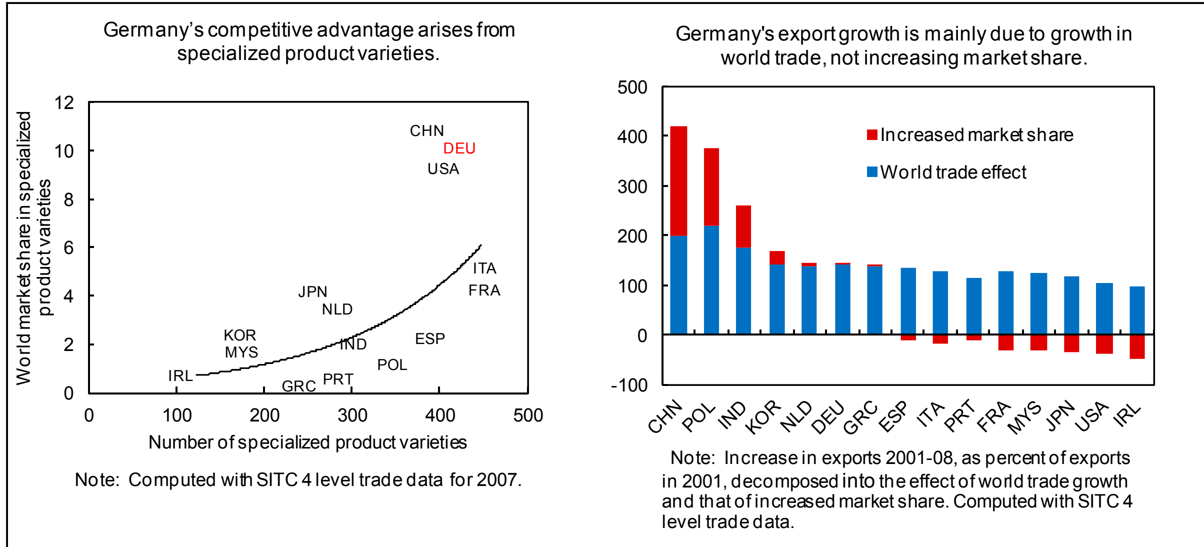
Exchange rate assessment based on CGER-like methodologies

	Fall 2010	Spring 2011
Macro Balance approach	-3	-2
External sustainability	-10	-9
Eq. Real Exchange Rate	-4	-8
Average	-6	-6

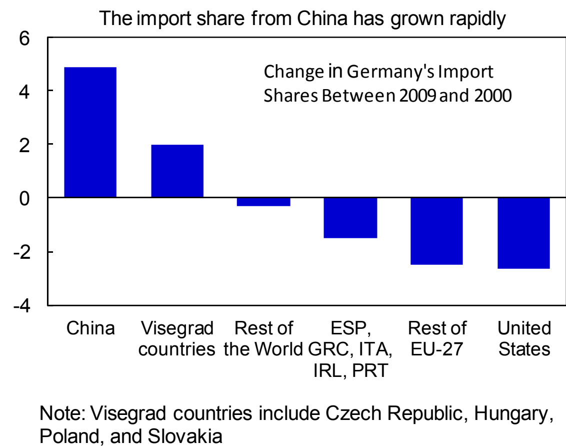
Note: Deviation from equilibrium exchange rate in percent, a negative sign represents undervaluation



19. **Germany's export competitiveness derives from a comparative advantage in a large number of specialized product varieties.** German firms have specialized in a large variety of capital goods, consumer durables, and pharmaceuticals and they enjoy significant world market shares in these products. The authorities noted that by the onset of the pre-crisis boom, the decline in competitiveness following unification had been counteracted. Germany was able to hold market share, allowing exports to ride the global trade wave. There is, however, a cautionary tale here. The U.S. also enjoys specialization in a large number of products, but has been losing market share in the past decade. Thus, global competition, especially from emerging nations, will likely challenge traditional German dominance.

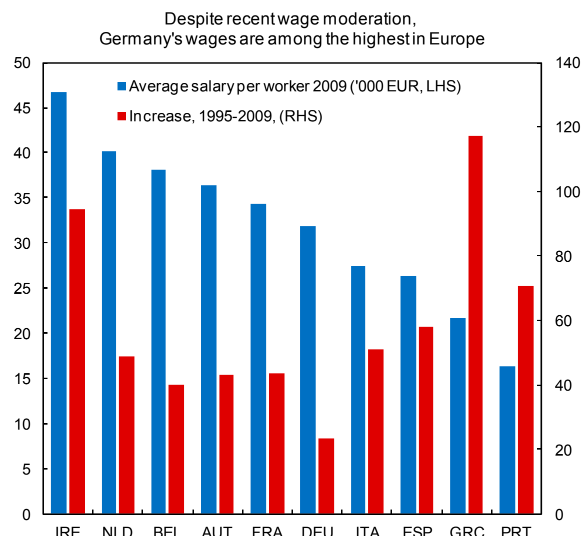


20. **The growth in intra-European imbalances, therefore, reflects continued German competitiveness alongside the rise of non-European, especially Chinese, competition.** With increased exports to the rest of Europe, Germany maintained its traditional supply chains, resulting in larger European imports, especially of intermediate goods from Visegrad countries (Czech Republic, Hungary, Poland, and Slovakia). However, the increased trade imbalance within Europe reflects the tilt in Germany's import towards products produced most cost-effectively by China. Thus, while German exports have remained largely insulated from Asian and lower-wage European competition, much of advanced Europe—including the periphery—faced the new reality of global low-wage competition. Consequently, the authorities felt that the periphery's weak competitiveness will require solutions in the periphery.



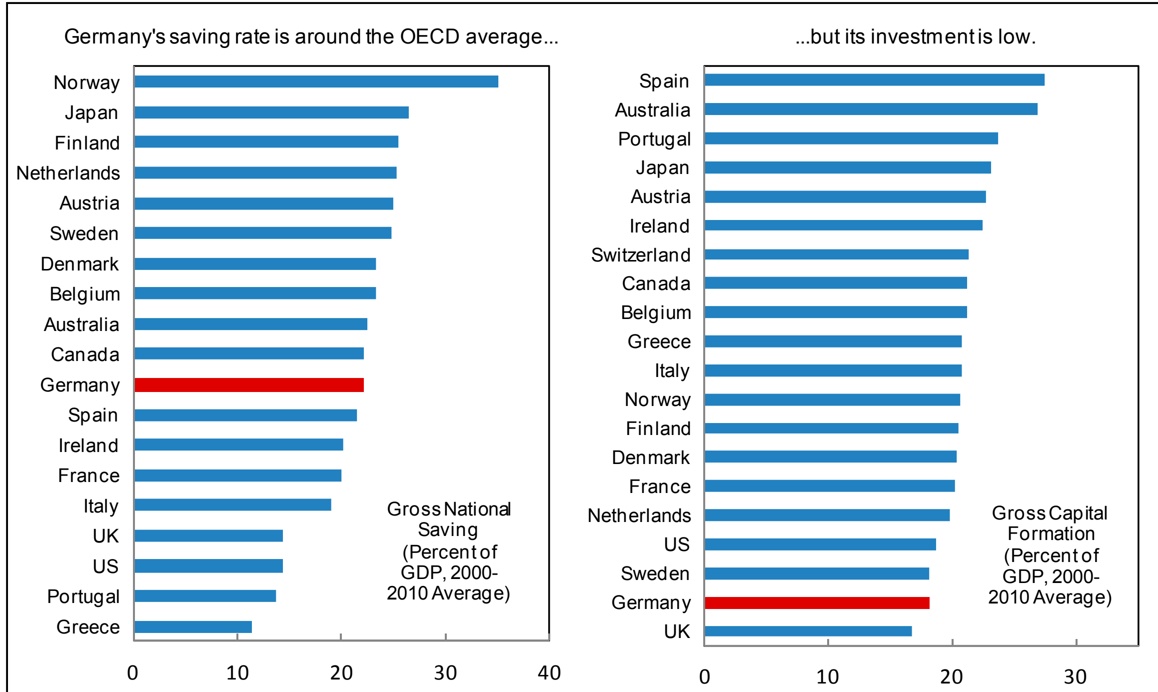
21. **In popular discourse, raising German wages to reduce German competitiveness is often recommended, as is reducing the household savings rate.**[1] But these approaches are neither analytically nor pragmatically sound.

- Despite recent wage moderation, German wages are amongst the highest in Europe (changes in nominal wages and unit labor costs are highly correlated). Since its competitiveness derives from product specialization, raising German wages would do little to improve export prospects of countries that do not compete with Germany in its specialized products. Higher wages would increase domestic consumption only if seen as sustainable by residents but would hurt if, as the authorities suggest, they reduce investment incentives further.

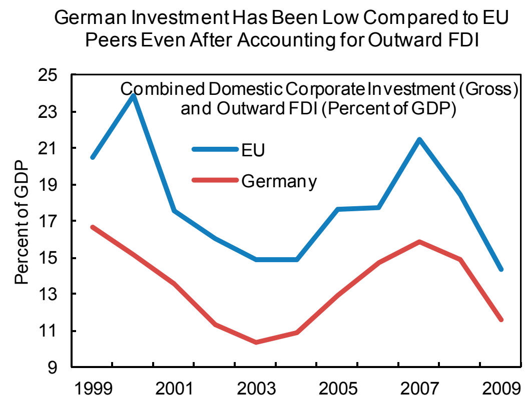


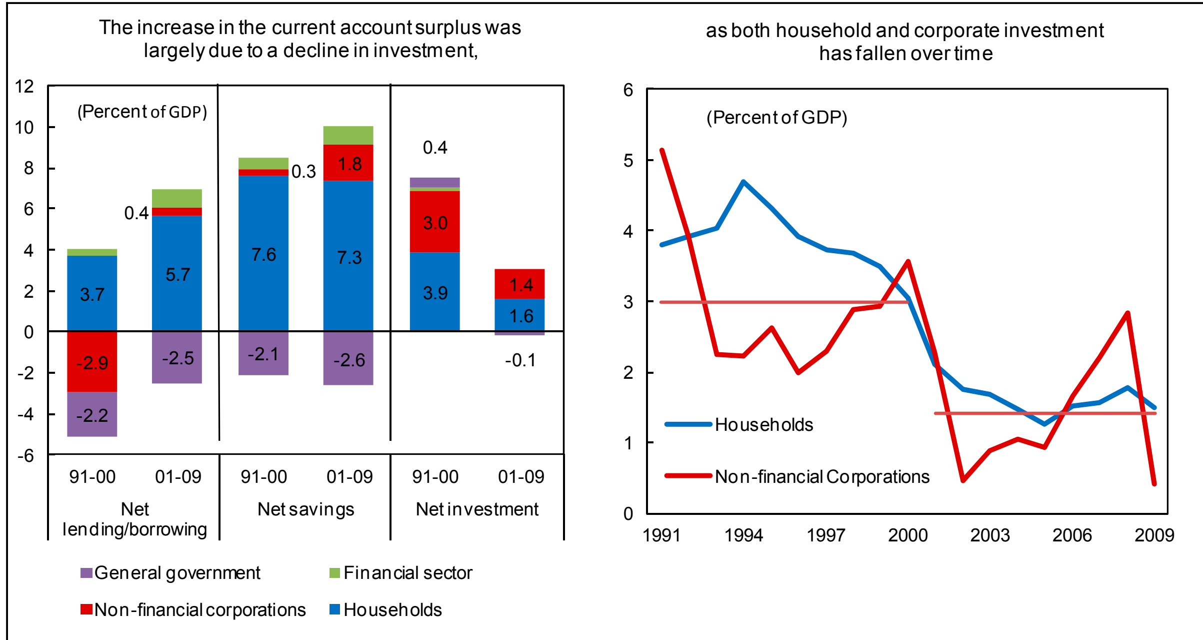
- The German national saving rate is about on par with advanced European peers. Household saving rates are also not exceptionally high. Reducing domestic savings rates will require bucking a long-standing tendency in Germany for precautionary savings; moreover, providing greater social security to reduce the incentive to save would go against public finance considerations; and finally, addressing Germany's traditionally high level of precautionary savings is best seen as the end result of raising domestic sources of growth, rather than the starting point.

[1] See Adam Posen in http://www.ip-global.org/2011/03/03/the-euro-payoff/.



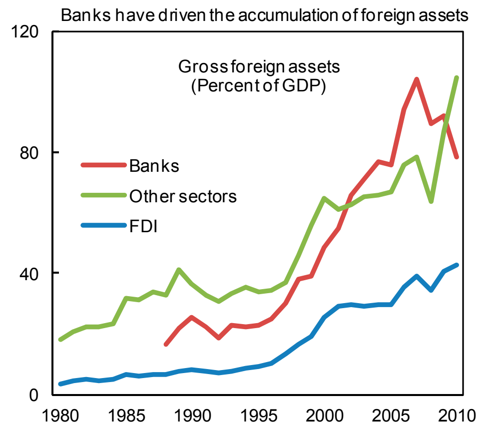
22. **The most sustainable approach to reducing the German current account surplus is likely through policy efforts to raise domestic investment rates, which are low among advanced economies.** The corporate sector was the main contributor to the increased surplus during the boom years. The rise in corporate savings, reflecting increased profits and low dividend payout, was not matched, as the authorities recognize, by a compensating increase in domestic investment. Indeed, corporate investment remained low compared to European peers even accounting for foreign direct investment (FDI) outflows. This should be a matter of some concern: corporations were unwilling to invest when the resources and the opportunities seemed ample. The reluctance to invest domestically reflects long-standing low returns to investment in Germany. The key to raising investment is likely to be a restructuring of public finance priorities (as discussed below). But, in addition, the broader growth agenda would increase permanent incomes, reduce uncertainty and, hence, stimulate consumption and investment, further contributing to reduced surpluses. Although the authorities expect investment to pick up given the recent recovery in capacity utilization, they see merit in improving the investment climate. They also recognize that reducing banks' incentives to seek higher yields abroad and more proactively develop domestic business would be a help.

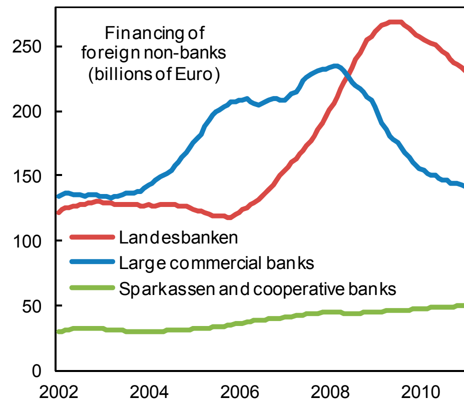




B. International Investment Position

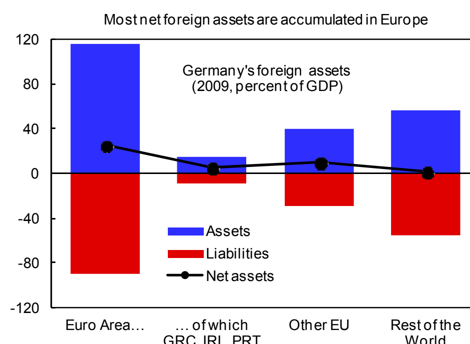
23. **Germany has exported capital to match its surpluses, increasing sharply its holding of international assets.** Outward foreign direct investment has increased to above 40 percent of GDP. While the authorities rightly emphasized the value of German FDI to the receiving economies, they also recognized that financial investments by banks—through loans and the purchase of stocks and bonds—were the primary drivers of the large outflows prior to the crisis. Since 2007 banks have reduced their holdings of foreign assets, which have been partly transferred to the public sector through the resolution agencies.



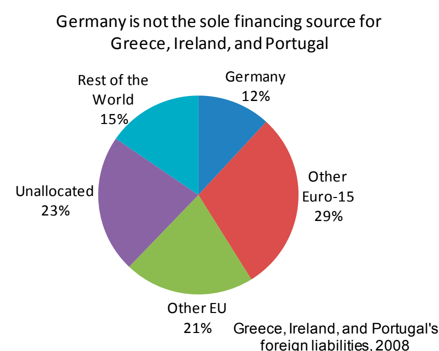


24. **Public banks contributed significantly to the accumulation of foreign assets.** *Landesbanken* rapidly increased their foreign investments in the run-up to the crisis, even as private commercial banks stabilized and then decreased their foreign exposure. While the *Landesbanken* used wholesale funding sources to finance their international investment, they also drew on the *Sparkassen*, whose share of deposits placed in the *Landesbanken* increased considerably. The decision by Germany's public banks to invest abroad in search of higher returns reflected the weak

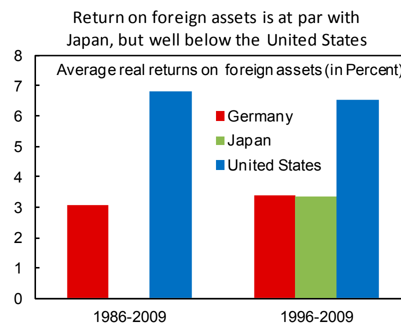
domestic demand for investment environment and their misplaced incentives to search internationally for yields, encouraged by the lack of a viable business model and a weak governance structure.



25. **Germany's foreign assets are primarily invested in Europe.** At the end of 2009, Germany's foreign assets were highly concentrated in the other Euro countries, for a gross exposure of almost 120 percent of GDP. The foreign asset position vis-à-vis Greece, Ireland, and Portugal was also significant, around 15 percent of GDP.



26. **However, Germany finances a relatively small share of the international liabilities of Greece, Ireland, and Portugal.** While, at the end of 2008, over 60 percent of the international liabilities of Greece, Ireland, and Portugal were financed within the European Union, Germany accounted only for a moderate share of 12 percent. Of the German banking sector's exposure to these countries, public banks account for 31 percent.

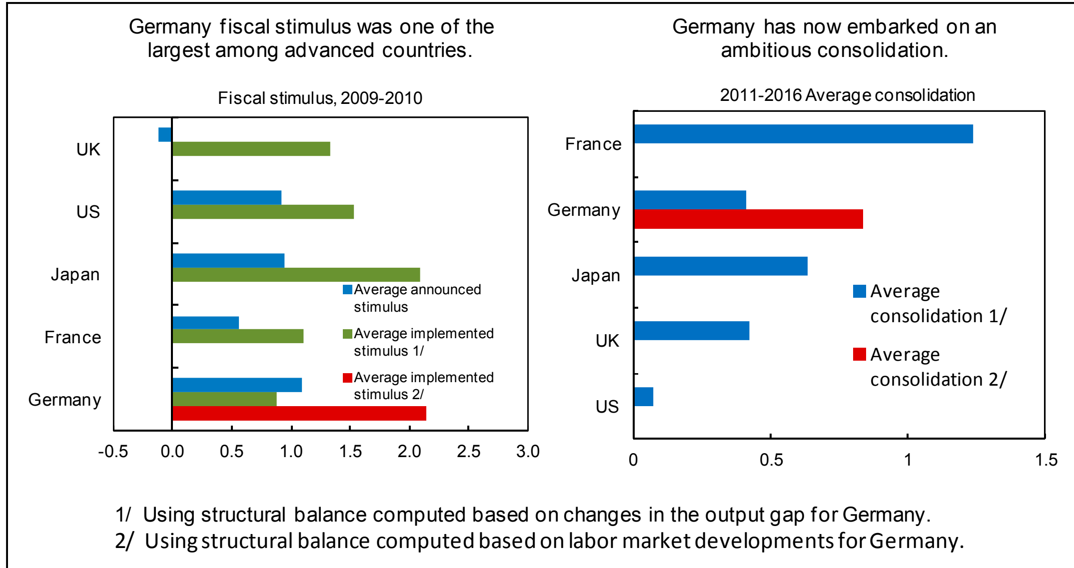


27. **The returns to Germany on its foreign assets have been relatively low.** Returns on foreign investment have been moderate and considerably below those realized by the United States. From 1986 to 2009, Germany earned an average 3 percent real return on its foreign assets. This is approximately half the return on U.S. foreign assets whose good performance can be partly attributed to the US dollar depreciation. Germany's return performance has only slightly improved since 1996.

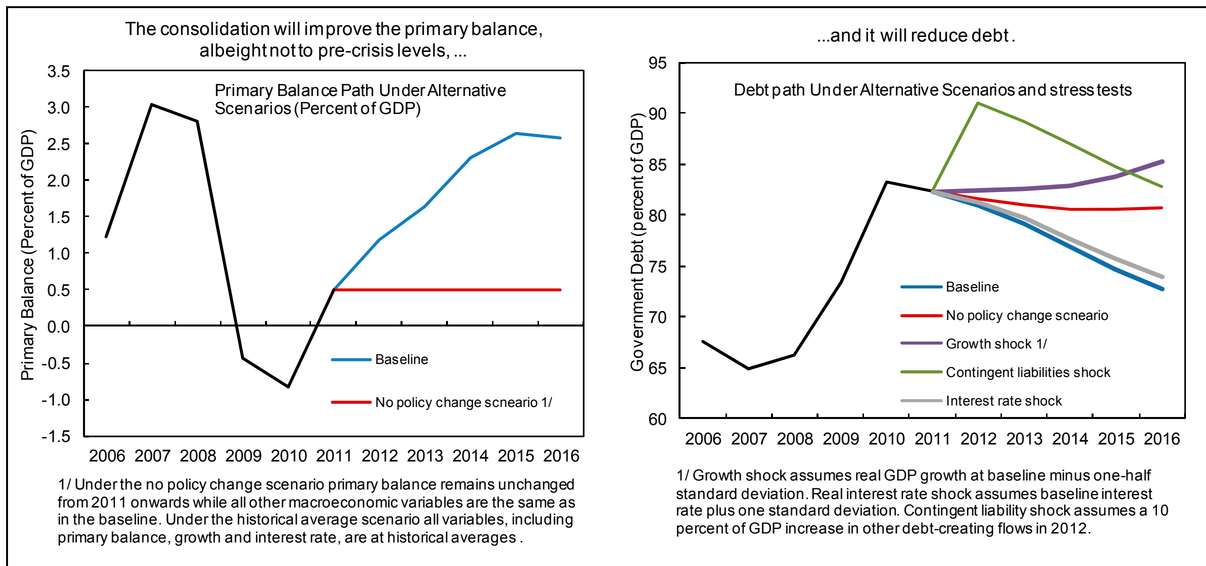
IV. Public Finances

28. **From a sizeable stimulus, the authorities are moving towards a gradual consolidation**. The German fiscal stimulus during the crisis phase was comparable to—or larger than—in other advanced economies. That stimulus is now set to be phased out and a consolidation process has begun. The package is ambitious by historical standards (Box 4). Staff estimates suggest that the size of the consolidation (at about ¾ percentage points of GDP per year) is likely to be larger than that implied by the authorities' estimates of the structural balance based on the output gap. The latter incorporates a larger allowance for the reduction in cyclically-adjusted spending than occurred on account of the strength of the labor market in the downturn. The European Stability and Growth Pact (SGP) target can be achieved in 2011, and the objectives of the national fiscal rule and the preventive arm of the

SGP are within reach at the latest by 2016. The increased primary surplus will help bring down the debt-to-GDP ratio from its current level of over 83 percent of GDP (having been boosted recently by banking sector support).



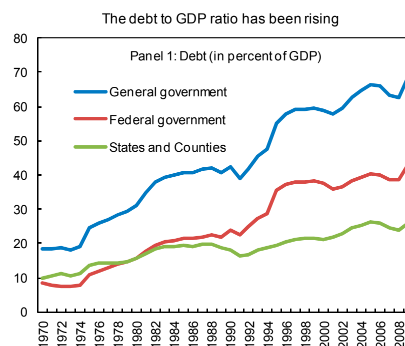
1/ Using structural balance computed based on changes in the output gap for Germany.
2/ Using structural balance computed based on labor market developments for Germany.



1/ Under the no policy change scenario primary balance remains unchanged from 2011 onwards while all other macroeconomic variables are the same as in the baseline. Under the historical average scenario all variables, including primary balance, growth and interest rate, are at historical averages.

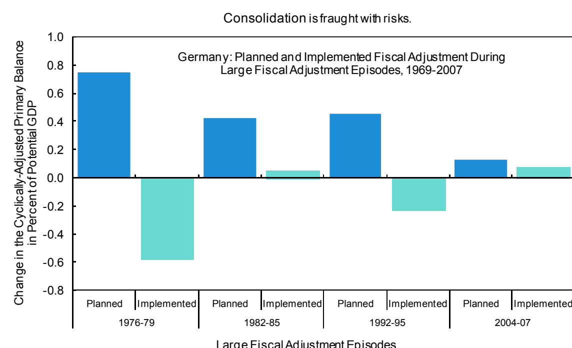
1/ Growth shock assumes real GDP growth at baseline minus one-half standard deviation. Real interest rate shock assumes baseline interest rate plus one standard deviation. Contingent liability shock assumes a 10 percent of GDP increase in other debt-creating flows in 2012.

Box 4. Large Fiscal Adjustments are Subject to Risks[1]



Fiscal consolidation has been a key concern for German policy makers. With the debt-to-GDP ratio on a generally rising trend, periodic efforts have been made to rein it in. Four large fiscal adjustment initiatives were in 1976–79, 1982–85, 1992–95 and 2004–07.

The lesson is that fiscal consolidation is subject to considerable risks and political commitment is a key to the success. Weakened macroeconomic conditions may override consolidation objectives (as in the 1970s) and unexpected impediments may arise (as after the unification during the 1990s). A political commitment to continue with the consolidation despite unfavorable circumstances was made in the 1980s. Even greater success was achieved in the 2000s when fiscal consolidation was combined with structural measures, including labor market and pension reforms alongside a reduction in the tax burden.

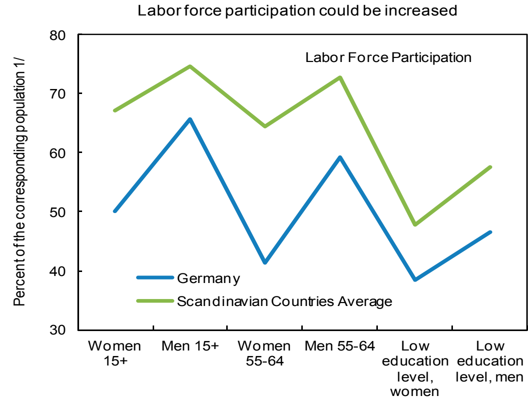


---

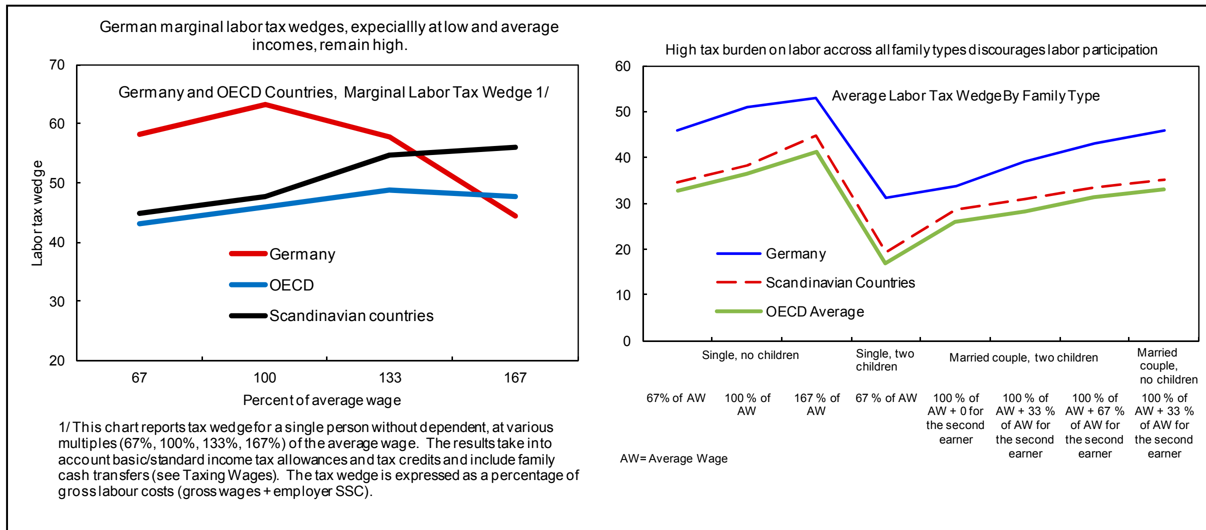
[1]*Based on Breuer, Christian, Jan Gottschalk, and Anna Ivanova: "Germany: Lessons from Past Experience"* in Chipping Away at Public Debt: Sources of Failure and Keys to Success in Fiscal Adjustment, *ed. by Paulo Mauro (forthcoming).*

29. **Staff views the proposed consolidation path as appropriate.** The German economy is on a path to close its output gap. From the European perspective, a slower pace of German consolidation will provide limited fiscal spillovers to the periphery, and elsewhere the need is less with output gaps also closing. At the same time, German debt at over 83 percent of GDP remains high, the demographic fiscal challenge lies ahead, and debt dynamics are susceptible to growth shocks and fiscal slippages. Adherence to Germany's near-structural balance rule will strengthen the credibility of that commitment. The authorities recognize that some of their proposed measures (e.g., military spending cuts), however, remain under discussion. In case the savings envisioned do not materialize, the authorities recognize that additional efforts would be required elsewhere. They also emphasized that cyclical revenue gains would not be used to finance structural measures. Staff agreed but recommended the pace of consolidation be slowed in case of a substantial negative shock to growth.

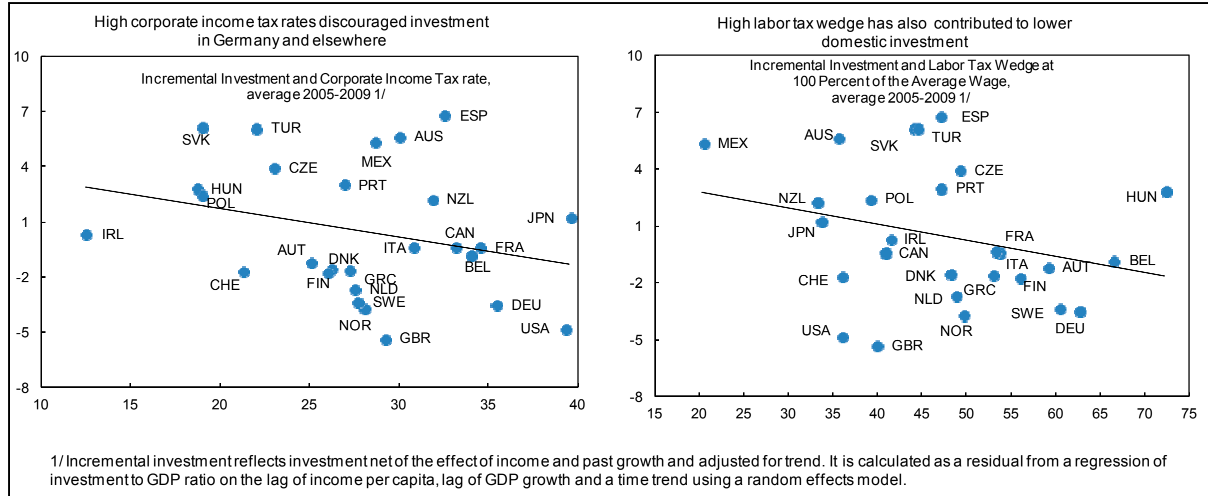
30. **From a longer-term perspective, and staying within the consolidation path, a rebalancing of public finances to promote growth is desirable.** The need to increase labor participation is evident on account of the projected decline in the workforce and the scope for doing so is validated by the Scandinavian experience. Low-skilled, female, and elderly labor force participation is low compared to Scandinavian countries, which, like Germany, also provide extensive social benefits. The German labor tax wedge is particularly high for low-income earners. The 2008 corporate income tax reform improved Germany's tax competitiveness. However, municipalities continue to rely on an inefficient and volatile trade tax with differential rates creating regional competition. The tax system also continues to favor debt over equity in corporate financing and tax constraints hinder the development of high-growth high-risk ventures. Together, these act to reduce labor and capital inputs, and hence potential growth.



1/The ratio for low eduction level (both men and women) was computed using total female and male popuation since the data on population by eduction level is not available.



1/ This chart reports tax wedge for a single person without dependent, at various multiples (67%, 100%, 133%, 167%) of the average wage. The results take into account basic/standard income tax allowances and tax credits and include family cash transfers (see Taxing Wages). The tax wedge is expressed as a percentage of gross labour costs (gross wages + employer SSC).



1/ Incremental investment reflects investment net of the effect of income and past growth and adjusted for trend. It is calculated as a residual from a regression of investment to GDP ratio on the lag of income per capita, lag of GDP growth and a time trend using a random effects model.

31. **Reducing labor taxes along the participation margins could be most effective (Box 5).** Marginal tax rate relief is best targeted at the participation margin of labor supply, and tagged to paid work. This can be implemented through the introduction of in-work credit programs for the elderly and secondary earners and an earned income tax credit for the low-income, with the possibility of a negative income tax. An alternative to the latter could be to raise the threshold for the low-income tax relief (the so-called mini-jobs) and reduce the speed at which tax benefits are withdrawn. Also, reforming the regime of income splitting for tax purposes could create better incentives for labor market participation as it would shift the marginal tax burden away from the more flexible partners towards inelastic primary earners.[2] While predicting the impact of such reforms is inherently difficult, a rough estimate suggests that tax credits for the elderly and secondary earners combined with the move to individual taxation of married couples could increase the labor force significantly (by about 900,000 people if the tax credit is 1,000 euros per person/family) with relatively small fiscal cost (0.7 percentage points of GDP). While the authorities agreed with the need to reduce the labor tax wedge, they favored a more generalized tax reduction. They also pointed to constitutional constraints regarding the elimination of income splitting and noted that improving the quality and availability of childcare is essential in stimulating the labor supply of women.

[2] Viktor Steiner and Katharina Wrohlich, 2004, "Household Taxation, Income Splitting and Labor Supply Incentives – A Microsimulation Study for Germany", DIW Discussion paper 421.

Simulation of the Impact of Tax Reforms

Income tax credit	Tax credit amount (Euros)			
	500	600	700	1000
Fiscal Cost (percent of GDP)				
Total	0.3	0.4	0.5	0.7
Elderly	0.1	0.1	0.2	0.2
Secondary Earners	0.2	0.3	0.3	0.5
Increase in the Labor Force (number)				
Total	288,000	345,000	402,000	575,000
Elderly	72,000	86,000	100,000	143,000
Secondary Earners	216,000	259,000	302,000	432,000
Elimination of Income Splitting				
Increase in the Labor Force (number)				
Total	330,000			
Women	430,000			
Men	-100,000			
Total Impact on Labor Force	618,000	675,000	732,000	905,000

32. **Further reform of the corporate income tax would also support growth.** Recent studies find that among all taxes, corporate taxes are the most harmful to economic growth, with recurrent taxes on immovable residential property being the least harmful. Despite a comprehensive reform of the corporate income tax in 2008, there is scope for improving the tax regime for enterprises. In particular, consideration should be given to abolishing the local level trade tax, and offset it by property and inheritance taxes. Also, in line with international trends, the debt bias in corporate financing could be reduced. This can be achieved by introducing an allowance for the normal return on new equity, which, while creating an initial fiscal cost, will help increase investment, wages and growth.[3] While the authorities agreed with the need to reform the trade tax and reduce the debt bias in corporate financing, they pointed out to the lack of political consensus for the former and the likely high fiscal cost of the latter, which would require a gradual approach.

33. **The proposed reductions in direct taxes might require larger revenues from indirect taxes and reductions in social entitlements.** Eliminating concessions in VAT and raising property and inheritance taxes will help bolster revenue. Staff estimates potential gains from these reforms at 3 percent of GDP. On the expenditure side, elimination of unconditional child transfers would have to be carefully designed to take into account all existing benefits and tax incentives. The evidence suggests that there is substantial scope to increase efficiency of education spending (Box 6), with which the authorities agreed, emphasizing their intentions to improve the quality of public finances in general.

[3] See de Mooij, Ruud A. "The Need for Tax Neutrality Between Debt and Equity", IMF staff discussion note (forthcoming).

Estimated Potential Revenue Gains from Tax Reforms

	Estimated potential revenue gains (percent of GDP)
Reduce VAT policy gap by half 1/	2.4
Increase Property Tax 2/	1
Total	3.4

1/ In Germany the estimated VAT policy gap is estimated at 44 percent. The VAT policy gap is defined as the difference between collections under current law, and those that would be obtained if all exemptions not consistent with best practice and all reduced rates were eliminated, in both cases assuming full compliance with the law. In Germany the VAT policy gap largely reflects reduced VAT rates.

2/ Increase in revenue from raising property taxes to yield the average ratio to GDP achieved in the United States, Canada and the United Kingdom.

Box 5. Taxation and Labor Supply[1]

- Empirical studies find that a high tax wedge significantly increases the unemployment rate by discouraging job search and making people more reluctant to accept formal jobs. Moreover, it induces trade unions to increase their wage claims, which increases the unemployment rate. For a given tax wedge, progressivity in the income tax tends to reduce involuntary unemployment since trade unions find it less attractive to claim high wages.

- The net impact of after-tax wages on formal hours worked is small for men. Women tend to be more responsive to tax rates.

- The responsiveness is larger for decisions on whether or not to take paid work. This may reflect, for instance, participation response by secondary earners (who alternatively engage in home production), the unemployed (who alternatively have access to social benefits), elderly workers (who alternatively retire early), or low skilled (who alternatively operate in the informal sector).[2]

- Studies also show that a high tax wedge may affect the amount of on-the-job training, and the willingness to work irregular hours, as well as lead to the underreporting of formal income.

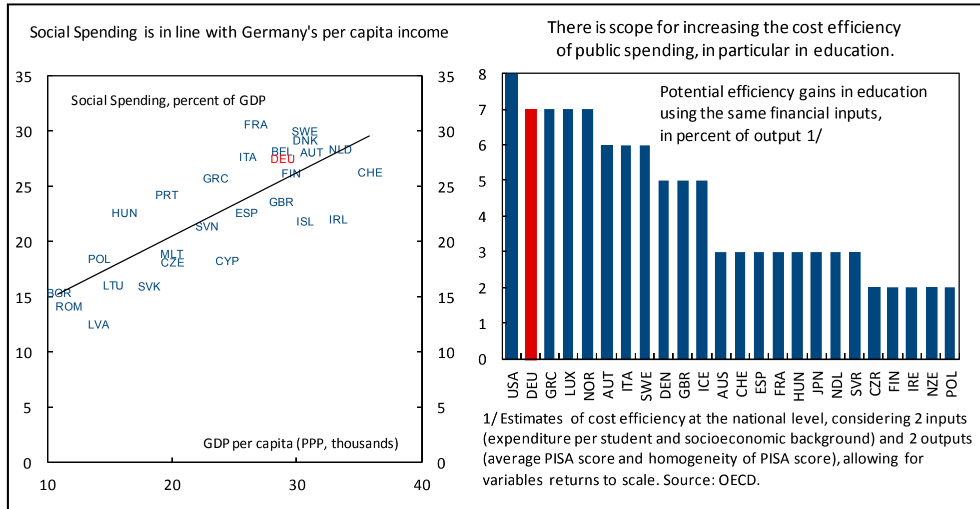
[1]Prepared by Ruud De Mooij.

[2]C. Meghir and D. Philips, 2010, Labour supply and taxes, in: Dimensions of Tax Design, The Mirrlees Review, chapter 3.

Box 6. Social Spending and the Efficiency of Public Expenditure

Social expenditures have declined recently, but they remain a significant part of overall expenditure in line with Germany's per capita income. In 2008 Germany spent 27.8 percent of GDP on social protection benefits—payments for sickness, disability, pensions, unemployment, housing, family and children's benefits. This represents a decline of 2 ¾ points from 2003, but still accounts for roughly ⅔ of public expenditure.

There is scope for increasing efficiency in public spending. Efficiency of social expenditure could be increased by the broader use of means testing instead of unconditional transfers, for example, for universal child benefits. Such measures would have to be viewed in conjunction with tax allowances. While spending on primary and secondary education in Germany is at about the OECD average, the educational attainment—as measured by scores in cross-country studies—is low, pointing to significant potential efficiency gains.



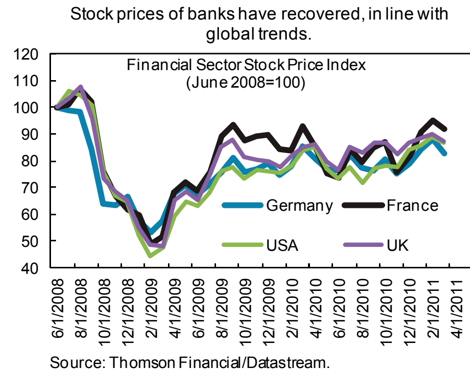
1/ Estimates of cost efficiency at the national level, considering 2 inputs (expenditure per student and socioeconomic background) and 2 outputs (average PISA score and homogeneity of PISA score), allowing for variables returns to scale. Source: OECD.

V. Financial Sector Stability

A. Status of the Financial System

34. **The banking system's return to broad stability reflects significant policy measures as well as economic recovery.** The German authorities injected significant capital into banks and provided the safety net of sovereign guarantees to access market financing. The concerted global efforts helped stabilize the international financial system, and in line with global trends, stock prices of German banks have regained much lost ground and credit default spreads have declined. Banks have raised their capital ratios (Figure 2). Asset quality has improved as banks have written-off toxic assets and experienced reduced losses in 2010. In a few cases, banks have transferred impaired assets and non-core business to winding-up institutions.

Stock prices of banks have recovered, in line with global trends.

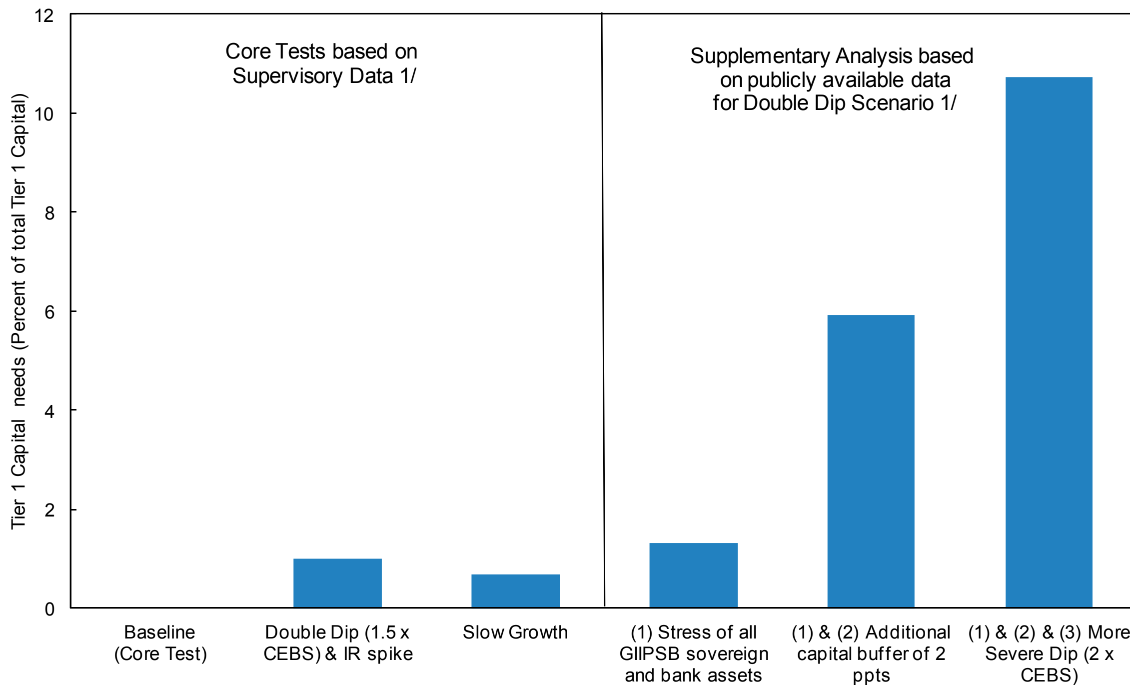


Source: Thomson Financial/Datastream.

35. **Stress tests conducted under the FSAP Update confirm that the majority of banks have sufficient capital buffers.** Solvency tests assessed the vulnerability of the banking system under two macroeconomic stress scenarios over 2011–15, (a) a sharp "double dip" recession, which leads to an inverted yield curve; and (b) a prolonged period of very low growth. A variety of risk factors, which have a potential impact for the German financial system, were considered, including, funding risks, sovereign risk, upcoming regulatory reforms, and behavioral responses. As the Financial System Stability Assessment (FSSA) notes, on the whole, the portfolios of German banks were found to be robust against cyclical fluctuations as well as direct spillover risks from peripheral sovereign debt exposure thanks to recent improvements in capitalization levels and asset quality. The results of liquidity stress tests indicate that banks can cope with large liquidity shocks, although larger banks and some specialized private banks, given their reliance on wholesale funding, appear more vulnerable than smaller retail banks, and could face higher funding costs in the future.

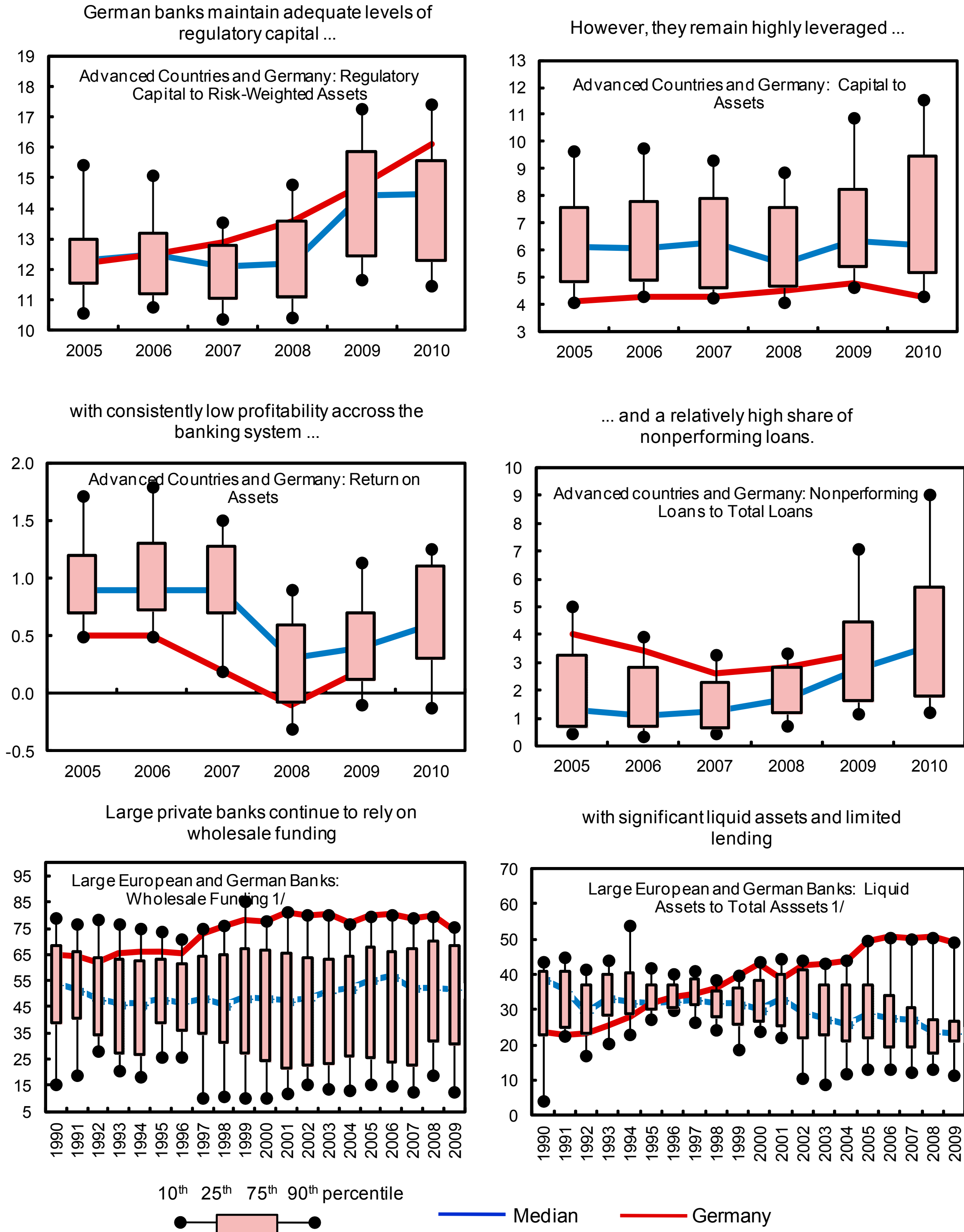
36. **However, pockets of vulnerabilities remain.** German banks remain highly leveraged and the quality of their capital is low by international standards. Their profitability is also relatively low and expected to remain so (Figure 2). While Basel III requirements are to be phased in, the market's anticipation of higher capitalization standards will create pressure particularly on the larger banks. In this setting, unanticipated impairments could require new capital raising efforts. Within this overall picture, certain banks under current stress and others that operate close to the regulatory minimum capital ratios face particular challenges. The authorities agreed with this overall assessment and noted that some banks have increased their capital and that they are closely monitoring the banks' progress on their way to complying with Basel.

Large German banks are relatively robust overall, but there are some tail risks.



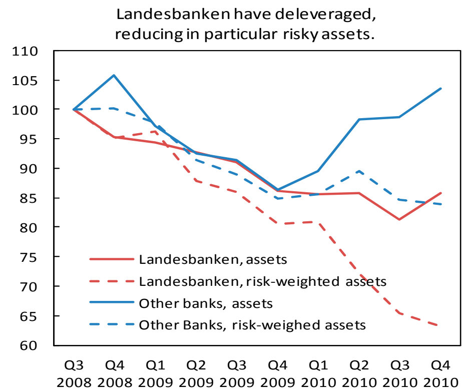
1/ The graph shows the outcome of the tests for the largest banks. The supplementary analysis for the double dip & interest rate spike scenario are based on publicly available data and thus not fully comparable with the core tests based on supervisory data. The outcome shows the capital needs by 2015 assuming that there is no policy action beforehand or a substantial change of bank behavior (other than with respect to payout or a material adjustment of business). The tests include three elements: a) Stress of sovereign debt holdings in the banking book as well as bank debt securities; b) an additional tier 1 capital buffer in 2015 of 2 percentage points and c) a more severe macroeconomic scenario corresponding to 2 times CEBS (i.e, 2.6. standard deviations in historical terms (1980-2010), accounting for the German unification).

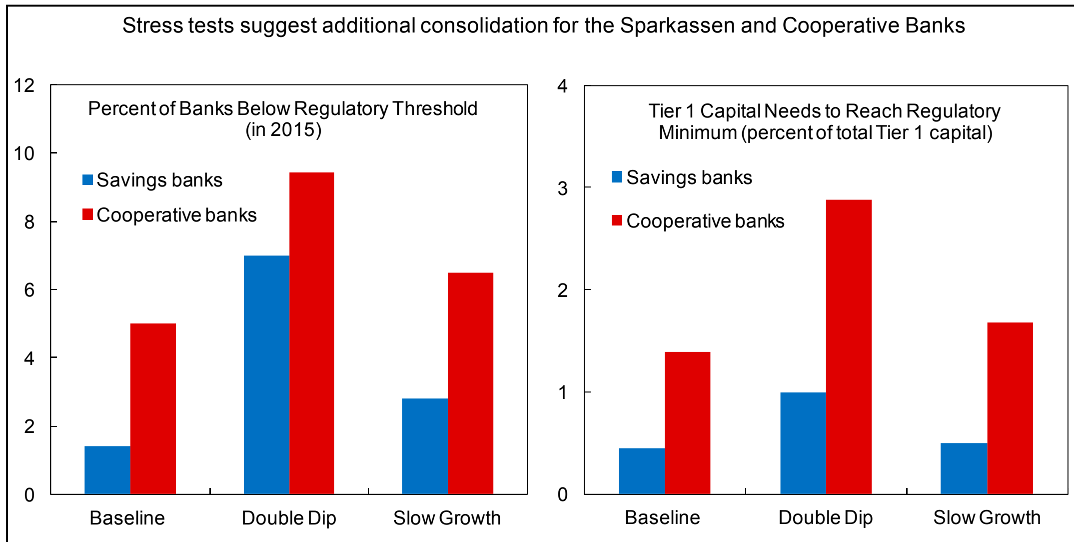
Figure 2. Germany and Advanced Countries: Financial Sector Health, 1990-2010



1/ The sample of banks included the banks that participated in CEBS stress tests in 2010 and other stock-listed European banks. For Germany the subsample includes only private banks while savings and cooperative banks, which represent a significant share of the financial system are not included. The omitted banks in Germany do not rely on wholesale funcing and maintain lower share of liquid assets.

37. **Moreover, significant long-standing structural issues remain.** In general, the *Landesbanken* problem has been punted into the future, although intensive discussions are underway with the European Commission on specific cases. While significant deleveraging has occurred, considerable work lies ahead. The authorities noted that this matter remains on the agenda and that sustainable business models are needed. However, staff encouraged a more radical approach, questioning whether *Landesbanken* were needed at all. In the interim, a greatly shrunken sector with strong capital buffers should be the goal. Moreover, in staff's view the resilience of the *Sparkassen* is being prematurely interpreted as a sign of strength despite their strong financial linkages with the *Landesbanken* and new challenges they face in an increasingly competitive European landscape. Competitive forces and changes in interest rates will also challenge the cooperative sector and especially the smaller private banks going forward. In the savings and cooperative banks, additional consolidation effects can be expected (including through distressed mergers), an outlook shared by the authorities.



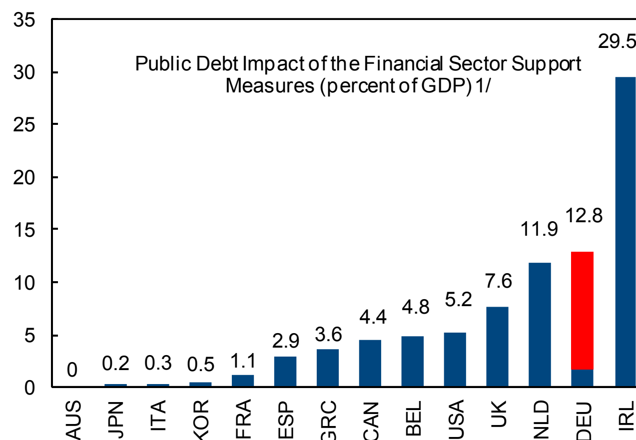


B. Managing the After-Effects of the Crisis

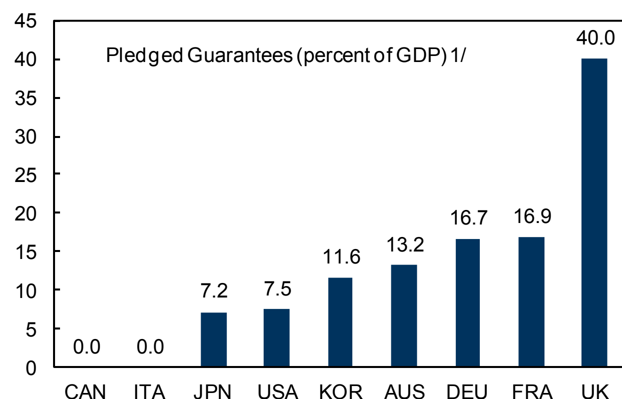
38. **The German authorities provided sizeable support to a number of financial institutions during the crisis**. Total government intervention in the financial sector as measured by the impact on public debt amounted to almost 13 percent of GDP. This includes about 1.7 percent of GDP in federal and state recapitalizations and guarantees for capital support; and the large portfolios of impaired assets/non-core business of the two winding-up institutions (and other asset run-off vehicles) at end-2010 amounted to 11.1 percent of GDP. Moreover, the federal government pledged 16¾ percent of GDP in guarantees for liquidity

support. Only less than half of that amount was issued in guarantees and most of these will be run down by end 2011.

39. **The legacy of the past crisis requires more forceful action.** Three principles should guide such further action, a view supported by the authorities. First, the objective should be to transfer the viable parts of the distressed banks back from state care to private competitive markets. This would imply a scaling back of the authorities "silent" ownership of banks. In this regard, recent developments are encouraging. Second, a more ambitious approach is needed to isolate the "good" segments of the banks' portfolios, guided by a realistic markdown of assets and a clarification of core banking business in the distressed institutions. The consequent reduction in uncertainty with regard to their viability should allow them to function as healthy institutions without state support. Finally, a plan to dispose of the "bad" assets in a deliberate manner but in a reasonable time frame must be drawn up. The international experience shows that protracted disposal of assets hurts their long-term value and recovery.



1/ Public Debt Impact of the Financial Sector Support Measures for Belgium, Germany, Greece, Ireland, the Netherlands, United States and United Kingdom as of end-December 2010, for other countries as of end-April 2010. Excludes treasury funds provided in support of central bank operations. For Germany the impact on the public debt includes portfolios of impaired assets and non-core business transferred to winding up institutions amounting to 11.1 percent of GDP. For Ireland it does not include assets purchased by the National Asset Management Agency (NAMA). The assets of bad banks in France have also not been included.



1/ For Germany as of end-December 2010, for other countries as of end-April 2010. Excludes deposit insurance provided by deposit insurance agencies.

C. Enhancing Preparedness for Future Crises

Restructuring authority and financing

40. **The new bank restructuring law is welcome and enhances the level of preparedness.** The law grants broad powers to the authorities to facilitate more timely and efficient resolution of banks that are deemed systemically relevant. The new law embodies many elements currently under discussion in European fora and is expected to be consistent with the anticipated outcome. Open questions relate to the coordination between various parties in the process of bank resolution, and to the provisions on resolution plans.

41. **The bank levy to fund the new resolution fund will build up additional resources but given its target size, interim contingency arrangements remain critical.** The envisaged calculation of the bank levy is focused on the bank's liabilities side (excluding deposits and capital) and interconnectedness (nominal derivatives positions). Measuring the latter risk remains an ongoing task, and initial contributions may be lower than expected due to a ceiling on the levy linked to bank profits. The authorities are aware of these issues and are finalizing regulations on the determination of the levy. Consideration should be given to broadening the levy to other systemic financial sector participants benefitting from a stable financial sector, such as insurance. Also, contingency arrangements for the event of a substantial need of resolution funding need clarification.

42. **According to staff, a phased unification of the deposit insurance schemes, along with synergies with the restructuring fund, would create greater certainty and stability.** The German deposit insurance regime is fragmented, and some parts lack full transparency, legal certainty, and well-defined funding modalities in line with international best practice. Also due to broad exemptions, the voluntary deposit protection and mutual guarantee schemes currently do not need to embody the minimum elements of the1994 European Union Directive. The European Commission staff has recently been in discussions with the German authorities on the removal of the exemptions for mutual guarantee schemes. As a first step to reduce these schemes' inconsistencies with the BCBS-IADI core principles,[4] the legal certainty, transparency and funding of the regime should be enhanced by providing for a harmonized and legally-binding deposit guarantee of €100,000 in all pillars. Also, the interaction between the deposit insurance schemes and the restructuring fund should be clarified. As a next step, resilience and credibility should be strengthened by limiting the high coverage promised under the voluntary schemes.

43. **The authorities recognized the relevance of the issues raised by staff but saw scope only for gradual change.** They noted that depositor confidence was maintained during the crisis and expect that issues such as lack of legal certainty, transparency, and higher *ex ante* funding, will be addressed once the discussions at the European level are completed. Staff pointed to the possible efficiency gains to be achieved by combining the resolution fund with deposit insurance under a unified approach, but the authorities prefer to keep these separate for now.

Supervision

44. **The need for more proactive supervision is a key and well-understood lesson from the last crisis.** This lesson is guiding a more forward-looking regulatory and

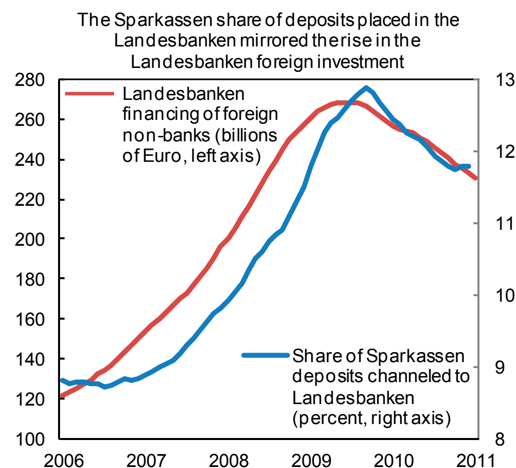
[4] See Basel Committee on Banking Supervision – International Association of Deposit Insurers Core Principles for Effective Deposit Insurance Systems.

supervisory process in Germany. In particular, for macroprudential supervision, the overall organizational structure and the needed instruments are yet to be established.

45. **Staff expressed concern that the reform of the organizational structure for financial supervision has dragged on.** After abandoning earlier plans to consolidate all prudential banking supervision into the Bundesbank, the authorities now intend to strengthen the role of Bundesbank for macro-prudential oversight based on a "10-point plan." Under this approach, the Federal Financial Supervisory Authority's (BaFin) micro-prudential integrated financial services supervision would be preserved. The authorities should proceed decisively in establishing clear structures and removing lingering uncertainty. Legal enhancements are needed to remove constraints on an expedient exchange of relevant information within and between institutions. Early consideration is needed to prevent risks slipping through the cracks. The authorities agree that further clarity is needed on the interactions between the Bundesbank, BaFin, and the European Supervisory Authorities, as well as the relationship between macro- and micro-prudential regulation.

46. **As noted by the FSSA, macroprudential instruments should be used to contain systemic risk.** While the authorities agreed with this broad objective, the specific arrangements and tools for doing so are still under consideration. The instruments under review include countercyclical capital buffers, systemic risk charges as foreseen under Basel III, and, more generally, higher levels and quality of capital (e.g., through Pillar 2 charges). The FSAP Update has estimated that, for most banks, such capital charges fall within the existing capitalization. Where needed, additional capital could be covered by contingent capital, for example.

47. **While the micro-prudential supervision framework is overall sound, there are areas where it can be improved.** The recent FSAP Update found supervision to be largely compliant with the Basel Core Principles for Effective Supervision. It recommended continued efforts along several dimensions: (a) regular stress testing of the banking and insurance sectors, for example, with respect to longer-term risks, U.S. dollar liquidity, and group-wide spillovers; (b) forward-looking assessment and action to head off vulnerabilities; (c) advance vetting of bank acquisitions of subsidiaries; and (d) timely reporting of emerging risk factors and shorter lags in the publication of financial sector data. The authorities are in broad agreement with these priorities and consider them part of their ongoing agenda.

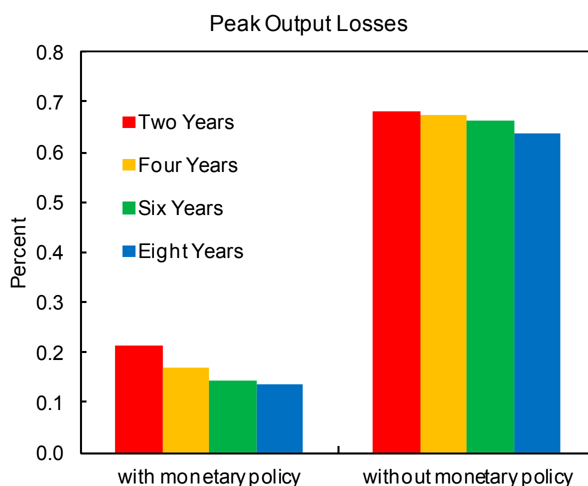


Public banks

48. **Staff outlined emerging challenges for the *Sparkassen*.** The *Sparkassen* hold a time-honored position in German banking and have

emerged from the crisis with a demonstration of stability. Nevertheless, it is not too early to consider the longer-term challenges and stability risks they face. They have sizeable exposure to the *Landesbanken*: despite their storied reputation for financing small and medium firms, the *Sparkassen* place a sizeable fraction of their deposits to the *Landesbanken*. In particular, as the *Landesbanken* rushed at the end of the previous decade to invest in dubious projects abroad, the *Sparkassen* increased the share of their deposits held with the *Landesbanken*. The *Sparkassen* are also partially responsible for *Landesbanken* losses as part owners and guarantors in a mutual protection scheme. One large *Sparkasse* faced significant financial stress during the crisis. Their valued deposit base will increasingly be under contest as European financial integration—particularly internet banking—unfolds, and adequate returns will be required on the higher and better-quality capital under Basel III. With the costs they have borne for supporting the *Landesbanken*, it is not surprising that some *Länder* have allowed for private ownership, though yet without voting rights in the case of *Sparkassen*. A gradual shift to private ownership, while carving out their public functions, will create a level playing field for their competitors challenged by new regulatory burdens (small private banks, cooperative banks). Such a gradual transfer is a tested process elsewhere in Europe and deserves serious consideration. The authorities believe that the *Sparkassen* form an integral part of the German financial system, and continued stable functioning during the crisis. Any reform would need to be considered in a medium- to long-term perspective.

Box 7. Effects of Raising Capital Adequacy Requirements



A regulatory increase in capital adequacy requirements in the European Union would generate modest output losses in Germany. In response to Basel III, commercial banks in the European Union may be expected to raise their capital ratios by about two percentage points on average over the next eight years, and to complete this adjustment well in advance of the deadline. A capital requirement shock is analogous to a permanent monetary policy shock, and is transmitted via the interest and exchange rate channels of monetary policy. Staff estimates a peak output loss in Germany of 0.14 to 0.22 percent assuming that monetary policy counteracts some part of the overall effect. Abstracting from monetary policy stabilization, the peak output loss in Germany is estimated at 0.64 to 0.68 percent.[1] The peak output loss is higher, the faster the speed of adjustment, and occurs shortly after the end of the adjustment period.

[1]These estimates are based on a 0.24 percent increase in the interest rate spread, following the Macroeconomic Assessment Group, 2010, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements," *Financial Stability Board and Basel Committee on Banking Supervision Final Report*.

VI. Staff Appraisal

49. **Enduring strengths and supportive short-term policy measures have helped achieve an impressive recovery from the crisis.** The proficiency of its industry, along with a sizeable, internationally-coordinated fiscal stimulus, targeted measures to support the labor market and stabilize the financial sector, helped bring output and employment above pre-crisis levels. Yet counteracting medium-term growth constraints and securing financial stability will be important to further build on these achievements and support economic wellbeing in Germany and elsewhere.

50. **The very success of the recovery has generated calls on Germany to play a more prominent international role.** Such a role would help assist global growth and reduce imbalances. In both respects, the scope for policy initiatives to achieve short-term gains is limited. Instead, a sustained effort will be required.

51. **Political viability of the longer-term measures requires common ground between enhanced German economic well-being and contributions to the global good.** German growth fluctuations have largely been driven by external developments. Despite a more prominent role for domestic demand in the past year, a durable rebalancing is needed. Better growth prospects (through a stepped-up growth potential particularly in the non-tradable sector) would generate a reinforcing combination of supply and demand responses. As the productive potential increases, confidence in a better future will raise the economy's notably low investment rate and boost consumption growth. Such autonomous demand would create more of an international locomotive role for Germany, while narrowing its current account surplus by addressing these underlying structural factors.

52. **The robust recovery offers a propitious context for tackling long-standing structural problems.** The commitment to fiscal consolidation is strong, and the German leadership in this area carries potential medium-term benefits for Europe. In other areas, however, the political momentum for reform appears weak. Stepping up potential growth would require important measures in areas such as tax policy and educational reform, which while widely understood, need to move up in policy priority and implementation. In financial sector policy, the new bank resolution framework is welcome, but in other long-standing matters, German authorities have been generally reactive to European initiatives. The political constraints to action will only increase if these challenges are confronted in a low-growth environment.

53. **The growth agenda must be multi-pronged but supported by specific measures to be effective.** The goal is to increase labor participation, deploy labor productively and complement it with physical investment and innovation, especially in areas outside Germany's traditional strengths. Tax policy to raise labor participation and improve the investment climate would need to be complemented by educational reform, enhanced provision of risk capital and a more efficient insolvency process.

54. **The government's fiscal consolidation path is appropriate but consolidation must build room for responding to negative surprises and for fostering growth.** With the output gap closing, longer-term considerations require lowering the public debt-to-GDP ratio to regain lost ground, enhance its fiscal credentials, and support the European Stability and Growth Pact. A reassessment of the speed of consolidation may be needed if growth turns out to be significantly weaker than expected. Moreover, space is required within the consolidation envelope for initiatives to foster a growth agenda.

55. **The financial system is broadly stable but pockets of vulnerability remain.** Improved capital ratios at banks imply that they could absorb considerable stress. Nevertheless, German banks remain highly leveraged, achieve low profitability, and the large banks remain highly dependent on market funding. These vulnerabilities apply with particular force to certain financial institutions, most prominently some *Landesbanken*. The delays in data publication and the lack of transparency in crucial areas are troubling. Moreover, while the overall level of direct exposure to the European periphery is limited, some banks are more exposed than others, and indirect effects through banks outside of Germany could have cascading effects.

56. **Forward-looking actions to limit systemic risk are required in four areas:**

- The legacy of the crisis requires continuing attention. The effort must be to carve out viable segments of the distressed banks and return them to private hands. The distressed assets should be sold at a deliberate pace, avoiding fire sales but minimizing delays that could cause the assets to lose value.

- Clarity on the regulatory and supervisory regime is overdue. To prevent risks slipping through the cracks, early consideration is needed to clarify the content of macro-prudential oversight likely to be designated to the Bundesbank, the relationship between macro- and micro-prudential regulations, and the necessary information sharing requirements.

- For the various deposit insurance schemes, a move towards common, statutory payout obligations across the pillars could be a first step to their eventual unification to realize economies of scale. Unified statutory schemes would also allow for the possibility of the use of their resources for early intervention and, hence, realize synergies with the proposed restructuring fund.

- A gradual shift of the *Sparkassen* to private ownership, while carving out their public functions, is a tested process elsewhere in Europe and deserves serious consideration.

57. It is recommended that the next Article IV consultation with Germany be held on the standard 12-month cycle, in accordance with the *Decision on Article IV Consultation Cycles* (Decision No. 14747-(10/96) (9/28/2010)).

Table 1. Germany: Selected Economic Indicators

Total area	357,041 square kilometers
Total population (2010)	81.6 million
GDP per capita (2010)	US$ 40,670

	2007	2008	2009	2010	2011 1/	2012 1/
			(Percentage change)			
Demand and supply						
Private consumption	-0.2	0.7	-0.2	0.5	1.3	1.2
Public consumption	1.6	2.3	2.9	1.9	1.4	0.6
Gross fixed investment	4.7	2.5	-10.1	6.0	8.2	3.4
Construction	-0.5	1.2	-1.5	2.9	6.7	3.5
Machinery and equipment	10.7	3.5	-22.6	10.9	11.0	3.5
Final domestic demand	1.2	1.4	-1.7	1.9	2.7	1.5
Inventory accumulation 2/	-0.1	-0.2	0.1	0.5	-0.9	-0.1
Total domestic demand	1.3	1.2	-1.9	2.4	2.1	1.5
Exports of goods and nonfactor services	7.6	2.5	-14.3	14.7	7.2	4.4
Imports of goods and nonfactor services	5.0	3.3	-9.4	13.0	5.4	3.7
Foreign balance 2/	1.6	-0.1	-3.2	1.3	1.2	0.6
GDP	2.8	0.7	-4.7	3.5	3.2	2.0
Output gap (In percent of potential GDP)	2.4	2.0	-3.8	-1.6	0.0	0.2
			(In millions of persons, unless otherwise indicated)			
Employment and unemployment						
Labor force	43.3	43.4	43.3	43.6	43.5	43.6
Employment	39.7	40.2	40.2	40.4	40.8	40.9
Unemployment 3/	3.6	3.1	3.1	3.2	2.7	2.7
Unemployment rate (in percent) 4/	8.8	7.6	7.7	7.1	6.3	6.2
			(Percentage change)			
Prices and incomes						
GDP deflator	1.7	1.3	1.3	0.7	0.2	1.1
Consumer price index (harmonized)	2.3	2.8	0.2	1.2	2.5	1.6
Average hourly earnings (total economy)	1.4	2.4	3.0	0.0	2.9	2.9
Unit labor cost (industry)	-1.8	7.6	15.7	-8.1	0.9	2.2
Real disposable income 5/	0.0	1.8	-0.9	0.8	0.8	1.1
Personal saving ratio (in percent)	10.8	11.7	11.1	11.4	11.0	10.9

Table 1. Germany: Selected Economic Indicators (concluded)

	2007	2008	2009	2010	2011 1/	2012 1/
	(In billions of euros, unless otherwise indicated)					
Public finances						
General government						
Expenditure	1,059	1,086	1,139	1,164	1,184	1,202
(In percent of GDP)	43.6	43.8	47.5	46.6	45.8	45.1
Revenue	1,066	1,088	1,066	1,082	1,135	1,172
(In percent of GDP)	43.8	43.9	44.5	43.3	43.9	44.0
Overall balance 6/	6	3	-73	-82	-49	-31
(In percent of GDP)	0.3	0.1	-3.0	-3.3	-1.9	-1.1
Structural balance	-22	-12	-24	-57	-46	-34
(In percent of GDP)	-0.9	-0.5	-1.0	-2.3	-1.8	-1.3
Federal government						
Overall balance 6/	-19	-14	-39	-57	-38	-24
(In percent of GDP)	-0.8	-0.6	-1.6	-2.3	-1.5	-0.9
General government debt	1,579	1,644	1,761	2,080	2,128	2,159
(In percent of GDP)	64.9	66.3	73.4	83.2	82.3	81.0
	(In billions of USD, unless otherwise indicated)					
Balance of payments						
Trade balance 7/	254.8	262.4	193.2	205.0	203.6	193.4
Services balance	-20.4	-17.1	-14.5	-10.6	-21.1	-24.7
Factor income balance	59.4	52.3	69.8	59.0	61.2	72.1
Net private transfers	-22.3	-24.7	-23.4	-22.3	-24.0	-24.0
Net official transfers	-22.7	-24.4	-22.6	-28.2	-32.2	-34.1
Current account	248.3	227.9	186.3	187.7	187.5	182.7
(In percent of GDP)	7.4	6.2	5.6	5.7	5.1	4.8
Foreign exchange reserves (e. o. p.) 8/	27.7	27.7	25.6	28.0	25.9	...
	(Percentage change)					
Monetary data						
Money and quasi-money (M3) 9/ 10/	10.7	9.7	-1.5	4.4	4.2	...
Credit to private sector 9/	3.3	6.6	-0.5	-1.9	-1.0	...
	(Period average in percent)					
Interest rates						
Three-month interbank rate 11/	4.3	4.6	1.2	0.8	1.1	...
Yield on ten-year government bonds 11/	4.3	4.1	3.3	2.8	3.2	...
Exchange rates						
Euro per US$ 11/	0.73	0.73	0.68	0.76	0.69	...
Nominal effective rate (1990=100) 12/	119.7	120.7	122.2	114.9	118.4	...
Real effective rate (1990=100) 13/	101.5	100.1	105.6	98.5	100.5	...

Sources: Deutsche Bundesbank; Federal Statistical Office; IMF staff estimates and projections.
1/ IMF staff estimates and projections.
2/ Growth contribution.
3/ National accounts definition.
4/ ILO definition.
5/ Deflated by the national accounts deflator for private consumption.
6/ Net lending/borrowing.
7/ Excluding supplementary trade items.
8/ Data for 2011 refer to March.
9/ Data for 2011 refer to the change in February.
10/ Data reflect Germany's contribution to M3 of the euro area.
11/ Data for 2011 refer to February.
12/ Data for 2011 refer to March.
13/ Based on relative normalized unit labor cost in manufacturing. Data for 2011 refer to February.

Table 2. Statement of Operations of the General Government

in percent of GDP	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	43.8	43.9	44.5	43.3	43.9	44.0	44.2	44.2	44.3	44.3
Taxes	23.9	24.0	23.7	22.9	23.4	23.5	23.8	23.8	23.9	23.9
Social contributions	16.5	16.4	17.1	16.8	17.0	16.9	16.9	16.8	16.8	16.8
Grants	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	3.3	3.3	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Expenditure	43.6	43.8	47.5	46.6	45.8	45.1	45.0	44.4	44.1	44.1
Expense	43.8	43.9	47.6	46.9	45.9	45.2	45.1	44.4	44.2	44.1
Compensation of employees	6.9	6.9	7.4	7.3	7.4	7.3	7.3	7.3	7.3	7.3
Use of goods and services	4.1	4.2	4.6	4.7	4.7	4.7	4.6	4.5	4.4	4.3
Consumption of fixed capital (if available)	1.6	1.6	1.7	1.6	1.7	1.4	1.4	1.3	1.3	1.3
Interest	2.8	2.7	2.6	2.4	2.4	2.3	2.5	2.5	2.5	2.4
Subsidies	1.1	1.1	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Grants	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.8
Social benefits	24.6	24.5	26.7	26.2	25.3	25.0	25.0	24.6	24.8	24.8
Other expense	1.9	2.1	2.4	2.6	2.3	2.3	2.2	2.0	1.8	1.9
Net acquisition of nonfinancial assets	-0.2	-0.2	-0.1	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0
Acquisitions of nonfinancial assets	…	…	…	…	…	…	…	…	…	…
Disposals of nonfinancial assets	…	…	…	…	…	…	…	…	…	…
Consumption of fixed capital	1.6	1.6	1.7	1.6	1.7	1.4	1.4	1.3	1.3	1.3
Gross Operating Balance	1.6	1.5	-1.4	-2.0	-0.3	0.2	0.6	1.1	1.4	1.5
Net Operating Balance	0.0	0.0	-3.1	-3.6	-2.0	-1.2	-0.9	-0.2	0.1	0.2
Net lending (+)/borrowing (–)	0.3	0.1	-3.0	-3.3	-1.9	-1.1	-0.8	-0.2	0.2	0.2
Net acquisition of financial assets	0.6	2.8	1.9	9.5	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	0.4	0.3	-0.1	2.5	…	…	…	…	…	…
Debt securities	0.1	1.5	0.3	5.1	…	…	…	…	…	…
Loans	0.0	0.4	0.2	2.3	…	…	…	…	…	…
Equity and investment fund shares	0.1	0.6	1.4	0.5	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.0	-0.7	…	…	…	…	…	…
Other accounts receivable	0.0	0.1	0.2	-0.1	…	…	…	…	…	…
Net incurrence of liabilities	0.4	2.6	4.9	12.8	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Currency and deposits	0.0	0.1	0.0	0.0	…	…	…	…	…	…
Debt securities	1.3	1.6	4.7	3.9	…	…	…	…	…	…
Loans	-1.0	0.8	0.2	8.9	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	…	…	…	…	…	…
Other accounts payable	0.1	0.1	0.0	0.0	…	…	…	…	…	…
Memorandum items:										
Structural Balance (output gap methodology)	-0.9	-0.5	-1.0	-2.3	-1.8	-1.3	-1.0	-0.3	0.1	0.2
Structural Balance (labor market methodology)	-0.6	0.2	-3.9	-3.9	-2.5	-1.6	-0.9	0.1	0.8	1.0
Public gross debt (Maastricht definition)	64.9	66.3	73.4	83.2	82.3	81.0	79.2	77.0	74.7	72.8

Sources: EUROSTAT; and IMF staff estimates.

Table 3. General Government Stock Positions

in percent of GDP	2007	2008	2009	2010
Stock positions:				
Net worth	…	…	…	…
Nonfinancial assets	…	…	…	…
Net financial worth	-42	-44	-48	-50
Financial assets	23.1	25.3	28.1	36.8
Monetary gold and SDRs	0.0	0.0	0.0	0.0
Currency and deposits	8.1	8.0	8.2	10.5
Debt securities	0.5	2.0	2.3	7.5
Loans	2.6	2.9	3.3	5.4
Equity and investment fund shares	8.3	8.7	10.4	10.6
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.1	0.1	0.1	-0.6
Other accounts receivable	3.5	3.5	3.7	3.4
Liabilities	65.4	69.2	76.4	86.8
Monetary gold and SDRs	0.0	0.0	0.0	0.0
Currency and deposits	0.3	0.4	0.4	0.4
Debt securities	47.4	50.6	56.9	59.2
Loans	17.6	18.1	18.9	27.0
Equity and investment fund shares	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0
Other accounts payable	0.1	0.1	0.2	0.1
Memorandum items:				
Publicly guaranteed debt	…	…	…	…
Debt (at market value)	…	69.2	76.4	86.8
Debt at face value	65.1	66.4	73.6	83.4
Maastricht debt	64.9	66.3	73.4	83.2
Debt (at nominal value)	…	…	…	…
Other economic flows:				
Change in net worth from other economic flows	…	…	…	…
Nonfinancial assets	…	…	…	…
Change in net financial worth from other economic flows	…	…	…	…
Financial assets	…	…	…	…
Monetary gold and SDRs	…	…	…	…
Currency and deposits	…	…	…	…
Debt securities	…	…	…	…
Loans	…	…	…	…
Equity and investment fund shares	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	…	…	…	…
Financial derivatives and employee stock options	…	…	…	…
Other accounts receivable	…	…	…	…
Liabilities	…	…	…	…
Monetary gold and SDRs	…	…	…	…
Currency and deposits	…	…	…	…
Debt securities	…	…	…	…
Loans	…	…	…	…
Equity and investment fund shares	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	…	…	…	…
Financial derivatives and employee stock options	…	…	…	…
Other accounts payable	…	…	…	…

Sources: EUROSTAT; and IMF staff estimates.

Table 4. Germany: Core Financial Soundness Indicators for Banks

(In percent)

	2005	2006	2007	2008	2009	2010 6/
Capital adequacy 1/						
Regulatory capital to risk-weighted assets	12.2	12.5	12.9	13.6	14.8	16.1
Commercial banks	11.6	12.5	13.3	13.5	14.9	15.4
Landesbanken	12.1	11.7	11.6	12.7	14.9	17.1
Savings banks	12.5	13.0	13.0	14.4	14.7	15.1
Credit cooperatives	12.1	12.2	12.9	14.2	14.0	14.7
Regulatory Tier I capital to risk-weighted assets 2/	8.0	8.2	8.5	9.5	10.8	11.8
Commercial banks	7.9	8.4	10.6	10.3	12.1	12.9
Landesbanken	7.3	7.1	7.1	8.3	10.5	12.1
Savings banks	8.0	8.4	8.4	9.5	9.7	9.9
Credit cooperatives	8.5	9.1	8.7	9.7	9.5	9.8
Asset composition and quality						
Sectoral distribution of loans to total loans						
Loan to households	28.5	27.6	25.6	24.4	26.3	26.2
Commercial banks	24.8	23.9	21.8	20.5	23.2	22.4
Landesbanken	6.8	6.2	5.2	4.9	5.2	5.4
Savings banks	62.2	61.1	58.2	56.4	57.6	57.7
Credit cooperatives	69.3	68.5	66.3	63.5	66.4	67.0
Loans to non-financial corporations	14.5	14.3	14.1	14.5	14.8	14.6
Commercial banks	13.3	12.6	12.4	12.6	12.9	12.1
Landesbanken	16.7	17.0	16.2	17.8	18.2	18.4
Savings banks	17.6	17.3	17.6	18.7	19.6	20.1
Credit cooperatives	12.0	12.1	12.4	12.7	13.6	14.3
NPLs to gross loans 5/	4.0	3.4	2.6	2.9	3.2	...
Commercial banks	3.3	2.6	1.8	2.0	2.5	...
Landesbanken	2.9	2.0	1.5	2.4	3.4	...
Savings banks	6.6	5.9	5.1	4.7	4.1	...
Credit cooperatives	7.3	6.6	5.5	5.1	4.4	...
NPLs net of provisions to capital 5/	34.6	28.6	21.6	25.3	42.4	...
Commercial banks	30.6	24.6	15.8	20.0	53.1	...
Landesbanken	25.0	16.1 4/	11.3	27.6	37.3	...
Savings banks	50.4	43.6	35.3	33.0	35.0	...
Credit cooperatives	49.0	43.0	35.9	33.3	41.9	...
Earnings and profitability						
Return on average assets (after-tax)	0.3	0.3	0.2	-0.3	-0.1	...
Commercial banks	0.5	0.3	0.5	-0.5	-0.2	...
Landesbanken	0.2	0.3	0.0	-0.4	-0.3	...
Savings banks	0.3	0.2	0.2	0.1	0.2	...
Credit cooperatives	0.5	0.5	0.3	0.2	0.3	...

Table 4. Germany: Core Financial Soundness Indicators for Banks (concluded)

(In percent)

	2005	2006	2007	2008	2009	2010 6/
Earnings and profitability (concluded)						
Return on average equity (after-tax)	9.2	7.5	4.7	-8.1	-2.0	...
Commercial banks	15.5	9.1	15.6	-15.1	-5.7	...
Landesbanken	5.6	9.7	0.9	-12.2	-8.5	...
Savings banks	5.6	5.0	4.2	2.1	4.4	...
Credit cooperatives	9.0	8.5	5.2	4.0	5.1	...
Interest margin to gross income	68.2	68.2	72.9	84.6	72.5	...
Commercial banks	55.3	61.8	66.3	94.6	63.0	...
Landesbanken	83.2	70.3	91.6	90.2	81.5	...
Savings banks	79.0	77.7	75.2	76.0	78.6	...
Credit cooperatives	74.7	65.2	71.3	69.9	76.9	...
Trading income to gross income	...	... ...	...	...	...	...
Noninterest expenses to gross income	61.0	62.3	64.9	73.4	65.1	...
Commercial banks	59.8	66.0	65.5	93.6	73.5	...
Landesbanken	59.3	53.6	61.1	54.6	51.1	...
Savings banks	66.0	65.8	69.5	68.8	66.6	...
Credit cooperatives	70.0	64.3	70.5	68.3	68.3	...
Liquidity						
Liquid assets to total short-term liabilities 3/	122.0	120.9	119.4	120.3	144.1	137.0
Commercial banks	110.7	111.8	113.0	114.8	131.1	126.2
Landesbanken	122.4	118.8	115.5	114.5	135.9	131.2
Savings banks	224.2	206.9	190.9	161.8	225.7	216.2
Credit cooperatives	181.4	174.8	167.1	146.1	204.2	203.8
Sensitivity to market risk						
Net open positions in FX to capital	6.9	6.7	6.9	6.6	5.3	4.4
Commercial banks	5.7	10.1	6.2	4.5	3.9	2.2
Landesbanken	5.6	4.2	6.6	5.2	5.5	5.5
Savings banks	11.7	10.1	10.9	12.2	9.6	9.1
Credit cooperatives	14.0	11.3	10.7	8.2	7.9	8.1

Source: Deutsche Bundesbank. The authorities provide annual data only and disseminate them once a year.

1/ A methodological break in the supervisory time series on the capital adequacy of German banks has taken place in 2007 due to changes in the regulatory reporting framework, following Basel II.

2/ 1998-2006 according to Capital Adequacy Regulation, Principle I. Since 2007 according to Solvency Regulation.

3/ 2000-2009 data compiled in accordance with IMF's FSI Compilation Guide. Data not available before 1 July 2000.

4/ Due to one off data availability, comparability of 2006 data with other years limited.

5/ A methodological break in the NPL series has taken place in 2009. Due to changes in the regulatory reporting framework for the audit of German banks.

6/ 2010 data are preliminary.

Table 5. Germany: Additional Financial Soundness Indicators

(In percent, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 11/
Deposit-taking institutions						
Capital to assets	4.1	4.3	4.3	4.5	4.8	4.3 11/
Commercial banks	4.4	4.4	4.3	5.0	5.4	4.1 11/
Landesbanken	4.0	3.8	3.7	3.8	4.7	3.9 11/
Savings banks	4.6	4.8	4.9	5.0	5.2	5.4
Credit cooperatives	5.4	5.6	5.5	5.3	5.2	5.5
Geographical distribution of loans to total loans						
Germany	75.2	72.6	71.1	71.2	72.9	...
EU-member countries	17.3	19.5	20.4	20.2	19.5	...
Others	7.5	7.9	8.5	8.6	7.6	...
FX loans to total loans	10.2	10.5	11.5	12.2	11.5	...
Personnel expenses to noninterest expenses	55.1	56.4	54.7	53.4	54.7	...
Commercial banks	50.7	52.5	51.7	47.6	49.4	...
Landesbanken	50.5	55.0	51.7	49.7	51.0	...
Savings banks	61.8	61.5	58.5	61.1	62.4	...
Credit cooperatives	60.1	60.9	59.8	61.0	61.9	...
Trading and fee income to total income	31.8	31.8	27.1	15.4	27.5	...
Commercial banks	44.7	38.2	33.7	5.7	37.0	...
Landesbanken	16.8	29.7	8.4	9.8	18.5	...
Savings banks	21.0	22.3	24.8	24.0	21.4	...
Credit cooperatives	25.3	34.8	28.7	30.1	23.1	...
Funding						
Customer deposits to total (non-interbank) loans	71.8	75.2	76.2	77.7	76.5	73.6
Commercial banks	85.5	95.7	92.6	90.7	89.7	84.9
Landesbanken	40.6	42.9	45.7	44.1	34.6	31.5
Savings banks	102.2	103.3	105.4	108.3	109.9	106.9
Credit cooperatives	113.6	113.1	114.7	119.6	122.7	119.0
Deposits/total assets	65.8	66.0	66.9	67.3	67.3	60.8 11/
Commercial banks	76.5	76.7	76.6	76.5	77.2	58.6 11/
Landesbanken	57.3	59.6	62.0	61.3	58.5	52.6 11/
Savings banks	86.3	85.7	85.2	85.8	86.8	86.7
Credit cooperatives	84.6	83.3	83.0	83.8	85.4	85.9
Interbank assets/total assets	40.7	41.7	43.1	43.3	41.3	35.0 11/
Commercial banks	41.3	43.0	45.1	45.5	43.2	32.6 11/
Landesbanken	57.0	55.6	55.4	51.3	47.7	39.1 11/
Savings banks	25.2	25.4	26.4	27.9	26.9	25.3
Credit cooperatives	27.0	27.1	28.2	30.6	29.9	28.2

Table 5. Germany: Additional Financial Soundness Indicators (concluded)
(In percent, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 11/
Funding (concluded)						
Interbank liabilities/total assets	28.3	28.4	29.1	28.7	26.7	23.4 11/
Commercial banks	37.6	36.8	35.7	35.1	32.2	24.3 11/
Landesbanken	33.1	35.8	38.8	34.7	30.6	27.0 11/
Savings banks	22.3	21.2	20.1	19.4	18.8	17.4
Credit cooperatives	13.2	12.8	13.2	14.8	15.5	14.1
Securitized funding/total assets	...	...	...	...	...	...
Loans/assets	43.8	42.5	41.2	40.6	42.1	...
Commercial banks	41.4	39.5	38.1	36.1	38.5	...
Landesbanken	32.0	32.6	32.5	35.2	36.5	...
Savings banks	60.4	59.9	59.1	59.0	59.9	...
Credit cooperatives	59.8	59.2	58.1	56.4	56.5	...
Securities holdings/assets	23.0	23.5	23.0	22.5	23.5	...
Commercial banks	19.8	19.7	18.0	18.5	19.2	...
Landesbanken	21.4	23.2	22.7	22.1	23.6	...
Savings banks	26.8	26.3	24.9	25.0	26.8	...
Credit cooperatives	24.1	24.1	23.5	23.9	27.5	...
Off-balance sheet operations to total assets	...	...	...	...	...	...
of which: interest rate contracts	...	...	...	...	...	...
of which: FX contracts	...	...	...	...	...	...
Spread between highest and lowest interbank rates 7/	2.0	2.6	4.6	10.5	15.0	...
Spread between reference loan and deposit rates 8/	353	317.0	285.0	273	342.0	...

Source: Deutsche Bundesbank. The authorities provide annual data only and disseminate them once a year.

1/ Indicator compiled according to definitions of the Compilation Guide on FSIs.
2/ Total debt to corporate gross value added.
3/ Return defined as net operating income less taxes, where net operating income and taxes are compiled according to the FSI Compilation Guide.
4/ Invested capital estimated as balance sheet total less other accounts payable (AF.7 according to ESA 1995).
5/ Excluding principal payments.
6/ Resident enterprises that filed for bankruptcy.
7/ Spread between highest and lowest three month money market rates as reported by Frankfurt banks (basis points).
8/ Spread in basis points.
9/ Profits after tax devided by equity.
10/ Residential property index (yearly average, 2005 = 100); aggregation of data for new dwellings and resale is not available.
11/ 2010 data are preliminary. Please note that in 2009 the accounting rules followed by banks (MFIs) in Germany were amended by the Act Modernising Accounting Law (BilMoG). German banks (MFIs) are affected beginning with the figures for December 2010. The main effect is that all derivatives acquired for trading purposes must now be reported on a gross basis on the balance sheet.

Table 6. Germany: Medium-Term Balance of Payments, 2008—16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Projections					
	(In billions of USD, unless otherwise indicated)								
Current account	228	186	188	187	183	186	184	172	153
In percent of GDP	6.2	5.6	5.7	5.1	4.8	4.8	4.6	4.2	3.7
Trade balance	262	193	205	204	193	193	191	183	169
Exports	1,448	1,119	1,263	1,448	1,516	1,581	1,647	1,717	1,790
Imports	-1,186	-926	-1,058	-1,244	-1,323	-1,388	-1,456	-1,535	-1,621
Nonfactor services	-17	-15	-11	-21	-25	-28	-31	-36	-43
Exports	259	233	240	262	275	287	299	312	325
Imports	-276	-248	-251	-284	-300	-315	-330	-348	-368
Balance on factor income	52	70	59	61	72	79	85	88	90
Credit	288	249	231	305	340	372	404	433	462
Debit	-235	-179	-172	-243	-267	-292	-319	-346	-371
Current transfers, net	-49	-46	-51	-56	-58	-60	-61	-62	-63
Capital and financial accounts	-236	-202	-175	-187	-183	-186	-184	-172	-153
Capital account, net	0	0	-1	0	0	0	0	0	0
FDI, net	-73	-41	-59	-68	-72	-73	-75	-77	-78
Portfolio investment, net	31	-98	-189	-210	-217	-223	-228	-232	-236
Other	-191	-68	76	91	106	111	119	136	160
Reserve assets	-3	4	-2	0	0	0	0	0	0
Errors and omissions	8	16	-13	0	0	0	0	0	0

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

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2011 Article IV Consultation—Informational Annex

Prepared by the European Department

June 9, 2011

Contents Page

I. Fund Relations 2
II. Statistical Issues 6

ANNEX I. GERMANY: FUND RELATIONS
(As of April 30, 2011)

Mission: May 4 to May 17, 2011 in Frankfurt, Bonn, Mannheim, Munich and Berlin. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2011/051711.htm. A one day conference, attended by officials from various ministries, the Bundesbank, representatives from research institutes and academia, was organized jointly with the Ministry of Finance at the conclusion of the mission and helped amplify key issues of the consultation in the public debate.

Staff team: Messrs. Kähkönen (Head), Mody, Ms. Ivanova, and Messrs. Bornhorst, and Sandri (all EUR), Brockmeijer, and Schmieder (MCM), Vitek (SPR), and Ms. Luedersen (LEG).

Country interlocutors: The *Bundesbank* President Weidman, Director General at the Ministry of Finance Kerber, members of the German Council of Economic Experts, and senior representatives at the Chancellery, several ministries, the *Bundesbank*, and *BaFin*. Mr. Temmeyer, Executive Director for Germany, also participated in the discussions. Additional meetings took place with research institutes, law firms, and financial market participants.

Fund relations: The previous Article IV consultation discussions took in February 2010 and the staff report was discussed by the Executive Board on March 30, 2010. The Executive Board's assessment and staff report are available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=23762.0

I. **Membership Status:** Joined August 14, 1952; Article VIII.

II.	**General Resources Account:**	**SDR Million**	**Percent of Quota**
	Quota	14,565.50	100.00
	Fund holdings of currency	10,648.48	73.11
	Reserve position in Fund	3,917.09	26.89
	Lending to the Fund	1,532.42	

III.	**SDR Department:**	**SDR Million**	**Percent of Allocation**
	Net cumulative allocation	12,059.17	100.00
	Holdings	11,801.38	97.86

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				
	2011	**2012**	**2013**	**2014**	**2015**
Principal					
Charges/Interest	0.79	1.55	1.55	1.55	1.55
Total	0.79	1.55	1.55	1.55	1.55

VII. **Exchange Rate Arrangement:**

Germany's currency is the euro, which floats freely and independently against other currencies.

Germany is an Article VIII member and maintains an exchange system free of restrictions on payments and transfers for current international transactions. It maintains measures adopted for security reasons, which have been notified to the Fund for approval in accordance with the procedures of Decision 144 and does so solely for the preservation of national or international security.

VIII. **Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT)**

An assessment under the international standard for AML/CFT was conducted by the Fund's Legal Department in May 2009. The detailed assessment report was adopted by the joint MENAFATF-FATF Plenary Meeting held in Abu Dhabi from February 17–19, 2010. The report concluded that, despite Germany introducing a number of measures in recent years to strengthen its AML/CFT regime, the AML/CFT framework is not fully in line with the standard. There are weaknesses in the legal framework and in sanctioning for non-compliance with AML/CFT requirements. The recommendations to address these include:

- amending the Criminal Code to: criminalize (i) ML in a way that covers all serious predicate offenses, and (ii) TF in a way fully consistent with international standards;
- amending the AML Act to: (i) improve preventive measures notably by imposing a reporting obligation based on suspicion rather than knowledge and that relates to the proceeds of criminal activity; and (ii) clearly establish that the FIU should carry out more of the core functions of an FIU as contemplated by the FATF standard;
- fully and effectively implementing the UN Security Council Resolutions (UNSCRs) on TF;
- applying sanctioning powers more effectively for breaches of AML/CFT obligations;
- strengthening the effective implementation of AML/CFT obligations imposed on designated non-financial businesses and professions (DNFBPs); and
- improving the collection of statistics and the provision of guidance and feedback to FIs.

Germany has made a clear commitment to further strengthen the national system for the prevention, detection and suppression of money laundering and terrorist financing.

IX. Staff Analytical Work on Germany, 2003-11

Growth, Current Account and Competitiveness

- Growth Linkages within Europe, *IMF Country Report No. 08/81.*
- Economic Impact of Shortages of Skilled Labor in Germany, *IMF Country Report No. 08/81.*
- What explains Germany's Rebounding Export Market Share? *CESifo Working Paper No. 1957.*
- Long-run Growth in German, *IMF Country Report No. 06/17*.
- Does Excessive Regulation Impede Growth in Germany? *IMF Country Report No. 06/17*.
- The Performance of Germany's Non-Financial Corporate Sector – An International Perspective, *IMF Country Report No. 06/17*.
- 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*.
- After the Crisis: Lower Consumption Growth but Narrower Global Imbalances? *IMF Working Paper No. 10/11.*
- The Crisis Impact on Potential Growth in Germany: The Nature of the Shock Matters, forthcoming.
- German Productivity Growth: an Industry Perspective, forthcoming.
- International and European Growth Spillovers: the Role of Germany, forthcoming.
- Current Account Imbalances: How much can structural policies help reduce Germany's surplus, forthcoming.

Inflation

- Inflation Smoothing and the Modest Effect of VAT in Germany, *IMF Working Paper No. 08/175.*
- Simulating Inflation Forecasting in Real-Time: How Useful Is a Simple Phillips Curve in Germany, the U.K., and the U.S.? *IMF Working Paper No. 10/52*.

Fiscal Policy and Entitlement Programs

- Tax Reform and Debt Sustainability in Germany: An Assessment Using the Global Fiscal Model, *IMF Country Report No. 06/436.*
- Business Tax Reform, *IMF Country Report No. 06/436.*
- Why is Germany's Deficit so Large? *IMF Country Report No. 06/17*.
- A Preliminary Public Sector Balance Sheet for Germany, *IMF Country Report No. 06/17*.
- Germany: A Long-Run Fiscal Scenario Based on Current Policies, *IMF Country Report No. 06/17*.

- Pensions and Growth, *IMF Country Report No. 04/340*.
- Federalism and the Political Economy of Adjustment, *IMF Country Report No. 04/340*.
- Do Fiscal Spillovers Matter? *forthcoming*

Labor Markets

- The Employment Effects of Labor and Product Markets Deregulation and their Implications for Structural Reform, *CESifo Working Paper No 1709, May 2006*.
- 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*.
- What Does The Crisis Tell Us About The German Labor Market? *Forthcoming*.

The Financial System

- Landesbanken: A Measure of the Costs for Taxpayers, *IMF Country Report No. 06/436.*
- The German Banking Sector: Credit Decline, Soundness and Efficiency, *IMF Country Report No. 06/17*.
- 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*.

Corporate Governance

- Germany's Corporate Governance Reforms: Has the System Become Flexible Enough? *IMF Working Paper No. 08/179*.

ANNEX II. GERMANY: STATISTICAL ISSUES

Data provision is adequate for surveillance. Germany has a full range of statistical publications and subscribes to the Fund's Special Data Dissemination Standard (SDDS). A ROSC Data Module report was published in January 2006. 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. The 2005 ROSC Data Module mission found that the macroeconomic statistics generally follow internationally accepted standards and guidelines on concepts and definitions, scope, classification and sectorization, and basis for recording. However, the sources for estimating value added for a few categories of service industries could be improved. A direct source for quarterly changes in inventories, which is an important indicator of changes in GDP over the business cycle, is lacking. There is no systematic, proactive process to monitor the ongoing representativeness of the samples of local units and products between rebases of the producer price index.

Comprehensive data reporting systems support the accuracy and reliability of the government finance and balance of payments statistics. However, although explanatory documentation exists, differences between the general government data in the *ESA95* classification and the general government cash data on an administrative basis is impairing fiscal analysis; Germany publishes—through Eurostat—general government revenue, expenditure, and balance on an accrual basis on a quarterly basis (*ESA95*) and submits annual data for publication in the *Government Financial Statistics Yearbook,* in *GFSM 2001* format. Monthly data are only disseminated on a cash-basis.

Germany has been participating in the financial soundness indicators (FSIs) project since its inception. Annual data for most of the 40 FSIs are posted on the FSI website with effect from 2005 and quarterly data with effect from the fourth quarter of 2008. The last data available relate to the third quarter of 2010, suggesting that timeliness needs some improvement.

Germany: Table of Common Indicators Required for Surveillance

(As of May 24, 2011)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items	
						Data Quality–Methodological soundness[8]	Data Quality–Accuracy and reliability[9]
Exchange Rates	05/24/2011	05/24/2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 11	May 11	M	M	M		
Reserve/Base Money	April 11	May 11	M	M	M		
Broad Money	April 11	May 11	M	M	M		
Central Bank Balance Sheet	April 11	May 11	M	M	M		
Consolidated Balance Sheet of the Banking System	March 11	May 11	M	M	M		
Interest Rates[2]	May 11	May 11	M	M	M		
Consumer Price Index	April 11	May 11	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 10	May 11	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government (cash basis)	April 11	May 11	M	M	M		
Stocks of General Government and Government-Guaranteed Debt[5]	December 10	May 11	A	A	A		
External Current Account Balance	March 11	May11	M	M	M	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	March 11	May11	M	M	M		

Germany: Table of Common Indicators Required for Surveillance (concluded)

(As of May 24, 2011)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items	
						Data Quality–Methodological soundness[8]	Data Quality–Accuracy and reliability[9]
GDP/GNP	Q1 11	May 11	Q	Q	Q	O, O, O, O	LO, O, O, O, O
Gross External Debt	December 10	May 11	Q	Q	Q		
International Investment Position[6]	December 10	May 11	Q	Q	Q		

[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] Includes external gross financial asset and liability positions vis-a-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC (published on January 18, 2006, and based on the findings of the mission that took place during July 5–20, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning methodological soundness, namely, (i) concepts and definitions, (ii) scope, (iii) classification/sectorization, and (iv) basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 8, except referring to international standards concerning accuracy and reliability, namely, (i) source data, (ii) assessment of source data, (iii) statistical techniques, (iv) assessment and validation of intermediate data and statistical outputs, and (v) revision studies.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/87
FOR IMMEDIATE RELEASE
July 12, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Germany

On July 6, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

In the first quarter of 2011 German GDP surpassed its pre-crisis level following growth of 3½ percent in 2010, and employment is higher than before the crisis. Staff projects the economy to expand by a healthy 3 percent in 2011, but growth is expected to slow as the fiscal consolidation takes hold, the output gap closes, and world trade growth decelerates. While Germany escaped the crisis with little permanent damage, its long-term growth prospects remain low (about 1¼ percent annually).

Rising commodity prices will temporarily lift German headline inflation from 1.2 percent in 2010 to 2½ percent in 2011. Core inflation, however, is projected to rise only moderately. Germany's current account surplus, which rose to about 7½ percent of GDP just before the Great Recession, has since receded to about 5 percent of GDP.

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The authorities injected a sizeable fiscal stimulus in 2009–2010 to counteract the economic downturn. With the economic recovery, they are moving towards a gradual consolidation. The pace of the recovery and the consolidation efforts imply that the objective of the European Union's Stability and Growth Pact (SGP), to bring the deficit below 3 percent of GDP, can be achieved in 2011. The goal of the national fiscal rule, which targets a close-to-zero structural fiscal balance at the Federal level by 2016, is also within reach. The increased primary surplus will help bring down the debt-to-GDP ratio from its current level of over 83 percent of GDP (having been boosted recently by banking sector support) to 73 percent of GDP by 2016.

The banking system's return to broad stability reflects both the significant policy measures and the economic recovery. The German authorities injected significant capital into banks and provided the safety net of sovereign guarantees to access market financing during the crisis. In 2010 banks have raised their capital ratios and asset quality has also improved. However, pockets of vulnerabilities remain. Banks continue to be highly leveraged and the quality of their capital is low by international standards. Their profitability is also relatively low and expected to remain so.

Executive Board Assessment

Executive Directors welcomed Germany's impressive recovery buoyed by the strength of the export sector and supportive policies, including a fiscal stimulus and targeted measures to support the labor market and stabilize the financial sector. Directors underscored, however, the importance of structural measures targeting labor, capital, and productivity to raise medium-term potential growth and domestic demand, particularly in the non-tradable sector, which would also support the role of Germany as an international locomotive and contribute to a reduction of global imbalances.

Directors observed that a multi-pronged agenda that tackled long-standing structural issues could raise potential output growth. The implementation of such an approach, whose goal would be to boost labor participation, domestic investment, and productivity, would include tax, education, and innovation policies, complemented by an enhanced provision of risk capital and a more efficient insolvency process.

Directors noted that the government's fiscal consolidation path, while appropriate, needs to allow room for fostering growth. They observed that, with the output gap closing, lowering the public debt-to-GDP ratio will enhance credibility and support the European SGP. Directors noted, however, that a reassessment of the speed of consolidation may be needed if growth turns out to be significantly weaker than expected. They also observed that the use of fiscal instruments for stimulating growth should stay within the planned consolidation path.

Directors considered that the German financial system has stabilized, although pockets of vulnerability remain. Improved capital ratios imply that the banks could absorb considerable stress. Nonetheless, Directors noted that German banks remain highly leveraged, achieve low profitability, and the large banks remain highly dependent on market funding. While the overall level of direct exposure to spillover risks from elsewhere in Europe is limited, some banks are more exposed than others and indirect effects through banks outside of Germany could have cascading effects. Directors also encouraged a more timely publication of key financial data and enhanced transparency of the regulatory and supervisory regime, the operations of public sector banks, and the deposit insurance schemes.

Directors stressed that actions to limit systemic risk in the financial system are required in a number of areas. First, the legacy of the crisis needs to be addressed, including establishing viable business models for the *Landesbanken*. Second, the regulatory and supervisory regime should be strengthened through clarification of the content of macro-prudential oversight, the relationship between macro- and micro-prudential regulations, and the necessary information sharing requirements. In this context, ensuring adequate and high-quality bank capitalization is important, especially where systemic risk considerations arise. Third, harmonization of the various deposit insurance schemes would allow for the possibility of the use of their resources for early intervention and help realize synergies with the restructuring fund. Finally, the role of the *Sparkassen* would need to be considered in the context of an integrated and competitive European financial system.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Germany is also available.

Germany: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 1/	2012 1/
Economic activity and prices	(Change in percent, unless otherwise noted)						
Real GDP	3.6	2.8	0.7	-4.7	3.5	3.2	2.0
Net exports 2/	1.1	1.6	-0.1	-3.2	1.3	1.2	0.6
Total domestic demand	2.4	1.3	1.2	-1.9	2.4	2.1	1.5
Private consumption	1.4	-0.2	0.7	-0.2	0.5	1.3	1.2
Gross fixed investment	8.0	4.7	2.5	-10.1	6.0	8.2	3.4
Construction investment	4.9	-0.5	1.2	-1.5	2.9	6.7	3.5
Gross national saving (percent of GDP)	24.4	26.1	25.2	23.2	23.6	24.1	24.1
Gross domestic investment (percent of GDP)	18.2	18.7	19.0	17.6	17.9	19.0	19.4
Labor force 3/	43.2	43.3	43.4	43.3	43.6	43.5	43.6
Employment 3/	39.0	39.7	40.2	40.2	40.4	40.8	40.9
Standardized unemployment rate (in percent)	10.2	8.8	7.6	7.7	7.1	6.3	6.2
Unit labor costs (industry)	-3.9	-1.8	7.6	15.7	-8.1	0.9	2.2
GDP deflator	0.2	1.7	1.3	1.3	0.7	0.2	1.1
Harmonized CPI index	1.8	2.3	2.8	0.2	1.2	2.5	1.6
Public finance	(In percent of GDP)						
General government balance 4/	-1.6	0.3	0.1	-3.0	-3.3	-1.9	-1.1
Structural government balance	-2.2	-0.9	-0.5	-1.0	-2.3	-1.8	-1.3
General government gross debt	67.6	64.9	66.3	73.4	83.2	82.3	81.0
Money and credit	(Change in percent over 12 months)						
Private sector credit 5/	3.4	3.3	6.6	-0.5	-1.9	-1.0	...
M3 6/	4.9	10.7	9.7	-1.5	4.4	4.2	...
Interest rates	(Period average in percent)						
Three month interbank rate 7/	3.1	4.3	4.6	1.2	0.8	1.1	...
Ten-year government bond yield 7/	3.8	4.3	4.1	3.3	2.8	3.2	...
Balance of payments	(In billions of USD, unless otherwise noted)						
Exports 8/	1,324.9	1,573.6	1,706.9	1,352.3	1,503.3	1,710.4	1,791.1
Imports 8/	1,163.0	1,339.2	1,461.6	1,173.7	1,308.9	1,528.0	1,622.4
Trade balance (percent of GDP) 9/	6.3	7.6	6.6	5.3	5.7	5.5	5.1
Current account balance	182.1	248.3	227.9	186.3	187.7	187.5	182.7
Current account (percent of GDP)	6.2	7.4	6.2	5.6	5.7	5.1	4.8
Exchange rate	(Period average)						
Euro per US dollar 7/	0.80	0.73	0.73	0.68	0.76	0.69	...
Nominal effective rate (1990=100) 7/	114.9	119.7	120.7	122.2	114.9	118.4	...
Real effective rate (1990=100) 5/ 10/	100.2	101.5	100.1	105.6	98.5	100.5	...

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

1/ IMF staff estimates and projections.
2/ Contribution to GDP growth.
3/ National accounts definition.
4/ Net lending/borrowing.
5/ Data for 2011 refer to February.
6/ Reflects Germany's contribution to M3 of the euro area. Data for 2011 refer to March.
7/ Data for 2011 refer to April.
8/ Goods and services.
9/ Trade in goods, including supplementary trade items.
10/ Based on relative normalized unit labor cost in manufacturing.

Statement by Hubert Temmeyer, Executive Director for Germany
July 6, 2011

I thank the staff for well-balanced reports and convey my authorities' appreciation of an open and constructive exchange of views during the Article IV and FSAP missions. My authorities broadly share the staff's assessment of the current macroeconomic situation and the prospects of the German economy for 2011 and 2012. Furthermore, the staff convincingly outlines the future policy challenges for continued and sustainable economic growth which largely coincide with my authorities' policy agenda. The following comments are meant to emphasize the main thrust of the latter and the more nuanced perspective my authorities would like to add to the staff's assessment in a few areas, in particular with regard to Germany's contribution to global growth. In this context, my authorities believe that stability and sustainability considerations should be better acknowledged.

The FSAP findings underline the strengthening of financial sector stability in Germany. The banking system has enhanced its resilience and capitalization, and solvency of insurers remains adequate. At the same time, the staff rightly points to persisting risks for financial stability. Going forward, further progress in strengthening the German financial system will be achieved on the back of a strong economic recovery which has evolved into a broad-based upturn.

Public finances

As is laid down in the staff paper, fiscal consolidation is clearly of overarching importance to my authorities. In the past two decades, the level of public debt has seen two major expansions each following extraordinary events – the German reunification and the global financial crisis – and there is a clear commitment and understanding across the main political parties and, importantly, the German public to significantly lower public debt at all levels of the German federal state. This is a demanding process which has gained momentum with the agreement on the inclusion of the widely and openly discussed "debt brake" (Schuldenbremse) into the German constitution now being implemented starting with FY 2011. My authorities are well aware of the positive spill-over effects that strict budget consolidation in Germany entails for the credibility of EU fiscal rules and budget consolidation in Europe in general.

Germany's international role

This year's staff report has put special emphasis on Germany's role in the world economy. My authorities entirely share the staff's analysis that Germany can best contribute to global economic growth and financial stability by safeguarding internal stability through sound public finances, a fiscal and economic framework conducive to growth, and a stable and sound financial system.

Since Germany's current account surplus has been subject to some international attention, it is noteworthy that it saw a significant reduction since 2008. This trend might continue as projected in the staff report and the recent WEO update. The development of

Germany's external account is largely explained by a multitude of private business decisions in Germany and abroad and is not the result of targeted policy measures. In fact, attempts to single out certain areas for policy action may even turn out to be counterproductive with regard to the actual outcome. For instance, I fully agree with the staff that raising wages in Germany as a means to reduce German competitiveness would neither be an analytically nor a pragmatically sound approach. Even the staff's suggestions for policy measures aimed at raising domestic investment, with which I broadly agree, might turn out to be ambivalent with regard to their impact on the external account. To be sure, increasing investment will generate additional demand in the first round. However, a strengthening in Germany's potential output might also foster international competitiveness and increase exports which then could hardly be considered as being an undesirable outcome.

The staff's assessment of spillovers to and from Germany somewhat appears to play down the country's contribution to growth in other countries. In this regard, the international debate tends to focus on Germany's domestic demand and private consumption. However, unlike some of its comparators, Germany has not experienced any major asset bubble or rather skewed consumption-savings proportions of private households in recent years. Private consumption in Germany proved to be very resilient during the global crisis with a reduction of only 0.2 percent in 2009 against the background of subdued negative wealth effects and household indebtedness. The staff's analysis should be more sensitive to such sustainability considerations and its positive effects. Furthermore, important automatic stabilizers inherent to the German social and economic model and significant and targeted labor market measures have stabilized household incomes. All this has helped to sustain domestic demand throughout the global crisis to the benefit of the European and global economy.

Since there are no major imbalances in the real economy and in view of very buoyant labor market developments, domestic demand and private consumption are making major contributions to growth in the current upswing. Indeed, the contribution to growth from domestic demand was twice that from net exports in the first quarter of 2011. Moreover, taking into account the size of its economy and its high degree of trade integration, Germany's relative contribution to sustainable growth may actually be much larger than indicated by its "autonomous" impulses as calculated by staff. This holds not only true for trade linkages, but also with regard to positive spill-over and second round effects arising from German FDI not least in CEE countries. That said my authorities share the staff's view that domestic demand could be further strengthened through the implementation of continued growth-enhancing structural reforms.

A fiscal and economic framework conducive to growth

The staff provides for a fair account of the German labor market by emphasizing the declining structural unemployment rate following significant labor market reforms earlier in the last decade while outlining that higher labor market participation should be a policy priority. In this regard, my authorities will consider lowering personal income tax rates as a transparent measure to narrowing the tax wedge, in particular for lower and medium incomes, as soon as this can be achieved with due regard to fiscal consolidation

needs. Tax policy, however, is only one element amongst others and labor market participation also crucially depends on the overall infrastructure, including the availability of child care facilities. Important steps have already been taken in this regard, also with a view to improving the educational system.

As regards corporate taxes, Germany has already implemented a comprehensive set of measures over the past decade which significantly decreased the rates of those taxes considered the most damaging for growth. This includes the lowering of personal income tax rates and, as part of the comprehensive corporate tax reform in 2008 which resulted in major tax cuts for the corporate sector, the lowering of the corporate income tax (*Körperschaftsteuer*). My authorities agree in principle with the staff's recommendation to reform the financing of the municipal level by replacing the – locally set – trade tax with other means of financing. However, a respective reform proposal did not find the majority across municipalities. In a different vein, the staff's views on the usefulness of introducing a tax allowance for tax equity could not convince my authorities since evidence suggests a 25 percent decrease of corporate income tax revenues in the event of the introduction of such measure. This would obviously be too costly and run counter to the overarching objective of fiscal consolidation.

Furthermore, my authorities fully agree with the importance of further implementing structural measures with a view to improve productivity growth, in particular in the service sector. With regard to the stated productive gap in the German services sector, due regard should be paid to the limitation in comparing measures of productivity across countries which are often subject to specific classification and sometimes ad-hoc assumptions which differ across countries.

Financial sector

FSAPs are an excellent tool to promote the soundness of the financial systems in member countries and to contribute to improving supervisory practices around the world. My authorities broadly agree with the staff's thorough analysis of the German financial sector and will use the recommendations to critically reflect on current structures and practices and make adjustments to the existing framework where appropriate and possible.

The assessment shows Germany's generally high level of compliance with the supervisory core principles. Most of the remaining deficiencies found in the banking sector will be dealt with in preparations for and the implementation of Basel III/European Capital Requirement Directive IV. With regard to the insurance sector and in the light of the introduction of Solvency II in 2013, there is the need to continue to further enhance supervisory capacity for being able to cope with the challenges ahead. This is particularly true for the supervisory resources of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin), especially for on-site supervision. The BaFin continues to strengthen its group-wide supervision in the insurance and reinsurance sector.

Achieving continued financial stability requires a constant upgrading of the regulatory and supervisory framework. To give only a few examples, the new bank restructuring law significantly strengthens the crisis management framework in Germany. My authorities share the staff's recommendation with regard to strengthening macroprudential supervision; a 10-point plan to reform the financial markets supervision structure envisages expanding the Bundesbank's mandate in macroprudential supervision, and respective legislation is under preparation.

The deposit insurance system in Germany will continue to be a credible and efficient pillar of financial stability. As the structure of the deposit guarantee schemes is adapted to fit the structure of the German banking system, unifying the schemes will not per se increase the credibility and resilience in this area. It should be also kept in mind that neither BCBS/IADI core principles nor the current EU Directive require a unified deposit guarantee system. For the statutory deposit guarantee scheme a legally binding deposit guarantee of EUR 100,000 as well as significant prefunding is in place. Any further reforms of the deposit guarantee schemes regime, including harmonized funding requirements, will be in line with the respective EU directive, which is currently under discussion.

Stress tests have significantly underpinned the assessment of financial stability. My authorities share most of the conclusions of the stress testing results. In the process of continuously enhancing this exercise, most of the Fund's suggestions on improving the Bundesbank stress tests have already been implemented. As assumptions for such stress tests are always debatable, my authorities would like to put into perspective some of these elements. Firstly, while the FSSA gives a rather pessimistic estimation of future profitability of the cooperative sector (2 percent in 2015), in my authorities' view such a decline in profitability seems unlikely, considering that 2008, when the crisis hit and the term structure was nearly flat, the return on equity (after tax) was 4 percent, in 2007 and 2009 above 5 percent for this sector. Secondly, the capital shortfall appears at least partly to be the result of rising capital requirements of Basel III rather than of the stress scenarios. In addition, the Fund's estimate of core Tier 1 capital seems significantly lower by around 2 percentage points than my authorities' estimates.

Savings and cooperative banks in Germany have proven to be resilient during the financial crisis and thereafter. Due to their retail orientation they benefit from a large share of stable deposits and their domestic orientation was a stable factor during the financial crisis. Regarding the admissibility of private capital for savings banks, one needs to take into account that savings banks aim at public goods, in particular in delivering banking services to a wide range of customers.

Existing weaknesses in the *Landesbanken* sector are being addressed. As a result of ongoing consolidation efforts, progress has been made with respect to lowering risk-taking and de-leveraging. However, profitability remains rather low and the capital structure has to be adjusted to the upcoming Basel III regulation. While the *Landesbanken* need to adjust their business model in some respects, it should be also kept in mind that they provide important services as central institutions for the savings banks.