G R O U P   O F   T W E N T Y

GERMANY
SUSTAINABILITY REPORT [1]

Prepared by Staff of the

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

[1] *Report 6 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a *set* of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

G-20 indicative guidelines identified Germany as experiencing "moderate" or "large" external and fiscal imbalances. Following external deficits in the decade after reunification, the current account improved strongly reflecting buoyant exports, given trade patterns and strong external demand. Private saving rose sharply, while investment declined on the back of tepid domestic demand. Although Germany has generally been fiscally prudent, the public debt and deficit exceed SGP limits, reflecting the costs of reunification and financial crisis. Thus, structural and tax reform are central to reducing imbalances and supporting growth.

Imbalances reflect both domestic and external causes—notably, reunification and the global cyclical upswing followed by the financial crisis.

- A rapidly rising current account surplus reflects a combination of factors, including: (i) favorable product specialization that allowed exporters to take advantage of a cyclical upswing in global demand; (ii) moderate wage growth supportive of competitiveness; (iii) weak investment, reflecting in part financial sector distortions; (iv) high private saving, given life-cycle needs of an aging population; and (v) an overhang from a construction boom following reunification.

- High public debt accumulation can be traced fundamentally to reunification efforts and policy measures in response to the financial crisis.

Reducing imbalances will have a positive impact on domestic and global growth and stability.

- *External surpluses* in Germany do not primarily reflect market failures or policy-induced distortions. Boosting domestic demand would, however, raise potential output while also supporting stronger and more balanced global growth.

- Germany plays a key anchoring role in the euro area and its solid *fiscal position* is essential for maintaining stability.

Structural reforms of the tax system, as well of financial, labor, and product markets will bolster growth and could help reduce external surpluses.

- A growth-friendly tax reform, reducing the taxation of secondary-earners' income and lowering corporate income taxes, would lower the current account surplus over the medium run.

- Further development of venture capital and private equity markets will help increase the availability of risk capital, spurring investment and productivity growth. Reorienting German Landesbanken to serve domestic clients could help increase investment and consumption.

- Streamlining regulation in the service sector and improving education could boost productivity growth and would reduce the trade surplus over the medium term.

The pace of consolidation envisaged and anchored by the new constitutional rule is appropriate. However, it could be more growth-friendly within the budget envelope. In case the economy slows considerably, less front-loaded tightening would be warranted.

INTERNATIONAL MONETARY FUND

GERMANY

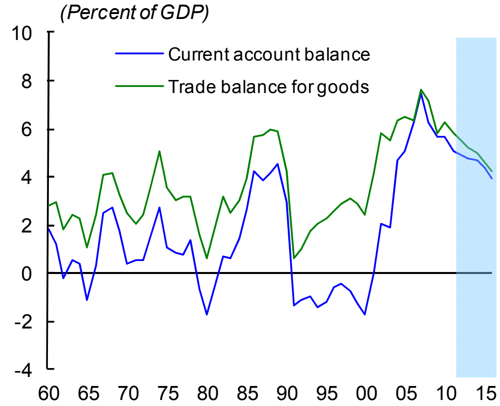
SUSTAINABILITY REPORT 2011[1]

Germany has experienced large current account surpluses over the past decade, while public debt has remained high. Large external surpluses can be attributed to a confluence of factors, including a cyclical surge in global demand for exports and modest wage growth that has helped strengthen competitiveness. An improvement in the private saving-investment balance has been driven by a decline in investment following the reunification boom and higher precautionary saving because of increased uncertainty. High public debt can be traced in a fundamental sense to reunification efforts and policy measures in response to the crisis. Structural policies—including tax and financial sector reforms—could help boost growth and reduce external surpluses. Fiscal space needs to be rebuilt, but the pace of consolidation can be measured—broadly in line with the authorities' current plans.

I. BACKGROUND

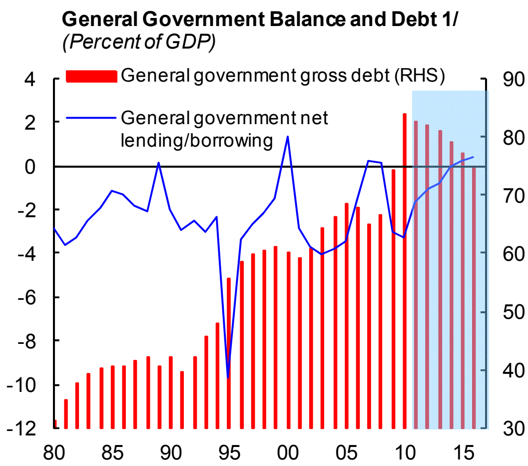
1. **Germany has had a long history of external surpluses and its fiscal record has been relatively strong, except around reunification.** The merchandise trade balance has been in surplus continually since the early 1950s, while the current account has stayed positive, with a few exceptions, notably in the 1990s. Germany enjoys a solid reputation for fiscal prudence. Nonetheless, the general government deficit has often exceeded the 3 percent Stability and Growth Pact (SGP) limit, and the general government debt stands well in excess of the 60 percent ceiling. Developments in Germany can be viewed across four broad time frames.

Current Account Balance and Trade Balance 1/
(Percent of GDP)



Source: IMF, *World Economic Outlook*.
1/ Pre-1991 data refer to West Germany.

[1] Prepared by Vladimir Klyuev under the guidance of Emil Stavrev, with input from Stephen Snudden and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.



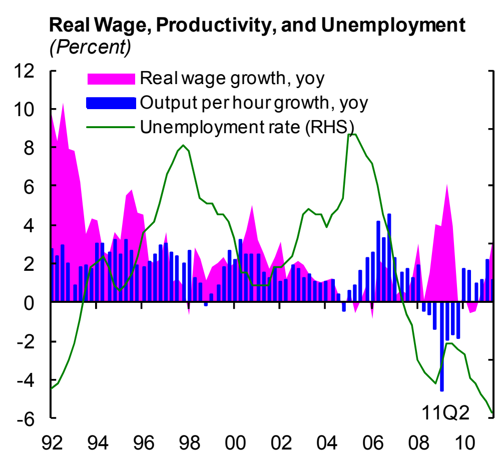
Source: IMF, *World Economic Outlook*.
1/ Pre-1991 data refer to West Germany.

A. Pre-unification

2. **There are considerable similarities between the 1980s and the period in the run-up to the crisis, but also key differences.** During both periods, the German trade surplus improved dramatically, buoyed by strong global demand. At the same time, national saving increased, helped in part by fiscal consolidation, even as private investment, as a share of GDP, declined. An analysis of the reasons for the strong trade performance, in the context of generally subdued growth in output, investment, and employment, pointed to structural rigidities rather than macroeconomic policies.[2] An important difference, however, is that during the 1980s the German economy had substantial structural rigidities, which were significantly smaller in the 2000s, following a number of reforms in the first half of the decade.

B. Reunification

3. **The 1990 reunification had long-lasting implications for Germany's growth, external balances, and public finances.** Efforts to reduce the income gap between eastern and western Länder (including the one-for-one currency conversion) led to a construction boom; a surge in wages, buttressed by generous unemployment support, and a narrowing of wage differentials, despite large productivity gaps; an increase in fiscal deficits and public debt levels underpinned by large transfers to the east, a liberal early retirement scheme, and the cost of converting East German enterprises into private firms; and a shift away from external surpluses to deficits as domestic demand exceeded production.



Source: Bloomberg L.P.

4. **Subsequent correction of the excesses of the early 1990s laid the ground for future current account improvement.** Both residential and non-residential construction declined steadily as a share of GDP. The wage growth slowed, owing to changes in worker bargaining behavior in the face of rising

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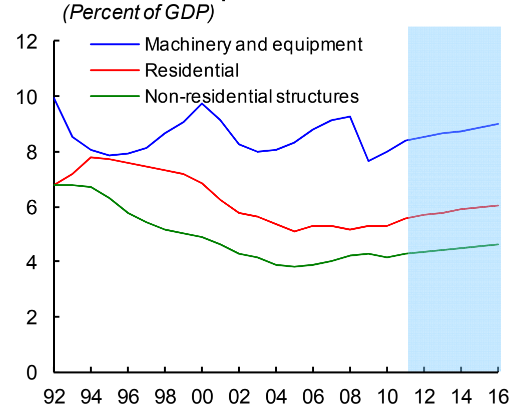
[2] L. Lipschitz, J. Kremers, T. Mayer, and D. McDonald, 1989, "The Federal Republic of Germany: Adjustment in a Surplus Country," *IMF Occasional Paper* 64.

unemployment.[3] A combination of tax and expenditure measures helped contain fiscal deficits even as the economy decelerated after the unification boom. In the meantime, the CPI-based real exchange rate depreciated 18 percent in the second half of the 1990s, more than reversing appreciation that occurred in the first half of the 1990s.

C. The 2000s

5. **After a decade of deficits, Germany's external position moved into surplus in the 2000s, while the fiscal position improved in the run-up to the crisis.** The current account balance rose sharply from a deficit of 1½ percent of GDP in 2000 to a surplus of 7½ percent in 2007, owing largely but not exclusively to an increase in the merchandise trade surplus,[4] noticeably against other Euro area members. The dramatic improvement in the current account between 2000 and 2007 reflected primarily a sharp swing in private saving-investment balances.

- *Net exports* contributed about four fifths of the 9½ percent increase in Germany's real GDP over that period, while domestic demand increased modestly by around 1½ percent. Despite the export boom and strong corporate profits, private fixed investment declined as a share of GDP by 2½ percentage points between 2000 and 2007. All major investment components declined as a share of GDP between 2000 and 2007, with construction continuing its long post-unification slide (with a tentative recovery starting just before the crisis), while M&E investment went through a major cycle.[5]



Source: IMF, *World Economic Outlook.*

- *Private saving* as a share of GDP rose 5¼ percentage points, owing largely to an increase of corporate saving. Household saving increased modestly (one percentage point), even as the labor share of national income fell from 71 to 64 percent. In contrast to the 8 percentage point turnaround in the private saving-investment balance,

[3] The unemployment rate climbed steadily from just over 5 percent in 1991 to nearly 10 percent in 1997. See also J. Decressin, M. Estevão, P. Gerson and C. Klingen, 2001, "Job-Rich Growth in Europe," Chapter III in *Selected Issues Paper* SM/01/307.

[4] Over that period both exports and imports rose substantially, as German firms extended their production lines into neighboring countries. About 4 percentage points of the increase in the current account was due to a decline in the deficit of the services account and a turnaround in the income account.

[5] It should be noted that in real terms the growth of M&E investment looks stronger, as its deflator declined relative to the GDP deflator.

the general government S-I balance improved only 1¼ percentage points.

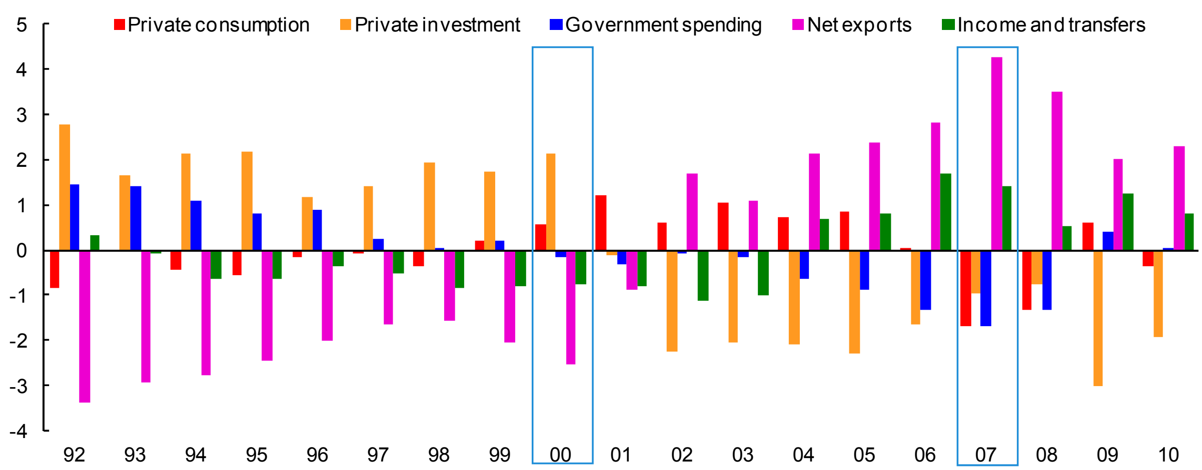
- *Fiscal consolidation efforts led to a surplus in 2007*. This was driven by spending cuts (including pension reform and a reduction of unemployment benefits, public-employee fringe benefits, and various subsidies) and supported by strong growth in output and corporate profits. Nonetheless, the ratio of general government debt to GDP has remained in excess of 60 percent since 2002.

D. The Crisis and Its Aftermath

6. **The current account and merchandise trade surplus narrowed noticeably during the crisis.** The surpluses are projected to decline further through 2016 in line with maturing global recovery and some deterioration in the terms of trade. The contribution of net exports to real GDP growth is expected to remain positive, although it is projected to decline gradually.

7. **The crisis delivered a significant blow to public finances.** Fiscal deficits reappeared and stood at about 3 percent of GDP in 2009 and 2010, reflecting the impact of automatic stabilizers and a relatively large stimulus. The increase in public debt well exceeds what is implied by cumulated general government deficits, notably because of financial system support measures, and is expected to remain close to 83 percent of GDP in 2011. The government has specified a set of consolidation measures, largely on the expenditure side, to bring the fiscal balance in line with its commitments under the SGP, G-20 Toronto commitments, and the national fiscal rule. As a result, the debt ratio is projected to decline to 77 percent on average in 2014–16, which is still above the SGP limit.

Components of Gross National Disposable Income
(Percent of GDP; deviation from 1992-2010 average)



Source: IMF, *World Economic Outlook*.

II. Root Causes of Imbalances

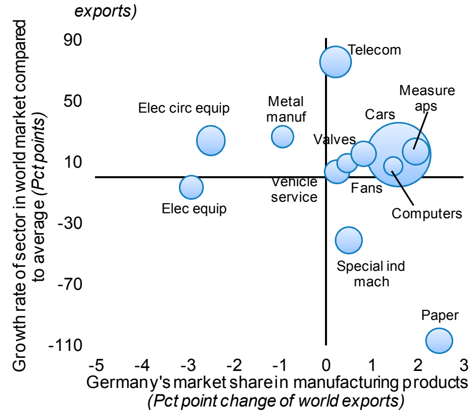
G-20 indicative guidelines identified Germany as experiencing "large" or "moderate" external surpluses and public debt, calling for an in-depth assessment of the root causes. External imbalances reflect a number of factors, such as improvement in competitiveness, niche exports, low investment rates, and increased national saving, some of which are clearly more important than others. Public debt increased largely due to reunification costs, the weak economy in the first half of the 2000, and the recent financial crisis.

A. External Imbalances

8. **The rapid increase in Germany's current account surpluses before the crisis reflects a combination of factors, led by wage behavior and the structure of exports.** In particular, favorable product specialization and wage moderation positioned Germany well to take advantage of a cyclical surge in global demand in the years preceding the crisis. Even as exports boomed, the private saving-investment balance improved, owing to a slowdown in private investment following the reunification boom and a rise in precautionary saving because of the increase in policy uncertainty, as a result of the reforms in the late 1990s and the early 2000s.

9. **Niche exports allowed Germany to benefit from a cyclical boom in global demand.** Exports benefited from a strong demand for capital goods, consumer durables and pharmaceuticals—products where the country is specialized and enjoys significant market share. Capital goods accounted for 45 percent on average of German merchandise exports in the 2000s, while motor vehicles and parts constituted another 18 percent. Unlike most other advanced economies, Germany was able to maintain its share of key markets, with the rise in world trade translating one-for-one into a rise in German exports.

Manufacturing Exports in Germany: 1995-05 1/
(Size of bubbles proportional to share in total goods exports)

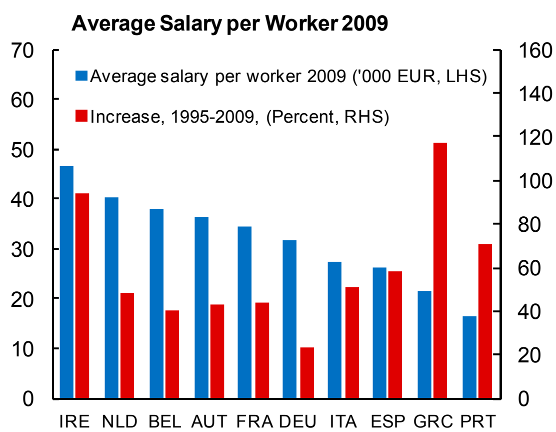


Source: UN Comtrade database.
1/ Excluding food and chemicals.

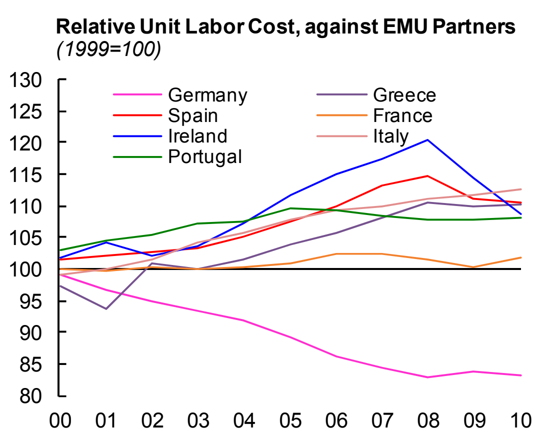
10. **Wage moderation boosted competitiveness, supporting exports, while dampening domestic demand.** Wage growth remained moderate during the expansion, helping firms maintain a competitive edge.[6] The euro appreciated

[6] It should be noted, though, that for German exporters the importance of competing on price has declined.

nearly 50 percent against the U.S. dollar between 2000 and 2007. However, since roughly half of its exports go to other euro area countries, Germany's nominal effective exchange rate strengthened only 14 percent, the CPI-based real exchange rate only about half of that, and the ULC-based REER declined slightly by 2007. At the same time, wage moderation resulted in declining labor income share, which dampened consumption and domestic demand, while boosting net exports by improving relative ULCs.



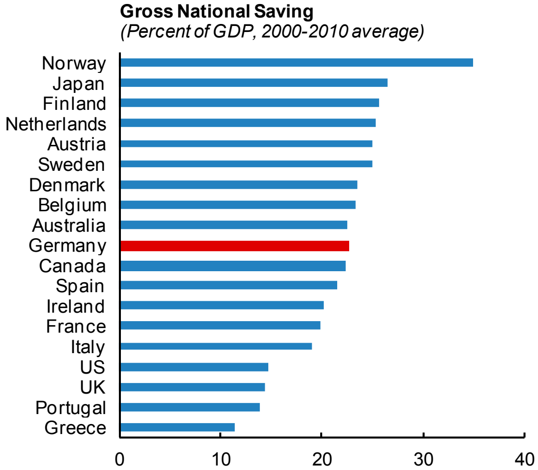
Sources: OECD; and IMF staff estimates.



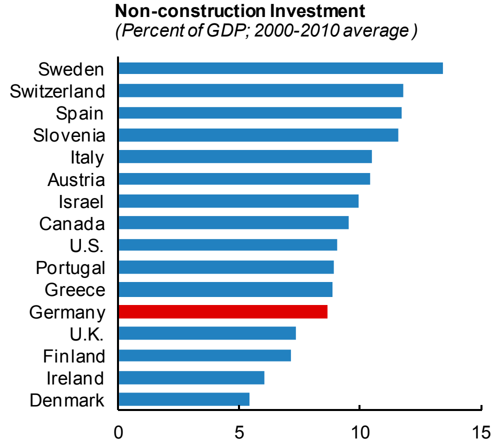
Source: European Commission.

11. **Cyclical divergence within the euro area also contributed to intra-area imbalances.** Domestic demand in Germany was considerably weaker than demand growth in several euro area members, notably in the periphery. Thus, the area-wide policy interest rate was arguably too low for the periphery and too high for slow-growing Germany, hindering equilibration of demand across the member states. In addition, because of structural rigidities in the euro area, wage and price adjustments were slow to operate and did not compensate for the lack of an exchange rate adjustment channel.

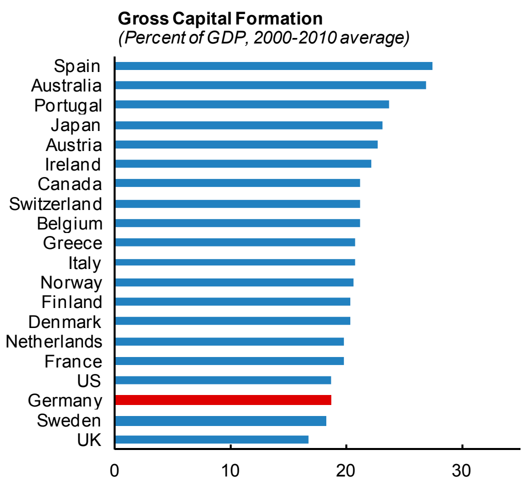
12. **The private saving-investment balance improved.** Both lower investment and higher saving contributed to the large increase in the current account balance before the crisis. Despite booming exports and rising corporate profits, private investment remained particularly lackluster, including relative to peers (the level of non-construction investment in Germany is lower than in most advanced economies). Indeed, investment as a share of GDP declined between 2000 and 2007. This is true not only for construction—which could be attributed to a long-lasting hangover from the reunification boom—but also for machinery and equipment. As a share of GDP, investment fell not only in services, but also in the booming manufacturing sector.



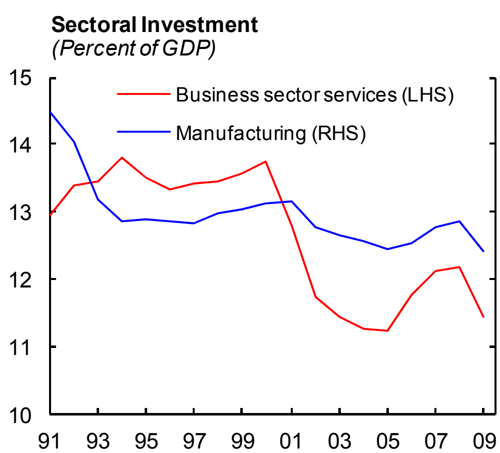
Source: IMF, *World Economic Outlook*.



Source: IMF, *World Economic Outlook*.



Source: IMF, *World Economic Outlook*.

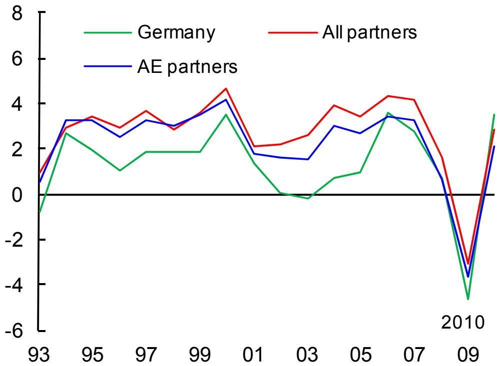


Source: OECD STAN database.

13. **The reasons for investment being low in Germany are not entirely clear.** Several explanations, without unequivocal evidence, have been suggested, including the uncertainty about the durability of the expansion, low productivity growth, particularly in the non-tradable sector, and gaps in the availability of financing. Further research would be needed to pin down the reasons behind the low investment rates in Germany.

- *Caution in the face of a surge in external demand.* The weakness of investment possibly reflected the fact that the strong export expansion may not have been viewed as durable. Germany's growth is linked to external developments to a greater extent than in most other large countries, and strong foreign demand may have been viewed as reversible. Indeed, soon after private investment finally started picking up, the global crisis broke out.

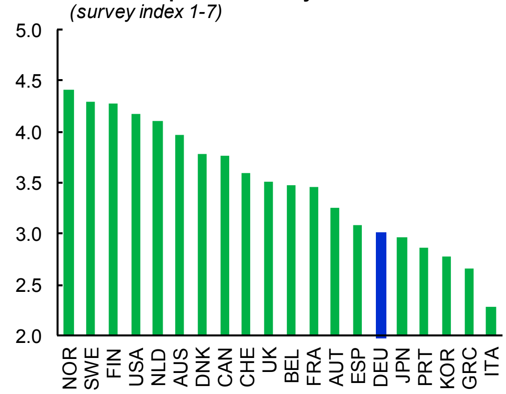
Real GDP Growth Rates
(Percent)



Source: IMF, *World Economic Outlook*.

- *Gaps and distorted incentives in the financial system*. A relatively underdeveloped framework for venture capital and private equity, as well as an inefficient insolvency process, has impeded investment in high-risk, high-growth sectors. At the same time, a broader issue concerning access to financing may have played a role, although supporting evidence is limited. In particular, it has been suggested that following the phasing-out of state guarantees, large state-owned banks have been more inclined to invest overseas—including in structured products originated in the U.S. and sovereign and bank debt of peripheral euro area nations, without adequate consideration of risk—rather than financing domestic investment.[7] While there may be some merit in this

Venture Capital Availability
(survey index 1-7)



Source: The Global Information Technology Report 2009-10, World Economic Forum.

hypothesis, given high corporate saving and a wide network of savings and cooperative banks that are geared toward financing domestic investment, including SMEs, the ill-conceived investment strategy of Landesbanken may be a more relevant consideration for issues pertaining to financial stability rather than for access to financing.

- *Low productivity growth in non-tradables*. Germany's labor and total-factor productivity growth has been relatively low, dragged down by a lackluster performance of the service sector. Fairly restrictive regulation of professional services; remaining barriers to entry and exit of firms; and certain deficiencies in the education system[8] impede productivity growth in the non-tradable sector.

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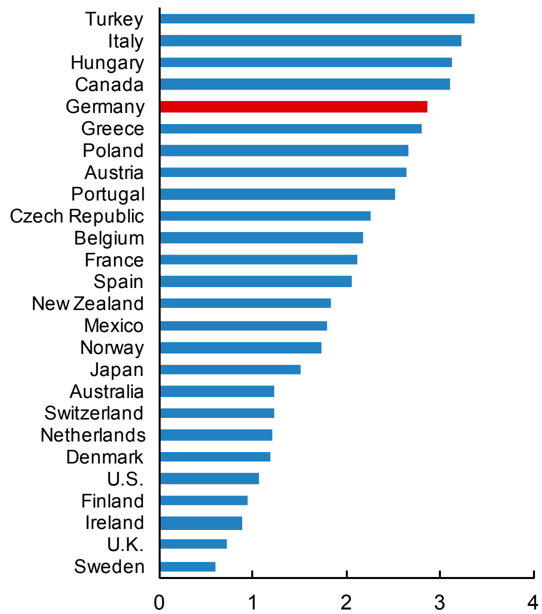
[7] Arguably, public ownership may have distorted their incentives and accounts for the lack of a viable business model.

[8] The 2010 OECD Economic Survey of Germany identified three main challenges: low tertiary graduation rates among younger cohorts; vocational training system that provides too much

(continued)

Regulation in Professional Services
(Higher index = stricter regulation)



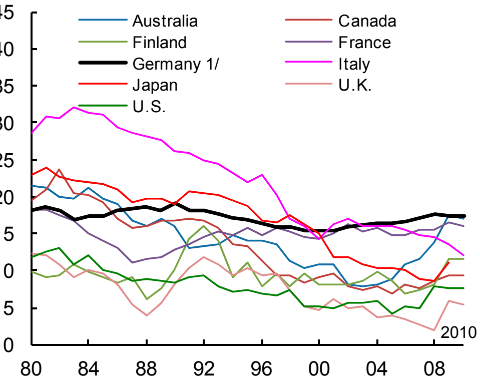
Source: OECD.

14. **Higher saving reflected both public and private sources.** National saving rose about 6 percentage points as a share of GDP between 2000 and 2007. Government, corporate, and household saving all increased.

- *Government saving* increased in the years just preceding the crisis, owing to fiscal consolidation efforts in the context of rapid growth.
- High *corporate saving* reflected an increase in profits during the export boom. Dividend payouts increased less than profits, possibly because of doubts regarding the sustainability of that boom. High profits did not fuel greater investment but rather were used to strengthen corporate balance sheets.

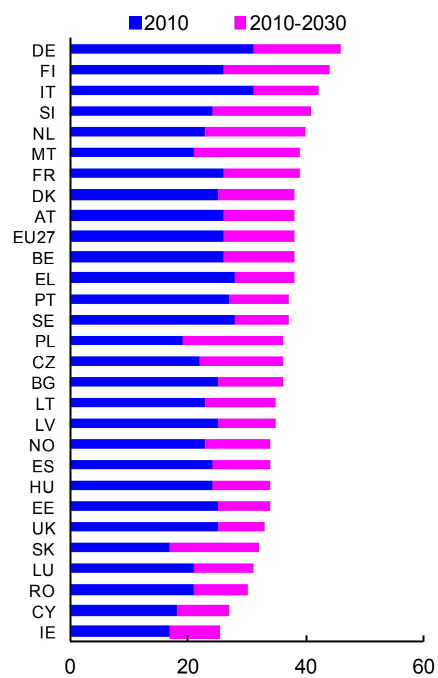
specialized and too little general knowledge, making it hard to adjust to changes in labor demand; and relatively low participation in lifelong learning.

Household Saving Rates
(Percent of disposable income, sa)



Source: Haver Analytics.
1/ Data prior to 1991 are for West Germany.

Old Age Dependency Ratio
(Population 65+ as % of population 15-64)



Sources: European Commission; and IMF staff estimates.

- The increase in *household saving* reflects the needs of an aging society and, possibly, policy uncertainty. Germany has one of the highest household saving rates in the OECD—it remained high even as it declined in many other advanced economies, in some cases spurred by overly easy access to credit. Moreover, after a decade-long post-unification slide, the saving rate rebounded over the course of the 2000s—even as the disposable income fell as a share of GDP. This reflects both tradition and the life-cycle needs of an aging society. At the same time, it is quite likely that the rise in household saving also reflects the impact of pension and labor market reforms in the first half of the 2000s, which reduced the generosity of pension and unemployment benefits.

B. Fiscal Imbalances

15. **The factors leading to accumulation of public debt have shifted over the years.** The cost of reunification largely explains the big leap in the debt-to-GDP ratio that occurred in the 1990s. A run-up in debt in the first half of the 2000s was mostly due to the weak economy and the attempts to improve growth prospects by cutting taxes. Inter-governmental relations also played a role, with federal co-financing of regional projects skewing the incentives toward their expansion and resulting in high administrative costs.[9] The SGP has not prevented Germany from maintaining a debt ratio above 60 percent during the last decade. Finally, between 2008 and 2010, the increase in the debt ratio was largely driven by financial sector support, which added 13 percentage points to the debt-to-GDP ratio. Discretionary measures and cyclical factors also contributed, as the fiscal balance deteriorated by 3.4 percent of GDP due to a combination fiscal stimulus (1.5 percent of GDP in 2009 and 0.7 percent in 2010) and automatic stabilizers, while nominal GDP was nearly unchanged.

[9] OECD, 2006, Economic Surveys: Germany.

III. ARE GERMANY'S IMBALANCES A PROBLEM?

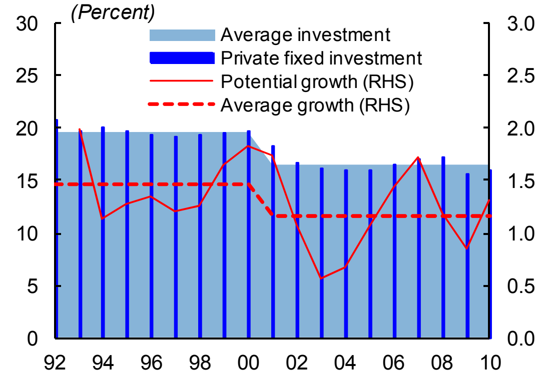
A. National Perspective

16. **Factors behind Germany's external surpluses do not primarily reflect market failures or policy-induced distortions.** Wage moderation was a reasonable reaction to its earlier excessive growth, which had led to a surge in unemployment, and there is little reason to believe that German institutions or government policies are holding wage growth down. While moderation may have led to some overshooting on the competitiveness front, now that the unemployment rate is at all-time lows, wage moderation may well dissipate. The strong growth of Germany's export markets was a development that was largely exogenous to Germany. Finally, with unfavorable demographic projections, it is not unreasonable for the country to run current account surpluses, although—as CGER estimates indicate—not as large as those observed lately.

17. **This said, from a domestic perspective, there are good reasons for boosting private demand and reducing vulnerability to external shocks.**

- *Low output and productivity growth reflect a trend decline in investment relative to GDP*. The impact is twofold—on demand in the short run and on productive capacity in the longer term.

Private Fixed Investment to GDP Ratio and Potential Growth
(Percent)



Source: IMF, *World Economic Outlook*.

- *Lackluster productivity growth in the non-tradable sector is holding back growth prospects*. An acceleration of services productivity would strengthen incentives to invest in the sector and also stimulate consumption, boosting domestic demand, by raising permanent income. This would improve the standard of living, while reducing current account surpluses over the medium term.

- *Germany has benefited from its dependence on foreign markets, but it also makes the country susceptible to external shocks*. German exports have so far remained largely isolated from low-wage competition, making a hefty contribution to GDP growth. Going forward, however, the country's position is likely to be challenged as emerging market producers move up the technological ladder, significantly limiting the external sector's contribution. Accordingly, this may result in sluggish GDP growth if domestic demand remains weak.

- *To some extent, these factors are mutually reinforcing.* Weak productivity growth, particularly in the non-tradable sector, lowers incentives to invest, holding back potential output and income, and thus consumption. In turn, lower domestic demand reduces the incentive to invest, notably in the services sector, thus dampening demand for labor and keeping wages and consumption in check.

18. **High public debt has well-known vulnerabilities associated with it.** However, it should be noted that Germany's public debt (both gross and net, in percent of GDP) is among the smallest in advanced G-20 economies. German bunds continue to be the benchmark asset in the euro area, and CDS spreads on German debt remain low. Thus, while fiscal space needs to be rebuilt, fiscal consolidation can afford to proceed at a measured pace, helping the output to recover from the crisis.

B. Global Perspective

19. **Germany could contribute to higher and more stable global growth by relying less on exports and more on domestic demand.** Increasing domestic demand in Germany could raise global growth, while a lower reliance on external growth sources could contribute to global rebalancing and thus to a more sustainable global growth.

20. **Germany's solid fiscal position is essential for maintaining stability in the euro area.** Because of its size and history of (relative) fiscal prudence, demonstrated again by the introduction of a constitutional-based structural balance rule, Germany plays a key anchoring role in the euro area. Should investors lose confidence in Germany's creditworthiness, the implications may be severe, with borrowing costs going up all across Europe. In addition, respect for the SGP by the largest member state is key for maintaining stability and budget discipline in the euro area.

IV. How to Address Imbalances?

A. Policy Priorities

21. **A number of factors should reduce Germany's current account surplus going forward.** The need for budget consolidation is smaller in Germany than in most of its trading partners, and the smaller fiscal improvement (relative to trading partners) would (other things being equal) lower its current account balance.[10] With anemic growth in advanced economies, the demand for German exports is likely to be low for a protracted period. This may, however, be offset by rising demand from emerging economies, particularly if they reorient their demand toward more consumption and investment. At the same time, the ongoing increase in productive capacity and technological sophistication of emerging market manufacturers may threaten Germany's competitive position. And with the unemployment rate at its lowest in nearly 20 years and 5 percentage points below its fairly recent peak, wage moderation may be running its course. In fact, wage growth had picked up just prior to the crisis, interrupting a period of wage discipline—but then the crisis put a lid of wages.

22. **Structural policies directed at promoting growth and stability could also help reduce external imbalances.** Importantly, policies that stimulate consumption and investment would shift growth towards domestic demand and reduce Germany's dependence on foreign demand, thus lessening the uncertainty and decreasing vulnerabilities. That, in turn, should boost investment, which is key to higher growth and potential output, and lower the need for precautionary saving. Overall, these structural policies, including tax reform, will raise welfare and are likely to lower current account balances over the medium term. Action on several fronts can help achieve these objectives.

- *Lower corporate taxation would stimulate investment*. While the 2008 corporate income tax reform improved Germany's tax competitiveness, abolishing the inefficient, volatile, and geographically uneven trade tax imposed by municipalities would further reduce the marginal effective tax rate.

- *Further development of venture capital and private equity markets would increase availability of risk capital, spurring investment and productivity growth*. The measures could include: (i) removing uncertainties regarding the tax treatment of venture capital firms; (ii) redesigning the change-of-ownership rule, which eliminates loss and interest carry-forward; and

[10] "Hitting Two Birds with One Stone: Does Fiscal Adjustment Lead to External Adjustment?" WEO September 2011, Chapter 4.

(iii) promoting faster restructuring proceedings for insolvent entities.

- *Reorienting German banks to serve domestic clients could help increase investment and consumption*. While the small institutions (cooperative banks and Sparkassen) are domestically oriented, the large, state-owned Landesbanken shifted a considerable part of their portfolio abroad in the run-up to the crisis and have now found themselves in a difficult situation and in need of government support. Reducing the states' ownership of these institutions (direct and via Sparkassen) would spur them to establish a viable business model, which would likely involve greater domestic lending. Staff research has found that a smaller public share of the banking system is associated with smaller current account balances.[11] Even if such reform has insignificant impact on investment and current account, it will benefit financial stability.

- *Less regulation and measures to improve education would spur productivity growth and domestic demand*. In the long run higher productivity would mean higher output, higher income, and commensurately higher domestic demand without a first-order effect on the current account. However, on the likely protracted transition path the prospect of higher productivity growth would stimulate additional investment, and higher permanent income would push current consumption up, reducing the trade surplus.

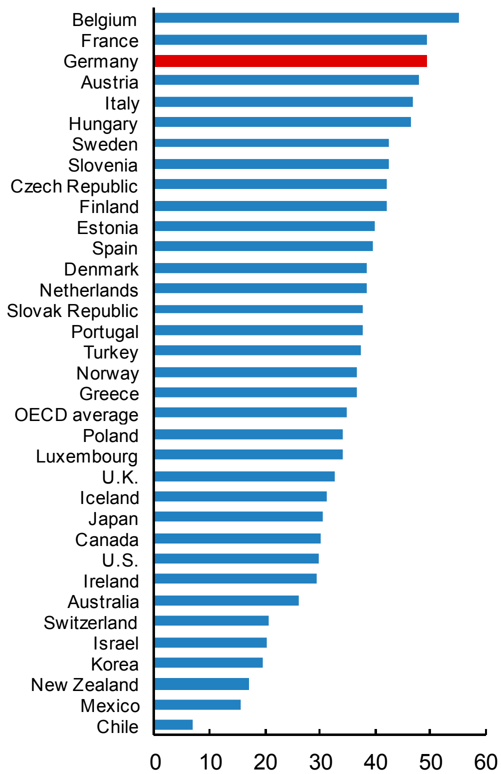
23. **The government has identified a set of measures to set the public debt ratio on a declining path.** The envisaged pace of consolidation is appropriate, balancing the budget around 2014, although it could be slowed in case of a substantial negative shock to growth. Fiscal adjustment is anchored by a new limit on structural deficits of the federal and state governments, which is enshrined in the constitution and should therefore improve the national implementation of the SGP.

- *Within the budget envelope there is scope for making the adjustment more "growth-friendly*." The large labor tax wedge facing low earners could be reduced by introducing in-work and earned income tax credits or by raising the threshold for low-income tax relief and reducing the speed of benefit withdrawal. A reform of the income-splitting regime could improve incentives for labor market participation by secondary earners. Abolishing the inefficient and volatile local trade tax would reduce the burden on corporations. Reduction in direct taxes would promote employment, investment, and growth,

[11] A. Ivanova, 2011, "Current Account Imbalances: Can Structural Policies Make a Difference?" forthcoming *IMF Working Paper*.

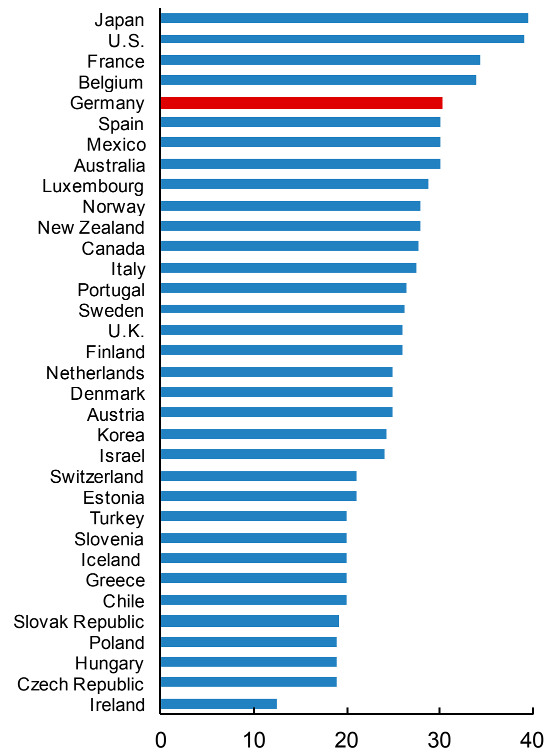
and could be paid for by eliminating concessions in the VAT, raising property and inheritance taxes, and cutting some poorly targeted social benefits (such as unconditional child support). There is also scope for increasing the efficiency of education spending.

Labor Tax Wedge
(Percent of labor costs, 2010)



Source: OECD.

Corporate Income Tax Rate
(Percent , 2011)



Source: OECD.

B. Toward an Upside Scenario

To address Germany's imbalances, possible elements contributing to an upside scenario could comprise product and labor market reforms combined with a tax reform to boost investment.

24. **Structural reform in the services sector to boost productivity and investment.**[12] In *product markets*, gradual convergence to best practice of regulations in retail trade and professional services would increase productivity in nontradables and raise investment. In *labor markets*, improving the availability of child care, along with tax reform, would increase labor participation of secondary earners, elderly, and low-skill workers (see below).

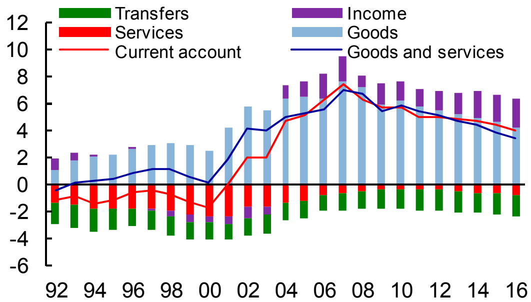
25. **A tax reform, alongside structural reform, to further support investment and employment, while minimizing distortions.** Alongside structural reform, a revenue-neutral tax reform that shifts taxes away from more distortive direct corporate income and personal income taxes to less distortive indirect taxes will help further promote investment, employment, and growth. Specifically, corporate taxes and personal income taxes are lowered (by 1 percent of GDP each) to increase investment and employment. For *corporations*, this emulates elimination of the municipal trade taxes and introducing an allowance for the normal return on new equity (to remove the debt bias). For *individuals*, the reforms (described briefly in paragraph 23) would affect those marginally attached to the labor force (secondary earners; elderly; low-skill workers) and hence may be expected to have a considerable effect on labor supply.[13] These tax cuts are financed by an increase in the consumption tax collection in the amount of 2 percent of GDP. This is achieved by moving towards best practice via eliminating concessions (reduced rates and exemptions) in the VAT.

[12] Structural reform scenario was done in close cooperation with the OECD, which provided estimates of the impact on productivity.

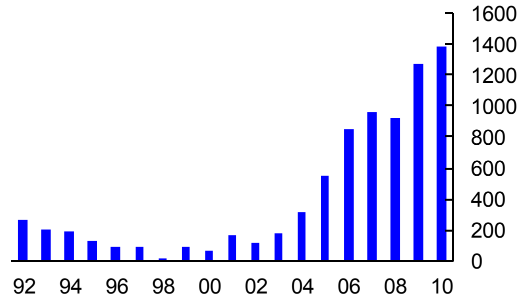
[13] The reason is that for these groups the incentives affect the participation margin (the decision of whether to seek employment as opposed to how many hours to work).

Figure 1. Germany: External Sector

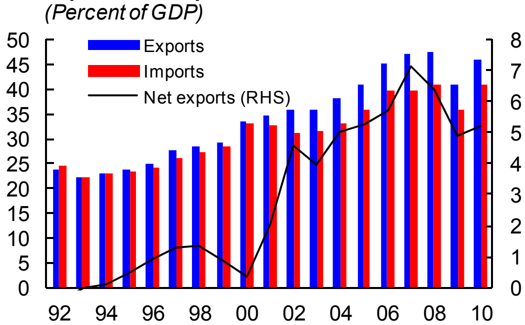
Current Account Balance Components
(Percent of GDP)



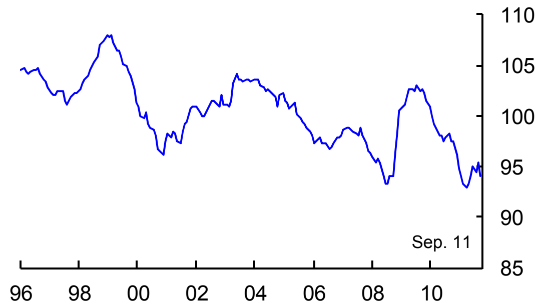
International Investment Position
(USD billions)



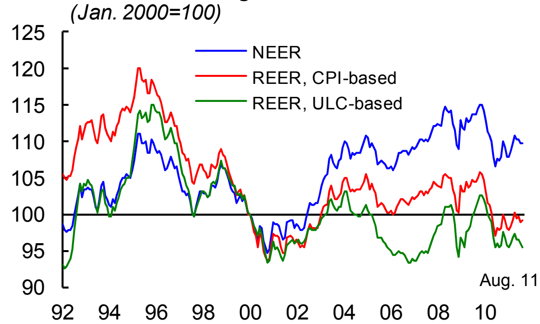
Exports and Imports of Goods and Services
(Percent of GDP)



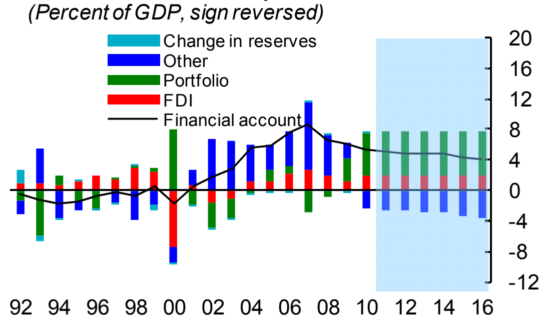
Terms of Trade
(2005 = 100; sa)



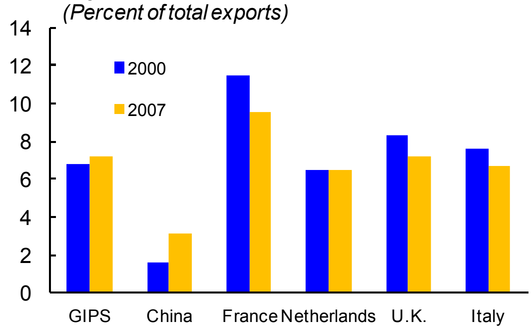
Effective Exchange Rate
(Jan. 2000=100)



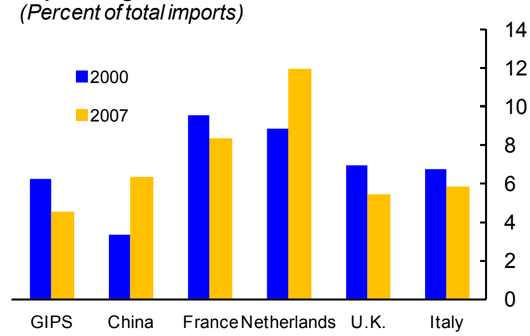
Financial Account Composition
(Percent of GDP, sign reversed)



Export Destination
(Percent of total exports)

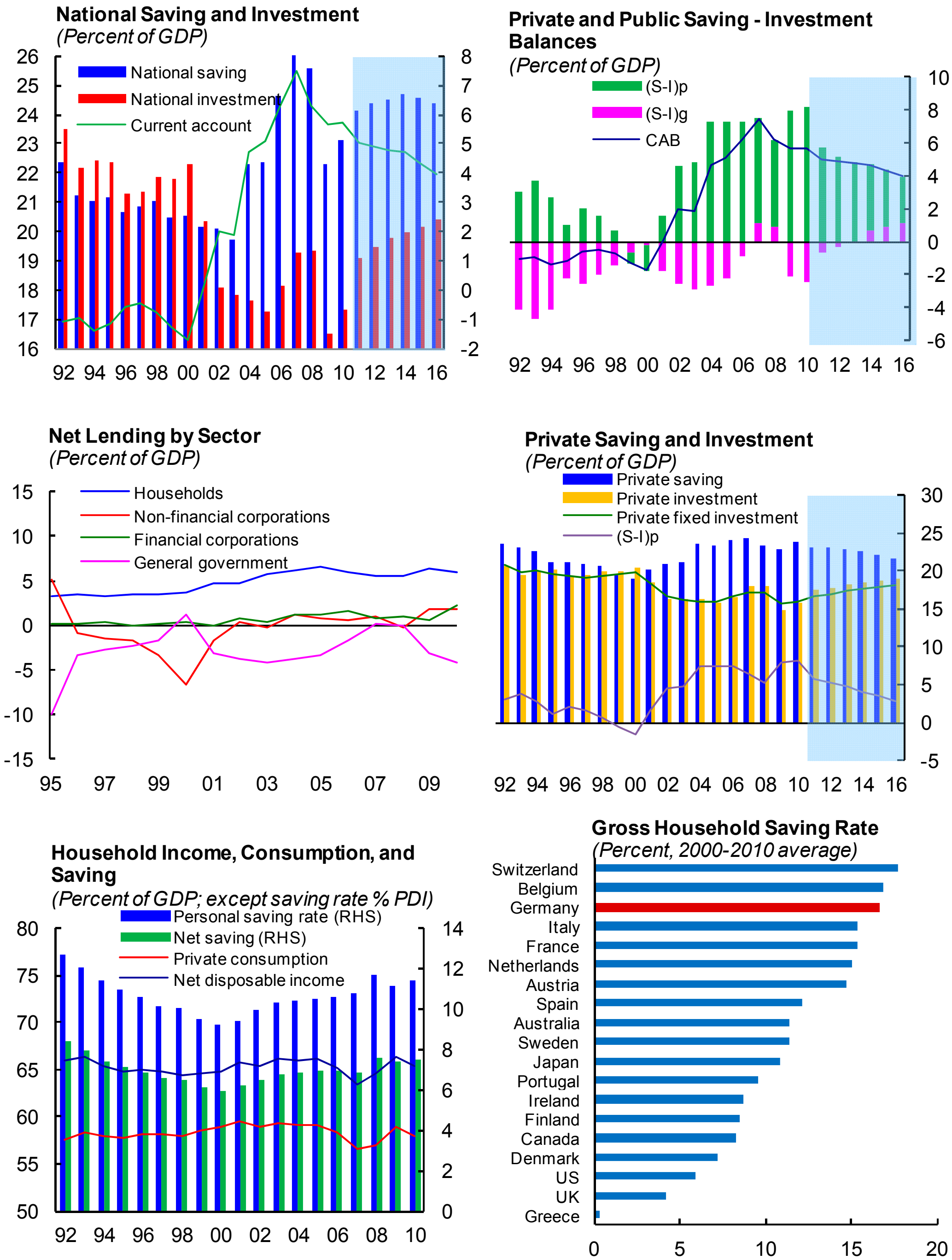


Import Origin
(Percent of total imports)



Sources: IMF, *World Economic Outlook; International Financial Statistics*; *Direction of Trade Statistics*; Global Data Source; Haver Analytics; and Bloomberg L.P.

Figure 2. Germany: Investment and Saving



Sources: IMF, *World Economic Outlook*; Global Data Source; Haver Analytics; and Bloomberg L.P.