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Germany: 2006 Article IV Consultation—Staff Report; Staff Statement; 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 2006 Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 11, 2006, 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 November 2, 2006. 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 staff statement of December 8, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 8, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Germany.

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

Selected Issues Paper

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

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

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INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2006 Article IV Consultation

Prepared by the European Department
(In consultation with other departments)

Approved by Michael Deppler and Adnan Mazarei

November 10, 2006

- **Discussions:** August 30 to September 11, 2006 in Berlin, Frankfurt, Bonn, Düsseldorf, and Munich, with Bundesbank President Weber, Federal Office of Financial Supervision (BaFin) President Sanio, State Secretaries Anzinger (Labor and Social Security), Mirow (Finance), and Pfaffenbach (Economy) and senior representatives at the Chancellery, the Ministries of Finance, Economics, Labor and Social Security, Health, the Bundesbank, and BaFin. Mr. Stein, the Executive Director for Germany, also participated in the discussions.

- **Outreach:** Meetings with parliamentarians from the SPD and CDU, the Finance Minister of North-Rhine Westphalia, representatives of Landesbanken WestLB, Helaba, and Berlin, employers' and labor union organizations, associations of financial institutions, rating agencies, research institutes, investment banks, private equity investors, and a real estate association. A one-day public symposium on long-run fiscal sustainability in Germany, organized by the European Department together with the Ifo Institute and Bertelsmann Foundation, will be held in Berlin on November 20, 2006.

- **Team:** Messrs. Chopra (Head), Traa, Odenius, Danninger, Ms. Carare (all EUR) and Mr. Cihak (MCM). Mr. Botman (FAD) joined the mission to present output from the Global Fiscal Model.

- **Selected issues papers:** (1) Exports and Domestic Demand in Germany: Has the Nexus Been Altered by Globalization? (2) Tax Reform and Debt Sustainability in Germany: An Assessment Using the Global Fiscal Model, (3) Business Tax Reform and, (4) Landesbanken: A Measure of the Costs for Taxpayers.

- **Publication:** The authorities released the mission's concluding statement and intend to publish this report.

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Glossary of Abbreviations and Terms

ALMP	Active labor market policy.
BaFin	Federal financial supervisory authority.
CDU/CSU	Union of Christian Democratic and Christian Social Parties.
CIT	Corporate income tax.
EPL	Employment protection legislation.
FDI	Foreign direct investment.
GFM	Global fiscal model.
IFRS	International financial reporting standard.
ILO	International Labor Organization.
LB	Landesbank.
NPL	Nonperforming loans.
NPV	Net present value
PPP	Public private partnerships
REIT	Real estate investment trust.
SPD	Social Democratic Party.
Kombilöhne	Public program to subsidize wages.
Landesbank	State-owned wholesale bank.
Pfandbrief	Covered bonds secured by real estate or specialized collateral.
Sparkasse	Local public savings bank.
Agenda 2010	Adjustment package launched in 2003 to reform the income tax, pension, health care, and labor market systems.
Hartz reforms	Labor market reforms in Agenda 2010, named after the head of the commission, Mr. Hartz. Hartz I-III (2003-2004) focused on ALMPs, labor market administration, and job placement. Hartz IV (2005) tightened unemployment benefits of short-term unemployed (UB-I), and merged the long-term unemployment and welfare programs into Unemployment Benefit II (UB-II).
Monopolkommission	Commission of economists and lawyers providing regular assessments on regulation in the German economy.
UB-I	Unemployment Benefit I provides assistance to short-term unemployed; replaces the former Unemployment Insurance system.
UB-II	Unemployment Benefit II provides assistance to long-term unemployed and social welfare recipients; replaces the former Unemployment Assistance and Social Welfare programs.

Executive Summary

Germany is benefiting from a cyclical upswing. Buoyant world demand has propelled exports, which have at last triggered a rebound in investment and an uptick in employment. The private sector's sustained restructuring and wage moderation have underpinned this progress. The fiscal deficit has been reduced and important reforms have been implemented to improve the functioning of labor markets and reduce the cost of entitlement programs. However, Germany still has a highly regulated economy that is financing a generous welfare state. These rigidities make it more difficult to deal with shocks, including the forces of globalization and aging. Policies need to address three interrelated challenges:

- Low trend growth, with lackluster productivity improvements in the more sheltered domestic (services) sectors.
- High and long-lasting unemployment, with high reservation wages limiting job opportunities for the poor and lower skilled.
- Risks to long-run fiscal sustainability despite commendable progress in recent years.

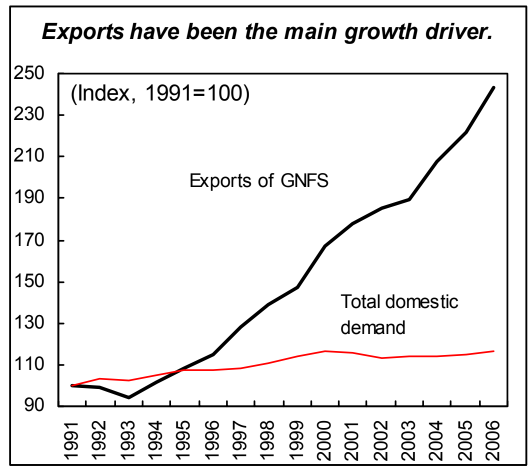
Considerable headway can be made in tackling these challenges if Germany takes advantage of the upswing to implement the following mutually-reinforcing policies:

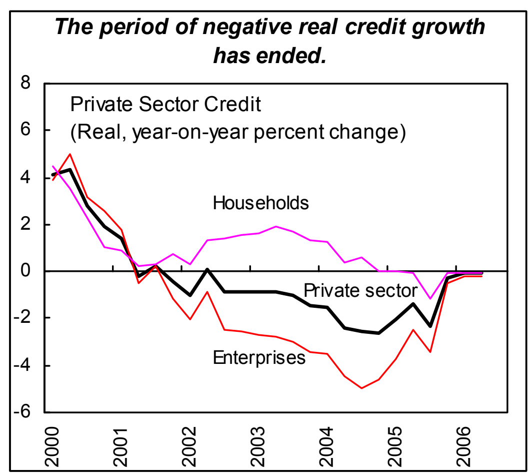
- **Labor market reforms** need to be reinvigorated to reduce structural unemployment. Benefits for the long-term unemployed should be reduced for those unwilling to work. New distortions such as sectoral minimum wages, selective wage subsidies, and tighter regulation of temporary work agencies should not be introduced. Ineffective active labor market programs should be culled.
- **Product market reforms** should aim to increase competition and enhance productivity. Contestability of markets in network industries should be improved by stepping up privatization and reducing access costs. Liberal professions and the guild system should be deregulated to lower the power of incumbents.
- **Capital markets and the financial sector** need to be made more dynamic and efficient to improve the allocation of capital. Efforts to improve the effectiveness of legislation for private equity and to establish REITs that include both residential and nonresidential property should be pursued with vigor. Public sector banks should be opened up more to private capital to facilitate market driven restructuring and improve profitability.
- **Fiscal policies** should aim to achieve structural balance by 2010 and further improve long-term sustainability. A sizeable reduction of the deficit is in train for 2005-2007, but after that additional high-quality measures need to be implemented to continue lowering the deficit. Health care reforms should strive to reduce the burden on payroll taxes, increase competition, and lower costs. The corporate income tax reform should be designed to avoid new budgetary burdens or distortions for firms.

I. Introduction

1. **After protracted weakness in domestic demand, a strong and gradually broadening cyclical recovery is finally underway** (Table 1, Figure 1). Fast export growth and record profits in the corporate sector, resulting in large part from steady business restructuring and the favorable external environment, have at last rekindled investment demand. Construction is also beginning to turn around. However, with continued wage moderation, consumption remains tepid despite an uptick in employment.

2. **Far-reaching adjustment of the private and public sectors have supported strong exports but held back domestic demand.**[1]





- Excessive wage increases in the early 1990s were followed by an extended period of wage moderation to recover competitiveness. Further, exporters responded quickly to globalization by shedding expensive workers and sourcing intermediate input production to lower cost countries.

- The domestic economy—with high labor costs and structural rigidities—lacked the dynamism to absorb surplus labor. The bust in the large construction sector, following a unification-related boom, exacerbated the decline in employment.

- Depressed property markets and the bursting of the equity bubble in 2000 caused a substantial increase in impaired loans earlier this decade, leading to reduced lending.

- Meanwhile, impending aging-related expenditure pressure spurred the government to undertake important

[1] A *Selected Issues Paper* describes the juxtaposition of slow domestic demand and fast exports in more detail.

entitlement reforms and restrain spending to improve fiscal solvency. These belt tightening efforts induced households to step up precautionary savings, which slowed consumption.

3. **Overall, adjustment in recent years has centered on wage moderation and fiscal containment, rather than efficiency-enhancing structural reforms** (Box 1). The current government has put priority on four areas: fiscal consolidation, business tax and health care reform, and making labor markets more flexible. It is too early to say whether a major turnaround will be achieved, because all the measures in these four areas have not yet been announced.

Box 1. Past Fund Policy Recommendations and Implementation

In past consultations, Directors called for comprehensive and mutually reinforcing policies to achieve fiscal sustainability and reduce structural rigidities to meet the challenges of globalization and aging.

Fiscal consolidation. Directors endorsed the authorities' policies to reduce the fiscal deficit below 3 percent of GDP by 2007, with some Directors calling for frontloading of adjustment and greater reliance on expenditure reduction. In the event, the deficit will be reduced to well below 3 percent in 2006. The structural adjustment of over 1 percent of GDP in 2006-07 is spread more evenly than was thought earlier, and has a significant expenditure component.

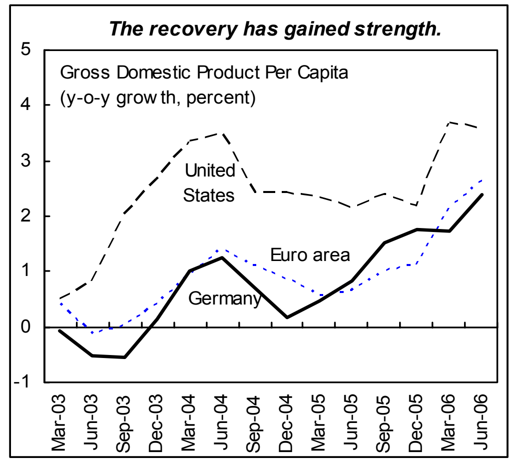
Fiscal reforms. Directors called for medium-term fiscal consolidation to enhance the sustainability of public finances. Consistent with Directors' recommendations, a first round of fiscal federalism reforms has been adopted to streamline the legislative process and give Länder more autonomy. More fundamental changes in intergovernmental financial relations are yet to be addressed.

Labor and entitlement reforms. Directors welcomed the Hartz labor market reforms but their effectiveness has been hampered by design flaws and weak implementation. There has been no progress in reforming employment protection legislation. Directors also saw a need for further recalibrating the entitlement system, and the decision to gradually raise the pension age remains to be enacted in law.

Productivity-enhancing reforms. Reforms in product and service markets have proceeded slowly. In the banking system, private investors have been recently allowed to buy shares in one Landesbank, but overall structural efficiency gains have been slim.

II. THE CURRENT SETTING

4. **After heavy reliance on exports, the cyclical upswing is now supported by a rebound in investment and is also aided by temporary factors.** Improved sales and profit expectations and an increased rate of capacity utilization have led to a strong increase of spending on plant and equipment, notwithstanding an increase in real interest rates by 1 percent in the last six months (Figure 2). The Coalition Agreement's €24 billion (1 percent of GDP) stimulus package for 2006-2009 has begun to take effect.[2] Moreover, the World Cup soccer tournament boosted the service sector, and the phasing out of homeowner subsidies is stimulating residential construction. The VAT increase from 16 to 19 percent in January 2007 is bringing forward consumption of durables and construction activity, estimated to boost growth in 2006 by ¼–½ percentage points (and lower it by the same amount in 2007). Real growth is projected to rise to 2.3 percent in 2006 (from 0.9 percent in 2005), with nearly three-quarters of the contribution to growth coming from domestic demand.



5. **Job growth has only recently started to turn around and overall consumption has remained subdued.** Full time employment has picked up for the first time in five years but the unemployment rate still stands at 10.6 percent in the national definition (8.2 in the ILO definition). The unemployment rate remains particularly high in East Germany at over 16 percent (national definition), where productivity is lower and adjustment has been hindered by large income transfers. Further, although wage costs have fallen, especially in manufacturing, they remain high in international comparison (Figure 3), resulting in continued wage moderation. Spending power has also been held back by terms of trade losses.

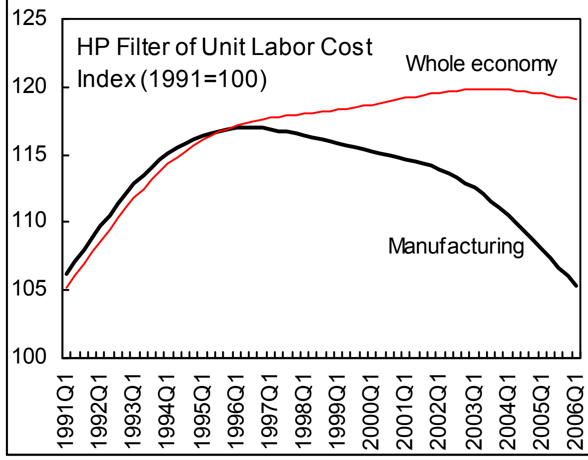
6. **External competitiveness is strong but restructuring of domestically-oriented sectors is lagging** (Box 2, Figure 4). Germany's large exporting companies operate globally, including by moving production capacity abroad and purchasing intermediate inputs from foreign suppliers, and have become less dependent on their home market. This has brought strong export penetration and market share gains both in advanced and emerging market

[2] The package includes accelerated depreciation in 2006-2007 for business investment, incentives for home remodeling, and interest subsidies for small and medium sized enterprises.

countries. By contrast, restructuring in the internal market has been slower with high reservation wages for low-skilled labor, and regulations that tend to favor incumbents.

7. **Inflation is moderate.** Energy and administered prices have kept headline inflation close to 2 percent in recent years. With moderate wage growth, core inflation has been around 1 percent a year. Given labor market slack, there have not been significant second round effects from energy prices. Unit labor costs in manufacturing have declined; but they have continued to increase in the more sheltered domestic sectors.

Manufacturers have adjusted ULC's, service sectors have not.



Box 2. Competitiveness and External Position

German companies are competitive. Germany is the only G7 country that has gained overall market share in world exports in recent years, even during periods of euro appreciation.

Labor shedding and wage moderation have lowered unit labor costs and the current level of the real exchange rate is broadly in line with fundamentals: various analytical approaches suggest only a small undervaluation in the range of 3 to 6 percent, as calculated by Fund staff using equilibrium exchange rate models, and by the Bundesbank using an indicator of trade deflators against nineteen trading partners. At the same time, research suggests that strong foreign growth has been an even more important factor than cost reduction in boosting German exports. And, Germany's strength in engineering products has allowed firms to benefit from the global investment cycle.

The rise in Germany's external current account surplus to an average of 4 percent of GDP in 2000-05 largely reflected a sharp reduction in domestic investment, both by nonfinancial enterprises and households. During this period business firms repaired their balance sheets by cutting investment and increasing saving. Residential household investment was weak as disposable incomes faltered and households picked up their saving in anticipation of aging amidst uncertainty about future entitlement income. The household saving ratio is expected to fall in the course of 2006 with advance purchases prior to the VAT increase. And, as the domestic investment cycle is now turning, business net saving is also expected to drop. The public sector, however, is projected to increase its saving to bolster its balance sheet.

III. Outlook

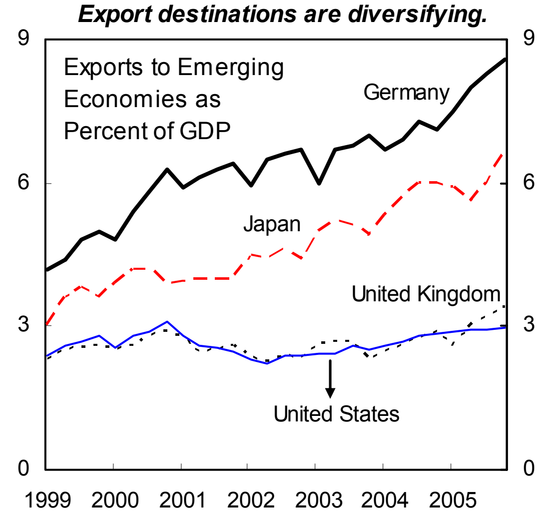
8. **Although the VAT hike is projected to slow growth in 2007, the authorities and staff expect its impact to be transitory.** The 3-point VAT increase is part of a package in which unemployment payroll taxes will be reduced from 6 ½ to 4 ½ percent. Further, the stimulus package (see ¶4) is phased to have a larger impact in 2007. Finally, the global economy is projected to remain strong, favoring German (capital good) exports. The staff projects GDP growth to slow to 1.4 percent in 2007, but because growth in 2006 has been boosted by various one-time effects this does not reflect a slowing of underlying growth, which is estimated to be between 1½-1¾ percent for the two years. Inflation is expected to rise from 1.7 percent in 2006 to 2.3 percent in 2007, with a jump in early 2007 again reflecting the VAT (Figure 4). Wage demands for 2007 are picking up due to strong corporate profitability and the VAT increase, but core inflation is projected to remain between 1-1½ percent.

Real GDP forecast

	2005	2006	2007
Staff (latest)	0.9	2.3	1.4
WEO (Sept)	0.9	2.0	1.3
Authorities (Oct)	0.9	2.3	1.4
Consensus (Oct)	0.9	2.2	1.2
Standard Deviation	…	0.1	0.3

9. **Risks to the recovery are balanced but the range of forecasts for 2007 is unusually wide.** Downside risks stem from volatile oil prices and geopolitics, and an unexpected tightening of euro-area monetary policy. A disorderly unwinding of global imbalances could result in a sharp euro appreciation and lower growth. Faster-than-expected slowing in trading partners could soften German exports, although the increased diversification of destinations could help mitigate this. Finally, consumption remains fragile and failure to deal with needed structural reforms could dampen confidence and continue to restrain household spending. On the upside, the recovery's momentum could get stronger if employment growth continues to gather pace and boosts household incomes. High-frequency indicators peaked in the second quarter of 2006, but they are holding up well (Figure 6). That said, it remains unclear how much spending has been brought forward into 2006 in anticipation of the VAT increase, and, therefore, how pronounced the dip will be in early 2007.

Export destinations are diversifying.



Medium-Term Projections, 2005-2011

(Percentage change from the previous period, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011
Real GDP	0.9	2.3	1.4	1.7	1.8	1.4	1.3
Total domestic demand	0.5	1.6	1.3	1.7	2.0	1.7	1.5
Private consumption	0.1	0.8	0.2	0.8	1.4	1.2	0.9
Gross fixed investment	0.8	5.4	4.8	3.9	3.7	3.4	3.1
Foreign balance (contribution)	0.4	0.7	0.2	0.1	-0.1	-0.2	-0.1
Unemployment rate	9.1	8.0	7.8	7.6	7.5	7.5	7.5
Employment growth	-0.2	0.6	0.3	0.3	0.3	0.3	0.3
CPI inflation	2.0	1.7	2.3	1.6	1.6	1.6	1.6
Saving-investment balances 1/							
Private	5.0	4.2	3.4	3.5	3.3	2.9	2.7
Public	-0.9	0.0	0.7	0.5	0.5	0.5	0.4
Current account balance 1/	4.1	4.2	4.1	4.0	3.8	3.4	3.1

Sources: Fund staff estimates.
1/ In percent of GDP.

10. **Absent a stronger push for structural reforms, the improved cyclical prospects do not change Germany's low growth potential over the long term.** In the medium run, the staff projects the recovery of domestic demand to close the output gap by 2008 and the external current account surplus to fall (Table 2). Recovering from its drawn-out adjustment, domestic demand is expected to rebound as consumption, investment, and total factor productivity recover to their longer run steady states. In the long run, however, Germany's slowing demographics are expected to reduce potential growth to just over 1 percent a year, although progress in labor, product, financial sector and (CIT) tax reforms could improve this outlook. If policies are successful in raising labor utilization and in bringing unemployment down, growth could speed up for some years, but eventually the declining population would constrain headline growth. Long-run per capita growth would be in the range of 1½-1¾ percent a year, in line with other advanced countries.

Germany: Decomposition of Long-Run Potential Output Growth

(Average percentage change a year, unless otherwise indicated)

	1990-99	2000-09	2010-19	2020-29	2030-39	2040-49
Real GDP	**2.0**	**1.3**	**1.4**	**1.1**	**1.1**	**1.2**
Total Factor Productivity (TFP)	**1.4**	**0.8**	**1.0**	**1.0**	**1.0**	**1.0**
Total Hours Worked	**-0.3**	**-0.2**	**-0.3**	**-0.8**	**-0.7**	**-0.4**
Working Age Population	0.4	-0.1	-0.2	-0.8	-0.7	-0.5
Participation Rate	0.1	0.3	0.1	0.1	0.1	0.0
Employment Rate	-0.2	0.0	0.0	0.0	0.0	0.0
Hours per Employee	-0.7	-0.5	-0.3	-0.1	0.0	0.0
Real capital stock	**2.0**	**1.4**	**1.5**	**1.4**	**1.2**	**1.2**
Memorandum items:						
Labor share of income (percent)	0.61	0.60	0.60	0.60	0.60	0.60
Population, e.o.p. (thousands)	82,087	82,643	82,498	81,046	78,459	75,124
Growth with lower unemployment rate 1/	2.0	1.3	1.6	1.1	1.1	1.2

Source: IMF staff calculations.
1/ The baseline scenario assumes a steady-state unemployment rate of 7.5 percent; in the lower unemployment scenario it drops to 5 percent in the next decade and then remains at this lower level.

IV. Policy Discussions

11. **The priority for Germany is to transmit its external strength to the domestic economy, thus further broadening the recovery and creating conditions for sustained high growth**. This requires policies that improve the efficiency of domestic markets and place near-term challenges in a long-run context. Such a strategy should exploit three mutually reinforcing elements: (i) improving labor market flexibility and bolstering employment to boost household income and domestic demand; (ii) raising productivity in product and financial markets; and (iii) reforming entitlements and adjusting fiscal policies to strengthen confidence in the sustainability of the welfare state.

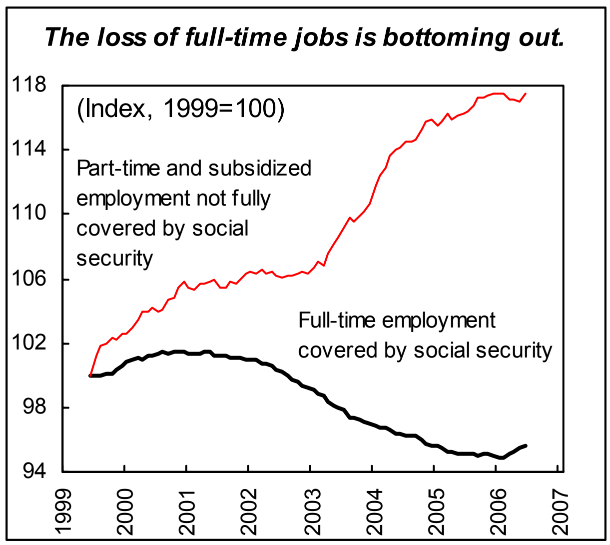
12. **The political environment is challenging and the partners in the grand coalition are having difficulty agreeing on substantial reforms.** The coalition partners have taken a decisive stance on fiscal adjustment, but they are not natural allies on reforms—the labor party (SPD) tends to defend the labor welfare state and the conservative parties (CDU/CSU) tend to defend the corporate welfare state. Negotiations on reforms are therefore difficult and risk delivering awkward compromises. Senior coalition parliamentarians agreed that their task is challenging. However, they felt that the coalition is tackling pressing issues, and praised the leadership's emphasis on harmonious relations in government. They asked that the coalition be judged on results without a premature verdict on process.

A. Fostering Employment Growth

Generous entitlements have kept reservation wages high, limited labor force participation (especially for elderly and female workers), and raised long-term unemployment. The discussions focused on boosting the effectiveness of the Hartz labor market reforms to strengthen employment growth, thus aiding domestic demand (Figure 7).

13. **The authorities' priority in labor markets is to improve the effectiveness of the Hartz IV reforms**. Many analysts and the staff stress that labor market deregulation beyond the Hartz reforms is essential, but others see labor policies as an instrument to address distributional concerns and preserve incomes for those at the bottom (Figure 8). Reflecting these differences, the Coalition Agreement did not include significant new reforms, focusing instead on improving the functioning of the Hartz legislation and evaluating the efficacy of active labor market policies (ALMPs).

14. **The authorities were pleased that short-term unemployment (in the UB-I system) is declining.** A key accomplishment has been the recent shortening of the duration of unemployment benefits from 18 to 12 months (except for elderly workers). Together with the cyclical upturn, these sharper incentives have lowered the number of beneficiaries and the budget costs. Revenues for UB-I are firming up with contributions to social security rising as full-time jobs recover after a long decline.



15. **The bigger challenge, however, is to lower long-term unemployment in the new UB-II system created by the Hartz IV reforms.** Some two-thirds of the 4½ million unemployed are in the UB-II system, which merged the long-run unemployment system (run by the Federal Labor Office) with the welfare system (run by local governments). The new system was intended to improve job placement, lower average benefit levels, and tighten means testing. However, administration has proved more difficult than expected, benefits remained more generous than intended, job placements have been few, and means testing has been inadequate. As a result, reservation wages have remained high and there are more beneficiaries than expected, preventing the intended decline of costs from pre-reform levels.

16. **Consequently, the authorities are contemplating modifications to labor policies.** Final decisions are pending and the policy debate spans a broad spectrum, ranging from

welfare-to-work policies to proposals to protect wage earners from market outcomes deemed socially undesirable.

- *Welfare-to-work.* A government commissioned study by the Council of Economic Advisors recommends lowering the UB-II benefit level by 30 percent for those unwilling to accept jobs with local authorities. Those who accept would retain their full benefit. The rationale is to place the burden of job search on the unemployed instead of the labor office.

- *Wage subsidies.* In a separate proposal, the authorities are considering introducing selective wage subsidies (*Kombilöhne*). A pilot program for elderly workers is being prepared.

- *Minimum wages.* The introduction of minimum wages is also under consideration to "protect" against competition from immigrants from low wage countries and to limit potential fiscal costs of wage subsidies.

- *Capturing unregulated sectors.* The authorities are contemplating new regulations for temporary work agencies, where jobs are growing quickly from a low base. Temporary agencies do not fall under any collective labor agreement and with the absence of minimum wage legislation this has raised concern about abusive labor practices.

17. **The staff supported the welfare-to-work proposals but argued that the other proposals go in the wrong direction and risk adding further distortions.** The staff recommended a shift to policies that support activity—instead of inactivity—and therefore saw merit in lowering the UB-II benefit level by 30 percent. However, minimum wages would be a serious policy error, as these would introduce subfloors in wage setting (further reducing job chances for low-skilled labor), where UB-II already effectively determines too high a reservation wage. Further, wage subsidies would run the risk of rent seeking and high fiscal costs, and regulating temporary work contracts (one of the few markets with increasing activity) would cut flexibility in the already overburdened labor market.

18. **The authorities are undertaking a review of active labor market policies (ALMPs) with a view to curtailing their number.** They explained that Germany has around 80 active programs and preliminary assessments indicate that most of them are ineffective. Fiscal costs amount to €16 billion a year (0.7 percent of GDP). The staff strongly supported the intention to cut ALMPs that were shown to have generated few net jobs, and instead focus on those that work well. Indeed, the multiple ALMPs are described by some as contributing to the "regulatory jungle" of labor policies.

19. **The authorities noted that there was no political consensus to relax employment protection legislation.** Firing costs are almost twice as high as in the OECD on average and the Coalition Agreement sought to extend the legal employment probation period from 6 to 24 months. However, because this liberalization had been made conditional on new restrictions on short-term contracts, and because the coalition partners could not agree on removing this offset, they decided to stick with the existing EPL legislation.

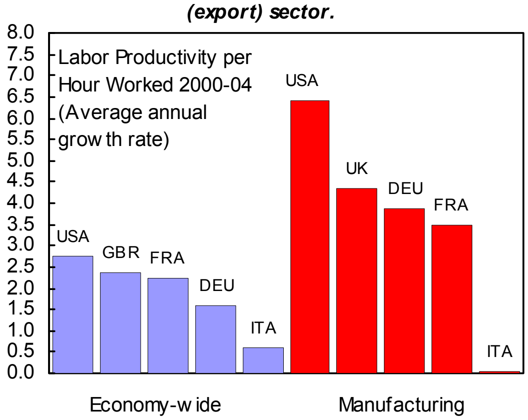
B. Raising Productivity to Support Growth and Wages

Regulatory barriers and significant public ownership continue to impede firm entry in product and services markets, limiting competition and restraining productivity growth. The discussions focused on rolling back public ownership, enhancing access to network industries, and lowering regulatory barriers for liberal professions and in the guilds.

20. **Productivity growth has been uneven across sectors and the domestic economy remains fragmented with unexploited economies of scale.** Foreign competition has stimulated adjustment and boosted productivity in the manufacturing sector, but there has been less productivity growth in domestic activity. As a result, labor productivity growth trails international performance and the domestic sectors—especially retail and wholesale trade and the liberal professions—account for a substantial share of the shortfall. Analysts note that lower productivity gains in the trade and retail sectors is related to barriers to IT adoption stemming from a lack of competition in telecommunication and other network industries. Although progress has been made in recent years, the staff noted that further liberalization is needed to facilitate the structural shift toward a services economy. For example, the OECD and EU Commission have emphasized that network industries in Germany do not face truly contested markets, despite the partial unbundling of services and privatization of some large firms in the industries (Figure 9).

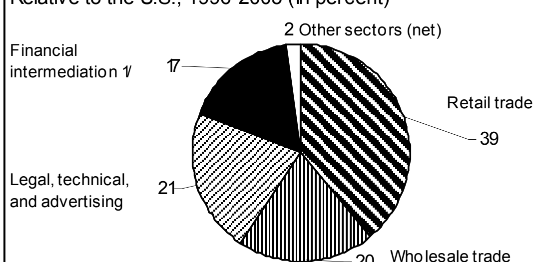
21. **The authorities noted that reform of network industries would continue and**

Economy-wide productivity growth has been relatively weak, held back by low productivity growth outside the manufacturing (export) sector.



Retail and wholesale trade accounts for most of the productivity gap with the U.S.

Contribution of Labor Productivity Growth Shortfall Relative to the U.S., 1996-2003 (In percent)



Source: Staff calculations based on data from Groningen Growth and Development Centre,60-Industry Database, March 2006, http://www.ggdc.net.
1/ Excluding insurance, pension funding and auxiliary activities.

highlighted the following initiatives and issues:

- *Electricity*. The Federal Regulatory Agency is starting to use its expanded powers to regulate (lower) pricing and enhance access for smaller operators.

- *Postal services.* The last vestiges of the postal monopoly will be removed on January 1, 2008, as planned.

- *Railways.* High level discussions are underway, focusing on whether the already agreed privatization of the German railways will be limited to its rolling stock or include a concession to the rail network itself. A decision will be taken soon.

- *Telecommunications.* Deutsche Telecom has requested restrictions on access to its new high-speed fiber network to earn back its investment in this area. According to the authorities, the decision will depend on whether the fiber network is found to have established a new market, and thus would avoid competitive interference, or is part of an already existing market, where restrictions would violate competition agreements.

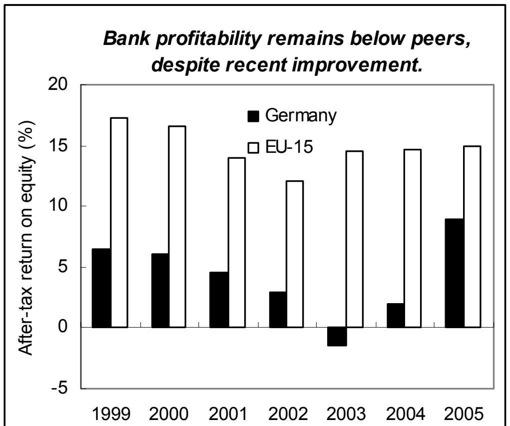
22. **The authorities agreed that there is room to deregulate the liberal professions, but were comfortable with the guild system.** Regulation for liberal professions (doctors, lawyers, notaries, etc.) is notably more restrictive than in the EU-15. The *Monopolkommission* has recommended revoking fixed-price lists and certain master's licensing requirements. However, the authorities emphasized that the guild system for crafts provides significant benefits for quality control and is a major provider of apprenticeship positions. Thus, no policy initiatives are planned to reform the guild system. For liberal professions, the authorities plan to lower bureaucratic hurdles to broaden the scope for activities within the existing framework.

23. **The authorities highlighted the initiative in the chancellery to reduce regulation costs**. According to OECD analysis, the administrative burden on enterprises exceeds the EU-15 average in product markets and tends to favor incumbents. An independent group of experts is reviewing these costs, using models from the Netherlands and U.K. Henceforth; new proposals will be subject to a cost-benefit review before submission to parliament. The authorities target lowering regulatory costs by a quarter, or the equivalent of 1 percent of GDP, by 2009.

C. Improving the Allocation of Capital

Financial sector profitability continues to fall short of peers and strains in the banking system could reemerge during the next downturn. Capital market activity is increasing but there is still substantial untapped potential. The discussions focused on structural reforms to improve the efficiency of the banking system and further deepen capital markets with the aim of improving the allocation of capital and enhancing financial sector stability.

24. **The cyclical upswing and abundant liquidity have improved earnings for banks and insurance companies** (Figure 10). Cost cutting, which is likely to become increasingly difficult, and lower provisioning, which probably cannot be repeated, have also aided bank earnings.[3] Revenue growth and return measures, however, continue to compare unfavorably to the EU average. The ratio of unprovisioned nonperforming loans (NPLs) over capital has declined since 2003 but is still high, which the authorities explained is in part due to Germany's tighter definition for NPLs making international comparability difficult. The staff stressed that without restructuring of the banking sector and innovative new products to boost revenue, profitability will remain subdued (Tables 3-5).



Source: Country authorities, and IMF staff calculations.

[3] Financial intermediation accounts for 17 percent of the labor productivity differential between Germany and the U.S. (see chart in Section IV. B).

Comparative Banking Sector Indicators, 1999-2005

	1999	2000	2001	2002	2003	2004	2005
Regulatory capital to risk-weighted assets							
Germany	11.5	11.7	12.0	12.7	13.4	13.2	12.2
EU-14 1/	12.3	11.8	11.9	12.1	13.2	13.2	12.9
United States 2/	12.2	12.4	12.9	13.0	13.0	13.2	13.0
Capital to assets							
Germany	3.7	3.7	3.8	4.1	4.2	4.0	4.1
EU-14 1/	5.7	5.7	5.8	5.7	6.0	5.9	5.4
United States 2/	8.4	8.5	9.0	9.2	9.2	10.3	10.3
Nonperforming loans to total gross loans							
Germany 3/	4.2	4.7	4.6	5.0	5.3	5.1	4.1
EU-14 1/	4.0	2.9	2.7	2.6	2.5	2.2	2.2
United States 2/	1.0	1.1	1.3	1.4	1.1	0.8	0.7
Nonperforming loans net of provisions to capital							
Germany 3/	39.2	44.7	46.1	47.5	52.1	46.2	35.0
EU-14 1/	19.2	18.2	15.5	15.0	13.2	12.3	11.2
United States 2/	...	...	-2.3	-1.9	-2.8	-3.1	-2.8
After-tax return on average assets							
Germany	0.2	0.2	0.2	0.1	-0.1	0.1	0.3
EU-14 1/	0.9	0.9	0.7	0.6	0.6	0.7	0.8
United States 2/	1.3	1.1	1.1	1.3	1.4	1.3	1.3
After-tax return on average equity							
Germany	6.5	6.1	4.6	2.9	-1.5	1.9	9.0
EU-14 1/	17.8	17.3	14.4	11.9	13.3	14.9	16.7
United States 2/	15.3	13.5	13.0	14.1	15.0	13.2	12.7

Source: Country authorities, Global Financial Stability Report, and staff calculations.

1/ Unweighted average for EU-15 countries excluding Germany, i.e. Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

2/ Data for 20 largest banking groups, accounting for about 2/3 of the U.S. banking system. The lower capital to asset ratios in German and other European banks compared to U.S. banks reflect mostly their relatively lower risk appetite (lower ratios of risk-weighted assets to total assets).

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

25. **Staff welcomed the increase in competition and the regulatory changes that are providing an impetus for reform.** Foreign banks are becoming more active in Germany through takeovers and direct banking (including via the internet). Banks are experiencing heightened price competition for mortgage, consumer, and business lending, which is lowering lending margins. Moreover, the mortgage banking sector is consolidating following last year's liberalization of the *Pfandbriefe* market, which is no longer reserved for mortgage banks and Landesbanken.

26. **Market-driven reform of Landesbanken (LBs) is essential, as staff analysis suggests that they have imposed a large opportunity cost on the economy (Box 3).** The withdrawal of government guarantees in 2005 is now spurring the LBs to reformulate their business strategies. Funding costs are rising and arbitrage opportunities—their traditional mainstay of earnings—are decreasing. To have more direct access to the retail market, the traditionally wholesale-oriented LBs are examining their relationship with the retail-based Sparkassen. Some LBs already have retail operations, others are seeking fuller vertical

integration with Sparkassen into a single banking conglomerate, and yet others are opting for looser cooperation, with a demarcation from Sparkassen but still providing services at market based fees. The staff found a greater willingness to lower public sector stakes in LBs, and in some cases ownership is already changing, including with participation of private equity investors. This should have positive consequences for performance.

Box 3. Landesbanken: High Opportunity Costs for the Taxpayer

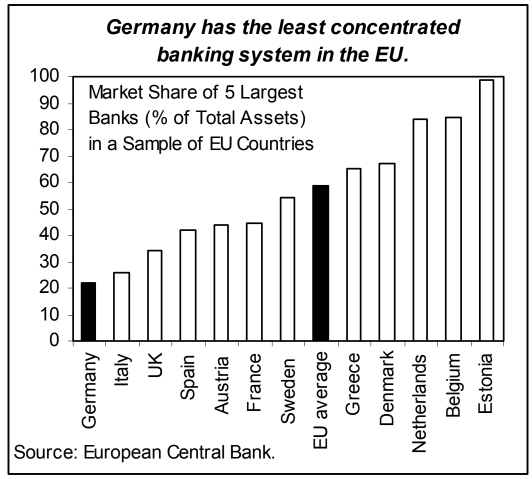
Landesbanken are a large component of the banking sector. They hold 20 percent of banking assets and their book equity represents 9 percent of assets on the public sector balance sheet. An accompanying *Selected Issues Paper* analyzes the rationale for public ownership of LBs and the opportunity costs their below-market financial returns imply for taxpayers.

LBs have provided unsatisfactory financial returns. Although some LBs have performed better than others, overall they have generated substantial direct costs to the taxpayers (in form of capital injections), and even larger opportunity costs because their returns have been well below peer EU banks. Staff analysis suggests that these opportunity costs have been ¼ percent of GDP annually (½ percent of tax revenues) since the early 1990s. Staff simulations also suggest that if these returns could be equalized from now on to market-based returns of comparator banks, the public sector net worth would improve by 10 percent of GDP (in present value terms, for comparison, public sector gross debt is 68 percent of GDP). This would be a significant gain, considering that Germany is struggling to reduce debt and finance aging cost.

It is difficult to find nonfinancial benefits to justify the low financial returns for taxpayers. LBs have a traditional mandate to foster local development and provide liquidity and financial services to local savings banks, but it is unclear what market failure LBs address and how they do this. Rather, LBs create potential distortions, arising from—admittedly waning—arbitrage opportunities, and from conflicting roles of the government as owner and supervisor. Further, lower returns earned by LBs are not offset by lower risk, as evidenced by poorer Z-scores (a measure of default probability) for these banks as a class than comparator banks, which suggests that they are more likely to become insolvent than other banks.

LBs represent an inefficient use of public assets. These findings strengthen the case for disengagement by Länder governments from banking in favor of higher yielding assets or debt reduction.

27. **The authorities do not share staff views on the need for reform of Sparkassen.** Staff noted that the fragmentation associated with the three pillar banking system and the Sparkassen system continued to impede revenue growth. Moreover, the regional principle, which confines Sparkassen to do business in their communities of origin, limits efficiency and impedes risk diversification. Thus, with new competition emerging in banking, including direct banking, Sparkassen could come under increasing pressure, arguing for creating the legal framework to open the door for private capital and market forces to guide restructuring, including through mergers across pillars. The authorities pointed out that Sparkassen are exploring efficiency gains through cost-sharing, including in back-offices, and expressed skepticism that larger efficiency gains could be obtained from liberalization of the regional principle to exploit scale economies. They also felt the system was competitive because of



the wide-spread presence of Sparkassen and low concentration ratio, and saw no need to open up the banks to private capital. Instead, the authorities stressed that they considered Sparkassen to be essential for access to banking services in remote areas and for lower-income households, and as key providers of credit to the Mittelstand and supporters of local cultural and community services. They were confident of the sector's ability to adapt under current ownership structures without a need for market based restructuring.

28. **The authorities continue to be vigilant in regulation and supervision**. Staff supported the move of the supervisory authorities toward risk-oriented supervision of banks, insurance companies, and financial services companies, and encouraged the publication of the methodology underlying this approach. With this move, it is important that supervision be guided solely by prudential criteria determined by the supervisory authorities, and avoid outside interference. The staff also recommended that the review of the supervisory agency (BaFin), which has been initiated as called for in the Coalition Agreement, should be used to reinforce its operational independence. The authorities noted that listed financial institutions will need to adopt IFRS for their consolidated accounts from 2007 onward and legislation to implement Basel II capital adequacy standards has been approved by parliament. A number of insurance groups are already internalizing models for assessing risk under Solvency II and participation in the relevant Quantitative Impact Studies is high. These actions are in line with the 2003 FSAP recommendations.

29. **Capital market activity is increasing and fostering efficiency gains, but there is ample scope for further market deepening.** Analysts estimate that mergers and acquisitions involving German firms could reach 9 percent of GDP in 2006 (€200 billion), a level last observed during the boom in 2000 and not too far behind the United States. Opportunities for further private equity participation are large as the business landscape remains fragmented. The role of venture capital for new startups, however, appears more constrained. Recognizing the benefits of private capital for the entry of new firms, innovation, economies of scale, and corporate governance, the authorities are formulating a more effective legal framework to mobilize additional market financing, including by streamlining tax incentives. Staff supported this objective and looked forward to the announcement of specific details.

30. **The authorities also attach high priority to establishing real estate investment trusts (REITs) to increase flexibility of property markets and deepen capital markets.** Germany has a large stock of real estate assets, but the sector has stagnated for a long time (Box 4). Staff welcomed the authorities' initiatives and noted that increasing flexibility in the real estate market has multiple benefits:

- The property market and construction industry are important sources of jobs, and Germany stands out for not using its potential to boost growth and productivity.

- Improvement in the real estate market would also bolster financial sector stability because a large share of NPLs is collateralized with real property.

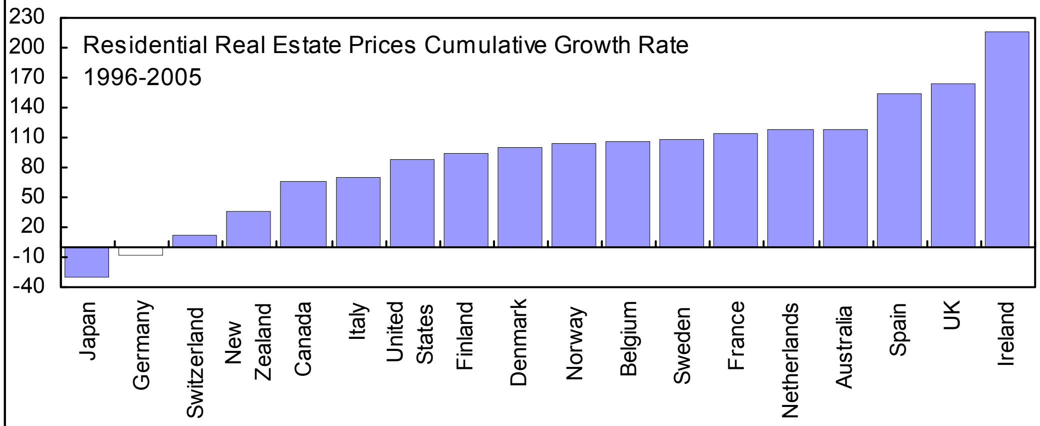
- Experience in other countries has shown that REITs are superior to the open-ended real estate funds in Germany, which had liquidity problems earlier in 2006, and thus would improve the availability of long-term saving instruments.

- Local governments and enterprises in Germany appear ready to divest large real-estate holdings to free up liquidity and focus on core activities.

31. **Staff cautioned that the activities of REITs should not be unduly limited and, in particular, calls to exclude residential real estate should be resisted**. Social concerns, including the potential impact on rental prices, should be addressed through other policy channels, such as budget transfers. The authorities clarified that negotiations are continuing on the scope of REITs and outstanding tax issues (e.g., the liability as property is transferred into REITs and the tax to be paid on dividend distributions) with the aim of introducing REITs in early 2007.

Box 4. Germany's Real Estate Market

Germany's underperforming residential real estate market.



Source: Bank of International Settlements.

Germany's stock of real estate is large. Residential real estate accounts for over half of all real estate, underscoring its significance for the economy. However, housing price increases have lagged well behind those in peer countries since the early 1970s (although they started from a higher level) and, at 43 percent of households, German homeownership trails Western Europe. Several features have contributed to this performance:

Sluggish income growth. Real disposable income grew by 1.2 percent per year since 1991, trailing most comparator countries.

Borrowing costs are high. Long-term mortgage rates are among the highest in the euro area, despite a decline by 0.7 percentage points since end-2002, lowering their spread over long-term government bond yields. This suggests that mortgage market competition is rising.

Rental yields are low. The average rental yield is 3½ percent. Rent controls in federal law cap the yield, and limit cumulative rent increases to 20 percent over three years.

Restrictions favor tenants. Landlords can terminate leases only under narrowly defined circumstances.

Large blocs of property are owned by local governments and corporations. During the housing shortage of the 1960s, public companies were created to provide housing, or industry provided housing for its employees. Both are now trying to unload properties to remove these low-yielding assets from their balance sheets.

D. Advancing Fiscal Consolidation and Long-Run Sustainability

Budget consolidation has been aided by the economic rebound, but there has also been significant structural adjustment. Nevertheless, the high structural deficit and aging-related pressures call for continued fiscal consolidation and entitlement reform. The discussions focused on fiscal objectives and policies for 2007 and the medium term, reform initiatives for the corporate income tax and health care systems, and long-run fiscal challenges.

32. **Germany is making sizeable progress toward reducing the structural deficit and improving the long-run fiscal outlook** (Table 6). The grand coalition has maintained the previous government's approach of cutting expenditure and decided to complement this by raising the VAT in 2007. Prominent expenditure measures include phasing out the home construction subsidy, reducing the commuter subsidy, lowering public sector employment, and freezing wage rates. Aging-related expenditure has also been reduced through lower pension indexation, tighter eligibility for early retirement, a gradual extension of the pensionable age from 65 to 67 starting in 2012, and higher co-payments in health care. Taken together, these efforts have resulted in a substantial improvement in the public sector balance sheet (see below). The improvement for the public sector has meant an adjustment burden for the private sector, which has contributed to holding back domestic demand.

33. **With assistance of the cyclical upswing, the authorities noted that a substantial reduction of the deficit is underway in 2006-2007.** Tax revenue has benefited from the economic rebound and is running well ahead of projections. Notably, the social security fund is in surplus with the uptick in employment, and corporate profit taxes are booming. For 2006, the staff projects the deficit to decline to 2.4 percent of GDP from 3.2 percent in 2005, thereby observing the commitments under the excessive deficit procedure one year ahead of schedule. Continued expenditure restraint is expected to contribute to structural adjustment of about ½ percent of GDP in 2006, exceeding initial plans. At the time of the mission (and prior to the update of the growth forecasts), the authorities cautiously projected the deficit to fall to 2.8 percent of GDP in 2006 and 2.3 percent in 2007, with a net contribution of ⅓ percent of GDP from the VAT hike and the partially offsetting cut in unemployment insurance contributions.

34. **For 2007, the staff noted that a lower deficit is achievable on current policies and that the authorities should therefore aim for a more ambitious target.** Specifically, assuming no expenditure slippage (an assumption that cannot be taken for granted), the fiscal deficit could be reduced further to at most 1.6 percent of GDP. This is 0.7 percentage point less (cumulative over 2006-2007) than indicated by the authorities, in part because their revenue estimates were based on a previous (lower) growth scenario. Taking 2006 and 2007 together, the structural deficit would then be reduced by about 1¼ percent of GDP, with about two-thirds of the improvement based on expenditure containment. In the outer years, however, problems with revenue buoyancy would remain because the largest tax bases (wages and consumption) have structurally weakened with the economy's drawn-out

adjustment, continued high unemployment, and only moderate structural reforms (Figure 11). Further, interest rates on the debt have been low recently, and may be expected to increase going forward. In view of these pressures and notwithstanding the cyclical pickup in revenue, the staff supported the authorities' firm intention to proceed with the VAT increase, which is part of their strategy to shift from direct to indirect taxes.

Fiscal Developments and Staff Projections1/
(In percent of GDP)

	2002	2003	2004	2005	Proj. 2006	Proj. 2007	Proj. 2008	Proj. 2009
Revenue	**44.4**	**44.5**	**43.4**	**43.5**	**43.4**	**43.6**	**43.4**	**43.4**
o/w Taxes	22.3	22.3	21.8	22.0	22.4	23.3	23.1	23.1
Social contributions	18.2	18.3	18.0	17.7	17.4	16.8	16.8	16.7
Primary Expenditure	**45.2**	**45.5**	**44.3**	**44.0**	**43.1**	**42.5**	**42.4**	**42.3**
Social benefits	27.1	27.5	26.9	26.7	26.2	25.9	25.8	25.8
Other	18.1	18.0	17.4	17.3	16.9	16.6	16.6	16.5
Primary balance	**-0.7**	**-1.1**	**-0.9**	**-0.5**	**0.4**	**1.1**	**1.0**	**1.0**
Interest	2.9	3.0	2.8	2.8	2.7	2.7	2.8	2.8
Overall balance	**-3.7**	**-4.0**	**-3.7**	**-3.2**	**-2.4**	**-1.6**	**-1.8**	**-1.8**
Structural balance	-3.2	-3.4	-3.4	-2.8	-2.4	-1.5	-1.9	-1.9
Debt-GDP ratio	59.6	62.8	64.8	66.4	67.5	67.4	67.5	67.4
Memorandum items:								
Authorities' targets								
Overall balance	-3.7	-4.0	-3.7	-3.2	-2.8	-2.3	-1.8	-1.3
Debt-to-GDP ratio	59.6	62.8	64.8	66.4	67.7	68.3	68.3	67.7

1/ Based on staff assessment of current measures and authorities' plans.

35. **Beyond 2007, even with the VAT increase the staff sees a risk that the deficit will get stuck at 1¾ to 2 percent of GDP.** Measures such as the cut in commuter and home construction subsidies will generate additional savings over time, but these will be insufficient to offset rising interest costs and some revenue losses from the corporate income tax reform (below). Hence, the authorities are expected to fall short of their targeted adjustment of ½ percent of GDP a year beyond 2007, which is the minimum necessary to achieve structural balance in 2010. This goal is appropriate and to meet it the staff recommended implementing additional cuts in subsidies and tax expenditures (which remain significant) and in spending on ineffective ALMPs. Emphasis on such measures would have the added advantage of reducing distortions in the economy. Analysis using the Global Fiscal Model suggests that a well chosen mix of policies to eliminate the structural deficit in this timeframe will have a modest negative effect on growth (Box 5).

Box 5. Germany: Analyzing Fiscal Plans with the Global Fiscal Model

The IMF's Global Fiscal Model (GFM) was used to analyze the implications of Germany's fiscal plans on public debt and economic activity. GFM endogenizes labor supply, consumption, and investment decisions, and is also suitable to evaluate economic spillovers to other regions (see section V). The *Selected Issues Paper* on GFM focuses on the effects of achieving structural balance and the three tax reform initiatives in 2007 and 2008: (i) a VAT increase from 16 to 19 percent, (ii) some offsetting reduction in unemployment insurance taxes; and (iii) a reduction in corporate income tax rates with base broadening.

Achieving structural balance over the medium term would significantly improve debt dynamics by prefunding future aging related liabilities. A combination of expenditure cuts, entitlement reform, revenue enhancement through base broadening and tax reform is most efficient and realistic. Eliminating the structural deficit by 2010 with such a policy mix would hold back short-run growth by about 0.2 percent a year relative to a scenario with no adjustment, but will bring compensating benefits in the long-run.

The government's proposed tax policy measures imply a shift from direct to indirect taxation. GFM suggests that this will increase economic efficiency over time. It will lead to some sacrifice in growth and consumption in 2007 (higher VAT), but increase labor demand and incentives to save and invest over the medium term (lower payroll and corporate tax rates). The tax reforms would lower the long-run debt ratio, but not enough to offset aging related fiscal pressures. Therefore, further adjustment in entitlement expenditure is needed.

36. **The authorities have put high priority on reforming the corporate income tax (CIT) and health care systems.** As both reforms are still in development, their projections do not take them into account. If designed well, the reforms would raise efficiency while containing budget costs. In view of the risks, the staff argued that they should be implemented carefully to avoid a need for later corrections (as has happened with some previous reforms), even if this means taking more time to negotiate sound agreements.

37. **The CIT reform aims to lower tax rates, which are to be compensated in part by base broadening.** The authorities noted that statutory corporate tax rates in Germany are high by international standards and they plan to reduce the tax rate from 39 to 29 percent.[4] Current proposals aim to limit the annual revenue loss to ¼ percent of GDP. The authorities' most recent proposal (finalized after the mission) includes limits on the deduction of interest costs only in specific cases where there is evidence of borrowing from foreign subsidiaries to shift profits abroad. This is a moderation from initial proposals of broader limits on interest and leasing cost deductions, which, as pointed out by staff and others, could have induced unintended distortions in business decisions. Reducing Germany's comparatively high rate of

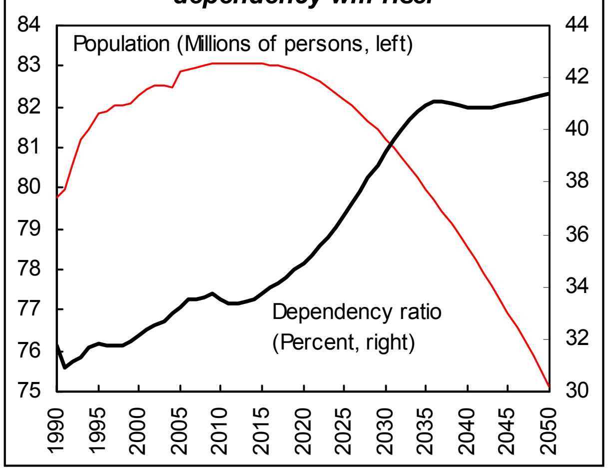
[4] A *Selected Issues Paper* discusses the proposed reforms in detail.

depreciation allowances is under consideration to broaden the tax base. The staff also noted that increasing revenue from the tax on business property should be considered, but the authorities pointed out that the impact of the overall reform would then be substantially different for proprietorships and corporations, and therefore was rejected. The authorities intend to implement the reform in January 2008.

38. **Cabinet proposals on health care reform do not appear sufficiently ambitious.** Health care costs are high and are the main fiscal pressure from aging. Thus, reform is critical. The government has proposed creating a new central health fund (to be launched in 2009) to pool wage-based contributions that are then disbursed to the individual insurance funds, with the insured allowed to switch funds. However, the central issue of changing the funding of healthcare to reduce pressure on labor costs has not been tackled. Further, although the reform aims to introduce competition among health providers and insurers, the upward trajectory of long-run health costs is unlikely to slow significantly. And, the financing of child healthcare will be gradually shifted to general taxes, but there is no indication yet of how the budget impact (¾ percent of GDP per year) will be offset. Parliamentary discussion could result in changes to the plan, but the risk that the reform will fall short of requirements is large.

39. **Germany's near-term fiscal challenges need to be seen in a long-run context**. Notwithstanding the progress made, given Germany's projected demographics, long-run debt sustainability is not yet assured and further adjustment in entitlement and other programs will need to be an essential part of the menu to address future fiscal pressures. Reforms to boost employment and productivity, combined with a more dynamic financial system and capital markets are also needed to raise growth and improve the fiscal outlook.

The population will decline, and dependency will rise.



40. **The progress made toward fiscal sustainability and the road that remains to be traveled can be seen in the long-run fiscal projections and public sector balance sheet**. The combined financial and nonfinancial net worth on the public sector balance sheet is nearly exhausted (current net worth in the table below). In addition, the staff has calculated the NPV of the impact of projected future fiscal deficits with increasing aging costs under current policies and alternative assumptions about the fiscal balance in 2010 (Figure 12). Taken together, the current net worth and implicit liabilities provide a view on the comprehensive (intertemporal) net worth of the public sector.[5] Two conclusions follow: (i) major progress has been made in strengthening the comprehensive net worth of general government in recent years (thereby presumably slowing the recovery in the private sector) and, (ii) the job remains incomplete and debt sustainability not assured even if the government achieves a zero fiscal balance by 2010.

General Government Indicative Balance Sheet 1/

(In percent of GDP)

	2003	2004	2005	2006	
Projected aging costs:				4.0%	2.7%
Financial net worth	**-45**	**-49**	**-51**	**-53**	**-53**
Gross debt	-63	-65	-66	-68	-68
Other	17	16	15	15	15
Nonfinancial net worth	**55**	**55**	**55**	**54**	**54**
Participations	5	5	5	5	5
Fixed capital stock	51	50	50	49	49
Current net worth	**10**	**5**	**3**	**1**	**1**
50-year projection of change in net worth (NPV) 1/	-191 a/	-150 b/	-114 c/	-30 d/	-7 e/
Comprehensive net worth=budget constraint	**-181**	**-145**	**-111**	**-28**	**-5**
Comprehensive financial net worth 2/	**-227**	**-194**	**-162**	**-81**	**-58**
Memorandum items:					
GDP (billions of euros)	2,163	2,207	2,241	2,306	2,306
Structural fiscal balance	-3.4	-3.4	-2.8	-2.4	-2.4

Source: Bundesbank; Ministry of Finance, and Fund staff calculations.

1/ Staff projections of fiscal scenarios for a rolling 50-year period:

a/ End-2003, unchanged policy scenario; 3 percent fiscal deficit in 2010, aging costs at 6.5 percent of GDP;

b/ End-2004, unchanged policy scenario; 3 percent fiscal deficit in 2010, aging costs at 4.0 percent of GDP (Agenda 2010);

c/ End-2005, unchanged policy scenario; 2 percent fiscal deficit in 2010, aging costs at 4.0 percent of GDP (Coalition Agreement);

d/ End-2006, normative scenario; assuming zero fiscal balance in 2010, aging costs at 4.0 percent of GDP (Staff);

e/ End-2006, normative scenario; assuming zero fiscal balance in 2010, aging costs at 2.7 percent of GDP (Authorities).

2/ Excludes the nonfinancial net worth as many such assets may not be marketable. Therefore, they would not be available to alleviate the public sector liquidity constraint.

[5] Not unlike a corporation adding an estimate of future pension obligations to its balance sheet.

41. **Moreover, projections of aging costs are still uncertain**. In 2003 the incremental aging costs by 2050 were estimated to be 6.5 percent of GDP. Under fiscal policies then in place, this would have resulted in a large debt buildup in future and a serious shortfall in the public sector comprehensive net worth of 180 percent of GDP (above). Since then, the reform of entitlement programs under Agenda 2010 and the coalition agreement lowered aging costs through 2050 to about 4 percent of GDP and the structural deficit (affecting long run projections) was reduced. As a result, by the end of 2005, the comprehensive deficit in net worth was reduced to just over 100 percent of GDP. If the government achieves budgetary balance by 2010 (measures are not yet in place to guarantee this), the shortfall in the comprehensive net worth could be reduced further to about 30 percent of GDP. Under the EU Aging Working Group assumption that aging costs have been reduced to 2.75 percent of GDP, comprehensive net worth would be close to zero as shown in the 2006 columns above. However, both these projections may prove too optimistic as health spending in particular may be underestimated. A risk scenario by IFO (not yet published) that extrapolates recent health care price increases to 2050 suggest that total aging costs could still rise by over 7 percent of GDP.

Aging Related Fiscal Expenditure Pressure

	AWG 1/	IMF 2/
(Percentage points increase 2004-2050)		
Total	**2.7**	**4.0**
Pensions	1.7	2.8
Health	1.2	1.1
Long-term care	1.0	1.0
Unemployment	-0.4	-0.5
Education	-0.9	-0.4

1/ EU Aging Working Group, 2006.
2/ IMF Staff Report and Selected Issues Papers on Germany, 2005.

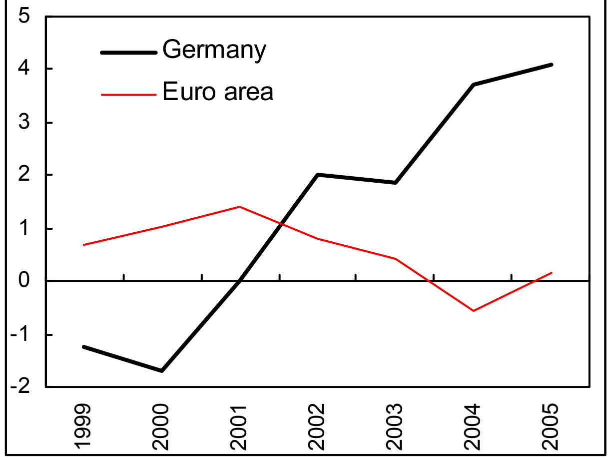
42. **The authorities intend to make further progress in reining in long term fiscal pressures.** In addition to the CIT and health care reforms yielding some efficiency gains for the budget, they saw additional potential for discretionary expenditure cuts. In this regard, they are exploring increased use of public-private partnerships (PPPs) to take over some infrastructure spending now carried on-budget; and they are considering reformulating their constitutional "golden rule" rule under which new debt placement cannot exceed capital spending. However, in the staff's view, PPPs should be approached with caution because they can result in large contingent liabilities. And, although there is indeed scope to improve the design of the golden rule, it needs to be done in a way that does not loosen fiscal constraints.

V. Spillovers

The German economy is at the center of the euro area with 30 percent weight. Its slow growth has had ramifications beyond its borders.

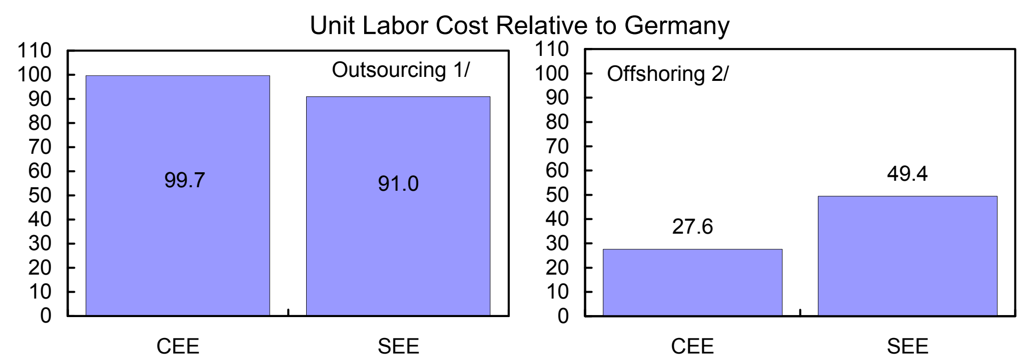
43. **Germany's external current account has gone from balance in 2001 to a surplus of 4 percent of GDP in 2005.** The counterpart is mostly found among the other euro-area countries, with the result that the euro area current account has remained broadly balanced over this period. Germany's export market share of intra-euro zone trade has risen, while it declined for France, Italy, and Spain. Thus, Germany's competitiveness gains have pressured other euro-zone countries to adjust as well.

German current account improved, while euro area remains balanced.



44. **Outside the euro-area, the new EU members have benefited from Germany's proximity**. These countries are attractive locations for intermediate production with a willing and low-cost workforce enjoying rapid productivity gains; reorganizing part of the production chain to these lower cost countries has contributed to improving German competitiveness. Thus, German FDI is flowing into Eastern Europe, providing these countries a boost. This location competition, however, added to pressure on German workers, especially those with weak skills. The authorities said that they do not intend to open up the economy to full labor mobility until the end of the transition period agreed among EU partner countries.

Offshoring reduces costs more than outsourcing.



Source: Marin D. (2006) "A New International Division of Labor in Europe: Outsourcing and Offshoring to Eastern Europe" Journal of the European Economic Association, forthcoming.
1/ Purchasing intermediate inputs from other providers in Central and Eastern Europe (CEE) and Southeastern Europe (SEE).
2/ Moving production capacity to CEE and SEE countries and thus increasing productivity closer to parent firm level.

45. **Moving beyond the EU to global repercussions, the authorities were confident that their policy agenda will assist in resolving global imbalances**. They recognize that the current account surplus is large and indicated that their reform agenda aims to strengthen the supply side of the economy to lay the basis for stronger domestic demand. Indeed, they were encouraged that employment and domestic demand had now begun to pick up. The authorities also stressed their intention to maintain open trading relations and welcomed foreign investment, including in the financial sector and network industries, and hoped that other countries would reciprocate.

46. **Staff analysis using GFM indicates that spillovers from German fiscal plans on partner countries are moderate**. Fiscal adjustment in Germany increases its current account surplus by reducing demand for imports. However, the effect on partner countries' growth and current account balances are moderate because a balanced adjustment package leads to only a temporary and small reduction in German consumption and import demand. Furthermore, as Germany is well integrated in international capital markets, there is an offset on partner country growth through lower interest rates, but this effect is also small.

VI. Staff Appraisal

47. **After several years of meager growth, a brisk cyclical recovery is finally underway**. Corporate restructuring and wage moderation have lowered costs and improved competitiveness and the current level of the real effective exchange rate is broadly in line with fundamentals. These private sector adjustments were accompanied by reforms of labor market and social welfare programs. The grand coalition that came into office a year ago committed to continue on this path. The upswing has also benefited from a robust expansion of the world economy, and strong exports are beginning to spur investment.

48. **Without deeper structural change, however, the improved cyclical prospects do not alter Germany's low growth potential.** External competitiveness has been restored, but domestic efficiency remains low and unemployment is intolerably high. The upswing provides a favorable setting to tackle these problems by implementing mutually reinforcing policies. Specifically, labor market flexibility needs to be improved to speed up job growth and increase labor utilization. Parallel productivity-enhancing reforms in product, service and financial markets are needed to magnify the impact of labor reforms. And, fiscal consolidation and entitlement reforms are critical to increase confidence in the sustainability of the welfare state. If the reforms are too timid or unduly delayed, Germany could miss out again on the increase in living standards seen in other leading economies over the last decade.

49. **Employment growth needs to accelerate to generate higher household income and consumption, thus broadening the recovery.** The recent uptick in full-time jobs is encouraging. However, reducing structural unemployment will require lower reservation wages to bolster employment prospects for the lower skilled. Policies need to raise labor

utilization through support for activity rather than inactivity, which will have the added benefit of reducing structural welfare costs.

50. **Recent labor market reforms need to be modified and their implementation strengthened**. Efforts to tackle the core problem of long-term unemployment have been expensive but largely unsuccessful. Therefore, improving the functioning of the Unemployment Benefit II system should be a top priority. As recommended by the Council of Economic Experts and several research institutes, the allowance provided under UB-II should be cut until there is demonstrated work effort. Introducing minimum wages, as proposed by others, would be a serious mistake because it would undermine job creation and hurt job seekers. Equally, new wage subsidies should not be introduced as UB-II already has elements of employment support and acts as a wage floor.

51. **More generally, many of Germany's active labor market programs and regulations are complex, expensive, and ineffective**. The ineffective programs should be eliminated; those that are retained should be simplified to increase transparency, including for job seekers.

52. **Additional deregulation of product and service markets is needed to strengthen competition and raise productivity, and should be higher on the policy agenda**. Productivity ultimately determines the standard of living and greater reliance on efficiency gains would put less burden on relative wage adjustments and be beneficial for Germany and its trading partners. The recommendations of the *Monopolkommission* to liberalize licensing requirements for crafts and price schedules for professional services, where conditions favor incumbents, should be implemented without delay. Further, it is essential to improve the contestability of markets in network industries to help capture efficiency gains and benefit consumers. This will require stepping up privatization and reducing network access costs.

53. **A more efficient financial sector would improve the allocation of capital to areas of highest return, strengthening economic performance**. Banks and insurance companies are healthier than in recent years, but the improvement in earnings is largely cyclical and they still underperform most EU peers. Adjustment needs to be accelerated in the large public banking pillar. The withdrawal of government guarantees has spurred Landesbanken to develop new strategies. Ownership structures of several banks are changing, which should have positive consequences for performance. However, it remains vital to allow more private capital to enter public sector banks to harness market signals and facilitate restructuring. Such changes are overdue as strains could reemerge during the next downturn and developments in neighboring countries risk leaving leave the German banking system behind.

54. **Supervision should be guided solely by prudential criteria determined by the supervisory authorities**. In this context, the ongoing review of BaFin provides a good opportunity to buttress its operational independence. The supervisory authorities' move

toward more risk-oriented supervision is appropriate, but the methodology underlying risk-oriented supervision should be published to strengthen transparency.

55. **Capital markets are deepening and playing a greater role in guiding corporate decisions**. The untapped potential remains large. The authorities should proceed in formulating a more effective legal framework for private equity because such financing can facilitate the entry of new firms, spur innovation, and enhance corporate governance.

56. **Increasing flexibility in the real estate market would also contribute to economic efficiency.** This market has stagnated with low liquidity and controls on rental markets. The immediate priority should be to introduce REITs covering both residential and commercial property. These trusts can facilitate divestiture and allow owners to focus on core activities.

57. **Good progress has been made in reducing the fiscal deficit in 2006 and policies are in place for further adjustment in 2007, thereby bolstering sustainability**. Although expenditure-based measures should continue to be the cornerstone for lasting fiscal adjustment, the VAT increase combined with a reduction in payroll taxes is a positive structural measure. The goal should be to reduce the deficit to below 2 percent of GDP in 2007, which is achievable without additional discretionary measures as long as the authorities do not yield to the expenditure demands that tend to accompany strong revenue growth. The past mistake of failing to consolidate during the upswing should be not be repeated. Thus, any additional revenue should be used to reduce borrowing, not to increase spending.

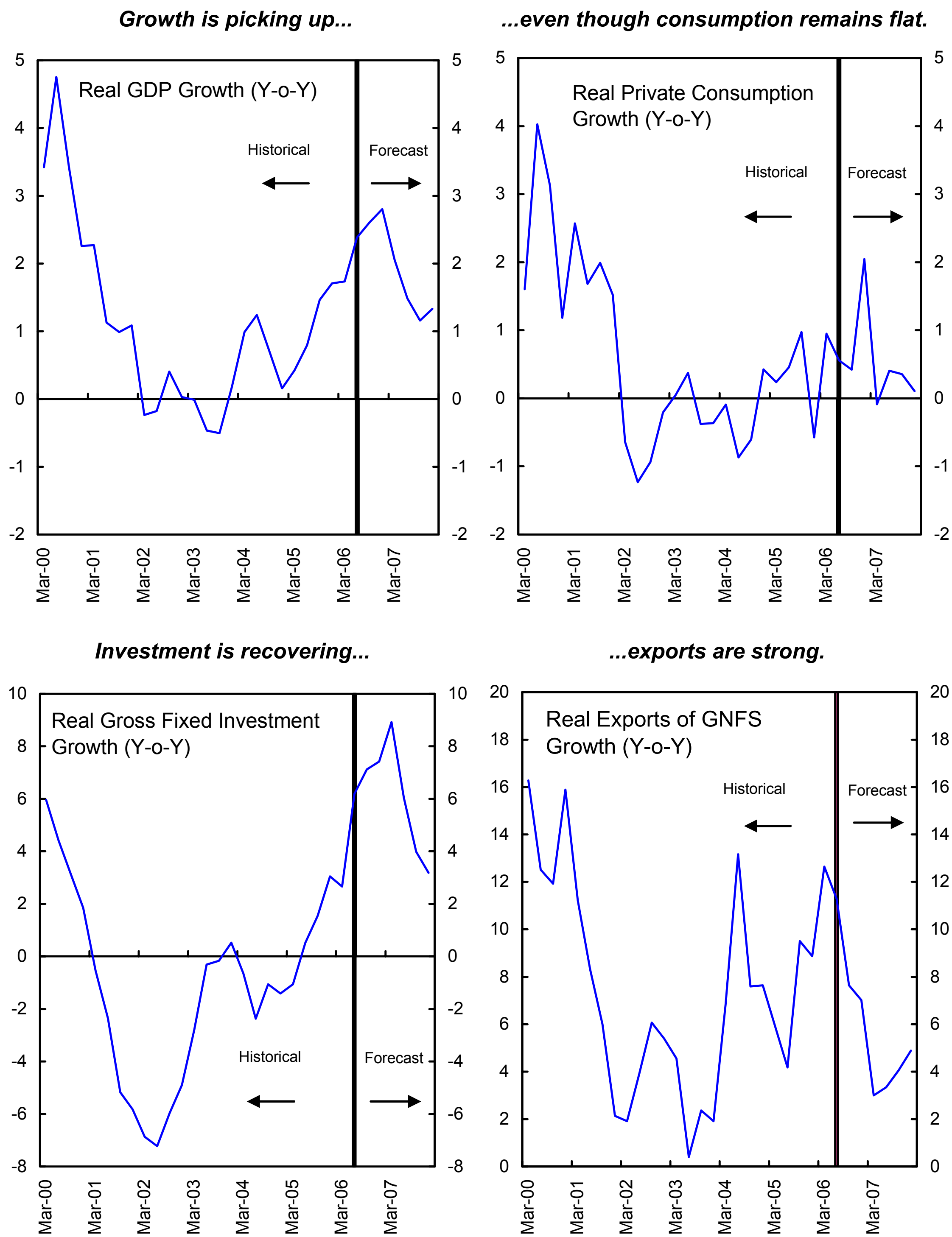
58. **Beyond 2007, however, unless additional measures are implemented, there is a danger that the deficit will begin to rise again.** The aim should be to implement structural adjustment of at least ½ percent of GDP a year to achieve structural balance by 2010 and anticipate pressure from population aging. To meet this goal, the authorities should further reduce subsidies and tax expenditures, cut spending on active labor market programs, and lower unemployment costs. Measures should also continue to focus on reducing aging-related structural expenditure by reforming entitlement programs.

59. **Corporate income tax and health care reforms need to be implemented in a way that meets stated objectives without increasing fiscal risks**. The budgetary cost of the planned reduction in statutory corporate tax rates should be capped at the agreed ¼ percent of GDP. Base broadening such as normalizing accelerated depreciation rates or raising revenue from the tax on business assets would be preferable to reducing interest deductibility as a business cost. Lowering the trajectory of health care costs will require a substantial increase in competition among health care providers and insurers without adding to bureaucracy, and further efforts are needed to decouple healthcare financing from payroll charges.. The current proposals do not meet these objectives.

60. **Although policies have made a solid contribution to reducing long-run aging costs, long-run fiscal sustainability is not yet assured**. Even if the structural deficit is eliminated by 2010 (for which measures are not yet in place), the debt ratio would come under pressure in the long run. Moreover, further research is needed to pin down better the remaining aging costs. A comprehensive strategy to secure long-run sustainability should combine fiscal measures with reforms to increase productivity and labor utilization.

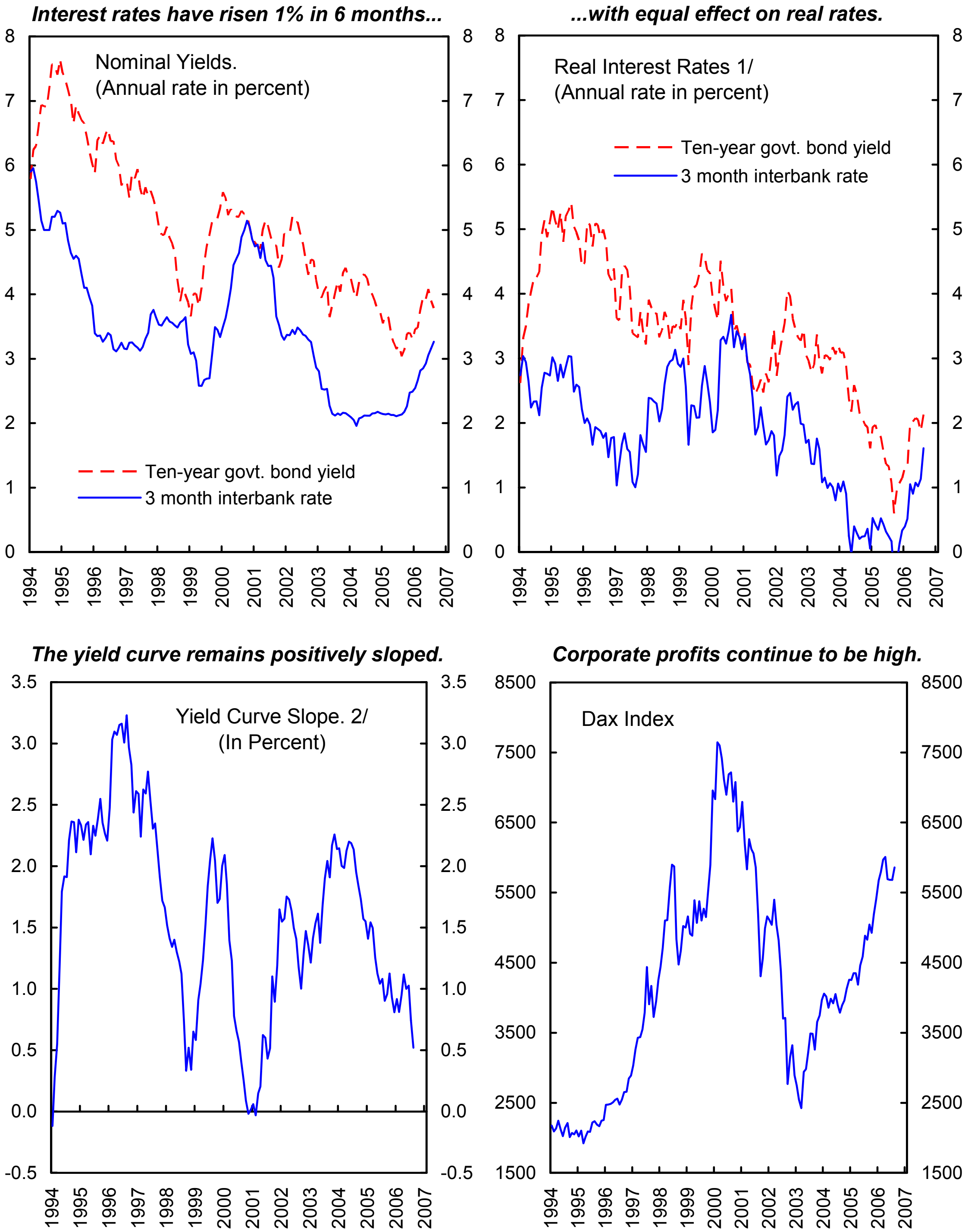
61. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Germany: National Accounts Indicators, 2000-2006



Source: Federal Statistical Office, and IMF staff calculations.

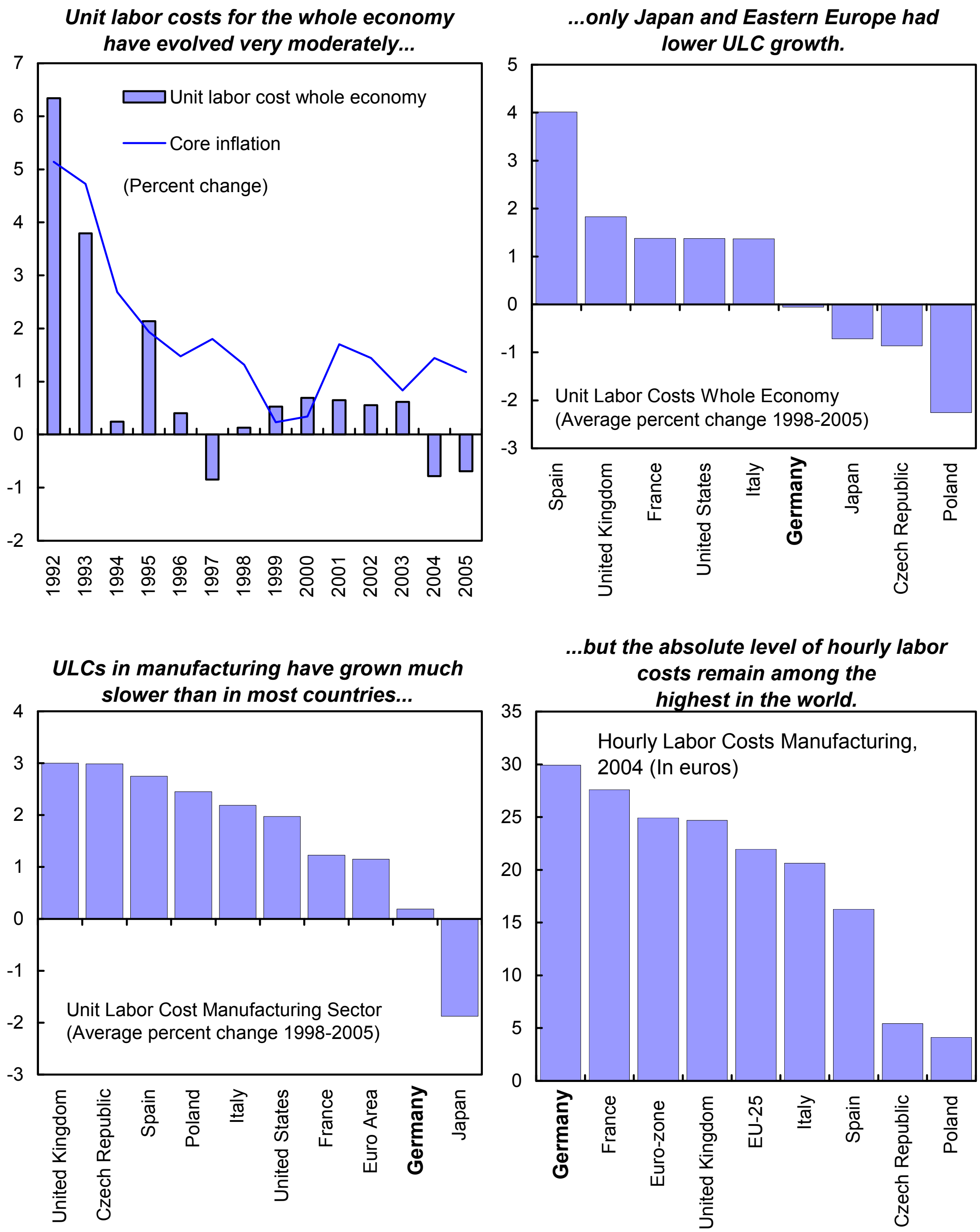
Figure 2. Germany: Financial Indicators



Source: DataStream, Bloomberg and IMF staff calculations.

1/ Yields minus consumer price inflation.
2/ Ten-year bund rate minus 3 month interbank rate.

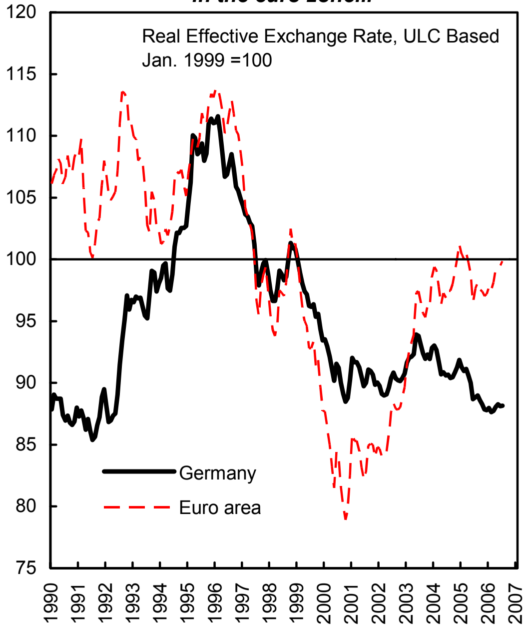
Figure 3. Germany: Unit Labor Cost



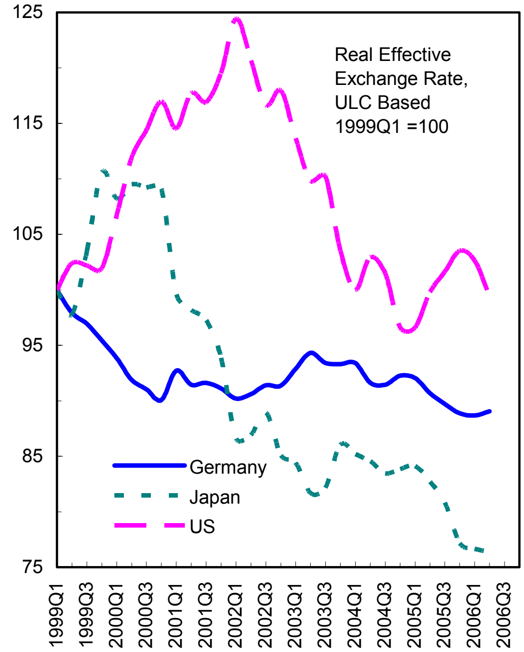
Source: Bundesbank, OECD, and Eurostat.

Figure 4. Germany: External Competitiveness

Germany has improved its competitiveness in the euro zone...

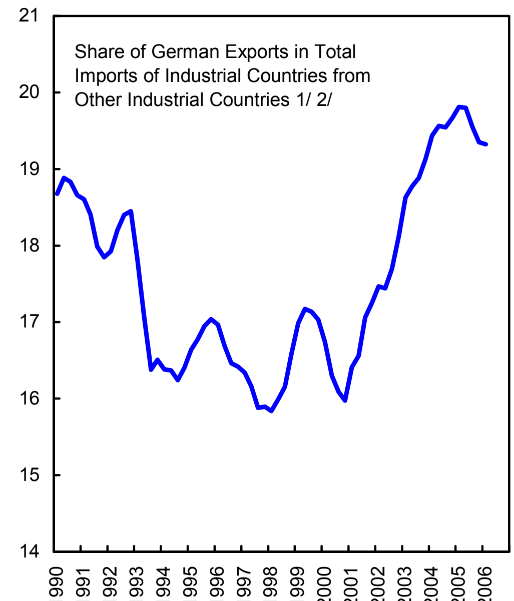


...and relative to the United States, but not Japan.



It regained export market share in the euro zone after the losses due to unification...

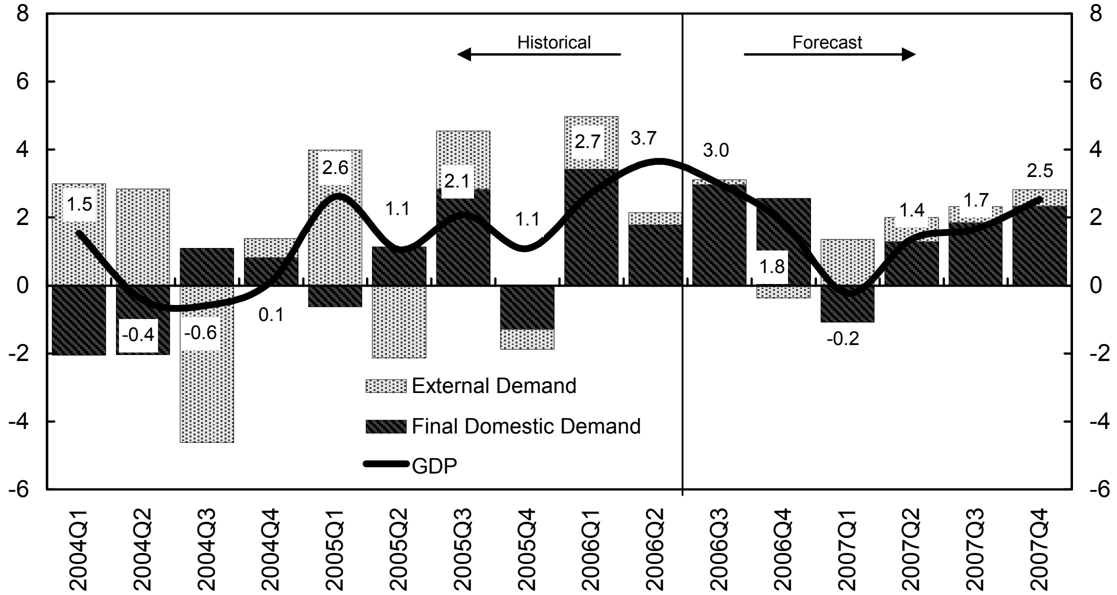
...and also in a broader set of industrial countries.



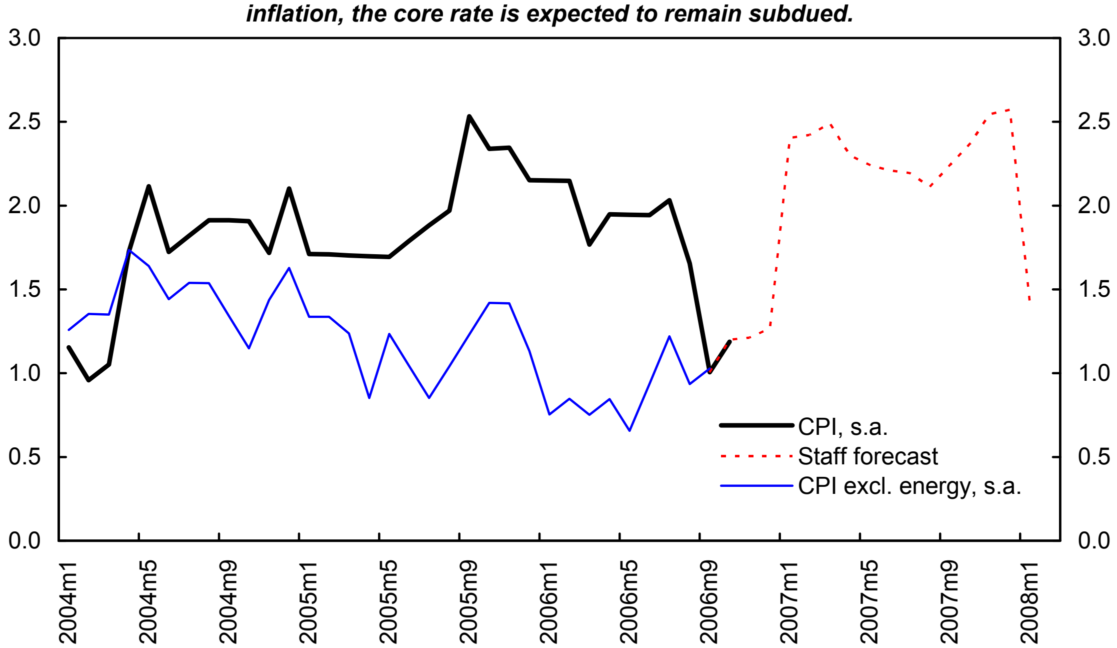
Sources: IFS, WEO, OECD, Direction of Trade Statistics, and IMF staff calculations.
1/ Three-quarter moving averages.
2/ Excludes Belgium and Luxembourg.

Figure 5. Germany: Quarterly Growth Projections and Inflation

Quarterly GDP Growth Contributions at Annualized Rates 2004-2007 (Calendar and seasonally adjusted).

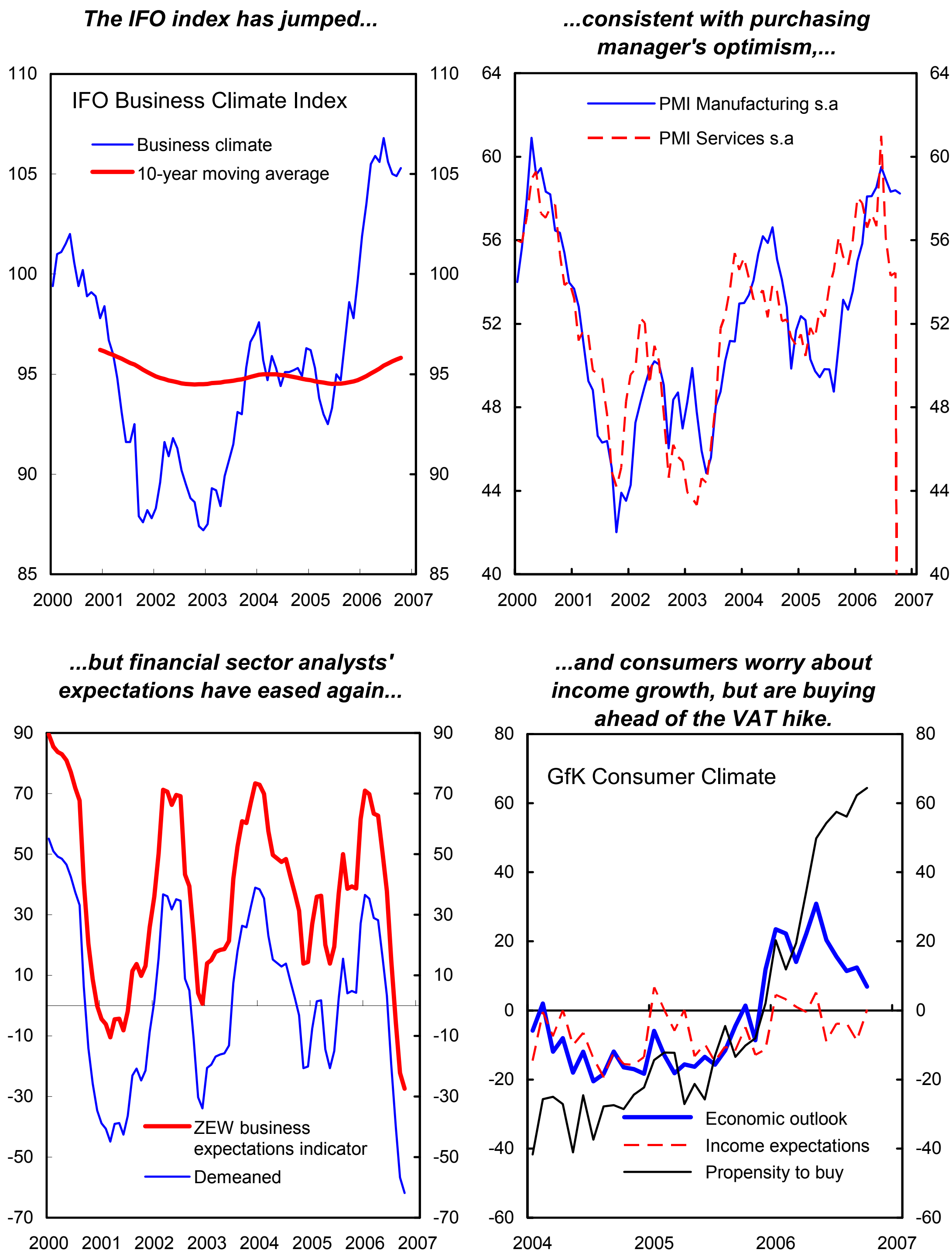


Headline inflation is expected to jump in January 2007 with the VAT hike, with low wage inflation, the core rate is expected to remain subdued.



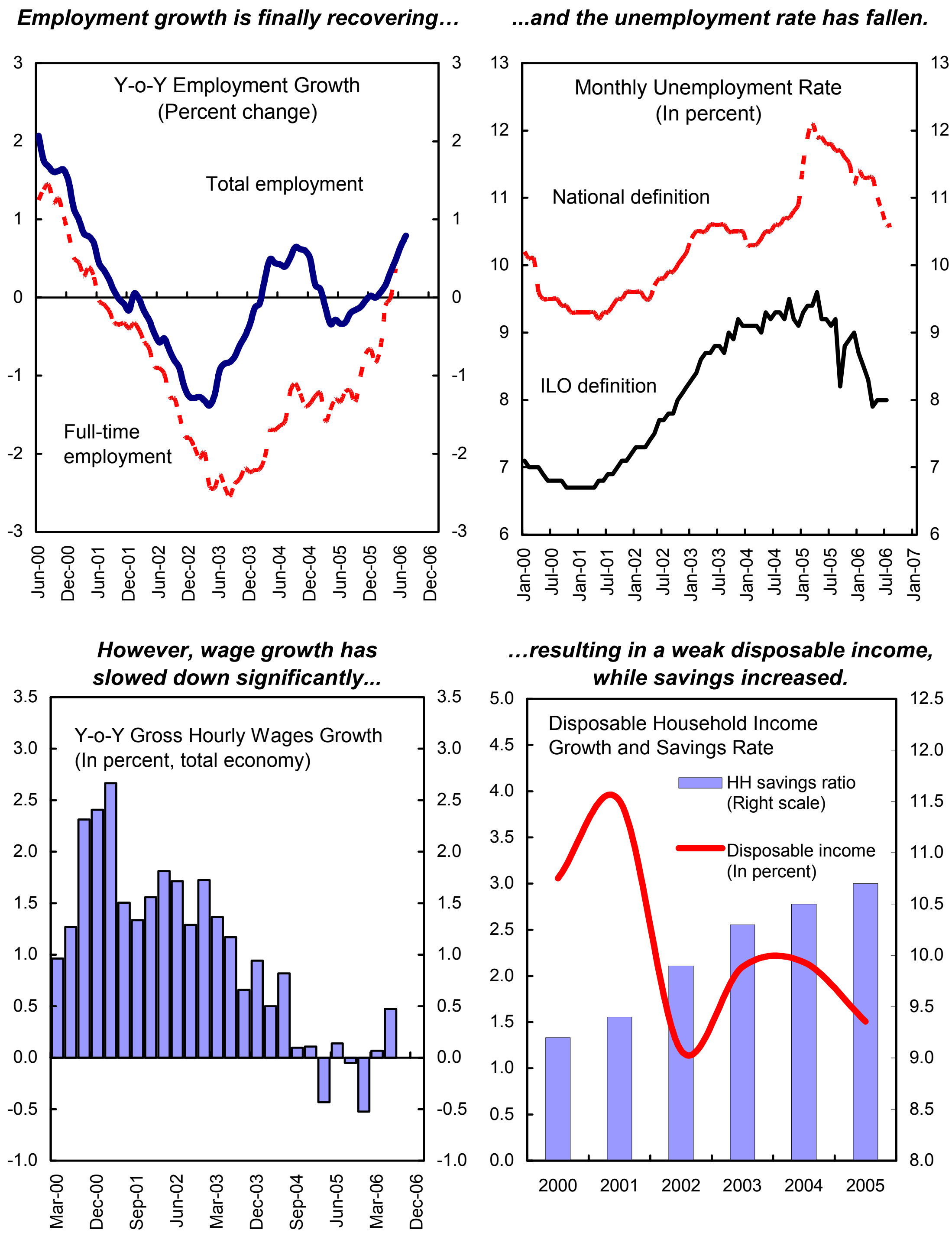
Source: Bundesbank, Federal Statistical Office, and IMF staff calculations.

Figure 6. Germany: Sentiment Indicators, 2000-2006



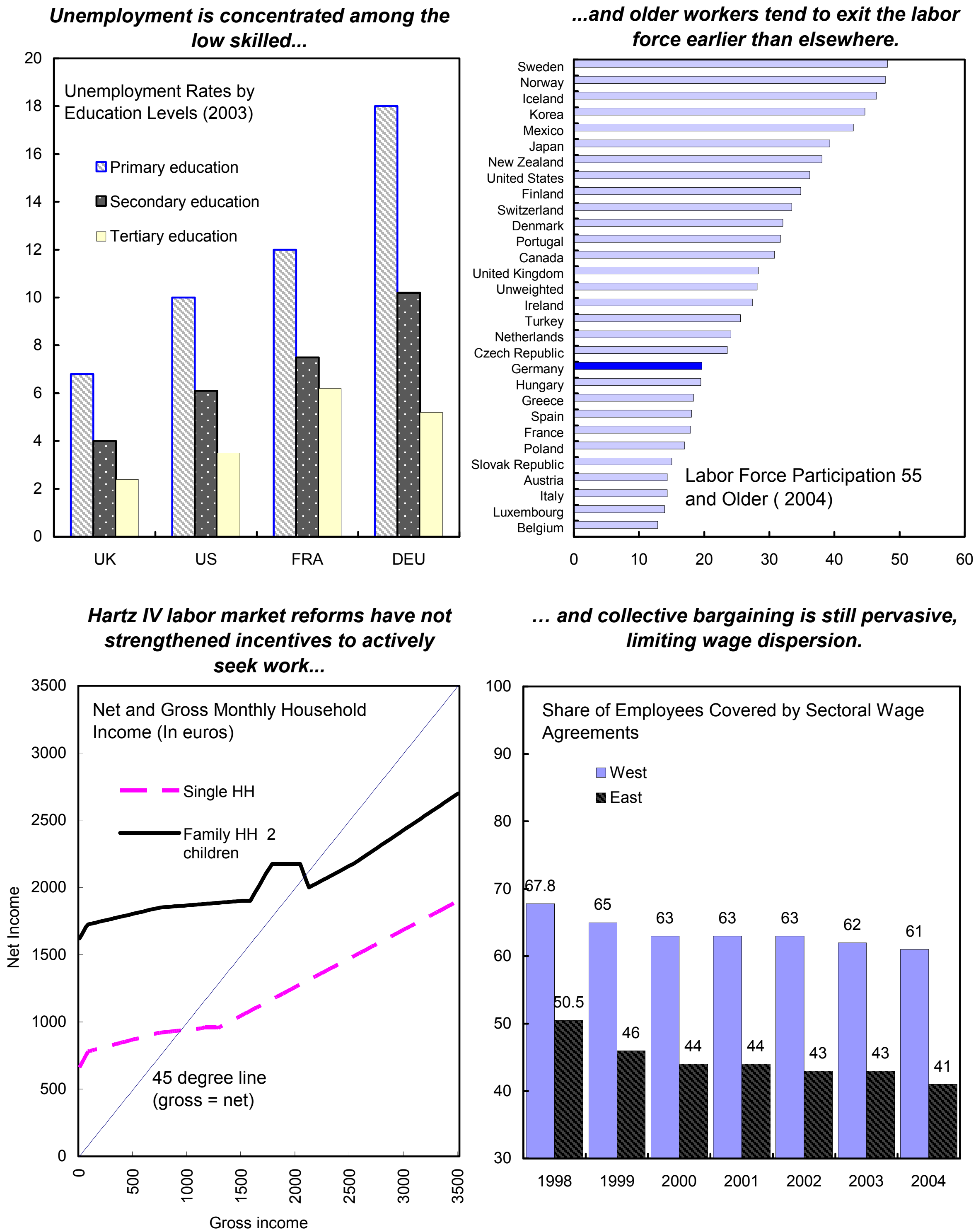
Source: IFO, Reuters, ZEW Institute, GfK AG, and IMF staff calculations.

Figure 7. Germany: Labor Market, Household Income, and Savings



Source: Bundesbank, Federal Statistical Office, and IMF staff calculations.

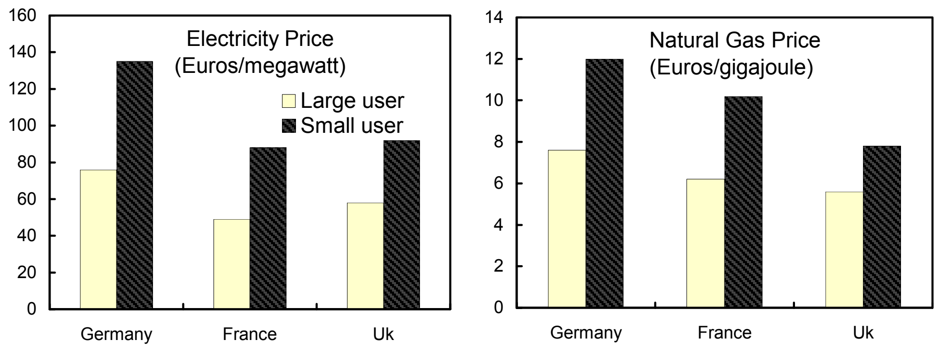
Figure 8. Germany: Labor Markets, Welfare System, and Collective Bargaining



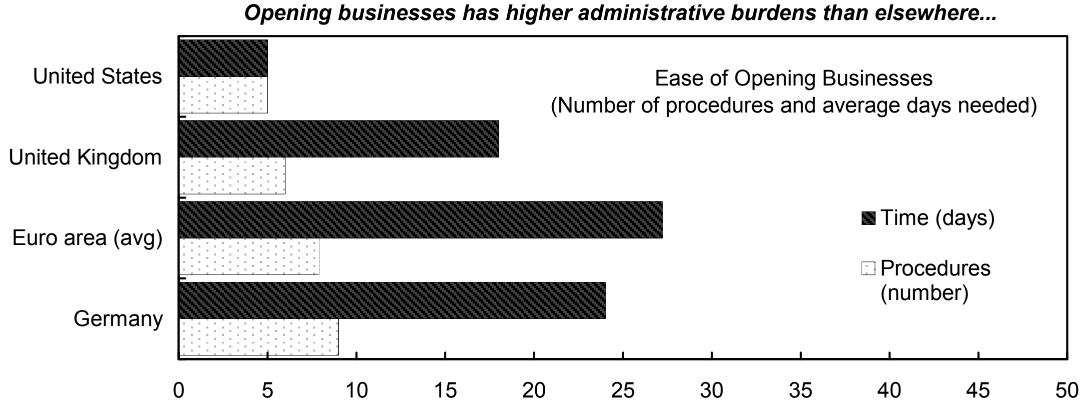
Source: IFO, WSI-Boeckler foundation, OECD, and IMF staff calculations.

Figure 9. Product and Services Markets

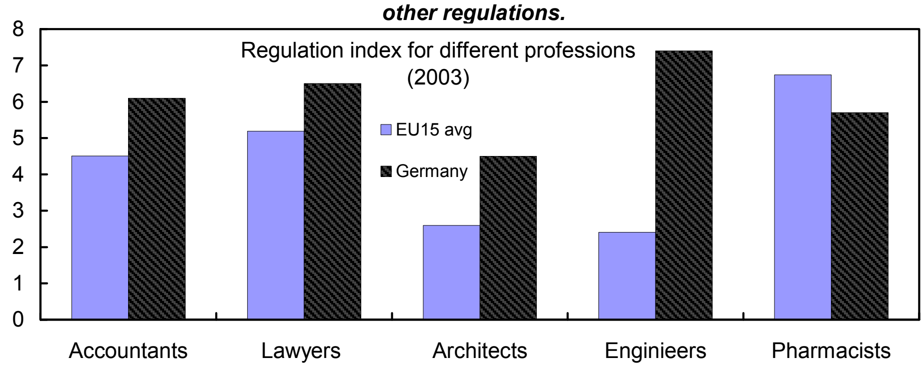
Prices in network industries remain high despite efforts to strengthen competition.



Opening businesses has higher administrative burdens than elsewhere...



and liberal professions are tighter regulated through licensing, pricing, and other regulations.

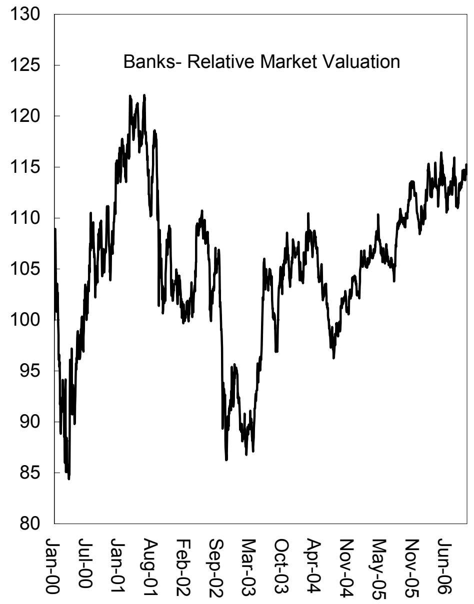


Source: OECD, World Bank, and Paterson (2003).

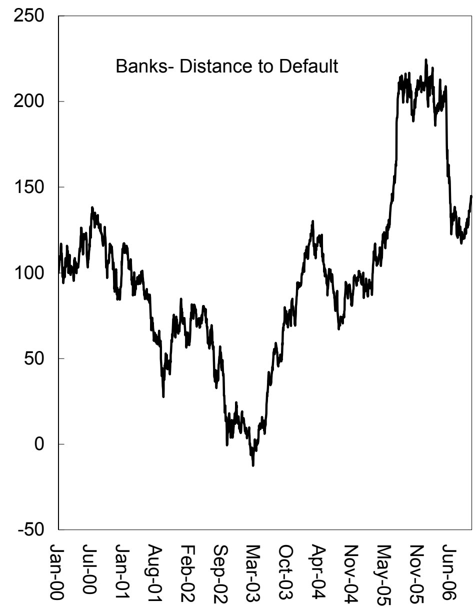
Figure 10. Germany: Relative Market Valuation and Distance to Default 1/

Large banks

Banks' relative valuation has recovered...

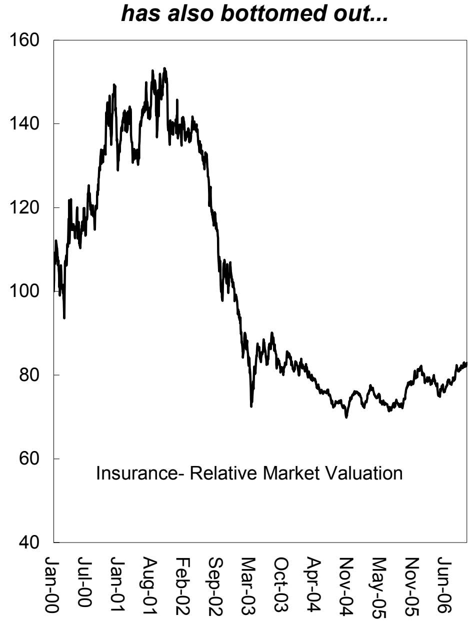


...and they are perceived as more stable than in 2003.

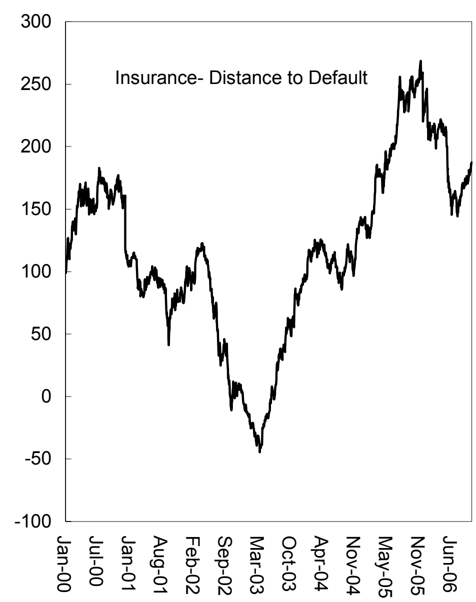


Insurance companies

Insurance companies' valuation has also bottomed out...



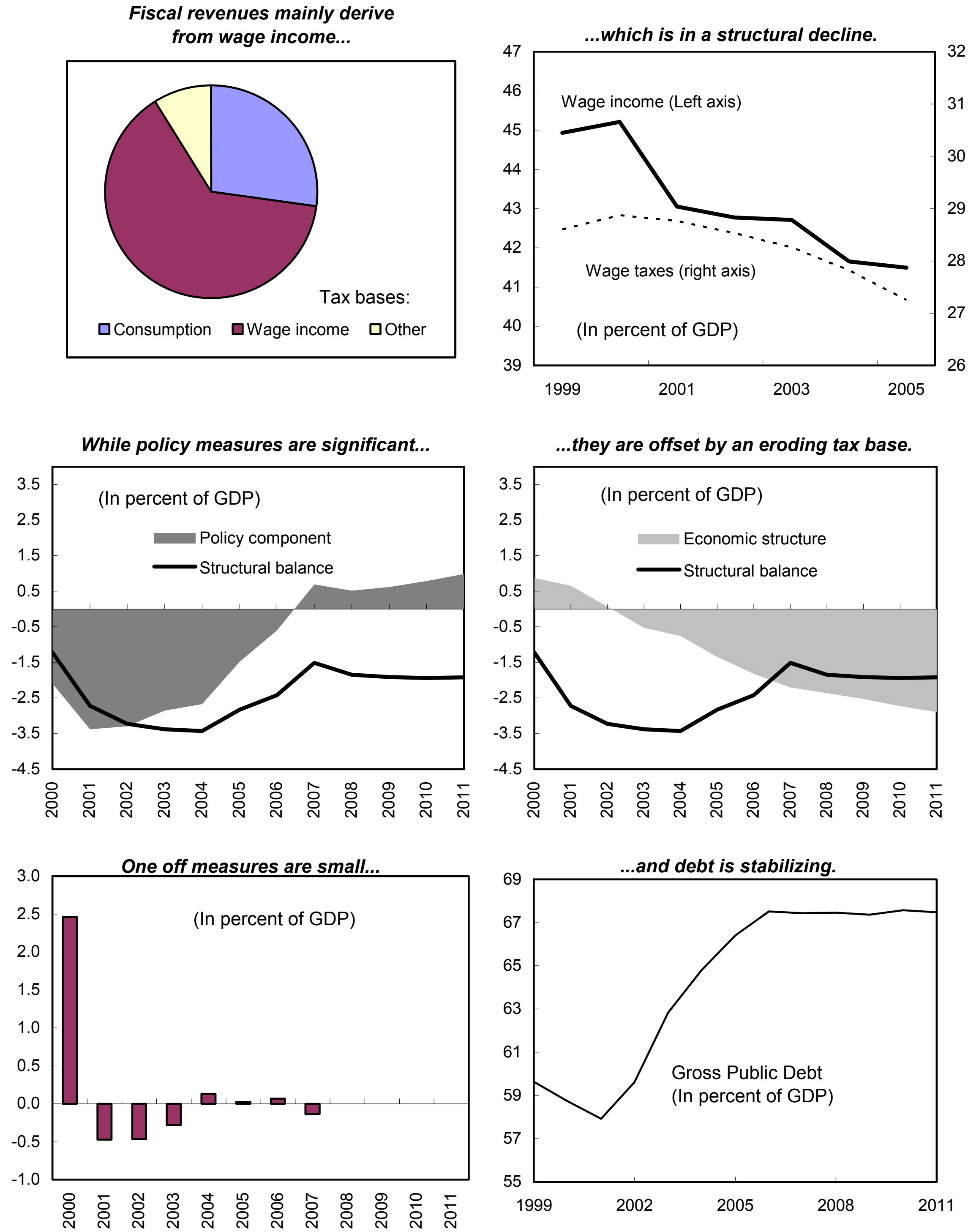
...and concerns about defaults are lower than in 2003.



Source: DataStream and IMF staff calculations.

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

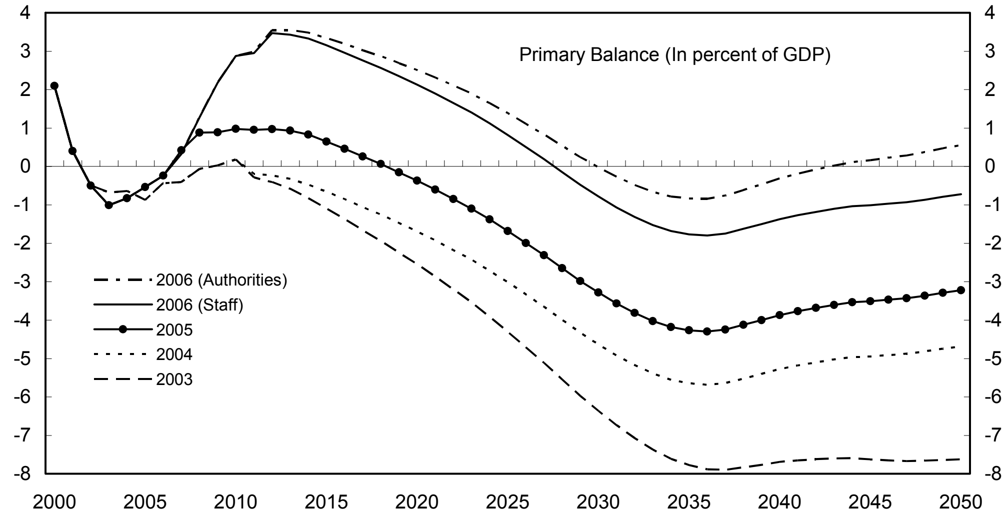
Figure 11. Germany: Decomposition of the Fiscal Balance



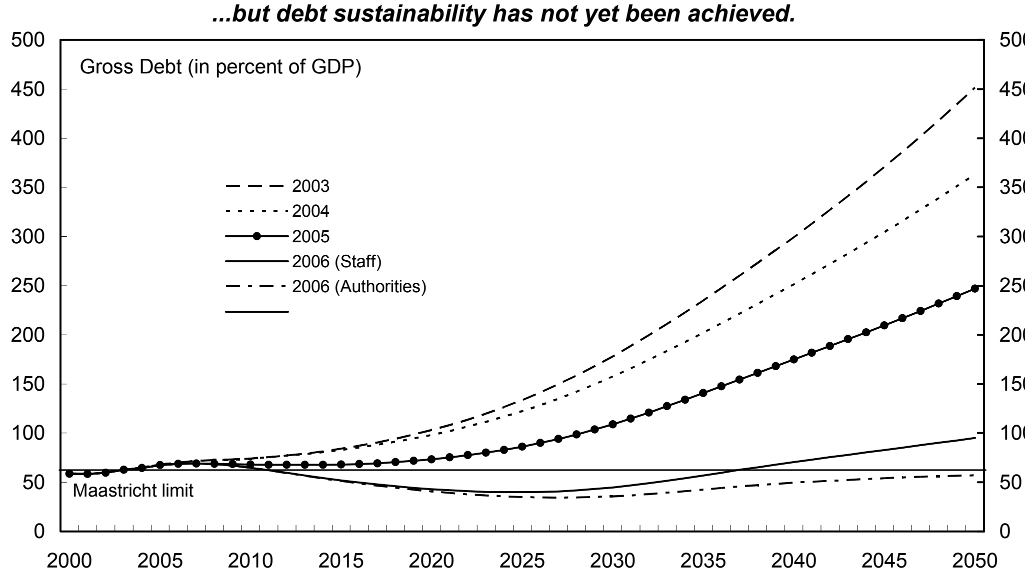
Source: Official data and IMF staff calculations.

Figure 12. Germany: Progress in Establishing Fiscal Sustainability 1/

Progress has been made to reduce long-run aging costs...



...but debt sustainability has not yet been achieved.



Source: Staff calculations and data provided by the authorities.

1/ Staff projections of fiscal scenarios for a rolling 50-year period:

End-2003, unchanged policy scenario; 3 percent fiscal deficit in 2010, aging costs at 6.5 percent of GDP;

End-2004, unchanged policy scenario; 3 percent fiscal deficit in 2010, aging costs at 4.0 percent of GDP (Agenda 2010);

End-2005, unchanged policy scenario; 2 percent fiscal deficit in 2010, aging costs at 4.0 percent of GDP (Coalition Agreement);

End-2006, normative scenario; assuming zero fiscal balance in 2010, aging costs at 4.0 percent of GDP (Staff);

End-2006, normative scenario; assuming zero fiscal balance in 2010, aging costs at 2.7 percent of GDP (Authorities).

Table 1. Germany: Basic Data

Total area	357,041 square kilometers
Total population (2005)	82.4 million
GDP per capita (2005)	US$ 33, 855

	2000	2001	2002	2003	2004	2005	2006 1/	2007 1/
				(Percentage change)				
Demand and supply								
Private consumption	2.4	1.9	-0.8	-0.1	0.1	0.1	0.8	0.2
Public consumption	1.4	0.5	1.5	0.4	-1.3	0.6	0.7	0.4
Gross fixed investment	3.0	-3.7	-6.1	-0.8	-0.4	0.8	5.4	4.8
Construction	-2.4	-4.6	-5.8	-1.6	-3.8	-3.6	3.1	3.2
Machinery and equipment	10.7	-3.7	-7.5	-0.1	4.2	6.1	7.3	6.3
Final domestic demand	2.3	0.4	-1.4	-0.1	-0.3	0.3	1.7	1.2
Inventory accumulation 2/	-0.1	-0.9	-0.6	0.8	0.3	0.2	-0.2	0.1
Total domestic demand	2.2	-0.5	-2.0	0.6	0.0	0.5	1.6	1.3
Exports of goods and nonfactor services	13.5	6.4	4.3	2.4	9.6	6.9	9.5	3.3
Imports of goods and nonfactor services	10.2	1.2	-1.4	5.3	6.9	6.5	8.7	3.4
Foreign balance 2/	1.0	1.7	2.0	-0.9	1.2	0.4	0.7	0.2
GDP	3.1	1.2	0.0	-0.2	1.2	0.9	2.3	1.4
Output gap (In percent of potential GDP)	1.8	1.7	0.5	-0.9	-0.9	-1.2	-0.3	-0.3
				(In millions of persons, unless otherwise indicated)				
Employment and unemployment								
Labor force	41.9	42.1	42.2	42.3	42.7	42.6	42.4	42.4
Employment	39.1	39.3	39.1	38.7	38.9	38.8	39.0	39.2
Unemployment 3/	2.9	2.9	3.2	3.7	3.9	3.9	3.4	3.3
Unemployment rate (in percent) 4/	6.9	6.9	7.7	8.8	9.2	9.1	8.0	7.8
				(Percentage change)				
Prices and incomes								
GDP deflator	-0.6	1.2	1.4	1.1	0.9	0.7	0.7	1.1
Consumer price index (harmonized)	1.4	1.9	1.4	1.0	1.8	1.9	1.7	2.3
Average hourly earnings (total economy)	2.9	2.6	2.1	1.6	0.2	0.9	1.1	1.4
Unit labor cost (industry)	-1.7	0.5	1.3	-1.7	-4.0	-3.3	-1.8	-0.6
Real disposable income 5/	2.1	2.1	-0.2	0.3	0.2	0.3	0.8	-0.1
Personal saving ratio (in percent)	9.2	9.4	9.9	10.3	10.4	10.6	10.6	10.3

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

1/ IMF staff projections.
2/ Growth contribution.
3/ National accounts definition
4/ Eurostat definition.
5/ Deflated by the national accounts deflator for private consumption.

Table 1. Germany: Basic Data (concluded)

	2000	2001	2002	2003	2004	2005	2006 1/	2007 1/	2008 1/
	(In billions of Euros, unless otherwise indicated)								
Public finances 6/ 7/									
General government									
Expenditure	930	1,005	1,031	1,048	1,040	1,048	1,057	1,069	1,096
(In percent of GDP)	45.1	47.6	48.1	48.5	47.1	46.8	45.8	45.2	45.1
Revenue	957	945	953	961	957	976	1,002	1,032	1,053
(In percent of GDP)	46.4	44.7	44.4	44.5	43.4	43.5	43.4	43.6	43.4
Overall balance	27	-60	-78	-87	-82	-73	-55	-37	-43
(In percent of GDP)	1.3	-2.8	-3.7	-4.0	-3.7	-3.2	-2.4	-1.6	-1.8
Structural balance	-25	-57	-69	-73	-76	-63	-56	-36	-45
(In percent of potential GDP)	-1.2	-2.7	-3.2	-3.4	-3.4	-2.8	-2.4	-1.5	-1.9
Federal government									
Overall balance	28	-27	-36	-40	-51	-57	-38	-29	-33
(In percent of GDP)	1.4	-1.3	-1.7	-1.8	-2.3	-2.6	-1.6	-1.2	-1.4
General government debt	1,211	1,224	1,278	1,358	1,430	1,488	1,558	1,595	1,638
(In percent of GDP)	58.7	57.9	59.6	62.8	64.8	66.4	67.5	67.4	67.5
Balance of payments									
Trade balance 8/	50.1	88.1	124.2	118.8	140.9	140.4	141.0	135.7	124.9
Services balance	-49.0	-49.9	-35.3	-34.3	-31.3	-27.9	-16.2	-11.3	1.3
Net private transfers	-9.3	-10.5	-11.8	-10.0	-11.2	-11.0	-12.6	-12.3	-12.7
Net official transfers	-18.7	-16.4	-15.7	-18.3	-17.1	-17.9	-17.4	-18.4	-18.9
Current account	-35.2	0.4	43.4	40.3	81.9	92.2	97.3	96.8	98.2
(In percent of GDP)	-1.7	0.0	2.0	1.9	3.7	4.1	4.2	4.1	4.0
Foreign exchange reserves (e. o. p.) 9/	53.4	49.5	40.5	32.5	33.8	33.7	30.0	...	...
Monetary data	(Percentage change)								
Money and quasi-money (M3) 10/ 11/	-1.0	6.1	...	3.5	2.2	5.2	4.2	...	...
Credit to private sector 10/	5.8	3.2	0.9	0.0	-0.2	2.1	4.6	...	...
	(Period average in percent)								
Interest rates									
Three-month interbank rate 12/	4.4	4.3	3.3	2.3	2.1	2.1	3.5	...	...
Yield on ten-year government bonds 12/	5.3	4.8	4.8	4.1	4.1	3.6	3.8	...	...
Exchange rates									
Euro per US$ (annual average) 12/	1.08	1.12	1.06	0.88	0.80	0.80	0.78	...	...
Nominal effective rate (1990=100) 13/	100.0	101.5	104.7	112.6	115.8	114.7	115.1	...	...
Real effective rate (1990=100) 14/	100.0	101.5	101.7	105.4	104.4	102.8	102.0	...	...

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

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

8/ Including supplementary trade items.

9/ From 1999 onward data reflect Germany's position in the euro area. Data for 2006 refer to August.

10/ Data for 2006 refer to the change from September 2005 to September 2006.

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

12/ Data for 2006 refer to October, 2006.

13/ Data for 2006 refer to October.

14/ Based on relative normalized unit labor cost in manufacturing. Data for 2006 refer to July.

Table 2. Germany: Medium-Term Balance of Payments

	Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011
(In billions of Euros, unless otherwise indicated)							
Current account	**92**	**97**	**97**	**98**	**94**	**86**	**81**
In percent of GDP	4.1	4.2	4.1	4.0	3.8	3.4	3.1
Trade balance	140	141	136	125	108	88	71
Exports	782	861	893	941	983	1,025	1,070
Imports	-642	-720	-757	-816	-875	-937	-999
Nonfactor services	-28	-16	-11	1	14	27	40
Exports	127	139	146	153	160	167	174
Imports	-155	-156	-157	-152	-146	-140	-134
Balance on Factor Income	-9	-3	-3	-4	-4	-4	-4
Credit	-139	-145	-154	-164	-170	-176	-182
Debit	-130	-143	-151	-160	-166	-172	-178
Current transfers, net	-29	-30	-31	-32	-32	-33	-34
Capital and financial accounts	-105	-97	-97	-98	-94	-86	-81
Capital account, net	-1	0	0	0	0	0	0
FDI, net	-10	-11	-11	-11	-12	-12	-12
Portfolio investment, net	-19	-19	-20	-20	-21	-21	-22
Other	-77	-67	-66	-67	-62	-53	-47
Reserve assets	2	0	0	0	0	0	0
Errors and omissions	13	0	0	0	0	0	0

Source: WEO.

Table 3. Germany: The Core Set of Financial Soundness Indicators for Banks, 1998-2005
(In percent)

	1998	1999	2000	2001	2002	2003	2004	2005
Capital adequacy								
Regulatory capital to risk-weighted assets	11.4	11.5	11.7	12.0	12.7	13.4	13.2	12.2
Commercial banks	11.9	12.4	13.0	13.6	14.4	14.4	13.6	11.6
Landesbanken	10.5	10.5	10.7	11.3	12.7	14.5	14.0	12.1
Savings banks	10.9	10.9	10.7	10.8	11.2	11.5	12.1	12.5
Credit cooperatives	11.0	11.2	11.2	11.1	11.0	11.7	12.1	12.1
Regulatory Tier I capital to risk-weighted assets 1/	7.4	7.6	7.7	8.0	8.6	8.8	8.7	8.0
Commercial banks	8.0	8.5	8.9	9.6	10.4	10.2	9.4	7.9
Landesbanken	6.1	6.2	6.2	6.6	7.9	8.9	8.3	7.3
Savings banks	7.0	7.0	7.0	7.1	7.3	7.4	7.7	8.0
Credit cooperatives	7.2	7.3	7.4	7.5	7.6	8.1	8.4	8.5
Asset composition and quality								
Sectoral distribution of loans to total loans								
Loan to households	33.3	31.2	30.6	29.7	29.5	29.7	29.3	28.5
Commercial banks	...	31.0	29.2	27.5	26.8	26.1	25.8	24.8
Landesbanken	...	8.3	8.2	7.9	7.5	7.5	7.1	6.8
Savings banks	...	63.8	63.6	62.4	61.9	62.9	62.3	62.2
Credit cooperatives	...	66.6	68.0	66.4	67.0	68.1	68.3	69.3
Loans to non-financial corporations	19.4	17.3	17.4	17.1	16.6	16.0	15.2	14.5
Commercial banks	...	22.3	20.7	19.3	17.7	15.6	14.3	13.3
Landesbanken	...	18.9	19.5	19.7	18.9	18.5	17.8	16.7
Savings banks	...	17.7	18.5	18.8	18.6	18.3	18.0	17.6
Credit cooperatives	...	13.0	13.6	13.4	13.2	12.9	12.4	12.0
NPLs to gross loans	4.5	4.2	4.7	4.6	5.0	5.3	5.1	4.1
Commercial banks	5.1	5.0	5.5	5.1	5.1	5.1	4.7	3.3
Landesbanken	2.8	2.5	2.7	2.8	3.7	4.4	4.3	2.9
Savings banks	6.1	5.7	5.6	5.9	6.4	6.8	7.0	6.6
Credit cooperatives	6.5	6.4	6.9	7.2	8.1	8.1	8.2	7.3
NPLs net of provisions to capital	42.2	39.2	44.7	46.1	47.5	52.1	46.2	35.0
Commercial banks	38.1	37.2	39.6	49.8	47.6	55.5	42.7	30.7
Landesbanken	32.5	26.0	29.6	27.9	31.6	34.9	35.5	25.0
Savings banks	56.4	51.6	49.2	52.2	53.6	58.1	55.3	50.6
Credit cooperatives	47.8	49.7	51.9	53.7	61.2	58.3	57.1	48.7
Earnings and profitability								
Return on average assets (after-tax)	0.3	0.2	0.2	0.2	0.1	-0.1	0.1	0.3
Commercial banks	0.6	0.3	0.3	0.2	0.0	-0.3	-0.1	0.5
Landesbanken	0.1	0.1	0.1	0.1	0.1	-0.2	0.0	0.2
Savings banks	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.3
Credit cooperatives	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.5
Return on average equity (after-tax)	10.2	6.5	6.1	4.6	2.9	-1.5	1.9	9.0
Commercial banks	15.2	7.0	7.3	4.2	0.0	-6.6	-1.4	15.5
Landesbanken	6.3	5.9	4.2	4.0	1.9	-5.2	-0.8	5.6
Savings banks	6.5	6.1	6.1	5.1	4.7	4.0	5.0	5.6
Credit cooperatives	5.1	4.7	4.1	4.4	6.6	5.2	5.3	9.0
Interest margin to gross income	75.0	73.2	67.8	69.8	73.4	70.2	73.5	68.3
Commercial banks	64.7	61.7	52.7	56.2	63.7	56.5	64.9	55.3
Landesbanken	72.0	77.6	72.4	75.0	75.8	79.0	79.4	83.2
Savings banks	81.9	81.3	80.9	80.8	81.3	80.6	79.6	79.0
Credit cooperatives	79.0	77.1	76.5	78.3	79.1	75.4	75.5	74.7
Noninterest expenses to gross income	63.6	66.0	68.4	71.4	67.2	66.5	65.5	61.0
Commercial banks	67.8	73.9	75.4	80.4	74.2	74.0	73.5	59.7
Landesbanken	46.5	54.8	55.9	57.1	56.1	53.1	53.5	59.3
Savings banks	66.5	65.7	68.9	69.9	66.5	66.4	64.9	65.9
Credit cooperatives	72.4	71.2	74.5	76.7	73.1	69.6	68.7	69.9
Liquidity								
Liquid assets to total short-term liabilities 2/	...	...	1.4	1.4	1.4	1.3	1.4	122.0
Commercial banks	...	...	1.2	1.2	1.2	1.2	1.2	110.7
Landesbanken	...	...	1.3	1.3	1.3	1.3	1.4	122.4
Savings banks	...	...	2.3	2.4	2.3	2.3	2.5	224.2
Credit cooperatives	...	...	2.0	2.1	2.2	2.2	2.2	181.4
Sensitivity to market risk								
Net open positions in FX to capital	5.2	6.6	7.4	10.8	6.1	3.7	3.7	6.9
Commercial banks	8.7	6.2	5.2	4.0	2.2	2.6	1.6	5.7
Landesbanken	8.4	9.5	11.4	10.8	12.8	4.0	6.2	5.6
Savings banks	3.3	4.8	6.0	5.7	5.1	4.5	4.1	11.7
Credit cooperatives	1.0	10.5	13.6	12.6	12.2	8.3	7.5	14.0

Source: Deutsche Bundesbank.

1/ According to Capital Adequacy Regulation, Principle I.

2/ The 2005 number follows the IMF's *Compilation Guide on FSIs.* Namely, it is the ratio (in percent) of assets and liabilities with a remaining maturity of three months or less. Given that this indicator is not available for earlier periods, the "liquidity ratio" used by prudential supervision is shown instead for 2000-04.

Table 4. Germany: Encouraged and Other Financial Soundness Indicators, 1998-2005
(In percent, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005
Corporate sector								
Total debt to equity 1/	93.0	79.3	96.3	104.8	150.8	129.6	120.2	111.0
Total debt to corporate GDP 2/	134.8	142.4	157.8	160.7	162.8	161.5	153.2	151.4
Return on invested capital 3/ 4/	8.3	6.5	6.3	7.4	8.9	8.3	9.3	9.7
Earnings to interest and principal expenses 1/ 5/	635.6	561.9	495.6	513.8	549.6	563.2	693.7	774.0
Number of applications for protection from creditors 6/	17,948	18,006	18,389	21,019	23,642	23,840	22,474	19,540
Deposit-taking institutions								
Capital to assets	4.0	3.7	3.7	3.8	4.1	4.2	4.0	4.1
Commercial banks	5.7	5.0	4.7	4.9	5.2	5.0	4.4	4.4
Landesbanken	3.7	3.3	3.4	3.8	3.8	4.0	4.0	4.0
Savings banks	4.1	3.8	3.9	4.0	4.2	4.3	4.5	4.6
Credit cooperatives	4.9	4.6	4.9	4.7	4.9	5.1	5.3	5.4
Geographical distribution of loans to total loans								
Germany	85.3	85.4	83.6	81.3	80.0	78.6	76.8	75.2
EU-member countries	8.4	8.6	9.6	11.6	13.2	14.6	16.9	17.3
Others	6.3	6.0	6.8	7.1	6.8	6.8	6.3	7.5
FX loans to total loans	9.1	7.8	9.3	10.2	9.6	9.1	9.6	10.2
Personnel expenses to noninterest expenses	56.0	54.8	54.1	53.1	53.1	53.8	54.4	55.1
Commercial banks	54.1	51.3	50.4	49.2	48.5	49.4	49.7	50.8
Landesbanken	52.8	51.0	51.9	49.8	49.6	49.0	50.2	50.5
Savings banks	59.9	59.9	60.0	59.3	59.5	60.6	61.3	61.8
Credit cooperatives	58.2	58.5	57.8	58.4	59.0	59.0	59.2	60.1
Trading and fee income to total income	25.0	26.8	32.2	30.2	26.6	29.8	26.5	31.7
Commercial banks	35.3	38.3	47.3	43.8	36.3	43.5	35.1	44.7
Landesbanken	28.0	22.4	27.6	25.0	24.2	21.0	20.6	16.8
Savings banks	18.1	18.7	19.1	19.2	18.7	19.4	20.4	21.0
Credit cooperatives	21.0	22.9	23.5	21.7	20.9	24.6	24.5	25.3
Customer deposits to total (non-interbank) loans	...	63.5	63.9	64.0	65.4	67.1	70.0	71.8
Commercial banks	...	62.6	63.0	68.6	74.2	78.4	85.3	85.5
Landesbanken	...	35.2	38.4	34.3	30.1	32.8	35.4	40.6
Savings banks	...	104.7	101.8	101.1	100.3	99.8	101.0	102.2
Credit cooperatives	...	113.6	108.0	110.3	110.8	111.7	113.2	113.6
Spread between highest and lowest interbank rates 7/	…	…	…	…	…	...	...	2.0
Spread between reference loan and deposit rates 8/	…	…	…	…	…	379	366	353.0
Insurance sector								
Solvency ratio, Life	…	…	…	…	170	176	179	180
Solvency ratio, Non-life	…	…	350	350	337	346	346	n.a.
Return on average equity, Life 9/	11.9	11.4	12.5	7.0	3.4	5.7	8.7	n.a.
Return on average equity, Non-life 9/	8.1	7.3	8.7	8.9	2.8	4.1	6.8	n.a.
Market liquidity								
Average bid-ask spread in the securities market (government bills) 7/	…	…	…	…	…	…	…	0.0
Average bid-ask spread in the securities market (corporate securities) 7/	…	…	…	…	…	…	…	0.1
Households								
Household debt to GDP	69.5	72.7	73.1	72.4	72.1	72.3	70.8	69.8
Household debt service and principal payments to income	5.2	4.8	5.2	5.1	4.8	4.3	4.0	3.8
Real estate markets								
Real estate prices, new dwellings 10/	99	99	100	101	102	100	100	100
Real estate prices, resale 10/	99	100	100	100	98	97	95	93
Residential real estate loans to total loans	13.7	16.2	16.4	16.1	16.2	18.0	17.8	17.8
Commercial real estate loans to total loans	6.8	6.4	6.4	6.2	6.2	6.6	6.4	6.1

Source: Deutsche Bundesbank
1/ As defined in the IMF's Compilation Guide on FSIs.
2/ Total debt to corporate gross value added, as corporate GDP is not available.
3/ Return is defined as "net operating income less taxes", where "net operating income" and "taxes" are defined in the IMF's Compilation Guide on FSIs.
4/ Invested capital is defined as "balance sheet total less other accounts payable (AF.7 according to ESA 1995)."
5/ Does not include principal expenses.
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, calculated on the base of the German MIR statistics for outstanding amounts.
9/ Taken from balance sheet data. Profits after tax devided by equity.
10/ Residential property (index, yearly average, 2000 = 100). An aggregation of the data for new dwellings and resale is not available.

Table 5. Germany: Financial System Structure, 1998-2005
(In billions of euros and percentage)

	1998			2000			2002			2003			2004			2005		
	Number	Assets Euro	Percent total	Number	Assets Euro	Percent total	Number	Assets Euro	Percent total	Number	Assets Euro	Percent total	Number	Assets Euro	Percent total	Number	Assets Euro	Percent total
Private depository institutions	3,246	5,139	82.2	2,709	5,995	79.9	2,337	6,290	79.1	2,199	6,299	78.1	2,147	6,480	78.1	2,089	6,903	78.4
Commercial banks	328	1,296	20.7	294	1,704	22.7	273	1,830	23.0	261	1,804	22.4	252	1,879	22.6	252	1,933	22.0
Of which																		
Big banks	3	562	9.0	4	970	12.9	4	1,056	13.3	4	1,045	13.0	5	1,218	14.7	5	1,227	13.9
Regional and other banks	241	634	10.1	200	613	8.2	186	665	8.4	173	671	8.3	163	568	6.8	158	603	6.8
Branches of foreign banks	84	100	1.6	90	121	1.6	83	109	1.4	84	88	1.1	84	93	1.1	89	103	1.2
Landesbanken	13	940	15.0	13	1,223	16.3	14	1,324	16.7	13	1,346	16.7	12	1,282	15.4	12	1,365	15.5
Savings banks	594	910	14.6	562	954	12.7	520	998	12.6	491	1,000	12.4	477	1,002	12.1	463	1,014	11.5
Regional institutions of credit cooperatives	4	201	3.2	4	227	3.0	2	199	2.5	2	187	2.3	2	201	2.4	2	224	2.5
Credit cooperatives	2,256	520	8.3	1,792	534	7.1	1,489	560	7.0	1,393	566	7.0	1,336	576	6.9	1,294	592	6.7
Mortgage banks	33	795	12.7	31	892	11.9	25	873	11.0	25	872	10.8	25	866	10.4	24	887	10.1
Banks with special functions	18	477	7.6	13	461	6.1	14	506	6.4	14	524	6.5	16	674	8.1	16	696	7.9
Building and loan associations 2/	34	...	...	31	154	2.1	28	164	2.1	27	173	2.1	27	184	2.2	26	192	2.2
Insurance companies	684	909	14.5	663	1,060	14.1	657	1,224	15.4	649	1,287	16.0	642	1,328	16.0	641	1,369	15.6
Life	123	517	8.3	123	605	8.1	114	659	8.3	109	688	8.5	108	716	8.6	107	734	8.3
Nonlife	271	129	2.1	257	138	1.8	246	152	1.9	241	153	1.9	237	159	1.9	233	164	1.9
Other	290	263	4.2	283	317	4.2	297	413	5.2	301	446	5.5	297	453	5.5	301	471	5.4
Investment funds 3/	805	206	3.3	1,019	298	4.0	1,133	271	3.4	1,108	304	3.8	1,103	308	3.7	1,129	338	3.8
Money market funds	39	18	0.3	39	20	0.3	42	37	0.5	43	36	0.4	42	31	0.4	42	31	0.4
Pension investment mutual funds	31	0	0.0	45	3	0.0	49	2	0.0	40	2	0.0	40	2	0.0	37	2	0.0
Securities-based funds	718	144	2.3	915	226	3.0	1,018	157	2.0	996	178	2.2	987	184	2.2	1,012	218	2.5
Open-end real estate funds	17	44	0.7	20	49	0.7	24	75	0.9	29	88	1.1	34	91	1.1	38	87	1.0
Total financial system	4,769	6,254	100.0	4,422	7,507	100.0	4,155	7,949	100.0	3,983	8,063	100.0	3,919	8,300	100	3,885	8,803	100.0
Memorandum items:																		
Majority foreign-owned banks	72	126	2.0	56	130	1.7	49	276	3.4	45	293	3.6	42	321	3.9	41	623	7.1
Foreign banks	156	225	3.5	146	251	3.2	132	386	4.7	129	380	4.7	126	414	5.0	130	414	4.7
Majority public sector owned banks	625	2,327	37.2	588	2,638	35.1	548	2,828	35.6	518	2,870	35.6	505	2,958	35.6	505	2,958	33.6

Sources: BaFin, Deutsche Bundesbank and staff estimates.

1/ Final data for private depository institutions; preliminary for other financial instituitons.
2/ Assets are not included in Bundesbank statistics until 1999.
3/ Figures refer to funds open to the public.

Table 6. Germany: General Government Finances

	2000	2001	2002	2003	2004	2005	Staff Proj. 2006	Staff Proj. 2007
					(In billions of euros)			
Revenue	**957.5**	**945.5**	**952.5**	**961.2**	**957.1**	**975.9**	**1,002.1**	**1,031.7**
Current	949.5	937.2	944.0	952.2	947.5	965.9	993.0	1,022.7
Direct taxes	254.0	230.0	227.2	226.1	221.1	227.5	246.2	252.2
Indirect taxes	245.1	247.7	250.3	255.7	260.2	265.5	270.2	299.0
Social security contributions	378.4	383.7	390.7	396.1	396.7	397.0	401.9	398.2
Other current	72.0	75.9	75.8	74.4	69.6	75.8	74.7	73.4
Capital	8.0	8.2	8.5	9.0	9.6	10.0	9.1	9.0
Primary expenditure	**865.4**	**940.6**	**968.2**	**984.1**	**977.1**	**986.5**	**994.0**	**1,004.9**
Current	851.3	870.2	899.2	916.2	913.9	923.4	930.4	941.1
Wages	166.1	166.2	168.7	169.0	169.4	167.5	166.5	166.8
Goods and services	82.4	85.3	88.4	90.4	90.2	96.1	97.6	100.0
Subsidies	34.8	32.9	31.7	29.7	28.3	26.8	26.0	25.7
Social benefits	532.7	551.2	579.8	594.2	592.8	597.7	604.3	611.7
Other current	35.3	34.7	30.6	33.0	33.3	35.3	36.0	36.9
Capital	14.0	70.4	69.0	68.0	63.2	63.1	63.6	63.8
Primary balance	**92.1**	**4.9**	**-15.7**	**-22.9**	**-20.0**	**-10.6**	**8.1**	**26.9**
Interest	65.1	64.5	62.7	64.1	62.5	62.0	63.0	64.1
Overall balance	**27.1**	**-59.6**	**-78.3**	**-87.0**	**-82.5**	**-72.6**	**-54.9**	**-37.2**
					(In percent of GDP)			
Revenue	**46.4**	**44.7**	**44.4**	**44.5**	**43.4**	**43.5**	**43.4**	**43.6**
Current	46.0	45.1	44.0	44.1	42.9	43.1	43.0	43.2
Direct taxes	12.3	10.4	10.6	10.5	10.0	10.2	10.7	10.7
Indirect taxes	11.9	11.9	11.7	11.8	11.8	11.8	11.7	12.6
Social security contributions	18.3	18.5	18.2	18.3	18.0	17.7	17.4	16.8
Other current	3.5	3.6	3.5	3.4	3.2	3.4	3.2	3.1
Capital	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Primary expenditure	**42.0**	**45.0**	**45.2**	**45.5**	**44.3**	**44.0**	**43.1**	**42.5**
Current	41.3	41.6	42.0	42.4	41.4	41.2	40.3	39.8
Wages	8.1	8.0	7.9	7.8	7.7	7.5	7.2	7.1
Goods and services	4.0	3.9	4.1	4.2	4.1	4.3	4.2	4.2
Subsidies	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.1
Social benefits	25.8	26.5	27.1	27.5	26.9	26.7	26.2	25.9
Other current	1.7	1.6	1.4	1.5	1.5	1.6	1.6	1.6
Capital	0.7	3.4	3.2	3.1	2.9	2.8	2.8	2.7
Primary balance	**4.5**	**0.4**	**-0.7**	**-1.1**	**-0.9**	**-0.5**	**0.4**	**1.1**
Interest	3.2	3.3	2.9	3.0	2.8	2.8	2.7	2.7
Overall balance	**1.3**	**-2.8**	**-3.7**	**-4.0**	**-3.7**	**-3.2**	**-2.4**	**-1.6**
Memorandum item:								
Structural fiscal balance	-1.2	-2.7	-3.2	-3.4	-3.4	-2.8	-2.4	-1.5
Gross public debt end-year	58.7	57.9	59.6	62.8	64.8	66.4	67.5	67.4

Sources: Ministry of Finance; and Fund staff projections.

APPENDIX I. Staff Analytical Work on Germany, 2002-06

Growth and Competitiveness

- Exports and Domestic Demand in Germany: Has the Nexus Been Altered by Globalization? *Forthcoming Selected Issues Paper*
- What explains Germany's Rebounding Export Market Share? *Forthcoming Working Paper.*
- Long-run Growth in Germany. *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*.
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- The Fiscal Challenge of Aging: What Needs to Be Done. *IMF Country Report No. 02/240*.
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- The Employment Effects of Labor and Product Markets Deregulation and their Implications for Structural Reform. *CESifo Working Paper No 1709, May 2006*.
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- Germany's Financial System: International Linkages and the Transmission of Financial Shocks. *IMF Country Report No. 03/342*.
- The Slowdown in Credit Growth. *IMF Country Report No. 02/240*.

APPENDIX II. Germany: Fund Relations

(As of September 30, 2006)

I. **Membership Status:**

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

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	13,008.20	100.00
Fund holdings of currency	11,329.00	87.09
Reserve position in Fund	1,614.74	12.41

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	1,210.76	100.00
Holdings	1,336.18	110.36

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				
	2006	2007	2008	2009	2010
Principal	--	--	--	--	--
Charges/Interest	0.09	0.07	0.07	0.07	0.07
Total	0.09	0.07	0.07	0.07	0.07

VII. **Exchange Rate Arrangement:**

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

Germany is an Article VIII member and maintains an exchange system free of restrictions on payments and transfers for current international transactions. It maintains measures adopted for security reasons, which have been notified to the Fund for approval in accordance with the procedures of Decision 144 (see EBD/06/123, October 24, 2006).

VIII. **Article IV Consultations:**

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (IMF Country Report No. 06/16) was discussed at EBM 06/2 (January 11, 2006).

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

The supervisory authorities' move towards more risk-based supervision is being reflected in the AML/CFT framework. In a 2003 evaluation, the Financial Action Task Force (FATF) found that the AML/CFT framework is generally of high quality. Improvements were recommended to make AML/CFT audits and inspections more systematic and frequent. In view of concerns about costs for supervised institutions, the numbers of audits and inspections have not increased substantially between 2003 and 2006. However, the authorities recognize that AML/CFT is an important issue, and have moved towards a more risk-based approach, in which the intensity of audits and inspections should reflect institutions' AML/CFT risk. To improve the quality of audit reports, BaFin has started a dialogue with the associations of certified public accountants and other auditors, resulting among other things in the publication by the association of certified public accountants of a significantly revised AML/CFT assessment methodology in 2005. Further steps in the AML/CFT framework include revisions of the law granting the BaFin the power to freeze funds without a court order or other involvement of prosecution authorities if there is a suspicion of terrorist financing, and requiring financial holding groups and financial conglomerates to develop a coordinated risk management approach for the whole group.

APPENDIX III. Germany: Statistical Issues

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

Germany adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. In April 2005, revised national accounts statistics were released to comply with EUROSTAT requirements. Germany adopted chain-linking to its price and volume measures, allocated financial intermediation services to the users, and introduced new data (e.g. based on hedonic pricing).

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 contributor to short-term deviation in the trend GDP growth rate, 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.

Other gaps are: although explanatory documentation exists, the lack of a table bridging the general government data in the ESA95 classification and the general government cash data on an administrative basis is viewed as impairing fiscal analysis; Germany only publishes general government revenue, expenditure, and balance on an accrual basis every six months (ESA95). Monthly data are, however, disseminated on a cash-basis.

Following the adoption of the ESA95 standard for fiscal reporting by member countries of the European Union, the IMF Statistics Department is collaborating with member states and Eurostat to implement a bridge table that makes simultaneous reporting for the ESA95 and the *Government Finance Statistics Manual 2001* possible. Germany has chosen not to use this option for the purposes of the *Government Finance Statistics Yearbook* (*GFSY*) 2006. The *GFSY* reports annual data for Germany using the framework of the *Government Finance Statistics Manual 2001*. These data refer to the central, state and local, and the general government.

The 2003 FSAP mission found that the availability and timeliness of financial soundness indicators were relatively weak. The situation has since improved. Germany is participating in the Coordinated Compilation Exercise for financial soundness indicators (FSIs). In 2006, as part of this exercise, the German authorities have compiled a comprehensive set of FSI data and metadata that will soon serve as a basis for regular compilation of FSIs.

Germany: Table of Common Indicators Required for Surveillance
(As of October 20, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	October06	10/10/2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	August 06	September 06	M	M	M
Reserve/Base Money	August 06	September 06	M	M	M
Broad Money	August 06	September 06	M	M	M
Central Bank Balance Sheet	August 06	October 06	M	M	M
Consolidated Balance Sheet of the Banking System	August 06	October 06	M	M	M
Interest Rates	October06	10/10/2006	M	M	M
Consumer Price Index	August	September	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 06	September06	Semi-annual	Semi-annual	Semi-annual
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	August	September06	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	August	September06	M	M	M
External Current Account Balance	July 06	September06	M	M	M
Exports and Imports of Goods and Services	July 06	September06	M	M	M
GDP/GNP	Q2 06	August 06	Q	Q	Q
Gross External Debt	H1 06	June 06	Semi-annual	Semi-annual	Semi-annual

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

Statement by the IMF Staff Representative
December 8, 2006

This statement provides information on economic developments since the staff report was issued. The new information does not alter the thrust of the staff appraisal.

Results for the third quarter of 2006 and data revisions for previous quarters have led to an upward revision of GDP growth projections. The staff's updated forecasts are for growth of 2.5 percent in 2006 and 1.5 percent in 2007 (Table below). Although third quarter growth was marginally below staff projections, growth estimates for the first and second quarters were increased, and recent high-frequency indicators have remained stronger than expected, together suggesting a higher growth rate for 2006.

Revised Quarter-on-Quarter Real GDP Growth
(In percent)

	2006				2006	2007
	Q1	Q2	Q3	Q4		
SR (SM/06/370)	0.7	0.9	0.7	0.5	2.3	1.4
Revised	0.8	1.1	0.6	0.6	2.5	1.5

Source: Federal Statistical Office and Fund staff projections

The revision in the first half of the year primarily reflects higher investment spending than was previously estimated. The Bundesbank estimates that growth in the second quarter includes some ¼ percentage point in one-time demand from the World Cup soccer tournament (mainly tourism exports).

Economic indicators suggest increasing traction for domestic demand. Full-time employment continued to expand over the summer months, boding well for a continued recovery. The construction sector is expanding, after a long decline, and industrial orders remained strong with a larger weight from domestic orders.

Year-on-year inflation is declining as anticipated. In October, inflation was 1.1 percent (CPI-HICP), slightly below the rate for August and mainly reflecting lower oil prices. Preliminary data for November point to an uptick to 1.5 percent as some price categories are increased ahead of the VAT hike in January 2007. The core rate of inflation, excluding energy prices, is slightly over 1 percent.

The recovery and the freeze on pensions and public sector wages are helping to lower the fiscal deficit. Tax revenue continues to exceed earlier expectations, and the authorities have revised their outlook for the general government deficit to 2.1 percent of GDP in 2006, and the federal budget for 2007 is consistent with a general government deficit target of 1.5 percent of GDP.[1] In the staff report (¶34 and associated text table), staff had argued that the authorities should aim to reduce the structural deficit by a cumulative 1¼ percent of GDP in 2006-2007. Budget details are still pending, but staff's preliminary estimate is that the authorities' latest deficit figures are consistent with a cumulative reduction in the structural deficit closer to 1 percent of GDP in 2006-2007.

The slightly lower structural adjustment reflects in part an additional cut in unemployment insurance (payroll) taxes. The November 2005 Coalition Agreement envisaged cutting the unemployment insurance contribution rate from 6.5 to 4.5 percent. With the recent strong tax revenues, the authorities have decided to reduce the unemployment insurance rate further to 4.2 percent instead. This concession is a political economy compromise, accommodating pressures to utilize some of the windfall revenue gain; the staff continues to recommend that permanent tax reductions be offset with permanent expenditure cuts.

As part of its outreach strategy, the staff held a one-day symposium on long-run fiscal sustainability in Berlin on Monday, November 20, 2006. The symposium was organized together with the IFO Institute for Economic Research and the Bertelsmann Foundation to stimulate the domestic debate on aging-related issues and fiscal sustainability and, in this regard, to draw attention to the value of a public sector balance sheet. The symposium revealed that the German authorities at both the federal and Länder level are increasingly focusing on aging and population decline in their deliberations of a new fiscal framework that could accommodate aging related pressures over the longer run, including in the negotiations on a second round reform of fiscal federalism and possible modifications to the tax revenue sharing arrangements. The experience in the symposium also suggested that such meetings can help to foster a better appreciation among analysts of the important strides that are being made by the authorities, and remaining challenges, in tackling future aging costs.

[1] The 2007 federal budget has been approved in the lower house of parliament (Bundestag). It projects a net debt placement of €19.6 billion, which would achieve compliance with Germany's constitutional Golden Rule for the first time in several years and be the lowest net debt placement since unification in 1991. The upper house of Parliament (Bundesrat) is scheduled to debate the federal budget on December 15th.

Statement by Klaus D. Stein, Executive Director for Germany
December 8, 2006

Overview

1. The German economy is experiencing a robust upswing this year, growing at its fastest pace since 2000. While exports remain very strong, the main contribution to output growth is expected to come from accelerating domestic demand. The upswing is driven by solid profit expectations and increased capacity utilization, alongside the ongoing improvement in the labor market.

2. Being well aware of the cyclical factors supporting the recovery, the German government strongly believes that the various reforms since the *Agenda 2010* of 2003 (in particular labor market reforms Hartz I-IV, as well as pension, health care, federalism, and capital market reforms) are beginning to show a positive impact on the economy. In addition, the carefully designed fiscal strategy, enacted by the Grand Coalition upon assuming office, is now supporting the upswing. The strategy rests on two pillars: the investment stimulating package *Impuls* and the gradually phased consolidation of the general government budget. This phased approach is now meeting its objective, which is to help the economy embark on a self-sustained growth path strong enough to endure the necessary fiscal consolidation.

3. However, the German economy is not yet out of the woods. Continued fiscal prudence and structural reforms are essential to address the challenges presented by globalization and population aging. My authorities are therefore continuing the reform process, labeled as path breaking in earlier staff reports. The reforms underway, while intensely debated within government and society, will eventually help ensure medium and long-term fiscal sustainability, promote employment, and further improve the environment for investment and job creation.

Economic Outlook

4. My authorities and the staff broadly agree on the economic outlook for this and next year. For 2006, the government projects real GDP growth of 2.3 percent, which it considers to be a conservative projection. Strong private investment and construction activity are the main drivers of growth. Importantly, the construction sector has started to expand again after many years of negative growth. The situation in the labor market has improved considerably and is bolstering the beginning recovery of private consumption. Export growth remains brisk reflecting a competitive manufacturing sector. Net exports are nonetheless contributing a smaller share towards output growth due to the acceleration of imports.

5. After benefiting from one-time effects this year, the economy will likely slow down somewhat at the beginning of 2007 due to the fiscal consolidation package. However, given the strong underlying momentum of the economy, my authorities share the staff's confidence that the slowdown will only be temporary – an expectation that is supported by current high-frequency indicators. Overall, my authorities expect real GDP to expand by 1.4 percent in 2007 and the labor market to show further improvement. Inflation, which has been well below the eurozone average, will likely move up due to the forthcoming VAT increase, though only on a temporary basis.

Advancing Fiscal Consolidation

6. Continued expenditure restraint and accelerating economic activity will pave the way for a significant improvement in public finances this year. The general government deficit is now expected to be at 2.1 percent of GDP, as compared to a projection of 3 ½ percent of GDP at the time of the last Article IV consultation. As a result, the Maastricht deficit criterion will be met one year earlier than expected.

7. In 2007, the bulk of the windfall revenues will be used for reducing the general government deficit, which is projected to be at 1 ½ percent of GDP. Nevertheless, my authorities remain convinced that further structural adjustment of the budget is essential. They will therefore proceed as planned to implement their fiscal consolidation package, a key element of which is the increase of the VAT rate by three percentage points. This increase will still leave the German VAT rate below the EU average. One percentage point of VAT is earmarked to help fund the forthcoming reduction of unemployment insurance contribution rates by one third. More generally, the tax increase reflects a deliberate shift from direct to indirect taxes aimed to enhance economic efficiency. It is worth noting that despite the VAT increase, the revenue to GDP ratio will remain largely unchanged in 2007.

8. The structural fiscal improvement this year and next will in total be well above one percent of GDP, in line with staff recommendations. Beyond 2007, my authorities remain committed to continued structural fiscal adjustment over the medium-term. Annual growth of general government spending will be limited to 1 percent in nominal terms over the period of 2006 to 2010. At the end of this period, my authorities expect a budget deficit of close to balance.

9. The staff's long-run fiscal projections and indicative public sector balance sheet are welcome analytical tools as they heighten awareness for the pressing issue of fiscal sustainability. While further adjustment measures will be required to ensure long-term fiscal sustainability, it should be noted that a number of actions are forthcoming or have already been implemented. These include *inter alia* the gradual increase of the retirement age and the phasing out of the homeowner subsidy. These measures will generate increasing expenditure savings over the longer term.

10. Entitlement reforms are progressing with a view to improving the long-term fiscal outlook. Further to the pension reforms of recent years, the cabinet recently decided to gradually raise the statutory retirement age from 65 to 67 years from 2012 onwards, as mentioned above. After intense debate on health care reform, the coalition government has been able to reach agreement on a substantive proposal. While stopping short of some more radical blueprints, the reform will instill more competition and transparency into the system through a broad array of measures to be phased in from April 2007. It will thus increase cost efficiency, while preserving the high quality of the German health care system. Furthermore, a reform proposal to strengthen the financial viability of long-term care insurance will be put forward in 2007.

11. The fiscal framework has been improved considerably by the federalism reform enacted earlier this year. Competencies of the federal government and the *Länder* have been disentangled. Fiscal discipline has been supported by clarifying the respective responsibilities of the federal government and the *Länder* in the context of the European Stability and Growth Pact. A second round of reforms focusing on the overhaul of financial relations between the various government entities will be launched in the near future.

Supporting Investment and Growth

12. As also acknowledged in earlier Article IV reports, since the 1990s Germany has made significant strides in liberalizing product markets and rolling back public ownership. Looking ahead, the government is determined to further improve the business climate, *inter alia* by reforming the corporate income tax (CIT), ensuring free and competitive product markets, and reducing the administrative burden. Alongside labor market reforms and improved conditions for research, development, and innovation, these actions should gradually feed into a pick-up in potential growth.

13. The proposed CIT reform will go a long way towards raising Germany’s attractiveness as a place to do business. The reform essentially involves a significant reduction of the composite corporate tax rate, which is currently among the highest in Europe, to just below 30 percent. This will be largely financed by broadening the tax base, although there will still be a reduction of the overall business tax burden by €5 billion. The thrust of the reform is thus in line with the international trend (tax-cut-cum-base-broadening policy). In the process, the tax system will be simplified, and various provisions will be introduced to reduce distortions in terms of tax treatment depending on the legal structure of the company, and to discourage profit shifting abroad.

14. The CIT reform is due for cabinet approval in March 2007 and for implementation in January 2008. It will be based on a recent proposal by a working group. This proposal differs in important respects from earlier deliberations that form the basis for the staff analysis. In

particular, the initial proposal to limit interest deductibility, criticized by the staff and others, has now been largely abandoned. Also, accelerated depreciation provisions will be eliminated, as proposed by the staff.

15. On the electricity and gas industries, the new regulatory framework on access to networks and unbundling of services is currently being implemented. On liberal professions, bureaucratic hurdles are being lowered. On the guild system, while there are no plans for further reforms at this stage, several guilds have already been deregulated in recent years. Furthermore, in the first half of 2007, the government will conduct a review of the recommendations of the *Monopolkommission*, an independent advisory body dealing with issues of regulation and fair competition. Finally, we would note the ongoing comprehensive initiative aimed at lowering the overall administrative burden, as well as the plans of some *Länder* to further relax restrictions on shopping hours, some of which henceforth will be among the most liberal in Europe.

16. Raising Germany's potential growth requires a substantial effort to boost research, development, and innovation. My authorities have made it a key priority to support this process. For example, from 2006 to 2009 the federal government will invest an additional €6 billion in R&D projects. This will contribute significantly to further increasing total R&D-investment (public and private) from currently 2.5 percent to 3 percent of GDP by 2010.

Fostering Employment

17. Unemployment has declined by more than half a million and the number of regular jobs subject to social security contributions has risen by more than 300,000 over the past year. Furthermore, the number of recipients of long-term unemployment assistance (UB-II) has declined markedly as of late. In particular, the latter shows that the labor market reforms of recent years are bearing fruit, even taking into account the support provided by the cyclical upswing.

18. Nevertheless, the still high unemployment is a matter of concern and its reduction remains high on the government's agenda. At the same time, further reforms must strike a careful balance between flexibility and security, and it is of utmost importance that they have the necessary backing in the broader public. Against this background, and after the far-reaching changes already implemented in recent years, my authorities intend to proceed gradually with further reforms.

19. In August, legislative changes were enacted to address inefficiencies and cost overruns that have emerged under the new UB-II system. Furthermore, the provisions of means testing that have been adopted under the Hartz IV reforms will be implemented more

rigorously. In addition, the cabinet intends to put forward proposals for further labor market reforms by the first quarter of next year, aimed at improving job incentives.

20. As regards active labor market policies (ALMPs), an evaluation including input from academia is currently being finalized. On this basis, a thorough overhaul of ALMPs is envisaged for 2007, aimed at eliminating those policies of limited effectiveness.

21. In order to strengthen incentives for labor demand and supply, the payroll tax wedge will be reduced considerably in 2007. The contribution rate for unemployment insurance will be lowered significantly, to be offset by a small increase of the contribution rate for pensions. This will result in a net reduction of non-wage labor costs by 1.9 percentage points.

Financial Sector

22. Numerous actions have been taken over the past years to improve the institutional framework governing financial markets. The German government is continuing along this path of swiftly and fully implementing agreed EU regulations while modernizing remaining national financial sector laws and regulations. This will ensure that the German financial system becomes even more effective in supporting economic growth, while maintaining strong prudential oversight.

23. Financial sector profitability has continued to rise this year and last, reflecting cost cutting, lower provisioning, and improved risk management, as well as cyclical factors. German banks are also increasingly tapping new sources of income generation. That said, profitability is not yet on par with international levels and innovation needs to advance further.

24. The restructuring of the *Landesbanken* (LBs) is making progress. Vertical integration of some LBs with regional savings banks (*Sparkassen*) is at an advanced stage. Others have been transformed into joint stock corporations operating under private law. This process will be continued.

25. That being said, my authorities consider that the staff's findings on the LBs' opportunity costs need to be qualified. First, caution should be used when extrapolating the results. The historic time period chosen for the analysis was one of unusually low profitability on the part of LBs. Also, the LBs face a changed regulatory environment following the recent withdrawal of government guarantees; they have reoriented towards new business models in recent years, and their performance has improved considerably. Second, the costs need to be contrasted with the LBs' benefits (including their role in promoting local economies), even if these are admittedly difficult to quantify.

26. Furthermore, conflicts of interest on the part of supervisory authorities are not an issue, contrary to staff suggestions. Owners and supervisors of the LBs are separate institutional entities, the former being the *Länder* and regional savings banks, the latter being federal agencies complying with the Basel Core Principles for Effective Banking Supervision. Indeed, the FSAP certified the supervisory authorities a high degree of independence and stated that political interference had not been considered to be an issue at any time. This continues to be the case.

27. The savings banks pillar of the German banking system continues to serve the economy well. The savings banks play a key role in the financing of small and medium-sized firms. This role continues to be usefully underpinned by the regional principle. In addition, the mostly long-term orientation of savings banks' business relationships is beneficial from a stability perspective. Market trends with potentially procyclical effects have been followed only to a lesser extent.

28. The planned introduction of real estate investment trusts (REITs) in Germany will promote flexibility in property markets. It will also broaden the range of investment vehicles by complementing the existing open-ended real estate funds, given their different risk-return-profiles. While the recent draft bill proposes to largely exclude the existing stock of residential real estate, this restriction should not be overestimated. Experience elsewhere shows that, despite the eligibility of residential real estate, markets for REITs are effectively dominated by commercial property.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/141
FOR IMMEDIATE RELEASE
December 14, 2006

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

IMF Executive Board Concludes 2006 Article IV Consultation with Germany

On December, 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

A cyclical recovery is underway with buoyant exports progressively spilling over into stronger domestic demand. Investment activity is accelerating with high corporate profits and the long contraction in the construction sector has bottomed out. Full-time employment has started to pick up for the first time since 2001, but overall consumption still remains tepid with slow wage growth.

GDP growth is projected to accelerate from 0.9 percent in 2005 to 2.5 percent in 2006 partly benefiting from the World Cup, temporary fiscal incentives, and some durables purchases in advance of the VAT hike. Growth is projected to slow to 1.5 percent in 2007, but the deceleration is likely transitory. Downside risks to the outlook relate to volatile oil prices, global monetary tightening, and if there were an abrupt unwinding of global imbalances. On the positive side, growth could accelerate if the tick up in employment were to gain further speed, thereby lifting household disposable incomes.

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[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.

Labor productivity growth in the exposed manufacturing sector has improved steadily while that in the more sheltered domestic economy trails international performance. Liberal professions and crafts, and network industries, need to be further deregulated and reformed.

The financial sector has become healthier. Abundant liquidity and the cyclical upswing have improved earnings of banks and insurance companies although bank profitability still compares unfavorably with the EU average. Capital market activity has accelerated, led by increased mergers and acquisitions. There is ample scope for further growth of capital markets and in the large real estate sector which has stagnated for some time.

The government is making good progress in reducing the fiscal deficit. In 2006 the deficit will drop below the 3 percent of GDP Maastricht limit one year ahead of the schedule under the excessive deficit procedure. The reforms in health care and the corporate income tax system remain under discussion. Germany’s long-term fiscal outlook is improving but aging-related fiscal pressures still need to be reduced further.

Executive Board Assessment

Executive Directors welcomed Germany’s brisk cyclical recovery, which has been aided by far-reaching private sector restructuring and the authorities’ decisive actions on fiscal consolidation. Directors welcomed the strengthening of investment and the early signs of a pickup in consumption, indicating that exports are spurring domestic demand.

Directors encouraged the authorities to use the economic upswing to undertake deeper structural reforms for raising Germany’s growth potential. External competitiveness is strong, but the domestic sector needs to be strengthened through mutually reinforcing policies that enhance labor utilization, boost productivity, and continue fiscal consolidation, thereby also bolstering the sustainability of the welfare state.

Directors were encouraged by the resumption of growth in full-time employment. At the same time, Directors stressed that a significant and durable reduction in unemployment will require lowering reservation wages to bolster employment of lower skilled labor. Policies to increase participation rates will also help reduce structural welfare costs.

Directors supported the authorities’ intention to strengthen the implementation of the Hartz IV labor market reforms. They called for tightening eligibility for unemployment benefits for those unwilling to work, and for cutting active labor market programs that are ineffective. Most Directors urged the authorities to refrain from introducing minimum wages, which could undermine job creation, and also cautioned against new wage subsidies. They also encouraged the authorities to relax the employment protection legislation.

Directors called for further deregulation of the services markets, including for liberal professions and crafts. They also saw a need to improve the contestability of markets in network industries to boost efficiency and benefit consumers. Directors supported the authorities’ initiatives to cut red tape and regulatory costs.

Directors underscored the importance of an efficient financial sector to improve the allocation of capital to areas of highest return. While recognizing that earnings in the financial sector have risen, Directors noted that performance still trails that of most EU peers. They welcomed changes in the ownership structure of several public banks, but stressed that allowing a larger role for private capital to facilitate restructuring remains vital.

Directors saw the ongoing review of the supervisory agency, BaFin, as a good opportunity to buttress its operational independence. They endorsed the shift toward risk-oriented supervision.

Directors noted that the continued deepening of capital markets—which are already playing an increasing role in guiding corporate decisions—will be crucial for bolstering German growth and employment. They welcomed the authorities' intention to clarify the legal framework for private equity and to introduce Real Estate Investment Trusts, which should cover both commercial and residential property.

Directors welcomed the authorities' strong expenditure-based measures for fiscal consolidation, which will remain key to adjustment going forward. At the same time, they viewed the increase in the VAT in 2007, combined with the cut in payroll taxes, as a key structural measure that will help boost employment and strengthen the consolidation effort. Directors encouraged the authorities to cut the structural deficit by around ¾ percent of GDP in 2007 and to eliminate it by 2010, in anticipation of the pressures of population aging.

Directors considered that Germany has made substantial progress in reducing long-term aging costs, but cautioned that fiscal sustainability will not be assured even if the structural deficit were to be eliminated by 2010. Accordingly, they encouraged the authorities to pursue a broad-based approach, encompassing both fiscal adjustment and growth-enhancing reforms.

Directors welcomed the efforts to reform the corporate income tax and health care systems. They urged the authorities to implement the reforms in a manner consistent with their stated objectives of improving efficiency and lowering cost pressures without increasing fiscal risks. On the corporate income tax, a reduction in tax rates largely financed by a broadening of the tax base would be appropriate. On health care, Directors urged the authorities to tighten the reform proposals to limit rising health costs, and called for continued efforts to decouple health care financing from payroll charges.

Directors observed that Germany has spurred internal competition within the euro area and that new EU members have benefited from Germany's proximity. They noted that further successful reforms in Germany, as outlined above, would have positive spillover effects for the region and the world.

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 for the 2006 Article IV Consultation with Germany is also available.

Germany: Selected Economic Indicators

	2001	2002	2003	2004	2005	2006 1/	2007 1/
Economic activity and prices	(Change in percent, unless otherwise noted)						
Real GDP	1.2	0.0	-0.2	1.2	0.9	2.5	1.5
Net exports 2/	1.7	2.0	-0.9	1.2	0.4	0.8	0.4
Total domestic demand	-0.5	-2.0	0.6	0.0	0.5	1.8	1.2
Private consumption	1.9	-0.8	-0.1	0.1	0.1	1.1	0.3
Gross fixed investment	-3.7	-6.1	-0.8	-0.4	0.8	5.7	4.0
Construction investment	-4.6	-5.8	-1.6	-3.8	-3.6	3.1	2.8
Gross national saving (percent of GDP)	20.0	20.4	19.7	21.1	21.4	21.9	22.3
Gross domestic investment (percent of GDP)	20.0	18.3	17.8	17.4	17.3	17.7	18.0
Labor force 3/	42.2	42.3	42.4	42.8	42.7	42.4	42.4
Employment 3/	39.3	39.1	38.7	38.9	38.8	39.0	39.2
Standardized unemployment rate (in percent)	6.9	7.7	8.8	9.2	9.1	8.1	7.8
Unit labor costs (whole economy)	0.5	1.3	-1.7	-4.0	-3.3	-2.9	-1.5
GDP deflator	1.2	1.4	1.1	0.9	0.7	0.5	1.2
Harmonized CPI index	2.0	1.4	1.0	1.7	2.0	1.7	2.3
Public finance	(In percent of GDP)						
General government balance 4/	-2.8	-3.7	-4.0	-3.7	-3.2	-2.1	-1.5
Structural government balance	-2.7	-3.2	-3.4	-3.4	-2.8	-2.3	-1.7
General government gross debt	57.9	59.6	62.8	64.8	66.4	67.2	66.9
Money and credit	(Change in percent over 12 months)						
Private sector credit 5/	3.2	0.9	0.0	-0.2	2.1	4.2	...
M3 5/	6.1	...	3.5	2.2	5.2	3.9	...
Interest rates	(In percent)						
Three month money market rate 6/	4.3	3.3	2.3	2.1	2.1	3.3	...
Ten-year government bond yield 6/	4.8	4.8	4.1	4.1	3.6	3.8	...
Balance of payments	(In billions of euros, unless otherwise noted)						
Exports 7/	731.1	756.2	769.6	842.5	909.0	1,019.5	1,075.0
Imports 7/	692.9	667.3	685.1	732.9	796.5	893.5	944.5
Trade balance (percent of GDP)	4.2	5.8	5.5	6.4	6.3	6.4	6.1
Current account balance	0.4	43.4	40.3	81.9	92.2	98.6	102.7
Current account (percent of GDP)	0.0	2.0	1.9	3.7	4.1	4.3	4.3
Exchange rate	(Period average)						
Deutsche mark per US dollar	2.18	....	....				
Euro per US dollar 6/	1.12	1.06	0.88	0.80	0.80	0.79	...
Nominal effective rate (1990=100) 8/	101.5	104.7	112.6	115.8	114.7	115.6	...
Real effective rate (1990=100) 9/	101.5	101.7	105.4	104.4	102.8	102.0	...

Sources: Deutsche Bundesbank; IMF, IFS; IMF, World Economic Outlook; and staff projections.
1/ Staff projections, if not otherwise indicated.
2/ Contribution to GDP growth
3/ Domestic definition on a national accounts basis; according to new integrated system of economic accounts (ESA95)
4/ On a national accounts basis; according to new integrated system of economic accounts (ESA95)
5/ Data for 2006 refer to August, 2006. M3 refers to Germany's contribution in the euro area.
6/ Data for 2006 refer to September, 2006.
7/ Includes supplementary trade items.
8/ Data for 2006 refer to September, 2006.
9/ Based on relative normalized unit labor cost in manufacturing. Data for 2006 refer to July, 2006.