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GERMANY

2013 ARTICLE IV CONSULTATION

August 2013

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 2013 Article IV consultation with Germany, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 3, 2013, 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 July 17, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its August 1, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Germany.

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

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International Monetary Fund
Washington, D.C.

GERMANY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 17, 2013

KEY ISSUES

Context:

- Germany's strong fundamentals underpin its role as an anchor of stability in Europe.
- But uncertainty surrounding prospects and policies for the *euro area*—more so than in Germany itself—are now weighing significantly on activity.
- Reviving growth in Germany is tied to a sustained reduction in this uncertainty.

Risks:

- Should the alleviation of euro area uncertainty and a gradual recovery in the region fail to materialize, German growth would remain below potential for longer.
- A rise in financial stress in the euro area could interact with already weak regional demand and uncertainty and amplify inward spillovers.
- Weaker global growth prospects could compound these risks.
- An extended period of low growth could also reduce the economy's potential.

Policy recommendations:

- The small projected loosening of the fiscal stance is appropriate and fiscal over-performance should be firmly avoided in the current growth environment.
- Financial reform momentum should be maintained both at the domestic and the euro area level in order to alleviate uncertainty and reduce downside risks. The main priorities are to build on recent improvements in financial stability and on progress towards reversing the fragmentation of banking systems across Europe.
- Over the medium term, efforts to raise the German economy's growth potential need to be sustained.

Approved By
Ranjit Teja and Kalpana Kochhar

Discussions took place in Berlin, Bonn, Frankfurt, and Hamburg during May 21-June 3. The staff team comprised Subir Lall (head), Selim Elekdag, Anna Ivanova, Faezeh Raei (all EUR), and Vanessa Le Leslé (SPR). The team was supported from headquarters by Maike Luedersen (LEG), Xiangming Fang and Mariza Arantes (both EUR).

CONTENTS

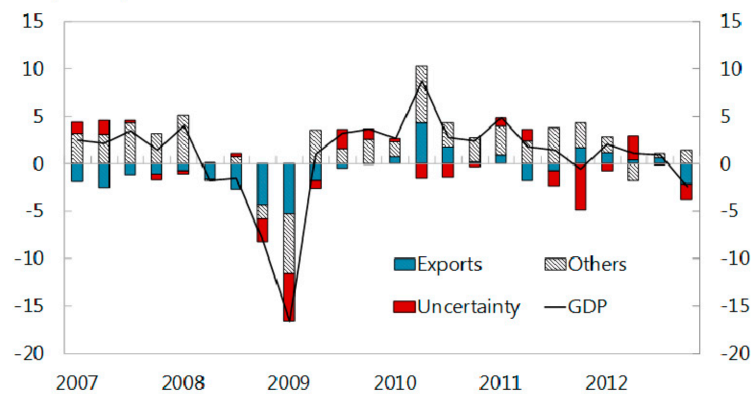
TABLES

ANNEXES

CONTEXT: THE IMPACT OF EURO AREA UNCERTAINTY

1. **Activity in Germany lost momentum in 2012.** This staff report argues that despite supportive domestic financial conditions and robust corporate balance sheets, the sharp slowdown during the course of last year and into early 2013 is mainly due to negative spillovers from the recession in the euro area that has been amplified by uncertainty about prospects and policies in the region more so than in Germany itself. In this sense, the circumstances for Germany have changed since the 2012 Article IV consultation: at that time, Germany seemed relatively immune to developments in the rest of the euro area although the risk of inward spillovers were flagged. Of course, euro area uncertainty is likely to be a factor restraining growth in other euro area economies as well. It is nevertheless reasonable to question the extent to which the staff's diagnosis is valid that euro area uncertainty is now playing an important key role in German economic prospects. The section "Point and Counterpoint to the Staff Views" (page 29) therefore attempts to highlight counterarguments to the staff's diagnosis and key policy recommendations, and offers some responses in order to provide additional context to the staff's preferred policy recommendations.

Germany: Uncertainty is Amplifying Spillovers
(Percent)



Source: IMF staff estimates.
Note: While GDP denotes real GDP growth (saar), exports and uncertainty refer to shocks from a structural VAR model.

RECENT DEVELOPMENTS AND OUTLOOK

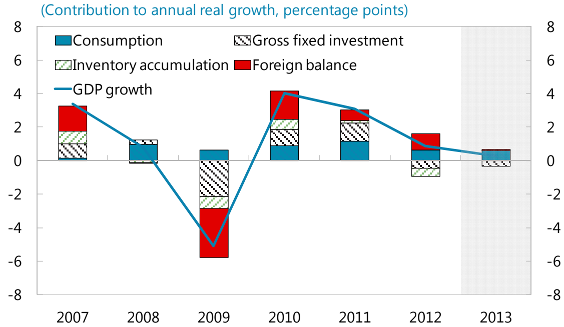
A. From Rebound to Moderation

2. **The rebound of 2010-2011 gave way to weakening momentum during the course of 2012 when growth fell below potential (Figure 1)**. While exports to the rest of the world began to recover by mid-2012, in line with improved prospects in the United States and emerging economies, exports to the rest of the euro area continued to decline as the deep recession in the region continued. However, as anticipated in last year's consultation, consumption grew robustly as unemployment remained near post-reunification lows and wages rose well above inflation. Negotiated wages in manufacturing rose 3.4 percent in 2012, well above the average of the preceding decade. Nevertheless, the decline in business investment continued to closely track exports to the euro area, leading to a contraction in activity in the last quarter of 2012, before stabilizing in the first quarter of this year. For 2012 as a whole, GDP grew by just under 1 percent, appreciably below potential.

Figure 1. Growth and Trade Developments

Real GDP growth weakened in 2012, driven by a decline in domestic investment and inventories.

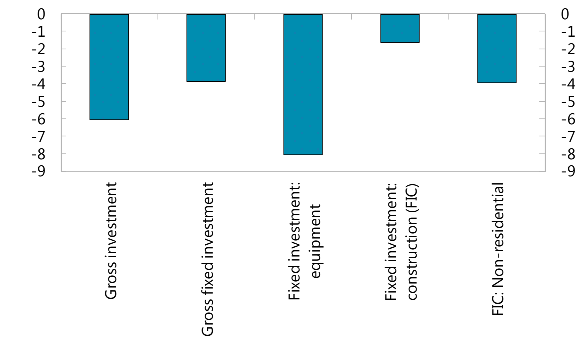
Germany: Demand Components of GDP Growth, 2007-2013
(Contribution to annual real growth, percentage points)



Sources: IMF *World Economic Outlook*; and staff calculations.

The decline in investment was broad based...

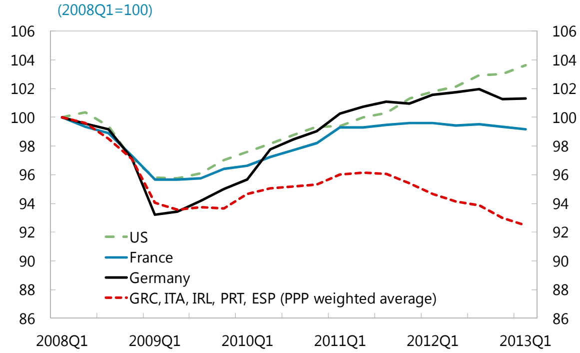
Germany: Decline in Investment and Its Components, 2012
(Percent)



Sources: Haver Analytics; and IMF staff calculations.

... suggesting that Germany has not decoupled from the rest of the euro area.

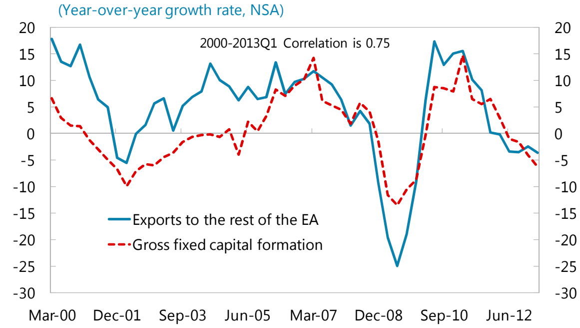
Selected Economies: Real GDP
(2008Q1=100)



Sources: IMF *World Economic Outlook*; and staff calculations.

There is a tight link between domestic investment and exports to the rest of the euro area.

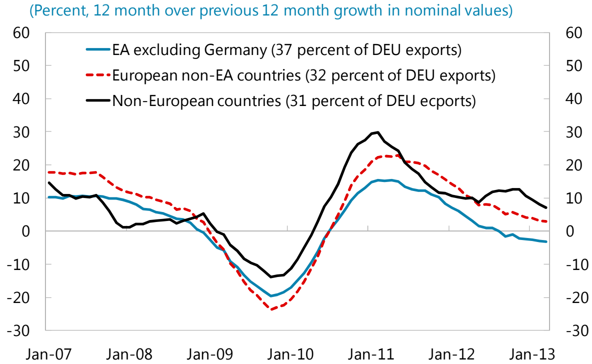
Germany: Exports to the Rest of the Euro Area and Gross Fixed Capital Formation
(Year-over-year growth rate, NSA)



Sources: Haver Analytics; and IMF staff calculations.

The decline in export growth is largely driven by a substantial slowdown of exports to Europe and, in particular, to the rest of the euro area, while exports to non-European countries has held up relatively well.

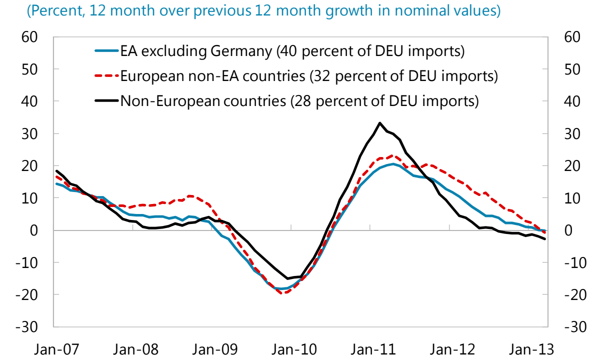
Germany: Exports Growth by Region, Jan 2007-Mar 2013
(Percent, 12 month over previous 12 month growth in nominal values)



Sources: Bundesbank; and IMF staff calculations.

In contrast, the decline in import growth in all three regions has converged more recently.

Germany: Imports Growth by Region, Jan 2007-Mar 2013
(Percent, 12 month over previous 12 month growth in nominal values)

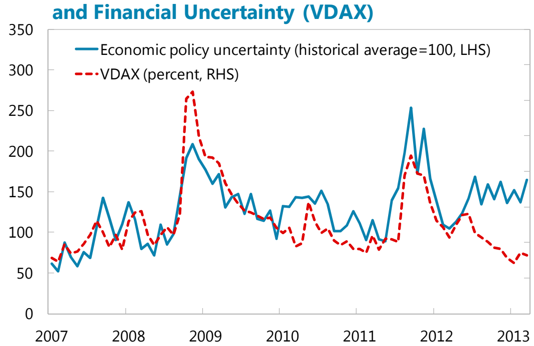


Sources: Bundesbank; and IMF staff calculations.

Figure 2. Economic Activity and Uncertainty

While German financial stress has recently abated, economic policy uncertainty remains elevated.

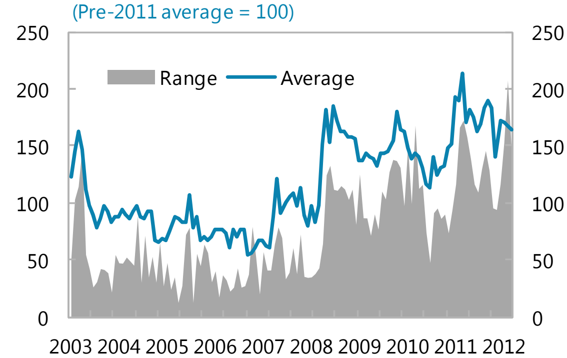
Germany: Economic Policy Uncertainty Index and Financial Uncertainty (VDAX)



Sources: Haver Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis(2012): PolicyUncertainty.com

The heightened level and dispersion of uncertainty is noteworthy.

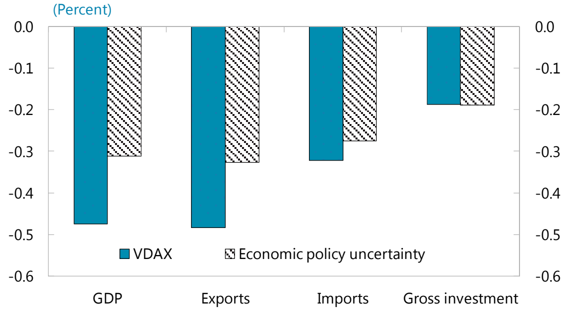
Selected European Countries: Economic Policy Uncertainty Index
(Pre-2011 average = 100)



Sources: Policy Uncertainty Index: Baker, Bloom, and Davis: PolicyUncertainty.com; and IMF staff calculations.

Elevated levels of financial stress and uncertainty are associated with a contraction of economic activity…

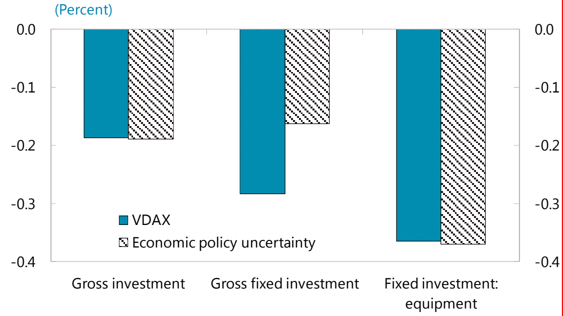
Germany: Correlations Between Uncertainty Measures and Economic Activity
(Percent)



Sources: Haver Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis(2012): PolicyUncertainty.com; and IMF staff calculations.

…and particularly so for investment.

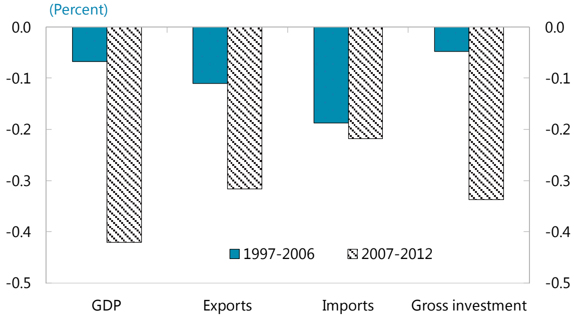
Germany: Correlations Between Uncertainty Measures and Selected Investment Categories
(Percent)



Sources: Haver Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis(2012): PolicyUncertainty.com; and IMF staff calculations.

Notice the post-2007 strengthening in the negative correlation between uncertainty and growth…

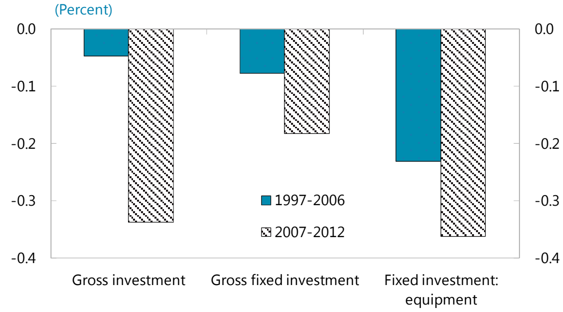
Germany: Correlations Between Uncertainty Measures and Economic Activity Over Time
(Percent)



Sources: Haver Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis(2012): PolicyUncertainty.com; and IMF staff calculations.

…which is, once again, all the more relevant for various components of investment.

Germany: Correlations Between Uncertainty Measures and Selected Investment Categories Over Time
(Percent)



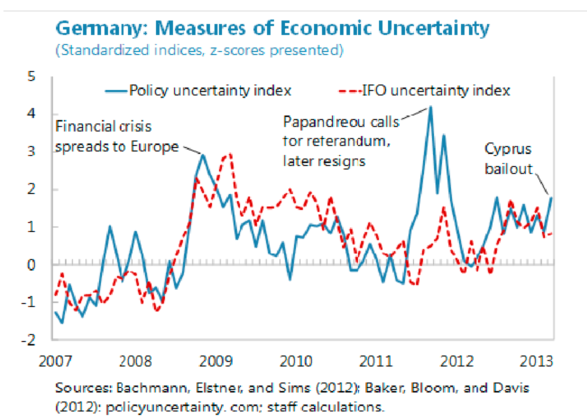
Sources: Haver Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis(2012): PolicyUncertainty.com; and IMF staff calculations.

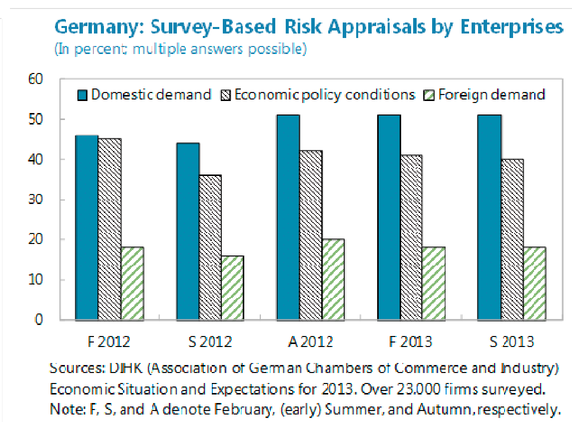
Box 1. What is the Effect of Uncertainty on Economic Activity in Germany?[1]

Heightened uncertainty appears to be holding back a more robust rebound in Germany. In the current environment, corporates find it worthwhile to delay projects which are costly to undo.

Measuring uncertainty can be challenging. The economic policy uncertainty index by Baker, Bloom, and Davis (2012) is an important advancement in the literature.[2] It has two underlying components: The dispersion of individual-level forecasts regarding consumer prices and federal government budget balances as a proxy for uncertainty, and the quantification of newspaper coverage of policy-related economic uncertainty. While this measure could be challenged, it is highly correlated with other uncertainty measures developed in the literature, including those based on confidential micro data from the German IFO Business Climate Survey (see figure below).[3] Moreover, the German and European measures of policy uncertainty move in tandem indicating uncertainty spillovers. In contrast, the VDAX—a measure of financial stress—has been on a downtrend over the last year, as expected given ample liquidity (see Figure 2 and paragraph 3).[4]

The index-based evidence is corroborated by firm-level surveys. A survey of 23,000 firms in Germany reveals that economic policy conditions are more of a risk factor than foreign demand (although these are not necessarily mutually exclusive). More generally, it seems that firms are now more sensitized to developments in the region. Other secondary sources of uncertainty are domestic in nature and include ambiguity regarding potential post-election tax increases and the future cost of energy.





[1] Prepared by Selim Elekdag.

[2] http://www.policyuncertainty.com/

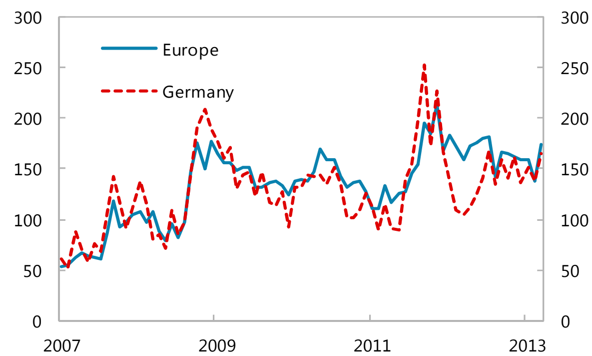
[3] Bachmann, Elstner, and Sims, 2012, "Uncertainty and Economic Activity: Evidence from Business Survey Data," NBER Working Paper No. 16143.

[4] The VDAX index (broadly the European counterpart of the VIX) is one measure of financial uncertainty (a financial "fear" index), and corresponds to the implied volatility of the DAX (German stock index).

3. **Elevated levels of uncertainty have been an important contributor to the unexpected weakening of business investment.** Both financial stress and policy uncertainty have been established in the recent economic literature to be associated with weakening economic activity (see Bloom (2009) and Cardarelli and others (2011)). Financial stress in the euro area has abated, in part due to decisive and timely policy actions by major central banks. However, policy uncertainty at the euro area level is still perceived as high, and uncertainty in Germany is closely linked to that of the region (Figure 2). Moreover, the sensitivity of various components of German GDP, and especially

investment, to uncertainty appears to have risen since the beginning of the global financial crisis (see Box 1). This sensitivity of German businesses to *euro area* uncertainty with the potential to dampen regional prospects further is also borne out in recent surveys, which indicate that this is one of the most important reasons to postpone investment and adopt a wait-and-see attitude for some 40 percent of SMEs, suggesting that the real option value of postponing investment is currently very high despite easy financing conditions. While heightened euro area uncertainty (as well as domestic policy uncertainty in some cases) may play an important role in restraining activity across a number of euro area economies, in the case of Germany, it seems to be a quite central factor, given the economy's strong competitiveness and the strength of German public and private balance sheets. As explored in the staff report on euro area policies (Country Report No. 13/231), the lack of competitiveness and still impaired balance sheets play a sizable role in some other euro area economies.

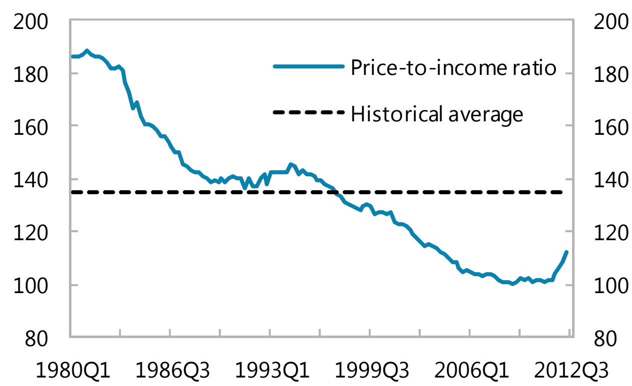
Economic Policy Uncertainty
(Index; historical average =100)



Sources: Haver Analytics; Policy Uncertainty Index: Baker,

4. **There are no signs of elevated inflation or asset price pressures.** Lower inflation in recent quarters reflects mainly a decline in food and energy prices and some widening of the output gap. Core inflation has, however, increased slightly reflecting rising wages. Nationwide property prices have continued to rise, driven mainly by stronger increases in apartment prices in some major cities. However, these prices remain below historical averages and do not appear excessive.

Germany: Property Price-to-Income Ratio



Sources: OECD; Global Property Guide; and IMF staff calculations.

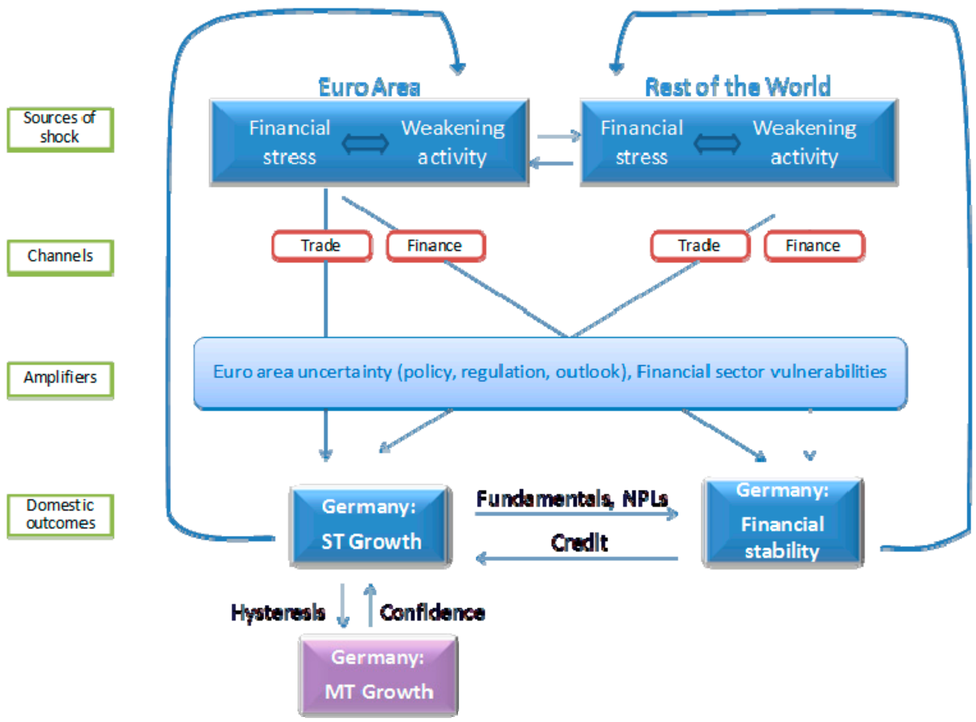
B. Outlook and Risks: Contingent on Euro Area Uncertainty

Staff Views

5. **The outlook for the remainder of 2013 and next year is heavily dependent on a gradual recovery in the rest of the euro area and a sustained reduction in uncertainty.** Consumption is expected to continue to expand robustly this year given favorable labor market conditions and wage agreements. However, exports to the euro area are expected to recover only gradually, and economic prospects for key emerging markets (EMs) have recently weakened. Euro area uncertainty is expected to continue to have an amplifying impact on investment through the end of the year and assumed to diminish subsequently. Growth for 2013 as a whole is thus projected at around 0.3 percent, reflecting continued below-potential growth in the second half of the year.

Growth in 2014 is projected to return to potential. Core inflation is expected to continue rising gradually over the next two years due to wage increases. Headline inflation this year is, however, projected to moderate due to the lower energy prices.

Germany: Risk Flow Chart



6. The baseline outlook is subject to a number of interrelated and mutually reinforcing downside risks (see Risk Flow Chart and Risk Assessment Matrix).

- Given its high degree of trade and financial openness, Germany is highly susceptible to a slowdown in external demand and/or elevated financial stress. At the regional level, euro area shocks could be transmitted via trade and financial channels. Higher borrowing costs associated with an exit from unconventional monetary policies in the United States could dampen growth, especially if the rise in yields is not commensurate with the pickup in global economic activity (see 2013 Spillover Report for a discussion). At the same time, the interaction between weaker economic activity and elevated financial stress in the euro area could be mutually reinforcing, owing to already strained balance sheets in a number of countries, and be further exacerbated by waning confidence or heightened euro area uncertainty. A deeper-than-expected slowdown in major emerging market trading partners would compound these risks. A significantly weaker German outlook would in turn affect both regional and global growth prospects, primarily through the trade channel.

- Policy uncertainty regarding the roadmap and key elements of reforms to the euro area architecture, prospects for a recovery of activity in the euro area, and the still unsettled regulatory and supervisory landscape for the financial system, represent another factor which could magnify the effects of the intertwined shocks discussed above.

- In terms of risks of a more medium-term nature, an extended period of low growth could lead to hysteresis-type effects by lowering potential growth.

- Risks to domestic financial stability may surface owing to, for example, a shock to confidence by depositors and creditors in systemically important institutions, which by increasing risk aversion, could disproportionately suppress economic activity and trigger contagion more broadly.

Authorities' Views

7. **The authorities agreed with staff's diagnosis that euro area uncertainty was the primary driver of the decline in business investment.** They agreed that domestic balance sheets and labor markets are strong in Germany, financial conditions remain supportive, and that exports to destinations outside of Europe are rebounding. They noted that businesses have postponed investment projects, adopting a wait-and-see attitude towards euro area uncertainty, rather than cancelling projects outright as they await uncertainty to diminish. They were optimistic that on the basis of reforms taken by other economies in the region, as well as decisions and measures adopted at the level of the EMU in recent months, uncertainty could be expected to recede relatively quickly. Therefore a rebound in pent-up investment demand could happen earlier than staff assume and lead to somewhat higher growth in 2013 than is currently being projected by staff.

8. **The authorities agreed that a number of downside risks cloud the outlook.** Germany remains susceptible to changes in external conditions, and the authorities supported the staff's conclusion that the decline in overall investment primarily reflected developments in the euro area and not domestic conditions. They noted that German businesses have been reorienting themselves towards the economies that drive global growth, and could expect to eventually be less vulnerable to adverse developments in the region. The authorities did not fully share the view that the roadmap towards reforms of the euro area architecture was uncertain and highlighted the many important advances made over the past year and the still ambitious agenda for this year. The impact of euro area risks could thus be somewhat lower than indicated by staff. The authorities also underscored that the risks facing the Germany economy are multifaceted and intertwined, creating a wide margin of uncertainty around individual risks' probabilities, especially when the time frame for the materialization of risks is unclear. They were of the view that a qualitative assessment of risks and impacts is somewhat easier to communicate and understand.

REVIVING GROWTH IN AN UNCERTAIN ENVIRONMENT

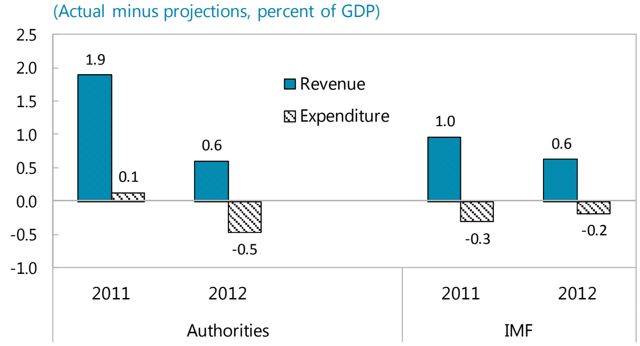
The main policy challenge over the near term is to reinvigorate growth and manage downside risks. Policies need to ensure that the fiscal stance does not induce headwinds to a recovery, and efforts need to be made to address the underlying causes of uncertainty in the euro area. Guarding against downside risks primarily involves maintaining steady progress on financial reforms both domestically and at the euro area level. Progress on financial reforms would also help alleviate an important source of uncertainty that is weighing on growth.

A. Fiscal Policy

Background

9. **Once again in 2012, the outturn was better than projected by both staff and the authorities**. The surplus of 0.1 percent of GDP was 0.8 percentage points stronger than projected at the time of the 2012 Article IV consultation. The staff's forecast error was largely on account of revenues while expenditures were only slightly below staff's forecast. Revenue overperformance reflected mainly higher tax revenues and social security contributions as labor market strength continued to surprise on the upside. The authorities' fiscal projections had a somewhat higher overall forecast error, reflecting both higher revenues and lower expenditures than projected in their 2012 Stability Program.

Fiscal Projections Forecast Errors
(Actual minus projections, percent of GDP)

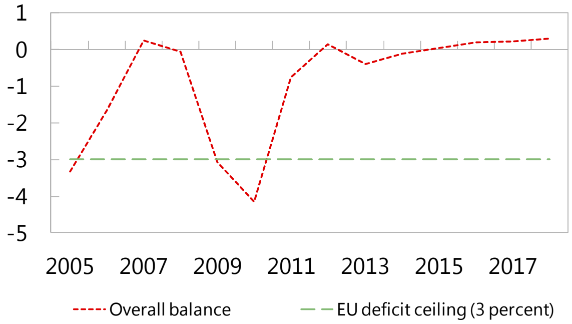


Source: IMF Article IV reports, Stability and Growth Program Projections, and IMF staff calculations.

10. **Following three successive years of robust fiscal performance, Germany's fiscal stance is comfortably in line with its medium-term objectives.** Germany has achieved the deficit goals at the federal level under the national debt brake rule (*Schuldenbremse*) well ahead of schedule and the general government balance is already in line with commitments under the Fiscal Compact of the Economic and Monetary Union (EMU).

General Government Fiscal Balance

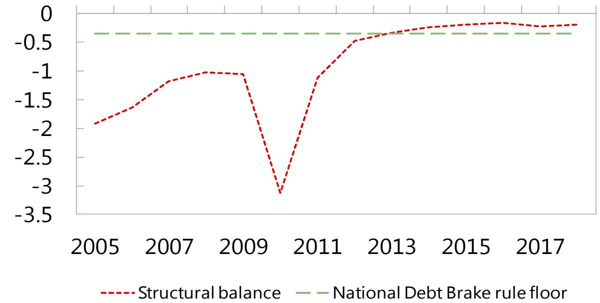
(Percent of GDP)



Sources: Destatis and IMF staff calculations and projections.

Federal Government Structural Balance

(Percent of Potential GDP)

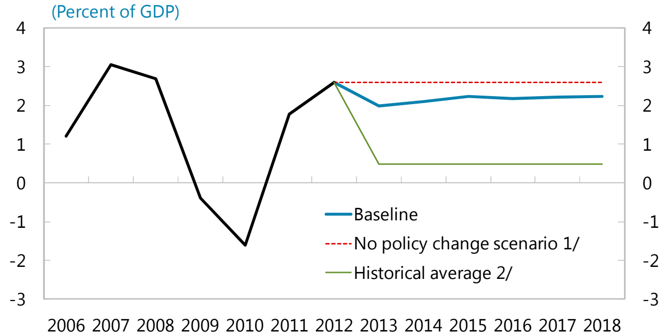


Sources: Destatis and IMF staff calculations and projections.

11. A modest loosening of the fiscal stance is projected for 2013 and with little further consolidation over the medium term. Staff projections point to a general government balance of –0.4 percent of GDP this year, consistent with a widening output gap. The structural fiscal position is projected to be in balance, implying a mildly expansionary stance. From 2014 onwards, only modest structural consolidation is foreseen. While public debt is projected to decline under the baseline, the debt trajectory remains sensitive to negative growth surprises.

Primary Balance Path Under Alternative Scenarios

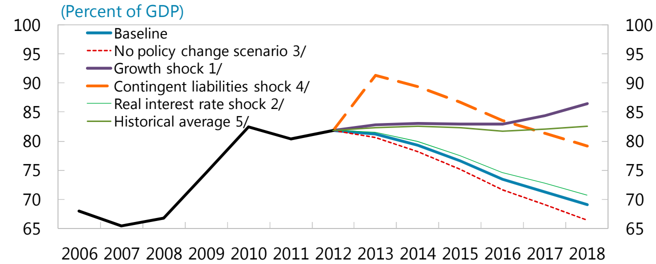
(Percent of GDP)



Sources: German Federal Statistical Office; and IMF staff estimates.
1/ "No policy change" scenario assumes that the primary balance remains unchanged from 2011 onwards, while all other macroeconomic variables are the same as under the baseline.
2/ "Historical average" scenario assumes that all variables, including the primary balance, growth and interest rates, are at historical averages.

Government Debt Path Under Alternative Scenarios and Stress Tests

(Percent of GDP)



Sources: German Federal Statistical Office; and IMF staff estimates.
1/ "Growth shock" scenario assumes real GDP growth at baseline minus one-half standard deviation.
2/ "Real interest rate shock" scenario assumes baseline interest rate plus one standard deviation.
3/ "No policy change" scenario assumes that the primary balance remains unchanged from 2011 onwards, while all other macroeconomic variables are the same as under the baseline.
4/ "Contingent liability shock" scenario assumes a 10 percent of GDP increase in other debt-creating flows in 2012.
5/ "Historical average" scenario assumes that all variables, including the primary balance, growth and interest rates, are at historical averages.

Staff Views

12. The fiscal stance is appropriate in the current low growth environment and fiscal overperformance should be firmly avoided. Past fiscal overperformance has largely reflected gains from exceptional labor market performance that has translated into higher revenues, particularly from taxes and social security contributions, and lower unemployment-related benefits. Interest payments on public debt also benefited from Germany's safe haven status. Looking ahead, with unemployment rates and employment creation having stabilized, further revenue and expenditure gains are less likely. Nevertheless, past official budget projections have also reflected some in-built conservatism. It will be important to avoid continued fiscal overperformance as this may imply a contractionary fiscal stance. Macroeconomic policy settings now need to be appropriately supportive of growth in Germany given the substantial downside risks, as flat growth could eventually translate into higher unemployment and weak longer-term domestic demand. In practical terms, this would imply that if fiscal overperformance appears definitive, planned expenditures should be accelerated, especially for public investment and other measures that enhance the economy's growth potential, including if necessary through reallocation across spending categories.

13. Unless growth strengthens, fiscal policies would need to be recalibrated. As discussed in the risk section, external shocks could have significant implications for the outlook. Should growth prospects sour and labor markets be expected to weaken, proactive fiscal policies would be needed. Automatic stabilizers should as usual be allowed to operate freely. However, a large shock may necessitate invoking the escape clause under the debt brake rule in order to support domestic activity and employment. The case for fiscal fine tuning to adjust to smaller growth shocks remains weak, especially when labor markets continue to remain robust. Germany's overall strong balance sheets provide an anchor for the region as a whole (see next section) and fiscal spillovers from Germany to the rest of the euro area are limited (see Box 2 and Point and Counterpoint). However, should growth not recover as envisaged, the fiscal stance will need to be reassessed.

Authorities' Views

14. The authorities agreed that fiscal overperformance should be avoided but thought it unlikely. They pointed to the difficulty of correctly estimating the natural rate of unemployment in the past given the structural changes in the labor market. They suggested that the gains from past reforms had now largely run their course, as evidenced by the stabilization of unemployment. They also noted that gains from savings on interest payments were relatively small (around €5 billion (0.2 percent of GDP) in 2012). Looking ahead, they doubted revenues would continue to surprise on the upside, and expected that expenditures would likely be in line with the budget.

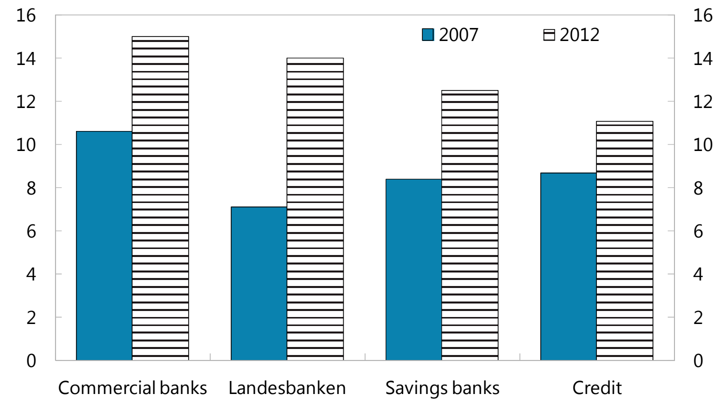
15. The authorities noted that the debt brake rule allows sufficient flexibility to respond to large unanticipated shocks to growth. They had demonstrated in the immediate aftermath of the collapse of Lehman Brothers that they were willing and able to take strong fiscal measures to support growth. They also agreed that fiscal spillovers to the economies in recession in the euro area are small. In light of this, they pointed out to measures being undertaken directly by Germany, for example to support financing for SMEs in other economies. Germany is implementing a plan to make around €800 million in financing available for SMEs in Spain, which would lower the borrowing costs for some SMEs, and could extend similar schemes to other economies where viable SMEs face difficulty in accessing financing.

B. Financial Sector Policies

Background

16. Banking system soundness has improved but vulnerabilities remain. Banks have continued to raise capital (Table 6) and the quality of capital has also improved. Funding conditions also remain favorable for most German banks and the system's reliance on wholesale funding has continued to decline. However, the capital of large German banks remains weaker than that of their global peers. Overall asset quality for bank has remained broadly stable, although there are some sectoral vulnerabilities. Co-operative and savings and some private banks are well on their way to meet Basel III capital, liquidity and leverage requirements, while banks undergoing restructuring are taking steps to strengthen their financial metrics to fully comply with the stricter regulatory framework.

German Banks Capital Adequacy
(Percent, Regulatory tier 1 capital to risk-weighted assets)

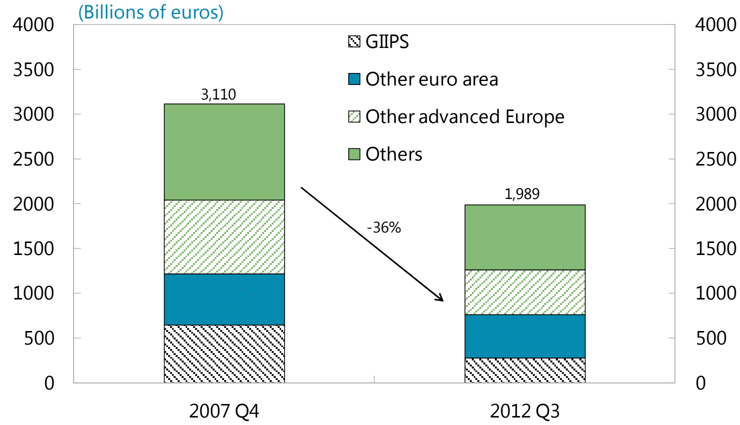


Source: Bundesbank.

17. The financial system continues to face several structural challenges:

- Earnings are weak. Competition in the domestic segment is intense, net interest margins are suffering from low interest rates and deleveraging, operating costs have not been reined in (in some banks related to extraordinary costs associated with restructuring efforts), and efficiency remains low.

Geographic Breakdown of German Banks' Consolidated Foreign Claims
(Billions of euros)



Source: BIS.

- Sectoral exposures need monitoring. Exposures to the euro area account for 41 percent of impaired assets, followed by exposures to international commercial real estate, securitizations and shipping loans.

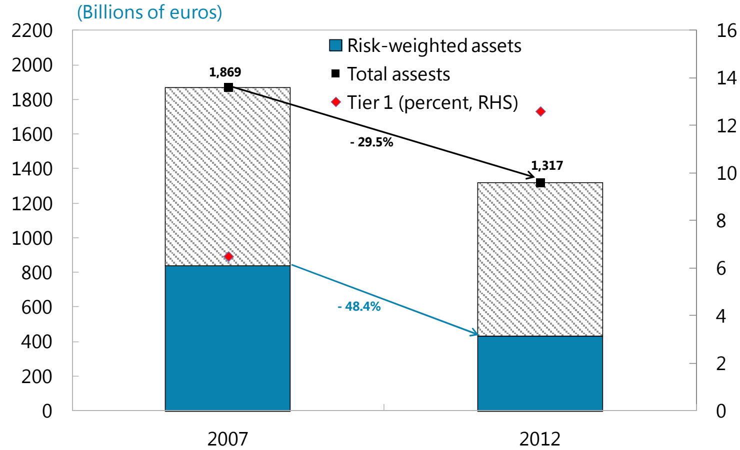
- Low interest rates are exerting pressure on insurance companies, and are particularly challenging for life and annuity insurers with guaranteed payments.

- Leverage in select large cross-border SIFIs remains higher than global peers (Figure 3), although the leverage ratios are in compliance with expected Basel III requirements.

18. Progress continues to be made on restructuring the domestic banking system.

- Of the €29 billion in capital and €174 billion in guarantees that distressed institutions received, around €12 billion of capital has been repaid to the financial stability fund (SoFFin) and only €1.1 billion in guarantees remain.

Landesbanken Deleveraging and Capitalization
(Billions of euros)



Source: German Savings Banks Association.

- The compression and risk reduction of Landesbanken balance sheets (mainly through asset sales and the natural rollover of assets) has led to an improvement in Tier 1 capital ratios. Earnings before tax have been positive for three consecutive years, and the business focus has been reoriented around domestic customers including corporate clients, central banking functions for the savings banks, and municipal finance.

19. Progress has been made in some areas of the financial reform agenda. The restructuring fund for banks set up in 2011 is fully operational. In addition, a macroprudential policy framework is now in place with the establishment of the Financial Stability Committee, in line with European Systemic Risk Board (ESRB) recommendations. Progress has also been made on recommendations in several areas of the 2011 FSAP Update (see Annex II). Support measures for the financial sector through SoFFin have been extended through end-2014 to strengthen the restructuring process and safeguard financial stability.

20. Further efforts to strengthen cross-border supervision of German banks active internationally remain a key priority. Germany is home to only one global systemically important bank (G-SIB), for which international cooperation efforts are deemed critical to ensure global financial stability. A trilateral college among German, U.S., and U.K. authorities is a good first step, on which to build further in-depth exchange of information and actionable group-wide supervision. Germany is also home and host to 21 and 40 supervisory colleges respectively. More broadly, around 25 German banks and 5 foreign banks operating in Germany are expected to move to ECB supervision under the Single Supervisory Mechanism (SSM), representing around two-thirds of banking system assets.

21. Despite the progress made, the financial regulatory landscape remains unsettled both domestically and at the euro area level.

- A German legislative proposal to separate the risky activities of large banks has been adopted by Parliament. Discussions at the EU level on the separation of investment and retail banking activities based on the Liikanen report are also ongoing. Eventually, the two versions will have to be harmonized to create a level playing field across the euro area, and the implications for the twelve affected banks' business models will only become clear at that stage.

- The recent draft Bank Recovery and Resolution Directive (BRRD) sets out future rules on how to restructure and resolve banks, and provides guidance on the rankings of various creditors in the bail-in regime. The full impact of the new rules on German borrowers remains to be seen, with the German SME sector possibly affected on both the lending side (through borrowing costs) and on the deposit side (through the bail-in regime).

- Deposit insurance reform, including depositor preference in bank resolution, is another important area and the BRRD introduced tiered depositor preference which is a major step forward. The two issues are treated separately in Germany, where the legal frameworks do not provide for depositor preference, but the merits of insured depositor preference are under consideration. The various banking associations in Germany that run domestic deposit insurance schemes have expressed reservations about a centralized euro area scheme.

Staff Views

22. The overall stability of the German financial system has helped maintain supportive domestic financial conditions (Figure 4). Germany's status as a safe haven and favorable funding conditions for banks have allowed bank lending rates to hover near all-time lows. However, bank lending remains moderate, and the demand for credit remains weak especially from businesses, against a backdrop of elevated uncertainty, particularly in Europe.

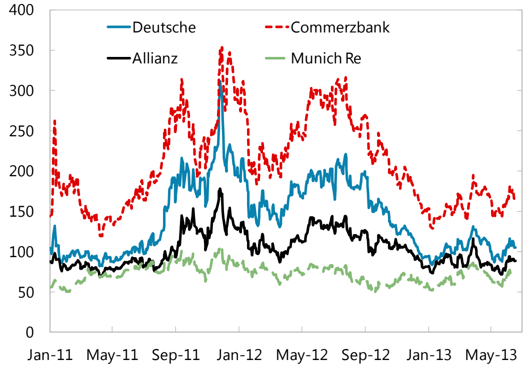
23. The introduction of a macroprudential policy framework is welcome but no new measures are needed at this juncture. There are currently no signs of excessive credit growth, weakening of lending standards, or excessive asset price increases. While the prices of apartments in some urban centers have risen more than nationwide trends, mortgage lending remains benign, but needs to be monitored.

24. While important progress has been made in implementing several FSAP recommendations, more progress is needed in some areas. The implementation of measures to enhance stress testing, strengthen the crisis management framework, reduce state aid support, and restructure weaker banks is welcome. However, it is also important to step up efforts to improve the supervision and resolution of cross-border SIBs to reform the fragmented deposit insurance regime, and to ensure that German legal and regulatory initiatives are carefully meshed with European proposals.

Figure 3. Financial Sector Vulnerabilities

The German financial system has been stable and the risk perception of large financial institutions has been generally declining since mid-2012…

German Banks 5-Year CDS Spreads

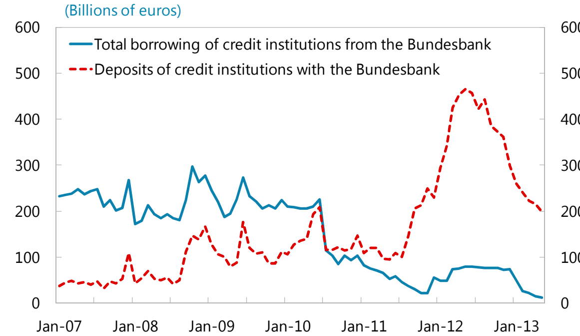


Source: Bloomberg L.P.

… with some signs of improvement in the euro area interbank market, as evidenced by the decline of deposits of German banks with the Bundesbank.

Bundesbank Lending to and Deposits of Credit Institutions in Germany, Jan 2007 - May 2013

(Billions of euros)

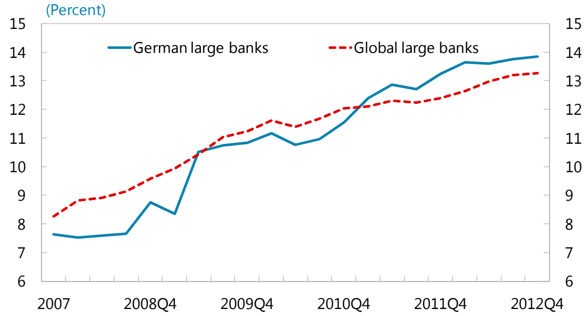


Source: Bundesbank.

Large German banks continue to raise regulatory capital ratios faster than their international peers.

Tier 1 Capital Adequacy Ratio

(Percent)

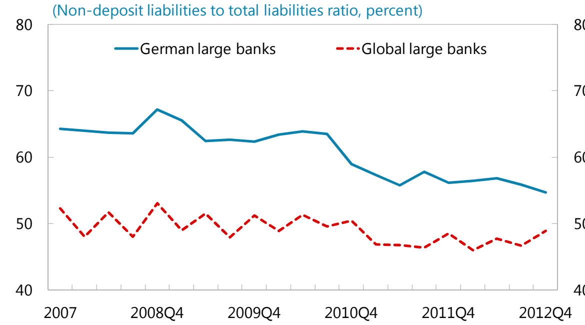


Sources: SNL financial.
Note: The ratios represents simple averages based on data for 60 large banks globally including G-SIFIs. Sample for Germany includes 6 banks.

However, vulnerabilities in the financial system remain, including reliance of large banks on wholesale funding…

Wholesale Funding Ratio

(Non-deposit liabilities to total liabilities ratio, percent)

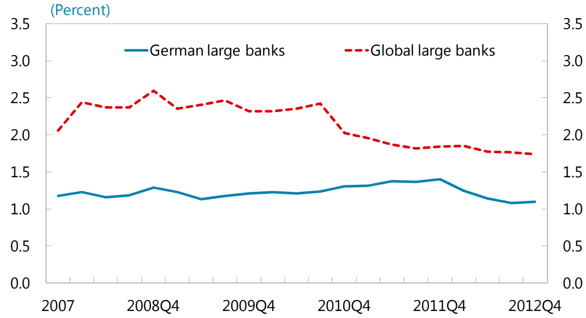


Sources: SNL financial.
Note: The ratios represents simple averages based on data for 60 large banks globally including G-SIFIs. Sample for Germany includes 6 banks.

… low profitability…

Net Interest Margin

(Percent)

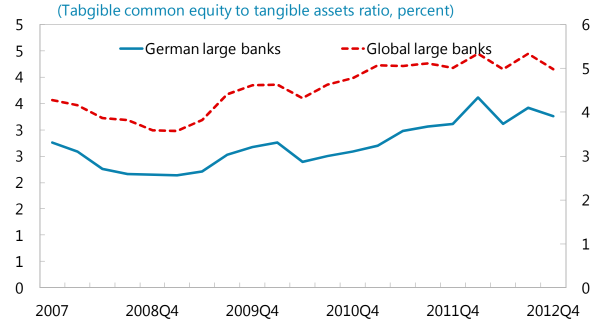


Sources: SNL financial.
Note: The ratios represents simple averages based on data for 60 large banks globally including G-SIFIs. Sample for Germany includes 6 banks.

⋯ and low capital quality, as measured by the leverage ratio

Tangible Common Equity Ratio

(Tabgible common equity to tangible assets ratio, percent)



Sources: SNL financial.
Note: The ratios represents simple averages based on data for 60 large banks globally including G-SIFIs. Sample for Germany includes 6 banks.

25. The banking system needs to continue to make efforts to increase capital and improve profitability. Bolstering capital through conservative earnings retention and raising capital whenever possible should remain a priority. Stronger capital ratios would ensure that German banks are well prepared ahead of the stress tests and the move to SSM. In addition, banks also need to make efforts to improve their profitability especially through greater efforts at reducing costs, improving efficiency and streamlining their business model to adapt to the new regulatory and operating environment.

26. The surveillance of large cross-border banks needs to be anchored by strong domestic supervision and close coordination with key financial center supervisory authorities. Supervisory colleges and crisis management groups are important steps. However, deepening coordination with non-euro area authorities, particularly with the United States and the United Kingdom, is essential ahead of the centralization of supervision of cross-border banks by the SSM. Continuing refinements to raise domestic supervisory standards to the highest possible quality would benefit not only German financial stability, but also global stability.

27. Taken together, financial reform momentum needs to be sustained both domestically and at the euro area level. While difficult to achieve, strong political backing for institutional reforms remains critical and is in the interest of all EMU members. Swiftly advancing the roadmap toward a full banking union based on the SSM, SRM and common safety nets, as recommended by the EU FSAP and euro area staff report (Country Report No. 13/231) is important to reverse fragmentation. Delaying or diluting the roadmap, including a centralized resolution authority and common deposit insurance mechanisms and backstops, would preserve an unsatisfactory status quo and run the risk of destabilizing confidence again.

Authorities' Views

28. The authorities agreed that credit conditions are benign and macroprudential measures are not warranted at this juncture. They underscored that the relatively low credit growth amid supportive financial conditions reflects low demand for credit—in part owing to uncertainty—and not any constraints on the supply of credit. They also agreed that overall house price trends suggest that valuations are still moderate, but need to be carefully monitored.

29. They highlighted progress made in restructuring weaker banks, including Landesbanken. The authorities believed their approach in providing wide-ranging Federal backing and allowing banks to clean-up their balance sheets over a long period of time worked better than more frontloaded methods used in other European countries. They also viewed the diversity of their banking sector as a source of stability, with local savings and cooperative banks largely unscathed by the financial crisis, and universal banks still considered as a desirable model going forward.

30. The authorities were of the view that progress on both domestic and European initiatives has been substantial. They contended that most domestic initiatives largely follow European guidelines, and as such did not expect particular challenges in harmonizing the German framework with the European one. The vision of German authorities for the design of the Banking Union however is not fully aligned with what is being considered at the European level. The authorities seem particularly reluctant to grant resolution to centralized euro area authorities, which they argue would require changes to the European Union treaty. The authorities would also have preferred a more rules-based bail-in framework, with limited flexibility and limited country discretion.

GERMANY AS AN ANCHOR OF REGIONAL STABILITY

Germany plays an important role in stabilizing the region due to its strong balance sheets and safe haven status, in part by better absorbing external shocks rather than amplifying them to key trading partners. It could help prevent excessive imbalances by facilitating more investment through structural reforms that increase the labor force and increase its productivity, and facilitate the allocation of resources into new areas outside Germany's traditional strengths in manufacturing exports.

Strengthening Germany's role as a regional anchor of stability

31. Germany's trade and financial integration with Europe and the rest of the world has accelerated. Trade as a share of German GDP has nearly doubled to 90 percent, in part reflecting higher exports to Emerging Asia and the development of a dynamic supply chain involving the Czech Republic, Hungary, Poland, and Slovakia (the CE4 economies; see FO/DIS/13/100 "The German-Central European Supply Chain Cluster Report"). As a regional safe haven, financial linkages are also extensive, driven by a growing volume of capital flows, a reflection of the cross-border intermediation activities of large German banks.

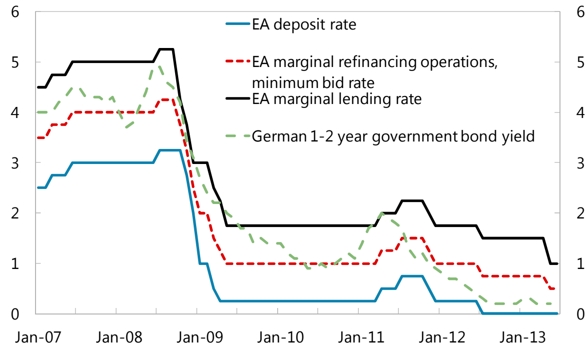
Staff Views

32. Against the backdrop of globalization, Germany has become increasingly sensitive to economic developments in the rest of the world. Greater trade and financial openness has increased the economy's exposure to global shocks. When measured in terms of final demand (by explicitly accounting for domestic value added content of exports), while the European Union is still Germany's largest trading partner, exposures to China and the U.S. are larger than what gross trade statistics suggest. While German growth is likely to have benefited from closer trade ties to these relatively faster growing regions, Germany has also become more sensitive to global trade downturns as witnessed by the experience of 2008-09. Germany's financial system is highly connected with the rest of the world and remains exposed to developments elsewhere.

Figure 4. Credit Conditions

The decline in investment is striking, amid favorable financing conditions…

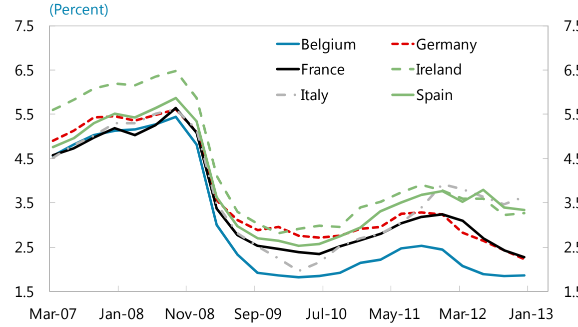
Liquidity Conditions
(Percent)



Sources: ECB; and Haver Anlaytics.

…particularly in Germany…

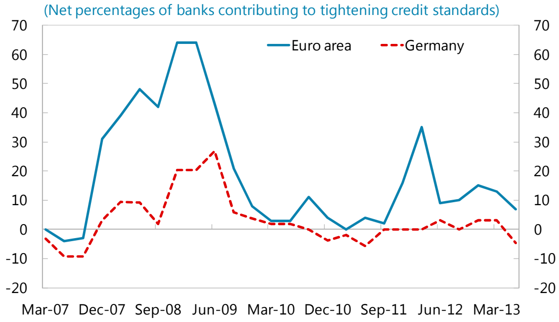
Lending Rates on New Loans to Non-financial Corporations
(Percent)



Sources: ECB; and IMF staff calculations.

…given the relatively supportive credit standards.

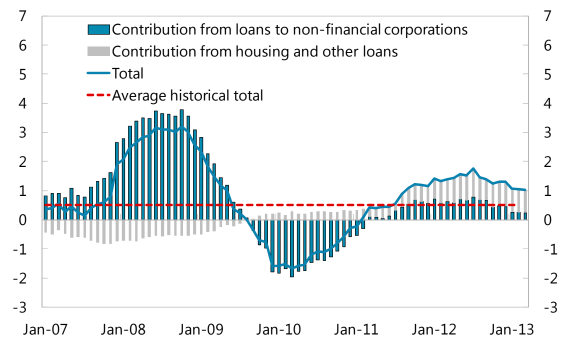
Credit Survey: Change in Credit Standards to Enterprises, Past 3 Months
(Net percentages of banks contributing to tightening credit standards)



Source: Haver Analytics.

While total credit growth remains above its historical average, there is a leveling off of credit growth to the corporate sector…

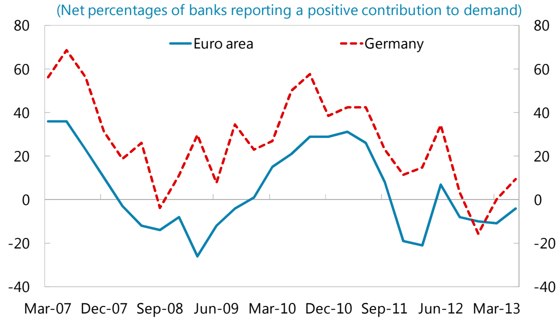
Germany: Lending by Monetary Financial Institutions
(Year-over-year growth rate)



Source: Haver Analytics.

…that is associated with low credit demand by enterprises as they hold off on investment.

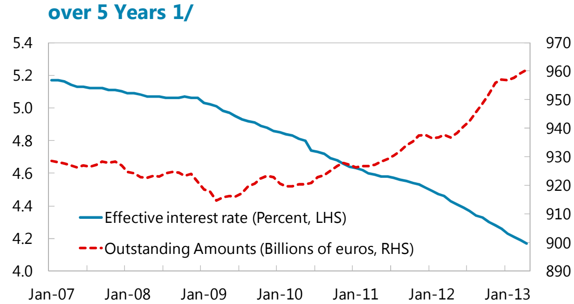
Credit Survey: Credit Demand by Enterprises in the Next 3 Months
(Net percentages of banks reporting a positive contribution to demand)



Source: Haver Analytics.

Housing loans, in contrast, have accelerated, reflecting favorable financing conditions and the demand for housing as a "store of value" in uncertain times.

Germany: Housing Loans to Households with Maturity over 5 Years 1/



Source: Haver Analytics.

1/ Housing loans with maturity over 5 years represent 95 percent of all housing loans and about 40 percent of total lending by Monetary Finanicial Institutions to domestic enterprises and households

33. Germany also generates outward spillovers through real and financial channels.

- A few large German banks are heavily interconnected to other European and international systemically important financial institutions (SIFIs). These internationally active banks continue to hold large foreign claims, which exposes them to adverse inward spillover risks. Robust home supervision should aim for a comprehensive mapping of the risks, both on- and off-balance sheets at home and abroad, to understand the linkages between these SIFIs and other parts of the domestic and global financial system.

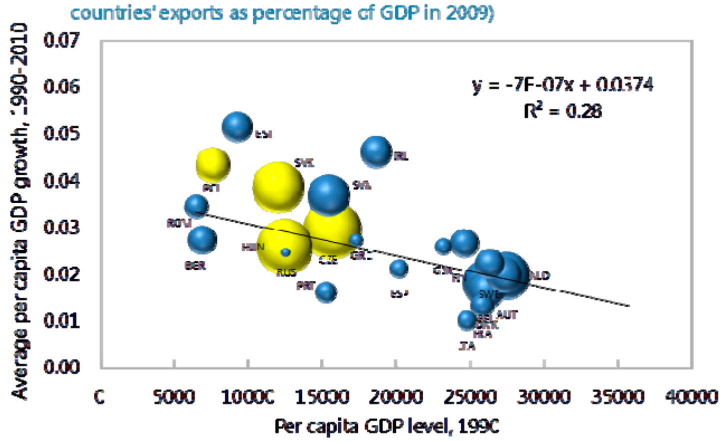
- As a reflection of deeper trade integration, intermediate exports across the region have increased substantially, including between Germany and the CE4. This is important because the growth of intra-supply chain trade owing to the exchange of intermediate goods implies that final demand in Germany is not necessarily the main determinant of CE4 exports to Germany.

- Fiscal stimulus in Germany has a relatively small impact on the rest of the euro area. Trade links are weak for smaller trading partners such as Greece and Portugal, and stronger for larger ones including Italy and Spain, so that the spillovers as a share of the trading partners' GDP is low in both cases (see Box 2).

- Germany also generates beneficial medium-term spillovers to the region. In the context of the supply chain with the CE4, there is evidence that income convergence in these four countries was higher than average. Higher growth in these countries was associated with technology transfers and financed by a relatively greater share of FDI inflows from Germany.

Income Convergence and the Role of Supply Chains

(Bubbles represent the share of Germany foreign value added imbodied in countries' exports as percentage of GDP in 2009)

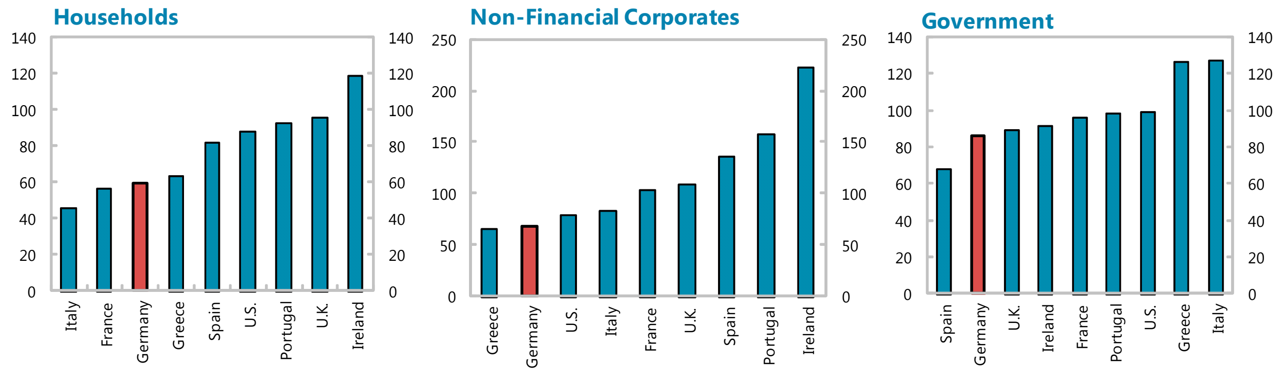


Sources: Penn World Table 7.1; WIOT; and IMF Staff estimates.

34. Owing to its strong fundamentals—including sound balance sheets—and its safe haven status, Germany plays the role of a regional anchor of stability. Although German growth has lately been too low to offset the contractionary forces in the region, the country has nevertheless played an important stabilizing role. In particular, balance sheets in Germany are generally healthy with, for example, low debt-to-GDP ratios in the household, corporate, and government sectors. This allows Germany to better absorb shocks from other trading partners instead of transmitting or amplifying them to its supply chain partners. Thus, maintaining strong balance sheets, preserving financial stability and ensuring that excessive external imbalances do not accumulate would generate continued beneficial spillovers from Germany for the region.

Germany: Debt-to-GDP Ratios Across Sectors

(Percent of GDP, 2011)



Source: OECD

Authorities' Views

35. **The authorities agreed that Germany's safe haven status and its generally strong public and private sector balance sheets have benefited the region**. The authorities pointed out that while the fiscal stance should not be contractionary, the costs outweigh the benefits of fiscal fine tuning. They underscored that it was important to maintain the strength of household balance sheets to ensure that easy financing conditions do not lead to future vulnerabilities owing to mortgage-related lending. More broadly, the authorities welcomed the German-Central European Supply Chain Cluster Report prepared by staff and agreed with its main conclusions.

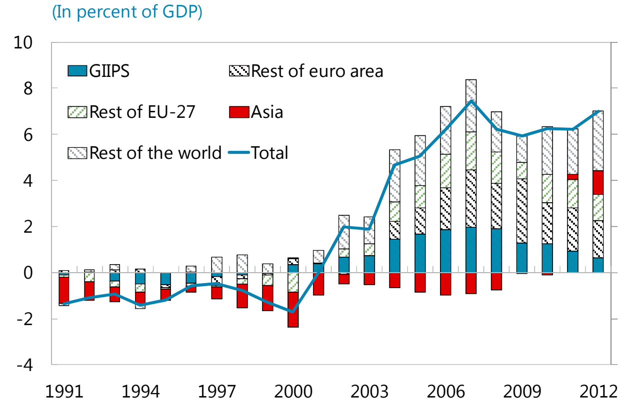
A. Maintaining External Stability

Background

36. **Germany's current account surplus widened by 0.8 percentage points to 7 percent of GDP in 2012, despite robust consumption growth and declining exports to the rest of the euro area**. The sharp decline in investment and the associated dampening of imports contributed to the widening of the balance. Overall, the current account surplus with the euro area, and in particular vis-à-vis the GIIPS economies, has been gradually declining since 2007, but that with the rest of the world has been rising. In line with the large current account surpluses, the German net international investment position rose to about 40 percent of GDP in 2012 with the private sector and net claims on the Eurosystem (Target 2 balances) providing major contributions (Figure 5). The latter have since declined in early 2013.

Germany: Current Account Balances by Region

(In percent of GDP)



Sources: Bundesbank.

Note: GIIPS denotes Greece, Ireland, Italy, Portugal, and Spain.

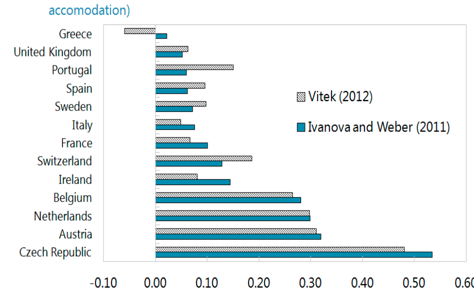
Box 2. Fiscal Spillovers[1]

Fiscal stimulus in Germany is likely to have a relatively small impact on the rest of the euro area and Germany's supply chain partners. Model simulations find that the maximum impact of a two-year 1 percent of GDP fiscal stimulus in Germany on the rest of the euro area amounts to 0.2 percentage points.[2] Fiscal spillovers from Germany to its main supply chain countries have increased over the past decade, but remain small overall. This is explained by the supply chain nature of trade integration: final demand in Germany is not the main determinant of CE4 exports to Germany.[3] The domestic impact of fiscal stimulus in Germany, in contrast, can be large, ranging between 0.7 and 0.9 percent of GDP on average over two years. Hence, fiscal policy can be an effective tool in addressing domestic growth shortfalls.

Fiscal spillovers are larger for relatively small and open neighboring countries. Countries in close proximity with relatively strong trade links to Germany, such as the Czech Republic, Austria, the Netherlands and Belgium would benefit most from a German fiscal stimulus. Countries in the euro area periphery would receive relatively small spillovers, reflecting weak trade links for the smaller economies (Greece, Portugal) and the large size of countries with stronger trade ties to Germany (such as Italy and Spain). Moreover, fiscal spillover estimates for some countries are likely to be overestimated due to the prevalence of trade in intermediate goods that conventional trade statistics do not capture, implying greater reliance on demand outside of Europe.

The Impact of 1 Percent of GDP Fiscal Expenditure Stimulus in Germany on Individual European Countries

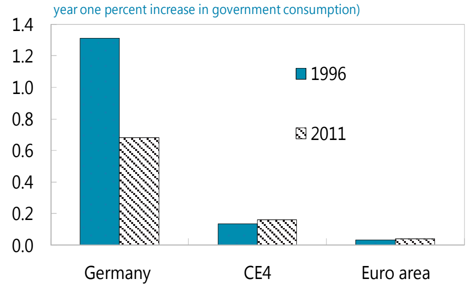
(Two-year average deviation of real GDP from the baseline, monetary policy accomodation)



Sources: Direction of Trade; IMF *World Econominc Outlook*; and staff calculations.

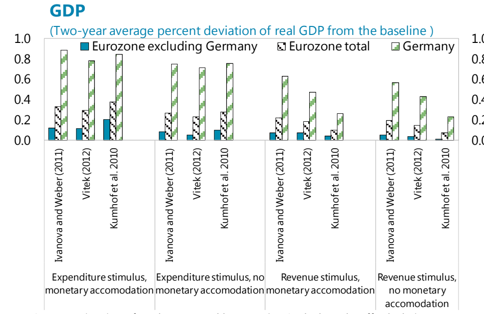
Spillovers from a German Fiscal Stimulus

(The percent deviation of real GDP form baseline owing to a German two-year one percent increase in government consumption)



Note: CE4 represents the Czech Republic, Poland, Hungary, and Slovakia.
Source: IMF staff calculations.

The Impact of Fiscal Stimulus in Germany on Eurozone GDP



Sources: Direction of Trade; IMF *World Econominc Outlook;* and staff calculations.

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[1] Prepared by Anna Ivanova.

[2] Three alternative methodologies are explained in Ivanova, A. and S. Weber (2011), "Do Fiscal Spillovers Matter?" IMF Working Paper No. 11/211; Kumhof, M., D. Laxton, D. Muir and S. Mursula, 2010, "The Global Integrated Monetary Fiscal Model (GIMF)—Theoretical Structure," IMF Working Paper No. 10/34; and Vitek, F. (2012), "Policy analysis and forecasting in the world economy: A panel unobserved components approach," IMF Working Paper No. 12/149.

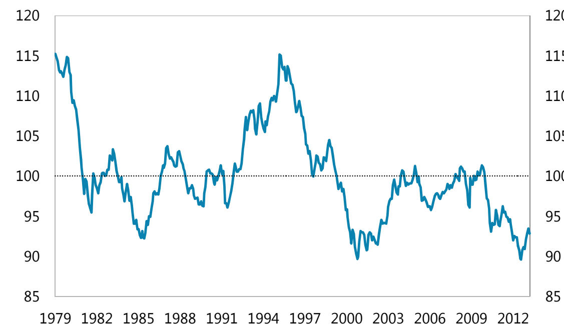
[3] See FO/DIS/13/100 "The German-Central European Supply Chain Cluster Report".

37. **The sectoral composition of the current account has changed in recent years.** The corporate sector contributed strongly to the increase in the current account surplus during 2000-10, as the rise in corporate savings exceeded investment. Over the past two years, however, corporate savings have declined in line with reduced profitability although their cash buffers remain substantial.

Staff Views

38. **Germany's external position remains substantially stronger than that implied by medium-term fundamentals and global economic policy settings**. Staff analysis suggests a cyclically-adjusted current account gap of 5-6 percentage points of GDP. In part, this reflects the lack of an exchange rate adjustment mechanism within the currency union and developments in other euro area countries, and therefore, part of the adjustment will reflect policy changes elsewhere. The real effective exchange rate is assessed to be undervalued by about 2-10 percent, and is some 8 percent below its historical average (see Table 8 for a summary of selected external assessment methodologies).

Germany: Real Effective Exchange Rate
(An increase in the index denotes an appreciation; historical average=100)



Sources: IMF INS database.

39. **The rebalancing of domestic sources of growth is expected to gain momentum as the decline in investment bottoms out and associated imports pick up**. Over the medium term, staff sees an additional reduction in the current account balance by about 2-3 percent of GDP over and above the natural rebalancing process as appropriate and could be linked to growth-enhancing structural reforms in non-traded sectors. Reflecting a strong labor market, it would not be inappropriate for real wages to rise, and therefore help improve the labor share of national income. This would help spur domestic demand, and make the economy less vulnerable to external shocks, while not endangering Germany's competitiveness. In addition, policy levers such as making the tax structure more growth-friendly within the fiscal envelope and reforming the financial sector could be beneficial in rebalancing the sources of the growth.

Authorities' Views

40. **The authorities welcomed staff initiatives such as the External Balance Assessment to better understand German external balances but urged caution in interpreting results**. They broadly agreed that the current account surplus was on the high side and agreed that an investment rebound and higher growth potential would facilitate a more durable rebalancing of the economy. With the robust growth in wages and consumption amid the favorable labor market conditions, they contended that rebalancing is underway.

41. **The authorities also noted that uncovering a reliable statistical relationship explaining German current account dynamics is proving to be difficult.** They explained that, similar to staff

analysis (including the EBA/ESR), they could not associate the German current account balances with any identifiable policy distortions. Therefore, the authorities emphasized that especially because the EBA/ESR are still work in progress, any econometric residuals from the analysis should not be characterized as unidentified policy distortions as this would be outright misleading and furthermore does not yield any actionable policy recommendations.

B. Germany and the Euro Area

Background

42. As the largest economy in Europe, Germany plays an important role in shaping policies at the regional level. With euro area uncertainty a drag on German growth, policies at the regional level pushed forward by Germany could have large payoffs in terms of a rebound in domestic activity. This in turn would also benefit Germany's closest trading partners, as discussed in the German-Central European Supply Chain Cluster Report.

Staff Views

43. Heightened uncertainty can weaken the impact of macroeconomic policies. The prevailing elevated levels of uncertainty in the euro area could make fiscal (or monetary) policy less effective because the real option value of inaction is very large, making households and firms less responsive to policy stimuli.

44. In addition to financial sector uncertainty, there is still a lack of clarity on the steady state architecture of EMU, and also ambiguity on policies to revive growth. The policy challenge in the short run is to restore growth, employment, and address other crisis-related issues, and for the medium term, it is more important than ever to provide clarity on the shared vision for the euro area (see Country Report No. 13/231).

Authorities' Views

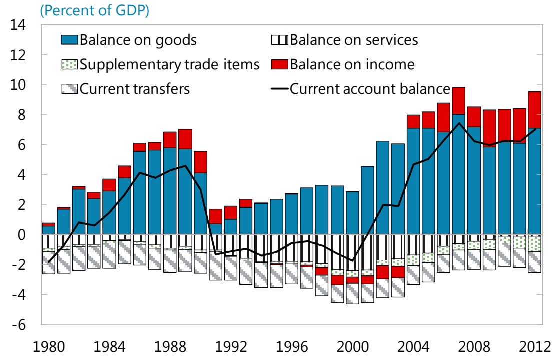
45. The authorities underscored that substantial progress has been made on euro area reforms over the past year. They pointed to progress towards the single supervisory mechanism (SSM) and the imminent adoption of the Bank Resolution and Recovery Directive (BRRD). The authorities are of the view that progress towards greater integration needs to be built on firm legal foundations as they involve far-reaching changes to institutional mechanism and a the shift of responsibilities from national to European institutions. Meaningful reforms to euro area architecture could thus only be achieved at a deliberate pace. The authorities were clear that a well functioning EMU is in the best interest of Germany, and that they are fully committed to an integrated and well-functioning EMU that serves the interests of all its members.

Figure 5. Current Account, Financial Flows, Savings and Investment

The German current account balance has increased substantially from the early 2000s.

Germany: Current Account Composition, 1980-2012

(Percent of GDP)

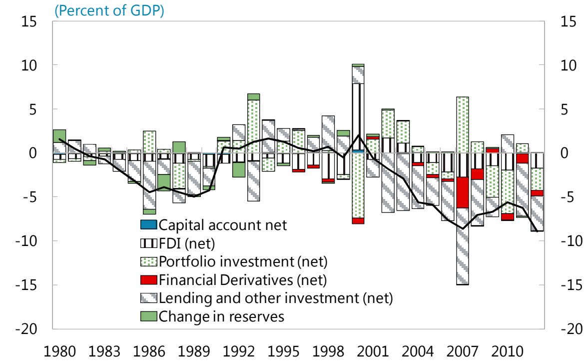


Sources: Haver Analytics; and IMF staff calculations.

Large current account surpluses financed substantial outflows.

Germany: Capital and Financial Account, 1980-2012

(Percent of GDP)

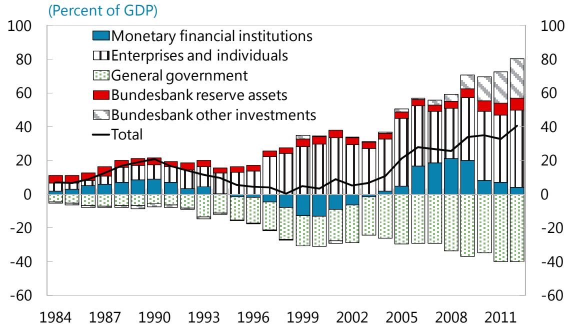


Sources: Haver Analytics; and IMF staff calculations.

As a result, the private sector has a strong net foreign asset position, but more recently, Target 2 balances have also contributed strongly.

Germany: Net International Investment Position by Sector, 1984-2012

(Percent of GDP)

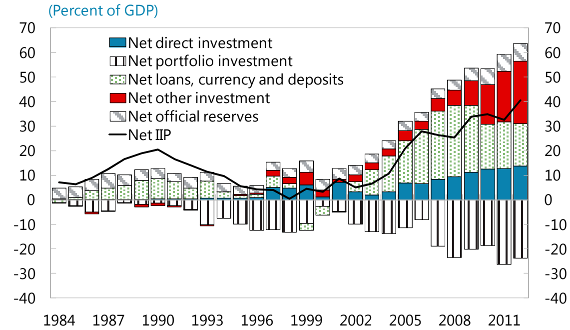


Sources: Haver Analytics; and IMF staff calculations.

Net foreign direct investment is not a major contributor to the IIP, though gross outward FDI is substantial.

Germany: Net International Investment Position by Instrument, 1984-2012

(Percent of GDP)

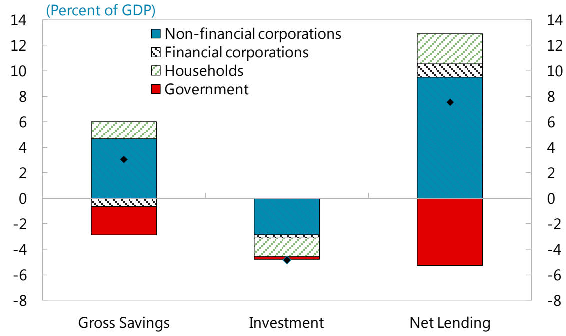


Sources: Haver Analytics; and IMF staff calculations.

The non-financial corporate sector was an important driver of rising current account surpluses over the past decade.

Germany: Change in the Current Account Surplus Between 2000 and 2010

(Percent of GDP)

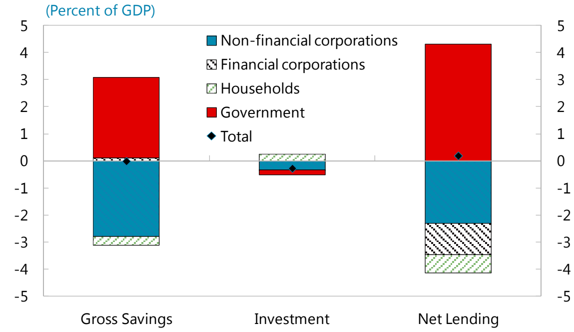


Source: Haver Analytics.

Its contribution, however, has declined in recent years.

Germany: Change in the Current Account Surplus Between 2010 and 2012

(Percent of GDP)



Source: Haver Analytics.

C. Structural Reforms to Raise and Diversify Growth

Background

46. Germany's potential growth at around 1¼ percent is low and highly dependent on external sources of demand. At the same time, with an aging population, a shrinking labor force will increasingly act as a drag on potential growth over the longer term. Raising potential growth is therefore important to maintaining living standards and long-term fiscal sustainability and reducing the economy's vulnerability to external demand shocks. In 2012, the inward migration of 369,000 workers into Germany was an important positive development, although this likely reflected some exceptional factors such as the deep recession in some other EMU member countries and this volume is unlikely to be maintained.

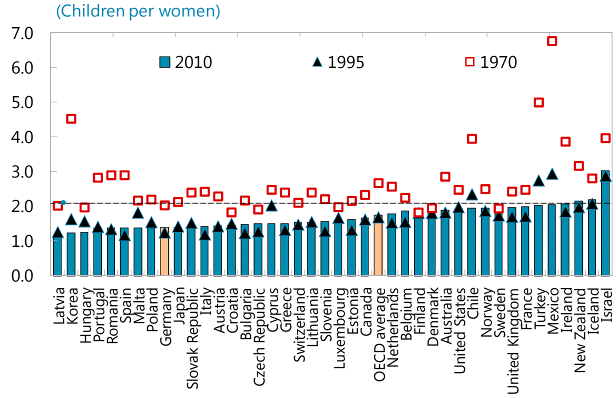
Staff Views

47. Raising potential growth and diversifying its sources requires additional labor market-related and structural reform efforts. Progress is needed on two broad fronts: (a) addressing the decline in the working-age population and (b) raising productivity outside of Germany's manufacturing exports sector.

48. In recent years, Germany has implemented some reforms to offset the shrinking of the labor force:

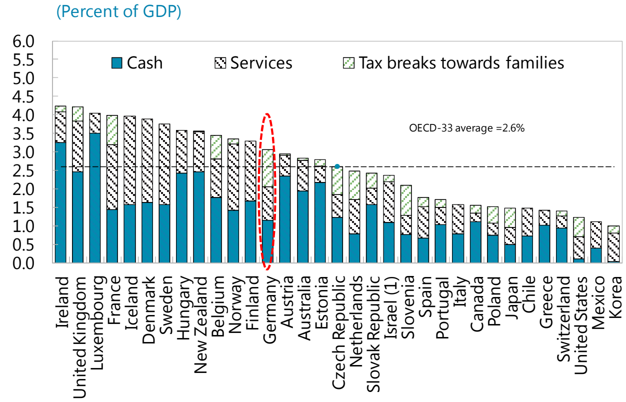
- To increase labor force participation rates of secondary earners and low-income workers, the contribution rate for statutory pension insurance was reduced and the personal basic tax-free allowance for income tax and the monthly pay threshold for mini-jobs were increased in 2013. Joint income taxation reform was introduced in 2009 which addresses some of the disincentives for second earners. However, the tax wedge for workers earning 50 percent and 67 percent of the average wage is still among the highest in the EU, and secondary earners still face significant fiscal disincentives due to the joint taxation of income for married couples and the free health insurance coverage for non-working spouses.

Total Fertility Rate
(Children per women)



Source: OCED.

Public Spending on Family Benefits
(Percent of GDP)



Souce: OECD

- To facilitate immigration, a law to enhance the recognition of professional qualifications obtained abroad came to force in 2012. The new EU Blue Card makes procedures simpler for the immigration of skilled workers from outside the European Union. Recent changes have also made it easier for international students to remain in Germany and work. In addition, training programs have been expanded to help increase the supply of skilled workers.

- Day care services are being expanded through several programs at the federal, Laender, and municipal levels, to provide needs-based day care for children under three, with a view to facilitating the participation of women in the labor force. The federal government is also providing support to the Laender towards raising the standards of services provided and maintaining high quality child care in the long term.

- Early retirement opportunities have also been restricted and the statutory retirement age is being raised to 67 from 65.

49. Looking ahead, reform efforts in this area should focus on:

- Removing remaining disincentives to increase labor force participation.

- Continued efforts to support inward immigration of both high- and medium-skilled workers. In addition to the successful programs for immigration of skilled workers, pathways for attracting medium-skilled workers are needed. Standardizing applications, and continued efforts to provide information especially to small- and medium-sized employers would help reap further benefits.

- Increasing the availability of full-time high-quality childcare and reviewing family policies with a view to identifying and addressing more efficiently disincentives to having children.

50. Raising productivity as well as measures to support investment outside of the manufacturing exports sector will also be necessary to raise potential growth. In this regard, recent efforts to increase spending on education and research are welcome. Further efforts to strengthen the human capital of workers especially in areas outside of manufacturing would be helpful. In addition, the following reforms would help raise the economy's growth potential:

- Reforms need to be sustained to increase competition and productivity in the services and infrastructure sector, including accelerating the integration of pan-European transportation and energy networks and increasing competition in network industries;

- Broadening the channels of financial intermediation would facilitate the allocation of resources to new areas of growth;

- While the government programs for high-risk start-ups at an early stage of development have proven to be successful, access to risk capital for firms at a more advanced stage of development and marketing remains limited;

- A framework, including tax provisions and regulation of institutional investors, that encourages a larger investor base for risk capital with appropriate financial stability safeguards would help stimulate innovation and broaden development of new growth engines.

51. Ensuring the long-term sustainability of public finances in the face of demographic pressures will be an important priority. In addition to the measures identified above to address the demographic challenge, the efficiency of public spending will need to be improved. This could include introducing spending reviews to support top down budgeting and medium-term budget strategy reports as well as examining healthcare spending for potential cost savings.

Authorities' Views

52. The authorities shared staff's view that demographic challenges pose a threat to longer-term potential growth. They agreed on the need for continued structural reforms to raise potential growth and productivity. In this context, they noted the recent reforms in immigration and the recent upturn in inward migration. They agreed that the unusually high rate of inward migration is unlikely to be sustained but efforts will be sustained. They also underscored the need for creating pathways for medium-skilled workers in the SME sector. In addition, the authorities also agreed with the importance of more effective and efficient family policies to reverse long-term unfavorable demographic trends. In this context, the authorities are undertaking a review of family policy to align family and work-life balance with a view to increase fertility rates and female labor force participation. Finally, the authorities noted that risk capital funding is an area of focus with several programs already in place to provide seed capital to new innovative firms. They were also in broad agreement with staff on the need to improve venture capital financing and the facilitation of exit and restructuring for companies.

POINT AND COUNTERPOINT

While the staff's conclusions articulated in the previous sections reflect extensive discussions not just with official counterparts but also with private sector and think-tank representatives and Fund staff, they can be debated. Three aspects of the staff's views are scrutinized below, with a view to providing the reader a better sense of the arguments and counterarguments.

53. With uncertainty as measured by financial market indicators such as the VIX and VDAX at multi-year lows, how can staff argue that uncertainty is high?

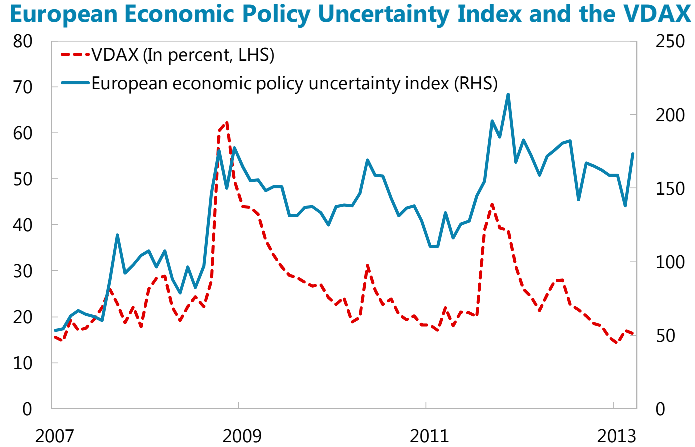
Argument: Historically, the VIX and VDAX indices have risen sharply during recessions or episodes of acute financial distress when economic and financial prospects were uncertain (for example, during the global financial crisis of 2008-09).[1] Moreover, both indices are widely used measures of

[1] The VIX and VDAX indices measure implied volatility of the S&P 500 and DAX (U.S. and German stock market indices), respectively.

financial uncertainty and are informally known as "financial fear" indices. Therefore the fact that these indices are hovering around multi-year lows seems to challenge the notion that uncertainty is elevated.

The Counterargument: The VIX and VDAX are dependent on financial market conditions, and both indicators are still below their historical averages primarily because of the unprecedented abundance of global liquidity amid historically low interest rates and the unconventional monetary policies implemented by major central banks (albeit prospects for exit from these policies have recently led to elevated financial market turbulence). Moreover, while these financial market indices have historically moved in tandem with the measure of economic policy uncertainty, more recently they have diverged: while the VDAX is still relatively low, the measure of European economic policy uncertainty remains elevated. Box 1 describes in more detail staff's approach to measuring uncertainty, recent influential contributions in the literature relating uncertainty to economic activity, and additional corroborating evidence on uncertainty in Germany.

European Economic Policy Uncertainty Index and the VDAX



Sources: Analytics; Policy Uncertainty Index: Baker, Bloom, and Davis (2012): PolicyUncertainty.com.

54. Is the diagnosis that euro area uncertainty is restraining German investment correct, given that the investment decline is highly correlated with German exports to the rest of the euro area?

Argument: Germany is a very open economy with an exports-to-GDP ratio of more than 50 percent, and with extensive trade linkages with Europe. Therefore, rather than uncertainty, it is the pronounced decline in exports to the euro area that has adversely impacted German investment—which has a sizeable import content—via the trade channel.

The Counterargument: Germany is a highly open economy, but while exports to the euro area have declined, exports to countries outside of the euro area—comprising around 60 percent of total exports—have held steady or have been on an uptrend. Furthermore, when the trade of intermediate goods is taken fully into consideration, export linkages to the euro area are even lower, implying that an even greater share of final demand for German exports lies outside of Europe. In any event, the correlation of business investment with exports to the euro area need not imply causality, as these could both be driven lower by a common factor—namely uncertainty. Furthermore, German corporate balance sheets are healthy and awash with cash, financial conditions are favorable with lending rates near multi-year lows, and banks are willing and able to lend. Household balance sheets remain sound and are bolstered by a strong labor market and rising wages, and confidence indicators are stable or rising. With nearly all conditions in place for a rebound, weak investment suggests that some other factor seem to be at play, which in the staff's view is mainly related to uncertainty surrounding prospects and polices for the euro area—more so than in Germany itself (see also Box 1).[2]

55. Should Germany not pursue a larger fiscal stimulus to generate beneficial positive growth spillovers to the rest of the euro area?

Argument: Given the significant current account surplus, the fact that around 70 percent of imports come from Europe, the relatively lower stock of public debt, and the fact that euro area GDP has contracted for six consecutive quarters, it follows that an expeditious German fiscal stimulus could effectively boost aggregate demand in the region.

The Counterargument: While Germany has a significant current account surplus, its sovereign debt is not low at 82 percent of GDP in 2012, although it is still lower than many other regional peers. More critically, however, along with the fact that German imports from the euro area are only about 38 percent of total, trade linkages with countries in the region that could benefit the most from a German fiscal stimulus are small, and therefore imply limited growth spillovers (see Box 2 for a review of estimates using alternative approaches). In addition, as highlighted in the staff's German-Central European Supply Chain Cluster Report, Germany's strong balance sheets provide a buffer against shocks from outside Europe to the country's trading partners, including those in Central and Eastern Europe. As a result, strong German balance sheets are important for the resilience and stability of the region.

STAFF APPRAISAL

56. Economic activity in Germany is expected to be weak in 2013. Domestic fundamentals continue to remain strong, and past reforms have paid off as seen in low unemployment. Wage increases over the past few years, which reflect the strength in labor markets, have interacted with strong household balance sheets to help ensure robust consumption growth. In contrast, despite strong corporate balance sheets and supportive financing conditions, corporate business investment has been declining since late 2011. Uncertainty surrounding prospects and policies for the *euro area*—more so than in Germany itself—has been associated with declining German exports to the region as well as a sharp pull back in overall business investment. As a result, the German economy is projected to expand at around 0.3 percent in 2013. A gradual pick-up in activity projected towards the end of the year is conditional on a further and tangible reduction in this uncertainty and a materialization of the expected gradual recovery in the rest of the euro area.

57. Risks to the outlook are tilted to the downside. Should the alleviation of euro area uncertainty and an expected gradual recovery in the region fail to materialize, growth in Germany

[2] Analysis in the Bank of England's Quarterly Bulletin (2013 Q2) also suggests that uncertainty regarding the euro area is holding back economic activity in the U.K.

can be expected to remain below its potential for longer, leading to a widening of the output gap which would eventually result in slack in the labor market. Another important source of risk is a rise in financial stress in the region, which could interact with already weak demand and uncertainty, to amplify the impact on the German economy through both trade and financial channels. These risks could be further compounded by weaker global growth prospects. A more medium-term risk is that of an extended period of low growth, which could result in a reduction of the economy's growth potential.

58. In the current low-growth environment, the modest loosening of the fiscal stance this year is appropriate. Germany has already achieved the deficit goals at the federal level under the national debt brake rule (*Schuldenbremse*) well ahead of schedule and the general government balance is in line with commitments under the Fiscal Compact of the Economic and Monetary Union (EMU). For 2013, a mildly expansionary fiscal stance is projected which is appropriate given the risks to the outlook. From 2014 onwards, only modest structural consolidation is projected, which is broadly consistent with a neutral fiscal stance while ensuring that public debt remains on a firmly declining path.

59. Given the weak growth environment and significant risks to the outlook, it will be important to avoid overperforming on consolidation. Over the past three years, the fiscal balance has exceeded plans, reflecting in part unusual factors such as the greater-than-expected strength in labor markets and the low interest rate environment. With the labor market adjustments expected to have run their course, fiscal overperformance due to these factors is unlikely. Nevertheless, fiscal overperformance should be firmly avoided as it could imply a contractionary fiscal stance that is unwarranted in the current low growth environment. Furthermore, unless growth strengthens as envisioned, fiscal policies would need to be recalibrated.

60. The soundness of the banking system has improved, but vulnerabilities remain. The level and quality of capital across the banking system has continued to improve, funding conditions remain favorable for most German banks, and the system's reliance on wholesale funding is declining. Overall asset quality has remained broadly stable, although there are vulnerabilities related to exposures to specific sectors such as shipping, international commercial real estate, and certain foreign asset holdings. Despite financial stability improvements, credit growth remains moderate, owing to weak credit demand stemming from uncertain prospects for the euro area, and a still unsettled regulatory landscape. The macroprudential framework that has been put in place is a timely evolution of the financial system, but there is no need to tighten policies at this juncture.

61. The financial reform momentum should be sustained both domestically and at the regional level. At the domestic level, further augmenting capital buffers, improving profitability and efficiency, and adjusting business models ahead of new international and European regulatory requirements would help consolidate financial strength. The surveillance of large cross-border banks needs to be firmly anchored by strong domestic supervision and close coordination with key financial centers' supervisory authorities. A clear, harmonized, and coherent roadmap towards achieving domestic and European initiatives, including steps towards reversing the fragmentation of banking systems across Europe and creating an integrated pan-European banking system, would help alleviate a major question mark over the European financial system.

62. Germany's strong fundamentals provide an anchor of stability to the region. Germany's safe haven status and strong balance sheets provide a buffer against external shocks for the region. Germany also plays a pivotal role in the development of policies and the evolving architecture of the EMU. Given the important role of euro area uncertainty and external demand for German growth, Germany's continued leadership towards further integration within the EMU is welcome. Germany can also play an important role in clearly articulating the longer-term shared vision for closer economic and financial integration among EMU member countries, which would provide a crucial anchor to the expectations of households, firms, and the financial system.

63. Efforts to support the economy's growth potential need to be sustained. In the context of an aging population, recent efforts to augment the labor force through tax measures, the expansion of day care services, training programs, and encouraging the migration of high-skilled workers are welcome. Looking ahead, lowering the tax burden for low wage and secondary earners, increasing availability of full-time high-quality childcare, facilitating migration of medium-skilled workers, as well as identifying and addressing disincentives to having children could hold promise. Further efforts to accelerate the pan-European integration and harmonization of energy and transportation networks would also help raise productivity and growth. Additional reforms to improve the productivity of the services sector remain important. Finally, broadening the sources of financial intermediation beyond bank-based channels could promote investment and create new drivers of growth beyond the manufacturing sector.

64. Ensuring the long-term sustainability of public finances in the face of rising demographic pressures requires a multi-pronged strategy. In addition to immigration and family policies, the strategy requires efforts to improve the efficiency of public spending, including on healthcare. Reforms to improve efficiency could include the introduction of elements such as spending reviews to support top down budgeting as well as medium-term budget strategy reports.

65. It is recommended that the next Article IV consultation take place on the regular 12-month cycle.

Selected References

Bloom, N., 2009, "The Impact of Uncertainty Shocks," *Econometrica*, Vol. 77, No. 3, pp. 623–85.

Cardarelli, R., S. Elekdag, S. Lall, 2011, "Financial Stress and Economic Contractions," *Journal of Financial Stability*, Vol. 7, No. 2, pp. 78–97

Germany: Risk Assessment Matrix

Source of Risks	Relative Likelihood	Impact	Policy response
Risks to the economic outlook			
I. Slowdown of external demand (including because of a deeper than expected slowdown in emerging economies). Given its high degree of trade openness, Germany is highly susceptible to a slowdown in global growth.	M	High	**If the output gap widens significantly, depending on the size and nature of the shock to the economy, invoking the escape clause under the fiscal rule could be appropriate to support German growth.**
II. Re-emergence of financial stress in euro area (which could be related to stalled or incomplete delivery of euro area policy commitments). Shocks from the euro area could be transmitted via trade and financial channels, resulting in lower growth. The interaction between weaker growth and elevated financial stress could be mutually reinforcing, and be further compounded by waning confidence or heightened policy uncertainty.	M	High	
III. Global oil price shock. Geopolitical risks could lead to a sharp increase in oil prices ($140/barrel), which could also dampen global growth prospects.	L	Medium	**The need for monetary tightening would need to be assessed in relation to risks of second-round effects.**
Medium-term risks			
IV. Slowdown of potential growth (which could be related to a protracted period of slower European growth). Strategies to counteract demographic pressures and increase productivity and investment may fail to deliver results. Large shocks could also have hysteresis-type lasting effects on growth.	H	High	**Strengthen efforts to increase potential growth by increasing labor force participation, productivity, and investment.**
Risks to the financial sector			
V. Domestic financial instability (which could be related to incomplete regulatory reforms or inconsistent approaches). A loss of confidence by depositors and creditors, which by inducing a disorderly deleveraging process, could disproportionately weaken growth, but also trigger contagion more widely.	L	High	**Reduce vulnerabilities of the financial sector, provide public backstop, and continue financial restructuring efforts.**

Note: The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relatively likelihoods of risks listed is the staff's subjective assessment of the risks surrounding the baseline (with L, M, H, denote low, medium, and high, respectively). The RAM reflects staff views on the sources of risk and overall level of concern as of the time of discussions with the authorities.

Table 1. Germany: Selected Economic Indicators, 2008–2014

Total population (2012, million)	81.9
GDP per capita (2012, USD)	41,517

	2008	2009	2010	2011	2012	2013 1/	2014 1/
			(Percentage change)				
GDP	0.8	-5.1	4.0	3.1	0.9	0.3	1.3
Output gap (In percent of potential GDP)	2.3	-3.7	-1.2	0.6	0.1	-0.6	-0.5
Private consumption	0.8	0.1	0.9	1.7	0.8	0.8	1.0
Public consumption	3.2	3.0	1.7	1.0	1.2	0.8	1.1
Gross fixed investment	1.3	-11.6	5.9	6.2	-2.5	-2.0	1.8
Construction	-0.7	-3.2	3.2	5.8	-1.5	0.2	2.8
Machinery and equipment	2.9	-22.5	10.3	7.0	-4.8	-3.1	1.4
Final domestic demand	1.3	-1.6	2.0	2.4	0.2	0.3	1.2
Inventory accumulation 2/	-0.1	-0.7	0.6	0.2	-0.5	0.0	0.0
Total domestic demand	1.2	-2.5	2.6	2.6	-0.3	0.2	1.2
Exports of goods and nonfactor services	2.8	-12.8	13.7	7.8	3.8	1.5	5.0
Imports of goods and nonfactor services	3.4	-8.0	11.1	7.4	2.2	1.6	5.3
Foreign balance 2/	0.0	-2.9	1.7	0.6	1.0	0.1	0.2
			(In millions of persons, unless otherwise indicated)				
Employment and unemployment							
Labor force	43.4	43.6	43.7	43.8	44.1	44.1	44.1
Employment	40.3	40.3	40.6	41.1	41.6	41.7	41.7
Unemployment 3/	3.1	3.2	3.1	2.7	2.5	2.4	2.4
Unemployment rate (in percent) 4/	7.6	7.7	7.1	6.0	5.5	5.6	5.5
			(Percentage change)				
Prices and incomes							
GDP deflator	1.1	1.1	1.1	0.7	1.1	1.0	1.0
Consumer price index (harmonized)	2.8	0.2	1.2	2.5	2.1	1.5	1.7
Average hourly earnings (total economy)	2.3	3.4	0.2	3.2	3.3	3.2	3.0
Unit labor cost (industry)	6.6	21.5	-14.0	-2.4	4.5	3.2	1.5
Real disposable income 5/	1.3	-0.5	0.9	1.2	0.7	0.7	0.9
Personal saving ratio (in percent)	11.5	10.9	10.9	10.4	10.3	10.2	10.1

Table 1. Germany: Selected Economic Indicators, 2008–2014 (concluded)

	2008	2009	2010	2011	2012	2013 1/	2014 1/
	(In billions of euros, unless otherwise indicated)						
Public finances							
General government							
Expenditure	1,090	1,145	1,191	1,175	1,190	1,213	1,230
(In percent of GDP)	44.1	48.2	47.7	45.3	45.0	45.3	44.9
Revenue	1,089	1,072	1,087	1,155	1,194	1,202	1,227
(In percent of GDP)	44.0	45.1	43.6	44.5	45.2	44.9	44.8
Overall balance 6/	-2	-73	-104	-20	4	-11	-3
(In percent of GDP)	-0.1	-3.1	-4.1	-0.8	0.1	-0.4	-0.1
Structural balance	-21	-26	-59	-23	5	-2	4
(In percent of GDP)	-0.9	-1.1	-2.3	-0.9	0.2	-0.1	0.1
Federal government							
Overall balance 6/	-17	-38	-83	-27	-12	-11	-9
(In percent of GDP)	-0.7	-1.6	-3.3	-1.0	-0.5	-0.4	-0.3
General government debt	1,652	1,769	2,057	2,085	2,165	2,176	2,174
(In percent of GDP)	66.8	74.5	82.4	80.4	81.9	81.3	79.3
	(In billions of USD, unless otherwise indicated)						
Balance of payments							
Trade balance 7/	242.3	172.2	190.1	194.6	204.6	198.9	196.1
Services balance	-15.1	-10.1	-2.7	-3.2	-3.9	1.5	7.7
Factor income balance	47.7	82.2	71.5	82.1	82.8	43.7	43.4
Net private transfers	-24.7	-23.4	-22.3	-23.4	-21.6	-22.1	-22.2
Net official transfers	-24.1	-23.8	-29.5	-25.9	-23.3	-24.4	-25.6
Current account	226.1	197.1	207.0	224.3	238.5	197.6	199.3
(In percent of GDP)	6.2	6.0	6.2	6.2	7.0	5.6	5.5
Foreign exchange reserves (EUR billion, e.o.p.) 8/	27.7	25.6	28.0	29.4	28.8	29.0	…
	(Percentage change)						
Monetary data							
Money and quasi-money (M3) 9/ 10/	9.6	-1.6	4.5	5.9	6.0	5.6	
Credit to private sector 9/	2.6	-1.6	-0.3	1.2	1.3	1.1	
	(Period average in percent)						
Interest rates							
Three-month interbank rate 11/	4.6	1.2	0.8	1.3	0.9	0.2	
Yield on ten-year government bonds 11/	4.1	3.3	2.8	2.7	1.4	1.4	
Exchange rates							
Euro per US$ 11/	0.73	0.68	0.76	0.76	0.76	0.77	
Nominal effective rate (1990=100) 12/	104.6	106.0	100.0	100.1	99.2	100.2	
Real effective rate (1990=100) 12/	102.1	102.8	95.8	94.8	93.9	94.5	

Sources: Deutsche Bundesbank; Federal Statistical Office; IMF staff estimates and projections.
1/ IMF staff estimates and projections.
2/ Growth contribution.
3/ National accounts definition.
4/ ILO definition.
5/ Deflated by the national accounts deflator for private consumption.
6/ Net lending/borrowing.
7/ Excluding supplementary trade items.
8/ Data for 2013 refer to April.
9/ Data for 2013 refer to April.
10/ Data reflect Germany's contribution to M3 of the euro area.
11 Data for 2013 refer to April.
12/ Data for 2013 refer to April.

Table 2. Statement of Operations of the General Government

in percent of GDP	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	43.7	44.0	45.1	43.6	44.5	45.2	44.9	44.8	44.6	44.5	44.5	44.6
Taxes	23.2	23.3	23.2	22.2	22.9	23.4	23.3	23.2	23.3	23.2	23.1	23.2
Social contributions	16.5	16.5	17.3	16.9	16.9	17.0	16.9	16.9	16.7	16.7	16.8	16.8
Grants	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	3.9	4.1	4.4	4.3	4.6	4.6	4.5	4.5	4.4	4.4	4.4	4.4
Expenditure	43.5	44.1	48.2	47.7	45.3	45.0	45.3	44.9	44.5	44.3	44.3	44.3
Expense	43.7	44.2	48.3	48.0	45.4	45.0	45.3	44.9	44.5	44.3	44.3	44.3
Compensation of employees	7.3	7.4	8.0	7.8	7.7	7.7	7.7	7.6	7.4	7.4	7.3	7.3
Use of goods and services	4.1	4.4	4.9	4.8	4.9	4.9	4.9	4.7	4.5	4.5	4.5	4.5
Consumption of fixed capital (if available)	1.7	1.7	1.8	1.7	1.7	1.6	1.5	1.5	1.5	1.5	1.5	1.5
Interest	2.8	2.8	2.7	2.5	2.5	2.5	2.4	2.2	2.2	2.0	2.0	1.9
Subsidies	1.0	1.0	1.2	1.1	1.0	0.9	1.0	1.0	1.0	1.0	1.0	1.0
Grants	0.8	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social benefits	23.9	23.9	26.2	25.4	24.4	24.4	24.8	24.9	24.8	24.9	24.9	25.0
Other expense	2.1	2.3	2.6	3.5	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Net acquisition of nonfinancial assets	-0.2	-0.2	-0.1	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Acquisitions of nonfinancial assets	…	…	…	…	…	…	…	…	…	…	…	…
Disposals of nonfinancial assets	…	…	…	…	…	…	…	…	…	…	…	…
Consumption of fixed capital	1.7	1.7	1.8	1.7	1.7	1.6	1.5	1.5	1.5	1.5	1.5	1.5
Gross Operating Balance	1.7	1.4	-1.4	-2.7	0.8	1.7	1.1	1.4	1.5	1.7	1.7	1.8
Net Operating Balance	0.0	-0.2	-3.2	-4.4	-0.9	0.1	-0.4	-0.1	0.0	0.2	0.2	0.3
Net lending (+)/borrowing (–)	0.2	-0.1	-3.1	-4.1	-0.8	0.1	-0.4	-0.1	0.0	0.2	0.2	0.3
Net acquisition of financial assets	0.7	2.7	1.7	7.4	0.3	…	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Currency and deposits	0.4	0.3	-0.2	1.5	1.0	…	…	…	…	…	…	…
Debt securities	0.1	1.6	0.1	4.0	-0.4	…	…	…	…	…	…	…
Loans	0.0	0.4	0.2	2.2	-0.1	…	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.5	1.4	0.4	-0.1	…	…	…	…	…	…	…
Insurance, pensions, and std. guarantee schemes	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.0	-0.7	0.0	…	…	…	…	…	…	…
Other accounts receivable	0.2	-0.1	0.2	0.0	-0.1	…	…	…	…	…	…	…
Net incurrence of liabilities	0.5	2.7	4.7	11.6	1.1	…	…	…	…	…	…	…
SDRs	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Currency and deposits	0.0	0.1	0.0	0.0	0.0	…	…	…	…	…	…	…
Debt securities	1.3	1.7	4.7	3.9	2.6	…	…	…	…	…	…	…
Loans	-0.9	0.9	0.2	7.7	-1.5	…	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Insurance, pensions, and std. guarantee schemes	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0	…	…	…	…	…	…	…
Other accounts payable	0.0	0.0	-0.2	-0.1	0.0	…	…	…	…	…	…	…
Memorandum items:												
Structural Balance (output gap methodology)	-1.1	-0.9	-1.1	-2.3	-0.9	0.2	-0.1	0.1	0.2	0.3	0.3	0.3
Public gross debt (Maastricht definition)	65.4	66.8	74.5	82.4	80.4	81.9	81.3	79.3	76.7	73.5	71.3	69.0

Sources: Government Finance Statistics and IMF staff estimates.

Table 3. General Government Stock Positions

in percent of GDP	2007	2008	2009	2010	2011
Stock positions:					
Net worth	…	…	…	…	…
Nonfinancial assets	…	…	…	…	…
Net financial worth	-42.6	-44.5	-49.0	-49.7	-51.2
Financial assets	23.1	25.3	28.4	36.4	35.1
Monetary gold and SDRs	0.0	…	…	…	…
Currency and deposits	8.1	8.0	8.3	9.4	10.1
Debt securities	0.3	1.9	2.0	5.9	5.1
Loans	2.4	2.8	3.1	5.1	4.8
Equity and investment fund shares	7.9	8.5	10.4	12.2	11.5
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.1	0.1	0.1	-0.6	-0.6
Other accounts receivable	4.2	4.0	4.5	4.3	4.1
Liabilities	65.7	69.8	77.4	86.1	86.3
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
Currency and deposits	0.3	0.4	0.4	0.4	0.4
Debt securities	47.5	50.8	57.4	59.3	62.0
Loans	17.8	18.5	19.4	26.2	23.8
Equity and investment fund shares	0.0	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.1	0.1	0.2	0.1	0.1
Memorandum items:					
Publicly guaranteed debt	…	…	…	…	…
Debt (at market value)	65.7	69.8	77.4	86.1	86.3
Debt at face value	65.4	66.9	74.6	82.6	80.7
Maastricht debt	65.2	66.8	74.5	82.5	80.5
Debt (at nominal value)	…	…	…	…	…
Other economic flows:					
Change in net worth from other economic flows	…	…	…	…	…
Nonfinancial assets	…	…	…	…	…
Change in net financial worth from other economic flows	…	…	…	…	…
Financial assets	…	…	…	…	…
Monetary gold and SDRs	…	…	…	…	…
Currency and deposits	…	…	…	…	…
Debt securities	…	…	…	…	…
Loans	…	…	…	…	…
Equity and investment fund shares	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	…	…	…	…	…
Financial derivatives and employee stock options	…	…	…	…	…
Other accounts receivable	…	…	…	…	…
Liabilities	…	…	…	…	…
Monetary gold and SDRs	…	…	…	…	…
Currency and deposits	…	…	…	…	…
Debt securities	…	…	…	…	…
Loans	…	…	…	…	…
Equity and investment fund shares	…	…	…	…	…
Insurance, pensions, and standardized guarantee schemes	…	…	…	…	…
Financial derivatives and employee stock options	…	…	…	…	…
Other accounts payable	…	…	…	…	…

Sources: Government Finance Statistics and IMF staff estimates.

Table 4. Medium-Term Projections, 2010-2018

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projections					
	(percentage change unless indicated)								
Real sector									
Real GDP	4.0	3.1	0.9	0.3	1.3	1.3	1.3	1.3	1.2
Total domestic demand	2.6	2.6	-0.3	0.2	1.2	1.3	1.3	1.3	1.3
Foreign balance (contribution to growth)	1.7	0.6	1.0	0.1	0.2	0.2	0.2	0.1	0.1
Output gap (percent of potential GDP)	-1.2	0.6	0.1	-0.6	-0.5	-0.3	-0.2	-0.1	0.0
Consumer prices	1.2	2.5	2.1	1.5	1.7	1.7	1.8	1.9	1.9
	(percent of GDP)								
External sector									
Current account balance	6.2	6.2	7.0	5.6	5.5	5.3	5.3	5.0	4.7
Goods and services balance	5.7	5.3	5.9	5.7	5.6	5.4	5.4	5.1	4.8
General government									
Overall balance	-4.1	-0.8	0.1	-0.4	-0.1	0.0	0.2	0.2	0.3
Gross debt	82.4	80.4	81.9	81.3	79.3	76.7	73.5	71.3	69.0

Sources: Federal Statistical Office, Bundesbank, and IMF staff estimates.

Table 5. Germany: Balance of Payments, 2009-2018

in percent of GDP	2009	2010	2011	2012	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
Current account	6.0	6.2	6.2	7.0	5.6	5.5	5.3	5.3	5.0	4.7
Trade balance	4.9	5.7	5.3	5.9	5.7	5.6	5.4	5.4	5.1	4.8
Trade in goods	5.2	5.7	5.4	6.0	5.7	5.4	5.3	5.1	4.9	4.6
Exports	35.3	39.7	43.0	44.1	43.7	44.9	45.0	45.5	46.4	47.7
Imports	30.1	34.0	37.6	38.0	38.0	39.4	39.8	40.4	41.5	43.1
Trade in services	-0.3	-0.1	-0.1	-0.1	0.0	0.2	0.2	0.2	0.2	0.2
Exports	7.3	7.6	7.7	8.1	8.5	8.3	8.3	8.5	8.7	9.0
Imports	7.6	7.7	7.8	8.2	8.5	8.1	8.2	8.3	8.5	8.8
Income balance	2.5	2.2	2.3	2.4	1.2	1.2	1.2	1.2	1.2	1.2
Receipts	7.5	7.6	7.6	7.5	7.4	7.9	8.3	8.5	8.8	10.1
Payments	5.0	5.5	5.4	5.0	6.2	6.7	7.1	7.3	7.6	8.9
Current transfers	-1.4	-1.6	-1.4	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Capital and Financial Account	-6.7	-5.6	-6.2	-8.9	-5.6	-5.5	-5.3	-5.3	-5.0	-4.7
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	-6.7	-5.6	-6.3	-8.9	-5.6	-5.5	-5.3	-5.3	-5.0	-4.7
Direct Investment	-1.4	-1.9	-0.1	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Domestic	0.7	1.7	1.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Abroad	2.1	3.7	1.4	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Portfolio investment balance	-3.2	-5.7	0.0	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2
Other financial transactions 1/	-2.2	2.1	-6.1	-3.9	-0.7	-0.6	-0.4	-0.3	0.0	0.2
Change in reserve assets	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	0.7	-0.6	0.0	1.9	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Federal Statistical Office, Bundesbank, and IMF staff estimates.

1/ Includes net financial derivatives

Table 6. Germany: Core Financial Soundness Indicators for Banks

	2007	2008	2009	2010	2011	2012
Capital adequacy 1/						
Regulatory capital to risk-weighted assets	12.9	13.6	14.8	16.1	16.4	17.9
Commercial banks	13.3	13.5	14.9	15.4	15.6	17.8
Landesbanken	11.6	12.7	14.9	17.1	17.7	18.8
Savings banks	13.0	14.4	14.7	15.1	15.8	15.9
Credit cooperatives	12.9	14.2	14.0	14.7	15.6	15.8
Regulatory Tier I capital to risk-weighted assets 2/	8.5	9.5	10.8	11.8	12.1	14.2
Commercial banks	10.6	10.3	12.1	12.9	13.1	15.0
Landesbanken	7.1	8.3	10.5	12.1	12.7	14.0
Savings banks	8.4	9.5	9.7	9.9	10.5	12.5
Credit cooperatives	8.7	9.7	9.5	9.8	10.4	11.1
Asset composition and quality						
Sectoral distribution of loans to total loans						
Loan to households	25.6	24.4	26.3	26.2	26.2	26.77
Commercial banks	21.8	20.5	23.2	22.3	21.4	20.75
Landesbanken	5.2	4.9	5.2	5.4	5.4	5.56
Savings banks	58.2	56.4	57.6	57.7	56.2	57.19
Credit cooperatives	66.3	63.5	66.4	67.0	66.8	68.73
Loans to non-financial corporations	14.1	14.5	14.8	14.6	14.6	14.85
Commercial banks	12.4	12.6	12.9	12.1	11.9	11.5
Landesbanken	16.2	17.8	18.2	18.4	19.1	20.8
Savings banks	17.6	18.7	19.6	20.1	20.3	21.45
Credit cooperatives	12.4	12.7	13.6	14.3	14.1	15.16
NPLs to gross loans 4/	2.6	2.9	3.3	3.2	3.0	
Commercial banks	1.8	2.0	2.3	2.1	2.0	
Landesbanken	1.5	2.4	3.2	4.1	4.0	
Savings banks	5.1	4.7	4.3	3.8	3.5	
Credit cooperatives	5.5	5.1	4.4	3.9	3.5	
NPLs net of provisions to capital 4/	21.6	25.3	36.9	34.2	31.2	
Commercial banks	15.8	20.0	29.8	20.4	19.3	
Landesbanken	11.3	27.6	35.1	46.0	43.2	
Savings banks	35.3	33.0	39.6	36.2	35.1	
Credit cooperatives	35.9	33.3	42.1	38.1	33.7	

Table 6. Germany: Core Financial Soundness Indicators for Banks (concluded)

(In percent)

	2007	2008	2009	2010	2011	2012
Earnings and profitability						
Return on average assets (after-tax)	0.2	-0.3	-0.1	0.2	0.3	
Commercial banks	0.5	-0.5	-0.2	0.1	0	
Landesbanken	0.0	-0.4	-0.3	-0.1	0	
Savings banks	0.2	0.1	0.2	0.4	1.3	
Credit cooperatives	0.3	0.2	0.3	0.5	0.7	
Return on average equity (after-tax)	4.7	-8.1	-2.0	3.7	6.5	
Commercial banks	15.6	-15.1	-5.7	2.0	0.8	
Landesbanken	0.9	-12.2	-8.5	-1.3	-1	
Savings banks	4.2	2.1	4.4	7.1	22.9	
Credit cooperatives	5.2	4.0	5.1	8.0	11.9	
Interest margin to gross income	72.9	84.6	72.5	73.2	72.9	
Commercial banks	66.3	94.6	63.0	62.7	59.8	
Landesbanken	91.6	90.2	81.5	84.4	94.5	
Savings banks	75.2	76.0	78.6	79.1	79.6	
Credit cooperatives	71.3	69.9	76.9	78.9	78	
Trading income to gross income				4.5	3.7	
Commercial banks				9.1	9.2	
Landesbanken				3.9	-4.8	
Savings banks				0.2	-0.1	
Credit cooperatives				0.0	0.1	
Noninterest expenses to gross income	64.9	73.4	65.1	63.7	63.9	
Commercial banks	65.5	93.6	73.5	72.5	67.9	
Landesbanken	61.1	54.6	51.1	54.7	59.8	
Savings banks	69.5	68.8	66.6	62.8	62.7	
Credit cooperatives	70.5	68.3	68.3	63.7	63.9	
Liquidity						
Liquid assets to total short-term liabilities	119.4	120.3	144.1	137.0	137.9	144.2
Commercial banks	113.0	114.8	131.1	126.2	124.3	129.5
Landesbanken	115.5	114.5	135.9	131.2	144.3	135.8
Savings banks	190.9	161.8	225.7	216.2	210.1	233.6
Credit cooperatives	167.1	146.1	204.2	203.8	208.4	230.6
Sensitivity to market risk						
Net open positions in FX to capital	6.9	6.6	5.3	4.4	4.5	3.9
Commercial banks	6.2	4.5	3.9	2.2	2.3	2.0
Landesbanken	6.6	5.2	5.5	5.5	7.4	4.8
Savings banks	10.9	12.2	9.6	9.1	7.7	7.8
Credit cooperatives	10.7	8.2	7.9	8.1	8.3	8.1

Source: Deutsche Bundesbank. The authorities provide annual data only and disseminate them once a year.
1/ A methodological break in the supervisory time series on the capital adequacy of German banks has taken place in 2007 due to changes in the regulatory reporting framework, following Basel II.
2/ 1998-2006 according to Capital Adequacy Regulation, Principle I. Since 2007 according to Solvency Regulation.
3/ Due to one off data availability, comparability of 2006 data with other years limited.
4/ A methodological break in the NPL series has taken place in 2009. Due to changes in the regulatory reporting framework for the audit of German banks.
* Revised data.

Table 7. Germany: Additional Financial Soundness Indicators

	2007	2008	2009	2010	2011	2012
Deposit-taking institutions						
Capital to assets	4.3	4.5	4.8	4.3	4.4	4.7
Commercial banks	4.3	5.0	5.4	4.1	4.0	4.1
Landesbanken	3.7	3.8	4.7	3.9	4.0	4.4
Savings banks	4.9	5.0	5.2	5.4	5.7	6.9
Credit cooperatives	5.5	5.3	5.2	5.5	5.8	6.3
Geographical distribution of loans to total loans						
Germany	71.1	71.2	72.9	74.9	75.7	76.8
EU-member countries	20.4	20.2	19.5	17.6	16.8	16
Others	8.5	8.6	7.6	7.4	7.5	7.2
FX loans to total loans	11.5	12.2	11.5	11.5	11.0	10.5
Personnel expenses to noninterest expenses	54.7	53.4	54.7	52.7	52	
Commercial banks	51.7	47.6	49.4	46.3	45.5	
Landesbanken	51.7	49.7	51.0	48.8	47.9	
Savings banks	58.5	61.1	62.4	61.9	61.7	
Credit cooperatives	59.8	61.0	61.9	60.5	59.7	
Trading and fee income to total income	27.1	15.4	27.5	26.8	27.1	
Commercial banks	33.7	5.7	37.0	37.3	40.2	
Landesbanken	8.4	9.8	18.5	15.6	5.5	
Savings banks	24.8	24.0	21.4	20.9	20.4	
Credit cooperatives	28.7	30.1	23.1	21.1	22	
Funding						
Customer deposits to total (non-interbank) loans	76.2	77.7	76.5	73.6	73.6	75.7
Commercial banks	92.6	90.7	89.7	85.0	83.1	84
Landesbanken	45.7	44.1	34.6	31.5	33.7	33.6
Savings banks	105.4	108.3	109.9	106.9	106.9	107.7
Credit cooperatives	114.7	119.6	122.7	119.0	117.7	118.7
Deposits/total assets	66.9	67.3	67.3	60.8	60.0	61.3
Commercial banks	76.6	76.5	77.2	58.6	58.0	60.3
Landesbanken	62.0	61.3	58.5	52.6	51.4	51.8
Savings banks	85.2	85.8	86.8	86.7	86.7	86.8
Credit cooperatives	83.0	83.8	85.4	85.9	86.3	86.6
Interbank assets/total assets	43.1	43.3	41.3	35.0	34.8	34.3
Commercial banks	45.1	45.5	43.2	32.6	32.7	34.1
Landesbanken	55.4	51.3	47.7	39.1	36.5	34.1
Savings banks	26.4	27.9	26.9	25.3	24.9	22.7
Credit cooperatives	28.2	30.6	29.9	28.2	28.0	26
Interbank liabilities/total assets	29.1	28.7	26.7	23.4	21.8	21.7
Commercial banks	35.7	35.1	32.2	24.2	22.5	23.6
Landesbanken	38.8	34.7	30.6	27.0	25.2	24.4
Savings banks	20.1	19.4	18.8	17.4	16.6	15.5
Credit cooperatives	13.2	14.8	15.5	14.1	14.3	14.2
Securitized funding/total assets						
Commercial banks						
Landesbanken						
Savings banks						
Credit cooperatives						
Loans/assets	41.2	40.6	42.1	38.2	37.7	38.4
Commercial banks	38.1	36.1	38.5	27.5	27.3	27.2
Landesbanken	32.5	35.2	36.5	35.0	36.1	38
Savings banks	59.1	59.0	59.9	60.9	61.7	62.9
Credit cooperatives	58.1	56.4	56.5	57.4	58.2	59
Securities holdings/assets	23.0	22.5	23.5	19.5	18.1	18
Commercial banks	18.0	18.5	19.2	12.6	11.0	11
Landesbanken	22.7	22.1	23.6	20.1	19.4	19
Savings banks	24.9	25.0	26.8	26.6	25.0	25.4
Credit cooperatives	23.5	23.9	27.5	27.5	26.6	27.8
Off-balance sheet operations to total assets						
of which: interest rate contracts						
of which: FX contracts						
Spread between highest and lowest interbank rates 7/	4.6	10.5	15.0	12.8	14.4	11
Spread between reference loan and deposit rates 8/	285	273	342	343		324

Table 7. Germany: Additional Financial Soundness Indicators (concluded)

	2007	2008	2009	2010	2011	2012
Insurance sector						
Solvency ratio, Life	206.8	191.5	186.2	180.8		177
Solvency ratio, Non-life (without reinsurance and health insurance)	321.6	315.3	290	314		306
Return on average equity, Life 9/	8.8	7.4	9.6	9.8		9.8
Return on average equity, Non-life 9/ (without reinsurance and health insurance)	4.1	3.4	4.2	3.3		2.8
Market liquidity						
Average bid-ask spread in the securities market (government bills)	0.0	0.0	0.0	0.0	0.0	0.01
Average bid-ask spread in the securities market (corporate securities)	0.1	0.3	0.3	0.1	0.3	0.01
Corporate sector						
Total debt to equity 1/	84.7	119.9	108.7	93.5	102.7	
Total debt to GDP 2/	76.0	80.6	78.9	79.2	71.73	
Return on invested capital 3/ 4/	9.6	10.6	7.9	8.6		
Earnings to interest and principal expenses 1/ 5/	774.5	674.9	665.8	788.9	742.71	
Number of applications for protection from creditors 1/ 6/	13599	13358	16167	15283	14553	
Households						
Household debt to GDP 1/	63.7	62.0	64.6	62.0	59.83	
Household debt service and principal payments to income 1/ 5/	4.4	4.4	3.4	3.179871	2.92	
Real estate markets						
Real estate prices, new dwellings 10/	94.20	94.80	96.50	100.00	106.30	111.6
Real estate prices, resale 10/	97.40	98.00	97.90	100.00	105.00	111
Real estate prices, new and resale 10/	96.30	96.90	97.40	100.00	105.40	111.2
Real estate prices, commercial property 11/	94.00	95.40	97.10	100.00	104.80	109.9
Residential real estate loans to total loans	16.5	15.7	16.9	16.8	16.7	17.1
Commercial real estate loans to total loans	5.4	5.2	5.8	5.7	5.7	5.7

Source: Deutsche Bundesbank. The authorities provide annual data only and disseminate them once a year.
1/ Indicator compiled according to definitions of the Compilation Guide on FSIs.
2/ Total debt to corporate gross value added.
3/ Return defined as net operating income less taxes, where net operating income and taxes are compiled according to the FSI Compilation Guide.

4/ Invested capital estimated as balance sheet total less other accounts payable (AF.7 according to ESA 1995).
5/ Excluding principal payments.
6/ Resident enterprises that filed for bankruptcy.
7/ Spread between highest and lowest three month money market rates as reported
8/ Spread in basis points.
9/ Profits after tax devided by equity.
10/ Residential property index (yearly average, 2010 = 100);
11/ Commercial property prices (yearly average, 2010 = 100), source: own calculations based on data from BulwienGesa AG, the index is compiled from retail, office, residential and logistic property. Capital growth index;

Table 8. Germany: Summary of External Assessment Methodologies

Current account	
(In percent of GDP)	
EBA	
Regression-based analysis	
Current account gap	+6.3
of which: residual	+5.5
CGER	
MB approach	+1.4
ES approach	+3.2
Real effective exchange rate (REER)	
(In percent; positive values denote REER overvaluations)	
EBA	
Regression-based analysis	
REER gap	+8.0
of which: residual	+8.0
CGER	
ERER approach	–4.0
ES approach	–9.0

Notes: EBA denotes the External Balance Assessment (for details see www.imf.org/external/np/res/eba/index.htm). CGER, ES, ERER, and MB denote the IMF's Consultative Group on Exchange Rate Issues, the macroeconomic balance, equilibrium real exchange rate, and external sustainability approaches, respectively; for details, see Exchange Rate Assessments: CGER Methodologies, IMF Occasional Paper No. 261 (2008).

Source: IMF staff calculations; 2013 Pilot External Sector Report (SM/13/167); 2013 Pilot Extenal Sector Report--Individual Economy Assessments (SM/16/168).

Annex I. Germany: Authorities' Response to Past IMF Policy Recommendations

IMF 2012 Article IV Recommendations	Authorities' Response
Fiscal Policy	
Allow automatic stabilizers to operate fully and deploy more active fiscal policies in the event of serious economic downturn	The 2012 fiscal outturn was better than projected, largely due to favorable macro-economic developments.
Financial Sector Policy	
Step up the pace of implementation of the 2011 Financial Sector Assessment Program (FSAP), including:	Further progress on the implementation of FSAP recommendations has been made, but more progress is needed in some areas (see Annex II for details).
• Reduction in outstanding public capital support to some banks; reduction in the size of the balance sheet of the two winding up institutions	SoFFin guarantees and capital injections have been reduced, the two winding up institutions are gradually deleveraging, and exit from government support is underway for some institutions, while being planned for others.
• Restructuring of the *Landesbanken* and reform of their business models	Progress has been made on the restructuring of *Landesbanken* but further efforts are needed.
• Strengthening of the crisis management framework	Progress on establishing recovery and resolution plans has been made but there is little momentum in reforming the fragmented deposit insurance regime.
Ensure that risks from the global activities of large banks are understood and internalized	Capital buffers of large banks have been strengthened but further efforts are needed to strengthen supervision of cross-border SIFIs. German initiatives on the financial sector have to be meshed with European proposals.
Structural Reforms	
Continue to take measures to raise potential growth and diversify its sources. Broaden the access to risk capital, including through the development of more arms-length financial intermediation	Steps to increase labor force through higher participation and migration of skilled workers as well as those directed at strengthening competition in network industries, financing research and development and providing risk capital, have been taken. Further efforts are needed on all these fronts.

Annex II. Main Outstanding 2011 FSAP Update Recommendations

Recommendation	Status
Continue to improve stress testing in the banking and insurance sectors. Rigorously ensure that any institution that displays weaknesses on a forward looking basis strengthens its balance sheet and takes managerial action.	System-wide and individual bank stress tests, including macroeconomic portfolio stress tests, have been improved by the Bundesbank, paving the way for EBA and ECB stress tests. Bundesbank and BaFin assess the quality of internal bank stress tests through on-site inspections. Stress tests on the insurance sector are conducted by BaFin and measure two main risks, (i) sovereign exposure and (ii) impact of low interest rates.
Grant supervisors power to vet in advance bank acquisitions of subsidiaries.	Legislative initiatives on this matter are not expected in the near term, and Germany awaits EU initiatives before acting.
Define the role of the Bundesbank as macroprudential supervisor, and institute free exchange of information between macro and microprudential supervisors.	The Financial Stability Committee (FSC) started its activities on March 18, 2013. The FSC consists of the Ministry of Finance (chair and deputy chair), the Bundesbank and BaFin. The latter two institutions have established several working groups to streamline communication, including with FMSA, which is a nonvoting member of the FSC. The Bundesbank is tasked with providing the FSC with financial stability analysis, and proposals for warnings and recommendations to be issued by the FSC.
Continue to strengthen on-site supervision.	The Bundesbank has expanded its on-site supervisory capacity, by setting-up new departments and hiring additional staff, and by broadening the scope of audit to new areas, including remuneration and LIBOR practices. BaFin is placing special emphasis on measures to identify and remedy IT risks. BaFin has stepped up its direct involvement in conducting on-site inspection for securities markets, further reducing reliance on external auditors.
Review reporting requirements to ensure timely and systemic information is available on emerging risk factors.	Proposals to strengthen reporting requirements are being developed, taking note of EBA guidelines, with new legislation and implementation expected in 2014.
Institute a harmonized and legally binding deposit guarantee of €100,000, backed by adequate prefunding.	No concrete action is expected before the conclusion of the discussions at European level, including on ex ante funding levels.
Ensure the financial strength of the new bank restructuring fund, and clarify the interaction	The Restructuring Fund is fully operational. Since inception, the Fund has ramped up €1.2 billion, far

between the restructuring fund and the various deposit guarantee and mutual protection schemes.	from the €70 billion overall target, but it enjoys access to contingency funding from the federal government. The interaction between the restructuring fund and the various deposit protection and mutual protection schemes is expected to be dealt with on a case-by-case basis.
Finalize specific strategies for exiting from the government support to banks, and require the affected banks to formulate strategic plans.	Almost no SoFFin guarantees remain outstanding and capital injections have been reduced further since 2011. The two winding up institutions are gradually deleveraging, although an additional transfer of around €100 billion was made as part of a *Landesbank* restructuring in 2012, and exit strategy from government support is underway for some institutions, while being planned for others.
Develop comprehensive strategy aimed at improving the efficiency and stability of the banking system: (a) Establish viable business models for the *Landesbanken*; (b) Loosen the regional constraints under which local banks operate; (c) Open up the public banks to private participation; and (d) Strengthen these banks' governance to reduce noncommercial influences.	The reform of the *Landesbanken* is under way, with aggregate balance sheets and RWAs substantially lower. One large *Landesbank* has been restructured in 2012. Overall, for the *Landesbanken* sector, capital has improved, and business models are being reviewed and streamlined to adapt to the new operating and regulatory environments. Sustaining restructuring efforts is key to ensuring the viability of business models. There are no plans to loosen regional constraints on local banks, open up the public banks to private participation, and reduce noncommercial influences.

INTERNATIONAL MONETARY FUND

GERMANY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 17, 2013

Prepared By: European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2013; unless specified otherwise)

Mission: May 21 to June 3, 2013 in Berlin, Bonn, Frankfurt, and Hamburg. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2013/060313.htm

Staff team: Mr. Lall (Head), Mr. Elekdag, Ms. Ivanova, and Ms. Raei (all EUR), and Ms. Le Leslé (SPR).

Country interlocutors: Bundesbank President Weidmann, Minister of Finance Schäuble, senior representatives at the Chancellery, several ministries, the Bundesbank, BaFin and the staff of the German Council of Economic Experts. Mr. Meyer, Alternate Executive Director, also participated in the discussions. Additional meetings took place with industry, research institutes, law firms, and financial market participants.

Fund relations: The previous Article IV consultation discussions took place in May 2012 and the staff report was discussed by the Executive Board on June 29, 2012. The Executive Board's assessment and staff report are available at http://www.imf.org/external/np/sec/pn/2012/pn1269.htm

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	14,565.50	100.00
Fund holdings of currency (Exchange Rate)	10,259.77	70.44
Reserve Tranche Position	4,305.78	29.56
Lending to the Fund		
New Arrangements to Borrow	3,247.19	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	12,059.17	100.00
Holdings	11,503.56	95.39

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund (SDR Million; based on existing use of resources and present holdings of SDRs, as of June 30, 2013):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.21	0.51	0.51	0.51	0.51
Total	0.21	0.51	0.51	0.51	0.51

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

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

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

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

The Fund assessed Germany against the AML/CFT in 2009. The detailed assessment report was adopted by the FATF in 2010. The assessors found that, while generally comprehensive, Germany's AML/CFT framework was not fully in line with the standard. Shortcomings were identified with respect to, inter alia, the money laundering and terrorist financing offenses, and AML/CFT preventive measures (including the reporting of suspicious transaction requirements, and customer due diligence requirements). In the 2012 and 2013 follow-up reports to the FATF, the authorities indicated having taken a number of legislative and structural measures during the three years that followed the assessment to address many of the deficiencies identified. They mentioned in particular having broadened the scope of the money laundering offense (by including additional predicate offenses), strengthened the reporting of suspicious transaction requirements, enhanced the identification of beneficial owner requirements, and strengthened sanctions for noncompliance with AML/CFT preventive measures. Remaining deficiencies to be addressed notably include the criminalization of self-laundering and shortcomings in the freezing of terrorist assets."

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National accounts Germany adopted the *European System of Integrated Economic Accounts 1995 (ESA95)* in 1999. The 2005 ROSC Data Module mission found that the macroeconomic statistics generally follow internationally accepted standards and guidelines on concepts and definitions, scope, classification and sectorization, and basis for recording. However, the sources for estimating value added for a few categories of service industries could be improved. A direct source for quarterly changes in inventories, which is an important indicator of changes in GDP over the business cycle, is lacking. There is no systematic, proactive process to monitor the ongoing representativeness of the samples of local units and products between rebases of the producer price index. **Government Accounts** Comprehensive data reporting systems support the accuracy and reliability of the government finance and balance of payments statistics. However, documentation exists to explain the differences between the general government data in the ESA95 classification and the general cash data on an administrative basis; Germany publishes—through Eurostat—general government revenue, expenditure, and balances on an accrual basis on a quarterly basis (*ESA95*) and submits annual data for publication in the *Government Financial Statistics Yearbook,* in *GFSM 2001* format. Monthly data are only disseminated on a cash-basis. **Balance of Payments Accounts** The Bundesbank compiles the balance of payments in close cooperation with the Federal Statistical Office. Balance of payments is compiled according to the Balance of Payments Manual, fifth edition (BPM5) and the legal requirements of the ECB and Eurostat. **Financial Soundness Indicators** Germany is participating in the Coordinated Compilation Exercise for financial soundness indicators (FSIs). In 2006, as part of this exercise, the German authorities compiled a comprehensive set of FSI data and metadata. There are, however, substantial lags in the publication of some of the financial soundness indicators such as nonperforming loans. In addition, the quality of data on bank exposures submitted to the BIS needs to be improved, including provision of the data on ultimate risk basis for advanced countries.

II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard since December 2, 1996.	Data ROSC is available.

Germany: Table of Common Indicators Required for Surveillance

(As of June 10, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items	
						Data Quality–Methodological soundness[9]	Data Quality–Accuracy and reliability[10]
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 13	May 13	M	M	M		
Reserve/Base Money[2]	April 13	May 13	M	M	M		
Broad Money[2]	April 13	May 13	M	M	M		
Central Bank Balance Sheet	April 13	May 13	M	M	M		
Consolidated Balance Sheet of the Banking System	March 13	April 13	M	M	M		
Interest Rates[3]	June 13	June 13	M	M	M		
Consumer Price Index	April 13	May 13	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[4] – General Government[4]	Q4 12	May 13	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Stocks of General Government and Government-Guaranteed Debt[6]	December 12	May 13	A	A	A		
External Current Account Balance	March 13	May 13	M	M	M	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	March 13	May 13	M	M	M		
GDP/GNP	Q1 13	May 13	Q	Q	Q	O, O, O, O	LO, O, O, O, O
Gross External Debt	Q4 12	May 13	Q	Q	Q		
International Investment Position[7]	Q4 12	May 13	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Pertains to contribution to EMU aggregate.
[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.
[7] Includes external gross financial asset and liability positions vis-a-vis nonresidents.
[8] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[9] Reflects the assessment provided in the data ROSC (published on January 18, 2006, and based on the findings of the mission that took place during July 5–20, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning methodological soundness, namely, (i) concepts and definitions, (ii) scope, (iii) classification/sectorization, and (iv) basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[10] Same as footnote 9, except referring to international standards concerning accuracy and reliability, namely, (i) source data, (ii) assessment of source data, (iii) statistical techniques, (iv) assessment and validation of intermediate data and statistical outputs, and (v) revision studies.

INTERNATIONAL MONETARY FUND

COM COMMUNICATIONS DEPARTMENT

Press Release No. 13/299
FOR IMMEDIATE RELEASE
August 6, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with Germany

On August 1, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Germany's economic rebound of 2010-2011 gave way to weakening momentum during the course of 2012. While exports to non-European trading partners began to recover by mid-2012, in line with improved prospects in the United States and emerging economies, exports to the rest of the euro area continued to decline as the recession in the region continued. Consumption grew robustly as German unemployment remained near post-reunification lows and wages rose well above inflation. Business investment however continued to closely track the decline in exports to the euro area, leading to a contraction in activity in the last quarter of 2012, before stabilizing in the first quarter of this year.

The outlook for the remainder of 2013 and next year is heavily dependent on a gradual recovery in the rest of the euro area and a sustained reduction in uncertainty. Consumption is expected to continue to expand robustly this year given favorable labor market conditions and wage agreements. Exports to the euro area are expected to recover only gradually. Uncertainty is expected to continue to have an amplifying impact on investment through the end of the year and assumed to diminish subsequently. Growth for 2013 as a whole is thus projected at around 0.3 percent, reflecting still below potential growth in the second half of the year. Growth in 2014 is projected to return to potential.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

This baseline outlook is subject to a number of interrelated and mutually reinforcing downside risks. Given its high degree of trade openness, Germany is highly susceptible to a slowdown in external demand and/or elevated financial stress. At the regional level, euro area shocks could be transmitted via trade and financial channels. At the same time, the interaction between weaker economic activity and elevated financial stress in the euro area could be mutually reinforcing, owing to already strained balance sheets in a number of countries, and be further exacerbated by waning confidence or heightened uncertainty. A significantly weaker German outlook would in turn affect both regional and global growth prospects, primarily through the trade channel. Policy uncertainty regarding the roadmap and key elements of reforms to the euro area architecture, prospects for a recovery of activity in the euro area, and the still unsettled regulatory and supervisory landscape for the financial system, represent another factor which could magnify the effects of the intertwined shocks discussed above. In terms of risks of a more medium-term nature, an extended period of low growth could lead to hysteresis-type effects by lowering potential growth. Risks to domestic financial stability may surface owing to, for example, a shock to confidence by depositors and creditors in systemically important institutions, which by increasing risk aversion, could disproportionately suppress economic activity and trigger contagion more broadly.

Executive Board Assessment

Executive Directors commended the German authorities for prudent economic management, preserving strong domestic fundamentals, healthy balance sheets, and financial system soundness. Directors noted that these positive developments have provided an important anchor of regional stability. Meanwhile, uncertainty surrounding policies and prospects for the euro area is weighing on business investment and exports to the region. Directors stressed that policy priorities in the near term should aim at reducing this uncertainty to rebuild confidence and managing downside risks to the outlook. They also emphasized that, given the size of Germany's economy and its large external imbalances, stronger and more balanced growth in Germany is critical to a lasting recovery in the euro area and global rebalancing.

Directors commended the authorities for achieving national and supra-national fiscal targets. They welcomed the modest loosening of fiscal policy to help generate growth in domestic demand. Most Directors supported the current policy stance for this year, although some saw scope for a more proactive stimulus, given the significant risks to the outlook. Going forward, Directors welcomed the authorities' intention to avoid over-performance on fiscal consolidation, and encouraged a recalibration of policy should growth fall short of expectations. Ensuring fiscal sustainability remains a long-term objective in light of demographic pressures.

Directors welcomed the improved soundness of the banking system, the introduction of a macroprudential framework, and progress in implementing the recommendations of the Financial Sector Assessment Program Update. They encouraged the authorities to build on these achievements and remain vigilant to vulnerabilities, including those related to a still unsettled regulatory landscape and the dependence on wholesale funding by some large banks. Key priorities are further improving capital buffers, profitability, and efficiency of the financial system, and facilitating the adjustment of business models ahead of new international and European regulatory requirements. Directors also urged continued efforts to strengthen the surveillance of large cross-border banks and enhance coordination with supervisory authorities in key financial centers.

Directors saw an important role for Germany in facilitating the advancement of the financial reform agenda at the regional level. In this context, they pointed to the merits of further aligning national legal and regulatory initiatives with European proposals, and of reducing the fragmentation of deposit insurance mechanisms and banking systems more broadly. Directors looked forward to German leadership in articulating a clear, coherent roadmap toward achieving European financial sector initiatives.

Directors welcomed the authorities' continued commitment to help forge a robust architecture for the economic and monetary union (EMU). They stressed that a clearly-communicated longer-term vision for closer economic and financial integration among EMU member countries would provide a crucial anchor to the expectations of households, firms, and the financial system.

Directors emphasized the need to sustain reform momentum to raise the economy's growth potential and promote a more balanced economy, which will contribute to a further reduction in external imbalances. They welcomed recent initiatives to increase labor force participation, and encouraged steps to raise real wages by lowering the tax burden. Additional efforts are also essential to accelerate the pan-European integration and harmonization of energy and transportation networks, improve the productivity of the services sector, and broaden the sources of financial intermediation.

Germany: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013 1/	2014 1/
Economic activity and prices	(Change in percent, unless otherwise noted)						
Real GDP	0.8	-5.1	4.0	3.1	0.9	0.3	1.3
Net exports 2/	0.0	-2.9	1.7	0.6	1.0	0.1	0.2
Total domestic demand	1.2	-2.5	2.6	2.6	-0.3	0.2	1.2
Private consumption	0.8	0.1	0.9	1.7	0.8	0.8	1.0
Gross fixed investment	1.3	-11.6	5.9	6.2	-2.5	-2.0	1.8
Construction investment	-0.7	-3.2	3.2	5.8	-1.5	0.2	2.8
Gross national saving (percent of GDP)	24.8	23.2	23.7	24.3	24.6	22.7	22.9
Gross domestic investment (percent of GDP)	18.6	17.2	17.4	18.1	17.6	17.1	17.3
Labor force 3/	43.4	43.6	43.7	43.8	44.1	44.1	44.1
Employment 3/	40.3	40.3	40.6	41.1	41.6	41.7	41.7
Standardized unemployment rate (in percent)	7.6	7.7	7.1	6.0	5.5	5.6	5.5
Unit labor costs (industry)	6.6	21.5	-14.0	-2.4	4.5	3.2	1.5
GDP deflator	1.1	1.1	1.1	0.7	1.1	1.0	1.0
Harmonized CPI index	2.8	0.2	1.2	2.5	2.1	1.5	1.7
Public finance	(In percent of GDP)						
General government balance 4/	-0.1	-3.1	-4.1	-0.8	0.1	-0.4	-0.1
Structural government balance	-0.9	-1.1	-2.3	-0.9	0.2	-0.1	0.1
General government gross debt	66.8	74.5	82.4	80.4	81.9	81.3	79.3
Money and credit	(Change in percent over 12 months)						
Private sector credit 5/	2.6	-1.6	-0.3	1.2	1.3	1.1	…
M3 6/	9.6	-1.6	4.5	5.9	6.0	5.6	…
Interest rates	(Period average in percent)						
Three month interbank rate 7/	4.6	1.2	0.8	1.3	0.9	0.2	…
Ten-year government bond yield 7/	4.1	3.3	2.8	2.7	1.4	1.4	…
Balance of payments	(In billions of USD, unless otherwise noted)						
Exports 8/	1,761	1,409	1,567	1,827	1,773	1,835	1,922
Imports 8/	1,534	1,247	1,380	1,636	1,572	1,634	1,718
Trade balance (percent of GDP) 9/	6.7	5.2	5.7	5.4	6.0	5.7	5.4
Current account balance	226.1	197.1	207.0	224.3	238.5	197.6	199.3
Current account (percent of GDP)	6.2	6.0	6.2	6.2	7.0	5.6	5.5
Exchange rate	(Period average in percent)						
Euro per US dollar 7/	0.73	0.68	0.76	0.76	0.76	0.77	…
Nominal effective rate (1990=100) 7/	104.6	106.0	100.0	100.1	99.2	100.2	…
Real effective rate (1990=100) 5/ 10/	102.1	102.8	95.8	94.8	93.9	94.5	…

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

1/ IMF staff estimates and projections.

2/ Contribution to GDP growth.

3/ National accounts definition.

4/ Net lending/borrowing.

5/ Data for 2013 refer to April.

6/ Reflects Germany's contribution to M3 of the euro area. Data for 2013 refer to April.

7/ Data for 2013 refer to April.

8/ Goods and services.

9/ Trade in goods, including supplementary trade items.

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

Statement by Steffen Meyer, Alternate Executive Director for Germany
August 1, 2013

I would like to convey my authorities' gratitude for productive and insightful discussions during this year's Article IV consultation. Staff's efforts to reach out to a broad range of stakeholders like think tanks, SMEs, and the financial sector are very welcome and resulted in a balanced and comprehensive assessment of the German economy. My authorities also welcome the innovative approach of presentation staff has chosen in the report as for example the section on "point and counterpoint" and the Risk Flow Chart that more clearly expresses the intertwined relationship of potential risks than the traditional Risk Assessment Matrix.

My authorities agree to the main thrust of the staff appraisal. I would like to highlight Germany's strong fundamentals, healthy balance sheets, appropriate fiscal position, solid private consumption, and its positive role as anchor of stability in the region. At the same time, my authorities recognize that they also have homework to do: uncertainty needs to be reduced and investment strengthened, and potential growth should be raised by appropriate structural reforms and demographic challenges have to be dealt with.

Recent developments and outlook

The German economy remains highly competitive and economic growth remains overall robust. Against the background of substantial trade linkages, my authorities are aware that favourable global economic developments and steady growth in Europe are very important for a positive economic outlook for Germany.

At the same time, the domestic resilience of the German economy has substantially improved. Employment in Germany has been increasing steadily over the past few years accompanied by wage growth roughly in line with productivity growth resulting in robust private consumption as the main driver of economic growth.

In 2012, Germany registered a growth rate of 0.7 percent. However, the dynamics declined steadily over the course of the year. Causes for the weak performance at the end of 2012 were lingering uncertainties resulting from a tangible slowdown in the world economy, financial market tensions and the situation in the Euro Area dampening the propensity of German firms to invest.

However, my authorities expect the German economy to expand again in 2013 and growth will gain strength over the course of the year. After a weak first quarter – which was mainly weather-related – my authorities expect the economy to start catching up and growth is projected to reach 0.5 percent for the whole year, slightly better than projected by staff. For 2014, the outlook is clearly positive. Against the background of strong fundamentals – favourable cash flow situation of the private sector, low interest rates, and increased domestic demand – my authorities project a growth rate of 1.6 percent.

Economic activity will mainly be driven by domestic demand contributing 0.7 percentage points and 1.5 percentage points to GDP growth in 2013 and 2014 respectively. In view of the positive development of disposable income of private households and moderate inflation, a leading role will be played by consumer spending and private-sector investment in housing. Furthermore, once the uncertainty among investors dissipates, companies are likely to set aside their reluctance and start to realise deferred investments. Net contribution to growth from exports will be weaker than in previous years: slightly negative in 2013; slightly positive in 2014.

Germany, External Stability, and the Euro Area

Staff's balanced analysis of Germany's current account in the staff report and the 2013 Pilot External Sector Report is welcome. The analysis shows that rebalancing is on its way. As staff rightly points out, the current account surplus with the Euro Area has been steadily declining since 2007. The overall trend might gain even more momentum as investment in Germany picks up and consumption holds up robustly. As stated in earlier Article IV discussions, I would like to highlight that the German current account surplus is not the result of targeted policy measures but the outcome of complex market processes and high (especially non-price) competitiveness of German enterprises. In addition, as staff highlights in both the staff report and the 2013 Pilot External Sector Report, policy gaps and the need for fiscal consolidation elsewhere play an important role.

My authorities' view coincides with staff's analysis that a fiscal stimulus in Germany to support demand in other European countries would not be advisable. As discussed in the German-Central European Supply Chain-Cluster Report and in the staff report, fiscal spillovers from Germany to the rest of the Euro Area are limited whereas healthy balance sheets serve as a buffer against shocks and generate positive spillovers that extend well beyond Germany.

My authorities agree with staff that the German economy plays an important role as an anchor of regional stability. This puts a premium on prudent policies to safeguard Germany's sound balance sheets and ensure relatively low debt to GDP ratios in the household, corporate and government sectors. My authorities are therefore committed to ensuring that the newly introduced and enhanced European procedures for economic and budgetary monitoring are implemented rigorously. There must be no relaxation in the efforts to reform – this also applies to Germany. Moreover, my authorities are fully committed to an integrated and well-functioning EU and Euro Area that serves the interest of all member states. A strengthened European integration is crucial to the long-run prosperity of Germany with its very open economy. Against this background, Germany fully subscribes that changes to the EMU architecture are necessary to create a stronger and more sustainable and resilient monetary union. I would like to emphasize that substantial progress has already been achieved in this regard.

This progress is also important in the shorter term to reduce uncertainty and thereby catalyze held-up investment in Germany. My authorities remain somewhat more optimistic than staff that uncertainty will recede against the background of strong European policy commitment to reforms and the measures already taken by other Euro Area member states and measures adopted at the regional level.

Reviving Growth

Germany's role as an anchor of regional stability has to be kept in mind when discussing policies to reinvigorate growth. Prudent macroeconomic and macroprudential policies as well as structural reforms play an important role in reinvigorating strong, sustainable, and balanced growth and firmly anchoring expectations of market participants. This will also contribute to further reduce uncertainty about economic prospects so as to trigger investment that has been postponed so far.

Fiscal Policy

In 2012, Germany's general government balance posted a small surplus. The balance is projected to stay close-to-balance or in surplus in the coming years.

My authorities broadly concur with staff's fiscal policy analysis. They remain committed to letting automatic stabilizers operate freely. Above that, the fiscal stance in 2013 will even be mildly expansionary given a considerable reduction in taxes, social insurance contributions and fees totalling nearly € 8 billion for companies and private citizens. While my authorities also agree that fiscal overperformance should be avoided, the recent better than expected outcome in Germany largely reflects reform dividends without exercising a dampening impact on economic activity.

The German economy is expected to grow above economic potential next year with a high level of employment, rising disposable income, and low interest rates. Against this background, my authorities agree with staff that there is no macroeconomic reason for proactive fiscal policies to support growth. A discussion about exceptional measures could even be counterproductive at this point in time, as it could undermine strong consumer confidence in Germany. During the crisis, the German authorities demonstrated that they can react quickly to exceptional circumstances.

I would also like to emphasize that the debt-to-GDP ratio in Germany is still high and demographic pressures are looming. Therefore, it is important that fiscal policy also focuses on the medium term. It is my authorities' objective to reduce the debt ratio by maintaining the current targets for the structural fiscal balance in compliance with the "debt brake" enshrined in the constitution and the commitments at the EU and Euro Area level. The debt-to-GDP ratio – which rose markedly in particular due to the stabilisation measures taken in response to the crisis – is forecasted to decline to below 70 percent of GDP by 2017.

Structural Reforms

Structural reforms are indispensable to address the demographic challenges Germany is facing and to increase potential growth. Against this background, my authorities are committed to further increasing the overall efficiency of public expenditure and to further reforms on the labour market, improving infrastructure, a comprehensive energy strategy, higher and more effective R&D spending, improving the general framework for competition, and facilitating access to financing for SMEs.

The positive developments on the labour market in recent years resulted not only from the good economic situation, but in large part from labour market reforms, reliable labour relations, and prudent wage agreements. It is now important to build on this success and further improve the functioning of the labour market. My authorities' comprehensive Skilled Workers Strategy is geared towards averting shortages of skilled labour and mobilizing individuals through new opportunities. Improving parent's ability to combine career and family commitments through promoting a family-friendly working environment and an expansion of childcare facilities is a central part of this strategy. Furthermore, education and training are strengthened and the EU Directive on Highly Qualified Employment was implemented to attract skilled workers from abroad.

My authorities attach great importance to state of the art and well functioning infrastructure. For this reason, the Infrastructure Acceleration Programme II provides additional resources for the construction of new or the upgrading of existing federal transport infrastructure. Furthermore, the revision of the Telecommunications Act optimises the framework for the expansion and construction of high-speed networks and creates incentives for investment in new networks. This supplements my authorities' Broadband Strategy. Further to this, a Strategy for Smart Networks has been developed in the first half of 2013.

Germany's energy policy is based on a secure, affordable and environmentally sustainable energy supply. My authorities launched a fundamental restructuring of Germany's energy supply towards renewable energy and higher energy efficiency ("Energiewende"). In this context, competition in the energy sector is to ensure that all consumers can benefit from low-cost energy.

Federal Government spending on research and development (R&D) is rising continuously. The High-Tech Strategy foresees R&D activities in five main areas:

climate/energy, health/nutrition, communications, mobility, and security. Also in the context of the High-Tech Strategy, an innovation policy concept has been drafted with a view to taking further measures to strengthen Germany's already high innovative capacities.

The Federal Government has improved the general framework for competition in Germany. The revision of the Act against Restraints of Competition ("8. Novelle des Gesetzes gegen Wettbewerbsbeschränkungen") has come into effect at the end of June. It aims at improving conditions of competition, particularly in the areas of merger control, the abuse of dominant positions, provisions on fines, and procedures governing violations of anti-trust rules.

By introducing the new Venture Capital Investment Grant, my authorities aim to improve access to capital for young, innovative companies. It supplements the European Angels Fund and the High-Tech "Gründerfonds". The new Mezzanine fund of fund for Germany has also been set up with the aim of expanding the availability for SMEs of financing which can substitute for a lack of equity.

Financial sector policies

I welcome staff's assessment that banking system soundness has improved and that progress has been made in implementing several FSAP recommendations. With financing costs being at very low levels in wholesale and retail markets, German banks are taking advantage of the historically low level of policy rates. In general, banks do not experience difficulties with funding and loans to the private sector are growing robustly. Moreover, with regard to the Landesbanken, substantial restructuring measures have enabled them to develop profitable, sustainable business models.

Furthermore, I am pleased to report that the German Financial Stability Act entered into force on 1 January 2013. It established a Financial Stability Commission (FSC) composed of members from the Federal Ministry of Finance, the Federal Financial Supervisory Authority (BaFin) and the Deutsche Bundesbank. The commission can issue warnings regarding threats to the stability of the German financial system and make recommendations to German public institutions that aim at averting those threats.

Moreover, intensity and effectiveness of SIFI supervision has been stepped up in line with FSB recommendations and proposals. It is my authorities' view that cross-border cooperation of microprudential supervision is most efficient if organized alongside the structure of the most important parts of the supervised group. Within the European Economic Area (EEA), Capital Requirement Directive (CRD) provisions and European Banking Authority (EBA) guidelines form a material part of supervisory cross-border cooperation. Additionally, there are efficient supervisory cooperation arrangements in place which contributes especially to an enhanced cooperation with supervisory authorities domiciled outside the EEA.