Germany: Table of Common Indicators Required for Surveillance

(As of June 4, 2019)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[8]	Frequency of Publication[8]
Exchange Rates	June 4, 2019	June 4, 2019	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 19	May 19	M	M	M
Reserve/Base Money[2]	April 19	May 19	M	M	M
Broad Money[2]	April 19	May19	M	M	M
Central Bank Balance Sheet	April 19	May 19	M	M	M
Consolidated Balance Sheet of the Banking System	April 19	May 19	M	M	M
Interest Rates[3]	May 19	May 19	M	M	M
Consumer Price Index	May 19	May 19	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government[5]	Q1:19	May 19	Q	Q	Q
Stocks of General Government and Government-Guaranteed Debt[6]	December 18	April 19	A	A	A
External Current Account Balance	March 19	May 19	M	M	M
Exports and Imports of Goods and Services	March 19	May 19	M	M	M
GDP/GNP	Q1:19	May 19	Q	Q	Q
Gross External Debt	Q4:18	March 19	Q	Q	Q
International Investment Position[7]	Q4:18	March 19	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)

Statement by Mr. Meyer, Executive Director for Germany
July 8, 2019

On behalf of my authorities, I would like to thank staff for the discussions and the candid, balanced, and at the same time thought-provoking assessment of the German economy. My authorities find their views well documented in the report.

The German economy continues to grow, making this year the tenth successive year of expansion. The labor market continues to perform well. The unemployment rate is expected to drop to historically low levels in 2019, whilst employment rises further. Consequently, personal incomes will again see a substantial increase: the German Federal Government expects that net wages and salaries of employees will grow by 5.1 percent in 2019,[1] a development which is also helped by measures taken by the Federal Government to strengthen income after taxes. In view of rising wages, employment and corporate investment, the domestic economy will remain the driver of economic growth.

Despite the recent growth slowdown and presence of certain external headwinds, output is projected to return to trend. However, and as staff rightly notes, this outlook is subject to significant uncertainty, especially against the backdrop of unresolved trade tensions and risks surrounding the Brexit process that need to be addressed as a matter of priority by all parties involved. Furthermore, heightened geopolitical risks weigh on investor sentiment.

Germany firmly supports an open, fair, and rules-based multilateral trading system which is more important than ever to safeguard the gains that free trade entails for every country while making sure that these are broadly shared. Germany's policies will remain firmly anchored within its responsibilities and commitments to the European Union and the euro area.

On top of this, staff rightly points out that Germany is facing its own multiple challenges of a more structural nature. These challenges include demographic change, digitization of commerce and society, and the energy transition with the phasing-out of production of electricity from nuclear power as well as coal in the context of climate change.

At the same time, these challenges create the opportunity to enhance domestic sources of growth and well-being.

[1] Net wages and salaries per employee are expected to grow by 3.8 percent in 2019.

Fiscal Policy

In line with our commitments at the European and national level, public debt is projected to decline below the debt ceiling of 60 percent of GDP this year. At the same time fiscal policy is projected to be expansionary. Robust social safety nets, progressive income taxation, as well as broad access to education and health systems ensure inclusiveness while supporting potential and productivity growth over the medium term.

Good times were used to rebuild fiscal buffers and to prepare for the significant challenges stemming from an aging society and associated contingent liabilities. The current sound fiscal position increases resilience, also in the context of the above-mentioned external risks that Germany faces. Automatic stabilizers will be able to operate freely in case of slower growth. Moreover, the sound fiscal position will allow decisive counter-cyclical action in case of a severe downturn. In this context, we see the fiscal rules as an important guide post to anchor expectations.

That being said, general government investment has been steadily increasing, both in absolute and relative terms, reaching a multi-year high of € 79.3 billion in 2018. The priorities of a strong and sustained increase of public investment, which is projected to rise further in 2019 and the coming years, lie in areas that are crucial for Germany's future, namely infrastructure, education, universities, research, and digital technology. The federal government strongly sponsors this increase in investment through a number of initiatives, including substantial fiscal support for other levels of government.

Germany is committed to promoting the international reform agenda on corporate taxation, in particular through supporting the establishment of a minimum taxation framework. To this end, we have issued a joint declaration with France on the taxation of digital companies and minimum taxation in December 2018 and look forward to making further progress on this front over the next years.

In this vein, we welcome staff's in-depth analysis of the German corporate tax system and thorough evaluation of reform proposals that aim to address existing shortcomings. Nevertheless, policy makers also face political constraints in undertaking substantial changes to certain features of the existing framework such as the local business tax (LBT) which is levied on the municipal level.

Similarly, we agree in principle with the desirability to reduce adverse incentives of relatively high marginal tax rates including social security contributions for low-, middle-, and secondary income earners. At the same time, staff correctly identifies associated difficulties in alleviating this burden, including constitutional constraints.

The phasing out of the solidarity surcharge for low- and middle-income earners, on which the Federal Government has recently agreed on, will reduce the labor tax wedge in line with staff recommendations, raising disposable incomes by around €11 billion annually. Thereby, it should have positive effects on incentives to work while boosting domestic demand. Overall, income tax measures taken in the current legislative period will boost disposable incomes of households by around €25 billion per year.

We also appreciate staff's work on regional fiscal differences which discusses differences in investment needs and financing envelopes on the state and municipal level. However, to some extent these reflect the institutional principles of subsidiarity and self-responsibility, and do not necessarily indicate a general need for policy action, particularly regarding the federal level.

Overall, large fiscal equalization mechanisms exist, and the federal government has embarked on a number of programs that aim to address investment needs at the local level, including through the allocation of additional funds for education, early childhood care, social housing, and public transportation. The *Partnerschaft Deutschland* initiative, which supports municipalities in accessing federal funds and implementing public investment projects, has garnered much interest from municipalities and we aim to further expand and scale up this initiative. Given the tight labor market and increasingly binding capacity constraints, especially in the construction sector, it should also be noted though that there are limits to expanding infrastructure investment beyond a certain degree at the current juncture.

<u>External Sector and Corporate Savings</u>

My authorities reiterate their view that the current account surplus is mainly a result of private sector decisions in international trade and investment, and not of domestic policy choices. My authorities expect that the current account surplus will continue to decline in the years to come as more people retire and real wages continue to rise, supporting the external rebalancing.

Given the exceptionally high model and estimation uncertainties for Germany in the IMF model, especially regarding unexplained residuals, we suggest classifying Germany's competitiveness position as overall neutral, in contrast to staff's assessment. Indicators such as Germany's real effective exchange rate based on the deflator of total sales against 19 trading partners or recent estimates based on the "productivity approach" with a very broad coverage of trading partners suggest that the German economy currently only has a rather small competitive advantage.

We take note of staff's finding that the build-up of corporate profits and gross savings has contributed to rising wealth inequality in a mutually reinforcing manner.

Corporate savings in turn have been a big driver of Germany's current account surplus. Foreign direct investment of German companies, which is statistically reported as corporate savings, is of particular relevance in this context. We believe more granular analysis is needed to identify potential policy distortions behind these trends that have contributed to rising corporate profits and that might incentivize retaining earnings rather than disbursing them.

At the same time, we would like to highlight that the fall in the labor share has been reversed, thanks in large part to higher wage agreements against the backdrop of a tighter labor market over the past years.

Moreover, family-owned firms, to which a large part of corporate savings accrue, constitute an integral part of the German economy and its success story.

Structural Reforms

The planned introduction of R&D tax credits will provide strong incentives for targeted investment in growth-enhancing R&D activities. Tax credits are capped at a base of €2 million per firm and will therefore primarily benefit small and medium sized enterprises, thus complementing well-tried direct funding for research and development in a reasonable manner.

We fully agree with staff that ensuring favorable conditions for the expansion of the labor supply and allowing workers to obtain and enhance the required skills are indispensable to safeguard strong and sustainable growth over the medium term. Given the projected decline in working age population, my authorities will further work towards promoting a higher labor force participation of women and the elderly, better training and integration of refugees into the labor market, as well as modernizing immigration laws.

Educational outcomes are being strengthened through an increased supply of all-day childcare and all-day schools which also promote the equality of opportunity.

We recognize the importance of providing high-speed internet access, both broadband and mobile, across the country, not least to aid the adoption and development of new technologies. To this end, besides encouraging private investments through investment-friendly regulation, we have set out a clear strategy and will provide substantial funding to support a nationwide fiber-based gigabit network.

The energy transition in Germany is well underway. In April 2019, the Federal Government set up a "Climate Cabinet" in order to coordinate policies and establish a legal framework to reach the overall climate goals for 2030. The "Climate Cabinet" will also discuss on how to ensure the transition to climate-neutrality by 2050. The energy supply is

stable and ample with Germany being a net exporter of electricity for the foreseeable future. The costs of producing energy from renewables is projected to decline further and below that of producing energy from fossil fuels. This trend would additionally be supported by increasing CO_2 prices.

We are therefore less concerned than staff that uncertainty surrounding the energy transition will somehow impede economic growth going forward. In Germany, a broad public debate is currently taking place on measures that could be taken to counteract climate change. In this context, measures like carbon pricing or an aviation tax are also being discussed. The introduction of higher taxes on fossil fuels, which is currently under discussion, could further aid the process towards a more energy-efficient economy. However, no concrete decisions have yet been made.

We agree that greater competition in product and services markets as well as in network industries can in principle be beneficial to consumers and create employment opportunities. However, we would be more cautious than staff regarding reforms to liberalize regulated professions. We consider many of the existing regulations to be **justified by legitimate concerns surrounding the potential deterioration of quality and consumer protection standards. Notwithstanding that, we are open to the emergence of new services, especially in the sharing economy, but believe that adequate regulations and compensatory mechanisms for the transition period need to be in place.**

Financial Sector and Housing Market

We share the view that macro-financial vulnerabilities are on the rise. Our analyses show that during the long phase of economic growth and low interest rates of the past years, cyclical systemic risks have built up in the German financial system. These comprise a potential underestimation of credit risk and a potential overvaluation of assets when real estate is used as collateral. These vulnerabilities could be further amplified by the build-up of interest rate risks. German banks have significantly topped up their capital since the global financial crisis and capital buffers are generally deemed comfortable. Nevertheless, given the gradual build-up of macro-financial vulnerabilities, the Financial Stability Committee recommended the activation of the countercyclical capital buffer (CCyB) to preventively strengthen financial sector resilience in May. Our supervisory agency Bafin has issued a general decree on June 28th,2019, to set the CCyB at 0.25 percent effective July 1st,2019, with banks having 12 months to meet the new requirement.

We agree with staff's assessments both on the relatively low level of profitability and its drivers in the German banking sector. Nonetheless, we consider it to be primarily the task of individual banks themselves to have viable profitability levels. This being said, we would like to point out that low profitability does not necessarily reflect high financial stability risks and could rather be the result of prudent risk-taking behavior for