Germany: Staff Concluding Statement of the 2023 Article IV Mission

May 16, 2023

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC – May 16, 2023: *An International Monetary Fund (IMF) mission, led by Kevin Fletcher, and comprising Ting Lan, Aiko Mineshima, Galen Sher, and Jing Zhou conducted discussions for the 2023 Article IV Consultation with Germany during May 2 – 16. At the end of the visit, the mission issued the following statement:*

Germany has weathered well the fallout from the Russian gas shut off, thanks to a strong policy response and mild winter. Tighter financial conditions and the energy price shock are nonetheless expected to keep economic growth muted in the near term. Headline inflation is falling steadily, but core inflation is proving to be stickier. A top policy priority in the near term is thus to support disinflation with a moderate tightening of the fiscal stance in 2023 as well as supply-side reforms. At the same time, it is important that the German authorities continue to closely monitor and address financial stability risks, which have risen on the back of rapidly rising interest rates and global financial market turbulence. Looking further ahead, Germany will have to navigate a new normal that entails population aging, an ongoing need to support efforts to combat climate change, and heightened risks of geo-economic fragmentation. To adapt to this new normal, Germany should undertake reforms to create fiscal space for higher public investment and rising aging-related spending, boost labor supply and productivity, accelerate the green transition, and enhance resilience to risks .

Recent economic developments and outlook

1.The German economy has demonstrated much resilience over the last year. Highly adverse economic outcomes following the Russian gas shut-off last summer—as contained in some scenarios—have not materialized. This resilience reflects not only a mild winter, but also impressive policy action to conserve energy, cushion the impact of higher energy prices, and secure future energy supplies.

2.Nonetheless, tighter financial conditions and the energy price shock have begun to weigh on near-term growth. Financial conditions have tightened considerably, reflecting both monetary tightening—which is necessary to reduce inflation—as well as turbulence in global financial markets. Tighter financial conditions are weighing on economic activity, especially in interest-sensitive sectors such as construction of

residential real estate, while the adjustment to higher energy prices (relative to pre-war levels) is constraining output in some energy-intensive sectors. As a result, the mission expects GDP growth to stay near zero in 2023, before gradually strengthening to 1-2 percent during 2024-26 as the lagged effects of monetary tightening gradually dissipate and the economy adjusts to the energy shock. Over the longer term, average GDP growth is expected to fall back below 1 percent due to headwinds from population aging, absent significant accelerations in productivity and/or labor supply growth.

3.Headline inflation is expected to continue to subside, but core inflation is likely to decline later and more slowly. Falling energy prices and continued normalization of supply disruptions are expected to drive headline HICP inflation from 7.6 percent in April down to around 4½ percent by late 2023. However, core inflation is expected decline more slowly, given lags in the pass-through from declining commodity prices and with the effects of rising nominal wage pressures on prices being only partially mitigated by a moderate pullback of recent increases in profit margins.

4.Uncertainty is high, with risks to the baseline forecast in both directions but tilted downward. Core inflation could remain elevated longer than expected due to higher-than-expected stickiness and/or nominal wage pressures. This would require tighter monetary policy, which could in turn fuel further headwinds for growth. Renewed global banking turbulence could further increase the German financial sector's funding costs and tighten financial conditions, with adverse knock-on effects for the real sector. On the upside, faster unwinding of supply disruptions and stronger recovery in external demand could spur faster growth.

Fiscal policy

5.The fiscal stance should be moderately tight in 2023 to support disinflation efforts. Spending on the gas and electricity brakes is likely to be lower than budgeted in 2023 due to falling energy prices, and fiscal revenue may also overperform. If, as expected, the government saves these windfalls, the fiscal stance as measured by the change in the cyclically-adjusted primary balance is expected to turn moderately contractionary in 2023. Such tightening is appropriate to support disinflation, with further fiscal contraction warranted in 2024 under the baseline scenario.

6.Germany's energy relief measures are generally well-designed, but targeting could be improved. Germany's main energy relief measures—the gas and electricity price brakes—maintain strong incentives for households and small firms to conserve energy. In addition, many relief measures for households are income-taxable and thus progressive. However, there is scope for further targeting this relief to those most in need. Given administrative challenges to providing income-based transfers for households that are not covered by the existing social safety net, the government could consider partially offsetting the cost of energy price relief via temporary solidarity taxes on higher-income households or greater claw-back of energy price relief provided to them. The gas and electricity price brakes should also be allowed to expire as planned by April 2024 at the latest to facilitate adjustment to structurally higher fossil fuel prices.

7.Over the medium term, Germany may need to create more fiscal room for investing in its future. The mission expects Germany's fiscal deficit to narrow to around ½ percent of GDP by 2027 as energy-relief measures phase out and the economy recovers. Although Germany has ample fiscal space to respond to shocks, there is hardly any room left under the constitutional debt-brake rule, which limits annual new structural

borrowing to 0.35 percent of GDP at the federal level. Even if one assesses fiscal room against an overall deficit of around 1¾ percent of GDP, which would stabilize Germany's debt ratio at around 60 percent of GDP, envisaged increases in aging-related and defense spending leave little scope for higher public investment or addressing other needs. To provide adequate funding for the green transition, digitalization, and boosting human and physical capital, Germany may need to create new fiscal room by undertaking expenditure reforms, mobilizing additional revenue, and/or adjusting the debt brake rule (see next paragraph). Such measures could include, for example, reforming property taxes and/or reducing subsidies that are distortionary or environmentally harmful.

8.Germany should consider adjusting the debt-brake rule to better align it with EU fiscal rules and lessen reliance on extrabudgetary funds. Germany has created multiple extrabudgetary funds totaling about 9 percent of GDP (the Climate and Transformation Fund, Special Defense Fund, and "Protective Shield") while the escape clause to the debt-brake rule was activated during the pandemic. Spending from these funds does not count against the debt-brake limit, even if the spending occurs after the debt-brake returns to force in 2023. However, such spending does count toward the general government deficit as measured under EU statistical standards. The extensive use of such funds has thus weakened the link between the debt-brake rule and debt dynamics, as well as with EU fiscal rules. In addition, the budget process for the special funds is less transparent than for the core budget. To enhance transparency, cohesion with EU fiscal rules, and the effectiveness of the debt brake, the government should consider revising the rule to limit use of extrabudgetary funds and increase somewhat the annual deficit limit, perhaps by 1 percentage point of GDP. The latter change would make the rule more realistic, given Germany's significant medium-term spending needs, while at the same time ensuring that debt continues to decline below 60 percent of GDP. It would also lessen incentives to rely on extrabudgetary funds. However, such adjustments should await the conclusion of the EU's review of its fiscal rules, which is nearing its latter stages, to facilitate consistency between EU and national rules.

9.Ongoing efforts to accelerate the implementation of public investment are welcome. Amid the energy crisis, the government moved quickly to expand LNG terminal capacity. The 2022 "Easter Package" also set out important measures to accelerate the expansion of renewables. Looking ahead, the mission welcomes plans to further accelerate public investment, including by (i) alleviating challenges from staff shortages at the local government level by utilizing external project managers and (ii) reforming public procurement to further simplify and digitize procedures.

Financial sector policies

10.The overall capital and liquidity positions of Germany's banking system and insurance system remain sound. In 2022, banks suffered significant mark-to-market losses due to revaluation of their securities portfolios, which temporarily lowers their profitability. Despite these losses, the German banking system's aggregate capital and liquidity levels remained substantial at end-2022, with capital at 19.2 percent of risk-weighted assets at end-2022 and liquidity coverage ratios of 154 percent for significant institutions and 178 percent for less-significant institutions. Germany's substantial deposit insurance coverage limits also support bank funding stability. Insurers similarly suffered mark-to-market losses in 2022, but their solvency positions were well hedged.

11.Nonetheless, financial stability risks associated with rapidly rising interest rates should be closely monitored. Recent bank distress in the US and Switzerland has

highlighted risks associated with excessive interest-rate exposure and unstable funding structures. The authorities should thus continue to identify banks that are most vulnerable to interest-rate and liquidity stress and subject them to intensive supervision. Given elevated risks associated with macroeconomic and financial market uncertainty, supervisors should also encourage a conservative approach to bank capital distributions. Further enhancing transparency around bank health by, for example, publishing additional risk analyses, disclosing more information on less-significant institutions (LSIs), and clarifying to the public the safety nets available could also reduce volatility in funding conditions. Data collection and stress tests of interest-rate risks at LSIs should also be enhanced. Meanwhile, the authorities should encourage investment funds to continue adopting liquidity management tools, including gates and notice periods. The volatility of bank funding conditions also underscores the need to further strengthen safety nets and crisis management frameworks. Toward this end, Germany should consider simplifying the structure of depositor protection by moving to a single mandatory scheme with a robust public liquidity backstop. Meanwhile, resolution plans should account for the potential joint resolution of several members of each institutional protection scheme (IPS) and even joint resolution of an IPS member with an IPS itself. Completion of the pan-European Banking Union and Capital Markets Union would further enhance financial stability and economic efficiency.

12.A broader macroprudential toolkit and further enhancing data collection would help promote longer-term financial stability in the real-estate sector. The last decade saw rising vulnerabilities in the real-estate market, with the share of lending with a high loan-to-value (LTV) ratio rising until COVID-19 along with rapidly increasing house prices.The partial correction of house prices that began in late-2022, from overvalued levels, could push some borrowers into negative equity. Given these risks, the mission welcomes the higher capital requirements that took effect in February 2023. To enhance the ability to respond to a new buildup of risks in the future, the law on borrower-based measures should be modified to address any perceived obstacles to their early activation and to add income-based instruments to the toolkit. The mission also welcomes the collection, starting in 2023, of more robust data on lending standards in residential real estate. To better assess risks in commercial real estate, the authorities should facilitate harmonization of definitions of lending standards across banks and collect and publish comparable data on LTV ratios, interest- and debt-service-coverage ratios, and debt-yield ratios.

Structural reforms

13. Accelerating the green transition is essential to meet climate goals. Germany met its 2022 CO2 emission target thanks to a sharp decline in emissions by industry and favorable weather. But continued efforts are needed to meet targets going forward. Toward this end, the government should resume the increase in domestic carbon pricing in 2024 as planned and consider further strengthening it. Take-up of existing programs that support the green transition could also be enhanced by simplifying procedures and ensuring cohesion across programs. Meanwhile, any additional subsidies for the green transition should be limited to addressing market failures and be fiscally affordable both in Germany and other EU countries, as single-market principles require a consistent approach across countries. Accelerating the expansion of EV charging stations and the smart grid network is critical, and revenue-neutral feebate schemes could further speed the green transition. The mission welcomes the introduction of the EU Carbon Border Adjustment Mechanism, which reduces carbon leakages, as well as Germany’s leadership

in creating the Climate Club, which aims to provide an inter-governmental forum for discussion, cooperation, and coordination on climate-change mitigation policies.

14. The government is making welcome efforts to boost Germany's human capital, including by increasing immigration and support for worker training. Plans to augment the Skilled Immigration Act should help dampen the projected decline in the labor force due to population aging. The recently passed Bürgergeld also includes, among other elements, training initiatives that aim to help the unemployed find better-paying jobs. It will be important to closely monitor the use of Bürgergeld and adjust its design if needed to ensure that it achieves its objectives and does not unduly lengthen unemployment spells.

15.Boosting labor productivity by further enhancing capital deepening and innovation is also essential to lift economic growth. Germany is an innovation leader in Europe. That said, Germany's labor productivity growth has declined over the last decade and trails non-European advanced economies. Germany's relatively low labor productivity growth is driven mainly by lower ICT capital deepening and weaker multifactor productivity. At the same time, new business registrations have trended downward. To lift productivity, Germany should (i) enhance incentives to undertake R&D, including by expanding R&D tax credits and increasing the availability of qualified workers; (ii) expand funding for young and innovative firms by reducing barriers to the participation of institutional investors in venture capital markets and by aligning the tax treatment of stock-ownership option plans with international standards; and (iii) lower market entry barriers for such firms, including by increasing use of digital government, reducing administrative red tape, and strengthening the competition framework.

16.Germany should assess and prepare for risks related to geo-economic fragmentation (GEF) while pursuing structural reforms to increase its attractiveness as an investment destination. Intensified global geo-political tensions have raised GEF-related risks. Extensive and broad-based GEF could increase output losses and financial instability, as cross-border trade, knowledge flows, and investment become more costly. Germany and its trading partners should therefore continue to support a multilateral, rules-based trading system that promotes mutually beneficial cooperation on trade and cross-border flows. At the same time, Germany should identify its critical dependencies, assess the impact and transmission channels of different GEF scenarios (e.g., stress tests of value chains), and develop strategies for coping with risks. Structural reforms, as outlined in previous sections, would also help retain Germany's attractiveness as an investment destination.

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The mission team thanks the authorities andall our other counterparts for their warm hospitality and for the constructive dialogue and productive collaboration.