Germany: Staff Concluding Statement of the 2021 Article IV Mission

May 20, 2021

Washington, DC: *An International Monetary Fund (IMF) mission, led by Mr. Shekhar Aiyar, conducted discussions virtually on the 2021 Article IV Consultation during May 7 – 19. At the end of the visit, the mission issued the following statement:*

Germany's economy contracted by just under 5 percent in 2020, outperforming most European peers. But a new wave of infections and associated lockdowns caused economic activity to plunge again in the first quarter of this year. While the pace of mass vaccinations is picking up, the recovery path remains uncertain and beset with risks. The authorities have maintained appropriately accommodative fiscal and financial policies, and most measures supporting households and firms have been extended through 2021. The aim should be to set the economy on a sustained recovery path by reducing labor market scarring, protecting vulnerable sections of the population, and ensuring that viable firms remain in business. Looking further ahead, Germany should use its fiscal space to expand public investment, facilitate structural transformation, and decarbonize the economy. This would also help reduce large external imbalances.

Economic Outlook

Growth is expected to gather strength as vaccinations become widely available and lockdowns are phased out. Forward-looking indicators suggest a continued pick-up in exports and an improved outlook for services sector activity, in line with the expected re-opening of the economy and the release of some pent-up savings. Output is forecast to return to its pre-crisis level in early-2022.

The outlook remains highly uncertain however, and the balance of risks is tilted to the downside. In the short run, if the vaccine rollout fails to outpace new infections—including mutant variants—lockdowns may need to be prolonged or reimposed, delaying the recovery and amplifying economic scarring. On the other hand, domestic demand could rebound more swiftly due to pent-up savings, and exports may grow more strongly than envisaged, driven by a sharper economic rebound and further policy support in key trading partners. Over the medium term, failure to adapt to the post-COVID economy—potentially characterized by transformed ways of working and consuming—coupled with lagging progress in digitalization and the green energy transition, could weigh on potential growth.

Fiscal Policy

Fiscal policy is projected to remain appropriately expansionary in 2021, with the escape clause to the debt-brake rule staying activated. In 2020, Germany recorded its first fiscal deficit in eight years, reflecting unprecedented policy support to combat the COVID-19 pandemic. Two fiscal packages announced in 2020 included ramped-up public health spending, grants to firms, subsidies for the expanded short-time work scheme ("Kurzarbeit"), transfers to subnational governments, and additional future-oriented public investment. Faced with new infection waves and corresponding lockdowns since late-2020, the government has extended several COVID-19 measures, most notably grants to firms. At the same time, a number of new measures have been announced, such as increased corporate tax loss carry-back; another round of one-off child benefits; an extension of the VAT cut on restaurant services; and increases in the apprenticeship subsidy. These extraordinary support measures comprise an excellent use of Germany's accumulated fiscal space.

The pace of withdrawing policy support should be carefully calibrated to the progress on containing the pandemic and the shape of the economic recovery. Given considerable uncertainty about the dynamics of the pandemic, it is preferable to err on the side of doing too much so as to minimize scarring effects, rather than too little. Support for households and firms should be continued until there is clear evidence of a sustained recovery, while public investment should be frontloaded to the extent possible. Additional measures should be implemented if the recovery falters. Public debt remains sustainable, and concerns about the temporarily higher debt stock should not hinder vigorous policy action. As the recovery firms up, a carefully calibrated withdrawal of emergency support should be accompanied by targeted measures to facilitate post-crisis resource re-allocation.

Looking ahead, Germany should use its fiscal space to lift potential growth and facilitate structural transformation. Fiscal policy should be deployed to address long-standing structural challenges such as boosting Germany's growth potential through greater physical and human capital investment; incentivizing innovation; bolstering labor supply; and increasing disposable income for low-income households. Making progress towards these goals would also help with external rebalancing.

Labor Market Policy

Labor market policies—underpinned by Kurzarbeit—should remain protective until there is evidence of a sustained recovery. From the outset of the pandemic, Kurzarbeit's parameters were adjusted to ease access and make benefits more generous for firms and workers. The expanded Kurzarbeit has helped Germany contain the impact on unemployment and support aggregate demand. The parameters of Kurzarbeit are scheduled to be normalized in a stepwise fashion over the course of 2021; an appropriate strategy under the baseline growth projection. The government should, however, stand ready to extend the expanded Kurzarbeit program beyond this year to limit job destruction and support domestic demand if downside risks materialize. As the recovery takes hold, a normalization of Kurzarbeit parameters will be important so as not to inhibit labor reallocation to growing firms and industries. Job search assistance and appropriate training programs should be made available to workers to facilitate their transition into post-pandemic jobs.

Continued policy support is needed for marginal workers and the self-employed to withstand the income shock and re-integrate into the labor market. Because they are not eligible for Kurzarbeit, marginal workers and the self-employed are bearing the brunt of job and income losses during the pandemic. The expanded access to the basic income program currently in place should therefore be maintained until the job market has recovered sustainably for these vulnerable groups. The pandemic is disproportionately affecting low-income workers, exacerbating underlying inequality trends. To redress these dynamics, the government could consider reducing social security contributions on lower incomes. This would not only help ameliorate income inequality but also encourage labor participation and support aggregate demand, given the higher propensity to consume of low-income households.

Policies for a Green and Digital Transformation

Germany's carbon emissions targets are set to become more stringent following the recent constitutional court ruling. Several measures could be considered to further strengthen Germany's multi-pronged climate action plan. A more well-specified schedule of carbon prices over a longer time horizon would provide a critical signal for ensuring that new investment is efficiently allocated to clean technologies. Higher carbon pricing in sectors with a relatively low cost of abatement, such as power and industry, could help reduce aggregate emissions in an economically efficient way. Introducing feebates, which reward agents with lower-than-average emissions while penalizing those with higher-than-average emissions in a revenue-neutral way, could reinforce mitigation incentives at the sectoral level. Price-based measures will need to be complemented with government investment in green infrastructure and technologies. To mitigate the potential adverse impact of higher carbon prices on households, the government has already set out a range of measures, including a reduction of the renewable energy surcharge and increases in subsidies for long-distance commuters and housing benefits. These could be complemented by additional measures targeted at lower-income earners.

The pandemic has increased the urgency of the long-standing need for a digital transformation. Changes to ways of working and consuming will likely persist well past the pandemic, underlining the importance of improved access to high-speed broadband networks and greater diffusion of Information and Communication Technology (ICT) tools. To accelerate the provision of high-speed broadband networks, the government should carefully monitor competitive dynamics in internet and mobile markets and facilitate new entrants if warranted. Increasing the availability of devices for online learning and ICT training for teachers, while introducing computers and programming earlier in the school curriculum could enhance students' digital skills and engagement.

Declining productivity growth calls for additional policy support to promote innovation. Germany should consider further raising the cap for R&D tax incentives, as a complement to the recently introduced faster depreciation schedule for digital goods. Promoting venture capital, reducing administrative red tape, and lowering compliance costs for businesses would help raise investment in promising new technologies. In this context, it is important for Germany to explore ways to enhance the participation of institutional investors in venture capital markets and also to accelerate the rollout of e-Government.

Financial Policies

A multi-pronged policy approach should remain in place to safeguard financial stability during the nascent recovery. Bankruptcies and financial losses have been relatively contained through early 2021, aided by various borrower support measures and insolvency moratoria introduced in response to the crisis. However, bankruptcies have started rising as some of these measures are phased out. Insolvency procedures should facilitate efficient restructuring or liquidation where appropriate. The recent transposition into national law of the EU Directive on Preventive Restructuring Frameworks provides a mechanism to further reduce disruptive insolvencies. Targeted liquidity and solvency support for viable firms in the form of grants, loan guarantees, and equity support should remain available as long as the recovery remains fragile.

The banking sector should accelerate plans to bolster profitability. German banks have so far weathered the COVID-19 shock relatively well. However, even though capital buffers appear sufficient to absorb a hit without triggering any regulatory capital shortfall in the baseline, the gradual unwinding of policy support could lead to larger loan impairments and provisioning requirements. To mitigate the risk that bank lending will be curtailed when it is needed most, the authorities should specify an appropriate timetable for banks that find their capital reduced as a result of the crisis to rebuild buffers. At the same time, banks need to improve their cost structures, including through greater use of digital technologies and consolidation, and enhance non-interest revenues (e.g., fees and commissions). Supporting reforms to the financial architecture at the European level—including the completion of the banking union—would spur greater cross-border financial flows and remove impediments to cross-border bank consolidation.

Vulnerabilities in real estate markets call for close monitoring, while remaining data gaps need to be addressed. Commercial Real Estate (CRE) remains susceptible to lower demand following behavioral changes engendered by the pandemic, increasing the vulnerability of German banks which are among Europe's most exposed to CRE. The rapid increase in residential real estate prices in recent years warrants close monitoring, although the risk is mitigated by the relatively low level of household indebtedness. The authorities should complete as soon as possible the ongoing process of closing data gaps, to allow for a full assessment of potential risks to financial stability. Germany should also consider expanding its macroprudential toolkit for real estate lending, including income-based instruments such as debt-to-income or debt-service-to-income caps, while recognizing that the CRE sector is characterized by considerable heterogeneity in financing structures.

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The mission team thanks the authorities and all our other counterparts for the constructive policy dialogue and productive collaboration.