Germany: Staff Concluding Statement of the 2016 Article IV Mission

May 9, 2016

Growth this year is expected to remain moderate as strong domestic demand buoyed by favorable fiscal and monetary conditions is offsetting weak external demand. Medium-term potential growth is projected to decline as the population ages. This has contributed to the large and persistent current account surplus by pushing up savings and holding back domestic investment. More progress on structural reforms would revitalize potential growth and enhance the authorities' leadership at the European level in this area. A more dynamic Germany would also benefit the still fragile economic recovery in the euro area. In the financial sector, the new supervisory and regulatory architecture must be completed and the risks around this transition will need to be managed.

Key policy messages:

- *Accelerate structural reforms to boost growth potential by broadening the labor market participation of refugees, women, and older workers, and spurring competition in the services sector.*
- *Step up public and private investment to meet infrastructure needs, while tackling administrative bottlenecks.*
- *Remove impediments to housing supply expansion to better relieve the pressure on the housing market.*
- *Develop the legal basis for real-estate-related macroprudential tools to better contain potential future excesses.*
- *Improve financial sector oversight and macroprudential policy analysis by enhancing data collection.*
- *Implement measures to strengthen the oversight role of banks' supervisory boards by increasing their responsibilities and tightening member qualifications standards.*
- *Together with the European competent authorities, complete the new bank resolution and crisis management agenda, as Germany is home to globally systemic institutions.*

1. Germany will remain on a moderate growth path in 2016 as strong domestic demand is offsetting weak foreign demand. A sizable fiscal expansion, further ECB monetary stimulus, and the continued effect of lower energy prices should more than compensate for lower demand from key advanced and emerging countries. Private consumption should continue to be dynamic as a strong labor market boosts real disposable income and credit keeps growing above trend, while residential investment should respond faster than in the recent past to surging housing demand. Core and headline inflation are expected to get close to 2 percent only in the medium-term as labor cost increases slowly pass through to prices. Given the large monetary and fiscal stimulus in the pipeline, growth could surprise on the upside. On the downside, a further slowdown in external demand, an erosion of confidence in the European project in parts of Europe, and a rekindling of stress in euro area sovereign bond markets are important risks to the outlook.

2. The current account surplus is projected to stay near record levels this year. Even though the growth contribution from net exports is expected to turn negative, favorable terms of trade effects will prevent the surplus from falling more rapidly. The persistent current account surplus reflects a combination of high savings and limited domestic investment partly due to modest medium term growth prospects and the risks to the outlook. Owing to a persistently sizable surplus over the medium-term, the net international investment position will continue to grow rapidly, reaching almost 90 percent of GDP by 2020.

3. A sizable expansion in government spending this year will be partly financed by revenue gains from a buoyant labor market and growing domestic demand. The new spending will go to social transfers, asylum-seeker and refugee assistance, and, to a smaller extent, public investment. Some income tax relief is also being implemented. All in all, the fiscal stimulus is expected to amount to close to 1 percent of GDP. Should revenues overperform, as they have in recent years, then the additional financial resources would best be used to promote further investment. In the medium run, the budget balance is expected to return to a surplus partially on account of declining interest payments, with the public debt ratio falling below 60 percent of GDP by 2020. The structural fiscal balance is expected to remain above the Stability and Growth Pact's Medium Term Objective of -0.5 percent of GDP.

4. A stronger effort is needed to efficiently address the public infrastructure needs, which will also require tackling administrative constraints. As public investment was low for many years, particularly at the municipal level, the capacity for planning and execution of new projects has suffered, which, together with more cumbersome regulatory requirements, is holding back a more vigorous investment effort. We urge the authorities to rapidly remove these bottlenecks. In this regard, the planned reform and expansion of the *Partnerschaften Deutschland* agency will be helpful. The creation of a federal transportation agency, financed through user fees, would also be important for a more efficient maintenance and upgrading of the federal roads system. Recent initiatives to stimulate private investment in fast broadband infrastructure, an area where Germany lags behind many peers, as well as complementary measures to foster venture capital and e-procurement, are welcome.

5. The projected decline in the labor force due to aging after 2020 calls for measures to boost labor supply in the medium term. Additional policies to integrate the current wave of refugees into the labor market, to broaden opportunities for full-time employment of women, and to extend working lives, would be important in this regard. These reforms would not only counter the projected growth decline in the medium term but also stimulate private consumption and investment in the short term.

6. Although many supportive measures have been taken and more are underway, further policy actions are recommended to promote a successful labor market integration of refugees. The government has helpfully removed a number of restrictions to access to employment and training for asylum-seekers and persons with a temporary suspension of deportation. Policy measures to allow recognition of informally acquired skills and facilitate more flexible forms of vocational training, with a strong on-the-job component and intensive language teaching, should be strengthened. In parallel, active labor market policies (such as temporary wage subsidies) that have proven successful in the past in other countries should be further enhanced. Lastly, the decision on how much to raise the minimum wage next year should take into account the challenge of integrating the refugees.

7. To further boost female labor supply, enhanced childcare and after-school programs should complement a reduction in the marginal tax burden on secondary earners. While female labor force participation is relatively high in Germany, almost half of employed women work only part time. Closing this gap would stimulate labor supply and employers' provision of on-the-job training, yielding productivity gains over time. Financial support for the expansion of childcare provision has increased over the recent years, and should be used to improve availability of high-quality full-time programs. Incentives to increase hours worked would also be raised by moving towards a system in which health insurance contributions depend on the number of adult household members covered, with targeted support for lower income households. Marginal tax wedges should be lowered to incentivize greater labor supply by women and other groups.

8. Pension reforms to promote longer working lives can bring the double dividend of increasing employment while reducing old-age poverty. As the old age dependency ratio is expected to rise, pressures on public finances will intensify. Existing automatic adjustment mechanisms to ensure the sustainability of the public pension system will give rise to sustained increases in contribution rates (pushing up the already high tax burden on labor) and declines in pension benefits (reducing old-age incomes). By extending working lives, a more adequate level of old-age income can be maintained, without a further rise in pre-retirement savings. To this end, indexing the retirement age to life expectancy and making the choice to remain in the labor force actuarially neutral would be helpful.

9. Competition-enhancing reforms in the services sector should be pursued much more vigorously. Progress on this front has been particularly slow, and is badly needed in light of low productivity growth. Infringement procedures by the European Commission regarding the minimum compulsory tariffs of architects and engineers have not been followed by any action yet. The long-awaited Act to Strengthen Competition in the Railway Sector has been under discussion for over three years. Meanwhile, the market share of new entrants in the long-distance rail passenger market segment has remained below 1 percent. Competition in postal services is still hindered by the ultra-dominant position of the domestic incumbent.

10. Even though price dynamics in hot spots deserve close monitoring, concerns about a housing bubble look premature. In recent years, the upward price trend has been largely driven by fundamental factors such as demographic developments, rising incomes, ratcheting up construction costs, and the greater relative attractiveness of the largest cities where the supply response has been particularly sluggish, as well as lower mortgage rates. Mortgage credit growth has also been trending up, but at a moderate pace with largely unchanged credit standards overall. To be ready to address potential imbalances, granular and timely data on a loan-to-loan basis should be collected, and the legal basis for macroprudential tools specifically targeted at the real estate sector should be established rapidly.

11. The government's policy package to help housing supply adjust to higher demand in the affordable segment is welcome. The main constraint to a greater housing supply response in areas under pressure is the availability of building land. A particular focus on increasing the availability of publicly-owned land as well as on loosening height and zoning restrictions in those areas and their vicinity is thus needed. The implementation speed and effectiveness of the package, which requires close cooperation between all levels of government, should be closely monitored. The authorities should stand ready to reinforce the measures if the desired effects on supply do not materialize. In parallel, the efficiency of real estate taxation could be improved by a combination of increasing property tax (through a long overdue update of property values) and reducing the real estate transfer tax rate. The latter measure would have the additional benefit of further incentivizing new construction.

12. The banking sector needs to adjust to a prolonged period of low interest rates. In addition to low interest rates, low profitability reflects various combinations of persistent crisis legacy issues, provisions for compliance violations, the need to adjust business models to the post-crisis regulatory environment and technological change, as well as long-standing structural inefficiencies. While restructuring efforts at large banks still need to bear fruits and cost-cutting remains slow, fee-based activities are picking up in the smaller banks—an encouraging sign. Risk-based solvency measures indicate substantial capital buffers on aggregate, and non-performing loans are generally low and declining. However, some institutions remain highly leveraged.

13. Prolonged low interest rates erode life insurers' ability to meet guaranteed commitments in the future. Supervisors need to closely monitor the sector, demand action plans from firms in difficulty, and keep safety net arrangements under review. Long transitional measures are allowed under the new EU Solvency II framework, and many life insurers are expected to rely on such measures—in particular those with a higher share of traditional products, lower trend profitability, and lower unrealized gains on the asset side. Authorities have appropriately re-focused their supervisory priorities on these firms. They should prepare a communication plan in coordination with the industry ahead of the publication of the new solvency measures in 2017, to explain the effect of the transition to Solvency II to various stakeholders.

14. The Germany FSAP analysis indicates that the Single Supervisory Mechanism and Single Resolution Mechanism have had a positive impact. Nonetheless, further enhancements in several areas should be high on the agenda of all the relevant authorities at the national and European level. First, the lack of comprehensive and granular supervisory data negatively affects all aspects of financial supervision and risk monitoring. Second, as the supervisory landscape evolves, supervisors need to communicate their expectations to banks—including on strengthening the oversight role of supervisory boards, internal control and audit, related party exposures, and operational risk—and develop guidelines and regulations that can be used to substantiate enforceable measures. Third, resolution planning for large banks with cross-border operations should be rapidly completed. Fourth, clarifying the necessary coordination arrangements involving the European and domestic authorities to handle a systemic crisis should be a key priority.

15. Large global banks are withdrawing from correspondent relationships in a number of countries. To prevent excessive curtailment of financial activities with emerging and developing economies, the authorities should encourage the relevant German banks to better manage the risks around these activities. They should also strengthen the dialogue and cooperation among national supervisors, including to harmonize regulatory frameworks and facilitate cross-border information sharing on customer due diligence.

The mission thanks the authorities for their cooperation and willingness to engage in extensive and frank policy discussions.

The views of the mission also reflect the findings of the Financial Sector Assessment Program (FSAP), which was conducted by the IMF over the period November 2015-March 2016. Countries with financial sectors that are considered systemically important, such as Germany, must undertake a mandatory stability assessment every five years.