INTERNATIONAL MONETARY FUND

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GERMANY

2012 ARTICLE IV CONSULTATION

July 2012

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 2012 Article IV consultation with Germany, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 8, 2012, 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 June 14, 2012. 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.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its June 29, 2012 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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GERMANY

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

June 14, 2012

KEY ISSUES

Growth prospects and risks: Several conditions are in place in Germany for a domestic demand-led recovery although the outlook is subject to considerable risks. The main risk facing Germany is an intensification of the euro area crisis, which would spill over into Germany through real and financial channels. Lower global growth prospects or a sharp rise in oil prices also pose risks to the outlook.

Managing the transition to domestic demand-led growth: The fiscal stance is appropriate under the baseline. The underlying strength of the labor market is expected to underpin domestic demand-led growth. In this regard, a pick-up in wages and asset prices should be seen as part of the natural process of private sector-led rebalancing.

Unfinished financial sector reform agenda: Continued progress on financial sector reforms would help guard against shocks. In particular, it will be important to ensure that risks from the global activities of the large German banks are fully understood and internalized, which would require strengthening cross-border supervision and cooperation. Greater efforts are also needed in restructuring the *Landesbanken* and reforming their business models, strengthening the crisis management framework and enhancing the deposit insurance regime. Steps to establish a framework for implementing macroprudential policies are also timely, although there is no need to tighten macroprudential policies at this juncture.

Germany's role in an interconnected world: Articulating more clearly the Economic and Monetary Union's shared vision of the post-crisis architecture will help in restoring market confidence. In addition, the positive short-run benefits of the implementation of ambitious structural reform agendas in several euro area countries could be complemented with pan-European actions, such as using EU structural funds more flexibly and increasing the lending capacity of the European Investment Bank. Overall, Germany's external position remains substantially stronger than that implied by medium-term fundamentals and global economic policy settings. With disinflationary pressures incipient in the periphery economies over the medium term, and monetary conditions in Germany accommodative from a cyclical perspective, inflation in Germany could be somewhat higher than the euro area average, which would help narrow the competitiveness gap between the economies at the core and in the periphery. Beyond this natural process, implementing policies to encourage higher investment and increase potential growth through domestic sources could play a role.

Reforms to raise potential growth and diversify its sources: Policies need to focus on increasing the labor force, raising the quality of human capital, and raising the productivity in the services sector. Efforts should also be stepped up to broaden the sources of financing to encourage innovation and new engines of growth. Raising potential growth and rebalancing its sources would also have beneficial spillovers to the rest of the euro area.

Approved By
Rodrigo Valdés (EUR) and Tamim Bayoumi (SPR)

Discussions took place in Frankfurt, Bonn, Munich, and Berlin on April 24–May 8, 2012. The staff team comprised Mr. Lall (Head), Ms. Ivanova, and Mr. Bornhorst (all EUR), Ms. Luedersen (LEG), Messrs. Kiff (MCM), Vitek (SPR), and accompanied by Mr. Temmeyer (OED). Mr. Valdés (EUR) attended the concluding meeting. The mission met with Bundesbank President Weidmann, Minister of Finance Schäuble (who chaired the concluding meeting), other senior officials; and financial sector, industry, and think-tank representatives.

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INTRODUCTION

1. **Despite facing considerable headwinds, the performance of the German economy has been remarkable**. Employment creation has been strong and unemployment has declined to post-reunification lows, in the face of a very challenging external environment. The contraction in activity in the last quarter of 2011 was followed by a sharp rebound in Germany early this year, helping the euro area avoid a technical recession. Several conditions are now in place in Germany for a domestic demand-led recovery. Underpinned by healthy corporate and household balance sheets, higher wages, well anchored inflation expectations, and low borrowing costs, growth is poised to reach potential in the second half of 2012.

2. **Policies need to guard against risks to the recovery**. The main risk facing Germany is an intensification of the euro area crisis, which would spill over into Germany through real and financial channels. Lower global growth prospects more broadly or an abrupt rise in oil prices due to geo-political shocks are also key downside risks to the outlook.

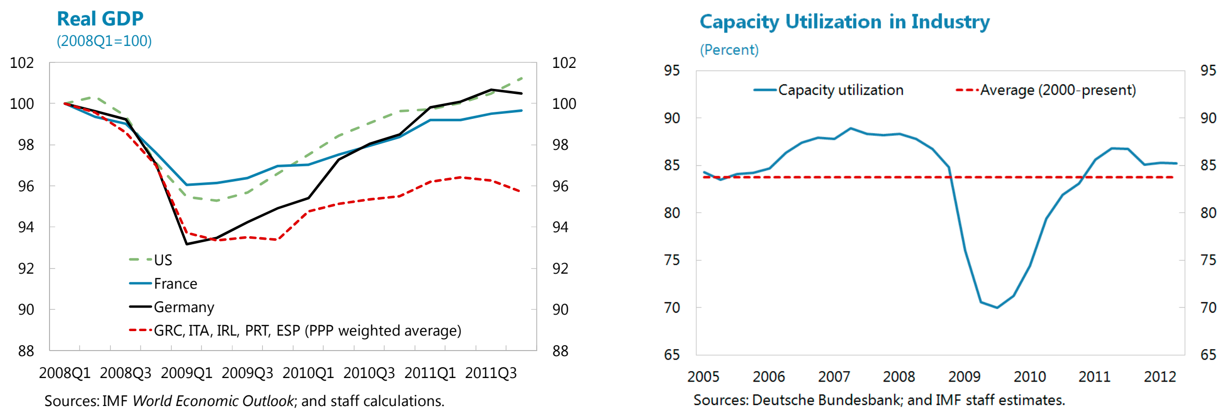
3. **Over the medium term, raising potential growth and its resilience need to be viewed in a multilateral context**. Germany is one of the world's most open large economies, making it susceptible to external developments in both the euro area and more broadly. Germany can play a pivotal role in addressing the challenges faced by the euro area, in addition to implementing its own structural reforms, to secure the region's stability and raise its growth potential.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. The Economic and Financial Context

4. **Economic growth appears to have bottomed out.** Financial market turbulence and weakening external demand led to a broad-based contraction of activity in Germany in the last quarter of 2011, with the notable exception of construction. Activity picked up in the first quarter of 2012, due to a rebound in external demand and strong consumption growth. Germany's cyclical position is more advanced than other large industrialized economies, and the output gap is expected to close in 2012 (Figure 1).

Germany's Strong Rebound



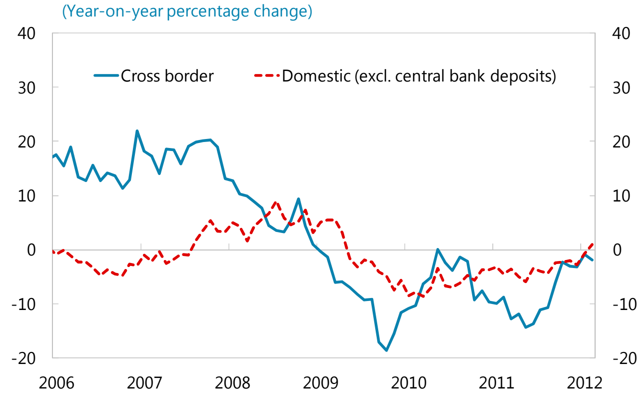
5. **The labor market is exceptionally strong.** Employment growth has been underpinned by higher labor force participation and an increase in net migration, and unemployment at 5.3 percent is at a post-reunification low. Helped by the reforms implemented in the 2000s, the labor market is trending towards a lower natural rate of unemployment, and since 2010, the creation of jobs with full social security benefits has grown faster than atypical employment. Reflecting the tighter conditions, wage growth has picked up. While nominal pay rates increased by about 2 percent in 2011, the normalization of working hours and significant one-off payments have pushed overall wage growth to near 3 percent (Figure 2).

6. **Fiscal consolidation is on track.** The overall deficit narrowed to 1 percent of GDP last year (from 4.3 percent in 2010), reflecting in part the phasing out of one-off financial sector support measures. The structural balance improved by about 1¼ percent of GDP in 2011, reflecting the withdrawal of stimulus and consolidation measures, including unwinding of temporary tax and labor market measures, the removal of some exemptions, and reductions in social spending and administrative costs. Overall, however, the financial crisis has led to an increase in public debt from 65 percent of GDP in 2007 to 81 percent in 2011, including due to financial sector support operations.

7. **The persistent capital outflows from Germany have reversed course markedly reflecting developments in the European periphery and risks to the global economy.** German banks have withdrawn from Europe's cross border interbank market and investment positions in economies under stress are being unwound. With strong demand for safe assets, German government bond yields have declined to record lows. The net private inflows into Germany are reflected in an increase in the Bundesbank's claims on the Eurosystem, which had risen to €644 billion by April (approximately 24 percent of GDP).

Interbank Lending by German Banks

(Year-on-year percentage change)

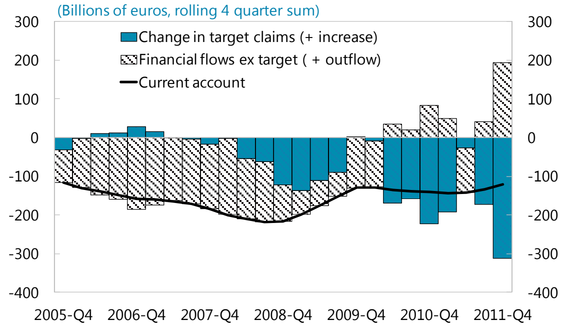


Sources: Deutsche Bundesbank; and IMF Staff calculations.

Financial Account Reversal in the Euro Area

Current and Financial Account of Greece, Ireland, Italy, Portugal and Spain

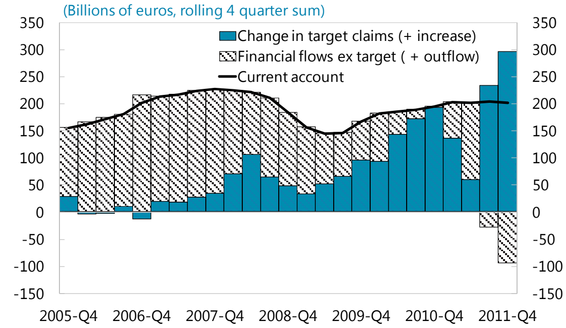
(Billions of euros, rolling 4 quarter sum)



Sources: Haver Analytics; IFS; and IMF staff calculations.

Current and Financial Account of Germany, Finland, and The Netherlands

(Billions of euros, rolling 4 quarter sum)

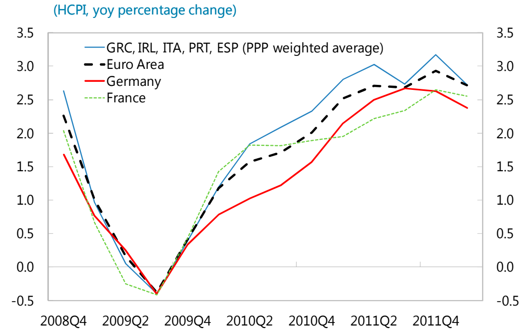


Sources: Haver Analytics; IFS; and IMF staff calculations.

8. **Higher inflation in recent quarters has mainly reflected the rise in energy prices.** Headline inflation has fallen to 2.2 percent in April 2012, in line with the moderation of fuel price increases, while core inflation remained low at 1.4 percent (y/y, ex energy, food, alcohol, and tobacco). Medium term price expectations remain well anchored below 2 percent, as implied by the break-even interest rate differential on 5-year Bunds (Figure 1).

Inflation in the Euro Area

(HCPI, yoy percentage change)



Sources: Haver Analytics; and IMF staff calculations.

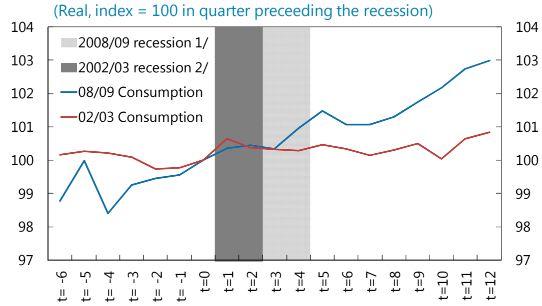
9. **Household and corporate balance sheets are healthy, and asset price developments remain benign.** Leverage in the household sector is low in comparison to other euro area economies, and indeed has fallen recently. Meanwhile, corporate profitability is high and debt-to-income ratios are lower than the euro area average. Equity prices in Germany have rebounded broadly in line with international comparators, and reversed some of the losses of the second half of 2011. Bond yields for banks and the public sector are at record lows, while yields for corporate bonds have remained largely flat. Nationwide house prices have risen moderately (1-4 percent in 2011) following years of stagnation, with stronger localized increases in some areas, spurring construction activity.

B. Outlook and Risks—Domestic Demand-Led Growth but External Risks Remain

Staff's Views

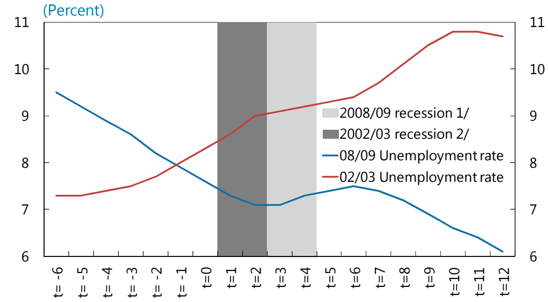
10. **Several elements are in place for a private sector-led rebound**. The recovery from the 2008/09 recession has already shown the resilience of consumption, underpinned by the strong labor market. Strong growth in Q1 is also encouraging, but the genuine switch to a domestic-led growth is yet to be seen. With rising household income and stable employment, strong balance sheets among households and firms, and a supportive financing environment, both consumption and investment, including residential investment, are expected to gather pace and propel growth to around potential by the second half of 2012. For the year as a whole, activity is expected to expand by 1 percent in 2012, and rise further to 1.4 percent in 2013 (Figure 1). Reflecting Germany's advanced cyclical position, net foreign demand is expected to contribute significantly less to growth in 2012 and 2013 compared to previous years. With structural gains in employment having largely run their course and demographic pressures taking hold, the pace of employment creation is expected to fall to near zero over the medium term, and the decline in the unemployment rate is expected to level off. In view of the loose monetary conditions for the euro area as a whole, the economy is projected to operate at slightly above capacity in the medium term. Consistent with these dynamics and a healthy growth in wages, headline inflation is projected to settle slightly above 2 percent.

Private Consumption
(Real, index = 100 in quarter preceeding the recession)



Sources: Haver Analytics; Federal Statistical Office; and IMF staff estimates.
1/ Lasts 4 quarters.
2/ Lasts 2 quarters.

Unemployment Rate
(Percent)



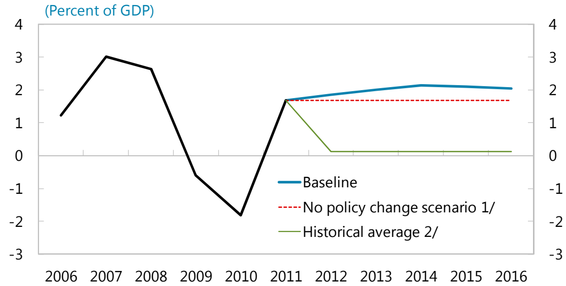
Sources: Haver Analytics; Federal Statistical Office; and IMF staff estimates.
1/ Lasts 4 quarters.
2/ Lasts 2 quarters.

11. **The downside risks to the near-term outlook are mainly external.** The baseline outlook is predicated on less volatile financial conditions and improving prospects for some of Germany's large trading partners. There are, however, numerous interrelated risks surrounding this baseline:

- **The German economy is heavily exposed to an intensification of the euro area crisis.** Given its high trade and financial openness, together with still significant cross-border bank exposures (see Policy Theme #2, Figure 6, and Box 4), an escalation of financial stress and further deterioration of confidence in the euro area periphery could lead to a sharp downturn in Germany. Under such an adverse scenario, domestic banks are likely to face higher funding costs and may incur trading losses; private demand would be reduced due to tighter financing conditions and deteriorating consumer and business confidence, while exports would suffer from weaker external demand. Depending on the precise nature of the shock, an intensification of the crisis could also lead to more abrupt deleveraging by the banks, and unlike in the baseline, this may involve a sharp cutback of banks' lending domestically.
- **Broader downside risks relate to a slowdown in global growth or a sharp rise in oil prices**. Given Germany's direct trade linkages, particularly with the United States and Asia, an unanticipated slowdown in activity would directly lower the demand for Germany's exports, in addition to the indirect linkages through other euro area trading partners. A sharp rise in oil prices due to geo-political factors would depress aggregate demand and put upward pressures on prices. More medium-term risks relate to a slowdown in potential growth if progress on structural policies proves insufficient. Lower growth would also have negative consequences for public debt, which is highly sensitive

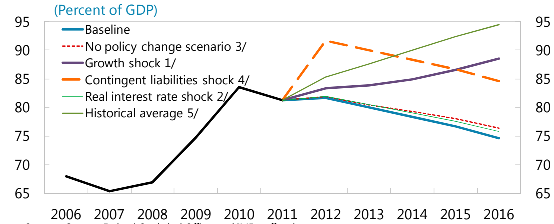
to growth dynamics. The risk that accommodative monetary conditions lead to a mispricing of assets is seen as low at the current juncture.

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.

The Authorities' Views

12. **The authorities broadly agreed with the staff's baseline.** They concurred with staff that conditions for a rebalancing of the economy towards domestic demand are in place, noting the strong performance of the labor market and sustained gains in real disposable income. The authorities were of the view that over the medium term, the net contribution of foreign demand to growth could approach zero. The authorities also shared staff's view that anticipated wage and price increases are part of the rebalancing of the German economy, and could help the euro area more broadly.

13. **The authorities assessed the downside risks somewhat differently and noted some upside potential.** They saw the identified risks as being of low probability, but rightly noted that several of them are interrelated and could materialize at the same time. They also noted another medium term risk stemming from insufficiently ambitious policies in the euro area, should they lead to contingent pressures on Germany's public finances or delayed progress on the needed restructuring of financial sectors in the euro area. On the upside, the authorities noted that growth may turn out to be higher as uncertainty recedes more quickly than anticipated and factors such as higher migration raise the economy's growth potential.

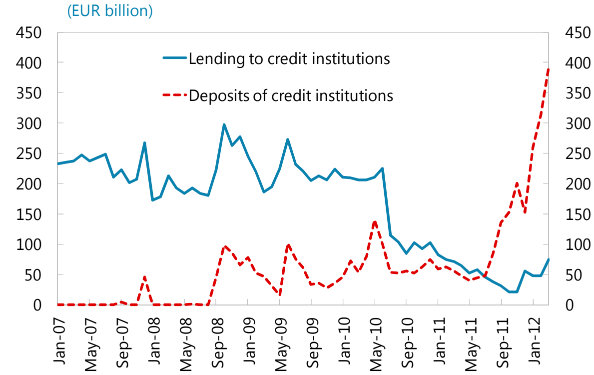
POLICY DISCUSSIONS

A. Policy Theme #1: Steering the Recovery in an Uncertain Environment

Background

14. **The 2012 budget implies a modest fiscal withdrawal, less than half of that last year.** Staff estimates an improvement of about ½ ppt of GDP in the structural balance, but automatic stabilizers are expected to operate fully. Consolidation plans envisaged for 2013 and beyond have been scaled back, given the strong performance last year. Germany, however, is well on track to achieve the national fiscal rule target of a deficit not exceeding 0.35 percent of GDP for the federal government from 2016 and a balanced budget for the *Länder* from 2020. The fiscal path is also likely to be in line with the requirements of the pan-European Fiscal Compact, since the German structural fiscal deficit is expected to fall below 0.5 percent of GDP already in 2013.

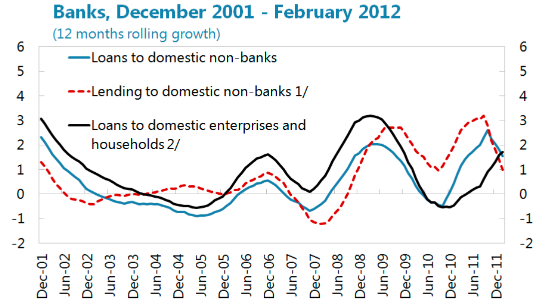
Selected Items of the Bundesbank's Balance Sheet



Source: Deutsche Bundesbank.

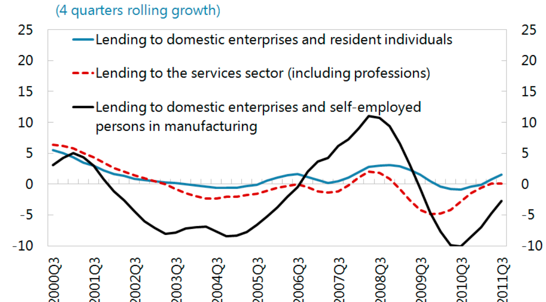
15. **Despite ample liquidity, credit growth remains moderate.** Bank balances with the Bundesbank are high, and lending rates are lower than elsewhere in Europe. German banks have also used LTRO funds both in December and February though the uptake was rather small despite the large number of participating banks. Nevertheless, the rise in bank lending is moderate, reflecting still low demand from households and firms.

Germany: Lending to the Economy by German Banks, December 2001 - February 2012



Sources: Deutsche Bundesbank; and IMF staff calculations.
1/ Includes negotiable money market paper, securities, equalisation claims
2/ Includes bills of exchange

Germany: Lending to Various Sectors by German Banks, Q4 2000 - Q4 2011



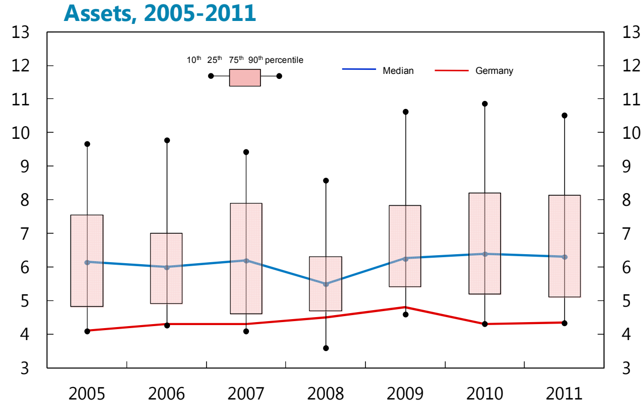
Sources: Deutsche Bundesbank; and IMF staff calculations.

16. **The strength of German banks has improved but vulnerabilities remain.** German banks are generally meeting the minimum levels of required regulatory capital and have ample liquidity. However, some remain highly leveraged and dependent on wholesale funding, have low capital quality and profitability (Figure 5), and some institutions are significantly exposed to the euro area periphery. Six larger banks were called upon to strengthen their capital position as a result of the latest European Banking Authority's (EBA's) stress test, and are well on their way to meet EBA requirements (one bank is in the process of being wound down). Some large international financial institutions also have substantial cross-border operations, and significant counterparty risk exposures related to their large derivative portfolios. As banks seek to deleverage, they are focusing on reducing exposures outside their core business lines and regions, generating outward spillovers. German banks have made some progress on raising core capital in line with Basel III, and in meeting the new liquidity and leverage ratios.

17. **As a backstop, the financial stability support mechanism (SoFFin II) was reintroduced on a preemptive basis with an overall amount of €480 billion available through end-2012.** Outstanding balances of public financial support to banks under the original Special Fund for Financial Market Stabilization (SoFFin I) continue to decline. Capital support to banks has been reduced by about one third, and few liquidity guarantees remain outstanding. The size of the portfolios of the two winding-up institutions remains high at just under 10 percent of GDP and a further increase is anticipated by mid-year with the transfer of a residual portfolio of non-core assets as part of the restructuring of a large *Landesbank*. As of end-2011, operational losses of SoFFin I are estimated at €22.1 billion, approximately half of it linked to the restructuring of Greek sovereign bonds.

18. **The institutional framework for macroprudential policies is evolving.** Building on initial recommendations set out in the authorities' 10-point plan, which envisaged a stronger role for the Bundesbank in macroprudential supervision, a recent legislative initiative proposes a Financial Stability Commission (FSC) for crisis management coordination and to address financial stability risks, to be established by early 2013. The FSC will comprise the Federal Ministry of Finance (BMF), the Bundesbank, the financial

Advanced Economies and Germany: Capital to Assets, 2005-2011



Source: IMF *Global Financial Stability Report*.

supervisor (BaFin), and a non-voting representative from the Federal Agency for Financial Market Stabilization. The FSC will be chaired by the BMF and draw on the financial stability analysis prepared by the Bundesbank. While no menu of instruments for macro-prudential purposes has been defined yet, and discussions are ongoing at the European level, measures such as prescribing effective loan-to-value ratios for mortgages and adjusting capital buffers (e.g., countercyclical capital buffer, systemic risk buffer) are under consideration.

Staff's Views

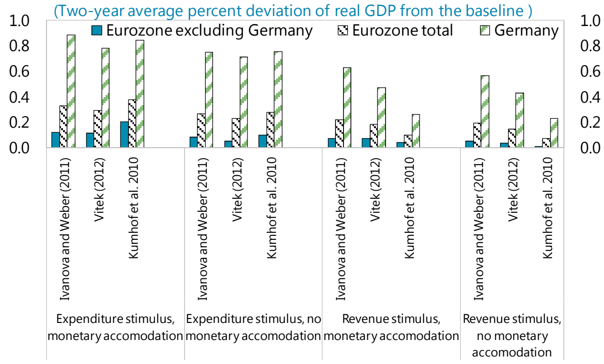
19. **The formally limited fiscal room should be deployed carefully under the baseline.** Within the constitutionally binding fiscal rule, the available fiscal room in 2012 is estimated at around ½ percent of GDP, unless the escape clause is invoked under exceptional circumstances. Fiscal spillovers from Germany would contribute only a small amount to real GDP growth in the rest of the euro area, concentrated in small and open neighboring countries (the Czech Republic, Austria, the Netherlands and Belgium) with limited impact on the euro area periphery economies (Box 1). Even in the absence of the fiscal rule, the benefits to the euro area periphery of a greater fiscal expansion in Germany would be limited. Moreover, Germany's status as a guarantor of the EFSF/ESM and potentially large contingent liabilities associated with the resolution of the euro area crisis, and medium-term concerns about aging pressures, also weigh on the room for short-term stimulus. In light of these considerations, and with the virtually closed output gap under the baseline, a deviation of fiscal policy from the 2012 budget is not called for, although automatic stabilizers should be allowed to operate fully. Any available fiscal resources could, instead, be used to facilitate reforms in the euro area periphery, including through increasing the lending capacity of the European Investment Bank, and enhanced and better targeted EU structural funds. This could help stabilize the external environment facing Germany over the medium term and facilitate reforms in the periphery economies.

Box 1. Fiscal Spillovers[1]

Fiscal stimulus in Germany is likely to have a relatively small impact on the rest of the euro area. The results presented in Figure 1 are based on three alternative approaches described in Ivanova and Weber (2011), Vitek (2012) and the GIMF model described in Kumhof et. al. (2010). These simulations suggest the maximum impact of a two-year 1 percent of GDP fiscal stimulus in Germany on the rest of the euro area at 0.2 percentage points if all the stimulus is concentrated in public investment and accommodated by monetary policy. In contrast, the impact on German domestic GDP can be potentially quite large ranging between 0.7 and 0.9 percent of GDP on average over two years, if stimulus is concentrated in public consumption and investment.

The Impact of Fiscal Stimulus in Germany on Eurozone GDP

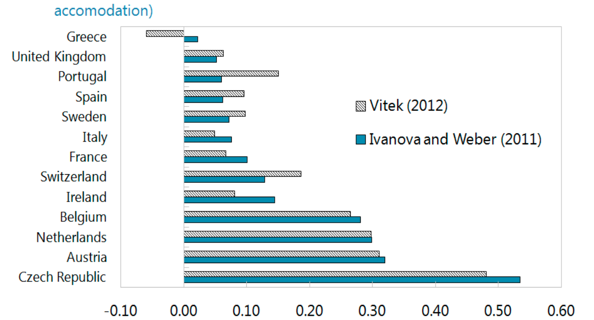
(Two-year average percent deviation of real GDP from the baseline)



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

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.

Fiscal spillovers from Germany are concentrated in small and open neighboring countries while the impact on the euro area periphery is limited. Economies with whom Germany has strong trade links, such as the Czech Republic, Austria, the Netherlands and Belgium are estimated to benefit most from a German fiscal stimulus. In contrast, the impact on real GDP in Greece, Italy, Ireland, Portugal and Spain is estimated not to exceed 0.15 percent with a particularly small impact on Greece given the offsetting monetary tightening that a procyclical fiscal loosening in Germany would entail. The relatively small fiscal spillovers to the euro area periphery in Ivanova and Weber (2011) can be explained by the relatively weak trade links with those countries that are relatively small compared to Germany (Greece, Portugal) while the countries with relatively stronger trade links (Italy and Spain) are also the ones that are closer to Germany in economic size. Spillovers can thus be expected to be small as only a portion of fiscal stimulus in Germany is transferred to these countries. Ireland is relatively small and has relatively strong trade links with Germany, implying larger spillovers.

[1] This box was prepared by Anna Ivanova (EUR), Stephen Snudden (RES) and Francis Vitek (SPR). The three alternative methodologies are explained in Ivanova, A. and S. Weber (2011), "Do fiscal spillovers matter?" IMF working paper WP/11/211; Kumhof, M., D. Laxton, D. Muir and S. Mursula, 2010, "The Global Integrated Monetary Fiscal Model (GIMF) --- Theoretical Structure", IMF Working Paper 10/34 (February 2010); and Vitek, F. (2012), "Policy analysis and forecasting in the world economy: A panel unobserved components approach", *International Monetary Fund Working Paper*, forthcoming.

20. **Only in the event of a renewed downturn would more active fiscal policies be needed.** Under such circumstances, and 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 activity and employment in Germany and help stabilize the euro area. To be timely and effective, a contingency plan should be developed, prioritizing revenue and expenditure measures with the highest payoff that could be quickly implemented. In the event of a negative shock, priority should be given to measures that could also spur long-term potential growth, including reduction in labor and corporate income taxes, and reorientation of social spending towards education and childcare support. The labor market could be supported through an expanded short work scheme.

21. **Ensuring financial stability remains a key priority.** In particular, it will be important to ensure that risks from the global activities of the large German banks are fully understood and internalized. In this regard, strengthening cross-border supervision and cooperation will be important. Some institutions, including the *Landesbanken*, remain vulnerable to increases in wholesale funding costs. The pre-emptive reactivation of the financial stability support mechanism (SoFFin II) is welcome as a backstop to limit the impact of deleveraging on the domestic economy and in other countries where banks retain significant exposures, and to ensure the system's stability, if downside risks materialize. The banks identified as having a capital shortfall are expected to comply with EBA requirements without resorting to Soffin II. Looking ahead, meeting Basel III requirements will create further pressure on banks to strengthen their balance sheets.

22. **Some progress has been made on the implementation of the 2011 FSAP Update recommendations, but much work remains (text table).** The current favorable macroeconomic conditions provide an opportunity to accelerate reforms. Among the key priorities, overall momentum in the reform of the *Landesbanken* needs to be stepped up, the crisis management framework should be strengthened by establishing resolution plans, and the challenges inherent in the fragmented deposit insurance regime should be addressed.

23. **Macroprudential policy frameworks should be put in place, but policies should not be tightened at this juncture.** Establishing a financial stability committee is a welcome step, and its independence from potential political influence should be ensured in line with the recommendations by the European Systemic Risk Board (ESRB). There is however no need to tighten macroprudential policies at the current juncture, and the near-term priority is to support the rebound of domestic demand accompanied by a natural relative price adjustment process.

The potential deployment of additional macro-prudential instruments in the future will need to take into account ESRB guidelines and be regionally consistent.

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.	Further stress testing improvements have been made to ensure forward-looking monitoring of institutions' balance sheet strength, and BaFin was calling for corrective action when weaknesses were found.
Grant supervisors power to vet in advance bank acquisitions of subsidiaries.	Legislative initiatives on this matter are not expected in the near term.
Define the role of the Bundesbank as macroprudential supervisor, and institute free exchange of information between macro and microprudential supervisors.	The adoption of legislative proposals for the establishment of a Financial Stability Commission (FSC) is expected by end year, including clarification of the roles and responsibilities of institutions and rules on information sharing.
Continue to strengthen on-site supervision.	Important progress has been made on reducing securities market supervision over-dependence on external auditors, but the banking supervisor does not anticipate changes in this area.
Review reporting requirements to ensure timely and systemic information is available on emerging risk factors.	Proposals to strengthen reporting requirements are being developed, with implementation expected in 2013.
Institute a harmonized and legally binding deposit guarantee of €100,000, backed by adequate prefunding.	For the mutual protection schemes, establishing a legally binding deposit guarantee of €100,000 in addition to mutual protection arrangements is being considered. However, no concrete action is expected before the conclusion of the discussions at European level, including on ex ante funding levels. Complementing the statutory coverage of €100,000, the coverage level under the commercial banks' private deposit protection scheme remains high despite a reduction over time from currently 30 percent of a bank's capital per depositor to 8.75 percent in 2025.
Ensure the financial strength of the new bank restructuring fund, and clarify the interaction between the restructuring fund and the various deposit guarantee and mutual protection schemes.	Contributions to the restructuring fund in 2011 were at the lower end of expectations, and are forecast to be even less this year, while contingency arrangements remain in place. 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.

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 proceeding only in a gradual manner. The restructuring of a large *Landesbank* is expected to be completed by mid-year. There are no plans to loosen regional constraints on local banks, open up the public banks to private participation, and reduce noncommercial influences.

The Authorities' Views

24. **The authorities see continued fiscal consolidation in Germany as a key credibility anchor in Europe.** They do not see any need or space for fiscal relaxation in Germany given favorable macroeconomic developments, small potential spillovers to the southern euro area periphery, and the constraints of the fiscal rule. The authorities also pointed out the potentially negative implications in the periphery economies if the ECB were to tighten monetary policy in response to fiscal relaxation in Germany given its cyclical position. They also saw the role of Germany as a fiscal anchor in the euro area as a strong motivation for delivering on their fiscal commitments. The authorities do not see the immediate need to have a contingency plan for a fiscal stimulus, and view the experience with the stimulus during the past crisis, which relied to some extent on capital expenditure, as a mixed success.

25. **The authorities were in broad agreement with the staff's assessment of the financial system**. They agreed that strengthening cross-border regulation and supervision will be important. They see the banks well on their way towards Basel III implementation and see EBA capital requirements as within close reach, but agreed that more progress on financial sector reforms is needed. The authorities share the staff's view on the importance of stress testing and the need for forward-looking monitoring of banks' balance sheet strength, and recognize the merits of strengthening reporting requirements. Concerning initiatives to vet in advance bank acquisitions of subsidiaries, the authorities expressed some reservations on potential interference with bank business interests. Further reforms of the business models of the *Landesbanken* were deemed useful but challenging given the need to attain consensus at the sub-national level.

26. **The authorities agreed with the recommendation to establish a macroprudential policy framework, and shared the view that there is no need to tighten macroprudential**

policies at the current juncture. The authorities expect to move forward quickly with the establishment of the FSC, well within the timetable set by the ESRB for mid-2013. The authorities envisage coordinating macro-prudential instruments consistent with European Union initiatives.

B. Policy Theme #2: Securing Higher and Stable Growth in an Interconnected World

Germany in an Interconnected World

27. **Background.** Germany has close links with the euro area through the common currency, which facilitated trade and closer financial integration, and as a regional safe haven (Box 2). More broadly, trade as a share of German GDP has risen from 62 percent in 2000 to 94 percent by 2011, in part reflecting in particular burgeoning Eastern European supply chains and higher exports to Emerging Asia. Financial linkages are also extensive, including through the cross-border activities of German banks and exposures to the Eurosystem (Target 2) of about 24 percent of GDP as of end-April 2012.

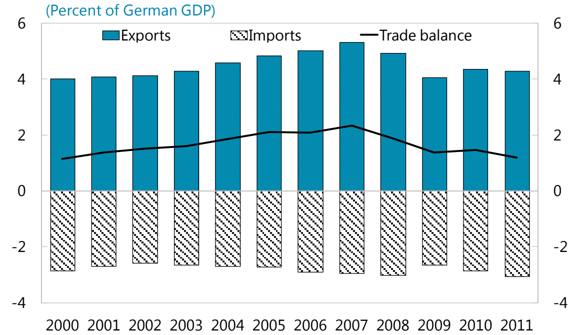
Staff's Views

28. **The German economy is sensitive to macroeconomic and financial market developments in the rest of the world.** Due to its high and rising trade and financial openness, business cycle dynamics in Germany are driven in large part by foreign shocks (see Box 3 and Vitek 2012). Trade linkages with the United States, United Kingdom and emerging Asia are particularly important in transmitting macroeconomic shocks. Trade linkages within the euro area are significant, but the transmission of shocks through this channel is mitigated somewhat by monetary policy stabilization within the currency union. Regarding financial shocks, the United States, United Kingdom and Japan are important from a portfolio channel, while banking sector linkages and related flows are important within the euro area and with the United States and the United Kingdom.

Box 2. Balance of Payment Linkages to Greece, Ireland, Italy, Portugal, and Spain

Germany's current account surplus with select economies—Greece, Italy, Portugal, and Spain—has fallen back to levels observed before the boom period of 2005–07. Following the demand adjustment in these economies, their deficits with Germany fell by about half from its peak in 2008 back to levels observed in 2004. Given the demand driven nature of the boom and subsequent adjustment, exports from Germany to these economies fell during the adjustment, while imports to Germany from these countries barely changed.

Exports to and Imports from Greece, Italy, Portugal, and Spain
(Percent of German GDP)

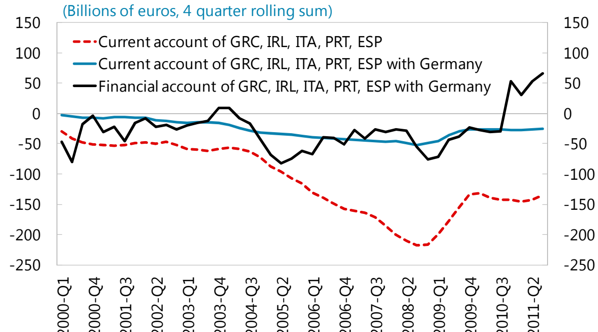


Sources: Bundesbank; and IMF Staff calculations.

The financial account has had more significant swings. While the current account remains in surplus with most of the peripheral countries (except Ireland), the variation in the financial account between Germany and the economies under stress has been three times larger than the current account variation and has changed signs. Moreover, there is almost no correlation between these two balances. Bilateral trade in goods and services has only a limited influence on bilateral cross-border financial flows.

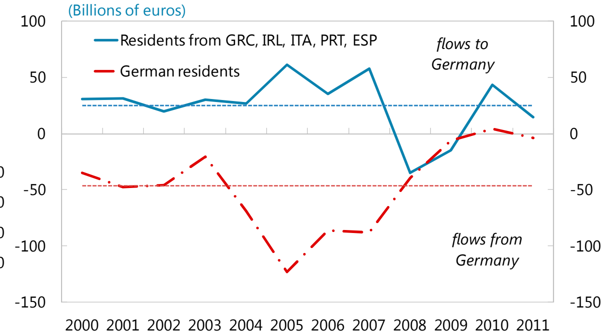
For much of the last decade, net private capital flows from Germany to these economies were—on average—lower than the current account balances. Financing by Germany in excess of its current account surplus vis-à-vis these economies was limited to short periods of time. From the perspective of Greece, Ireland, Italy, Portugal and Spain, current account transactions with Germany since 2003 represent about ¼ of their combined current account deficit. Net financial private inflows from Germany financed about one fifth of the current account deficit over the same period.[1] The change in the direction of private capital flows is primarily driven by German residents.

Financial and Current Account of Germany and Greece, Ireland, Italy, Spain and Portugal
(Billions of euros, 4 quarter rolling sum)



Sources: Deutsche Bundesbank; Haver Analytics; and IMF staff calculations.

Financial Flows Between Germany and Greece, Ireland, Italy, Spain and Portugal
(Billions of euros)



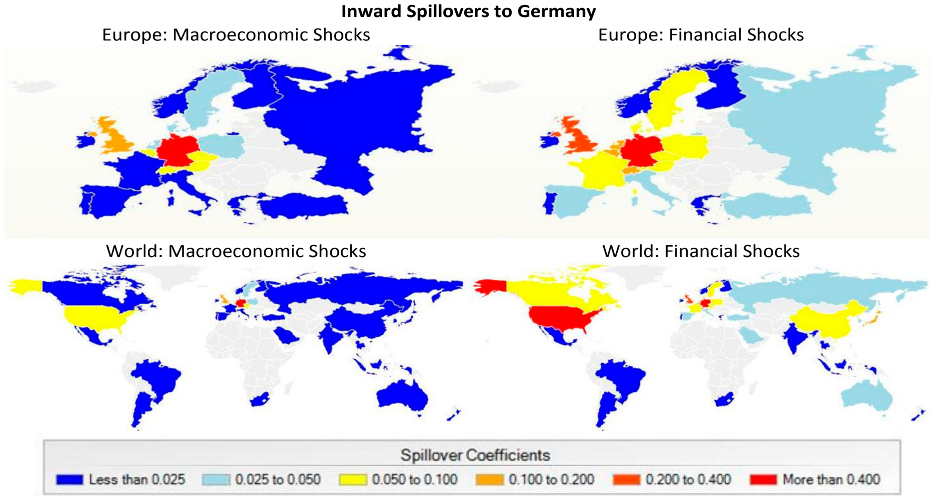
Sources: Deutsche Bundesbank; and IMF staff estimates.

[1] Changes in claims on the Eurosystem (TARGET2) are not part of private bilateral capital flows.

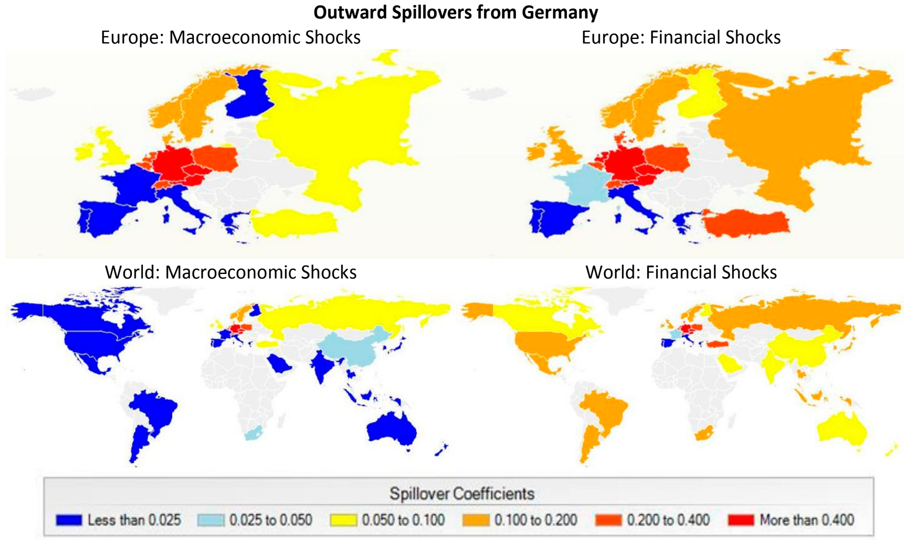
Box 3. Spillovers Through Cyclical Fluctuations

Empirical analysis that takes into account trade linkages as well as international money, bond and equity market linkages (Vitek 2012) suggests that the German economy is sensitive to macroeconomic and financial market developments in the rest of the world (inward spillovers).[1] For example, financial shocks in the United States which increase its output gap by one percent are estimated to raise the output gap in Germany by 0.52 percent. It also suggests that Germany is an efficient transmitter of business cycle fluctuations to its regional supply chain, but has not been a major originator of such shocks (outward spillovers). Within the euro area, outward spillovers are mitigated by monetary policy responses, explaining the small effects on countries such as France and Spain. The empirical analysis, however, does not account for trend growth in demand and, hence, the potential benefits from a permanent increase in potential growth.

Inward Spillovers to Germany



Outward Spillovers from Germany



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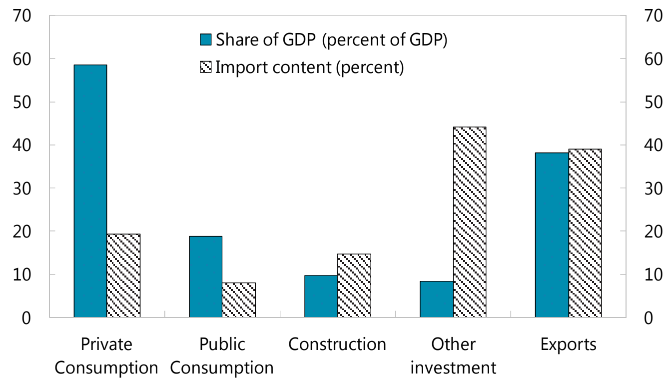
[1] The inward/outward spillover coefficients measure the percent increase in the output gap in the recipient economy (Germany/other countries), which occurs in response to macroeconomic or financial shocks in the source economy (other countries/Germany) which raise its output gap by one percent, on average over the business cycle. Inward and outward spillover coefficients for Germany with respect to itself are one by definition.

29. **Germany also generates outward spillovers through real and financial channels.** Given its regional supply chains, Germany is a conduit for the distribution of real and financial shocks to its immediate European neighbors, and also generates financial spillovers to other economies where its banks play a significant role. Given the German economy's large size, it also is a source of more stable demand for exports from key trading partners generated by domestic consumption and investment and not linked to its regional manufacturing supply chain. This suggests that raising domestic demand will be supportive of raising the level of exports from these trading partners. The large exposures of German banks through their overseas operations (Box 4) also generate outward spillovers to economies in Europe and beyond.

Importance of Demand Components and Import Content
(2000-2007 Average)



Sources: Federal Statistical Office; Deutsche Bundesbank; and IMF staff estimates.

30. **Germany's traditional current account surplus increased substantially in the mid-2000s, peaking at 7½ percent of GDP in 2007 (Figure 6).** This reflected a rise in exports, particularly to economies outside the euro area, which was only offset partly by higher imports from these economies. The rise in external surpluses translated into a steady improvement in Germany's net international investment position (IIP) to a positive 35 percent of GDP at end-2011, from near-balance a decade ago. About ½ of the net IIP position at end-2011 reflected net claims on the Eurosystem.

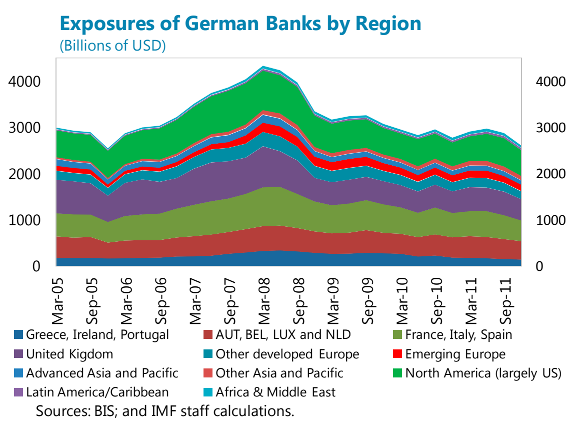
31. **The increase in the external surplus was largely driven by the corporate sector (Figure 6**). Corporate savings increased significantly by the mid-2000s, on the back of strong profits (Figure 7). While profitability was helped by wage increases which fell short of productivity growth over a sustained period, there were various factors that encouraged the strengthening of corporate balance sheets. These included changes to the tax regime, changes to the close relationship between corporates and banks, regulatory changes (Basel II), and the increased globalization of production which required access to international bank financing. The effects of regulatory changes and the impact of globalization were likely more pronounced for German corporates due to their heavy reliance on bank-based financing. In contrast to savings, investment was slow to respond. Almost a whole decade of disappointingly low growth, unfavorable demographic trends, and interest rate developments vis-à-vis many European

Box 4. Outward Financial Spillovers

German banks have large foreign exposures concentrated in advanced economies. Their foreign exposures comprised about USD 2.8 trillion at the end of Q4 2011, representing ¼ of total assets of German monetary financial institutions and about 4½ times their total capital. More than ¾ of total bank exposures are concentrated in advanced economies with the majority in Europe and the United States. Total exposures to Greece, Ireland, and Portugal, at USD 139 billion, comprise almost 10 percent of exposures to advanced Europe. Exposures to emerging Europe are relatively small and concentrated in Poland, Russia, Turkey and Hungary.

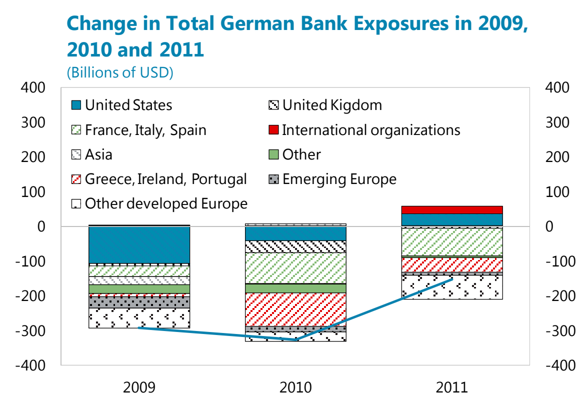
In 2011 total exposures to Europe declined substantially while those to the US have edged up. Exposures decreased substantially in Spain, Ireland, Italy, Portugal, Greece, Norway, Denmark, Belgium, Austria, France, and Luxembourg. Exposures to the United States, however, rose after the decline during 2009-2010. Exposures to emerging Europe, in particular to Hungary, have also declined, while those to emerging Asia and Latin American have risen.

German bank exposures are concentrated in advanced Europe and the US.



Sources: BIS; and IMF staff calculations.

Exposures to advanced Europe were reduced substantially in 2011 while exposures to the US, and to a lesser extent emerging Asia and Latin America increased.

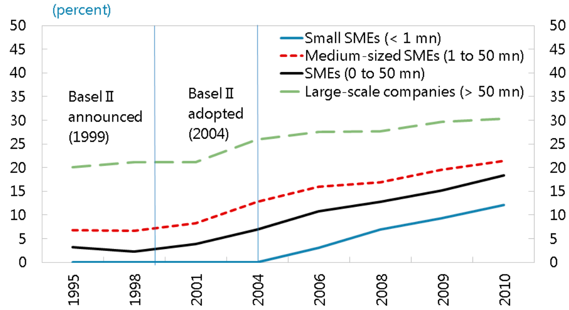


Sources: BIS; and IMF staff calculations.

The potential for further outward spillovers from bank deleveraging in Europe remains. Total exposures to advanced European countries remain large (15 percent of total assets of German banks and over 250 percent of their total capital). Looking forward, German banks will likely continue deleveraging in Europe particularly with regard to their respective non-core businesses in each country, while preserving their core businesses abroad, including in emerging Europe.

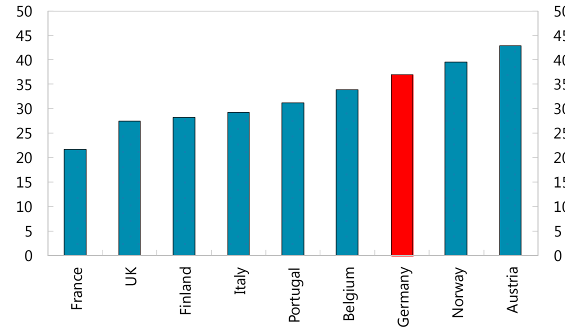
countries, likely contributed to the cautious investment response of corporates. Nevertheless, the level of investment has been consistently below that predicted by traditional determinants, beginning in the mid-80s.

Germany: Equity Ratio of Enterprises, 1995-2010, Median Value 1/
(percent)



Source: Deutsche Sparkassen - und Giroverband
1/ Equity ratio is the ratio of company's equity to total assets.

Corporate Reliance on Bank Financing, 2000-2009
(Share of loans in total liabilities, percent)



Source: EUROSTAT.

32. **Overall, Germany's external position remains substantially stronger than that implied by medium-term fundamentals and global economic policy settings**. In part, this reflects the lack of an exchange rate adjustment mechanism within the currency union and developments in other euro area countries. Staff estimates suggest that Germany's real effective exchange rate is undervalued by 0-10 percent. Looking ahead, part of the adjustment will therefore reflect policy changes elsewhere—including reigning in large fiscal deficits in some large advanced economies as well as fiscal and structural adjustments in the euro area periphery. The rebalancing of domestic sources of growth that is expected to occur to a large extent naturally as a reflection of tighter labor markets, high liquidity, and low interest rates, will also help by boosting domestic demand and reduce the current account balance to around 4 percent of GDP in the medium term. With disinflationary pressures incipient in the periphery economies over the medium term, and monetary conditions in Germany accommodative from a cyclical perspective, inflation in Germany could be somewhat higher than the euro area average, which would help narrow the competitiveness gap between the economies at the core and in the periphery. Beyond the natural process, implementing policies to encourage higher investment and increase potential growth through domestic sources (discussed below) could play a role.

Staff sees an additional reduction in the current account balance by 2 percent of GDP over and above the natural rebalancing process as appropriate.[1]

33. **Germany can play a pivotal role in supporting the adjustment process in the euro area and helping restore market confidence.** Articulating more clearly the European Union's shared vision of the post-crisis architecture of the union would help in durably restoring market confidence by providing an anchor to medium-term market expectations. A key element of this post-crisis Economic and Monetary Union (EMU) architecture is common understanding on greater financial and fiscal integration (see forthcoming 2012 Euro Area Article IV staff report). While the natural rebalancing process in Germany will help, efforts on structural reforms in the periphery could be reinforced through pan-European actions. These could include boosting and better targeting EU structural funds and increasing the lending capacity of the European Investment Bank.

The Authorities' Views

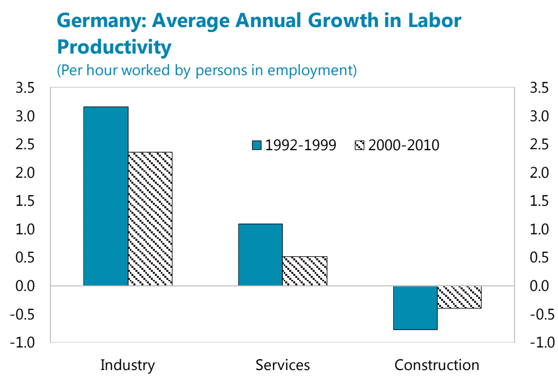
34. **The authorities noted that while the German current account surplus may not be fully explained by fundamentals in models, this does not imply the conclusion that the current account position is stronger than implied by fundamentals.** They noted that the price competitiveness of the German economy is currently quite favorable, but saw the elements for rebalancing in Germany as largely in place. They agreed that some policy levers to raise potential growth could be beneficial. They agreed that monetary policy settings appropriate for the EMU may imply somewhat higher inflation in Germany, and this is consistent with the natural adjustment process.

35. **While agreeing with Germany's importance in the EMU, the authorities offered some nuances regarding pan-European actions.** While acknowledging some of the shortcomings of the current institutional design of the EMU, they believed that rigorous adherence to reform plans underway in the crisis economies is key to restoring market confidence, and that patience is needed in seeing the payoff from reforms. They were of the view that discussions on redesigning the architecture of the EMU would be premature before a solid track record had been established on policy implementation and its beneficial outcomes. Overall, they stressed their commitment to more rather than less integration in Europe, and saw ample space to improve the quality of spending of common pools of resources.

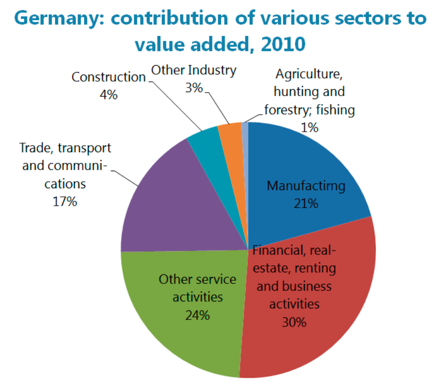
[1] Staff estimates of the current account balance of 2 percent of GDP consistent with medium-term fundamentals are based on a model described in Ivanova (2012) "Current Account Imbalances: Can Structural Policies Make a Difference?" IMF Working Paper No. 12/61.

Structural Reforms to Raise Potential Growth and Diversify its Sources

36. **Background**. Germany's potential growth at around 1¼ percent is low and has been highly dependent on external sources of demand. Moreover, with the aging of the population, the shrinking of the labor force would adversely affect potential growth over the longer term. In addition, productivity growth in the services sector unrelated to manufacturing, which provides some 60 percent of private employment and about 70 percent of value added, was about a quarter of that in goods production during 2000-07. Investment has also lagged and has contributed to external imbalances despite healthy corporate balance sheet positions.



Sources: Federal statistical office of Germany (Destatis); and IMF staff calculations.



Sources: Federal statistical office of Germany (Destatis); and IMF staff calculations.

Staff's Views

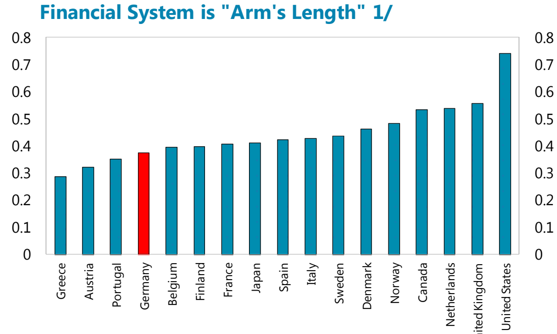
37. **Policies to increase labor force participation, investment, and productivity growth, especially in areas outside Germany's traditional strengths, need to be stepped up.** As discussed in detail in the 2011 Article IV consultation report, tax reform priorities include reduction of labor taxes at the participation margin and further improvements in the corporate tax regime, including the possible introduction of in-work and earned income tax credit programs and a reform of the regime of income splitting, reforms of the local level trade tax and the introduction of an allowance for the normal return on new equity.[2]

38. **Reforming the financial sector will be an essential complement to raise the economy's growth potential and increase its resilience**. Broadening the channels of financial intermediation would facilitate the allocation of resources towards innovation and new engines of growth. This would require a greater development of intermediation outside traditional

[2] See Box 5 in Germany's 2011 Article IV staff report on the link between taxation and labor supply.

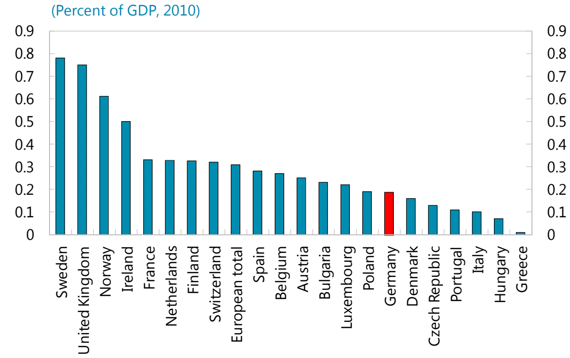
banking channels, using so-called arms-length finance. Changes to regulation and supervision would have to keep pace with the development of a more arms-length system in order to ensure financial stability. In addition, ambiguities in the tax treatment of venture capital firms should be addressed and consideration should be given to the reduction of differences in the tax treatment of venture capital firms with other European countries. The regulatory framework may also need to be reexamined with a view to encouraging a larger investor base for risk capital. The intellectual property held by universities and research institutions needs to be deployed in industry more easily. Recent reform initiatives in the area of corporate and personal insolvency are welcome, and in addition it may be useful to explore the feasibility of out-of-court restructuring procedures to reduce the stigma associated with business failure. Strengthening the resilience of the financial system will also be important, and will also require efforts to reduce outstanding capital support to banks and the sizeable balance sheets of the two winding-up institutions, while seeking to minimize potential losses to the state.

Financial Index Capituring the Degree to Which Financial System is "Arm's Length" 1/



Source: September 2006 *WEO*, chapter 4.
1/ Lower value means more relationship-based.

Cross-country Comparison: Private Equity-Investment
(Percent of GDP, 2010)



Source: German Private Equity and Venture Capital Association.

The Authorities' View

39. The authorities agreed with the need to continue structural reforms to raise potential growth. They noted the need for further progress on raising labor force participation, particularly for women, improving education infrastructure and improving competition in services, while underscoring that these need to be undertaken while adhering to broader fiscal objectives. The authorities also expressed interest in the staff's recommendation on developing arm's length financial systems in Germany and were in broad agreement with the recommendation on improving conditions for venture capital financing.

STAFF APPRAISAL

40. **Several conditions are in place in Germany for a domestic demand-led recovery following the downturn at end-2011**. The drag from last year's decline in external demand is receding, while domestic labor market conditions have continued to strengthen. Underpinned by healthy corporate and household balance sheets, higher wages, well anchored inflation expectations, and low borrowing costs, growth is poised to reach potential in the second half of 2012.

41. **The near-term outlook is, however, clouded by a number of downside risks from external sources**. The main risk facing Germany is an intensification of the euro area crisis, which would spill over into Germany directly through real and financial channels, and indirectly through dampened business and consumer sentiment. Lower global growth prospects more broadly would also cloud the outlook for activity. An abrupt rise in oil prices due to geo-political shocks also remains a downside risk to the outlook.

42. **The main policy priority in the near term is to manage the transition to domestic demand-led growth and guard against the downside risks.** The fiscal stance, with a modest structural consolidation and the full operation of automatic stabilizers, is appropriate under the baseline, given Germany's advanced cyclical position, limited fiscal spillovers on growth in the euro area periphery, and Germany's status as an EFSF/ESM guarantor. Looking ahead, a pickup in wages and some asset prices would be part of the natural process of rebalancing the sources of growth. Allowing these developments to proceed, while adhering to Germany's macroeconomic policy framework, will also help to appropriately further reduce Germany's high current account surplus.

43. **Securing financial stability in the face of external risks remains a key priority**. Despite some gradual progress achieved, the banking system remains vulnerable to external shocks given its high leverage ratios, the low quality of bank capital, significant cross-border exposures, and large reliance on wholesale funding. It will also be important to ensure that risks from the global activities of large banks are fully understood and internalized. The pre-emptive reactivation of the backstop facility for financial institutions (SoFFin II) is welcome, even though banks are expected to meet EBA capital requirements without the use of public support, under the baseline. Steps to establish a framework for implementing macroprudential policies following European Union initiatives are timely, although there is no need to tighten macroprudential policies at this juncture.

44. **The current environment provides a window of opportunity to build momentum in financial sector reforms in line with the 2011 Financial Sector Assessment Program (FSAP) Update recommendations**. Efforts to reduce outstanding public capital support to some banks and the sizable balance sheets of the two winding-up institutions should be stepped up, while paying due regard to minimizing potential losses to the state. Progress is also needed on a comprehensive strategy aimed at improving the efficiency and stability of the banking system. In particular, greater efforts are needed in restructuring the Landesbanken and reforming their business models. In addition, the crisis management framework should be strengthened by establishing resolution plans and enhancing the deposit insurance regime.

45. **As the euro area's largest economy, Germany can play a pivotal role in addressing the challenges posed by the crisis**. Articulating more clearly the Economic and Monetary Union's shared vision of an appropriate post-crisis architecture will help in restoring market confidence. The positive short-run benefits of the implementation of ambitious structural reform agendas in several euro area countries should be complemented with pan-European measures. These could include using EU structural funds and increasing the lending capacity of the European Investment Bank. Moreover, the reduction of imbalances in the euro area would be helped by the natural rebalancing of Germany's economy. In this context, consistent with the mandate of the European Central Bank, disinflationary pressures incipient in the periphery economies, essential for their relative price realignment, could imply inflation in Germany that is somewhat higher than the euro area average for some time.

46. **Germany should seize the opportunity to undertake its own structural reforms to raise potential growth and diversify its sources, reinforcing reform momentum in the euro area**. Higher domestically driven growth would help raise the economy's potential above that envisaged under the baseline while generating positive outward spillovers. Ongoing efforts to increase the labor force through the higher participation of female and older workers and the migration of skilled workers are welcome. Raising the quality of human capital will require reforms to the system of education and training. Raising productivity in the services sector would be helped by greater competition, including at the regional level in network industries such as transportation and energy.

47. **There is a need to broaden the access to risk capital through structural financial reforms.** Efforts should be stepped up to develop more arms-length financial intermediation as a complement to the well-established relationship-based system in Germany. Recent reform initiatives in the area of corporate and personal insolvency are welcome. The policy framework needs to be reexamined with a view to encouraging a larger investor base for risk capital.

Broadening the channels of financial intermediation would facilitate the allocation of resources towards innovation and new engines of growth.

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

Table 1. Germany: Selected Economic Indicators, 2008-2013

Total population (2011, million)	81.8
GDP per capita (2011, USD)	44,556

	2008	2009	2010	2011	2012 1/	2013 1/
			(Percentage change)			
Demand and supply						
Private consumption	0.6	-0.1	0.6	1.4	0.9	1.3
Public consumption	3.1	3.3	1.7	1.1	1.0	0.8
Gross fixed investment	1.7	-11.4	5.5	6.4	0.6	2.3
Construction	-0.7	-3.0	2.2	5.8	-0.2	1.6
Machinery and equipment	3.6	-22.8	10.5	7.6	0.4	1.5
Final domestic demand	1.3	-1.7	1.7	2.3	0.9	1.3
Inventory accumulation 2/	0.0	-0.8	0.6	0.2	-0.4	0.0
Total domestic demand	1.3	-2.6	2.4	2.5	0.4	1.3
Exports of goods and nonfactor services	2.7	-13.6	13.7	8.2	2.7	3.5
Imports of goods and nonfactor services	3.3	-9.2	11.7	7.8	2.0	3.6
Foreign balance 2/	-0.1	-2.8	1.4	0.7	0.5	0.2
GDP	0.8	-5.1	3.6	3.1	1.0	1.4
Output gap (In percent of potential GDP)	2.3	-3.7	-1.5	0.2	0.0	0.1
			(In millions of persons, unless otherwise indicated)			
Employment and unemployment						
Labor force	43.4	43.5	43.6	43.7	43.7	43.8
Employment	40.3	40.3	40.5	41.0	41.4	41.5
Unemployment 3/	3.1	3.2	3.1	2.7	2.3	2.3
Unemployment rate (in percent) 4/	7.6	7.7	7.1	6.0	5.3	5.2
			(Percentage change)			
Prices and incomes						
GDP deflator	1.0	1.1	0.7	0.7	2.0	1.7
Consumer price index (harmonized)	2.8	0.2	1.2	2.5	2.2	2.0
Average hourly earnings (total economy)	2.3	3.0	0.0	2.9	3.3	3.3
Unit labor cost (industry)	6.8	21.6	-8.6	-2.2	2.3	1.5
Real disposable income 5/	1.4	-0.7	0.8	1.0	0.6	1.0
Personal saving ratio (in percent)	11.7	11.1	11.3	10.9	10.7	10.5

Table 1. Germany: Selected Economic Indicators (concluded)

	2008	2009	2010	2011	2012 1/	2013 1/
	(In billions of euros, unless otherwise indicated)					
Public finances						
General government						
Expenditure	1,090	1,142	1,186	1,173	1,195	1,219
(In percent of GDP)	44.0	48.1	47.9	45.6	45.1	44.7
Revenue	1,088	1,066	1,080	1,146	1,177	1,208
(In percent of GDP)	44.0	44.9	43.6	44.6	44.5	44.3
Overall balance 6/	-1	-76	-106	-27	-18	-11
(In percent of GDP)	-0.1	-3.2	-4.3	-1.0	-0.7	-0.4
Structural balance	-21	-30	-57	-26	-17	-12
(In percent of GDP)	-0.8	-1.2	-2.3	-1.0	-0.7	-0.4
Federal government						
Overall balance 6/	-15	-38	-80	-30	-18	-12
(In percent of GDP)	-0.6	-1.6	-3.2	-1.1	-0.7	-0.4
General government debt	1,655	1,774	2,068	2,089	2,176	2,187
(In percent of GDP)	66.9	74.7	83.5	81.2	82.2	80.2
	(In billions of USD, unless otherwise indicated)					
Balance of payments						
Trade balance 7/	242.3	172.2	190.1	193.7	186.5	185.4
Services balance	-15.1	-11.2	-5.7	-9.0	-10.0	-9.9
Factor income balance	47.7	80.9	66.2	67.4	49.6	32.9
Net private transfers	-24.7	-23.4	-22.3	-23.4	-21.6	-21.2
Net official transfers	-24.1	-22.8	-28.4	-23.2	-26.4	-27.5
Current account	226.1	195.8	199.9	205.4	178.2	159.9
(In percent of GDP)	6.2	5.9	6.1	5.7	5.2	4.6
Foreign exchange reserves (EUR billion, e.o.p.) 8/	27.7	25.6	28.0	29.4	28.7	…
	(Percentage change)					
Monetary data						
Money and quasi-money (M3) 9/ 10/	9.8	-1.6	4.4	5.9	7.0	…
Credit to private sector 9/	6.6	-0.6	-1.9	1.0		…
	(Period average in percent)					
Interest rates						
Three-month interbank rate 11/	4.6	1.2	0.8	1.3	0.9	…
Yield on ten-year government bonds 11/	4.1	3.3	2.8	2.7	1.9	…
Exchange rates						
Euro per US$ 11/	0.73	0.68	0.76	0.76	0.76	…
Nominal effective rate (1990=100) 12/	104.1	106.1	100.1	100.1	99.2	…
Real effective rate (1990=100) 13/	99.1	104.6	98.0	96.5	96.2	…

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 2012 refer to March.
9/ Data for 2012 refer to March.
10/ Data reflect Germany's contribution to M3 of the euro area.
11/ Data for 2012 refer to April.
12/ Data for 2012 refer to April.
13/ Based on relative normalized unit labor cost in manufacturing. Data for 2012 refer to February.

Table 2. Statement of Operations of the General Government

in percent of GDP	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	44.9	43.6	44.6	44.5	44.3	44.2	44.0	43.9	43.8
Taxes	23.2	22.3	22.2	22.3	22.5	22.7	22.7	22.7	22.8
Social contributions	17.3	16.9	17.0	16.8	16.5	16.3	16.1	16.0	15.9
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	4.3	4.2	5.3	5.3	5.2	5.1	5.1	5.1	5.1
Expenditure	48.1	47.9	45.6	45.1	44.7	44.3	44.1	44.0	43.9
Expense	48.2	48.2	45.7	45.2	44.8	44.4	44.2	44.0	43.9
Compensation of employees	8.0	7.9	8.1	8.1	8.0	8.0	7.9	7.9	7.9
Use of goods and services	4.8	4.8	4.6	4.6	4.6	4.6	4.5	4.5	4.5
Consumption of fixed capital (if available)	1.8	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Interest	2.7	2.5	2.7	2.4	2.4	2.3	2.2	2.1	2.1
Subsidies	1.1	1.1	0.9	0.8	0.8	0.8	0.8	0.8	0.8
Grants	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social benefits	26.2	25.5	24.5	24.4	24.2	24.0	24.0	23.9	23.9
Other expense	2.7	3.6	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Net acquisition of nonfinancial assets	-0.1	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Acquisitions of nonfinancial assets	…	…	…	…	…	…	…	…	…
Disposals of nonfinancial assets	…	…	…	…	…	…	…	…	…
Consumption of fixed capital	1.8	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Gross Operating Balance	-1.5	-2.9	0.6	0.9	1.1	1.4	1.5	1.5	1.5
Net Operating Balance	-3.3	-4.6	-1.1	-0.8	-0.5	-0.2	-0.1	-0.1	-0.1
Net lending (+)/borrowing (–)	-3.2	-4.3	-1.0	-0.7	-0.4	-0.1	-0.1	0.0	0.0
Net acquisition of financial assets	1.7	7.5	…	…	…	…	…	…	…
Monetary gold and SDRs	0.0	0.0	…	…	…	…	…	…	…
Currency and deposits	-0.2	1.5	…	…	…	…	…	…	…
Debt securities	0.2	4.1	…	…	…	…	…	…	…
Loans	0.2	2.3	…	…	…	…	…	…	…
Equity and investment fund shares	1.4	0.4	…	…	…	…	…	…	…
Insurance, pensions, and std. guarantee schemes	0.0	0.0	…	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	-0.7	…	…	…	…	…	…	…
Other accounts receivable	0.1	-0.1	…	…	…	…	…	…	…
Net incurrence of liabilities	4.9	11.8	…	…	…	…	…	…	…
SDRs	0.0	0.0	…	…	…	…	…	…	…
Currency and deposits	0.0	0.0	…	…	…	…	…	…	…
Debt securities	4.7	4.1	…	…	…	…	…	…	…
Loans	0.3	7.8	…	…	…	…	…	…	…
Equity and investment fund shares	0.0	0.0	…	…	…	…	…	…	…
Insurance, pensions, and std. guarantee schemes	0.0	0.0	…	…	…	…	…	…	…
Financial derivatives and employee stock options	0.0	0.0	…	…	…	…	…	…	…
Other accounts payable	-0.1	-0.1	…	…	…	…	…	…	…
Memorandum items:									
Structural Balance (output gap methodology)	-1.2	-2.3	-1.0	-0.7	-0.4	-0.2	-0.1	-0.1	-0.1
Public gross debt (Maastricht definition)	74.7	83.5	81.2	82.2	80.2	78.1	76.3	74.6	72.6

Sources: Government Finance Statistics and IMF staff estimates.

Table 3. General Government Stock Positions

in percent of GDP	2007	2008	2009	2010
Stock positions:				
Net worth	…	…	…	…
Nonfinancial assets	…	…	…	…
Net financial worth	-43	-45	-49	-52
Financial assets	23.1	25.1	28.3	34.8
Monetary gold and SDRs	0.0	0.0	0.0	0.0
Currency and deposits	8.1	8.0	8.3	9.5
Debt securities	0.3	1.8	2.1	6.3
Loans	2.5	2.9	3.2	5.2
Equity and investment fund shares	7.9	8.5	10.4	10.3
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.1	0.1	0.1	-0.6
Other accounts receivable	4.0	3.8	4.2	4.0
Liabilities	65.7	69.7	77.4	86.9
Monetary gold and SDRs	0.0	0.0	0.0	0.0
Currency and deposits	0.3	0.4	0.4	0.4
Debt securities	47.5	50.7	57.4	60.0
Loans	17.8	18.3	19.4	26.4
Equity and investment fund shares	0.0	0.0	0.0	0.0
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	0.0
Financial derivatives and employee stock options	0.0	0.0	0.0	0.0
Other accounts payable	0.1	0.1	0.2	0.1
Memorandum items:				
Publicly guaranteed debt	…	…	…	…
Debt (at market value)	…	69.7	77.4	86.9
Debt at face value	…	…	…	…
Maastricht debt	65.4	66.9	74.7	83.5
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. Germany: Medium Term Projections, 2010-2017.

	2010	2011	2012	2013	2014	2015	2016	2017
			Projections					
	(percentage change unless indicated)							
Real sector								
Real GDP	3.6	3.1	1.0	1.4	1.3	1.3	1.3	1.3
Total domestic demand	2.4	2.5	0.4	1.3	1.2	1.2	1.2	1.2
Foreign balance (contribution to growth)	1.4	0.7	0.5	0.2	0.2	0.2	0.2	0.2
Output gap (percent of potential GDP)	-1.5	0.2	0.0	0.1	0.1	0.2	0.2	0.3
Consumer prices	1.2	2.5	2.2	2.0	2.1	2.1	2.1	2.1
	(percent o f GDP)							
External sector								
Current account balance	6.1	5.7	5.2	4.6	4.3	4.2	4.0	3.9
Goods and services balance	5.6	5.1	5.2	5.1	4.9	4.8	4.6	4.5
General government								
Overall balance	-4.3	-1.0	-0.7	-0.4	-0.1	-0.1	0.0	0.0
Gross debt	83.5	81.2	82.2	80.2	78.1	76.3	74.6	72.6

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

Table 5. Germany: Core Financial Soundness Indicators for Banks

(In percent)

	2007	2008	2009	2010	2011	2011Q4
Capital adequacy 1/						
Regulatory capital to risk-weighted assets	12.9	13.6	14.8	16.1		16.4
Commercial banks	13.3	13.5	14.9	15.4		15.6
Landesbanken	11.6	12.7	14.9	17.1		17.7
Savings banks	13.0	14.4	14.7	15.1		15.8
Credit cooperatives	12.9	14.2	14.0	14.7		15.6
Regulatory Tier I capital to risk-weighted assets 2/	8.5	9.5	10.8	11.8		12.1
Commercial banks	10.6	10.3	12.1	12.9		13.1
Landesbanken	7.1	8.3	10.5	12.1		12.7
Savings banks	8.4	9.5	9.7	9.9		10.5
Credit cooperatives	8.7	9.7	9.5	9.8		10.4
Asset composition and quality						
Sectoral distribution of loans to total loans						
Loan to households	25.6	24.4	26.3	26.2	26.2	
Commercial banks	21.8	20.5	23.2	22.3	21.4	
Landesbanken	5.2	4.9	5.2	5.4	5.4	
Savings banks	58.2	56.4	57.6	57.7	56.2	
Credit cooperatives	66.3	63.5	66.4	67.0	66.8	
Loans to non-financial corporations	14.1	14.5	14.8	14.6	14.6	
Commercial banks	12.4	12.6	12.9	12.1	11.9	
Landesbanken	16.2	17.8	18.2	18.4	19.1	
Savings banks	17.6	18.7	19.6	20.1	20.3	
Credit cooperatives	12.4	12.7	13.6	14.3	14.1	
NPLs to gross loans 5/	2.6	2.9	3.2	*)		
Commercial banks	1.8	2.0	2.5	*)		
Landesbanken	1.5	2.4	3.4	*)		
Savings banks	5.1	4.7	4.1	*)		
Credit cooperatives	5.5	5.1	4.4	*)		
NPLs net of provisions to capital 5/	21.6	25.3	42.4	*)		
Commercial banks	15.8	20.0	53.1	*)		
Landesbanken 4/	11.3	27.6	37.3	*)		
Savings banks	35.3	33.0	35.0	*)		
Credit cooperatives	35.9	33.3	41.9	*)		

Table 5. Germany: Core Financial Soundness Indicators for Banks (concluded)
(In percent)

	2007	2008	2009	2010	2011	2011Q4
Earnings and profitability						
Return on average assets (after-tax)	0.2	-0.3	-0.1	0.2		
Commercial banks	0.5	-0.5	-0.2	0.1		
Landesbanken	0.0	-0.4	-0.3	-0.1		
Savings banks	0.2	0.1	0.2	0.4		
Credit cooperatives	0.3	0.2	0.3	0.5		
Return on average equity (after-tax)	4.7	-8.1	-2.0	3.7		
Commercial banks	15.6	-15.1	-5.7	2.0		
Landesbanken	0.9	-12.2	-8.5	-1.3		
Savings banks	4.2	2.1	4.4	7.0		
Credit cooperatives	5.2	4.0	5.1	8.0		
Interest margin to gross income	72.9	84.6	72.5	73.2		
Commercial banks	66.3	94.6	63.0	62.7		
Landesbanken	91.6	90.2	81.5	84.4		
Savings banks	75.2	76.0	78.6	79.1		
Credit cooperatives	71.3	69.9	76.9	78.9		
Trading income to gross income				4.5		
Commercial banks				9.1		
Landesbanken				3.9		
Savings banks				0.2		
Credit cooperatives				0.1		
Noninterest expenses to gross income	64.9	73.4	65.1	63.7		
Commercial banks	65.5	93.6	73.5	72.5		
Landesbanken	61.1	54.6	51.1	54.7		
Savings banks	69.5	68.8	66.6	62.8		
Credit cooperatives	70.5	68.3	68.3	63.7		
Liquidity						
Liquid assets to total short-term liabilities 3/	119.4	120.3	144.1	137.0		137.9
Commercial banks	113.0	114.8	131.1	126.2		124.3
Landesbanken	115.5	114.5	135.9	131.2		144.3
Savings banks	190.9	161.8	225.7	216.2		210.1
Credit cooperatives	167.1	146.1	204.2	203.8		208.4
Sensitivity to market risk						
Net open positions in FX to capital	6.9	6.6	5.3	4.4		4.5
Commercial banks	6.2	4.5	3.9	2.2		2.3
Landesbanken	6.6	5.2	5.5	5.5		7.4
Savings banks	10.9	12.2	9.6	9.1		7.7
Credit cooperatives	10.7	8.2	7.9	8.1		8.3

Source: Deutsche Bundesbank.

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/ 2000-2009 data compiled in accordance with IMF's FSI Compilation Guide. Data not available before 1 July 2000.
4/ Due to one off data availability, comparability of 2006 data with other years limited.
5/ A methodological break in the NPL series has taken place in 2009. Due to changes in the regulatory reporting framework
*) NPL figures for end-2010 under review

Table 6. Germany: Additional Financial Soundness Indicators
(In percent, unless otherwise indicated)

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

Table 6. Germany: Additional Financial Soundness Indicators (concluded)
(In percent, unless otherwise indicated)

	2007	2008	2009	2010	2011
Insurance sector					
Solvency ratio, Life	206.8	191.5	186.2	180.8	
Solvency ratio, Non-life (w/o reinsurance and health insurance)	321.6	315.3	290	314	
Return on average equity, Life 9/	8.8	7.4	9.6	9.8	
Return on average equity, Non-life 9/ (w/o reinsurance and health insurance)	4.1	3.6	4.2	3.3	
Market liquidity					
Average bid-ask spread in the securities market (government bills)	0.0	0.0	0.0	0.0	0.0
Average bid-ask spread in the securities market (corporate securities)	0.1	0.3	0.3	0.1	0.3
Corporate sector					
Total debt to equity 1/	84.5	120.2	109.0	93.8	
Total debt to GDP 2/	137.6	142.6	151.0	139.1	
Return on invested capital 3/ 4/	9.6	10.6	7.9	8.6	
Earnings to interest and principal expenses 1/ 5/	774.5	707.9	655.8	764.2	
Number of applications for protection from creditors 1/ 6/	13,599	13,358	16,167	15,283	
Households					
Household debt to GDP 1/	63.7	62.0	64.6	62.0	
Household debt service and principal payments to income 1/ 5/	4.4	4.4	3.4	3.2	
Real estate markets					
Real estate prices, new dwellings 10/	101.0	102.0	104.0	100.0	106.3
Real estate prices, resale 10/	101.0	102.0	101.0	100.0	104.9
Residential real estate loans to total loans	16.5	15.7	16.9	16.8	16.7
Commercial real estate loans to total loans	5.4	5.2	5.8	5.7	5.7

Source: Deutsche Bundesbank.
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 by Frankfurt banks (basis points).
8/ Spread in basis points.
9/ Profits after tax devided by equity.
10/ Residential property index (yearly average, 2005 = 100); aggregation of data for new dwellings and resale is not available.

Table 7. Germany: Risk Assessment Matrix[1]

(Scale—high, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized
1. Strong intensification of the euro area crisis	**Medium** Heightened financial stress could adversely alter the outlook for the euro area.	**High** Direct effects through lower export demand and inward financial spillovers, indirect effects through deleveraging and uncertainty.
2. Slowdown of world growth	**Medium** Slowing demand from emerging Asia and the U.S.	**High** Lower export demand could hurt Germany's export performance.
3. Slowdown of potential growth	**Medium** Strategies to counteract demographic pressures and increase productivity may fail to deliver results.	**Medium** Potential growth would decline in the medium term.
4. Sharp increase in oil prices	**Medium** Geo-political risks could lead to a sharp increase in oil prices.	**Medium** Higher energy prices could depress demand and raise inflation.
5. Mispricing of assets	**Low** Loose liquidity conditions in the banking sector may lead to excessive asset price increases	**Medium** Subsequent price corrections could be costly.
6. More acute deleveraging by the German banking system	**Low** Write-downs could be higher than expected, and meeting capital requirements could be challenging.	**Low** Deleveraging could force banks to reduce domestic lending, with negative effects on activity.

[1] The RAM shows events that could materially alter the baseline path - the scenario most likely to materialize in the view of the staff.

Table 8. Authorities' Response to Past IMF Policy Recommendations

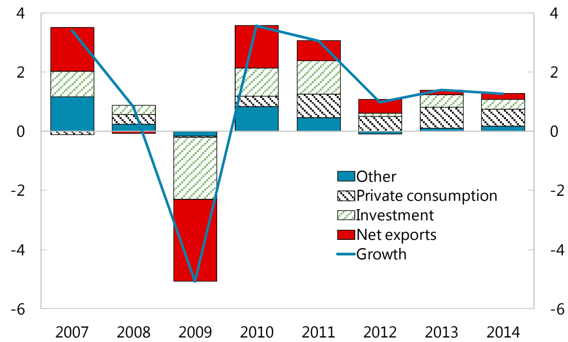
(Scale—fully consistent, broadly consistent, or marginally consistent)

IMF 2011 Article IV Recommendations	Authorities' Response
Fiscal policy The fiscal consolidation path is appropriate.	**Fully consistent** The 2011 outturn was better than projected due to favorable macro developments; no new consolidation measures were taken.
Financial sector policy I Address the legacy of the financial crisis by stepping up the resolution of the winding-up institutions and reduce vulnerabilities	**Broadly consistent** Banks are strengthening their capital buffers, but progress in the winding-up institutions is slow.
Financial sector policy II Consolidate *Landesbanken* and revisit their business model, clarify the regulatory and supervisory regime, and gradually shift the ownership the *Sparkassen* away from the public sector, while carving out their public functions.	**Marginally consistent** Consolidation efforts in the *Landesbanken* sector are slow. The proposed Financial Stability Committee will help clarifying the regulatory and supervisory roles for macroprudential oversight.
Structural reforms To raise potential growth, increase labor force participation, including through tax policy measures, facilitate conditions for investment, including through tax reform and reform the education system. Enhance the provision of risk capital and provide for a more efficient insolvency process.	**Broadly consistent** Measures to increase the labor force have been taken, and reforms of the education system are underway in the *Länder*; there are reform initiatives for the insolvency process.

Figure 1. Germany: Real Sector Developments

The deceleration in activity is broad based, but domestic sources of demand are expected to lead the recovery.

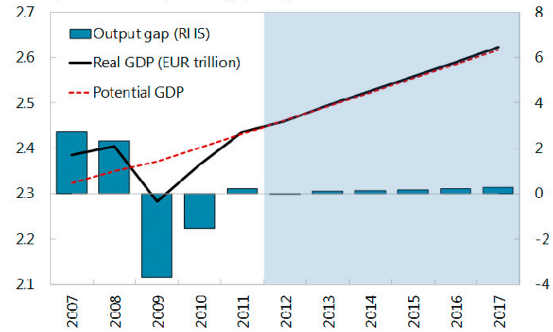
Demand Components of GDP Growth
(Contribution to annual real growth, percentage points)



Sources: Statiscal Office; and IMF staff projections.

GDP will return to potential as cyclical effects fade.

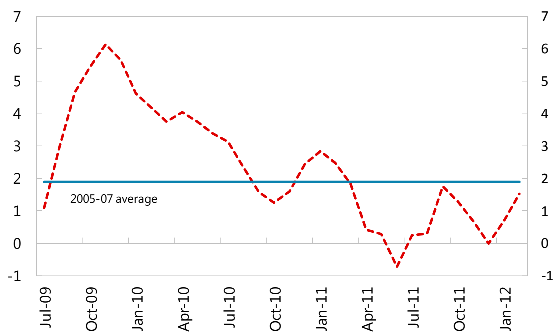
Real and potential GDP, Output Gap
(EUR trillion and percentage points)



Sources: Statistical office; and IMF staff projections.

The external environment has deteriorated as world trade growth has slowed...

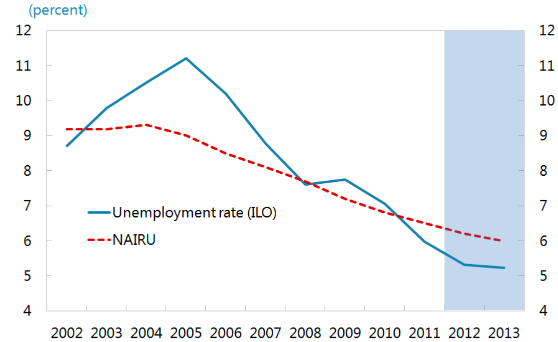
World Trade Volume
(Rolling quarterly growth rate, sa, not annualized)



Sources: CPB; and IMF staff estimates.

.. .but domestic conditions are healthy, backed by robust labor market developments.

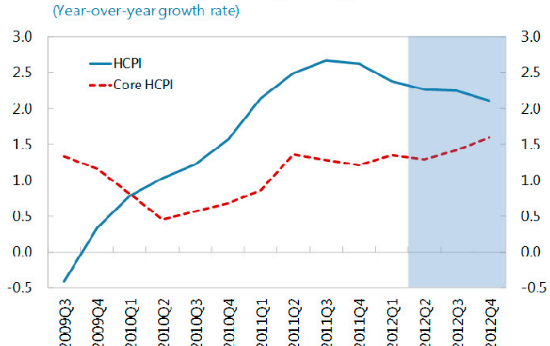
Unemployment Rate and Natural Rate of Unemployment
(percent)



Sources: Statistical office; and IMF staff projections.

Inflation has picked up due to higher energy prices, but core inflation remains well contained.

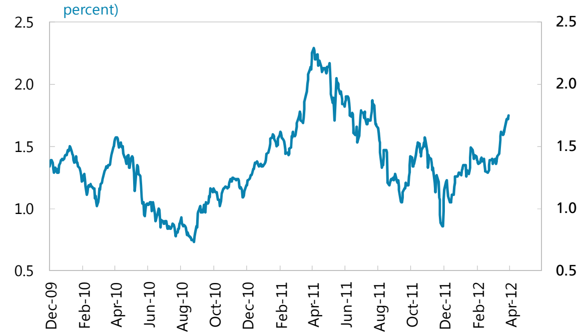
HCPI and HCPI Excluding Energy and Food
(Year-over-year growth rate)



Sources: Haver analytics; and IMF staff projections.

Inflation expectations are well anchored below the ECB's target rate of 2 percent.

Five Year Break Even Inflation Rate
(Difference between yields on five year Bunds and inflation indext debt, percent)

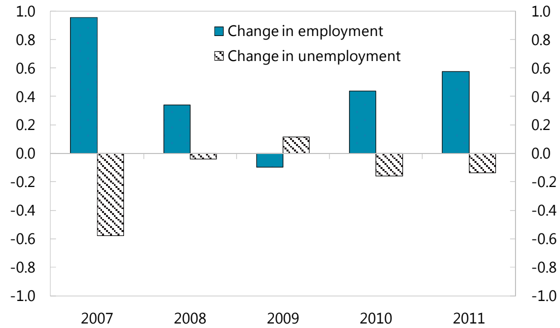


Sources: Bloomberg; and IMF staff estimates.

Figure 2. Germany: Labor Market Developments

The labor force is growing…

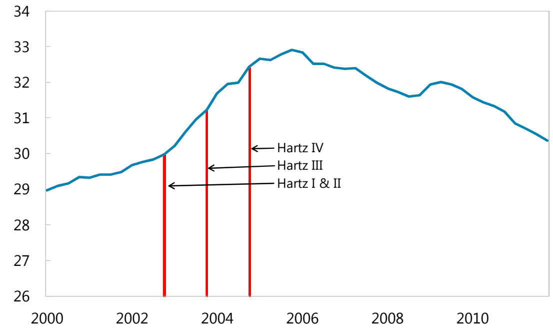
Annual Change in Employment and Unemployment
(Millions of people)



Sources: Haver Analytics; and IMF staff estimates.

…and the share of atypical employment is falling.

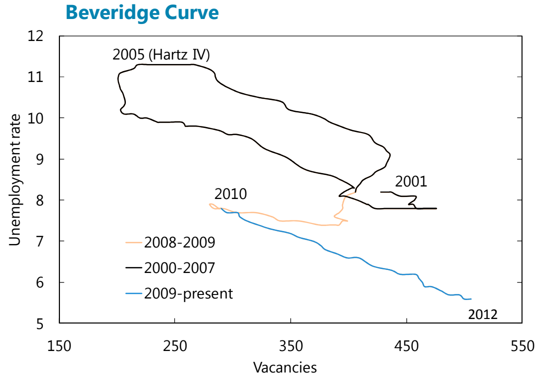
Jobs Without Full Social Security
(Percent of total employment)



Sources: Haver Analytics and IMF staff estimates.

The matching efficiency of the labor market has improved…

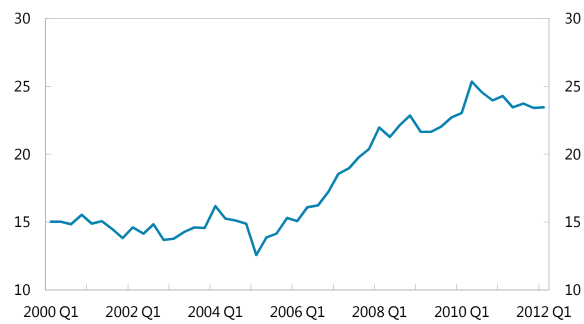
Beveridge Curve



Sources: Haver Analytics; and IMF staff estimates.

…and the exit rate from unemployment has shifted to a new level.

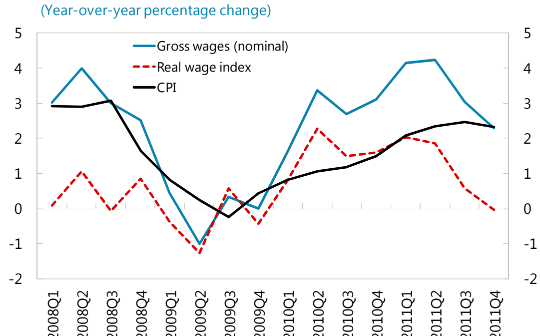
Average Monthly Exit Rate From Unemployment
(Percent of unemployed persons, s.a.)



Sources: Federal Employment Agency; Bundesbank, and IMF staff calculations.

Wages have edged up, but so has inflation.

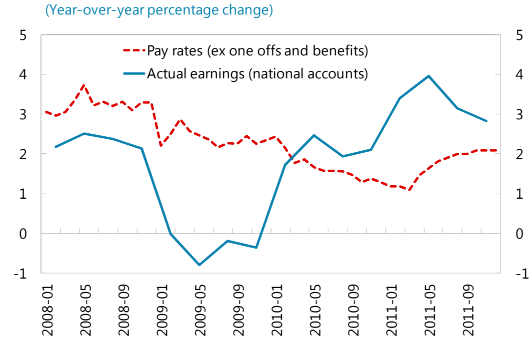
Gross Wages, Real Wages and Consumer Prices
(Year-over-year percentage change)



Source: Statistical office.

Agreed pay increases are moderate, but one offs are growing large.

Basic Pay Rates and Actual Earnings
(Year-over-year percentage change)



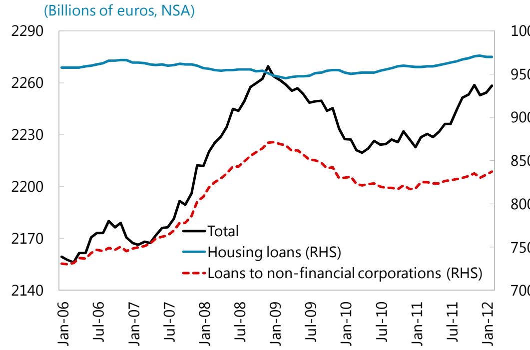
Sources: Deutsche Bundesbank; and IMF staff estimates.

Figure 3. Germany: Credit, Interest Rates, and Lending Standards

Domestic credit is on an upward trend.

Germany: Consumer, Housing and Enterprise Loans

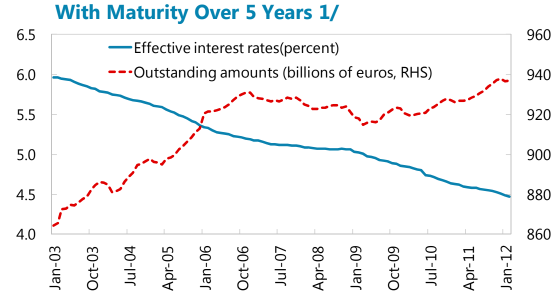
(Billions of euros, NSA)



Sources: Haver; and IMF staff calculations.

The pickup in housing loans is associated with low interest rates.

Housing Loans to Households With Maturity Over 5 Years 1/



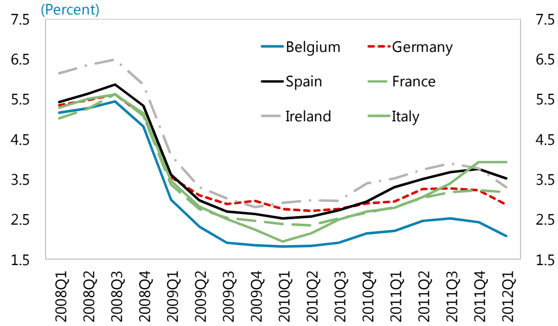
Source: Haver Analytics.

1/ Housing loans with maturity over 5 years represent 95 percent of all housing loans and about 40 percent of total lending by Monetary Financial Institutions to Domestic Enterprises and Households.

Interest rates on corporate loans are also low.

Lending Rates on New Loans to Non-financial Corporations

(Percent)

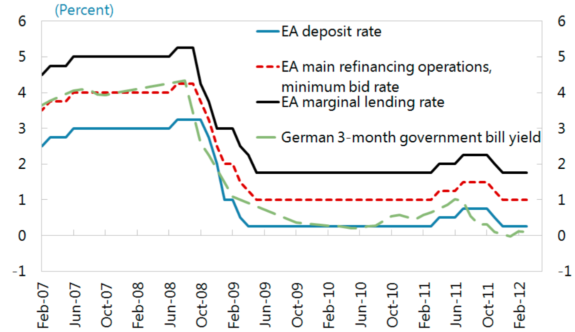


Sources: ECB; and IMF staff calculations.

Overall liquidity conditions are loose.

Monetary Policy Rates and German Government Bill Yield

(Percent)

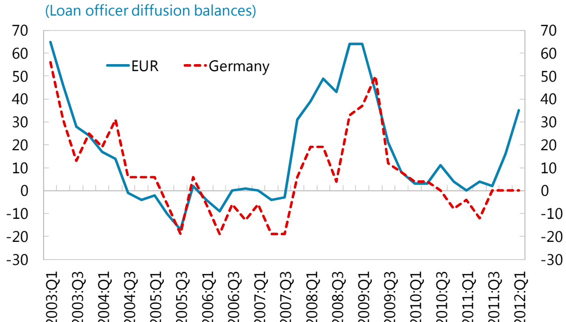


Sources: ECB; Bbk; Reuters; and Haver Analytics.

Credit standards for enterprise loans changed little since the second half of 2011…

Credit Survey: Change in Credit Standards to Enterprises, Past 3 Months

(Loan officer diffusion balances)

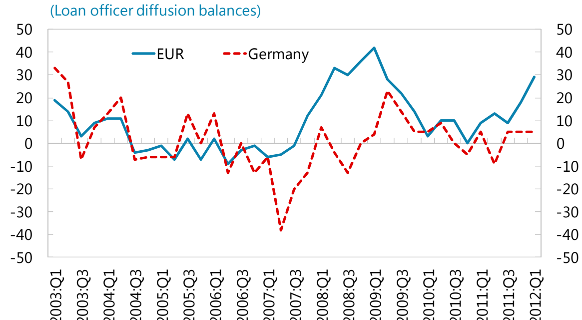


Source: Haver Analytics.

…as did credit standards for mortgages.

Tighter Credit Standards for Mortgages, Past 3 Months

(Loan officer diffusion balances)

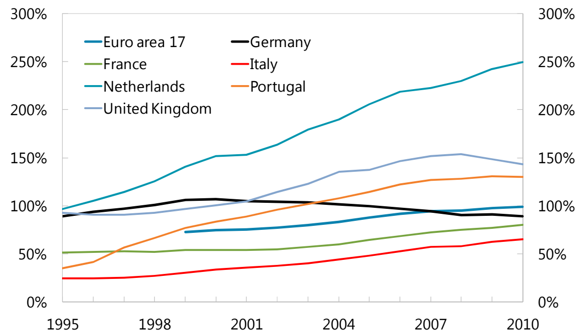


Source: Haver Analytics.

Figure 4. Germany: Balance Sheets and Asset Price Developments

Households' indebtedness is low.

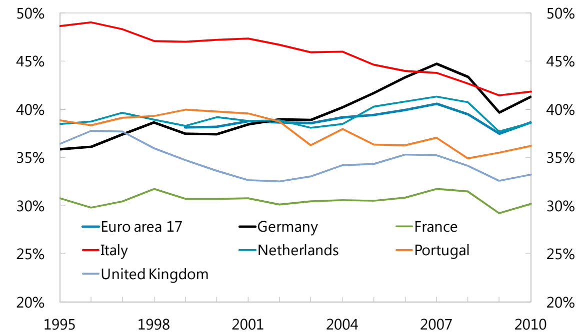
Household Gross Debt-to-Income Ratio
(Loans and liabilities as percent of disposable income)



Source: Haver Analytics.

Firms are profitable.

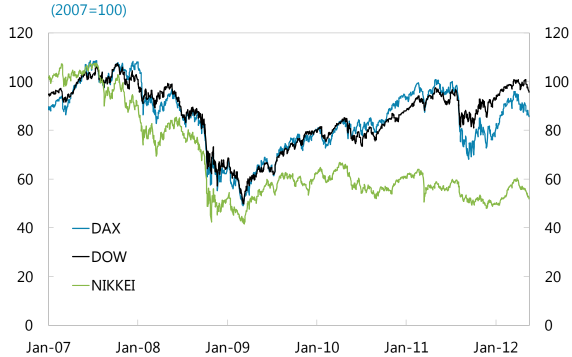
Business Profit Share of Non-Financial Corporations
(Gross operating surplus in percent of gross value added)



Source: Haver Analytics.

Equity prices have recovered...

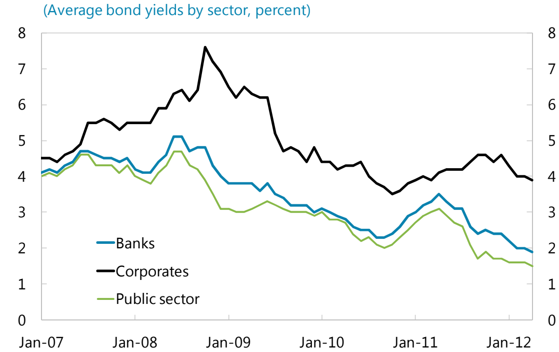
Equity Indices
(2007=100)



Sources: Datastream; and IMF staff calculations.

...while bond yields remain depressed.

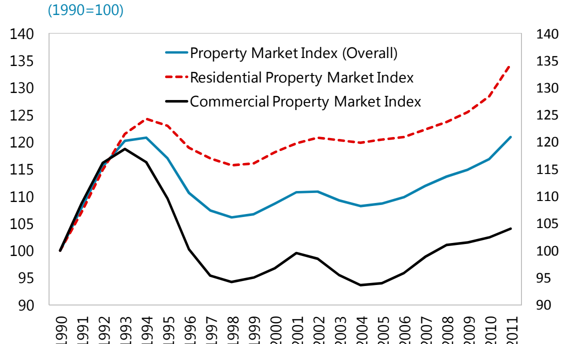
Bond Yields
(Average bond yields by sector, percent)



Source: Deutsche Bundesbank.

Residential property prices have increased in 2011.

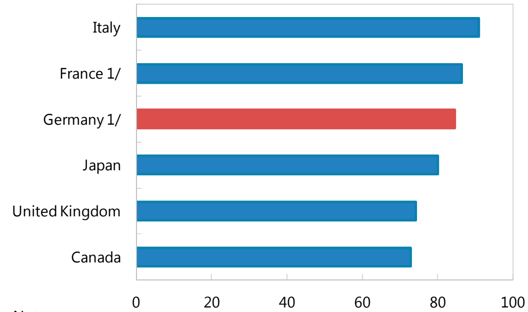
Germany: Property Market Indices, 1975-2011
(1990=100)



Source: BulwienGesa.

Households are not highly leveraged.

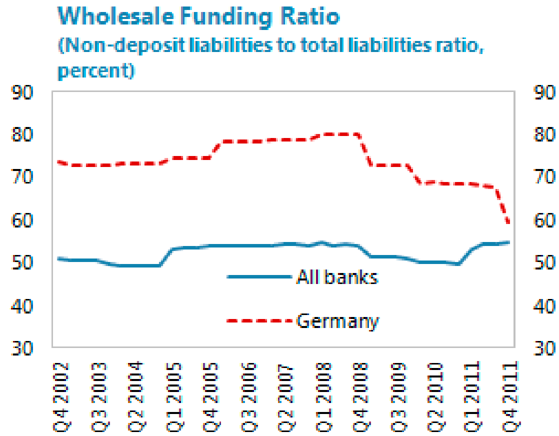
Home Equity
(Non-financial assets less mortgages in percent of non-financial assets, 2009)



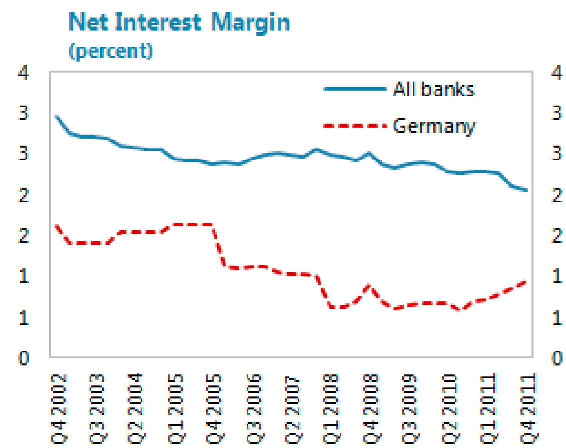
Notes:
1/ Data for 2008
Sources: OECD; and IMF staff calculations

Figure 5. Germany: Vulnerabilities of Large Banks

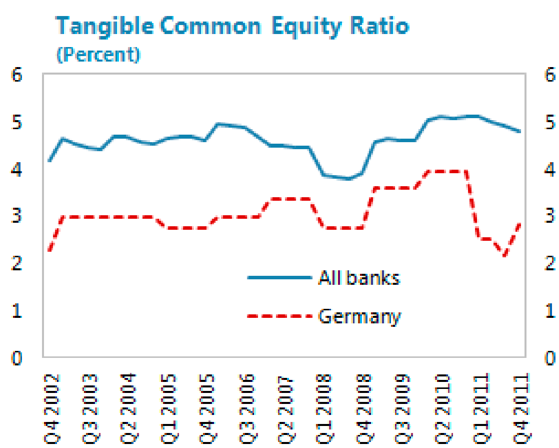
Large German banks continue to rely on wholesale funding…



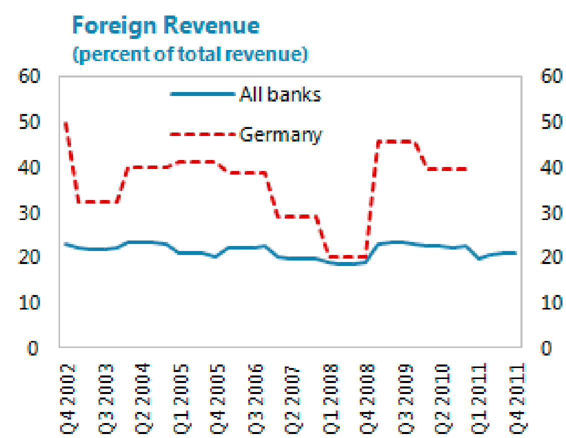
…exhibit low profitability…



…have relatively low capital quality…



…and generate substantial income abroad.

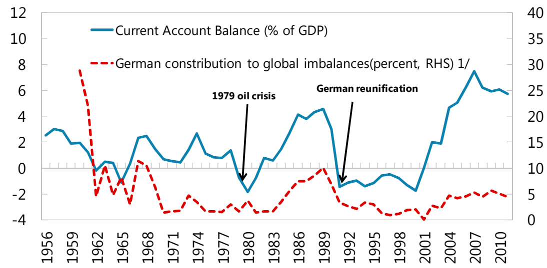


Sources: Datastream, Worldscope, Bloomberg, and IMF staff calculations.
1/ Simple averages, based on a sample of 83 large global financial institutions, incorporated in 21 countries, representing almost 75 percent of global banking system assets. Germany is represented by seven institutions. Sample composition changes over time as institutions are merged or delisted.

Figure 6. Germany: External Position

The German current account surplus increased substantially in mid-2000.

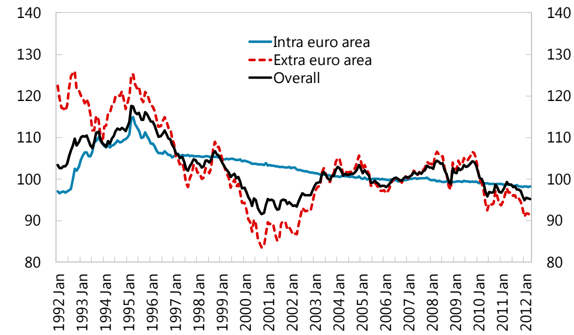
German Current Account and Its Contribution to Global Imbalances



Sources: DataStream; IMF *World Economic Outlook*; and staff calculations.
1/ Equal to contribution of an absolute value of German current account balance-to-GDP to a PPPGDP weighted average of absolute values of current accounts to GDP across the world.

While the real exchange rate depreciated vis-à-vis its trading partners in the euro area (EA) since the introduction of the euro, it returned to the levels of the early 2000s vis-à-vis non-euro area trading partners after appreciating until 2009.

Germany: Real Effective Exchange Rate Index, 1995=100

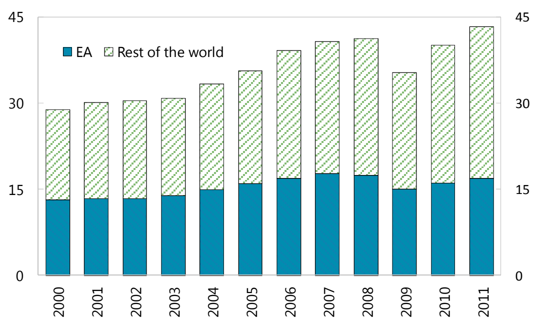


Source: IMF Information Notice System (INS).

Nonetheless, exports have grown largely on the back of demand from outside the euro area.

Exports by Destination

(Percent of GDP)

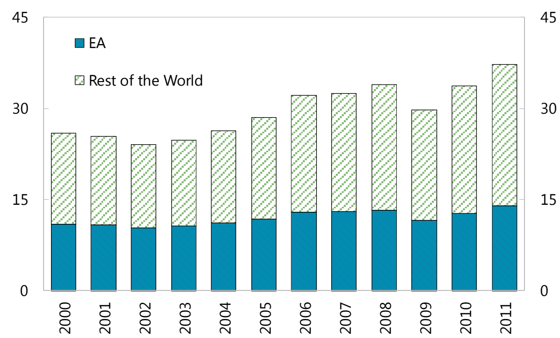


Sources: Bundesbank; and IMF Staff calculations.

German imports are also sourced more from outside.

Imports by Origin

(Percent of GDP)

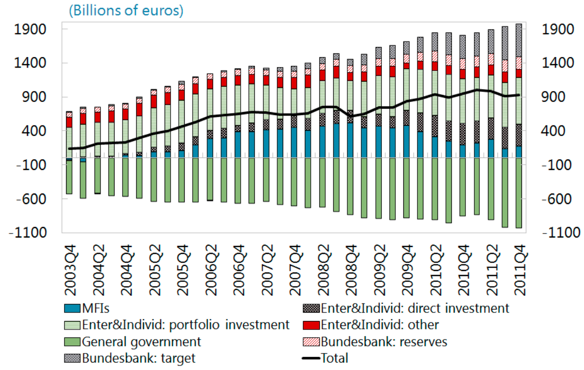


Sources: Bundesbank, and IMF Staff calculations.

The net foreign asset position of the private sector strengthened substantially since early 2000s.

Germany: Net International Investment Position

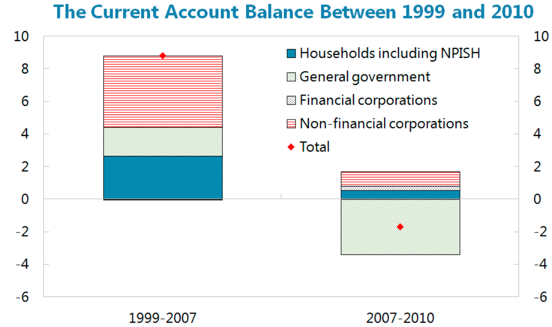
(Billions of euros)



Sources: Deutsche Bundesbank; and IMF staff calculations.

The corporate sector played a major role in raising current account surplus during this period.

Contribution of Different Sectors to The Changes in The Current Account Balance Between 1999 and 2010

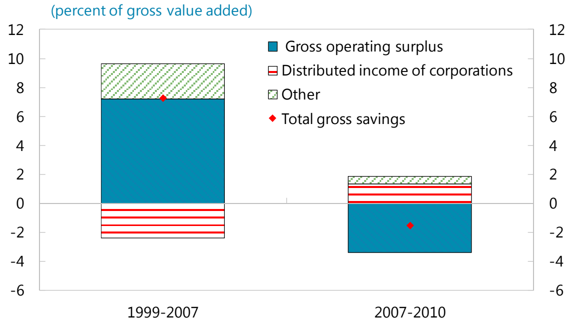


Source: EUROSTAT.

Figure 7. Germany: Corporate Sector Developments

Corporate profits rose substantially by mid-2000s, driving an increase in gross savings.

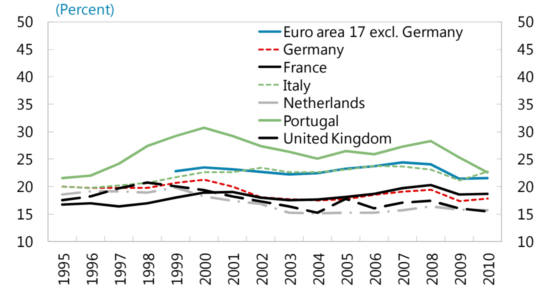
Germany: Composition of Change in Gross Corporate Savings, 1999-2010
(percent of gross value added)



Sources: EROSTAT

Corporate investment declined in early 2000s and remains low in international comparison.

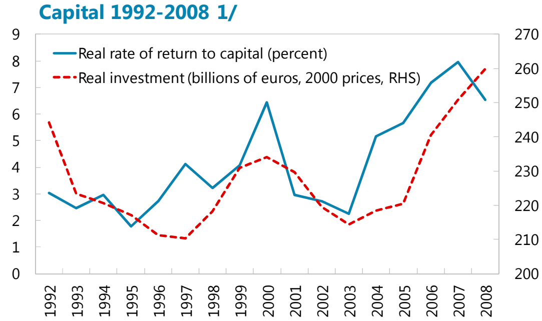
Selected European Countries: Investment Rate of Non-financial Corporations 1/
(Percent)



Source: Eurostat.
1/ Gross fixed capital formation as percent of gross value added of non-financial corporations

The return to capital and slow investment response in mid-2000s can explain the behavior of investment.

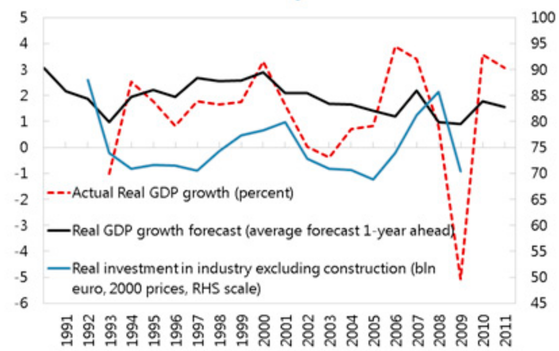
Germany: Investment and Rate of Return to Capital 1992-2008 1/



Sources: Federal Statistical Office of Germany; and IMF staff calculations.
1/ All sectors excluding real estate. Real return to capital was computed using the methodology proposed in Bai, Hsieh and Qian (2006).

The slow response was likely a reaction to almost a whole decade of disappointingly low growth.

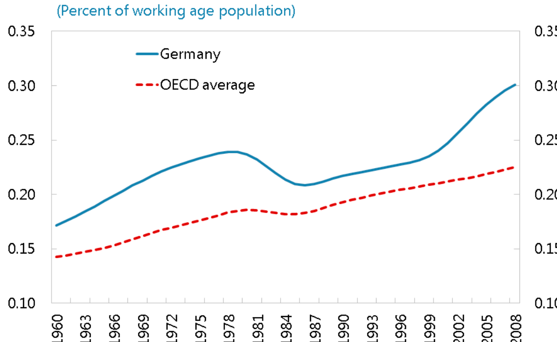
Real Investment in Industry and Real GDP Growth



Sources: Consensus Forecasts; Federal Statistical Office of Germany; IMF, *World Economic Outlook;* and staff calculations.

Unfavorable demographic developments dampened expectations of growth potential...

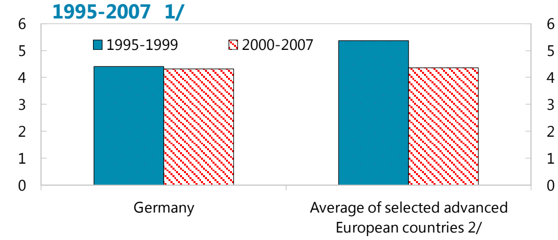
Germany and OECD: Old Dependency Ratio
(Percent of working age population)



Source: IMF *World Economic Outlook*, 2006.

... and the loss of interest rate advantage vis-à-vis other European countries might have also contributed.

Germany and Selected European Countries: Effective Interest Rate on Corporate Debt, 1995-2007 1/



Sources: EUROSTAT; and IMF staff calculations.
1/ Effective interest rate is computed as percent of interest expense in a given year in the total previous year loans and debt securities, excluding financial derivatives.
2/ Selected European countries included France, Italy, UK, Austria, Belgium, Portugal, Norway and Finland.

INTERNATIONAL MONETARY FUND

GERMANY

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 14, 2012

Prepared By | European Department

CONTENTS

ANNEX I: FUND RELATIONS

(As of May 5, 2012; unless specified otherwise)

Mission: April 24 to May 8, 2012 in Frankfurt, Bonn, Munich and Berlin. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2012/050812.htm

Staff team: Messrs. Valdes (Reviewer), Lall (Head), Ms. Ivanova, and Mr. Bornhorst, (all EUR), Mr. Kiff (MCM), Mr. Vitek (SPR), and Ms. Luedersen (LEG).

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

Fund relations: The previous Article IV consultation discussions took place in May 2011 and the staff report was discussed by the Executive Board on July 6, 2011. The Executive Board's assessment and staff report are available at http://www.imf.org/external/np/sec/pn/2011/pn1187.htm

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

		SDR Million	Percent of Quota
II.	**General Resources Account:**		
	Quota	14,565.50	100.00
	Fund holdings of currency	10,131.67	69.56
	Reserve position in Fund	4433.94	30.44
	Lending to the Fund	2853.54	

		SDR Million	Percent of Allocation
III.	**SDR Department:**		
	Net cumulative allocation	12,059.17	100.00
	Holdings	11,819.17	97.86

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Payments to Fund (SDR Million; based on existing use of resources and present holdings of SDRs, as of May 5, 2012):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.43	0.52	0.52	0.52	0.52
Total	0.43	0.52	0.52	0.52	0.52

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.

VII. 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.

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

An assessment under the international standard for AML/CFT was conducted by the Fund's Legal Department in May 2009. The detailed assessment report was adopted by the joint MENAFATF-FATF Plenary Meeting held in Abu Dhabi from February 17-19, 2010. The report concluded that, despite Germany introducing a number of measures in recent years to strengthen its AML/CFT regime, the AML/CFT framework is not fully in line with the standard. The report identified weaknesses in the legal framework and in sanctioning for non-compliance with AML/CFT requirements. The authorities have amended some laws and regulations to address some of the deficiencies, but it is too early to know whether practical implementation of some measures has improved. The areas where action is still required to demonstrate that deficiencies have been addressed include:

- amending the Criminal Code to criminalize TF in a way fully consistent with international standards;
- ensuring that entities report transactions when an institution suspects or has reasonable ground to suspect that a transaction involves the proceeds of crime;
- ensuring that the FIU carries out more robust analysis of Suspicious Transaction Reports (STRs);
- fully and effectively implementing the UN Security Council Resolutions (UNSCRs) on TF;
- applying sanctioning powers more effectively for breaches of AML/CFT obligations;
- strengthening the effective implementation of AML/CFT obligations imposed on designated non-financial businesses and professions (DNFBPs); and

- improving the collection of statistics and the provision of guidance and feedback to FIs.

Germany has thus demonstrated a commitment to strengthen the national system for the prevention, detection and suppression of money laundering and terrorist financing.

IX. Staff Analytical Work on Germany, 2003-12

Growth, Current Account and Competitiveness

- Growth Linkages within Europe, *IMF Country Report No. 08/81*.
- Economic Impact of Shortages of Skilled Labor in Germany, *IMF Country Report No. 08/81*.
- What explains Germany's Rebounding Export Market Share? *CESifo Working Paper No. 1957*.
- Long-run Growth in Germany. *IMF Country Report No. 06/17*.
- Does Excessive Regulation Impede Growth in Germany? *IMF Country Report No. 06/17*.
- The Performance of Germany's Non-Financial Corporate Sector – An International Perspective. *IMF Country Report No. 06/17*.
- Investment Trends in OECD Countries: Long-Term Developments and Future Prospects. *IMF Country Report No. 04/340*.
- Does PPP hold in the Long Run? Germany and Switzerland. *IMF Country Report No. 04/340*.
- Business Investment in the Current Cycle. *IMF Country Report No. 03/342*.
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The Financial System

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- Germany's Three-Pillar Banking System. *IMF Occasional Paper 233 (2004)*.
- Germany's Financial System: International Linkages and the Transmission of Financial Shocks. *IMF Country Report No. 03/342*.
- Credit Conditions in Germany Following the Global Sub-Prime Crises, *IMF Working Paper, forthcoming*.

Corporate Governance

- Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?, *IMF Working Paper No. 08/179*.

ANNEX II: STATISTICAL ISSUES

Data provision is adequate for surveillance. Germany has a full range of statistical publications and subscribes to the Fund's Special Data Dissemination Standard (SDDS). A ROSC Data Module report was published in January 2006. The authorities make substantial use of the Internet to facilitate on-line access to data and press information.

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.

Comprehensive data reporting systems support the accuracy and reliability of the government finance and balance of payments statistics. However, although explanatory documentation exists, differences between the general government data in the *ESA95* classification and the general government cash data on an administrative basis is impairing fiscal analysis; Germany publishes—through Eurostat—general government revenue, expenditure, and balance 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.

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. 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.

Germany: Table of Common Indicators Required for Surveillance
(As of May 05, 2012)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items	
						Data Quality–Methodological soundness [8]	Data Quality–Accuracy and reliability [9]
Exchange Rates	05/05/2012	05/05/2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 12	May 12	M	M	M		
Reserve/Base Money	April 12	May 12	M	M	M		
Broad Money	April 12	May 12	M	M	M		
Central Bank Balance Sheet	April 12	May 12	M	M	M		
Consolidated Balance Sheet of the Banking System	March 12	April 12	M	M	M		
Interest Rates[2]	May 12	May 12	M	M	M		
Consumer Price Index	April 12	May 12	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 12	May 12	Q	Q	Q	LO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government (cash basis)	April 12	May 12	M	M	M		

Stocks of General Government and Government-Guaranteed Debt[5]	December 11	May 12	A	A	A			
External Current Account Balance	March 12	May12	M	M	M	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	March 12	May12	M	M	M		
GDP/GNP	Q1 12	May 12	Q	Q	Q	O, O, O, O	LO, O, O, O, O
Gross External Debt	December 11	May 12	Q	Q	Q		
International Investment Position[6]	December 11	May 12	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition
[6] Includes external gross financial asset and liability positions vis-a-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA)
[8] 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).
[9] Same as footnote 8, 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
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700 19th Street, NW
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IMF Executive Board Concludes 2012 Article IV Consultation with Germany

On June 29, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

The German economy's performance has been remarkable despite facing considerable headwinds. Financial market turbulence and weakening external demand led to a broad-based contraction of activity in Germany in the last quarter of 2011, with the notable exception of construction. However, economic growth appears to have bottomed out and activity picked up in the first quarter of 2012 fueled by a rebound in external demand and strong consumption growth.

Several conditions are now in place in Germany for a domestic demand-led recovery. Employment creation has been robust and unemployment at 5.3 percent is at a post-reunification low. Helped by the reforms implemented in the 2000s, the labor market is trending towards a lower natural rate of unemployment, and since 2010, the creation of jobs with full social security benefits has grown faster than atypical employment. Reflecting the tighter conditions, wage growth has picked up. While nominal pay rates increased by about 2 percent

[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.

in 2011, the normalization of working hours and significant one-off payments have pushed overall wage growth to near 3 percent. Bond yields for banks and the public sector are at record lows, while yields for corporate bonds have remained largely flat. Bank lending rates are lower than elsewhere in Europe, but the rise in bank lending is moderate, reflecting still low demand from households and firms. Headline inflation has fallen to 2.2 percent in April 2012, in line with the moderation of fuel price increases, while core inflation remained low at 1.4 percent. Medium-term price expectations remain well anchored below 2 percent.

Germany's current account surplus remained large at 5 ¾ percent of GDP in 2011, in part reflecting a relatively comfortable competitiveness position. At the same time, private capital outflows have reversed their course as German banks have withdrawn from Europe's cross border interbank market and investment positions in economies under stress are being unwound. The net private inflows into Germany are reflected in an increase in the Bundesbank's claims on the Eurosystem, which had risen to €644 billion by April (approximately 24 percent of GDP). With strong demand for safe assets, German government bond yields have declined to record lows.

The strength of German banks has improved but vulnerabilities remain. While German banks are generally meeting the minimum levels of required regulatory capital and have ample liquidity, they remain highly leveraged, dependent on wholesale funding, have low capital quality and profitability, and some institutions are significantly exposed to the euro area periphery. Some large international financial institutions have substantial cross-border operations, and significant counterparty risk exposures related to their large derivative portfolios. Six larger banks that were called upon to strengthen their capital position as a result of the latest European Banking Authority's (EBA's) stress test are well on their way to meet EBA requirements (with one bank in the process of being wound down). The authorities have reintroduced the financial stability support mechanism (SoFFin II) on a preemptive basis with an overall amount of €480 billion available through end-2012.

Fiscal consolidation is on track. The overall deficit narrowed to 1 percent of GDP in 2011 (from 4.3 percent in 2010), reflecting in part the phasing out of one-off financial sector support measures. The structural balance improved by about 1¼ percent of GDP in 2011, reflecting the withdrawal of stimulus and consolidation measures, including unwinding of temporary tax and labor market measures, the removal of some exemptions, and reductions in social spending and administrative costs. Overall, however, the financial crisis has led to an increase in public debt from 65 percent of GDP in 2007 to 81 percent in 2011, including due to financial sector support operations.

Executive Board Assessment

Executive Directors commended Germany's strong macroeconomic management, which has resulted in a favorable economic performance despite the uncertain external environment. They noted, however, that the near-term outlook is clouded by downside risks, including a strong intensification of the euro-area crisis and potentially lower global growth prospects. The main priorities in the period ahead will be to manage the transition to domestic demand-led growth, secure financial stability, and address the challenges posed by the euro-area crisis in conjunction with European partners.

Directors underscored Germany's pivotal role in reducing euro-area and global imbalances. They called on the authorities to continue to work with European partners to outline clearly and concretely the further efforts needed to enhance the broader European response to the ongoing crisis. Furthermore, they urged the authorities to implement policies to spur domestic demand growth, which will have important beneficial spillover effects in the euro area and globally.

Directors agreed that a natural rebalancing of the sources of growth will likely occur in response to tight labor market conditions, ample liquidity and low interest rates, and disinflationary pressures in the euro-area periphery countries. They stressed, however, that structural reforms to encourage higher investment, remove labor market bottlenecks, and increase economic efficiency and productivity will be crucial to boost potential growth and aid the rebalancing process.

Most Directors viewed the current fiscal stance as appropriate, while allowing automatic stabilizers to operate fully. In the event of a serious economic downturn, more active fiscal policies within available fiscal space and consistent with the EU fiscal framework would be needed. A few Directors were of the view that a fiscal stimulus is warranted to aid the regional and global economic recovery. Directors encouraged growth-oriented revenue and expenditure reforms, including measures to enhance tax and expenditure efficiency.

Directors noted that, despite progress in financial reform and in securing financial stability, the banking sector remains vulnerable to external shocks because of high leverage, dependence on wholesale finance, and low capital quality and profitability. They urged the authorities to step up the pace of implementation of the 2011 Financial Sector Assessment Program Update recommendations. In this regard, Directors called for greater efforts to restructure Landesbanken and strengthen the crisis management framework. They also welcomed pre-emptive reactivation of the backstop facility for financial institutions, as well as the steps being taken to establish a framework for implementing macroprudential policies following European Union initiatives. Directors noted that broadening the channels of financial intermediation would facilitate the allocation of resources towards innovation and new engines of growth.

Directors commended the exceptional performance of the labor market resulting from past reforms, and welcomed the ongoing efforts to increase the labor force through the higher participation of female and older workers and the migration of skilled workers. They encouraged further enhancements to the system of education and training.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with Germany is also available.

Germany: Selected Economic Indicators

	2007	2008	2009	2010	2011	2012 1/	2013 1/
Economic activity and prices	(Change in percent, unless otherwise noted)						
Real GDP	3.4	0.8	-5.1	3.6	3.1	1.0	1.4
Net exports 2/	1.5	-0.1	-2.8	1.4	0.7	0.5	0.2
Total domestic demand	1.9	1.3	-2.6	2.4	2.5	0.4	1.3
Private consumption	-0.2	0.6	-0.1	0.6	1.4	0.9	1.3
Gross fixed investment	4.7	1.7	-11.4	5.5	6.4	0.6	2.3
Construction investment	-0.3	-0.7	-3.0	2.2	5.8	-0.2	1.6
Gross national saving (percent of GDP)	25.9	24.8	23.2	23.6	23.9	23.2	22.6
Gross domestic investment (percent of GDP)	18.4	18.6	17.2	17.5	18.2	17.9	18.0
Labor force 3/	43.4	43.4	43.5	43.6	43.7	43.7	43.8
Employment 3/	39.8	40.3	40.3	40.5	41.0	41.4	41.5
Standardized unemployment rate (in percent)	8.8	7.6	7.7	7.1	6.0	5.3	5.2
Unit labor costs (industry)	-2.8	6.8	21.6	-8.6	-2.2	2.3	1.5
GDP deflator	1.5	1.0	1.1	0.7	0.7	2.0	1.7
Harmonized CPI index	2.3	2.8	0.2	1.2	2.5	2.2	2.0
Public finance	(In percent of GDP)						
General government balance 4/	0.2	-0.1	-3.2	-4.3	-1.0	-0.7	-0.4
Structural government balance	-1.1	-0.8	-1.2	-2.3	-1.0	-0.7	-0.4
General government gross debt	65.4	66.9	74.7	83.5	81.2	82.2	80.2
Money and credit	(Change in percent over 12 months)						
Private sector credit 5/	3.3	6.6	-0.6	-1.9	1.0	0.9	…
M3 6/	10.8	9.8	-1.6	4.4	5.9	6.3	…
Interest rates	(Period average in percent)						
Three month interbank rate 7/	4.3	4.6	1.2	0.8	1.3	0.9	…
Ten-year government bond yield 7/	4.3	4.1	3.3	2.8	2.7	1.9	…
Balance of payments	(In billions of USD, unless otherwise noted)						
Exports 8/	1,579	1,760	1,400	1,552	1,807	1,784	1,845
Imports 8/	1,345	1,534	1,234	1,367	1,624	1,604	1,663
Trade balance (percent of GDP) 9/	7.6	6.6	5.4	5.8	5.4	5.5	5.4
Current account balance	248.0	226.1	195.8	199.9	205.4	181.7	165.8
Current account (percent of GDP)	7.4	6.2	5.9	6.1	5.7	5.2	4.6
Exchange rate	(Period average in percent)						
Euro per US dollar 7/	0.73	0.73	0.68	0.76	0.76	0.76	…
Nominal effective rate (1990=100) 7/	103.8	104.1	106.1	100.1	100.1	99.2	...
Real effective rate (1990=100) 5/ 10/	99.9	99.1	104.6	98.0	96.5	96.2	...

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 2012 refer to April.

6/ Reflects Germany's contribution to M3 of the euro area. Data for 2012 refer to April.

7/ Data for 2012 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 Hubert Temmeyer, Executive Director for Germany
June 29, 2012

I thank the staff for a focused and balanced analysis of the German economy and convey my authorities' appreciation of the fruitful and detailed discussions they had with the IMF team during this year's Article IV mission. Their dedication to gather a broad range of views and a continued dialogue is considered to be very helpful for achieving a mutual understanding of the issues at stake.

Macroeconomic outlook

The staff paper rightly describes the robust economic development of the German economy over the course of the past year and we agree that the main downside risks to the near-term outlook are of an external nature. While the discussion generally focuses more on risks arising from the debt crisis in some euro area countries, the emphasis on the high global interconnectedness of the German economy in the staff report is important and requires a broad assessment of risks. I agree with the staff on the main downside risks, but potential upside risks, in particular the possibility that uncertainty recedes more quickly than anticipated, should also be taken into consideration.

External vs. domestic drivers of economic growth

My authorities remain fully committed to further strengthening domestic sources of growth whose contribution to annual real growth has markedly increased and already surpassed the contribution of net exports in the last years. Overall, we agree with the staff that the conditions for higher domestic demand remain favorable, namely increasing household incomes and employment, strong balance sheets of households and the corporate sector, and a supportive financing environment. While a pick-up in asset prices can have positive effects on wealth and consumption, my authorities nevertheless will monitor increases closely to detect any formation of asset price bubbles early on. At the same time, since Germany is among the world's most open large economies, external demand will naturally continue to play an important role for its economic growth. Currently, many regions in the world enjoy higher growth rates, whereas demographic strains weigh on Germany's potential growth. Furthermore, as pointed out by the staff, German export performance also benefits other European countries.

Current account developments

In the current cyclical position of the German economy, higher domestic demand fuelled by favorable labor market developments, robust construction activity and favorable financing conditions will likely contribute to a rebalancing between euro area countries. However, in this process medium-term price stability in the euro area must be maintained. The main driver for an improved competitiveness of euro area countries with current account deficits is the continued implementation of their respective reform agendas. It is important to note that, after reaching its peak already in 2007, the volume of the German current account surplus with other euro area countries has diminished by over 40 percent by 2011.

I should emphasize that paragraph 34 of the staff report does not correctly reflect my authorities' views, as they do not agree with the statement that the German current account position is stronger than implied by fundamentals. The mere fact that the underlying model cannot explain a country's current account position with a limited set of fundamentals does not by itself allow such a conclusion. Furthermore, my authorities do not see that specific current account benchmarks of two or four percent of GDP, as suggested by staff, are helpful. As stated on the occasion of last year's Article IV discussion, the German current account surplus is not the result of targeted policy measures, but the outcome of complex market processes and largely explained by a multitude of private business decisions.

Securing sustainable growth and steering through an uncertain economic environment

The continued steadfast implementation of sound structural, macroeconomic, and financial sector policies is the basis for sustainable growth, both in the short term and the medium term.

Structural policies

Regarding potential growth and the strengthening of domestic sources of growth, we agree with the staff that a higher labor participation, in particular among women and older persons, as well as increased migration will be needed. The staff's policy recommendations are well taken, as they address foreseeable supply-side challenges on the labor market and the need to sustain the profitability and competitiveness of the German economy.

The employment rate of women and men aged 20-64 is approaching my authorities' target of 77 percent while the EU employment rate target of 75 percent has already been surpassed. To better tap the domestic workforce, and also to attract qualified workers from abroad, the German government has established, in 2011, the "Skilled Labor Strategy" which includes measures to improve the availability of childcare facilities, to promote more family-friendly working hours in cooperation with the relevant business associations, to reduce, by 2015, the share of persons aged 20-29 that lack vocational training from 17 percent to 8.5 percent, to increase the number of academics and the share of women with a degree in natural sciences, to reintegrate the older unemployed into the labor markets, and to increase the effectiveness of existing labor market instruments.

Regarding growth-oriented tax policy, any measure will need to be analyzed in the context of fiscal sustainability. As pointed out last year, the introduction of an allowance for the normal return on new equity would result in significant revenue losses, as observed elsewhere, and is therefore not under consideration.

Fiscal policies

Fiscal consolidation and respecting the requirements of the European Stability and Growth Pact is a key common objective of all EU countries. In addition, the Treaty on Stability, Coordination and Governance, including the Fiscal Compact, was signed by 25 EU member states. Compliance with these legal commitments is essential since a sound and predictable fiscal framework, including national fiscal rules, constitutes a much needed anchor and an element of crisis resolution in an uncertain financial market environment. It will be instrumental in securing confidence through a credible fiscal policy and the reduction of elevated levels of public debt in many EU countries, including Germany.

My authorities agree with the staff that there is no need for a fiscal stimulus at the current stage of the business cycle and are skeptical about a debt-financed stimulus of the economy. The staff paper correctly reiterates the findings that potential spill-over effects from expansionary fiscal measures in Germany to relevant EMU partner countries would be negligible.

Financial sector

When assessing the vulnerabilities of the German banking sector, it has to be differentiated between specific parts of the sector. German banks differ substantially in business models and funding structure. The profitability of banks has been improving after the financial crisis with especially the savings and cooperative banks remaining profitable even during the crisis. While wholesale funding, which has been decreasing substantially, continues to be part of the banks' funding strategy, the share of deposits relative to total liabilities has been rising for several years. The adjustment process in the *Landesbanken* sector is ongoing. Progress is being made with respect to reducing risk weighted assets, focusing on core business as lending to domestic SMEs and municipalities as well as downsizing, including the restructuring process of a major *Landesbank*.

Raising capital as required by Basel III is well on track. Additionally, the early compliance of the majority of affected German banks with the capital requirements of the European Banking Authority (EBA) has helped to foster the resilience of institutions and to address vulnerabilities. When assessing the quality of capital, it should be kept in mind that the recent EBA exercise showed that German banks are able to convert their supposedly low quality capital into core tier 1 capital. In March 2012 my authorities reactivated the Special Financial Market Stabilization Fund (SoFFin) that can provide guarantees and loans to stabilize banks, if required. This was done for precautionary purposes only with currently no foreseeable cases of utilization.

My authorities remain committed to the recommendations of last year's FSAP to enhance the existing financial stability framework where appropriate. Financial stability requires constant work on the regulatory and supervisory framework and progress on the FSAP recommendations is being made.

Systemic oversight and macro-prudential supervision will be strengthened through an operationally independent Financial Stability Commission comprising all relevant regulatory and supervisory bodies in Germany with a central role for the Bundesbank. Its most prominent task will be the continuous analysis of financial stability, identification of potential threats and issuance of recommendations and warnings. As a precondition for successful analytical work, the Bundesbank will have access to all necessary information from the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) and the possibility to request economic and trade data from financial institutions under supervision will further enhance information flows. At the same time, the BaFin will have comprehensive access to financial stability analysis conducted by the Bundesbank. It is envisaged that the Financial Stability Commission will be established by January 2013.

Further steps are being taken to improve the crisis management framework. After the bank restructuring law coming into force in December 2010 the setting up of recovery and resolution plans – in line with recommendations from the Financial Stability Board (FSB) – is progressing.