

International Monetary Fund

Germany—2014 Article IV Consultation Preliminary Conclusions

Berlin, May 19, 2014

Key policy recommendations:

- *Germany can strengthen its role as an anchor of regional stability.*
- *More infrastructure investment, further clarity on the energy regulatory framework, and reforms to further increase competition in the services sector would support growth in Germany and the rest of the euro area.*
- *Future increases in the minimum wage should take into account potential adverse employment effects in regions with relatively high unemployment.*
- *Banks should keep strengthening their capital position ahead of the completion of the ECB's Comprehensive Assessment.*

1. The German recovery is expected to gain further momentum and keep outpacing that in the rest of the euro area. Germany remains an anchor of regional stability. Balance sheets are generally healthy, fiscal consolidation has been broadly achieved underpinning confidence, and financial conditions for enterprises are favorable. Private consumption should benefit from solid wage and employment growth, while business investment should continue to strengthen. However, while domestic demand is expected to contribute to growth more than in the past, the decline in the current account surplus is projected to be gradual. Risks to the outlook are broadly balanced. The main upside risk stems from the possibility of a long-awaited and stronger-than-expected rebound in private investment. Downside risks include faltering growth in the rest of the euro area, where domestic demand is constrained by the need to repair balance sheets both in the private and the public sectors, at a time when high unemployment and low and declining inflation are hampering the repair process. A sharp slowdown in emerging markets would negatively affect German exports, while an escalation in geopolitical tensions surrounding Ukraine would likely hit investment by increasing uncertainty and hurting market confidence.

2. Policies should focus on increasing growth in Germany while at the same time supporting the recovery in the euro area. Higher public and private investment and services sector reform in Germany would raise medium-term output, reduce the large and persistent current account surplus, and generate appreciable positive demand spillovers to the rest of the euro area, thus helping rebalancing within the monetary union. In a broader context, Fund staff have also called for more accommodative monetary conditions to support the regional recovery.

3. Stronger public investment, particularly in the transport infrastructure, is needed and feasible. The government's decision to boost spending in this area is welcome, but the amount is small relative to estimated needs. Additional investment up to 0.5 percent of GDP per year over four years could be financed without violating fiscal rules and would have only a minor impact on the debt-to-GDP ratio given the growth offset. Such a program would yield a persistent increase in GDP by crowding in private investment and would also stimulate growth in the rest of the euro area. Measures to ensure that the financed projects have true economic value need to be put in place. It would also be important to explore the role that the private sector could play in these initiatives through public-private partnerships.

4. Unlike spending on investment, pension expenditures do not increase potential output, and have negligible outward spillover effects. Planned increases in benefits to certain categories of pensioners are particularly costly. Measures to facilitate early retirement for workers with long contribution periods will likely reduce older workers' labor market participation and add to skills shortages in some sectors, while further increasing already high social security contributions down the road.

5. Greater clarity about the future energy sector regulatory framework would encourage private investment. While the goals of the Energiewende are clear, there are implementation challenges. Surveys indicate that uncertainty about energy policy has been discouraging investment by firms outside the energy sector. The announced reform of the renewable energy law has usefully clarified important elements of the strategy, including – for the short term – the

contentious regime of exemptions for energy-intensive, internationally-active firms. However, the private sector still perceives the exemption regime in the medium-term as uncertain. At the same time, hostility by some affected parties continues to delay the needed grid extension. Estimates of investment needed to upgrade the energy infrastructure are about 1-1½ percent of GDP per year until 2020. Mobilizing this investment potential would help strengthen the outlook.

6. Further reforms in services sector regulation could boost competition and productivity.

There is scope for deepening competition in several areas of the services sector. In professional services (accountants, architects, engineers, lawyers, tax consultants, etc...), greater flexibility could be introduced in the areas of exclusive rights, compulsory chamber membership, and regulation on prices and fees. While barriers to competition are generally low in network industries, in rail transportation and postal services we would welcome the reinforcement of the regulator's powers to stop discrimination against the incumbent operators' competitors.

7. The new nationwide minimum wage will help reduce growing wage inequality, but it risks exacerbating unemployment in some regions. Expert estimates suggest that the proposed minimum wage will be binding for about 20 percent of workers in some federal states where unemployment is already relatively high. While the employment effects of changes in minimum wage regulation are notoriously difficult to predict, sizable adverse effects in these areas could materialize. Decisions by the to-be-created commission on the future level of the minimum wage should take these employment effects into account and give adequate consideration to the interests of those not well represented by employers' and employees' associations. In addition, alternative ways to achieve income redistribution could usefully be explored.

8. The banking sector keeps downsizing through the disposal of legacy assets, thus building up capital buffers, but requires continued close monitoring. Capital building efforts should continue while the ECB's Comprehensive Assessment (CA) is in progress, and supervisors are in active dialogue with assessed banks about their capital plans. While asset quality is generally not a problem, the CA will help bring clarity about the health of banks still holding sizable portfolios of hard-to-value legacy assets. In addition, supervisors should continue pressing to ensure that all large banks comfortably meet forthcoming minimum standards on leverage ratios. Close cooperation and coordination within SSM joint supervisory teams will be important in this context.

9. Low interest rates are contributing to an upturn in the housing cycle and have rekindled residential investment without threatening financial stability to date. Real housing price inflation remains low outside of some "hot spots". In addition, mortgage debt growth is subdued. Nonetheless, while concerns about a housing bubble are premature, preparations against it are not. Hence, the macroprudential toolkit should be readied. We welcome the authorities' progress in making the new Financial Stability Committee fully operational and in expanding their statistical coverage of the mortgage market. We encourage them to consider expanding the set of macroprudential tools to include loan-to-value and debt-service-to-income instruments.

10. While stable, the life insurance sector requires policy action. High average guaranteed interest rates and a high duration gap between assets and liabilities make it vulnerable in the medium-term to a persistent low interest rate environment. Measures taken so far to force life insurers to build up reserves might prove insufficient, and further policy action is rightly being considered. One avenue to protect the interest of the majority of policyholders would be to amend a regulation that compels insurers to share part of their hidden valuation reserves – including on fixed-income assets – with holders of matured or cancelled policies.

We wish to thank the authorities for their hospitality and willingness to engage in open and candid discussions.