EUROPEAN COMMISSION

Brussels, 2 February 2005

Commission's assessment of the December 2004 update of the stability programme of Germany[1]

Background

Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[2] stipulates that participating Member States, that is, those which have adopted the single currency, had to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their stability programmes, which may also be examined by the Council in accordance with these same procedures.

The Commission initiated the Excessive Deficit Procedure for Germany on 19 November 2002 and the Council decided on 21 January 2003 that an excessive deficit existed in Germany. At the same time, the Council recommended to Germany to bring the situation of an excessive deficit to an end in 2004 at the latest. Following the Council conclusions of 25 November 2003 and the decision of the European Court of Justice of 13 July 2004, the Commission, in its Communication of 14 December 2004[3] addressed to the Council, concluded that 2005 should be considered the relevant deadline for the correction of the excessive deficit. The Commission also concluded that action taken by Germany appeared to be broadly consistent with a correction of the excessive deficit by 2005 and that no further steps were necessary at that point under the excessive deficit procedure. The Commission noted, however, that if failures in implementing the envisaged correction measures should emerge at a later stage, it would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact. The presidency conclusions of the Ecofin Council of 18 January 2005 confirmed this position. Germany re-affirmed

---

1 Excerpt from the explanatory memorandum of the Commission recommendation for a Council Opinion adopted by the Commission on 2.2.2005.

2 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website:http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

3 Document COM(2004) 813 of 14 December 2004.

its commitment to take all necessary measures to bring its deficit below 3% of GDP in 2005 and to keep it below 3% in 2006.

The first stability programme of Germany, covering the period 1998-2002 was submitted on 4 January 1999 and assessed by the Council on 15 March 1999[4]. Updates were presented every following year. Germany submitted the most recent update of its stability programme on 1 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[5], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[6]. This evaluation warrants the following assessment.

Commission assessment

The German cabinet adopted the update of the German stability programme on 1 December 2004. It covers the period from 2004 to 2008. The programme complies broadly with the data requirements of the "Code of Conduct on the content and format of stability and convergence programmes". Deficiencies relate to (i) the information on external assumptions, (ii) the mixing of incompatible data (policy effects are compared sometimes to a baseline unknown to the reader, and sometimes to 2004 as the reference year); (iii) the presentation of rounded figures for key data. However, improvements are noted in terms of details e.g. in using ESA 95 as a consistent statistical framework in the parts on the macro-economic scenario and the budgetary projections.

The macro-economic scenario underlying the programme projects real GDP growth at 1.7 % for 2005, practically unchanged from an expected rate of 1.8 % in 2004. Adjusted for substantial calendar effects, the figures imply an acceleration of growth by ¾ pp in 2005. In the final three years covered by the programme, growth is expected to remain flat at 2 % p.a. According to Commission services calculations applying the commonly agreed methodology to the figures of the programme, real GDP growth would be somewhat higher than potential, which is estimated to average 1½ % over the period 2004-2008. The output gap would however remain negative until 2008. For the year 2005, the projections of the Commission services are slightly less favourable than those of the programme and downward risks have increased since the Commission services autumn forecast. While real GDP growth projections of the update carry some downward risk for 2005, they appear plausible for the remaining years. However, the GDP deflator underlying the forecast appears to be somewhat high and may imply an overestimation of tax revenues towards the end of the programme period.

---

4 OJ C124, 5.5.1999

5 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the Ecofin Council on 10.7.2001.

6 COM (2002) 668 final, 27.11.2002.

As in previous updates, the medium-term budgetary strategy aims at a balance between structural reforms, budgetary consolidation and cyclical stabilisation. The programme aims at reducing the general government deficit to below 3 % of GDP in 2005 and at ensuring a continuous decline in the following years. The deficit is projected to be reduced from 3.7 % of GDP in 2004 to 2.9 % of GDP in 2005, and thereafter to decline steadily by ½ percentage point of GDP per year to 1½ % of GDP in 2008. Compared to the previous programme, the current update follows almost the same path of adjustments, although delayed by one year, on the basis of a slightly weaker growth scenario. The primary balance is projected to swing from a deficit of ½ % of GDP in 2004 to a surplus of 2 % of GDP in 2008. According to Commission services calculations based on the projections of the programme and the commonly agreed methodology, the cyclically-adjusted balance would also improve by 0.6 pp in 2005, but only by 0.3 pp annually in 2007 and 2008 to reach -1.3 % of GDP in 2008. A close-to-balance budgetary position would therefore not be reached by the final year of the programme.

As far as it is possible to judge on the basis of current information, the measures announced by the German authorities in November 2004 should be sufficient to reduce the deficit to 2.9% of GDP in 2005, compared with the deficit projected at 3.4% by the Commission services autumn forecast of October 2004. However, this is subject to two main risks: First, growth may be lower than expected. Second, expenditure on social transfers may be higher for reasons other than unexpectedly low growth. Also, the most important one-off measure to reduce the deficit remains subject to a decision by Eurostat. In the years after 2005, the budgetary situation remains vulnerable, although the general government deficit is likely to stay below 3 % of GDP. The budgetary stance laid out in the update seems insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position close to balance or in surplus is achieved. In view of the improvement in the cyclically-adjusted balance towards the end of the programme period by less than 0.5 pp, the adjustment projected in the update is quite small, despite the implementation of remarkable structural reforms likely to reduce medium-term expenditures. Moreover, the path of budgetary adjustment seems rather optimistic towards the programme horizon, in particular as regards the expected surpluses of the social security system. Furthermore, tax revenues seem to be estimated somewhat favourably from 2006 on. It should also be noted that the one-off measures taken in November 2004 to bring the deficit below 3 % of GDP in 2005 weaken to some extent the budgetary position towards the end of the programme period and beyond. Also in view of this risk assessment, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3 % deficit threshold with normal macroeconomic fluctuations before 2008.

The debt-to-GDP ratio is projected to remain above 60 % of GDP throughout the period covered by the programme. After increasing by 6 pp between 2001 and 2004 to 65½ % of GDP, it is projected to fall to 65 % of GDP by 2008. The projected path for the debt is subject to the same risks as for the deficit ratio: any slippage in the latter would delay the reduction of the debt ratio as from 2007.

The update reviews the important structural reforms implemented in the labour market as part of the "Agenda 2010" package, and in the public pension and health care systems. These reforms are the main reason for the decline of monetary transfers by 2 % of GDP and of government final consumption by 1½ pp between 2004 and 2008. In 2005, a new social benefit scheme is being introduced, which strengthens the incentives for the unemployed to look for jobs while not fully removing the unemployment trap for low-paid work from the tax-benefit system. The sustainability of the public pension system was reinforced by linking pensions and the contribution rate to demographic developments. Incentives for later retirement were partially strengthened and the portability of supplementary pension schemes improved. The reforms in the health care sector led to substantial expenditure relief in 2004. However, they will only partly contain future spending pressures.

Germany appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, of which the projected budgetary cost of an ageing population is an important element. However, long-term sustainability hinges crucially on the achievement of the planned budgetary consolidation in the medium-term. The already legislated structural reforms and in particular the pension reform is likely to reduce the budgetary impact of ageing. However, the exonerating budgetary impact of the ongoing reforms is subject to considerable uncertainty, and the update concedes that further measures are needed to contain notably health-related expenditures.

Overall, the economic policies outlined in the 2004 update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, no reduction of the cyclically-adjusted deficit occurred in 2004. The planned medium-term adjustment in the cyclically adjusted balance from 2007 onwards is below ½ pp of GDP and, moreover, subject to risks. It will not lead to a close-to-balance budgetary position over the period covered by the programme. This is despite the fact that Germany has implemented important structural reforms, notably concerning the labour market and pension systems, which put the country in a better position to face the consequences of an ageing population. It remains crucial for Germany to succeed in moving to higher trajectories of actual and potential growth by mobilising its underutilised employment reserves.

In view of the above assessment, it would be appropriate for Germany to (i) do the necessary to ensure the correction of the excessive deficit in 2005; (ii) to implement budgetary adjustments in the years beyond 2005 that will allow a budgetary position of close to balance to be achieved by the end of the programme period; and (iii) continue with structural reforms in order to further improve the long-term sustainability of public finances, in particular as regards the health care system.

Table: Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP Dec 2004**	**1.8**	**1.7**	**1 ¾**	**2**	**2**
	COM Oct 2004	1.9	1.5	1.7	--	--
	SP Jan 2004	*1.7*	*2 ¼*	*2 ¼*	*2 ¼*	--
HICP inflation (%)	**SP Dec 2004**	**--**	**--**	**--**	**--**	**--**
	COM Oct 2004	1.7	1.3	1.1	--	--
	SP Jan 2004	--	--	--	--	--
General government balance (% of GDP)	**SP Dec 2004**	**-3 ¾**	**-2.9**	**-2 ½**	**-2**	**-1 ½**
	COM Oct 2004	-3.9	-2.9	-2.6	--	--
	SP Jan 2004	*-3 ¼*	*-2 ½*	*-2*	*-1 ½*	--
Primary balance (% of GDP)	**SP Dec 2004**	**- ½**	**0**	**½**	**1 ½**	**2**
	COM Oct 2004	-0.8	0.2	0.5	--	--
	SP Jan 2004	*- ¼*	*½*	*1*	*1 ½*	--
Cyclically-adjusted balance (% of GDP)	**SP Dec 2004**[1]	**-3.0**	**-2.4**	**-1.9**	**-1.6**	**-1.3**
	COM Oct 2004	-3.4	-2.4	-2.1	--	--
	SP Jan 2004[1]	*-2.5*	*-2.1*	*-1.6*	*-1.4*	--
Government gross debt (% of GDP)	**SP Dec 2004**	**65 ½**	**66**	**66**	**65 ½**	**65**
	COM Oct 2004	65.9	66.7	67.1	--	--
	SP Jan 2004	*65*	*65 ½*	*65 ½*	*65*	--

Note:
[1]Commission services calculations on the basis of the information in the programme
Sources:
Stability programme (SP); Commission services autumn 2004 economic forecasts (COM) adjusted to include the additional budgetary package presented in November, cf: Communication from the Commission to the Council: "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice", 14 December 2004, COM(2004) 813; Commission services calculations