



**COUNCIL OF
THE EUROPEAN UNION**

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NOTE

From: General Secretariat of the Council
To: Delegations

Subject: Council Opinion on the updated Stability Programme of Germany, 2009-2013

Delegations will find attached the Council Opinion on the updated Stability Programme of Germany, 2009-2013, as adopted by the Council on 26 April 2010.

Encl.:

Draft Council Opinion

on the updated stability programme of Germany, 2009-2013

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On 26 April 2010 the Council examined the updated stability programme of Germany, which covers the period 2009 to 2013.
- (2) After a sharp, export-driven contraction at the turn of 2008/09, real GDP rebounded strongly in mid-2009, thanks to expansionary policies and a revival of foreign demand. However, a renewed loss of momentum towards the end of 2009 underscored the fragility of the current economic recovery. While the labour market has remained resilient so far, reflecting partly state-funded short-time working arrangements, the banking sector suffered considerable losses and write-downs from investments in structured assets.

¹ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

Due to sizeable fiscal stimulus measures (in 2009 and 2010) adopted in line with the European Economic Recovery Plan (EERP) as well as crisis-related revenue shortfalls and higher expenditure, the general government budget shifted from a balanced position in 2008 to a deficit of above 3% of GDP in 2009. These developments have led to the opening of the excessive deficit procedure for Germany on 2 December 2009 with the Council setting a deadline of 2013 for the correction of the excessive deficit. While in the medium-term the recovery should be supported by past structural reforms, notably in the labour market, sound corporate and household balance sheets and a strong competitive position, a key challenge will be to raise potential growth, in particular by strengthening domestic sources of growth. Combining the necessary fiscal consolidation with the stabilisation of the banking sector, ensuring access to finance by the non-financial sector and further enhancing the adjustment capacity of the labour market will be pivotal elements to support the economic recovery.

- (3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential output has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Germany it is important to undertake reforms in the areas of competition in services, labour market integration and education and training.

- (4) The macroeconomic scenario underlying the programme envisages that after a slump of 5% in 2009, real GDP growth will be restored, moving from 1.4% in 2010 to an average rate of 2% over the rest of the programme period. Assessed against currently available information², this scenario appears to be based on somewhat favourable growth assumptions. Real GDP growth projections for both 2010 and 2011 are slightly above the Commission services' autumn 2009 forecast. Moreover, the programme envisages a slightly stronger expansion of private consumption in 2011, supported by a more favourable outlook for employment, unemployment and wage growth. The programme's projections for inflation could turn out to be on the high side in 2011, but appear realistic for the rest of the programme period.
- (5) The programme estimates the general government deficit for 2009 at 3.2% of GDP. The significant deterioration from a balanced budgetary position in 2008 reflects to a large extent the impact of automatic stabilisers, but was also brought about by stimulus measures amounting to around 1¾% of GDP which the government adopted in line with the EERP. The widening of the deficit was mainly expenditure-based due to increased social transfers, higher public investment and subsidies to support short-time work. According to the programme, fiscal policy is planned to remain supportive in 2010 before turning restrictive in the outer years of the programme. In view of Germany's relatively favourable budgetary and economic situation the continued fiscal expansion in 2010 is appropriate and in line with the EERP. In line with the exit strategy advocated by the Council and with a view to correcting the excessive deficit by 2013 and returning to a sustainable public finance position, the expansionary fiscal stance in 2009 and 2010 is followed by a significant fiscal tightening from 2011 on.

² The assessment notably takes into account the Commission services' autumn 2009 forecast, but also other information that has become available since then, including the Commission services' February 2010 interim forecast.

- (6) According to the programme, the nominal general government deficit will increase from 3.2% of GDP in 2009 to 5½% in 2010, which is in line with the Council Recommendation under Article 126(7) of 2 December 2009. The further widening of the deficit in 2010 is mainly fuelled by fiscal stimulus measures and the impact of automatic stabilisers. General government revenue is projected to shrink by almost 2% of GDP on the back of household relief measures (such as tax deductibility of health-care and long-term-care contributions, reduced contribution rate to health-care insurance, increased child allowance and higher basic personal allowance) as well as weaker domestic demand. The projected increase in general government expenditure by around ½% of GDP can be mainly attributed to the worsening situation on the labour market and continued investment in public infrastructure undertaken as a part of the fiscal stimulus (around ¼% of GDP according to the Commission services' estimation). The course of fiscal policy in 2010 will remain strongly expansionary, as reflected by a 2½% of GDP increase in the structural deficit (cyclically-adjusted net of one-off and other temporary measures, as recalculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology). The strong deterioration in the structural balance can be mainly accounted for by the new stimulus measures introduced in 2010 and lagged effects of some of the stimulus measures adopted in 2009 (e.g. the reduced contribution rate to health-care insurance, additional infrastructure investment). The change in the structural deficit calculated according to the commonly agreed methodology (top-down approach) amounting to -2½% of GDP differs from the change explained by the information on the discretionary measures undertaken in 2010 (bottom-up approach) estimated by the Commission's services at around -1¾% of GDP. This discrepancy can be associated with the negative composition effects on tax revenue, particularly due to weak private consumption and wage growth, and likely revenue losses from profit-related taxes.
- (7) The main goal of the medium-term budgetary strategy is to correct the excessive deficit by 2013 with an average annual fiscal effort of almost ¾% of GDP in 2011-2013, which is in line with the Council Recommendation under Article 126(7) of 2 December 2009.

The programme projects the general government balance to improve from 2011 onwards. In nominal terms, the consolidation is expected to take place in equal steps in 2011 and 2012 – around 1 percentage point each – followed by a smaller adjustment of around ½ percentage point in 2013. The envisaged adjustment path is based on the technical assumption of expenditure-driven consolidation at the federal level (with restraint spread equally across all categories of expenditure except for interest payments and transfers to other government levels and abroad). This technical assumption is related to the consolidation requirements implied by the new national budgetary rule. The expected consolidation is projected to be borne mainly by the Federal government (around 2% of GDP over the period 2011 and 2013) and to a lesser extent by the Länder (around ½% of GDP). In structural terms (recalculated in accordance with the commonly agreed methodology), the deficit is projected to improve by around ½% of GDP in 2011, around 1% of GDP in 2012 and around ¾% of GDP in 2013. Given rising debt and interest payments increasing towards the programme horizon, the primary balance needs to improve faster than the headline deficit. Germany's goal over the medium-term is to achieve a general government budget close-to-balance in structural terms. According to the programme, this implies a medium-term objective (MTO) of - ½% of GDP. Given the most recent projections and debt level, the MTO reflects the objectives of the Pact. However, the updated stability programme does not envisage achieving the MTO within the programme period.

- (8) The budgetary outcomes could turn out worse than projected in the programme, in particular in the year 2011 and beyond. This is related to the lack of specific consolidation measures beyond 2010, the need to effectively implement the new national budgetary rule at the central and sub-federal level of the government without postponing consolidation requirements to later years, the uncertainty about the possible introduction of further tax cuts envisaged in the Coalition agreement and their reconciliation with the necessary budgetary retrenchment as well as to the somewhat favourable growth assumptions. Additional financial market stabilisation measures could further burden the budget, although some of the costs of the government support could be recouped in the future.

- (9) Government gross debt is estimated at 72½% of GDP in 2009, up from 65.9% in the year before. Apart from the increase in the deficit and the decline in GDP growth, a significant stock-flow adjustment (around 1% of GDP) reflecting primarily bank rescue operations contributed to the rise in the debt ratio. The debt ratio is projected to increase by a further 9½ pps. over the programme period up to 82% of GDP, mainly driven by continued government deficits and to a lesser extent by unspecified debt-increasing stock-flow adjustments of around ½% of GDP p.a. between 2011 and 2013. The debt projection included in the programme relies on the assumption that the level of debt will not be affected by the establishment of "bad banks". In addition to the risks attached to the deficit path, the evolution of the debt ratio is subject to risks related to possible further burdens related to financial market stabilisation. The government gross debt ratio is above the Treaty reference value and is on an increasing trend over the whole programme period.
- (10) Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis, and tax ratios to return to pre-crisis levels and that include the projected increase in age-related expenditures show that the budgetary strategy envisaged in the programme, taken at face value and with no further policy change, would not be sufficient to stabilise the debt-to-GDP ratio by 2020.
- (11) The long-term budgetary impact of ageing is slightly above the EU average. The budgetary position in 2009 as estimated in the programme compounds the budgetary impact of population ageing on the sustainability gap. Achieving primary surpluses in the medium term would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report³ as medium.

³ In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

- (12) Germany's fiscal framework has been considerably strengthened by the new budgetary rule anchored in the Constitution in August 2009. Following the structure of the preventive arm of the SGP, the new rule is a close-to-balance rule setting the ceiling for the federal structural deficit at 0.35% of GDP from 2016 onwards, with a transition period starting in 2011. The regional budgets of the *Länder* must be structurally balanced as of 2020, but their respective consolidation paths are still unclear. Missing retrenchment plans at the sub-federal level and uncertainties related to future financing needs of the social security funds constitute a potential risk for the consolidation of the general government budget. Nevertheless, the new rule enhances fiscal credibility and reduces considerably the discretionary leeway compared with the former budget rule which could not prevent debt accumulation in the past decades. The newly created Stability Council (*Stabilitätsrat*), composed of the finance ministers of the *Bund* and the *Länder*, will regularly monitor federal and regional budgets, including the implementation of consolidation measures in the framework of the SGP. However, its recommendations are not binding and it is not entitled to impose any sanctions. The new framework is planned to be further enhanced by changeover from a bottom-up to a top-down approach of budgetary planning, improving the expenditure control by the Ministry of Finance and thus supporting the compliance with the consolidation predetermined by the budgetary rule. Furthermore, the government plans a gradual overhaul of the federal budgeting and accounting system with stronger focus on a performance-based assessment of revenues and expenditures.
- (13) Despite Germany's overall good quality of public finances, there is still room for improvement. On the revenue side, corporate and income tax codes remain complex, and the tax system offers numerous concessions. Despite further plans to increase spending on education and R&D, the relatively low ratio of investment to public consumption points to the potential for a more growth-oriented composition of expenditures.

While the programme recognises the importance of a comprehensive review of public subsidies, it does not outline any concrete plans in this regard. Additional efficiency gains could be realised by improving the budgetary coordination between the federal and the regional governments and through further re-organisation of public administration (e.g. wider use of quality management, outsourcing, e-government, reduction of public sector employment etc.)⁴. The need for fiscal consolidation limits the scope for subsidies to the public pension system from the general budget. Recent ad-hoc modifications of the pension adjustment formula undermine the credibility of the undertaken pension reforms, as the envisaged correction in later years might prove difficult. Regarding statutory health-care insurance, the government established a special committee at ministerial level to reconsider the financing of the health-care system, in particular to examine the options for decoupling the health-care insurance contributions from wage income with a view to reducing non-wage labour costs. First results are expected in July 2010.

- (14) Overall, in 2010 the budgetary strategy set out in the programme is consistent with the Council Recommendation under Article 126(7) of 2 December 2009. However, from 2011 on, taking into account the risks, the budgetary strategy may not be consistent with the Council Recommendation under Article 126(7) of 2 December 2009. In particular, the consolidation path from 2011 onwards is not backed up by any concrete measures and no information is provided regarding the possible implementation of the expansionary measures proposed in the new government's coalition agreement and their reconciliation with the necessary budgetary retrenchment. The national budgetary rule – a focal point of the consolidation plans – remains to be implemented at all levels of governments. Moreover, economic recovery proving more sluggish than currently expected could undermine the budgetary objectives.

⁴ See *Bundesrechnungshof* (2009), "Chancen zur Entlastung und Modernisierung des Bundeshaushalts".

In view of the risks, the average annual fiscal effort may fall short of the adjustment recommended by the Council under Article 126(7). Given debt projections presented in the programme and the risk of possible further financial market stabilisation measures, the budgetary strategy is not sufficient to bring the debt-to-GDP ratio back on a downward path. The envisaged expenditure-driven consolidation as well as planned increases in education and R&D spending would be consistent with the aim of supporting the recovery of potential growth. However, the projected decline in the overall investment ratio below its 2009 level is a source of concern.

- (15) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data⁵. In its recommendations under Article 126(7) of 2 December 2009 with a view to bring the excessive deficit situation to an end, the Council also invited Germany to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the stability programmes. The respective section of the programme update provides only very limited information on how the German government plans to progress in the implementation of the Council's recommendation.

The overall conclusion is that in the wake of the financial and economic crisis, Germany's public finances have deteriorated substantially on the back of automatic stabilisers and a wide ranging response in line with the EERP to counter the crisis. The envisaged expenditure-based consolidation from 2011 onwards would lead to a correction of the excessive deficit by 2013. However, taking into account the risks, the budgetary strategy from 2011 on may not be consistent with the Council Recommendation under Article 126(7) of 2 December 2009. This is linked to the lack of specific measures underpinning the proposed retrenchment path after 2010, uncertainty as to the implementation of further tax cuts envisaged in the new government's coalition agreement and their reconciliation with the necessary consolidation, risks related to the strength of the economic recovery and the possible need of further financial market stabilisation measures.

⁵ In particular, the data is missing on property income, implicit interest rate on debt, detailed categories of stock-flow adjustment and cyclical developments, while categories "Compensation of employees and intermediate consumption" and "Social payments" are displayed in a different aggregation. This has the effect of making the assessment objectively more difficult.

Hence, full implementation of the enhanced medium-term budgetary framework and the strong commitment at all levels of the government to adhere to it will be crucial to achieve fiscal consolidation as envisaged. Considering the need to reconcile the necessary fiscal consolidation with the strengthening of the economy's long-term growth potential, the envisaged expenditure-based consolidation seems appropriate, as would the planned increase in education and R&D spending. Given increasing public debt and repeated ad hoc changes to the pension adjustment formula as well as uncertainties surrounding the financing of the statutory health-care insurance, renewed attention should be given to measures aimed to improve long-term sustainability of public finance.

In view of the above assessment and also in the light of the recommendation under Article 126(7) TFEU of 2 December 2009, Germany is invited to:

- (i) specify the measures necessary to underpin the envisaged consolidation; implement the budgetary strategy for 2011-2013 as outlined in the programme to correct the excessive deficit by 2013; seize, as prescribed in the EDP recommendation, any opportunity beyond the fiscal efforts, including from better economic conditions, to accelerate the reduction of the gross debt ratio back towards the 60% of GDP reference value;
- (ii) ensure full implementation of the new constitutional budgetary rule at all levels of government, and reverse the deviation from the pension adjustment formula in 2008 as envisaged.

Germany is also invited to submit in time for the assessment of the effective action under the excessive deficit procedure an addendum to the programme to report on progress made in the implementation of the Council Recommendation under Article 126(7) of 2 December 2009 and to outline in some detail the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit.

Germany is also invited to improve compliance with the data requirements of the code of conduct.

Comparison of key macro-economic and budgetary projections

		2008	2009	2010	2011	2012	2013
Real GDP (% change)	SP Jan 2010	1.3	-5.0	1.4	2	2	2
	COM Nov 2009	1.3	-5.0	1.2	1.7	n.a.	n.a.
	SP Jan 2009	1.3	-2.3	1¼	1¼	1¼	n.a.
HICP inflation (%)	SP Jan 2010	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	COM Nov 2009	2.8	0.3	0.8	1.0	n.a.	n.a.
	SP Jan 2009	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Output gap ¹ (% of potential GDP)	SP Jan 2010	3.2	-2.6	-2.1	-1.3	-1.1	-0.9
	COM Nov 2009 ²	3.0	-2.9	-2.6	-2.2	n.a.	n.a.
	SP Jan 2009	2.2	-0.9	-0.7	-0.7	-1.0	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	SP Jan 2010	6.6	4.5	4.9	5	5½	5½
	COM Nov 2009	6.6	4.0	3.8	3.7	n.a.	n.a.
	SP Jan 2009	7.1	7.0	7	7	7	n.a.
General government revenue (% of GDP)	SP Jan 2010	43.7	44.4	42½	42	42	42
	COM Nov 2009	43.7	44.6	43.3	42.9	n.a.	n.a.
	SP Jan 2009	44	43½	42½	42½	43	n.a.
General government expenditure (% of GDP)	SP Jan 2010	43.7	47.6	48	47	46	45
	COM Nov 2009	43.7	48.0	48.3	47.5	n.a.	n.a.
	SP Jan 2009	44	46½	46½	45½	45½	n.a.
General government balance (% of GDP)	SP Jan 2010	0.0	-3.2	-5½	-4½	-3½	-3
	COM Nov 2009	0.0	-3.4	-5.0	-4.6	n.a.	n.a.
	SP Jan 2009	-0	-3	-4	-3	-2½	n.a.
Primary balance (% of GDP)	SP Jan 2010	2.7	-0.6	-3	-2	-½	½
	COM Nov 2009	2.7	-0.6	-2.2	-1.7	n.a.	n.a.
	SP Jan 2009	2½	-0	-1	-0	½	n.a.
Cyclically-adjusted balance ¹ (% of GDP)	SP Jan 2010	-1.6	-1.9	-4.4	-4.1	-3.1	-2.3
	COM Nov 2009	-1.5	-1.9	-3.6	-3.5	n.a.	n.a.
	SP Jan 2009	-1.2	-2.4	-3.5	-2.4	-2.1	n.a.
Structural balance ³ (% of GDP)	SP Jan 2010	-1.2	-1.8	-4.4	-3.9	-3.0	-2.3
	COM Nov 2009	-1.1	-1.9	-3.6	-3.5	n.a.	n.a.
	SP Jan 2009	-0.8	-2.5	-3.4	-2.4	-2.1	n.a.
Government gross debt (% of GDP)	SP Jan 2010	65.9	72½	76½	79½	81	82
	COM Nov 2009	65.9	73.1	76.7	79.7	n.a.	n.a.
	SP Jan 2009	65½	68½	70½	71½	72½	n.a.

Notes:

¹ Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 1.0%, 0.7%, 0.9% and 1.2% respectively in the period 2008-2011.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2008 and 0.1% of GDP in 2009 deficit-increasing according to the most recent programme and 0.3% of GDP in 2008 deficit-increasing according to Commission services' November 2009 forecast. There are no one-offs and other temporary measures for years 2010-2013 according to the most recent programme and for years 2009-2011 according to Commission services' autumn 2009 forecast.

Source:

Stability programme (SP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations.