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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Germany, 2001-2005

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were 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 the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Germany's first stability programme covering the period 1998-2002 was submitted on 4 January 1999 and assessed by the Council on 15 March 1999[2]. The first update of the programme was submitted on 1 December 1999, to which supplementary information was added on 1 February 2000, and assessed by the Council on 28 February 2000[3]. The second update of the stability programme, covering the period 2000-2004, was submitted on 11 October 2000 and assessed by the Council on 27 November 2000[4].

Germany submitted its third and most recent update of the stability programme, covering the period 2001-2005, on 5 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The new update of the German stability programme presents macro-economic and government finance projections for the period 2001-05. The update is broadly in line with the revised "code of conduct on the content and format of stability and convergence programmes"[5]. However, the quantitative information provided by the programme leaves a considerable degree of ambiguity due to the even increased use of rounding and period averaging. Moreover, the programme lacks detailed figures on social security, which – although not directly requested by the code of conduct - would be essential in the case of Germany.
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> Economic activity in Germany slowed down sharply in 2001 as the economy was hit by a number of exogenous shocks, in particular the oil price hike in 2000-01 and the strong deceleration in the US economy from the second half of 2001 on. They affected predominantly domestic demand, underlining once more the high vulnerability of the German economy to externally induced shocks. Both private consumption and equipment investment turned out to be much more sluggish than initially projected. In addition, construction investment, which – partially due to the ongoing impact of the reunification process (over-investment in the new Länder) - has been in a process of downsizing since the mid-1990s, took another unexpectedly strong dive. Overall GDP growth in 2001 is now estimated at some 0.6%, i.e. more than two percentage points below the projections of the October 2000 programme.

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1 OJ L209, 2.8.1997
2 OJ C124/03, 5.5.1999
3 OJ C098/01, 6.4.2000
4 OJ C374/01, 28.12. 2000
5 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

As a consequence of the growth slowdown, but due also to an upward revision of the deficit in 2000, the general government deficit in 2001 is now estimated to be significantly higher than projected by the October 2000 update of the programme. While the October 2000 programme set a deficit target of 1½ % of GDP, first national accounts estimates show the deficit to have reached 2.6 %. Even this value is subject to upside risks as the estimate could not incorporate rather unfavourable end-of-the-year data.

Tax income, especially from companies, was particularly adversely affected by the growth slowdown, although part of the shortfall in company taxes seems to be due also to an underestimation of the impact of the important 2001 tax reform. By contrast, general government expenditure remained broadly on target. There are, however, important exceptions. Most notably, in the health care sector, the abolition of the budget ceilings on consumption of pharmaceuticals at the beginning of the year led to expenditure rises much above projections. Furthermore, some regional governments (Länder) increased expenditure above the ceilings agreed upon in the framework of the Finanzplanungsrat.

The macroeconomic scenario of the updated programme projects output growth in 2002 to accelerate moderately to 1¼ %. This represents a substantial downward revision in comparison with the previous programme's growth projection of 2½ %. However, even this revised forecast appears very optimistic. In the light of the marked slowdown of the economy in the second half of 2001 and the effect of this on the annual growth rate for 2002 (overhang effect), a strong upturn of the economy would be needed already from the first quarter of the year for this growth to materialise. Current short-term indicators show this to be a rather unlikely event. The Commission services' Autumn forecast assumes the upturn to occur only in the second quarter. Under such conditions any growth rate above the 0.7% projected by Commission services is difficult to derive. In fact, in their Annual Economic Report to be published at the end of January 2002 the German authorities are likely to acknowledge this and revise their growth forecast for 2002 downwards to ¾ %.

For the period 2003-05, the baseline scenario of the programme expects average output growth per year to accelerate to around 2½ %. This is based on the assumption of a strong expansion of domestic demand. This would be an unusual growth pattern for the German economy during an upswing phase. Furthermore, the baseline scenario assumes annual average output growth of 2% over the period 2001-2005. Taking account of the unrealistically high growth assumption for 2002, such an average growth rate could only be achieved by very strong annual growth rates in the later years of the programme. For this reason, the lower-growth scenario of the programme, which assumes average growth to be ¼ percentage point lower compared to the baseline scenario, seems more realistic. Even this scenario implies growth in 2003-05 to be significantly above current estimates for potential growth in Germany. It would thus require favourable external and internal conditions, notably the projected pick-up in the world economy, continued wage moderation and enhanced efforts in the domain of structural reform, particularly in the labour market and in social security and benefit systems, in order to raise the growth potential of the economy.

Under the lower-growth scenario. the deficit ratio is projected to rise to some 2½ % of GDP in 2002, close to the value of 2.7% projected by the Commission services' Autumn forecast. This projection is still subject to upside risks. First, the deficit estimate for 2001 could be subject to upward revisions which could also imply a higher deficit in 2002. Second, growth in 2002 may be below the projected rate of the lower-growth scenario, with important consequences for tax income and social transfers. Third, there are certain risks on the expenditure side, notably in the social security systems. Consequently, there is a non-negligible risk that the government deficit ratio in 2002 might come very close to the 3% of GDP reference value.

The programme projects a balanced general government budget by 2004, thus confirming the target set in the previous update. If this were achieved, Germany would comply with the requirements of the Stability and Growth Pact from 2004 on. In cyclically-adjusted terms, the German accounts would move into a small surplus in 2004, too. It is commendable that the German government remains determined to achieve budgetary balance as early as possible. However, even in the baseline scenario this would require a considerably higher effort than planned in the October 2000 update in light of the expected higher deficit for 2002. Furthermore, in the lower-growth scenario additional adjustment measures on top of the consolidation projected in the update would be required. In the absence of such measures there is a high risk that Germany's budgetary position in 2004 and 2005 will not comply with the requirements of the Stability and Growth Pact.

According to the update the debt level will not fall below the Treaty's reference value in 2002, even though the significant proceeds from the UMTS licences had been used entirely for debt redemption in 2000 and 2001. In view of future expenditure pressures stemming from the ageing of the population, which will be important in the case of Germany, the slow decline in the debt ratio remains a source of concern. Moving to a balanced budgetary position by 2004 is, although necessary, not sufficient to put public finances on a sustainable footing. This requires, in addition, structural reforms on a wide scale. The recently implemented reform of the pension system is a step in the right direction. This needs to be complemented by structural reforms geared towards a rise in labour market participation rates, particularly of women and older workers.

A key problem of the German economy remains its high vulnerability to external shocks. Indeed, the German economy has, despite its large size, in recent years not been able to generate an endogenous and durable growth process. While this is also due to the ongoing impact of the reunification process (especially in the construction sector), a lack of reform, particularly in the labour market and in the social security systems, appears as the other main factor behind this weak performance. Insufficient incentives to create jobs and to take up work, especially for the segment of low skilled workers, call for a review of the tax-benefit and wage formation systems, as well as regulatory changes to encourage labour mobility and flexibility.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the Stability Programme update of Germany and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Germany, 2001-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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 co-ordination of economic policies[6], 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:

On [12 February 2002] the Council examined the updated stability programme for Germany which covers the period 2001-2005. The updated programme projects general government finances to improve from a deficit of 2½ % of GDP in 2001 to a balanced position in 2004 and 2005. The government gross debt is expected to decrease from 60% of GDP in 2001 to 55½ % in 2005.

The Council notes that the new update broadly complies with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[7], although there is some need for improvement, notably regarding the exaggerated use of rounding.

The Council notes that the estimated deficit outcome for 2001 (2.6% of GDP) is clearly higher than projected in the October 2000 update (1½ % of GDP). The Council acknowledges that this important nominal divergence is primarily due to the strong slowdown in the economy, with 2001 GDP growth more than two points below the projections of the October 2000 update of the programme. While the federal government implemented the budget as planned, the Council notes that overruns in other expenditure occurred, notably in the health care sector and at the level of some regions (Länder).

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6 OJ L209/1, 2.8.1997

7 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

The baseline macro-economic scenario of the updated programme expects annual output growth of 1¼ % in 2002. For the period 2003-05 annual average output growth is estimated to accelerate to some 2½ %. The Council notes that on the basis of available indicators, the 2002 growth rate appears too optimistic; as a consequence, the implied growth rate for the years 2003 to 2005 also appears too upbeat. The Council, therefore considers the lower-growth scenario more appropriate. Even in this scenario, growth in the period 2003 to 2005 would be on the high range of expectations, requiring favourable external and internal conditions, notably the expected pick-up of world economic growth, continued wage moderation and enhanced structural reform efforts, especially in the labour market.

The Council considers that, mainly due to lower than projected growth, there is a non-negligible risk that the general government deficit in 2002 comes very close to the 3% of GDP reference value. With a view to avoid breaching the 3% of GDP deficit laid down in the Treaty the Council has given to Germany an early warning in the terms of the Stability and Growth Pact[8].

The Council notes that the German authorities maintain their intentions to balance the budget by 2004, as planned in last year's update and as recommended in the BEPGs. Germany would thus comply with the requirements of the Stability and Growth Pact from 2004 on; in cyclically adjusted terms the government accounts move into surplus also in 2004. The Council welcomes the confirmation of a balanced budget in 2004; while it notes that achieving it requires a considerable effort the Council encourages the German government to pursue it with determination. As a consequence, the Council recommends that, once the recovery of the economy is firmly established, discretionary measures above those already implied by the current update be implemented.

The Council urges the German authorities to ensure strict budgetary implementation at all levels of government. As shown once again by the budgetary outcomes for 2001, this will be crucial to attain the projected deficit targets. While the Council welcomes the recently implemented change to the law on budgetary principles, stating that all levels of government should contribute to the achievement of the medium-term budgetary targets, the mechanism enshrined therein is not yet sufficient to guarantee compliance with mutually agreed objectives by all levels of government.

The Council notes with satisfaction that the German authorities will continue in their efforts to bring the debt level down below the Treaty's reference value. However, in view of the significant pressures for increased public spending due to an ageing population, the slow decline in the debt ratio remains a source of concern given the need to ensure the sustainability of public finances. If debt reduction is to make a noticeable contribution towards meeting the budgetary cost of ageing populations, then the target of a balanced budget position by 2004 must be reached. In addition to intensified budgetary consolidation efforts the recently implemented reform of the pension system is a step in the right direction. This needs to be complemented by structural reforms geared towards a rise in labour market participation rates, particularly of women and older workers. Such measures should be enacted as soon as possible, given that the budgetary impact of ageing populations will take hold soon.

The Council notes that the German economy, despite its large size, remains highly vulnerable to external shocks and has so far not been able to generate an endogenous and durable growth

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process. While acknowledging that this still reflects the German unification process, the Council recommends the implementation of structural reforms geared to improve the growth potential of Germany, in particular in the labour market and in social security and benefit systems.