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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
SEC(2009) 1544 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Germany

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”[2], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is

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1 See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No. 103/2009

2 OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the German authorities in July 2009[3] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for Germany on 7 October 2009[4].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 October 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to data notified by the German authorities in July 2009, the general government deficit in Germany was planned to reach 3.9% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the planned deficit was not close to the 3% of GDP reference value but that the planned excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, on the basis of the information available at the time of the report. Furthermore, the planned excess over the reference value could not be considered temporary.

According to more recent data notified by the German authorities in October 2009, the general government deficit in Germany is now planned to reach 3.7% of GDP in 2009, thus remaining above and not close to the 3% of GDP reference value. Based on the Commission services' autumn 2009 forecast, the planned excess over the reference value still qualifies as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it does result from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services autumn 2009 forecast, real GDP in Germany is projected to contract sharply by 5% in the year 2009. Furthermore, the planned excess over the reference value cannot be considered temporary. According to the Commission services' autumn 2009 forecast taking into account the fiscal measures adopted in the current year affecting the budget for 2010 and for 2011, the deficit would widen to 5.0% in 2010 and 4.6% of GDP in 2011 on a no-policy change assumption. This assumption takes into account that, according to government plans, some part of the measures taken in line with the EERP will be maintained in 2010 but rolled back in 2011. Benefiting from the room of manoeuvre gained as a result of successful consolidation between 2005 and 2008,

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3 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notifications of Germany can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

4 All EDP-related documents for Germany can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

Germany was able to introduce an appropriate sizeable fiscal stimulus package for 2009 and 2010 of around 1¾% of GDP on average per year, whereby a number of measures is of limited duration (e.g. infrastructure investment, reduced contribution rate to unemployment insurance). The deficit criterion in the Treaty is not fulfilled.

According to data notified by the German authorities in October 2009, the general government gross debt has been well above the 60% of GDP reference value since 2002 and is planned to stand at 74.2% of GDP in 2009. The Commission services' autumn 2009 forecast expects the debt-to-GDP ratio to rise rapidly by almost 9 percentage points to 73.1% in 2009 and reach 79.7% in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the Decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Germany, the double condition is not met. Considered on their own merit, the relevant factors in the current case present on balance a relatively favourable picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Germany. This opinion, adopted by the Commission on 11 November 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Germany with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Germany, special circumstances are considered to exist. In particular, the economy faces a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services autumn 2009 forecast, real GDP in Germany is projected to contract sharply by 5% in the year 2009. The recession reflects the abrupt decline in private investment and foreign trade in the export-oriented manufacturing sector as a consequence of the financial crisis and the global downturn. The scale of the downturn was unexpected, with the government forecast presented in the January 2009 addendum to the December 2008 update of stability programme projecting a fall in real GDP of 2¼% for 2009 and the Commission services' January 2009 interim forecast expecting a decline of 2.3%, after 1.3% growth in 2008.

According to the October 2009 EDP notification, the general government deficit in Germany is planned to reach 3.7% of GDP in 2009 taking into account the economic downturn and the fiscal impact of the economic recovery plan. The Commission services' autumn 2009 forecast projects that the deficit would amount to 3.4% of GDP in 2009 and, taking into account the measures adopted in the current year affecting the budget for 2010 and 2011, that it would widen to 5.0% of GDP in 2010 and fall to 4.6% in 2011 on a no-policy change assumption. This assumption takes into account that, according to government plans, some part of the measures taken in line with the EERP will be maintained in 2010 but rolled back in 2011. Benefiting from the room of manoeuvre gained as a result of successful consolidation between 2005 and 2008, Germany was able to introduce an appropriate sizeable fiscal stimulus package for 2009 and 2010 of around 1¾% of GDP on average per year, whereby a number of measures is of limited duration (e.g. infrastructure investment, reduced contribution rate to unemployment insurance).

Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2013. Recognising that the German budgetary position in 2009 resulted from measures amounting to 1½% of GDP, which were an appropriate response to the European Economic Recovery Plan, and the free play of automatic stabilisers, the German authorities should implement the fiscal measures in 2010 as envisaged. In particular, in view of fiscal room for manoeuvre and a large external surplus, a credible and sustainable adjustment path would require the German authorities to ensure an average annual structural budgetary adjustment of ½% of GDP over the period 2011-2013, specify the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. The budgetary consolidation should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus.

General government gross debt has been above the 60% of GDP reference value since 2002 and is planned to stand at 74.2% of GDP in 2009. According to the Commission services' autumn 2009 forecast the debt ratio is expected to rise further to 73.1% of GDP in 2009 and reach 79.7% of GDP in 2011. Rapid budgetary consolidation is therefore also necessary with a view to bringing the government gross debt ratio on a declining path that approaches the

60% of GDP reference value at a satisfactory pace. The German authorities should seize any opportunity beyond the structural budgetary adjustment, to accelerate the reduction of the gross debt ratio back towards the reference value.

The necessary consolidation efforts could be supported by the recently adopted new budgetary rule that has been anchored in the German Constitution. The new rule results from the reform of federal fiscal relations and constitutes a crucial complement to the fiscal stimulus packages, reinforcing the credibility of a timely fiscal consolidation. It follows the structure of the Stability and Growth Pact (SGP) in the sense that it sets a ceiling for the federal structural deficit at 0.35% of GDP from 2016 onwards with a transition period starting in 2011. The regional budgets must be structurally balanced as of 2020. Nevertheless, the German medium-term budgetary plan needs to be spelled out in more details, as the draft financial plan for 2009-2013 includes from 2011 onwards a sizeable cumulative fiscal consolidation objective ("*globale Minderausgaben"*) which is neither allocated to the revenue or expenditure side (let alone to subcomponents) nor supported by measures[5]. The government plans the modernisation of the federal system of budgeting and accounting with a stronger focus on a performance-based assessment of revenue and expenditure. Germany should effectively enforce the new fiscal rule at the federal and *Länder* level, monitor its execution and strengthen the coordination between different levels of government.

As regards the long-term sustainability of public finances, the long-term budgetary impact of ageing is close to the EU average. Given increasing public debt, a reduction in the risks to long-term sustainability of public finances as defined by the Commission Communication[6] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[7] on 10 November 2009 would require improving primary surpluses over the medium term, preserving the achievements of past pension reforms and further reforms of the social security system aimed at curbing the increase in age-related expenditures. The risks related to the financial market stabilisation measures (e.g. recapitalisation, guarantees) could have a potential negative impact on the long-term sustainability of public finances, primarily via their impact on government debt, although some of the cost of the government support could be recouped in the future.

Enhanced surveillance under the EDP, which seems necessary in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the German stability programme which will be prepared between 2010 and 2013 could usefully be devoted to this issue.

5 German Federal Ministry of Finance, Monatsbericht des BMF, August 2009, available at: http://www.bundesfinanzministerium.de/nn_84526/DE/BMF__Startseite/Aktuelles/Monatsbericht__des__BMF/2009/08/inhalt/mobe__dokument__gesamt,templateId=raw,property=publicationFile.pdf

6 Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

7 Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

Key projections of Commission services' autumn 2009 forecasts

	2007	**2008**	**2009**	**2010**	**2011**
Real GDP (% change)	2.5	1.3	-5.0	1.2	1.7
Output gap[1,2] (% of potential GDP)	2.7	3.0	-2.9	-2.6	-2.2
General government balance (% of GDP)	0.2	0.0	-3.4	-5.0	-4.6
Primary balance (% of GDP)	3.0	2.7	-0.6	-2.2	-1.7
Cyclically-adjusted balance[1] (% of GDP)	-1.2	-1.5	-1.9	-3.6	-3.5
Structural balance[3] (% of GDP)	-1.2	-1.1	-1.9	-3.6	-3.5
Government gross debt (% of GDP)	65.0	65.9	73.1	76.7	79.7

Notes:
[1] Output gaps and cyclically-adjusted balances calculated by Commission services.
[2] Based on estimated potential growth of 0.9%, 1.0%, 0.7%, 0.9% and 1.2% respectively in the period 2007-2011.
[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2008 (deficit-increasing) according to the Commission services' autumn 2009 forecast.

Source:
Commission services' autumn 2009 forecast

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Germany,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[8] (which is part of the Stability and Growth Pact), provides for a Decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 479/2009[9] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

8 OJ L 209, 2.8.1997, p. 6.
9 OJ L 145, 10.06.2009, p. 1-9.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Germany. The Commission therefore addressed such an opinion to the Council in respect of Germany on 11 November 2009[10].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Germany, this overall assessment leads to the following conclusion.

(7) According to data notified by the German authorities in October 2009, the general government deficit in Germany is planned to reach 3.7% of GDP in 2009, thus exceeding and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. According to the Commission services' autumn 2009 forecast, real GDP in Germany is projected to contract sharply by 5% in the year 2009. Furthermore, the planned excess over the reference value cannot be considered temporary, since according to the Commission services' autumn 2009 forecast, taking into account the measures adopted in the current year affecting the budget for 2010 and for 2011, the deficit would widen to 5.0% of GDP in 2010 to fall down to 4.6% of GDP in 2011 on a no-policy change basis. The deficit criterion in the Treaty is not fulfilled.

(8) According to data notified by the German authorities in October 2009, the general government gross debt (which has been above the 60% of GDP reference value since 2002) is planned to stand at 74.2% of GDP in 2009. According to the Commission services' autumn 2009 forecast the debt ratio is expected to rise further to 73.1% of GDP in 2009 and reach 79.7% of GDP in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council Decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Germany, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this Decision.

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10 All EDP-related documents for Germany can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Germany.

Article 2

This Decision is addressed to the Federal Republic of Germany.

Done at Brussels,

For the Council
The President