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Recommendation for a

COUNCIL RECOMMENDATION TO GERMANY

with a view to bringing an end to the situation of an excessive government deficit

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

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 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.

(4) The Council has decided on [2 December 2009], in accordance with Article 104(6), that an excessive deficit exists in Germany.

(5) In accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1] (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit 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. In deciding whether special circumstances exist, "relevant factors" as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit the Council should

[1] OJ L 209, 2.8.1997, p. 6.

request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Germany. In particular, the German economy faces a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' 2009 autumn forecast, real GDP in Germany is projected to contract sharply by 5% in the year 2009. The downturn reflects the abrupt decline in private investment and foreign trade in the export-oriented manufacturing sector as a consequence of the global financial and economic crisis. The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework.

(7) 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).

(8) 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.

(9) 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. 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 implement the fiscal measures in 2010 as envisaged; 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.

(10) 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.

(11) 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 Länder 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 a sizeable cumulative fiscal consolidation objective ("*globale Minderausgaben"*) from 2011 onwards which is neither allocated to the revenue or expenditure side (let alone to subcomponents) nor supported by measures[2]. 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.

(12) 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[3] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[4] 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.

(13) 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. 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.

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2 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

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

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

(14) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, 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. In addition, Germany should improve the framework for competition in services and promote the integration of the low skilled and long term unemployed into the labour market through a flexicurity approach which combines better access to qualifications with improved incentives to work.

(15) In addition, in view of the importance of achieving its medium-term objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, Germany should also ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) 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 and, starting consolidation in 2011, put an end to the present excessive deficit situation by 2013.

(2) The German authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the German authorities should:

    (a) ensure an average annual structural budgetary adjustment of ½% of GDP over the period 2011-2013, which 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;

    (b) 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.

(3) In addition, the German authorities should seize any opportunity beyond the structural adjustment, to accelerate the reduction of the gross debt ratio back towards the reference value.

(4) The Council establishes the deadline of 2 June 2010 for the German government to take effective action to implement the fiscal measures in 2010 as envisaged and to outline the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The German authorities should report on progress made in the implementation of these Recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2010 and 2013.

Furthermore, the Council invites the German authorities to implement reforms with a view to raising potential GDP growth. This includes reforms conducive to enhancing the quality of public finances. In particular, 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 well as reforms to improve the framework for competition in services and promote the integration of the low skilled and long term unemployed into the labour market through a flexicurity approach which combines better access to qualifications with improved incentives to work.

This Recommendation is addressed to the Federal Republic of Germany.

Done at Brussels,

For the Council
The President