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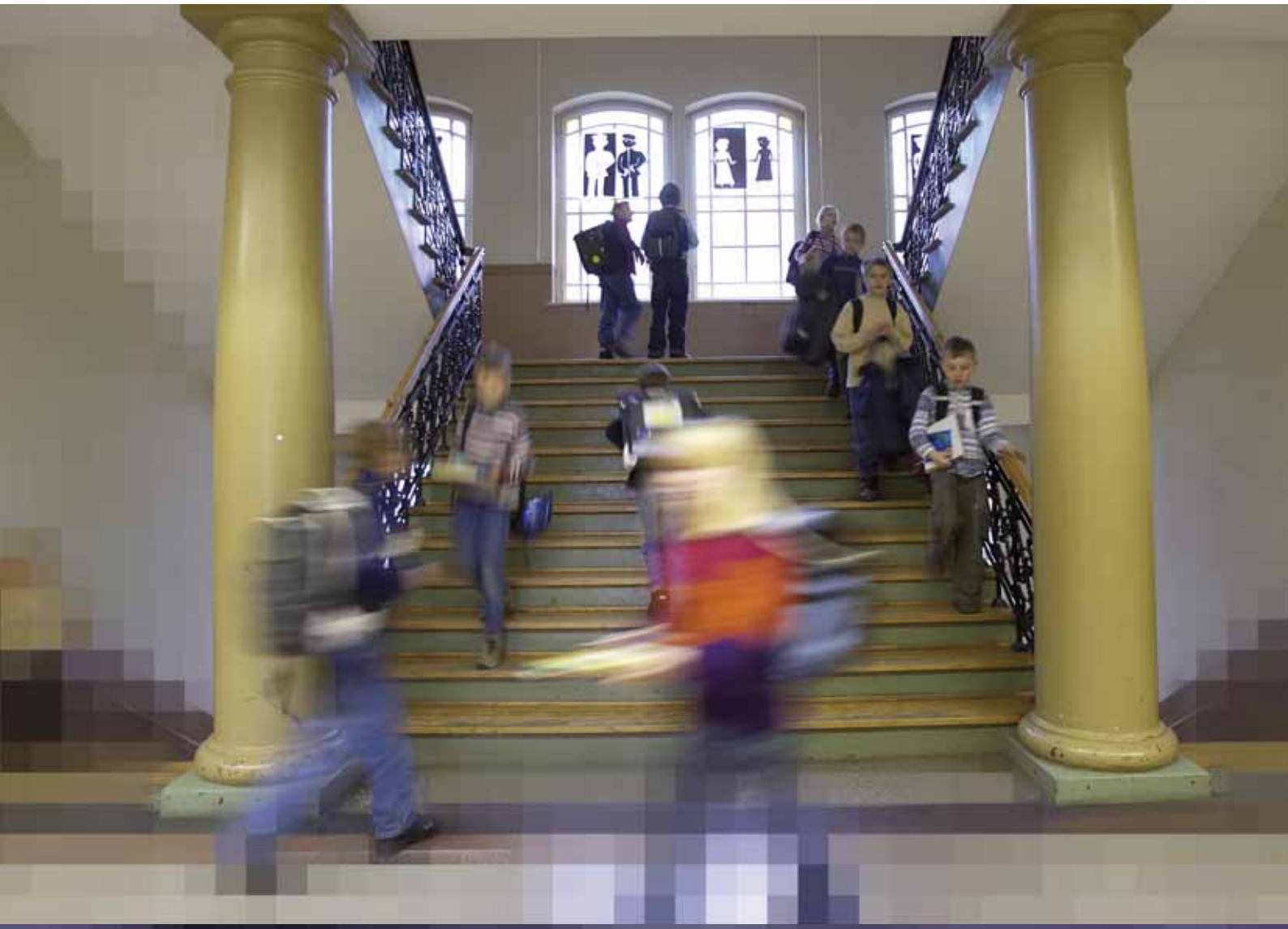

Overall Economic Policy

A Growth Policy to Fit Cyclical Conditions
2009 Annual Economic Report

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Preface

A Growth Policy to Fit Cyclical Conditions

This year's Annual Economic Report is being published during what may likely be the most serious recession in the history of the Federal Republic of Germany. For a long time, Germany was one of the winners in the globalisation process. Now, in return, the global crisis is having a particularly hard impact on our economy.

The Federal Government's response to this economic policy challenge is a growth policy to fit cyclical conditions, as the title of the 2009 Annual Economic Report shows. We are pursuing a strategy that combines policies that are right for growth with policies that are necessary for responding effectively to current cyclical conditions. We have acted expeditiously and decisively in the face of the global economic downturn. In an act of tremendous financial effort, we have adopted a series of measures that make long-term sense, that can be implemented quickly and that will have a rapid impact.

Together with the measures already adopted in 2008, the German government is targeting over 80 billion euros toward the goals of overcoming the crisis and achieving the comprehensive modernisation of the country. Even when compared to other countries, this represents a massive stimulus for growth. The policies we have enacted demonstrate clearly that the government is capable of effective action and thereby strengthen both private sector and public confidence in the future – these are key factors for overcoming the recession.

Our concept gives us the opportunity to emerge from the crisis in a stronger position. That's why it is essential not to bury the adopted measures in discussion before they have had a chance to work, but rather to implement them quickly and consistently so that the stimulus can kick in at the intended time.

In Germany, we are building a bridge toward future growth and employment. I call on all businesses, on parties to collective bargaining agreements, and on every individual to cross this bridge so that together we can overcome the challenges posed by the global economic crisis.

Michael Glos
Federal Minister of Economics and Technology

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The 2009 Annual Economic Report of the German Federal Government
In accordance with Section 2 of the Act to Promote Economic Stability and Growth (*Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft*, StWG), the Federal Government hereby submits its 2009 Annual Economic Report to the German Bundestag and the Bundesrat.

The Federal Government's discussion of economic and fiscal policy in Part I of the report focuses on core issues of economic policy. In this part, the Federal Government also refers to the 2008-2009 Annual Report of the German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*). As stipulated by the StWG, Part II of the report discusses the government's projection for overall economic trends in 2009. The German version of this Annual Economic Report also contains an Annex which provides a detailed inventory of the measures that the Federal Government has taken since midway through the current legislative period as well as the measures planned for 2009 (available at www.bmwi.de).

The Federal Government would like to thank the Council of Economic Experts for its detailed and comprehensive analysis of economic developments in 2008 and the outlook for 2009, as well as for its substantive discussion of the guiding principles of economic policy. Through its publication of the Annual Economic Report, the Federal Government also provides benchmark data for the overall orientation of the economy, in accordance with Section 3 StWG.

In preparing the Annual Economic Report, the Federal Government discussed its growth and employment strategy with the *Länder* and municipalities within the framework of the *Konjunkturrat für die öffentliche Hand* (a government economic advisory board). This strategy was also discussed with union representatives as well as with the *Gemeinschaftsausschuss der Deutschen Gewerblichen Wirtschaft* (a joint committee that serves as a coordinating body for German business associations).

Executive Summary

This year, the German economy is facing the greatest test to its resilience since reunification. Short-term prospects for growth have deteriorated drastically. Declining demand from Germany's trading partners and the escalation of the financial crisis are having a particularly powerful impact on the German economy due to its strong dependence on exports. Foreign trade and investment, which have been a key engine for growth in recent years, will not contribute to economic growth in 2009. While consumer spending may be able to stabilise current trends – partially due to fiscal policy stimuli – it will not be able to fully counteract the dampening effects of the global economy. For 2009 as a whole, the Federal Government expects gross domestic product (GDP) to decline by 2 percent (price-adjusted). The labour market will not escape this development unscathed. Mastering this challenge represents the central task for all actors who bear responsibility for the general economy. This includes government, parties to collective bargaining agreements, companies and the credit industry. In an act of tremendous financial effort, the Federal Government adopted a series of measures that can be implemented quickly, that will have a rapid impact, and that make sense over the long term. These measures aim to restore confidence, to put a stop to the vicious circle of the downturn, to prevent structural rigidities, to secure jobs, to strengthen the forces for growth and to modernise the country. The federal, *Länder* and municipal levels are called upon equally to engage in this effort.

The German economy is in considerably better shape to tackle these challenges than it was at the end of the previous economic cycle. The Federal Government's reform strategy has borne fruit. German companies have improved their competitiveness compared to the rest of the world. In recent years, they have successfully restructured themselves and are now in an excellent position in terms of international competition. The flexibility and adaptivity of the German economy have increased as a result of economic and employment policies that have consistently targeted structural reforms. In 2008, Germany achieved record employment, with total employment exceeding 40 million on average for the year – the highest level in the history of the Federal Republic. Unemployment has fallen from 4.9 million on average in 2005 to 3.3 million in the past year. And for the first time since November 1992, unemployment fell below three million in October 2008. Thus for the first time since the 1970s, the natural rate of unemployment is markedly lower than it was during the previous upswing. There are many indications that, due to its improved adaptability, the labour market will not only prove to be more stable but can also recover more quickly from negative economic impacts.

In recent years, fiscal policy in particular has made great progress in the way of consolidation. In 2004, the government deficit stood at 3.8% in relation to nominal GDP. By 2008, the total government budget was nearly balanced. Thus in terms of fiscal policy as well, Germany is in a substantially better starting position than it was at the end of the previous upswing. The fiscal discipline of the past three years has provided budgets with the breathing room that will make it possible to pursue a fiscal policy that fits the cyclical conditions of the present situation. As a result, the so-called "automatic stabilisers" can operate to their full effect. Furthermore, Germany's economic and fiscal policy are in a position to effectively counteract both the loss of confidence on financial markets as well as the economic downturn, as has been

shown with both the package of measures to stabilise the financial markets as well as the “Pact for Employment and Stability in Germany”.

During the two global economic crises that were triggered by rising oil prices in the 1970s and 1980s, as well as the recession in the early 1990s that followed in the wake of German reunification, structural rigidities on various markets impeded both adjustment and recovery. Now as before, the German economy is in need of structural reforms. In contrast to these previous downturns, however, Germany is having to cope above all with a slump in international demand as well as a crisis on financial markets. For this reason, the Federal Government will take short-term steps to strengthen the German economy, in order to minimise the impending long-term costs of a severe slump in demand. In so doing, the government will pursue a growth policy that is tailored to fit cyclical conditions. This involves combining policies that are right for growth with policies that are necessary for responding effectively to current cyclical conditions. During the earliest possible stage of the economic downturn, the Federal Government will implement stabilising measures to stimulate demand while simultaneously enhancing long-term potential growth. In this way, government policy will contribute to the simultaneous strengthening of both domestic demand as well as forces for growth. It is crucial for these measures to achieve timely results in order to put a stop to the vicious circle of the downturn, to prevent structural rigidities and to avoid job losses.

In the fall of 2008, it was essential first of all to decisively counteract the profound loss of confidence among banks. In order to secure the deposits of private citizens as well as the supply of credit to companies, and in order to restore confidence in the stability of the financial system, the Federal Government adopted a comprehensive rescue package for Germany’s financial system. This package was firmly embedded in the overall approach taken by the international community. The Financial Market Stabilisation Act (*Finanzmarktstabilierungsgesetz*, FMStG) encompasses a package of measures that aim to revive confidence in the financial system and to restore order to commercial transactions between financial institutions. These measures are time-limited, and they are designed to minimise potential burdens that may result for taxpayers. Assistance under the Act is tied to strict conditions. In addition, new accounting rules will apply for a limited period of time. The Federal Government has announced an unlimited guarantee on all private deposits in Germany, thereby guaranteeing that German deposit guarantee schemes for banks will function effectively for all private individuals regardless of the amount of their deposits.

In order to minimise the extent to which the financial crisis and the international economic slowdown can spread to the general economy, the Federal Government has acted in a timely manner to adopt a series of measures. By adopting the “Package of Measures to Reduce Tax Burdens, Stabilise Social Insurance Contributions and Invest in Families” as well as the 15-point programme “Securing Jobs by Strengthening Growth”, the Federal Government has already taken steps that will reduce tax burdens on private citizens and businesses by approximately 30 billion euros in 2009 and 2010. In addition, the *Kreditanstalt für Wiederaufbau* will safeguard the financing and liquidity of companies, thereby securing funding for investments totalling approximately 20 billion euros. The rapid implementation of the Federal Constitutional Court’s decision regarding the commuter tax allowance – which will lead to tax shortfalls totalling approximately 8.5 billion euros in 2009 and 2010 – will provide an additional economic stimulus.

The Federal Government responded to the unexpectedly fast and powerful deterioration in the economic outlook by adopting the “Pact for Employment and Stability in Germany”. Adverse trends have been exacerbated by interactions between negative cyclical forces, problems on financial markets and ongoing crises in certain key sectors. These multi-layered problems involving demand and financing necessitate a targeted and balanced package of measures. It is precisely for this reason that the Federal Government decided to adopt a broad and integrated approach. The “Pact for Employment and Stability in Germany” targets five core areas: public investment; the supply of credit to the economy; employment and skills; tax reduction; and sustainable fiscal policy. One key priority is to reduce taxes and social insurance contributions. This will boost consumer purchasing power while simultaneously improving incentives for employment and private investment. These tax cuts will be complemented by additional public investments in infrastructure as well as policies to promote education and skills development. The measures that address the labour market aim to avoid layoffs and to build skills. The Pact contains measures for 2009 and 2010 that involve total funding in the amount of 50 billion euros. Together with the measures already adopted in 2008, the German government is targeting over 80 billion euros toward the goals of overcoming the crisis and achieving the comprehensive modernisation of the country. Even when compared to other countries, this represents a massive stimulus for growth.

Short-term crisis management is crucial. At the same time, however, the Federal Government is not losing sight of medium-term challenges involving demographic changes, rising environmental risks and developments on global markets. Now as before, the Federal Government is convinced that a social market economy is the best economic system for coping effectively with these challenges. A social market economy involves the consistent pursuit of the politically necessary balance between two key components: (a) economic efficiency and (b) social cohesion that aims to achieve “prosperity for all”. In recent years, the Federal Government has carried out structural reforms that have established greater latitude for the guiding ideas of freedom and competition, and this has paved the way to new successes, particularly on the labour market.

Good structural conditions form the basis for strong and sustained growth. Ensuring such conditions is even more important in the present situation, because they open up medium- and long-term prospects for economic activity. Thus the Federal Government will keep working to create more favourable conditions for commercial activity. This includes, among other things, improving incentives for business start-ups and for maintaining businesses that are inherited. We will continue to reduce bureaucracy. We will also modify regulations for certain sectors, and we will make procurement law more SME-friendly. Not least, the Federal Government will set the conditions for infrastructural improvements. Particular emphasis will be placed on regional development, especially in eastern Germany.

One key building block for achieving sustained, higher levels of growth will be to structure public expenditure and revenue in a manner that promotes sustainable growth. Germany needs to have an efficient state. In return for paying taxes and social insurance contributions, citizens and companies have the right to expect the state to spend their money in an efficient, thrifty and careful manner. For this reason, the Federal Government will continue to press forward with the qualitative consolidation of public budgets as part of the effort to achieve a modern and efficient

state. Quantitative and qualitative fiscal consolidation complement each other: in order to set a more innovative, future-oriented policy agenda, it is essential to ensure that the structural consolidation of public budgets is both successful and durable. This is particularly true in the current situation, in which public budgets will run higher deficits. Our goal of maintaining balanced national and federal budgets remains unchanged. Therefore, in conjunction with the package of measures enacted during Stage II of the reform of Germany's federal system, the Federal Government will establish new constitutional rules limiting annual budget deficits. These new rules will set strict limits on the level of net borrowing permitted under normal economic conditions. However, public budgets will be given the breathing room to adapt to cyclical conditions.

All individuals in Germany must have equal prospects for entering a vocation and for improving their social position. One of the necessary preconditions for ensuring this is a tax system that creates incentives for achievement and advancement, particularly among lower and middle income earners. Good starting conditions for everyone are necessary as well. For this reason, the Federal Government is taking steps to increase investments in education, in order to establish greater equality of opportunity for all and to improve prospects for social advancement in Germany. A particular priority will be placed on early childhood education. This is because a child's socioeconomic background should play a less important role in influencing his or her future educational opportunities and thereby his or her ability to take part in social prosperity.

Germany's social insurance systems face major challenges. These include demographic shifts and changing career paths over the medium and long term. An additional task at the present time will be to mitigate cyclical fluctuations. These systems must remain viable and affordable while simultaneously providing appropriate social protection. For this reason, in recent years the Federal Government has implemented key measures in the area of pension law to promote the financial consolidation of the statutory pension insurance system. The efficient use of funds is also a core issue for health policy. It is only by fostering competition that we will be able to create incentives to improve both quality and economic performance in the health care system. Thus, among other things, the Federal Government will assess whether competition within the health care system can be further enhanced.

Another essential concern of the Federal Government is to ensure a cost-efficient and sustainable energy supply. In this connection, it is crucial to enhance competition in the electricity and gas sectors. Given Germany's strong dependence on fossil energy resources, the bulk of which must be imported, the central objectives of our energy policy continue to be economic efficiency, security of supply and environmental compatibility. Further, we aim to keep reducing greenhouse gas emissions in Germany. These goals can best be achieved through an energy and climate policy based on energy efficiency, which will reduce both the consumption and cost of energy. The Federal Government's Integrated Energy and Climate Programme has laid the groundwork for this type of policy.

Investment in research and innovation form the basis for sustained growth, for jobs and for the incomes of tomorrow. In order to help German industry maintain and expand its position in key markets of the future, the Federal Government has

revamped its research and innovation policy by adopting the High-Tech Strategy for Germany. For the first time, government activities and measures to promote research and innovation have now been bundled into a national strategy.

External openness and international competition remain the key to success that will enable Germany to attain and maintain a world-leading position in terms of both prosperity and technology. As global economic circumstances become increasingly difficult, it is even more crucial for German companies to be able to take advantage of economic opportunities worldwide. At the same time, Germany must remain open and attractive to foreign investors. In order to confront the challenges posed by financial market turmoil and the global economic downturn, the Federal Government is taking measures that are being coordinated at the international and European levels. The weaknesses within the international financial system that have been exposed during the course of the financial crisis have shown that a new global financial architecture is necessary to prevent, as much as possible, the risk of systemic crises on financial markets in the future. For this reason, the Federal Government is working with its partners to modify international rules for financial market actors over the medium and long term. The central priorities in this connection are to strengthen the oversight of equity, risk and liquidity management; to improve transparency, valuation standards and rating processes; to intensify cooperation between national regulatory authorities; and to strengthen cross-border crisis management.

Table 1: Selected key figures for macroeconomic trends in Germany[1)]

	2007	2008	Annual projection 2009
	Year-on-year changes in %		
Gross domestic product (price-adjusted)	**2.5**	**1.3**	**-2.25**
Total employment (domestic)	1.7	1.5	-0.7
Unemployment rate in % (as defined by the Federal Labour Agency) [2)]	*9.0*	*7.8*	*8.4*
Use of GDP (price-adjusted)			
Private households and private non-profit organisations	-0.4	0.0	0.8
Plant and equipment	6.9	5.3	-11.9
Construction	1.8	2.8	-0.3
Domestic demand	1.1	1.6	-0.1
Exports	7.5	3.9	-8.9
Imports	5.0	5.1	-5.0
Contribution of foreign trade and payments to GDP growth rate [3)]	*1.4*	*-0.3*	*-2.2*
Gross wages and salaries per person employed (nominal)	1.6	2.3	2.0

1) Up to 2008, preliminary figures from the Federal Statistical Office as of 15 January 2009.

2) Based on total number of persons employed.

3) Contribution to GDP growth rate.

I. Coping effectively with global economic challenges

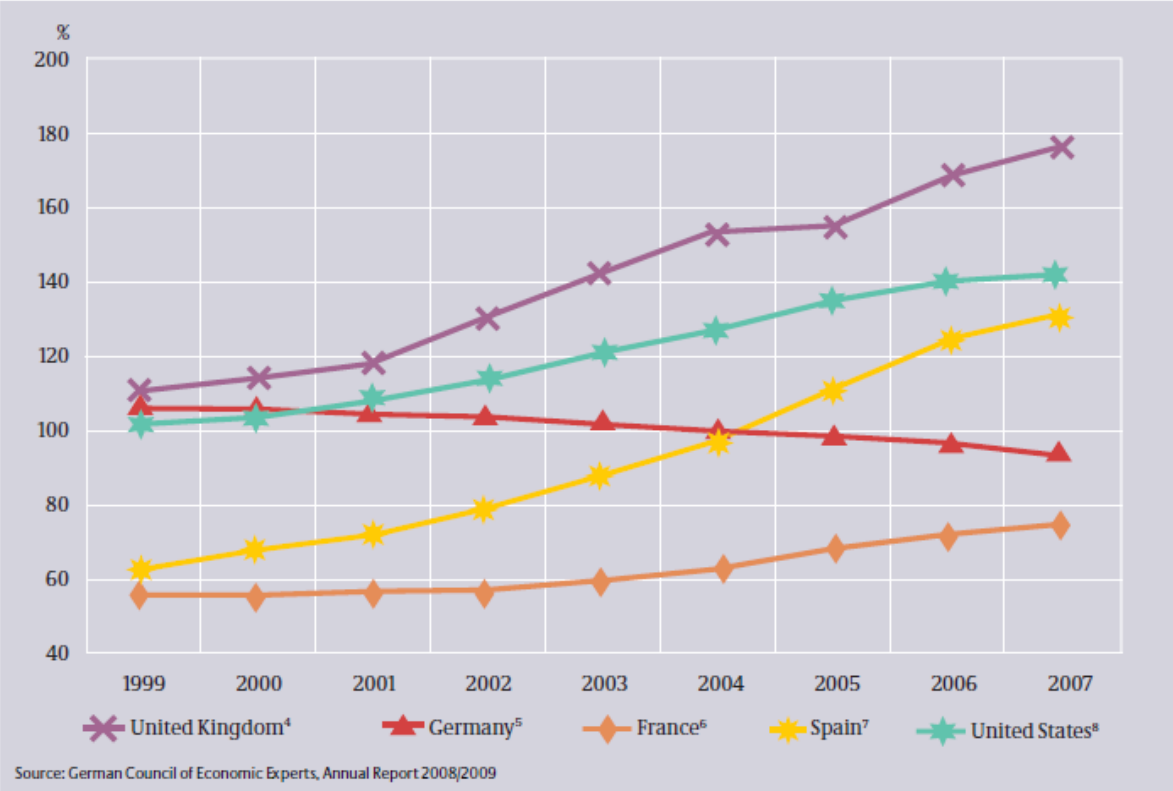
A. Short-term stabilisation, long-term reforms

1. The year 2008 marked the end of a sustained upswing in the global economy. After a good first quarter in 2008, the German economy also began to feel the impact of the weakening world economy and the financial crisis. The global economy has weakened drastically, and the worldwide economic crisis is presenting German economic policy with major new challenges. It is crucial to correctly identify the

causes and to know which of its own strengths Germany can rely on. The German government has demonstrated that it can act quickly, even within very short time periods if circumstances so require. The Federal Government is decisively assuming its responsibility for Germany. Together with the German *Länder* and municipalities, the Federal Government adopted a stimulus package in an act of tremendous financial effort whose levels of concentration and coordination were unprecedented in the history of the Federal Republic. It is crucial for these measures to achieve quick results in order to restore confidence, to put a stop to the vicious circle of the downturn, to prevent structural rigidities and to avoid job losses.

Due to the successes it has achieved in recent years – thanks not least to the results of structural reforms – Germany is well-equipped to face these difficult times. The number of unemployed persons is at its lowest level since 1992. The labour market has become more adaptive and flexible. Companies have improved their competitiveness and solidified their finances. A balanced general public budget provides government with the latitude to react to the deterioration of the global economy with a growth policy to fit cyclical conditions. The global downturn thus confronts a more resilient German economy than was the case during the 2001 downturn.

Figure 1: Household indebtedness in relation to disposable income in selected countries



[4] OECD; [5] Deutsche Bundesbank; [6] Banque de France; [7] Banko de España; [8] Federal Reserve.

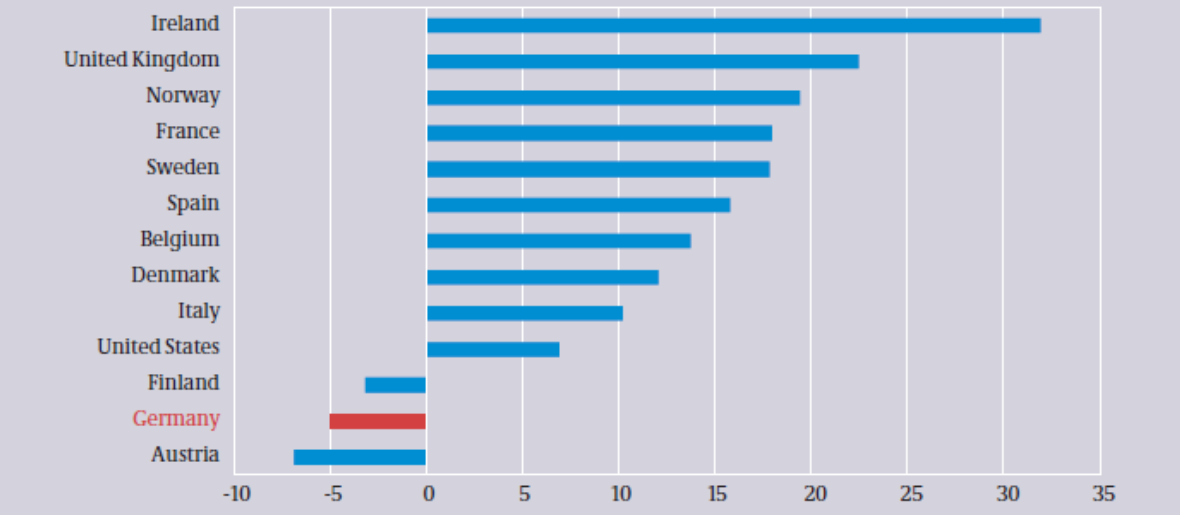
A downturn in the global economy

2. The starting point for the current economic downturn was the real estate bubble in the United States, which itself can be traced back to an excessively expansive monetary policy, lapses in financial market regulation, and bank lending policies that

did not accurately reflect the degree of risk. The systemic risks on financial markets – the extent of which had been underestimated by many – were laid bare when the real estate bubble burst. Massive write-offs by banks and insurance companies led to a loss of confidence on financial markets, which was further compounded by the increasing dissemination of non-transparent financial products in recent years. In late summer 2008, the interbank market practically ceased to function. It was only through internationally coordinated action by central banks and governments that a collapse of the financial system could be prevented.

The growth of the real estate bubble went hand-in-hand with a high level of willingness among American private households and companies to take on debt. Sharp increases in purchases of imported goods were financed through capital imported from countries with higher levels of saving, a development that served to exacerbate global current account imbalances. In the current, highly risk-averse climate, such imbalances can no longer be financed to the same extent as before – a view that is also shared by the German Council of Economic Experts in their Annual Report (Item 34 ff.). Furthermore – particularly in those economies where high levels of household indebtedness had led to a real estate bubble – asset price corrections and more restrictive bank lending practices have had a negative impact on the propensity to consume and invest. To be sure, Germany experienced neither a real estate bubble nor a high level of household indebtedness in the run-up to the financial crisis; nevertheless, the reduction of these imbalances is having a direct impact on Germany due to its close trade and financial links with countries affected by these problems (see Figures 1-3).

Figure 2: Overvaluation of real estate in selected countries,* 1997–2007 (in percent)



* Price increases (in percent) on residential property for the period 1997–2007 that cannot be explained on the basis of fundamental factors (such as growth in per capita disposable income; growth in potential workforce; or trends in short-term and long-term interest rates). For additional details, see CEE Annual Report, Item 51 ff.

Sources: International Monetary Fund; German Council of Economic Experts, Annual Report 2008/2009

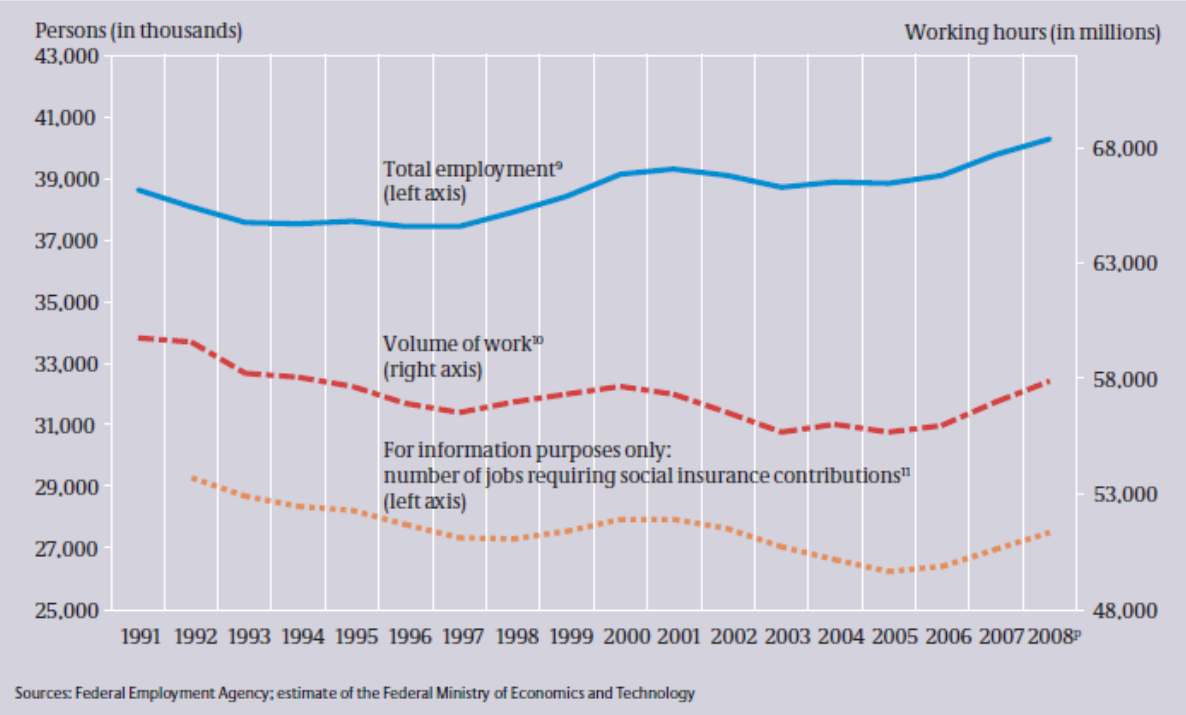
Germany's total exports amount to 48 percent of gross domestic product. In certain key sectors, the share of exports is even substantially higher. At the same time, the importance of imported inputs is also increasing. Germany's economy has an

especially high level of international interdependence. Thus Germany faces a particularly strong challenge if key trade partners slip into recession, because weakening foreign demand – and its potential negative impact on the labour market – can be counteracted only to a limited extent by the domestic economy.

3. In addition, there are other factors apart from trade relations that are putting a brake on the German economy. For example, declining returns on German foreign direct investment, wealth effects, and the direct impact of the deteriorating global consumption and investment climate on the German economy can also serve to weaken consumer spending and investment in Germany. The mechanisms by which global trends spread to national economies – and whose quantitative significance remains far from fully understood – have gained in power and speed as globalisation marches forward. As one of the most open industrialised nations in the world, Germany is disproportionately affected by these trends due to its pattern of specialisation – and its particular emphasis on exports of capital goods – within the international division of labour.

4. Thus, in contrast to the great majority of economic downturns during the post-war period, Germany confronts above all a crisis in international demand. Despite the German economy's ongoing need for structural reforms, this time it is not primarily the supply side that is impeding growth, in contrast to the first two global oil crises in the 1970s and 1980s as well as the downturn in the 1990s in the aftermath of the "reunification boom" in Germany. The crisis of confidence in financial markets is

Figure 3: Employment trends



[9] Employed persons, self-employed persons and family workers (domestic);
[10] Total hours worked by gainfully employed persons (domestic); source: Institute for Employment Research (IAB);
[11] Annual averages calculated on the basis of month-end totals;
[p] Estimate of the Federal Ministry of Economics and Technology for 2008.

having a damaging impact on business financing across the globe, and this is having a disruptive impact on the functioning of the economy.

As global markets become increasingly intertwined, slumping demand and concerns about the future spread and intensify from country to country – emanating in this case from the epicentre of the financial crisis, the United States.

In sum, this year the German economy – and with it German economic policy – is confronting its greatest challenges at least since reunification. Mastering these challenges represents the central task not only for the makers of economic policy but rather for all actors who bear responsibility for the general economy. This includes parties to collective bargaining agreements; companies; and credit institutions, whose paramount importance in ensuring the smooth functioning of the economy has become powerfully clear in recent months.

The German economy's resilience has increased

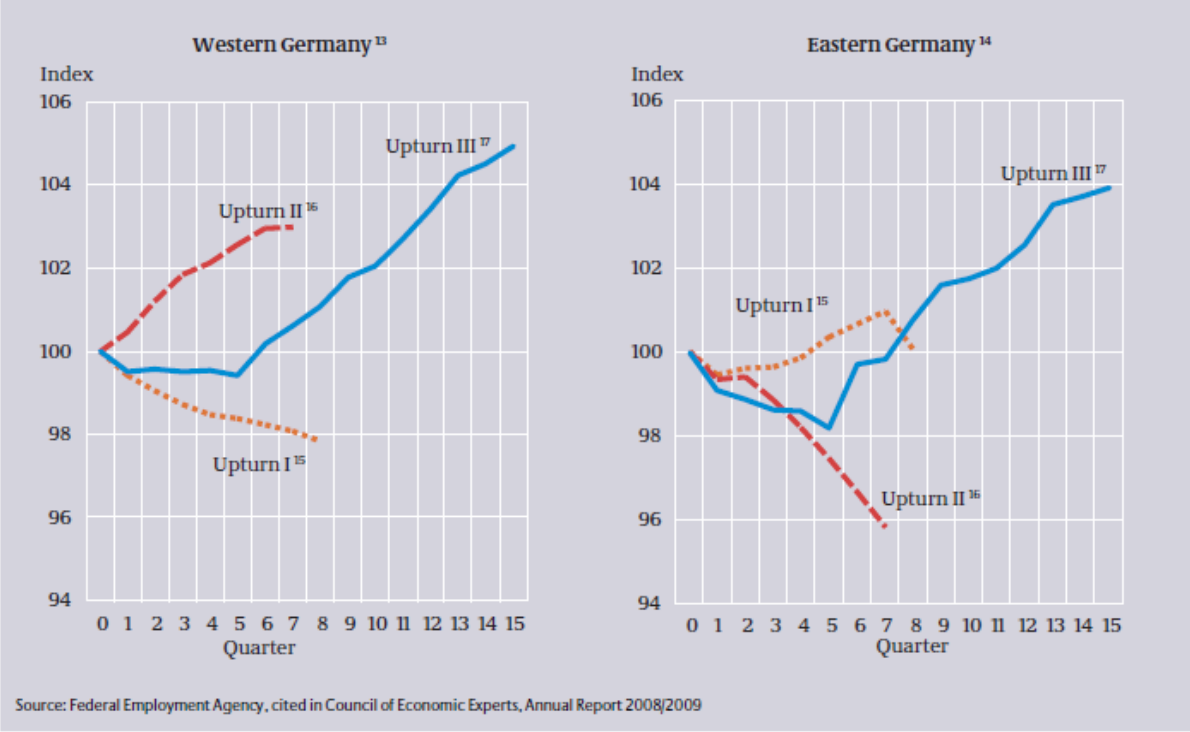
5. The German economy is in considerably better shape to tackle these challenges than it was at the end of the previous economic cycle, i.e. in the first quarter of 2001. The Federal Government's reform strategy has borne fruit. German companies have improved their competitiveness compared to the rest of the world. The flexibility and adaptivity of the German economy have increased as a result of structural reforms, particularly within the labour market. In this connection, the parties to collective bargaining agreements have played a key role: by concluding flexible and moderate wage agreements, they have helped make possible the impressive employment growth that Germany has enjoyed in recent years. Furthermore, public budgets have largely been consolidated. As a result, the German economy today is substantially more resilient than it was a few years ago. Other ameliorating factors at the present time include the drop in oil, fuel and food prices during recent months as well as favourable developments in exchange rates.

Figure 4: Changes in total employment and the number of jobs requiring social insurance contributions (yearly averages)

In recent years, German companies have successfully restructured themselves and are now in an excellent position in terms of international competition. They took advantage of the upswing to consolidate their finances. In addition, the Federal Government's 2008 corporate tax reform reduced the average overall tax burden on companies to under 30 percent as of 1 January 2008 (see also Item 25). Thus companies have a stronger capital base for making investments. In the view of the Council of Economic Experts (CEE Annual Report, Item 95 ff.), the high level of self-financing particularly within small and medium-sized German firms, together with the relative stability of Germany's three-pillar banking system, will make an important contribution toward stabilising the German economy.

6. The labour market is also in a comparatively good position to cope with these challenges. In 2008, Germany achieved record employment, with total employment exceeding 40 million on average for the year – the highest level in the history of the Federal Republic. Unemployment has fallen from 4.9 million on average in 2005 to 3.3 million in the past year. And in October 2008, unemployment fell below three million – its lowest level in 16 years. The recovery of the labour market was driven primarily by the expansion of jobs requiring social insurance contributions (see Figure 3). These developments on the labour market also contributed to a marked reduction, compared to previous years, in the number of persons threatened with poverty. However, the slowdown already began to manifest itself by late 2008 as employment growth flattened out; the number of unemployed took a relatively strong jump in December (up 114,000 to 3.102 million); and the number of persons in short-time employment increased. In the coming months, it is expected that the impact of the economic downturn will become increasingly visible on the labour market.

Figure 5: Trends in the number of jobs requiring social insurance contributions during various periods of economic expansion, in eastern and western Germany[12]



[12] Seasonally adjusted values calculated in accordance with the Census X-12-ARIMA procedure; [13] excluding Berlin; [14] including Berlin; [15] second quarter 1993 – second quarter 1995; [16] second quarter 1999 – first quarter 2001; [17] fourth quarter 2004 – third quarter 2008.

According to the Council of Economic Experts (CEE Annual Report, Item 481), in 2008 the German economy succeeded in reversing the decline in full-time employment for the first time since reunification. In September 2008, the number of persons employed in jobs requiring social insurance contributions had increased by 580,000 (or 2.1%) over the previous year. Approximately two-thirds of these jobs were full-time positions (see Figure 4). In contrast to the previous upswing, the number of persons employed in jobs requiring social insurance contributions also rose solidly in eastern Germany by 1.8 percent (see Figure 5).

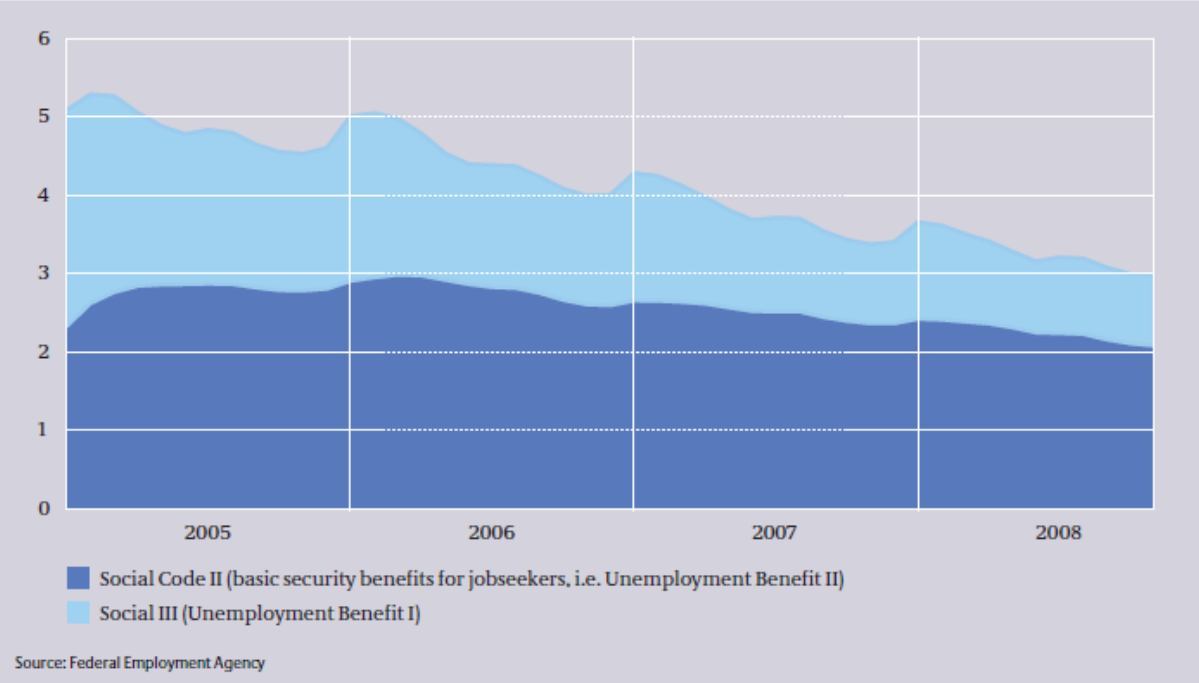
These marked improvements are more than simply the consequences of a cyclical recovery. Rather – as confirmed by the Council of Economic Experts (CEE Annual Report, Item 293) – they can be traced back to the Federal Government's reform efforts as well as to the sense of responsibility demonstrated by the parties to collective bargaining agreements. On the labour market, jobseekers are now being placed more quickly in new positions that are better-suited to their skills, and the instruments of active employment promotion have become more efficient. Unemployed persons are looking for work both earlier and more intensively. As a result, vacant positions can be filled with greater ease and speed. In addition, impediments to hiring by companies have been reduced thanks to more flexible rules governing part-time work as well as numerous elements of flexibility within collective wage agreements, such as the increased use of working time accounts and opt-out clauses. Furthermore, parties to collective bargaining agreements have exercised good judgement by concluding moderate, realistic wage agreements. As a result of all these factors, the unemployment rate has fallen by one-third in the past three years, from 11.7 to 7.8 percent. Nearly all employment groups have benefited from these developments, including older workers, low-skilled workers and the long-term unemployed (see Figure 6).

Thus for the first time since the 1970s, the natural rate of unemployment is markedly lower than it was during the previous upswing. There are many indications that, due to these modified patterns of adjustment, the labour market will not only prove to be more stable but can also recover more quickly from negative economic impacts. The Council of Economic Experts shares the view that, due to its improved flexibility and responsiveness, the labour market will not experience the type of strong and sustained decline in employment that occurred during the previous downturn. According to the Council, "Efforts to implement further reforms … should not subside, and it is essential to continue pursuing collective bargaining policies that are conducive to higher employment. In the expected case of a solid cyclical downturn, it is crucial to maintain the employment level that has been achieved and to strengthen the foundations for future employment growth" (CEE Annual Report, p. 265).

As the Council observes, fiscal policy has also made great progress in the way of consolidation in recent years (CEE Annual Report, Item 302). In 2004, the government deficit stood at 3.8% in relation to nominal GDP (see Figure 7). By 2008, the total government budget was nearly balanced. However, the federal budget recorded a deficit, and the budgets of the *Länder* also ran a slight deficit overall. Yet these deficits were counterbalanced by strong, repeated surpluses at the municipal level as well as within the social insurance system. The fiscal discipline of the past three years now provides budgets with the breathing room that will make it possible to pursue a fiscal policy that fits the cyclical conditions of the present situation. As a result, the so-called "automatic stabilisers" can operate to their full effect. Thus in

terms of fiscal policy as well, Germany is in a substantially better starting position than it was at the end of the previous upswing. For this reason, Germany's economic and fiscal policy is in the position today to effectively counteract both the loss of confidence on financial markets as well as the economic downswing.

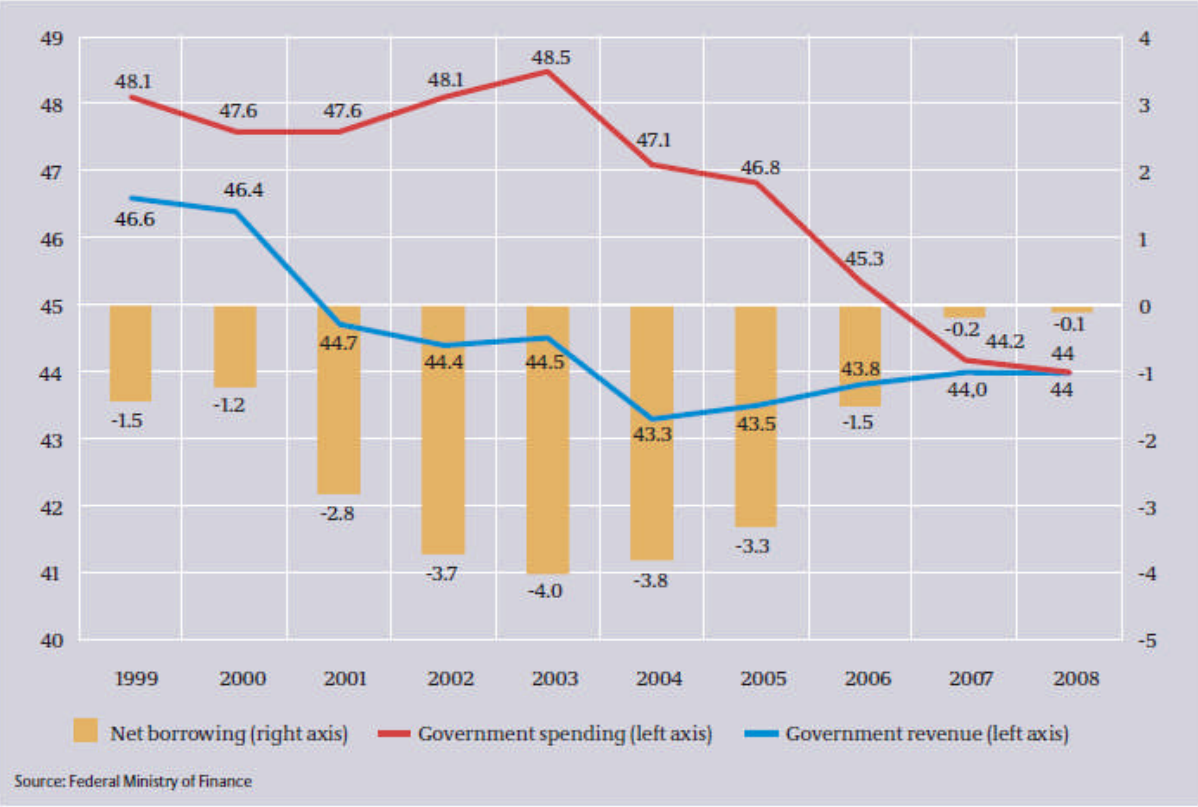
Figure 6: Number of unemployed persons according to the legal categories of the German Social Code



Stabilising financial markets

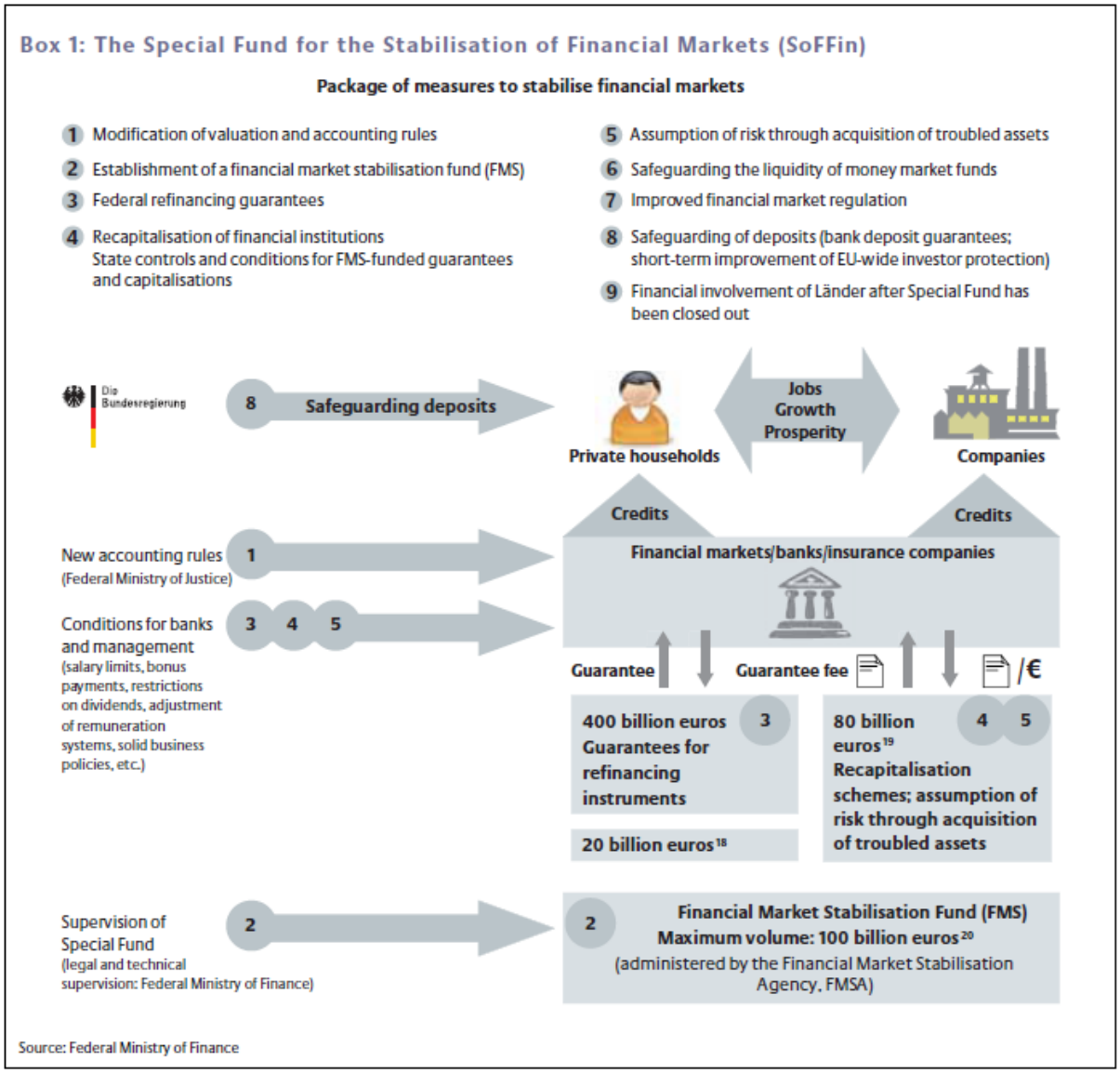
7. As the Council of Economic Experts observes, the excessively expansive monetary policy of the United States, carried out over a long period of time, laid the foundations for the expansion of credit in the real estate sector and for the real estate bubble in the United States (CEE Annual Report, Item 174). In the summer of 2007, as the crisis on the U.S. subprime lending market gathered steam, a comprehensive revaluation of financial risk took place. The securitisation market, where assets were pooled and sold to investors, stood at the centre of these developments. Rising default rates on high-risk mortgage loans and on loans to non-creditworthy borrowers exposed the level of risk that banks had removed from their balance sheets and transferred to largely unregulated special purpose vehicles (SPVs). Doubts regarding the value of opaque assets held by such SPVs led to massive value adjustments among holders of these debt instruments. The upshot was a profound loss of confidence among banks that caused interbank lending to come to a near standstill. This in turn triggered dramatic liquidity problems at certain credit institutions, thereby exacerbating the crisis of confidence. According to the Council of Economic Experts, there was a risk in September 2008 of a "systemic breakdown that by itself would have led to a collapse of banks, insurance companies and other financial institutions worldwide" (CEE Annual Report, p. 117).

Figure 7: Germany's path to a balanced government budget



Source: Federal Ministry of Finance

Box 1: The Special Fund for the Stabilisation of Financial Markets (SoFFin)
Package of measures to stabilise financial markets



[18] The fund may borrow up to 20 billion euros (i.e. 5% of the total guarantee volume of 400 billion euros) as a budgetary precaution to back up the guarantees;
[19] The fund may borrow up to 80 billion euros for recapitalisation schemes and the acquisition of troubled assets;
[20] In total, the fund may borrow up to 100 billion euros (20 billion euros to back up the guarantees plus 80 billion euros for recapitalisation and troubled asset acquisition).

- One of the stabilisation fund's tasks is to safeguard the flow of liquidity between financial institutions. To achieve this, the fund has up to 400 billion euros at its disposal for the purpose of issuing guarantees (3).

- In addition, the fund can recapitalise financial institutions through the acquisition of shares in cases where (a) the federal state has a substantial interest and (b) the mere issuance of a guaranty has no prospects for success (4).

- Furthermore, the fund can be used to buy up troubled assets from financial institutions in order to safeguard the capital base of the affected institutions (5).

- Both German financial institutions as well as the German subsidiaries of foreign financial institutions have access to these instruments, subject to the condition

that they are financially solvent companies. In exceptional cases, the stabilisation fund may provide assistance to ailing financial institutions that have systemic importance, as long as such assistance goes hand-in-hand with a clear plan for restructuring.

- Stabilisation measures conducted under the auspices of the stabilisation fund (measures 3, 4 and 5) may be made subject to conditions in order to ensure fair competition among all financial institutions, to safeguard the interests of taxpayers, and to ensure that owners and management assume their due responsibility. Recapitalisation schemes may be subject to the strictest conditions.

- Such conditions may include: requirements affecting business policies, e.g. rules specifying that credit be granted to small and medium-sized enterprises; the stipulation of upper limits on executive salaries; and the prohibition of salary bonuses.

Governments and central banks worldwide were forced to intervene in order to secure the deposits of private citizens, ensure the supply of credit to companies and restore confidence in the stability of the financial system. In October 2008, the EU and the G7 agreed to basic principles and instruments that should be put into action by individual states, taking national circumstances into account.

On 13 October 2008, the Federal Government adopted a comprehensive rescue package for Germany's financial system, the measures of which were firmly embedded in the overall approach taken by the international community. And by 18 October 2008, the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*, FMStG) – whose purpose is to secure the supply of credit to the German economy and to safeguard savings and investments – had already entered into force. The Act encompasses a package of measures that aim to revive confidence in the financial system and to restore order to commercial transactions between financial institutions. These measures are designed to minimise potential burdens that may result for taxpayers (see Box 1).

The Federal Government has announced an unlimited guarantee on all private deposits in Germany, thereby guaranteeing that German deposit guarantee schemes for banks will function effectively for all private individuals regardless of the amount of their deposits. In addition, new accounting rules will apply for a limited period of time (see Box 1). These rules are meant to prevent fundamentally healthy, but temporarily illiquid, assets from triggering further write-offs that could lead to a downward spiral. In addition, the Federal Government has established a Special Fund for the Stabilisation of Financial Markets (*Sonderfonds Finanzmarktstabilisierung*, SoFFin).

As of 2 January 2009, five institutions have made use of the stabilisation fund. So far, guarantees totalling 95 billion euros have been issued in accordance with Section 6 of the Financial Market Stabilisation Fund Act (*Finanzmarktstabilisierungsfondsgesetz*, FMStFG), and one recapitalisation in the amount of 8.2 billion euros has been undertaken in accordance with Section 7 FMStFG.

8. The Council of Economic Experts explicitly welcomed the design of the Federal Government's rescue package. According to the Council, the package represents "an

important contribution toward the stabilisation of financial market actors as well as the general public." However, the Council also states that it is too early to render a conclusive assessment of the package (CEE Annual Report, Item 256). The Federal Government and the Council are in agreement that the financial system can be restored to sound footing only if it is comprehensively restructured (CEE Annual Report, Item 241). Structural adjustments are particularly necessary in the *Landesbank* sector (i.e. public sector banks backed by the German *Länder*). This sector must be reformed in order to ensure that these banks remain competitive in the future. Any postponement of necessary consolidation measures risks weakening the entire public banking sector in Germany, and this could have a negative impact on business financing, particularly for small and medium-sized firms. At the same time, the Council argues correctly that, after the state's stabilisation and restructuring measures have succeeded, the government must pull back and concentrate once again on its core tasks (CEE Annual Report, Item 256).

Strengthening the economy in the short term

9. In order to minimise the extent to which the financial crisis and the international economic slowdown can spread to the general economy, the Federal Government has adopted a broad spectrum of measures. By pursuing a growth policy that is tailored to fit cyclical conditions, the government is combining – in the words of the Council – "policies that are right for growth with policies that are necessary for responding effectively to current cyclical conditions" (CEE Annual Report, Item 441). The government's concept focuses simultaneously on (a) overcoming the crisis in the short term and (b) improving prospects for economic growth over the long term. Our aim is for Germany to emerge from the crisis stronger than it was when the crisis began. The centrepieces of government policy are to safeguard jobs and to uphold the ability of companies to invest. Our measures will boost investment in future-oriented sectors, particularly education. We will promote skills development among workers while simultaneously providing sustained tax relief to businesses and private households.

10. Already in 2008, the Federal Government took action to provide tax relief to businesses and private households. The corporate tax reform that was enacted in 2008 will by itself reduce taxes by seven billion euros annually in 2009 and 2010 (see Item 25 below). With its "Package of Measures to Reduce Tax Burdens, Stabilise Social Insurance Contributions and Invest in Families", which was adopted on 7 October 2008, the Federal Government will lower the tax burden on citizens and companies by over six billion euros in 2009 and by nearly 14 billion euros annually from 2010 onward (see Box 3).

Box 2: A growth policy to fit cyclical conditions

- Lengthy cyclical crises which are rooted in a loss of confidence and a massive slump in international demand – and which threaten to develop a negative dynamism of their own – can inflict long-lasting damage upon the potential for growth and employment. In situations like these, policymakers are called upon to counteract these developments with stabilising measures. The measures taken must target the root causes of the crisis, boost overall economic demand, and above all strengthen both private sector and public confidence in the future. They

must be implemented quickly and have a rapid impact in order to prevent a self-perpetuating downward spiral.

- Confidence can be bolstered only through measures that are embedded in a credible, consistent and sustainable concept for growth. Temporary measures must build bridges toward long-term growth. Only in this way can positive expectations arise that in turn foster a willingness to actually spend higher incomes and to take advantage of new investment opportunities. Positive expectations are the mechanism that propels longer-term growth above and beyond immediate fiscal stimulus measures.

- Such measures can be "pre-financed" by the state as long as this financing is part of a convincing strategy to consolidate public sector budgets. For this reason, enshrining new constitutional rules on annual budget deficits – which the Federal Government strives to do – will play a key role in building confidence and thereby boosting growth.

- In order to ensure that government policy enhances the long-term potential for growth rather than simply generating short-lived bursts of spending that raise the debt of future generations, it would make sense to move those measures forward that will have a lasting impact on economic growth. In particular, these include "shovel-ready" infrastructural measures that can be implemented quickly as well as tax relief for private households. The Council of Economic Experts explicitly advocates this type of cyclically-aligned growth policy. (CEE Annual Report, Item 22).

11. Furthermore, the Federal Government has taken action in response to the deteriorating economic outlook by adopting, on 5 November 2008, the 15-point programme "Securing Jobs by Strengthening Growth". The aim of the programme is to overcome the cyclical downturn as quickly as possible and to safeguard jobs. The programme's measures were designed in accordance with the Council's recommendations (CEE Annual Report, Item 420) to pursue an economic policy that is tailored to cyclical realities while simultaneously promoting sustained growth – in other words, a policy that is targeted, that can be implemented in the short term, and that makes sense over the long term (see Box 4).

These measures will provide the impetus for public and private investments and contracts totalling approximately 50 billion euros. In addition, the *Kreditanstalt für Wiederaufbau* will safeguard the financing and liquidity of companies, thereby securing funding for investments totalling approximately 20 billion euros. The Federal Constitutional Court's decision regarding the commuter tax allowance will provide an additional economic stimulus. Until the necessary revisions to legislation on the commuter tax allowance are enacted, an amount of 30 cents per kilometre also for the first 20 kilometres will be deductible as professional expenses; moreover, this provision applies retroactively as of 2007. The resulting tax shortfalls will not be offset through other taxes or contributions.

12. In late 2008, it became increasingly clear that both the speed and scope of the crisis were more profound than originally expected. In situations like these, policymakers are called upon more than ever to provide a sense of direction and to

prove that they are capable of effective action. We must now focus our considerable energy on the concerted implementation of all initiatives that have been prepared at various government levels, in order to deliver a pooled, dynamic stimulus to the economy. Our goal is to safeguard jobs, strengthen the forces for growth and modernise the country – all of these elements have equal priority. In this process, the federal, *Länder* and municipal levels are called upon to work jointly in activating the most important resources that will stimulate trust, confidence and strong economic development.

With its "Pact for Employment and Stability in Germany", the Federal Government has taken action in five core areas:

1. Municipal investment programme; future-oriented government investment:
The central initiative here involves a campaign to promote education and skills development, because the creativity of the German people is our most important productive force. We will also place increased emphasis on promoting climate protection and energy efficiency. In 2009 and 2010, federal, *Länder* and municipal governments will promote investment in education and high-performance infrastructure in order to make Germany more modern and more efficient over the long term. The focus will be on investments that can be implemented quickly, that will have a broad economic impact, and that will not involve unaffordable follow-up costs.

2. Credit and guarantee programme; promoting entrepreneurial investment, innovation and demand:
In the current crisis, it is essential to protect the substance of the German economy. At the same time, however, the crisis can pave the way toward improving this substance. In order to further ensure the supply of credit to the economy – above and beyond what is already being done under the Financial Market Stabilisation Act – new measures will be taken to expand the available instruments for securing the private sector's access to credit. On top of the KfW's already existing special programme for small and medium-sized enterprises (volume: €15 billion), these measures will provide access to guarantees worth a total volume of €100 billion. The aim here is to make sure that no healthy, competitive companies – which often possess outstanding potential for succeeding on global markets – are driven out of business due to the current upheavals in the banking sector. To ensure strong medium-term prospects, the decisive factor will be for companies to maintain their current high level of research and innovation, in order to prevent any backsliding from their outstanding position in relation to their competitors worldwide. They will receive additional help for this purpose. For example, Germany's major automakers and their extensive network of suppliers form a cluster of technology and innovation that is unique in the world. This structure should be maintained. At the same time, we will take steps to accelerate the transition to low-consumption, climate-friendly vehicles. There is also a great need for Germany to invest in networks of the future. This applies in particular to the construction of a high-performance broadband network.

Box 3: Package of measures to reduce tax burdens, stabilise social insurance contributions and invest in families

- **Reducing tax burdens:** The Federal Government has expanded its tax incentives for private households that function as contractors and/or employers by providing a 20% tax cut on expenditures up to a maximum of 20,000 euros per year. In addition, tax deductions for social insurance contributions to health insurance and long-term care insurance will be improved substantially starting in 2010.

- **Stabilising social insurance contributions:** As of 1 January 2009, the contribution rate for unemployment insurance was reduced by 0.5 percentage points to 2.8 percent. It will remain fixed at this level through the end of 2010 as part of the "Pact for Employment and Stability in Germany" (see also Box 5).

- **Investing in families:** As of 1 January 2009, the child tax credit will be increased from 3,648 euros to 3,864 euros for each child. As a result, total tax exemptions for children will rise from 5,808 euros to 6,024 euros per child. The child benefit will increase by 10 euros per month for the first and second child, and by 16 euros per month for each child thereafter. In addition, housing benefits will improve substantially starting on 1 January 2009; for example, heating costs will be included for the first time. Moreover, benefits in the form of a one-time lump sum payment, calculated retroactively as of 1 October 2008, will be provided for the 2008-2009 heating period.

Box 4: Package of measures "Securing Jobs by Strengthening Growth"

- **Financing and liquidity of companies:** The KfW has expanded its financing instruments, particularly for small and medium-sized firms, in order to prevent a potential credit crunch. To this end, additional credit in the amount of 15 billion euros will be made available through the end of 2009.

- **Additional incentives for private investment and innovation:** The Federal Government has introduced a declining balance depreciation rate of 25% for movable assets for a period of two years. In addition, special depreciation allowances as well as tax deductions for investments will be expanded substantially for small and medium-sized businesses. From 2009 to 2011, the Federal Government will also provide an additional three billion euros in funding to stimulate further investment in the energy efficiency of buildings. Finally, in 2009, a special programme will provide 200 million euros in additional funding for the joint federal/*Länder* programme, "Improving the Regional Economic Structure", which targets structurally weak regions.

- **Public investment:** To ensure a steady level of investment in important infrastructural projects, the Federal Government is providing additional funds for the KfW's infrastructure programmes for structurally weak municipalities. These funds are expected to generate loans totalling approximately three billion euros. Furthermore, the Federal Government is speeding up urgent transport investments by making available an annual amount of 1 billion euros for this purpose in 2009 and 2010.
- **Private households:** While implementing its plans to reform the motor vehicle tax by converting it into an emissions-based tax, the Federal Government will ensure

that older vehicles are not penalised with additional taxes in the initial years following the reform. The government has introduced a one-year motor vehicle tax exemption for all purchases of new motor vehicles that are first registered between 5 November 2008 and 30 June 2009. This exemption will be extended to a maximum of two years for motor vehicles that comply with Euro 5 and Euro 6 standards. Furthermore, tax bonuses for work performed by skilled craftsmen to maintain and modernise buildings will be markedly expanded starting in 2009.

- **Employment:** To help spur employment, the duration of compensation for short-time employment (*Kurzarbeitergeld*) has been extended from 12 to 18 months. At the same time, the Federal Government has expanded the ways in which short-time employment can serve as a platform for advanced training. Furthermore, 1,000 additional job placement officers will be assigned to employment agencies to help workers find new jobs during their notice period, i.e. before they actually become unemployed ("job-to-job placement"). Also, the Federal Employment Agency's special programme for low-skilled and older workers (WeGebAU) will be intensified.

3. Securing jobs and developing skills:
The recession places the jobs of many employees – both low-skilled and highly skilled – at risk. At the same time, Germany is positioning itself within the global division of labour as an economy that places an ever-higher priority on developing advanced and specialised skills and capabilities. Therefore, the paramount principle for labour market policy in 2009 must be to avoid layoffs and to build skills. To this end, short-time employment will be made more attractive and less bureaucratic through the simplification of procedures and the reimbursement of 50% of social insurance contributions. The government will also promote a combination of short-time employment and advanced training.

4. Strengthening citizens; providing tax relief to private households and small and medium-sized companies:
To mitigate the impact of the economic slump while simultaneously building a bridge to the next upswing, the government will provide sustained relief to private households, particularly those that pay taxes and social insurance contributions. The tax relief we implement will involve long-lasting policies rather than one-off measures. As a result, these policies will provide a sustained boost to domestic demand during the crisis while simultaneously fostering people's willingness to work hard and lifting their confidence in the future. To this end, the government will increase the basic personal allowance, lower the entry-level tax rate and reduce the rate of contribution to statutory health insurance. Additional family- and child-related benefits will work especially to the advantage of households that have to spend a major part of their income for consumption purposes.

5. The goal of maintaining balanced national and federal budgets remains unchanged.
In the current situation it will be necessary to take on higher budget debts, a view shared by the Council of Economic Experts (CEE Annual Report, Item 441). Pursuing a balanced federal budget without taking the current economic situation into account would result in a pro-cyclical fiscal policy that would be counterproductive not only for the current business cycle but also for long-term growth. However, pursuing an anti-

cyclical fiscal policy requires that deficits accumulated in bad economic times be balanced out in good economic times. This may make it necessary to undertake further consolidation measures once the global financial and economic crisis is overcome – a step that is also provided for by the European Stability and Growth Pact.

13. The "Pact for Employment and Stability in Germany" is the result of an unprecedented joint effort by all levels of government. The pact provides wide-ranging funding and incentives to stimulate business activity and contains new measures worth a total volume of 50 billion euros. Together with the measures already adopted in October 2008, the German government is targeting over 80 billion euros toward the goals of overcoming the crisis and achieving the comprehensive modernisation of the country. The rapid implementation of the Federal Constitutional Court's decision regarding the commuter tax allowance – which will lead to tax shortfalls totalling approximately 8.5 billion euros in 2009 and 2010 – will provide an additional economic stimulus. And this does not even take into account the programmes being implemented by the *Länder*. This is a massive stimulus for growth and a powerful answer to the global recession. The so-called "automatic stabilisers" will also have an impact as well. Government policy will develop its full impact only when all policy elements work in synergy – these elements include the measures taken at all levels of government; the promotion of private and public investment; ensuring the private sector's access to credit; skills development and tax relief for citizens; and the institutionalisation of a long-term consolidation strategy grounded in new constitutional rules on government borrowing.

Box 5: The "Pact for Employment and Stability in Germany to Safeguard Jobs, Strengthen the Forces for Growth and Modernise the Country"

<u>Future-oriented government investment:</u>

- The Federal Government is providing additional funding totalling approximately 14 billion euros in 2009 and 2010 for investment in education and infrastructure. Of this amount, about four billion euros will be spent for additional investment at the federal level.

- The other 10 billion euros will go to a municipal investment programme to support additional investment at the *Länder* and municipal levels. The Federal Government expects at least half of these 10 billion euros to be spent in 2009 and to be used primarily for investment at the municipal level. The governments of the *Länder* will contribute 25% co-financing.

- 65 percent of the funds that the Federal Government provides for the municipal investment programme – i.e. 6.5 billion euros – will be targeted toward the educational sector to promote *Länder* and municipal investment in child day-care centres, school infrastructure, higher education facilities (particularly the energy-efficient renovation of buildings) and research.

- The other 3.5 billion euros can be used for the modernisation of municipal infrastructure, particularly hospitals (regardless of who operates them), urban development, rural infrastructure and noise mitigation measures for municipal roads.

- The *Länder* can thus undertake rapid investments that are tailored to local needs and that are based on their own decisions. They will ensure that the funds are used to make additional investments that will also and especially have a positive impact on financially weak communities.

- Furthermore, the Federal Government will spend half of its four billion euros in federal-level investment on measures to expand and repair the federal transport infrastructure (roads, railways and waterways). The other two billion euros will be invested in federal buildings and equipment as well as research conducted by the federal ministries.

- Investments in education and infrastructure will also be designed in a way that clearly advances the agenda of climate protection and energy efficiency.

<u>Speeding up investment by simplifying public procurement law:</u>

- Public procurement will be simplified in order to facilitate speedier investment. To this end, for a period of two years, new ceilings will be in effect for restricted and negotiated tenders (neither of which involves an open tender) involving construction services; the respective ceilings are one million euros for restricted tenders and 100,000 euros for negotiated tenders. Likewise, negotiated tenders involving the provision of services or supplies will be subject to a ceiling of 100,000 euros. Below these respective ceilings, procurement authorities may conduct restricted or negotiated tenders without providing proof of exceptional circumstances. The *Länder* and municipalities are likewise called upon to simplify their procurement procedures by raising their procurement ceilings.

- In addition, the Federal Government is working to achieve a determination that – in accordance with the relevant Communication of the European Commission – the urgency of the current economic situation warrants a temporary shortening of tendering periods under the contracting regulations for supplies and services (*Verdingungsordnung für Leistungen*, VOL) as well as for construction services (*Vergabe- und Vertragsordnung für Bauleistungen*, VOB). This temporary shortening of tendering periods would apply for a period of two years.

<u>Credit and guarantee programme:</u>

- We will stay on the policy path that has been taken to safeguard the credit supply to the economy – particularly under the Financial Market Stabilisation Act (see Box 1) – by adding new measures and by expanding existing instruments, e.g. the programmes of the KfW.

- To this end, the eligibility criteria for the KfW's special programme targeting small and medium-sized firms will be relaxed in 2009, in order to ensure that the programme can be accessed in a manner that fulfils its aims. This will improve financing for projects and equipment, for example.

- A similar credit programme for larger companies will also be established.

- Better use will be made of the existing domestic guarantee instruments to ensure that businesses have access to loans. These instruments will also be expanded.

- In addition, new guarantee instruments to support external financing for companies will be assessed, with the primary aim of improving the financial situation of key actors in this area such as credit insurers, leasing companies and factoring companies.

- On top of the KfW's already existing special programme for small and medium-sized enterprises (volume: €15 billion), these measures will provide access to guarantees worth a total volume of €100 billion.

Expansion of federally guaranteed export financing:

- The Federal Government is currently examining options for expanding federally guaranteed export financing.

More support for innovation:

- The Central Innovation Programme for SMEs (ZIM) supports research and development projects conducted by small and medium-sized enterprises with up to 250 employees. Support in the form of grants is provided for collaborative R&D projects throughout Germany and for R&D projects run by individual companies in eastern Germany.

- In order to help small and medium-sized businesses meet their increased R&D funding needs during the economic crisis, this support will be expanded in 2009 and 2010 to cover (a) R&D projects run by individual companies in western Germany and (b) R&D projects run by larger firms (up to 1,000 employees) in both eastern and western Germany. Levels of support provided within this framework will be higher for eastern German firms. 450 million euros per annum in additional budget funds (of which 100 million euros will be targeted toward eastern German firms) have been earmarked for this purpose.

The Federal Government's broadband strategy:

- The Federal Government will take action to significantly upgrade and expand Germany's broadband system, to close gaps in coverage as quickly as possible, and to press forward with the construction of wired and wireless high-capacity networks. Our priorities include reducing investment costs, providing funding and support, and ensuring that regulatory measures are oriented toward investment and growth.

- Our goal is to ensure that those areas currently lacking coverage have access to efficient broadband connections by no later than 2010.

- We want broadband connections with transmission rates of at least 50 megabits per second to be available to 75% of households by no later than 2014, and to all households by 2018. To help achieve these objectives, the Federal Government plans to unveil a comprehensive broadband strategy by mid-February 2009 (see Item 42).

Boosting demand for passenger cars:

- From the moment the Federal Cabinet adopts the measure, private car owners who scrap a motor vehicle that is at least nine years old and that has been

registered under their name for at least one year may apply for a “green rebate” of 2500 euros if they also purchase and register a new or one-year-old environmentally friendly vehicle that complies with Euro 4 standards or better. New cars must be registered by 31 December 2009 to qualify for the rebate.

- The Federal Government has earmarked a total of 1.5 billion euros for this economic and environmental programme to boost the demand for passenger cars.

Motor vehicle tax reform:

- The Federal Government has taken a first step to mitigate the slowdown in consumer demand by introducing a temporary motor vehicle tax exemption (see Box 4), a measure which forms part of the legislative package “Securing Jobs by Strengthening Growth”. In a second step, the government will convert the current motor vehicle tax into an emissions-based tax as soon as this is technically feasible. Current plans are to implement this tax conversion as of 1 July 2009. This will provide the legal clarity that will enable consumers to plan purchases quickly and securely.

- It is anticipated that the reformed tax will include the following features: a linear tax based on CO_2 emissions levels; a CO_2 tax allowance; and a base rate that serves as a minimum tax. At a later date, a decision will be taken regarding the level at which older vehicles (i.e. vehicles registered prior to 5 November 2008) will be taxed after 2013.

Promoting applied research in the field of mobility:

- For 2009 and 2010, the Federal Government has earmarked an additional 500 million euros for funding programmes and KfW loans that can be used, for example, for the development of hybrid engine, fuel cell and storage technologies. The funding programmes will be adapted to the EIB programme adopted by the European Council.

Securing jobs

- Securing jobs, stabilising contributions:
  - In 2009 and 2010, the Federal Employment Agency will reimburse employers for 50% of the social insurance contributions they would otherwise have to shoulder alone for short-time workers.
  - Employers may apply for 100% reimbursement of social insurance contributions for the periods during which short-time workers receive advanced training.
  - Application and processing procedures will be simplified.
  - In addition, the contribution rate for unemployment insurance will be fixed at 2.8% through the end of 2010.

- Promoting labour market activation and skills development:

The Federal Government will also expand its policies to train, support and activate people to join the labour market. To this end, the following measures will be carried out:

  - For 2009 and 2010, 1.2 billion euros in additional federal funds will be made available for worker activation and training measures conducted by the

agencies that provide basic security benefits for jobseekers, and 770 million euros will be directed toward similar measures implemented by the Federal Employment Agency. These measures will focus in particular on workers over 25 years of age who have no professional qualifications; young people who have been unable to secure traineeships after long periods of searching; and expanded training and job placement for care providers.

- In addition, the Federal Employment Agency's programme for low-skilled and older workers (WeGebAU) will be broadened in scope and topped up by 200 million euros annually with the aim of expanding the programme's skills development offerings.
- Resources available to Germany from the European Social Fund to support (a) skills development during short-time employment and (b) projects that provide advisory services to companies for the purpose of securing jobs will be topped up by a total of 200 million euros in 2009 and 2010.
- To promote the rehiring of workers in temporary employment, additional funding for training and skills development will be provided from the Federal Employment Agency's budget in 2009 and 2010.

➢ 5,000 additional staff will be hired into new positions at employment agencies. Half of the positions will be allocated to Social Code III (employment promotion) and half to Social Code II (basic security benefits), and the positions will focus on job placement, support services and the provision of benefits.

<u>Income tax reduction:</u>

➢ The Federal Government will reduce income taxes, thereby providing private households with tax relief amounting to 2.9 billion euros in 2009 and 6.05 billion euros starting in 2010. These tax cuts will also benefit small and medium-sized companies (partnerships).

➢ The basic personal allowance will be increased by 170 euros to 7,834 euros (with effect from 1 January 2009); and as an initial step toward the reduction of fiscal drag, the remaining tax thresholds will be raised by 400 euros (also with effect from 1 January 2009).

➢ In addition to raising the basic personal allowance to 7,834 euros, the entry-level tax rate will be reduced from 15 percent to 14 percent with effect from 1 January 2009 as a measure specifically targeted toward the lowest income earners.

➢ In 2010, the basic personal allowance will be increased to 8,004 euros, and tax bracket thresholds will be raised by another 330 euros.

<u>Reducing the rate of contribution to statutory health insurance:</u>

➢ As of 1 July 2009, the Federal Government's contribution to statutory health insurance will be raised by three billion euros for 2009 and by six billion euros for 2010.

➢ Correspondingly, the rate of contribution to statutory health insurance that is co-financed by employers and employees will be reduced by 0.6 percentage points.

<u>Family- and child-related benefits:</u>

- All child benefit recipients will receive a one-time payment (child bonus) of 100 euros per child, which will be disbursed by the family benefit authorities. This bonus will not be taken into account when calculating the social security benefits provided to welfare recipients. The one-time payment will be taken into account in 2009 income tax returns under the child tax credit.

- The standard social benefit rates for children in Social Codes II and XII will be adjusted and further variegated. For children aged 6 to 13, benefits will rise to 70 percent of the adult rate with effect from 1 July 2009.

Introduction of new rules to limit government deficits:

- As part of Stage II of the reform of Germany's federal system, the Federal Government aims to adopt new rules limiting annual budget deficits and to enshrine these rules in the Constitution (see Box 9).

Long-term reforms – central challenges facing economic policy

14. In recent years, trust in the social market economy and its automatic acceptance as Germany's economic system have diminished. There is widespread talk of an increasing social divide in Germany. The mechanisms of the economy have become harder to understand and less transparent. Many people perceive working life and career paths as increasingly insecure. Demographic challenges, growing environmental risks and global competition are additional factors that magnify this insecurity. Now as before, the Federal Government is convinced that a social market economy is the best economic system for coping effectively with the current challenges. The serious pursuit of a social market economy involves consistent adherence to the politically necessary balance between two key components: (a) economic efficiency and (b) social cohesion that aims to achieve "prosperity for all".

Thus, in the Federal Government's view, the social market economy is comprised of free competition embedded within a solid regulatory framework that must be continually adapted and improved. In recent years, the Federal Government has carried out structural reforms that have established greater latitude for the guiding ideas of freedom and competition, and this has paved the way to new successes, particularly on the labour market. In this way, the social market economy's competitive framework itself fulfils a social function. It is an ongoing task to shape this system in a manner that ensures equal opportunity and fair compensation for performance – at the international level as well.

15. All individuals in Germany must have equal prospects for entering a vocation and for improving their social position. One of the necessary preconditions for ensuring this is a tax system that creates incentives for achievement and advancement, particularly among lower and middle income earners. Good starting conditions for everyone are necessary as well. For this reason, the Federal Government is taking steps to increase investments in education, in order to establish greater equality of opportunity for all and to improve prospects for social advancement in Germany.

To this end, the heads of government at the federal and *Länder* levels decided on 22 October 2008 to launch a new skills development initiative (see Box 12). The federal and *Länder* governments have agreed to the goal of raising spending levels for education and research in Germany to 10 percent of gross domestic product by

2015. A particular priority will be placed on early childhood education, a policy that is expressly favoured by the Council of Economic Experts (CEE Annual Report, Item 435). This is because a child's socioeconomic background should play a less important role in influencing his or her future educational opportunities and thereby his or her ability to take part in social prosperity. Thus the Federal Government will contribute four billion euros to the quantitative and qualitative expansion of child care services for children under three years of age.

Germany cannot afford to let talent go to waste. Through concrete measures such as the "National Pact to Promote Training and Young Skilled Workers", an initiative carried out by government and the private sector (see Item 86), we will press forward with the expansion of career-oriented practical training for young adults in order to provide every individual with the opportunity to enter the labour market. In a parallel effort, the *Länder* will establish conditions to make it easier for individuals to move between vocational and academic forms of training. The Federal Government will also increase the financial assistance available to trainee master craftsmen (*Meister-BAföG*). In addition, "career advancement grants" (*Aufstiegsstipendien*) will be made available to highly talented individuals with vocational training who wish to pursue university studies. Existing obstacles to hiring and employment must be further reduced.

Even people who are solidly established in their careers need new prospects now and then. In the working world of today, no one can assume that he or she will spend their entire working life performing the same activity at the same job. Life-long learning must become the norm because, in the course of demographic shifts, it will be essential to draw upon the employment potential of older workers. The goal of the German government is therefore to raise the proportion of workers participating in some form of advanced training to at least 50 percent (see Box 12). Furthermore, within the framework of the Federal Government's SME Initiative, concepts will be developed to promote long-term human resources policies, family-friendly working conditions and a demographically appropriate business culture within small and medium-sized enterprises.

16. Germany needs to have an efficient state. Both citizens and companies know this. In return for paying taxes and social insurance contributions, they have the right to expect the state to spend their money in an efficient, thrifty and careful manner. Thus the Federal Government faces the challenge of making continued progress with the qualitative consolidation of public budgets as part of the effort to achieve a modern and efficient state. At the same time, we will continue to reduce bureaucratic burdens for businesses and private citizens. The Federal Government is working closely with the *Länder* to help modernise administrative structures and make them more responsive to people's needs (see Item 35).

17. The private sector itself has a key role to play in improving the business environment. In this connection, the private sector's voluntary commitment to social issues, above and beyond what is legally mandated, is increasing in significance. Such activities strengthen both the competitiveness of companies on one hand as well as social cohesion on the other. In Germany, the number of firms that are integrating the principles of corporate social responsibility (CSR) into their business strategies is steadily rising. The Federal Government is taking steps to encourage the adoption of CSR policies and to draw domestic and international attention to the

German private sector's commitment to CSR. Our aim is to enhance the general public's awareness of existing CSR activities and to promote networks among the actors involved. Corporate governance codes – i.e. codes of nationally and internationally recognised standards of good and responsible business management – also play an important role in improving the business environment.

18. The general public is becoming increasingly alarmed over the issues of climate change and volatile energy prices. In order for Germany to achieve its ambitious climate protection goals and ensure a supply of energy that is affordable for everyone, we must further reduce our dependency on imported fossil fuels and increase our energy efficiency. As a pace-setter in the fields of climate protection and energy efficiency, Germany clearly takes its climate policy responsibilities seriously. At the same time, consumers and industry have the right to expect that Germany will work to achieve its climate protection targets as efficiently and affordably as possible. For this reason, the Federal Government is expanding its support for research and development on energy technologies. On the other hand, however, excessive regulations that simply cause industries to relocate their operations abroad are counterproductive.

19. Increased investment in research and development will open up new avenues for growth. In recent years, German industry has raised its R&D expenditures. Even in difficult economic times, research and development must remain a priority. Thus to support the private sector's efforts, the Federal Government will maintain a consistent focus on the implementation of its High-tech Strategy and the expansion of R&D investments.

20. In light of the weaknesses that have been exposed within the international financial system, the Federal Government and the Council of Economic Experts (CEE Annual Report, Item 260 ff.) agree that a new global financial architecture is necessary to prevent the risk of systemic crises on financial markets in the future. For this reason, the Federal Government is working with its partners to modify international rules for financial market actors over the medium and long term. The central priorities in this connection are to strengthen the oversight of equity, risk and liquidity management; to improve transparency, valuation standards and rating processes; to intensify cooperation between national regulatory authorities; and to strengthen cross-border crisis management. The aim is to improve the conditions governing the functioning of financial markets so that they will operate with lower leverage and greater transparency in the future. At the global financial summit held in Washington on 15 November 2008, the G20 agreed that new rules governing the financial system should follow these basic principles (see also Item 92). Because solutions to global crises increasingly require international cooperation, Germany needs strong and reliable international partners (see Item 90).

B. Boosting confidence with a solid policy environment

21. Good structural conditions form the basis for strong and sustained growth. Ensuring such conditions is even more important in the present situation, because they open up medium- and long-term prospects for economic activity. The current upheavals on financial markets make it necessary not only to take coordinated action at the international level but also to undertake committed efforts at the national level by reassessing the domestic policy environment, setting the right incentives and

limiting risk. In recent years, Germany has already taken steps that have clearly improved the overall business environment. These include instituting corporate tax reform, cutting red tape and fostering greater competition, for example on energy markets (see Item 70). Over the medium term, the Federal Government will keep working to create more favourable conditions for commercial activity. This includes, among other things, improving incentives for business start-ups and for maintaining businesses that are inherited. We will also modify regulations for certain sectors, and we will make procurement law more SME-friendly. Moreover, the Federal Government will work to improve infrastructure and foster even greater competition.

Adjusting national financial market regulations

22. Even in normal times, efficiently functioning financial markets are a decisive factor in boosting the productivity level of every country's economy. The task of financial markets is to channel capital in directions where it can be used efficiently, to spread risk and to enable the transformation of maturity and volume. In order for financial markets to fulfil this task in a satisfactory manner, it is important to establish the right incentives and to limit risk. The financial crisis has made it clear that globalised financial markets require a global financial architecture (see Items 7 and 90). At the same time, national-level rules must be reassessed and adjusted as well.

Reforming financial oversight

23. For this reason, in 2009 the Federal Government will submit proposals to overhaul financial market oversight. This effort forms part of the legislative package adopted by the Federal Government to stabilise financial markets and to minimise negative repercussions on the real economy. The aim is to strengthen the institutional linkages between the Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin). The Council of Economic Experts has advocated that responsibility for banking supervision be transferred to the Deutsche Bundesbank (CEE Annual Report, Item 284). In the Federal Government's view, in the future there should be a "single regulator" that serves as a contact partner to the financial industry. This would also appear to be the best model in terms of compatibility with European institutions. In addition, the Federal Government plans to strengthen the ability of financial supervisory authorities to intervene in future crises. Moreover, financial oversight must also be reformed at the European and international level (see Item 90). On 1 October 2008, the European Commission submitted a proposal to amend European rules on bank capital requirements (directives 2006/48/EC and 2006/49/EC), a step that the Federal Government welcomes in principle.

Enhancing legal certainty

24. By adopting the Act to Limit Risks Associated with Financial Investments (Risk Limitation Act), the bulk of which went into effect on 19 August 2008, the Federal Government has taken steps to increase transparency, clarity and legal certainty on capital markets. The Act seeks to ensure that investors' capacity to influence companies is commensurate with their share of voting rights. In the future, shareholders who acquire 10 percent or more of a company's shares must disclose the objectives of their involvement as well as the origins of the financial resources used to acquire the shares. The information rights of company employees will be increased substantially. These measures will allow company management, employees, creditors and shareholders to respond promptly to investors' plans. The Act will also enhance the protection of consumers who take out loans. The practice of selling debt obligations to other financial investors has alarmed many borrowers, who

are concerned that new creditors – particularly in the case of mortgage contracts – might not adhere to the conditions that were agreed upon with the original lender. For this reason, the Risk Limitation Act contains a series of measures to increase transparency both before and after the conclusion of contracts and to prevent their unwarranted cancellation or enforcement.

Fostering a conducive tax environment

Enhancing investment incentives

25. Investment incentives are shaped, among other things, by a country's overall tax environment. For this reason, in its legislative package "Securing Jobs by Strengthening Growth", the Federal Government also took action to improve depreciation allowances in 2009 and 2010 (see Box 4). In addition, Germany's 2008 corporate tax reform – the main elements of which have been in effect since 1 January 2008 – cut taxes by over seven billion euros in 2008 alone. This fosters investment and enhances Germany's international competitiveness while simultaneously helping to secure both jobs and tax revenue over the long term (see CEE Annual Report 2008, Item 32).

Another key building block of the 2008 corporate tax reform went into effect on 1 January 2009 with the introduction of an all-inclusive tax (*Abgeltungsteuer*) on income from capital. The current yields and the results of the sale or redemption of an investment are thus subject to an attractive tax rate of 25 percent. The tax deduction from capital gains settles the tax claim, i.e. there is basically no longer any obligation to cite these gains in the tax return. However, taxpayers still have the possibility of having these revenues assessed for tax. This form of capital gains taxation is generally unbureaucratic and is customary in many EU member states.

26. The Council of Economic Experts basically takes a positive view of the all-inclusive tax (CEE Annual Report, Item 377). However, it does note a lack of integration with corporate taxation and a lack of neutrality in terms of corporate structure and type of finance. Furthermore, the intended effect of simplification only holds good for a small proportion of taxpayers. However, the neutrality of taxation in terms of corporate structure was improved with the 2008 corporate tax reform. The Federal Government achieved this by lowering the rates for corporations on the one hand and by reducing the taxation on retained profits for unincorporated firms on the other. It was not possible to achieve full neutrality in terms of financing, as called for by the Council, in the interest of avoiding even greater tax shortfalls. The Council's criticism that the all-inclusive tax has only a slight impact on the simplification of taxes seems excessive. After all, the fact that the tax deduction defines the tax claim provides relief for the vast majority of taxpayers, since tax returns are substantially simplified.

27. The Council regards tax-based assistance for research and development as an important measure that will strengthen the forces for growth in Germany over the long term (CEE Annual Report, Item 429). In a working group, the Federal Government studied the options for tax-based R&D assistance and found that a tax-based support instrument is generally feasible and has positive effects. Compared with assistance in the form of grants, tax-based R&D support has advantages in terms of the reach of its effects, but it also involves the use of considerable additional funding. No decision has yet been taken on this.

Reforming inheritance tax

28. By reforming the inheritance tax, the Federal Government aims to facilitate the transfer of companies to successive generations and in this way to safeguard jobs. For this reason, in the future it will be possible to transfer operations and companies wholly or almost wholly tax-free. This will also help to strengthen business activity in Germany. At the heart of the reform is the uniform assessment of different types of assets (as demanded by the Federal Constitutional Court), which is based on the commercial value or fair market value (see 2008 Annual Economic Report, Item 33). The relevant rules have been designed in such a way that they not only safeguard jobs but also take account of economic and commercial realities and necessities.

The person taking over the company has a choice: first, if he continues operations for seven years – including the continued payment of a certain wage total – 85 percent of the inherited corporate assets will be exempted from inheritance tax. Here, the proportion of administrative assets (e.g. real estate assigned to third parties) may not exceed 50 percent. Under this arrangement, small and medium-sized firms additionally benefit from a sliding deduction amount totalling 150,000 euros. It ensures that operating assets totalling up to one million euros remain untaxed. The allowance is reduced to zero on operating assets with a total value of three million euros. Second, there is an option whereby 100 percent of operations can be transferred tax-free. In this case, the person taking over the company must continue operations for 10 years and also pay a certain wage total, and the proportion of administrative assets must not exceed 10 percent.

The reform is designed in a way that continues to favour asset transfers within tight family circles. For this reason, personal allowances have been raised substantially (see Table 2). Irrespective of this, when an owner-occupied residential property is inherited, the surviving spouse or partner is not required to pay any tax. When an owner-occupied residential property is left to children, dwelling space of up to 200 m^2 will be tax-free in future. The Council of Economic Experts takes a highly critical view of the inheritance tax reform, particularly with respect to the arrangements providing tax relief on operating assets. It proposes general deferral rules for types of assets whose liquidity is limited and which are difficult to mobilise, and lower tax rates for Tax Bracket I (to offset the extra burden deriving from the higher valuation) (CEE Annual Report, Item 368). In contrast, the Federal Government sees the need for precisely targeted relief. This solution clearly reduces the burden on companies, while under a deferral arrangement the tax obligation would remain in full.

Table 2: Personal allowances under the inheritance tax

	Inheritor	Personal allowance New	Personal allowance Old
Tax bracket I	Spouse	**500,000 €**	307,000 €
	Children and stepchildren	**400,000 €**	205,000 €
	Grandchildren, great-grandchildren	**200,000 €**	51,200 €
	Other persons in tax bracket I (e.g. parents and grandparents)	**100,000 €**	51,200 €
Tax bracket II	Parents and grandparents (in the case of gifts)	**20,000 €**	10,300 €
	Siblings		
	Nieces and nephews		
	Stepparents		
	Stepsons, stepdaughters		
	Parents-in-law		
	Divorced spouses		
Tax bracket III	Other inheritors	**20,000 €**	5,200 €
	Registered partners	**500,000 €**	5,200 €

Source: Section16 of the Inheritance Tax Act; section 16 of the Inheritance Tax Reform Act

Enabling employees to participate more in the success of companies

29. Employees make a decisive contribution to the economic success of the companies they work for. For this reason, the Employee Share Ownership Act aims to allow employees to participate more in the capital of the employing company than in the past and to use shareholdings to build up assets. If they invest capital-forming payments in company shares, they will receive a higher tax credit for their savings (20 percent as opposed to 18 percent in the past). The income thresholds up to which this tax allowance for savings is granted have been increased to 20,000 euros for singles and 40,000 euros for married couples. Furthermore, in the future a company can transfer shares worth up to 360 euros (previously: up to 135 euros) without causing an employee's taxes or social insurance contributions to rise. In order to open up employee shareholding to SMEs in particular, shareholding is also being fostered through special employee participation funds. These funds are managed by an investment company (and thus by a licensed, professional fund manager) and are supervised by the Federal Financial Supervisory Authority (BaFin).

Making companies stronger

30. Small and medium-sized businesses are the backbone of the German economy. Particularly within the framework of its SME Initiative, the Federal Government implemented a large number of measures in 2008 to benefit small and medium-sized firms. Important policy projects included the reform of the Limited Liability Companies Act (*GmbH-Gesetz*, see Item 31), the reform of the inheritance tax (see Item 28), the Energy Efficiency Programme (see Box 11) and the third SME Relief Act (*Mittelstandsentlastungsgesetz*; see 2008 Annual Economic Report, Item 35). Further key steps to be taken in 2009 include improving the conditions for start-ups and business financing; continuing the implementation of the EU Services Directive; pressing forward with bureaucracy reduction; and updating German accounting law. In other relevant areas, the policy environment will undergo regular adjustment to current needs and requirements (see Items 36-38 and Box 6). For example, the

legislative package “Securing Jobs by Strengthening Growth” also targets the needs of small and medium-sized firms (see Box 4).

Promoting start-ups and improving financing conditions

31. Business start-ups generate new ideas and new products that inject fresh input into the competitive arena and create new, sustainable jobs. Therefore, in order to help entrepreneurs achieve a successful launch into the economic arena, the Federal Government has further reduced start-up costs. The reform of the Limited Liability Companies Act went into effect on 1 November 2008. Among other things, it established a new category of limited liability company, the “limited liability entrepreneurial company” (*haftungsbeschränkte Unternehmergesellschaft*). This new legal form will allow new companies, particularly less capital-intensive start-ups in the services sector, to launch business operations with less share capital and with a simpler, less expensive notarial certification process. Furthermore, the Federal Government’s promotion of business advisory services for start-ups and small and medium-sized companies was thoroughly restructured to enhance transparency and efficiency.

Box 6: The tourism sector – an example

- As part of its SME policy, the Federal Government is working to enhance the strength of Germany’s tourism industry, which is made up primarily of small and medium-sized businesses.

- In particular, the government is raising its financial support for the German National Tourist Board, which markets Germany throughout the world as a key travel destination, to more than 26 million euros in 2009.

- And by revising statutory information requirements under the German Civil Code, the government is helping to put travel operators who conduct business through catalogues on a more equal footing with Internet travel services.

32. Small, research-intensive start-ups often find it particularly difficult to secure adequate financing. In August 2008, the Federal Government adopted the Act to Modernise Framework Conditions for Capital Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen*, MoRaKG), which among other things improves overall tax conditions for the German venture capital market. In this way, the government has made it easier for new, unlisted companies to attract venture capital. Furthermore, in order to improve general financial conditions for businesses, particularly small and medium-sized firms, the Federal Government is continuing to improve its assistance programmes within the framework of the European Recovery Program (ERP) and the KfW Banking Group. In 2008, credit and equity guarantees amounting to over one billion euros were granted to small and medium-sized firms within the framework of the guarantee bank (*Bürgschaftsbank*) programme operated by the Federal and *Länder* governments.

Implementing the EU Services Directive

33. The EU Services Directive aims to simplify the business environment for service providers and thereby to unleash greater potential for growth and jobs. In the beginning of 2009, a systematic assessment of all service-related laws and

regulations is to be completed at all levels (i.e. federal, *Länder* and municipal governments as well as professional associations) for the purpose of identifying unreasonable or unjustified restrictions on the activities of service providers. If this review uncovers any need for further action, the relevant legal provisions must be modified accordingly by the end of 2009. Moreover, extensive legal and organisational measures need to be taken. For example, the necessary "points of single contact" must be established at *Länder* level. These contact points can carry out, upon request, all relevant procedures and formalities that service providers must complete in order to engage in business activity. The Federal Government's aim is to set up a coherent, well-functioning system. The *Länder* must also take the necessary steps to help create an EU-wide Internal Market Information (IMI) system for the Services Directive – i.e. a system of cooperation and information exchange between relevant public authorities in all member states. Furthermore, service providers must be enabled to complete all relevant procedures and formalities electronically prior to the expiration of the implementation deadline at the end of 2009.

Pressing forward with bureaucracy reduction

34. To give economic actors – especially start-ups and SMEs – more "room to breathe", the Federal Government plans to relieve the business sector of growth-inhibiting, unnecessary administrative costs. The goal is to reduce the current administrative cost burden by 25 percent. The government has set itself the interim goal of achieving half of this envisaged reduction by the end of 2009. According to calculations conducted by the Federal Statistical Office on behalf of the Federal Government, Germany's business sector incurs administrative costs amounting to 47.6 billion euros annually as a result of obligations to provide information. Of this amount, roughly 22.5 billion euros in administrative costs are generated by national-level legislation alone, and the other 25.1 billion euros are attributable to regulations arising from EU and international law.

The Federal Government has already combed through a large number of administrative areas, including those relating to statistics, bookkeeping, social insurance law, commercial law, pricing law, road traffic law, and crafts industry statistics (see the Federal Government's report of 10 December 2008 on the application of the standard cost model and the status of bureaucracy reduction). The results are substantial: so far, these efforts have identified potential cost savings totalling 7.1 billion euros per year. Measures that lower administrative costs by about 3.5 billion euros per year have already gone into effect. This works to the benefit of businesses, private citizens and public administration authorities.

Since 2006, new Federal Government legislative proposals are required to contain statements on expected administrative costs and/or savings. These statements, together with the opinions of the independent National Regulatory Control Council (*Nationaler Normenkontrollrat*), provide important information to guide the work of legislators and to help prevent the creation of new, unnecessary bureaucratic burdens.

35. Furthermore, in the project "People-friendly Administration through e-government", the Federal Government is working together with the *Länder* to modernise administrative structures and make them more responsive to people's needs. Examples here include online vehicle registration, citizens' portals, the electronic health card, and the upgrading of personal identification cards into so-

called “citizen’s cards”. Both the introduction of new electronic procedures as well as the optimisation of existing electronic procedures can help significantly reduce administrative costs. In terms of cost reduction, the government is focusing in particular on electronic transactions between companies and public administration authorities. It is expected that paper-based communication between businesses and public authorities will have virtually ceased to play a role by 2012. For example, in the future it may no longer be necessary for employees to submit tax returns in paper form. Instead, financial authorities would send a pre-completed tax return to citizens containing the information already known to tax officials, as is already the case in France, for example.

Making procurement law more SME-friendly

36. Germany is modernising and simplifying its procurement law in order to enable more companies to participate in the competition for public contracts. In particular, procurement law will be structured so that small and medium-sized firms can be better integrated into the procurement process. In its draft Act to Modernise Procurement Law, the Federal Government proposes that all contracting authorities be required to divide public contracts into specialised and partial lots. The draft legislation also contains a new Part A for Germany’s general regulations on the awarding of public contracts for supplies and services (*Verdingungsordnung für Leistungen*). These regulations will be streamlined to cut bureaucratic red tape, and their substantive content will be improved. For example, excessive documentation requirements will be curtailed, and a provision will be introduced requiring all public tenders to be published online at a centralised location. This will boost competition and lead to greater efficiency in public sector purchases of services. Furthermore, in order to expedite public sector investment during the economic crisis, certain public procurement rules have been temporarily eased as part of the Federal Government’s “Pact for Employment and Stability in Germany” (see Box 5).

Updating the statutory fee schedule for architects and engineers

37. The planned sixth revision of the statutory fee schedule for architects and engineers will substantially simplify and streamline this fee code. On the basis of a new calculation method, these fees will be uncoupled from construction costs. This will create incentives for cost-efficient construction which in turn will promote consumer protection. To comply with European rules, the statutory fee schedule’s scope of application will be limited to plans produced by offices located in Germany. Furthermore, the fees will be adapted to current circumstances. The Federal Government aims to achieve a cabinet decision on this matter in spring 2009.

Modernising the law on commercial balance sheets

38. The Act to Modernise Accounting Law is designed to save businesses more than one billion euros in costs. This will free up capacity for innovation and investment. The Act is expected to enter into force in spring 2009. The Act is designed to provide the modern and efficient accounting rules that businesses – especially SMEs – need. These updated rules will increase the informative value of the annual financial statements required under commercial law. As a consequence, the modernised accounting law contained in the Commercial Code will continue to offer companies a proper alternative to the international accounting standards (IFRS/IAS) while avoiding the disadvantages of the latter, which are complex, time-consuming and expensive. Increasing the informative value of financial statements also means that the commercial risks in “special purpose” entities must be made more transparent in the

future. Such vehicles were used by banks, for example, in order to pass on certain financial risks to capital markets.

Box 7: Examples of bureaucracy reduction

- **... in the social insurance funds in general:**
  Two acts amending *inter alia* the Common Provisions on Social Insurance (Social Code IV) will reduce the burden on commerce by a total of 208 million euros. For example, the deadlines by which employers must submit reports of contributions have been harmonised. Employers are now required to report changes in fewer cases than before. Furthermore, additional savings of approximately 180 million euros per year are expected due to a revised reporting procedure between municipal reporting authorities and federal pension insurance authorities. This involves the transmission of death and birth reports as well as address changes.

- **... in accident insurance:**
  The Act to Modernise Accident Insurance provides that, following a transitional period, employers will no longer submit wage documentation to accident insurance funds as of 1 January 2012. According to standard cost measurements, the submission of this documentation costs over 60 million euros per year. Of this amount, roughly 50 million euros per year will be saved when, as of 1 January 2009, the collection offices for social insurance contributions and the pension insurance funds begin forwarding the necessary information for calculating contributions to the accident insurance funds.

- **... in applying for social benefits:**
  The Federal Cabinet's adoption of a bill to establish a procedure for electronic income documentation (ELENA Procedure Act) will, following a transition period through 1 January 2012, basically end the use of paper-based income documentation as part of the application process for social benefits. This will save the business sector roughly 75 million euros per year in the field of employment promotion.

- **... in the field of tax administration:**
  The Act to Reduce Tax Bureaucracy is at the heart of a comprehensive legislative package that includes measures to substantially raise the thresholds above which accounts must be kept (a step targeted to benefit SMEs), to further simplify the wage tax procedure, and to revoke a large number of obsolete tax administration rules. Furthermore, paper-based procedures will be further replaced with electronic procedures. In the future, the electronic transmission of data will play a greater role both for companies and for other taxpayers. The taxation procedure for companies is to be further simplified, for example by raising the thresholds for advance monthly reporting of turnover tax and for wage tax reporting. In the future, audits that financial administration authorities and pension insurance funds conduct in company offices are to take place at the same time.

- **... in patent protection:**
  With a view to accelerating technical advances and innovation, the Federal Government has presented a draft act to simplify and modernise patent law. It aims to reduce fees for electronic patent applications, to scale fees according to the number of patent claims, to speed up legally binding electronic transactions

with the Patent Office and the courts, and to shorten court proceedings to review issued patents.

Infrastructure – improving underlying conditions

Public-private partnerships (PPPs)

39. Public-private partnerships (PPPs) can help public infrastructure tasks to be completed more economically. Together with the *Länder*, municipalities and the private sector, the Federal Government has established the consultancy company *ÖPP Deutschland AG* (*Partnerschaften Deutschland*) to advance the market for PPPs in Germany. The company's main task is to provide advice exclusively to the public sector on specific PPP projects and to develop standards which can then be applied to project-related consultancy. More than 70 private companies are involved in Partnerschaften Deutschland. This creates a pooling of public and private expertise in the PPP field which will make Partnerschaften Deutschland a centre of excellence in Germany.

Transport and logistics

40. Mobility is of vital importance for conducting business in Germany, because transport and logistics are central elements of modern production and service processes. With its Freight Transport and Logistics master plan, which was adopted by Cabinet in July 2008, the Federal Government has presented a concept for action to achieve a more efficient use of infrastructure. The Council of Economic Experts shares the view that, in the current economic situation, the upgrading of transport infrastructure can provide significant stimuli for growth and jobs (CEE Annual Report, Item 22). The Federal Government will invest over 11 billion euros in this sector in 2009, a historic high. Government investment will continue at a high level in the coming years as well (fiscal planning for 2010 to 2012). The new "Transport Innovation and Investment Programme" worth a billion euros in both 2009 and 2010 will embed targeted cyclical elements within the Federal Government's long-term transport strategy. The programme, also known to the public as the "Construction and Transport Jobs Programme", is designed to eliminate bottlenecks in the federal transport infrastructure and – where necessary – to provide targeted economic stimuli. In particular, maintenance work is to be stepped up, and the commencement of new projects brought forward. Furthermore, as part of the "Pact for Employment and Stability in Germany", the Federal Government will spend an additional two billion euros on measures to expand and repair the federal transport infrastructure (roads, railways and waterways) (see Box 5).

41. The Federal Government aims to strengthen railway transport as a whole and to ease the burden on the federal budget at the same time. A role here can be played by the project to sell a 24.9 percent stake in Deutsche Bahn's Verkehrs- und Logistik AG to the private sector, although the public sector will retain responsibility for the infrastructure. The privatisation process will continue as soon as the outlook on capital markets improves. Furthermore, the Federal Government is currently drafting a new airport concept and a national port concept in order to overcome capacity constraints, to make ports more competitive and to contribute to environment and climate protection through the more efficient use of ports and airports.

The telecommunications market: closing gaps in broadband coverage

42. The Federal Government will continue to improve the preconditions for the growth-, innovation- and job-oriented development of telecommunications markets. A core aim of our policy is to achieve the rapid expansion of Germany's broadband infrastructure. In terms of competition, prices and market penetration, broadband is continuing to develop very positively. It is now necessary to step up the creation of a high-performance nation-wide broadband infrastructure and to plug the final gaps in coverage by extending high-performance broadband infrastructure into rural areas. The Federal Government adopted a new broadband strategy in February 2009. Our goal is to ensure that those areas currently lacking coverage have access to efficient broadband connections by no later than 2010. We want high-performance telecommunications networks (of at least 50 megabits per second) to be available to 75 percent of households by no later than 2014, and to all households and all companies by 2018, so that Germany can utilise the full potential of broadband internet. In this context, the Federal Government is examining the possibility of establishing a broadband centre of excellence.

Postal sector

43. A competition-based market for postal services creates advantages for consumers and commerce. The EU's Third Postal Services Directive provides for the final removal of monopoly rights for traditional providers of letter delivery services in the European Union by 31 December 2010. For some member states, an additional transition period will apply. Germany opened its market for letter delivery services well before this deadline when Deutsche Post AG's remaining exclusive licence for letter delivery expired on 31 December 2007.

Up to now, the turnover of Deutsche Post AG that directly serves the postal system has been exempt from turnover tax. On 24 September 2008, the Federal Government adopted the draft of a Third Act Amending the Turnover Tax Act in order to adapt the current rules to the liberalised postal market which has existed since 1 January 2008. As a result, the exemption from turnover tax for postal services will be restricted to the extent necessary under EU law. Thus all business mail will become subject to taxation. This will remove the unequal tax treatment of the postal service companies, thereby fostering equality of opportunity for new competitors. The new rules now open up the scope of tax exemption to all postal service providers. However, this is subject to the condition that such providers offer all the universal services (basic coverage with postal services) for the entire territory of the Federal Republic of Germany.

Supporting regions undergoing structural change

44. The Federal Government supports regions undergoing structural change. In order to stimulate additional investment in structurally weak areas and to strengthen regional forces for growth, particularly in the current difficult economic environment, the Federal Government has increased its funding for the Joint Federal/*Länder* programme "Improving the Regional Economic Structure" above the regular amount of more than 600 million euros per year, from 1 January 2009 until 2012. To this end, the Federal Government is providing the *Länder* with an additional one-time payment of 200 million euros (100 million euros in cash and a commitment appropriation for an additional 100 million euros) (see Box 4). The *Länder* are matching this extra funding. On 1 October 2008, an additional package of measures for rural areas entered into force. Furthermore, rules were tightened up to prevent subsidy-driven corporate

relocations. Also, the adoption of rules of publication has increased the transparency of provided assistance.

Common Agricultural Policy

45. At European level, in the course of the changes to the Common Agricultural Policy, direct aid to farmers will be further decoupled from production, state intervention in the market will be reduced, and the promotion of rural development will be expanded up to 2013. Furthermore, rules have been simplified, and bureaucratic burdens on commerce and administration have been reduced. The so-called “health check” on the Common Agricultural Policy is thus increasing the market orientation of European agriculture, strengthening the competitiveness of agricultural companies and improving the prospects of rural areas.

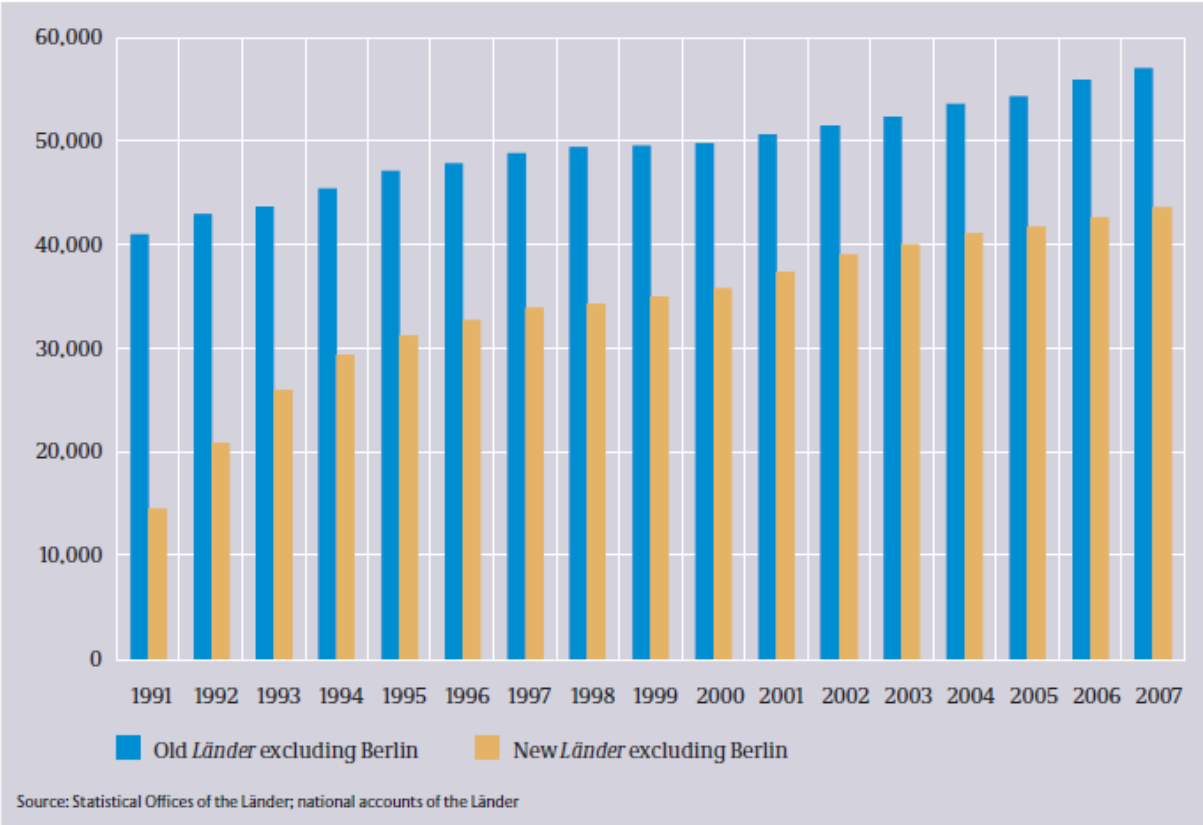
Pressing forward with the rebuilding of eastern Germany

46. Even in the 20th year after the fall of the Berlin Wall, the process of economic recovery in the new *Länder* continues to be a national challenge. Much has already been achieved. Inefficient industrial combines have been replaced by modern small and medium-sized firms. The number of unemployed persons is at its lowest level since 1991. Much remains to be done, however, since at 12.2 percent the unemployment rate is still twice as high as in the west of the country (6.1 percent). Productivity has risen substantially, but remains below the level in western Germany. The Federal Government will resolutely continue its policy to support eastern Germany and thereby help strengthen growth and innovation and create new jobs. For example, the Federal Government has extended the investment allowance until 2013. Forces for innovation are being further strengthened by the new programme “World-class research and innovation in the new *Länder*”. Various programmes, such as the nationwide Municipal-Combi programme, aim to help cut high levels of long-term unemployment in structurally weak areas. These measures are helping to ensure that eastern Germany achieves a self-sustaining level of economic development by the time the Solidarity Pact II expires in 2019.

Providing international support to companies

47. As of 1 January 2009, the German Office for Foreign Trade was merged with the Invest in Germany GmbH agency to create the new federal agency Germany Trade & Invest GmbH. This means that the Federal Government now has an internationally competitive institution to promote foreign trade and investment and to attract inward investment. The resulting synergies will make it possible to give even better support to German firms operating abroad and foreign firms doing business in Germany. The substantive and organisational pooling of the foreign activities of the new company under the umbrella of Germany’s bilateral chambers of commerce, which are partly funded by the Federal Government, will also strengthen the chambers’ position as the central representatives of German commercial interests abroad.

Figure 8: Comparative productivity[21] in eastern and western Germany, 1991–2007



[21] Gross value added in current prices per person employed (domestic).

C. Formulating growth-oriented public budgets

48. One key building block for achieving sustained, higher levels of growth is to structure public expenditure and revenue in a manner that promotes sustainable growth. In this connection, it is crucial that institutions and rules dealing with fiscal policy are calibrated to ensure more results-oriented budgeting processes. Quantitative and qualitative fiscal consolidation complement each other: in order to set a more innovative, future-oriented policy agenda, it is essential to make sure that the structural consolidation of public budgets is both successful and durable.

49. In recent years, the Federal Government's policy for growth and jobs and the structural consolidation of public budgets have helped to achieve a steady and substantial reduction in levels of new Federal Government debt. After continuously cutting deficits at all levels of government (i.e. federal, *Länder*, municipalities and social insurance funds) in recent years, Germany succeeded in achieving a nearly balanced national budget in 2008 – and this despite the fact that (a) state assistance to publicly owned banks (which had no cash effects) and (b) part of the government's court-mandated reimbursement of the commuter tax allowance were already included on the 2008 national accounts.

Through consistent fiscal consolidation as well as statutory pension insurance reform, Germany has reached key milestones in recent years that will help restore the long-term sustainability of public finances. As a result, Germany has sustainably enhanced the central conditions for maintaining prosperity, equal opportunity and effective government in an aging society. We have restored a level of financial flexibility that makes it possible, during the current economic downturn, to pursue a

fiscal policy that fits cyclical conditions, i.e. by allowing automatic stabilisers to function to their full effect.

The Council of Economic Experts shares the view that the state should not respond to cyclical declines in government revenue and increases in government expenditure by raising taxes or cutting spending (CEE Annual Report, Item 413). Our success in consolidating public finances gives us the opportunity to implement powerful, targeted policies that aim to boost public and private investment, reduce financial burdens on citizens and companies, stimulate consumption and safeguard positive developments on the labour market. For example, the Federal Government's "Package of Measures to Reduce Tax Burdens, Stabilise Social Insurance Contributions and Invest in Families" will lower the tax burden on private households by over six billion euros in 2009 and by nearly 14 billion euros annually from 2010 onward (see Box 3). The legislative package "Securing Jobs by Strengthening Growth" provides stimuli for both private and public investment (see Box 4). The "Pact for Employment and Stability in Germany" contains additional measures that encompass a total volume of 50 billion euros. Altogether, the German government is targeting over 80 billion euros toward the goals of overcoming the crisis and achieving the comprehensive modernisation of the country. Furthermore, the Federal Government will continue its vigilant observation of ongoing economic developments.

Box 8: Key strategic elements in government policy toward the New *Länder*

- **Securing funding for government measures to support eastern Germany:**
  The Solidarity Pact II has earmarked105 billion euros to fund supplementary grants for special needs in the eastern German *Länder* for the period 2005-2019. The goal of this funding is (a) to cover the extra costs for eastern Germany's infrastructural needs dating back to the division of Germany and (b) to balance out the weaker financial position of eastern German municipalities (Basket I). An additional 51 billion euros have been pledged to promote convergence in economic performance between eastern and western Germany (Basket II).

- **Boosting eastern Germany's capacity for investment and innovation:**
  Numerous programmes are being implemented to boost the competitiveness of the eastern German economy by promoting specific strengths, potentials and future-oriented economic sectors. In addition, the Investment Allowance Act was extended through 2013 to strengthen the industrial and commercial basis of the eastern German economy.

- **Using targeted policies to attract international investors:**
  International investors can contribute to the modernisation of eastern Germany's economic structure and to enhance its economy's international linkages.

- **Providing labour market support:**
  Support will be directed toward special target groups, particularly the long-term unemployed, low-skilled workers, youths, and older workers.

- **Coping effectively with demographic shifts:**
  Strategies for action are being developed to cope effectively with demographic shifts, for example through the pilot project “Demographic change – the future design of services of general interest in rural regions”.

Bringing Stage II of Germany’s federalism reform to a successful conclusion

50. Even if the measures necessary to combat the current economic and financial crisis make higher levels of government debt inevitable, the Federal Government remains committed to its goal of achieving a fiscal policy that is solid and sustainable over the long term. To this end, new rules limiting net borrowing (at least by the Federal Government) will be agreed upon and enshrined in the German constitution in conjunction with Stage II of the reform of Germany’s federal system. These new deficit rules are to be adopted during the current legislative term and will enter into force at a date to be determined by the Federalism Commission, but no later than 2015 (with the possibility of a transition period that will be defined accordingly). It may also be necessary to undertake further consolidation measures once the global financial and economic crisis is overcome – a step that is also provided for by the European Stability and Growth Pact. The *Länder* have also been called upon to participate in the implementation of deficit rules whose basic elements are binding upon both the federal and *Länder* governments. The Council of Economic Experts has confirmed the Federal Government’s assessment that all *Länder* must be capable on their own of achieving balanced budgets by no later than 2019.

Box 9: Key elements of new constitutional rules on government borrowing

- In keeping with the “close to balance” provision of the European Stability and Growth Pact, public budgets should be nearly balanced under normal economic conditions. In line with the medium-term target stipulated for Germany, structural borrowing – adjusted for financial transactions – for the entire public sector is in future to be permitted only up to a maximum of 0.5 percent in relation to nominal GDP.

- A cyclical component is to ensure that symmetrical consideration is given to cyclically driven changes in federal revenues and expenditures. The scope for borrowing will be expanded in difficult economic times; conversely, in good times this scope will be narrowed or turned into an obligation to build surpluses. In this way, a pro-cyclical fiscal policy will be avoided.

- A control account will be established to ensure adherence to the borrowing rules while the budget is being implemented. This account will balance out overshooting or undershooting of the permissible scope for structural borrowing in individual budget years. If a negative account balance exceeds a certain threshold, an obligation to balance out the control account will take effect.

- In order to safeguard the state’s ability to act in emergency situations, such as natural disasters or other unexpected and exceptional situations (such as a global financial crisis), a derogation is envisaged whereby a special need for additional financial resources can be met by additional borrowing. This derogation will be permitted only on the basis of a decision by a qualified majority in parliament.

D. Safeguarding and augmenting positive achievements on the labour market
51. Developments on the labour market were very positive in 2008 (see Item 15 and Figure 3). By November 2008, the number of unemployed persons had fallen below three million; this was the lowest figure in 16 years. Total employment in Germany exceeded 40 million on average in 2008 – a historic high. These developments are attributable to more than just the economic upswing that Germany had been enjoying since 2005. Rather, they are also the fruits of labour market reforms. Germany's labour market is now in a stronger position and has achieved greater resilience – and these factors will further mitigate the impact of the financial and economic crisis on the labour market above and beyond the stabilising effects of unemployment insurance. It is the task of government to safeguard the successes that have been achieved and to stabilise the labour market both now and for the future.

Non-wage labour costs cut
52. The Federal Government has succeeded in substantially reducing non-wage labour costs. Social insurance contributions that are co-financed by employers and employees have been cut from 41 percent at the beginning of the current legislative term to 39.25 percent as of 1 January 2009. As a result, the financial burden on employers and employees will be reduced by 5.8 billion euros respectively in 2009. This provides relief to companies, boosts the purchasing power of workers and heightens the attractiveness of labour as a factor of production. Overall, contribution rates remained largely stable at the beginning of 2009. The Federal Government fulfilled its declared target of keeping the co-financed contribution rates of employers and employees below 40 percent. The co-financed contribution rate for statutory health insurance did rise by 0.6 percentage points on average to 14.6 percent as of 1 January 2009. However, the contribution rate for unemployment insurance was reduced to 2.8 percent at the same time thanks to recent positive developments on the labour market and will be maintained at this level as part of the "Pact for Employment and Stability in Germany". If necessary, federal budget funding will be provided in the form of a loan in order to hold the unemployment insurance contribution rate constant at 2.8 percent; this will be done on the basis of an act requiring the federal budget to offset shortfalls in unemployment insurance. The "Pact for Employment and Stability in Germany" also provides that, as of 1 July 2009, the Federal Government's contribution to statutory health insurance will be raised by three billion euros for 2009 and by six billion euros for 2010. Correspondingly, the rate of contribution to statutory health insurance that is co-financed by employers and employees will be reduced by 0.6 percentage points (see Box 5).

The Council of Economic Experts criticised the reduction of the unemployment insurance contribution rate to 2.8 percent that went into effect on 1 January 2009, because it considers this rate to be unsustainable (CEE Annual Report, Item 703 ff.). Yet it is a fact that, in recent years, the Federal Employment Agency has built up substantial surplus funds due to comprehensive labour market reforms, the strong economy, and a federal subsidy in the amount of one percentage point of turnover tax. Contributors should benefit from this surplus in an appropriate and timely manner through a restitution of contributed funds.

Pressing forward with labour market reforms
53. Labour market reforms have contributed to the improvement of labour market conditions in both eastern and western Germany. This is confirmed in an analysis by the Council of Economic Experts, which has studied the periods of economic

expansion since German reunification (CEE Annual Report, Item 480 ff.). The most recent upswing had a substantially more positive impact on employment than earlier periods of expansion, and the flexibility and dynamism of Germany's labour market have increased. For the first time since reunification, the eastern German labour market has clearly benefited from these developments (see Figure 5). The Federal Government is convinced that this validates its reform strategy and will therefore press forward with reforms.

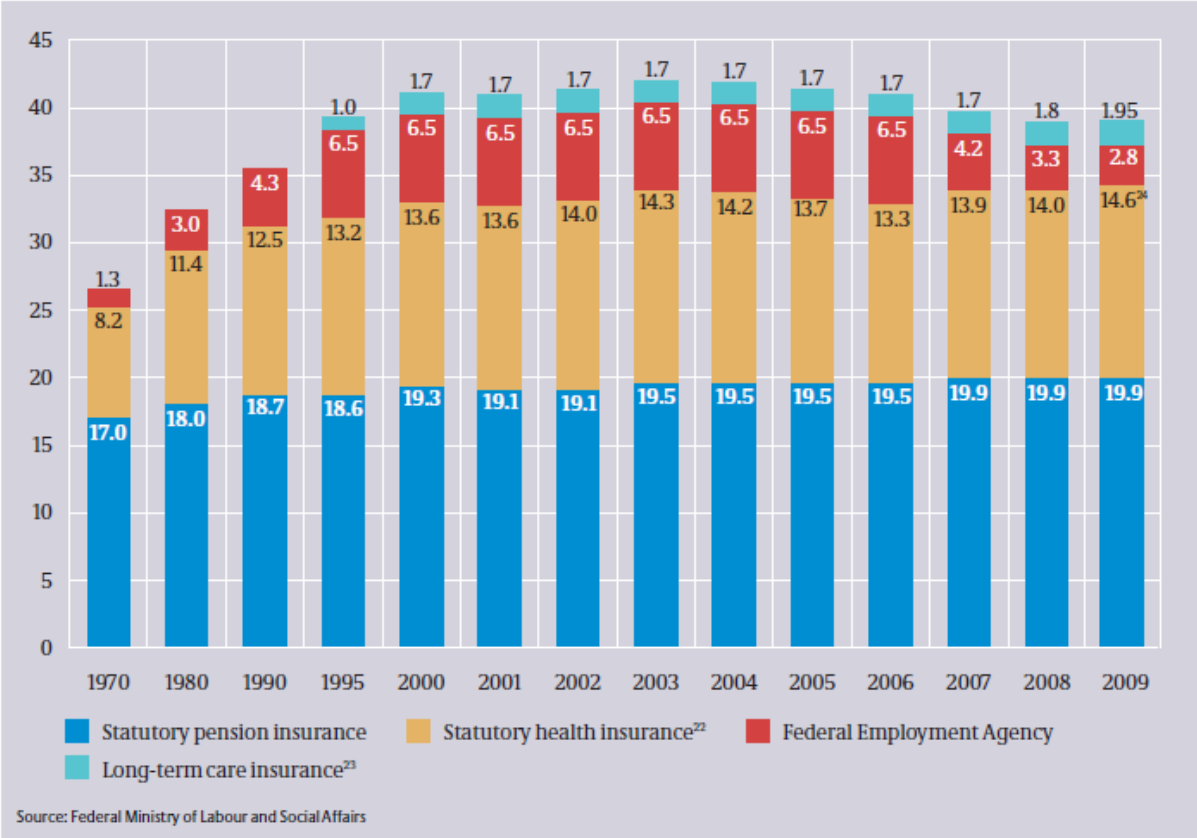
Reorienting labour market instruments

54. The Act on the Reorientation of Labour Market Policy Instruments (*Gesetz zur Neuausrichtung der arbeitsmarktpolitischen Instrumente*) entered into force on 1 January 2009. Among other things, the Act highlights job placement as a core area of labour market policy by strengthening job placement services and cutting red tape. It provides greater flexibility for local job placement services in order to expedite placement and to help job-seekers find more sustainable employment. The Act strengthens the preventive elements of employment promotion policy in order to reduce the risk that difficult-to-place persons will experience long-term unemployment. Ineffective instruments are eliminated. In addition, the Act provides individuals with the legal right to receive financial support to obtain a belated lower secondary school leaving certificate (*Hauptschulabschluss*) within the framework of a pre-vocational training measure or on-the-job advanced training. Furthermore, the Act accentuates the importance of innovative approaches toward labour market policy, in both the area of basic security benefits for jobseekers as well as the area of employment promotion.

Securing jobs and developing skills

55. The recession will place the jobs of many employees – both low-skilled and highly skilled – at risk. At the same time, it is undisputed that, within the global division of labour, the German economy must place an ever-higher priority on developing advanced and specialised skills and capabilities. Further, the aging of German society exacerbates the shortage of qualified specialists. For this reason, concerted efforts must be made to maintain the vocational qualifications of all labour market participants and to enhance these qualifications to fit the markets of the future. Therefore, the paramount principle for labour market policy in 2009 must be to avoid layoffs and to build skills. To ensure that the labour market successfully navigates the economic waters until the next upswing, the Federal Government is enhancing the attractiveness of short-time employment and simplifying relevant procedures. Firms will be able to take advantage of the crisis to develop their employees' skills and provide them with advanced training. To this end, the Federal Government is providing financial support to combine short-time employment with advanced training measures. It is also increasing its support for worker activation and training measures conducted by the Federal Employment Agency and the agencies that provide basic security benefits for jobseekers. These policies will also help to prevent future shortages of qualified specialists (see Box 5).

Figure 9: Average annual social insurance contribution rates (as a percentage of gross earnings subject to contributions)



[22] General rate of contribution, not including a special additional contribution of 0.9 percentage points as of 1 July 2005 which is to be covered solely by insured persons;
[23] Contribution rate for long-term care insurance excluding the 0.25 percentage point rate increase as of 1 January 2005 for persons without children;
[24] Not including the planned rate reduction by 0.6 percentage points as of 1 July 2009.

Restructuring basic security benefits for jobseekers

56. Ever since the introduction of the basic security benefits scheme for jobseekers (*Grundsicherung für Arbeitsuchende*), the Federal Employment Agency and municipal authorities have been cooperating successfully within the framework of "joint agencies" (*Arbeitsgemeinschaften*) to implement this programme. However, on 20 December 2007, the Federal Constitutional Court issued a decision that the specific structure of this cooperation, i.e. in the form of joint agencies, is incompatible with the German constitution. As a rule, both benefit providers – the Federal Employment Agency and municipal authorities – are required to perform their tasks independently, using their own administrative institutions (i.e. with their own staff, equipment and organisational structures). According to the Federal Constitutional Court, the joint agencies are not consistent with this principle of the independent performance of tasks. However, the Court also confirmed that the single-source provision of services established under the basic security benefits scheme for jobseekers is a constructive approach. Against this backdrop, the Federal Government will develop a new proposal to restructure the basic security benefits scheme in accordance with the requirements of the Federal Constitutional Court. This restructuring is to take place by 31 December 2010.

Expanding the pool of skilled labour

57. The demand for highly qualified workers has grown substantially in recent years, primarily due to the shift toward research- and knowledge-intensive societies. Certain

sectors and regions have already experienced shortages of qualified specialists that have led to losses in value creation, particularly within the fields of mathematics, informatics, natural sciences and technology (also known as MINT). The Federal Government has responded proactively to this situation: with the nation-wide skills development initiative “Advancement through Education” (see Box 12) as well as the action plan “Using labour migration to help secure a pool of skilled labour in Germany”, which was adopted on 16 July 2008. The action plan aims to facilitate the migration of qualified specialists to Germany, in order to add first-rate talent that can enhance Germany’s international competitiveness. Corresponding measures went into effect on 1 January 2009. In addition, the action plan contains an agreement to conduct regular monitoring of the labour market based on (a) scientific projections and (b) the recommendations of a joint committee; this committee has yet to be convened and is to include social partners.

Demographic change is another key factor that makes it essential to maximise the employment potential of current workers and firms and to maintain the employability of older workers. In 2006, roughly 43 percent of Germany’s working-age population participated in some form of advanced training. The Federal Government’s goal is to work together with the *Länder* and social partners to raise this level to 50 percent by 2015. It is especially important to get low-skilled workers to participate in training programmes, and this will require focused efforts on the part of companies, employees and social partners. Within the framework of the Federal Government’s “Advancement through Education” initiative, the Federal Employment Agency will enhance its vocational training efforts. In certain cases, these efforts will also provide training support for employed persons. Older workers employed in small and medium-sized companies as well as low-skilled workers can develop targeted skills as part of the Federal Employment Agency’s special programme, “Advanced training for low-skilled and older workers employed in companies” (WeGebAU). This programme will be expanded at all levels within the framework of the legislative package “Securing Jobs by Strengthening Growth” – the aim is to enhance employability and prevent layoffs by providing on-the-job advanced training.

Additional initiatives are needed to improve employment prospects for young people. For this reason, during the “years of training” that started in 2008 and will continue through the end of 2010, the Federal Government is providing a training bonus to finance additional training for eligible applicants who have been unable to secure a training place despite submitting numerous applications or who have discontinued a course of training. Furthermore, a career entry support programme will provide eligible trainees with systematic assistance in making the transition from school into vocational training.

Boosting employment through household-related services

58. The Act to Promote Families and Household-related Services (*Gesetz zur Förderung von Familien und haushaltsnahen Dienstleistungen*, FamLeistG) entered into force on 1 January 2009. Its aims are to stimulate employment, to help individuals combine family and career, and to facilitate the provision of home care services. The Act substantially expands tax incentives for both (a) household-related employment subject to social insurance contributions and (b) household-related services (including long-term care services). In the future, 20 percent of expenditures up to 20,000 euros – i.e. up to 4000 euros per year – will be tax deductible. The new legislation will unite the tax rules on household-related employment subject to social

insurance contributions on one hand, and household-related services (including long-term care services) on the other, under a single provision. This will reduce bureaucracy while providing a targeted stimulus for legal employment in both the private household and service agency sectors.

Posted Workers Act and Minimum Working Conditions Act

59. In order to enable the introduction of minimum wages in specific additional sectors, the Federal Government on 16 July 2008 adopted bills updating the Posted Workers Act and the Minimum Working Conditions Act. Specific sectors can be included within the scope of application of the Posted Workers Act if more than 50% of their workforce is bound by collective wage agreements and if the employers and trade unions submitted a joint application before the end of March 2008. By 31 March 2008, employers and trade unions from eight sectors had applied to be included under the Posted Workers Act. Of these, the following sectors have been included under the Act: long-term care services, guard and security services, special mining services, textile services in custom manufacturing, and waste management services. Under the Minimum Working Conditions Act, minimum wages can be established for sectors in which less than 50% of the workforce is covered by collective wage agreements if a permanent expert committee finds that social distortions exists in a particular sector. In January 2009, the Federal Government expanded the Posted Workers Act to cover sector-specific minimum wages in the following sectors: guard services, long-term care services, large-scale industrial laundries, waste management and special mining services. For temporary workers, a minimum wage threshold that provides for free collective bargaining is being established under the Temporary Employment Act.

Protecting working-time accounts from insolvency

60. Flexible working-hour arrangements – beyond traditional short-term options like flexitime or short-time work accounts – are in use in many major sectors covered by collective agreements, such as the metal-working, electrical and chemical industries. These arrangements provide employees with the possibility of collecting the additional hours they work in a special account and then using this overtime primarily to take longer-term leaves at a later date. Social insurance contributions are not deducted until the overtime hours are taken off. On 1 January 2009, the Act Improving the Framework Conditions for Safeguarding Flexible Working Hour Arrangements and Amending Other Acts entered into force. This Act strengthens obligations to protect these overtime accounts in cases of insolvency and, starting on 1 July 2009, allows for the limited transferability of working hour credits when employees change employers.

E. Enhancing the efficiency of social security systems

61. Germany's social security systems face key challenges: from cyclical fluctuations in the short term and from demographic shifts in the medium and long term. These systems must remain viable and affordable while simultaneously providing appropriate social protection.

Old-age insurance system successfully reformed

62. The German legislature has implemented a fundamental modernisation of Germany's old-age insurance system. The Council of Economic Experts has confirmed that, in recent years, the government has implemented all of the principal pension law measures aimed at the financial consolidation of the statutory pension

insurance system (CEE Annual Report, Item 612). However, the Council also criticises what it views as a temporary departure from the path toward consolidation. This is because the Pension Adjustment Act of 2008 suspended the “Riester reform steps” (named after the former Minister of Labour and Social Affairs, Walter Riester), which slow the rate of pension increases in eight steps in order to take into account the fact that younger workers must invest increasing amounts of money in private, supplementary pension plans. This pension adjustment formula serves to limit increases in contribution rates to the statutory pension system and thereby helps to ensure intergenerational equity. According to the Council, the government’s decision to suspend the reform steps – i.e. to suspend reductions in the rate of pension increases – in 2008 and 2009 damaged confidence in the reliability of pension policy (CEE Annual Report, Item 617 ff.). The Federal Government does not share this view. This is because the reform steps that were suspended in 2008 and 2009 will be implemented retroactively in 2012 and 2013. This postponement was enacted in order to allow pensioners to benefit in a more timely manner from the economic upturn of recent years. In this way, the pension adjustment rate in 2008 and 2009 was 0.6 percentage points higher than would otherwise have been possible. Originally, pensions were set to increase by 0.46 percent in 2008. Instead, the suspension of the reform step led to an adjustment rate of 1.1 percent.

The Council continues to focus on the issue of poverty among the elderly. It has come to the conclusion that “poverty among the elderly is currently not a socially relevant problem” (CEE Annual Report, Item 646). However, the Council maintains the view that this issue may emerge as a problem over the medium to long term. It draws the conclusion that the effective prevention of old-age poverty must begin with a pro-employment labour market policy, the expansion of workplace health policies, and appropriate educational measures. The Federal Government shares this view.

Improving private, supplementary pension plans

63. The Retirement Assets Act of 2002 introduced tax-subsidised support for supplementary, private pension plans (known as “Riester pensions”) through the provision of a basic supplement, a child supplement and a tax deduction for special expenditures. These plans have undergone continuous improvement: for example, the supplement granted for all children born 1 January 2008 and thereafter has been increased to 300 euros. In addition, a one-time “career entry bonus” of 200 euros has been added to the basic supplement for directly eligible persons under 25 years of age.

Furthermore, the range of investment possibilities for private, capital-based pension plans have been expanded, thereby making this instrument even more attractive. For example, under the Home Ownership and Pensions Act (*Eigenheimrentengesetz*, also known as the “*Wohn-Riester*” or “Riester housing plan”), owner-occupied housing and owner-occupied cooperative apartments may be included in tax-subsidised support for private pension plans retroactively to 1 January 2008. Furthermore, persons receiving pensions due to disability or fully reduced earning capacity are now included among those who are directly eligible for Riester pensions. The attractiveness of these pension plans is underscored by the fact that the number of Riester contracts continues to grow (nearly 12 million by the end of September 2008).

Enhancing competition in the statutory health insurance system

64. The primary aim of health policy is to combine high-quality health care with the efficient use of funds. It is primarily by fostering competition that we will be able to create incentives to improve both quality and economic performance in the health care system. The main components of recent reforms to the system – such as the new financial architecture, the reorganisation of health insurance funds (*Krankenkassen*), and the streamlining of institutions – expand and improve the preconditions for greater competition in the health care sector. New possibilities for the conclusion of individual contracts constitute a key instrument for strengthening competition. To this end, it was necessary to modify and enhance the competitive framework for contractual relations between statutory health insurance funds and service providers. The Act to Enhance the Organisational Structures of Statutory Health Insurance (*Gesetz zur Weiterentwicklung der Organisationsstrukturen in der Gesetzlichen Krankenversicherung*)implements these modifications. From now on, individual contracts concluded by statutory health insurance funds will be governed by substantive procurement law. This means that, depending on their structure, contracts concluded by the health insurance funds must be opened up to EU-wide tendering. This will eliminate the legal uncertainty that up to now has impeded the conclusion of contracts (e.g. for pharmaceutical discounts) that foster more efficient care for insured persons. Ultimately, the efficient use of resources in the health care system also helps to achieve the economic policy goal of reducing non-wage labour costs. To this end, it is important to prevent the contribution base from being weakened by shifting cost burdens to the statutory health insurance system. The Federal Government will assess what steps can be taken to further enhance the competitive framework of the system.

65. Since 1 January 2009, the statutory health insurance system has been financed through a Health Fund (*Gesundheitsfonds*) that is financed by member contributions, employer contributions and an increasing federal subsidy drawn from the federal budget. The Federal Government establishes a uniform rate of contribution for all health insurance funds by means of statutory orders. In the Health Fund's first year, this contribution rate will cover 100 percent of the statutory health insurance system's necessary expenditures. For the first half of 2009, a contribution rate of 14.6 percent has been set that will be co-financed by employers and employees, plus an additional 0.9 percent to be covered entirely by insured persons. Starting on 1 July 2009, the co-financed contribution rate will be reduced by 0.6 percentage points.

The health insurance funds then receive allocations from the Health Fund which are based on the composition of the population they insure, according to age, gender and risk. This will balance out the different risk structures of the various health insurance funds much more effectively. Health insurance funds that cannot cover their expenses using the standardised allocations must work harder to tap potential sources of economic efficiency, for example by exercising flexibility in the structuring of health care services. Health insurance funds that cannot adequately improve their economic efficiency will have to charge supplementary premiums from their members. Conversely, health insurance funds that achieve surpluses can distribute rebates to their members. This will clearly enhance competition between health insurance funds to provide better quality and service.

The Council of Economic Experts explicitly acknowledges the improved incentives that derive from the new system of risk structure equalisation (CEE Annual Report,

Item 663 ff.). However, the Council repeats the criticisms raised in its 2008 annual report regarding measures adopted on the financial side. For example, it asserts that the competition-enhancing function of rebates and supplementary premiums is cancelled out by the fact that any supplementary premiums are capped at a maximum of one percent of the income subject to contributions. Because this cap may put health insurance funds with lower-income members at a disadvantage, the Council argues that an imbalance may arise between the various health insurance funds that will then have to be rectified within the framework of the Health Fund. However, the Council underestimates the increased pressure that will be placed on the health insurance funds as a result of the establishment of the Health Fund and the introduction of potential rebates and supplementary premiums. This pressure will force individual funds to function in an economically viable manner by fully tapping existing and potential sources of efficiency. The Council has also recommended that the social compensation component (*sozialer Ausgleich*) be financed by the Health Fund rather than by individual health insurance funds; on this issue, agreement has been reached that an expert report, to be concluded in 2011, will clarify whether or not adjustments should be made to the design of supplementary premiums.

Enhancing competition in the private health insurance system

66. Starting in 2009, the requirement that all persons in Germany must have health insurance will apply to the private health insurance sector as well. At the same time, starting in 2009, private health insurance companies must offer a “basic plan” (*Basistarif*) whose coverage largely corresponds to the coverage provided under statutory health insurance. These basic plans are not permitted to contain risk surcharges or benefit exclusions. Private health insurance companies are now legally obligated to conclude contracts for such plans (i.e. they cannot refuse applications from privately insurable persons). The introduction of maximum premium limits will ensure that these plans remain affordable for insured persons. Finally, starting in 2009, competition for customers will be intensified within the private health insurance sector as well. For example, if a person who is currently privately insured opts to switch to the basic plan (the deadline for persons who are currently privately insured to make this switch is 30 June 2009) and also changes providers in the process, part of that person’s old-age reserves (*Alterungsrückstellungen*, i.e. funds reserved to offset age-related risks) will be shifted to the new provider as well. All new private health insurance contracts concluded as of 2009 must contain a permanent right to change providers, including the partial carry-over of old-age reserves to the new provider.

Hospital financing

67. Hospital financing has been reorganised starting in 2009. The Hospital Financing Reform Act contains a series of measures to improve the ability of hospitals to finance their operating costs and thereby to enhance their overall economic situation. These measures include (a) the partial assumption by health insurance funds of costs arising from hospital salary increases and (b) the establishment of benchmarks that will provide for the timely monitoring of hospital prices and that will replace the current system under which hospital prices are strictly tied to total base wages. Furthermore, the Act contains a legally binding request that the Federal and *Länder* governments submit, by the end of 2009, a reform proposal concerning investment financing for hospitals in the form of lump-sum investments that will be tied to hospital-provided services.

Long-term care insurance
68. The Long-term Care Enhancement Act (*Pflege-Weiterentwicklungsgesetz*) makes a key contribution to the improvement of home care. As a first step, benefit amounts will increase in 2008. In 2009, an entitlement to advisory services for long-term care (i.e. case management) will enter into force. The Act also provides for the establishment of an increased number of long-term care support centres. These measures are designed to boost the construction and expansion of care structures close to home and to provide positive stimuli for employment. The Long-term Care Enhancement Act raised the contribution rate for long-term care insurance by 0.25 percentage points to 1.95 percent as of 1 July 2008. It is expected that this contribution rate will be sufficient to finance long-term care benefits through the middle of the coming decade.

Fundamental revision of the housing benefit
69. The housing benefit has been significantly improved as a result of the revision that went into effect on 1 January 2009. The new housing benefit will be provided retroactively to 1 October 2008 in the form of a one-time lump-sum payment. The revision substantially strengthens the housing benefit as an instrument for covering housing expenses. The benefit will reach a higher number of recipients, particularly low-income and pensioner households. Current recipients will see their housing benefit increase by 60 percent on average (from an average of roughly 90 euros to about 140 euros per month). Altogether, approximately 800,000 households – including about 300,000 pensioner households – will benefit from the revision, which expands the benefits provided by the Federal and *Länder* governments by 520 million euros annually. The core feature of the revision is the first-time inclusion of heating costs in the housing benefit. From now on, the housing benefit will be calculated on the basis of (a) the amount of gross rent eligible for consideration, excluding heating and hot water costs, and (b) a heating cost component scaled according to the number of persons in a household (e.g. 24 euros for one person, 31 euros for two persons, etc.).

F. Implementing an efficient energy policy
70. Another essential concern of the Federal Government is to ensure a cost-efficient and sustainable energy supply. For this reason, we welcome the successes that the Federal Cartel Office has achieved in combating anti-competitive practices within the energy sector. The Federal Cartel Office has concluded price abuse proceedings against numerous gas suppliers, who have now made voluntary, substantial financial commitments that will benefit the affected consumers. The steady acquisition of stakes in public utilities by market-dominant energy producers limits access to markets and threatens to choke off competition. The Federal Government also welcomes the fact that, in a recent decision issued in November 2008, the Federal Court of Justice expressed its clear and distinct support for the Federal Cartel Office's efforts to foster competitive market structures in the energy supply sector and thereby to safeguard consumer interests. This decision by the Federal Court of Justice has served to counteract further vertical integration in the electricity sector. The Federal Government will continue to take steps to enhance competition in the electricity and gas markets.

71. Intensified competition in the electricity and gas sectors provides key benefits to consumers, because it is only through greater competition that consumers can truly take advantage of opportunities to switch energy providers. And consumer

willingness to try out new providers is in fact rising. According to statistics compiled by the Federal Network Agency and published in its 2008 Monitoring Report, roughly 1.3 million residential customers switched energy suppliers in 2007. Thus the Federal Government's ordinances on general supply conditions and the Federal Network Agency's efforts are having an impact. Because gas and electricity providers' prices can vary considerably, it is often worthwhile for consumers to make a switch. Greater competitive pressure induces energy suppliers to structure their prices in a consumer-friendly manner, and this benefits all consumers.

72. A system of incentive-based regulation went into effect on 1 January 2009. The new system replaces the previous cost-based regulation of network charges which required that charges for the use of energy networks be approved by the Federal Network Agency. Incentive-based regulation is designed to create conditions similar to genuine competition within the monopoly segments of networks; companies will be measured against efficient competitors, and this will generate incentives for improving efficiency.

Box 10: Highlights of the report on Germany's oil and gas market strategy:

- Key energy sources such as coal, uranium and renewable energies are available in sufficient quantities around the world. High prices for oil and gas over the medium term provide an impetus for greater investment in (a) developing these energy sources and (b) saving energy.

- Energy remains an expensive good despite recent sharp drops in prices. For example, oil prices have risen considerably since the beginning of the decade, when a barrel of oil cost less than 30 US dollars. Higher prices for oil imports reduce domestic purchasing power. However, over the medium term, steeper oil prices will set comprehensive adjustment processes in motion – the demand for less energy-intensive goods will increase, and energy productivity in production processes will improve.

- Measures to boost energy efficiency and to enhance the use of renewable energy are of central significance for achieving long-term energy security. Such measures are already being implemented by the Federal Government as part of its Integrated Energy and Climate Programme.

- The Federal Government has adopted a variety of policies to intensify competition in the electricity and gas sectors. For example, the revised Act against Restraints on Competition – which aims, among other things, to help limit increases in electricity and gas prices over the medium term – went into effect in late 2007.

- Germany needs a broad energy mix that includes domestic coal. Any other policy would lead to even greater dependence on imported energy sources.

- It would be the wrong approach for the state to set social tariffs for energy. Instead, direct measures are being implemented to provide low-income earners with relief from high energy prices. These include the revised housing benefit, which took effect on 1 January 2009 and includes a one-time lump sum payment to reimburse heating costs (retroactively to the fourth quarter of 2008). This

measure will increase the housing benefit by 60 percent on average. Furthermore, everyone is called on to use energy more efficiently.

- Over the long term, Germany needs new technological solutions to help reduce its increasing dependence on energy imports. For this reason, the Federal Government is expanding its support for research and development on energy technologies. The government's Energy Research Programme has earmarked 2.1 billion euros for this purpose for the period 2008-2011.

73. Independent of short-term fluctuations, energy prices will trend upward over the long term due to increasing global demand. Germany's strong dependence on fossil fuels – the bulk of which must be imported – poses particular risks as far as prices are concerned. Against this backdrop, economic efficiency, security of supply and environmental compatibility continue to be central tenets of Germany's energy policy. On 5 November 2008, the Federal Government adopted a report on Germany's oil and gas market strategy (see Box 10). This report unveils a concept for energy security that encompasses short-, medium- and long-term measures for addressing issues of both supply and demand on energy markets. The International Energy Agency estimates that – in the absence of additional policy measures – global energy consumption will jump 45 percent by 2030. This strengthens the Federal Government's political resolve to reduce oil consumption through the use of market-based instruments, to tap all possibilities for boosting energy efficiency and energy savings, and to ensure a broad energy mix. For this reason, the Federal Government is working actively to expand global renewable energy use. Our actions include taking the initiative in launching the International Renewable Energy Agency (IRENA).

European energy policy

74. On 13 November 2008, the European Commission submitted a wide-ranging legislative package to promote energy security and energy efficiency. This package includes a framework communication on energy efficiency; revisions of the Energy Performance of Buildings Directive, the Energy Labelling Directive and the Oil Stocks Directive; and a proposal for a directive on the labelling of tyres. These proposals are now being discussed by the Council and the European Parliament. During these deliberations, the Federal Government has taken the position that solidarity in crisis prevention efforts among the 27 member states needs to go hand-in-hand with effective measures at the national level. In addition, it is Germany's view that the private sector must continue to take the lead responsibility in planning and financing upgrades to the energy infrastructure. However, under certain circumstances it may be necessary for the member states – and, on a case-by-case basis, the EU – to provide political support for specific projects.

75. In view of the most recent gas dispute between Ukraine and Russia in January 2009, the Federal Government calls on both countries to ensure the secure, long-term supply of gas. This dispute underscores the necessity of further diversifying transport routes and sources of supply.

Achieving climate protection targets

76. Climate protection is one of the Federal Government's chief policy priorities. Germany has already greatly reduced its emissions of climate-damaging greenhouse

gases and is well on track to meet its Kyoto target of reducing emissions by 21 percent on average for the period 2008-2012 (compared to the base years 1990/1995). By the end of 2007, Germany had succeeded in reducing its greenhouse gas emissions by 22.4 percent. On 11-12 December 2008, the European Council agreed upon an energy and climate package which ensures that the European Union will comply with the ambitious climate protection targets it formulated in March 2007 and March 2008. These targets include, in particular, a 20 percent reduction in greenhouse gas emissions by 2020 compared to 1990 levels. Furthermore, the European Council even agreed to a 30 percent reduction in greenhouse gas emissions by 2020 compared to 1990 levels, on the condition that other industrialised nations commit themselves to comparable emissions reductions and that economically more advanced developing countries make a contribution commensurate with their respective responsibilities and capabilities.

A comprehensive international climate protection agreement covering the period after 2012 is to be reached in Copenhagen in 2009. In order to set a positive signal for the international climate negotiations, Germany is offering to reduce its greenhouse gas emissions by 40 percent by 2020 (compared to 1990 levels) as Germany's contribution to an international climate protection agreement covering the post-2012 period. Germany's offer is subject to the condition that the European Union reduce its emissions by 30 percent (compared to 1990 levels) during the same period and that other countries set equally ambitious targets.

77. The share of renewable energies in Germany's total final energy consumption (electricity, heating, fuels) more than doubled between 2000 and 2007 (from 3.8 to 8.6 percent). In 2007, renewables helped reduce CO_2 emissions by approximately 110 million tons. Renewable energies have developed into an increasingly important economic factor in Germany and have helped boost job creation, particularly in eastern Germany.

The Federal Government's Integrated Energy and Climate Programme

78. The Federal Government's Integrated Energy and Climate Programme (*Integriertes Energie- und Klimaprogramm*, IEKP) encompasses a broad spectrum of measures that provide a strong impetus to improve energy efficiency and to expand the use of renewable energy. The programme will reduce total emissions by roughly 35 percent (compared to 1990) and will thus make a major contribution to the achievement of Germany's ambitious climate protection targets by 2020. In addition, it will promote technological advances in the fields of energy efficiency and renewable energy.

An energy and climate policy based on energy efficiency is likely to reduce energy costs, because energy consumption will decline. Lower energy consumption and the expanded use of renewable energy will also help Germany to gradually reduce its dependence on fossil fuel imports. All of this will boost energy security while cutting greenhouse gas emissions in Germany.

Numerous measures and laws have already been adopted within the framework of the Integrated Energy and Climate Programme. The first legislative package included the Renewable Energies Act, the Combined Heat and Power Act and the Renewable Energies Heat Act, as well as an act to open up electricity and gas metering services to competition. These acts have already entered into force. A second legislative

package includes the revised Energy Saving Ordinance as well as measures to speed up the expansion of the power grid and to implement a pollutant-based toll system.

Box 11: Key measures contained in the Integrated Energy and Climate Programme

Energy Efficiency

- **Combined Heat and Power:**
  The Federal Government aims to double the share of combined heat and power in the generation of electricity by 2020, from its current level of roughly 12 percent to approximately 25 percent.

- **Opening up electricity and gas metering services to competition:**
  By liberalising electricity metering services, the Federal Government will lay the groundwork for the speedy dissemination of new technologies that will enable the timely measurement of consumption (smart metering) and thereby lead to energy savings.

- **Upgrading the power grid:**
  The rapid expansion of extra high voltage transmission networks in Germany is urgently necessary due to the fast-growing role of renewable energies in the generation of power, the expansion of cross-border electricity trading and the construction of new conventional power plants. The Act to Accelerate the Expansion of Extra High Voltage Transmission Networks will make this possible.

- **Revising the Energy Saving Ordinance:**
  The revised Energy Saving Ordinance will raise the required energy performance of buildings by an average of 30 percent (through standards for new buildings as well as key modifications in existing structures).

- **Energy-efficient retrofitting of buildings:**
  The Federal Government has extended the CO_2 building renovation programme of the *Kreditanstalt für Wiederaufbau* (KfW) through 2011 and has earmarked between 1.5 and 1.6 billion euros for each additional year of funding. The programme was originally scheduled to end in 2009.

- **Expanding the energy advice programme:**
  Energy-related advisory services have been expanded particularly through the Special Fund for Energy Efficiency in SMEs; through on-site advisory services in residential buildings; and through advisory services in consumer advice centres.

- **Revising the Heating Costs Ordinance:**
  Changes to rules on the consumption-based calculation and distribution of heating and hot water costs will give owners of rented multi-family dwellings more incentives to retrofit buildings and to tap additional possibilities for energy savings.

- **Clean power stations:**
  Ambitious standards will reduce nitrogen oxide emissions in new power plants.

- **Energy-efficient products and services:**
  Tighter standards, together with clear and consumer-friendly labelling on all electrical appliances and equipment, will boost sales of energy-efficient products and services.

- **Energy research and innovation:**
  New Federal Government initiatives will highlight the policy priorities of energy efficiency, renewable energy and carbon storage.

Transport

- **Enhancing the impact of the heavy goods vehicle (HGV) toll (*Lkw-Maut*)**
  The environmental impact of Germany's HGV toll system will be enhanced by (a) further scaling toll rates according to emission class and (b) lowering toll fees for vehicles that have been retrofitted with particulate filters.

- **Converting the motor vehicle tax into an emissions-based tax:**
  As soon as technically feasible, the Federal Government will convert the current motor vehicle tax into a tax based on emissions of pollutants and CO_2. This measure forms part of the government's "Pact for Employment and Stability in Germany".

Renewable energy

- **Revising the Renewable Energies Act:**
  The aim of the revised Renewable Energies Act is to increase the share of renewable energy in the power supply to at least 30 percent by 2020 and to increase this share continually thereafter. Additional aims include the needs-driven upgrading of power grids to integrate renewable energy as well as the creation of incentives to improve the needs-driven flow of renewable energy into the power system. These goals are to be pursued while simultaneously taking into account the priorities of economic efficiency, security of supply and environmental compatibility.

- **Renewable Energies Heat Act:**
  The Renewable Energies Heat Act aims to increase the share of renewable energy in the heat supply to 14 percent by 2020.

- **Revising the Gas Network Access Ordinance:**
  New regulations on the injection of biogas into natural gas networks will make the distribution of biogas both easier and more attractive.

- **Biofuels:**
  In the future, biofuels will be assessed according to their potential for reducing greenhouse gases. The use of specific biofuels should be increased only if it can be assured that their cultivation and processing are ecologically and socially sustainable.

Non-CO_2 greenhouse gas emissions

- **Chemicals Climate Protection Ordinance:**
  The Chemicals Climate Protection Ordinance aims to reduce fluorinated greenhouse gas emissions from refrigeration equipment.

- **Refrigeration technology:**
  Within the field of refrigeration technology, the Federal Government provides support for the development of technologies that serve climate protection purposes.

Energy conservation in buildings
79. Roughly 40 percent of energy in Germany is used for heating in buildings and for hot water. During this legislative term, energy savings in buildings is one of the Federal Government's priorities in the area of housing and construction policy. KfW programmes to support energy-efficient construction and building renovation, together with other housing and construction policy measures, contribute to climate protection and to employment in the construction and crafts sectors. These investments enhance climate protection, growth and employment while simultaneously reducing the burden of soaring energy costs on businesses and private households.

G. Innovation to create the jobs of tomorrow
80. Investment in research and innovation provides the basis for sustained growth, for jobs and for the incomes of tomorrow. In 2009, the Federal Government is increasing its funding for research and development by eight percent – or roughly 12 billion euros – compared to 2008. This means that the government is once again significantly raising its level of R&D investment. Our goal is for total R&D investment – by the federal government, *Länder* governments and the private sector – to equal three percent of gross domestic product by 2010.

Germany's High-tech Strategy: achieving visible success
81. In order to help German industry maintain and expand its position in key markets of the future, the Federal Government has adjusted its research and innovation policy by adjusted adopting the High-Tech Strategy for Germany. For the first time, government activities and measures to promote research and innovation have now been bundled into a national strategy. For example, new directions in key areas of the biotechnology sector have been taken: the Pharmaceuticals Initiative for Germany, the Bioenergy and Healthy Nutrition Initiative and the cluster initiative "Bioindustry 2021" all aim to make Germany a European leader in these fields. In addition, the Federal Government's health research programme, which will be unveiled in 2009, will set up a consistent, systematic structure to tap the potential for innovation in the health sector. In the field of aerospace, we have added space robotics to our existing research and development priorities.

Other government initiatives include the Leading-edge Cluster Competition, which was held for the first time in 2007-2008. In the end, five cutting-edge, internationally competitive clusters from science and industry – representing a diversity of regions such as Saxony, Hamburg and the Rhein-Neckar area – were selected from a pool of 38 applicants to receive special project funding.

Modernising Germany's scientific landscape
82. One essential factor in attracting top-notch talent and implementing cutting-edge international research projects is a sufficient pool of funding. Through the Initiative for Excellence, federal and *Länder* governments have provided 1.9 billion euros in funding to German institutions of higher education in order to give them a crucial

boost in strengthening their institutional profiles and structures. In addition, as part of Germany's Skills Development Initiative (see Box 12), the federal and *Länder* governments have agreed to continue and expand the Initiative for Excellence, the Higher Education Pact and the Pact for Research and Innovation after these measures have been evaluated.

The "Academic Freedom Act" initiative will enhance Germany's international attractiveness as it competes with the academic systems and innovation policies of other countries. This initiative includes a pilot project (to run through 2010) that will provide large non-university research institutions with greater autonomy in structuring and allocating finances and staff. This will lay the groundwork for (a) modern institutional management structures that are more task- and results-oriented and (b) financial procedures that are tailored to the needs of science and research.

Figure 10: Trends in research and development expenditures by the federal and Länder governments

Cultivating innovative start-ups

83. The Federal Government has launched numerous programmes to support innovative businesses from the start-up phase to the expansion phase. These include the High-tech Start-up Fund, which provides seed money to technology start-ups; the European Recovery Program (ERP) start-up fund; a fund of funds jointly run by the ERP and the European Investment Fund; and the EXIST programme, which aims to help translate innovative research activities into successful business launches. Moreover, both the Act on the Modernisation of Framework Conditions for Capital Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen,* MoRaKG) as well as the 2008 corporate tax reform provide

additional tax relief to businesses and open up more room for innovation (see Item 32).

Expanding support for innovation in small and medium-sized firms
84. On 1 July 2008, the Federal Government launched the Central Innovation Programme for SMEs (ZIM) to support cooperative research and development projects between companies and R&D facilities and to promote innovation networks. An already existing government programme that supports R&D projects run by individual companies in eastern Germany will be integrated into the new ZIM programme as of 1 January 2009. Thanks to the simple application process and the growing awareness of the ZIM programme among SMEs, the number of applications is currently about 20 percent higher than initially anticipated. Another new initiative, the “Innovative SMEs” programme, provides small and medium-sized firms with easier access to technology-specific funding. The government has also set up a central “research and innovation” advisory service that assists SMEs and start-ups in finding appropriate funding sources for research and innovation. The ZIM programme will be expanded in order to help small and medium-sized enterprises meet their increased R&D funding needs during the economic crisis (see Box 5).

Strengthening information and communication technologies in Germany
85. In order to enhance Germany’s international position in the field of information and communication technologies (ICT), the Federal Government has launched an “IT Summit” process that brings leaders from government, industry and science together for regular dialogues. So far, three IT Summits have taken place (see CEE 2008 Annual Report, Item 65). Information and communication technologies have a key role to play in boosting energy efficiency and thereby protecting the climate. As a result, “Green IT” has become an important new area of economic and government activity. Other top policy priorities include integrating small and medium-sized enterprises even more solidly into the digital economy; expanding and upgrading the IT infrastructure; and tapping the full potential for electronic communication between the government, the private sector and private citizens.

Investing in education
86. Investments in education are down-payments on the future that also provide high returns. The Council of Economic Experts confirms this and recommends that education spending be significantly increased in order to enhance the potential for growth (CEE Annual Report, Items 22 and 432). At the Education Summit on 22 October 2008, the federal and *Länder* governments adopted a joint Skills Development Initiative for Germany (see Box 12) that aims to raise spending levels for education and research to 10 percent in relation to gross domestic product. The Federal Government has already taken solid strides toward this goal by raising its share of funding for the operating costs of child day-care centres and for the Higher Education Pact.

Crucial investments – particularly in “MINT” subjects (mathematics, informatics, natural sciences and technology) – include improving the quality and breadth of early childhood and school education as well as reducing the drop-out rate in MINT study courses. The Federal Government is also working actively to make higher education funding more targeted in nature and to improve the conditions that enable mothers with small children to combine work and family.

As part of the “Pact for Employment and Stability in Germany”, the Federal Government will provide 6.5 billion euros for *Länder* and municipal investments in child day-care centres, school infrastructure, higher education facilities (particularly the energy-efficient renovation of buildings) and research.

Vocational education and training

87. To remain innovative and competitive, the German economy needs well-trained, highly skilled workers. In 2008, the government successfully implemented its ““National Pact for Training and Young Skilled Staff in Germany”. Some of the pact’s main goals – e.g. to add over 60,000 new training places and to recruit over 30,000 new companies to offer training – were clearly surpassed as early as September 2008. Altogether, over 600,000 new training contracts were concluded in Germany in 2008. In addition, the relationship between the supply and demand of training places further improved in 2008 by 1.5 percent – although this was a slightly slower rate of growth than in 2007. According to the Federal Employment Agency, as of 30 September 2008 there were 19,500 unfilled training places available for 14,500 unplaced applicants.

88. Germany faces major challenges in the area of vocational education and training. On the one hand, in past years many young people failed to secure a training place despite submitting numerous applications and therefore had to be placed in substitute arrangements. On the other hand, companies increasingly complain that training places remain unfilled because applicants fail to fulfil the necessary requirements. In order to better fulfil the specific requirements of companies and to enhance the transparency of the job world, the Federal Government will increasingly bundle related job tasks into occupational groupings with common skill sets, and will then offer opportunities for specialisation within these groupings. Further, the Federal Government offers supplemental measures for applicants in special need of assistance (see Items 60 f. and 128 f.).

Box 12: Advancement through Education – the Skills Development Initiative for Germany

- The federal and *Länder* governments have agreed to the goal of raising spending levels for education and research in Germany to 10 percent of gross domestic product by 2015. A strategy group will formulate proposals for joint financing efforts by the end of 2009.

- *Länder* governments will intensify their support for timely pre-school language instruction for children.

- The *Länder* will also develop coordinated educational objectives for child day-care centres and primary schools, and they will refine and consistently implement common educational standards for schools.

- The federal and *Länder* governments aim to cut the number of pupils who quit school without a leaving certificate in half – from eight percent to four percent – by 2015. Likewise, they aim to halve the number of young adults who fail to complete some form of secondary school from 17 percent to 8.5 percent. All schools that lead to a lower secondary school leaving certificate (*Hauptschulabschluss*) are to offer career-oriented practical training.

- Furthermore, the *Länder* will establish conditions to make it easier for individuals to move between vocational and academic forms of training. The Federal Government will also increase the financial assistance available to trainee master craftsmen (*Meister-BAföG*). In addition, “career advancement grants” (*Aufstiegsstipendien*) will be made available to highly talented individuals with vocational training who wish to pursue university studies. This grant programme can be expanded if third parties provide additional funding.

- It is the shared goal of the federal and *Länder* governments to raise the national average of young people who enter university studies to 40 percent. The federal and *Länder* governments will continue their joint implementation of the 2020 Higher Education Pact, tailoring the programme to the country’s needs and thereby tapping the full potential of the roughly 275,000 additional students who will enter university studies by 2015.

- Furthermore, the federal and *Länder* governments are working together with the social partners to raise the percentage of the working population participating in some form of advanced training from 43 to 50 percent by 2015. A particular priority will be placed on low-skilled workers. This will require focused efforts on the part of companies, employees and social partners.

H. Opening up opportunities through European and international economic policy

89. As global economic circumstances become increasingly difficult, it becomes even more crucial to improve the global regulatory framework. At the same time, Germany must remain open and attractive to foreign investors. In order to confront the challenges posed by financial market turmoil and the global economic downturn, the Federal Government is taking measures that are being coordinated at the international and European levels (see Box 13).

90. Because solutions to global challenges increasingly require international cooperation, Germany needs strong and reliable international partners. This is especially true when it comes to cooperation with emerging and developing economies that have an increasingly prominent role to play in solving global problems such as the financial crisis and the food crisis. The Federal Government’s development policy provides these countries with support in building and expanding sustainable and resilient economic and financial systems, and Germany strives to incorporate these states into the globalisation process as equal partners. Furthermore, Germany supports the view that the international financial institutions – such as the World Bank, the International Monetary Fund and regional development banks – should make additional funds available for the purpose of stabilising the economies of emerging and developing countries.

Box 13: Core elements of Germany’s external economic policy in 2009

- The Federal Government will continue to demonstrate its emphatic support for a successful conclusion to the Doha Development Round of the World Trade Organisation (WTO).

- We also believe that the Transatlantic Business Dialogue between the European Union and the United States and, in particular the Transatlantic Economic Council (TEC), has a crucial role to play in boosting competitiveness and employment in actively maintained.

- Furthermore, the targeted expansion of bilateral economic relations with countries such as Russia, China and Brazil – together with the conclusion of agreements between the EU and India, Central America and the Andean Community – will open up new market opportunities for German companies.

- The EU's reform of its Generalised System of Preferences will bring about tariff reductions for numerous developing countries. As a result, these countries will gain new opportunities for trade with Europe.

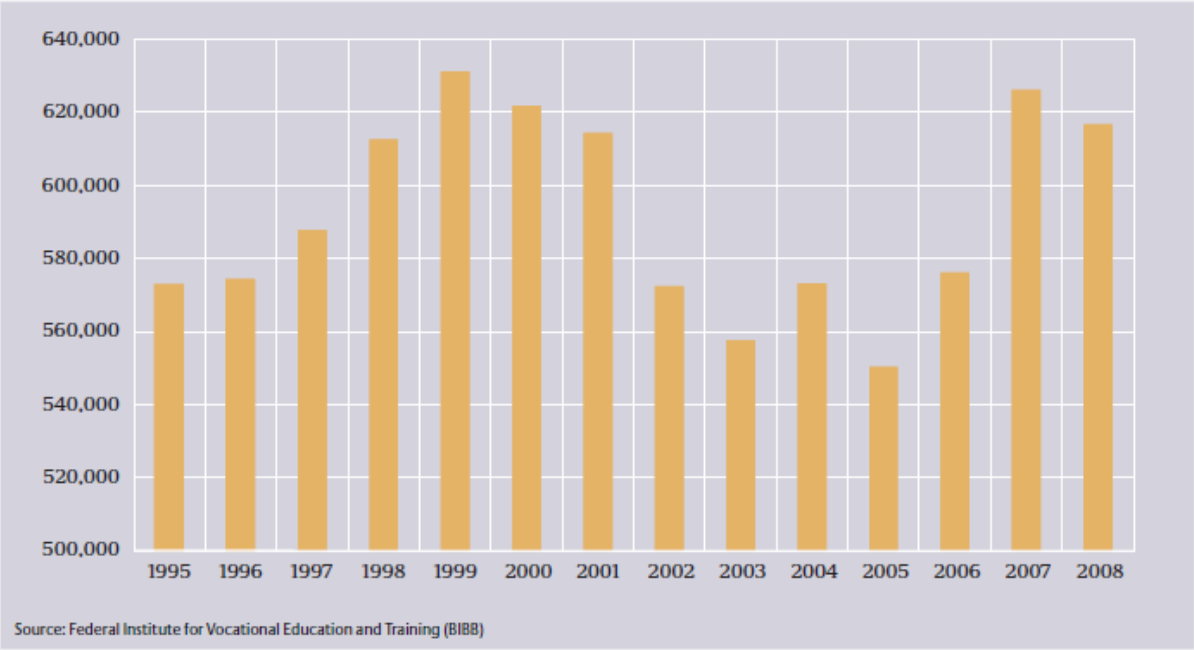
- The Anti-Counterfeiting Trade Agreement (ACTA) between the European Union, the United States, Japan and other countries will help in the fight against counterfeiting and piracy.

- The Federal Government is prepared to support German exporters with a substantially higher volume of federal export credit guarantees. Sufficient capacity has been ensured by the authorisation of up to 117 billion euros for export credit guarantees within the federal budget.

- As of 1 January 2009, the German Office for Foreign Trade was merged with the Invest in Germany agency to create the new "Germany Trade & Invest" agency (see Item 47). This step will help ensure that Germany's economy remains open and attractive to foreign investors.

- The amendment of the Foreign Trade and Payments Act (see Item 94) will safeguard Germany's national security interests without compromising our country's open investment environment.

Figure 11: Training contracts concluded in Germany



Improving the framework conditions for financial markets
91. In response to the financial crisis, many countries adopted measures designed to have a rapid impact in order to stabilise the confidence of financial market actors and the general public. These actions were coordinated internationally. In order to eliminate the weaknesses in the international financial system that have been exposed by the crisis, and in order to sustainably improve the underlying conditions for stable and transparent financial markets, regulatory efforts at the international level must be reinforced. The recommendations issued by the Financial Stability Forum in April 2008 as well as the initiatives launched by EU member states provide key building blocks for the action that needs to be taken. Our primary priorities must be to strengthen the oversight of equity, risk and liquidity management and to improve transparency, valuation standards and rating processes. The goal is to strengthen owner liability through higher capital adequacy requirements.

Furthermore, it is necessary to intensify cooperation between national regulatory authorities and to strengthen cross-border crisis management. Within the EU, this would include the creation of informal mechanisms to facilitate early warnings and to expedite the exchange of information. Closer links need to be established between relevant national authorities so that they can observe and assess cross-border financial transactions more effectively. The European Council has also called for new rules on bank deposit guarantees in the member states (Bundesrat printed paper 778/08). In addition, it has proposed that compensation and incentive systems be reviewed to ensure that all financial actors assume the appropriate level of responsibility for their actions. The European Council has called on the member states to take steps toward the implementation of these principles and priorities. The Federal Government will be intensively involved in these discussions.

92. Furthermore, at the global financial summit held in Washington in mid-November 2008, the G20 agreed on an action plan containing a broad range of concrete measures (see Box 14).

Strengthening multilateral trade rules
93. A speedy conclusion of the Doha Development Round would strengthen multilateral trade rules and thereby enhance the predictability and reliability of the world trade system for companies involved in international commerce. A successful conclusion to the talks would also send out an important signal promising more dynamic global economic growth in the coming years, and this could help restore confidence in the markets. For this reason, the Federal Government also welcomes the fact that the heads of state and government attending the global financial summit reaffirmed their commitment to free trade and cross-border investment. Germany emphatically supports this position and will move decisively to oppose protectionist measures. In difficult economic times like the present, there is an increased risk that the political will to press forward with the opening of markets – which is a key aim of the Doha Development Round – will diminish. There is also the danger that governments will enact protectionist measures at the national level, for example by raising tariffs, misusing trade defence instruments or increasing agricultural subsidies. In the past, protectionist measures have served to exacerbate economic problems, not solve them. For example, protectionist policies worsened the global economic crisis in the 1930s. In contrast, the maintenance of open markets during the Asian financial crisis in the 1990s was a decisive factor in speeding up economic recovery in the affected countries.

It is also crucial to conclude regional and bilateral free trade agreements as a means to increase and improve market access opportunities for businesses. To this end, the EU is placing a particular focus on reaching agreements with fast-growing emerging economies: for example, negotiations with India, South Korea and ASEAN were launched under the German EU Presidency. It is also important to undertake further reforms to reduce customs barriers. Furthermore, as Europe's leading industrial nation, Germany has a vital interest in strategic economic partnerships. The expansion of economic relations between the EU and the United States is especially important in this respect. In Germany's view, the Transatlantic Economic Council (TEC Process) has proven to be very effective, particularly in reducing trade and investment barriers and strengthening convergence in the areas of regulation and standards. For example, U.S. authorities now recognise the use of International Financial Reporting Standards (IFRS) by foreign companies. As a result, these companies no longer have to engage in the costly process of converting their financial reporting in accordance with U.S. standards. Strategic economic partnerships have also been established – or are being developed – with other countries and regions such as the African, Caribbean and Pacific group of states. These partnerships often contain key development policy components as well.

Box 14: Results of the global financial summit on 15 November 2008

- Strengthening transparency and accountability: financial market actors must provide comprehensive disclosure of financial information, including disclosure on complex financial products. Financial actors should no longer engage in excessive risk-taking.

- Enhancing sound regulation: All financial markets, products and participants should be regulated or subject to oversight.

- Promoting integrity in financial markets: The G20 will undertake measures to bolster investor and consumer protection, to avoid conflicts of interest and to combat market manipulation, fraud, corruption and money laundering.

- Reinforcing international cooperation: The international coordination of crisis prevention, crisis management and crisis resolution efforts should be strengthened.

- Reforming international financial institutions: The Financial Stability Forum (FSF) should be expanded to include key emerging economies. The International Monetary Fund (IMF), in collaboration with the FSF, should strengthen its early warning capacities and play a key role in responding effectively to crises. Emerging and developing economies should receive greater voice and representation in the IMF and World Bank.

Maintaining an open investment environment

94. In order to maintain an open investment climate while simultaneously safeguarding public security, the Federal Government has laid out the legal basis for an instrument that will allow for the review, in rare exceptional cases, of foreign investments in German companies. The draft legislation for a 13th Act Amending the Foreign Trade and Payments Act and the Foreign Trade and Payments Ordinance

will not impair Germany's open investment climate. Restrictions or prohibitions may be imposed against foreign investments only under the narrow condition, as provided by European law, that such investments pose a threat to public policy or public security in the Federal Republic of Germany. As far as investments in individual companies are concerned, this is conceivable only in rare exceptional cases. The draft legislation avoids the addition of bureaucratic red tape for investors and provides for tight deadlines to ensure legal certainty and security of planning.

95. In recent years, investments from sovereign wealth funds have gained in significance. For this reason, the Federal Government explicitly supports various international initiatives that aim to contribute to an open international investment climate. For example, under the aegis of the IMF, a set of general principles has been developed in close coordination with key sovereign wealth funds to enhance the transparency of these funds' structures, procedures and investment strategies and to promote responsible conduct. These "Generally Accepted Principles and Practices" (also known as GAPPs or the Santiago Principles) were adopted and published in October 2008. In turn, common principles for the inward investment policies of recipient countries are being developed within the framework of the OECD. These principles will be based on the OECD Ministerial Council's June 2008 declaration supporting an open investment environment. They are expected to state that restrictions may be imposed on investments only in cases involving "legitimate national security concerns" and that such restrictions should take into account the principles of transparency, proportionality and accountability. A final OECD report on this issue is expected in mid-2009. Moreover, the EU has launched an initiative to develop a voluntary code of conduct for sovereign wealth funds that will include uniform EU-wide standards. The German government welcomes these initiatives.

The Heiligendamm Process

96. The rise of large emerging economies such as Brazil, China, India, Mexico and South Africa presents both enormous opportunities as well as new challenges. It is important for emerging economies to take their share of responsibility for the development of effective policies to shape the globalisation process. This includes taking relevant measures to enhance openness toward cross-border investment, to promote and protect innovation, and to address key issues in the fields of energy policy, climate protection and development cooperation. Because Germany's economy is strongly geared toward exports and international investment, we have a particular interest in integrating emerging economies within processes of globalisation, not only in the economic sense but increasingly in the political sense as well. This is the chief aim of the Heiligendamm Process, which was adopted under Germany's Presidency of the G8 in 2007 (see Box 15).

Protecting intellectual property

97. Piracy and counterfeiting are a source of increasing problems for German industry. According to OECD estimates, global trade in counterfeit goods amounts to an annual value of at least 150 billion euros. Since this estimate includes only a part of all counterfeit products, the actual damage is likely to be significantly greater. According to industry association calculations, the damage to German companies alone accounts for roughly 30 billion euros. The fight against piracy and counterfeiting is a global task. Because German industry is both globally active and innovation-driven, it has a vital interest in the global protection of intellectual property. For this reason, the Federal Government is working actively to achieve

improvements at the international level. This includes ongoing cooperation with our G8 partners as well as the Heiligendamm Process initiated during Germany's G8 Presidency in 2007 (see Box 15). Within the Heiligendamm Process, joint deliberations on the more effective implementation of intellectual property rights are being held with major emerging economies such as China, India, Brazil, Mexico and South Africa. Furthermore, since June 2008 the European Union, Japan, the United States and other countries have been involved in negotiations on the Anti-Counterfeiting Trade Agreement (ACTA) – a new international agreement to strengthen protections against piracy and counterfeiting. Another component of the EU's overall strategy is to enshrine more effective intellectual property rules in free trade agreements with non-EU states.

The European Economic Recovery Plan

98. On 26 November 2008, the European Commission unveiled a legislative package to support the European economy. The programme sets out a coherent framework for steps to be taken at the EU level and for measures to be adopted by member states while taking into account their own specific national circumstances. In the German government's view, it is important to take this type of coordinated approach. At the same time, however, European rules should not interfere with the flexibility needed for decision-making at the national level. On 11-12 December 2008, the European Council agreed on a European Economic Recovery Plan and advocated a series of measures.

These include in particular:

- a 30 billion euro increase in European Investment Bank loans in 2009/2010, which will be targeted especially toward small and medium-sized enterprises and toward the policy priorities of climate protection, energy efficiency and infrastructure;
- additional measures by the European Social Fund to promote employment;
- measures to ensure that funding from the European Globalisation Adjustment Fund has a more rapid impact on employment;
- the simplification of procedures within the Structural Funds; and
- an easing of restrictions on state aid, particularly by raising the *de minimis* threshold for state aid to 500,000 euros for a period of two years.

The European Council has also advocated – and adopted guidelines for – increased, coordinated measures that member states can take to boost demand, depending on national circumstances. These include increasing public spending, lowering tax burdens, reducing social security contributions, providing support to certain categories of enterprises, and granting direct aid particularly to vulnerable households.

Such measures are to be accompanied by intensive efforts to implement the structural reforms envisaged in the Lisbon Strategy.

Altogether, the plan provides for funding in the amount of roughly 1.5 percent of EU gross domestic product. The European Council has emphasised that the revised Stability and Growth Pact remains the cornerstone of the EU's budgetary framework. Further, the Pact affords the necessary flexibility that allows Recovery Plan measures to be implemented in a manner consistent with the goal of achieving sustainable public finances over the long term. With this in mind, the European

Council calls on the member states to return as soon as possible to their medium-term budgetary targets, in accordance with the Pact and the pace of economic recovery.

The Federal Government supports the decisive action that the member states and the EU have taken to promote growth and employment. The Recovery Plan is a toolbox containing many useful instruments, such as the mobilisation of additional European Investment Bank loans and the faster implementation of Cohesion and Structural Funds. The measures adopted by the member states need to have a rapid impact, make long-term sense and bolster confidence. In this connection, Germany has taken quick and comprehensive action to implement its stimulus packages of 7 October 2008, 5 November 2008 and 14 January 2009 (see Boxes 3, 4 and 5). The German government also emphasises the importance of upholding the letter and spirit of both the Stability and Growth Pact as well as the seven-year Financial Perspective.

Box 15: Key policy priorities of the Heiligendamm Process

- **Investment conditions, including issues of corporate social responsibility:**
  Best practices are discussed on the basis of a stocktaking exercise to assess current investment conditions. Issues of corporate social responsibility are also examined in this context.

- **The promotion and protection of innovation:**
  For modern economies, innovation is the key to the competitiveness. The Heiligendamm Process examines issues surrounding both the promotion as well as the protection of innovation, including a focus on intellectual property rights.

- **Energy efficiency and technology cooperation:**
  Our world faces major challenges due to the increasing global consumption of energy and the accelerating pace of climate change. With the International Energy Agency's support, the G8 states and large emerging economies engage in joint deliberations on (a) how best to increase energy efficiency and (b) how technology cooperation can help to enhance energy security and reduce greenhouse gas emissions.

- **Development cooperation, with a particular focus on Africa:**
  The G8 countries and major emerging economies exchange views on issues of shared responsibility for development policy, particularly in relation to Africa. Talks focus above all on the effectiveness of development cooperation; opportunities for joint action in Africa by the G8 and leading emerging economies (also referred to as "triangular cooperation"); and growth and responsibility in Africa.

The European Union's Lisbon Strategy for Growth and Jobs

99. By adopting the Lisbon Strategy, the 27 member states and the European Community have agreed to a long-term reform strategy that aims to boost the competitiveness of the European Union. At their Spring Summit in March 2008, the EU heads of state and government adopted a new three-year cycle for the Lisbon

Strategy (for the period 2008-2010) and agreed to focus their reform efforts on the following areas:

- research, development and innovation,
- improving the business environment, particularly for small and medium-sized enterprises,
- enhancing employability for more and better jobs; and
- energy and climate policy.

The March 2008 European Council also re-affirmed the Lisbon Strategy's Integrated Guidelines, which serve as a framework to guide Community and member state policymaking. The guidelines will therefore remain in effect, in basically the same form, throughout the current cycle.

On 15 October 2008, the Federal Government submitted Germany's National Reform Programme for 2008-2010, which is geared toward these issues and priorities.

Debates on the future of the Lisbon Strategy after 2010 are already underway. Proposals on the strategy's future design are expected during the course of 2009. In Germany's view, it is important that the strategy continues to pursue the three key objectives of economic success, social cohesion and environmental responsibility. It must also continue to place a priority on ensuring the high quality and long-term sustainability of public finances. Furthermore, the strategy must strive to shape globalisation processes effectively; to place a particular focus on energy and resource efficiency; to press forward with research and development; to create a business environment that promotes competition; and to find effective solutions to demographic trends.

II. The Federal Government's projection for 2009

A downturn in the global economy

100. In 2009, developments in the world economy will be shaped by the impacts of the global financial and economic crisis. The year 2008 thus marks the end of a four-year global upswing during which the world economy grew at annual rates exceeding four percent. The crisis was caused by the bursting of the liquidity-fed real estate bubble in the United States and certain other industrialised nations – a development long anticipated by experts. What has followed is a crisis of adjustment with severe repercussions on demand, production and employment. To be sure, the world economy grew by about 3.7 percent last year, according to a November 2008 assessment by the International Monetary Fund. Nevertheless, the slowdown was already making itself felt during the course of 2008. According to calculations by various international organisations, the global economy is likely to expand by only about one percent on average in 2009. In industrialised countries, the economic slump that started in 2008 is likely to continue. Emerging economies – which until recently have been developing with a high level of dynamism – will increasingly feel the strain as well.

101. The global economic downturn started with disruptions on global financial markets, which were set into motion in the second half of 2007 by the real estate and mortgage crisis in the United States. Since then, these disruptions have snowballed into a global financial crisis that is gaining substantially in intensity. After initially

striking the financial sector, the crisis has now spread to the non-financial sector. According to the official findings of the National Bureau of Economic Research (NBER), the U.S. economy has been in recession since the end of 2007. Credit conditions have worsened considerably. Overall, the downturn is likely to continue in 2009.

102. In Japan as well, the worldwide cyclical downturn is having a negative impact on the economy, particularly on the export sector. However, compared to the United States and other industrialised nations, the outlook for Japan in 2009 appears somewhat more favourable.

103. In 2008, economic activity in the euro zone – and, similarly, in the entire European Union as well – weakened tangibly. Due not least to their far-reaching involvement in high-risk U.S. securities as well as to their strong degree of economic openness, euro zone countries are being hit both directly and indirectly by the impacts of the financial crisis and the global economic downswing. Due to the financial crisis, credit conditions for the business sector have deteriorated throughout Europe, and a further worsening of conditions cannot yet be ruled out. The euro's strong rise against the U.S. dollar, together with the dramatic increase in oil prices through mid-2008, helped bring an abrupt end to the economic upturn in the euro zone. The downturn will persist throughout the first months of 2009, and it will have a varied impact on the euro zone countries. Those countries that saw excessive developments on their real estate markets in recent years – such as Spain and Ireland, but including Denmark and France as well – will experience further structural adjustments. The decline in previously exaggerated real estate prices and the thinning out of excess capacity in the construction industry will continue. But even those countries that did not experience a real estate boom – such as Austria and Germany – will feel the delayed, indirect repercussions of the global financial crisis and the economic downturn, particularly in the form of a global slump in demand and harsher credit conditions.

The other EU states will also be unable to escape the effects of the global financial crisis and economic decline. Especially in the United Kingdom, upheavals in the real estate, banking and financial sectors are exerting downward pressure on the economy. In the United Kingdom and the United States, the financial and construction sectors take up a greater share of value creation than in Germany. In contrast, the global financial crisis and economic downturn have had a delayed and indirect impact on EU member states in Central and Eastern Europe. Some countries, such as the Baltic states and Hungary, were particularly hard-hit as the financial crisis spread. Those countries with high current account deficits, low currency reserves and high levels of foreign debt face difficult times ahead.

104. The economies of emerging and developing countries are also likely to lose steam, particularly in Asia, but growth in these countries will still remain stronger than in industrialised states. Emerging and developing economies will not be able to isolate themselves from the economic downturn in industrialised nations. Still, the largest emerging economies – including Brazil, Russia, India and China – will continue to expand at an above-average rate in the future. Nevertheless, some countries such as Russia will experience deteriorating terms of trade due to falling oil and gas prices resulting from the worldwide drop in demand. Real economic growth

will therefore be substantially slower in Russia than in other large emerging economies.

Assumptions underlying the 2009 annual projection
105. In brief, the 2009 annual projection is based on the following assumptions:

- Based on projections by international organisations, the world economy and world trade will expand significantly more slowly in 2009 than in 2008: the world economy is expected to grow by approximately 1 percent (in price-adjusted terms) and world trade by about percent.

- As in past years, technical assumptions – i.e. not predictions – regarding exchange rates and the price of oil for 2009 are based on the average rates/prices recorded during the final weeks prior to the projection. Thus the projection for 2009 assumes an average oil price of 45 US dollars per barrel of Brent crude oil (54% lower than the average for 2008) and an exchange rate of 1.32 US dollars to the euro (10% lower than the average for 2008). The current European Central Bank refinancing rate of 2.0% is also assumed for 2009.

- Total payroll (price-adjusted) is expected to remain in line with total productivity growth.

- While the financial crisis has not yet been overcome, the projection assumes that it will not intensify. Germany's Financial Market Stabilisation Act is expected to fulfil its objectives. Furthermore, the projection assumes that a credit crunch – i.e. a significant and broad-based deterioration in the supply of credit to businesses and private households – will not occur.

- The projection takes into account all of the measures adopted prior to the compilation of this Annual Economic Report (see especially Box 5).

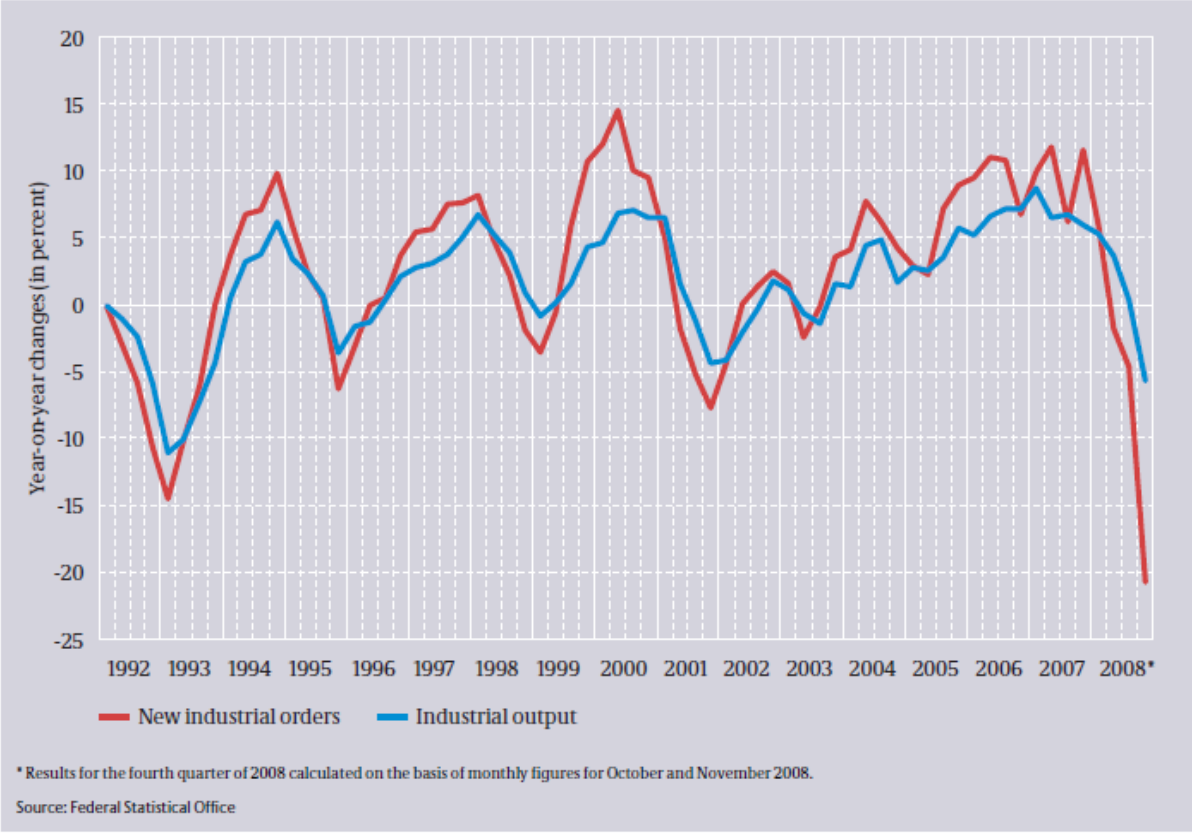
The German economy: caught in the downward spiral of the world economy
106. Due to the intensifying financial crisis and the related acceleration of the global economic downturn in 2008, Germany's economy grew at an even slower pace last year than the Federal Government had anticipated in its 2008 annual projection (see Box 16). The German economy is now in a deep recession. In 2009, the synchronous, worldwide economic slump will have powerful negative repercussions on economic activity in Germany. Foreign demand, which served as the engine for growth in recent years, is likely to continue its substantial decline in 2009. While improvements in the euro's exchange rate against the US dollar will boost Germany's price competitiveness, this positive development for German exports will not be able to compensate for the negative impacts generated by the weakening of economic activity across the globe.

In its Annual Report published in November 2008, the Council of Economic Experts proceeded from the assumption that – based on the data available at the time – net foreign demand would have neither a negative nor a positive effect on growth (CEE Annual Report, Item 156 ff.). Since early November 2008, however, the economic outlook has deteriorated with extraordinary speed.

Two positive developments helping the German economy include favourable exchange rate trends and, in particular, the steep drop in raw materials prices. For example, prices of Brent crude oil, which reached historic highs in the summer of 2008, have since then fallen by over 70 percent. This brightens the overall price situation in Germany considerably. The increase in consumer prices – which sapped the purchasing power of private households in 2008 and contributed to the stagnation of real private consumption – will slow down substantially in 2009. This will have a positive effect on the real incomes of private households. However, this improvement in purchasing power will be counteracted over the course of 2009 by a decline in employment. Overall, the Federal Government expects real private consumption to increase in 2009, thanks in part to the newly adopted measures affecting taxes and social insurance contributions. Private consumption will thus serve as a stabilising factor for the economy. In the short term, however, a generally weak domestic economy will not be able to counteract the economic damage inflicted by declining foreign trade and investment.

107. The recession in Germany is taking place in tandem with a marked contraction in investment activity, particularly in the area of plant and equipment investment. The onset of 2009 has seen a powerful decline in both capacity utilisation – which was still above average in 2008 – as well as orders. Trends in construction investment will be mixed in 2009. Commercial construction is likely to decline due to the slump in plant and equipment investment, and residential construction is also not expected to make a tangible contribution to growth. In contrast, public sector construction will expand solidly as a result of the newly adopted measures to stabilise the economy. Thus construction investment will play a stabilising role in 2009 in contrast to negative trends in plant and equipment investment.

Figure 12: Trends in industrial output and new industrial orders (quarterly year-on-year averages)

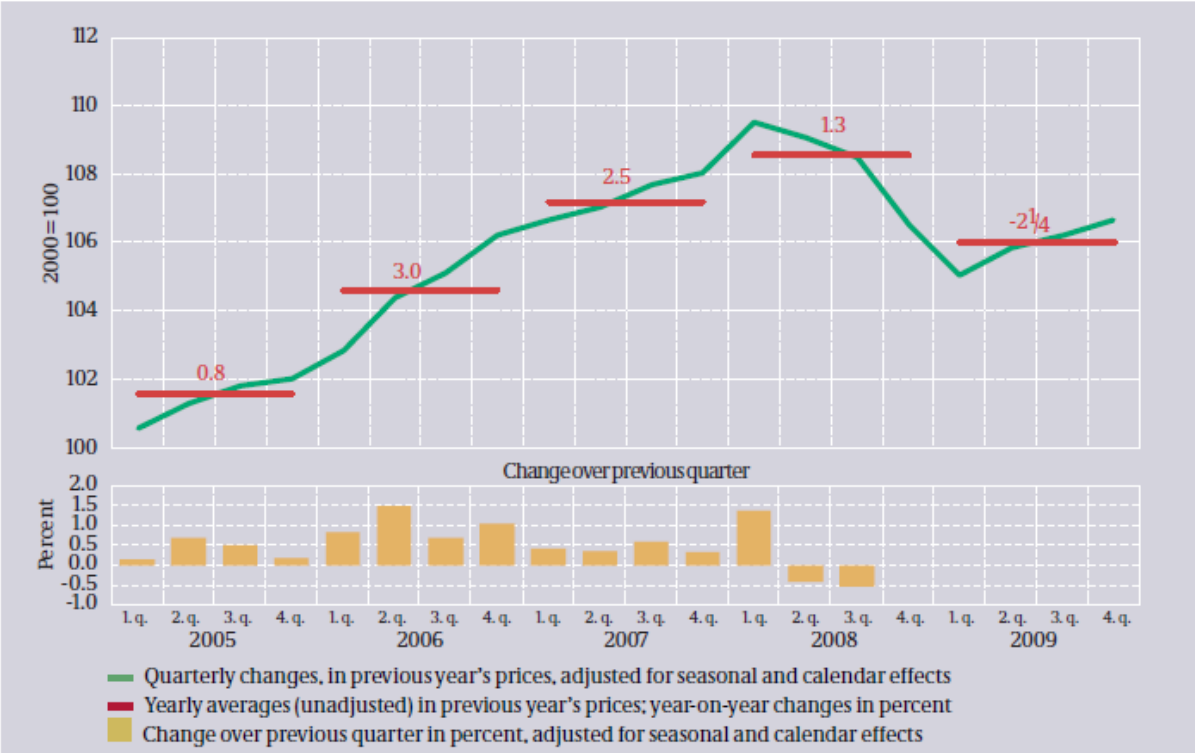


108. Not all sectors of the economy are affected equally by the downturn. The decline in output is particularly pronounced in the manufacturing industry. Within this sector, motor vehicle production as well as the production and processing of metals are especially hard hit. Parts of the chemical industry are also experiencing considerable slowdowns. In contrast, the railway industry, mechanical engineering and plant construction are likely to prove relatively resilient in 2009.

In large part, the services sector will have a stabilising influence on the economy. Nonetheless, certain segments of the services industry, especially business-related services, are being dragged down by the decline in industrial activity. For example, the credit and insurance industries will likely suffer from the effects of the financial crisis while transport services are likely to be hit by the slump in industrial output.

109. While the labour market remained quite stable through the end of 2008, the downturn will have a marked impact here as well over the course of 2009. Nevertheless, compared to the expected decline in gross domestic product, the drop in employment on average for the year is likely to be less pronounced than in past downturns. This is partly due to the positive trends on the labour market in 2008. For example, during the upswing, German companies experienced increasing difficulty in finding qualified personnel to fill open positions. For this reason, firms will presumably try to hold on to their qualified personnel at first; then, as the downturn runs its course, they will likely react to sagging demand by having employees take off their accumulated overtime hours and/or perform short-time work. Demographic trends will also ease the overall situation.

Figure 13: The 2009 annual projection – GDP trends in Germany (price-adjusted)



Sources: Federal Statistical Office (for figures through the third quarter of 2008); Federal Ministry of Economics and Technology estimate (for the fourth quarter of 2008 and for 2009)

110. For 2009 as a whole, the Federal Government expects gross domestic product to decline by 2 percent (price-adjusted). However, the projected annual change in GDP provides an insufficient picture of economic trends in 2009. This figure is distorted mathematically due to the pace and pattern of the economic slowdown in 2008. During the final quarter of 2008, the level of economic activity was much lower than the annual average, and the resulting statistical carry-over accounts for approximately 1percentage points (see Figure 13 and Table 3).

GDP would probably have fallen much more in 2009 if the German government had not adopted its various stimulus measures. The comprehensive "Pact for Employment and Stability in Germany" provides effective stimuli for growth, so that economic activity will stabilise over the course of the year. This is what is needed to steer Germany back onto a positive course toward more jobs and higher growth.

Factors that could produce better or worse than projected outcomes

111. Factors that could generate worse-than-projected outcomes include an intensification of the financial crisis. If asset values were to decline further and cause another powerful wave of value adjustments in the financial sector, this would reduce the capital base of banks and thereby dampen their willingness to provide credit. In addition, if the global economic downturn were to increase further in speed and/or magnitude, this could have an even more severe impact particularly on Germany's export-oriented manufacturing sector. Other risks include the ongoing high current account deficit in the United States as well as the possibility of a powerful increase in the euro's rate of exchange against the US dollar.

112. However, there are also factors that could lead to better-than-projected outcomes. For example, the world economy could recover faster than expected from its synchronous slowdown, in part due to domestic and international measures enacted by governments to stimulate growth. The positive impacts of programmes to stabilise financial markets and to stimulate the economy in all industrialised countries could work in a mutually reinforcing manner. Due to the structure of its exports, Germany in particular would stand to benefit from a surge in global economic activity. Moreover, the problems currently affecting banks could subside more quickly than expected.

Slumping foreign trade and investment: putting a brake on growth

113. The OECD has forecast that the economies of its member countries will be in recession in 2009: it expects real economic activity in the OECD states to decline by 0.4 percent this year. Now as before, Germany's main trading partners continue to be other industrialised nations, despite the dynamic development of its trade relations with developing and emerging economies in recent years. In 2007, over 80 percent of Germany's exports went to other OECD states.

Germany's export-oriented economy is being hit by the global economic downturn to the same extent that it benefited from the recent upswing (see Figure 14). In recent years, foreign trade was the driving force for growth in Germany: from 2004-2007, net foreign demand accounted for approximately 60 percent of overall economic growth. However, given the current weakness of the global economy, foreign trade is likely to have a decisively negative impact on growth in 2009.

The available indicators corroborate this downward trend. For example, as of November 2008, the manufacturing sector has seen new orders from abroad decline by 27 percent (adjusted for seasonal and calendar effects) from their peak in November 2007 – an average drop of roughly 2 percent per month. Likewise, the export expectations of the manufacturing industry (excluding the food and beverage industry) fell drastically between November 2007 and December 2008, from an index value of 51 to –32 (seasonally adjusted).

114. In 2009, German products will retain the higher level of price competitiveness that they achieved in recent years due to the pursuit of moderate wage policies. Unit labour costs in Germany will rise mainly due to the cyclical decline of productivity growth in the economy as a whole, but this increase will be moderate compared to other countries. The price competitiveness of German companies has also improved due to the recent decline in the exchange rate of the euro against the US dollar. However, this shift in the exchange rate cannot compensate for the worsening sales prospects that German exporters face as a result of the solid downturn in the United States and the rest of the world.

During the global economic expansion that preceded the financial crisis – and particularly as emerging economies sought to catch up with the industrialised world – demand increased for the high-quality capital goods that German exporters specialise in. This will change in 2009: the economic downturn in the industrialised countries – coupled with slow growth for example in Central and Eastern Europe, in key emerging economies such as China and India, and in oil-exporting states – will lead to a steep decline in the demand for capital goods.

After the high – and sometimes double-digit – growth rates that German exports achieved in recent years, exports are expected to contract by 8.9 percent in 2009. The slump in exports and domestic demand is expected to be accompanied by a five-percent real rate of decline in the imports of goods and services in 2009. World market prices for energy and non-energy commodities are also projected to fall on average in 2009, not least due to the economic slowdown. On balance, the terms of trade are expected to improve in 2009 compared to 2008. In numerical terms, net exports are expected to make a negative contribution to growth in 2009 in the amount of –2.2 percentage points.

Table 3: Key figures for macroeconomic trends in Germany[25]

	2007	2008	Annual projection 2009
	Year-on-year changes in %		
Production of gross domestic product (GDP)			
GDP (price-adjusted)	**2.5**	**1.3**	**-2,25**
Employment (in Germany)	1.7	1.5	-0.7
GDP per person employed	0.7	-0.2	-1.5
GDP per hour worked	0.6	-0.1	-1.5
Unemployment rate in % (according to national accounts) [26]	*8.3*	*7.2*	*7.9*
Unemployment rate in % (as defined by the Federal Labour Agency) [26]	*9.0*	*7.8*	*8.4*
Use of GDP (in current prices)			
Consumption expenditures			
Private households and private non-profit institutions serving private households	1.4	2.2	1.7
Government	2.4	4.0	4.7
Gross fixed capital formation	7.2	5.2	-3.9
Changes in inventories (in billions of euros)	*-10.9*	*-2.9*	*-2.9*
Domestic demand	2.8	3.5	1.1
External balance of goods and services (in billions of euros)	*171.0*	*157.9*	*125.6*
(in % of GDP)	*7.1*	*6.3*	*5.1*
Gross domestic product (nominal)	**4.4**	**2.7**	**-.25**
Use of GDP (price-adjusted)			
Consumption expenditures			
Private households and private non-profit institutions serving private households	-0.4	0.0	0.8
Government	2.2	2.2	2.4
Gross fixed capital formation	4.3	4.1	-5.0
Machinery and equipment	6.9	5.3	-11.9
Construction	1.8	2.8	-0.3
Other plant and equipment	8.0	6.6	0.9
Changes in inventories (contribution to GDP growth rate) [27]	*0.1*	*0.3*	*0.0*
Domestic demand	1.1	1.6	-0.1
Exports	7.5	3.9	-8.9
Imports	5.0	5.1	-5.0
External balance of goods and services (contribution to GDP growth rate) [27]	*1.4*	*-0.3*	*-2.2*
Gross domestic product (real)	**2.5**	**1.3**	**-2.25**
Price trends (2000 = 100)			
Private consumption expenditures[28]	1.7	2.2	0.9
Domestic demand	1.7	1.9	1.2
Gross domestic product[29]	1.9	1.4	2.0
Distribution of gross national income (GNI) *(residence concept)*			
Wages and salaries	3.0	3.6	1.2
Entrepreneurial and property income	4.5	1.7	-2.9
National income	3.5	2.9	-0.3
Gross national income	4.3	2.7	-0.2
Additional information (residence concept):			
Employed persons	1.8	1.6	-0.8
Gross wages and salaries – total	3.4	3.9	1.2
– per person employed	1.6	2.3	2.0
Household disposable income	1.6	2.6	1.8
Savings rate in % [30]	*10.8*	*11.4*	*11.5*

[25] Up to 2008, preliminary figures from the Federal Statistical Office as of 14 January 2009.

[26] Based on total number of persons employed.

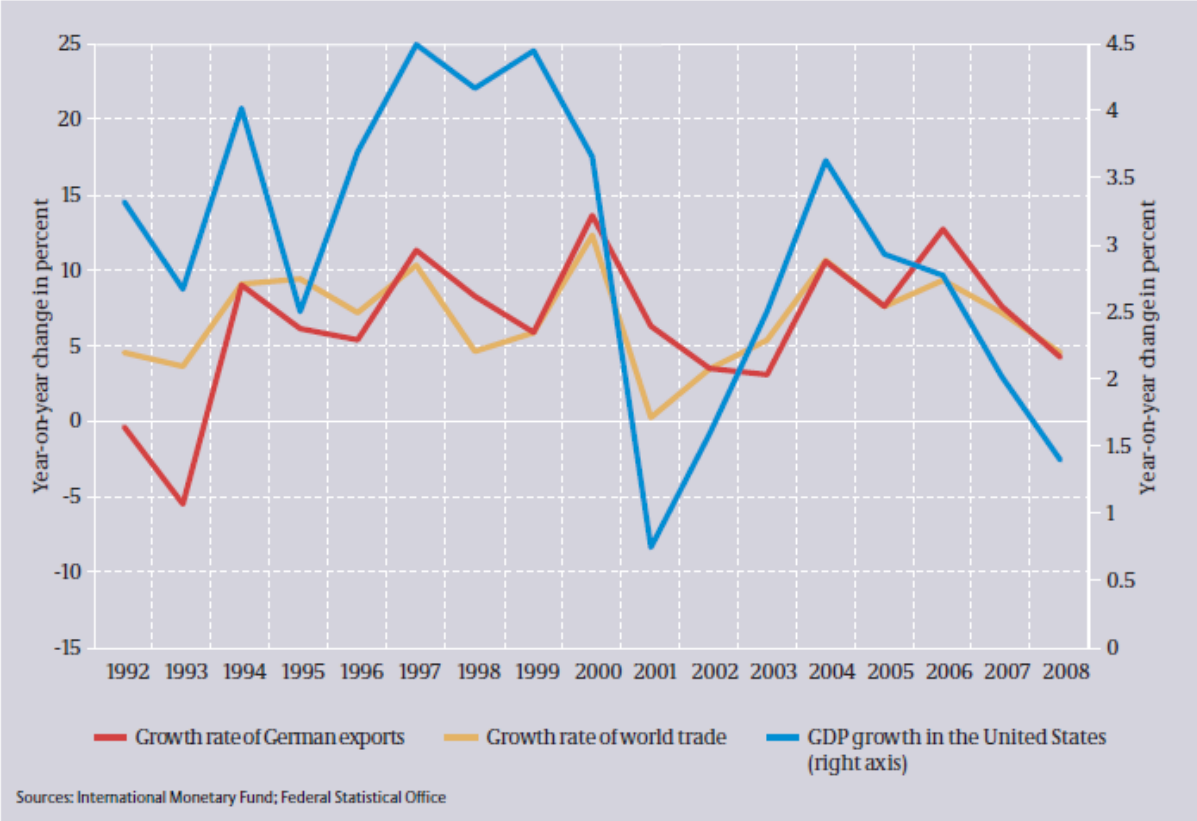
[27] Contribution to GDP growth rate.

[28] Year-on-year changes in the consumer price index: 2007: 2.3%; 2008: 2.6%; 2009: 0.5%.

[29] Year-on-year changes in unit labour costs: 2007: 0.4%; 2008: 2.1%; 2009: 3.5%.

[30] Savings as a percentage of household disposable income including pension fund reserves.

Figure 14: Growth rates of world trade, United States GDP and German exports



Cyclical decline in investment

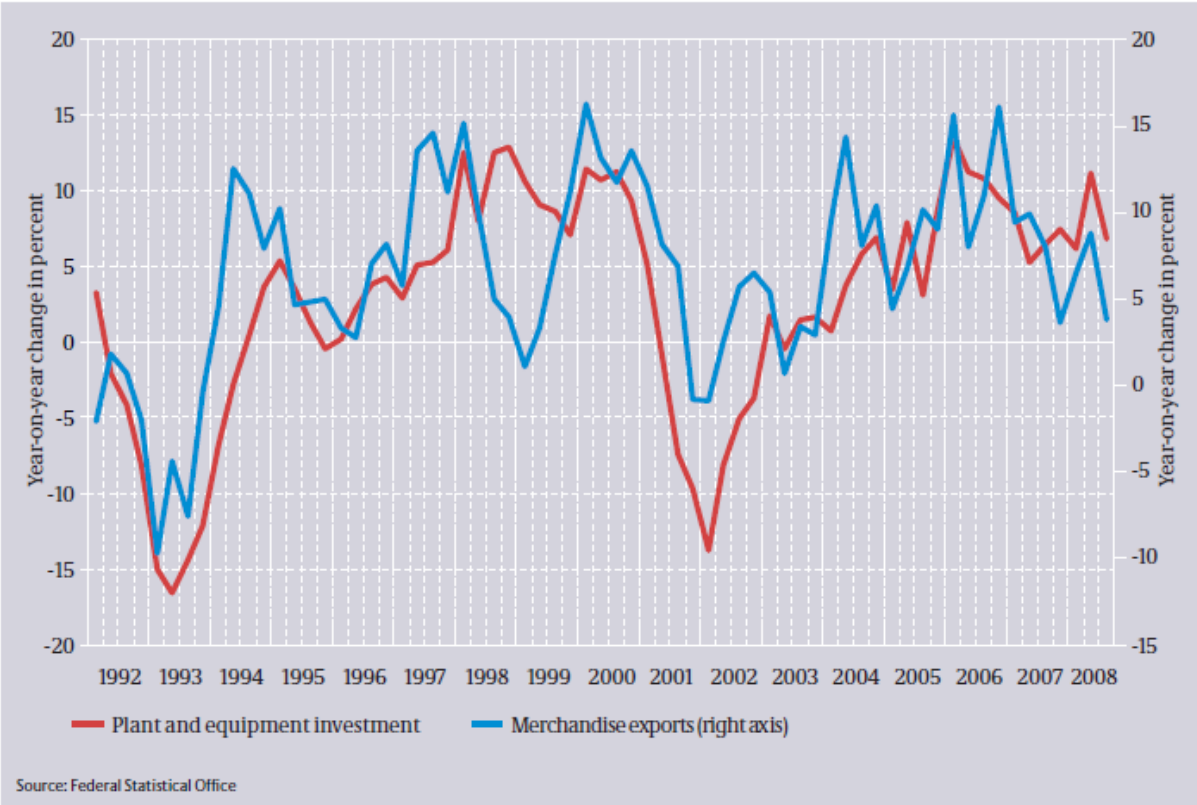
115. The global economic downward spiral has also brought an end to the upswing in investment. A substantial decline in investment activity is expected in 2009 (see Figure 15 on the relationship between plant/equipment investment and merchandise exports). Gross fixed capital formation will decline markedly in 2009.

Plant and equipment investment is projected to shrink at a real rate of 11.9 percent in 2009 after growing dynamically in recent years, with average annual growth rates of over four percent since 2004. The latest available indicators corroborate this downward forecast. According to the ifo Business Climate Survey, assessments of the current situation and expectations have worsened dramatically among the companies surveyed. Since reaching their peak in November 2007, new orders for capital goods have plummeted. The number of cancelled orders is on the rise as well. The automotive industry is particularly hard hit by sagging demand. With the special exception of August 2008, new industrial orders have fallen each month since November 2007 for a cumulative drop of 24 percent. These negative developments are not yet fully reflected in output levels, which have fallen by roughly seven percent during the same period (through November 2008). Domestic sales of capital goods are also on the decline.

Moreover, capacity utilisation in the manufacturing industry has recently taken a substantial slide, falling 3.4 percentage points to 84.5 percent since its peak in the second quarter of 2007. For now, capacity utilisation still remains above the long-term average of 83.9 percent but is likely to continue declining due to the deteriorating sales outlook.

Furthermore, financing conditions for businesses have worsened as the financial crisis has taken its course. For example, banks use the short-term interbank offered rate (Euribor) as a benchmark for the short-term interest rates they offer to businesses and consumers. However, as a reflection of the high perception of risk in the present situation, the Euribor remains unusually high above the European Central Bank's key interest rate. Nevertheless, German firms are still well-capitalised for the time being due to their strong earnings in recent years. This will help spur investment activity along with the declining balance depreciation rate of 25% for movable assets, which is being introduced for a period of two years as part of the 15-point programme "Securing Jobs by Strengthening Growth".

Figure 15: Trends in plant/equipment investment and merchandise exports



116. While the global economic downturn and the financial and real estate crises are having a strong impact on plant and equipment investment in Germany, the impact on construction investment is less severe. Germany's real estate market did not feature the excesses that characterised other countries. Rather, in the aftermath of the reunification boom, sustained structural adjustments took place through 2005 to reduce the excess capacity that had accumulated in the construction industry. In total, construction investment is projected to decline only slightly in 2009 at a real rate of 0.3 percent. Public sector construction – particularly in the priority areas of education (e.g. child day-care centres, schools and higher education facilities) and infrastructure (e.g. transport, hospitals, urban development and information technology) – will expand strongly (by 22.3 percent) as a result of the newly adopted measures to stabilise the economy.

This will allow for the further implementation of long-needed repairs and upgrades to the public infrastructure.

Investment in commercial construction will not be able to escape the impact of the decline in plant and equipment investment. New orders are tending downward. In addition, cancellations of orders are to be expected, and it is likely that the timelines of many commercial construction projects will be extended. Tougher financing conditions are also proving to be a burden to both construction firms and investors. As a result, investment in commercial construction is projected to decline in 2009 by a real rate of 5.7 percent.

Private housing construction remains sluggish in general. Uncertainties connected to the future of the economy and the tightening of financing conditions are dampening demand. In contrast, finishing trades are experiencing positive development, and incentives for increasing the energy efficiency of buildings are having a supportive impact on this sector. Nevertheless, investment in private housing construction is expected to decline overall by 3.1 percent in 2009.

Consumer spending as a stabilising factor

117. Real consumer spending has remained stagnant in recent years despite the strong upturn in the overall economy (CEE Annual Report, Box 3). In 2008 in particular, consumer spending was dampened above all by steep rises in energy and food prices as well as a substantially higher propensity to save, despite the fact that income prospects improved. The primary factor that influences consumer spending is disposable income, which is comprised of net wages and salaries (which account for roughly 42 percent of disposable income); social benefits other than social transfers in kind, minus social insurance contributions (roughly 24 percent); and mixed income (self-employment) and property income minus income tax (roughly 34 percent).

Collective wage agreements form the basis for gross wages and salaries. In 2009, actual earnings per person employed are expected to grow by 2.0 percent, which is likely to lag behind the increase in collective wages (negative wage drift). In light of the slumping economy, many companies are likely to attempt to stabilise their costs by taking advantage of contractual clauses allowing for flexibility in employee compensation. Due to negative developments on the labour market, the growth rate of aggregate gross wages and salaries is expected to be 1.2 percent lower than the growth rate of actual earnings. Despite the reductions in income taxes and social insurance contributions, aggregate net wages and salaries are expected to climb one percent less than the respective gross totals due to progressive taxation. Trends in social benefits other than social transfers in kind are generally determined by trends in benefits provided to non-employed persons. The latter will increase due to the rising number of registered unemployed persons and statutory pension adjustments. Disposable income will also grow as a result of the Federal Government's recently adopted measures involving family-related benefits (e.g. the increased child benefit; the child bonus; and new, higher social benefit rates for children under Social Code II/XII) as well as the extended duration of compensation for short-time employment. Net wages and salaries will also rise due to the fact that transport costs between home and workplace will remain fully tax deductible. The mixed income (i.e. from self-employment) and property income of private households is projected to increase by 1.0 percent in 2009. Taken together, all of these factors are expected to boost household disposable income by 1.8 percent in 2009.

118. The savings rate has been tending upward in recent years. Due to the public's increasing focus on the issue of old-age pensions as well as the support provided by the state for private pension plans, savings levels are expected to rise once again in 2009. The savings rate is expected to average 11.5 percent in 2009 after averaging 11.4 percent last year.

119. Given these trends in disposable income and savings rates, consumer spending is projected to rise in 2009 by 1.7 percent in current prices. Because the private consumption deflator is expected to increase by 0.9 percent this year, consumer spending is projected to grow at a price-adjusted rate of 0.8 percent in 2009. This means that – against the backdrop of the steep decline in other key indicators of aggregate demand – consumer spending is expected to have a stabilising effect on the German economy in 2009. The Consumer Climate Survey conducted by the Consumer Research Institute (*Gesellschaft für Konsumforschung*, GfK) in Nuremberg also indicates that consumer spending will play a stabilising role in 2009. According to the GfK survey, consumer sentiment has actually been improving in recent months despite the clear downward trend in industrial indicators.

Government consumption as a boosting factor

120. In 2009, growth in government consumption is expected to show a similar level of dynamism as in 2008. In year-on-year terms, government consumption is projected to increase by 4.7 percent in 2009. The main drivers of this increase are the ongoing growth in social benefits in kind – particularly in the area of statutory health insurance – as well as additional civil service salary increases that were agreed to in last year's collective wage agreement. Consequently, government consumption is expected to grow at a price-adjusted rate of 2.4 percent in 2009.

Price trends expected to remain calm

121. Last year, changes on the consumer price index were driven by a drastic increase in the price of oil from an average of 70 US dollars per barrel of Brent crude in 2007 to a peak of over 140 US dollars per barrel in mid-2008. By the end of 2008, the price had slid to under 40 US dollars per barrel. In accordance with the 2009 annual projection's technical assumptions concerning oil prices and exchange rates (see Item 105), the price of oil is expected to fall by nearly 50 percent in 2009 to 34 euros per barrel. This development, coupled with weak demand across the globe, will ease the rate of inflation considerably in 2009. Wages will not exercise any significant upward pressure on price levels this year. Increases in food prices are likely to ease considerably. Prices for energy commodities are likely to remain well below last year's averages. Due to statistical base effects, price levels may even fall during the course of 2009. However, these declines in price levels will be neither broad-based nor sustained. The consumer price index is projected to register an increase of 0.5 percent on average in 2009, well below the European Central Bank's stability target. If energy commodities and food are excluded, the consumer price index is expected to rise by 1.1 percent, i.e. at a higher rate than that of the index as a whole.

The labour market: caught in the grip of the economic downturn

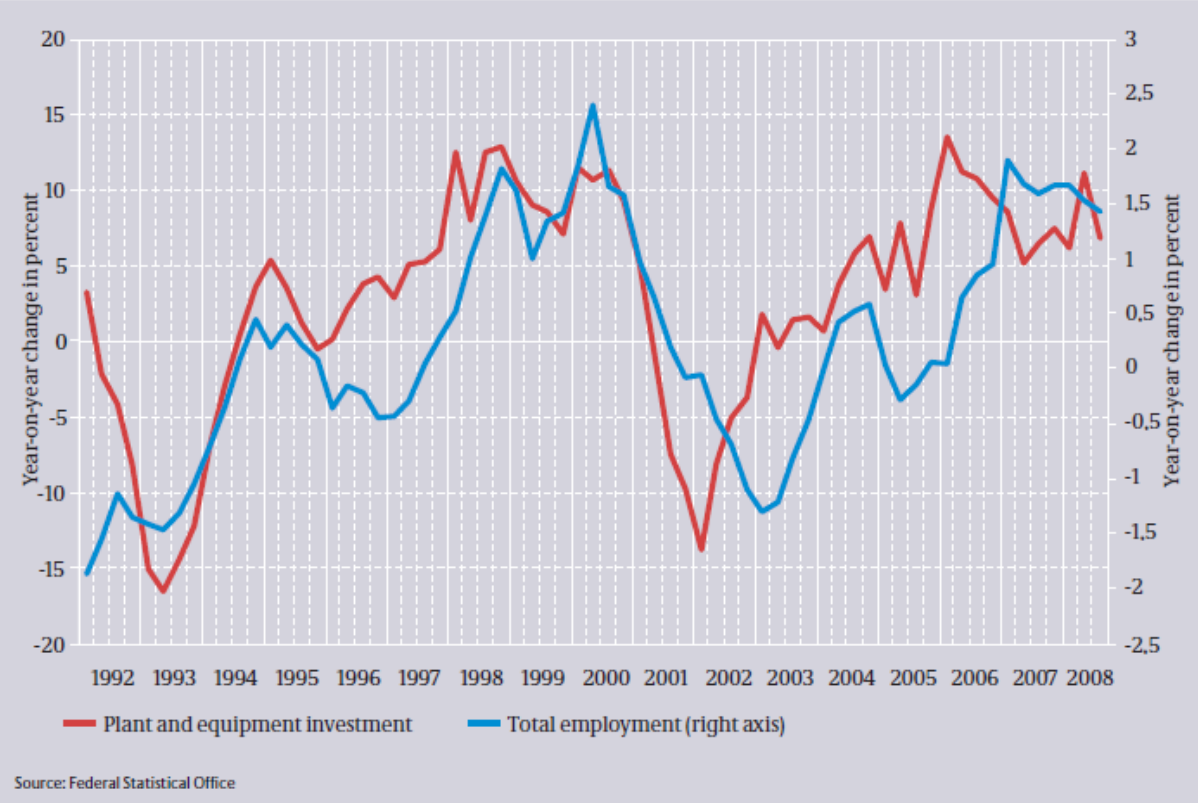
122. Positive developments on Germany's labour market continued through the end of 2008. Nevertheless, the level of dynamism on the labour market weakened noticeably in the final months of the year. Already in December 2008, the number of registered unemployed persons rose in seasonally adjusted terms for the first time since spring 2006. The Federal Government expects the number of registered

unemployed persons to be 250,000 higher on average in 2009 than in 2008. Due to a large statistical carry-over (because employment figures toward the end of 2008 were significantly lower than the annual average), this average annual increase in unemployment will be much lower than the actual rise in the number of registered unemployed throughout the course of 2009, which is expected to amount to 500,000 from the fourth quarter of 2008 through the fourth quarter of 2009. The rate of unemployment, as defined by the Federal Labour Agency, is projected to increase by 0.6 percentage points on average in 2009 to 8.4 percent. The comparable global unemployment rate as measured by the International Labour Organization (ILO) is expected to rise by 0.7 percentage points to 7.9 percent.

123. Compared to previous cycles, however, it appears at this time that the increase in unemployment will be less severe despite a global economic environment that is worse overall. During the period of global economic expansion that recently ended, certain sectors experienced shortfalls in the supply of skilled labour. Because the affected companies were unable to fully satisfy their demand for skilled employees, it is likely in the present situation that they will attempt to retain their core workforce at first. Initially, businesses will have their employees take off accumulated overtime hours or will extend holiday shutdowns in order to adjust output to declining demand. If these instruments are exhausted, firms are then likely to resort to short-time employment if necessary. The Federal Government expects a steep rise in the number of employees performing short-time work. In this connection, two key measures newly adopted by the German government – the extended duration of compensation for short-time employment, combined with government funding for 50 percent of the social insurance contributions that employers would otherwise have to shoulder alone for short-time workers – are expected to mitigate job losses. Demographic trends are also likely to dampen the anticipated rise in registered unemployment. In 2009, the number of older workers exiting the workforce will be higher than the number of younger workers entering it. The increased wage differentiation introduced in recent years should now have a stabilising effect on employment as well.

Rising registered unemployment will be mirrored by a decline in the number of employed persons as the economy weakens (on the relationship between plant/equipment investment and employment, see Figure 16). For the first time ever, total employment in Germany averaged over 40 million in 2008. The annual average is projected to fall by 300,000 in 2009, and total employment is expected to decline by roughly 700,000 over the course of the year.

Figure 16: Trends in plant/equipment investment and employment



A reversal in functional income distribution

124. Like nominal gross domestic product, national income is also expected to decline slightly in 2009. However, different types of income will develop in a divergent manner: while wages and salaries are expected to increase by 1.2 percent in 2009 (after increasing 3.6 percent in 2008), entrepreneurial and property income are expected to fall markedly by 2.9 percent (after rising by 1.7 percent in 2008). The drop in entrepreneurial and property income reflects in particular the heavy impact that the downturn is expected to have on export-oriented companies. It is quite normal for profit income to decline steeply during a cyclical downswing. This means that the distribution of income then shifts in favour of wage income. As a result, the share of wages (i.e. wages and salaries as a share of national income) will grow in 2009 for the first time since 2000.

Public budgets: absorbing the impact of the economic downturn and government stimulus plans

125. After achieving a nearly balanced national budget in 2008, total net borrowing in Germany will likely increase in 2009 to just under three percent in relation to nominal gross domestic product. This anticipated negative development is due primarily to the economic downturn itself as well as to the government measures that have been adopted to mitigate the crisis. The increase in net borrowing can be explained both cyclically (as automatic stabilisers are allowed to function to their full effect) as well as structurally (as discretionary measures are enacted to stabilise the economy). Thus Germany is pursuing a clearly expansionary fiscal policy in 2009 which is consistent with the decisions taken by the European Council as well as with the European Stability and Growth Pact.

Box 16: Review of the 2008 annual projection and actual outcomes

- In 2008, certain key risks that were mentioned in the 2008 Annual Economic Report as factors that could lead to less favourable outcomes did materialise. Consumer spending did not improve to the extent expected, the turmoil on financial markets snowballed into an outright financial crisis, and the world economy deteriorated more powerfully before the end of 2008 than anticipated. As a result, Germany – like other industrialised nations – has slipped into a deep recession.

- In the end, Germany's economy did not quite achieve the 1.7 percent growth rate that was forecast in the 2008 annual projection (see Table 4). To be sure, the German economy got off to a good start in 2008. But as the year progressed, economic activity began to decline markedly and slowed down even more sharply in the final months of the year. According to preliminary calculations, gross domestic product grew by 1.3 percent on average in 2008, i.e. 0.4 percentage points below the Federal Government's expectations at the outset of 2008.

- Consumer spending stagnated with a real growth rate of 0.0 percent in 2008, clearly below the projected real growth rate of 1.1 percent. This outcome can be attributed primarily to the loss of purchasing power that resulted from steep increases in energy and food prices as well as to a marked rise in the rate of savings.

- In contrast, real gross fixed capital formation grew better than expected, with an actual growth rate of 4.1 percent compared to the projected growth rate of 2.3 percent. This difference can be attributed primarily to plant and equipment investment which grew by 5.3 percent and thus exceeded expectations by 1.2 percentage points. The 2008 annual projection also forecast that the expiration of declining balance depreciation rules on 1 January 2008 would have a negative impact on the economy, but this impact did not occur to the full extent predicted. Investment in commercial construction also advanced at a higher rate than expected in connection with stronger plant and equipment investment.

- Overall, with a real growth rate of 1.6 percent, domestic demand grew somewhat more robustly than the 2008 annual projection had forecast.

- The 2008 annual projection expected foreign trade to provide a positive contribution to GDP growth of 0.4 percentage points. Instead, foreign trade slowed growth by 0.3 percentage points. In particular, export activity cooled off much more quickly than expected before the end of the year due to the rapid decline in global demand.

- In contrast, the labour market performed better in 2008 than the Federal Government had forecast. A total of 3.13 million persons were unemployed on average in 2008 – 300,000 fewer than anticipated. Likewise, total employment was 330,000 higher on average for the year than expected. These positive developments can be attributed primarily to labour market reforms and various data revisions. Gross wages and salaries also benefited as a result, rising 3.9 percent instead of the projected 3.1 percent.

- As the 2008 Annual Economic Report had forecast, the pace of consumer price increases cooled down over the course of the year. However, consumer prices ended up rising by 2.6 percent on average last year, 0.3 percentage points higher than expected. This increase was attributable, among other factors, to the steep rise in oil prices through mid-year.

- Public budgets fared considerably better than was expected at the beginning of 2008. Germany achieved a balanced national budget in 2008 despite the fact that state assistance provided to publicly owned banks – which had no cash effect – was also included in the accounting figures. Another factor that had a negative impact on the national budget was the government's partial reimbursement of the commuter tax allowance to private households (in response to the Federal Constitutional Court's decision), which was already posted on the national accounts in 2008. In contrast, substantially higher tax revenues had a clearly favourable effect on public budgets. The moderate reduction in net borrowing – which fell by roughly percentage point to 0.1 percent in relation to nominal gross domestic product – was attributable primarily to cyclical factors.

Table 4: Comparison between the 2008 annual projection and actual outcomes[31)]

	Annual projection 2008	Actual outcomes 2008
	Year-on-year changes in %	
Origin of gross domestic product (GDP)		
GDP (price-adjusted)	**1.7**	**1.3**
Employment (in Germany)	0.7	1.5
GDP per person employed	1.0	-0.2
GDP per hour worked	0.8	-0.1
Unemployment rate in % (according to national accounts) [32]	*7.8*	*7.2*
Unemployment rate in % (as defined by the Federal Labour Agency) [32]	*8.2*	*7.8*
Use of GDP (in current prices)		
Consumption expenditures		
Private households and private non-profit organisations	3.1	2.2
Government	3.0	4.0
Gross fixed capital formation	3.3	5.2
Changes in inventories (in billions of euros)	*-3.6*	*-2.9*
Domestic demand	3.2	3.5
Net foreign demand (in billions of euros)	*174.8*	*157.9*
(in % of GDP)	*7.0*	*6.3*
Gross domestic product (nominal)	**3.3**	**2.7**
Use of GDP (price-adjusted)		
Consumption expenditures		
Private households and private non-profit organisations	1.1	0.0
Government	1.0	2.2
Gross fixed capital formation	2.3	4.1
Machinery and equipment	4.1	5.3
Construction	0.5	2.8
Other plant and equipment	5.9	6.6
Changes in inventories (contribution to GDP growth rate) [33]	*0.1*	*0.3*
Domestic demand	1.4	1.6
Exports	5.8	3.9
Imports	5.9	5.1
Net foreign demand (contribution to GDP growth rate) [33]	*0.4*	*-0.3*
Gross domestic product (real)	**1.7**	**1.3**
Price trends (2000 = 100)		
Private consumption expenditures[34]	2.0	2.2
Domestic demand	1.8	1.9
Gross domestic product[35]	1.6	1.4
Distribution of gross national income (GNI) *(residence concept)*		
Wages and salaries	2.7	3.6
Entrepreneurial and property income	5.6	1.7
National income	3.7	2.9
Gross national income	3.2	2.7
Additional information (residence concept):		
Employed persons	0.7	1.6
Gross wages and salaries – total	3.1	3.9
– per person employed	2.4	2.3
Household disposable income	2.8	2.6
Savings rate in % [36]	*10.6*	*11.4*

[31] Up to 2008, preliminary figures from the Federal Statistical Office as of 14 January 2009.

[32] Based on total number of persons employed.

[33] Contribution to GDP growth rate.

[34] Year-on-year changes in the consumer price index: 2008: 2.3%; 2008: 2.6%.

[35] Year-on-year changes in unit labour costs: 2008: 0.4%; 2008: 2.1%.

[36] Savings as a percentage of household disposable income including pension fund reserves.

Index of key words

Non-wage labour costs
Minimum wage
MINT (mathematics, informatics, natural sciences and technology)
Employee shareholding schemes
Act to Modernise Framework Conditions for Capital Investments (MoRaKG)
Multilateral trade rules
Food prices
National Reform Programme
OECD
Job vacancies
Public investment
Public budgets
Public-private partnerships (PPPs)
Opt-out clauses
Oil and gas market strategy
Oil prices
Co-financed contributions to social insurance
Commuter tax allowance
Long-term care insurance
Postal services
Private households
Health insurance, private
Skills development initiative
Reform strategy
Pension increases, adjustments
Rescue package
Risk structure, balancing of
Borrowing rules
Emerging economies
Solidarity Pact II
Special Fund for the Stabilisation of Financial Markets (SoFFin)
Social Code
Social insurance contributions
Tax burden
Electricity and gas markets
Power grids
Collective wage agreements
Green rebate
Corporate tax reform (2008)
United States
Procurement law
Transport investment
Debt, indebtedness
Energy security
Crisis of confidence
Employment, full-time
Growth and employment potential
Growth promotion
Exchange rates
Advanced training for low-skilled and older workers employed in companies (WeGebAU) programme

Advanced training
World Bank
Global financial summit
Reunification
Housing benefit
World Trade Organization (WTO)
Temporary employment
Central banks
Central Innovation Programme for SMEs (ZIM)