Fiscal policy

The financial and economic crisis brought with it extreme levels of uncertainty and the risk of severe macroeconomic disturbance and damage. In this environment, public finances have made a major contribution to stabilisation in Germany. This was chiefly due to the fact that although public finances themselves deteriorated dramatically, the confidence in their long-term sustainability did not. The automatic stabilisers played a timely part in supporting overall economic momentum. This effect was supplemented by cuts in tax and social contribution rates and higher spending. In order to safeguard the stability of the financial markets, extensive schemes were launched to support financial institutions, as was also the case in other countries. In connection with the sovereign debt crisis in some euro-area countries, Greece was granted a loan, and potential refinancing problems in other euro-area countries were forestalled by issuing implicit guarantees of EU aid as well as explicit guarantees of a temporary European rescue mechanism.

Given the potential dangers, decisive fiscal policy responses were appropriate. However, the way in which some of these policies have been implemented is to be viewed critically, and the fundamental problems associated with actively managing the economy again became apparent. The final assessment of fiscal policy during the crisis will ultimately depend on whether it is possible to reduce the high structural deficit and quickly rein in both the soaring debt ratio and risks emanating from guarantees.

Compliance with the new national debt brake is essential in this situation. In the European context, the key lesson to be learnt from the crisis is the need to improve rules to safeguard sound public finances at European level. The existing fiscal framework failed to prevent the emergence of critical financial developments in some countries. Moreover, the crisis stretched the fiscal framework to breaking point, exposing its shortcomings and revealing the need for reform. As long as the euro-area countries continue to be responsible for their own national fiscal policy, rigorous compliance with the agreed budgetary rules has to be ensured so as to obviate the need for support measures to ward off the danger of serious repercussions. As a last resort, the restructuring of a country's sovereign debt should also be an option, although a suitable framework should be established for this to ensure that financial stability is not jeopardised. In addition, wider macroeconomic surveillance might help to identify severe distortions and imbalances earlier. However, ongoing macro-management of the economy is neither promising nor advisable – both at national and international level.

The effects of the crisis on German public finances

Dramatic worsening of public finances since crisis broke out

Public finances far worse

In the years prior to the financial and economic crisis, the public finance situation in Germany improved perceptibly. Although the debt ratio, at around 65%, breached the reference value specified in the common European regulations, the general government budget was all in all balanced in 2007 and 2008. The slump in macroeconomic activity that began in the second half of 2008 did not impinge on the 2008 budgets and, for the year as a whole, the overall economic environment was in fact still very favourable for public finances.[1] In 2009, however, the deficit ratio jumped to 3%. Based on current assessments, this figure is set to go up again in 2010 although, thanks to the brightening macroeconomic setting, the deficit ratio could remain well below the 4% mark. The wide financing gap is likely to be primarily structural. The debt ratio has soared and last year already reached 73½%. A further sharp rise is likely in 2010. In addition, there are extensive risks, in particular due to government support measures for the financial markets, the bulk of which took the form of guarantees. On the whole, the situation of public finances is now much worse than it was before the crisis.

Automatic stabilisers

Impact of economic slump on public finances in 2009

The automatic stabilisers, ie rising government spending on the labour market in the wake of the downturn and concomitant shortfalls in revenue from taxes and social contributions, made a major contribution to the deterioration of the fiscal balance in 2009.[2] The size of the impact was considerably dampened, though, because the variables that are particularly relevant for public finances – unemployment, gross wages and salaries, and private consumption – developed more steadily than GDP, which contracted sharply (see the chart on page 73).[3] By contrast, revenue from profit-related taxes plummeted after having recorded extremely sharp growth up to and including 2008. Overall, approximately €40 billion, or 1½% of GDP, of the deterioration in the fiscal balance in 2009 is likely to be attributable to the effects of the automatic stabilisers. In addition, there were shortfalls in profit-related taxes in the order of ½% of GDP, which can be interpreted as a correction of excessive revenue growth in the previous upturn.[4]

1 The cyclical component of the fiscal balance is calculated here using the disaggregated framework which is employed in the ESCB, see Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pp 61-76.
2 For the purposes of this article, the fiscal impact of the automatic stabilisers is equated to the change in the cyclical component of the general government deficit ratio.
3 This has been taken into account here by applying a disaggregated cyclical adjustment method rather than an aggregated approach based solely on GDP.
4 As revisions to macroeconomic forecasts also lead to a reassessment of the respective shares of the cyclical and trend components of economic growth, the above-mentioned estimates regarding the automatic stabilisers are provisional. For an analysis of the development of revenue from profit-related taxes, see Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 33-57, as well as R Morris et al (2009), Explaining government revenue windfalls and shortfalls: an analysis for selected EU countries, ECB Working Paper Series, No 1114.

Recovery in 2010

The counterswing in profit-related taxes might well run its course in 2010, while the economic recovery is likely to perceptibly improve the budget position via the automatic stabilisers (just under ½% of GDP). Mirroring last year's divergent development, the strong economic recovery will, however, not improve the deficit to the same extent as the sharp GDP growth suggests.

Expansionary fiscal measures

Discretionary responses to economic slump

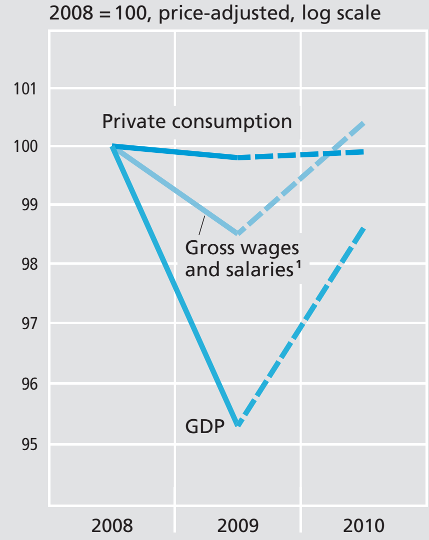
In addition to the automatic stabilisers, fiscal policymakers in Germany – and in a number of other countries – responded proactively to the economic slump with comprehensive stabilisation measures. However, initiatives explicitly taken to support economic momentum cannot be unambiguously distinguished from other fiscal measures and, in any case, such a distinction would not be appropriate for evaluating fiscal policy. The following analysis is therefore based on an estimate of the overall impact that fiscal policy measures have on the deficit.[5] Of particular importance was the fiscal loosening announced in October 2008 followed by the two economic stimulus packages, one in November 2008 and one in January 2009[6], and a smaller package of measures in mid-2009. At the end of 2009, further relief measures were implemented (see the table on page 74).

Bulk of measures permanent

Overall, the fiscal measures pushed up the deficit by 1½% of GDP in 2009 and by a further 1% of GDP in 2010. In terms of the financial volume, tax cuts, which are predominantly of a permanent nature, are particularly relevant on the revenue side. They are supplemented on the expenditure side by government investment, increases in child benefit, the car scrappage scheme and measures to support the labour market (*inter alia* more generous arrangements for short-time working benefits, see pages 61 to 63). All in all, less than half of the impact on the deficit is of a temporary nature, and a number of those measures that are temporary will only be phased out slowly.

GDP, private consumption and gross wages and salaries

2008 = 100, price-adjusted, log scale



Sources: data for 2008 and 2009: Federal Statistical Office; for 2010: joint assessment of the German economic research institutes from October 2010; Bundesbank calculations. — **1** Price-adjusted using the GDP deflator.

Deutsche Bundesbank

5 In particular, therefore, the effects of measures adopted earlier (eg withholding tax) and changes necessitated by other factors (eg reinstatement of the standard travel allowance for commuters following a ruling by the Federal Constitutional Court) are also included.
6 The measures implemented as part of the economic stimulus packages are described in more detail in Deutsche Bundesbank, Public Finances, Monthly Report, February 2009, pp 64-65.

Measures affecting the deficit in 2009 and 2010*

As a percentage of GDP, estimated change compared with 2008, deficit-increasing: +

Measures	2009	2010	2010 *of which* tem-porary
Total[1]	1.3	2.4	1.1
Package of measures announced in October 2008	0.3	0.6	0.0
of which			
Expanded deductibility of contributions to the health and long-term care insurance schemes from 2010 (following ruling of the Federal Constitutional Court)	–	0.4	–
Increase in child benefit from 2009	0.1	0.1	–
Lower contribution rate to the Federal Employment Agency 2009-2010	0.2	0.1	0.0
November 2008: economic stimulus package I	0.2	0.3	0.2
of which			
More favourable tax depreciation allowances 2009-2010	0.1	0.2	0.2
Investment in transport, economic promotion	0.1	0.1	0.1
January 2009: economic stimulus package II	0.7	1.1	0.6
of which			
Investment	0.1	0.3	0.3
Economic promotion in a broader sense (including €1.5 billion for the car scrappage scheme)	0.1	0.1	0.1
Income tax cuts in 2009 and 2010	0.1	0.2	–
Additional central government funds for the statutory health insurance scheme to finance the cut in the contribution rate from July 2009	0.1	0.3	–
Support for the labour market (short-time working benefits, reintegration, training, placement), rise in contribution rate to the Federal Employment Agency postponed	0.1	0.2	0.2
Transfers to families (child bonus, higher child benefits under the Second Book of the Social Security Code)	0.1	0.0	0.0
Between end of 2008 and mid-2009: various additional measures	0.2	0.2	0.1
of which			
Reinstatement of the 2006 standard travel allowance for commuters from 2009 (end of 2008/start of 2009; following ruling of the Federal Constitutional Court)	0.0	0.1	–
Extension of the car scrappage scheme (April 2009)	0.1	0.0	0.0
Tax relief measures for enterprises (mid-2009)	0.1	0.0	0.0
End of 2009: various measures by the newly elected German government from 2010	–	0.4	0.2
of which			
Increase in child benefit	–	0.1	–
Tax relief measures (above all business tax, lower turnover tax rate for hotel stays, inheritance tax)	–	0.1	–
Increase in central government grant to the statutory health insurance scheme	–	0.2	0.2

Source: Federal Ministry of Finance, Bundesbank calculations. — * The values reported here have generally been taken from the respective draft legislation, but in some cases they have been adjusted to recent information and the underlying national accounts definition (for instance, measures from the Investment and Repayment Fund have been allocated based on the timing of the outflow of funds). Behavioural adjustments as a result of the measures, such as cuts in other government expenditure on the labour market or on investment, are disregarded. The financial impact of the measures is therefore not fully captured. — **1** The following list contains only the most important measures.

Deutsche Bundesbank

Special measures to stabilise financial institutions and euro-area member states

Support for financial institutions

In addition to the above-mentioned fiscal measures, extensive support measures for financial institutions were taken in order to directly limit the consequences of the crisis on financial markets. For instance, Industriekreditbank (IKB) received support from the KfW banking group and the German government as early as 2007 and 2008 and was later sold. Following the insolvency of Lehman Brothers and the ensuing escalation of liquidity and solvency problems in the financial sector, a special Federal fund – the Financial Market Stabilisation Fund (*Sonderfonds Finanzmarktstabilisierung,* SoFFin)[7] – was set up in October 2008 to prevent serious repercussions for the real economy resulting from the possible collapse of further systemically important financial institutions in the wake of the crisis. SoFFin is assigned to the general government sector and its purpose is to stabilise domestic financial institutions by means of guarantees (up to a maximum of €400 billion), recapitalisations and risk assumptions (up to the limits of the maximum credit facility of €80 billion). In July 2009, "bad bank" and consolidation models were adopted under which financial assets subject to a severe impairment risk as well as (in the consolidation model) risk positions and individual business units can be hived off to government-backed special purpose entities. In addition, a number of Federal states notably gave assistance to state-owned financial institutions (WestLB, BayernLB, HSH Nordbank, LBBW, SachsenLB, NordLB) by means of capital injections or guarantees for securing or hiving off risk assets and for issuing bank debt securities.

Support for highly indebted euro-area countries

In a number of euro-area member states, public finances deteriorated – not wholly but partly due to the crisis – to such an extent that doubts arose as to their solvency. The resulting risks came to a dramatic head. As a result, in May 2010 the euro-area finance ministers and the IMF decided to support the necessary consolidation process in Greece, which faced an acute risk of insolvency, by granting a loan based on strict conditionality. The aim was to prevent contagion effects from jeopardising the stability of the entire euro-area financial system. Even before the euro-area finance ministers could finalise the package, the situation on the capital markets escalated. They therefore agreed on a European Stabilisation Mechanism comprising two modules which can be used to grant loans subject to various conditions, especially consolidation requirements. In the first module, the European Financial Stabilisation Mechanism (EFSM), which has an unlimited duration, is provided with an EU credit line equivalent to €60 billion.[8] Borrowing by the new "European Financial Stabilisation Facility" (EFSF) special purpose vehicle is backed by guarantees from euro-area member states

7 See also Deutsche Bundesbank, Cornerstones of the Financial Market Stabilisation Act (Finanzmarktstabilisierungsgesetz), Monthly Report, November 2008, pp 30-31, and Deutsche Bundesbank, Annual Report 2009, p 91.
8 However, based on the Council decision of 9-10 May 2010, the maximum amount of the EFSM credit line is not absolute but is determined by the difference between the own funds ceiling and the payment appropriations of the EU budget.

Effects of the interventions to support financial institutions and euro-area countries on the Maastricht deficit and debt level

The Maastricht deficit and the Maastricht debt level play a pivotal role in the European fiscal framework. They are essentially calculated on the basis of the rules established by the European System of Accounts 1995 (ESA 95), which stipulate that transactions should be recorded in such a way as to reflect the economic reality behind them. In individual cases, this can mean, for example, that entities or transactions that are not recorded directly in government budgets are attributed to general government in the national accounts. Responsibility for providing a concrete interpretation of the ESA rules – the need for which has become apparent in some cases – and for monitoring their application lies with Eurostat. However, in view of the high complexity of the underlying transactions, the difficulties sometimes experienced when categorising transactions within the elaborate system of rules, existing alternative booking and accounting options and occasional information deficiencies, it cannot be ruled out that interventions of a similar economic substance may ultimately be recorded differently. It is therefore crucial for the EU budget rules in particular that statistical recording is transparent and free from political influence.

The Maastricht deficit and gross debt level are intended to function as indicators which, as far as possible, measure the fiscal situation in a way that is precise, allows comparability over time and across countries and enables a prompt implementation of budgetary surveillance. The Maastricht deficit reflects the change in general government net financial assets/liabilities caused by transactions. The Maastricht debt level records general government gross debt (at nominal values).[1] Of course, this indebtedness represents only part of the government's overall fiscal position and takes no account of existing financial or non-financial assets. For example, debt-financed acquisitions of financial assets increase gross debt, whereas the change in the net asset position depends on the underlying value of the financial assets acquired. Valuation issues are particularly complicated in the context of public interventions during financial market crises.

Interventions to support financial institutions[2]

The aim of public interventions providing direct support to financial institutions can be to improve solvency, such as through recapitalisations or assistance in the area of risk positions. However, they can also be targeted at improving the liquidity situation, often through guarantees for bank debt securities.

From the onset of the financial market crisis until the end of the first half of 2010, government recapitalisations amounting to a total of €47½ billion were conducted in Germany (see table on p 78). In the statistics, such recapitalisations are usually only recorded in full as financial asset acquisitions if the government is acting in a similar way to a private investor, with corresponding expectations of a return on the investment. Then, the deficit is not affected, although the gross debt level increases if the transaction is debt-financed. To facilitate statistical recording in times of crisis, when uncertainty is high, a Eurostat decision announced in July 2009 stipulates that recapitalisations are, as a general rule, to be recorded as having no impact on the deficit if the EU State Aid rules on rates of return are complied with. By contrast, deficit-increasing capital transfers are booked if capital reserves are increased at banks which have been recording losses for several periods and if no additional ownership rights or other entitlements to return are acquired (such as in the case of HRE). A deficit is likewise recorded if a recapitalisation exceeds the sales proceeds achieved through a timely privatisation (as in the case of IKB). In total, €7½ billion of the capital measures in Germany were recorded in the deficit.

The offloading of financial institutions' risk positions to external entities often occurs at above-market prices. These entities thus take on market value losses and the risks associated with future performance, which – in the case of settlement via special purpose entities backed and controlled by general government – is a key reason for them being classified in the general government sector.[3] The government backing can take the form of guarantees, capital or a combination of the two. This generally leads to a reduction in the balance sheet of the institution receiving the support, while the general government balance sheet is extended and the gross debt level (ie without deduction of the assets acquired) rises. The direct impact on the deficit corresponds to the difference between the purchase price[4] and the market price. By contrast, subsequent (unrealised or realised) decreases in value have no further impact on the deficit (as they are booked as revaluations)[5], although they would curtail the reduction in gross indebtedness resulting from realisation. Owing to valuation problems during the financial crisis, the Eurostat decision of July 2009 allows for alternative approaches to approximating market prices, although in most cases – contrary to the usual procedure – subsequent (realised) asset losses are to be booked as having an impact on the deficit. As things stand, a total of €65 billion from the First Winding-up Agency (*Erste Abwicklungsanstalt*), including Phoenix (WestLB) and the special purpose entity Sealink-Funding (SachsenLB) set up in 2008, is included in Germany's debt level. On the basis of the available valuations, the effect

1 The Maastricht debt level records explicit indebtedness; it does not include implicit liabilities, such as those arising from a pay-as-you-go pension system, or potential liabilities, such as those resulting from guarantees. — **2** In July 2009, a special Eurostat decision was published on the statistical recording of interventions conducted in the course of the financial crisis. This decision is valid for a limited period of time and aims to take account of the particular challenges for statisticians raised by aspects of the crisis. See also Deutsche Bundesbank, Public finances, Monthly Report, August 2009, pp 77-81. The original decision was modified in September 2009 through a supplementary accounting guidance note. — **3** The Eurostat decision published in July 2009 and the guidance note released in September 2009 led to a (temporary) softening of the rules for majority privately owned special purpose vehicles. Provided that these are only active in acquiring assets (including granting loans) for a short temporary duration and have the sole purpose of addressing the financial crisis, they can be recorded outside the general government sector even if they receive a government guarantee and are subject to government

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on the deficit was confined to just under €2½ billion. Pursuant to the Eurostat decision, further deficits could arise in the future wherever market prices were not taken as the basis for calculations. According to the Federal Ministry of Finance, the potential impact on the debt level arising from the transfer of assets to the HRE resolution agency at the end of the third quarter could reach 8½% of GDP.

Government guarantees are contingent liabilities and are usually only recorded once they have been called. The guarantees provided in the context of the financial market support measures amounted to around €182½ billion in mid-2010. This figure does not include guarantees for entities which are already classified in the general government sector or – as in the case of the LBBW entity – are collateralised by a debt-financed deposit and are thus already reflected in the debt level. Most of the €182½ billion was accounted for by guarantees from the Financial Market Stabilisation Fund (*Sonderfonds Finanzmarktstabilisierung* or *SoFFin*) on debt securities issued by financial institutions that should generally have an adequate capital base, meaning that the probability of a call on the guarantees is likely to remain low. However, guarantees of just under €15 billion were also provided for risky bank assets (BayernLB, HSH Nordbank); the likelihood of a call on these guarantees could well be considerably higher, leading in some cases to corresponding commitment appropriations in the budgets.

As a basic principle, ESA provides for transactions to be classified according to the economic reality that they reflect. Eurostat initially decided that the KfW banking group's intervention to support IKB in 2007 should be recorded in the central government budget even though KfW itself belongs to the financial corporations sector. In Eurostat's view, it was clear that KfW had not acted in its own business interests but, ultimately, on behalf of the Federal Government in order to safeguard financial market stability in Germany. However, Eurostat reversed this assessment in its decision of July 2009, stipulating that written or other irrefutable evidence that the institution was acting on government instructions was a precondition for such a reclassification. The losses recorded by KfW in the course of the IKB rescue (almost €8½ billion) now have only an indirect effect on government accounts through a devaluation of its shareholding in KfW, which is recorded as having no impact on the deficit.

Interventions to support euro-area countries

For the loans to Greece – provided, in Germany's case, via KfW by means of an official assignment backed by a guarantee from the Federal Government – there is irrefutable evidence that KfW is acting on government instructions.[6] The associated exposures incurred by KfW are attributed to general government in the national accounts, ie as a loan from the Federal Government of Germany to Greece financed through notional borrowing from KfW. Up to the end of the first half of 2010, €4½ billion (of a total of €22½ billion planned for the period up to 2013) was booked for the first tranche as increasing the debt level.

If the EFSF were to grant loans to euro-area countries in difficulty, it would likewise seem appropriate to record this as increasing the debt level in the accounts of the member states providing the guarantee. In accordance with the Eurogroup agreements reached at the beginning of June 2010, loans are to be provided as required via a special purpose vehicle established under Luxembourgish law. The euro-area member states guarantee its funding in accordance with their share in the paid-up capital of the ECB.[7] All key decisions regarding the granting of lending facilities or the disbursement of funds must be taken unanimously by the countries providing the guarantee. The special purpose vehicle itself does not take any decisions on whether to disburse loans; ultimately, it merely implements support measures on behalf and at the risk of the euro-area countries. While the guarantee undertakings themselves are not initially booked in the national accounts, if the special purpose vehicle were to take up or grant loans on the instruction of the countries providing the guarantee, this would – like Germany's lending to Greece via KfW – need to be recorded as having an impact on the debt level of the guarantor states. The gross debt level and the stock of financial assets would rise accordingly. By contrast, the deficit would probably only be affected in the event of defaults in the form of debt cancellations. Although a final decision regarding the statistical recording of such transactions has yet to be reached, at the most recent meeting of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) in July 2010, Eurostat expressed its support for booking them in such a way that the debt level increases. This would seem appropriate given the orientation towards reflecting the economic reality behind transactions. Furthermore, the alternative of establishing "off-balance-sheet" mechanisms, which could be used to implement fiscal policy measures above and beyond the existing borrowing limits, would run counter to the reform objective, namely the strengthening of fiscal discipline and statistical rigour, and could potentially create new leeway for bypassing budgetary rules.

control if the expected losses are small in comparison with their liabilities resulting from these activities. — **4** When calculating the purchase price, account would have to be taken of any nominal capital amount contributed to the government resolution agency by the transferring institution. Naturally, this does not alter the fact that the ESA balance sheet of such a government special purpose entity would usually be likely to show negative capital on the basis of market values. — **5** However, this is not true of debt cancellations, which constitute transactions and must, in all cases, be booked as a capital transfer. — **6** The basis for this is the Monetary Union Financial Stability Act (Währungsunion-Finanzstabilitätsgesetz) passed on 7 May 2010. — **7** In Germany, the guarantee provision is based on the Act Assuming Guarantees in Connection with a European Stabilisation Mechanism (Gesetz zur Übernahme von Gewährleistungen im Rahmen eines europäischen Stabilisierungsmechanismus) of 22 May 2010.

Public interventions to support financial institutions and euro-area countries

€ bn, until end of 2010 Q2

Interventions to support ... [1]	Deficit	Debt level	Contingent liabilities [2]
... financial institutions			
Recapitalisations	7.4	[4] 47.3	.
Acquisition of assets through special purpose entities	2.4	[4] 65.0	.
Other (LBBW deposits; guarantees)	.	12.7	182.5
... euro-area countries [3]			
Greece	.	4.4	17.9
EFSF	.	.	147.6

1 Effects of interest income, interest expenditure and guarantee fees on deficit and debt level not included. — **2** Excluding guarantees for government-sector entities or interventions already reflected in the debt level. — **3** Contingent liabilities equal to the (as yet unused) maximum guarantee authorisation. — **4** Including any disposals or return flows.

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totalling €440 billion.[9] Euro-area countries with solvency problems can apply for EFSF loans up to the end of June 2013. It is envisaged that the Facility will generally operate *in tandem* with the IMF, as was the case with the aid granted to Greece. Ultimately, the risks arising from potential loans under the two modules are borne by the member countries.

Risks and burdens only partially reflected in Maastricht ratios

The measures to support financial institutions and euro-area countries facing imminent solvency problems entail large burdens and risks for public finances in Germany. However, these are only partly reflected in the Maastricht ratios on which public attention is usually focused. In particular, underwriting guarantees appear in the ratios as contingent liabilities as a rule only once they have been taken up (see also the box on pages 76 and 77).

Interim assessment

On balance, the support measures for financial institutions in Germany increased the deficit by 0.1% of GDP in both 2008 and 2009 and the debt level by a total of 4% of GDP by the end of 2009.[10] The government guarantees for financial institutions granted on account of the crisis amounted to 7% of GDP.[11] In 2010, resolution agencies set up to support WestLB and HRE are notably expected to lever up the deficit and debt levels. Eurostat has already ruled that the First Winding-up Agency (WestLB) – and consequently its debt – is to be assigned to the general government sector, which will push up the debt level by a further 1% of GDP.[12] Additional debt amounting to 1% of GDP is expected to accumulate up to 2013 from the German contribution to loans for Greece.

Hard to assess the extent of risks

It is impossible at the moment to say just how great a burden the commitments entered into in connection with supporting financial institutions and highly indebted euro-area states will end up placing on the German government's budget. It should be noted that although a large part of the above-men-

9 The volume of the loans actually issued is smaller than the volume of guarantees, inter alia due to a planned overcollateralisation of 120% and the fact that the EFSF sets up cash reserves when granting a loan. The lending volume available is therefore likely to be below €300 billion.
10 This includes inter alia revenue effects (such as guarantee fees).
11 This excludes government guarantees for public sector entities.
12 It should be noted that the debt of the "Phoenix" special purpose vehicle of €23 billion, which is reflected in the balance sheet of the First Winding-up Agency, has been included in the debt level since 2008.

tioned gross debt is statistically offset by a corresponding formation of assets (eg in the form of a credit claim), the government may remain saddled with asset losses after its current intervention expires. Reliably quantifying the extent to which the guarantees assumed to date will eventually turn into financial burdens is currently just as difficult as assessing the risks from other fiscal and monetary stabilisation measures. Furthermore, SoFFin's facilities can still be applied for until the end of the year.[13] Moreover, other member states could take up loans from either module of the European Stabilisation Mechanism. Lastly, Germany bears financial risks as a shareholder of the IMF and, to the extent of its paid-up capital share in the ECB, owing to the extension of the Eurosystem's eligible collateral framework and the bond purchase programme which the Eurosystem launched in May 2010.

Assessing the fiscal stabilisation impact

High uncertainty when gauging fiscal stabilisation impact

After the sharp slump in economic activity in the latter part of 2008 and the first part of 2009, the German economy began to stabilise in the second quarter of 2009 and is now growing again at a considerable pace. Although uncertainty persists, the financial markets are also currently in much better shape than they were at the peaks of the various phases of the crisis. It is extremely difficult, however, to gauge the extent to which this is attributable to the fiscal measures taken. It is particularly hard to assess the effects of measures to stabilise the financial markets and possible alternative courses of action. All in all, had no measures been taken to support the financial markets, the economy would have run the danger of plunging into an even more dramatic downturn, so that the impact of the stabilisation measures, albeit not quantifiable, may be assessed as being very large.

Simulation results dependent on model

It appears more feasible to quantify the impact of other fiscal measures and of the automatic stabilisers. Yet it must be pointed out that the results vary from model to model and that it is especially difficult to model the peculiarities of the financial and economic crisis. On the one hand, given the extremely high level of uncertainty and the significant deterioration in public finances, the fiscal measures adopted to boost macroeconomic demand may have been counteracted to a greater degree than usual by increased precautionary saving and efforts to partially compensate for asset losses sustained. Furthermore, the fact that many German enterprises were in a positive financial position when the crisis hit is likely to have helped them survive without government aid. On the other hand, capacities were seriously underutilised, the capital markets appeared to consider the long-term sustainability of German public finances not to be severely impaired, and government action to combat the crisis may have boosted confidence in its ability to overcome it. Finally, models are generally not designed to consider the extent to which the economy might have nosedived into a spiralling macro-

13 The measures may also entail a longer commitment. Moreover, part of SoFFin's existing guarantee and loan authorisations are to be transferred to the planned Restructuring Fund (a new special Federal fund managed by the Financial Market Stabilisation Agency).

economic downturn with mutually reinforcing feedback effects between the real economy and the financial system.

Decline in GDP in 2009 mitigated by measures and automatic stabilisers

According to a simulation using the Bundesbank's macroeconomic model, the decline in real GDP in 2009 would have been around 1 percentage point stronger before factoring in the deficit-increasing measures amounting to 1½% of GDP. This was chiefly attributable to the car scrappage scheme which triggered considerable frontloading effects.[14] The automatic stabilisers additionally curbed the decline in GDP by a similar magnitude. By contrast, the model suggests that the exceptional development of profit-related taxes mentioned above is likely to have generated only a small stabilising effect. Overall, the model simulation shows that discretionary measures and the automatic stabilisers had a positive effect of roughly 2% on GDP in 2009.

Fiscal measures still generating positive stimulus in 2010

Fiscal measures will raise the deficit ratio further in 2010 by approximately 1 percentage point. Yet the net growth effect will amount to little more than ½ percentage point, not least owing to the sharp curbing of demand following the ending of the car scrappage scheme. By contrast, the automatic stabilisers will tend to trim the deficit thanks to the positive overall economic momentum, although the fact that the macroeconomic growth structure (unlike in 2009) is now less favourable for public finances will dampen this effect (see chart on page 73).

Assessing fiscal policy during the crisis

Fiscal stabilisation requires confidence in sustainable public finances

In principle, fiscal policy can play an important role in stabilising financial markets and macroeconomic development. However, a crucial requirement for this is sound public finances. Developments in a number of EU countries during the crisis have shown that rising general government deficits and debt can actually have a destabilising effect if confidence in the long-term sustainability of public finances dwindles.

Financial market stabilisation measures appropriate on the whole

In the exceptional situation of the financial and economic crisis, it was appropriate for the German government to stabilise domestic financial institutions as well as – as the crisis progressed – other EU states. There was a danger of even greater disruptions to the financial markets with severe implications for the real economy. However, the aim for the future should be to reform the regulation and supervision of financial markets with a view to more reliably underpinning financial stability and generally enhancing the individual responsibility of market players so as to nip distortionary developments in the bud, wherever possible without necessitating government aid. The rules for public finances stipulated at European level require a complete overhaul,

14 Whereas the car scrappage scheme caused a net rise of around ¼% in GDP in 2009, its discontinuation is having an even greater reverse impact in 2010 as not only the additional demand generated in 2009 but also the consumption that was brought forward has now dropped out. Furthermore, the calculations also take account of the fact that the automatic stabilisers would have had a greater impact had there been no discretionary measures, thus curbing the decline in GDP to a larger extent. By contrast, the effects of measures that do not affect the deficit, such as guarantees and support measures for the financial sector, on economic development are generally disregarded.

not least with these aims in mind (see pages 83 to 84).

Timely cyclical smoothing via automatic stabilisers

In the recent crisis, the automatic stabilisers likewise made a timely and perceptible contribution to stabilisation and significantly mitigated the economic slump. The automatic stabilisers are particularly suited to smoothing cyclical fluctuations through the vehicle of public finances as they are not reliant on protracted discussion and decision-making processes and operate symmetrically over the business cycle.

Fiscal stimulus justified by exceptional situation

Recent experience confirms that using fiscal policy to actively stimulate the economy should be viewed sceptically. However, in the exceptional situation of the crisis it was justifiable and useful to provide an expansionary fiscal stimulus, even if this has once again highlighted the concrete problems that are associated with such an interventionist policy.

Requirements of fiscal stimulus measures ...

The fundamental objective of a fiscal stimulus is to boost economic activity by temporarily increasing aggregate demand during a phase in which supply-side output capacities are not being utilised to their full potential. An expansionary stimulus during a downturn must be counterbalanced by restrictive measures in good times, however, if a permanent increase in indebtedness is to be avoided. Economic stimulus packages should therefore have a timely impact and be of limited duration. It is also advantageous if they are narrowly targeted and thus have a high multiplier effect, and if they do not hamper other fiscal policy goals by generating misallocation or distortions.

... often not met in the past ...

However, past experience has shown that, due to the delays in identifying a downturn, in deciding and implementing the fiscal measures and in the time it takes for them to take effect, measures aimed at kick-starting the economy often do not begin to have an impact until the economy is already on the path to recovery. In addition, it is often difficult to promptly decide whether the causes of a downturn are cyclical, and therefore temporary, or structural. In the latter case, economic stimulus programmes actually slow down the economy's necessary adjustment process. In many cases, the stimulus measures are not of limited duration and, in the following upswing, the necessary consolidation steps are often not taken for reasons of political expedience. Furthermore, there is a temptation to misuse fiscal policy for short-term impulses, especially ahead of elections.

... and only partially met in this crisis, too

When macroeconomic risks are as exceptionally high as they were at the turn of 2008-2009, it is nonetheless appropriate in principle to resort *inter alia* to fiscal stimulus measures to try and mitigate abrupt and steep slumps. However, the measures taken only partially met the aforementioned requirements. The two economic stimulus packages of November 2008 and January 2009 were adopted promptly at a time when the full brunt of the recession was only just emerging (see the chart on page 83). Yet – leaving aside the non-quantifiable confidence-boosting effects of the announcements – these packages mainly did not begin to take effect until the second quarter of 2009, and a significant part of the active fiscal expansion is taking place now in 2010, that is in a phase in which the economy would very probably have continued to recover even without additional stimuli.[15] It would have been better to focus the second economic stimulus package more on 2009. The Act to Accelerate Growth (*Wachstumsbeschleunigungsgesetz*) adopted at the end of 2009, which extended the scope of the measures to 2010, was superfluous even at the time of its adoption. Its superfluity has been further highlighted by the fact that growth in 2010 is now expected to be very sharp. Furthermore, over half of the measures taken will put a permanent strain on public finances; it would have been preferable to restrict the duration of these measures. The car scrappage scheme is one example of a measure that was relatively effective in terms of stimulating economic activity in the short term, but overall was somewhat problematic (see page 50).

At national level, adoption of new budgetary rules of key importance

A key criterion for assessing the fiscal policy track record during the crisis is the extent to which public confidence in the sustainability of public finances remained intact. Credible budgetary rules can play a crucial role in achieving this. Not only can they lower the risk premiums on interest payable, they also prevent an additional unsettling of consumers and investors. This in turn makes it possible for monetary policymakers to maintain price stability at low interest rates. At national level, it was thus of particular significance and especially welcome that the expansionary fiscal measures in Germany were linked to the adoption of new constitutional budgetary rules which will significantly restrict the future scope for borrowing and will mean that the rules are not as easy to circumvent as they were in the past by invoking loosely defined exemption clauses and exploiting other loopholes. A transitional arrangement has mapped out a sound consolidation path. Thus central government's structural new borrowing is to be cut in equal stages from the level reached in 2010 to a maximum of 0.35% of GDP by 2016, while state governments must have eliminated their deficits entirely by 2020 at the latest.

Necessary reform of European fiscal framework still outstanding

There is as yet no comparable tightening of budgetary rules at European level. The current regulations and their implementation by the responsible institutions have proven insufficient. In a number of EU member states, severe fiscal distortions could not be prevented and, in some cases, this resulted in a loss of confidence in the sustainability of public finances.

Foundations of monetary union need reinforcing

In addition, the foundations of monetary union, one of which is the member states' national autonomy for their own fiscal policy, were stretched to breaking point by the support package for Greece, which was agreed at the beginning of May 2010, and then again only a week later by the decision to set up the European Stabilisation Mechanism. However, given the short-term risks for the stability of the financial markets and European monetary union, intervention in this particular situation was justifiable in spite of fundamental concerns. The reform of the European fiscal framework that is currently

15 One noteworthy exception here is the car scrappage scheme which triggered a clear increase in registrations of new cars as early as February 2009.

being debated thus needs to focus on stabilising and reinforcing the weakened foundations of monetary union.

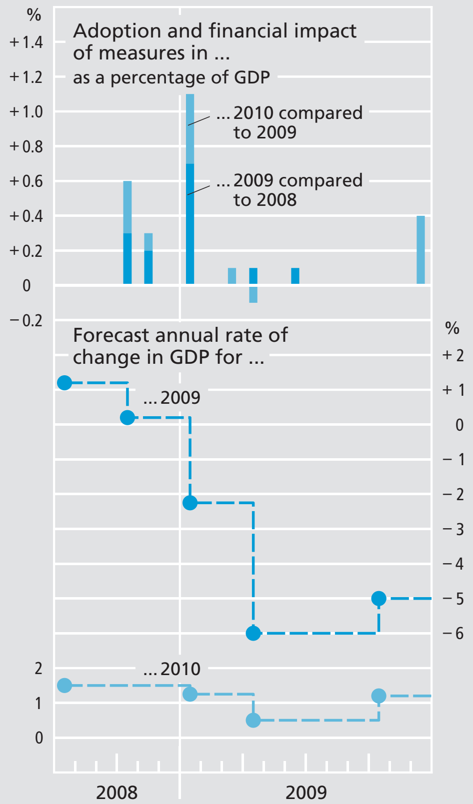
Need to strengthen statistical basis as well as Stability and Growth Pact

In order to prevent future crises, the statistical basis of the budgetary surveillance procedure has to be improved so as to ensure that the information available for analysing government budgetary developments is reliable. In addition, the Stability and Growth Pact must be made more stringent. The crisis has underlined the particular relevance of the debt criterion which, so far, has not been given sufficient importance. Rules should be laid down for debt ratios in excess of 60% spelling out a timetable for their reduction and the sanctions for non-compliance. It is also essential to improve the often inadequate implementation of the rules, for example by making the imposition of sanctions more rule-bound and less subject to political bargaining. The European Commission's proposals on reforming the Stability and Growth Pact put forward at the end of September 2010 are a step in the right direction.

Centralised fine-tuning should be avoided

As a complement to the fiscal framework, a greater measure of macroeconomic surveillance at European level may also contribute to the timelier detection of serious distortions and imbalances. However, the independence of monetary policy and autonomous responsibility for national fiscal policies, which persists at the present stage of EU integration, as well as the subsidiarity principle must be upheld. Nor may this lead to centralised fiscal and economic policy fine-tuning. The crisis again exposed the limits of such central macro-management at supranational level in

Real-time forecasts of real gross domestic product and adoption of fiscal policy measures*



Sources: Federal Ministry of Finance, Federal Ministry of Economics and Technology, Bundesbank calculations. — * Forecasts from the government's spring and autumn estimates as well as the updates to the German stability programme of December 2008 and January 2009. For information on the measures, see the table on p 74.

Deutsche Bundesbank

Europe when the EU bodies combined their call for deficit-increasing measures as part of the European Economic Recovery Plan with the prospect of a generous interpretation of the fiscal rules. This further eroded confidence in the sustainability of public finances in a number of countries.

However, even greatly improved prevention mechanisms in the context of budgetary rules

Creditors should be more involved in crisis resolution in future

can offer no promise that euro-area countries will not experience financing problems in the future. For this eventuality an orderly restructuring of the affected country's sovereign debt should be considered so that creditors, too, are involved in resolving the crisis, not least with a view to underpinning the no-bail-out clause anchored in the Treaty on the Functioning of the European Union. Together with better regulation and supervision of the financial markets, this can help limit risks to financial stability. This would, in sum, accord with the principle of national fiscal responsibility, and higher interest rates for countries pursuing unsound fiscal policy as compensation for the risk of partial defaults could exert a disciplinary effect from the outset via market mechanisms. If, during systemic crises, the option of financial support is nevertheless chosen as a last resort in order to avoid jeopardising financial stability in the euro area, the resulting moral hazard can be contained by charging appropriate interest rate premiums on loans granted and by attaching strict conditionality. If this conditionality is infringed, then tough sanctions must definitely be imposed.

Exiting expansionary fiscal policy in Germany

Consolidation requirements under excessive deficit procedure rather unambitious

Now that the German economy has turned the corner and is expanding at a rapid pace again, it is essential to swiftly correct the dramatic deterioration of the public finance situation that arose during the crisis. The deficits have to be reduced rapidly and the rise in the debt ratio has to be stopped, then reversed.[16] In the current excessive deficit procedure against Germany, the Ecofin Council has stipulated steps to correct the excessive deficit by 2013 at the latest as a minimum requirement at European level. This deadline was already rather unambitious when it was set and, as things currently stand, Germany should push its deficit back below the 3% ceiling next year already. Once this has been achieved, the next objective is to implement measures to achieve a structurally balanced budget.

National debt brake must be rigorously implemented

At national level, the new debt brake specifies minimum consolidation requirements for central and state government. In its draft budget for 2011 and medium-term financial plan up to 2014, central government has clearly bound itself to the new borrowing limit. In particular, it has not yielded to the temptation to backload the necessary consolidation process by artificially inflating the starting deficit in 2010 used as the baseline structural borrowing limit for the transitional period from 2011. In keeping with this logic, the starting point has to be adjusted again to take account of most recent developments when the 2011 budget receives final parliamentary approval in November. It would also be advisable to plan in a safety margin for unforeseen budgetary burdens in order to avoid having to make readjustments at short notice. However, according to current plans for 2011 and the medium term, the deficit will regularly come close to reaching the ceiling. Furthermore, some consolidation measures

Safety margin with respect to borrowing limit required

16 See Deutsche Bundesbank, The cyclical effects of concurrent fiscal consolidation within the euro area, Monthly Report, July 2010, pp 30-31.

that have been included in the planning are yet to be spelled out in detail.

Buoyant conjuncture should be used to reduce deficit faster

The crisis has driven home the need for sound public finances. In view of high general government deficits and debt, considerable additional risks – in particular from underwriting guarantees – and, not least, foreseeable demographic burdens, any better-than-expected development, for example of tax revenue, labour market-related expenditure or interest payments, should be used to reduce the deficit faster and not as an excuse to increase spending or cut taxes. This would also be in line with the fundamental intent of both the national and European fiscal frameworks. Politically it is doubtless harder to consolidate public finances than to implement expansionary measures. Yet recent events have underscored the fact that a failure to maintain budgetary discipline in better times significantly inhibits the government's scope for action in times of crisis and can even propel public finances into a free fall.