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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/112

10:00 a.m., July 20, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| | J. K. Orleans-Lindsay, Temporary |
| | S. Kolb, Temporary |
| B. de Maulde | X. Blandin |
| A. Donoso | M. Teijeiro |
| | M. K. Bush |
| M. Finaish | T. Alhaimus |
| | M. B. Chatah, Temporary |
| T. Hirao | T. Yamashita |
| J. E. Ismael | Jaafar A. |
| | L. Leonard |
| A. Kafka | C. Robalino |
| G. Laske | G. Grosche |
| G. Lovato | |
| R. N. Malhotra | |
| Y. A. Nimatallah | |
| J. J. Polak | |
| A. R. G. Prowse | |
| | O. Kabbaj |
| | E. I. M. Mtei |
| | J. L. Feito |
| J. Tvedt | |
| N. Wicks | T. A. Clark |
| | Wang E. |

J. W. Lang, Jr., Acting Secretary
J. C. Corr, Assistant

Also Present

Administration Department: H. J. O. Struckmeyer, Deputy Director. African Department: R. O. Carstens, L. Schmitz. Asian Department: A. Ariyoshi. European Department: P. B. de Fontenay, Deputy Director; F. C. Adams, J. T. Boorman, B. Christensen, A. Fidjestol, H.-J. Huss, H. B. Junz, S. Mitra, P. J. F. Nyberg, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; N. Kirmani, E. J. Zervoudakis. Fiscal Affairs Department: O. Pettersen. Legal Department: A. O. Liuksila. Research Department: A. D. Crockett, Deputy Director; M. D. Knight. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. El-Khouri, K. A. Hansen, I. R. Panday, P. Péterfalvy, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, J. Bulloch, M. Camara, V. Govindarajan, D. Hammann, N. U. Haque, L. Ionescu, M. Lundsager, E. Olsen, G. W. K. Pickering, J. E. Rodriguez, A. A. Scholten, Shao Z., S. Sornyanyontr, A. J. Tregilgas, Wang C. Y., M. A. Weitz.

1. FEDERAL REPUBLIC OF GERMANY - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Federal Republic of Germany (SM/84/142, 6/22/84; Sup. 1, 7/17/84; and Sup. 1, Cor. 1, 7/18/84). They also had before them a report on recent economic developments in Germany (SM/84/152, 7/3/84).

Mr. Laske made the following statement:

My authorities are in broad agreement with the analysis and the assessment presented by the staff.

Relative to previous periods, the period under review witnessed quite a remarkable turn for the better. Inflation has abated further, the growth rate has surpassed earlier expectations, and the external accounts again have shown a satisfactory surplus. These developments have been supported by a prudent stance of fiscal and monetary policies, as well as continued efforts to correct structural maladjustments. Less encouraging developments in the labor market continue to be a source of major concern. In this area, particular efforts will be required by labor and business leaders and also by the Government to secure a sound basis for future growth of the German economy. It remains to be seen whether the agreements ending the recent strikes in the metals and printing industries have been positive contributions to this end.

As I have indicated, growth performance in 1983 was better than originally hoped for. While the recovery was fueled in its initial stage by strong private consumption, boosted by a sizable decline in the savings ratio, it soon became more broadly based. Private investment picked up, especially in the latter part of 1983, and the foreign balance is also exerting a positive influence.

In the meantime, some information has become available suggesting that the recovery lost some of its momentum in the first half of 1984. In March and April, before the above-mentioned strikes, slight declines were recorded in production in manufacturing as well as in the flow of new domestic orders. This may well have been a transitory development, since more recent figures for May show a small increase in production. The volume of domestic and foreign orders was also higher in May than in April. These figures, however, do not yet reflect the full impact of the strikes, which began in the second half of May and progressively spread through the afflicted industries.

My authorities were not overly concerned about the earlier slowdown in the recovery, but the strikes have caused significant production losses. As a result, GNP in the second quarter may

have been 1 percent smaller than it would otherwise have been. A first assessment of the strikes' effect on performance in 1984 comes to the conclusion that the production losses may be partially, but not fully, offset during the remainder of the year. Thus, real growth may not reach the upper end of the forecast range of 2.5-3 percent.

The labor market continues to be a cause for worry. Although some signs of improvement have become visible, such as a reduction of involuntary part-time employment, unemployment has risen again since February 1984 on a seasonally adjusted basis. My authorities believe, however, that the ongoing weakness in the labor market does not call for policies aimed at deliberately stimulating demand. In their view, priority must be given, on the one hand, to the removal of rigidities and disincentives that impair the desirable smooth and efficient functioning of the labor market and, on the other hand, to the continuing consolidation of the government budgets. It continues to be our objective to reduce the absorption of resources by the public sector and to make more of them available for private investment as the primary source for growth and new jobs. An important contribution to improving the labor situation would be moderate wage increases and a continued strengthening of industrial profitability. In their desire to set a good example for the private sector, and as a means of containing the rise in public expenditure, my authorities have decided to freeze civil service salaries for almost one year.

The medium-term and longer-term effects of the recent strikes in the metals and printing industries are not yet fully assessed, since the agreements hammered out between the representatives of these industries and organized labor are complex and complicated. They require careful analysis. A first, tentative appraisal shows that the wage increase agreed for 1984 and the reduction of weekly working hours starting in April 1985 will cause hourly wage costs to rise by 4 percent for the average of these two years. The direct cost effect of the cut in working hours will be softened by the understanding that working time can be arranged in a more flexible manner than has been possible under the labor contracts in force so far. These agreements can be said to follow the traditional line of moderation in wage settlements, although the labor dispute this time was considerably longer than those of the past and was characterized by some unpleasant features of dogmatism and antagonism.

An important positive element of the new wage contracts is their lifetime of at least 18 months, so that the next round of wage negotiations in these two important industries will not start before the middle of 1986. This should provide the economy with time to adjust to the altered conditions before wage negotiations have to be conducted again.

As for economy-wide developments in wages, the contracts negotiated so far this year show a diversity of features. While the two industries just discussed have put heavy emphasis on a reduction in working time, other industries have settled for straight pay increases, and a third group stressed "early-retirement schemes," which are supported by financial assistance from the Government. On average, the wage raises already agreed and those still to be negotiated this year are likely to provide for increases in the 3-3.5 percent range. Given an inflation rate of slightly less than 3 percent, this raise may imply considerably smaller increases in real wages after taxes.

Better progress than initially expected has been made in the consolidation of the public sector finances. The authorities brought this about by determined restraint in expenditures and by higher revenues, which benefited from the pickup in economic activity. My authorities continue to hold the view that the share of government-controlled expenditures in GDP should be reduced further. This goal can be achieved only if the growth rate of public expenditure continues to be lower than the growth rate of nominal GNP. The outline of the Federal Government's budget for 1985, which was set out by the Cabinet a few weeks ago and needs to be approved by Parliament later in the year, follows exactly this line. It provides for an increase in expenditures of 2.4 percent over actual expenditures in fiscal year 1984, while nominal growth of GNP is projected to reach about 5.5 percent. The overall deficit and thus net new borrowing in 1985 shall be limited to DM 24 billion, about DM 5.5 billion less than the borrowing needed for this year's budget. In the review of the medium-term fiscal program discussed by the Cabinet simultaneously with the 1985 budget, my authorities have, therefore, decided that public expenditures shall grow by no more than 3 percent annually for four years, while nominal GNP growth may continue to be in the 5.5 percent range until 1988.

Since taking office late in 1982, the authorities have intended to initiate a reform of the tax system with a view to reducing marginal tax rates, which, owing to bracket creep, have become quite high in recent years. To this end, the Government has recently taken the decision to implement such a reform in two steps in 1986 and 1988. It will smooth the present progressivity in the income tax scale and provide for certain increases in family related benefits. These measures are expected by 1988 to reduce the tax burden by about DM 20 billion annually. It is the firm intention of my authorities to press ahead with economizing on expenditures, especially those of a structural character. Thus, the medium-term financial program envisages a progressive reduction of new borrowing. However, this reduction must be interrupted in 1986, for one year only, when the first installment of the planned changes in the tax system would become effective.

For a number of years, German monetary policy has been guided by the twin objectives of keeping inflation in check and providing the economy with sufficient liquidity for an adequate rate of growth. The annual target range for the permissible expansion of central bank money has been determined according to this principle. Over the period reviewed in the staff report, when the external accounts were in equilibrium, domestic considerations could play a more prominent role in the formulation of monetary policy. By allowing monetary expansion to exceed the target range in the first half of last year, monetary policy has helped to stimulate economic activity without endangering the achievement of better price stability. Despite this cautious monetary easing, the target range established for 1983 was met for the year as a whole. For 1984, the Central Bank Council has established a target range of 4-6 percent, somewhat narrower than the one for 1983. This does not indicate a tightening of monetary policy, as the staff report explains in detail. The recently released figures for June indicate that central bank money has been growing at an annual rate of almost 5 percent, thus staying close to the middle of the range.

The conduct of monetary policy in Germany, as in other countries, has been complicated by high, and recently even rising, U.S. interest rates. This has also exerted pressure on the rate of the deutsche mark against the dollar, which last week rose to a level that the exchange markets--and the authorities--have not seen for quite some time. Despite rising U.S. interest rates, the Bundesbank has not seen a need to raise its interest rate, because market rates in the longer maturity ranges remained virtually unaffected by this development. On the basis of long-term rates, the interest rate differential in favor of the dollar grew to about 5.5 percentage points. This differential has not put such pressure on Germany's balance of payments that a deliberate policy response was required.

When the Central Bank Council of the Deutsche Bundesbank on June 29, 1984 raised its discount rate to 4.5 percent, it did so for technical reasons rather than with the intent of making its policy stance more restrictive. This reasoning was spelled out quite clearly in the Bundesbank's press release, which was circulated to the Executive Board on July 2, 1984 (EBD/84/180).

The increase in the discount rate was designed to bring this rate better into line with money market rates, which had been edging up in a reaction to international interest rate movements. Borrowing at the Bundesbank's discount window had thus become a subsidized source of liquidity for the banks. With a simultaneous increase in rediscount quotas and an offer to banks for new open-market transactions at an unchanged interest rate, the Bundesbank demonstrated the unaltered stance of its policy. With this action, the Bundesbank wanted to give an incentive to the

banks to discontinue borrowing heavily for very short periods at its more expensive loan window and to come to its discount window for somewhat longer periods instead. The new set of measures is likely to have only a minor effect on the cost of central bank money, but it will bring the provision of such money into a somewhat longer time frame. It must not be overlooked, however, that the independence that German interest rates appear to have gained from international and U.S. rates is not only relative but also fragile. If rates were to continue rising in this country, market rates in Germany are likely to react in view of the historically high interest rate differential.

The staff in SM/84/142 calculates Germany's net foreign asset position by valuing the Bundesbank's gold holdings at market prices. My authorities believe the deutsche mark and dollar amounts resulting from this calculation are hypothetical numbers with little practical significance.

Mr. de Maulde observed that Germany, which was important to the world economy, was strongly committed to effective Fund surveillance. A week earlier, formalities at the Franco-German border had been lifted, one more sign of the closeness of the ties between France and Germany. On the occasion of the 1983 Article IV consultation with Germany (EBM/84/113 and EBM/83/114, 7/29/83), he had commented: "The Germans have done much better in the field of structural adjustment than they themselves admit and the staff assess," a point disputed at that time. The better than expected economic onturn in 1983 and the general thrust of the staff paper suggested that he had not been overoptimistic. Despite an international environment of deep concern to the European countries, he remained confident about Germany's medium-term and long-term economic prospects.

The structural evolution of the German economy in 1983 was particularly interesting, Mr. de Maulde continued, because Germany could be considered a textbook example of the implementation, with remarkable consistency, of the kinds of structural adjustment policies that were the standard Fund prescription, such as policies to contain inflation, to roll back budget deficits, to reduce state involvement in the economy and, to restore profit margins. A major achievement in 1983 had been the improvement in industrial profitability, as evidenced by the increase of 16 percent in the gross profits of producing enterprises, following an increase of 7 percent in 1982. It appeared from Mr. Laske's remarks that the authorities did not consider those results sufficient and were looking for a further strengthening of industrial profitability as a way to improve employment. The staff guardedly endorsed the same approach when it stated that the share of profits in national income, and the rate of return on fixed capital, remained far below their levels in the 1970s. Was it possible to say, even tentatively, what was the optimal apportionment between profits and the returns to productive inputs? At what point could it be said that the restoration of profits had gone far enough, and upon what considerations should such a judgment be based? He invited the

staff and Mr. Laske to comment. In a related area, the consequences of the reduction in the work week in the metals and printing industries on the financial position of enterprises remained unclear. What was the impact on earlier projections and policy assumptions?

The situation in the labor market continued to be a major concern of the German authorities, Mr. de Maulde noted. The information in Chart 2 of SM/84/142, which showed a surge both in capacity utilization in manufacturing and in unemployment, was of special interest in that respect. In commenting favorably on the recovery, the staff remarked that "apparently the recovery of economic activity, at present real wages, continues to be of a highly labor-saving character," thereby highlighting a structural problem of crucial importance. While he understood the staff's reasoning, namely, that the decline in relative labor costs had improved the profitability of enterprises and had therefore been a major element in the recovery of investment, was it inevitable that more investment led to more unemployment? When could the process be expected to reverse itself, so that more jobs would be created than destroyed through adjustment and modernization? Did the example of Japan provide any hints of a solution? The problem was shared by all industrial countries in varying degrees.

He agreed fully with Mr. Laske that the removal of rigidities and disincentives would help to improve the labor market, Mr. de Maulde added. However, a strong case could also be made for industrial policies geared toward alleviating the contradiction of more investment yet less employment. Such an approach might entail renewed consideration of the pace--although not the principle--of the rollback in public expenditure.

On the move toward structural fiscal consolidation, Mr. de Maulde remarked, the medium-term fiscal program for 1984-88, which aimed at reducing the ratio of public expenditure to GNP by 1 percent each year, from 48 percent in 1984 to 43.5 percent in 1988, was impressive. What kinds of public services or entities would be affected by that development? Furthermore, was continued restraint in public salaries or recruitment consistent with effective public administration? Would public sector investment remain large enough to allow Germany to adapt smoothly to the new international division of labor? The first system of social security in the modern world had been introduced in Germany by Chancellor Bismarck; it was considered to have played a major role in the remarkable pace of industrialization in the country in later years. However, it seemed that nineteenth-century solutions were no longer generally in favor.

Monetary policy appeared to be well conducted and finely tuned, Mr. de Maulde stated. The sound job accomplished by the Bundesbank deserved commendation. The firmness and flexibility of Germany's monetary policy had been made possible by the kind of sound budgetary discipline that could be considered lacking in some other countries. That policy had achieved its two basic objectives of keeping inflation in check and providing sufficient liquidity for an adequate rate of economic growth. The German authorities should also be commended for having kept official interest rates unchanged and monetary growth on a steady course, despite

the recent rise in U.S. interest rates. However, he fully shared Mr. Laske's concerns about a further rise in U.S. rates, which would have devastating effects, not only in Europe but also elsewhere.

It was doubtful whether the momentum of short-term growth would remain as strong as the staff predicted, Mr. de Maulde commented. Indeed, the recovery had already begun to lose momentum in the spring of 1984; the main economic indicators at that time had become less encouraging. The exceptionally long and difficult strikes might also be regarded as an alarm signal. Furthermore, U.S. interest rates posed threats to European economies. Beyond the short term, a continued mediocre rate of activity in Germany presented a clear danger to the world economy at a time when the U.S. recovery would also be losing momentum. The staff projected in its report for the 1984 Article IV consultation with the United States (SM/84/162, 7/6/84) that GDP growth in the United States would decline to 3.9 percent in 1985 from 6.8 percent in 1984. Such a decline would threaten the whole world's recovery and, in turn, quickly imperil the economic strategy of the German authorities. In the period ahead, imagination and flexibility would be needed. He was confident that the German authorities would set an example in that respect.

Mr. Lovato noted that recent developments in the German economy had been mainly favorable and constituted a promising basis for the consolidation of balanced growth. Once again, the German authorities ought to be congratulated for their careful and effective conduct of economic policy. A particularly reassuring aspect was the recent shift in the composition of overall demand away from consumption toward investment and the net foreign balance. The shift was partly the result of spontaneous and exogenous factors, such as the appreciation of the U.S. dollar and its influence on exports, and partly a consequence of appropriate policies. The various fiscal measures described in Part II of SM/84/152 appeared to be designed to discourage consumer demand while providing a favorable environment for productive investment, the only exception being the fall in public capital formation. The change in the composition of demand was warranted in the present phase of the cycle because it reduced the risk that the recovery might soon reach the constraints arising from the rate of capacity utilization and from the external accounts. In order to avoid the possibility that the economic upturn might stimulate price increases even before the first of those bottlenecks was approached, it would be necessary to maintain the recent tendency toward moderation in wage agreements. In that respect, Mr. Laske's statement that the wage raises already agreed and those still to be negotiated in 1984 were likely to provide for increases in the range of 3-3.5 percent was reassuring.

Current trends in the fiscal balance represented another favorable aspect of the recovery, Mr. Lovato continued. The success of the authorities was remarkable; in particular, if the changes in the General Government's budget balance were considered net of cyclical effects and as percentages of GDP, as was done in a recent OECD publication, Germany would be seen to have achieved the most consistent and steady reduction in fiscal deficits among all the major industrial countries during the

past few years. That development would positively influence the prospects for private economic activity, leaving considerable room for a relatively accommodating monetary policy, provided that external financial conditions allowed such accommodation.

Indeed, a more expansionary stance of monetary policy could turn out to be crucial to sustain the recovery in the months ahead, Mr. Lovato remarked. As the staff noted, domestic demand had slackened somewhat in the first months of 1984, for reasons still not well understood; that element constituted one of the main uncertainties in the short-term outlook. A related issue was how to evaluate the current monetary stance: had the low growth rate of the Bundesbank money stock, which had recently been near the bottom end of the target range, produced the slackening of demand? Such a judgment appeared invalid, in view of the sharp reduction in credit demand by the public sector, which had left ample room for credit expansion by private agents, as shown by Chart 13 in SM/84/152. Nevertheless, if the recovery appeared to be slackening further in the coming months, an additionl monetary stimulus would be necessary, particularly given the need to consolidate the fiscal progress already achieved.

A prudent relaxation of the monetary stance would probably not provide an unwarranted impulse to inflation, Mr. Lovato considered, if, as indicated in Appendix II of SM/84/142, unit labor costs increased moderately in the rest of 1984. The staff had prepared the data in that appendix without taking into account the effect of the recent strikes in the industrial sector or, more important, the consequences of the labor agreements that had recently been reached. According to Supplement 1 to SM/84/142, changes in unit labor costs for the remainder of 1984 ought to remain modest. However, the pressures in that area in 1985 could intensify.

A further potentially important factor in sustaining a balanced recovery in coming months was the trend in public investment, Mr. Lovato suggested. As the staff noted, and the German authorities recognized, the current trend in public sector capital formation should be reversed; some increase in capital expenditures was expected in the 1984 budget. He invited the staff or Mr. Laske to say which areas would benefit most.

Developments in the German economy were crucial because of their influence throughout Europe, Mr. Lovato said, particularly in view of the institutional links arising out of the European Monetary System (EMS). The establishment of balanced, noninflationary growth in the Federal Republic of Germany could not fail to have a beneficial influence on neighboring countries, provided that it was coupled with a strong European commitment. His authorities were deeply aware of that fact and intended to continue to pursue a policy of close collaboration with the German authorities.

Mr. Hirao stated that he agreed with the thrust of the staff appraisal. Germany was on its way to economic recovery after the prolonged recession that had begun in late 1980. It was encouraging that economic performance in 1983 and early 1984 had been better than expected a year earlier. Real GNP had increased by 1.3 percent in 1983 after two consecutive years of

negative growth, while the rate of inflation had continued to slow. Private investment had increased by 4.8 percent in 1983, following a decline of 4.3 percent in 1982. The profit margins of enterprises had improved as a result of labor shedding and moderation in wage settlements. Capacity utilization had risen close to rates that would induce capacity-increasing investment. The unemployment rate remained high, exceeding 8 percent, but even in that respect the worst appeared to be over. While the recovery was attributable to autonomous factors and to structural adjustment efforts in the private sector, public policies, particularly efforts at fiscal consolidation and the relatively flexible monetary policy, had also played a role in sustaining it. The authorities should be highly commended for their prudent economic management.

He fully shared the authorities' view that continued fiscal consolidation was essential for sustaining the recovery of private investment, Mr. Hirao said. The problems faced by the German economy at present, such as the persistent fiscal deficit, high unemployment, and relatively low growth, were common to industrial countries. They were the result not only of cyclical factors, but also, to a considerable extent, rooted in the structure of the economy. The maturity of the economy, as well as the high standard of welfare, appeared to have had a significant bearing on the stagnation in private investment during the past decade. A lasting economic recovery in Germany would depend on a continued reduction in the share of the public sector. The authorities had made important progress in that direction during 1983, when the rising trend of public expenditure as a share of GNP had been reversed and the fiscal deficit had declined to 2.7 percent of GNP. It was also encouraging that the authorities were currently framing a medium-term fiscal adjustment program in which the ratio of expenditure to GNP was projected to decline steadily to 43.5 percent by 1988. He hoped that they would maintain persistent consolidation efforts in line with that program.

In the 1983 budget, Mr. Hirao continued, expenditures had been restrained through the firm commitment of the authorities. Social entitlements had been cut, public investments had been significantly reduced in real terms, and, consequently, federal expenditures had risen by less than 1 percent in nominal terms. In light of the political and social difficulties involved in holding down social expenditures, the authorities should be commended for their achievements. He also welcomed the freeze on civil servants' wages in the 1984 budget. As the staff suggested, perhaps further steps could be taken to restrain subsidies for structurally weak industries.

On the revenue side, Mr. Hirao added, the introduction of several measures to stimulate private investment, including the reduction in business taxes within the overall restrictive framework, was welcome. Those measures appeared to have contributed effectively to the economic recovery. He also welcomed the program of income tax relief recently proposed by the authorities in a medium-term context. In view of the already high tax burden, it would be appropriate to reduce fiscal drag in order to prevent the overall tax burden from rising any further.

Since late 1981, Mr. Hirao observed, monetary policy had been gradually eased in view of the improvement in the external balance and the easing of interest rates abroad. The successive lowering of interest rates had been appropriate, given the limited scope for maneuver on the fiscal side, and it appeared to have played an important role in the recovery in 1983. In the early months of 1984, despite an increase in interest rates abroad and a subsequent widening in interest rate differentials, the exchange value of the deutsche mark had remained relatively stable, although more recently the mark had come under renewed pressure. He agreed with the staff that the progress achieved in fiscal consolidation had significantly improved market confidence in the long-run strength of the deutsche mark. That confidence had made it possible for the authorities to keep official interest rates unchanged during most of the past year. He shared the view of the Bundesbank that it had not needed to raise its rates, because market rates in the longer maturity ranges had remained virtually unaffected. The authorities should be commended for their prudent, fine-tuned conduct of monetary policy.

Despite the general favorable climate in the German economy, Mr. Hirao remarked, the presence of a large number of unemployed workers continued to pose an important problem, upon which the authorities had made some interesting observations. They had noted that a rate of economic growth of 2.5 percent would create only 100,000-150,000 jobs a year, although more than 2 million workers were recorded as unemployed. They had also noted that capacity utilization had almost risen to rates that would induce capacity-increasing investment despite the presence of many unemployed workers. Those observations indicated clearly that the current unemployment problem was largely structural; he strongly believed, therefore, that the solution would lie not in expansionary financial policies, but in the restoration of profit through the removal of rigidities in the labor market and increased productivity from enhanced investment. The authorities had adopted several direct measures to reduce the number of unemployed workers, such as offering financial incentives for foreign workers to return to their home countries and encouraging early retirement. The effect of those measures was by no means insignificant. At the same time, it was encouraging to note that the effort to moderate high wage levels had already shown results: unit labor costs had risen by less than 1 percent in 1983. The restraint in public sector wages would help to achieve wage moderation in the private sector in 1984 and beyond. The medium-term and long-term effects of the recent settlement of strikes in the metals and printing industries were not yet clear; he hoped that they would not seriously undermine the progress made so far on the labor front.

The continued commitment by the authorities to liberal trade policies was welcome, Mr. Hirao went on, although trade policies of the European Community had often been in a less liberal direction. He emphasized the importance of positive adjustment policies, which would encourage a shift of resources to promising industries so as to achieve increased economic efficiency. He hoped that the authorities' commitment to the principle of free trade would serve as an effective means of promoting the needed adjustment in the structure of the economy.

Mr. Kafka said that the German authorities should be congratulated on their success in reducing the rate of inflation and increasing growth at a moderate pace, which they should be able to sustain, contrary to some gloomy predictions made during the 1983 Article IV consultation. The authorities had made substantial progress in reducing the fiscal deficit and redressing the expansion of the government sector. Progress had also been achieved in reducing taxation; however, not much had been done to decrease subsidies--they might even increase.

Germany's maintenance of a liberal attitude toward nontariff barriers was welcome, Mr. Kafka continued. It had helped to increase imports in 1983 by 4.5 percent in volume terms according to the staff, and by even a little more according to the OECD. Nevertheless, protectionist pressures might arise, given the Bundesbank's conclusion that, in a number of technologically advanced areas, German exports had expanded more slowly than exports by the United States and Japan. However, he agreed with the staff that it might be erroneous to adopt an excessively restrictive concept of high technology; Germany's reputation for innovation and product quality had not declined at all.

The employment problem and the envisaged solutions were matters of greater concern, Mr. Kafka considered. In 1983, employment had fallen by 450,000, the average duration of registered unemployment had increased from six to seven months, and the average working hours per employed worker had fallen by 0.25 percent, about as much as in 1982. Clearly, employment was a long-term problem, but the approaches being considered would not be the best solutions. Trade union demands for a gradual reduction of the work week constituted a daring increase in leisure time that was out of line with any other major industrial country, although attempts were being made in the same direction in France. However, it was possible that the modest wage increases thus far negotiated and the increased flexibility under the new contracts regarding the arrangement of labor time, as well as the longer duration of the contracts, would prevent an undue rise in labor costs. The Government had also decided to provide financial support for early retirement on the assumption that the incentives would create 300,000 new vacancies annually. It would be preferable to place more emphasis on growth-oriented policies as the best means of increasing employment; for example, the way in which social security charges could add to labor costs and distort incentives to employment should be looked at.

The authorities correctly held the view that a lasting recovery would depend on increases in productivity growth during times of declining fiscal stimuli such as the present, Mr. Kafka remarked. The transfer of public enterprises to the private sector and the reduction of government expenditures, particularly those related to social security, would enhance profitability and might raise productivity unless they were offset by rising labor costs.

Monetary policy and exchange rates had been properly managed during 1983, Mr. Kafka went on. He agreed with Mr. Laske that the recent increase in the discount rate did not constitute a restrictive measure, but rather the correction of policies that had, in effect, subsidized the financial system. The staff's projections were less optimistic than those of the OECD with regard to real GDP growth and, especially, the volume of imports of goods and services by the manufacturing sector. He invited the staff to comment on the differences. Finally, Germany was continuing to increase its official development assistance (ODA), which currently stood at 0.49 percent of GDP, well above the average of all members of the Development Assistance Committee.

Mr. Nimatallah said that the performance of the German economy during 1983 had been encouraging in many respects. The recovery had been stronger than initially expected. Continued progress had been made in reducing inflation, moderating wage costs, and increasing the profitability of enterprises. The external sector continued to be strong, and the exchange rate for the deutche mark had remained relatively stable. Those positive developments had resulted from the pursuit of prudent, yet flexible, policies by the authorities. Although the overall fiscal stance had been restrictive, measures had been introduced to stimulate private investment and thereby to accelerate the recovery. Furthermore, the authorities seemed to have found the right balance in monetary policy by permitting a decline in interest rates to help raise consumption and investment expenditures, while controlling inflation and keeping the exchange rate stable.

The main tasks of economic policy at present were to strengthen and sustain the recovery, Mr. Nimatallah continued, particularly important objectives in view of the weakening of the recovery earlier in 1984 and the recent strikes in the industrial sector. The policies for 1984 and for the medium term appeared well designed to put the economy on a path of sustained growth. Pursuit of appropriate policies in the economies of Germany's trading partners would facilitate that task.

He agreed with the authorities that continued success in the fiscal consolidation effort was necessary to maintain business confidence in the strength of the economy, Mr. Nimatallah said. The fiscal stance for 1984 was broadly appropriate. Further steps had been taken to improve business incentives by reducing business taxes and liberalizing depreciation allowances. At the same time, spending had been kept under strict control. A freeze had been placed on wages and salaries of civil servants, unemployment benefits had been reduced, and the National Pension Scheme had been modified further. Those measures were expected to result in a further reduction in the ratio of government expenditures to GNP and in the ratio of the budget deficit to GNP. Further restraint on government expenditure might be needed in the medium term to control the fiscal deficit. However, the information presented in the supplement to SM/84/142 with regard to tax reductions and expenditure controls envisaged in the Federal Budget Plan for the medium term was encouraging. It was clear that the authorities were determined to continue with their efforts to reduce gradually the share of the government sector in the economy, for which they should be commended.

The task of monetary policy in allowing growth to proceed while keeping inflation under control had been made easier by the success of the fiscal consolidation effort over the past two years, Mr. Nimatallah considered. In the period ahead, monetary policy should be kept on a steady course and the domestic recovery should not be endangered by a sharp response to temporary external developments. As long as domestic policies were steady and on the right track, confidence in the long-term strength of the deutsche mark would be preserved.

The news that the labor dispute in the metals and printing industries had eventually been settled was welcome, Mr. Nimatallah remarked, at least with regard to the stopping of production losses in the short run. However, for the medium and long run, it was not clear whether the settlement would set a good precedent for similar labor requests in the future. The issue was not the reduction of working hours, but who would pay for the lost hours of work. A better solution to unemployment in industrial countries in the long run was to reduce the work hours of the fully employed, but at lower pay, in order to give an opportunity to the unemployed. One of the luxury components of consumption at present was the leisure time enjoyed by people in certain high-income brackets; such consumption could not be realized without partial sacrifice of income. He hoped that in the future, not only in Germany but also in other industrial countries, settlement of labor disputes on the question of reduced work hours would not be concluded at the expense of other workers. Otherwise, cost-push inflation would again be triggered, and an unhealthy redistribution of income might result.

In the external sector, Mr. Nimatallah went on, the authorities were to be commended for their stance against protectionism, both nationally and within the European Community and the General Agreement on Tariffs and Trade (GATT). The authorities had not introduced any new trade restrictions at the national level, although he understood that the European Community intended to introduce import restrictions on certain agricultural commodities. He urged the members of the European Community to resist pressures to impose such restrictions. Finally, he encouraged the German authorities to maintain their ODA at least at its present level in real terms and to continue to facilitate the flow of direct investment and other private flows to the developing countries.

Mr. Polak recalled that he had begun his intervention during the 1982 Article IV consultation with Germany (EBM/82/109, 8/18/82) by remarking that:

> ...after nearly three decades of satisfactory development, subject only to minor cyclical fluctuations that could be easily overcome, the German authorities have had to face structural difficulties of an almost intractable nature. It was not surprising that policy formulation has become difficult, and that both the authorities and the staff are a little hesitant.

The German authorities had come a great distance since that time; there was no hesitancy in their approach, which was characterized by confidence and determination, inspired by the fact that the approach was showing results. It was also fully endorsed by the staff.

The approach centered on a fiscal policy that was based on three general tenets, Mr. Polak continued. First, the budget deficit had to be reduced in order to bring down interest rates and the growth in interest payments by the Government. Second, that reduction should be accomplished through expenditure cuts accompanied by tax cuts to neutralize fiscal drag. Third, those cuts should aim at reducing the size of the government sector and, more generally, at reducing government interference in private decision making. He fully supported the authorities' approach, which went to the heart of the problems and was aimed at correcting the rigidities that had become evident during the past few years.

At the time of the 1983 Article IV consultation with Germany (EBM/83/113 and EBM/83/114, 7/29/83), Mr. Polak recalled, the staff had doubted whether the fiscal stance would permit an economic upturn. As it had turned out, fiscal policy had encouraged an upturn through its effects on business confidence and on interest rates--GNP was expected to grow by a little less than 3 percent in 1984. He welcomed the announcement in the summer of 1983 of medium-term targets to cover the period to 1988. The process of deficit reduction would be more or less completed in 1985, when the federal deficit would be brought down to about 1 percent of GNP, at which it was expected to remain until 1988. He hoped that the reduction in the share of public expenditure in GNP would include a cutback in subsidies to enterprises; at present, such subsidies continued to increase. He supported the timing of the measures to reverse fiscal drag, the first installment of which was set for 1986. It did not appear necessary to advance those measures, as recently suggested by the OECD.

On monetary policy, Mr. Polak welcomed the continued ability of the Bundesbank to keep monetary growth on target. The staff appeared to support a slightly more expansionary stance, toward the upper half of the target zone. However, the authorities seemed to have already accepted that position implicitly by not following the upward move in U.S. interest rates. Their ability to keep German interest rates stable while U.S. interest rates rose was clear evidence of the room for maneuver that Germany's good economic policies had permitted, a situation clearly to the benefit of all Germany's partners in the EMS. In the past few years the money supply had, by design, increased by a few percentage points more than the growth in money GNP. The implied decline in velocity was consistent with falling interest rates; however, the process might have run its course for the time being. If interest rates were to stop falling during the recovery, as they appeared to have done since the middle of 1983, there would be no need for monetary policy to accommodate a further decline in velocity. In other words, if money GNP did not grow by more than 5 percent in 1984, the staff did not have a strong case for arguing in favor of monetary growth in the upper half of the present range of

4-6 percent. However, it might be beyond the ability of anyone, including the Bundesbank, to fine-tune the rate of growth in the monetary aggregates to the implied extent.

It was a matter for satisfaction that Germany had almost achieved the targets recommended for industrial countries in the World Economic Outlook publications over a number of years with respect to monetary policy, the reduction in inflation, fiscal policy, the reduction in the deficit, and trade policies, Mr. Polak considered. In Germany, as in other countries, the prescribed measures had worked: growth had improved, as had the outlook for further growth. On the other hand, the prospects for a decrease in unemployment were not strong, although there was a slight chance that that judgment might be premature.

The staff and Mr. Laske had correctly paid a great deal of attention to unemployment, Mr. Polak observed. A constructive approach to the problem, which seemed to have eluded industrial countries in Europe, first required a correct diagnosis. Was unemployment caused by the size of the government sector, which was being reduced? What part was played by rigidities in the labor market, which certainly had to be tackled? Was the level of real wages incompatible with full employment? In SM/84/142, the staff referred several times--on page 3, on page 11, and in its appraisal--to the possibility that real wages were too high to permit a substantial decline in unemployment. In the most recent OECD economic survey, which addressed the issue of diverging employment trends in the United States and in Europe, developments in real wages also figured prominently as an explanation of high unemployment. Furthermore, the analysis in DM/84/27 (4/16/84) supported the view that real wages in Germany were higher than was compatible with full employment. A similar case might be made for some smaller countries, such as the Netherlands, which had not been considered in that paper. He supported Mr. de Maulde's request for the staff to comment on the degree to which the share of profits should increase and on how much it might be expected to increase in 1984 and 1985 without reliance on the kind of labor-saving investment that aggravated unemployment. There was evidence that the nonlabor share of GNP in Germany had recently returned to its 1965 level, having been considerably above that level in the years since 1965.

The staff's conclusion in SM/84/142 was totally at variance with its conclusion in the report for the 1984 Article IV consultation with the Netherlands (SM/84/47, 2/15/84), Mr. Polak commented. In the latter paper, the staff had referred to nonwage impediments to increases in employment, remarking that all schemes to reduce unemployment would flounder when remuneration for not working was close to that for working. The issue was not discussed at all in the papers before Directors; for example, there was no comment on the influence of the social security system on wage incentives. Perhaps the omission was justifiable, but it would have been interesting to have an explicit demonstration that the level of payment for not working, which was not quite as high in Germany as in the Netherlands, was not an important factor in the persistence of unemployment in Germany. More generally, it would be essential to achieve a better understanding

and a better public awareness in many European countries of the linkages among labor costs, social security, and unemployment; it would also be *important to establish broader familiarity with research on the subject*, which was becoming increasingly available.

He joined other speakers in commending the German authorities for their adherence to a liberal trade policy, Mr. Polak said, and he urged the authorities to persist in their efforts to prevail over those of their partners in the European Community who were less convinced in that regard. In the present circumstances, the importance to the world economy of Germany's stance on the subject could not be overestimated.

Mr. Wicks commented that in carrying out its surveillance role, particularly in the course of Article IV consultations with larger members, the Fund had correctly placed increased emphasis on the international implications of domestic policies. There was a good deal of interesting material on the question at various places in SM/84/152; the short section on trade and aid in SM/84/142 was particularly welcome. However, in the latter paper, the staff might have gone further in its analysis, given that Germany was the third largest market economy in the world. The particular focus of such an analysis could have been an assessment of the openness of domestic capital markets and the international role of the deutsche mark and, second, the links between structural adjustment in a mature industrial economy and progress toward a more open trading system. In that regard, the issue of industrial subsidies and aid to ailing industries could have been addressed. While the staff rightly encouraged the authorities to reduce public sector subsidies for fiscal reasons, it might also have examined the implications for trade.

The German authorities could take great credit for creating conditions favorable to a resumption of growth, Mr. Wicks continued, although activity had weakened in the first part of 1984 and manufacturing production had fallen in March and April, even before the metalworkers' strike. At the time of the discussions between the staff and the authorities, an interpretation of that pause in the recovery had not been formulated; he invited the staff and Mr. Laske to say whether the situation was clearer at present. It seemed likely that consumption would remain subdued; there were also doubts about the outlook for investment. In the supplement to SM/84/142, the staff reported that business confidence, which had begun to decline in March, had continued to deteriorate in May, that it remained to be seen what further effect the metalworkers' strike might have had, and that fiscal incentives appeared to have played a part in the surge in investment in 1983. The latter point suggested that some of the upswing could represent a bringing forward of spending rather than additional investment. The outlook for a strengthening of domestic demand was, therefore, somewhat uncertain; growth during 1984 could depend significantly on net exports. He hoped that it would be possible to maintain a reasonable balance between domestic and external demand. On that basis, the recovery in Germany and, therefore, in the rest of the world was more likely to be sustainable.

The staff commented that the immediate cost to the economy as a whole of the metalworkers' strike appeared minor, Mr. Wicks stated. It was a matter of concern that the wage effects could spill over into other sectors, thereby affecting overall competitiveness. The staff commented that the current metalworkers' strike, if successful, would require reappraisal of the outlook for the economy and of the policy stance appropriate to it. Did the staff believe that such a reappraisal was necessary? The general discussion of labor market policies in SM/84/142 had been useful, although it might have been somewhat fuller. For example, the staff might have addressed the question of the extent to which fiscal incentives to investment had affected substitution between capital and labor. German unemployment had fallen during the second part of 1983 but had risen since, including a further increase in June 1984. The authorities were correct in their view that improved employment prospects were ultimately dependent on a continued recovery in business profits and on greater wage flexibility; the example set by the authorities with regard to wages in the public sector was commendable.

The German authorities had succeeded for the most part in meeting their fiscal objectives, Mr. Wicks noted. They had reduced Federal borrowing and they had switched expenditure away from consumption, for example, by reducing social entitlements and increasing the value-added tax, while encouraging investment by the corporate sector through incentives, such as reduced business taxes and interest rate subsidies. Because of the importance of a firm strategy, the announcement of the medium-term financial plan was welcome, including the intention to reduce the federal borrowing requirement to DM 22.5 billion by 1988. Recently, fiscal consolidation had outpaced the Government's own forecast, and the Federal deficit in 1983--DM 31 billion--had been lower than expected. Furthermore, Finance Minister Stoltenberg had recently said that the deficit outturn for 1984 would again be below target. At the 1983 Article IV consultation, the staff had cautioned against too rapid a withdrawal of fiscal support. He wondered how the authorities might respond to the overconsolidation. The proposed income tax reform, designed to be consistent with the Government's medium-term fiscal objectives, should help to offset, at least in part, the effect of fiscal drag on the personal sector. It was envisaged in the medium-term financial plan that the contribution of the Bundesbank's profits to revenue would fall by more than half during the next few years, but developments thus far in 1984 suggested that in 1984 they might be at least as high as they had been in 1983. He invited Mr. Laske to comment on the realism of the medium-term forecast of the Bundesbank's profits.

On monetary policy, Mr. Wicks said, the authorities should be congratulated for their success in reinforcing Germany's impressive inflation record. The Bundesbank had implemented monetary policy flexibly and had succeeded in maintaining downward pressure on inflation while providing scope for the recovery. He hoped that the authorities could continue that policy. In the supplement to SM/84/142, the staff noted that central bank money, which had expanded at a rate near the bottom of the target range earlier in 1984, had moved toward the middle of the range in May and June

and that its growth rate had increased to 4.75 percent on an annual basis. He agreed with the staff that it would not be particularly worrisome if the growth rate of central bank money moved into the upper half of the current range, and that the authorities should be cautious about jeopardizing the recovery in response to temporary external pressures, provided that fiscal objectives were being met. The deutsche mark appeared weaker against the U.S. dollar than economic fundamentals would suggest. However, the recent fall in the value of the deutsche mark might have reduced somewhat the room for maneuver. He noted that the Bundesbank had recently raised the discount rate by half a percentage point and that it had increased banks' rediscount quotas.

Germany maintained its position as one of the strongest economies in the world, Mr. Wicks stated, and the German authorities had again achieved notable successes in establishing the conditions for renewed and sustained growth. Nevertheless, Germany suffered, if only in a more limited way, from some of the same problems confronting other mature industrial economies, particularly pressures on the fiscal position and structural problems in the labor market. Following the expansion of the past decade, serious difficulties had arisen in restoring a proper balance between the public and private sectors, and inflexible in labor practices were at least partially responsible for the current rate of unemployment, which was high and likely to remain high for some time to come. However, in both respects, the German authorities had set examples that other countries would no doubt wish to study in framing their own policies. He agreed with Mr. Polak's remarks commending the authorities for their attempts to resist protectionist pressures in Europe. He hoped that they would continue to do so.

Ms. Bush remarked that it was encouraging that the economic recovery in Germany in 1983 had been stronger than foreseen at the time of the 1983 Article IV consultation. Prudent financial management had continued to produce good results, including an admirably low rate of inflation. Economic recovery, as evidenced by the 2.75 percent increase in real GNP in 1983, had replaced the stagnant or negative real growth rates of the previous four years, as measured on a year-over-year basis. Although the resumption of growth had been a substantial achievement, there were questions about the durability of the recovery and about the sources of growth in the medium term. Private consumption and, later, investment and exports, had contributed significantly to the recovery, but it appeared that the growth might have faltered somewhat in recent months. Did the staff have any more up-to-date information in that regard? For the longer term, the authorities would continue to be faced with the question of how to provide the impetus for real economic growth. The growth of real public consumption had been low or negative since 1981; it was expected to continue to be modest again in 1984, a reasonable outcome in view of the already large size of the public sector and the desire of the authorities to reduce it further. Private consumption had also been either negative or low since 1980, reflecting slowdowns or declines in the growth of real disposable personal income in the past few years.

On the positive side, Ms. Bush continued, the revival of business investment should be a factor in the continuation of the current recovery, apparently on the basis of a recovery in profitability, a low increase in unit labor cost, and a possible backlog of investments. However, even allowing for the recovery of business investment, it was still unclear whether Germany might not once again be faced with relying principally on external demand to sustain medium-term economic growth.

Total employment had declined over the past three years, and unemployment had risen steadily, at least through the middle of 1983, Ms. Bush noted. Among other developments, the growth of the potential labor force, as indicated in Table 5 of SM/84/152, appeared to have reached a peak in 1980 and to have fallen sharply since then. Perhaps demographic factors, which had contributed to the large supply of labor in recent years, were declining in importance, thereby helping to reduce unemployment. Recent signs of an improvement in the labor situation included a drop in the number of short-time workers, a slight drop in the unemployment rate, a recovery of productivity, and a deceleration in the rise of unit labor costs. If disaggregated employment data were available, it might be possible to see where job losses had occurred and where increases in employment had been made or might be expected, particularly with regard to the services sector. In that context, it was surprising that employment in the general government sector had risen steadily as a share of total employment for a number of years. Was that development the result of a decline in total employment or of an absolute increase in the number of workers in public employment? It would also be useful to have an assessment by Mr. Laske and the staff of the effects on labor costs and on the overall economy of the recent labor settlement, which had involved a reduction in the work week from 40 hours to 38.5 hours.

Expenditure by the General Government sector was approaching 50 percent of GNP, Ms. Bush remarked, a proportion similar to that in other countries of the European Community. However, it was in strong contrast to the public spending in the United States and Japan of about 35 percent of GNP in 1983, the main difference being the size of transfers to households. The German authorities had already begun to reduce the ratio from a peak of almost 50 percent in 1981 to 48 percent in 1984, and they had set a target of 43.5 percent for 1988. Because the ratio of revenue to GNP had also been high, deficits had been low. Interestingly, there had been a relative shift from personal income taxes to social security contributions as components of total revenue. She invited the staff or Mr. Laske to comment on the effects, if any, of that shift.

She agreed with the authorities that continued fiscal retrenchment was required to leave room for private sector investment, Ms. Bush stated. Expenditure cuts or restraint had occurred in such difficult areas as wages of civil servants, pensions, unemployment compensation, and health benefits. Successful containment of subsidies to such sectors as coal, steel, and agriculture would assist fiscal retrenchment. It appeared that expenditure restraint over the coming few years could open the way to tax cuts to encourage private sector savings and investment, which would be a positive outcome of the sustained effort to contain public spending.

Mr. Leonard said that the German authorities should be commended on the performance of the economy over the past year. Furthermore, the official projections of GNP growth of 2.5-3 percent in 1984, in line with the projections by the OECD, were an encouraging indication that the current recovery could be sustained. Nevertheless, downside risks existed. As the staff pointed out, economic growth was in a period of transition. In 1983, the driving force behind the recovery had been consumer demand, fueled by a significant decline in the personal savings rate. In 1984, growth would have to be supported by the external sector and by increased domestic investment. The performance in the external sector was encouraging, with strong growth in exports thus far in 1984. The outlook for manufacturing production, however, was open to question and could have adverse implications for investment. Manufacturing production had fallen in March and April, prior to the metalworkers' strike, and preliminary estimates by the Bundesbank apparently indicated strike-related losses during May and June equivalent to 3 percent of annual manufacturing output. Although the loss could normally be made good by overtime working in the remainder of the year, only about 2.5 percent of metalworkers had worked any overtime at all in 1983, and those who had done so had averaged only two additional hours a week. Overtime work would have to increase considerably if production in 1984 were not to suffer.

The possibility to which Mr. Laske had referred--that real growth might fall short of the upper end of the forecast range--could not be ruled out, Mr. Leonard continued. Even if the expected growth were fully realized, the state of the labor market continued to be a matter of concern. Unemployment had been 8.2 percent in 1983, with little prospect of a significant decline in 1984. Given that current capacity utilization was below the rate that tended to trigger new investment, he agreed with the staff that current unemployment problems reflected in large part structural rigidities. It would, therefore, be important for the authorities to pursue policies that encouraged improved profit margins and continued moderation in unit labor costs so as to increase the opportunities for investment and growth, particularly in labor-using activities. He hoped that, in providing assistance to ailing industries, the authorities would ensure that shifts in resources to sectors with higher long-term growth potential were not inhibited.

He shared some of the concerns raised by Mr. de Maulde and Mr. Polak with regard to the appropriate ratio between wages and profits, Mr. Leonard remarked. It would be useful to know whether employment was likely to increase if the wage/profit ratio improved in favor of profits. It appeared that such an improvement would be needed to expand the supply of goods and services in the domestic market, given that the German productive sector appeared to be competitive internationally. The staff had expressed concern about the impact on labor market conditions of the movement toward a shorter work week; the recently settled metalworkers' strike had included an agreement to shorten the work week from 40 hours to 38.5 hours. Did the German authorities regard that settlement as the beginning of a general trend? In the absence of offsetting adjustments

in compensation, such a trend could have an adverse impact on unit labor costs and profit margins and, thereby, on unemployment and the overall economic outlook.

He broadly supported the authorities' goal of reducing the size of the public sector within the economy, Mr. Leonard stated. Public expenditure and the deficit had been reduced in 1983 as proportions of GNP without any apparent adverse impact on economic growth, giving encouragement to the belief that the Government's medium-term policy in that area would help to increase the availability of resources to the private sector and improve investor confidence. In attempting to contain government expenditures, the authorities could give closer consideration to restraining public sector subsidies which, at 5.6 percent of GNP, seemed to present opportunities for reduction. The authorities should also be encouraged to use any margin for maneuver to implement measures in support of industrial expansion and increased investment. In particular, high priority should be given to implementing the recently formulated tax reform measures; excessive delays could dampen their positive psychological impact on the private sector.

On monetary policy, Mr. Leonard welcomed the authorities' determination to maintain a rate of monetary growth that increased market confidence and ensured adequate liquidity for economic growth. He also supported the staff's view that, insofar as the underlying strength of the deutsche mark could be expected to continue, the authorities should avoid closely tying domestic interest rates to those in the United States.

Mr. Feito remarked that the Fund tended to judge the quality of economic policy management by examining the values of certain economic variables, neglecting to some extent the question of what those values might have been if national authorities had followed a different policy course. Even allowing for the excellent performance of the German economy during the past 18 months, the results did not fully capture the wisdom embodied in the German authorities' macroeconomic policies. Indeed, the criticism had been leveled against the authorities in the past year that they had been implementing excessively restrictive fiscal and monetary policies. However, the staff and Mr. Laske had made it clear that, if the authorities had adopted more aggressive fiscal policies or more expansionary monetary policies, the recovery under way might well not have taken place. He fully agreed with the staff and Mr. Laske on the role that fiscal and monetary policies should play in assisting the noninflationary recovery of the German economy. On specific fiscal actions, the points made by the staff, and apparently endorsed by the authorities, were well taken, particularly the convenience of concentrating expenditure restraint on public subsidies and the need to alleviate the tax burden shouldered by middle-income earners. That stance of fiscal policy was appropriate, not only from the standpoint of Germany, but also from that of the international community.

Developments in the labor market were a cause for concern, Mr. Feito continued. In that regard, he agreed with Mr. Nimatallah, Mr. de Maulde, and and Mr. Polak. Germany shared with other European countries a most disappointing unemployment picture. The gradual increase in unemployment in recent months appeared to be the result of the interaction between falling investment flows and inadequate pricing of labor services. Unemployment might, thus, continue to increase through a vicious circle in which inappropriate real wage levels reduced investment, which in turn called for lower real wage levels to prevent unemployment from growing. Therefore, real wage moderation, meaning constant real wages, was not a sufficient condition to arrest the growth of unemployment; if frequently seen as such, it was because current real wage expectations and policy attitudes harked back to the environment of the late 1960s and the first half of the 1970s, when the rates of growth of investment had warranted yearly increases in real wages. The position had been made worse by the high real interest rates of recent years, which had not only imposed a sizable burden on profitability but also increased the opportunity costs of allocating investible resources to productive purposes.

In the short run, it appeared that little could be done to improve the grim situation in the labor market, Mr. Feito considered. Wage restraint and flexibility in the wage pattern would seem to offer the only way out of the vicious circle of falling investment and growing unemployment, provided that international interest rates declined significantly. In the face of the prevailing high returns on financial assets, it should come as no surprise that the recorded increases in the rate of profit on fixed capital had failed to bring about more than a weak recovery of investment. According to the data supplied by the staff, the current rate of return on fixed capital continued to be lower than in the early 1970s. Given that real interest rates were much higher at present than in the early 1970s, the inescapable conclusion was that profitability rates would fail to promote adequate investment unless they were supported by a decline in interest rates.

Rates of profit, adjusted to take account of real interest rates, could indicate the existing incentives to allocate wealth to capital formation, Mr. Feito added; the share of enterprise profits in national income might not so indicate, although the staff appeared to imply that it might. The share of profits in national income--or, indeed, that of any other factor of production--could not be used to ascertain the incentive to invest in the absence of additional information on the way in which techniques of production had evolved over the period in question. In any event, wage restraint and flexibility would have to be accompanied by a fall in real interest rates if investment and growth in Germany and Europe were to bring about full employment.

The apparent independence of German interest rates from international rates or rates in the United States was not only relative and fragile, as Mr. Laske had pointed out, but also largely illusory, Mr. Feito suggested. Those interest rate differentials appeared to be founded on expectations of a reversal of current trends in the exchange rate of the deutsche mark

against the dollar. To the extent that the expectations were fulfilled and the dollar declined against the deutsche mark, the positive effects of the interest rate differentials on the German economy would be offset by the negative impact of exchange rate appreciation on the profitability of sectors producing tradable goods. However, if the exchange rate expectations were not fulfilled and if interest rates in the United States remained constant or continued to rise, the current differential would vanish rapidly.

There were two disappointing features of German labor market policies, Mr. Feito stated, namely, the attitude toward foreign workers and measures to encourage early retirement as a means of alleviating unemployment. He did not deny the expediency of measures intended to encourage foreign workers to leave the country, but such measures were misguided on economic grounds. From a longer-term perspective, taking into account trends in population and the labor force, labor did not appear to be a commodity in excess supply in Germany. A policy that aggravated the natural scarcity of labor by reducing the foreign share of the labor force would put upward pressures on real wage rates, make the wage pattern more rigid, increase the relative prices of goods and services dependent on cheap labor, and promote labor-saving investment, not necessarily the most productive form of investment. If that policy were reversed in the future, it would at best have resulted in unnecessary waste of fiscal resources while doing nothing to improve the short-run prospects in the labor market.

The encouragement of early retirement was also of doubtful efficacy as a solution to unemployment, Mr. Feito added. The effect would tend to be similar to that arising from offering incentives to foreign workers to leave the country. In addition to constraining the longer-run potential of the economy, such measures were a poor substitute for policies that emphasized appropriate pricing of labor services and labor market flexibility. Although the staff had suggested that the main threat to an improvement in the labor market stemmed from a shortening of the work week, a judgment with which he fully agreed, it had failed to comment on the two measures to which he had referred and on which he would appreciate comment from the staff.

Mr. Tvedt said that, as he had observed on the occasion of the previous Article IV consultation with Germany, it would have been useful--as Mr. Wicks had also pointed out--if the staff had discussed German economic policy in the international context more thoroughly, as part of the Fund's surveillance of member countries' exchange rate policies and economic policies in general.

The increasingly positive features of economic developments in Germany in 1983 were welcome, Mr. Tvedt continued. Economic growth had improved, the rate of inflation had remained low, and the surplus on the current account of the balance of payments had remained moderate. Given the great importance of the German economy, especially for Europe, those developments had been gratifying. However, it was disturbing that unemployment showed no clear signs of declining from the present rate.

GNP growth of between 2.5 and 3 percent was expected in 1984, a low figure compared with earlier cyclical upswings. The situation in the world economy in general, and especially interest rate developments in the United States, suggested that the growth prospects were more uncertain than the staff had indicated. Improved growth in Germany was increasingly dependent on impulses from abroad, because only marginal increases were foreseen in private and public consumption, and the outlook for investment demand was somewhat ambiguous. Furthermore, business confidence appeared to have been weakening, a trend that the recent labor market conflict might have intensified.

The forecasts for 1984 were based on the current comparatively tight fiscal policy and an unchanged monetary and credit policy, Mr. Tvedt noted. The authorities' belief that fiscal consolidation would contribute to stimulating private investment was shared by the staff. Over time, it might be desirable to reduce the public sector's large share of GNP, which was, however, at present in part related to the continued low utilization of resources; if employment had been higher, current fiscal policy would have lowered that share. Moreover, thus far, the concentration of expenditure cuts on social transfer payments had presumably contributed to restraining private consumption, whereas public subsidies to industry had not been affected. It might be questioned why equally effective measures to reduce expenditure on support to industry had not been taken. Furthermore, the general government deficit was estimated to amount to only 1.5 percent of GNP in 1984; after adjustment for cyclical factors, might there be at present a budget surplus in the public sector? He invited the staff to comment. Against the background of high unemployment, low price increases, and a surplus on the current account of the balance of payments, it was doubtful whether such a tight fiscal policy was proper at the present juncture.

The authorities' proposal to cut income taxes without raising other taxes or reducing expenditure was welcome, Mr. Tvedt considered. If the prospects for 1985 should deteriorate relative to the projections in the latest World Economic Outlook of a growth rate of 2.5-3 percent of GNP, there would be even more reason to consider a relaxation of fiscal policy. For example, the proposed tax reform could be speeded up, particularly since the protracted labor market conflict had had a dampening effect not only on industrial production and the inflow of orders, but perhaps also on the propensity to invest and on general sentiment in the business sector.

He agreed with the staff that "monetary policy, especially through its role in reducing interest rates in early 1983, played a significant part in last year's recovery and...will need to continue to play a supportive role in stimulating private spending," Mr. Tvedt went on. From both a German and a Nordic point of view, it had been beneficial that the German authorities had accepted and sustained a substantial, widening interest rate differential between Germany and the United States despite a rising dollar exchange rate. Mr. Laske's statement that the recent increase in the discount rate did not herald a change in the present policy stance was, therefore, encouraging. He also agreed with the staff's positive

comments on the German authorities' resistance to pressures to introduce protectionist measures; however, it was a matter for concern that the subsidies to the business sector would increase by over 9 percent in 1984 while the planned support of DM 3 billion for restructuring the steel industry contained certain protectionist features. The recently approved support for German agriculture also gave grounds for concern. Finally, Germany's transfers to developing countries were somewhat out of line with the country's strong economy; the authorities ought to accelerate the increase in official development assistance as a proportion of GNP.

Mr. Kolb remarked that it was astounding that the initial phase of the recovery in Germany had been so much stronger than forecast. The resurgence of activity had been based on a strengthening of domestic demand, especially private consumption, in a way that had not been precisely anticipated. At the time of the 1983 Article IV consultation, Directors had expressed concern about the possibility that the fiscal policy then in place might affect the recovery negatively because it had been regarded as unduly restrictive. However, events had shown such fears to have been ill founded.

With hindsight, Mr. Kolb continued, it appeared that the particular policy mix adopted by the authorities might have boosted the recovery to a higher point than expected. On the one hand, fiscal policy had tended in the main toward balance, although biased toward restrictiveness. On the other hand, monetary policy had clearly tended toward expansion. The authorities' efforts to reduce in the medium term the importance of the public sector and eventually to balance the budget had avoided the creation of additional public demand. However, at the same time, their efforts to reassess the components of the budget selectively in order to stimulate investment had eventually succeeded. The point had been reached in the recovery at which the leading effects of domestic consumption were less important, and the investment-stimulating features of that fiscal policy were coming into play. Thus, although fiscal policy had not created domestic demand in the first place, it had nevertheless produced positive results in the end because of its focus on the supply side of the economy at the appropriate moment. In addition, the fiscal stance adopted by the authorities had avoided upward pressure on interest rates and inflation.

The avoidance of such pressure had allowed monetary policy to be geared toward expansion, Mr. Kolb considered. Because inflationary pressures seemed to stem mainly, perhaps only, from wage demands, it was possible for monetary policy to concentrate largely on the second of its two main objectives, namely, the generation of sufficient liquidity to fuel appropriate economic growth. In sum, the preconditions for a continuing noninflationary recovery appeared to be present, insofar as fiscal and monetary policy could help to provide them.

Like other speakers, he was concerned about the projected increase in subsidies, Mr. Kolb said, which were not consistent with the general policy stance of the Government. The authorities were to be commended for

maintaining the amount of official development assistance, and especially for the consideration that they were giving to possible alternative courses of action in ODA. In that connection, he invited the staff to elaborate on the possibility of combining debt and trade relief, a topic briefly, but tantalizingly, mentioned in SM/84/142.

Mr. Wang joined previous speakers in commending the German authorities on the moderate noninflationary recovery that they had achieved in 1983. As in other major industrial countries, the main policy issue for Germany was how to promote and to sustain economic growth without rekindling inflation. To achieve that goal, the German authorities had made fiscal policy the main instrument for preserving the low rate of inflation and for adjusting the structural components of the budget so as to reduce the deficit. They had made remarkable progress in fiscal consolidation. General government expenditure had been cut back in 1983 and was expected to be further pruned in 1984. The deficit had also been reduced, to 2.5 percent of GNP in 1983 compared with 3.5 percent in 1982; a further decline to 1.5 percent was expected in 1984. Such fiscal retrenchment had played a great part in the noninflationary recovery of 1983; the main thrust of fiscal consolidation in 1984 was to maintain and build upon business and consumer confidence.

Nevertheless, Mr. Wang continued, the risk of over-consolidation was worth examining carefully. In order to reconcile the medium-term objective of reducing the federal deficit with the more immediate aim of reviving the economy, it might be necessary to reduce government expenditure gradually, and over a longer period than currently envisaged. Unduly large reductions in budget deficits could have a negative impact on the moderate recovery, which had not been strong enough to prevent the unemployment rate from rising to 8.2 percent, from 6.7 percent in 1982.

Employment objectives warranted greater attention in shaping and implementing fiscal policy, Mr. Wang considered. If unemployment remained high, it would be questionable whether the authorities could manage to reduce the budget deficit substantially. A return to high employment could, perhaps, improve the public sector accounts, given the high productivity of labor and the competitiveness of German products. Furthermore, with interest rates low and inflation under control, the authorities had more room to maneuver in adopting a relatively accommodating fiscal policy to deal with unemployment.

Both monetary and exchange rate policies appeared to have been managed appropriately during 1983, Mr. Wang remarked. Target rates for monetary growth in 1983 had provided a stimulus to recovery and kept inflation under control. According to the information in SM/84/142, money growth in the first quarter of 1984 had actually fallen below the lower limit of 4 percent. It would be interesting to know the reason for and the impact of such tightening. In view of the hesitation in the recovery in the first quarter of 1984, and assuming that fiscal consolidation was maintained, monetary policy could become more accommodating, provided that there was no immediate risk of inflation. Despite several recent

increases in U.S. interest rates, the authorities had succeeded in maintaining the level of rates in Germany; they had also been able to maintain steady monetary growth. Clearly, market confidence in the long-run strength of the deutsche mark was increasing, and the authorities also had further room for maneuver in using monetary policy to encourage consumption as well as investment.

The information in Appendix II to SM/84/142 indicated that increases in exports had contributed to recovery in 1984, Mr. Wang noted. According to a staff projection, the change in Germany's foreign balance would shift from minus 0.5 percent of the previous year's GNP in 1983 to 0.75 percent in 1984. How had the staff arrived at that projection? What would be the impact of the continuing increase in U.S. interest rates on German monetary policy and, consequently, on exports and economic recovery? Would the authorities persist in adhering to the current pattern of monetary policy? If so, would higher interest rate differentials cause an outflow of capital, thereby impairing investment? If not, would a change in the current policy result in an appreciation of the deutsche mark that could threaten export performance?

The German authorities were to be commended for their support of open trade practices, Mr. Wang stated. It was encouraging that they had refrained from imposing new domestic trade restrictions when many other industrial countries had strengthened their protectionist measures. However, as the staff had mentioned, there had been an increase in restrictions in the European Community; as an important member, Germany could play an even greater role in shaping Community trade policy and in helping to remove the remaining trade barriers. He welcomed the increase in Germany's development assistance; he hoped that it would be increased further as a proportion of GNP, despite expenditure restraint.

Mr. Prowse commented that Germany had produced the first "economic miracle" of the midtwentieth century; if current policy could be maintained, it might be the first country to produce the second "miracle." The most obvious factor behind the dimming of previous excellent economic performance had been the growth in the size of government and, later, the growth in public sector deficits. He welcomed, therefore, both the authorities' medium-term objective of reducing the share of general government in the economy and its more immediate objective of reducing the public sector deficit. The authorities had put in place a responsible, balanced set of fiscal and monetary policies, which were bearing fruit. As the staff pointed out, unlike most other industrial countries, Germany had achieved substantial progress in implementing its program of fiscal consolidation, which most observers believed was crucial to sustaining the recovery of private activity and thereby the medium-term growth of private sector employment. For such reasons, he could support the German authorities' approach to economic management and the staff's broadly favorable assessment of that approach.

The Fund's surveillance function as practiced in Article IV consultations should be taken seriously, Mr. Prowse continued. Nonetheless, it was encouraging that the German authorities had not followed all the suggestions put forward in the course of the Executive Board's discussion of the 1983 consultation. Indeed, their judgment had been superior, most notably in rejecting the stimulatory fiscal policy that some Directors, not including himself, had favored.

Germany's external sector had made a relatively weak contribution to the current recovery, compared with previous ones, Mr. Prowse observed, even though Germany had maintained its international competitiveness in recent years. He invited the staff to comment on the point. Perhaps the explanation was that the major share of Germany's export markets was in Europe. How well had German exports maintained their share of the North American market relative to, say, Japanese exports?

Wage policy was also relevant to the prospects of sustaining the recovery, Mr. Prowse went on. Wage restraint would be essential not only to increased output but also to the recovery of employment. As the staff noted, the authorities acknowledged that increased employment depended to a great extent on wage flexibility; while that was a straightforward objective, what specific policies did the authorities have in mind or would the staff recommend for achievement? The wage/cost problem was perhaps less serious than some Directors had suggested, even after the recent conclusion of the labor disputes in the metalworking and printing industries. Between the first quarter of 1982 and the end of the first quarter of 1984, the index of unit labor costs in Germany had increased by 1.6 percent in local currency terms. While the recent wage settlements would probably raise the index by about an additional 4 percent in 1984 and in 1985, Germany's performance relative to other European countries, particularly Italy, had been reasonably favorable in recent years.

On monetary policy, Mr. Prowse noted, the staff suggested that the growth in the central bank money stock should move toward the upper half of the present range, or toward 6 percent. The staff's view appeared to be that there was continuing scope for moderately expansionary monetary policy because of "improved economic fundamentals." Fiscal performance "gave a margin of flexibility to the German monetary authorities that they could now exploit in favor of domestic expansion"; the staff went on to argue that "a faltering of the domestic recovery should not be risked through short-term monetary policy in response to what might be short-lived external shocks." However, he could not agree with the staff's judgment, because the position that it described no longer held, as a result of the recent weakening of the deutsche mark against the U.S. dollar as short-term interest rate differentials had widened. It was not clear to what extent the authorities could retain the relative autonomy of their monetary and interest rate policies. It might be time to assign external objectives to monetary policy; the developments described in the supplement to SM/84/142 supported that view. A further reason for skepticism with regard to the appropriateness of a more expansionary monetary

policy was that the recent settlement in the metal industry dispute could stimulate inflationary expectations despite the fact that its direct impact on labor costs would not be very great.

He fully agreed with the staff that the progress achieved with regard to fiscal consolidation was fundamental, leading to a strengthening of international confidence in the German economy, Mr. Prowse said. It would be essential to maintain the momentum of fiscal consolidation throughout 1984. He hoped that the authorities would not be deflected from their objective by suggestions that the cyclically adjusted or structural deficit was in surplus. Although the current deficit in 1983 had been 2.7 percent of GNP--a proportion among the lowest in the European Community and lower than in Japan or in the United States--the government sector in Germany was substantially larger than the government sector in several other major industrial countries. Furthermore, it had grown rapidly in the last two decades. Thus, it would be inappropriate to assess the budget situation simply on the basis of the current deficit. The share of the public sector in GNP had reached 50 percent in the early 1980s, an extremely high figure for an economy that had been regarded as a paragon of the market process in the 1950s and early 1960s. How did the authorities intend to achieve their objective of reducing the share of the public sector? A good deal of public expenditure consisted of transfer payments and the like, while there were relatively few public enterprises, so that the scope for reducing such public business activities appeared limited. Nevertheless, the authorities were taking the first steps toward privatizing public enterprises. Was there scope for further progress in reducing the share of the government sector through such measures, or would the issue eventually come down to making difficult choices regarding welfare? The staff stated that the bookkeeping value of government capital in federal enterprises was only 0.75 percent of GNP, which seemed a small figure. He invited the staff to comment further.

Structural adjustment policy was related to the difficulties associated with reducing the budget deficit, Mr. Prowse suggested. Government intervention in the economy, through subsidies and tax concessions, was impeding such adjustment; it was, therefore, disappointing that the staff restricted its assessment of the topic to the remark that "there has not thus far been much success in lowering subsidies" and to the hope that "more of the expenditure restraint in Germany could be achieved through a reduction in the still rather large subsidies paid by the public sector." If Germany had been seeking approval of a stand-by arrangement with the Fund, he would have wished to see much stronger comments on the topic. The authorities should be commended for their relatively good record in resisting protectionist pressures, particularly within the European Community, and they intended to reduce subsidies, remove certain regulations, and rely more on market forces. Nevertheless, a number of investment-stimulating measures, such as tax concessions, depreciation allowances, and tax incentives, had increased the degree of subsidization of German industries; public subsidies to industry, after declining in 1982, had increased by 2.5 percent in 1983 and were budgeted to rise by more than 9 percent in

1984, which was a matter for concern. Moreover, those subsidies had been concentrated on declining sectors of industries, such as coal, steel, and agriculture.

The history of such measures in many countries supported the proposition that they tended to maintain existing structures rather than to foster structural change, Mr. Prowse added, and that they tended to be self-perpetuating, contributing substantially to problems of fiscal balance without contributing to adjustment. A typical example was noted by the staff on page 20 of SM/84/152, where it expressed doubts about the decision in February 1984 to promote research and development in high-technology industries, saying: "This move was a reaction to the perceived development lag of Germany in this area compared with other industrial countries, especially Japan and the United States. The evidence on this lag, however, is mixed." The causes of that lag, if it existed, were even more mixed. While financial assistance to industry might be necessary, it had to be linked to plans for effective restructuring and, preferably, for being phased out according to a predetermined timetable. Such assistance should be subject to regular, impartial, critical review of its objectives, design, and administration. He invited the staff to say whether the subsidization of German industry, which was becoming an increasing burden on the budget, met those criteria.

Mr. Mtei recalled that, during the 1983 Article IV consultation with Germany, his chair had welcomed the indications that the recession had bottomed out and that a recovery in economic activity was under way. His chair had also stressed the importance of sustained recovery in Germany to the vitality of the international economy as a whole. The staff's analysis showed that developments since that time had been mixed. On the one hand, inflation had continued to decline, owing to moderation in wage settlements and the falling prices of imports, while the current account position had been fairly comfortable. On the other hand, the domestically generated recovery had failed to gather momentum; for 1983 as a whole, the staff remarked, "the upturn remained weaker than it had been at similar stages in previous recoveries." Furthermore, Mr. Laske indicated that the recovery, while not very strong, had begun to lose momentum in the first half of 1984. The staff's observation that "the sources of the initial recovery may perhaps have been of a temporary character" was equally important. In addition, there was the problem of labor unrest at a time when unemployment was as high as 8.5 percent.

Given the low inflation rate, the substantial excess capacity, the high unemployment rate, and the current account surplus, Mr. Mtei continued, he agreed with the staff that no serious constraint to a stronger recovery was evident. The obstacle to the recovery could well be the appropriateness of the policy mix that the authorities were using to sustain the pickup in economic activity. The authorities were resolved to reduce the fiscal deficit through expenditure retrenchment. However, the concern of his chair at the 1983 Article IV consultation--that the speed with which the deficit was to be reduced might not permit a strong recovery in the immediate future--appeared to have been borne out.

Developments since then had confirmed the fragility of the recovery; the authorities should focus on actions that might be needed not only to stem the recent decline but also to strengthen growth. It was particularly encouraging that the authorities had considered the risk of fiscal "overconsolidation," but he was not convinced of the effectiveness of the ad hoc measures being implemented to stimulate investment. An easing of fiscal policy could be crucial in present circumstances, especially because there was no evidence at present of a sustained upswing in private demand.

The odd feature of the present fiscal stance was that fiscal retrenchment was being accompanied by increasing subsidies to industries that had, over the years, become more and more uncompetitive, Mr. Mtei considered. Contrary to the authorities' declared objective of reducing state subsidies, such subsidies had actually increased by 2.5 percent in 1983 and were to increase by a further 9.5 percent in 1984. The problem was not unique to Germany; the information in the table on page 19 of SM/84/152 clearly illustrated the pervasiveness of the problem in the European Community. A substantial reduction or elimination of subsidies would have salutary effects on the budgetary position and would ease the need for expenditure cuts in more productive sectors of the economy.

The scope of monetary policy in stimulating the recovery, which had been much in evidence since 1981, appeared to have been reduced, Mr. Mtei remarked. While the target range for the growth of central bank money had been fixed at 4-7 percent since the fourth quarter of 1981, actual growth had been close to the upper end of the band and had reached about 7 percent in 1983. For 1984, not only had the range been narrowed to 4-6 percent, but the growth in central bank money had been below the lower limit during the first quarter. The effect of such a tightening of monetary policy in conjunction with the accelerated pace of fiscal consolidation could only be harmful to economic activity. He hoped that the authorities would reconsider the possibility of easing the monetary stance in view of the uncertain path of Germany's economic recovery.

Government subsidies not only affected fiscal policy, Mr. Mtei went on, but also had external effects. Apart from the possibility of leading to friction with trading partners, they could have an impact on the medium-term to long-term competitiveness of the export sector. The staff highlighted the fact that the subsidies had not necessarily been designed to increase competitiveness. Rather than subsidize sectors that could withstand competition, the authorities might need to focus their attention on the high-technology capital goods sector, where Germany's ultimate comparative advantage lay. Benign neglect of that sector might have accounted for the declining share of Germany in world exports of high-technology goods, vividly illustrated in the table on page 51 of SM/84/152.

Growing restrictions on international trade, including the imposition of import quotas or voluntary undertakings to restrain exports of certain goods by specified countries, to which the staff referred briefly, were a

cause for concern, Mr. Mtei stated. Unless such restrictions were rolled back, the fragile recovery under way would stand little chance of maturing, and the entire international community would thereby be worse off. Finally, the German authorities should be commended for gradually increasing their official development assistance from 0.44 percent of GNP in 1980 to 0.49 percent in 1983 despite their domestic economic difficulties. He urged them not to relent in their aid efforts and to seek to attain the globally agreed target for official development assistance of 0.7 percent of GNP as sson as possible.

Mr. Chatah observed that economic developments in Germany over the past 18 months pointed to a definite improvement in most indicators of economic performance. After declining for almost three years, real GNP had registered positive growth in 1983, surpassing earlier expectations. Price inflation had moderated further to less than 3 percent, and the balance of payments had continued to be strong. As the staff indicated, however, those positive developments had not been reflected in the labor market, where unemployment had continued to increase, reaching 8.2 percent of the labor force, or more than twice the rate prevailing only three years earlier. The staff provided a thorough analysis of those developments in light of the policies pursued by the German authorities. He was in broad agreement with that analysis and the staff's assessment of the outlook for 1984.

An important factor behind the improved performance of the German economy in 1983 was the progress achieved toward fiscal consolidation, Mr. Chatah continued. That progress had not only strengthened private sector confidence but also permitted a less restrictive monetary policy than would perhaps have been necessary otherwise. Projections for 1984 indicated a further reduction in the fiscal deficit from 2.5 percent of GNP to 1.5 percent. At the same time, however, there appeared to have been a tightening of monetary policy, with the official target range for the growth of central bank money set at 4-6 percent, compared with actual growth of 7 percent in 1983. Moreover, according to the staff, the actual growth of central bank money during the first quarter of 1984 had been less than 4 percent, although it had increased to 4.75 percent in May and June.

The differing views of the German authorities on the appropriate monetary growth target were interesting, Mr. Chatah considered. One argument in favor of a lower target was the expectation by some observers that the growth in production in 1984 would probably outpace the rise in potential output as more economic slack was taken up. However, the data for the first few months of 1984 seemed to indicate some hesitancy in the growth of economic activity. That situation, in conjunction with the relative stability of the deutsche mark and the moderate inflation rate, could raise the question whether a slightly less restrictive policy might not be desirable for the rest of 1984, as some speakers had already noted. If he was correctly interpreting the staff on that point, it also favored an easing of monetary policy. He invited the staff to comment on the differing views expressed by speakers.

As to developments in the labor market, Mr. Chatah said, the substantial rise in unemployment in 1983 and the prospects for 1984 were particularly disconcerting, given the improvement in the general economic environment. One aspect of the staff's interesting analysis of that anomaly appeared inconsistent: on the one hand, the staff gave the impression that wage rigidities were, in part, responsible for the persistence of a high unemployment rate; on the other hand, it stated that wage incomes, net of taxes, would decline in 1984 for the fifth consecutive year. He invited the staff to comment.

The persistence of high unemployment while capacity utilization was rising close to rates that would induce capacity-increasing investment led to the conclusion that a large portion of unemployment might not be cyclical, Mr. Chatah went on. The question was whether there had been a technological shift toward a higher capital-labor ratio. An increase in the marginal capital-labor ratio, if it had, in fact, occurred, might be partially related to movements in wages but could also stem from advances in labor-saving technologies. In any event, the apparently noncyclical nature of the unemployment problem suggested that a more structural approach should be taken to deal with it.

The stated commitment of the German authorities to liberal trade policies was welcome, Mr. Chatah remarked, as was their resistance to increased restrictions by the European Community. However, the reversal of the spiral of reciprocal protectionism in industrial countries depended more on the actual trade policies adopted by the European Community than on the fact that those policies might not be advocated by all members of the Community. He hoped that Germany's commitment to the principle of liberal trade would find greater reflection in the policy decisions of the European Community. He joined Mr. Kolb in noting the possibility that access to the German market for developing countries, particularly major debtors, would be increased on a temporary and discretionary basis. Any increase in access to the German market would be welcome. However, it was important that such temporary trade relief granted on a selective basis should take fully into account the distortions that it might create, both with regard to resource allocation across countries and the stability of exports from any particular group of countries granted such trade relief. Perhaps Mr. Laske or the staff could elaborate on the issue.

Mr. Ismael recalled that, at the time of the 1983 Article IV consultation with Germany, many Executive Directors, including his chair, while noting the signs of a moderate recovery in 1982, had been apprehensive that the recovery had not then been well established and could falter. However, economic growth had accelerated during 1983. Gross domestic production had grown beyond the depressed level of 1982, with expansion in the last quarter well above the annual average rate. Increased tax receipts, together with containment of the expenditure side of the Federal and Länder budgets and social security accounts, had led to a reduction in the overall public borrowing requirement. Monetary policy had remained moderately restrictive; despite an increase in the value-added tax in the middle of the year and the weakness of the deutsche mark against the dollar, price increases had been moderate by international standards.

Despite continuing high real interest rates, Mr. Ismael continued, investment had been stronger than in 1982, partly as the result of fiscal incentives for productive investment and partly owing to the much-improved rate of capacity utilization. Although exports had gained in strength only toward the end of 1983, while imports had increased substantially, the trade surplus had decreased only slightly. The balance of payments on current account had been in slightly greater surplus than in 1982, owing to a considerably reduced deficit in invisible trade.

The weak aspect of the economy was the difficulty experienced in certain industries, particularly steelmaking, coal mining, and shipbuilding, Mr. Ismael considered, where workers had been laid off with severe effects on traditionally industrial areas such as the Ruhr, the Saarland, and Bremen. In that regard, he associated himself with the question raised by Mr. Polak on the linkages among wages, social security, and unemployment. In general, the German authorities deserved praise for their remarkable economic performance in 1983. They should also be commended for their continued efforts to resist protectionist tendencies and for increasing official development assistance to almost 0.5 percent of GNP.

Mr. Malhotra said that he joined other speakers in commending Germany on the performance of its economy in 1983, which had been better than expected. The moderate recovery was particularly welcome, although it was a matter for concern that its momentum appeared to have faltered in the first half of 1984. However, other indicators of performance, except employment, were good, including the inflation rate and the balance of payments. Fiscal performance had improved, and monetary policy continued to be skillfully managed.

Germany was the third-largest market economy in the world, Mr. Malhotra continued, and its performance was of great interest not only to its neighbors but also to countries far removed geographically. The possibility that the recovery, which was still fragile, might falter was therefore disturbing. Some Directors, noting that the pace of fiscal consolidation had been stronger than expected, had concluded that it had not inhibited recovery. However, although the recovery in 1983 had been somewhat better than expected, it had been relatively moderate, especially in the light of the stagnation of output in the previous three years. Furthermore, the mix of fiscal and monetary policies also had to be taken into account. Clearly, in the recent past, monetary policy had been providing some welcome expansionary stimulus, but he wondered what measures would be taken if the recovery in 1984 did not continue along the expected path.

The German authorities' medium-term objectives included reduction in the role of government, and they wished therefore to bring down budget expenditures, Mr. Malhotra noted. However, the pace of the reduction in the fiscal deficit could be questioned, especially as it appeared that the fiscal position was in balance on a cyclically adjusted basis. On the monetary side, while the modest stimulus was welcome, especially because interest rates had been kept relatively low, it would be a matter of concern if the rate of monetary growth fell below the upper portion of

the range established for 1984. Indeed, if the rate of recovery in 1984 did not materialize as expected, there would be scope for further monetary stimulation in view of the low rate of inflation and the lack of fiscal stimulus. The overall mix of fiscal monetary policies could be altered somewhat or actions taken in each area to sustain a desirable pace of recovery.

The relative weakness of domestic demand continued to be a problem, Mr. Malhotra went on. He joined Ms. Bush in wondering whether the sources of a sustainable recovery could be easily identified, an issue to which the German authorities would undoubtedly be addressing themselves. Another point of interest was the rapidity with which the practical limits of capacity utilization had been reached. In that context, the moderate growth in GNP was somewhat surprising; perhaps the margin for increased capacity utilization had been quite small, following the earlier period of low growth. Unemployment remained high, and the staff's assessment that it was due to structural problems was probably correct. However, the problem might not simply be the structure of wages; Mr. Polak had raised a number of relevant issues in that regard. The problem of structural unemployment was a relatively recent phenomenon that had not been dealt with comprehensively in economic literature. It appeared to be related to the capital-intensive nature of modern technology, to the increasing tendency of workers, including employed workers, to seek greater leisure time, and, perhaps, to changing attitudes toward work itself. The complexity of the issue did not permit easy solutions, but in view of the clear need to stimulate growth, short-term measures to deal with unemployment should not be ruled out in Germany or in other countries.

Commenting on trade policy, Mr. Malhotra said that he agreed with the staff that Germany's record on protectionism had been better than that of many other countries. However, Germany benefited from protectionist measures taken by the European Community and subsidized its industries heavily. He was less concerned about the fiscal impact of such subsidies than about their implications for trade, because they could be considered a form of disguised protectionism. While the authorities' attempts to deal with the severe unemployment problems in certain regions were understandable, the share of subsidies in Germany's GNP was surprisingly high. In fact, subsidization was a problem in several industrial countries; agricultural subsidies, for example, were granted not only in Germany but in other industrial countries as well. He hoped that recent initiatives to reform the European Community's Common Agricultural Policy (CAP) would bear fruit. More generally, subsidies and other forms of protectionism in industrial countries reflected the unfair distribution of the burden of adjustment in the world economy as a whole.

The German authorities should be commended for their record on official development assistance, Mr. Malhotra considered, with regard to not merely its volume, but also its quality. They had generally provided assistance on IDA terms and, unlike some other countries, had not tied it to procurement within Germany. They had encouraged international competitive bidding, a point that was particularly commendable. Despite its

program of rapid fiscal consolidation, Germany could afford to achieve quickly the internationally accepted target for official development assistance of 0.7 percent of GNP. Perhaps the authorities had that goal in mind. Despite their concern with regard to burden-sharing within IDA, the authorities needed to be more open to the idea of setting up a facility supplementary to IDA in order to ensure that IDA-type funding did not suffer a cut of 25 percent, even in nominal terms, over IDA-VI. Support by Germany and some other countries could help to overcome the difficulties being experienced in that regard.

Mr. Teijeiro observed that economic performance in Germany in 1983 and early 1984 had been better than projected by the staff at the time of the 1983 Article IV consultation. He commended the authorities for their successful management of the economy. The moderation of inflationary pressures, interest rates, and labor costs had all helped to improve profit margins and to stimulate private investment.

The fiscal progress was among the most fundamental elements strengthening the German economy, Mr. Teijeiro continued. He supported the commitment to reduce the size of government. A reduction in public expenditure growth to about half the projected growth of nominal GNP would increase the private sector's confidence in the program of fiscal consolidation. He also supported the reduction in the subsidies paid by the public sector. It was encouraging that the progress achieved and the continued fiscal austerity under way would make it possible to introduce tax reductions.

Monetary policy, particularly through its role in reducing interest rates in early 1983, had played a significant role in the 1983 recovery, as both the staff and the German authorities acknowledged, Mr. Teijeiro noted. While economic activity had picked up, inflation had continued to be moderate, with consumer prices rising by 3 percent in 1983. The stability of monetary policy had played a major role in achieving growth while keeping inflation low.

Monetary and fiscal policy had also been successful in creating conditions that encouraged more reasonable wage settlements, Mr. Teijeiro remarked, which had, in turn, contributed to improved business profits, thereby helping to sustain growth. However, unemployment was a matter of concern. Further analysis would be needed to identify the factors behind the unsatisfactory prospects for reductions in unemployment in the years ahead.

Germany continued to be a supporter of open trade policies in comparison with other members of the European Community, Mr. Teijeiro commented. Current levels of protection in the European Community were indefensible at a time when the world economic situation was critical. Germany's attitude was helping to prevent a worsening of the situation, but the position continued to be unsatisfactory. Although the recent price and production measures under the Common Agricultural Policy should be welcomed, it was a matter of great concern that the Community intended to

restrict imports of certain agricultural commodities, such as cereal substitutes, as part of the CAP reform package. Agricultural protection had devastating effects on developing countries, particularly at a time when many of them were overburdened by financial constraints. As he had noted on an earlier occasion, it had been estimated that the income lost by developing countries as a result of the common agricultural policy exceeded the European Community's total assistance to developing countries. He stressed the importance of stronger efforts to reduce protectionism as an important complement to Germany's concern about the economic situation of developing countries, which was reflected in the level of its official development assistance.

The Executive Directors agreed to resume their discussion in the afternoon.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/111 (7/18/84) and EBM/84/112 (7/20/84).

### 2. RULES FOR 1984 REGULAR ELECTION OF EXECUTIVE DIRECTORS - REPORT AND DRAFT RESOLUTION

1. The Board of Governors is requested to vote without meeting pursuant to Section 13 of the By-Laws of the Fund upon the draft Resolution, entitled 1984 Regular Election of Executive Directors.

2. The Secretary is directed to send the Report of the Executive Board to the Board of Governors on the 1984 Regular Election of Executive Directors and the draft Resolution entitled 1984 Regular Election of Executive Directors as set forth in EBD/84/190 (7/11/84), to each member of the Fund by mail or other rapid means of communication on or before July 25, 1984.

3. To be valid, votes must be cast by Governors or Alternate Governors on or after July 25, 1984 and must be received at the seat of the Fund on or before September 4, 1984. Votes received after that date will not be counted.

4. The effective date of the Resolution of the Board of Governors shall be September 4, 1984, the last day allowed for voting.

5. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto shall be confidential until the Executive Board determines the result of the vote.

6. The Secretary is authorized to take such further action as he shall deem appropriate in order to carry out the purposes of this decision.

Decision No. 7759-(84/112), adopted
July 19, 1984

3. STAFF COMPENSATION - 1984 SALARY SCALE

The Executive Board approves the salary scale set forth in EBAP/84/156 (7/18/84) on the basis of the decision adopted at EBM/84/109 (7/17/84).

Adopted July 19, 1984

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to an Executive Director, as set forth in EBAP/84/153 (7/16/84).

Adopted July 18, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/155 (7/17/84) and by an Advisor to Executive Director as set forth in EBAP/84/155 (7/17/84) is approved.

APPROVED: April 15, 1985

LEO VAN HOUTVEN
Secretary