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AGENDA

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July 5, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Federal Republic of Germany - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the Federal Republic of Germany.

This subject will be brought to the agenda for discussion before the informal Board recess, on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Nyberg (ext. 75208) or Ms. Christensen (ext. 75663).

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INTERNATIONAL MONETARY FUND

FEDERAL REPUBLIC OF GERMANY

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with the Federal Republic of Germany

Approved by L. A. Whittome and C. David Finch

July 5, 1983

I. Introduction

Article IV consultation discussions were held in Bonn and Frankfurt from May 18 to June 1, 1983. The German authorities were represented by officials of the Federal Ministries of Finance, Economics, Economic Cooperation, Labor, and Agriculture, of the Federal Chancery, and of the Deutsche Bundesbank. Mr. Gerhard Laske, Executive Director for Germany, attended the meetings as an observer. The staff mission consisted of Hans Schmitt, Duncan Ripley, Pierre Dhonte, Peter Nyberg, and Benedicte Vibe Christensen (all EUR), with Naheed Kirmani (ETR) participating in the trade discussions, and Valerie Pabst (EUR) as secretary. Germany has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Economic Background

Real GNP peaked in the first quarter of 1980 following two years of rapid expansion carried by strong increases in private consumption and in gross fixed investment (Chart 1). The unemployment rate reached a cyclical low in that quarter though at a level that was noticeably higher than at earlier peaks (Chart 2). Consumer price inflation accelerated to an unacceptable rate of more than 5 1/2 per cent for the year as a whole; wage income per employee rose even faster and profits were severely compressed (Chart 3). Deteriorating terms of trade aggravated a widening deficit on external current account (Chart 4). As the exchange rate for the deutsche mark came under pressure, gross official reserves were drawn down sharply despite substantial foreign borrowing by the authorities in that year.

1. A delayed recovery

Real GNP was barely maintained in 1981, and then fell by over 1 per cent on average in 1982. By the fourth quarter of 1982 it had dropped some 3 per cent below its level in the first quarter of 1980. Unemployment seasonally adjusted rose to 7 1/2 per cent of the labor force. At the turn of 1983, however, the recession appeared to have bottomed out. A moderate gain in economic activity seemed likely, although not strong enough to prevent a further rise in unemployment.

The leveling off of economic activity in 1981 was the result of a decline in domestic demand nearly balanced by a rise in the net foreign balance. The accelerated deterioration in 1982 was in part due to a further sharp fall in private consumption. It declined in 1981 for the first time in the postwar period, by more than 1 per cent, and then dropped by another 2 1/4 per cent in 1982. The main reason was a fall in real disposable income, brought about by moderating wage outturns and falling employment.

The decline in investment in private machinery and equipment also gained momentum in 1982, while construction continued to sag. The poor investment performance persisted notwithstanding an improvement in the underlying conditions. Interest rates were easing; wage moderation was contributing to an improvement in profit margins; and stabilization of import prices together with wage restraint gave promise of a significant slowing down of price increases (Charts 3 and 6).

However, a sharp downturn in foreign demand in the second half of the year and continued weak consumer demand overshadowed these positive factors. To be sure, stocks, which had been run down in 1981, were replenished to some extent, partly in reflection of a good harvest and some involuntary stockbuilding. On balance, nevertheless, domestic demand again made a negative contribution to growth of about 2 per cent. The contribution of the external balance was 1 per cent compared to over 2 per cent the year before.

It was not until the turn of the year that a somewhat firmer prospect for recovery began to emerge. Preliminary results for the first quarter of 1983 suggest a rise in the seasonally adjusted real GNP of 1/2 per cent above its fourth quarter level. Real private consumption expenditure rose by 1 1/2 per cent on the same comparison. Still, a number of transitory factors contributed some part to the implied decline in the savings ratio. Among them were an early Easter, an exceptional bunching of maturing savings certificates, and some purchases in anticipation of the midyear rise in VAT.

Investment in machinery and equipment has also begun to show some first signs of revival though partly at least in response to an investment bonus which has since lapsed. There has also been a pickup in construction orders in response to various fiscal incentives, but new starts have yet to come through despite declining interest rates and mild weather. Export orders thus far show no clear upward trend.

2. Price and wage moderation

Inflation as measured by consumer prices slowed during 1982 as both foreign and domestic cost increases were smaller than in 1981. However, because enterprises tried to improve profit margins, prices increased more than cost pressures alone could account for. Indeed, the GNP deflator rose rather more rapidly in 1982 than it had the year before.

The increase in consumer prices fell back moderately from 6 per cent in 1981 to 5 1/2 on average in 1982. Through the year, and particularly during the second half, the improvement was stronger, with the index rising 4 1/2 per cent December on December in 1982, as against 6 1/2 per cent the year before. Import unit values rose by only 1 per cent in 1982 in sharp contrast with the 12 1/2 per cent average increase recorded a year earlier. The growth in domestic unit labor cost slowed to 3 1/2 per cent from 4 1/2 per cent in 1981.

The deceleration in unit labor costs was hampered by a rise in productivity per man hour in industry of only 1 1/2 per cent in 1982, compared with 2 per cent in 1981. The slow rate of productivity growth in 1982 was caused by a rapid fall in production that outpaced the rate of labor shedding, which was also quite high. The rather low rate of investment over the last three years may also have contributed.

The rise in the yearly unemployment rate in 1982--by 2 percentage points to 6 1/2 per cent--stems from a fall in employment of nearly 2 per cent and a rise in the labor force of 1/2 per cent. The easing in the labor market also caused a further rise in the number of employees working part time, and a continued fall in the number of advertised vacancies. The number of advertised vacancies in 1982 was one-third the number in 1980, though more recently there have been signs of a renewed increase, and also some reduction in the number of employees on short-time work.

The slack in the labor market has contributed to a moderation in wage settlements. Earnings per man hour worked in industry rose by only 5 1/2 per cent in 1982 compared with 7 per cent in 1981 and 8 1/2 per cent in 1980. Settlements concluded thus far promise a further deceleration in the growth of hourly earnings to an average of 3 1/2 per cent in 1983. In real terms, and for the economy as a whole, earned incomes per employee fell by 2 1/2 per cent after tax in 1982, the third year in a row that such incomes declined.

The GNP deflator, nevertheless, rose by almost 5 per cent in 1982, compared to some 4 per cent the year before. With unit labor costs rising by 3 1/2 per cent for the economy as a whole, profit margins clearly improved. For manufacturing alone the rise in the deflator accelerated to some 6 per cent in 1982 against an increase in unit labor cost of 4 per cent. Taking cyclical factors into account the underlying improvement was stronger. Normalized unit labor costs at the end of 1982 may have been some 4 1/2 per cent lower than actual labor costs calculated on a 1980 base.

Developments in oil prices contributed to the slowing down of the rise in import prices; another significant factor was the strengthening of the deutsche mark. In effective terms (MERM) it appreciated by 4 per cent on average in 1982 compared with a depreciation of 7 1/2 per cent in 1981. 1/ Against the dollar alone it depreciated by 7 per cent in 1982, but against other EMS currencies it appreciated by almost 9 per cent largely because of two realignments (Chart 5).

3. A strong external balance

The deficit on external current account peaked in 1980 at the equivalent of 2 per cent of GNP; it declined in 1981 before turning into a surplus equivalent to 1/2 per cent of GNP in 1982 (Chart 4). The swing between 1981 and 1982 primarily reflected an improvement in the terms of trade, but also cyclical developments and the delayed effect of an increase in competitiveness. By year-end Germany was, therefore, in a better position as regards the evolution of prices and the balance of payments than most industrial countries to accommodate a recovery in economic activity.

The swing in the external account was brought about largely by a strengthening of the trade balance, though the long-term deterioration in services was also interrupted. In 1981 the development of real flows was sufficiently favorable to more than offset the deterioration in the terms of trade; in 1982, however, most of the improvement was attributable to a 4 per cent strengthening in the terms of trade. This change, which began in the fourth quarter of 1981, was not only the result of weak commodity prices, but also of the effective appreciation of the deutsche mark.

The trade balance benefited also from the real depreciation of the deutsche mark that began in the first quarter of 1980. Measured by normalized relative unit labor costs, competitiveness improved by a cumulative 14 1/2 per cent in 1980 and 1981, before stabilizing in 1982. The consequent gain in market shares was most striking in 1981, when German exports rose by 5 1/2 per cent in real terms, against a market growth of 2 per cent. In 1982, with markets expanding at only 1/2 per cent, export growth slowed to 2 per cent.

The swing in the trade balance also reflected changes in the relative cyclical position of Germany. Whereas the real GNP of trading partners remained flat on average in both 1981 and 1982, German GNP declined in each year.

The current account deficit in 1981 was financed by official borrowing abroad that also covered a net outflow on private capital account. With the strong improvement in the current account balance in 1982, official borrowing could be reduced, although persistent interest rate differentials helped keep net private capital flowing out. Net official borrowing

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1/ According to the Bundesbank's trade-weighted index, the appreciation amounted to 6 1/2 per cent in 1982, against a depreciation of 2 1/2 per cent in 1981. The main reason for the difference is the greater weight of the U.S. dollar in MERM (25 per cent) than in the Bundesbank index (9 per cent).

first assumed significance in 1980, and in the three years to end-1982 had cumulated to DM 46 billion, of which DM 28 1/2 billion came from OPEC countries.

The net foreign asset position of Germany, excluding direct investments, amounted to DM 80 billion at the end of 1982, or to US$34 billion. On the lending side, the recorded exposure of German banks and their foreign branches amounted to DM 332 billion of which DM 16 billion was accounted for by state trading countries. Total bank lending to Brazil, Mexico, and Argentina amounted to almost DM 15 billion.

Capital movements during the first quarter of 1983 were dominated by speculative inflows in anticipation of a realignment in the EMS. Official reserve holdings rose by DM 17 billion from the beginning of 1983 to the realignment in mid-March reflecting mainly intervention purchases to limit the upward pressure on the deutsche mark. Since the realignment and until the end of May, net foreign assets of the Bundesbank declined by DM 18 billion. Net official reserves at the end of May, 1983, amounted to DM 69 billion or 14 per cent of 1982 imports of goods and services.

III. The Policy Discussions

The German authorities were satisfied that an economic recovery was under way even though it remained modest for the present. The public did not expect any short-run governmental stimulus to demand. The present upturn in activity rather reflected improved confidence that policies would help strengthen a market-oriented economy. This confidence centered on expectations of continued budgetary discipline and on an easing of government regulations. It was not at all clear in these circumstances that reflationary policies would on balance enhance activity. By stirring fresh uncertainties they might, on the contrary, act as a damper. Government policy would therefore continue to center on improving the structural conditions for growth.

1. Exchange rate policy

Over the three-year period from January 1980 to December 1982 the deutsche mark depreciated substantially against the dollar and the yen, but appreciated against EMS currencies (Chart 5). On balance, the nominal effective (MERM) exchange rate of the deutsche mark declined by some 3 1/2 per cent 1/; in real effective terms--defined by normalized relative unit labor costs--the drop came to 14 per cent. In the first half of 1983 the deutsche mark has remained fairly steady in nominal effective terms.

While concerned about exchange rate movements the German authorities did not have a specific overall exchange rate target. They continued

1/ The Bundesbank's effective exchange rate index, however, showed an appreciation of 6 per cent in the same period.

to see only a limited role for intervention policy. Intervention could in their view be useful for short periods of time but could not be used to offset the effects of basic differences in national policies. It was recalled that intervention in 1980, which amounted to DM 29 billion, had in fact done little to stabilize the deutsche mark. The stabilization of the mark in early 1981 had required a sharp increase in interest rates.

Intervention is, of course, mandatory in the EMS, when intervention points are reached. The German authorities noted that, until a greater degree of policy convergence was achieved, exchange rate realignments would also remain an important part of the normal functioning of the EMS. The latest realignment on March 21, 1983, was thought to have been broadly appropriate. Germany had experienced a gain in cost competitiveness against the other EMS countries of 4-5 per cent since the realignment in mid-1982, compared to an effective appreciation of the central rate of the deutsche mark of 5 1/2 per cent.

The German authorities noted that, from the beginning of 1983 to the March realignment, foreign exchange purchases amounted to DM 13 billion through intervention within the EMS. Since then until the end of May intervention by the Bundesbank or other EMS central banks to support the deutsche mark amounted to DM 19 billion as the deutsche mark remained at the bottom of the band. The authorities would be happy to see some strengthening of the deutsche mark in relation to the U.S. dollar; they thought that the recent weakening in the deutsche mark was dominated by temporary interest rate differentials.

2. Monetary policy

Monetary policy contributed substantially towards economic stabilization over the last several years. Both the containment of inflationary pressures and the need for external balance required the maintenance of a tight monetary policy through the summer of 1981. It was feared that any relaxation that contributed to the weakness of the deutsche mark would also exacerbate inflationary pressures in the domestic economy. However, as the external trade balance improved and interest rates abroad began to ease, especially from mid-1982, monetary policy was reformulated to facilitate a recovery of domestic demand (Chart 6).

The target range for the increase in central bank money was set at 4-7 per cent from the fourth quarter of 1981 to the fourth quarter of 1982. The target increase was based on assumptions of an unavoidable price increase of 3 1/2 per cent and a growth in potential production of 1 1/2-2 per cent on average in 1982. Although the range was the same in the previous year, the outcome for central bank money growth was 6 per cent in 1982 compared with 3 1/2 per cent the year before. It remained consistently in the upper half of the target range in 1982, at more than twice the growth of nominal GNP on a fourth quarter-over-fourth quarter basis, and may well have contributed to the recent improvement in economic activity.

Falling interest rates abroad made it possible to translate monetary ease into lower interest rates at home without placing undue downward pressure on exchange rates. The lombard rate was cut in several steps in 1982 from 10 1/2 per cent to 6 per cent, and the discount rate from 7 1/2 per cent to 5 per cent. Liquidity was at times increased through open market operations, usually at rates below the lombard rate, and in addition the Bundesbank increased rediscount quotas by a total of DM 5 1/2 billion in June, and lowered reserve requirements by 10 per cent in October, releasing some DM 5 1/2 billion. This process, in the view of the authorities, may now have reached its limit.

An unchanged target range of 4-7 per cent was announced for the growth of central bank money between the fourth quarters of 1982 and 1983, based on the same assumptions with respect to inflation and growth as the year before. In the first quarter of 1983 central bank money grew at a rate of 10 1/2 per cent, substantially exceeding the upper limit of the range. However, following a further reduction in the discount rate to 4 per cent and the lombard rate to 5 per cent in mid-March, long-term interest rates in Germany actually firmed, giving rise to a sudden steepening of the yield curve, as capital moved out of the country.

Since monetary policy started easing in the fall of 1981, short-term interest rates have declined from a peak of 13 per cent to almost 5 1/2 per cent in June 1983, and long-term rates from 11 1/2 per cent to nearly 8 per cent. However, short-term real interest rates have declined by less, as the rate of inflation also abated by 3 1/2 per cent in that period.

With interest rates firming abroad, the impact of domestic monetary ease has shifted since the turn of the year from interest rates to exchange rates. The authorities stressed that the overshoot in the growth of central bank money was in large part due to special factors that should be self-reversing. Among these they listed speculative inflows in anticipation of the EMS realignment, an exceptional amount of long-term savings certificates maturing at once, and more recently the disbursement of central bank profits to the Government. Nonetheless in May the rate of growth of central bank money, at 9 1/2 per cent, remained well above the range. The authorities expected that the growth of central bank money would return close to the upper end of the target range by year-end.

3. Fiscal policy

The initial budget for 1982 had projected a deficit for the federal government of DM 27 1/2 billion; the actual outcome was DM 37 1/2 billion (Chart 7). The Government had not tried to offset the budgetary consequences of the weaker-than-expected level of economic activity. Nevertheless, compared to the year before there had been no increase in the deficit in relation to GNP; for both the federal and the general governments it remained virtually constant at 2 1/2 per cent and 4 per cent, respectively. The effects of the automatic stabilizers on the revenue and the expenditure sides only just offset the fiscal retrenchment that had been built into the original budget estimates, and which two supplementary budgets, one proposed in June and the other in October, had left intact.

In shaping the budget for 1983 the new Government relied mainly on the retrenchment measures already proposed by its predecessor. Additional expenditures that it introduced in a short-run support program were matched by additional revenues. Its lower growth expectations, however, caused it to revise the projected federal deficit from DM 29 billion to DM 41 billion. Again, compared to the year before, this left the deficits of both the federal and the general governments virtually unchanged in relation to GNP. To restrain expenditures social entitlements were reduced and limits placed on wages and salaries of civil servants. Revenues were raised by a percentage point increase in VAT from midyear and in unemployment insurance contributions by employers and employees.

On taking office in October 1982, the new Government considered itself confronted with a short-run task of reviving domestic activity, and the long-term aim of reducing the burden of government on the economy. The short-run objective was tackled by an immediate program to stimulate investment. The outgoing Government had already in the spring of 1982 introduced a 10 per cent cash bonus on above-average investment orders placed before the end of 1982. The new program added measures to stimulate investment, particularly in housing, including interest rate subsidies, increased tax deductibility of interest paid on private housing, a boost to public construction, and more broadly a reduction in the trade tax. These measures were to be financed by the increase in VAT, already mentioned, and by a compulsory interest-free loan levied on higher incomes.

A lasting recovery of investment, however, continued to depend, in the view of the authorities, on a permanent reduction in the share of the public sector in the economy. The proportion of public expenditures including transfers rose from 39 per cent of GNP in 1970 to 50 per cent in 1982, the share of investment expenditures declining in favor of consumption and, more recently, interest payments. The revenue burden on the economy rose over the same period from 39 per cent to over 46 per cent. In consequence, the debt of the public sector rose from DM 123 billion (18 per cent of GNP) in 1970 to over DM 600 billion (38 per cent of GNP) in 1982. The overriding aim of fiscal policy was to reverse these trends, which were thought to have contributed substantially to a decline of the investment ratio and hence of growth across the cycle.

Expenditure restraints had managed to keep public spending barely constant in relation to GNP in 1982, and were likely to do little better in 1983. Although the authorities had increasingly stressed the need to cut spending, reducing the deficit remained a policy target in its own right. Large deficits created their own upward push on expenditures; interest payments on the federal debt were projected to amount to DM 27 billion in 1983 compared to an overall deficit of DM 41 billion in 1983. Though the response of interest rates to lower deficits would be limited in the present international environment, this nevertheless provided one reason for containing them. Early reductions in the tax burden had therefore to be ruled out, though not further improvements in the tax structure.

At the time of the discussions, a budget proposal for 1984 was before the Cabinet, to be submitted to Parliament in June 1983. The federal deficit at DM 39 billion was to remain almost unchanged in amount from 1983. The nominal rise in federal expenditures was to be limited to 2 per cent, or to less than half the projected growth of nominal GNP. Economies were to be concentrated on further cuts in social benefits and a freeze on civil servants' pay. However, to stimulate investment, the yield from the previous year's increase in VAT would finance a second round of business tax reductions, notably of property taxes, along with better write-off facilities for business losses, and with special depreciation allowances for smaller firms. Tax privileges for certain types of housing construction were, however, to be reduced.

A medium-term fiscal plan would as usual be presented along with the 1984 budget. By 1987 it was expected that the deficit of the Federal Governent would be down to DM 25 billion, and that of the general government to DM 35-40 billion, or 2 per cent of GNP. While nominal GNP was on average expected to grow by 6 per cent per annum, federal expenditures would grow at an annual rate of only 3 per cent after 1984. The authorities were confident this could be done without placing the essentials of the social security system at risk. Provided retrenchment measures were successful, there would eventually be room for reductions in the tax burden. A cut in the personal income tax was already under discussion though no target date had been set for it.

4. Employment policies

The authorities did not hold out much prospect of an early reduction in unemployment. At the end of 1982 the seasonally adjusted unemployment total exceeded 2 million. The labor force was expected to grow by a further 700,000 by the end of the decade with the largest increases concentrated in 1983 and 1984. Abstracting from purely cyclical variations, it was calculated that a sustained growth in real GNP of 3 per cent annually would be required to absorb the increase in the labor force. It was also noted that, to raise the growth of output by 1/2 per cent annually, a permanent increase in the investment ratio of some 2 percentage points would be required.

To promote such investment, an increase in the rate of return above interest rates was thought to be required. In manufacturing the share of profits in value added is still as low as 26 per cent compared to 34 per cent in the early 1960s. In the face of persistently high interest rates abroad it might have seemed possible to achieve improved profitability by allowing continued monetary ease to depress exchange rates. This course was firmly rejected, however. By threatening the credibility of the anti-inflationary policy stance, it would undermine the prospects of wage restraint, and with it the possibility of stable profit expectations. Instead of stimulating investment it could depress it still further.

Primary reliance would therefore have to be placed on productivity increases combined with wage restraint. For its part the Government had announced a 2 per cent salary increase for civil servants ("Beamte"), effective July 1, 1983, to be followed by a freeze until April 1, 1985. For all public employees together, wage and salary increases were to decelerate from about 3-4 per cent in 1983 to less than 1 per cent in 1984. The procedure for annual adjustments in pensions was also to be reviewed. It was hoped that wage settlements in the private sector, particularly for workers with low levels of training, would be similarly restrained. There would be no increase in the number of government employees for the present.

Enhancing employment opportunities by first improving profit margins was likely to prove a drawn-out process. Consideration was therefore being given to measures that would reduce the number of unemployed more directly. In response to the low demand for labor enough foreign workers had already left in 1982 to offset the number of new foreign entrants to the labor force. Further repatriation could be encouraged by allowing returnees to encash their accrued pension benefits; perhaps some 100,000 of them would take advantage of the opportunity. The prospective fiscal impact needed to be dealt with, however, before the scheme could become operational.

The Government intended to continue its established labor market policies, whereby an estimated 10-15 per cent of the unemployed obtained vocational training or were otherwise assisted. In addition, advancing full retirement benefits from the age of 65 to 58 was being considered; it could reduce the work force by 300,000-400,000 perhaps, and the Government could contribute to pensions what it saved on unemployment insurance. The possible contribution of shortening the work week was also being debated; a possibly precedent-setting agreement had been reached in the chemical industry for a workweek of less than 40 hours for older workers. The effect on employment would depend largely on the extent of the wage offset.

5. Trade and aid

A threat to the incipient recovery in Germany was thought to be the danger of increased protectionism abroad. Substantial gains in German competitiveness a few years ago had found reflection in strong increases in export market shares; these had now stabilized. A further significant improvement in German competitiveness could risk strengthening protectionist tendencies among some of her major trading partners. This possibility provided an external reason for avoiding domestic policies that would tend to depreciate the external value of the deutsche mark.

Pressures for protection had tended to abate in the past year, reflecting greater optimism about the prospects for a recovery and increased public awareness of the dangers of retaliation. The Government had rejected protectionist calls from some industries such as watches and shoes, which were experiencing increased competition from newly industrialized countries. The most difficult area was the steel industry;

the Government had agreed in principle to extend financial support, but only for restructuring needs. Also, efforts were being made to persuade partners in the EC to reduce the subsidization of steel and to adhere strictly to the program to phase out state aids by 1985. Unless these efforts were successful, pressures would intensify to provide matching subsidies or erect barriers to intra-EC trade.

With regard to agriculture, where international trade frictions have tended to increase, particularly on the issue of export subsidies, the authorities were open to constructive discussions, but agreed with other EC members that the basic elements in the Common Agricultural Policy, which is one of the main cohesive elements in the Communities, could not be jeopardized. The objective of the authorities was an appropriate balance between the requirements of trade policy and those of agricultural policy. Efforts were being made to contribute to stabilization of international markets by allowing stocks to accumulate in certain cases. Furthermore, increases in support prices had been modest this year; for Germany, the increase in intervention prices in domestic currency, after taking into account changes in monetary compensation amounts, averaged only 2 per cent.

Most direct commercial policy actions fell within the framework of the European Communities; quantitative restrictions at the national level covered a negligible proportion of total imports. Germany continued to be a strong supporter in the EC of open trade policies; the end result would nonetheless have to reflect compromise. The authorities reiterated their strong opposition to bilateral and sectoral approaches to trade, and to the concept of "reciprocity" and "fairness" in trade practices, where these were used to justify restrictions. They did not support adoption of the new commercial policy instrument under consideration in the Communities, as it could open the way for protectionist measures; if adopted, its use would need to be carefully scrutinized. Regarding complaints about German technical norms and standards by some trading partners, the authorities said these were applied in a nondiscriminatory way by the private sector without government interference; nevertheless, the Government had indicated willingness to look into the matter.

The authorities attached importance to coordinated moves at the international level to phase out restrictions, and to harmonize trade policies with the financing requirements of developing countries. Efforts by the latter to reduce their own restrictions would be conducive to willingness of other countries to increase market access. The authorities welcomed the strengthened cooperation between the Fund and the GATT in keeping markets open, particularly for developing countries burdened by debt.

Energy policy continues to focus on conservation and on diversifying the sources of oil supply. It was noted that in 1982 Germany received more crude oil from the North Sea than from Saudi Arabia. The decoupling of energy consumption from growth was expected to continue; between the early 1970s and the early 1980s energy consumption grew by only 9 per cent while real GNP rose by 27 per cent. Environmental aspects of energy policy had become increasingly important. Progress in conservation continued to be achieved through reliance mainly on market forces with government support for research and development.

Net disbursements of official development assistance (ODA) rose from 1975 to 1981 by 10 per cent per annum in national currency, and by 8 1/2 per cent in real terms, to 0.47 per cent of GNP. In 1982 disbursements increased by 7 per cent in deutsche mark--but dropped by 1/2 per cent in U.S. dollars--resulting in an increase to 0.48 per cent in relation to GNP. There has not yet been any final decision on appropriations for official development assistance for 1983, or on the medium-term outlook for ODA. However, appropriations were expected to increase at a higher rate than aggregate government expenditure.

IV. The Economic Outlook

Economic developments in Germany are, at present, characterized by some recovery in domestic production and demand, a low rate of inflation, improved business confidence, and a positive balance on current account. Unemployment is still rising, however, and the rate of capacity utilization is low (Chart 1). The recovery would continue and become self-sustaining during this and next year, since no constraints on domestic resources or on the external account are present. Nevertheless, the recovery still appears somewhat precarious. External demand impulses are weak, and increased consumption depends on a fall in the propensity to save. Much depends on a recovery of investment. Even moderately unfavorable foreign or domestic developments could still cause the recovery to falter.

1. An incipient recovery

German exports may be expected to pick up during 1983 and 1984 in line with some revival in foreign markets. Still, because of the negative overhang from 1982, the average growth of exports in 1983 will remain just below market growth. Furthermore, though exports are expected to grow faster in 1984, import demand will also pick up as domestic demand increases. Thus, in contrast to earlier cyclical upswings, the foreign balance is not likely to provide a substantial demand stimulus in 1983 or 1984. The main contribution to a revival of demand must be of domestic origin.

Real government consumption is likely to remain unchanged in 1983, and may even decrease in 1984. Though private consumption revived early in 1983, its foundations remain fragile. Employment can be expected to decline substantially in 1983 and to stabilize only during 1984. Since wage increases will remain moderate relative to price rises, real disposable household incomes are also likely to decrease in 1983, and to rise only modestly in 1984. However, a fall in the savings ratio of households seems also to be in process. It should continue with a further increase in consumer confidence, a continuing desire to maintain consumption levels, and perhaps a further decline in real interest rates. The fall in the rate of inflation may also increase private consumption through wealth effects.

Even so, a sustained recovery will depend mainly on a revival of domestic investment. The demand for housing has already picked up strongly. The rise in orders and building permits received should keep construction investment lively in 1983 and probably also in 1984. Investment in machinery and equipment should be supported by a growing need for capital replacement and by further efforts to rationalize production. However, for investment to remain strong also in 1984, despite the initial hesitancy in final demand, further improvements in profitability will be required. These depend on moderate wage agreements, and on accelerating productivity growth as the recovery gains momentum.

Provided that the decline in the household savings ratio continues and provided that enterprise profits continue to improve, economic growth will probably rebound from minus 1 per cent in 1982 to plus 1/2 per cent in 1983, and could accelerate to 2 per cent in 1984. Should the postulated increase in the propensities to invest or consume falter for any reason, economic growth in 1984 will be substantially lower.

2. Prices, profits, and investment

The rate of increase in prices should continue to decrease in 1983 despite the 1 percentage point increase in the VAT on July 1, 1983. During 1984, however, rising international raw material prices together with increased demand pressure, as the recovery continues, may cause the inflation rate to bottom out. All in all, the rise in the consumer price index should, on average, fall to some 3 per cent in 1983, and stay there in 1984. The GNP deflator is expected to rise at similar rates.

A continued slack in the labor market should contribute to further moderation of wage increases. A further fall in the demand for labor is foreseen in 1983, before it stabilizes during 1984. The rate of unemployment is expected to average 8 1/2 per cent in 1983 and may exceed 9 per cent in 1984, partly as a result of demographic developments. Despite the tendency for longer-term unemployment to become concentrated on particular groups and areas, the total is large, and labor bottlenecks are not likely to emerge very soon, therefore, as the recovery proceeds.

Wage demands are therefore unlikely to rise very sharply. The Government for its part has decided virtually to freeze nominal public sector wage rates in 1984; the demonstration effect from this should help exert a dampening effect on nominal wage demands in the private sector also. Overall the increase in average nominal wages may slow to 3 1/2 per cent in 1983, and further to 2 1/2 per cent in 1984. At the same time, as activity increases, productivity can also be expected to rise. The growth in unit labor costs is therefore projected to moderate to 2 per cent in 1983, and perhaps to less than 1 per cent the year after.

The prospect for unit labor costs, set against the outlook for the GNP deflator, promises a further significant improvement in the profitability of enterprises. This should provide some of the means as well as an incentive to raise investment expenditure. Though total real wage incomes will fall in 1983 and possibly in 1984, household disposable incomes will be supported by rising distributions of property and entrepreneurial incomes, and by transfer payments. Households' real disposable incomes are still expected to decline in 1983, but to recover modestly in 1984.

3. Balance of payments prospects

Assuming no further gains in external competitiveness, exports are likely to rise roughly in line with market growth. To the extent that Germany succeeds more rapidly than its trading partners in containing labor costs, the assumption of no increase in competitiveness implies some appreciation of the nominal effective exchange rate. This would redistribute the gains in profitability from traded to nontraded goods. By promoting imports and restraining exports it would contribute to a balanced expansion of world trade.

With competitiveness broadly unchanged imports of merchandise will remain depressed in 1983 for cyclical reasons, but will pick up in 1984 with an accelerating recovery of domestic demand. However, the implicit deterioration in the real external balance will be overshadowed by changes in the terms of trade. The terms of trade are expected to improve by 3 per cent in 1983, as a result of declining oil prices and weakness in the prices of other imported raw materials. This change will be partly reversed in 1984. A decline of 2 per cent in the terms of trade is to be expected as import prices start picking up.

The services balance is not expected to change significantly in 1983, as some improvement in net investment income will outweigh a slight deterioration in the balance on other services. For 1984, however, the modest rise in real disposable household incomes may cause a deterioration in the tourism balance. Altogether the current account surplus should reach DM 17 1/2 billion in 1983, equivalent to 1 per cent of nominal GNP. It should narrow again in 1984, perhaps to DM 14 billion or 3/4 per cent of nominal GNP.

The net foreign asset position of Germany which, as previously noted, amounted to DM 80 billion for the Bundesbank, commercial banks, and enterprises together at the end of 1982, is expected to strengthen further in 1983 and 1984, in line with developments in the current account. There is expected to be no net official borrowing abroad in 1983 and 1984 as gross borrowing will roughly be matched by rising amortization payments.

V. Staff Appraisal

After a recession lasting almost three years, and a dramatic increase in the number of unemployed, a recovery of economic activity seems now to be under way. The main preconditions appear to be in place. Inflationary pressures have moderated markedly. Profits--though still low by historical standards--have strengthened. The growth of fiscal expenditure has been curbed. And the confidence of the business and household sectors has been bolstered. Further, the surplus on external account and the large amount of slack in the domestic economy give assurance that there will be ample room in which activity can expand.

At least a portion of the current recovery can be attributed to special factors. Nevertheless, the expectation of real GNP growth of 1/2 per cent on average for 1983 appears to be attainable. The uncertainties surrounding the 1984 outlook are greater; the expectation of sustained revival is based on a further decline of the savings ratio, and of interest rates, with investment bolstered by business confidence, and by rising profits. A sustained recovery is essential in view of the underutilization of domestic resources and of the importance of Germany for the international economy. Should the recovery be seen to falter, supporting measures should certainly be considered.

The easing of monetary policy since late 1981 has been one stimulus to the revival of activity now being experienced. The growth of central bank money remained consistently in the upper half of the target range during 1982, increasing at more than twice the rate of growth of nominal GNP, and partly due to special factors, its growth accelerated sharply in early 1983. As interest rates declined abroad domestic interest rates could also be reduced. However, the easing of monetary policy appears now to have reached its limit. A further reduction in domestic short-term interest rates in mid-March at the time of the EMS realignment brought on a firming rather than a further decline in long-term rates. Some weakening of exchange rate expectations may have been the reason. The need to support the deutsche mark rather longer than usual following the realignment, and its continuing weakness against the dollar, point in the same direction.

The staff agrees with the authorities that downward pressure on the exchange rate would not only risk rekindling inflation but also strengthen protectionist tendencies in neighboring countries. Although real long-term interest rates remain high, attempts to reduce them through accelerated monetary expansion are likely to be counterproductive. The overshooting of the monetary target in the first part of 1983 was at least in part due to special factors that should correct themselves. Until a change in the underlying assumptions is required, the original target range would still seem consistent with the projected recovery in economic activity. It seems desirable, therefore, that the growth of central bank money should return close to the upper end of the target range as soon as possible.

In supporting the recovery the authorities place primary emphasis on continuing the effort to consolidate its structural prerequisites. Rather than engage in short-term demand expansion they remain firm in seeking to limit the resources absorbed by the public sector. The staff agrees that the strong rise in public sector expenditure over the last decade has reduced the resources available to the private sector, and contributed to the squeeze on investment. Gross fixed investment rose by only 7 per cent in real terms since 1970 while real GNP increased by 30 per cent. A higher level of productive investment is needed to strengthen the prospects for economic growth and employment in the medium term. The confidence of the business sector in the policy of fiscal retrenchment must therefore remain firm. The staff therefore welcomes the present policy of expenditure restraint. It offers assurance that the government will reduce its claims on resources.

The initial impact of expenditure restraint is necessarily deflationary until it is offset by increases in private expenditure in response to a lower tax burden, or to lower interest rates as the fiscal deficit declines. The authorities have used the room for maneuver afforded by their spending policies to restrain the fiscal deficit, with little change in the tax burden. However, the hoped-for decline in interest rates is now being frustrated mainly by external developments. The positive effects of expenditure cuts may therefore be delayed, unless the authorities are prepared to shift their emphasis from reductions in the deficit to reductions in taxes, that will raise private spending by raising disposable incomes. To maintain confidence, however, any tax cut must be clearly linked to a convincingly restrained monetary policy, and to a firm commitment to continue expenditure reduction on schedule.

The recovery now in prospect is not expected to be rapid, nor will it lead to absorption of the almost 2 1/2 million unemployed. It is encouraging, therefore, that the authorities have steadfastly resisted pressures for protectionist measures as a means of sustaining employment, both within and outside the European Communities. The continued commitment of Germany to free trade principles will be essential to promote a more liberal Community trade policy. Domestically the German Government intends nevertheless to increase reliance on market forces by reducing unnecessary regulation. This is to be welcomed and should enhance the prospects for economic growth and employment. The staff hopes that the exceptions to this general policy will be reduced in number and in importance.

The share of ODA in GNP has remained almost stable at 0.48 per cent in 1982. The staff hopes that the discussions of the 1983 budget will give rise, at a minimum, to the maintenance of this share in the current year.

It is recommended that the next Article IV consultation with the Federal Republic of Germany be held on the standard 12-month cycle.

Germany - Fund Relations

(As of May 31, 1983)

Date of membership:	August 14, 1952.
Status:	Article VIII.
Quota	SDR 3,234 million.
Fund holdings of deutsche mark:	SDR 725.8 million (or 22.4 per cent of quota).
Germany's holdings of SDRs:	SDR 1,965.6 million (or 162.3 per cent of net cumulative allocation of SDR 1,210.8 million).
General Arrangements to Borrow:	The maximum commitment of Germany is DM 4,000 million (SDR 1,474 million); net borrowing by the Fund, SDR 582.9 million.
Supplementary financing facility:	The maximum commitment of Germany is SDR 1,050 million; net borrowing by the Fund, SDR 772.2 million.
Gold distribution:	1.37 million fine ounces (four distributions).
Last consultation:	The staff report for the 1982 Article IV consultation with Germany (SM/82/142, 7/19/82) was considered by the Executive Board on 8/18/82 (EBM/82/109 and EBM/82/110).
Exchange system:	Since March 13, 1979, Germany has participated together with Belgium, Denmark, France, Ireland, Italy, Luxembourg, and the Netherlands in the exchange rate mechanism of the European Monetary System (EMS). Under this agreement, Germany maintains spot exchange rates of the currencies of the other participants within margins of 2.25 per cent (in the case of the Italian lira, 6 per cent) from cross rates derived from central rates expressed in ECU. The participants in the EMS are not keeping the exchange rates for other currencies within fixed limits. However, they intervene in cooperation with the other participants, with a view to ensuring a proper functioning of the system, through smoothing out fluctuations in exchange rates.

Basic Data

Area and population

Total area	248,667 square kilometers
Total population (November 1982)	61,659,000
GNP per capita (1982)	US$10,694

	1982	1979	1980	1981	1982	1983 1/
	In per cent	Volume changes; in per cent				
Demand and supply (volume)						
Private consumption	55.1	3.1	1.5	-1.2	-2.3	0.1
Public consumption	20.2	3.5	2.8	2.0	-0.1	-0.1
Gross fixed investment	19.8	7.3	3.2	-3.8	-5.6	2.1
Construction	11.6	5.6	3.7	-4.2	-4.5	3.1
Machinery and equipment	8.2	9.6	2.5	-3.4	-7.2	0.7
Final domestic demand	95.2	4.1	2.1	-1.2	-2.5	0.5
Stockbuilding 2/	0.3	1.3	-0.7	-1.2	0.6	0.1
Total domestic demand	95.5	5.8	1.7	-2.5	-0.5	0.5
Exports of goods and services	33.6	4.9	5.8	8.5	3.5	0.8
Imports of goods and services	29.1	10.3	4.4	1.2	0.5	0.9
Foreign balance 2/	4.5	-1.3	0.4	2.2	0.4	--
GNP	100.0	4.0	1.8	-0.2	-1.1	0.5
Manufacturing output	...	5.0	0.2	-1.3	-2.3	0.6
		In millions; annual averages				
Employment and unemployment						
Labor force		26.92	27.17	27.36	27.36	27.52
Wage and salary earners		22.66	22.99	22.88	22.46	22.00
Foreign workers		1.93	2.02	1.91	...	...
Unemployed		0.88	0.89	1.27	1.83	2.34
(In per cent of total labor force)		(3.3)	(3.4)	(4.8)	(6.7)	(8.5)

1/ Staff projections.
2/ Change as per cent of previous year's GNP.

	1979	1980	1981	1982	1983 1/
		Changes in per cent			
Prices and incomes					
GNP deflator	4.0	4.4	4.2	4.8	3.8
Consumer price index	4.1	5.5	5.9	5.3	3.5
Terms of trade 2/	-6.1	-6.4	-4.3	4.2	3.0
Average hourly earnings (industry)	6.8	8.5	7.2	5.4	3.5
Unit labor costs (total economy)	3.1	6.0	4.7	3.5	1.7
Real disposable income 3/	3.8	1.8	-0.3	-2.5	-1.2
Personal savings ratio	(12.6)	(12.9)	(13.6)	(13.5)	(12.8)
		In billions of deutsche mark			
Public finances 4/					
General government					
Expenditure	670.2	724.4	769.0	802.9	834.2
Revenue	631.8	677.1	706.6	739.8	768.8
Financial balance	-38.4	-47.3	-62.4	-63.1	-65.4
(in per cent of GNP)	(-2.8)	(-3.2)	(-4.1)	(-3.9)	(-3.9)
Federal Government					
Financial balance	-26.1	-27.6	-37.9	-37.7	-40.5
(in per cent of GNP)	(-1.9)	(-1.9)	(-2.5)	(-2.4)	(-2.4)
Balance of payments					
Trade balance (f.o.b./c.i.f.) 5/	22.6	8.9	28.6	52.4	62.1
Services balance	-12.6	-12.9	-16.4	-16.3	-15.6
Net private transfers	-10.0	-11.0	-11.9	-12.2	-12.3
Net official transfers	-11.2	-13.5	-14.9	-15.9	-16.8
Current account	-11.2	-28.5	-14.7	8.1	17.4
Long-term capital balance					
Private	13.6	-15.5	-9.2	-21.2	...
Official	-1.5	20.8	18.0	5.1	...
Short-term capital balance 6/	-5.8	-4.7	3.6	11.2	...
Adjustment items 7/	-2.3	2.2	3.6	-0.4	...
Changes in net foreign position of the Deutsche Bundesbank	-7.3	-25.7	1.3	2.7	...
Current account balance in per cent of GNP	-0.8	-1.9	-1.0	0.5	1.0

1/ Projections.
2/ Based on unit values.
3/ Deflated by the consumer price index.
4/ The data for the territorial authorities and the Federal Government are on an administrative basis; those for general government are on a national accounts basis.
5/ Including supplementary trade items.
6/ Including net errors and omissions.
7/ Valuation adjustment and increase in SDR allocation.

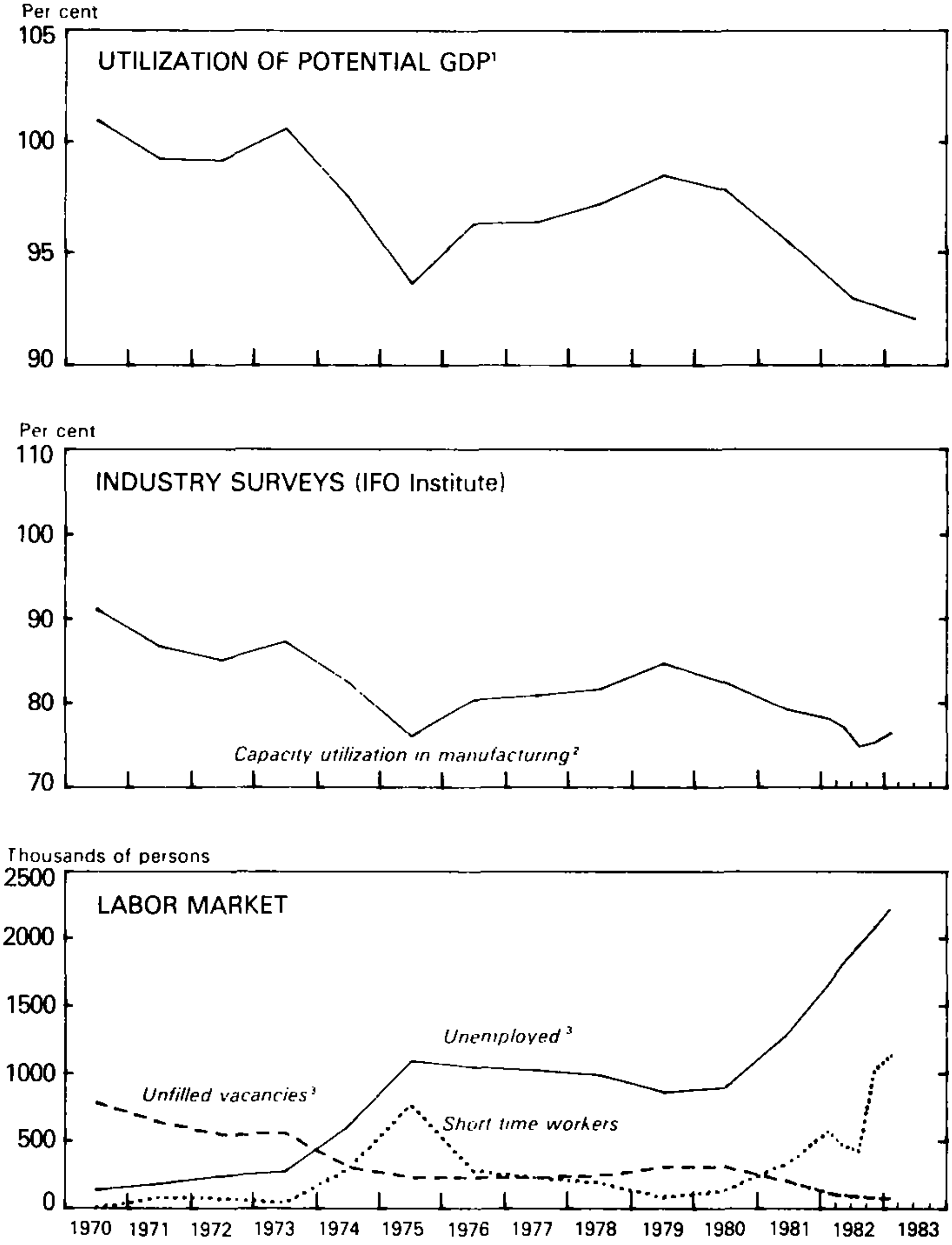
	1979	1980	1981	1982
	In billions of deutsche mark			
Foreign reserves of the Bundesbank 1/				
Net monetary reserves	88.9	63.4	65.3	69.1
	Annual averages; changes in per cent			
Monetary data				
Central bank money	9.1	4.8	4.4	4.9
Money and quasi-money (M3)	8.9	5.2	6.5	6.5
Bank lending	12.1	10.1	9.5	7.4
Of which:				
Public authorities	12.0	8.9	10.2	13.4
Private nonbanks	12.2	10.4	9.4	5.6
	End of period; in per cent			
Three month money market rate	9.6	10.2	10.8	6.6
Yield on bonds outstanding	8.0	9.1	9.9	8.0
	Changes in per cent			
Exchange rates				
US$ per DM (end of period)	5.6	-11.6	-13.1	-5.1
US$ per DM (annual average)	9.6	0.9	-19.7	-6.9
Effective rate (MERM, end of period)	7.4	-7.9	-0.7	5.1
Effective rate (MERM, annual average)	6.2	1.0	-7.4	4.2
Relative normalized unit labor costs (annual average)	0.9	-3.9	-11.0	0.2

1/ End of period.

CHART 1

GERMANY

RESOURCE UTILIZATION



Sources IFO Institute *Wirtschaftskonjunktur* and *IFO Schnelldienst* Deutsche Bundesbank, *Monthly Report* and *Supplement 4* and staff estimates

[1] Actual GDP (at 1976 prices) in per cent of normally utilized potential GDP as calculated by the Deutsche Bundesbank 1983 result is staff estimate

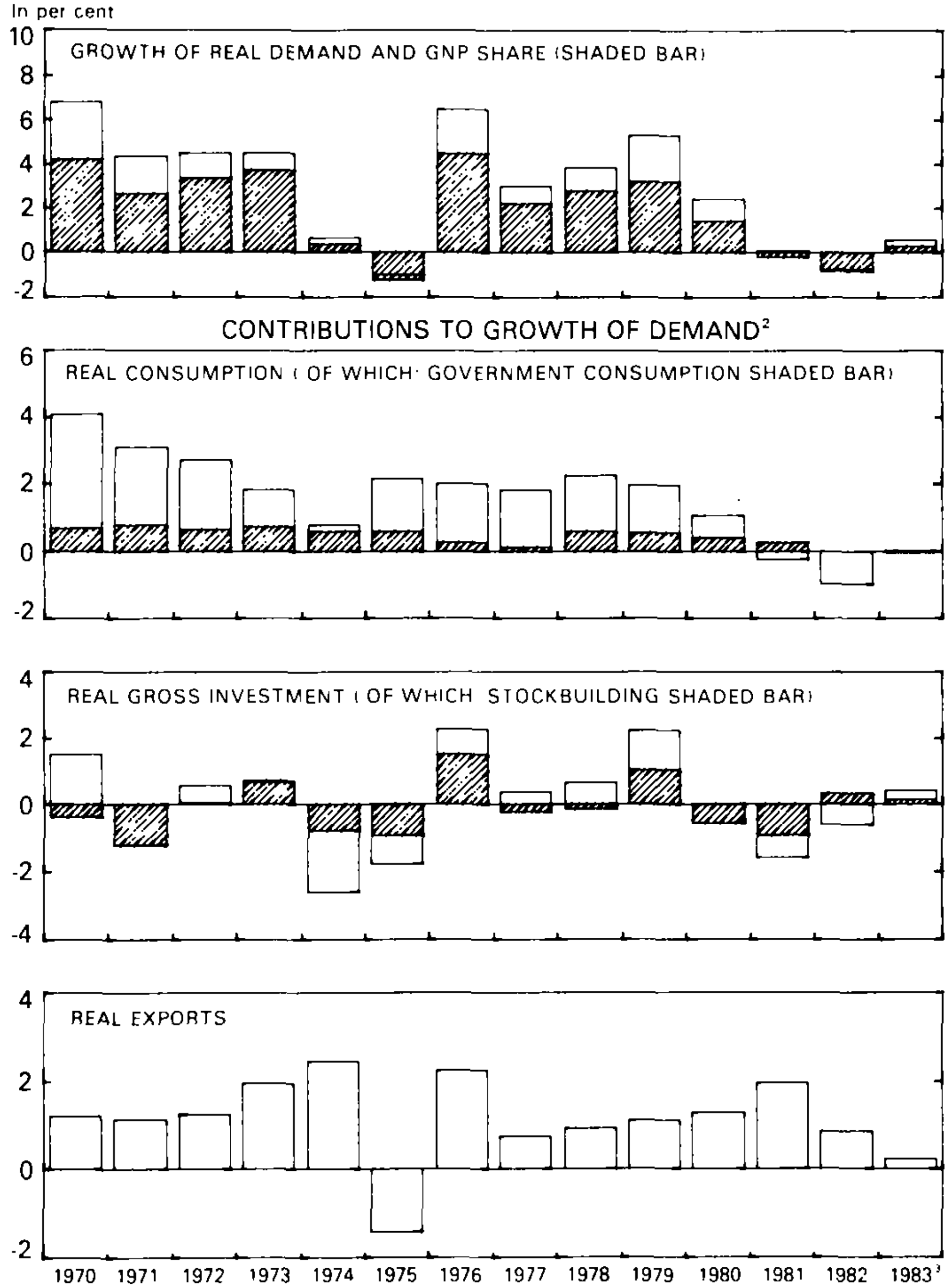
[2] In per cent of the normal level of utilization

[3] Quarterly averages shown are seasonally adjusted

CHART 2

GERMANY

CONTRIBUTIONS TO DEMAND[1]



Sources: Statistisches Bundesamt, *Volkswirtschaftliche Gesamtrechnungen 1981* and *Wirtschaft und Statistik 3/1983* and staff estimates.

[1] Total domestic demand plus exports

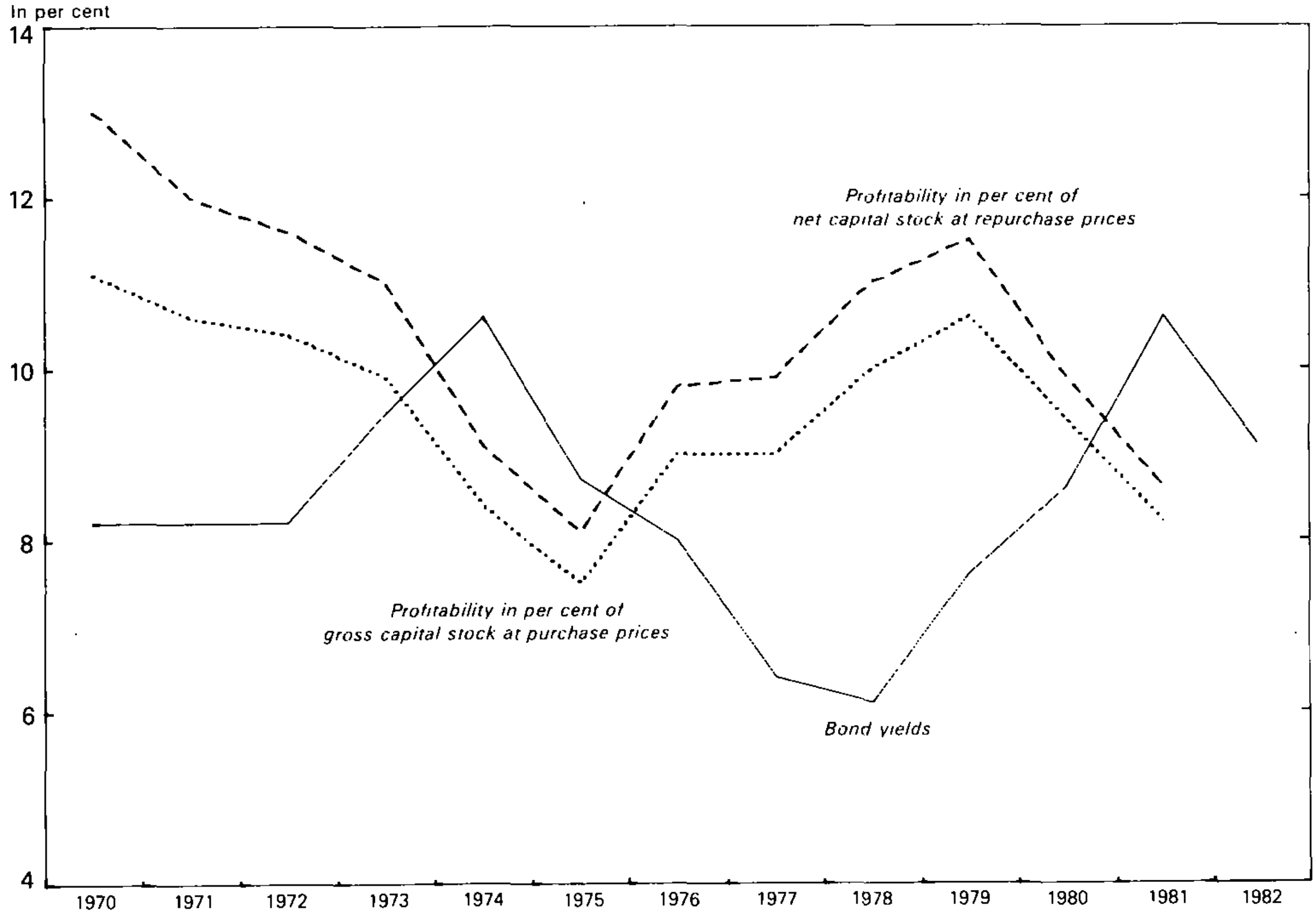
[2] Changes in per cent of previous year's real demand

[3] Staff projections

CHART 3

GERMANY

PROFITABILITY[1] AND BOND YIELDS



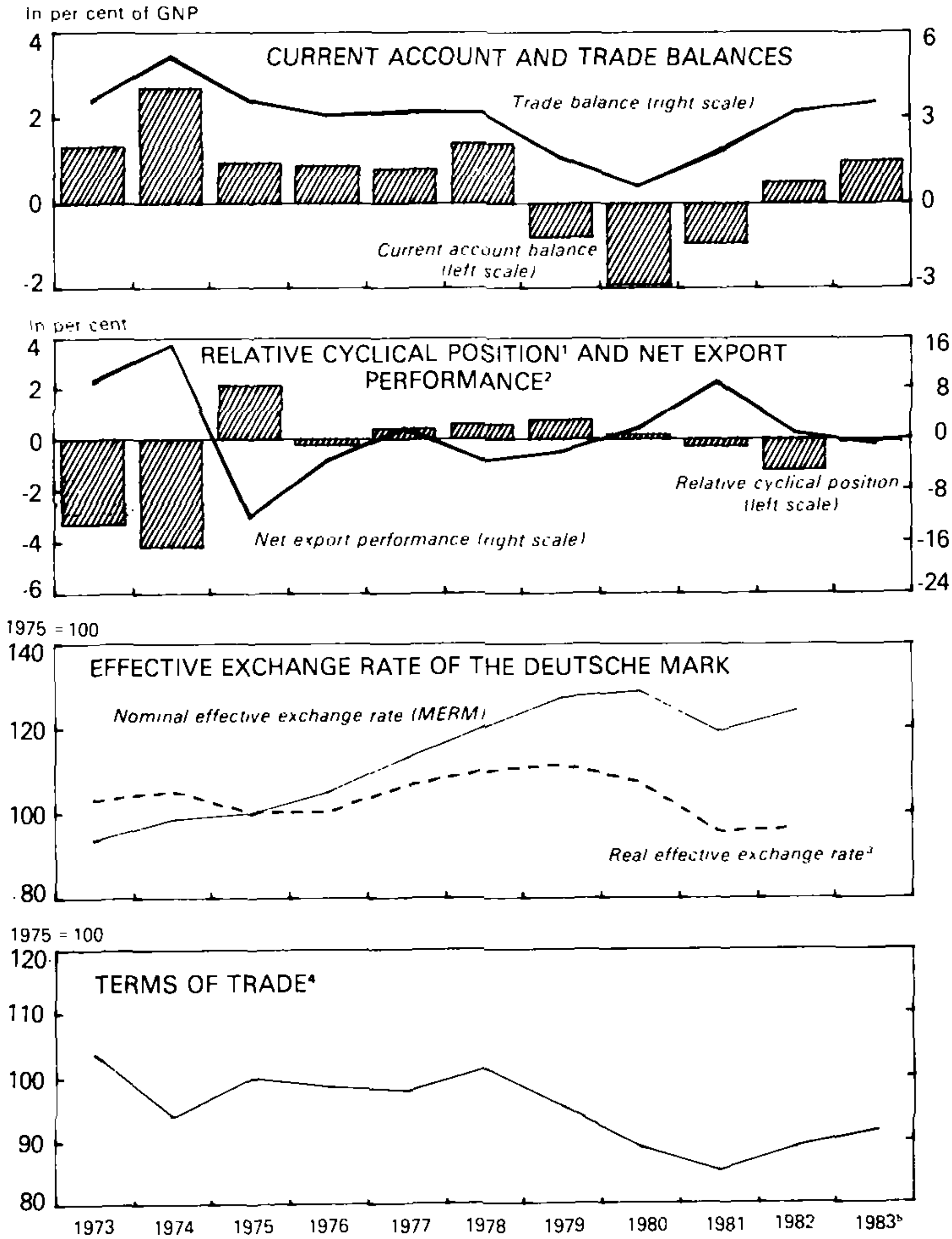
Sources: Statistisches Bundesamt, *Volkswirtschaftliche Gesamtrechnungen, 1981* and Deutsche Bundesbank *Monthly Report*

[1] Gross entrepreneurial and property income less estimated remuneration of the entrepreneur

CHART 4

GERMANY

MAJOR DETERMINANTS OF THE BALANCE ON CURRENT ACCOUNT



Sources: Deutsche Bundesbank, *Monthly Report*; IMF, *International Financial Statistics*; and staff estimates, June 1983.

[1] The difference between the weighted real GNP growth rates for Germany and partner industrial countries. A minus figure indicates a relatively lower growth in Germany.

[2] Percentage change in the volume of exports minus percentage change in the volume of imports.

[3] Relative normalized unit labor costs, adjusted for exchange rate changes.

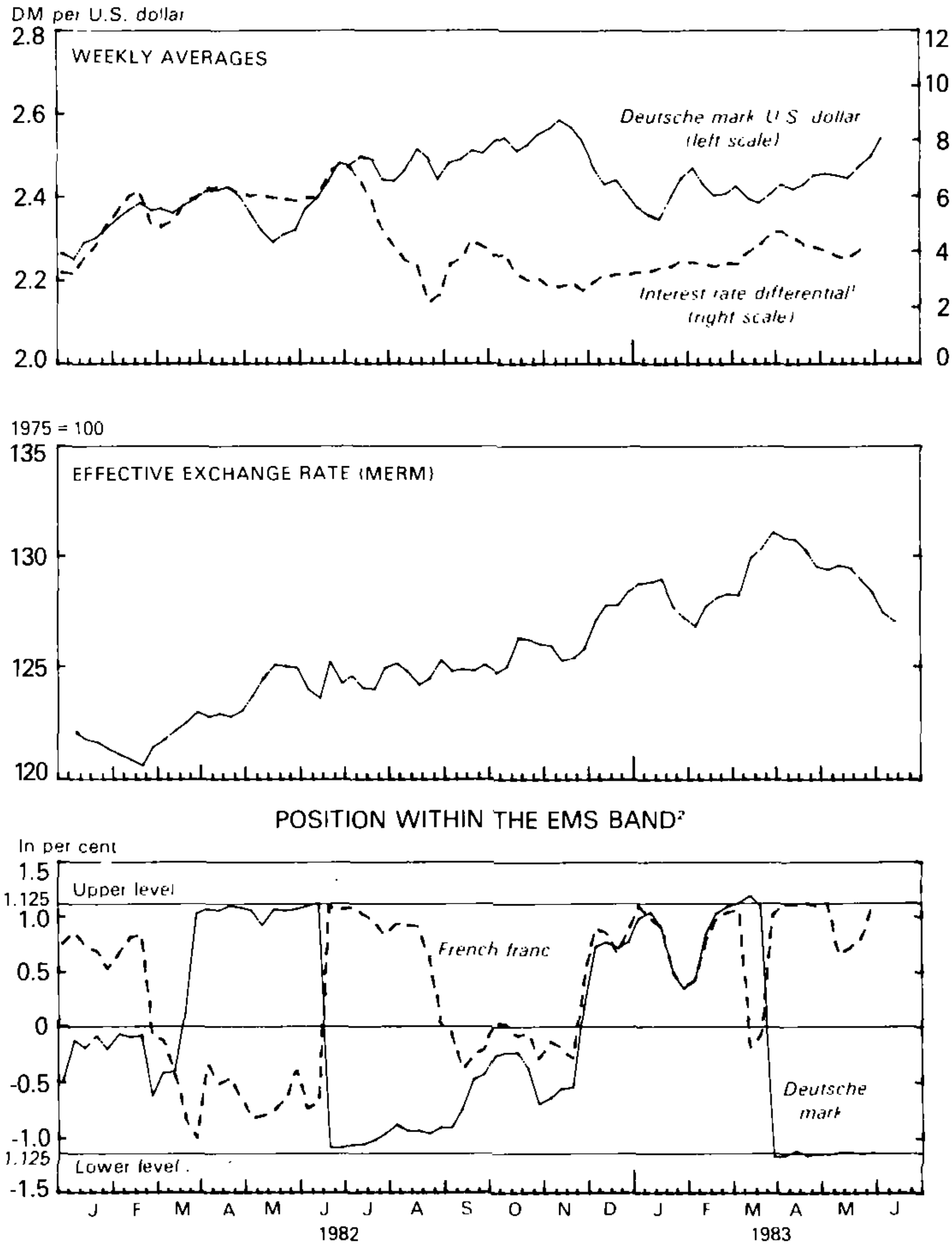
[4] Based on unit values.

[5] Staff projections.

CHART 5

GERMANY

EXCHANGE RATE AND INTEREST RATE MOVEMENTS



Sources: IMF, Treasurer's Department, and staff estimates.

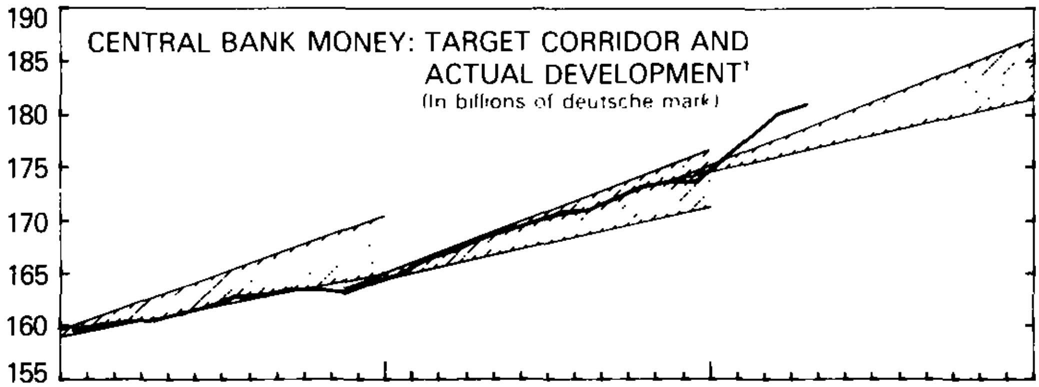
[1] Three month Eurodollar deposit rate minus three month Euro DM rate.

[2] Based on London noon quotations; these rates may at times exceed the intervention limits within the EMS.

CHART 6

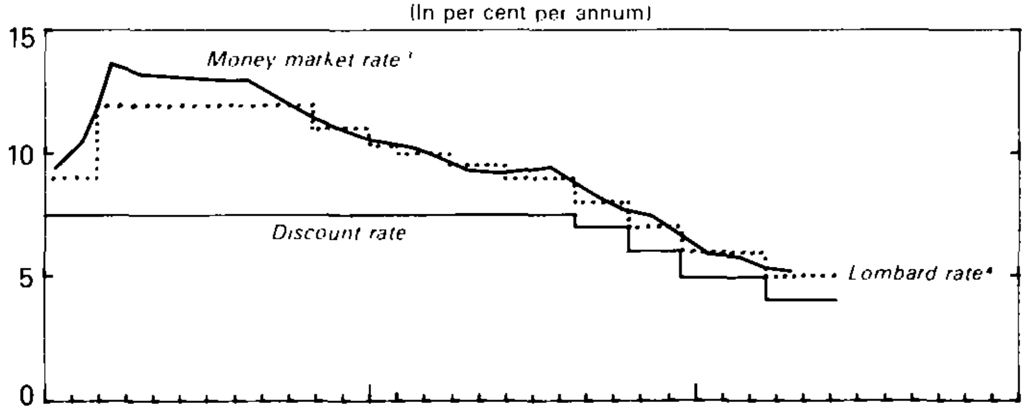
GERMANY

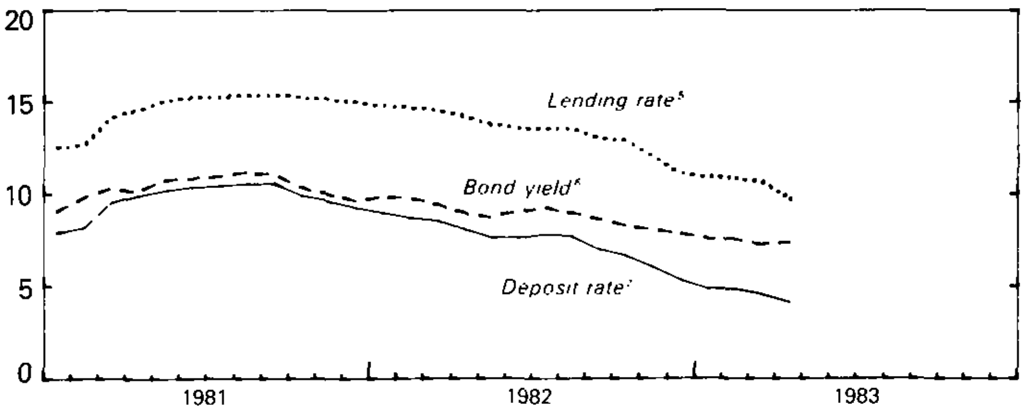
SELECTED INDICATORS OF MONETARY POLICY



NOMINAL INTEREST RATES[2]

(In per cent per annum)





Source: Deutsche Bundesbank, *Monthly Report, Supplement 4*.

[1] The target lines in the chart represent a development consistent with a smooth path of growth during the year. For each of the years 1981-83, the target growth corridor for central bank money, on a fourth quarter-over-fourth quarter basis was 4-7 per cent.

[2] Period averages except for discount and lombard rates, which are end of period.

[3] 3 month money market rate.

[4] From February 20, 1981 to May 6, 1982 interest rate on special lombard loans due to suspension of normal lombard facility.

[5] Current account loans (under DM 1 million).

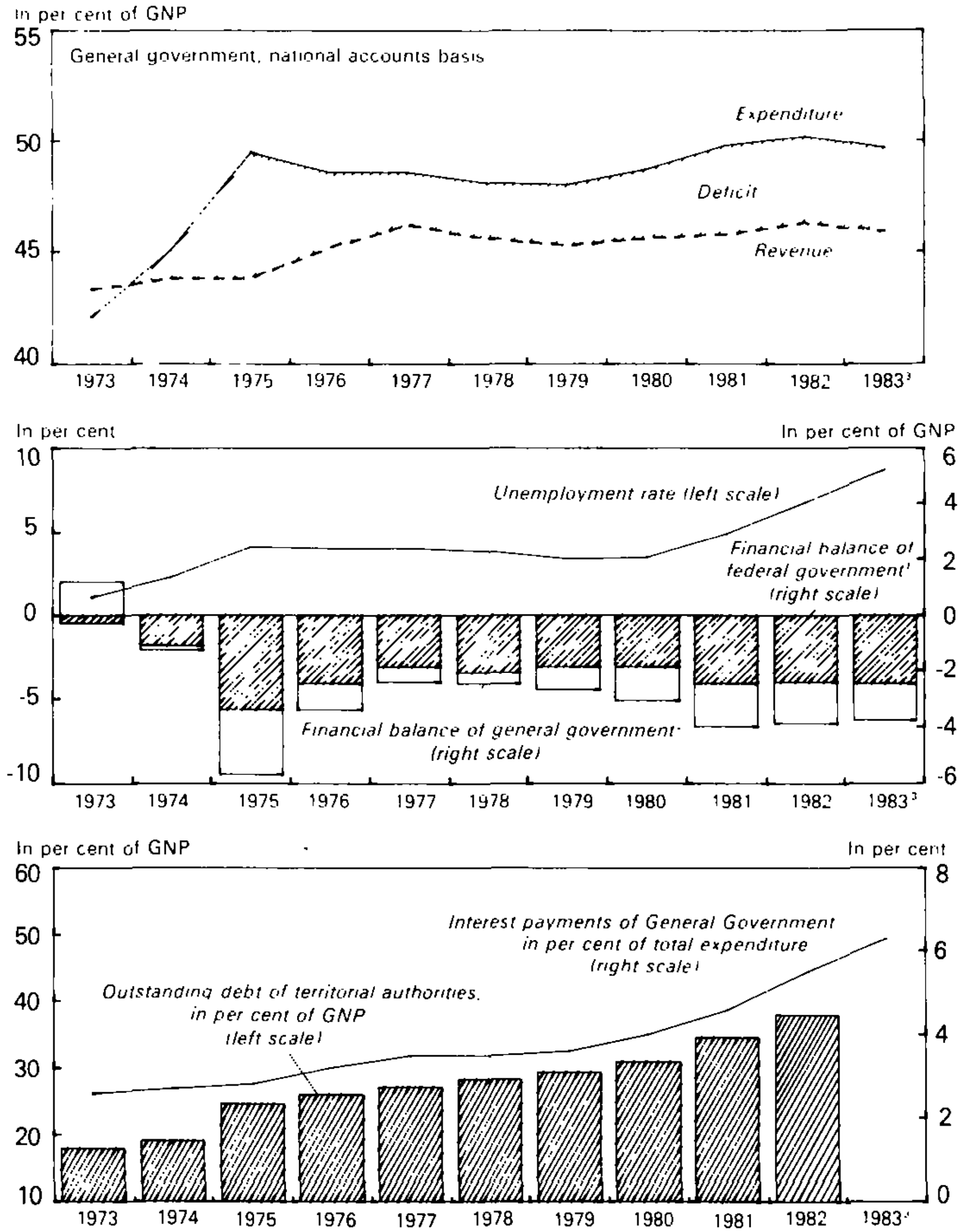
[6] Yield on government bonds.

[7] 3 month deposit rate.

CHART 7

GERMANY

SELECTED INDICATORS OF FISCAL POLICY



Source: Data provided by the German Ministry of Finance.
[1] Administrative basis.
[2] National accounts basis.
[3] Estimates by the German Ministry of Finance.