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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/114

3:00 p.m., July 29, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	
B. de Maulde	
	M. Teijeiro
R. D. Erb	
M. Finaish	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
	Jaafar A.
R. K. Joyce	M. Casey
A. Kafka	
G. Laske	G. Grosche
	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
J. Tvedt	
N. Wicks	C. Taylor
	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

African Department: R. O. Carstens. Asian Department: R. J. Hides, A. Chopra, S. M. Schadler, M. Zavadjil. European Department: L. A. Whittome, Counsellor and Director; B. Christensen, O. J. Evans, L. Hansen, W. E. Lewis, L. G. Manison, P. Mentré de Loye, P. J. F. Nyberg, K.-W. Riechel, D. M. Ripley, H. O. Schmitt. Exchange and Trade Relations Department: C. D. Finch, Director; S. Mookerjee, Deputy Director; S. J. Anjaria, G. Belanger, M. Guitian, N. Kirmani, A. B. Petersen. Fiscal Affairs Department: E.-A. Conrad. Legal Department: W. E. Holder, A. O. Liuksila, J. V. Surr. Research Department: A. D. Crockett, Deputy Director; J. Artus, C. P. Blackwell, M. D. Knight. Western Hemisphere Department: S. T. Beza, Associate Director; G. Oliveros. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: C. J. Batliwalla, J. Delgadillo, S. El-Khouri, L. Ionescu, P. Kohnert, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, J. Bulloch, T. A. Connors, G. Ercel, I. Fridriksson, G. Gomel, H. Kobayashi, M. J. Kooymans, W. Moerke, Y. Okubo, G. W. K. Pickering, E. Portas, J. Reddy, J. Schuijer, Shao Z., Wang C. Y.

1. YUGOSLAVIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors resumed from the previous meeting (EBM/83/113, 7/29/83) their consideration of a staff paper on the mid-year review under the stand-by arrangement for Yugoslavia (EBS/83/141, 7/8/83; Cor. 1, 7/13/83; and Sup. 1, 7/28/83).

Mr. de Groote remarked that the staff paper gave a somewhat brighter picture than had emerged from the Board's earlier review in March 1983 (EBM/83/46 and EBM/83/47, 3/11/83). Some progress had been made along the lines recommended at that time. The Yugoslav authorities were especially to be commended for their speedy action to meet the performance criteria under the current stand-by arrangement. He could therefore support the proposed decision, provided that the Executive Board concluded that there was a need for fundamental and rapid action on the general reorientation of economic policies.

With all possible goodwill, Mr. de Groote continued, it was hard to consider that the Yugoslav authorities had done everything required to cope with the dramatic external situation of the country over the longer term. Certainly, impressive measures had been taken to curtail public consumption, cut back gross fixed investment, and limit imports from the convertible currency area. He had also noted with satisfaction the staff's view that the demand-oriented steps taken--albeit in a preliminary way--in the fields of monetary, fiscal, and credit policy, had already had some effect. Nevertheless, Yugoslavia would still have a current account deficit of $750 million with the convertible currency area in 1983, and some of the measures taken could have detrimental effects in the medium term. The forced curtailment of imports and the administrative cutbacks in investment could worsen the situation for the future. In addition, it was not certain whether a trade policy that resulted in 1983 in increased imports from, and decreased exports to, the nonconvertible currency area could be maintained in the coming years. He was also concerned about the future of tourism, since shortages of food, gasoline, and spare parts had caused the present year's performance to be extremely disappointing.

In view of Yugoslavia's serious difficulties, Mr. de Groote observed, the only approach was a fundamental policy reorientation that would re-establish the powers of the Federal Government over regional and local authorities, enterprises, and the various agencies of public administration, while leaving the running of the economy to the influence of market-oriented forces. It was paradoxical that the preoccupation with competition and the autonomy of individual units at the economic decision-making level had so far prevented the Federal Government from applying the macroeconomic policies for which Yugoslavia had come to be known among the socialist countries. Little room was left for market-oriented price and incomes policies where nothing like an overall price or wage level existed, and only limited room for the operation of monetary and fiscal policies where a critical mass of expenditure was escaping the control of central credit institutions and fiscal agencies. Yugoslavia's experience clearly brought out the lesson that a certain degree of centralization might be a prerequisite for the implementation of a non-dirigiste economic model. The need for re-establishing some minimum degree of authority, without which the operation of the market mechanism could not be monitored, was all the more urgent because Yugoslavia would not wish to maintain a current account deficit of $750 million with the convertible currency area.

With those considerations in mind, Mr. de Groote said, he was concerned about various statements in the staff report; for example, on page 11: "interest rates in real terms have been more negative than contemplated," on page 15: "the recent depreciation of the dinar has resulted in new price distortions...," and on page 16: the foreign exchange allocation system "as presently implemented...is not sufficiently flexible to ensure the appropriate allocation of scarce foreign exchange resources."

The requests for waivers of the performance criteria on the settlement of arrears and on public sector revenue, although unavoidable, increased his concern, Mr. de Groote commented. The staff was undoubtedly right in recommending medium-term measures that would lead to greater efficiency in the allocation of resources. The next question was one of timing. What had the Yugoslav authorities to gain, even in the short run, by postponing the moment when the long overdue reorganization of the economy came into effect?

The liquidity position of Yugoslavia, which was another serious cause for anxiety, Mr. de Groote remarked, also affected other countries, especially those that could continue their own adjustment effort only by maintaining access to financial markets, and whose creditworthiness might suffer if judgments and forecasts were extrapolated from Yugoslavia's situation to their own. The attitudes of many of the participants in the joint financing package under preparation and described in Annex I to the staff paper would change only if Yugoslavia succeeded in proposing convincing policies. The need for fundamental reform should dictate the performance criteria to be incorporated into the revised Fund arrangement with Yugoslavia, which he hoped could be expected in the near future, so that the dialogue with the member, to which Mr. Polak had alluded, could continue.

Mr. Tvedt observed that the staff paper demonstrated the extremely difficult situation in which Yugoslavia found itself, and further underlined the seriousness of the structural problems that had existed before the authorities undertook the Fund-supported adjustment program.

Significant progress had been made in several key areas, Mr. Tvedt continued, but partly due to very adverse circumstances, the present situation was highly volatile. The measures implemented by the authorities so far in 1983--the exchange rate depreciation, interest rate changes, and increases in administered prices--seemed to be very strong. Nevertheless, further action might even be justified in certain areas because of higher than expected inflation.

As indicated in the staff paper, some aspects of Yugoslav economic development were hard to predict for various reasons, including unstable relationships between variables or unexpected responses to policy changes, Mr. Tvedt noted. In addition, the unpredictable impact of such sharp policy initiatives as the ones recently taken caused projections for the rest of the year and beyond to acquire a large margin of uncertainty. Consequently, the Fund should exercise some flexibility in its approach to the Yugoslav program if developments deviated markedly from the envisaged path.

While accepting the policies undertaken in 1983 as necessary and welcoming the improvement of the current account balance, Mr. Tvedt mentioned his concern about the compression of imports. If it continued, it was likely to have detrimental effects on economic growth and on the prospects for recovery in the medium term. However, the external constraint was an extremely tight one, and the only course Yugoslavia could follow seemed to be full and vigorous pursuit of the adjustment efforts already begun, in particular, an active exchange rate policy, rationalization of the exchange markets, and a realistic pricing policy. Such a course would entail temporary sacrifices, but the reward ought to be a balanced and more efficient economy in the medium term.

From the Fund's point of view, Mr. Tvedt remarked, he valued highly the dialogue that had been established with the Yugoslav authorities. Much was at stake for the Fund, just as it was for Yugoslavia, and the Fund's involvement in the adjustment process would undoubtedly continue for some time. He was encouraged by the cooperative spirit of the authorities as well as by their commitment. He supported the proposed decision, including the waivers.

Mr. Wang said that since the 1982 Article IV consultation and discussions on the stand-by program, the Yugoslav authorities had continued to make great efforts to further improve their current account and external liquidity position, and to carry on with the process of restructuring their economy. Additional progress had been made in many fields, especially in the current account of the balance of payments. In the first four months of 1983, real wages in the socialized sector had fallen by 10 percent, compared with the same period of 1982. Domestic demand had been curtailed. The current account deficit had been reduced during the first four months of 1983 to only around $125 million, or about $1 billion less than during the same period of 1982. The decline of external reserves had been checked and external liquidity eased to a certain extent. The performance criteria for the first half of 1983 had either been met or were expected to be met. For all of that, the Yugoslav authorities were to be commended.

In light of the current world economic situation, the slower than expected improvement in Yugoslavia's balance of payments position, and the level of official reserves, Mr. Wang considered, the authorities had demonstrated strong determination and commitment to the international community in continuing to pursue the necessary policies of adjustment. He had been pleased to note the staff's positive response to the desire of the Yugoslav authorities to enter into a new stand-by arrangement after the present one expired. He supported the proposed decision, including the waivers.

Mr. Erb observed, with regard to Yugoslavia's three-year stand-by arrangement with the Fund, that not only had the authorities expressed interest in another arrangement after the present one expired in six months, Mr. Polak had also reported in his statement that the Yugoslav authorities argued against unduly rapid changes that did not take note of political and social constraints. The latter argument had been made fairly extensively by Mr. de Vries in the Executive Board's previous discussion of the Yugoslav program.

He could agree with the staff that a request for a further stand-by arrangement could be contemplated, Mr. Erb added, provided that the authorities adhered to tighter demand management policies and continued to restructure the economy in a timely fashion. The authorities had been slow to make needed changes in the past; they seemed to believe that the pace of adjustment sought by the Fund staff was inconsistent with political realities in Yugoslavia. But it was the responsibility of the Executive Board to ensure that the pace of adjustment agreed by the staff and management was consistent with the Fund's policies. If the authorities had concluded that political realities required a much longer period to carry out the necessary structural adjustments, they should seek additional longer-term financing from other sources.

The Yugoslav authorities had almost completed a three-year adjustment program under an arrangement with the Fund, Mr. Erb continued. Substantial additional adjustment was still required. Although the Yugoslav economy had been hit by events that were unanticipated at the start of the program, the more timely implementation of policies recommended by the staff earlier in the program would have left Yugoslavia in a stronger position. The authorities could not afford to postpone needed policy actions any longer because they were fast approaching the point where substantial financing from the Fund would not be possible. Yugoslavia had large drawings outstanding and would have to think about making repurchases in the near future.

Referring specifically to the mid-term review, Mr. Erb said that he supported the thrust of the staff appraisal as well as the revised decision. Demand management policies would have to be aimed in the period ahead at containing domestic demand through tighter monetary and incomes policies. Demand would have to be constrained in order to free resources for the external sector on a sustainable basis. He recognized that the credit ceilings had been set at levels that appeared tight; but he had noted past experience with rising interenterprise credits during periods when the growth of bank credit should have been restrained, and he was therefore inclined, like the staff, to prefer tighter ceilings on bank credit.

Interest rates had been moved in the correct direction, Mr. Erb commented. Nevertheless, substantial increases in interest rates on dinar savings deposits were still necessary to increase savings and to induce savers to shift their foreign currency deposits into dinar deposits. It was clear from Table 14 (EBS/83/141) that interest rates on selective credits extended by the National Bank were still much lower than the expected rate of inflation, and that a sizable portion of credit was interest free. It was hard to imagine how investment and borrowing could be rationalized at prevailing rates of interest. He urged the authorities to follow the advice of the staff and to make continued significant movements toward positive real interest rates.

The authorities should continue to follow a flexible exchange rate policy to assist in the adjustment of the balance of payments, Mr. Erb continued, while making greater efforts to adjust administered domestic prices to reflect exchange rate changes. There was much more room for flexibility in the setting of prices; selective price freezes would result in further price distortions. A more rational price system would improve the allocation of resources and in the long run should improve the financial position of enterprises. Although the authorities had taken steps to improve the system for allocating foreign exchange, it was still insufficiently flexible to ensure the appropriate allocation of scarce foreign exchange resources. There was also a need for a more rational method of handling the foreign exchange accounts of residents and for a better debt management system.

The external financial position of Yugoslavia was very tight, Mr. Erb remarked. He had noted from Table 6 (EBS/83/141) on the balance of payments with the convertible currency area that reserves were expected to show a decline in 1983 of $85 million, instead of a projected increase of $628 million, which had been the initial target under the program. The current account position was admittedly slightly worse than had been expected, and external financial flows had not been as strong as expected. Indeed, the staff had noted in its appraisal that the tight foreign exchange position was largely the result of a much slower than expected disbursement of the foreign assistance package, there being a larger proportion of unusable suppliers' credits and a smaller share of financial credits to be disbursed in 1983. The staff had then gone on to note that slowness in implementing the package meant that only up to $500 million in suppliers' credits seemed likely to be utilized during 1983. Yugoslavia's tight external position suggested to him, first, that great emphasis needed to be placed on building up the reserve position, a matter on which the staff should be firm in negotiating any future program. Second, much greater effort needed to be made by other countries to fulfill the commitments they had made if they wished to ensure that there would be no repetition of the shortfalls that had affected Yugoslavia's external position during the current year.

Consequently, Mr. Erb considered, the staff should develop a reporting and monitoring procedure to ensure that external commitments were being met in line with expectations and, if not, the reasons they were not met. At times, some commitments might not be met because of developments within the recipient country; at other times, foreign governments and the banking sectors might change their commitments. But whatever the cause of the failure, in programs where external financing assumed such great importance, the staff should make it clear why external flows had not been forthcoming.

Mr. Prowse said that he supported the proposed decision, including the waivers. Directors should keep in mind the immensity of what was being attempted in Yugoslavia. The somewhat critical discussion so far might fail to reflect an appreciation, not merely of the nature of the domestic economy, but also of the real difficulty of the external situation. Moreover, the program and the performance criteria attached to it were in a way breaking new ground. Yugoslavia's economy had the curious quality of being neither a straightforward centrally planned economy nor a straightforward market economy; and therein lay probably the source of most of the difficulties that Directors had emphasized.

For his part, Mr. Prowse noted that while there was cause for some disappointment with what had been achieved, some substantial progress had also been made. The flexible adjustments of the exchange rate were notable. Interest rates, even though they remained negative in real terms for privileged borrowers, were nevertheless some 18 percent or 20 percent higher than they had been. There had been a substantial reduction in real wages in the socialized sector, far greater than could be found under any other country's program. There had been some achievements even in the difficult area of administered prices.

Yet as Directors had made more than sufficiently clear, Mr. Prowse continued, there had been great disappointments. The rate of inflation was quite unsustainable; the rate of adjustment to structural problems was so slow as to be difficult to discern; and the economy was stagnating, making major structural adjustments that much more difficult to achieve. A higher level of economic activity was certainly desirable and he foresaw continuing difficulty with the adjustment program so long as it continued to decline in real terms.

It was in a way surprising, Mr. Prowse remarked, that Yugoslavia had managed to achieve as much as it had in the face of the difficulties confronting the Federal Government. The performance criteria under the stand-by arrangement were in some respects unique. Apart from the problems with the formation of prices and the allocation of resources, incomes policy had posed special difficulties for the Yugoslav economy. But the most unusual performance criterion related to government revenue, which was to be kept within a ceiling with surpluses being frozen. He understood that the original intention had been to substitute a ceiling on revenue growth for one on expenditure, but he wondered whether the staff had reached any conclusions on the value of the criterion. Would the staff include it in a further program or perhaps replace it with a more effective criterion?

In concluding, Mr. Prowse stated that the key issue, as Mr. de Groote had said, was the speed of adjustment in the Yugoslav economy. The staff had ended its appraisal on the same note. He recalled that Mr. de Vries had left the impression, during the Board's earlier review of the program, that the Yugoslav authorities were in fact committed to steady change in permitting the increased operation of market forces in their economy. He did not believe that the Fund was in a position to insist on the economy evolving in one direction or another; what it had to require was that the chosen direction be clear, and that the economic structure be as efficient and as effective as possible in order to move in the chosen direction in a timely way. Thus, before another program and arrangement could be agreed with Yugoslavia, the direction of the institutional changes that the authorities were committed to make in their economy would have to be clarified.

The Director of the European Department agreed with Mr. Prowse that although the position reached by the Yugoslav economy was far from satisfactory, considerable progress had been made. Quite apart from the reduction of real wages and containment of real domestic demand, to which frequent reference had been made, it should be noted that the current account deficit had fallen from the equivalent of 5.5 percent of GSP to 1.75 percent. That improvement had taken place in the context of a dramatic deterioration in the capital account. Three or four years previously, Yugoslavia had been receiving gross external capital inflows of $3-4 billion a year. Subsequently, it had been necessary to reach a standstill agreement to prevent a massive outflow of capital. Furthermore, as Mr. de Groote and others had emphasized, there had been a significant change in Yugoslavia's current account with the nonconvertible currency area; exports were some 19 percent lower than they had been in 1982, and imports 8 percent lower. That shift could not be expected to continue, but it represented a notable achievement.

Certainly, much more needed to be done, the Director said, and it was above all essential that the current account with the convertible currency area move into surplus in 1984. The staff's forecast of a $750 million deficit on current account in 1983 was not based on a carefully quantified series of assumptions. It was plain to the staff that the import compression in the first months of 1983 was neither sustainable nor efficient. It was also clear that imports would rise with the additional financing that was expected to become available. In particular, oil stocks were low and would have to be built up. It was also necessary to bear in mind the once-for-all element of the diversion of trade from the nonconvertible currency area, which was unlikely to be as strong in the second half of the year. The bulk of receipts from tourism were not registered until August or September; so far they had shown few signs of deterioration and had even improved in nominal terms compared with 1982. One reason might be that foreign tourists were no longer buying dinar notes before going to Yugoslavia, because of changes in exchange regulations as well as anticipated changes in the exchange rate, so that the beneficial effects of tourism on foreign exchange receipts were more likely to show up in the balance of payments figures. In sum, the staff's estimate of a deficit of $750 million for 1983 was an approximate forecast, based on estimates made with a degree of caution.

When the fiscal part of the program had been drawn up at the end of 1982, the Director continued, the fiscal accounts--there were thousands of such accounts in the public sector--were traditionally in balance. The authorities had been determined to exercise strict control over expenditures. It had not been possible to introduce a performance clause on public expenditure because the data were available only with a long delay. In looking for another monitoring instrument, the staff had thought of a ceiling on revenues as an indirect way of controlling public expenditures and of securing a shift in the composition of the national expenditures, away from the public and toward the private sector. It should be borne in mind, however, that the distinction between public and private goods sectors was not as clear in the Yugoslav economy as in a market economy; for instance, housing was in the public sector. By the spring of 1983, it had become obvious that a cautious approach was insufficient and that action had to be taken to make fiscal policy contribute more directly to domestic demand restraint.

Legislation had been introduced early in 1983, allowing part of the excess revenue to be frozen, the Director went on; but the measure approved was complicated, and left large loopholes. The Yugoslav authorities had agreed with the staff view that the mechanisms for freezing excess public sector revenues should be strengthened; further legislation had been introduced, which would indeed contribute to the overall reduction in demand. The limit on public revenue growth had nevertheless been retained, partly with the same objective of changing the composition of demand but more with a view to freezing any additional excess revenue. As Executive Directors would have noted, the performance criterion had been reworded to exclude the frozen amounts from the percentage limits on the increase in revenue. The upshot was a criterion for fiscal policy that resembled the Fund's traditional approach, which it had not been possible to apply directly at an earlier stage owing to the absence of legislative authority.

Whether the staff would continue to use a limit on revenues, if Yugoslavia entered into another stand-by arrangement in 1984, was an open question, the Director noted. Certainly, the freeze mechanism, if it could be effectively and flexibly applied, was a more direct and open approach to controlling spending. The amounts that had so far been agreed should be frozen and would remain immobilized until the end of 1985, the minimum period in the view of the staff; given present economic and financial prospects, he would assume that they should be frozen for a considerably longer period.

An interest rate of 30 percent on dinar saving deposits was not as unattractive as it might seem since interest income was not taxable, the Director remarked; the attractiveness of household deposit rates depended on one's view about future inflation. The reason for the delay in introducing changes in commercial bank interest rates was the need for numerous entities to reach a self-management agreement to accept those changes formally before they could be implemented. As to whether real interest rates should be positive, the staff had been convinced that interest rates should encourage dinar savings and at the same time bring discipline to bear on investment decisions. Even though there was legislative authority for controlling the growth of interenterprise credit, no device was foolproof. Nevertheless, the Yugoslav system was sufficiently flexible to enable the authorities to find some other instrument that would have the same effect.

The interest-free credits to which Mr. Erb had referred, the Director explained, were in fact the counterpart to foreign exchange accounts. Although the credit was interest free in a formal sense, the commercial banks had to bear the exchange risks incurred in paying interest on those accounts and the cost to them was not inconsiderable.

Nonwage incomes were derived primarily from services, interest payments, and that part of the agricultural sector that was in private hands, the Director observed. From the figures that were available, the staff had made the broad estimate that approximately 50 percent of household income came from such sources. There was a high number of self-employed people in the agricultural sector, and it was not uncommon for workers in the industrial sector to gain part of their income from small agricultural plots. As to whether the income effect of interest rate increases might offset the substitution effect, as far as dinar deposits were concerned, the income effect would probably not be very great. More important was the wealth effect associated with the increase in the dinar value of deposits in foreign exchange accounts as a result of the depreciation in the dinar.

Although it was unfortunate that four waivers had had to be granted in one year, the Director noted, two of them were related to arrears, which had existed at the time the program for 1983 had begun. The timetable for disbursements from the commercial banks had slipped so that the dates for the abolition of arrears could simply not be met. The third waiver related to a small incentive given to foreign tourists to encourage their expenditures. The fourth waiver pertained to fiscal policy, which had been tightened, so that in effect the earlier fiscal performance criterion had been more than reaffirmed.

In response to a question about proposed changes in the foreign exchange allocation system, the Director commented that a surrender requirement was a disincentive to exporters in any country, if the official exchange rate was indeed not at an equilibrium rate.

Almost $5 billion of Yugoslavia's external debt would fall due in the coming two years, some $2.7 billion of medium-term debt in 1984, and nearly $2 billion of short-term debt in early 1985, which would have been continuously rolled over until that date, the Director of the European Department stated. At the same time, usable reserves were low and would have to be built up if Yugoslavia was to emerge from its difficulties. Therefore, some effort would inevitably have to be made to deal with the financing problem in 1984. As far as the Fund was concerned, as Executive Directors had reaffirmed, attention should continue to be focused on the type of adjustment that was currently being undertaken, including action on the exchange rate, interest rates, and domestic prices. It was fair to say that the Yugoslav authorities were determined to move in that direction, although there remained a difference of view about the speed of the adjustment process. In that connection, Mr. de Groote had touched on a basic concern in asking whether the Federal Government had sufficient powers in the present crisis situation to be able to manage the economy effectively. It was also possible to question whether the continuing threat posed by the existence of large foreign exchange denominated accounts at Yugoslav banks was compatible with the satisfactory working and adjustment of the economy, and whether the very heavy bank indebtedness of Yugoslav enterprises, with the profound effect on their financial position of any change in interest rates, could be allowed to continue. Finally, and most fundamentally, there was the question whether sufficient changes could be forced through in a short time in an economy where it was impossible for enterprises to become bankrupt.

Mr. Polak said that many of the Executive Directors' observations had also been made by the Managing Director when he had visited Yugoslavia in June. The central point was the question of urgency. There was no difference of view between Yugoslavia and the Fund, or between Yugoslavia and its foreign creditors, on the necessary direction of policy or on the adjustments that would have to be made. As the Managing Director had made clear to the President and to the Prime Minister, Yugoslavia had very little time in which to show that it was moving decisively in the direction of a stronger payments position. Yugoslavia could not count on additional money unless it could show that it was prepared, within a relatively brief period, to take the necessary action to justify the use of resources provided by the Fund and by supporting member governments.

As for the size of the current account surplus for 1983, Mr. Polak said, the figure announced for the first five months showed an even greater surplus than for the first four months. Thus, there was more reason to expect that the target of a current account deficit of no more than $500 million with the convertible currency area could be attained, bringing the necessary improvement in 1984, which should aim at a certain surplus, within closer reach, if the right policies were followed.

The special characteristics of the Yugoslav economy and of its method of decision making might well entail a real economic cost to the country, Mr. Polak recognized, because the difficulty of agreeing on all the necessary structural measures would make it necessary to rely more on measures to compress demand. On balance, a more rapid adjustment in the structure of the economy might permit a higher standard of living, given the balance of payments constraint. The choice was one for the Yugoslav authorities. It was reasonable for the staff to ask for better, stronger, and more timely measures in order to attain the objectives on which there was no disagreement. But to go further and ask for a fundamental reorientation of the economic system posed the risk of advocating a development that was not compatible with the social and political aims of Yugoslavia. The Fund should be extremely careful not to overstep the mark in that respect.

As to whether the authorities in Yugoslavia agreed that the economy should be developing in the direction of a market economy, Mr. Polak went on, they were certainly aware of the importance of market indicators and were prepared to place greater reliance on such factors as prices, interest rates, and the exchange rate. But it had to be recognized that many people in the country held different views, and held them strongly. Great freedom and great dirigisme existed side by side in Yugoslavia. One element of freedom was that until recently foreign exchange earned from exports had not been subject to a surrender requirement, which many western countries still imposed. In addition, many Yugoslavs were taking advantage of the possibility of holding bank balances expressed in foreign currency. It had been found necessary, in a country in the middle of Europe that relied heavily on the income earned by its nationals in other European countries, to allow a great measure of freedom to hold and use foreign assets.

The waivers being granted by the Fund under the stand-by arrangement were not substantial, Mr. Polak considered. On arrears, it had been discoverd that setting a fixed date to precede another date on which a Fund drawing would become possible had resulted in far too rigid a time schedule in a fluid situation, particularly with respect to the uncertain speed with which foreign banks were releasing new money. The requirement that arrears be cleared up six weeks later than originally proposed did not alter the basic objective, namely, that Yugoslavia would not be able to draw the third tranche under the stand-by arrangement until it had paid off arrears. Thus, the substantive performance criterion remained valid. As for the limits on government revenues, no better mechanism had seemed to be available, particularly owing to the difficulty of monitoring government expenditure. Almost inevitably, the higher than expected rate of inflation had produced higher receipts for the Government. Fortunately, the Government had not cut taxes but had allowed revenue to accumulate, above the limits set by the Fund, as part of its own self-imposed policy of expenditure control. Nevertheless, the authorities had agreed to freeze an extra Din 5 billion of June public sector receipts.

The decision was:

1. The Government of Yugoslavia has consulted in accordance with paragraph 3(d) of Executive Board Decision No. 7363-(83/47), March 11, 1983, and paragraph 12 of the letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia dated December 30, 1982 in order to establish performance criteria subject to which purchases may be made by Yugoslavia during the remaining period of the stand-by arrangement for Yugoslavia (EBS/81/5, Supplement 2 (2/2/81)).

2. The letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated July 8, 1983, setting forth the policies and measures which the authorities of Yugoslavia will pursue for the remaining period of the stand-by arrangement, shall be annexed to the stand-by arrangement for Yugoslavia, and the letter of December 30, 1982,

annexed to the stand-by arrangement as supplemented by the letters of February 18, 1983 and May 4, 1983, shall be read as supplemented by the letter of July 8, 1983.

3. Yugoslavia will not make any purchase under the stand-by arrangement that would increase the Fund's holdings of its currency in the credit tranches to more than 25 percent of quota or increase the Fund's holdings of its currency resulting from purchases of supplementary financing to more than 12.5 percent of quota:

(a) during any period in which the data for the preceding period indicate that the limit on outstanding net domestic assets of the banking system described in sentence 6 of paragraph 9 of the annexed letter, and as specified in the attached memorandum of understanding, has been exceeded; or

(b) until the availability date for the first advance under the medium-term external bank financing agreement with Yugoslavia has been communicated by the International Coordinating Committee to the Fund.

4. The Fund waives until September 30, 1983, the application of the performance criterion specified in paragraph 3(b)(iv) of Executive Board Decision No. 7363-(83/47) adopted March 11, 1983 and extends until September 30, 1983 the waiver of the application of the performance criterion in paragraph 3(c)(i) of the stand-by arrangement in EBS/81/5, Supplement 2, February 2, 1981, in respect of the arrears existing during 1983.

5. For purchases after September 30, 1983, and in accordance with the letter from the Governor of the National Bank of Yugoslavia and the Federal Secretary for Finance of Yugoslavia, dated July 8, 1983, the intentions relating to public sector expenditures referred to in paragraph 3(b)(iv) of Executive Board Decision No. 7363-(83/47), March 11, 1983, shall be supplemented and modified in accordance with the last three sentences of paragraph 7 of the annexed letter.

Decision No. 7483-(83/114), adopted
July 29, 1983

2. FEDERAL REPUBLIC OF GERMANY - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Federal Republic of Germany (SM/83/153, 7/5/83). They also had before them a staff report on recent economic developments in Germany (SM/83/154, 7/11/83).

Mr. Laske made the following statement:

My authorities are in broad agreement with the staff's report. It adequately reflects the difficult period through which the German economy is going and the approach my authorities have adopted for coping with the problems and challenges they are facing. We are pleased that the staff is in agreement with the basic thrust of our policies.

The German economy has experienced three years of a rather severe recession. GNP has declined for two years in a row, the profitability of German industry has deteriorated markedly, productive investment is at an unsatisfactorily low level, business failures reached an unprecedented high number, and--last but not least--unemployment rose to record figures for the last three decades. On the brighter side, we can register a steep decline in the rate of inflation--less than 3 per cent on an annual rate most recently--and a significant improvement in our external accounts.

The latest indications support the expectation that this year real GNP may increase by more than 0.5 per cent, which would be better than projected in our recent World Economic Outlook publication. The trough of the recession was probably passed sometime in December 1982. Since that month private consumption expenditure and industrial production have been on an upward trend, and it can be expected that an improved sales outlook will in time induce the business community to revise upward its investment plans. Investment in plant and equipment is still subdued at the moment, while residential construction has picked up handsomely. For the first time, however, foreign demand does not appear to contribute in a significant way to the recovery which obviously is under way.

This recovery is based on the progress so far achieved in the adjustment of the German economy which, as I have mentioned, finds strong expression in the reduced inflation rate and the better balance in the external current account. Moderate wage settlements in practically all sectors of the economy, most prominently perhaps for civil servants and public sector employees, have decisively contributed to these improvements.

While we are certainly pleased with these favorable developments, the German authorities remain concerned about basic structural weaknesses in the economy. The absorption of resources by the public sector has greatly increased over the last decade, reaching almost one half of GNP in 1982. We believe continued vitality of the economy and its ability to grow depend more on the activities of the private sector than on income redistribution through the budgets. Decreasing the share of the public sector in the economy is essential, therefore, in order to allow the private sector to play its proper role.

Another indication of structural maladjustments is the subdued private investment activity, which in turn reflects the impaired profit-generating capacity of German enterprises. This is illustrated by the fact that the share of equity capital in balance sheet totals has declined over the last 15 years or so by as much as one third, from 30 per cent to 20 per cent. To stimulate business initiative and innovative power requires that wage developments are kept in line with productivity gains and that the public sector's financing requirements leave sufficient room for productive investment to increase. Not dealing adequately with the structural weaknesses would hinder the German economy in resuming a more satisfactory growth path and in reducing unemployment to a less disturbing level. We recognize that this cannot be achieved quickly but will need time. What is considered important by my authorities is a marked and visible reduction in the structural component of the Federal Government's deficit. Some progress has already been made in this direction, but much stronger advances are clearly needed.

Last year's budget deficit, contrary to earlier intentions and expectations, was not reduced because of the budgetary costs of the prolonged recession, primarily for rising unemployment benefits. The measures adopted by the Government which assumed office last autumn are designed to limit the increase in this year's budget deficit to a much smaller amount than would have resulted from unchanged policies. An intensified effort is now being made in the federal budget for 1984 to limit the rise in public expenditures to a rate that is significantly below the projected nominal increase in GNP. This effort rests heavily on cuts in entitlement programs which, it is commonly agreed in Germany, have become overly generous and unaffordably expensive in recent years. These expenditure-saving measures are being combined with actions in the tax area that intend to encourage private investment and to strengthen the profitability of enterprises.

Although these fiscal measures will go some way in the direction of restructuring the Federal Government's budget, their effect on the size of the deficit in money terms cannot be large in the short run, mainly because of the continuing high level of unemployment and the public expenditure associated with it. For the years to come it has already been decided, in the framework of the medium-term fiscal planning for the public sector as a whole, to continue keeping the growth of expenditure by a significant margin below the rise in nominal GNP. The objective is to reduce the deficit of the General Government to 2 1/2 per cent of GNP by 1987, a percentage that is much more in line with our historical experience.

It is the objective of monetary policy to contain inflationary pressures and to allow a progressive strengthening of the recovery, while not disturbing the process of external adjustment. German interest rates continued to decline last year in nominal and in real terms, more markedly so since August. The Government's determined policy to consolidate its budget over the medium term appears to have contributed to this process to an important, though not precisely measurable, degree. Due to the dependence of interest rate developments in Germany on those in international rates, this positive influence could so far not exert a stronger impact. The continuing efforts of the Government to improve the structure of the budget will permit German interest rates to move more independently of rates abroad.

Early last March the Bundesbank decided to lower its rates by a rather large margin, an action that was considered desirable to give support to the emerging recovery. With the extent of this move the room for maneuver has been fully exhausted. The recent slight increase of market rates in Germany in reaction to rising interest rates in the United States has clearly demonstrated this. Only a few weeks ago the Central Bank Council of the Bundesbank reviewed and confirmed this year's monetary target of 4-7 per cent for the growth of central bank money. In announcing its decision the Bundesbank has stated that the overshooting which occurred in the first half of this year had been caused by temporary factors that appear to have run their course. The target established is, therefore, considered to be achievable and continues to be appropriate.

Mr. de Groote observed that, more than ever, economic developments in Germany had an impact on the other economies of Europe, especially the smaller industrial economies, and the central question was to find the most appropriate measures to support the recovery of growth in Germany. After three years of zero or negative growth, the outlook for 1983 and 1984 was for modest real GNP growth. As was rightly stated in the report on recent economic developments, the recovery under way could bring only partial relief at best. Further structural problems remained to be dealt with, and their solution raised delicate issues because, at the present bottom of the recession, some of the required structural adjustments might work against the recovery.

Germany had been trying to reduce its fiscal deficit, using what was called a medium-term approach, Mr. de Groote continued, which was often taken to mean that no success had as yet been seen in the short term. That might well be the most appropriate approach, since more severe fiscal measures could produce undesirable contractionary effects. Aside from the need to reduce the deficit, it was believed that the size of the public sector, even if it were financially in balance, might have reached or even passed the critical threshold where it became an obstacle to the restoration of the long-term profitability of investment.

Certain nuances relating to the appropriate size of the public sector had not been explicitly brought out in the staff report, Mr. de Groote considered. First, the size of the public sector was largely the result of choices that depended on the general public's preference for private versus public goods and services, and the redistribution of income. Competing claims on resources were a problem only when the choice led to systematic deficits. Whether or not to reduce the size of the public sector could thus be regarded as largely a matter of preference, depending on what assumptions were made about the medium-term or long-term effects of the budget on the performance of the economy. But those effects could not be evaluated without looking at the composition of the budget on both the revenue and the expenditure sides. During the discussion of the 1982 Article IV consultation, several Executive Directors had taken up the suggestion of the OECD that government expenditures should be more consistently directed toward productive investment. He had found no elaboration of that point in the present staff report, apart from a mere reference to the budget proposals for 1984, which envisaged tax changes aimed at stimulating investment. All of the attention seemed to be directed toward blanket reductions in the size of the overall budget, rather than to the envisaged pattern of expenditure reduction. Such an approach might well do as much harm as good to the economy, especially at a time of depressed economic activity.

Unemployment had become still another point of concern, Mr. de Groote continued. As the staff had noted, even if a sustained growth rate of 3 per cent a year was assumed, no major improvement in employment was to be expected. It was therefore remarkable, and encouraging, that the authorities had been able to resist pressures for protectionist measures, especially in view of the most recent events in other major industrial countries. But that alone did not lessen his concern about other possible adverse consequences of the employment problem in the longer term. He found it somewhat disturbing that so little attention had been given to further structural measures, and he wondered whether Mr. Laske or the staff could indicate more precisely the views of the German authorities on long-term wage policy. Beyond the enumeration of possible future measures, there were few signs in the staff's report of the policy options that would have to be considered. Yet employment should surely not be viewed as a residual variable, but as one of the factors that could possibly contribute in a positive way to the restoration of activity; for instance, action could be taken to change the relative share of wages and profits in the value added by manufacturing, and consideration given to the way in which social security benefits were financed. It was not sufficient to look at the historical evolution of wage-profit shares, as was done in the staff report; intercountry comparisons might be more relevant because similar developments had taken place in other countries as well.

His chair appreciated the positive role that Germany had been playing in preserving and strengthening the European Monetary System, Mr. de Groote stated. Much remained to be done, however, beyond exchange rate alignments. At present, as on previous occasions, there was a tendency in Germany to concentrate on domestic developments and national policies, with perhaps too little attention being given to their repercussions on the policies of different countries, and the need for coordination. Germany was obviously an important participant in the international economic policy game; affected by the policies of the other major industrial nations, it had a significant effect on almost every other European economy. If the U.S. dollar rate remained high, the German authorities would face important choices on the appropriate level of interest rates and the possible need for exchange rate intervention. Because of the size of the economy, the options open to Germany highlighted, better than those of any Western European country, the need to examine the possibility of exchange rate cooperation and intervention arrangements among the dominant monetary centers in the international monetary system--the United States, Japan, and the European Economic Community--with Germany playing a major role in the European arena.

Mr. Caranicas stated that the complexities and importance of the German economy from an international standpoint deserved full and careful examination by the Executive Board. While the short-run outlook and the design of policies currently in place had to be assessed in the standard fashion, it was useful to touch briefly on some more medium-term issues. Those issues pertained to other industrial economies as well, but were of concern not only to them but to the international community at large.

After a long-lasting recession, recovery seemed to be under way in Germany, Mr. Caranicas noted. The prerequisites to sustain a cyclical upturn and to enable the economy to move back to a pattern of steady growth appeared to be more firmly in place than some months previously. Leading indicators, particularly the business climate and the inflow of orders, also suggested that a moderate upswing was taking place. However, according to the latest OECD Economic Outlook, it was difficult to determine whether those indicators signaled a sustained recovery because the figures were strongly influenced by special factors. The authorities claimed--and the staff appeared to agree--that the recovery was expected to be neither rapid nor strong. While the German authorities were pleased with the latest favorable developments, as Mr. Laske had put it, they "remain concerned about basic structural weaknesses in the economy." Macroeconomic policies conducive to a sustained recovery would have to be pursued although it could be argued that slow growth or near stagnation were almost inherent characteristics of a mature economy like Germany's.

Policies directed at reflating domestic activity should thus be replaced largely by measures centered on improving the structural conditions necessary for growth, Mr. Caranicas continued. Those conditions were usually defined as a reduction in public sector expenditures and fiscal deficits, and a resumption of private investment. While he shared the view that business confidence had to be restored to promote the growth and investment that would augment employment, and while he agreed that such confidence was closely related to the size and composition of the public sector's claims on real resources, he did not think that short-term anticyclical policies should be entirely forgone. He accepted the premise that a marked shift to active expansionary policies might be counterproductive, with short-term gains being more than offset by long-term penalties. But in a country like Germany, where there was less danger of resurgent inflation, too rapid a reduction in fiscal deficits could inhibit the pace of domestic recovery, and indirectly the long-awaited and still elusive world recovery.

It should not be forgotten that gross fixed capital formation, which in real terms at the end of 1982 had been about 10 percent below the cyclical peak in early 1980, was expected to remain well below its pre-recessionary level until late 1984, Mr. Caranicas remarked. The latest investment survey by the IFO institute in Germany suggested that a new investment cycle was not yet under way. Low capacity utilization and modest growth expectations apparently were making the prospects for capital widening poor, with rationalization and replacement remaining the predominant investment motives.

Some policy stimuli could be useful at the present stage, Mr. Caranicas considered. He welcomed the easing of monetary policy and was not concerned with the recent overshooting of the target range. He did wonder, however, why long-term interest rates, especially on the lending side, had remained high, and submitted that some further reduction was warranted, without any serious risk of adverse exchange rate effects. Similarly, he appreciated the Government's attention to the problem of the budget deficit as a medium-range policy target, with the expansion of the deficit to be stemmed by means of a deceleration in the rate of growth of public spending. It was worth noting that the latest survey by the OECD of Germany's economy did not reflect a shared belief in the harmful effects of official deficits, but said rather that the speed with which Germany was pushing a reduction in its budget deficit raised dangers for recovery in the medium term. In that respect, it would be interesting to receive from the staff some reasonable estimates of the cyclical versus the structural component of the fiscal deficit.

The staff's examination of exchange rate movements seemed somewhat sketchy, Mr. Caranicas continued. It was stated in the staff report that policymakers did not have a precise exchange rate target, and saw a limited role for intervention; but there was no discussion of what the authorities considered proximate determinants of exchange rate movements, in particular with respect to the pivotal deutsche mark/dollar rate. In addition, a more careful consideration of the experience of the European Monetary System (EMS), and of Germany's assessment of that experience, would have been useful. His authorities were of the view that the EMS, while not preventing the fundamentals from being reflected in the rates between two currencies, had nonetheless reduced their erratic gyrations, thus rendering the exchange rate system more stable and orderly.

He had noted with appreciation the strong decline in energy use in the German economy, Mr. Caranicas went on, and wondered whether the staff had made an in-depth investigation of the nature of Germany's energy conservation. It would be interesting to know whether the transition to less energy-intensive production techniques had been a more important phenomenon in Germany than in other industrial countries, and whether energy saving had extended to household consumption or been confined mainly to industrial use.

To conclude, Mr. Caranicas said that the German authorities deserved praise for their balanced approach to the problems still besetting the economy. Fiscal policies were being conducted in a way that tended to preserve the low level of inflation achieved and to improve the structural composition of the budget, with the aim of reducing the deficit. The authorities had continued their cautious policy of easing monetary conditions in small steps, in line with the requirement of an international convergence of economic conditions in the medium term, as advocated at the Williamsburg summit. Germany also followed a policy that helped to maintain an open international trading and investment system so necessary for higher levels of employment and growth of the world economy. Finally, the authorities were to be commended for their continued efforts to resist protectionist tendencies, and for maintaining the level of their official development assistance. The recent cancellation by the German Bank for Reconstruction and Finance of debts incurred by Uganda before 1982, and the rescheduling of other debts over a period of ten years were noteworthy.

Mr. Nimatallah observed that the German economy was at a critical turning point. After more than two years of recession and rising unemployment, there were signs of a moderate recovery. But that recovery was not yet well established and could falter. The prospects for business investment, private consumption, and export growth were still uncertain. The main task for the authorities, therefore, was to promote the recovery without jeopardizing the progress made in reducing inflation. The authorities had made a good start by adopting prudent but flexible policies that had laid the basis for sustained growth. Inflation, and inflationary expectations, had been brought under control. Wage settlements were expected to remain moderate, although business profits and business confidence were slow to improve. The external position was strong and the current account was likely to remain in a comfortable surplus in 1983 and 1984.

Germany was thus better placed than most other industrial countries to accommodate a recovery, Mr. Nimatallah continued. The question was how best to build on those foundations. There were no easy answers to that question. He agreed with the authorities on the need to take a longer-term view. The present policy stance seemed broadly appropriate and well designed to create a climate of confidence for investors and consumers. There was some room for maneuver, which the authorities could use to foster the recovery; however, a durable recovery would depend not only on Germany's policies but also on those of its main trading partners.

The right balance seemed to have been found for monetary policy, Mr. Nimatallah commented. The authorities had used the opportunity provided by the improved external environment to bring domestic interest rates down and to follow a more accommodating policy. The benefits were being felt in the revival of domestic demand. The scope for any further easing of monetary policy depended to a considerable extent on external factors. For the present, it was important for the authorities to avoid sudden shifts in either direction. The target rates for monetary growth in 1983 should provide an adequate stimulus to recovery and give the assurance that inflation would be kept under firm control.

A more difficult choice faced the authorities in trying to reconcile the medium-term objective of reducing the federal deficit with the more immediate aim of reviving the economy, Mr. Nimatallah remarked. He agreed with the authorities that it was prudent to follow a course aimed at gradually reducing goverment expenditure and government borrowing over time. It was equally important to improve further the quality of government expenditure. He welcomed the intention to increase the investment component of such expenditure and to ensure that public investment was put to more efficient use. The commendable measures taken to encourage private investment had made a significant contribution to the present recovery, and he hoped that the authorities would be prepared to take similar measures in 1983 if the recovery appeared to be faltering. For example, there might perhaps be scope for limited tax cuts to offset the adverse effects on growth, should foreign demand for exports continue to weaken. Reference was made in the staff paper to proposed improvements in the tax structure and to discussions of a possible reduction of income taxes. It would be helpful if the staff or Mr. Laske could elaborate on those proposals.

A sustained reduction in unemployment would require a combination of productivity growth and wage restraint, Mr. Nimatallah said, as the authorities themselves recognized. In that respect, the public sector wage freeze in 1984 should set an important example to the rest of the economy.

He would like to commend the authorities for their firm stand against protectionism--at the national level, within the European Communities, and at the General Agreement on Tariffs and Trade (GATT), Mr. Nimatallah stated. He was also encouraged to see that Germany was taking a prudent long-run view of the need for structural adjustment in the industrial sector. It was important for industrial countries to increase their productivity. One of the ways was to assist and revive industries only when they had a comparative advantage. Germany was moving in the right direction, and he hoped that other industrial countries would review their policies in the same longer-term perspective. The principle of comparative advantage should be prominent in considering whether to assist a faltering industry or to let it migrate to a country where it could be most productive.

Finally, Mr. Nimatallah encouraged the German authorities to maintain their official development assistance at least at its present level in real terms. As he had said in the recent discussion of the 1983 Article IV consultation with the United States, cutbacks were a false economy. In helping countries to develop, Germany and other industrial donor countries would benefit from the income and employment that aid created in their own economies.

Mr. Polak noted that the German economy was slowly recovering, after its disappointing performance during 1982 when real growth had been negative, compared with an original forecast of about 1-1.5 percent growth. By contrast, the outcome for 1983 seemed likely to surpass the Government's forecast of zero growth and to reach at least 0.5 percent, according to Mr. Laske. The actual outturn over the first half of 1983 of 1-1.5 percent at an annual rate might well be the figure for the year as a whole, if account was taken of the acceleration of growth expected toward the end of the year. Nevertheless, the recent upturn rested on a rather narrow basis. It was largely due to temporary government incentives for nonresidential investment and housing construction. Investment projects might thus have been advanced in order to benefit from such incentives, which would explain why, as noted on page 13 of SM/83/153, the demand for housing had already picked up strongly. The recent OECD Economic Outlook had concluded, from the latest survey of investment, that a new investment cycle was not yet under way, but the most recent indicators, pointed to a 2.1 percent increase in investment demand. In addition, the dip of the inflation rate below 3 percent had strengthened business and consumer confidence, as reflected in the increase in retail sales--by 2 percent in May compared with the preceding year--and increased order books.

On government finance, the actual outcome of the public sector deficit had belied earlier projections for a number of years, Mr. Polak observed. In 1982, the projection had been for the Federal Government to have a deficit of DM 29.5 billion, whereas the outcome had been DM 37.5 billion. The budget for 1983 had again indicated a deficit of DM 29 billion, but based on an assumed GNP growth rate of 3 percent, and the figure had had to be adjusted to a deficit of DM 41 billion. Also, the deficit had remained at about 4 percent of GNP instead of declining as intended. However, the figures masked a substantial reduction of the structural component of the deficit, by 1.5 percent in 1982 and by an additional percentage point in 1983. The OECD was therefore probably correct in its observation that Germany would find its public sector account in approximate balance or even surplus were it to return to high employment.

The German Government had thus made a heavy investment in the pursuit of a policy of recovery through expenditure restraint and the intended reduction of the budget deficit, Mr. Polak stated. Against that background, it was understandable that the authorities would not want to jeopardize their course of action by shifting, as suggested very tentatively by the staff, from reductions in the deficit to reductions in taxes, at the very moment when their earlier approach was giving preliminary indications of at least some measure of success. The staff was right to draw attention to the continued policy of restraint and to recall that deficits created their own upward push on expenditure. That was clear from Chart 7, which revealed that interest payments on government debt alone had risen to more than 6 percent of expenditure. Between 1982 and 1984, the interest burden would increase by 64 percent in nominal terms compared with a 14 percent increase in government expenditure in 1984. Business confidence in government policies was dependent upon the pursuit of a policy to reduce the deficit, even if that policy did not fully succeed.

After several years of disappointment in that respect, a decision to postpone reaching the goal might be harmful. Moreover, Government had managed to stabilize current government revenues as a percentage of GNP at about 44.5 percent since 1977, whereas the tax burden in many other countries had risen.

Monetary expansion had been far above the target growth range of 4-7 percent, Mr. Polak commented and, like the German authorities, he would consider a return to the upper part of the target zone desirable. If the growth rate for the money supply were 7 percent for a year as a whole, that would still imply an increase in the liquidity/GNP ratio, and thus leave room for more recovery in the real economy than was predicted at present. Some increase in interest rates was unavoidable, in response in part to rising U.S. interest rates, to relieve the pressure on the deutsche mark exchange rate. As soon as the upward pressure on interest rates stemming from exchange rate factors abated, however, it would be important to ensure that a reduction of interest rates in Germany was not hampered by an insufficiently firm budgetary policy.

Mr. Senior remarked that while the German economy was clearly going through a most difficult period, a significant adjustment had been achieved, placing the economy in a much better position to expand growth in the years to come. A strong external position and the substantial reduction in the inflation rate were the most positive developments. The improvement in the terms of trade, as well as the fall of interest rates abroad in 1982, had contributed to the progress in those two areas, and had facilitated the implementation of economic policies. However, the authorities' prudent combination of policies had also played an important role. Of particular significance was the moderation in wage settlements, which had resulted in a deceleration in unit labor costs and had thus contributed to reducing the rate of inflation. At the same time, wage moderation had permitted an improvement, although a limited one, in profit margins, a necessary condition for increasing investment if the private sector was to be the engine of economic growth in the years ahead.

Most recent economic indicators suggested that the improvement in the inflation rate and the external position had continued in 1983, Mr. Senior went on. Moreover, there were some favorable signs indicating that an incipient economic recovery, albeit still weak, was under way. Thus, profit margins had continued to improve in 1983, while private consumption and investment had also shown an upward trend, although not at the desired rate. Mr. Laske's expectation that real GNP for 1983 might increase by more than the rate projected a few months previously was welcome. But sluggish economic growth and rising unemployment continued to pose a difficult challenge for the policymakers. The main policy issue for Germany, as well as for other major industrial countries, was how to promote and sustain economic growth without rekindling inflation. Supporting the recovery would necessitate a higher level of productive investment, which in turn required the implementation of measures to correct the structural weaknesses of the German economy.

In the fiscal field, Mr. Senior noted, the authorities faced the dilemma of reconciling the longer-run need for fiscal consolidation with the shorter-run danger that sharply cutting government expenditures might endanger the incipient recovery. In that respect, the preference given to a medium-term approach, under which the fiscal deficit, including its structural components, would be reduced gradually, rather than by means of a shock adjustment, was welcome. Developments in the domestic economy as well as exogenous factors in the past several years had altered the authorities' expectations, making it necessary for the fiscal deficit to be reduced by less than originally envisaged. Given the moderate economic recovery contemplated in the near future and the still slow pace of increase in domestic demand, it would seem advisable to maintain a flexible fiscal policy stance. Thus, he welcomed the measures taken to reduce expenditures in the federal budget for 1984 which, combined with some action to stimulate revenue in order to promote investment, were expected to reduce the deficit moderately in the short run. Did the staff, or Mr. Laske, know what type of measures, if any, were contemplated in the 1984 budget in order to increase disposable income? Specifically, did the authorities anticipate any cuts in personal income tax in the near future, and if so, what would the possible impact be on consumption demand by households?

The fall in U.S. interest rates during 1982 had allowed the authorities to ease monetary policy and thus nominal interest rates in Germany, especially at the shorter end of the maturity spectrum, where the decrease had been significant, Mr. Senior observed. However, although money growth had been above the targets during the first half of 1983, a further decline in short-term interest rates had not been accompanied by a decline in long-term rates. The explanation might lie in the recent upward movement in U.S. interest rates, as well as in some weakening of exchange rate expectations associated with the EMS realignment. But excessive emphasis on maintaining a strong exchange rate, especially to avoid a further weakening against the dollar, had also played an important role. Thus, he concurred with the authorities that the aim of monetary policy should be to contain inflationary pressures and support economic recovery. He also agreed with the staff that, if the process of recovery showed signs of leveling off, supportive measures in several areas, including monetary and fiscal policy, should be considered.

Mr. Hirao noted that after a prolonged recession, dating back to late 1980, a recovery of economic activity seemed to be under way in Germany. Although the rate of unemployment was expected to reach an average of 8.5 percent in 1983, a number of indicators showed that the preconditions for recovery appeared to be in place. He agreed with the staff that the prospect of real GNP growth of 0.5 percent for 1983 seemed obtainable.

Ths fiscal deficit of both the Federal Government and the general government had remained virtually constant at a high level since 1981, Mr. Hirao remarked. Despite the authorities' efforts to reduce the fiscal deficit, it had exceeded the targets set in the past few years, partly reflecting the weaker than expected economic recovery. The difficulties confronting the economy, such as low growth, high unemployment, and a large fiscal deficit, had not been due to cyclical factors alone; they had also stemmed to a considerable extent from the economic structure. The maturity of the German economy, as well as the high standards of social welfare, must have had a significant bearing on the weakening of private initiative and on the stagnation of private investment. The staff had pointed out that gross fixed investment had risen by only 7 percent in real terms since 1970, while real GNP had increased by 30 percent. In addition, during the past decade, the share of public expenditure in GNP had increased markedly, absorbing more than 50 percent of GNP in 1982, or more than in France, the United Kingdom, or the United States. He fully supported the authorities' view that a lasting recovery of the German economy would depend on a permanent reduction in the share of the public sector in the economy. To meet those structural difficulties, it was essential for Germany to carry out a medium-term program to cut government spending and reduce the deficit with a view to making more resources available for private investment. In that respect, it was encouraging to note that recent wage settlements had been much more moderate than in the past in almost all sectors of the economy.

It was appropriate that the German authorities were trying to reduce the government deficit through expenditure cuts rather than by resorting to revenue increases, Mr. Hirao continued. He welcomed their continued effort to restrain expenditures on social benefits and civil servants' pay. In light of the political and social difficulties of reining in social benefits, the authorities should be commended for their achievements in that area. Efforts should be maintained over the medium term to adjust the level of social benefits, which was not in conformity with current growth prospects.

At the same time, Mr. Hirao added, the composition of public expenditure should be changed in favor of productive purposes. He noted that measures had been taken to stimulate investment activity within the framework of a consolidation effort. Business and other tax reductions since 1982 seemed to have contributed effectively to enhancing private investment, notably in housing construction.

The interest payments of the Federal Government accounted for as much as 66 percent of the overall deficit in 1983, Mr. Hirao commented. In that respect, he welcomed the medium-term fiscal plan, presented in May 1983, under which the deficit of the Federal Government was expected to be reduced gradually to about 1.2 percent of GNP in 1987.

Since late 1981, Mr. Hirao remarked, monetary policy had been eased gradually following the improvement in the external balance and the easing of interest rates abroad. The successive lowering of interest rates had been appropriate, and might well have contributed to the recent improvement in economic activity. However, with interest rates abroad firming, the operation of monetary policy had also come under constraint. Despite a reduction in domestic short-term interest rates in mid-March, long-term interest rates had actually tended to increase somewhat, giving rise to a steeper yield curve, as capital moved out of the country. That development had been accompanied by the weakening of the deutsche mark, which was predominantly influenced by temporary interest rate differentials. Under the circumstances, he agreed with the authorities that the easing of monetary policy had reached its limits. As for the recent overshooting in the growth of central bank money, the authorities' view was that it had been mainly due to special factors, which might be self-reversing. He hoped that the rate of growth of central bank money would soon return to the upper end of the target range.

As for exchange rate policy, Mr. Hirao remarked, it was unfortunate that the steadily improving fundamentals of the German economy, particularly with respect to inflation and the external balance, were not reflected in the exchange rate. The deutsche mark had been weakening vis-à-vis the U.S. dollar, mainly due to interest rate differentials and sometimes to political developments. He hoped that the market would place more emphasis on the fundamentals so that the exchange rate reflected the real value of the deutsche mark.

As for trade and industrial policy, Mr. Hirao commended the authorities for rejecting calls for protection from some industries that were experiencing increased competition from newly industrializing countries. What was needed was a positive adjustment policy, which would encourage a shift of resources to promising industries, in order to increase efficiency in the economy. In that context, he believed that the authorities' continued commitment to the principles of free trade would serve effectively as a means of promoting the needed adjustment in the structure of the German economy.

Mr. Teijeiro said that he shared most of the views expressed by the staff in its appraisal. Germany seemed to be consolidating progress in many areas. The preconditions for a sustained recovery of economic activity might be more evident there than in other industrial countries. The moderation of inflationary pressures, interest rates, and labor costs were all factors that should improve profit margins and stimulate private investment. Contributing significantly was the success over the years in creating conditions that encouraged reasonable wage settlements, unlike the rigid wage indexation that was still practiced in many countries.

With respect to fiscal management, Mr. Teijeiro continued, there was indeed a need to reduce the size of the general deficit, and the main emphasis should be placed on reducing outlays. Public expenditure, at 50 percent of GNP, seemed high for a market-oriented economy. He shared the view of the German authorities that a lasting recovery would depend heavily on a permanent reduction in the share of the public sector in the economy.

Achieving a quick and significant reduction in public expenditure presented difficulties, however, in a context of low utilization of productive capacity and high unemployment, Mr. Teijeiro stated. Given the pressing need to alleviate the pressure on interest rates in the capital market and improve the prospects for private investment, he wondered whether the authorities had considered the possibility of raising taxes; for example, a temporary tax on wages to finance unemployment insurance would permit active workers to finance those temporarily unemployed, thereby making more resources available to finance private investment. He had doubts about the advantages of paying retirement benefits at an earlier age. If the number of people encouraged to retire were to exceed the number of currently unemployed, the Government would be faced with having to pay more in pensions than it would save in unemployment benefits.

Monetary and exchange rate policies had been managed appropriately during the past year, Mr. Teijeiro noted, judging from the results with respect to interest rates and inflation. He shared the view of the German authorities that intervention in the exchange markets had a limited role and could not be used to offset the effects of great differences in national policies.

Germany's general trading policy, according to the staff, was based on the principle of relying on market forces to bring about an efficient allocation of resources, Mr. Teijeiro noted. He wondered whether the policies being applied in the agricultural and textile sectors could be considered as promoting an efficient allocation of resources. The price of sugar within the European Community, for example, was nearly double the price of more efficient producers like Australia and Brazil; the same was true of a wide range of primary products sold by developing countries. The European Community had rapidly become a large exporter of subsidized wheat, its share of world exports rising significantly in the past five years. The European Community was also a leading exporter of beef, and for many years had been the world's largest exporter of dairy products, with producer prices two and three times the level of low-cost, efficient agricultural producers. Agricultural protection had devastating effects on developing countries, particularly at a time when many of them were overburdened by financial constraints. It had been estimated that the income lost to developing countries as a result of the Common Agricultural Policy exceeded the European Community's total assistance to developing countries.

He recognized that Germany continued to be a supporter of open trade policies, when compared to other members of the European Economic Community, Mr. Teijeiro remarked. Germany's current attitude was helping to prevent the situation from worsening, but that might not be enough. Current levels of protection in the European Community were already indefensible at a time when the world economic situation was calling for an improved flow of goods.

Mr. Erb said that he agreed with the staff that the stage was set for a recovery in Germany but that there was a fair amount of uncertainty about the likely strength and duration of the incipient recovery. His attention had been caught by the staff's comment in its appraisal that supporting measures should be considered if the recovery was seen to falter. Could the staff give some indication of what supporting measures it would recommend and their possible timing?

Although it was stated discreetly, on page 16 of SM/83/153, the staff seemed to be recommending a tax cut in the context of long-term expenditure and monetary restraint, Mr. Erb observed. The difficulties that most governments, including the German Government, had in reducing their deficits, and the already high level of debt and interest payments in Germany, made him hesitant to encourage tax cuts unless they were accompanied by even greater expenditure cuts. He would also like to ask the staff what its policy advice would be if the recovery turned out to be stronger than expected. Monetary policy should be implemented over time so that it was consistent with the previously announced targets for monetary growth, Mr. Erb considered. The Bundesbank had established a high degree of confidence in its implementation of monetary policy, and it could therefore deviate from its announced targets for a short time, but not indefinitely. He had been pleased to learn from Mr. Laske's statement that the Bundesbank had reviewed and confirmed the monetary target range for the growth of central bank money in 1983.

Finally, Mr. Erb commended the German authorities for their relatively good record in resisting protectionist sentiments. Germany did support freer trade policies in the European Community, and he hoped that by continued persuasion they would succeed in eliminating some EC policies that were obstacles to a freer world trade environment.

Mr. Kafka stated that the German authorities deserved commendation for the noteworthy progress they had made in reducing inflation to less than 3 percent at an annual rate. That progress had been bought at a heavy price in unemployment. The substantial improvement in the external account had been due to better terms of trade and to the economy's cyclical position relative to that of other countries. But it was also noteworthy that Germany had taken the liberal side in the European Community. Exchange rate policy had been appropriate.

The past year had been the third one of recession for Germany, Mr. Kafka commented. The result had been an increase in the federal budget deficit compared to what had been foreseen, and the share of public sector expenditure had remained uncomfortably high. There could be no objection to the essence of the economic program, which was aimed at establishing the structural preconditions for recovery, and in particular at limiting absorption by the public sector and at relying on the private sector as the locomotive of expansion. But since the scope for stimulatory monetary policies seemed to show signs of having been exhausted, the recovery would be slow and uncertain. Nor was it easy, in the policy context chosen by Germany, to allow expenditure cuts to be reflected in tax reductions rather than in reductions in the deficit; the effect of the tax reductions themselves on private expenditures was uncertain.

As for the expenditures of the Central Government, Mr. Kafka concluded, the recent measures taken by the authorities to limit both entitlements to social benefits and increases in public sector salaries, combined with incentives to private investment, seemed appropriate. The policy of offering incentives might be given somewhat greater emphasis over direct public sector expenditure reductions or tax cuts.

Mr. Joyce said that he agreed with the staff's assessment that Germany had successfully established the preconditions for noninflationary growth, and that the best policy for the authorities at the present stage was to allow the recovery to proceed at its own cautious pace without excessive short-term stimulus. He also agreed with Mr. Laske that real GNP growth in 1983 was likely to exceed 0.5 percent and that, as the staff projected, there would be further significant strengthening of growth in 1984. His authorities also accepted the underlying assumptions on prices, although they felt that the projected appreciation of the deutsche mark should moderate the influence of rising international commodity prices. At the same time, higher than expected growth might also reduce the projected current account surplus. There had indeed been a downward adjustment of the surplus in the latest Bundesbank figures.

During the recent OECD survey of the German economy, Mr. Joyce observed, a number of delegations had said that the authorities were being unduly cautious and that the Government's credibility might suffer if further action was not taken to improve consumption and reduce unemployment. His authorities did not agree; they believed that expansionary policies at present would serve neither Germany's short-term nor medium-term interests. The authorities were right to pursue policies of restraint on both the fiscal and monetary front. As had been pointed out by other Directors, there was a danger that the forces expected to fuel consumption and hence recovery in the short term might not yield the results anticipated. In that event, as Mr. Nimatallah had said, the authorities should be ready to consider contingency measures, such as additional cuts in income tax, in order to revive consumption.

One continuing concern for the short term was the rate of monetary expansion, Mr. Joyce remarked. Central bank money, after running near the top of the target range in 1982, had been going well beyond the target in 1983. He was aware that the Bundesbank felt that the overshooting in the first half of the year could be attributed to special factors that might have largely run their course. However, efforts to bring the stock of money back within the target range might require a more restrictive monetary stance if the rate of money growth was reflecting a change in the demand for money. Such a change could be attributable to a stronger than expected elasticity response following the fall in interest rates through 1982, or to an underlying change in expectations. He would be interested in the staff's view on the likely effect of a further firming of interest rates on the revised growth estimates.

He welcomed Mr. Laske's remark that his authorities remained concerned about basic structural weaknesses in the economy, Mr. Joyce continued. The authorities were right in thinking that sustainable recovery in the medium term called for renewed confidence by business and labor in the Government's intentions. The current stance of fiscal policy, which aimed at reducing over time the share of public expenditure, could make a major contribution in that respect. Continued wage restraint in the public service, because of its impact on government finances and of its demonstration effect, could also be helpful. In addition, he welcomed the second round of business tax reductions, financed in 1982 by an increase in the value-added tax. However, if the tax cuts were to have a lasting influence on profit margins--the other essential element in stimulating investment--they must be left in position for some time. He would be interested in anything Mr. Laske could say about the intentions of his authorities in that respect.

The transition from the short term to the medium term required the sort of smooth shifting of gears normally associated with German technology, Mr. Joyce remarked. There was always a danger that the lag in investment response might be drawn out longer because of poor profits in recent years, the present low rates of capacity utilization, and the impact of high real rates of interest, which were probably more significant for the financing of European industry than they were in North America. Like Mr. Caranicas, he had noted from the The Wall Street Journal of July 29 that an investment survey by one of the leading economic institutes in Germany, IFO, indicated that investment in plants in Germany was again expected to fall in 1983. Indeed, the survey suggested that for the first time in the history of the Federal Republic of Germany, there might be no net expansion in manufacturing capacity in 1983.

Finally, Mr. Joyce mentioned that he had some trouble with the reference in the staff report to the dangers of protectionism. He understood the German authorities' concern that protectionist action by other countries might reduce Germany's export potential. He also welcomed their determination to resist protectionist pressures at home. However, as pointed out in the staff report, most commercial policy actions by members of the European Communities fell within the purview of the Community. Germany was a major member of the Community, and must therefore continue to carry a significant responsibility for the protectionist measures adopted by the Community, including the Common Agricultural Policy. The Fund, so far as he knew, had no formal mechanism for consulting with the European Communities. It was therefore understandable that members, as they had done through their Executive Directors at the present meeting, would express concern about the Community's actions whenever Article IV consultations were conducted with individual members of the Community. Nevertheless, he welcomed the important role played by Germany in trying to ensure that the economic policies of the European Community were at least in some respects more outward looking.

Mr. Wicks said that he agreed with the staff's general appraisal but that he wished to comment on the structure of the report, because the Fund's surveillance role was assuming increasing importance in Article IV consultations with larger economies. An examination of the degree of convergence of the economy concerned with the economies of other major industrial countries was part of the surveillance process. Another part was to see whether the country concerned was a good member of the international community as far as its economic policies were concerned. With those objectives in mind, he considered that the staff report could have laid a little more emphasis on the external implications of Germany's policies. Section 5 of SM/83/153 on trade and aid went some way in that direction, but he would have liked in addition to have a short section on Germany's policy with respect to its capital markets. Some of the useful material on that subject contained in the report on recent economic developments could have been incorporated in the staff report, together with a policy appraisal. His authorities attached importance to developing a clearer appreciation of the stance of major industrial countries' capital markets. Discussion of capital market matters would help to prevent a too narrow concentration on the aid record of major industrial countries, and would place the external sector of their economies in a clearer perspective. Aid was important, but at a time when many developing countries were in need of larger flows of nondebt-creating inward investment, the Fund should look at the volume of capital flows from private markets in industrial countries.

On a more general point, which he had made on previous occasions, staff reports should include a brief section bringing together all the strands of the impact of a member's economic policy on other countries and on the international economy in general Mr. Wicks stated. The issue dealt with would not always be the same; the general approach would be to summarize the role of the member's economy in the global economy, to identify the issues of main concern to neighboring economies and the rest of the world, and to look at that member's contribution to world growth and development. The individual strands of such an analysis were already scattered through the staff report under discussion. But as he had mentioned when the staff report for the 1983 Article IV consultation with the United States had been discussed, attention should be focused more sharply on those aspects of members' policies. An overview in a few summary paragraphs could contain, for instance, the sort of information given by Mr. Teijeiro on the effects of the European Community's Common Agricultural Policy on international trade.

As for the economic outlook, Germany had made admirable progress in both lowering inflation and laying the foundations for a sustained recovery, Mr. Wicks observed. But some of the latest indicators showed that the recovery was still rather weak, despite the modest rise in GNP for the first quarter of 1983 and some restoration of business confidence. It was too early to judge whether the authorities' policy of lowering interest rates and encouraging investment had had a sustained impact. With only a weak recovery in world trade in prospect, and with its competitiveness broadly unchanged, Germany would be more dependent than previously on an upswing in domestic activity. He therefore agreed with the staff that there was a need for a sound domestically based recovery. There were signs that much of the increase in GNP in the first quarter of 1983 had been the result of temporary investment incentives and possibly of some anticipatory consumer buying in advance of the July increase in the value-added tax. It must therefore be of concern to the German authorities that industrial production and industrial orders, to meet both domestic and export demand, had remained flat since March. Business confidence had ceased to improve since the election, while unemployment had continued to rise, as indeed it had in many other European economies. Long-term interest rates had also been rising since March, and even short-term rates had been edging up recently.

Because of those real uncertainties about the strength of the recovery, he would have appreciated more analysis by the staff of the outlook, Mr. Wicks continued. For instance, given the bottoming out in the rate of inflation, and the recent rise in interest rates, it would have been helpful to have more detailed forecasts of how savings would behave in 1984, and specifically, whether the ratio of savings to GNP would continue to fall. It was somewhat surprising that the staff emphasized the need for investment to lead the recovery. Certainly, investment had to become a major component of the increase in domestic demand, but at the present stage of the recovery, consumption would have to increase first. Moreover, there were signs that investment was not in fact on a rising trend. If that continued to be the case, did the staff foresee another year of negative growth of GNP?

On monetary policy, the Bundesbank had made an appropriate response to the special factors generating the monetary overshoot in 1983, Mr. Wicks remarked. However, many of those special factors should have already reversed themselves. Nevertheless, the authorities intended to aim for the upper part of the target range-monetary expansion of from 4-7 percent. If at the same time nominal GNP should rise by about 3-4 percent, was not the target range somewhat on the high side? Could Mr. Laske say how Germany's monetary policy would be affected by a continuation of high interest rates in the United States, in both real and nominal terms?

As for fiscal policy, the structural budget deficit had been reduced, Mr. Wicks observed, and the Cabinet had agreed to a tight budget for 1984, limiting expenditure growth to 2 percent. He welcomed the medium-term financial plan under which a reduction in borrowing was foreseen. Although the authorities clearly had a firm grip on fiscal policy, he asked Mr. Laske how they viewed the suggestion put forward by the staff on page 16 of SM/83/153 that those medium-term plans should be applied flexibly, if external developments frustrated the hopes for a decline in interest rates. The staff's suggestion was in line with the recommendation in the World Economic Outlook report for 1983, which had argued that countries with low rates of inflation, including Germany, could jeopardize the global recovery by too fast a reduction in their budget deficits.

The German authorities were to be congratulated on their success in reducing the rate of inflation, which was still about the lowest of any European Fund member, Mr. Wicks said. He also commended them for their success in achieving modest wage settlements in both the public and the private sectors. The next wage round might be more difficult to negotiate, because of the desire of the public sector's union to secure a reduction in working hours; he would welcome any comments by Mr. Laske.

Finally, Mr. Wicks asked the staff whether any assessment had been made of the effect on inflation of the recent fall of the deutsche mark against the U.S. dollar, or of the increase of the value-added tax (VAT) in July. With respect to the latter, he had noted from the OECD Economic Outlook that the increase in the VAT would add 0.75 percent to the price level.

Mr. Prowse said that he broadly agreed with the staff's conclusions. He very much welcomed Germany's commitment to a policy of free trade, and indeed its leadership in that respect within the European Community. He had noted, for instance, that the German authorities had rejected pressures for increased protection for such industries as watches and shoes, and that the financial assistance being provided to the steel industry was only for purposes of restructuring.

The staff had usefully drawn attention to the subject of agricultural protection, Mr. Prowse considered, both in the staff report and in the report on recent economic developments. It was somewhat disappointing that the German authorities had responded by expressing the belief that the Common Agricultural Policy was a major factor in the cohesiveness of the Community, and that its basic elements could not be jeopardized. He took it that other EC members had accepted that fundamental position, but that there was still scope for moderation.

Noting the importance of investment in the German economy, Mr. Prowse regretted that for some time the level of investment had remained subdued, as indeed it had in the U.S. economy. In some respects, the failure of investment to recover was a most serious impediment to the medium-term recovery of the international economy. In that context, the German Government seemed to be following an appropriate policy.

It was extraordinary that an economy whose miraculous performance had been the inspiration for other countries attempting to rely on the market mechanism, should have reached the point where the government sector accounted for 50 percent of economic activity, Mr. Prowse observed. Therefore, he endorsed the staff's remark that the longer-term prospects for the German economy, and hence for many other Western economies, would depend on rolling back the share of the government sector.

There might be a slight divergence of views between the authorities and the staff on how to promote the recovery, Mr. Prowse considered. He would tend to agree with the authorities. The recent OECD Economic Survey seemed to urge some stimulus of the German economy. In its appraisal the staff had discussed the authorities' use of their room for maneuver to restrain the fiscal deficit, with little change in the tax burden. The staff had argued that the impact of external developments would delay the positive effects of cuts in spending unless the authorities were prepared to shift toward tax reductions in order to raise disposable income, concluding however that in order to maintain confidence, "any tax cut must be clearly linked to a convincingly restrained monetary policy, and to a firm commitment to continue expenditure reduction on schedule." It was not clear to him whether the staff did in fact believe that there was scope in present circumstances for tax cuts and, if so, whether it was advocating such action. It hardly seemed appropriate to tighten an already tight monetary policy, as suggested by the staff. The authorities seemed to prefer to emphasize a modest continued reduction in the fiscal deficit, as noted on page 26 of the report on recent economic developments, as well as on page 9 of the staff report, where it was noted that "early reductions in the tax burden had therefore to be ruled out, though not further improvements in the tax structure."

Mr. Malhotra said that he was glad to note the signs of incipient recovery in the German economy after three years of weak activity. Germany had an enviable record in controlling inflation, bringing the rate considerably below the average rate of inflation in European economies. Its current account of the balance of payments was in surplus. However, the rate of unemployment was extremely high, and was expected to rise still further in 1984. He was concerned that the German economy, which had an impact on the rest of the world, had not registered a healthier rate of growth. While the growth rate in 1983 was estimated at about 0.5 percent, it was worrying to note the staff's judgment that the outcome for 1984 might be uncertain.

The German Government had been trying to reduce the budgetary deficit, but had not been able to meet its targets, Mr. Malhotra noted. While he realized the concern of the German authorities with what they regarded as structural deficiencies that could retard long-term growth of the economy, in retrospect, the failure might not necessarily have been unsatisfactory. Larger reductions in budgetary deficits in the past two years might have retarded even the incipient recovery now in evidence. He would offer the same observation with respect to the outcome of monetary policy. Flexibility in the pursuit of policy objectives was more important than too meticulous an effort to achieve targets, either on the fiscal side or on the monetary side.

The staff and Mr. Laske had taken some satisfaction from the fact that wage settlements had been moderate for some time, Mr. Malhotra commented. It seemed worth considering to what degree that moderation was related to high and rising rates of unemployment. Should there be a strong recovery, one element that might have contributed to the moderation in wage settlements might disappear. But the major question, looking to the medium term, was whether there was any real hope that unemployment would decline appreciably, even if a rate of growth of 2-3 percent a year was achieved. While recognizing that some of the conditions for restoring the process of growth--less inflation, better potential for greater profitability, and wage restraint--had been established, they might not prove sufficient to reduce unemployment significantly.

If unemployment remained at high levels, the question then would be whether the authorities would be able to reduce the budgetary deficit substantially, as unemployment entitlements might remain high, Mr. Malhotra continued. Like Mr. de Groote, he believed that employment objectives deserved to be given greater attention in staff reports. The authorities must surely be analyzing the problem closely. In an economy like that of of Germany, where the level of technical competence was high and the labor force presumably had an important contribution to make to output and productivity, it would not be desirable to leave such an important reservoir underemployed over a long period. The issue was therefore worthy of in-depth study. Pertinent remarks had also been made by Mr. Wicks on improving the coverage of staff reports, especially those on important economies that had a major impact not only on neighboring countries but on the rest of the world.

He agreed with the staff, Mr. Malhotra mentioned, that the German record on trade policies, especially within the European Community, had been relatively better than that of many other countries. At the same time, the trading policies of the European Community, specifically with respect to textiles and agriculture, left much to be desired. He urged the Government of the Federal Republic of Germany to play an even greater role in shaping EC trading policies. In particular, he would urge reconsideration as soon as possible of the Multifiber Arrangement and the bilateral agreements concluded under it, with a view to their early dismantlement. Those agreements were deviations from the principles of the GATT.

He was aware that the Government of Germany had made efforts to improve its official development assistance (ODA) performance, which had reached about 0.48 percent of GNP, a relatively good record, Mr. Malhotra stated. That assistance had been provided on generous terms, namely, on IDA terms for the most part. Furthermore, Germany had not insisted on its aid being used for procurement only from Germany; the procedures provided for international tendering. That approach was no doubt in line with Germany's liberal trading policies. A recent UNCTAD resolution on ODA had called for a commitment on the part of developed countries to redouble their efforts to achieve the UN target for ODA. He hoped that Germany could rapidly better its already good performance.

Mr. Tvedt said that he welcomed the increasingly positive features of economic developments in Germany, characterized by low inflation and a current account surplus which were important preconditions for the recovery of economic activity. Domestic demand and production seemed to be strengthening. It should be underlined, however, that according to the leading economic indicators, the recovery was still weak and highly precarious. In particular, uncertainty surrounded the growth of investment, which was especially important for a lasting recovery. On the negative side, unemployment was high and rising.

He doubted whether the forecast GNP growth of 2 percent in 1984 could be realized, Mr. Tvedt continued, given the economic policy program outlined for that year and the prevailing economic situation. Fiscal policy was expected to be tightened, and monetary policy to remain unchanged, with the result that real interest rates would be relatively high and changes in the real disposable income of households negligible. It was therefore imperative that the German authorities should ensure that a lasting economic upswing got under way, not least in view of Germany's importance in the world economy. Consequently, if the recovery were seen to falter, supporting measures should certainly be considered and implemented.

He agreed with the German authorities that in the medium term it would be desirable to bring the public budget into approximate balance, Mr. Tvedt said. The structural budget deficit, however, seemed in large measure to have been corrected since 1980 on the basis of the figures mentioned by Mr. Polak.

Because of both global and internal considerations, Mr. Tvedt doubted the appropriateness of further fiscal entrenchment in Germany in 1984. While the signs of economic recovery remained weak, inflation was firmly under control and the external balance was strong. Virtually all industrial countries were facing the problem of how to bring about better balance in their public finances. However, if all countries attempted to accomplish that at the same time, the cumulative, depressionary effects on the world economy could be expected to become very strong. Germany appeared to be one of the countries where a further improvement of the budget balance was less urgent; the adjustment could therefore be extended over a longer period. In present circumstances, an improvement in the actual budget balance could be achieved to a substantial extent through the automatic effects of a renewed increase in production and incomes. The favorable balance of payments and inflation situation of Germany provided the authorities with the possibility of stimulating domestic demand.

He welcomed the German authorities' resistance to protectionist measures, Mr. Tvedt said. He also welcomed the rise in Germany's development assistance, but he believed that as a proportion of GNP it should be increased more than was planned at present.

In concluding, Mr. Tvedt joined Mr. de Groote and Mr. Wicks in pointing out that it would have been beneficial if the staff report had contained a more thorough discussion of German economic policy in an international context, as part of the surveillance of member countries' exchange rate policies and general economic policies that the Fund should undertake in connection with Article IV consultations.

Mr. Orleans-Lindsay said that economic and financial developments in Germany, as in other major industrial countries, were of concern to developing countries because of the high degree of integration of the German economy in the international economy and the global impact of Germany's economic and financial policies. As in some other major industrial countries, Germany had made considerable progress in stabilizing its economy, both internally and externally. However, the achievement had been made at great cost in terms of sluggish growth and a relatively low level of investment in machinery and equipment, coupled with a low rate of capacity utilization and rising unemployment of a structural nature, which required medium-term remedial measures. Nevertheless, it was reassuring to note that the attempts to stimulate the economy had so far resulted in what the staff had described as an incipient recovery.

It was commendable that the German authorities had not given in to pressures for a relaxation of policies that would have meant reversing the gains made in keeping the rate of inflation low, arriving at reasonable wage settlements, obtaining a modest upturn in domestic production and demand, and registering a positive balance on the current account in the external sector, Mr. Orleans-Lindsay said. The major obstacle confronting the German authorities was the need to ensure that there were strong foundations to the incipient revival of economic activity that would support the real recovery projected, namely, a growth rate of 0.5 percent for 1983, and 2.5 per cent or more in 1984 and beyond. Therefore, he shared the staff's view that the emerging revival of economic activity was largely dependent on the degree of stimulus given to domestic investment.

In his statement, Mr. Laske had mentioned his authorities' concern about the basic structural weaknesses in the economy--the fact that the public sector over a ten-year period had absorbed almost half of GNP in 1982, and that the vitality and ability of the economy to grow would depend more on private sector activities than on the redistribution of income, Mr. Orleans-Lindsay observed. He welcomed the policy of expenditure restraint, with the size of the fiscal deficit to be limited to about DM 39 billion, based on a nominal increase of 2 percent in federal expenditure, far below the projected nomimal growth in GNP, in line with the auhtorities' medium-term fiscal plan. He hoped that the proposed changes in the fiscal structure would be made with great caution, so as not to undermine the basis of the social security system.

In the monetary area, Mr. Orleans-Lindsay added, the authorities were again to be commended for a cautious approach in maintaining the target for the rate of growth of monetary aggregates in the range of 4-7 percent, which had no doubt contributed greatly to containing inflationary pressures and furthering the moderate recovery in domestic demand. Interest rates had been allowed to fall gradually, in step with rates abroad. But with the uncertainties surrounding interest rate developments abroad, he wondered how the German authorities, even with an improved budget structure, could pursue an interest rate policy without subjecting the deutsche mark to undue downward pressure at a time when the authorities were concerned about exchange rate movements. As the staff had pointed out, the German authorities would be happy to see some strengthening of the deutsche mark relative to the U.S. dollar.

In their foreign trade policies, the authorities had adopted a laudably firm stance against pressures for protection, Mr. Orleans-Lindsay noted. However, he urged them to resolve the problems relating to the steel industry. He welcomed the efforts being made to phase out restrictions and to harmonize trade policies with the financial requirements of developing countries, as well as to provide a relatively high level of official development assistance.

Mr. Camara noted the welcome signs that in Germany, an important factor in the international economy, the recession appeared to have bottomed out during the past year and some recovery in economic activity was under way. The evidence was the turnaround in private consumption--which had increased in real terms during the first quarter of 1983 by 1.5 percent--increased investment in machinery and equipment, and the pickup in construction activity. Taking into account the progress made in controlling inflation, and the relatively strong balance of payments position, Germany seemed to have more room for maneuver than other industrial countries in trying to raise the utilization of capacity and in giving impetus to the recovery in the international economy.

The importance of a sustained recovery in Germany had been highlighted by the staff in its appraisal, Mr. Camara noted. It had been suggested that measures should be taken to buttress the economy should it begin to lose momentum. That suggestion raised two issues that had not been clearly addressed in the report. The first was the extent to which the present policy mix was appropriate to sustain the pickup in economic activity in Germany. He had read in the press of the concern in some quarters, including the OECD, about the possibility that the speed with which measures were being taken to reduce the budget deficit might not permit a strong recovery in the immediate future. It would be helpful if the staff could throw some light on the matter from its own perspective. The second issue concerned the action that the authorities might consider taking if the recovery began to falter. The staff had suggested in its appraisal that the easing of monetary policy, which had been one of the stimuli to economic activity, appeared to have reached its limits. If that was so, would direct fiscal action be necessary in order to stimulate demand? Or would the staff advise the continuation of indirect action by way of incentives to spur investment, which seemed to be the present approach?

Germany's monetary policy had been pragmatic, paying due consideration to the need to control inflation, and later to protecting the value of the deutsche mark, Mr. Camara continued. Interest rates had been on a downward trend, but the firming of rates abroad might make it difficult to maintain that trend. As a matter of fact, there had been some increase in market rates in response to rising interest rates in the United States.

Domestic policy considerations aside, the magnitude of the recovery in Germany would also depend on developments in its major trading partners, Mr. Camara said. Foreign trade remained an important element of the German economy, with exports and imports accounting for 33 1/3 percent and 31 percent, respectively, of GNP in 1982. However, he had noted the staff's assertion that external demand remained weak. On the import side, German industry could benefit from the fall in inflation in major trading partner countries. As for exports, any increase in protectionist tendencies would have adverse effects on a number of key industries in Germany. The staff reported that the German authorities had resisted pressures for protectionist measures and attached importance to the harmonization of trade policies with the financing needs of developing countries. In the same vein, the staff had gone on to say that the efforts of developing countries to reduce their own restrictions would encourage other countries to open up their markets. The point was well taken, but he hoped that it did not leave the impression that developing countries were the principal culprits as far as protectionism was concerned.

Finally, Mr. Camara thanked the German authorities for their economic assistance to developing countries and hoped that the move to reduce expenditure would not lead to a reduction in aid in the current year.

Mr. Jaafar said that he had not yet discerned any encouraging evidence of economic recovery in Germany. The expected revival for the whole of 1983 was still in doubt, although the underlying conditions appeared favorable. Reports of weakness in exports and evidence of slack in consumer spending did not offer much scope for any restoration of private investment activities, which were a precondition for a durable recovery. Consumer spending was not strong and could not be expected to lift Germany out of the recession, because of high unemployment and wage moderation, which had already taken a heavy toll on disposable income, in spite of offsetting factors such as the sharp fall in the savings ratio and some inflow from the transfer of income. Admittedly, the incentive to spend on consumer durables could strengthen somewhat, in response to the reported decline in interest rates, but not strongly enough, in his assessment, to ignite investment. It should not be forgotten that the severe recession had been with Germany for the past three years.

It would be desirable for private investment to recover quickly to permit sustained growth in the medium term, Mr. Jaafar continued. The necessary conditions for such growth seemed to be in place. First, there was already some moderation in wage increases, and the fall in unit labor costs should improve corporate earnings and thus revive business confidence. Second, lower interest rates should encourage capital formation. On the other hand, there was still a high level of unused capacity, and private spending was lacking in vigor. Exports were an equally fragile source of growth, with the reported weakness in demand on the part of Germany's major trading partners.

Among the policy options available to the authorities, Mr. Jaafar noted, monetary policy appeared to offer limited room for maneuver because of the external constraints of a strong dollar and high U.S. interest rates. A more expansive monetary policy stance could risk larger capital outflows, even though there was evidence that funds might tend to remain in Germany in the expectation of a rise in the deutsche mark. In that respect, he had seen reports suggesting that the mark was largely undervalued. Such an exchange rate expectation, together with the reported surplus on current account, could provide a possible incentive for keeping funds in the domestic economy that would be utilized for capital formation. Nevertheless, he could support the staff's view that the growth of monetary aggregates should remain in the upper range of the target set by the authorities. Any further relaxation should be considered in light of any evidence of a reduction in U.S. interest rates and the dollar exchange rate.

As for the fiscal option, while he could go along with the objective of removing structural imbalances in the budget, he encouraged the authorities to follow a flexible approach, Mr. Jaafar said. The overriding factor was the need to nurse and sustain the recovery, which was important not only to Germany but to the world economy. That objective could be achieved through measures to stimulate private consumer spending. In that respect, like Mr. Prowse, he concurred with the recommendation in the recent OECD Economic Survey that tax measures should be introduced to encourage demand. The staff had been more cautious in stating that any tax cut should be linked to a policy of monetary restraint and a firm commitment to reduce expenditure as scheduled. Did the staff still consider that no tax reduction was called for?

He had been encouraged to note the authorities' determination to resist any protectionist pressures, in spite of the adverse economic domestic circumstances, Mr. Jaafar said. He would encourage Germany, as a member of the European Community, to continue to exert its influence on the rest of the membership in order to remove any remaining trade barriers, in particular to the products of the developing countries. He associated himself with the remarks of others on the protectionist policy of the European Community. Finally, he commended the German authorities for their commitment to maintain official development assistance at 0.48 percent of GNP.

Mr. Abiad joined others in noting the staff's statement that, should the recovery in Germany be seen to falter, supporting measures should be considered. He would be glad if the staff could shed some additional light on the nature and scope of the measures in question.

There had been a substantial decline in investment activity in 1982, Mr. Abiad observed, in spite of what the staff had termed an improvement in the underlying conditions, including greater wage moderation and enhanced business profitability. The implications for the employment situation in the years ahead were important. The calculations made by the authorities, which showed that the increase in the labor force could hardly be expected to be absorbed, even with a robust growth in GNP and a solid increase in investment, were less than encouraging. Clearly, an important consideration would be not only the level of the necessary investment but the degree of its labor intensity.

Two of the measures being considered as part of the more direct approach to dealing with the unemployment problem were a shortening of the workweek and the encouragement of further repatriation of immigrant workers, Mr. Abiad noted. It would be useful if the staff could indicate the extent of similarity between the schemes being envisaged by the German authorities and those implemented by other countries and, second, the degree of success of other countries with such measures. It would also be helpful to know the staff's view concerning the impact on workers' remittances of any additional repatriation of immigrants.

It was encouraging to note the authorities' restated determination to resist protectionism and restrictive trade practices, Mr. Abiad commented. However, he had some difficulty in relating that resistance to the authorities' view that developing countries' efforts to reduce their own restrictions would make other countries more willing to open access to their markets. The same restrictive concept of reciprocity was inherent in both cases; moreover, the implication was that developing countries could afford to reduce restrictions to the same extent as industrial countries. If the latter implication was accepted, the outcome might be that developing countries would ultimately have to abandon the protection of infant industries, a practice that was not only widely accepted but even recommended by international development institutions.

Finally, Mr. Abiad said, it was noteworthy that Germany's official development assistance had maintained a stable share in GNP in the past two years. However, it was explained on page 12 of the staff report that, between 1975 and 1981, net ODA disbursements had increased on an annual basis by 10 percent in terms of national currency or by 8.5 percent in real terms. He would appreciate some elaboration on the implicit deflator used in those calculations. Moreover, for 1983, it was indicated that ODA appropriations were expected to increase at a higher rate than aggregate government expenditures. He wondered whether the latter reference was to federal expenditures, which according to the staff report were expected to rise by only 2 percent in nominal terms.

Mr. de Maulde said that the staff report as well as Mr. Laske's statement suggested to him that Germany had continued to have considerable success in pursuing its long-term economic policy, but that the outlook for the short term remained cloudy and might well call for new action. To elaborate, he referred first to the policy of structural adjustment, the most striking feature of which appeared to be the degree of its consistency over time, verging on obstinacy. That consistency probably accounted for a large part of the success achieved. The staff reports for Article IV consultations with Germany over the past three years indicated that the priorities of the authorities had remained remarkably similar. Three objectives had been paramount: containing inflation, rolling back budgetary deficits, and restoring profit margins. Year after year, the pursuit of those objectives had taken precedence over all other policy goals, whatever the external climate.

It was his belief that the success achieved by the German authorities was even greater than stated in the present staff report, Mr. de Maulde continued. First, there was the admirable fact of continuous progress against inflation since 1981. That performance was all the more impressive considering the dedication required to squeeze out an extra percentage point of inflation from an annual rate of 5 or 6 percent than from much higher levels. Taking into account the latest wage agreements, he agreed that inflationary expectations had been brought down to a level at which they should not be considered a serious threat to future price stability. Real long-term interest rates no longer constituted an indicator in that respect because they were determined by external factors, and more specifically, the need to avoid disruptive portfolio shifts and capital outflows.

Referring to the question of the budgetary deficit, which was different from the question of the share of the Government in the economy, Mr. de Maulde stated that he fully accepted most of the points made in the staff report about the need to pay attention to the consequences of a large and growing deficit. At the same time, the deficit might not really be large, if one adopted the full employment concept and made allowance for the interest cost of debt incurred as a result of past deficits. He would welcome further information from the staff or Mr. Laske on the consequences both for revenue and expenditure of each additional percentage point in the unemployment rate. Moreover, the deficit was not growing as a percentage of GNP, as had been well documented in the staff report. Consolidation or retrenchment were facts in Germany, not concepts.

As for profit margins, Mr. Laske was right to point out that the financial situation of the manufacturing sector had deteriorated during the past 15 years, Mr. de Maulde remarked, but Germany would not appear to be at a particular disadvantage, since the phenomenon had been universal. In fact, compared with other major industrial countries, Germany was still in a relatively favorable position, and had been better able than others to hold onto its record in the 1960s. Moreover, the staff had shown that the present situation of many firms, especially in the export sector, had been improving in 1982. If the consequences of the present high level of unused capacity on production costs and therefore on profitability was factored in, the underlying improvement would be even better.

An indirect proof of his assessment that Germany had done much better in the field of structural adjustment than the authorities themselves admitted and the staff considered, Mr. de Maulde suggested, was the evolution of the external account. The turnaround in the current account of the balance of payments between 1980 and 1982 from a deficit of DM 28.5 billion to a surplus of over DM 8 billion was no small achievement. Exports had increased during that period at twice the rate of imports, an achievement that was all the more remarkable for a country whose exports already claimed a fairly large share of the market and would normally be expected to expand at best at a rate close to the growth of the market. In 1982 exports had increased by 8 percent in value and 2 percent in volume, compared with an increase for all industrial countries of 3 percent in value and a decline of 2.5 percent in volume. Thus, Germany had succeeded in continuing to increase its market share, no doubt a direct reflection of the quality of German products and good business organization, but also of a continuous improvement in competitiveness, or even overcompetitiveness in certain sectors.

On the problems of economic management, more particularly on the real side and in the shorter term, Mr. de Maulde mentioned his discomfort with the official forecast, which seemed to him to be clearly overoptimistic in the assessment of overall demand. Public finances were programmed to have at best a neutral and probably a slightly restrictive impact. Although higher profits were creating the conditions for additional investment in the corporate sector, he seriously questioned whether there was any automatic relationship between the two, especially as far as timing was concerned. Real household income was expected to remain stable and even to decline in a number of sectors, including the public sector, as the result of wage policy, an increased tax burden, and growing employment. In such a context, he would not expect much support for consumption from a further decline in savings ratios. In addition, the use of monetary policy to encourage consumption as well as investment was severely constrained by the international environment. External demand, if it was buoyant enough, could turn out to be the deus ex machina, as it had been in 1982. On a quarter-to-quarter basis, export growth had tended to weaken in the course of 1982, and the first quarter results for 1983 had confirmed the trend, probably reflecting the difficult external situation of a number of Germany's trading partners and suggesting that the growth of German exports might be much closer to the average export growth of other industrial countries in 1983 and 1984 than it had been in 1982. From a more conceptual point of view, he was not sure that it would be entirely appropriate for a country in Germany's position to rely too much on the growth of external demand in the present world economic situation.

To conclude, Mr. de Maulde considered that there was a high risk that the German economy might remain virtually stagnant in 1983. In that respect, the staff had stated in its appraisal that "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." He would like the staff to come forth with a clearer indication of the type of measures it considered necessary and appropriate. Mr. Laske could also make a contribution to the Article IV consultation discussion if he was in a position to indicate his authorities' contingency plan.

As a footnote, Mr. de Maulde mentioned that some of the comments in the staff report about Common Market policies seemed to him to be neither fully appropriate nor completely accurate.

The staff representative from the European Department noted that Executive Directors had appropriately focused on the likely strength and the duration of the German recovery. A formal forecast for 1984 had not been included in the tables in the staff report, which essentially described an outlook that was apparently being reviewed in the context of the new World Economic Outlook exercise. It had been considered advisable to discuss the old forecast more in terms of the issues raised than in terms of the numbers. The recovery would certainly not be buoyed by external developments; the export outlook was pessimistic at best. Similarly, the outlook for consumption was precarious, and depended greatly on a reduction in the savings ratio. That ratio had fallen somewhat, but it could not be counted on to continue its decline. It was therefore by a process of elimination that the staff had focused on investment as the necessary motor of recovery. There again, there were the best of hopes but not a great deal of certainty about the prospects.

The grounds for optimism were mainly the beginnings of the recovery that had been registered, although as pointed out in the staff report, those depended to a large extent on particular stimuli that might or might not be sustained throughout 1984.

In taking up the issue of whether the policies in place were adequate to sustain such recovery as was hoped for, the staff representative noted, the question arose of the correctness of the policy mix, namely, whether it should promote a cyclical upturn, as opposed to conditions for a sustained growth process across the cycle. Unfortunately, the requirements for meeting those two objectives tended in some respects to conflict. It was quite clear that across the cycle, the growth process--not just in Germany but also in other industrial countries--had been significantly weakened in the course of the 1970s by substantial increases in government spending, particularly in current spending. The increase in public investment spending in Germany had been very moderate, and most of the rise in the ratio of total spending to GNP had been accounted for by current spending, including current transfers, contributing beyond any doubt to the crowding-out effect on investment. To promote growth across the cycle, the focus would have to be on reducing government current spending, perhaps also subjecting government investment expenditure to fairly close scrutiny with respect to the degree to which it might improve the allocation of resources by the private sector.

At the same time, if an attempt was made in an equilibrium situation to reduce government spending concurrently in all industrial countries, the temporary effect would necessarily be a recession, the staff representative commented. The recession would be the cost of the structural adjustment. The question then was one of how much of an adjustment was desired, how fast, and at what cost in terms of a temporary recession. It was difficult to give a clear answer because the matter was essentially one of social preference. Against that background, it seemed fair to judge that there were some indications of a cyclical recovery, despite the continued efforts of the German authorities to correct the structural imbalance, and that unless there was a serious faltering of the recovery that seemed to be in process, the present policy mix might be as good as could be hoped for.

Should the economic recovery falter, and become disappointing to the German authorities as well as to the international community because of the importance to it of the German economy, the staff representative continued, the question was to find the type of supporting measures that would not, for the sake of short-term benefit, affect the achievement of the medium-term aims. There was considerable reason to believe that the structural imbalance was the result of too vigorous fiscal action in the past, in terms of short-term targets. A number of Directors had pointed out that the staff's recommendation was somewhat obscure. The staff would want to retain the focus on the total of government spending as the major reason for the crowding out of investment across the cycle. Hence, it would be advisable to create room for the recovery of private investment, and eventually of consumption, by continuing to reduce it. The two mechanisms for promoting a "crowding in" were a reduction in the government deficit, which would lower interest rates, or alternatively, a reduction in taxes, which would increase disposable income. Should the recovery falter, the staff would on balance wish to see the immediate reduction of the deficit de-emphasized, and a start made on reducing taxes. The staff was well aware of Mr. Polak's point that any delay in reducing deficits would increase the burden of interest in government expenditures, so that that course of action should not be pursued too vigorously either. The choice was difficult, but the staff felt that it might be desirable to promote the "crowding in" that was possible as government spending came down by means of lower taxes rather than by a reduction of the deficit. The German authorities' attitude was even more cautious than that of the staff, in that a cut in income taxes was being envisaged for some future date. The staff might encourage its introduction earlier rather than later, should the recovery falter.

In response to a question by the Chairman, the staff representative explained that the premise underlying the staff's argument was that any crowding out that would take place if deficits increased because of tax reductions would presumably result from interest rates that were higher than they would otherwise be. However, it seemed to the staff and to the German authorities that Germany was one component in a global capital market. The degree to which German policy shifted toward reducing taxes instead of deficits would not have a significant effect on international interest rate levels. Some Directors had expressed a wish for a fuller or more explicit discussion of Germany's economy in the international context. But the staff did in fact have that context in mind in suggesting that, if for external reasons the interest rate could not be brought down, Germany would do well to switch attention to the more direct approach of "crowding in" private spending through reductions in taxes.

The target range for the money supply had been considered to be still somewhat loose by some Directors, the staff representative observed, because it envisaged an increase in the growth of money throughout the year of 7 percent whereas the growth in nominal GNP might be, at the outside, about 4 percent. It was true that the result would be an additional increase in the ratio of the money stock to nominal GNP. That result was to be seen in the medium-term way in which the German authorities defined their monetary policy. The "irreducible" rate of inflation was related to the growth of potential output. To the extent that the growth in the money stock exceeded the actual rate of growth of the economy, it was meant to provide an additional stimulus within the limits of what could be accommodated, given the idle capacity within the economy as well as the balance of payments position. It seemed to the staff that, on balance, the existing range for the increase in central bank money was probably close to what would be sustainable with balance of payments equilibrium in that medium-term context. If the recovery was somewhat stronger than currently anticipated, a point raised by Mr. Erb, it could be accommodated within the monetary targets and within the payments constraint, and some excess domestic capacity would be taken up.

The effect of recent exchange rate developments on the rate of inflation had been mentioned by Mr. Wicks, the staff representative recalled. Although there had been a depreciation of the mark compared with the dollar of about 5 percent from December 1982 to June 1983, in effective terms there had been a 1 percent appreciation of the mark. Moreover, the unit value of imports had in fact declined in May compared with December 1982 by nearly 5 percent. Thus, there was no particular inflationary impulse from the external side. The effect of the value-added tax had been calculated as equivalent to increasing the consumer price index by 0.6 percent. Since the rate of price increase in July, over the preceding year, had been 2.2 percent, the underlying rate of inflation was therefore 1.6 percent, an impressive achievement.

There was room for speculation about the effect on the observed moderation of wages of a decline in unemployment following a stronger economic recovery, the staff representative remarked. The degree of unemployment had probably been one of the factors promoting wage restraint. It also seemed possible that, in reverse, the wage level had had something to do with the high rate of unemployment. It had been observed that a 3 percent rate of growth over a span of several years would not necessarily absorb the stock of unemployed; it might perhaps absorb new entrants into the labor force. The reason was that real wages in Germany, and in many other industrial countries, tended to be so high as to discourage labor-using investment; they tended to promote investment of a labor-saving character. An analogous development had been the type of investment common in the 1970s when energy prices had risen significantly, leading to energy-saving investment. Until the imbalance in the labor market had been corrected, a process that was under way in many industrial countries, it would have to be accepted that unemployment levels would remain unduly high in comparison with the levels customary in the 1960s and early 1970s.

Because of the sharply higher cost of labor it was now difficult to separate precisely the cyclical and structural components in the government deficit, for example, the staff representative said. With labor costs as high as they were, employment was unlikely to be reduced to 2 percent, no matter what the pressure of demand might be. There was the related question of the need to increase profit margins. As Mr. de Maulde had observed, such an increase might be a necessary though not sufficient condition for a full recovery. Insofar as profitability was a necessary condition for an increase in investment, until profit margins improved, it could not be assumed with confidence that the conditions for sustained growth in the medium term had been re-established.

In answer to more specific questions, the staff representative noted that Germany's energy-saving record was good, in comparison with other countries in Europe, and had affected nearly all sectors of the economy.

The German authorities valued the role of the European Monetary System in promoting policy coordination, especially with neighboring countries, the staff representative noted. In that sense, they were keen to maintain the system.

As for the deflator used in calculating Germany's foreign aid disbursements, the staff representative mentioned that official development assistance had risen 10 percent a year in nominal terms between 1976/77 and 1981/82. In volume terms, the German authorities had calculated its rise at 8.5 percent, implying a deflator of 1.5 percent. He did not know the source of that deflator.

Referring to the structure of the staff report, the staff representative from the European Department agreed that it would be useful, in Article IV consultation reports, to cover as fully as possible the international repercussions of developments in an individual economy, although it was necessary to be conscious of the limitations of what could be done when dealing with only one country at a time. A more thorough review of the interaction of the main countries in the world economy was made routinely in the World Economic Outlook exercise, where individual economies were evaluated in an international context. While there was constant feedback between Article IV consultations and the World Economic Outlook exercise, to some extent there would always be matters that could not be evaluated fully in separate consultation discussions.

The Director of the Exchange and Trade Relations Department said that he would take up the matter of the coverage of staff reports with Mr. Wicks personally. Meanwhile, he would observe that a constant concern was to keep the staff reports focused on the broader issues. It was clear from the discussion of the staff report for the 1983 Article IV consultation with Germany that an improved and broadened analysis of trade issues, including greater emphasis on agricultural protectionism and the policies of the European Communities, would be helpful. Other occasions for dealing with those issues were the periodic staff papers on trade policies, which permitted EC policies to be dealt with in a broader context, thereby reducing to some extent the need to encompass too much within the confines of the analysis of an individual country. On additional points relating to the consequences of German policies on capital markets, the staff would examine how those consequences could be better accounted for in future staff reports.

In general, the Director of the Exchange and Trade Relations Department remarked, the points that the staff had been trying to make on protectionism had been well taken by the Executive Board. However, there seemed to have been some misunderstanding of the last full paragraph on page 11 of SM/83/153. As he understood it, the German authorities were in no sense attributing responsibility for the problem of increasing protectionism to the developing countries. Rather, they wished to emphasize the importance of enabling exports of developing countries burdened by debt to expand through the provision of greater market access for those countries. The last sentence of the paragraph might perhaps have been clearer if the phrase "the exports of" had been added before "developing countries," so that the full sentence would read "The authorities welcomed the strengthened cooperation between the Fund and the GATT in keeping markets open, particularly for the exports of developing countries burdened by debt."

Mr. de Maulde inquired whether the staff could give a more specific estimate of the impact on revenue and expenditure, and thus on the budget balance, of each change of 1 percentage point in the rate of unemployment.

The staff representative from the European Department reported that an increase in the rate of unemployment of 1 percent had been calculated to increase expenditures by 3 percent, and to lower revenues by DM 6.5 billion. The deficit would then increase by DM 9.5 billion. Other calculations of the effect of a change in the rate of employment were also feasible. Further information could be provided to Mr. de Maulde.

Mr. Laske noted that three questions had been raised relating to fiscal policy, to which he would respond. The first question concerned the type of tax measures contemplated for 1984 in order to support the recovery that seemed to be under way. As pointed out in the staff report, the value-added tax (VAT) had been increased by 1 percentage point, effective in mid-1983. Thus, the increase in the VAT would have its effect for a full year for the first time in 1984. Compensating tax measures were foreseen, which would allow enterprises to absorb at least part of the VAT in their own profit margins. In other words, the rate of taxes that were not related to profits of enterprises would be adjusted downward; that was one of the measures described in the staff report as being aimed at strengthening the profitability of enterprises.

Second, Mr. Laske observed, many Directors had asked whether the authorities might not be intending to compress the budget deficit too fast. In nominal terms, the deficit for 1983 would be about DM 3 billion higher than the deficit eventually recorded in 1982. The decline in the deficit contemplated at the present stage in the 1984 budget would amount to only about DM 2-2.5 billion. That did not really represent a program for eliminating the deficit immediately. As the staff representative had stressed, the main emphasis in the fiscal area was on measures to improve the structure of the deficit in order to ensure that the economy had the potential to expand with the support of fiscal policy.

Reference had been made by Directors to the possibility of a contingency plan, Mr. Laske observed. In a formal sense, there was no such plan, although a number of people in policymaking positions would be thinking about what would have to be done in case the recovery did not proceed as hoped. Contingency planning could be more damaging than constructive, from a psychological point of view, if it became public knowledge that plans to deal with a faltering of the recovery were being prepared. His authorities stood ready to react flexibly to emerging signs of less favorable developments than were currently foreseen. The recovery predicted for 1983, with growth estimated at between 0.5 percent and 1 percent, accelerating to 2.5 percent in 1984, was admittedly not strong. A much more vigorous upswing in economic activity would not be unwelcome, but it would be better if it did not materialize on the basis of measures that would lead only to a short-lived upsurge in activity, to a rekindling of inflation, and to the prolongation of the distortions present in the economy.

On monetary policy, Mr. Laske noted, a question had been asked about the possible response of the authorities to a failure of real international interest rates--mainly those in the United States--to decline. The level of international interest rates was viewed by his authorities as an important parameter for their own economic policy formulation. They would accept given levels of international rates, and not respond in a short-term way, for instance, by exchange market intervention, because experience had shown that attempts to change the fundamentals by that means could not be successful in the long run.

Germany's position on the European Monetary System (EMS) had been questioned in various discussions, Mr. Laske recalled, and he could only repeat what he had said before, namely, that Germany valued the EMS highly. That should be obvious from the geographic distribution of Germany's foreign trade; almost one half of that trade was conducted with countries in the European Communities. Not all of those countries were active members of the European Monetary System, but the broad exchange of goods and services between European countries that were members of the EMS made the advantages of the System obvious. While Germany fully supported the EMS, it realized that the exchange rates of members of the system could not be fixed rigidly, irrespective of cost-price and other developments in the member countries; such developments had been dealt with by exchange rate adjustments and realignments.

Commenting on Mr. Wicks's suggestion that capital markets should be discussed in the staff report, Mr. Laske recalled that there were no restrictions on the German capital market, which was open to any borrower. The only criterion applied by the market was creditworthiness. Total long-term capital outflows in the first five months of 1983 and amounted to DM 13 billion, a considerable sum, demonstrating the openness of Germany's capital market.

A lively discussion was under way in Germany about the advantages of cutting working hours, Mr. Laske remarked. Not surprisingly, the positions of the major parties--trade unions on the one side and associations of enterprises on the other--were somewhat at variance. The trade unions believed that shorter daily or weekly working hours could create additional jobs, but at the same time, they were in favor of maintaining the wage level. The reply of the employers' associations was that a cut in working hours with full wage compensation would push up costs to such an extent that the drive for labor-saving investment would be given new impetus so that the net effect on the job market might be negative. The discussion was in its early stages, and was likely to continue, especially if, as was feared, the absolute level of unemployment could not be reduced quickly in the years to come. Another aspect of the discussion, emanating from academic circles, was the idea of reducing lifetime work, by permitting earlier retirement, in order to make a greater number of jobs available. There would of course be financial repercussions, especially on the social security system, which would have to pay pensions at a much earlier stage; one possibility would be to reduce retirement benefits. From the information available to him, the discussion of reducing the retirement age had not yet been taken up by those concerned with the practical implications.

Finally, Mr. Laske said that he would relay the remarks made by Executive Directors on protectionism and regulations in the European Community to his authorities, together with the expressed desire that Germany should continue to urge its partners in the Community to take a stand for an open trading system.

The Managing Director made the following summing up:

Executive Directors generally commended the German authorities for their consistent and successful conduct of economic policy and for their achievement in restoring relative price stability. The main question to which Directors addressed themselves concerned the prospective strength and sustainability of the recovery in economic activity currently in process. Many of the preconditions for growth seemed to be in place. Profit margins, severely compressed for several years, seemed to be strengthening. But the recovery still looks very weak and precarious. Some of the upturn at the beginning of the year was influenced by temporary stimuli. Although nominal interest rates had declined substantially during the last two years, real interest rates, and in particular long-term rates, had not declined to the same extent. While consumer confidence appeared to be strengthening, Directors noted that there was as yet no upturn in investment and that no early reduction in unemployment was in prospect. Productivity growth and continued wage restraint were essential to secure a revival of investment and an increase in employment.

Directors generally agreed that monetary policy could not under present circumstances be expected to provide a further noninflationary boost to activity. There remained little room for an additional reduction in interest rates, particularly on the short end, since further downward pressure on the exchange rate would not be welcome from either a domestic or an international perspective. Excessive monetary growth would jeopardize the welcome moderation of inflationary pressures. The present monetary target still appeared compatible with a pickup in growth of the magnitude foreseen. It was hoped that the overshooting of the monetary target in the first half of 1983 was the result of temporary factors that would reverse themselves. Directors noted the recently expressed intention of the monetary authorities to maintain the monetary target and the expectation that the growth of central bank money would return to the upper part of the target range by the end of the year.

Directors expressed the hope that policies would promote growth in domestic demand as Germany was in a stronger balance of payments position than most countries. It was also noted that, although the deutsche mark had recently weakened against the U.S. dollar, it had maintained its value in nominal effective terms due to the March realignment within the European Monetary System.

The medium-term orientation of fiscal policy toward restraint in expenditure and a reduction in the fiscal deficit was widely endorsed. Directors agreed that the size of the government sector could only be reduced gradually and that the beneficial effects of reducing the deficit through expenditure restraint would only be realized with a lag. A number of Directors agreed that the longer-term growth prospects of the German economy were linked to a gradual reduction in the size of the public sector. However, several Directors expressed concern that fiscal policy might be unduly restrictive at a time when there was no clear evidence of a sustained upswing in private demand. Although recognizing that the pursuit of a firm fiscal policy could have a positive effect on private confidence, a number of Directors urged the German authorities to show flexibility in the short run in reducing the fiscal deficit, should the pickup in domestic demand falter.

Many Directors commended the German authorities for their efforts to resist protectionism, both in Germany and in the context of the European Community, despite difficult labor market conditions. Some urged that such efforts be further intensified, particularly with respect to agricultural products. It was hoped that in spite of fiscal restraint the ratio of official development assistance to GNP would be maintained or, even better, increased.

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

APPROVED: February 10, 1984

LEO VAN HOUTVEN
Secretary