SM/84/142
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

July 30, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Federal Republic of Germany - Staff Report for the 1984 Article IV Consultation

The following corrections have been made in SM/84/142 (7/18/84):

Page 7, last para., line 1: for "share of taxes...46 percent of GNP..." read "share of direct and indirect taxes... 23 1/2 percent of GNP..."

Page 8b, Chart 10, second panel: add footnote 6 to the words "Deposit rate"

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

further. At the same time, further steps were taken to improve business incentives by lowering business taxes and by introducing a special 10 percent depreciation allowance for small- and medium-sized enterprises on machinery and equipment acquired after May 1, 1983. The loss carry-forward provision for enterprises was strengthened, and a special depreciation allowance was introduced on expenditure for research and development.

The 1984 deficit of the Federal Government was originally budgeted at DM 34 billion or 2 percent of GNP; the rest of the public sector was projected to be in approximate balance. However, the Federal Government deficit is now expected to be close to DM 30 billion, inasmuch as the level of activity is already higher than was assumed at the time the 1984 budget was formulated. In addition, the Bundesbank profit transfer was underestimated, while interest payments, as well as transfers to the Federal Labor Office, will probably be lower than projected. On the other hand, there has not thus far been much success in lowering subsidies, as additional support has had to be given to the coal and steel and to the agricultural sectors.

To solidify expectations, the medium-term fiscal program for 1984-88 was scheduled to be presented to Parliament in July, 1984. Nominal expenditure by the general government is projected to continue growing at the 3 percent rate set for 1984, against annual increases in nominal GNP of 5 1/2 percent, reducing the ratio of public expenditure to GNP from 48 percent in 1984 to 43 1/2 percent in 1988. The Government has not specified a precise long-term target for the deficit. The Council of Economic Experts reportedly considers a deficit for the territorial authorities, excluding the social security system, equivalent to about 1 percent of GNP to be sustainable.

If the share of direct and indirect taxes were to be kept stable at 23 1/2 percent of GNP from 1983 to 1988, a tax reduction of some DM 20 billion would be required during this period. No further cuts in busines taxes are currently being contemplated. However, to smooth out the progressivity of the tax system, the Government was considering as one alternative the cutting of personal income taxes by the full DM 20 billion, though perhaps with some compensatory increase in indirect taxes. A second alternative was to reduce personal income taxes by some DM 10 billion without compensating increases elsewhere. Neither option would become feasible before 1986, and if the larger cut were decided upon some phasing was likely to be necessary.

3. Monetary policy

Monetary policy appears not only to have provided scope for the economic recovery in 1983, but also to have contributed a significant stimulus of its own. The German representatives recalled that at the start of 1983 the rate of monetary growth envisaged was looked upon as a plausible offset to the possibly restrictive short-term impact of the budget. Responding to declining domestic inflation, an improvement in the external trade balance, and moderating interest rates abroad, monetary policy had been progressively eased since the autumn of 1981. This easing contributed to the decline in domestic interest rates that helped raise consumer spending and expenditure on housing in early 1983, as well as to the increase in business investment later in the year. It was not, however, pushed so far as to depress the exchange value of the deutsche mark, and domestic price inflation continued to abate.

German monetary policy continues to be guided by target ranges set for the growth of central bank money (Chart 9). That range was fixed at 4-7 percent between the fourth quarters of 1982 and 1983, as it had been between the fourth quarters of 1981 and 1982; since mid-1982 the stated aim was to keep actual growth in the upper half of the band. A 3 1/2 percent increase in prices was regarded as unavoidable for 1983 and the growth in potential output was assumed to be 1 1/2-2 percent; it was also expected that velocity would decrease given adverse income expectations at the end of 1982. Although monetary growth was remarkably steady at about 6 percent through 1982, it swung well above the target range in early 1983. The expansion for the year as a whole was brought back within its upper limit of 7 percent only near the end of the year.

Monetary developments in 1983 were difficult to interpret at first. The sharp acceleration in monetary growth in the first quarter of 1983 could, at least in part, be ascribed to reversible special factors. Massive inflows of capital prior to the realignment of exchange rates in the EMS led the authorities on March 18 to lower the discount and lombard rates by a full percentage point to 4 percent and 5 percent, respectively. However, to regain control of bank liquidity, they decided at the beginning of April to reverse an increase in rediscount quotas granted in February. Liquidity was tightened further through open market operations as it became evident that, despite a sustained capital outflow following the realignment, central bank money continued to expand well above the target range. Money market rates then began to rise, and were followed in September by an increase from 5 to 5 1/2 percent in the lombard rate (Chart 10).

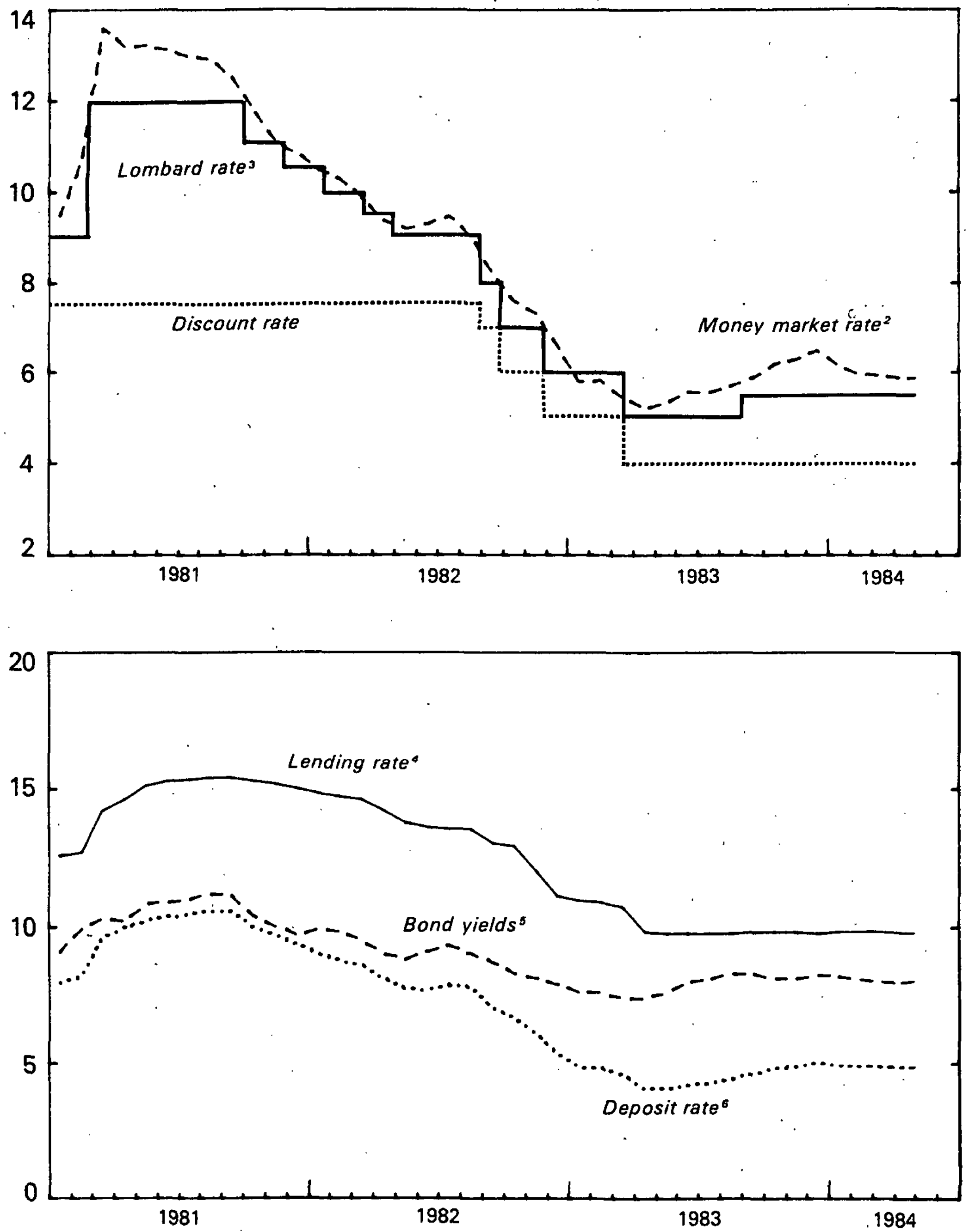
The German representatives stressed that, although the growth in the central bank money stock declined rapidly in the course of the year, lending by the banking system to domestic nonbanks progressed steadily throughout the period. For some it was this that mattered from the point of view of sustaining economic growth. Changes in the behavior of savers in response to changes in market interest rates were the main reason for fluctuations in the demand for money relative to other finan-

CHART 10

GERMANY

NOMINAL INTEREST RATES[1]

(Percent per annum)



Source: Deutsche Bundesbank, *Monthly Report.*

1Period averages, except for discount and lombard rates, which are end-of-period.

23-month money market rate.

3From February 20, 1981 to May 6, 1982 interest rate on special lombard loans after suspension of normal lombard facility.

4Current account loans (under DM 1 million).

5Yield on government bonds.

63-month deposit rate.