SM/83/153
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

August 5, 1983

To: Members of the Executive Board

From: The Acting Secretary

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

The following corrections have been made in SM/83/153 (7/5/83):

Page 5, line 2: for "DM 46 billion of which DM 28 1/2 billion" read "DM 54 billion, of which DM 30 billion"

1st full para., line 1: for "excluding direct" read "including direct"

2nd full para., line 3: for "DM 17 billion" read "DM 16 billion"

line 6: for "DM 18 billion" read "DM 17 billion"

Page 7, para. 1, line 8: for "DM 5 1/2 billion" read "DM 5 billion"

Page 10, para. 3, lines 4-6: for "being considered; it could...perhaps, and the Government" read "being considered, and the Government"

Page 20, Monetary data for private nonbanks for 1982: for "5.6" read "5.7"

Corrected pages are attached.

Att: (4)

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first assumed significance in 1980, and in the three years to end-1982 had cumulated to DM 54 billion, of which DM 30 billion came from OPEC countries.

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

Capital movements during the first quarter of 1983 were dominated by speculative inflows in anticipation of a realignment in the EMS. Official reserve holdings rose by DM 16 billion from the beginning of 1983 to the realignment in mid-March reflecting mainly intervention purchases to limit the upward pressure on the deutsche mark. Since the realignment and until the end of May, official reserves of the Bundesbank declined by DM 17 billion. Net official reserves at the end of May, 1983, amounted to DM 69 billion or 14 per cent of 1982 imports of goods and services.

III. The Policy Discussions

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

1. Exchange rate policy

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

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

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

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

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

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

2. Monetary policy

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

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

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

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

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

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

3. Fiscal policy

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

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

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

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

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

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

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

4. Employment policies

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

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

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

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

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

5. Trade and aid

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

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

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

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

	1979	1980	1981	1982
	In billions of deutsche mark			
Foreign reserves of the Bundesbank 1/				
Net monetary reserves	88.9	63.4	65.3	69.1
	Annual averages; changes in per cent			
Monetary data				
Central bank money	9.1	4.8	4.4	4.9
Money and quasi-money (M3)	8.9	5.2	6.5	6.5
Bank lending	12.1	10.1	9.5	7.4
Of which:				
Public authorities	12.0	8.9	10.2	13.4
Private nonbanks	12.2	10.4	9.4	5.7
	End of period; in per cent			
Three month money market rate	9.6	10.2	10.8	6.6
Yield on bonds outstanding	8.0	9.1	9.9	8.0
	Changes in per cent			
Exchange rates				
US$ per DM (end of period)	5.6	-11.6	-13.1	-5.1
US$ per DM (annual average)	9.6	0.9	-19.7	-6.9
Effective rate (MERM, end of period)	7.4	-7.9	-0.7	5.1
Effective rate (MERM, annual average)	6.2	1.0	-7.4	4.2
Relative normalized unit labor costs (annual average)	0.9	-3.9	-11.0	0.2

1/ End of period.