SM/85/194
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

August 12, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Federal Republic of Germany - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/85/194 (7/5/85):

Page 2, line 1: for "fiscal incentives have"
read "fiscal incentives and labor disputes have"

Page 3, line 3: for "levelled out (Chart 3)", read "levelled out before increasing again somewhat in the first half of 1985 (Chart 3)"

1st full para., line 3: for "DM 17.7 billion"
read "DM 17.8 billion"

last sentence: for "Data available...unchanged."
read: "Thus the current account...by DM 7.3 billion."

last para., lines 3-6 : for "investment. German purchases... substantially" read "investment (including...substantially"

Page 7, para. 1, line 8: for "1985. Another area"
read "1985; a reduction...for 1986. Another area"

Page 13, 3rd full para., last line: for "DM 25-30 billion."
read "DM 30 billion."

Page 14, 2nd full para., line 3: for "the gentlemen's agreement of"
read "the gentlemen's agreement (in its latest version of"

- over -

Page 25, under Public finances, last column, line 1:	for "880.8" read "882.0"
line 2:	for "849.9" read "851.8"
line 3:	for "-30.9" read "-30.2"
line 5:	for "-25.6" read "-25.3"
under Balance of payments, column 4, line 5:	for "17.7" read "17.8"

Corrected pages are attached.

Att: (6)

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CONTAINS CONFIDENTIAL
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INTERNATIONAL MONETARY FUND

FEDERAL REPUBLIC OF GERMANY

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Article IV Consultation with the Federal Republic of Germany

Approved by Brian Rose and J.T. Boorman

July 3, 1985

I. Introduction

Article IV consultation discussions were held in Bonn and Frankfurt from May 20-May 31, 1985. The German authorities were represented by officials of the Federal Ministries of Finance, Economics, Labor, Economic Cooperation and Agriculture, and of the Deutsche Bundesbank. Mr. Grosche, Executive Director for Germany, attended the meetings as an observer. The staff team consisted of Messrs. Rose, Fidjestol, Lipschitz, and Nyberg (all EUR), with Mrs. Ramos (ETR) as secretary. Germany has accepted the obligations of Article VIII, sections 2, 3, and 4. The last Board discussion was on July 20, 1984 (EBM/84/112 and EMB/84/113).

II. Background to the Discussions

The recession of the early eighties reached its trough in the final quarter of 1982 with inflation still relatively high but starting to fall and unemployment at an historically high rate and still rising. The recovery that began in 1983 was initiated by an autonomous increase in demand rather than any shift in policy; indeed, since 1982, macroeconomic policies have been firmly committed to reducing the size of the Government and of the fiscal deficit in the medium-term, and to lowering inflation. At the time of the discussions, the economy was into a third year of modest growth with the inflation rate less than half that in 1982 and a growing current account surplus. Unemployment, however, remained at around 8 percent of the total labor force with little prospect of rapid improvement, and the structure of demand was characterized by a considerable dependence on net exports.

Growth in 1983 was due initially to a rise in consumption and subsequently to a strengthening of fixed investment following an improvement in profitability. In 1984 the pattern of demand changed: private consumption and fixed investment grew less rapidly (though

fiscal incentives and labor disputes have distorted the timing of investment expenditures) and, despite an increase in government current spending, the expansion of final domestic demand slackened. In contrast to 1983, the foreign balance had a large positive influence on GNP. In fact, of the 2 1/2 percent real growth in 1984, one percentage point was due to the foreign balance and another half percentage point to stockbuilding.

The relative weakness of domestic demand and the size of the contribution to growth of the foreign balance (even more pronounced when measured in through the year terms) are unusual for the phase of the cycle and in sharp contrast to the pattern of recovery in 1975-77 (Chart 1). The growth of consumption has been particularly slow, as both falling employment and small increases in wages have held back the growth of household real incomes. In the past, consumption has usually grown throughout the cycle, but in 1984 private consumption was still below the level achieved in 1980. Construction has been and remains fundamentally weak owing largely to an oversupply of residential housing already on the market and a restrained public construction program. Thus, the dynamism in the recovery has so far come chiefly from exports and investment in machinery and equipment.

Inflation fell to 2-2 1/2 percent in 1984 despite a rise in import unit values of 6 percent, induced in large part by the depreciation of the deutsche mark against the U.S. dollar. A slight quickening of price increases in the first quarter of 1985 was due largely to the sharp appreciation of the U.S. dollar. Average hourly wage and salary rates in the whole economy rose by less than 3 percent in 1984 and, for the second year in the row, productivity increased rapidly. As a result, unit labor costs rose by only 1/2 percent in the economy as a whole, while they fell in industry by 1 percent. Calculations by the Bundesbank show an increase in total production costs of only 1 1/2 percent, of which more than two-thirds was due to imported goods and services. Thus, while domestically generated inflation fell substantially, profit margins were widened and, with the higher volume of output, rates of return on capital rose considerably (Chart 2).

While relative price developments were generally favorable--as evidenced by real wage costs, profits, and external competitiveness--and aggregate price performance was excellent, there continued to be doubts about the potential response of the real economy to stronger nominal demand. An official estimate of the growth of productive potential, at around 2 percent, is about half that of the 1960s, owing to a weakening of total investment, an accelerated rate of obsolescence of capital equipment in recent years, and an increasing amount of structural unemployment. Actual growth should, of course, be higher than the growth of potential during an upswing, as slack in the economy is taken up, but there are questions about the amount of spare capacity in the economy and about how fast the slack can be taken up without reigniting inflation. The fall in employment came to an end during 1984 and since the third quarter employment has shown a slight rise. The improvement in the labor market is also reflected in a fall in the numbers of short-

time workers and an increase in the number of vacancies. The unemployment rate, which had increased by more than 1 percentage point during each of the preceding three years, levelled out before increasing again somewhat in the first half of 1985 (Chart 3). In spite of the continuing high level of unemployment, capacity utilization in manufacturing has risen by nearly 7 percentage points since March 1983, though this is still somewhat below the last peak reached in the second half of 1979 (a time when the economy was suffering from inflationary pressures). It is, moreover, the manufacturing sector that is the principle beneficiary of the most dynamic components of demand--that is, exports and business fixed investment--and where bottlenecks are most likely to emerge.

As noted above external transactions provided a substantial fillip to German growth in 1984 and the first quarter of 1985. The current account surplus rose from DM 10.5 billion in 1983 to DM 17.8 billion in 1984. Most of this increase was on account of merchandise trade, despite a substantial deterioration in the terms of trade. While import unit values rose by 6 percent--about two-thirds of this directly related to the appreciation of the U.S. dollar in which about a third of imports are invoiced--export prices increased by only 3 1/2 percent. 1/ Developments in trade volumes clearly dominated the price effects on the trade balance as the rapid response to strong market growth abroad and improved competitiveness offset the usual short-run J-curve effects. The volume of exports rose by 9 percent and that of imports by a little more than 5 percent. Trade with the United States played an unusually important role: the value of exports to the United States increased by 42 1/2 percent and the share of the United States in overall export earnings rose from 7 1/2 percent to 9 1/2 percent. Thus the current account surplus with the United States rose by DM 14.1 billion over the previous year, while the total current account surplus increased by DM 7.3 billion.

More than DM 8 billion, of the almost DM 13 1/2 billion widening of the identified capital account deficit in 1984, was on account of long-term portfolio investment (including foreign investment in German official borrowers' notes). German purchases of foreign currency bonds rose almost threefold (with U.S. and Canadian bonds attracting special interest), while nonresident purchases of German official borrowers' notes fell substantially. Short-term nonbank capital outflows also increased sharply; long-term lending by German banks, however, was reduced as banks continued to be cautious in lending to developing countries and centrally planned economies, and concentrated on government-guaranteed export financing. The large (DM 7 billion) increase in errors and omissions in the balance of payments suggests that not all capital inflows were recorded.

1/ The deterioration in the terms of trade meant that the increase in real national income was approximately 1/2 a percent less than the rise in GNP.

Exchange rate movements of the deutsche mark have been difficult to explain in 1984 and the first half of 1985. At times the deutsche mark has depreciated sharply against the U.S. dollar despite changes in interest rate differentials in favor of deutsche mark investments and a strengthening of the current account position. In general, however, movements in the exchange rate seem to have been related in large part to shifts in the desired currency composition of portfolios. The value of the deutsche mark fell by 11 1/2 percent against the U.S. dollar and by 3 percent in effective (MERM) terms during 1984 (Chart 4). The effective depreciation of the deutsche mark was coupled with better price and cost performance in Germany than in its trading partners and the deutsche mark depreciated by 5 percent in real effective terms. 1/ The first quarter of 1985 saw particularly large fluctuations in the deutsche mark/dollar exchange rate. A sharp rise in the dollar in February was temporarily halted by a substantial and coordinated intervention at the end of that month and the beginning of March, and then the dollar began to fall back from mid-March, generally fluctuating between DM 2.98-DM 3.15 per dollar (end-1984, DM 3.15). On June 24 the rate was DM 3.07 per dollar.

Movements of the deutsche mark against the dollar in the first half of 1985 were broadly similar to those of most other currencies, so that between the end of 1984 and late June 1985 the effective value of the deutsche mark changed little, appreciating by something over 1 percent.

The stability of the European Monetary System (EMS) since the last realignment in March 1983 can be attributed to a number of factors. First, there has been a greater degree of convergence in policies. Second, although the cumulated differences in price and cost performance since the last realignment are significant, their effect on trade has been offset, in part, by cyclical factors as, for example, Germany's recovery preceded that of France. Third, interest rate differentials have produced stabilizing capital flows. Fourth, coordinated intramarginal intervention has left some of the other major central banks with large deutsche mark assets, available for intervention should the need arise.

Intervention in the foreign exchanges (apart from mandatory intervention within the European Monetary System) was undertaken not to alter the level of (or trend in) any particular bilateral exchange rate, but only to prevent or counteract disorderly market conditions. The two major episodes of intervention since the last consultation--September 21 and 24, 1984 and end-February beginning-March, 1985--were undertaken to re-establish orderly conditions in a "one-way" market.

1/ Measured as relative unit labor costs adjusted for exchange rate changes and cyclical effects on productivity.

Changes in the structure of government expenditure had, however, been less than ideal. A disproportionate burden of expenditure restraint had been borne by public investment, which had fallen by 25 percent in real terms since 1980; it was, however, budgeted to rise slightly in 1985. Also, in the last two years, government subsidies had grown rapidly, owing largely to greater support for coal mining, the steel industry, and agriculture; a smaller increase was budgeted for 1985; a reduction of Federal Government subsidies is scheduled in the order of DM 1 billion for 1986. Another area where expenditure restraint had been markedly unsuccessful had been that of health insurance; expenditure in this area had far exceeded budget projections in 1984 and a further rapid increase was expected in 1985.

The staff mission, while supporting the policy of continuing to reduce the size of government expenditure in relation to GNP, raised the question of the extent to which reduced rates of growth of expenditure should be matched by lower taxes or by a lowering of the deficit. On the basis of the Government's medium-term fiscal projections, which were acknowledged to be simple statistical extrapolations rather than policy intentions, the general government deficit would continue to be reduced until, by 1989, the government accounts were in surplus. At what point would the negative effects on demand of a further withdrawal of fiscal stimulus outweigh the positive effects on real interest rates and confidence? Considered from the financial side, a deficit of about 2 percent of GNP would maintain the stock of general government debt more or less constant in proportion to GNP.

The German representatives responded that it was unlikely that the figures implicit in the medium-term fiscal projections would be fully realized. As the financial position of municipalities, which account for the bulk of public investment, improved, it was probable that they would raise their investment expenditures. As long as this investment enhanced productive potential, such an increase would be in line with the objectives of fiscal consolidation. It would, however, have to be accompanied by restraint at other levels of government so that the annual rate of growth of spending of the territorial authorities remained at about 3 percent.

There was no precise official target for the deficit but, in the view of the Government, the present deficit was still too high. One figure that was sometimes mentioned as a possible objective was a general government deficit of 1 percent of GNP (compared with the projected 1 3/4 percent in 1985). An important criterion (perhaps the most important in the minds of the German representatives) was that of limiting the share of interest payments in Federal Government expenditure. Such payments reduced the room for discretionary action in fiscal policy and, despite the success at reducing the deficit, the share of interest payments was still rising (11 percent in 1984, possibly rising to 13 percent by the end of the decade).

The Government's view was that a lowering and restructuring of taxes was essential, subject, for the immediate future, to the constraint of a continued slight downtrend in the absolute level of the deficit. It was acknowledged that tax reductions would stimulate private expenditure and have beneficial supply-side effects. In 1983 and 1984 there had been significant tax cuts for business which had had the desired effect of increasing after-tax profits and thereby stimulating investment. It was, therefore, appropriate that the next stage in the process provide tax relief to households. The Bill passed by parliament in June provided for personal income tax relief of DM 19 1/2 billion a year (about 1 percent of 1986 GNP) in two phases--DM 11 billion from 1986 and a further DM 8 1/2 billion from 1988. The first phase would consist chiefly of an increase in standard exemptions and family deductions (about DM 7 1/2 billion) and to a lesser extent (some DM 3 1/2 billion) of a reduction in marginal tax rates. The second phase would reduce marginal tax rates further. The full package would more or less correct for the effects of fiscal drag since the last income tax adjustment in 1981. It was intended in the life of the next parliament to reduce marginal tax rates on average incomes and to introduce further tax reductions for businesses as part of the ongoing process of tax reform.

2. Monetary policy

Monetary policy is also medium-term in orientation insofar as the authorities base their target growth range for Central Bank Money (CBM) on a projection of the growth of potential (rather than actual) real output and a tolerable rate of inflation. Insofar as the ultimate objective of monetary policy was the safeguarding of the real value of the currency, the Bundesbank had, at times, to take into account the impact of exchange rate changes on domestic price stability. The German representatives reaffirmed, however, that monetary policy was not set with any specific exchange rate target or target range in mind. Despite the size and speed of changes in the deutsche mark/dollar exchange rate in 1984 and 1985, and the effects of these changes on prices and the terms of trade, monetary policy had not been deflected from its set course which had been based largely on domestic considerations.

The target range for CBM growth during 1984 was 4-6 percent. Although real GNP growth turned out to be more rapid than the estimated growth of potential output, inflation was somewhat lower than expected and CBM grew at a rate of 4 1/2 percent, slightly below the mid-point of the target range (Chart 6). Both narrow money and the broad (M3) aggregate grew more slowly than CBM. Short-term interest rates were remarkably stable during the year, the three-month money market rate fluctuating narrowly around 6 percent. Longer-term rates trended downward in the second half, the government bond yield falling from 8 percent in mid-year to 7 percent by December. In all, monetary policy accommodated a 5 percent increase in nominal GNP (3 percent real and a 2 percent rise in the deflator) in through-the-year terms, without any evidence of undue financial stringency.

the time pattern of investment, substantially raising the level of investment in 1983 and artificially depressing the level in 1984), but the most recent evidence from investment intention surveys, domestic orders received by capital goods manufacturers, and capital goods imports all suggest an underlying strengthening of investment. The German representatives noted that the improvement in profits in this recovery had surpassed that of recoveries in recent cycles, and they thought that this profitability performance would help to sustain investment.

Construction investment is projected to fall by some 3 percent in 1985, as a small rise in business and government construction will not offset a large drop in residential construction. Part of the fall in 1985 reflects base effects--construction had been boosted in 1984 by fiscal incentives that expired at the end of the year--but the German representatives said that there was an underlying oversupply of residential buildings that could not (and indeed should not) be offset by special policy measures.

No significant change in price inflation from the current rate of 2-2 1/2 percent rate is projected in 1985. Productivity is expected to rise by 2-3 percent in the economy as a whole and, despite some picking up in the rate of wage increases, no appreciable rise in unit labor costs in manufacturing is expected. However, despite the continuing favorable development of labor costs and profits, not much, if any, reduction in unemployment is expected on average in 1985, although some improvement is expected in employment, particularly in the latter part of the year.

On the basis of the market growth and exchange rate assumptions in the current WEO exercise, the staff is projecting an increase in the current account surplus from around DM 18 billion in 1984 to almost DM 33 billion in 1985. The authorities envisage a somewhat smaller current account surplus in the region of DM 30 billion.

The staff foresees continued low inflation in 1986. It is projecting a somewhat stronger and more balanced structure of domestic demand in 1986 with the growth of consumption picking up to 2-2 1/2 percent and continued strong investment in machinery and equipment. The German representatives noted that three quarters of the tax cut at the beginning of 1986 was expected to be reflected in additional consumption within the year. They thought that the multiplier effects of the rapid growth of investment and exports in 1984 and 1985 would, by 1986, have a substantial positive effect on consumption, and that this would help to sustain the recovery in the face of a lessening contribution from the foreign balance. GNP growth is expected to remain in the 2 1/2 - 3 percent range.

Assuming a current account surplus of 2 percent of GNP during 1985 to 1990 and a growth rate of nominal GNP of 5 percent through the period, the net foreign asset position of Germany would improve from

14 percent of GNP at the end of 1984 (gold and foreign exchange reserves calculated at market values) to 21 percent of GNP at the end of 1990. If it is assumed that the current account surplus declines from 2 percent of GNP in 1985 to 1 percent of GNP during 1987 to 1990 the net foreign asset position would be 17 percent of GNP at the end of 1990.

5. Capital market policies

The mission took the opportunity of the consultation discussions to obtain the views of the German authorities on changes in the regulations governing the German capital market and its integration with the world market. In October 1984, in a move coordinated with the French Government, the German Government had authorized the ministry of Finance to table a draft bill repealing the 25 percent withholding tax on interest on securities held by nonresidents with retroactive effect from August 1. Even before this bill was passed by Parliament in December 1984, it had a significant influence on capital flows. Previously, foreign investors had exhibited a preference for foreign deutsche mark bonds or official borrowers' notes, neither of which had been subject to the withholding tax. From the latter part of 1984, the distortion in yields between foreign deutsche mark bonds and regular deutsche mark bonds had been corrected, and official borrowers' notes 1/ had declined in importance with the greater attractiveness of regular deutsche mark bonds.

New regulations on the German capital market had been issued in a Bundesbank statement and entered into force on May 1, 1985. The Bundesbank statement had replaced the "gentlemen's agreement" (in its latest version of January 1980) between the Bundesbank and the leading German banks in the field of foreign deutsche mark bonds. There were two aspects to the new agreement. First, all resident banks, including legally independent foreign-owned banks, would now be able to lead-manage issues of foreign deutsche mark bonds. The Bundesbank continued to consider it important that the market for deutsche mark bonds be based in Germany. It was assumed by the Bundesbank that German-owned banks would have reciprocal lead-management rights in the home countries of those foreign-owned banks operating in Germany.

Second, in the past the Bundesbank had resisted the introduction of various new types of instruments into the German capital market. There had been a concern that capital market paper should have clear and simple conditions, preferably with long maturities and fixed interest rates, and that money market instruments should not be traded in this market. From May 1, 1985, when the new regulations had become

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1/ Official borrowers' notes are a credit arranged between the Government and a financial institution and, while they can be negotiated two or three times, the borrower has to be informed each time ownership of the note changes. The transferability of such instruments is thus limited.

	1981	1982	1983	1984	1985 1/
		Changes in percent			
Prices and incomes					
GNP deflator	4.2	4.6	3.2	1.9	2
Consumer price index	6.3	5.3	3.3	2.4	2 1/2
Terms of trade 2/	-6.6	3.8	1.7	-2.2	-1
Average hourly earnings (industry)	7.1	5.6	3.7	3.2	4 1/2
Unit labor costs (total economy)	4.6	3.1	1.1	0.4	1 1/2
Real disposable income 3/	-0.3	-2.8	-0.5	0.8	1 1/2
Personal savings ratio	(13.5)	(12.8)	(11.3)	(11.5)	(11 1/2)
		In billions of deutsche mark			
Public finances 4/					
General government					
Expenditure	768.1	798.0	818.8	852.4	882.0
Revenue	708.6	743.3	772.5	811.5	851.8
Financial balance	-59.5	-54.8	-46.3	-40.9	-30.2
(In percent of GNP)	(-3.8)	(-3.4)	(-2.8)	(-2.3)	(-1.7)
Federal Government					
Financial balance	-37.9	-37.7	-31.9	-28.6	-25.3
(In percent of GNP)	(-2.5)	(-2.4)	(-1.9)	(-1.6)	(-1.4)
Outstanding public sector debt					
Total debt	545.6	614.8	671.7	718.2	...
(In percent of GNP)	(35.3)	(38.4)	(40.1)	(41.0)	...
Foreign debt	66.8	79.3	94.6	103.6	...
(In percent of GNP)	(4.3)	(5.0)	(5.6)	(5.9)	...
Balance of payments					
Trade balance (f.o.b./c.i.f.) 5/	28.7	53.4	47.7	53.2	65 1/2
Services balance	-14.6	-17.1	-10.2	-3.9	-5
Net private transfers	-11.7	-11.9	-11.9	-11.9	-33
Net official transfers	-14.9	-16.2	-15.1	-19.6	
Current account	-12.4	8.2	10.5	17.8	27 1/2
Long-term capital balance					
Private	-9.7	-19.1	-12.5	-12.1	...
Official	18.0	4.8	5.1	-1.4	...
Short-term capital balance 6/	1.8	9.1	-7.2	-7.3	...
Adjustment items 7/	3.6	-0.4	2.4	2.1	...
Changes in net foreign position of the Deutsche Bundesbank	1.3	2.7	-1.6	-1.0	...
Current account balance in percent of GNP	-0.8	0.5	0.6	1.0	1 1/2

1/ Based on forecasts by the German authorities, and on staff estimates.
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. The data for 1985 refer to budget figures. Public sector debt of the territorial authorities.
5/ Including supplementary trade items.
6/ Including net errors and omissions.
7/ Valuation adjustment and increase in SDR allocation.

	1981	1982	1983	1984
	In billions of deutsche mark			
Foreign reserves of the Bundesbank 1/				
Net monetary reserves	65.3	69.1	67.5	66.5
	Annual averages; changes in percent			
Monetary data				
Central bank money	4.4	4.9	7.3	4.8
Money and quasi-money (M3)	6.4	6.5	6.6	3.9
Bank lending:	9.5	7.3	6.3	6.3
Of which:				
Public authorities	10.2	13.4	7.9	3.1
Private nonbanks	9.3	5.6	5.8	7.3
	End of period; in percent			
Three month money market rate	10.8	6.6	6.5	5.8
Yield on government bonds outstanding	9.9	8.0	8.3	7.0
	Changes in percent			
Exchange rates				
US$ per DM (end of period)	-13.1	-5.1	-12.7	-13.5
US$ per DM (annual average)	-19.6	-6.9	-5.0	-10.3
MERM effective rate, (end of period)	-0.7	5.1	-3.1	-3.1
MERM effective rate, (annual average)	-7.4	4.2	2.3	-2.7
Bundesbank effective rate (end of period) 2/	1.3	6.3	-1.7	-1.4
Bundesbank effective rate (annual average)	-5.4	5.1	3.1	-1.4
Relative normalized unit labor costs (annual average)	-10.9	0.2	-1.1	-4.1

1/ End of period.

2/ The Bundesbank effective rate is a double-weighted index (using trade data for industrial goods) of the currencies of 14 industrial countries. While the MERM index attaches a weight of 25 percent to the U.S. dollar, the Bundesbank index attaches a weight of 14 percent.