

**FOR
AGENDA**

SM/04/341
Supplement 1

October 20, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Germany—Staff Report for the 2004 Article IV Consultation**

The attached supplement to the staff report for the 2004 Article IV consultation with Germany (SM/04/341, 9/29/04), which has been prepared on the basis of additional information and contains the draft background section of the Public Information Notice, is tentatively scheduled for discussion on **Monday, October 25, 2004**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Germany indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Traa (ext. 36876) and Mr. Decressin (ext. 37140) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the Caribbean Development Bank, the European Commission, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2004 Article IV Consultation

Supplementary Information

Prepared by the European Department
(In consultation with the Policy Development and Review Department)

Approved by Alessandro Leipold and Martin Fetherston

October 20, 2004

1. This supplement reports on information that has become available since the issuance of the staff report and reflects contacts with the authorities during the Annual Meetings in early October 2004 and more recently. The new information does not change the thrust of the staff appraisal.

Economic developments and outlook

2. **Monthly economic indicators show some tentative signs of firming in domestic demand but a slowing in net export growth:**

- **Retail sales** in the third quarter of 2004 were up slightly from the previous quarter, but still below activity of a year earlier. Value-added taxes in real terms also increased slightly in the third quarter.
- **Business investment** in machinery and equipment has resumed growing, albeit at a moderate pace, as profitability continues to strengthen. However, construction spending is still falling.
- **Employment** on a seasonally adjusted basis increased slightly in the last four monthly observations from May to August. However, labor supply also increased and headline unemployment has risen by 0.1 percentage point to 9.9 percent (ILO definition).
- **Manufacturing output and exports** have been closely linked and have provided the impetus behind growth this year, reflecting strong global demand for German capital goods and machinery. Orders for manufactured goods, however, have slowed somewhat in recent months, alongside export orders, from high levels earlier in the year—consistent with moderating expectations for the coming months.

- **The IFO business climate index** has declined somewhat from the first quarter of the year, reflecting an easing of the expectations component of the index, while the current business conditions component has remained stable. This development is consistent with strong orders already on the books for exporters, but with increasing concern about oil prices and the pace of global economic expansion leading into 2005. Indeed, the ZEW index of investor and analyst sentiment fell sharply in October and is at a 16-month low.

3. **The rise in oil prices will affect Germany via lower external demand growth and also as a supply shock.** Through about mid-2004, the growth impulse for Germany from the global expansion surprised on the upside. However, early indicators for the third quarter showed the emergence of some softening, and the new sharp rise in oil prices to above US\$50 a barrel (which has triggered an update of WEO baseline assumptions) is now causing a downward revision in output growth for 2005 in many trading partners—suggesting some slowing in Germany’s net export growth next year. In addition, although the appreciation of the euro had dampened considerably the rise in domestic energy prices in the early part of the year, this effect is now receding and oil prices are also rising in euro terms. Thus, the risk factor for the outlook involving oil mentioned in the staff report is now materializing.

4. **On balance, with domestic demand still fragile and export growth likely to slow, the projections for output growth have been revised downward.** Specifically, the staff projection for real GDP growth is revised from 2.0 percent to 1.9 percent for 2004; and from 1.8 to 1.5 percent for 2005 (in line with the latest consensus forecast of the main German research institutes for 2005). Even with these revisions, the growth outlook remains within the range of 1½-2 percent for 2004 and 2005 envisaged by the authorities.¹ The underlying expansion from 2004 to 2005, corrected for the number of working days, is now just under ½ percentage point of GDP, down from an estimate of ¾ percentage point in the staff report.²

5. **Inflation and wage setting continue to be moderate.** Headline inflation in the period July-September 2004 (annualized) was 1.5 percent; excluding energy it was 1.1 percent. Moreover, there has been no evidence of oil price increases spilling over into wage setting behavior so far.

Fiscal developments and outlook

6. **In early October, the authorities issued a supplement to the 2004 federal government budget, and obtained authorization to widen the borrowing requirement for 2004.** The supplementary budget reflects that tax revenue had been below original

¹ The authorities expect growth to be at the upper limit of the range in 2004, as does the staff.

² Corrected for working days, real GDP growth is projected to be 1.3 percent in 2004 and 1.7 percent in 2005.

budgetary projections, and that expenditure on unemployment benefits had been above projections, leading to a larger deficit than was embedded in the 2004 budget. These effects were already anticipated in the staff report projection of the 2004 general government deficit of 3.9 percent of GDP, which remains unaltered.

7. **The revision to the growth outlook does not alter the key fiscal policy recommendations for 2005 outlined in the staff report.** Germany needs to take the opportunity of the upswing to bring down the structural deficit and stem the rise in debt. In the staff report, the structural deficit was projected to be cut by $\frac{1}{2}$ percent of GDP in 2005 on the basis of measures already in the pipeline (implemented in the 2004 budget) and some one-time effects such as the normalization of Bundesbank profits from an unusually low level in 2004. To attain the goal of reducing the structural deficit by at least $1\frac{1}{2}$ percent of GDP over the period 2004-2006, the staff recommended adopting additional policy measures totaling about $\frac{1}{3}$ percent of GDP for 2005 before the budget is finalized. With the downward revision to growth, the overall general government deficit would then likely be 3.1 percent of GDP in 2005, reflecting the free play of automatic stabilizers.

8. **Although near-term prospects have weakened, the staff continues to believe that a structural adjustment of $\frac{3}{4}$ percentage point in 2005 is appropriate.** In assessing the tradeoffs, the staff is of the view that longer run considerations dominate the restraining effect this adjustment will have on the recovery in the short run. Further, the latest source of weakness is linked to a supply shock (oil prices) that may well be lasting. And, to the extent that the additional fiscal measures focus on corporate subsidies and tax exemptions, this would affect mainly buoyant profit income, mitigating the contractionary implications. Thus, reducing the structural deficit and bringing underlying debt dynamics under firmer control, combined with reforms to boost potential output growth, remains the priority. A clear indication that Germany is consistently tackling its long-run challenges could also have positive confidence effects. As adjustment was not pursued with sufficient vigor during the last upswing, and with 2006 being an election year, postponing the additional adjustment recommended for 2005 could lead to another missed opportunity to consolidate as the growth rate returns to potential and the economy continues to recover.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 04/..
FOR IMMEDIATE RELEASE

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Germany

On [October 25, 2004], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.¹

Background

After three years of stagnation, a cyclical recovery, driven by strong external demand, is taking hold. Profitability in nonfinancial firms has picked up and corporate balance sheets are being repaired. However, firms remain cautious with their spending plans, and a poor job market is dampening consumption demand, while high oil prices and demographic pressures affect supply. On balance, headline growth is projected to be 1.9 percent in 2004 and 1.5 percent in 2005, but after adjusting for a larger number of working days in 2004 this still implies a moderate expansion in underlying growth.

On the policy front, Germany has made important headway over the past year in addressing deep-seated structural problems. The implementation of structural reforms under Agenda 2010 is on track despite significant popular opposition. Combined with improved wage flexibility, reforms to lower reservation wages and strengthen job intermediation are making the labor market more competitive. Important progress has also been made in the areas of pension and health care reform. Further reforms will be needed to raise potential output growth and prepare for population aging.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the [October 25, 2004] Executive Board discussion based on the staff report.

The 2004 general government deficit will remain well above the Maastricht reference ratio for the third consecutive year. Cumulative tax cuts amounting to nearly 1 percent of GDP in 2004-2005 have been only partially offset by durable measures to reduce expenditure. In 2005, the fiscal deficit is projected to be reduced from its current high level partly on account of measures already agreed in connection with the 2004 budget and because of a normalization of Bundesbank profits, which were unusually low in 2004. However, given the still fragile recovery, and on current policies, the 2005 fiscal deficit is likely to remain above 3 percent of GDP.

The financial sector is recovering and updated stress tests confirm the system's resilience, but progress in market-driven restructuring has been slow. Nevertheless, the banking system is in a better position now to support the economic recovery.

Executive Board Assessment

<summing up here>

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Germany: Selected Economic Indicators

	2000	2001	2002	2003	2004 1/
Economic activity and prices	(Change in percent, unless otherwise noted)				
Real GDP	2.9	0.8	0.1	-0.1	1.9
Net exports 2/	1.0	1.6	1.9	-0.6	1.9
Domestic demand	2.0	0.2	-1.5	-0.4	-0.2
Private consumption	2.0	1.7	-0.7	0.0	0.0
Gross fixed investment	2.7	-4.2	-6.4	-2.2	-1.1
Construction investment	-2.6	-4.8	-5.8	-3.2	-1.9
Gross national saving (percent of GDP)	20.3	19.4	19.5	19.7	21.1
Gross domestic investment (percent of GDP)	21.7	20.3	18.6	17.8	17.3
Labor force 3/	41.8	42.0	42.1	42.2	41.9
Employment 3/	38.7	38.9	38.7	38.3	38.1
Standardized unemployment rate (in percent)	7.8	7.8	8.7	9.6	9.7
Unit labor costs (whole economy)	0.1	3.3	-0.4	-1.2	-0.8
GDP deflator	-0.3	1.3	1.5	1.1	1.1
Harmonized CPI index	1.4	1.9	1.3	1.1	1.8
Public finance	(In percent of GDP)				
General government balance 4/ 5/	1.3	-2.8	-3.7	-3.8	-3.9
Structural government balance	-1.6	-2.9	-2.9	-2.2	-2.4
General government gross debt 5/	60.2	59.4	60.9	63.8	65.7
Money and credit	(Change in percent over 12 months)				
Private sector credit 6/	5.8	3.2	0.9	0.0	0.2
M3 6/	-1.0	6.1	...	3.5	1.7
Interest rates	(In percent)				
Three-month money market rate 7/	4.4	4.3	3.3	2.3	2.1
Ten-year government bond yield 7/	5.3	4.8	4.8	4.1	4.0
Balance of payments	(In billions of euros, unless otherwise noted)				
Exports 8/	690.2	739.3	763.7	772.4	839.8
Imports 8/	680.1	694.1	667.4	677.5	703.8
Trade balance (percent of GDP)	2.9	4.6	6.3	6.1	7.8
Current account balance	-27.9	1.7	45.7	48.1	97.4
Current account (percent of GDP)	-1.4	0.1	2.2	2.3	4.4
Exchange rate	(Period average)				
Euro per U.S. dollar 7/	1.08	1.12	1.06	0.88	0.82
Nominal effective rate (1990=100) 9/	97.8	98.5	99.5	103.5	104.3
Real effective rate (1990=100) 9/ 10/	100.8	100.0	100.1	103.1	102.6

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.

1/ IMF staff projections, unless otherwise indicated.

2/ Contribution to GDP growth.

3/ Domestic definition on a national accounts basis; according to the new integrated system of economic accounts (ESA95).

4/ On a national accounts basis; according to the new integrated system of economic accounts (ESA95).

5/ For 2000, includes the proceeds from the sale of mobile phone licenses (UMTS) of about 2.5 percent of GDP. The proceeds are used to buy back public debt; the buy-back is phased over 2000 and 2001.

6/ From 1999 onward, data reflect Germany's *contribution to M3* in the euro area. Data for 2003 refer to May.

7/ Data for 2004 refer to September 15, 2004.

8/ Includes supplementary trade items.

9/ Data for 2004 refer to August.

10/ Based on relative normalized unit labor costs in manufacturing.