January 31, 2002
Approval: 2/6/02

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/108

10:00 a.m., October 24, 2001

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman

A. Krueger, Acting Chair and S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	
	D. Ondo Mañe
	E. Nyambal, Temporary
	K. Kpetigo, Temporary
I.E. Bennett	F. Vermaeten, Temporary
	P.H. Whitehall, Temporary
M.J. Callaghan	N.J. Davidson, Temporary
R.F. Cippà	W. Szczuka
	F. Zurbrügg, Temporary
	S. Urbinbaev, Temporary
K. Bischofberger	F. Haupt, Temporary
	H. Vittas
	F. Manno, Temporary
	D. Lombardi, Temporary
	Low K.M.
	T. May, Temporary
V.L. Kelkar	P.R.D. Prasad, Temporary
W. Kiekens	J. Prader
	S. Çakir, Temporary
	C. Josz, Temporary
O.-P. Lehmussaari	I. Kupča, Temporary
R. Quarles	M. Lundsager
	J.W. Ralyea III, Temporary
P. Duquesne	G. Bauche
	S. Boitreaud, Temporary
	M. Daïri
A.V. Mozhin	A. Lushin
	Y. Lissovolik, Temporary
	S. Vtyurina, Temporary
	O.E. Garner, Temporary
	R. Villavicencio, Temporary
	E. González-Sánchez, Temporary
	S.P. Collins
	M. Walsh, Temporary
M. Portugal	R. Junguito
	A. Maciá, Temporary
	J. Milton, Temporary
	J. Mafararikwa, Temporary
A.S. Shaalan	M.B. Chatah
	S.A. Bakhache, Temporary
	Jin Qi
	A.Y.T. Wong, Temporary
	Y.G. Yakusha
	P.A. Nijsse, Temporary
	D. Radev, Temporary
K. Yagi	T. Komatsuzaki, Temporary
	Y. Saito, Temporary
A.G. Zoccali	J.A. Costa, Temporary
	L. Ocampos, Temporary

S.J. Anjaria, Secretary and J. Prust, Acting Secretary

T. Davidson, Assistant; S. Soromenho-Ramos, Assistant; and O. Vongthieres, Assistant

Also Present

ECB: G. Grisse. IBRD: A. Banerji, Middle East and North Africa Regional Office. European I Department: M.C. Deppler, Director; S.M. Schadler, Deputy Director; R. Corker, C. Cottarelli, J. Decressin, E. Detragiache, L. Eskesen, A. Gagales, A. Jaeger, C. Klingen, L. Kodres, T. Krueger, A. Leipold, S. Thakur, A.Zanello. External Relations Department: T.C. Dawson, Director; G. Hacche, Deputy Director; D. Hawley, C. Lotze, W. Murray. Fiscal Affairs Department: S. Danninger, S.A. Symansky, D. Zakharova. International Capital Markets Department: G. Hausler, Director. Legal Department: W.E. Holder, Deputy General Counsel; H.W. Krull. Middle Eastern Department: E. Gardner, D. Grigorian, A. Jbili, K. Nashashibi, S. Williams. Monetary and Exchange Affairs Department: E.J. Frydl, M.K. Moore. Policy Development and Review Department: J. Boorman, Counsellor and Director; M. Allen, Deputy Director; M. Fetherston, R. Glennerster, A. Masood, J. Seade, M. Singh. Research Department: K. Rogoff, Economic Counsellor and Director. Secretary's Department: S. Bhatia, P. Cirillo, K. Friedman, L. Hubloue, P. Ramlogan, T. Turner-Huggins. Treasurer's Department: E. Brau, Treasurer. Western Hemisphere Department: A.M. Jul. Office of the Managing Director: A.A.E. Bertuch-Samuels, A. Bauer, S.B. Brown, R. Moghadam, R.S. Teja. Advisors to Executive Directors: I. Abel, A. Baukol, B. Couillault, S.S. Farid, A. Fidjestøl, A.R. Ismael, N. Jadhav, D.H. Kranen, M.F. Melhem, S. Rouai, K. Sakr, M.R. Shojaeddini. Assistants to Executive Directors: A.S. Al Azzaz, S. Alcaide, V. Bhaskar, G.M. Blome, J.G. Borpujari, M. Di Maio, N.H. Farhan, N. Joicey, R. Maino, R. Manivat, M. Marques, G. Nadali-Ataabadi, M.L. Nikitin, T. Skurzewski, Tong Y, Wei X.

1. INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE—PROVISIONAL AGENDA

The Executive Directors considered a draft provisional agenda for the Fourth Meeting of the International Monetary and Financial Committee (EBD/01/77, Rev. 1, 10/22/01).

The Chairman expressed his satisfaction that the IMFC meeting would take place on November 17, 2001 in Ottawa, Canada, and he thanked the Canadian authorities for offering to host the meeting. It was particularly important that, in the aftermath of the shocking events of September 11, 2001, the international community send a clear signal that it was a time for cooperation and the search for common ground. The IMFC was an inclusive body—rather than an exclusive, select body—that derived its legitimacy from its representation of the entire Fund membership. In that regard, it was important that the Committee have sufficient time to meet to consider the most pressing matters of concern to the international community. To that end, the Committee would begin with a working lunch on November 17 (after the meeting of the G-20) and continue with the meeting through the rest of the day.

Mr. Yagi made the following statement:

> We agree that the draft agenda appropriately focuses on the most pressing issued for discussion. However, under the current economic situation I strongly believe that the importance of assuring adequate liquidity for the Fund in order to maintain confidence in the international financial system cannot be overstated. It is worrying that the Fund's liquidity ratio has been falling sharply. We need to monitor closely its development to draw attention to this very important issue. We hope that you, Mr. Chairman, could point out the necessity of ensuring an adequate level of Fund liquidity in your introductory remarks for the item on policy response of the international community.
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> On item 4, my chair believes it is important for the Committee to discuss issues concerning the review of the quota and the orderly presentation in order to provide us with political guidance. Thus this item should be explicitly mentioned in footnote 5 and included in the Managing Director's statement on the report.

Mr. Daïri made the following statement:

> We welcome this discussion. We have some concern that, while this IMFC meeting was considered to be exceptional is just the venue and the restrictions on the attendance. So, we would need to have this agenda much more focused. The agenda is being widened to the point where it may be broader than a normal IMFC meeting. In this context, I would welcome some clarification about whether we want to make it exceptional in focusing on the most urgent matters or whether is it a kind of business as usual meeting.

Mr. Quarles made the following statement:

I would agree with Mr. Daïri that our understanding, and certainly our desire, is that this meeting be based on a very focused agenda, and we were pleased with what was provided here in the draft. I think Mr. Daïri must be referring to footnote 5, but our understanding is that that the central focus of the discussion is going to be item number 2 and item number 3. So, we are pleased that this is a more focused agenda than in the past. We would not want this to become a business as usual or very broad agenda, and there are a couple of things that would help that.

We were hoping, as well, that the communiqué that would be issued from this meeting would also be extremely short, sharp, and focused, which would have the advantage of perhaps someone would actually reading it, other than the NGOs. Also, there is a practice of heads of delegations submitting long statements for the record. We would encourage that either that not be done or that those statements be much shorter. We should focus on the communiqué and a much more interactive meeting, rather than on the whole secretariat process of reproducing those statements, which could dilute the focus of what we hope will be a very precise and exceptional meeting.

Mr. Shaalan made the following statement:

I certainly go along with the views expressed by Mr. Daïri and Mr. Quarles on the need to focus the agenda to current priority areas. We cannot give the impression that this is business as usual. I would agree that items 2 and 3 are, by far, the most important for now. I have one query though namely whether any thought was given to a general SDR allocation.

On combating money laundering and financial terrorism, we need to be very careful in defining the role of the Fund in its engagement in these activities. This is a broad subject and we need to know exactly what we are going to do. Most importantly, we need all countries to be committed at budget time to provide the necessary resources to carry out effectively whatever function we decide upon. There is no sense in committing ourselves to these activities without providing the sources to carry out the functions effectively.

Mr. Duquesne made the following statement:

We agree with what was said by Mr. Daïri and Mr. Quarles on the necessity of focusing the agenda. Having said that, we have in mind that, during our last discussion of the draft agenda, which took place after September 11, basically the two main issues that were supposed to be on the table were to be the global economy and globalization. I would prefer that we maintain that focus. An alternative way of doing things would be to mix point

2 and 3 because combating money laundering and financing of terrorism is also a way of strengthening the global economy. Also, the title of item 4 (the status report on the IMF reform agenda) could be changed to something like "the Fund's response to the challenges of globalization." In such a situation, in introducing the new item 2 (the policy response of the international community), the possibility of introducing a temporary oil element within the CFF, which was contained in the Managing Director's statement of October 5, could be considered in Ottawa.

On sustaining poverty reduction in low income countries, we think it would be useful for Ministers to be presented with an update concerning the completion of the financing package for the interim PRGF and also we think we would address under that item post-conflict countries matters.

On the item on combating money laundering and the financing of terrorism, let me reiterate that we are more convinced than ever that the IMF must take into full account the international standards on money laundering in its policy advice and programs, in full cooperation with the FATF. We would like also to have an update of the efforts the Fund is taking concerning offshore centers and the FATF and hedge funds.

The second topic would be the Fund's response to globalization, and of course the IMFC gathering in a more formal forum will admittedly be under great scrutiny in the current circumstances on this topic. We think that the topic has not disappeared at all from the public's concern. Indeed, since September 11, to a certain extent it is more than ever on the table, and it is impossible to imagine that it will be set aside.

Mr. Bischofberger made the following statement:

I would just like to associate myself with other speakers who expressed a clear preference for focusing the agenda on the items 2 and 3. I have some sympathy with what Mr. Duquesne said to strengthen further the agenda by focusing it on the things which are now on top, meaning strengthening the global economy and globalization. Let me just on behalf of my authorities thank the Canadian authorities, which were able to host this important meeting at short notice.

Mr. Bennett made the following statement:

I, too, support a shorter communiqué and briefer, if any, interventions, and I would like to see whether, for reasons of logistics and timing and recognizing that we only have but half a day, the communiqué can be largely if not entirely prepared in advance so that the time devoted to the communiqué changes in Ottawa is kept to the minimum. It often takes longer to write a shorter communiqué than a longer communiqué—that has certainly been my experience. The sooner we started on it to focus on exactly what we think Ministers may want to communicate, the better off we might be.

Mr. Portugal made the following statement:

Let me first associate myself with your own words opening this meeting, being pleased to have the meeting take place, and thanking the Canadian Government for being prepared to host it. I have the same views on the agenda as Mr. Daïri and Mr. Quarles. It has to be a focused meeting. The two most important items are Agenda Item 2, the state of the global economy, and the policy responses by countries and by the international community, and Agenda Item 3, which is very important, and to which we attach great importance, on the Fund's role in combating money laundering and financing terrorism.

I also agree with those that said that we need to have a sharp, short, and focused communiqué; and I agree with Mr. Bennett's suggestion that perhaps we should start discussing it in Washington before going to Ottawa. I also agree with Mr. Quarles's suggestion about having short statements for the Ministers, but we will have to agree beforehand among all of us because if it is like in previous occasions, for instance, that the statements are used to prepare the communiqué, and then some Ministers present a short statement and others present a long one, some views would not be reflected in the communiqué. I would consider that the items listed in footnote 5 are for information only, and are not intended that they appear in the communiqué. If that is the case, then we have to present views, and it would be impossible to have a short communiqué. I agree with what Mr. Quarles and Mr. Bennett have said, but we have to agree on that beforehand otherwise, if we do not know how the meeting is going to be organized, in the end everyone will be forced to present long statements.

Ms. Manno made the following statement:

We agree with the need to have a focused discussion. I want to raise a few points of clarification. I understand now we have a luncheon, and we may also have a dinner, so we have to decide also what we will address during those sessions. I agree with what Mr. Portugal said on the communiqué and on the statements of the delegation. It is very important to decide in advance if the statement should address also the other topics that are presented in the Managing Director's status report, and in this case, of course, the communiqué should reflect this.

Mr. Collins made the following statement:

I also will reiterate gratitude to the Canadian authorities for their initiative. We, too, agree with this meeting being exceptional to a degree but certainly focused, and I think that, like others, items 2 and 3 capture that. Item 3 is certainly exceptional, as we have never had a separate agenda item of that nature before. I think that proves that we are all zeroing in on what is important. However, we cannot neglect what is going on in the world economy, and that is to be captured under item 2.

I have only a few elaborations on what we would envisage being discussed under some of the bullet points in item 2.

I think the second bullet under item 2, the policy response of the international community, ought to pick up a few of the points that the Managing Director will report on under item 4 because some of those I think do require substantial discussion, not simply a report. So we will be looking at some of the main crisis prevention and crisis resolution issues, including codes and standards and the CCL, and crisis resolution including PSI. All of those I think could be grouped within the second bullet.

For the third bullet, sustaining poverty reduction in low income countries, we are keen that the discussion covers debt sustainability in HIPC Initiative countries. There has been an exceptional shock, and we need to be alive to the fact that we do need to ensure that the HIPC Initiative countries reach a sustainable debt position at the end of the process. We would have preferred some specific mention of that in one of the footnotes, but even if not, we would hope the discussion would cover that, as well as the other issues that would come up in that regard.

On the communiqué, we agree that a shorter, more focused communiqué is preferred. How short is a matter of debate, but our best intention is to make it shorter than in the past.

Mr. Portugal cautioned against adding elements to the item on strengthening the global economy, as suggested by Mr. Collins. The international community was currently facing exceptional circumstances, and the progress on the normal work of the Fund could appropriately be covered by a status report, as suggested by the proposed Agenda Item 4. There was no pending issue related to the normal work of the Fund on which ministerial decision was required at the current juncture.

Mr. Collins clarified that the issues covered in footnote 5—such as private sector involvement in crisis prevention and resolution—referred to matters integral to the international response to the global slowdown. Indeed, the current exceptional circumstances appeared to require progress on issues at the heart of the work of the Fund. Such important issues, while not requiring active ministerial decisions, should be reflected in the communiqué.

Mr. Daïri stressed that the Committee should focus on the most urgent issues, and that all other issues could be referred to in the spring meeting. The Ottawa meeting was exceptional, and the reduced size of delegations presented a governance and public perception problem to the Fund. Although it was for understandable reasons, the restricted attendance by delegations negatively affected the ability of multi-country constituencies to be appropriately represented.

Mr. Quarles said that he disagreed with Mr. Collins's suggestions of broadening the scope of the agenda by having a substantive discussion on such issues as private sector involvement and the CCL. Although such issues were important, there were no matters that required ministerial consideration and decision, and the issues could be handled in the context of the proposed report for the information of Ministers. The current meeting needed to focus clearly on the most pressing issues currently facing the international community. In that context, items 2 and 3 should not be combined and treated as a single item, as suggested by Messrs. Duquesne and Bischofberger. As Mr. Shaalan and some others had pointed out, item 3 on combating money laundering and the financing of terrorism represented a different type of matter than the Fund would focus normally. It was therefore important that a separate substantive discussion take place. On another matter, it was far too early to have Ministers consider the issue of a general SDR allocation or other quota matters, as suggested by Mr. Yagi.

Mr. Duquesne considered that the issue of combating money laundering and the financing of terrorism was first an economic question, and not only one that required political guidance. Thus, the issue was a central part of attempts to strengthen the global economy. On the issue of globalization, perhaps Ministers could have a discussion during the lunch or dinner. The matter remained important, despite the tragic events of September 11, and there were likely to be public demonstrations in Ottawa against globalization. Therefore, there needed to be some consideration of the costs and benefits of globalization.

Mr. Lehmussaari made the following statement:

> I would also like to thank the Canadian authorities for arranging this meeting, and I agree with Mr. Daïri and Mr. Quarles that we should put most of the focus on items 2 and 3. I also think that we should keep them separate.
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> On Mr. Shaalan's point on an SDR allocation, I would recall that there is the principle that we should discuss these issues in the Board before we take them up to the IMFC. Such a discussion has not yet taken place and it will not take place before the upcoming IMFC meeting, so I would be reluctant to pick it up in this occasion.
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> Also, expanding footnote 5 for all the issues that we have been recently discussing, which is basically some of the issues that are still in a very early stage, I would be reluctant to include those issues, and in particular I think Mr. Yagi's proposal to take into this quota a review discussion into this meeting, it would be quite early. We just had a long discussion on quota formula, and as far as I am concerned, there was some progress, but there is

still a long way to go, and I do not know what we can really say to the Ministers at this point.

Mr. Daïri considered that it was extremely important that the communiqué reflect a unified and strong view of the international community. Therefore, all divisive and unsettled issues should be set aside for the time being.

The Chairman agreed with Mr. Daïri that, in order to combine a short, sharp communiqué with a focused discussion, the agenda should be streamlined to focus on matters where there can be full agreement. In that regard, there was not yet agreement on the matters of a general SDR allocation or a revision of the quota formula.

Mr. Low made the following statement:

> I also join other colleagues in thanking the Canadian authorities for offering to hold the meeting on such short notice, and I can also agree with what Mr. Daïri and Mr. Quarles mentioned about streamlining or focusing the agenda. As we all know, this is an exceptional circumstance, and the discussion should be quite focused on items 2 and 3 as the most important. Given the short time that we have, I do not think we have sufficient time to discuss all the other issues, and similarly, the communiqué should be also very short and focused on these two most important issues. So, as far as the items in footnote 5, I think if the status report is going to be issued as a report for information, it can be left as that. I do not think we need to bring it to the agenda, because once you have it in the agenda you cannot escape some Ministers referring to them. I agree totally that we should be much more focused in this regard.

Mr. Kelkar made the following statement:

> Like my colleagues, I want to thank the Canadian authorities for agreeing to host this meeting. This will help the international community, as you mentioned, Mr. Chairman, to formulate their responses. Like Mr. Daïri and Mr. Quarles, I also agree that the meeting should be focused and restricted to only item 2 and 3. In order to ensure that the communiqué is short and the statements are shorter, I think we should perhaps even delete agenda item 4, because as soon as it is on the agenda it will get statements, and the meeting will get longer. I think we should have the agenda only on items 2 and 3.

Mr. Collins said that he would be strongly opposed to dropping item 4. It was important to take stock—even briefly—of the progress of the Fund’s work since the last IMFC meeting. Clearly, Ministers may wish to include in their comments on the item on strengthening the global economy any of the elements that could be included in the status report dealt with under item 4.

Mr. Portugal suggested a possible compromise between the suggestion to delete Agenda Item 4 and the suggestion to have ministerial comments on the item. The item could remain, but Ministers would undertake not to comment on the elements contained in footnote 5. A second option could be to delete the item from the agenda. A third option could be to ignore, for the purposes of the communiqué, any comments on the status report on the IMF reform agenda. Clearly, if one Minister refers to the item, then others could be inclined to offer their own comments in order to have the views reflected in the communiqué.

Mr. Collins reiterated that the issues under item 4 were integrally important to the policy response of the international community to the slowdown in global growth, and they should be open for comment by Ministers.

Mr. Ondo Mañe made the following statement:

> I welcome this discussion, and like other Directors, I would like to thank the Canadian authorities for hosting this meeting. We are agreed that the discussion should be focused, we agree with Mr. Duquesne on the reform for the item 2 and 3, we welcome the emphasis placed on the sustainability of poverty reduction in low income countries, including post-conflict countries. The issue of debt sustainability should also be addressed in discussing poverty reduction issues. The impact of the recent events on developing countries and other countries should be also addressed in our discussion.
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> Finally, I would like to agree with Mr. Daïri on the particular organizational problem of multi-country constituencies regarding how to get clear to take some decision. If we try to include in the next meeting all the discussions, we still have the difficulty, for example, of the African group to approve, for example, the statement that will be addressed to the Managing Director and to the President of the World Bank. We have normal difficulty to meet with our authorities on that issue, so we will strongly recommend the Board to be more focused on the items that all the members agree and they are aware to discuss in this statement, particularly because in this particular circumstance we did not follow the processes that our constituencies use to make and to take the decision.

Mr. Al-Turki made the following statement:

> I join others in thanking the Canadian authorities for hosting this meeting in these exceptional circumstances. On the agenda, I agree that it should be focused on what we can do meaningfully under these circumstances, and in this regard I agree with Mr. Daïri that the agenda should focus exclusively on items 2 and 3. With regard to the communiqué, I support the call by Mr. Bennett to start discussing it in Washington before we go to Ottawa.

Mr. Zoccali made the following statement:

I join other colleagues in thanking the Canadian authorities for having taken on the difficult task of having the views of the international community clearly expressed at this critical juncture. Having said this, I agree with all those that have said that this is not business as usual. The up side of this is perhaps that the seed has been sown for a more effective process following these tragic events, but I think we must be focused, and this focus in our view must be on the outlook and the risks that are presently affecting the world economy. If the present downturn is not arrested, we might very well have to be thinking out of the box as we go forward. Consequently, points 2 and 3 of the agenda should be focused on narrowly.

If the issue of globalization raised by Mr. Duquesne is to be discussed, perhaps this might be done in an informal manner by our ministers during the dinner. In order, to focus however, we should agree on what Mr. Portugal has suggested, namely the items that Ministers´ statements should cover and to further help that process, also on a maximum length of the communiqué, perhaps one or a maximum two pages to require us to maintain that focus. In that regard, I would agree with the suggestion that Mr. Bennett has put forth, that we start the discussion of the communiqué here in Washington.

Mr. Cippà made the following statement:

Let me also thank the Canadian authorities for organizing this meeting on a short notice. On the content of the agenda, I agree with others that this is an exceptional meeting and we should try to focus on these two items, strengthening the global economy and combating money laundering. On this issue about what kind of discussion should we have regarding policy response, I think I sympathize with Mr. Collins; I do not think that we should forget what is contained in footnote 5. After all, this comes under the heading resolution of crisis and prevention of crisis, so basically our policy response can, of course, incorporate some exceptional measures, but should also be based on its major part, on the work that has been done in the last six months.

My final point is that we should probably also discuss a little bit more on the format of the discussion. Will the discussion be the same as in the past or since it is an exceptional meeting should we just envisage some changes in the format of the discussion, too?

Mr. Kiekens made the following statement:

The draft agenda is for me perfect, as it is a good compromise. What we need is an operational understanding among ourselves on what it in fact means, and I have the following proposals in this regard. I think we should have an understanding among ourselves that we will not induce our Ministers to go in any lengthy technical discussion of item 4.

Second, of course the IMF is part of the policy response, and so when Ministers have a point on how the Fund should react in the coming weeks and months, that should be dealt with under bullet point 2 to the policy response of the international community and of course point 3, sustaining poverty reduction.

So I insist on having a clear understanding. Mr. Portugal raised it, and I reiterate it. We should have an operational understanding that we discuss Fund technical business only to the extent that it is part and parcel of the policy response for the whole economy and for poverty reduction.

The communiqué should be outstanding, and it should be prepared carefully by our staff, but experience shows that starting to discuss it early only lengthens the time, so my frank advice is we must have an outstanding draft in the pockets of the Secretary, and we discuss it in Ottawa. In that draft communiqué, we should also make it clear that globalization is not forgotten. Item 2 sufficiently covers the issues of globalization, and we must deal with that in the communiqué.

My last point is that we should also be very clear among ourselves that this focused meeting and focused communiqué will not harm our work program for the next six months. We should not suffer from that, and I think we can also agree that we know what to do and that if we need guidance from our Ministers, we are in daily contact with them in order to know what we should do in the next six months for the ongoing business of the Fund.

Mr. Callaghan made the following statement:

I agree with nearly everything that Mr. Quarles said. This is a special meeting, and I even like the idea of having the headings of the topics on the agenda reflecting the fact that it is a special meeting. Mr. Duquesne raised the issue of globalization. The great fear I have with that is I do not know what can be covered. It will open up the agenda even more, and move away from keeping it very focused.

On the world economic outlook, I think that Mr. Rogoff had indicated earlier that if there were to be an IMFC meeting, he would be doing some preliminary updates. I know he had indicated that there would be an interim *WEO* in December, but are we going to see any updates before Ottawa?

There are also a number of other procedural matters, such as when will the presentation by the Economic Counsellor take place? Will it be at lunch or afterwards? These types of things need to be sorted out.

Mr. Mozhin made the following statement:

Like others, I am grateful to the Canadian authorities, and I also share the main sentiment around the table that we need to have a very focused meeting, not business as usual type of meeting. The real question is how do we achieve this objective. In listening to my colleagues, I have a sense that, of course, there are many important issues under the Fund mandate, and everyone has his own priorities and rankings of these issues, so it is not clear to me, indeed, what is going to be the focus of this meeting. A number of speakers suggested that perhaps the way to achieve a focused meeting would be by working on the communiqué early. I agree with Mr. Kiekens that this has to be a very good communiqué. We have to think what is the message at this critical stage the Fund is willing to send to the outside world. So I see many reasons to begin discussing the communiqué as early as we can.

Mr. Villavicencio made the following statement:

We want to thank the Canadian authorities for hosting the IMFC meeting. We agree that in these exceptional circumstances we need to have a more focused agenda, as other Directors said. We think that there are many issues to discuss which are considered in items 2 and 3. The emphasis on the global economy and the policy response is adequate. On issue number 3, this chair always has supported all efforts to combat financial abuse, and we certainly agree that financial terrorism is another form of abuse that needs to be addressed by the international community. However, we think that it is important for the Board to have more information on what will be the Fund's role in this area before informing the IMFC.

On point number 4, we actually side with Mr. Kiekens' remarks, and on the final communiqué we agree with the proposal to begin discussing the draft in Washington.

Ms. Jin made the following statement:

First of all, I would like to join others to thank the Canadian authorities for hosting this meeting. Second, I would like to associate myself with other Directors for having a focused agenda for this meeting. Since this meeting is such a special one, we have a focused agenda, we have a restricted number of delegation members, maybe we should have something reflected in the communiqué to mention that this is a special meeting, in that case we do not harm the formality and functioning of future meetings.

Mr. Yakusha made the following statement:

Like others, we support a more focused agenda, and we, as a multi-constituency chair, are especially sensitive to restrictions which are probably

> necessary, but given this restrictive attendance, we think it would not be entirely appropriate to discuss the whole spectrum of the issues related to the reform of the Fund. We should not create the impression that part of the members are left out of the context of those discussions, so we are very much in favor of a focused agenda and of discussing the communiqué in advance in Washington.

The Chairman noted the unanimous praise for the Canadian authorities' offer to host the upcoming meeting. The IMFC, as well as the joint Fund-Bank Development Committee, represented, at a high political level, the international community. It was essential to demonstrate that the Fund, with its universal membership, was able to act successfully as the machinery for international cooperation. Indeed, the urgency of the current situation made the search for common ground all the more important. To that end, Directors had underscored the need to have a focused meeting, so that a strong message of solidarity among the international community could be communicated to the public. However, the meeting of the G-20 Ministers immediately preceding the IMFC meeting might detract from such a focus. The Chairman asked Mr. Bennett for an outline of the intended discussion of the G-20.

Mr. Bennett replied that, inevitably, there would be some overlap among the issues covered by the G-20 and the IMFC. Clearly, the G-20 would spend less time on the world economic outlook, given that the IMFC was to meet immediately following the G-20 meeting. The G-20 deputies were meeting in Toronto, and they would discuss the agenda. He would circulate to the Board, through the Secretary, the draft agenda of the G-20. He agreed that it would be useful to be informed of the agendas of the meetings of the various groupings.

The Chairman reiterated the importance of enhancing the unity of the international community through clarifying its purpose with a single message, which was strengthening the global economy and combating money laundering and the financing of terrorism. The body that delivers that message should be representative of the entire international community, and not a self-selected group of countries. It would be regrettable if there were to be a variety of political messages emanating from different groupings of countries. In that regard, it was important to consider how a body like the G-20, which was a forum for informal discussion, rather than an organization, could support the common aims of the international community.

There appeared to be full support that the upcoming IMFC meeting should be focused, which meant that it could not be treated in a business-as-usual manner, the Chairman continued. That meant that the focus should not be on unresolved issues or issues that required further consideration. For example, it was not the moment to dwell on the issue of a possible quota increase; rather, the focus must remain on demonstrating the common will of the international community to counteract the slowing global economy and fight against financial abuse. However, Mr. Collins's broader points should not be forgotten. Indeed, the Chairman said that his intention had been to provide a stocktaking to the Committee of the developments since his October 5 statement that had been sent to Governors. For example, that morning, he had had a video conference with the heads of the other international financial institutions, where it had been revealed that requests from members for additional financing had been surprisingly muted. The suggestion was of an incorrect perception in some quarters of an international economy facing a severe crisis that needed a radical response. A more appropriate response appeared to be carefully reviewing the situation on a country-by-country basis. In that regard, the Fund's liquidity position appeared to be sufficient to cope with the current challenges. However, if the performance of the global economy worsened, then other options might need to be considered, including an SDR allocation. In the current circumstances, however, the consideration of an SDR allocation might be counterproductive, as that could give the impression that the provision of liquidity was more important than appropriate policy responses.

The IMFC meeting could begin with a presentation by the Economic Counsellor on the prospects of the global economy in the aftermath of the September 11 attacks, the Chairman considered. This would not be a comprehensive World Economic Outlook (WEO) exercise, as an interim *WEO* was planned for December. However, a tentative assessment could be presented—albeit with considerable uncertainty. The aim would be to provide an opportunity for an exchange of views, so as to demonstrate the political will of the international community to stand on common ground and to show that policy actions were being undertaken. In that regard, he would remind Ministers from the advanced economies that they had a particular responsibility to strengthen the global economy, and he would call on them to outline their intended policy response. As global growth depended crucially on the developments in the advanced economies, they faced a special challenge to sustain and strengthen global growth.

He would agree with Mr. Collins and others that it was very important to sustain poverty reduction in low-income countries, the Chairman remarked. The challenge was all the more critical in the context of the global growth slowdown. In that regard, a decision was made at the morning meeting among the heads of international financial institutions. They concluded that an extraordinary meeting of the joint Fund-Bank implementation committee on the HIPC Initiative was needed to assess the current status and provide an update to Ministers.

On combating money laundering and the financing of terrorism, a task force had been established, and a report would be presented for Board consideration, the Chairman stated. The Board meeting would determine the kind of message sent to the IMFC.

The status report on the IMF reform agenda had been intended to update Ministers on the progress in areas such as involving the private sector in crisis prevention and resolution, the Chairman informed. It was also important to clarify that the events of September 11 would not impede progress by the Fund in a wide variety of areas. However, he suggested with the apparent backing of most Directors that the Ministers should not select the topics. Clearly, Ministers could raise any issue they wished, but it was important to maintain the focus of the meeting on the items of strengthening the global economy and combating money laundering and the financing of terrorism.

On the issue of globalization, before September 11, he had intended to have the matter on the agenda, the Chairman said. However, he would not advise that globalization be at the center of the upcoming discussions, as that might undermine the focus of the agenda. Also, it was important not to give the impression to the public that the attacks of September 11 were a direct consequence of globalization—and perhaps one of the downsides of globalization.

Mr. Duquesne considered that there was no risk of sowing public confusion between the outcomes of globalization and terrorism. The events of September 11 did not dispel the concerns among the public about globalization, and the Fund should not appear to change its agenda because of the terrorist attacks. Perhaps Ministers could discuss globalization at the dinner.

Mr. Daïri said that, on the issue of globalization, it was important to stress that globalization was not only about markets, but also about people. There needed to be a consideration of social conditions—especially poverty—by the international community so that this human dimension be fully integrated into the various aspects of globalization.

The Chairman said that he agreed with Mr. Daïri's views.

Mr. Callaghan asked whether the topics covered by the status report on IMF reform agenda would be detailed in the communiqué.

The Chairman replied that that the Board would need to decide the matter, but that he would suggest a short and focused communiqué. Based on his own personal experience, he would caution against an overly-predetermined procedure to prepare the communiqué. It would be preferable for Ministers to exchange views, and then the communiqué could be based on that discussion. The preparatory process should outline the main messages of the communiqué. However, an extensive drafting of the communiqué before the meeting might inhibit a truly interactive exchange of views. It should be left to Ministers to determine the specific outcome of their discussions.

Mr. Shaalan shared the Chairman's views on avoiding a situation in which the communiqué was already drafted before the Ministers met.

The Secretary stated that Directors' views would be considered carefully in determining the process and procedures relating to the organization of the IMFC meeting. The next step would be to consult with the Chairman of the IMFC. After that consultation, Directors and IMFC members would be informed about the details on how the meeting would unfold.

An assessment of the post-September 11 economic situation would be provided by the Economic Counsellor to the Board in the context of the WEMD session on November 9, the Secretary informed. The issue of a general SDR allocation would be considered by the Board on December 10 on the basis of a staff paper.

On the communiqué drafting process, it was clear that the IMFC had a unique and substantive communiqué, the Secretary considered. The drafting process had been constantly monitored, with a view to improving the process on an ongoing basis. Indeed, improvements had been made, and would continue to be made. His own view was that the Ottawa meeting was exceptional, and that Directors and IMFC members wished to see a short, focused communiqué. However, there had been a variety of suggestions on the drafting process—ranging from starting the process early to drafting the communiqué at the last moment. A compromise between those two points would be found.

In response to a question from Mr. Shaalan, the Secretary said, that after consulting with the Chairman of the IMFC, Directors would be informed about the format of the discussions and the items that the statements should cover.

Mr. Kiekens considered that, as the IMFC would have a short, focused communiqué, it would be regrettable to see several other communiqués from other groupings that could undermine the message of the international community. Specifically, the G-20 should not use a draft of the IMFC communiqué as the basis for their own communiqué. Similarly, the text of the G-20 communiqué (which would be issued before the IMFC meeting) should not be imposed on the IMFC. Indeed, he would suggest that the G-20 communiqué be discreet and not enter in any detail into the issues on the IMFC agenda. A good model would be the communiqué of the G-10, which always dealt with precise technical points.

Mr. Daïri agreed with the suggestion made by Messrs. Shaalan and Portugal on limiting the items that would be reflected in the communiqué. Perhaps that point could be discussed with the IMFC Chairman. Also, on the item on the status of IMF reforms, the Managing Director could circulate his remarks, rather than making introductory remarks. Otherwise, ministers may wish to react to the remarks during the meeting.

The Chairman said that Mr. Daïri's suggestion was constructive. Perhaps his introductory remarks could be circulated, and no discussion would take place at the meeting.

On Mr. Kiekens's suggestion to the G-20, the Chairman suggested that the points be considered carefully. It was important not to divert energy toward an unhealthy competition among groups. Rather, there was a need to demonstrate clearly the common ground of the international community. It was a matter of some concern that the IMFC meetings were not taking place as usual in Washington, D.C. For instance, it was unclear whether the G-24 would meet, as the group was not able to meet in Ottawa. It would be most regrettable if there was an impression that the lower-income countries were less represented at the upcoming meetings. The message should be that all countries—including the lower-income countries—were appropriately represented at the IMFC meetings. In that regard, the G-20 should be careful to avoid giving such an impression in its communiqué.

Mr. Bennett clarified that the goals of the G-20 were similar to those of the IMFC, and there was no intention to be in competition with the IMFC. The G-20 had tried to be helpful to the IMFC, so there should be no impression that the G-20 would undermine the IMFC. Indeed, the back-to-back meetings of the G-20, the IMFC, and the Development

Committee should provide a clear message of unity in terms of a common approach to the pressing problems facing the international community.

The Chairman, in concluding the meeting, said that, after consulting with the IMFC Chairman, the Board would be informed about the agenda and the precise preparations. The provisional agenda would be circulated soon to Directors.

2. GERMANY—2001 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for 2001 Article IV consultation with Germany (SM/01/290, 9/25/01; Sup. 1, 10/22/01; Cor. 1, 10/23/01). They also had before them a background paper on selected issues in four euro-area countries—France, Germany, Italy and Spain (SM/01/307, 10/5/01; Sup. 1, 10/5/01).

Mr. Bischofberger submitted the following statement:

> Although Germany has experienced an unexpected and significant slowdown of economic growth, my authorities are staying on their path of achieving budgetary balance in the medium-term and are continuing with structural reforms to increase potential growth. This will ensure that Germany can continue to meet the dual goals of completing its reunification and playing its appropriate economic role in Europe and in the World.
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> Although the economic prospects have worsened, the economic downturn in Germany, which started in the second half of last year, came unexpectedly, especially after the strong GDP growth in late 1999 and the first half of last year, which led to an annual growth rate of 3 percent in 2000. With the benefit of hindsight, it was fortunate that the first stage of the tax reform was put into effect at the beginning of this year since it generated -- as a welcome byproduct -- a significant fiscal stimulus of over 1 percent of GDP.
>
> The staff's growth projections for Germany for 2001 and 2002 have been revised downward several times this year. The heightened uncertainties in the aftermath of the events of September 11 have made reliable forecasts even more difficult. However, since oil prices have come down recently and animal disease-related problems in the food sector are disappearing, inflationary pressures have abated significantly. While this clearly improves the economic outlook, some current indicators point to the opposite direction.
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> Fiscal policy in Germany is medium-term oriented and geared towards eliminating the deficit of the general government. As outlined in the Stability Program, the deficit will be reduced over the course of several years until a balanced budget is reached. Under current assumptions, my authorities expect to eliminate the deficit of the general government in 2004 and achieve a balanced Federal budget in 2006. German fiscal policy aims at providing a framework of stability, predictability, and dependability. This is all the more

important during these times of heightened uncertainty. The salient characteristic of the exacerbation of the on-going worldwide economic downturn by the events of September 11 is a sharp increase in uncertainty. This additional uncertainty stems from non-economic factors, which have further eroded consumer and business confidence, as apparent in the sharp drop of the IFO-business climate indicator published last Friday. Once these factors cease, the economic situation will improve. Therefore, and taking also into account the well known lags of fiscal policy, "proactive" fiscal measures may do more harm than good. More generally, the costs of diminished credibility due to missed deficit targets resulting from discretionary fiscal action must be carefully weighed against the uncertain counter-cyclical benefits of such measures.

The Stability and Growth Pact (SGP) is the key instrument in achieving and maintaining fiscal sustainability in Europe. Moreover, the SGP is underpinning the credibility of the Euro as the common European currency, especially in the run-up to the introduction of the Euro bills and coins at the beginning of next year. The staff supports the medium-term goals of the SGP, but advocates expenditure ceilings rather than deficit targets as an efficient means in achieving these goals. Expenditure ceilings are -- and have been traditionally -- one of the core elements of the German budgetary process. They are instrumental in achieving consolidation goals. However, they are not a substitute for a medium-term consolidation strategy as outlined in the yearly updated Stability Program. In response to the current economic downturn, my authorities let the stabilizers work fully on the revenue side. However, on the expenditure side, in line with the broad economic guidelines, they try to compensate at least some of the higher spending by very tight budget execution, i.e., by identifying any slack within existing expenditure ceilings and redirecting these resources towards the higher spending due to cyclical developments.

Since the beginning of this year the first stage of a comprehensive tax reform has been in place. It has been praised by national and international observers as a key instrument in improving Germany's attractiveness to international investors and as a means of improving the potential growth path. At the completion of the reform—the second stage begins in 2003, and the third and final stage begins in 2005—the top marginal tax rate will have been lowered from 53 percent to 42 percent and the lowest rate from 25.9 percent to 15 percent. The corporate tax rate has already been cut to 25 percent. With this reform, Germany has left the group of countries with relatively high income and business tax rates.

Last year's discussions revealed widespread apprehensions concerning the pro-cyclical impact of the tax reform in Germany. In fact, the opposite has come true, not only for Germany but also for the United States, where tax reform plans were also implemented despite warnings of a possible procyclical impact. One important conclusion can be drawn from this experience: tax reforms should not be perceived as a means of fine-tuning the economy. They usually cannot be synchronized with the business cycle. This is due to the length of legislative procedures and the electoral cycle. The window of sufficient political support may be open only for a short time. We should therefore focus our analysis of tax reforms on their structural impact and their capability to enhance the medium-term growth prospects rather than on trying to determine the implications with regard to perceived cyclical needs.

In addition to the tax reform, Germany has made important progress in modernizing its framework for economic activity since the last Article IV discussion. Over the last 12 months, important reform packages, where progress had been stalled for several years, were put into effect.

The liberalization of product markets has remained at the center of structural policy. The rewards of the progress made in opening the telecommunications and energy markets are clearly visible in high quality service and lower prices. The OECD acknowledges that "considerable progress has been made in liberalizing network industries." Yet, the agenda remains unfinished and further reforms are envisaged, including in the railway sector, the postal service, and the telecommunications sector with respect to local calls.

The pension reform—enacted at the beginning of this year—represents a large stride forward in limiting the fiscal impact of an ageing population. The major new element for the German pension system is the inclusion of a non-mandatory private component, partly replacing the existing pay-as-you-go system. As a result it will reduce the burden of future generations and minimize the unavoidable reduction of pension increases, thereby assuring the financial sustainability of the system. The privately funded component is being subsidized on the basis of individual choice either through cash transfers or tax allowances up to a certain amount.

The recent slowdown of economic activity in Germany took its toll on the German labor market with the typical time lag. The strong development of employment in the last three years came to an end at the beginning of this year. Despite the progress achieved in the past, labor market rigidities undoubtedly remain one of the most intractable structural problems, with a negative impact on potential growth. However, as acknowledged in the background papers, legislative regulation of the German labor market is less restrictive than in most other large EU countries. Moreover, the relative scope of the problems of the German labor market has to be put into perspective by comparing the German unemployment rate with the rate of other large EU countries. Nevertheless, the situation of the German labor market remains difficult, and the relatively high unemployment rates among low-skilled workers are of particular concern in this context. To tackle this problem, the staff recommends, above all, promoting greater wage differentiation. This is seen as a necessary adjunct to the across-the-board wage moderation, which the German wage bargaining system has produced. Although this is a valid point, wage differentiation may have made more progress in recent years than it is sometimes realized. There are a great number of different wage agreements in the economy, which provide considerable wage differentiation across branches, regions, and skills. Furthermore, the wages of the low-skilled have not been overproportionally raised for more than a decade. When trying to explain the relatively high unemployment rate of low-skilled workers, one should not solely look at wage costs, but also at structural factors. The number of low-skilled jobs has decreased considerably in Germany for quite some time due to technological progress, while the number of low-skilled workers has remained roughly constant. The disappointing results of pilot schemes to subsidize non-wage costs of the low-skilled as an incentive for job creation could also indicate that costs are not the only factor here and that other counter-measures, including additional training, are required to solve this protracted problem.

Although the structural reform agenda remains unfinished, it is worth mentioning that the consensual decision-making process in Germany, which sometimes slows down the modernization process, has also led to a smooth and steadfast reform pace accompanied by a high degree of social peace and moderate wage settlements. The OECD, for example, acknowledges in its last Economic Survey that the Alliance of Jobs "has succeeded in reaching a broad understanding to promote employment, and in particular contributed to limiting the adverse impact on job creation of the recent oil price shocks." The social security net in Germany is still one of the most sophisticated in the world. Medical healthcare coverage is universal, without "waiting lists" or exclusions for poorer patients. Education up to and including a university degree is free, with income supplements if necessary. Unemployment and social assistance payments are generous and there is no such group as the working poor. One job is generally sufficient to support a whole family. Although my authorities agree that there is always a need for adjustment and modernization, they assess that, in general, the social security system is an asset rather than a problem.

The fight against terrorism is of utmost importance for the German government. Abuses of the financial system in order to support terrorist activity must be eliminated. Even though Germany has an excellent track record in combating money laundering, the government has recently, in close cooperation with other industrial countries, presented a comprehensive set of additional measures aimed at strengthening the existing regulations even further and at closing still existing loopholes. In order to counter the financing of terrorism, a package of measures is to be introduced within the framework of a Fourth Financial Market Promotion Act. One prominent measure is the installation of a bank account information exchange as a central database at the Federal Banking Supervisory Office (FBSO), in which banks will be required to post information on all bank and securities accounts held in Germany, in order to reveal money flows in support of terrorism. Credit institutions will be required to set up adequate internal systems to protect against money laundering and money flows for terrorism. This will allow business transactions to be screened for risk groups and conspicuous features. Another important measure is the setting up of an administrative Central Financial Intelligence Unit at the FBSO following the international standard to collect and analyze suspicious transaction reports in one body. In addition, the fight against money laundering will be further strengthened by employing additional manpower. Also, on September 19, the German government approved a comprehensive anti-terrorist package, with a volume of DM 3 billion per year. These additional expenditures are aimed at improving external and internal security and strengthening anti-terrorist activities. The additional expenditures will not interfere with the medium-term consolidation strategy. The tax on cigarettes and the General Insurance Tax will be raised next year in order to generate the needed additional revenue of DM 3 billion per year.

Despite all the current problems and challenges the German economy is facing in the short and medium-term, the major task remains the completion of the reunification of the former western and eastern parts of Germany. It has become more and more apparent that the integration of 18 million people and the transition of a state-planned economy to the economic level of former West Germany is a task for a generation rather than for a decade. Although the achievements so far are impressive, there is still a sizeable productivity gap between the West and the East and unemployment in the East is twice as high as in the former Western part. Massive West-East transfers of roughly 5 percent of GDP per year are still needed to foster the catching-up process. The reunification related requirements might have contributed to Germany's unsatisfactory growth performance over the last decade. However, my authorities perceive the reunification as a challenge that they happily accept.

Moreover, Germany continues to fulfill its specific responsibilities towards Europe and the World. The bulk of the net budgetary resources of the EU are provided by Germany. According to a study of the OECD, Germany has supported the transition process in Middle and Eastern Europe and the former Soviet Union by US$ 47.5 billion between 1990 and 1999. This is more than half of the total amount (US$ 90.9 billion) provided by G7-countries for this purpose. In addition, Germany's ODA share of GDP is above the average level of OECD countries and Germany has played a leading role not only in enhancing but also in financing the HIPC-Initiative.

Mr. Wijnholds submitted the following statement:

It is not an easy task to add to the policy advice that the German government already receives. Minister Eichel is in the comfortable position of being advised on a regular basis by a total of six leading economic institutes. Unfortunately, their latest message paints a somewhat bleak economic picture, which was presented by several newspapers under the headline “On the edge of a recession”. Although it will have to be seen if the recent deep fall of the IFO-confidence indicator was just an incident or a warning for even more serious problems ahead, it is clear that the German economy has not yet regained its full strength and important policy decisions still have to be taken. I think that it was under former Chancellor Kohl that the word ‘umdenken’ (changing mindsets) became fashionable. And I think that especially with regard to the labor market, a lot of ‘umdenken’ still needs to be done.

Fiscal policy

With regard to fiscal policy, I support the German authorities in adhering to the fiscal path set out in the Stability Program. Moreover, I agree with the authorities that adhering to the existing European budgetary framework, despite the worsening of economic conditions, is preferable to allowing automatic stabilizers to work freely and fully. The latter would require a fiscal position that is balanced or in surplus, a situation not yet achieved. Fiscal slippage at this stage would risk undermining credibility. Therefore, I do not agree with the staff that the focus should be turned towards expenditure targets only. Policies that only focus on maintaining expenditure targets, could in the current situation result in potentially large fluctuations in deficit levels and lengthen the process towards attaining a sound government balance, which is close to balance or in surplus.

In this context, I also have reservations regarding the suggestion of the staff to accelerate the tax reductions planned for 2003 in case of less favorable economic developments. The negative effects on the general deficit will effectively constitute a postponement of the much-needed fiscal consolidation. Moreover, such hasty actions increase the risk of design flaws. This is especially true because to date little is known about the economic impact of the current tax reform. Bringing forward the tax reforms planned for 2003 will therefore limit the scope for benefiting from lessons of the previous tax reform measures. Furthermore, structural fiscal policies are ill suited to function as a fine-tuning device, given the various lags involved in their implementation.

Structural policies

With the tax reform, I have come to what should be the main part of the German policy effort: the structural reforms. Apart from the tax reform, I welcome the renewed pension legislation, which resulted in the introduction of an industry-wide private pension scheme in the metal industry in September. This new pension law is an important step in making the German economy resilient in times of demographic change.

Labor market

An area where major structural reforms still have to be initiated is the labor market. In paragraph 33 of the staff report, the staff notes that recent legislative and regulatory changes have been seen in markets as moves towards increased legislation. Contrary to what the staff suggests, I think that increasing the possibilities for part time work will increase the flexibility of the labor market. Experience in the Netherlands shows that labor market participation could increase by promoting part time work, while at the same time changes in the number of hours worked can be more easily absorbed within the existing labor force if the share of part time workers is larger. However, the proposals mentioned to limit public contracts to firms that remunerate employees in accordance with local collective bargaining agreements, is a clear case for concern. This not only undesirably limits competition for public contracts; it might even violate European procurement rules.

When looking at the regional unemployment figures in Germany, it becomes clear that there are large regional differences. While in September of this year unemployment in Bavaria and Baden-Württemberg was only 4.9 percent of the labor force, which might be close to full employment, unemployment in Mecklenburg-Vorpommern amounted to 17.5 percent and in Sachsen-Anhalt even 18.8 percent of the labor force. Even when we only look at the western states, there is a large difference between the 4.9 percent of Bavaria and Baden-Württemberg, the 8.6 percent unemployment rate in Saarland and the even higher 12.4 percent in Bremen. These figures point to a lack of regional flexibility in the labor market. On the demand side, this might partly be caused by the lack of regional wage differentiation under the nationwide collective labor agreements, even though the flexibility to deviate from the collective labor agreements seems to have increased. Still, the limited flexibility in differentiating wages makes it harder for companies in the lagging regions to compete with the smaller, more uniform labor markets in good performing countries like Ireland, Finland and the Netherlands, where consensus among social partners is easier to accomplish. It is illustrative that net emigration from the Eastern Länder has risen again to nearly 50.000 persons in 1999, after having fallen below 20.000 in 1997. I think that the staff's conclusion that Germany needs wage moderation as well as more wage differentiation could have somewhat more nuance. I would say that the Northern and Eastern states need wage moderation, while the southern states, where high tech and machine building provide a larger share of total employment, need more wage differentiation.

Indeed, within regions there still seem to be limited possibilities to differentiate wages according to productivity differentials. In this context, I think that a closer evaluation of the Active Labor Market Policies would be necessary. The staff notes in paragraph 32 that over 1 percent of GDP is spent on Active Labor Market Policies. The incentive structures of the Active Labor Market Policies, however, seem to be insufficiently geared towards an efficient allocation of labor. One step in that direction would be to increase the wage differentiation to bring it more in line with labor productivity differentials. Another useful measure could be to further liberalize the market for temporary work agencies. In general, instead of providing wage subsidies, labor market policy should put more emphasis on market liberalization measures and on diminishing the quality mismatch between supply and demand for labor. It might be preferable to re-train the unemployed instead of providing green cards to skilled foreigners. I hope that the new legislation, which was recently proposed by the current government coalition parties, the so-called 'Job Aqtiv Gesetz', will include steps in these directions. My understanding is that this law would not only include 'pull factors' for the unemployed to enter the labor market, but also 'push factors'. Maybe the staff can elaborate on that.

Product markets

Finally, I have a few words about product markets. The staff report rightly acknowledges the progress that has been made in the liberalization of telecommunications services, electricity and, to a lesser extent, postal services. However, the OECD Economic Survey for Germany from May 2001 shows that despite liberalization in these sectors, prices for telecommunications services, electricity and natural gas are still among the highest in the European Union. Another sector where still large market distortions exist, is the financial sector. The recent agreement to phase out government guarantees for the Landesbanken, reached under pressure from the European Commission, is an important step in the right direction. However, the fact remains that 40 percent of the volume of all banking business is generated by public credit institutions. Therefore, all levels of government divesting from the financial sector should be the next step to create an open and competitive market for financial services in Germany and in Europe.

Mr. Padoan and Mr. Lombardi submitted the following statement:

Short-Term Assessment

Economic developments in Germany have been characterized by a slowdown since mid-2000. The comprehensive staff report as well as an illuminating statement by Mr. Bischofberger enlighten us on the role of several factors that have contributed to such a slowdown: namely, higher import oil prices that were absorbed via a compression of disposable income, leading to a slowdown in consumption; a steady decline in the growth of exports especially toward the European Union; finally, as revised data show, the slowdown in investment begun last year and then followed by a major shakeout in inventory accumulation in the first quarter of this year.

However, as the staff acknowledges, it is difficult to spell out a comprehensive story about the slowdown in Germany. As we have learned from the latest issue of the *WEO*, business confidence patterns between the United States and the euro area have recently shown a correlation larger than what could be expected by looking only at the co-movements in economic activity and especially trade flows. These results point to spillovers in business confidence among the two regions that might have played a role in shaping the expectations of consumers and firms in Germany, thereby contributing to the slowdown we have observed in Germany since last year. In this respect, the recent tragic events of September 11 have further weakened business confidence in the United States. According to the latest survey of business confidence in Germany by IFO, the closely watched business climate indicator plunged to a near eight-year low of 85.0 from 89.5 in August. Furthermore, to the extent that the U.S. business climate may worsen further, this could have a negative impact on German developments. We would like to hear the staff comments on the impact of these recent data on the short-term developments of aggregate demand.

According to the results reported in Box 2 of the report, the impact of stock prices on consumption are found to be statistically not significant. In addition, the impact of share prices on business investment is higher in the United States than in Germany. However, it is also evident that the effect on aggregate demand of prices in Telecommunications, Media and Information Technology stocks are relatively much more important in Germany than in the United States compared to the impact of other-sector stock prices. This would imply that deterioration in the short-term economic perspectives of the "New Economy" sectors compared to the other and more traditional sectors ought to have a proportionally larger impact on the German economy. To what extent has this effect played a relevant role, if any, on the recent German developments? We would appreciate the staff's comments.

Furthermore, and still on the short-term outlook, recent evidence provided by an IMF Working Paper on "Monetary Policy Under EMU" (WP/01/102) points to heterogeneous responses of euro area countries to monetary policy shocks. In particular, in the case of Germany it appears that monetary policy exerts a relatively weaker effect on output compared to the impact estimated for other euro area economies. To the extent that this is true, the recent, and possibly future, interest rate cuts in the euro area are bound to provide little relief to the German economy, especially if lower interest rates are accompanied by a stronger euro.

Long-Term Assessment

As the staff report notes, Germany has grown at a slow pace since the 1990s, averaging only 1.5 percent. This result is in stark contrast with the average rate of growth experienced in the 1980s. The reunification has certainly played a role in hampering growth. While transfers from the federal government to East Germany have been of roughly 5 percent of West German GDP, the catching up that was initially expected has not materialized so far. How much have regional asymmetries influenced the holding back experienced in the last decade? In particular, the dynamics in unit labor cost might have well played a role, but we think that other factors such as a slow TFP growth due to weak physical and human capital accumulation might have been important. A deeper analysis of the consequences of German reunification on slow aggregate growth could have been useful.

Enhancing potential growth should be at the forefront of German authorities' efforts. Indeed, in 2000 one-sixth of firms reported labor shortages as a constraint to the expansion of their activities. This points to serious labor market segmentation and rigidities that dampen the labor supply, thus reducing the potential of the economy. Evidence of labor shortage is also reported among skilled workers that possibly face weak incentives to join the labor market. If these rigidities persist, they risk jeopardizing the possibility for Germany to fully benefit from the introduction of new communication and information technologies. Regardless of the current adverse developments in this sector, new technologies will undoubtedly exert a beneficial role in increasing the long-run supply and income.

On the other hand, we notice very favorably that Germany has launched a series of reforms in tax policy, product market liberalization and social security contributions including the introduction of a private "pillar." On the first issue, we would like to hear from the staff whether there is any sign that the resulting substantial reduction in the firms' cost of capital has had an effect in spurring investment decisions. On product market liberalization, we would like to know whether the staff foresees further room for maneuvering and, if so, in which areas. Finally, with regard to social security contributions, it has been noted that their dynamics tend to be procyclical. Therefore, it would be interesting to know from the staff whether the recent reform may have an impact in reducing the procyclicality of social security expenditures.

In concluding this statement, we thank the staff for the excellent set of papers provided for this discussion and wish the German authorities success in all their future endeavors.

Mr. Mozhin and Ms.Vtyurina submitted the following statement:

The past few days have given indications that the economic situation in Germany has worsened significantly. The GDP growth is now projected at ¾ of a percent for 2001 and the fiscal deficit is to be above the targeted level, which is most likely going to result in additional government borrowing next year. A significant slip in IFO index has also added pessimism to the already grim outlook. We thank the staff for a set of well-written papers and a recent update. Presenting an adequate analysis of the economic situation in Germany, as well as many other countries, is a difficult task given the present rapidly changing environment.

The debate at this point has seriously shifted to the discussion of additional fiscal stimulus to aid the ailing economy. The pressure is mounting on the government from Germany's leading unions for a multi-billion euro rise in infrastructure spending and higher wages, and from a business community for bringing forward the planned tax cuts. Six German leading economic think tanks have added their voice to the latter plea. At the same time, the opponents of these measures, including the government, suggest that if implemented, they will significantly undermine the achievement of the budget goals under the Stability and Growth Pact. In the words of one market analyst "this is the first real test of Europe's monetary and fiscal policy regime."

As at the discussion on the developments in the euro area, the staff sentiment is such that under these special circumstances, i.e. a significant global slowdown, there should be some relaxation of the fiscal policy through allowing a full use of automatic stabilizers and bringing forward the 2003 tax cuts to reinvigorate growth. As the authorities, we are not so sure that this would be the best policy option.

In general, we do not see it appropriate to breach the targets under the SGP. Sure, there could be arguments offered, and in fact they have been presented by the staff at the euro area discussion, that the targets were not going to be achieved anyway, and that the pact was designed for "good times", and that given the present circumstances it is not going to be so significant to breach these targets further. Yet, when reading Mr. Bischofberger's statement it is apparent that the pact seems to be important for the governments of most of the euro area countries who want to show the public that years of work on the pact have not been wasted.

We are not convinced that the proposal to bring forward the 2003 tax cuts is going to achieve the desired goal since in the staff's own words "in the first half of 2001, the effects of sizable tax cuts failed to revive growth as the global economic slowdown began to take hold." If these tax cuts have not helped significantly during the better times, we doubt they will be useful under the present circumstances.

Our two additional concerns relate to the consequences of additional fiscal stimulus to inflation and the ability of the European Central Bank to lower interest rates if fiscal policies in the euro area become expansionary. With inflation getting back on the downward path just recently (could the staff clarify the reasons for an unexpected surge in food price inflation in the first half of 2001?), and with interest rates considered to be high, at least for the German economy, there seem to be limited room for fiscal policy actions that will not adversely effect the conduct of the monetary policy. We also have a feeling that the upcoming elections will already exert pressure on public finances even without application of directed stimulus measures.

The fiscal deficit is already going to exceed the projected targets because of a sharp slowdown in growth. But even before the slowdown, the German government (along with several other euro area countries) has not used the strong growth environment to speed up fiscal consolidation, which is evident from the rise in structural deficits. This, in our view, further underscores the need for fiscal restraint. We also agree with the authorities that they should stick to the SGP framework at present for the reasons listed in para 29. We believe that counter cyclical fiscal policy should be pursued under the framework once the medium-term consolidation efforts have been completed. As to other federal systems, mentioned by the staff, that allowed for significant counter cyclical steps in budget balances, we would point out that, in our view, in the United States, for example, the decision to initiate a fiscal stimulus package of $60-75 billion after September 11 could not have been made had the United States not had a fiscal surplus (or a balance).

Finally, we agree with most of the arguments in Mr. Bischofberger's statement regarding bringing the tax cuts forward, especially with: the need to allow the stabilizers to work fully on the revenue side, and to identify any slack within existing expenditure ceilings, and to redirect these resources towards higher spending stemming from cyclical developments; tax reforms (especially in euro area countries) should not be perceived as means of fine-tuning the economy but rather serve their original purpose of eliminating structural rigidities in the economy to spur medium-term growth; and taking into account fiscal policy lags, proactive measures can do more harm then good.

Regarding the medium-term objectives, we strongly share the authorities' intentions to accommodate a further reduction in taxes and Social Security contributions by lowering subsidies, saving on interest rate payments, reducing the size of the civil service and restraining wages. Since we agree with the staff that improvements are needed in ensuring the Länder's contributions to the fiscal objectives, we are concerned that the achievement of better accountability is constrained by the constitutional independence of the Länder. We urge all levels of the government to work together towards the attainment of the medium-term objectives.

Frankly, the fact that both the authorities and the staff agreed that in Germany "the reasons for the sharpness and persistence of the slowdown, even in the face of a considerable fiscal and monetary stimulus, were a puzzle" does not provide much comfort. In any event, if macroeconomic policies were not to blame for the slowdown, then, besides high sensitivity of German consumers to inflation and the economy's correlation with the U.S. business cycle, the staff was right to examine the structural rigidities that might have had an impact on the economy's ability to resist shocks. It is not so clear though, at least at the initial glance, how structural problems could have been responsible for such a sharp correction in growth since labor and, to some extent, product market rigidities have been standing in the way of faster growth over the past decade.

Looking at this issue one may examine the deepness of the recent reforms and initiatives to enhance labor market productivity by attracting skilled workers and creating jobs for the low-skilled ones. The study conducted by the staff on the reasons for the relatively poor employment performance draws important and valid conclusions about impediments stemming from less pronounced and insufficient wage moderation, highly restrictive firing environment and generous benefits system. We note that the authorities are making important proposals on how to address these issues, yet we would share the staff's concern about their effectiveness if financial incentives to seek work were not raised considerably. We also see some merit in the staff' conclusion that the recent attempt to create a significant amount of part time jobs backfired in a way that it did not provide a solid base for disposable income growth, and, thus, resulted in a sudden drop in income and consumption as soon as there was a halt in employment growth because of weakness in demand. In this vein, the recently passed legislation granting employees the right to convert full-time jobs into part-time jobs also creates a concern about incentives for job creation. On a positive note, we do welcome the recent work arrangement signed with a major automobile producer, which incorporates more incentives for both job creation and acceptance, and, thus, a fairer level playing field for both sides involved.

Finally, we wonder if the perception indicated in para 16 (that Germany is likely to be relatively insulated from job reductions by multinationals because of restrictive regulatory environment and high firing costs) is not too optimistic, and still holds true after such manufacturing conglomerates as Siemens AG and Adam Opel AG announced job cuts last week.

The developments in the financial sector will need to be watched carefully. It is good news that this sector is deemed to be sound and in a relatively good shape to withstand the slowdown, increased insolvencies, and lower non-interest income. Nonetheless, a high exposure to developed countries currently in the downturn as well as to construction and real estate sectors could be areas of potential stress and will need to be monitored carefully.

We found very helpful the analysis of the developments in the capital account in Box 5. We would agree with the staff that the examination of capital flows could play an important role, as larger and more variable flows could present potential financial vulnerabilities. It was interesting to learn that Germany plays such a significant intermediation role in directing financial flows from and outside the euro area (9.8 percent of GDP in inflows and 9.0 percent in outflows). It is unfortunate, however, that the analysis of the capital account flows is hampered by the coarseness and imprecision of aggregate data. We agree with the staff that more work is needed in this area through the implementation of more direct and micro-oriented methods focused on risks and exposures of large institutions.

With this said, we wish the authorities success during these challenging times.

Mr. Lehmussaari and Mr. Nikitin submitted the following statement:

We would like to thank the staff for a very interesting set of papers. We especially appreciate the extensive analysis on fiscal and labor market issues – two topics that are at center stage in European policymaking.

The slowdown of the German economy has indeed been sharp. GDP forecasts have been revised downwards -- the most recent revision published by the six leading research institutes just a few days ago—and the unemployment rate is on an upward trend. Also, recent results of a business climate survey seem to indicate that the fall in economic activity is more serious than what was earlier expected. The recovery of growth depends on a reversal of the external shocks that accounted for much of the slowdown. We agree with the staff that in the current situation the snapback of a revival of business confidence might not be that automatic.

The authorities and the staff appear to be puzzled by the fact that the downturn in economic activity was so sharp amid stimulative fiscal and monetary policies. This is indeed surprising, but as discussed in the latest *WEO*, the increasing use of ICT may be speeding up the pace of macroeconomic adjustment since advanced supply chain management allows firms quickly to identify the backup in inventories. In addition, ICT-related shocks are playing a greater role in macroeconomic fluctuations through real and financial linkages across countries. In this context, we would like to note to some extent counterintuitive developments presented in Box 1 regarding trade statistics during the period January–June 2001. According to statistics, nominal exports to the United States grew at a rate of 11 percent while those to the European Union shrank at a rate of 6 percent. We would appreciate some additional comments from the staff as regards the linkages in economic activity between the United States and Germany during the current slump.

Fiscal Policy

We agree with the authorities' view that the scope for adjusting macroeconomic policies to address the slowdown is limited. The consolidation effort in Germany, while having followed a generally consistent path over the years, has not been ambitious enough. It is unfortunate that the decline in expenditure ratio in 2001 has been insufficient to compensate the decline in revenue ratio. After a prolonged period of favorable external conditions, the country still has a sizeable general government deficit. Therefore, a high priority must be given to fiscal consolidation in the medium-term, and we welcome the authorities' intention to eliminate the deficit of the general government by 2004.

The likely sizeable tax shortfall in 2001 indicates that the achievement of the 1½ percent deficit indicated in the Stability Program for this year will not be achieved. As noted by the authorities, the 2002 deficit target could also come under pressure because of lower than expected revenues. While measures to stimulate the economy could help in the downturn, they could also undermine credibility in the Stability and Growth Pact. Therefore, discretionary fiscal measures would be inappropriate in the current situation. The most relevant issue is the degree to which automatic stabilizers should operate. In our view, the automatic stabilizers should be allowed to operate in order to dampen the contractionary stance in fiscal policy in 2002 projected by the staff, but only to the extent that this would not put to risk the 3 percent deficit limit nor endanger reaching the balanced budget in the medium-term.

We find the discussion on whether the annual Stability Program deficit targets add a pro-cyclical element to fiscal policy somewhat misplaced. At this juncture, a fulfillment of close-to-balance or surplus position would allow for automatic stabilizers to work fully in the present downturn and thereby contribute to dampening the negative effects on demand. For Germany, the problem is not the constraints of the Pact, in principle, but the fact that Germany has not yet fulfilled its medium-term target and the room for automatic stabilizers is, therefore, curtailed.

Labor Market

While the timing of recovery is one of the burning questions, the question of sustainability of expansions has proven very problematic. In this context, we found the staff analysis on the German labor market very insightful. According to the staff, Germany's potential growth is currently estimated at about 2 percent, while it is assumed that potential growth could rise somewhat in the medium-term. This outcome relies heavily on favorable employment developments.

In the selected issues paper, the staff illustrate the weaknesses of the German labor market in an interesting way. The staff clearly point out the lackluster performance of employment in Germany compared to many other European countries when measured in full-time equivalent units. While the staff rightly note that part of the lackluster employment growth performance can be explained by slow growth in the services sector, in our view the weak performance of the labor market is mostly related to the specific structural aspects inherent in the German labor market. Thus, better wage differentiation across skills and regions, as also advocated by the staff, seems to be the best option for addressing problems in the labor market. While we agree with the staff that wage moderation has played a role in promoting job growth, it has not adequately addressed problems in the area of low-skilled workers. Also in this context, we take note of very high reservation wages in Germany. Clearly, the authorities have many challenges ahead in tackling structural issues related to the labor market.

Equally important, the staff calculations indicate that labor productivity growth has been disappointing in recent years. One of the reasons for low labor productivity seems to be the fact that "Germany does not appear to be blessed with a more spontaneous new economy" as the staff note in the report. If low labor productivity persists, it is a serious constraint to any permanent improvement in potential growth. Newly created firms in the ICT sector have been highly innovative and their contribution to productivity growth has increased in recent years. Therefore, it is of the utmost importance that the authorities put more focus on improving the use of information technology in order to enhance capital deepening and total factor productivity growth. Structural policies should encourage the widespread adoption and effective use of ICT.

Mr. Kiekens and Mr. Prader submitted the following statement:

In the time since the Board's last Article IV discussion on Germany, the authorities have implemented some long-overdue reforms, including significant changes in the pension and tax systems and the liberalization of some product markets. Another major change will come at the end of the year, when the last step in the transition to the euro will be completed by the issuance of notes and coins, which will then entirely supplant the respected and beloved Deutschemark. With the economy booming in 2000, as it had not done since reunification, Germany also managed a significant reduction of its unemployment rate.

But this gratifying series of happy moments and exuberance in Germany's economic life was interrupted in mid-2000, starting with the weakening of growth following the oil price increases. In January, the official forecast for growth in 2001 was 2.75 percent, but this figure had to be reduced somewhat at the beginning of summer. The shock of September 11 has gutted the economic scenarios underlying the original staff report, and German official forecasts for growth in 2001 and 2002 have been sharply reduced to 0.75 percent and 1.0-1.5 percent respectively. The size of last week's plunge in the IFO's business climate index, the steepest since the oil shock of 1973, surprised everyone, even the professional forecasters and the markets--and showed the tremendous effect of international uncertainties on German business confidence. We can be reasonably confident of some upward corrections in coming months, but there can be no doubt that the downward trend of economic prospects will be longer and stronger than was feared by most observers. The economic slowdown has also dealt a heavy blow to one of the government's politically central goals, its promise to lower unemployment at least to 3.5 million by the time of the election scheduled for 2002. In September, unemployment had been rising for eight consecutive months. An assessment just published by Germany's six leading economic research institutions sees Germany now "on the brink of recession." Hopefully the recovery of growth will kick in during the first half of 2002, as assumed by both the IMF staff and the German research institutes.

One result of the economic growth revisions is to make the fiscal deficit for 2001 higher than had been assumed, so that budget planning for 2002 will also have to be revised. So far the government has resisted all siren songs urging reflation measures to reverse the worsening of economic prospects, and takes pride in responding to the crisis with a steady, tranquil hand. The government is right to continue its cautious budget policy despite present challenges, and to maintain its commitment to the goal of achieving general government fiscal balance by 2004. This goal would seem to put Germany among the European Union's less ambitious fiscal performers, but must be considered fairly ambitious in light of the huge fiscal burden, amounting to some 5 percent of West German GDP per year, connected with its continuing political and social obligations arising from reunification.

Lower tax receipts and the higher costs of rising unemployment will increase the deficit and strain Germany's compliance with the Stability and Growth Pact (SGP). Although the rules of the SGP provide significant room for maneuver in fiscal policy, the minister of finance faces a truly Sisyphean task: the recent laudable attempt to contain the deficit tide by paying for additional security measures with higher taxes on cigarettes and insurance policies will be swamped by the higher costs of rising unemployment and lower tax revenues. Nonetheless, the deterioration of Germany's fiscal outcomes for 2001 will be mitigated by the conservative spending ceilings of the 2001 budget.

Mr. Bischofberger rightly states that the aims of the tax reform were structural and not conjunctural. Nonetheless the timing of the first stage of the significant lowering of income taxes accomplished by the 2000 tax reform has turned out to be most exact, providing significant support to growth in 2001. The debate on whether the tax cuts planned for 2003 should be speeded up to give the economy another push has become quite lively but will not be easy to decide. The finance minister's hesitation is understandable, since a rise in government indebtedness resulting from accelerated tax relief would affect the consolidation program and its credibility. Also, due to the sharp increase in uncertainty following September 11, much of the possible benefit of the tax cut could be lost to "Angstsparen" (precautionary saving), which always prevails in times of great uncertainty. German consumers might spend only part of their tax relief.

While the tax reform of 2000, with its lower corporate and personal income taxes, represented a significant structural reform, Germany remains a "high tax country," whose effective tax burden (including social security contributions) is among the highest in the European Union and all of Europe. The present budget situation and the political debate rule out further changes in taxation, but consideration should be given to additional reforms to be undertaken after the current short-term slowdown and the political business cycle.

Coming almost a year after the tax reform, the May 2001 passage of the pension reform legislation concludes an arduous decades-long debate and represents an important chapter in the reform efforts of the present government. These reforms go in the right direction by correcting the so-called generation compact, and by introducing the principle of private pensions and distributing the burden more equitably between generations. But this is clearly only the beginning of a long process of making the pension system safe for the future. Future governments will have to continue these efforts. Given Germany's traditional emphasis on social cohesion and stability, the magnitude of the government's feat of reforming both the taxation and pension systems while overcoming labor union resistance deserves to be recognized. The trade unions also deserve credit, both for accepting the reforms and for showing considerable self-restraint in wage negotiations. The moderate wage agreements together with prudent fiscal policies will also increase the room for the European Central Bank to ease its policies, thereby giving a hand to the fight against recession.

The one area where German structural reform is lagging somewhat is the labor market reform. The staff report deplores the sluggish pace of change and even identifies several changes in labor market regulations, which actually go in the wrong direction by increasing labor market rigidity. It is possible to regard Germany's structural reform picture more cheerfully, as showing how the German authorities are practicing their own brand of structural streamlining by focusing on a number of significant aspects of structural reforms—which in the arena of Germany's debate on structural reforms is already more than could be hoped for—and saving the work on other equally important reforms for another day. But again, given the premium placed by German society on social stability, reforms in the labor area will be a true test of any future governments' resolve and strength.

The German social market economy adopted in the late 1940s and early 1950s implied a free market economy that was significantly regulated. Now, with increasing globalization, the need for adjustments and adaptations has become obvious. We therefore welcome the steps taken to liberalize the financial and telecommunications markets. These overdue reforms are needed to make Germany competitive in the global marketplace. In light of the restructuring of the financial sector, we also welcome Germany's participation in an FSAP, and encourage the authorities to increase the degree of cooperation and coordination among their various agencies of banking supervision.

Mr. Bennett submitted the following statement:

Over the last few years, the German authorities have undertaken important reforms for which they deserve to be commended. In particular, the authorities deserve recognition for their efforts in implementing major tax and pension reform. Significant progress has also been made in the liberalization of a number of product markets such as the telecommunications, electricity, and gas markets.

Despite these changes, it is clear that still more needs to be done. As shown on the Table on page 12 of the staff report, Germany's growth rates over the last 10 years have consistently lagged behind that of other large European countries, and have lagged even further behind smaller euro area countries and the United States. The current slowdown represents the third time since reunification that a recovery has failed to take hold, and the effects of the global slowdown seem to be more pronounced in Germany than in many other countries. The story is the same on the employment front; it has faired poorly relative to other large continental European countries.

Why has Germany lagged behind? In our view, it is clear that persistent labor market rigidities contribute significantly, and until these are addressed, Germany's economic performance is destined to remain below potential. In this respect, I was pleased to see that the authorities also view the labor market as the "remaining major frontier for reform".

The staff reports that the authorities have begun the process of building consensus for changes in these areas, particularly to address the shortage of skilled workers and the insufficient jobs for low-skilled workers. But as the staff has pointed out, the initiatives implemented by the authorities cannot be very effective if wage differentiation across skills levels and regions remains low by industrial country standards. The broad-based wage moderation that Germany has recently experienced can form only part of an enduring solution; financial incentives to seek work are not raised. In particular, Germany's generous benefit system weakens job-search incentives and adds to non-wage labor costs; or significant restrictions on termination of employment and lay-offs remain in place, as they inhibit hiring and dampen productivity.

In this respect, it would be helpful if the staff could tell us whether the authorities have a timetable setting out specific measures to reduce these labor rigidities in order to improve the medium-term economic prospects of Germany.

Of course, in addition to reducing labor market rigidities, we encourage Germany to continue product market liberalization (such as further liberalizing shop opening hours) and to work with other European countries to reduce trade barriers, particularly for agriculture.

Finally, on Germany's fiscal policies, we recognize the difficult trade-offs involved in accepting a higher short-term deficit in order to provide economic stimulus. However, we would argue that, given the most recent information on the extent of the economic slowdown in Germany and the fact that ECB monetary policy may not be sufficiently expansionary for Germany's situation, any increased stimulus as a result of maintaining nominal spending targets is warranted and that flexibility on this front would not damage—and indeed might enhance—the credibility of the German authorities.

Mr. Rustomjee submitted the following statement:

We thank Mr. Bischofberger for his insightful statement and the staff for producing a well-articulated set of papers reflecting Germany' recent economic developments and the challenges for the medium-term, and by giving appropriate prominence to the fiscal and structural reform issues.

We agree with the staff that economic performance in Germany during 2000 reflected important achievements, particularly as regards the structural reforms, but also setbacks in securing the resumption of sustained growth.

Following the strong economic recovery observed during the later part of 1999 and the first half of 2000, assisted by strong global demand and the depreciation of the euro, expansion appeared to have lost momentum since the second half of 2000 and into the first half of 2001, as a result of high oil prices, the impact of the slowdown in the global economy, a decline in investments in plant and machinery, and sliding business confidence. The prospects for the rest of the current year and for 2002 remain subject to a number of uncertainties related in particular to the fragility of the international outlook, which has become clouded even more by the September 11 events in the United States, raising questions as to whether the slowdown will not be even more pronounced than currently projected. Indeed, the staff, the OECD, and even the German authorities are now expecting that economic growth in 2001 will rise by only 0.75 percent, less than half of the 2 percent increase predicted about six months ago, while GDP growth in 2002 is forecasted to rise by only 1.5 percent down from the government's initial 2.25 percent growth projection.

The progress made in reducing the standardized unemployment rate to around 7.9 percent during the last year, shows sign of being reversed, with unemployment inching up again. Despite the increase in the oil prices in the world market and the depreciation of the euro, underlying inflation has remained relatively low, aided by the reasonable wage settlements and also by the cost moderation effect of the liberalization of product markets undertaken lately.

We commend the authorities for their fiscal consolidation efforts in the recent past, which have allowed them to shift the general government balance to a surplus position in 2000. These efforts are consistent with the authorities' medium-term fiscal policy orientation as set out in the Stability and Growth Pact, in particular, their goal to eliminate the general government deficit by 2004, mainly anchored on expenditure restraint. We view the current implementation of the long-awaited tax and pension reforms as an important set of steps that will assist the fiscal objectives.

However, as a result of the economic decline, the fiscal position is projected to deteriorate significantly in 2001 to a deficit of over 2 percent of GDP, before recovering slightly in 2002. We therefore see merit in the staff's recommendation that given the current slowdown and the revenue shortfall it would be advisable to maintain the fiscal stimulus by keeping the 2001 expenditure target and allowing the operation of the automatic stabilizers, even if this were to mean exceeding the Stability Program deficit target for the current year. We note the authorities' commitment to curb expenditure growth over the medium-term through cuts in subsidies, interest savings, and restraint on wages. However, at a time when unemployment is inching up and growth is faltering, we wonder if reducing the size of civil service, at the proposed rate of 1.5 percent a year will be opportune. In addition, in our view, the states and local authorities should be made more accountable for their fiscal projections and contribute more actively to Germany's fiscal objectives. The authorities' expressed interest in undertaking a review of standards and codes will help to further enhance fiscal transparency.

Structural reforms will continue to play a critical role in improving competitiveness and enhancing economic growth prospects. In this context, the authorities have made significant progress in product market liberalization, particularly in the telecommunications sector and to a lesser extent, in the electricity and gas sectors, and we are pleased to note the authorities' intention to extend these reforms to more complex and sensitive sectors, such as public services and water supply. However, the recent renewed extension of the postal monopoly seems less consistent with the general trend that the authorities appear to be following in this area of reforms.

In our view, more forceful actions are required in reducing structural unemployment and rigidities in the labor market, which are critical to sustain growth over the long-term. We welcome the important initial steps, which have been taken to address the shortage of skilled workers and in creating jobs for the low skilled. However, like the staff we consider that more needs to be done, including through the promotion of wage differentiation across skill levels and regions as well as tax-based incentives to hire low-skilled workers.

Germany's level of ODA is 0.26 percent of GNP, falling far short of the United Nations established target of 0.7 percent. We would urge the German authorities to consider substantially raising the level of this assistance, which will be critical for many of the low-income countries in their fight against poverty, as soon as their fiscal position improves.

We very much welcome the authorities' commitment to the new trade round, most particularly, their intention to press for the liberalization of agricultural policy together with improved market access for developing countries. We urge the authorities to press ahead with this approach, which will substantially improve the economic prospects of the world's lowest-income members. It would also be important that other trade concerns expressed repeatedly by developing countries, especially those related to textiles and clothing be taken into consideration.

Mr. Al-Turki submitted the following statement:

The expectation of a robust economic outcome in Germany was a major part of the global economic strength foreseen a year ago. In the event, the German economy has slowed markedly this year. The outlook is also uncertain with considerable downside risks to the mild recovery set for next year. Yet, an early and sizable economic revival in Germany is crucial for not only the country itself but also the rest of the euro area and the world.

Notably, the growth spurt in Germany ended well before the current worldwide economic worsening in the wake of the recent tragic events in the United States. Therefore, the challenge is to first isolate the adverse factors that the recent external deterioration has only served to deepen. I will focus my remarks accordingly.

First, given Germany's economic weight in the euro area and the world, German economic policy is not only a taker but also an initiator of global developments. Indeed, both national and global interests require a readiness of the major advanced economies to be innovative. In that context, the staff's attribution of the recent and the prospective economic outturn in Germany primarily on external circumstances is problematic. This linkage is evident in, for instance, the prognosis in paragraphs 15 and 18 of the report. The staff also notes that the economy's failure to grow "even in the face of considerable fiscal and monetary stimulus" is a "puzzle". Clearly, the challenge is to analyze any such "puzzle". Here, options would include further review of the adequacy of the growth stimulus and the possibility that the transmission mechanisms may have changed.

Second, among the presumed external reasons for the poor outcome, the staff repeatedly highlights the price of oil. Again, the need is to back up the assertion with adequate analysis. Specifically, to be a major factor, oil as an input would need to play a role much larger and out of line with the experiences of most advanced economies. In addition, it is necessary to consider the role of the fiscal wedge in oil prices, both absolutely and in relation to the other sources of energy. Moreover, the report confirms that the economy's competitiveness is unimpaired. Besides, as the staff makes clear in Box 1, "Oil prices did not, according to the data, cause a sharp increase in the consumption deflator, which grew at a modest 1.4 percent last year." Further, considering the trend in real terms, the wide market swings, and the deviation of product and crude prices, any meaningful reference to oil price movements needs to be suitably qualified. Given this context, I will appreciate an elaboration of the staff's view on the role of oil prices in the economic slowdown of Germany.

Third, I share the staff's stress on the downside risks to the projected recovery. As the report notes, a repetition of the earlier weakness of the euro and the supportive fiscal and monetary policies is unlikely for the period ahead. Indeed, the authorities have attested to a lack of scope for macroeconomic easing to address the slowdown. Meanwhile, the tension between local and euro-area priorities is also evident in perceptions of the interest rate as too high for conditions in Germany. As the staff rightly noted, there are questions whether the current policy framework has adequate scope for addressing unforeseen shocks. Against that background, I will be interested in hearing the considerations behind the authorities' optimism for a recovery stronger and earlier than the staff projection.

Fourth, given the circumstances noted in the report, I see a need to be on an active lookout to stimulate growth. Specifically, there is a strong case for using all available scope for monetary easing and fiscal support. I agree with the staff that the automatic stabilizers should be allowed to operate fully. This is indeed a delicate balancing act in view of the central role of Germany in the euro area. Here, the staff makes a useful suggestion to shift the emphasis from fiscal balance goals to expenditure targeting.

Fifth, indications that the authorities attach an enhanced priority now for more structural reforms are welcome. Here, the staff's innovative and insightful background studies on the labor market are welcome. As the report points out, further wage moderation is crucial for Germany to have the impressive job-rich growth achieved by its leading euro area partners. Action on a number of issues that the staff identifies in this area is critical. As Mr. Bischofberger points out in his statement, additional training is important to alleviate the problem of technological unemployment. Among other structural reforms, completion of the ongoing efforts for greater product market flexibility is crucial. I also welcome the progress made in liberalization of the financial and telecommunication markets.

Finally, I welcome the authorities' efforts to promote further trade liberalization, including improved market access for developing country exports in the European Union. I also encourage the authorities to complement these efforts by raising Germany's ODA over the medium-term.

Mr. Portugal and Mr. Junguito submitted the following statement:

At the outset, we thank the staff for the excellent set of papers focusing on issues of interest to the euro area and the report on Germany, and Mr. Bischofberger for his useful and comprehensive statement.

After enjoying last year its highest growth rate in a decade, and despite benefiting from a fortuitously supportive fiscal policy and making considerable progress in structural reforms, Germany experienced an economic slowdown caused mainly by a combination of negative supply shocks and external events.

It was evident that even before the tragic events in the United States on September 11, near-term growth prospects for the euro-area economies were waning markedly, particularly for Germany whose strongest post-reunification growth surge came to an abrupt halt in the middle of last year. Sharply higher energy and food prices, which pushed headline inflation up to a seven-year high this May, triggered Germany's slowdown. Following these adverse supply shocks, growth weakened further with the downward correction in equity markets, particularly for the technology sector, which occurred synchronously with the sharp cyclical slowdown in the United States. The large and persistent challenges of reunification have also contributed to the drag on growth, including the fiscal consolidation required to offset substantial budgetary transfers to the eastern part of Germany, which is yet to converge to output and productivity levels of the West.

In addition to the origins of the current slowdown being attributed mainly to supply shocks, discussion about the scope for active macroeconomic policies in Germany is complicated by the fact that monetary policy, the best instrument for short-term demand management, lies outside the purview of the authorities, while fiscal policy is constrained by the still large tax and debt burdens and by the need to preserve credibility of the euro-area fiscal agreements.

Throughout most of last year and into this August, monetary policy appeared too tight from a German perspective, despite the weakness of the euro. With the more recent fall in real long-term interest rates, monetary conditions now seem broadly neutral. We believe, however, that given the overall economic prospects for the euro zone there is room for further cautious monetary easing by the ECB, without posing risks to price stability. Such cuts in interest rates would certainly be more appropriate to facilitating a recovery in euro-area growth, including that of Germany.

In the absence of an independent monetary policy, fiscal policy bears the burden of adjustment to the business cycle, even though it is a weak tool for demand management. We broadly share the staff's view that there should be no constraints on the automatic stabilizers to reduce the amplitude of economic cycles, particularly within a monetary union. In the face of a slowdown, tax revenues must be allowed to fall, while non-cyclical public spending is maintained. While we support the medium-term nominal deficit reduction goals of the Stability and Growth Pact (SPG), strict enforcement of these targets, in the current conjuncture, could imply an unwanted negative fiscal stimulus this year and the next. It would be preferable to achieve such fiscal consolidation efforts on the upturn of the economic cycle.

The authorities should be commended for the major progress in product and service markets liberalization, which reduced the costs of telecom and electricity services, and in tax reform that reduced Germany's high tax rates, improving incentives to invest and to work. The introduction of a private pension pillar and the gradual reduction in the replacement rate of the public pension are welcome indications of a change in approach to this sensitive area.

As Mr. Bischofberger recognized in his statement, labor market rigidities still remain a difficult structural problem producing a negative impact on economic growth. In light of the important effect of employment on disposable income and consumption, further labor market reforms should be a priority in the near term to strengthen employment creation and sustain growth in the long run. High unemployment, currently at around 8 percent of the labor force, reflects to a large extent the legacy of reunification with eastern Germany's jobless rate being more than twice that of the west. Central wage negotiations with its across-the-board pay increases have served to keep aggregate labor costs low. However, given the shortages of skilled workers and high unemployment among the unskilled, there is room for further decentralization in collective bargaining, by allowing for wage agreements that reflect both skill differences and market conditions, helping to narrow the large divergences in regional unemployment rates. We are encouraged by the authorities' recognition of these problems and their action to start building consensus on labor market reform.

We are reassured that, given the strong capitalization of Germany's financial sector, neither the present slowdown nor problems in the construction and real estate sectors would pose significant systemic difficulties. However, the authorities need to continue monitoring the situation closely in this current environment of unusually large uncertainty. Greater coordination among the three supervisory agencies and the intention to establish a new financial supervisory structure that merges banking, securities, and insurance companies are welcome steps to improving management capacity, and towards consolidation in the euro-area financial markets. We welcome the authorities' intention to participate in an FSAP.

We note that Germany has been found totally compliant with the 28 operational recommendations of the FATF 40 standards to deter money laundering. Mr. Bischofberger's Statement announces further initiatives in this area, including the creation of a Financial Intelligence Unit and of a central database for bank accounts information.

We welcome the priority Germany is giving towards the launch of a new world trade round, and strongly support their intention to press, within the European Union, for liberalization of the heavily protected agricultural sector, which imposes high costs to the German taxpayers and consumers and prohibitive barriers on developing countries' exports.

It is regrettable that the authorities consider unlikely that ODA could be raised to the U.N. development target of 0.7 percent of GNP, given the present commitment to expenditure restraint. We note that when the Fund recommends expenditure restraint to member countries the need to protect and increase social spending is always emphasized. ODA expenditures have a similar nature and should be subject to the same type of consideration.

The short-term economic prospects for Germany as well as for all other countries have been dimmed somewhat by the recent catastrophic events and subsequent developments in the external environment. We, nonetheless, share the staff's assessment that Germany's economic fundamentals are sound, and that the major progress in implementing a number of key structural reforms during the past year augurs well for the authorities' ability to better manage cyclical fluctuations and shocks, and to raise the country's growth potential above the present estimated level of around 2 percent a year.

Mr. Barro Chambrier submitted the following statement:

At the outset, I would like to thank the staff for a well-written report and Mr. Bischofberger for his informative statement. After a strong performance until the middle of 2000, the German economy was severely affected by the slowing global demand and the contraction of private consumption stemming from the rise in oil prices, the impact of the depreciating euro on disposable incomes, the collapse of stock prices and the end of a three year investment boom outside of construction. From a growth rate of 3 percent in the first half of 2000, real GDP fell to about ½ percent thereafter. The fiscal deficit rose slightly due to the fiscal stimulus of over 1 percent of GDP in the first half of 2001 to revive growth. Inflation was contained and notable progress was achieved in the structural area, including tax and pension reform and product market liberalization.

Although downside risks dominate in the short-term, growth prospects for the medium-term remain good, as GDP growth is expected to be higher than in the 1990's. In order to realize this growth potential, Germany needs to address a number of structural challenges in the labor and product markets that inhibit investment in new technology and human capital and fuel high unemployment, particularly for lower-skilled workers. Given the fact that monetary and fiscal policies are constrained by the start-up cost of European Monetary Union and the sizable public debt burden, structural reforms, particularly in the labor market will play a key role in helping to adjust to shocks and revive the economy.

Fiscal policy

Germany has a key role to play in the recovery of the European and global economy. Thus, the main objective of fiscal policy should be to further support the recovery of economic activity without jeopardizing the medium-term target of eliminating the fiscal deficit of the general government by 2004 and achieving a balanced budget by 2006. The authorities intend to reach this goal along a pre-determined annual path, as set out in their stability program. However, in the midst of the current economic slowdown, we encourage the authorities to use more flexibility in the implementation of short-term fiscal policy. In particular, the authorities should let the automatic stabilizers operate, even if it meant overshooting the nominal deficit targets in 2001, so as to have enough room to maneuver to boost economic growth. If demand and output remain weak in 2002, we call for a more active fiscal support, in particular bringing forward the 2003 tax cut. On the latter, we commend the authorities for beginning the first stage of their comprehensive tax reform. When completed these reforms will further increase the German economy's competitiveness, and contribute to the creation of more employment opportunities.

Structural reforms

In the absence of independent monetary and exchange rate policies, addressing the structural weaknesses in the labor, product and financial markets is critical for ensuring external competitiveness and sustained growth. High levels of unemployment, particularly among lower-skilled workers and shortages in high skilled-workers call for innovative reforms in the labor market, in order to introduce more flexibility and appropriate incentive mechanisms, to adapt the wage-bargain system to technological changes and international competition while reforming the social safety net. The recent initiatives aimed at offering work visas to IT high skilled foreign workers, encouraging the creation of low-skill jobs and increasing incentives for the unemployed to find work are steps in the right direction. However, the authorities will only achieve lasting results if they build on these efforts to bring average wages in line with productivity and introduce greater differentiation of wages across skill levels. Given social resistance to increasing wage dispersion and lowering employment benefits, we encourage the authorities to consider the use of selective tax breaks for businesses that employ low-skilled workers. This strategy should be complemented with pension and health sector reforms, so as to avoid an undue burden on labor costs. In this regard, we welcome the recent introduction of a private pension pillar and encourage the authorities to further restrain the generosity of the public system in order to contain future increases in social security contribution.

Developments in the product market are more encouraging, in particular with the liberalization of telecommunications, electricity, gas industries, and railway services. We invite the authorities to consolidate the progress made thus far and to keep the momentum of reforms, especially with regard to the liberalization of shop opening hours or regulations governing mergers and acquisition of corporations because such changes could help boost economic efficiency and job creation.

As regards the financial sector, we encourage the authorities to watch closely the impact of the downturn in the telecommunications, construction and real estate and banks' exposure to the United States and Japan. We are also of the view that reviewing regulations that prevent financial institutions from merging and phasing out public guarantees to the publicly-financed institutions will provide incentive for restructuring and help improve credit allocation and profitability. We support improved coordination among the banking, securities and insurance supervisory agencies as well as Germany's participation in the FSAP.

On reunification, we commend the German authorities for their impressive performance, and for having made the financial sacrifice to ensure a smooth merger of the western and eastern economies. As Mr. Bischofberger reminds us, the task is far from over, and the reunification related requirements may have contributed to Germany's low growth performance in the recent past, but we are confident that the investment made in the process will enable Germany to reap fully the benefits in the medium to longer term.

Development assistance

We very much appreciate the assistance of Germany to developing countries and to the countries in our constituency in particular, and the commitment and support of the German authorities to the HIPC initiative. While we fully recognize the added costs of reunification, as noted above, we hope that it will be possible in the future for Germany to raise its ODA which remains below the 0.7 percent recommended by the United Nations. We welcome the support of the German authorities for a new trade round and hope to continue to have their support for efforts to increase market access for low-income countries and enable the full implementation of the EU decision to grant quota and duty-free access to the 48 poorest countries.

Ms. Yagi and Mr. Toyama submitted the following statement:

After a brief economic recovery that was slower than those of other euro area economies, the German economy is again experiencing an economic slowdown partly due to the deteriorating external environment, in particular, higher oil prices and the slowdown in the U.S. economy. This short-lived recovery indicates that reunification and its impact on the economy have become a burden in the form of fiscal drag, stagnation in eastern Germany, and a decline in the construction sector in recent years. It also indicates that the inflexible labor market has hampered self-sustained recovery. During the period of economic recovery, however, there were some positive changes. Employment growth was stronger than in previous growth periods, if only modestly. Equity ownership by individuals increased and capital markets developed, contributing to the diversification of financial risks. Deregulation took place in the telecommunications and the electricity markets and tax reform was implemented. I suspect these changes have helped to alleviate the current slowdown to some extent. I urge the authorities to implement important structural reforms, including labor market reform, in order to raise labor participation and increase productivity.

Regarding fiscal policy, the staff advises the authorities not to stick to the nominal deficit target of the SP, since it would have pro-cyclical effect in this economic downturn, but instead to maintain the planned expenditure level. I made my view clear on this point at the Board meeting on the euro area last week; i.e., the automatic stabilizer should be allowed to work fully while the authorities show a strong commitment to the SGP, and fiscal adjustment should be undertaken as soon as growth resumes, in order to attain the objective of the SGP and sustain the credibility of the fiscal framework. As a medium-term challenge, I would stress the importance of putting in place safeguards in the fiscal framework to ensure credibility. In light of recent economic developments that would indicate stagnation in 2001 and weaker than envisaged growth in 2002, this view seems to be becoming more relevant.

In the labor market, rigidities in wages and employment have brought about a shortage of skilled workers and unemployment of low-skilled workers. Greater differentiation in wages would give workers the incentive to obtain skills and would help to increase employment at the bottom end of the labor market, thereby reducing the mismatch in the labor market. As Germany is subject to competition with countries in transition, it needs to induce its industries to high value added areas and to make its wages flexible at the low end of the labor market in order to increase employment. Tax incentives for labor participation, which have had a positive effect in other countries, should also be considered. The creation of environment that would make it easy to review traditional business models and employment categorization is also important in order to link the fruits of the IT revolution to productivity growth. From this standpoint, I have concerns about recent legislation and regulatory changes that might hamper labor market flexibility.

I welcome the deregulation and price declines in the telecommunications and industrial electricity markets. A decrease in communications costs is expected to promote the use of IT and help to provide new business opportunities as well as enhance the efficiency of traditional industries. What Germany needs most is to renew the dynamism of its industries in order to attract capital. Further deregulation to create areas with potential business opportunities and institutional arrangements to make it easy to conduct corporate takeovers are important. In this regard, I welcome the authorities' commitment to reach an agreement on an EU Directive on corporate takeovers.

Germany forms the core of the euro area economy, along with France and Italy, and is the largest of the three. It will be hard for the euro area to realize stable growth unless Germany strengthens its basis for medium-term growth. I do not believe it is impossible to reconcile the German tradition of social solidarity with efficient economic structure. With these remarks, I wish the authorities the best in their future endeavors.

Mr. Chatah and Mr. Bakhache submitted the following statement:

Economic performance in Germany since re-unification has been characterized by three recoveries that failed to gain the necessary momentum to sustain a pick-up in economic growth to its potential level. While there seems to be agreement on the immediate causes behind the current slowdown, there is some divergence of views with regard to course of action in the period ahead. With regard to the immediate causes of the slowdown, the staff report points to the rise in oil price as the trigger, which was accentuated by the food price increases and the global slowdown. Box 1, however, sheds doubt on the role of oil prices in causing the slowdown last year leaving the real culprit behind the reversal in the recovery uncertain. In any case, the challenges for the authorities are two-fold. On the one hand, a decision on the appropriate policy action in response to the ongoing slowdown is needed. On the other, the authorities and the staff need to examine the underlying reasons behind the relatively weak and short-lived recoveries of the 1990's and try to draw policy lessons.

Before moving to the two aforementioned issues, it should be noted that, notwithstanding the recent slowdown, significant actions in important structural areas, namely, tax reform, product market reform, and pension reforms were taken. These reforms are impressive and the authorities should be commended for the progress achieved. We are hopeful that the momentum achieved on these fronts will be carried to the labor market. In this regard, while we agree with Mr. Bischofberger's statement that the issue of high unemployment among the low skilled should be seen from different angles, we see scope for the introduction of further flexibility in the labor market if employment is to be increased. Wage moderation in the labor market is a welcome sign that efforts are being made in this area. It is encouraging that the authorities consider the labor market as the remaining major frontier for reform, and that they had started the process of building support to advance needed reforms in this area. Labor market reforms, along with other structural measures already taken, would make an important contribution to enhancing potential growth.

Moving to the short-term outlook for the German economy, it is becoming clearer that a quick recovery in economic activity in Germany, and globally, is becoming less likely. The question becomes whether there is room within the tools available to the German authorities to make policy changes to counter this potentially prolonged and/or deep slowdown. Here it is worth noting that monetary conditions in the euro area remain particularly tight for Germany and along with wage moderation, existing price pressures do not appear to represent a serious concern on the inflation front.

As the staff rightly points out, policy makers are constrained by euro area policies as well as by the medium-term requirements of the Stability and

Growth Pact. We can sympathize with the German authorities' emphasis on the credibility of the monetary union and of fiscal policy and hence their desire to stick to the stability pact fiscal deficit target for 2001. At the same time, there is merit in a reconsideration of that position along the recommendations of the staff, particularly in light of the recently increasing slippages in the global economy. We are of the view that automatic stabilizers should at least be allowed to work and that this can be done without unduly risking the attainment of the medium-term fiscal target. Expenditure cuts to meet the nominal fiscal target may be counterproductive at this time. Failure to revive economic growth in Germany, and more broadly in Europe, can be damaging in and by itself. It can also undermine the credibility of the monetary union and the achievement of the fiscal target over the medium-term. In our view, the balance of risks points to the need for avoiding an undue negative fiscal stimulus.

Beyond allowing automatic stabilizers to operate we do not see considerable scope for further action including in the tax area. In this regard, we tend to agree with Mr. Bischofberger that tax cuts should be considered from a medium-term perspective and not from a cyclical standpoint. In this regard, while there could be room for advancing the timing of the agreed tax cuts, it is not clear whether such a move would appreciably improve consumer spending. In particular, it may well be the case that given that this tax cut is expected, consumers have already accounted for it by making changes to their consumption behavior accordingly. Furthermore, in a period of uncertainty, consumers may well chose to save tax cuts instead of increase spending, frustrating their economic stimulus effects.

Turning to the medium-term, it is important to get a feel of how Germany compares to other European countries in terms of recovery periods and whether there are lessons to be learned in this regard. In any case, as is clear from the report, reforms in key structural areas would be important to remove impediments to growth. Given that fiscal consolidation has been constraining growth, the authorities' emphasis on expenditure restraint to guide fiscal policy in the medium-term is well placed. This permits the achievement of the twin objective of reducing the role of government in the economy, and reducing public debt, which provides the ground for reducing taxes. With regard to structural reforms, needless to say, there is ample room for further liberalization, particularly in the labor market, if the authorities intend to expand the growth potential of the economy. All these considerations could lend support to a higher and more sustained level of growth over the medium-term.

Finally, we welcome the German authorities' support for a new trade round and their intention to press for the liberalization of agricultural policy with improved access for developing countries that would address existing distortions in Europe and help promote global trade. We wish the authorities success.

Ms. Jin submitted the following statement:

At the outset, I would like to thank the staff for the well-written, analytical and insightful papers, and Mr. Bischofberger for his informative and helpful statement.

At the last consultation discussion, Germany was enjoying the strongest whole-year economic growth in 10 years, although with hindsight the current prolonged slowdown was just beginning. With the much sharper-than-expected deterioration in the external environment, which will be deepened further by the recent tragic events, the upswing came to an abrupt end this year. According to remarks made by Mr. Welteke, Bundesbank President, yesterday and Mr. Eichel, Finance Minister, last week, the real growth rate is expected to be lower than one percent in 2001. The stagnation of growth will generate a series of vicious effects and risks—lower fiscal revenue and the subsequent enlarged deficit, the suspension of employment growth, and a further decline in business and consumer confidence.

We note the call from some research institutes for the government to relax some of its spending constraints to avoid a deeper and more painful downturn. Generally speaking, a prolonged downturn will have harmful repercussions for the German economy itself, the economies of the euro area, and those of the world. Therefore, many hope appropriate policy measures will be taken to foster the largest economy in the euro area. The German authorities adhere to a medium-term orientation and do not see much need or scope for policy adjustments to address the current slowdown, as indicated in Mr. Bischofberger's and in Mr. Welteke's call for the "level-headed use of policy instruments". As the authorities are the best judge of the economy and their country's culture, their reaction must be considered carefully. Just as treatment should be tailored to curing the root of an "illness", it is important to look further into the reasons underlying the economic slowdown before moving on to concrete policy discussions and to a debate on "slowdown vs. stimulus policy".

The staff report explores the reasons behind the growth slowdown at the beginning of Sections II and III. We learn from Box 1 that the downturn was initially brought about by a consumption slowdown last year. "It was compression of disposable income rather than the erosion of consumers' purchasing power through price increases that caused the slowdown in consumption." While paragraph 15 states that the immediate cause of the slowdown was because "the oil price shock sparked the downturn, and food price hikes and the global slowdown poured further cold water on activity during 2001." There seems to be some inconsistency. We have to admit that it is still a “puzzle” to us, especially in the context of policy considerations. We wonder what caused “the compression of disposable income” and what policy actions might have been overlooked in avoiding and/or offsetting this result. Could the staff please comment and clarify?

As to the reasons behind the persistence of the slowdown for demand and output, the authorities point to the reunification legacy, while the staff also emphasizes labor market weaknesses. We think both are important components of the complete picture. The ongoing reunification process has had a great impact on the economy of the western part of Germany, of which the fiscal burden is just one example. Therefore we must put our analysis and policy considerations in this context, and remember Mr. Bischofberger’s words, “it is a task for a generation rather than for a decade.”

On the fiscal front, there is no doubt that significant progress has been made over the past three years. The general government balance turned to a surplus of 1.2 percent of GDP, compared with 2.7 percent in 1997. Looking ahead, the German authorities have reiterated their firm commitment to medium-term fiscal discipline within the framework of the Stability and Growth Pact (SGP), and put the focus of fiscal policy on eliminating the general government deficit by 2004. As to how to let the automatic stabilizer play fully, the authorities strongly believe that missing deficit targets will damage the credibility of fiscal policy and that proactive fiscal measures may do more harm than good. This is a question with no clear-cut answers and both the arguments of the staff and the authorities sound reasonable and persuasive, viewed in their different contexts. Therefore, considering the ownership of the policy, and in the spirit of “putting oneself in another’s shoes”, we are prepared to agree with the authorities. We hope that the stabilizer will be allowed to play freely within the framework of the SGP and that flexibility be given when necessary.

We congratulate the authorities on the encouraging results of the first stage of the tax reform carried out earlier this year, which, as indicated by Mr. Bischofberger, has generated a significant fiscal stimulus, partly offsetting this year’s decline in investment and helping to avoid an even sharper growth decline. The authorities’ envisaged tax reforms for the coming years are praiseworthy viewed from a medium-term perspective. They will have positive supply-side effects on incentives to invest, help improve Germany’s attractiveness to international investors, and enhance potential growth.

On structural reforms, we share the view of the staff and the authorities that emphasis should be on the necessity for further structural reforms, the fundamental resolution for lasting output growth. We are reassured that liberalization of product markets remains at the center of the authorities’ structural policy. The privatization and deregulation programs have improved competition, on the one hand, giving private enterprises further business opportunities and confidence while on the other helping to lower prices and increase consumer choices as well as fostering the development of high technology sector. These essential improvements will benefit the upgrading of the output level without generating great pressure on price levels. The authorities' further plans for reforming railways, the postal service, and telecommunications sectors are welcome.

Turing to the labor market, how to reduce the protracted problem of high unemployment in a sustainable way will be an even greater challenge for the German authorities in the deteriorating economic environment. Substantial progress has been made over the past year, mainly through across-the-board wage increase moderation, supported by tax and pension reform. We are encouraged by the authorities' active exploration of measures to provide work incentives, such as the experimental schemes in several states using tax transfer mechanisms to raise incentives for the lower skilled workforce. We welcome the government's approach based on the "three-pillar pension system", whose benefits were further elaborated in Mr. Bischofberger's. From the medium-term perspective and the long-term task of reducing labor market rigidities and promoting steady employment growth, we encourage the authorities to pay attention to the staff's suggestion of promoting greater wage differentiation.

Last but not least, we are very impressed by the figures of Germany's support provided to transitional economies given by Mr. Bischofberger. We also appreciate the authorities' efforts and important role in strengthening the HIPC initiative and their financial contribution. We encourage them to continue their efforts in this respect, in particular, to increase their ODA contribution toward the U.N. standard.

With these remarks, we wish the authorities further success.

Mr. Kelkar submitted the following statement:

We thank the staff for the well-written report and the useful analysis of the rules based fiscal policy and employment and growth in the selected issues paper. These together with Mr. Bischofberger's thoughtful statement have been helpful in assessing the recent economic developments and the prospects and policy issues in Germany, following the rich discussion we had a few days ago on euro-area.

At the last year's Article IV discussion on Germany, we had a reasonable degree of confidence that the growth momentum seen in Germany would be sustained, despite some risks to the short-term outlook at that time due to high oil prices and uncertainty of the speed of recovery of the global economy. It is disheartening how the terrorists attacks in the United States and developments in the world economic environment since then have considerably altered the economic prospects, not only for Germany, but also for the entire world. The major challenge for the German authorities, also as a lead player in the euro-area, is to ensure that all possible transitory economic policy measures are put in place to cushion this severe shock while continuing with structural reforms to improve its potential growth and protect the medium-term euro area interests. In this regard, we commend the German authorities for the considerable progress made in the tax system, pensions and product markets.

Fiscal Policy

The staff has precisely laid down how constrained the macro economic policy framework in Germany is, in the context of the Stability and Growth Pact (SGP) for the monetary union and the existing labor market rigidities. The report clearly pointed out the authorities' firm commitment in establishing the credibility of both fiscal and monetary policy, even if they have to bear high costs in terms of output volatility in absorbing temporary shocks such as the one they are experiencing at present. While we share the authorities' view that wage moderation in the labor market could help in adjusting to shocks, we would welcome the staff's comments on several concerns. Would the much sharper weakening of the economic prospects call for a positive fiscal stimulus for the next two years and impart greater flexibility to annual and medium-term targets under SGP? Would credibility not be firmed if Germany achieves its medium-term target of eliminating general government deficit by 2004, by accelerating the labor market and other structural reforms? Would it be reasonable to continue to assume that the fiscal target for 2004 can be achieved? And are there possibilities for a larger reduction in top marginal income tax rates than currently planned, as it appears that a 42 percent rate by 2005 is rather high?

The staff has indicated the possibility of bringing forward the tax cuts planned for 2003 and the authorities' concerns about the effectiveness of such a move, while also raising the issue on its implications for the fiscal consolidation framework. We are not sure why there should be a concern about the effectiveness of advancing tax cuts. The credibility issue needs to be put in context of the severity of external shock and costs of alternative means of absorbing it.

The SGP was formulated in the context of the global environment of prosperity and growth. However, when there is a sharp synchronized downturn in the global economy for the first time, it appears necessary to revisit the SGP in the context of new realities of the global economy.

We also welcome authorities' interest in undertaking a fiscal transparency review of standards and codes (ROSC).

Monetary and Exchange Rate Policies

As the environment has changed from the earlier supply-side shocks to a more demand-side shocks now, and as the downside risks for recovery of economic activity is much greater, there appears to be a wider scope for macro-economic policy to support growth, in particular through the easing of euro-area monetary condition. Given the likelihood of a further increase in unemployment than currently projected and easing on wage pressures, Germany would be a major beneficiary from a further cut in interest rate by the European Central Bank. A further significant cut in interest rate would not bring undue pressure on the euro, given the fact that there have been sharper cuts in interest rates, particularly in the United States and the moderation of wage pressures. In addition, it might have a favorable impact on the financial sector vulnerability indicators. We would appreciate the staff's views on this latter aspect in the case of Germany. We welcome the authorities' willingness for a financial sector assessment exercise in Germany. However, the timing of this exercise appears uncertain, as it would be undertaken only after the enactment of a new financial supervisory structure, the timing of which is also unclear.

Structural Reforms

The potential growth of Germany has been severely constrained by the structural rigidities, particularly in the labor market. We share the staff's views on the labor market issues. While appreciating the authorities' attempts to address labor market problem through special schemes and various regulatory means, it would be essential to introduce greater flexibility to labor market to make a more productive use of the labor force and raise potential output. It would also help to bring about a reduction in the natural rate of unemployment.

We welcome the authorities' strong record of liberalization of product markets in several major areas such as telecommunication, electricity, gas and some segments of postal services and allowing private local railway services. We hope that the authorities would be successful in their plans for the deregulation of more difficult areas of public service and utilities.

Germany's potential growth remains very low. Can the staff comment on the possible areas of structural reforms that could bring about a significant increase in the potential output in the medium-term?

Trade and ODA

We welcome the authorities' support for the launch of a new round of trade negotiations and their intention of pushing forward the liberalization of agricultural policy and improved market access for developing country exports.

The impact of energy prices among EU countries, particularly as between Germany and France differs significantly. Can the staff comment on the reasons for this differential impact and on the implications of this on EU-wide energy policy?

We urge the authorities to separate the ODA commitments from commitment for expenditure restraint under the SGP, and increase its Germany's contribution to ODA to reach at least the U.N. target of 0.7 percent of GNP.

Mr. Oyarzábal and Mr. Varela submitted the following statement:

At the outset, let us thank the staff for an excellent set of papers on Germany, as well as Mr. Bischofberger for his helpful and informative. Germany's economic performance until the middle of last year was outstanding and the authorities should be commended for it. Real GDP growth, at 3 percent, was the highest annual average rate in nearly 10 years. This performance was the result of sound macroeconomic policies, coupled with strong external demand in line with the world growth, the evolution of the euro exchange rate and favorable domestic demand. However, during 2001 we have seen a sharp drop in the GDP growth (0.7 percent) expected for the year, due to a deterioration of private consumption, higher oil prices, the decrease in construction activity and a recent reduction in business confidence following the terrorist attacks of September 11.

Despite the slowdown of the economy, it is important to recognize Germany's structural advances, especially in the area of pension reform, liberalization in the telecommunications sector and deregulation of the electricity market. In addition, we welcome the incentives to labor and investment provided by the recent tax reform, and the measures to counter terrorisms financing that are being introduced within the framework of the Fourth Financial Market Promotion Act.

Labor Market

It is important for Germany to address structural problems in the labor market, especially improving flexibility in wages but will help labor markets to clear in different region and for different skills. Also, the easing of restrictions in the terms of employment and layoffs will encourage private firms to continue hiring during periods of uncertainty.

Reducing the widening gap between wages and productivity would contribute to improve competitiveness. The announcement that wages settlements for 2002 are expected to be moderate is encouraging. Wage moderation will help to carve up the shocks on the supply side, especially when the main contributing factor to the slowdown has come from this side of the economy.

With regard to the problem of shortage of skilled workers and insufficient jobs for the low-skilled workers, we welcome the Government policies to tackle these issues, such as the green card initiative that facilitates the immigration procedures to non-European specialists. In this regard, it would have been enlightening to have a deeper analysis of this policy, especially as it compares with other countries with similar schemes.

Fiscal Policy

On the fiscal side, we agree with Mr. Bischofberger that providing a stable and firm fiscal framework is the best strategy to diminish the present uncertainty, that is exacerbating the on-going international economic downturn.

We support the authorities' commitment to the present fiscal policy stance, and their intention to let the automatic stabilizers operate in case the economic performance is lower than expected, however strictly abiding by the stability and growth pact.

Product Market and Financial Sector

We commend the authorities for the advances made in product market liberalization, especially in the areas of telecommunications and electricity, where service prices in both sectors have declined considerable. Nevertheless, prices are still higher than in other European Union countries. We also welcome the additional efforts made in deregulating the gas industry and postal services, as well as the plans to address public services, waste management and water supply.

With regard to the financial sector, it is reassuring to note that the supervisory authorities consider that the sector is sound and healthy enough to confront the effects of the economic slowdown and that the exposure to potential external risks is manageable as the German bank's total cross-border exposure to emerging markets is geographically well distributed. However, given that the banking exposure to developed countries suffering from economic downturn is substantial, we consider that it is fully justified to pay attention to development in this area, as recommended by the staff.

We welcome the authorities' decision to participate in the Financial Sector Assessment Program. That will allow a better appraisal of the current state of the German financial institutions. Furthermore, the banking associations commitment to meet with the proposed standards of the Basel II Capital Accord is most welcome.

Finally, we concur with the authorities and the staff that the consequences of the sharpness of the slowdown in an environment of strong fiscal and monetary stimulus are a puzzle. And more pieces have been added to this puzzle after the events of September 11. Nevertheless, we rest assure in the German authorities' wisdom to firmly handle this situation and wish them success in their future endeavors.

Mr. Low and Ms. Manivat submitted the following statement:

After a strong economic performance in the second half of 1999 and the first half of 2000, Germany is now confronted with a major downturn. There is already no lack of public debate on the appropriate policy response and the Board's deliberations today will add to this debate. Against the backdrop of the fragile global economic outlook and the uncertainty on how consumers and investors will adjust their behavior and expectations, the German authorities have a formidable task in balancing the short-term considerations with their medium-term commitment, i.e. how to prevent a looming recession while maintaining stability and credibility. Unfortunately, the answers are not obvious. Nevertheless, we would like to offer some views on the more important areas of concern, namely, fiscal policy and structural reforms, with particular focus on the labor market.

Fiscal policy

Many of the indicators paint an unfavorable outlook for Germany. The export-oriented manufacturing sector dipped into a recession; capacity utilization in the manufacturing sector declined; the September business climate index posted the biggest monthly drop in almost 28 years; and unemployment is on the rise. The staff admitted that the reasons for the sharpness and persistence of the slowdown, despite considerable fiscal and monetary stimulus, "were a puzzle." From our discussions on the *WEO* and Monetary and Exchange Rate Policies of the Euro Area, it was noted that there might be some underestimation of the strength of the linkages between U.S. and European growth and an overestimation of the Euro area's resilience to external shocks. With these in mind, the authorities should all the more be concerned about taking the right policy action; too little or too late a response may be costly to the German economy and may have serious repercussions for the other European countries and the world economy.

Nevertheless, we sympathize with the German authorities' cautious approach. After all, there is general wisdom that it is better to err on the side of caution. Mr. Bischofberger's arguments are quite persuasive, particularly about the lags of fiscal policy. In order to eliminate the general government deficit by 2004, public expenditure growth will be kept below 2 percent a year in nominal terms, while on the revenue side the automatic stabilizers will be allowed to work fully. We also note a certain degree of flexibility embedded in the Stability and Growth Pact. Nevertheless, the constraints in the framework provide the authorities with less room to maneuver. Moreover, the targets were set based on the projections made in October 2000. The staff has also pointed out that the sizable tax cuts implemented in January failed to revive growth. It is therefore not surprising that the authorities have questioned the effectiveness of the staff's proposal to bring forward the tax cuts planned for 2003. While we are confident that the authorities will continue to monitor developments closely and keep all options open, we wonder if Mr. Bischofberger could shed further light into the authorities' contingency plans to revive growth if the automatic stabilizers do not deliver what is anticipated, bearing in mind the important contribution of German growth to EU growth and thus to the global economy.

Structural reforms

Turning to the structural issues, the problems are multi-dimensional and indeed challenging. The authorities are to be commended for the significant strides in pension and tax reforms and liberalization of the product markets. In particular, we welcome the introduction of the private pension system that should help contain increases in social security contribution rates as the population ages and are encouraged that health care reform will be a priority during the next legislative period. Liberalization of product markets have yielded tangible results in terms of high-quality service and lower prices, and further reforms in the railway sector, postal service, and telecommunications should greatly benefit consumers in the period ahead.

Germany's continued growth potential depends crucially on the Government's resolve to tackle labor market rigidities. We are not altogether clear, however, exactly what needs to be done to improve the situation. The staff argues that there should be greater wage differentiation across skills and regions in order to solve the problems of skilled labor shortages and high unemployment among the unskilled. The staff also acknowledges social resistance to reductions in the level and duration of benefits, yet stops short of making a recommendation on an alternative measure. Both the staff and the authorities appear skeptical about the scheme to provide tax breaks to the low skilled, and we wonder whether there are plans to modify or discontinue the scheme. The staff's clarification is welcomed. We would also like to have more information on the legislation to be introduced in 2002 that would require the unemployed to sign a contract specifying their obligations to seek work and undergo training, in particular whether such a measure has been used effectively in other countries.

On the financial sector, we concur with the staff that the problems of the construction and real estate sectors, as well as potential risks from rising insolvencies, underscore the need to be vigilant in supervision. According to a credit rating agency's estimate, gross problem assets are at 5-15 percent of the total. We also note the increased external capital flows intermediated through Germany, which may be creating new vulnerabilities for financial institutions. In this regard, we find the analysis in Box 5 of the staff report very interesting but not satisfying since clear trends in the capital account are not discernible. It appears that we will not be able to fully appreciate the vulnerabilities in the German financial sector until more direct and different methods focusing on risks and exposures of large institutions are employed, or when Germany participate in an FSAP following the enactment of a new financial supervisory structure.

In the meantime, however, we note with some concern the recognition that poor management and governance contributed to the significant losses by a publicly owned bank that is the tenth largest bank in Germany. It seems that Germany has not been spared the problems of public sector banks that some developing countries that are under Fund-supported programs have encountered. However, we note that the staff fell short of providing the same definitive advise to the German authorities on the need to privatize public sector banks so as to improve their efficiency through greater competition. This appears to be more urgent given that public banking institutions account for 40 percent of total banking business in Germany, as noted by Mr. Wijnholds.

Conclusion

We note that identifying both the short-term policy options and long-term challenges for Germany are not easy tasks. After the reunification, Germany has managed to overcome many hurdles and solidify progress on many fronts. While many obstacles remain, sound macroeconomic management and persistent structural reforms will bolster confidence and strengthen long-term growth prospects, maintaining the country's standing in Europe and in the global economy. With these remarks, we wish the authorities continued success in their endeavors.

Mr. Cippà submitted the following statement:

Like in most Article IV discussions we will be having in the near future, in the case of Germany a dramatic deterioration of the economic outlook has taken place since the last consultations. Whereas last year the staff considered the near-term outlook for the German economy to be better than it had been for several years, we are now faced with growth rates for 2001 and 2002 that have been revised downward significantly as well as with a high degree of uncertainty regarding the short-term outlook. With the German economy "at the edge of a recession", as noted in the recent joint report of the six leading economic research institutes, the authorities are faced with the daunting task of managing the slowdown, while continuing their strong efforts to implement the various structural reform efforts. I fully agree with the staff that it is important not to lose sight of the significant progress that has been achieved in this area.

Clearly, the major tax reform introduced at the beginning of the year, which significantly reduced marginal tax rates and broadened tax bases, as well as the crucial passage of the pension reform, which introduced a private pension pillar, deserve particular mentioning. However, to effectively dispel the authorities' concern that there is a growing perception that the reform momentum had now been lost, it is essential to tackle the long-standing rigidities of the labor market. Reading Mr. Bischofberger's statement and the staff report, it is clear that there is full agreement between the authorities and the staff regarding the negative impact the existing structural problems are having on potential growth.

One important aspect influencing growth performance in Germany is the slow pace of convergence between Eastern and Western regions. The slower-than-expected catching up and the remaining large asymmetries between the regions in several areas could provide further explanations for the relatively slow growth rates since unification. Like Messrs. Padoan and Lombardi, I think a more detailed analysis of these issues could have been helpful.

Fiscal Policy

As stressed by Mr. Bischofberger in his statement, fiscal policy in Germany is solidly based on the medium-term goal of eliminating the general government deficit. The rules based system with a well-defined timeframe and annual deficit targets are an important element to provide macroeconomic stability and credibility. Since my own country is following a similar medium-term oriented fiscal policy, it will not come as a surprise that I support the German authorities stance. This being said, the severe deterioration of the economic outlook poses the difficult challenge of balancing the credibility benefits of adhering to a predefined medium-term plan and the potentially large short-term damage caused by the procyclical element of such fiscal policies. The German authorities have made it very clear in recent statements that they have no intention of backing off from the targets established under the Stability Program and that they see no need for additional measures to stimulate the economy.

After reading Mr. Bischofberger's statement, my understanding is the following: while there is a general agreement between the authorities and the staff on the benefits of the medium-term fiscal consolidation program, there seem to be important differences as regards the specific fiscal policy stance next year. The staff argues that the lower growth in 2001 and 2002 will make it difficult to meet the deficit targets and, therefore, the authorities should focus on expenditures ceilings and allow the automatic stabilizers to operate fully on the revenue side. The staff report indicates that at the time of the mission, the authorities did not expect significant slippage from the official deficit targets and, therefore, did not contemplate offsetting revenue measures. Clearly, the situation has deteriorated further and the only realistic way to achieve the deficit targets now would be through additional expenditure restraint. My understanding is that also the recent statement by the leading economic research institutions underscores the necessity for fiscal policy to remain neutral in 2002, in order not to exacerbate the economic downturn. I wonder if Mr. Bischofberger can give us some additional insight regarding the authorities' thinking on the fiscal stance next year.

Structural Reforms

As I noted at the outset, the government has made impressive progress in various areas of structural reform. The introduction of a private pension pillar is an important first step to address the future strains on the social security system due to the demographic developments. It will help limit further increases in non-wage labor costs that would certainly be detrimental to employment creation. However, further steps will be necessary and discussions will have to be pursued on issues concerning the relative size of the public and private pillars of the pension system as well as the retirement ages. Moreover, I share the staff's concern about the upward trend in the health care system that should be at the top of the political agenda during the next legislative period.

The staff correctly highlights the necessity to urgently pursue a further liberalization of the labor market in order to address the still high structural unemployment and boost potential growth. I welcome the authorities' statement that they view the labor market as the major remaining frontier for reform. The problems are well known: market rigidities, centralized wage bargaining, high non-wage labor costs and disincentives to enter the labor market due to the generous benefit system. In addition, the shortage of high-qualified workers has exacerbated the labor market problems and raises questions about the ability of the educational system to meet the market demand. I tend to share the staff's view that the quick halt in employment growth as soon as demand showed weakness is symptomatic of labor market regulations that discourage hiring when uncertainty rises.

More generally, I think Mr. Bischofberger makes an important point when stressing the impact of the consensual decision-making process in Germany on the pace of structural reform. While this process does imply a slower pace, experience has shown that at this pace, reforms are more continuous and accompanied by social peace. An important ingredient of the latter is of course Germany's generous social safety net. While I agree that a well-endowed social safety net is an important asset, I have to stress that this asset becomes a problem if it impedes employment creation and becomes fiscally unsustainable. I am convinced that Germany can increase the reform pace without endangering the consensual decision-making process and social peace.

Finally, I would like to thank the staff for the interesting set of papers and wish the German authorities success in the current challenging domestic and global environments.

Mr. Zoccali and Mr. Costa submitted the following statement:

An important aspect in this year's Article IV consultation with Germany centers on the determinants of the accelerating downturn of the economy. After growing at a 4 percent annualized rate in the fourth quarter of 1999 through the first half of 2000, the German economy entered a phase of a marked slowdown in the second half of last year, the third time since reunification that a rebound has failed to take hold. Clarity regarding this dynamic is important to help draw out the most effective policy advice for this major economy, particularly at this critical juncture when recessionary conditions prevail in many countries around the world.

A first conclusion of the staff's analysis is that the failure to maintain the growth momentum in Germany was not due, on this occasion, to inappropriate macroeconomic policies. While interest rates set by the European Central Bank may have been on the high side in relative terms, considering the cyclical and external conditions facing European economies, and Germany in particular, the substantial depreciation of the euro has helped to compensate for that fact. Fiscal policy under the purview of the national authorities has, thus, needed to play a more supportive role in assisting the recovery and much is expected of the tax cuts amounting to 1 percent of GDP, introduced in 2001. The staff's supplement indicates the prospects of a reasonably strong recovery on a quick reversal in business confidence and on the occurrence of a global upturn. Mr. Wijnholds notes that Germany's six leading economic institutes are less sanguine, and their recommendation is that some further fiscal easing is needed to improve near-term growth prospects. A staff comment on the effectiveness of the recommendations to advance by one year the next phase of the personal tax cuts and boosting investment spending by local authorities would be welcomed.

In light of recent developments, the projected negative fiscal stimulus for this year is likely to be substantial if the authorities stick to their original SP target. Therefore, we find merit in the staff's support for the medium-term SGP goals while allowing, in the midst of the current slowdown, full play of automatic stabilizers, in the face of larger than expected revenue losses, and adherence to the expenditures targets. Given the credibility gained by the German authorities regarding their commitment to fiscal discipline, a postponement of the agreed date for fiscal balance in 2004 would, in our view, be less damaging in the present circumstances. Underestimating the intensity and duration of recessionary conditions, on the other hand, could have a more deleterious effect on the budget and on the medium-term growth prospects of the economy.

In trying to explain the present slowdown and after dismissing macroeconomic policies as a cause, the staff analysis contemplates among other variables, the impact of higher oil and food prices on inflation during 2000. A harmonized CPI increase of 2.1 percent last year does not seem, however, to be a very robust explanation for the slowdown. Moreover, the moderate wage settlements agreed in recent years and the expectation that these will remain subdued in the future calls weaken the assertion in paragraph 23 of the main report that “the major impetus to the slowdown had been from supply-side shocks.”

The “legacy of the overbuilding in the construction sector and the fiscal burden of reunification” highlighted by the German authorities deserve a more nuanced consideration. The staff concludes, that the dragging impact on growth of the sharp reduction in construction activity, after the boom experienced during the initial years of the reunification period, may not be significant given the low, and contracting, participation of the sector in total GDP. If this conclusion holds, the reverse, namely, the growth stimulus that may be desired from the clarification of public spending commitments in Eastern Germany, in the new Solidarity Pact on Infrastructure, may also not represent an effective trigger for aggregated demand as exemplified by the experiences of Japan. In this regard, the channeling of substantial fiscal resources into the eastern Länder has had a disappointing effect on the growth potential of the economy. In addition to sizeable transfer payments, still amounting to over 5 percent of GDP to the eastern Länder, the announced plans to boost construction activity in East Germany by allocating federal resources amounting to some ½ percent of GDP per year through 2019 raises the issue of its productivity as compared to more substantial tax relief given Germany’s relatively high tax burden.

During the Board’s discussion of Euro area monetary and exchange rate policies last week, it became clear that the slowing U.S. economy since the second half of last year and particularly after the tragic events of last September, have had a larger than initially projected impact on the Euro area as a whole and on the German economy in particular. In this regard, the “new economy” sector of the German stock market evidenced rapid growth until March 2000 and then an even sharper fall than the Nasdaq. In addition, the market slowdown in U.S. aggregate demand and, to a lesser degree in the

Euro area, heightened the vulnerability of German exporters, despite their competitiveness. This confirmation substantially weakened business confidence and the main driver of German growth: its strong export performance.

Another important factor that may have contributed to the severity of the slowdown that deserves in our view special emphasis is alluded to in paragraph 22 of the staff paper, namely, the concern of a growing perception that a clear and broad based structural reform agenda, particularly as regards the labor market, was losing momentum. The shortage of skilled workers that Germany is facing, particularly in the high- tech area, which has led to the implementation of a "green-card" scheme to attract non-European high-tech specialists calls particular attention to labor market rigidities. Insufficient wage differentiation and labor mobility, along with weak active labor market policies aimed at improving training may constitute important underlying causes of the skill miss-match and of the structural unemployment, that still need to be addressed.

It does not seem possible to meaningfully address the labor market issues or any other structural aspect in the German economy without first making a clear differentiation between the West and the East given the marked differentials in productivity and unemployment, which in the Eastern Länder exceeds 17 percent. Low levels of productivity in the East, and insufficient wage differentials with the West perpetuate the need for large financial transfers. In fact, it could be asserted that even 10 years after reunification this challenge on German economy seriously constrains the federal government's room to implement durable supply-side and counter-cyclical economic and social policies. A more candid treatment of this trade-off, which as Mr. Bischofberger notes in his helpful statement, is happily accepted by the German authorities might, nevertheless, serve to enhance the value added of the surveillance exercise.

In any event, we commend the German authorities for the progress made in the structural reform area. Pension reform represents a major achievement both on economic and political grounds, and the creation of a private pension pillar, provides an even stronger underpinning for the development of the German capital market. Tax structure reforms have provided opportune relief and we join others in underscoring the desirability of further reducing the still high tax burden. Additionally, the liberalization in telecommunications and utilities sectors opened the way for stronger growth, including the creation of additional jobs. Similarly the recent agreement on revenue sharing between the different levels of government, which for any federal system of government represents a milestone undertaking, has introduced appropriate incentives and more direct responsibility for efficient revenue collection at the local level.

Finally, we welcome the priority assigned by the German authorities to its international role and wish to acknowledge its exemplary contribution to the provision of international financial assistance, in particular for the transition process in Central Eastern Europe and the HIPC Initiative. In this regard, German support for a new trade round for the liberalization of the European Common Agricultural Policy and for improving market access for developing countries in general constitutes an important pillar for world economic cooperation.

Mr. Daïri submitted the following statement:

We thank the staff for the well-written report, and Mr. Bischofberger for his insightful statement. A much promising economic recovery in Germany came to a halt in the second half of 2000 due to a slowdown in private consumption and investment. Growth for 2001 has been continuously adjusted downward from 2.5 percent last year to 0.7 percent most recently. The slowdown in growth took effect notwithstanding an accommodative macroeconomic policy environment and improved economic fundamentals brought about by commendable structural reforms aimed at increased economic resilience. Moreover, recent projections point to a downward revision in growth for 2002. The setback in recovery, however, has not altered the staff's projections for the medium-term outlook, in view of the expectation that growth would resume in the first half of next year, with lower food and oil prices and under the assumption that developments since the tragic events of September 2001, while increasing uncertainties, will only result in a short delay in recovery. This being said, the authorities need to be more vigilant and flexible to reorient macroeconomic policies, if necessary. While on growth issues, like Mr. Al-Turki, we find the analysis of oil price impact on growth inconclusive. We note a substantial difference of opinion between the authorities and the staff about the transmission mechanism of this effect. A further elaboration by the staff will be appreciated.

Recent monetary easing by the European Central Bank, in concert with the Fed's lowering of interest rates, is welcome. Monetary policy, however, should ease further, if world economic growth continued to be weak. The authorities have made it clear that they do not wish to increase budget deficit for next year, in order to allow more room for lowering of the rates by the ECB. At the same time, the authorities are cognizant of the risks involved in interest rates cuts due to concerns about the public acceptance of the euro.

According to the authorities, the scope for further fiscal stimulus is constrained under the Stability and Growth Pact (SGP). As the staff point out, the authorities' view should be reconsidered carefully. Adhering to the annual SP deficit targets would imply a reduction in expenditures in 2001, causing a negative fiscal stimulus, which would further damage growth prospects. Current expenditures should be maintained at the present target levels in 2001, while allowing the automatic stabilizers to operate fully. We also agree with the staff's suggestion with regard to maintaining the original pace of deficit reduction in 2002, compared to 2001, rather than trying to meet the original SP target. Even under this proposal there will be a negative fiscal stimulus of more than 0.5 percent of GDP next year. We agree with Mr. Bennett that the authorities' flexibility in this area and their response to recessionary pressures might enhance their credibility.

The authorities are encouraged to consider all available options for stimulating the economy, including bringing forward the planned tax cuts for 2003, if growth remained sluggish. To address the procyclical nature of the SP targets, expenditure ceilings should be set in consistence with a medium-term tax policy and public debt targets. Nevertheless, the authorities' emphasis on curtailing expenditure in the medium-term is well placed. This policy is required to allow further reduction in the tax burden and social security contributions, as well as to place the public debt on a declining path.

Significant advances have been made on the structural front, especially in the areas of tax and pension system and the product market. Privatization and deregulation have brought about large benefits, demonstrated by a sharp decline in prices, particularly in telecommunication and electricity sectors. This achievement should encourage the authorities to press ahead with further privatization and reform, including in the more difficult areas of public services and water supply. It is regrettable that an agreement on a EU Directive on corporate takeover had not been reached, however, the authorities are considering pressing ahead with their own legislation in this respect.

Progress in labor market, however, has been relatively slow. The labor market is the area most in need of reform to unleash the potentials of economic growth and job creation. We are pleased to note the authorities' plan for reforming the labor market, including increasing work incentives for the unemployed. Promoting greater wage differentiation across the skill levels and regions would be helpful in this regard. The authorities dismiss the concerns raised by the staff about the recent legislative and regulatory changes in the labor market on the basis that these changes were aimed at promoting part-time employment and modernizing the system of "co-determination." Since the concern that these changes serve as counter-incentive to job creation is widely shared, the authorities are encouraged to engage in a public relation campaign to clarify their objectives.

We share the view that the financial sector is sound and able to weather the economic slowdown relatively well. However, supervisors need to be vigilant and watchful of developments in the telecommunication, construction, and real estate sectors. We agree with the staff that the German banks also need to be closely watched in view of their large exposure to

> developed countries that are currently suffering from economic downturns. The staff may wish to comment on the recent announcement that the fourth largest bank is planning substantial job cuts.
>
> There is indication in the media that the informal economic activities are growing in Germany as the date for introducing the euro notes and coins is approaching. According to news reports, cash prices for certain assets are higher than those paid through bank instruments. The staff may wish to elaborate on this point.
>
> Finally, we encourage the authorities to increase their ODA to meet the U.N. target. With these remarks we wish the authorities further success.

Extending his remarks, Mr. Bischofberger noted that, on October 25, the authorities would officially release the growth forecast figures. They would, of course, correspond to those already mentioned by Finance Minister Eichel.

Accordingly, for 2001, the authorities expected average annual growth of 0.75 percent, and for 2002, 1 to 1.5 percent. The new numbers were in line with the staff projections and the forecast of the six leading economic institutions in Germany, which had issued their new numbers October 23.

The new data would impact tax revenues and expenditures sensitive to the business cycle, Mr. Bischofberger declared. However, the magnitude of that impact was still uncertain. In the middle of November, the official projections on tax revenues for 2001 and 2002 would be updated and refined for use in reviewing the 2001 budget, as well as to adjust the 2002 budget, which was being discussed in the German parliament and which would be agreed upon by the end of the year. In his response to the growth forecasts and policy suggestions of the leading six German economic institutions, Mr. Eichel had once again emphasized that, notwithstanding the revised near-term economic outlook, the medium-term fiscal and deficit targets would be adhered to. There was broad agreement between the staff and the authorities on Germany's economic situation and the direction of economic policy. The still existing differing views on specific questions were small, but Directors had keenly identified them.

Mr. Daïri remarked that he agreed with Mr. Al-Turki's comments on the effect of oil prices. There was not sufficient evidence from the paper that oil prices had been a major factor in triggering the slowdown in Germany; and it was not clear that the description of the effect of the decline of oil prices on stock market valuation was correct. The staff might have reached a different conclusion, had they measured the drop during a period of three months rather than two years. There was agreement between the authorities and the staff that the reasons for the extent and severity of the slowdown were puzzling, and that the agreement was surprising.

On fiscal policy, Mr. Daïri had mixed feelings about the staff's suggestions. The authorities' concerns about the credibility of fiscal policy were appreciated and understood;

but it was important to avoid strengthening the credibility of fiscal policy at the expense of the credibility of monetary policy. Could the staff comment on market participant and independent analyst views of the factors affecting credibility in Germany?

Comments by the staff or Mr. Bischofberger on the news reports that there was differentiation in the prices of some assets, depending on whether they were paid in cash or in bank instruments, were also welcome, particularly given that Germany was on the eve of a currency substitution, Mr. Daïri said.

The Deputy Director of the European I Department (Ms. Schadler) replied that the sharpness and persistence of the slowdown in Germany was indeed a puzzle. The staff could explain for the most part the turnaround in the year 2000, but the persistence and the size of the downturn in 2001 defied the ability of most models to explain.

Directors had raised questions on two aspects of the slowdown in particular, the Deputy Director observed. The first was on oil prices. There had been a huge increase in oil prices, especially in late 2000 and early 2001, and food prices had also increased owing to agricultural diseases. The terms-of-trade loss in 2000 had been about 1.6 percent of GDP, and a good share of that had been due to the oil price increase. All things being equal, a terms-of-trade loss like that would generally lead to a loss of output growth of up to 1 percent.

Part of the confusion arose out of Box 1, the Deputy Director surmised. Some puzzles remained in the data, as seen by looking at the consumption deflator (as opposed to the consumer price index). Little effect of the oil price increase was seen here. Instead, in the short-term, the staff saw that disposable incomes decelerated significantly. Thus, the conclusion was that the oil price increase was absorbed, not by producers passing the price increase through to a final consumer so that it showed up in the consumption deflator, but rather in disposable incomes. Examples were rising unemployment, less profits, and smaller wage bonuses. Therefore, it was not that the process of absorbing the price increase through incomes meant that the oil price increase did not have a large effect. Rather, it meant that it did not come through the channel the staff had expected, which was a higher increase in final goods prices.

There had been some questions about why the effect of the oil price increase seemed to have differed among various countries in the euro area, the Deputy Director said. The differences among countries were related to their dependency on fossil fuels and varying tax responses to the oil price increase.

A second group of questions arose over the role of the new economy and of linkages between Germany and other industrial countries, particularly the United States, the Deputy Director continued.

Certainly, a good part of the downturn in Germany was the result of a drop in plant and equipment investment, the Deputy Director asserted. In that respect, the slowdown looked similar to that in the United States. The drop in plant and equipment investment was not as large in Germany as in the United States, but it was quite pronounced and the timing was more or less identical. That led the staff to question whether there were linkages apart from trade, because during 2000 the trade linkages looked surprisingly weak. In fact, exports from Germany to the United States had continued to increase rapidly through 2000 and had only begun to slow in 2001. There were probably other linkages, but relatively little evidence to surmise whether they had a real impact.

It was also hard to distinguish between what could be called linkages and what was simply an economic response to common shocks, the Deputy Director declared. Certainly, the shocks in the world economy and the technology sector had been similar for Germany and the United States, and it might simply be a case of two economies responding in a similar way to similar shocks. Yet it was certainly true, as the staff had pointed out in Box 2, that the responsiveness of the German economy to what was termed "new economy" share prices—an increasingly popular index—appeared to be much lower than that of the U.S. economy. The estimates thus far showed that, for the size of the drop in the stock indices in Germany, a slowdown in GDP growth of only about 0.3 percent could be expected. That failed to explain the actual and much larger slowdown, but it certainly contributed to it, and the econometric evidence suggested that it was a statistically significant influence.

The information technology and new economy sector in Germany, by all measures, was significantly smaller than in the United States, the Deputy Director pointed out. It was hard to measure, but by most definitions it was half as large in Germany as in the United States relative to GDP, about 5 or 6 percent. Thus, although its influence was significant, it probably did not explain the downturn.

With regard to the short-term outlook, there had been many questions about the latest reports on confidence indicators in Germany, the Deputy Director recalled. The IFO and the ZEW indicators tended to receive the most attention, because there appeared to be significant linkages between those indicators and subsequent GDP growth. They had some predictive power that in other countries was not necessarily as accurate. Most other European countries did not have as strong a link between their confidence indicators and future GDP growth. In Germany, historically, there had been a strong link, and thus the staff took the confidence indicators fairly seriously. There had been a huge, unexpected drop in the IFO indicator in the data released the previous Friday. It was larger than the staff had seen for several decades. The last time there had been such a significant drop was perhaps as far back as 1973. The critical question was whether it was a one-time event in the pessimistic post-September 11 atmosphere that would bounce back in one or two months; or was it was a sign of something more serious and lengthy setting in?

The staff was in the process of considering how to interpret the confidence data, the Deputy Director explained. The ZEW indicator had given quite a different reading. Instead of falling sharply like the IFO indicator, it had generally leveled off. There was more post-September 11 information in the latest IFO index than in the ZEW index, but in the current turmoil, the staff might not be getting a clear reading. If the indices bounced back, even partly, in one or two months, the staff would be comfortable projecting 1 to 1.5 percent growth for 2002. If there were no sign of that, growth was more likely to be about 1 percent or even less.

With regard to the longer-term perspective, some Board members had asked why the staff had not paid more attention to the problems of East Germany to explain the relatively disappointing growth of the 1990s, the Deputy Director remarked. Considerable emphasis had been placed on that in the staff report, although not as a separate study. East Germany generated only about 12 percent of total GDP, so even if that region had shown no growth at all, it could not have been blamed for slow growth for the economy as a whole. Even if the West grew at its potential of around 2.25 percent, overall growth would be around 2 percent. The 1.5 percent growth during most of the 1990s suggested that much more was occurring to slow economic growth in Germany as a whole than just the weakness in the East. Indeed, most Eastern European countries successful in transforming themselves into free market economies were experiencing growth rates considerably in excess of 2 to 2.5 percent. In any event, in more normal times, once the construction sector pulled itself together again, the East was likely to become an impetus to growth.

On fiscal policy, there had been a range of questions about whether more fiscal stimulus would affect the economy and whether that would be desirable, the Deputy Director said. The staff position in that regard was quite clear. The multipliers in Germany, in particular during the last several years, came in at just below 1. That meant that, in principle, there should be an effect. There was always the issue that Mr. Daïri had raised—confidence—and on that there were two distinctly different views. The authorities strongly argued that confidence would be damaged by any discretionary fiscal stimulus for next year, because people expected that the stability plan would be respected. They felt reassured that the government was addressing the fiscal problem, and departing from it would be a blow to confidence.

However, some fiscal changes might not necessarily cause much damage in confidence, the Deputy Director continued. For example, bringing forward the tax cut already planned for 2003 would mean simply accelerating action already factored into popular opinion, and it might even help people understand that the government was being responsive to a weak situation, while still respecting the overall plan. Thus, the confidence factor could probably be argued both ways. At the current stage, the stimulus was not needed, but it might be in the absence of a clear turnaround in growth during 2002, or if the confidence indicators, for example, continued to be weak for one or two months.

The current round of tax cuts to be completed in 2005 would put Germany in about the middle range of the euro area countries in terms of statutory, corporate, and personal income taxes, the Deputy Director remarked. It was an ambitious program. At some stage, reexamination of the tax changes might be in order, but for the moment it seemed certain that the existing program would generate noticeable benefits over the next few years.

There had been much discussion of labor markets in the statements, the Deputy Director observed. Mr. Mozhin had inquired whether the staff report was accurate in saying that some of the rigidities in the German labor market actually helped insulate workers from unemployment. Now that joblessness was rising significantly, certainly that assertion was not entirely true. The rise in unemployment would be slower in Germany than in the United States, where job termination was easier. But that factor was not insulating the German economy much.

Box 4 precisely answered Mr. Kelkar's question on the priorities for structural reform, the Deputy Director noted. Aggressive labor market reform was needed to lower the NAIRU. That would be the best method of promoting growth over the next few years.

Total factor productivity growth in Germany relative to other European countries, or even the United States, had not been so different, the Deputy Director explained. But the difficulty in Germany was that TFP growth had been accompanied by declining, or at most very small increases, in the labor input. That combination would not produce the potential growth that should be seen in Germany. Thus, the measures outlined specifically in the paper to create more responsiveness of the labor market to growth opportunities were the highest priority for structural reform. The staff also listed in paragraph 36 a number of items that should be priorities for product market reform.

The Deputy Director commented on the effects of structural reforms on the cost of capital and investment in the midst of a downturn. It was necessary to compare investment growth now to the counterfactual had those reforms not taken place, something that was impossible to measure accurately. Those structural reforms were important. They probably had a current effect and certainly would in future years. Presently, the restructuring appeared to have started in earnest in response to the tax reform, one part of which allowed banks to sell shares from their portfolios without the capital gains treatment that had previously prevailed. And banks were engaging in forward sales of equity, which would eventually lead to a rationalization of the structure of industry, and presumably in that context spur investment.

Mr. Kelkar noted that a report in the previous day's Financial Times had raised the issue of the need to stick to the stability pact guidelines for macroeconomic policies. However, perhaps the stability pact had been formulated in a period when there were different conditions in the global economy. Now, with a synchronized downturn, and given the weight of the European Union in the world economy, the stability pact parameters should be revisited to ensure that the fiscal straightjacket did not work as a constraint on policy flexibility for the entire world economy. This was because the world economy was now in a different condition. As the *World Economic Outlook* pointed out, the synchronized downturn was a new phenomenon. Given the size of the German economy and the European Union, a number of leading German institutions, as the Financial Times story suggested, were now also raising the issue of whether a more supportive fiscal policy might be in order. Staff comments in that regard would be welcome.

The Deputy Director of the European I Department (Ms. Schadler) observed that the fiscal problem in some European countries, including Germany, was quite real. However, while the deficit needed to be reduced, perhaps the adjustment could be postponed a bit. The automatic stabilizers should be allowed to operate, to avoid excessive withdrawal of stimulus during the current time of weakness. The changes in the world situation, including the impact of September 11, justified modification of the plan.

Mr. Duquesne made the following statement:

Since we broadly share the views of Mr. Kiekens and Mr. Prader, I will try to be reasonably brief on the three main topics: The downturn, public finance, and unemployment.

Clearly, the economic downturn hit the country just as it started to recover after some years of disappointing growth. And indeed, as noted by the staff, Germany enjoyed in 2000 its best year since unification. Unfortunately, the weakness of the activity in 2001 will be the worst since unification, except for1993. The German economy suffered early from a slowdown of activity and much remains to be done to arrive at a satisfactory explanation for that. The lagging effects of reunification and certain structural factors may point to the emergence of a new German regime of durable but slow growth.

The staff seems reluctant to give a precise number for growth in 2002, but obviously the outlook is not very encouraging. I wonder, as a newcomer to this Board, if the formulation in the supplement, assessing growth as "well below 1.5 percent," can help address the situation. We would like the staff to elaborate a bit more on the prospects for German growth and its components. In particular, I would appreciate knowing how exports are fairing. It is puzzling to read in the main staff report—in Box 1, page 6—that the slowdown observed in exports in the beginning of 2001 was mainly due to exports to the European Union, while exports to the United States were still vigorous. Therefore, a recovery in the United States will not be sufficient to achieve recovery in Germany.

Indeed, there is much uncertainty. The recent analysis of the six leading research institutes sees Germany on the brink of recession. This is bad news for France, Germany's main trading partner and one of the very best friends of Germany.

The authorities' response to the deterioration of the economic outlook will send an important signal not only in Germany, but also to all European countries. Thanks to Mr. Bischofberger's useful statement, we have a glimpse of the authorities' stance on this. We fully support the German authorities' determination to stick to the essence of the Stability and Growth Pact. The pact will provide a predictable framework toward a medium-term balance of the public finances in the monetary union. Like Mr. Bischofberger, we believe that the pact is underpinning the credibility of the euro as the single European currency. We have also been supportive at least for the last two years of the notion that expenditure targets have a major role to play, as a supplement to, not a replacement for, the implementation of the Stability and Growth Pact.

Against this backdrop, some have expressed concern about the European lack of response to the current downturn. The German authorities will use the room to maneuver in the existing framework. Indeed, as clearly stated by Mr. Bischofberger, the German authorities will let the automatic stabilizers work fully on the revenue side and will limit the procyclicality of the fiscal policy.

On the expenditure side, we commend them for using reallocation of resources and for trying to respect the expenditure ceilings. However, despite such flexibility, the fiscal stance could be too tight and put an additional drag on already weak activity. This is clearly the main challenge for the authorities to cope with.

The staff points out that the downward revision for growth could make it difficult to respect the deficit targets for 2001 and 2002, to say the least, and that the fiscal deficit could end up being around minus 2 percent next year. This is nevertheless an improvement of 0.2 percent in comparison with the staff projection for this year. Given the major uncertainties surrounding growth forecasts, especially when taking into account the recent sharp decrease in the IFO index, even a 2 percent figure may be difficult to achieve next year. Let me just recall that the OECD forecast for this year, if I am right, is 2.5 percent of deficit, and the same is true for the figure just given by the six institutes—2.5 percent for 2001. The six institutions even give a breakdown for the deterioration of the figures in comparison with last year: 1.5 percent, including 0.5 due to the tax reform, 0.75 for slowdown, and 0.25 for public expenditure. Staff comments on the robustness of this forecast, either for this year or next year, would be appreciated.

As noted by Mr. Kiekens, September was the eighth consecutive month of rising unemployment. Such a disappointing evolution points to the Achilles' heel of the German economy—the difficulty in achieving job-intensive growth. As recalled by the staff, structural rigidities of the labor market have deprived Germany of the evolution observed in France, Spain, and to a certain extent Italy, have already seen. After certain achievements in structural reforms such as in taxes and pensions, we believe the authorities should maintain this course and put structural reforms on the labor market at top of their future agenda. In particular, we share the staff's view that looking for more wage differentiation and a tax break in favor of employment of low-skilled workers are promising avenues. We also support Mr. Wijnholds's remarks in relation to part-time work.

We share the concerns of our German friends on the economic situation, but we are also confident that the German authorities will take the needed decisions to promote economic recovery. We also share Mr. Bischofberger's vision of the social and economic role of the social safety net. We are also quite happy and proud to share very soon the same notes and coins.

Finally, let me wish "Viel Gluck" in their endeavor to the German authorities.

Mr. Collins made the following statement:

I think as has already been pointed out, the staff report is rather sobering in the sense of how it highlights the gaps in our understanding of the workings of the German economy and perhaps all economies. In particular, we note this question of the nature of the international linkages. As has already been pointed out, and as the staff have noted, everyone is perplexed in trying to explain and understand the causes of the sharp downturn in the German economy, but I think we should also remember that this fall and its extent were not chosen. This is another case where it is sobering to go back and look at what we were saying exactly 12 months ago, when we were congratulating the authorities about the robust strengthening in economic growth and saying the outlook was very bright and the economy would likely weather the higher oil prices. This is another case where we should pause and see what additional work is needed because of our failure to predict the downturn, for the difficulties we have in understanding developments to date must temper the confidence of our predictions of future economic developments and basing policy decisions on these predictions.

As I said, the gaps in our knowledge of the performance of the economy are many, but what seems to be highlighted in the staff report and even some of the discussion now is this question of the international linkages. The impression seems to be that they are much stronger than previously anticipated, even though we still cannot fully explain the nature of those linkages. Or perhaps it is a question of economies responding to common shocks even though the source of those shocks may be somewhat different.

The impression from the paper is that the external environment contributed to the strong growth in 1999/2000, and the rapid slowing of the economy in 2000. And the key assumption highlighted in the paper is that the projected recovery in the global economy, and more specifically in the United States, will determine the outlook for the German economy. So, I have a little bit of a concern that we can sometimes be putting so much in terms of the international connection where we cannot even explain things. And I think it is unfortunate if any impression exists that the short-term prospects for the German economy are largely dependent on what happens overseas and what policymakers overseas can do to revive their own economies.

As the staff already noted, we do not understand the linkages fully, and the business cycle linkages between the major economies were a chapter in the latest *WEO*, although I think this is clearly an area where we have to give greater attention. The focus has been on the connection between Germany and the United States. And one of the puzzling aspects is that Germany seems to be more dependent on the U.S. economy than other EU partners, even though the United States accounts for only 10 percent of German exports. It has already been noted that we have this rather perplexing fact that the sharp slowing in export growth in the first half of 2001 did not result from a slowing in the growth of exports to the United States in response to any weakening in U.S. demand; it was a sharp slowing in exports to Germany's EU partners. So the main linkage between the U.S. economy and the German economy must be through nontrade linkages, and as the report highlights, these are very hard to isolate, although increasingly important.

When you look at the components of demand growth in Germany in recent years, final domestic demand growth has been robust. Over the last three years it has been in the range of 2.6 to 2 percent, and the very strong growth in 2000, which was the highest for sometime, was at 3 percent. That was because of the net export contribution to growth, which was 1.1 percent. In the previous years, net exports were detracting from growth. The forecasts in the paper, which are perhaps optimistic, show that in 2001 it is not the weakness in net exports that is going to be holding back the economy; the contribution there is going to be 0.8 percentage points to the 0.8 percent projected increase in GDP. It is the weakness in domestic demand, the flat domestic demand growth. Private consumption growth is forecast to rise compared with 2000, but this is offset by declines in gross fixed investment and construction investment. So, in some respects, the weakness in 2001 is very much weak domestic demand, not external demand. Then this comes back to the linkages between the external and the domestic economy. What is holding back domestic demand?

Perhaps it is the confidence element, and perhaps domestic investment decisions are influenced by the fact that many large and important German companies have substantial investments in the United States; this could be an important channel of the influence on the German economy.

Private consumption growth appears to have held up reasonably well in 2001, 1.9 percent compared with 1.5 percent the previous year. But what would have been the outcome for private consumption if it were not for the fortuitous tax cuts in the first half of 2001? The paper says the effects of the sizable tax cuts failed to revive growth, as the global economic slowdown began to take hold, and some Directors have commented that there is no case to bring forward the tax cuts because they did not work in 2001 in reviving growth. Perhaps, but they could have been important in holding up private consumption growth, one of the strong components in maintaining growth in 2001. The paper states the recovery in 2002 depends on the strengthened timing of the improvement in the external environment, and this is highlighted in the statement that the recovery depends heavily on the revival in external demand, not confidence.

But external demand, the mechanism through which the strengthening world economy will impact on the German economy in 2002, is not evident on the basis of the projections. They have been revised down, but if we just look at the forecasts in the paper, there is projected to be a slight fall in export growth in 2002, which when combined with rising imports results in a small detraction in net exports. The recovery in 2002 is driven by much stronger private consumption growth, with business investment and construction still declining. I suppose the puzzling aspect is what is going to be driving this strong pickup in consumption growth in Germany in 2002? No growth in employment is assumed, and with continued wage moderation, disposable income will not rise, although the easing in price pressure should boost real disposable income. As the staff noted and as Mr. Dairi has pointed out, consumer confidence is going to be the key, and whatever will drive it.

As already noted in the paper, the margin of uncertainty is wide. While the forecasts have been revised down, if a sizable recovery in private consumption growth, which is the main driver of growth in 2002, does not happen, I would have some doubts about the robustness of the forecast. But I also have doubts about the robustness of the forecast of strong growth in private consumption in 2002.

Where does all this leave me? For one, we clearly have a long way to go in understanding and explaining the business cycle links between the major economies, and if we use the German economy as a case study, it is hard to piece the story together. I think, as I said earlier, it is unfortunate if we develop the impression that the future course of the German economy is going to be largely dependent on international developments. It is going to be dependent on policy settings at home. Tax cuts in the first half of 2001, I think, were perhaps important in holding up consumer demand. Now, Mr. Bischofberger in his statement acknowledges this, noting that it was fortunate and a welcome by product of tax reform. While as he says tax reform should proceed on its own merits and should not be seen as a means of fine-tuning an economy, I do not think it makes sense to implement tax reform irrespective of the cycle, and basically leave it to luck whether a pre-announced reform strategy is pro- or anti-cyclical. There is always some room for movement within that.

With the declining activity in the German economy and the many uncertainties—including the uncertainty facing private consumption growth, the backbone of the growth story in 2002—there is already a strong case to take whatever action is available to support domestic demand growth. Certainly, this means letting the automatic stabilizers work; growth would be substantially adversely affected if the government stuck to the deficit target contained in the stability program. But I think domestic demand would be supported if the planned tax cuts were brought forward, with the outlook for domestic demand being as weak as it is. Perhaps that could help boost confidence. It would not revive growth, but it could certainly help hold things up.

As for the longer-term issues, they really are the most critical and perhaps the most important. And, we would certainly endorse all the comments in the staff report about the need to address labor market rigidities and the further liberalization of product markets in Germany. It is particularly unfortunate, however, that some of the recent changes appear to be going in the wrong direction. Now, this is a very difficult political area, and as Mr. Bischofberger has highlighted, consensus needs to be established about the importance of addressing these wage rigidities and improving the incentive to work. Obtaining this consensus is that much more difficult, as activity is declining, as unemployment is rising, and as economic growth is weak. But hopefully the work of the Fund by highlighting the cost to the economy of the existing policies can contribute to developing the much-needed consensus to support further reform.

Mr. Callaghan made the following statement:

At this stage, there is not a lot more to be said. I shall just make a few general observations.

I think as has already been pointed out, the staff report is rather sobering in the sense of how it highlights the gaps in our understanding of the workings of the German economy and perhaps all economies. In particular, this question of the nature of the international linkages. As has already been pointed out, and as staff have noted, everyone is perplexed in trying to explain and understand the causes of the sharp downturn in the German economy, but I think we should also remember that this fall and the extent of this fall were not picked. This is another case where it is sobering to go back and look at what we were saying exactly 12 months ago when we were congratulating the authorities about the robust strengthening in economic growth and saying the outlook was very bright and the economy should weather the higher oil prices. This is another case where we should pause and see what additional work is needed because of our failure to pick the downturn, for the difficulties we have in understanding developments to date must temper the confidence of our predictions of future economic developments and basing policy decisions on these predictions.

As I said, the gaps in our knowledge of the performance of the economy are many, but what seems to be highlighted in the staff report and even some of the discussion now is this question of the international linkages. The impression seems to be that they are much stronger than previously anticipated, even though we still cannot fully explain the nature of those linkages, or perhaps it is a question of economies responding to common shocks even though the source of those shocks may be somewhat different.

That said, the impression that you certainly get from the paper is that it has been the external environment that has been contributing to the very strong growth experienced in 1999/2000 and it is the external environment that is attributed for the rapid slowing of the economy in 2000. And the key assumption highlighted in the paper is that the projected recovery in the global economy, and more specifically in the U.S., will determine the outlook for the German economy. So, I have a little bit of a concern that we can sometimes be putting so much in terms of the international connection where we cannot explain things. And I think it is unfortunate if any impression comes that the short-term prospects of the German economy are largely dependent on what happens overseas and what policymakers overseas can do to revive their economies.

As the staff already noted, we don’t understand the linkages fully, and the business cycle linkages between the major economies were a chapter in the latest WEO, although I think this is clearly an area where we have to give greater attention. The focus has been on the connection between Germany and the U.S., and one of the puzzling aspects of that is that Germany seems to be more dependent on the U.S. economy than other EU partners, but the U.S. accounts for only 10 percent of German exports. It has already been noted that we have this rather perplexing aspect that the sharp slowing in export growth in the first half of 2001 didn’t result from a slowing in the growth of exports to the U.S. in response to any weakening in U.S. demand; it was a sharp slowing in exports to Germany’s EU partners. So the main linkage between the U.S. economy and the German economy must be through nontrade linkages and as the report highlights, these are very hard to isolate, yet they seem to be increasingly important.

When you look at the components of demand growth in Germany in recent years, final domestic demand growth has been very robust. Over the last three years it has been in the range of 2.6 to 2 percent, and the very strong growth in 2000, which was the strongest growth for sometime, at 3 percent, was because of the net export contribution to growth, which was 1.1 percent. In the previous years, net exports were detracting from growth. Now, if we just look at the forecasts in the paper, and I know these are now perhaps optimistic, if we look at 2001, it is not the weakness in net exports that is going to be holding back the economy; the contribution there is going to be 0.8 percentage points to the 0.8 percent projected increase in GDP. It is the weakness in domestic demand, the flat domestic demand growth. Private consumption growth is forecast to rise compared with 2000, but this is offset by declines in gross fixed investment and construction investment. So, in some respects, the weakness in 2001 is very much weak domestic demand, not external demand. Then this comes back to the linkages between the external and the domestic economy, what is holding back domestic demand?

Perhaps it is the confidence element and perhaps domestic investment decisions are influenced by the fact that many large and important German companies have substantial investments in the U.S. and this could be an important channel of the influence on the German economy.

On private consumption growth, it appears to have held up reasonably well in 2001, 1.9 percent growth compared with 1.5 percent growth the previous year. But what would have been the outcome for private consumption if it wasn't for the fortuitous tax cuts in the first half of 2001? The paper says the effects of the sizable tax cuts failed to revive growth, as the global economic slowdown began to take hold, and some Directors have commented that there is no case to bring forward the tax cuts because they didn't work in 2001 in reviving growth. But the tax cuts may not have revived growth, but they could have well been very important in holding up private consumption growth. It was one of the strong components in holding up growth in 2001. While the paper states the recovery in 2002 depends on the strengthened timing of the improvement in the external environment, and this is highlighted in the statement where it says that the recovery depends heavily on the revival in external demand, not confidence. But external demand, the mechanism through which the strengthening world economy will impact on the German economy in 2002, is not evident on the basis of the projections. They have been revised down, but if we just look at the forecasts in the paper, there is projected to be a slight fall off in export growth in 2002, which when combined with rising imports results in a small detraction in net exports. The recovery in 2002 is driven by much stronger private consumption growth, with business investment and construction still declining. I suppose the puzzling aspect is what is going to be driving this strong pickup in consumption growth in Germany in 2002? No growth in employment is assumed, and with continued wage moderation, that will be holding down disposable income, although the easing in price pressure should be boosting real disposable income. As staff noted and as Mr. Dairi has pointed out, consumer confidence is going to be the key, and what will drive that.

As already noted in the paper, the margin of uncertainty is wide and while the forecasts have been revised down, if a sizable recovery in private consumption growth, which is the main driver of growth in 2002, does not eventuate, I would have some doubts about the robustness of the forecast, but I also have doubts about the robustness of the forecast strong growth in private consumption in 2002.

Where does all this leave me? Well, one, we clearly have a long way to go in understanding and explaining the business cycle links between the major economies and if we use the German economy as a case study, it is hard to piece the story together. I think, as I said earlier, it is unfortunate if we develop the impression that the future course of the German economy is going to be largely dependent on international developments, it is going to be dependent on policy settings at home. Tax cuts in the first half of 2001, I think, were perhaps important in holding up consumer demand. Now, Mr. Bischofberger in his statement acknowledges this, noting that it was fortunate and a welcome by product of tax reform. While as he says tax reform should proceed on its own merits and should not be seen as a means of fine-tuning an economy, I don't think it makes sense to implement tax reform irrespective of the cycle, and basically leave it to luck whether a preannounced reform strategy is pro- or anticyclical. There is always some room for movement within that. In the circumstances facing the German economy, with the decline in activity, the very many uncertainties we're talking about, including the uncertainty facing private consumption growth which, as I said, seems to be the backbone of the growth story in 2002, I think there is already a very strong case to take whatever action is available to support domestic demand growth. Certainly, this means letting the automatic stabilizers work, growth would be substantially adversely affected if the government stuck to the deficit target contained in the stability program. But I think domestic demand would be supported if the planned tax cuts were brought forward and with the outlook for domestic demand being as weak as it is, there is a very strong case for bringing forward the timing of the tax cuts and perhaps that could help boost confidence. It wouldn't revive growth. But it could certainly help hold things up.

As for the longer term issues, they really are the most critical and perhaps the most important. And, we would certainly endorse all the comments in the staff report about the need to address labor market rigidities and the further liberalization of product markets in Germany. It is particularly unfortunate, however, that some of the recent changes appear to be going in the wrong direction. Now, this is a very difficult political area, and as Mr. Bischofberger has highlighted, consensus needs to be established about the importance of addressing these wage rigidities and improving the incentive to work. Obtaining this consensus is that much more difficult, as activity is declining, unemployment rising, and with economic growth weak. But hopefully the work of the Fund by highlighting the cost to the economy of the existing policies can contribute to developing the much needed consensus to support further reform.

Ms. Lundsager made the following statement:

While Germany has taken some important steps to improve its medium-term growth prospects, it currently faces a serious growth slowdown resulting from declining domestic confidence and exacerbated by weaker growth in the rest of the world, particularly Germany's major trading partners.

It was quite interesting to note that it was not exports to the United States that declined, but rather exports to EU partners.

We largely concur with the staff appraisal of the situation and would emphasize a few points on structural issues, as well as fiscal and monetary policy.

Further progress on structural issues appears necessary to boost confidence in the near term and improve prospects for stronger productivity growth in the medium term. While fiscal and monetary policy can play a role, the scope for dramatic action is limited given constraints of the Stability Pact and the Euro-area. As a result, it is incumbent on German authorities to pursue policies that increase flexibility in financial, product, and labor markets to help the economy adjust to the current downturn. Even with a fairly rapid recovery in confidence, the staff and the authorities project growth at a meager 1.0 to 1.5 percent next year, underscoring the need for the authorities to do all they can on the structural side.

Aggressive labor market reforms remain the primary missing element of the authorities' economic strategy. Indeed, the government has taken some steps that could make the labor market less flexible, such as strengthening the influence of workers' councils. While there are plans afoot to encourage unemployment recipients to find work, there is ample room to do much more. The amount of funds spent on 'active labor market policies', at over one percent of GDP, appears to be bearing little fruit. Perhaps some of these funds can be channeled to more productive uses and thereby provide a political boost to unpopular proposals to limit unemployment benefits.

The authorities deserve credit for the bold tax reform that took effect this year and has important stages still to come. In addition to improving incentives to work, these tax cuts may help to increase the distribution of after-tax income, which the staff has rightly noted is needed to help promote productivity increases. We note, however, that even after the tax reform is fully in effect, top marginal rates will still be on the high side, particularly when adding in social security contributions. And, the pension reform actions, while laying down an important foundation, must be built upon to secure solvency for the state pension system.

On the banking side, Germany continues to have too many banks and too many specialized banks with public-sector links. The industry is highly concentrated with nontransparent ownership structures, apparently to discourage outside investors. This system does not encourage effective restructuring and reorganization that are needed to promote dynamic and employment-friendly productivity growth. In addition, the relative lack of public disclosure and uniform criteria for non-performing loans and provisioning is disturbing, which we discussed in last year's Euro-zone review. While there may be no hidden time bomb here, it is surprising that Germany does not publish this data, when many countries, industrial, developing and emerging market, have made such strides on increasing transparency of the financial sector and its oversight.

The authorities have taken some initial steps to improve the situation. For example, the authorities and the EC have agreed on the phasing out of public sector guarantees to banks during the next five years. And, the capital gains tax on companies' sales of equities will be eliminated next year, which will lead to some disentanglement of cross-shareholdings. These steps will help improve the efficiency of Germany's banking sector. However, additional steps are needed. As Mr. Wijnholds notes, governments at all levels could consider divesting themselves of financial firms altogether. Clearly, there are many issues for the forthcoming FSAP to explore.

On fiscal issues, we concur with the staff's view that the authorities should not take new action to reduce the budget deficit to meet Stability Pact targets this year. Fiscal policy is best framed in a medium-term context—providing for a credible path towards fiscal discipline, emphasizing expenditure restraint and also allowing for increased efficiency in Germany's revenue structure. Fiscal targets are important for the government's (and Euro Area's) credibility but it is important not to be dogmatic in the pursuit of this goal. In the near term, the key question is whether tax cuts scheduled for 2003 should be advanced to 2002, if merited by a weakening in domestic demand. If the authorities decide that economic developments merit some action, then bringing forward the 2003 tax cut appears to be the best policy choice to pursue. In the medium-term, progress on fiscal consolidation will likely require action on health care costs and further clarifications to fiscal federalism arrangements.

Inflation risks going forward appear to be minimal, despite the uptick this year in core and overall inflation rates. The growth slowdown, unemployment increase, and prospects for lower energy prices, suggest that inflation pressures will be under control in 2002. Thus, as the staff notes, further interest rate cuts appear reasonable from the perspective of the German economy.

It is somewhat surprising to see in Figure 14 that the productivity and GDP per capita gap between Eastern and Western Germany has not fallen in the past six years, despite sizable transfers from Western Germany (amounting to 4 to 5 percent of West German GDP annually). I am surprised that infrastructure spending has not had more of an impact on productivity. We would be interested in the staff's views as to further steps that are needed to boost productivity in Eastern Germany.

> Finally, I welcome the detailed box in Mr. Bischofberger's statement providing details on the authorities' efforts to combat terrorism. The actions listed will help strengthen international efforts to track terrorists' funds and bolster anti-money laundering efforts more broadly.

Mr. Bischofberger said that he would confine his remarks to three recurring issues of the discussion and written statements: the economic outlook, the appropriate fiscal response, and the unfinished reform agenda, including the banking sector.

On the current economic situation, Ms. Schadler had made clear that the indicators now tended to outline a worsened picture for the German economy, Mr. Bischofberger said. Nevertheless, several things should be kept in mind. The deep drop in the sentiment indicator in the business climate indicator was only part of the picture. Ms. Schadler had mentioned that. The other sentiment indicator published by the ZEW pointed in the other direction. Moreover, the stock markets appeared confident.

One reason that the indicators pointed in different directions was that the IFO indicator was based on surveying business people, Mr. Bischofberger surmised. Business people tended to be more cautious and to be taken aback by bad news. The ZEW indicator, on the other hand, was based on the answers financial analysts and portfolio managers gave when asked for their interpretation of the current situation. Therefore, it might be less puzzling that the indicators pointed in opposite directions. The authorities were convinced that the development of the IFO indicator was more V-shaped and not U-shaped. There was optimism that the economic situation in 2002 would not be as bad as some people argued, with growth at a rate of between 1 and 1.5 percent.

Regarding the fiscal response to the current situation, he was grateful to those who had encouraged the authorities to stay on the medium-term consolidation path, Mr. Bischofberger said. Furthermore, he would not speculate on specific fiscal reactions to possible revenue shortfalls as long as hard data was not available. If, however, the situation turned out worse, whatever room for maneuver was available within the framework of the Stability and Growth Pact would be utilized.

On the broad issue of structural reforms, there were many issues under discussion, Mr. Bischofberger commented. There was one remark by a Board member that product market reform had not resulted in a sufficient decrease in prices. To a certain degree, that was true, but it should be indicated that at least telecommunication prices for long distance calls had decreased dramatically, and in the electricity sector business prices had fallen 50 percent in the last three years. That was, of course, a good development, although a better performance might have been expected. Price decreases could have been steeper had there not been environmental taxes, which were intended. A second element, not to be ignored, was that a high degree of reliability in public services was promoted. Those services and their quality were certainly higher than they might have been in a completely open market.

There was one question regarding the extension of the monopoly of postal services, Mr. Bischofberger added. The basic rationale for that was to keep a level playing field for the German postal services, something not achieved in most European countries.

On the remaining reform agenda in the labor market, the "Job Aqtiv" law was designed to increase the pull and the demand factors on that market, Mr. Bischofberger asserted. Unemployed workers would be trained under agreement to accept available jobs. Refusals would entail implications for the duration of the person's entitlement benefits. There was no firm timetable for the implementation of that legislation, but everything was being done to have it implemented as soon as feasible.

On limiting contracts to public firms that had collective bargaining agreements, conducting business activity in Germany meant that one should abide by German laws and rules, Mr. Bischofberger observed. Otherwise, the social consensus in Germany could be endangered. The measure was supported by German employers, federations, and trade unions. Of course, a possible ruling by the European court might alter the situation.

On whether the reduction of the size of the civil service by about 1.5 percent annually might be contributing to unemployment, the strategy was to streamline the bureaucracy over the long-term by taking advantage of the normal fluctuations in retirements, Mr. Bischofberger noted. Therefore, the impact on unemployment was insignificant.

On active labor market policies, a topic mentioned by many Directors, Germany was spending about 1 percent of GDP in this area, largely in line with other European countries, Mr. Bischofberger said. While there were clearly different views on the effectiveness of current labor market policies, it should be kept in mind that, according to estimates by the authorities, unemployment in East Germany alone would rise by about 400,000 if active labor market policies were abandoned. In addition, roughly 40 percent of the envisaged spending in 2001 would be dedicated to vocational training, which was important in reducing the high unemployment rate of low-skilled workers.

Germany needed most to renew the dynamism of its industries in order to attract capital, Mr. Bischofberger said. In 2000, Germany had been the largest destination of direct investment in Europe and the second largest in the world. Critics might note that such a development had much to do with the acquisition of a major German telecommunications company by a British telecommunications company. The volume of that acquisition was certainly striking. But it showed something important. A steel-producing company that had been, until recently, widely perceived as a sleeping old-industry company whose major business had been to produce excellent large steel tubes, could be turned in a short time into the biggest German mobile phone provider, which attracted a huge buyout from abroad.

On the puzzle behind the slow catching up of East Germany relative to West Germany, the problem was increasingly one to be faced by a generation, not just a decade, Mr. Bischofberger considered. Mistakes had been made in the early stages of the reunification process, but for the most part, there had been little else to do but to provide the resources necessary for the East to catch up with the basic investments, needed to bring out the potential there; and that investment would pay off better as reforms were completed.

As Mr. Callaghan had noted, trying to understand how national economies might be linked together was like trying to aim at a moving target, Mr. Bischofberger stated. The *WEO* had discussed thoroughly the microeconomic linkage between companies, and noted that they might play a more pronounced role in the future, and that it would be worthwhile to have more research on the subject.

On the uses and limits of fiscal policy, there was need to balance carefully the potential benefits of fiscal stimulus, Mr. Bischofberger declared. Stimuli could be beneficial, but one should not lose sight of the costs of losing credibility in the medium-term. Experience told policymakers that credibility, once lost, was hard to regain.

After recessing at 1:16 p.m., the Executive Board reconvened at 2:35.

Mr. Lehmussaari noted that he had listened with intent to Mr. Bischofberger's remark that Germany spent as much money on labor market programs as most other countries in Europe. In that context, the statistics highlighted in the staff paper were striking. It was clear from those statistics that employment generation in Germany had been about half of that in France, Italy, and Spain. Even discounting the numbers somewhat, the message was clear that Germany's job growth had been moderate compared to other European countries. Among the list of labor market reforms needed to improve the employment creation, could the staff detect any one or two particular measures that would be of special help in Germany compared to other countries? What were the differences in the countries referred to in the table?

Mr. Daïri said that it would be useful to have some comments from the staff on how efficient the initiatives in Germany were compared to those in other countries. That would, of course, require comparing the costs and benefits of the various initiatives as they might help some other countries, particularly developing countries.

The representative from the European Central Bank (Mr. Grisse) commented that Germany had always been a bit special in that the need to protect the credibility of the central bank had always played a decisive role. In this regard, the question, when it came to ECB policy, was not whether short-term interest rates were low enough for growth, but whether they were high enough to preserve price stability. In that respect, the ECB had always paid careful attention to the German inflation data and was pleased that the headline inflation rate was again at 2 percent.

One special thing about the transmission mechanism was that the German investment figures were much more reactive to long-term financing conditions than to short-term ones, the ECB representative stated. In that regard, the most important point was that long-term rates in Germany were presently low. Against that background, the whole interest rate pattern was judged on behalf of the German institutes as expansive and stimulative. Therefore, the problems discussed in the current Board meeting, in the view of the ECB, could not be resolved by interest rate policy, but by other policy considerations.

Regarding coming reforms in the financial supervisory authority, the ECB was highly in favor of them, especially since the latest version of the acts show that the central bank was playing an adequate role, the ECB representative reported.

Mr. Duquesne noted that it had been his impression that the ECB looked at inflation in the euro zone in general, and not just in Germany. Also, German rates were the same as in the other countries in the euro zone. As such, Mr. Grisse was speaking either about short-term or long-term rates in Germany, which, if one accepted the slight premium on long-term rates, were not exactly the same economically. Finally, in referring to the German forecasting institutions, one should note that 5 out of 6 had argued in favor of diminishing interest rates.

The Deputy Director of the European I Department (Ms. Schadler) noted that it was often the case that the staff gave precise numerical projections at Board meetings. However, the projections the staff had given in 2000 had turned out to be remarkably off the mark, and the current circumstances were unusual. September 11 had been an incalculable and unexpected shock. The staff was in the process of doing a new round of formal projections, which was also completely out of the ordinary; it was not normally done at the current time of year and it would be unproductive to offer specific numbers at the moment. In another week, the staff would set out a full display of projections.

The staff strongly supported the observations made by Mr. Callaghan on consumption and demand, the Deputy Director said. It was hard to be optimistic about consumption at the moment. The outcome of the current round of forecasts was going to be a significant lowering of the private consumption growth projections currently in the staff paper.

There had been a number of questions and observations about linkages and some frustration that more was not known about this extraordinarily complex issue, the Deputy Director recalled. The staff had discussed that issue with several people in Germany, although no formal work had been done. It was an intractable problem in many respects, although worth further investigation. At Siemens, the staff had discussed their perspective on the slowdown, and on linkages. Siemens' view at the time was that the trend over the last few years was for production to be dispersed worldwide to a greater extent than in the past. They tended to choose the places for their production facilities in order to be close to a specific market. If there were a particular kind of electronic device used in North America, for example, they would locate a factory to make those things in North America. Thus, when there was a slowdown in a regional market, the regional production unit would slow down its production. They were not certain that they saw the linkages working the way the Fund staff was describing. Rather, they saw, for example, the dispersion of production to some degree reducing the impact on German production of slowdowns in Asia or the United States. Siemens was not cash constrained, meaning that it was not in a situation where profit declines in North America would freeze investment somewhere else. Many other firms might feel the profit squeeze much sooner. It was important to keep something in mind, however. While it was easy to say that globalization increased linkages, the macroeconomics of the structure of production and how companies were actually responding to shifts in world demand might not bear that out.

The Deputy Director remarked on the efficiency of different types of labor market initiatives in various European countries, and whether the selected issues paper had some explanation for those relative differences in labor market performance. The staff had looked principally at the role wage moderation had played in the relatively employment-rich recovery of the 1990s, with the focus being less on labor market institutions and other considerations. There was a section, however, on active labor market and employment protection policies in the various countries. Germany should not be singled out as an outlier in either of those two respects among the four countries under scrutiny. Germany came out relatively less well in the comparison of employment growth during the 1990s, and one could see to some degree that it was the result of less aggressive wage moderation there than elsewhere. But it was also worth pointing out that Germany had started with the lowest unemployment rate of the four countries, so to some degree the slower fall of unemployment or the slower employment growth was not as surprising.

On the nexus of fiscal and growth forecasts, if the growth forecasts were to become weaker over the course of the next few weeks, filtering the data through stabilizers would change the deficit, the Deputy Director commented. The staff had taken the structural adjustment that the German authorities envisaged in their budget of 0.6 percent of GDP, with a stabilizer adding about 0.4 percent of GDP to the fiscal deficit. That changed the deficit from 2.2 percent of GDP in 2001 to 2 percent of GDP in 2002.

Mr. Duquesne recalled that the OECD assumed growth of 0.7 percent in 2001, and anticipated a deficit of 2.4 percent. For 2002, it projected 1 percent of growth, and a deficit of 2.5 percent.

The Deputy Director of the European I Department (Ms. Schadler) said that she had not spoken to the OECD, and that different forecasts at different institutions were to be expected. The starting point in 2001 was an open question. The staff had obtained as up-to-date statistics as possible for Germany in 2001, and projected a deficit of 2.2 percent of GDP. It was unknown why the OECD had arrived at 2.4 percent. The revenue data seen by the Fund staff held up well through the period on which it was available, so there was no reason to revise it.

The staff had built into the projections a structural adjustment of 0.6 percent of GDP and a smaller cyclical influence in the opposite direction, the Deputy Director explained. The research institutions in Germany had recently unveiled their projections for 2002 with a deficit of 2 percent of GDP, again with a growth forecast of 1.3 percent of GDP. The deficit figure for 2001 was 2.5 percent of GDP.

The staff representative from the European I Department (Mr. Corker) observed that Mr. Collins had asked how long the construction sector was going to continue declining, and when East-West convergence would begin again. These were linked questions, because construction was a big part of the eastern German economy—at the moment, 11 percent of value added, compared with about 4.5 percent of value added in western Germany. The decline in the construction sector was, in fact, masking some of the more positive developments in eastern Germany. Since the mid-1990s, the manufacturing sector in eastern Germany had been growing, albeit from a small base, at around a 7 percent annualized rate. The staff had talked to many experts and looked at the research institutions' own forecasts. Everyone was saying that the construction sector would continue to decline for one to two more years. That was consistent with the staff forecast, although the staff did not explicitly forecast each sector. The staff concluded, therefore, that there was a high likelihood that once the process ended and capacity was reduced to more normal levels in the construction sector, there would probably begin a reassertion of East-West, i.e. eastern German growth exceeding that in west Germany.

On when there would be convergence between East and West, the answer had much to do with labor markets, the staff representative said. There was much anecdotal evidence of more wage flexibility creeping into the eastern German labor market, and more flexibility of employment conditions. That was exactly what was needed to promote a narrowing of productivity differentials between the two regions. There was still, as everyone knew, a large discrepancy between unit labor costs still in eastern Germany relative to western Germany. It was essential for the difference to continue to erode, and the staff saw some promising signs in that regard.

The Acting Chair made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They noted that Germany's third post-reunification growth spurt came to an abrupt end in the middle of last year. Notwithstanding the downturn, the authorities have made important progress in improving the structural foundations of the German economy during the past year. The pension and tax reforms, and the great strides achieved in liberalizing product markets, are expected to make a significant contribution to longer-term economic prospects. Directors urged the authorities to apply equal vigor to reforming labor markets.
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> Directors observed that the prospects for recovery are heavily dependent on a pickup in business confidence and global growth, and that the outlook has been further clouded by the uncertain effects of the terrorist attacks on the United States. While predicting the timing of the upturn in growth remains difficult, Directors considered that, barring further setbacks, a recovery should start in the first half of 2002. They noted, nonetheless, that confidence remains precarious and that the risk of continued global weakness injects a sizable element of caution into the forecast. On the positive side, Directors noted that underlying inflation is low and that headline inflation should continue to decline in the period ahead.
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> Directors were encouraged to see evidence of continued wage moderation, which will remain essential in creating favorable conditions for recovery and getting unemployment back on a declining track. They

commended wage bargainers for putting job creation ahead of pay increases in recent years.

While acknowledging the constraints on macroeconomic policies to stimulate growth, Directors urged the authorities to continue to explore carefully the room for supporting an early recovery. Directors considered that recent interest rate cuts by the ECB should help support growth, and, while further action on monetary policy will be determined by euro area considerations, receding risks to price stability, including in Germany, are creating additional welcome room for further monetary policy easing.

Directors noted that Germany's fiscal policy options remain circumscribed by the need to eliminate the structural budget deficit and reduce the sizable public debt burden. They emphasized Germany's pivotal role in the Stability and Growth Pact, which gives added weight to the importance of maintaining policy credibility by adhering closely to the path of fiscal consolidation. Nonetheless, Directors did not view the likely overshooting of this year's fiscal deficit target as a cause for particular concern as it simply reflects the cyclical weakness in revenues.

For 2002, most Directors agreed that the automatic stabilizers should continue to operate. They noted that, even though this could result in another overshooting of the deficit target, Germany, by sticking to the medium-term expenditure path, would still reach medium-term deficit targets on schedule. A number of Directors proposed that, absent a quick rebound in business confidence, the authorities should consider bringing forward tax cuts that are already factored into medium-term fiscal plans. Other Directors, however, cautioned against using structural tax reforms for cyclical fine-tuning.

Looking ahead, Directors emphasized that expenditure restraint should remain the cornerstone of Germany's fiscal adjustment strategy. They viewed the government's cautious expenditure growth target as an appropriately ambitious response to projected demographic strains and the need to reduce the tax burden further. Directors recommended that all levels of government develop more regular reporting, monitoring, and assessment of fiscal projections in order to raise the profile of spending limits and to increase accountability. Some Directors suggested that the expenditure growth targets should assume greater prominence within the fiscal framework, noting that a shift of emphasis away from annual deficit targets could mitigate the need for undue tightening in a downturn and reduce the scope for slippage in the structural deficit during an upturn. Other Directors, however, observed that annual deficit targets play an important role in instilling discipline and reassuring market participants that consolidation is on track.

Directors noted that the abruptness of the latest downturn raises questions about the resilience of the economy. While acknowledging that external factors have played a key role in the current slowdown, Directors also observed that trend output growth has been low in Germany for some time, and a number of them referred in this connection to the continued challenge stemming from reunification. Moreover, Directors considered that the fragility of employment growth points to insufficient flexibility to cope with rapid change and to take advantage of new growth opportunities. Directors therefore strongly welcomed the important progress that the authorities have made in implementing structural reforms, which should enhance Germany's growth potential in coming years, and highlighted, in particular, the improved business environment that will result from tax reforms and liberalization of product markets. It will, nevertheless, be important to keep up the structural reform momentum in order to further improve economic performance and resilience.

Directors agreed that a consistent and coherent set of labor market reforms heads the list of remaining structural policy priorities. They encouraged the authorities to review regulations that deter hiring and to combine wage moderation with policies that foster greater wage differentiation across skills and regions. Directors welcomed the authorities' intention to strengthen incentives for the unemployed to find work, although some Directors questioned whether they would be successful without reform of unemployment benefits. Directors also suggested that the authorities give priority to assessing the effectiveness of active labor market policies, in particular the merits of tax-based incentives for employment at the low end of the wage scale.

Directors considered Germany's financial sector to be generally sound, but stressed that, against the backdrop of the global slowdown, financial sector supervision must remain particularly vigilant. They noted that the downturn in sectors such as telecommunications, real estate, and construction, as well as bank exposures to countries in recession and to emerging markets, warrant especially close attention. Directors encouraged the authorities to take steps to facilitate further restructuring in the banking sector and improve transparency in the financial sector. In this context, they welcomed the planned phasing out of guarantees to public banking institutions and looked forward to further steps to create an open and competitive market for financial services. Directors also welcomed the authorities' recent initiatives to strengthen efforts to fight money laundering and financing for terrorism, as well as their intention to participate in a Financial Sector Assessment Program.

Directors noted that the quality of German official statistics is generally good. However, in certain areas, such as the quarterly national accounts data where revisions are frequent, they encouraged further improvement.

> Directors commended the authorities for their full support for the initiation of a new trade round, and a number of them welcomed their intention to press for the liberalization of agricultural policy within the EU. Directors urged the authorities to raise their level of official development assistance to the UN target of 0.7 percent of GNP.
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> It is expected that the next Article IV consultation with Germany will be held on the standard 12-month cycle.

3. REPUBLIC OF YEMEN—POVERTY REDUCTION AND GROWTH FACILITY—THIRD ANNUAL ARRANGEMENT—REVIEWS, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA; AND EXTENDED ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the first and second reviews under the third annual arrangement for the Republic of Yemen under the Poverty Reduction and Growth Facility, and the fifth and sixth reviews for the Republic of Yemen under the Extended Arrangement, and its request for a waiver of performance criteria (EBS/01/172, 10/10/01).

The staff representative from the Middle Eastern Department (Mr. Gardner) submitted the following statement:

> This statement notifies the Executive Board that the authorities have indicated that they do not expect to be able to complete the last outstanding prior action (passage of an amended investment law) before the end of the current PRGF/EFF arrangements on October 28, 2001. It also provides information on the impact of recent oil market and regional developments on Yemen's economic and financial outlook for 2001 and the near-term. Finally, it provides information received from the authorities on a medium-term plan for the upgrading of military equipment, as well as on the status of the General Sales Tax. This new information does not change the thrust of the staff appraisal contained in EBS/01/172.
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> The investment law was to be considered by Parliament the week of October 7, 2001, but following events in the region, Parliament has suspended its normal deliberations and has been meeting in joint session with the Consultative Council (a second chamber that has an advisory role and meets by Presidential order). Parliament is expected to resume its normal deliberations shortly, but the authorities do not believe that passage can be secured before October 24, 2001. However, the authorities have given assurances that the text of the law has been agreed upon and that the law should be voted on in a short order of time. In view of the exceptional nature of the events that have led to the nonobservance of this prior action, the

authorities have requested and the staff recommends that the Executive Board consider completing the reviews and granting the requested waivers.

The lowering of projected (WEO) oil prices (by US$1.80 per barrel in 2001, and US$3.50 for 2002) will result in a net loss of budgetary revenues of US$175 million in 2001, and a narrowing of the budget surplus to 2.1 percent of GDP (from 4 percent of GDP in the staff report). The budgetary impact is estimated at 1.6 percent of GDP in 2002, which essentially wipes out the projected surplus under current policies. These developments illustrate the vulnerability of public finances to oil price developments and the need to pursue adjustment in the non-oil fiscal balance to protect against such shocks.

The balance of payments impact of the drop in oil prices is estimated at US$112 million (1.3 percent of GDP) in 2001 relative to the staff report projections. Given the overperformance to date on international reserves, the foreign exchange reserves projected for year end (US$3.3 billion) should still be achievable, although reaching this objective will preclude any additional foreign exchange intervention, and the authorities should stand ready to accept a faster rate of nominal depreciation in the months ahead. For 2002, the balance of payments impact of lower oil prices is estimated at US$196 million (2.3 percent of GDP) relative to the projections contained in the staff report.

The impact of the international situation will likely result in some slowdown in non-oil sector activity. The impact on the non-oil sector will be most immediately felt in a drying up of tourism receipts which, however, were limited to begin with, and possibly a decline in workers' remittances. Also, prospects for a revival of activity in the port of Aden (and the Free Trade Zone) could be clouded by the rise of insurance premia for vessels calling into Aden. Finally, direct investment and other capital inflows are likely to be more sluggish than previously anticipated (except for the flows related to the oil sector).

The authorities have informed staff that they intend to initiate a military rehabilitation plan with a view to replacing military equipment that was destroyed in the 1994 conflict or has became obsolete. The rehabilitation plan is to be implemented over a five-year period starting in 2002. The staff understands that it includes a deal for the purchase of MIG aircraft for some US$300 million. The authorities have indicated that the plan will be implemented in conjunction with a reform of military personnel policies (e.g., retirement of overage personnel, elimination of mandatory enlistment) and that the upgrading of military equipment will be financed in part by the savings realized on personnel expenditures (which absorb about 66 percent of defense spending). On the basis of existing information, the annual cost of the aircraft purchases would amount to about 10 percent of the defense budget (0.5 percent of GDP) per year for five years. The authorities have given assurances that the cost of the military rehabilitation plan will not be allowed to undermine the government's medium-term reform program.

Following the approval of an inadequate GST law in February 2001, the authorities sent the law back to parliament with a presidential letter asking parliament to adopt a set of amendments without further modifications. In the absence of any response, it became clear over the summer that progress could only be achieved by reopening negotiations with the parliamentary finance committee. The draft amendments presently under consideration, however, still contain a number of serious weaknesses in the list of exemptions. The authorities agree with the staff that passage of the amendments as presently drafted would undermine revenue performance and have indicated their commitment to continue working with parliament towards a more acceptable compromise.

Mr. Shaalan submitted the following statement:

I thank colleagues for their constructive criticism, which I shall convey to the authorities. Most Directors, if not all, pointed to the slow pace of the implementation of structural reforms, which has admittedly lagged and has not been successful at meeting the program's quantitative targets; Yemen definitely lagged behind in the implementation of structural reforms. Why?

Mr. Ralyea and some other colleagues have rightly stated that Yemen lacked the institutional and implementation capacity to put in place such a complex set of structural measures. I emphasize that the delays were not from lack of commitment by the Yemini authorities. The staff has responded to most of the concerns raised by the two items not implemented on time: the amendments to the investment law and the establishment of the GST law.

The investment law was passed and the staff proposed some amendments which have been accepted by the committee, and which parliament is about to ratify. The reason for the delay is the unfortunate events of September, where both houses of parliament have been in session, and it is very difficult to put forward a law to parliament at a time when they are both in session. In my conversations with the Minister earlier this week, he assured me it would be only days before those measures are implemented.

The GST is a little more complicated. Here, I want to point out that the authorities have submitted to parliament a GST law, and that parliament has changed it radically. The staff made clear that the authorities had not approved the changes. They wanted to fully support the GST law worked out with the staff. The process now is that the government, through special committees, is trying to get those laws amended appropriately along the lines recommended by the staff. Hopefully, this process will result in a more adequate GST law. As many colleagues know, I, for one, am very much against exemptions in

GST taxation, and it is my understanding that the GST law in Yemen has excessive exemptions built into it. The government would like to eliminate those exemptions, or at least reduce them radically.

Privatization is lagging behind. But, as the staff mentioned, you really need to have a political consensus to have a privatization process that can be successful. This is not new to Yemen. In many of our member countries, this has been the case. When you mention privatization to members, they do not even want to hear of it. But, sooner or later they are heavily engaged in the process. So, it is a matter of building political consensus in Yemen.

The question of decentralization must be assessed carefully, and I will communicate to the authorities the importance of their attaching this and the assistance they must seek from the World Bank to make it workable. Finally, I would like to take the opportunity to thank colleagues again, and to thank Mr. Seade, who has worked on Yemen for some years, and wish him every success in his new assignment.

Mr. Daïri submitted the following statement:

We thank the staff for a well-written report, and Mr. Shaalan for his helpful statement.

Economic performance in Yemen in 2001 so far has been encouraging and broadly in line with program objectives. Under difficult social and political conditions, decisive policy implementation has helped consolidate the recent gains in macroeconomic stability. Aided by the continued buoyancy of the non-oil sector and a smaller-than-envisaged contraction of the oil sector, growth is expected to exceed the program target in a single-digit inflation environment. Despite large one-off expenditures in the latter part of the year, which are likely to cause some widening in the non-oil fiscal deficit, overall expenditure restraint has been commendably maintained in the face of higher oil revenues, which is expected to lead to a higher-than-programmed overall fiscal surplus. We agree with the staff that these one-off expenditures did not pose risks to the medium-term objectives of the program. Higher oil prices have also contributed to a stronger external position and a buildup of international reserves above the program levels, while the external debt burden has been reduced with official debt relief. A combination of factors, inter alia, local elections and the change in government, caused delays in advancing the structural reform agenda. Nevertheless, the pace of reform has since picked up with the fulfillment of two of the five remaining structural performance criteria. We agree with the thrust of the staff appraisal, and, in view of the authorities' proven track record, progress in preparation of a full PRSP and commitment to complete the unfinished reforms, support the proposed decisions.

Achieving medium-term macroeconomic stability in light of the country's depleting oil reserves hinges on a strengthened policy framework aimed at a more sustainable non-oil fiscal deficit. This calls for broadening the revenue base and continued efforts to contain and rationalize expenditures. On the revenue side, we welcome the completion of the transfer of large taxpayers' tax files into the newly established LTU so that it becomes fully operational. Securing an early passage of a revised GST law should also be high on the agenda to enhance revenue performance and to allow initiation of the income tax reform, which remains pending. The staff or Mr. Shaalan may wish to comment on the authorities' legitimate concern that widespread smuggling would cause the GST's burden to fall mostly on domestic producers. This being said, the authorities' commitment to achieving parliamentary approval of a broad-based GST and immediate implementation following enactment of the law is encouraging.

On the expenditure side, while commending the authorities for their bold action in July in raising the diesel price beyond the program target, we join the staff in encouraging them to continue to phase in market-based pricing as well as develop effective social measures to limit the impact on the poor. In this respect, the recent rise in electricity prices in an effort to stem the growing losses of the Public Electricity Company (PEC) and to protect the budget from contingent liabilities is also a step in the right direction. In this context, we look forward to an early implementation of the PEC restructuring plan, agreed with the World Bank. The authorities are also well-advised to speed up civil service and pension reforms with a view to containing the wage bill and ensuring the long-term financial viability of the public pension fund; their intent to have a draft pension law for cabinet discussion by year-end is realistic. With higher expenditure pressures in 2002, associated with fiscal decentralization as well as the likely implementation of the PRSP, the need to preserve fiscal discipline at all levels of government cannot be overemphasized. We join the staff in encouraging the authorities to give priority to improving expenditure quality and targeting as well as ensuring adequate maintenance funding.

Monetary policy is appropriately aimed at sustaining the recent reduction in inflation. The timely issuance of newly created central bank CDs, coupled with the steady build-up of government deposits at the central bank, should preempt possible inflationary pressures. While we note that the more extensive intervention this year to resist pressures on the exchange rate and the attendant risks to inflation did not affect competitiveness, we are reassured by the authorities' recognition of possible adverse effects on competitiveness of the non-oil exports from further real appreciation of the rial. On the banking sector, we welcome the notable reduction in nonperforming loans and the establishment of a notification system of bad borrowers. The authorities' commitment to obtain parliamentary approval by year-end of amendments to the banking law granting the central bank greater powers to enforce prudential regulations is reassuring. Progress in bank restructuring and the judicial reform is encouraging and should help financial sector development and achieve a more effective financial intermediation.

To promote higher growth in the non-oil sector and lasting improvement in living standards, Yemen needs a timely and vigorous implementation of structural reforms. We welcome the authorities' measures aimed at further liberalizing the trade regime which is already among the most liberal, regionally and globally. Strengthening the legal and judicial framework and simplifying the investment procedures are key to creating an environment conducive to private sector development. We welcome the authorities' efforts at seeking an early passage of the amended investment law, as indicated in Mr. Shaalan's statement. While we note the delays in advancing the privatization agenda due to ongoing discussions on the relevant modalities, we join the staff in underscoring the importance of transparency in the process. Could the staff or Mr. Shaalan provide some clarification on the reasons behind the parliament's rejection of a World Bank privatization loan? Having said that, we wonder whether the large number of structural performance criteria and benchmarks, including in areas requiring parliamentary approval, is warranted, and welcome the staff's clarification on the extent of streamlining of conditionality in Yemen's case. Finally, in light of the pressing social needs, we look forward to the forthcoming preparation of a full PRSP, which has benefited from a wide participation of all social partners, elaborating the sources of growth, the roots of growing poverty in Yemen, and a timetable for the implementation of various poverty-alleviation measures.

Mr. Al-Turki made the following statement:

Yemen's adjustment and reform effort continues to make progress. The economy has also been responsive. Growth this year is set to exceed the program targets. Lower inflation, a reduction of the public debt and a continued rise in external reserves are also expected. While firmer oil prices have helped, the economic outcome also reflects improved policies. In particular, the authorities have built on past policy gains through containment of budgetary spending and further structural reforms. The outlook is also promising with a likely continuation of the recent favorable trends for growth and stability.

Mr. Shaalan's comprehensive statement provides ample testimony of the difficult conditions in which the program has proceeded. While there were indeed slippages, the program is broadly on track with substantial progress on several fronts. I can therefore support the conclusion of the review with grant of the requested waivers. That said, it is important to stress that there is no room for complacency. Here, I welcome Mr. Shaalan's assurances of the authorities' continued policy commitment.

I broadly agree with the staff appraisal and will add a few remarks on the key issues.

I commend the authorities for their considerable success in containment of fiscal spending. While the one-off rise in outlays has limited the outcome, program priorities were maintained so that the underlying fiscal position has improved. The decision not to offset the one-off spending increase was appropriate for the viability of the program's agreed policy package. The fiscal outcome so far this year is evidence of the continued progress in fiscal consolidation.

Going forward, I endorse the staff's stress on further pension and civil service reforms. Expectations that a draft law in this regard will be ready by the end of the current year are reassuring. Here, I support the authorities' request for a follow-up technical assistance. On fiscal decentralization, a deliberate approach is indeed essential to avoid an excessive burdening of the administrative capacity of the local authorities. Regarding revenue reforms, I welcome the progress toward legislative passage of the GST law. I also look forward to the reform of direct taxes that is to follow implementation of the GST. This is another area for the Fund to be helpful with timely technical assistance.

Regarding other structural reforms, the progress in improving the financial system is welcome. I note in particular the strengthening of central bank supervision with implication especially for the reduction of nonperforming loans. To build on this progress, an early completion of the pending legislative action for the Central Bank's ability to enforce prudential regulations is important. A faster pace is also crucial for the ongoing bank restructuring effort. Here, staff has noted a number of useful suggestions for further reforms preparatory to the privatization of the Yemen Bank for Reconstruction and Development. Effective functioning of a market-led economy is indeed critically dependent on an assurance of well-defined property rights and enforceability of contracts. Much remains to be accomplished in the authorities' ongoing efforts in these areas. Faster progress in these areas is essential for success of the authorities' poverty reduction effort.

With these remarks, I wish the authorities success.

Mr. Ralyea made the following statement:

The United States values its relationship with Yemen and recognizes that Yemen faces difficult challenges associated with unification and economic adjustment. We also appreciate Yemen's cooperation in the international fight against terrorism. We are convinced that the national authorities wish to take steps that will help promote a more sound economy and a rising standard of living for the Yemeni people. It is with this shared objective in mind that we have carefully reviewed Yemen's most recent performance under its Fund-supported program.

That performance is a picture of stark contrasts. The authorities met or exceeded all the quantitative performance criteria, but failed to comply with any of the structural performance criteria on time. The country enjoys budget and current account surpluses, yet continues to draw on a Fund-supported program. Yemen has one of the most liberal trade regimes in the region, which contrasts markedly with its restrictive investment regime. A lack of institutional capacity makes it hard if not impossible to target subsidies. Nonetheless, an ambitious fiscal decentralization program is in train without proper assurance that the local capacity is in place and a clear cut division of responsibility. The central bank spent $430 million in the first nine months of this year defending the "floating" rial.

Perhaps these contrasts reflect political realities on the ground. We note that difficulties in getting laws passed through Parliament account for several of the missed structural criteria. But that does not explain the authorities' decision to postpone implementation of the parliamentary-approved oil tax, despite oil-related subsidies that equal three percent of GDP. In sum, we find it hard to get a handle on the authorities' commitment to economic reform.

To date, the international community has been willing to give Yemen the benefit of the doubt. The latest example is a stock of debt reduction on Naples terms by Paris Club creditors in June with the understanding that reforms envisioned in the Fund-supported program would be implemented. That brings us to this discussion, in which the Board is being asked to consider the completion of four reviews for a country that has no visible short-term liquidity need.

Yemen's macroeconomic performance over the past year has been strong, in part because of expenditure restraint. However, fiscal pressures are mounting from decentralization, plans to modernize the military, and the eventual evaporation of oil revenues.

At the same time, progress on structural reform has been limited. Board consideration is accompanied by a request for waivers of all the five structural performance criteria. Granted two of the three criteria, including the politically difficult increase in the diesel tariff, were completed subsequent to the end of the review, period and the authorities indicate that a third may be completed shortly. But that does not take into account the fact that three unmet conditions in the previous arrangement were "streamlined" out of the program. We note the continual delay in implementing several of the performance criteria; for example, the GST law was to be promulgated in December 1999 under the original schedule while the amendments to the Central Banking law were scheduled to be approved by November 1999. We also note that while two prior actions for this review were completed, the third and final prior action was stalled as a result of the extraordinary circumstances in that region.

Given the above, this chair will regrettably have to abstain on today's vote.

Going forward, we would not expect to see a follow-on program for Yemen unless external shocks created temporary balance of payments difficulties. Should such an event occur, we would expect to see significantly more progress on structural reforms, while maintaining macroeconomic stability. I highlight four areas where we think more can and should be done.

First, passage and implementation of the general sales tax law (GST) is a critical step to putting the medium-term fiscal position on a sustainable track. Given that oil reserves are likely to be depleted in twenty odd years, the GST should be an extremely high priority. As we know, non-oil related sources of revenue also mitigate the vulnerability of budgetary revenues to swings in oil prices. Moreover, we understand that progress on a new income tax law and the law to strengthen the supervisory powers of the central bank are on hold until Parliament promulgates the GST law.

Second, restructuring and eventual privatization of many state-owned enterprises is necessary to limit contingent liabilities of the central government. If done correctly, it would also increase the efficiency of domestic resources, thereby adding to economic growth. For starters, we would argue that the authorities should establish a formula to automatically adjust local diesel prices for changes in world oil prices. To work effectively, the formula details should be made public. We also suggest that the tariff on electricity prices be raised to fully cover both the operating and financing costs of the electricity parastatals. Those measures would complement the restructuring measures already underway.

Third, the apparent lack of a framework for carrying out the decentralization process, coupled with the desire for speed, is worrisome. The potential seems to exist for public revenues to be used inefficiently. It could also wreak havoc on the authorities' desire to implement an effective poverty reduction strategy. The World Bank has some expertise in supporting decentralization efforts, and we encourage the authorities to tap this expertise.

Fourth, continuing the momentum for financial sector reform through passage of the central bank law is key for long-term economic growth and financial sector soundness. In addition, the strengthening of the central bank's authority will aid in Yemen's efforts to combat the financing of terrorism (an effort which we fully welcome) by expanding the central bank's ability to identify and block terrorist assets.

Finally, we are concerned that the authorities may be throwing good money after bad. We suspect that the exchange rate weakness is not transitory on the grounds that de facto dollarization of the economy continues and the lengthy period over which intervention has taken place. Thus, we fully agree with the staff that low inflation should be pursued through an active interest rate policy rather than intervention in the exchange market to support the rial.

We strongly urge the Yemeni authorities to move forward swiftly on implementation of these key reforms. In this way, we think Yemen will be able to achieve the economic advancement and higher living standards of which we know it is capable.

Mr. Haupt made the following statement:

The staff report presents a rather mixed picture of developments under Yemen's Fund-supported program. On the one hand, macroeconomic developments have been strong. On the other, the window of opportunity afforded by abundant oil revenues could have been utilized more forcefully for the implementation of certain structural reforms that are vital for improving the country's precarious longer-term balance-of- payments prospects. The politically difficult increase in diesel prices is no doubt an important step forward and to be welcomed. However, it is somewhat disappointing that all five structural performance criteria and one of the agreed prior actions—some of which covered crucial and overdue reforms—remained incomplete or were met only behind schedule. Hence, while this chair can go along with the proposed decisions, it is not without some reservations.

Having said that, I broadly share the recommendations in the staff appraisal. I shall therefore only make three further comments for emphasis:

Firstly, the need for strong adjustment is underscored by the sizeable financing gaps expected in coming years. According to Table 7, in the period 2002-2005, the total financing gap will amount to about US$1.6 billion. These gaps are expected to be filled mainly by debt relief from non-Paris Club creditors. Yet such relief is likely to fall far short of the total amount needed. Moreover, the financing gaps may well turn out to be even larger, since they do not seem to account for the downward revisions in projected oil prices and the expected slowdown in non-oil sector activity resulting from recent international developments.

Secondly, while we recognize the authorities' efforts to restrain expenditures, fiscal adjustment remains one of the most important challenges, as evidenced by the projected steep fall of the revenue-to-GDP ratio in coming years. Non-oil revenues are expected to linger around their present low level of 10.5 percent of GDP in the period up to 2004. This underscores the need to press for the passage of a convincing GST law and to avoid further delays of the income tax reform. I very much welcome the related assurances made by Mr. Shaalan in his helpful statement. On the expenditure side, decisive efforts will be needed to further reduce subsidies on petroleum products, to restructure public enterprises and to carry out civil service reform.

Thirdly, on exchange rate policy, I share the staff's view that sufficient exchange rate flexibility should be allowed for in order to avoid a loss of competitiveness of the non-oil economy. Monetary policy should remain focused on the objective of low inflation. It will need to be supported by an adequately prudent fiscal stance.

Finally, I very much welcome the authorities' intention not to draw on the EFF resources.

Mr. Boitreaud made the following statement:

Let me thank the staff for this focused report and for their supplementary statement that provides us with a useful update of the country's outlook following recent international developments. I share the staff's appraisal and I support the completion of the reviews.

I would however stress three points concerning these reviews.

First, the Republic of Yemen's authorities have to be praised for the consolidation of macro-economic stability achieved, as underscored in the staff's report, by a strong and committed budgetary discipline. The 70 percent increase in the price of diesel effective last July assesses the commitment of the authorities to continue on the pace of streamlining public expenditures and reducing subsidies. I must add that such a tightening of public demand will help to slow down the continuous appreciation of the real effective exchange rate. On a side note, it can be hoped that the recent upgrading of military equipment will be conducted in a manner that will not jeopardize the medium-term reform program.

Second, I fully understand that international and domestic factors have delayed the passage in Parliament of an ambitious reform package comprising an amended investment law, the much awaited new General Sales Tax and several other fiscal reforms. Although I support the waiver requested, I strongly encourage the authorities, despite the difficult political environment, to ensure a rapid and proper implementation of all the performance criteria.

Progress toward fiscal and legal reforms have been slow and the authorities should not lose the momentum generated in the last months.

Third, I wish to emphasize the importance of promoting a climate favorable to private investment. If the fiscal reforms seem to have been initiated, the privatization agenda has not made real headway during the lifespan of this program. This issue must however be addressed urgently both to provide the business sector with more technical skills and to improve the quality of corporate governance.

Finally, we look forward to the forthcoming preparation of a full PRSP in order to address the growing social needs of the population. With these comments, I wish the best to the authorities.

Mr. Whitehall made the following statement:

The authorities have consolidated the gains achieved in recent years in terms of macro-stability and have built up a substantial cushion of external reserves, buttressed by two years of above average oil export prices. They have also prudently restrained expenditure given the risk of lower oil prices in the future. However, their record on structural reform has been somewhat mixed and we are being asked to consider a waiver of performance criteria. We support the staff's appraisal and support completion of the review but wish to comment briefly on a few issues.

First, like other chairs, we become concerned when countries fail to meet performance criteria or structural benchmarks. It is important to consider whether the authorities have demonstrated commitment to the reform agenda in general, whether exogenous factors have hindered the progress of an otherwise committed administration and finally, the degree of difficulty in pursuing an ambitious reform agenda in the current cultural, ideological or political context. Our objective is to strive for a balanced assessment which is consistent with our previous assessments of other countries under similar circumstances.

The reform agenda is ambitious and delays in legislation are to some extent understandable, particularly given the change in government. However, I think we need to encourage Yemen to get back on track and accelerate the pace of reform. In this regard, we look forward to the presentation of the pension law at years-end. We note Mr. Shaalan's Statement which indicated that parliament was unable to consider new legislation owing to recent developments in the region in the wake of the September 11 tragedy in the US. We look forward to an update from staff on when they expect promulgation of the investment law , which was expected to occur in October.

Second, like other chairs, we are pleased with the decision to limit the losses of the electricity company and to significantly increase the price of diesel. The price of diesel is the core structural condition and it was increased well beyond that agreed under the program. This development sends a positive signal of the authorities' commitment to phasing out subsidies. We would like to see the same level of commitment demonstrated, in due course, in the area of the GST. The GST is a main concern, being outstanding for some time. We feel that Yemen needs to make a serious effort to broaden the revenue base given the potential for reduction in oil prices, and erosion of their prosperity in the future.

Third, the staff has reported in Box 1 that progress has been slow in the areas of privatization and bank restructuring which are no longer covered by conditionality. This is not the expected outcome and we also want to register our concerns there as well and wish to encourage the authorities to redouble their efforts in these areas. Can the staff give us an update on exactly what are the modalities which need to be determined so the privatization program can resume and how transparency of the process can be improved?

With these remarks, we wish the authorities success as they persevere with their reform agenda.

Mr. Çakir made the following statement:

Up to now, the authorities' program implementation has been sending conflicting signals. They have demonstrated their determination and their ownership of the program by increasing the diesel price much higher than stipulated by the program. Yemen's macroeconomic performance broadly conforms to the program and their external debt indicators have improved. Unfortunately these accomplishments are marred by serious delays of the required structural measures. But on balance, the program is generally achieving its targets. We think the authorities' efforts deserve our support, and agree with the waivers requested.

I will comment on the structural conditionality, where there are some difficulties. We generally applaud the effort to streamline the conditionality, but given the close relation between banking sector reform to macroeconomic stability, we were surprised at the omission of this issue from the conditionality for future reviews. Can the staff explain why the authorities turned down a World Bank privatization loan? How important is the banking sector restructuring to macroeconomic stability?

It appears that the government's determination to move ahead with structural reforms is not fully shared by parliament. We note that the government is continuing its efforts to build a consensus for the general sales tax, and we expect the government to maintain its fiscal policy stance and continue with its fiscal reforms. Since the government presumably has a majority in the parliament, it should try to work for the enactment of laws that are vital for achieving medium-term sustainability.

As to the exceptional expenditure overruns, we think the expenditures for electricity repairs were well justified. We can also agree that given the modest fiscal deficit, offsetting measures may not be needed. However, we are not fully convinced about the need for the expenditures for "border demarcation."

Finally, on the decentralization efforts, we have often be skeptical about decentralization. Unless governance reforms are undertaken at the central level of the government, the inefficiencies and problems found there will be replicated at local levels, making the total fiscal losses of poor governance higher. Yemen seems not to be an exception to this rule, and we urge the authorities to take another look at their decentralization efforts. With these comments, I wish the authorities success in their endeavors.

Mr. Vittas made the following statement:

Yemen's recent macroeconomic performance has been satisfactory reflecting the buoyancy of oil revenues as well as the commendable restraint the authorities have shown in maintaining expenditure discipline, thereby markedly improving the external and fiscal accounts and ensuring that much of the oil windfall has been saved for the benefit of future generations.

By contrast, progress in pushing forward structural reforms has been rather disappointing. Despite the considerable effort made under these arrangements to streamline structural conditionality, only 2 of the 5 structural performance criteria under the program have been met and even those 2 were not implemented in accordance with the original timetable envisaged under the program. In addition, none of the structural benchmarks has been observed so far, notwithstanding the fact that one of them has been converted into a prior action for the completions of the program reviews.

Against this background, it is only with some hesitation that I can go along with the proposed decisions, and if I do so it is mainly for two reasons aside from satisfactory macroeconomic performance.

First, I recognize that the failure to meet the structural performance criteria and structural benchmarks does not reflect primarily a lack of effort or commitment on the part of the authorities but rather the difficult political and social environment within which they have operated as well as shortcomings in administrative capacity that can probably be overcome only gradually with the help of further technical assistance from the Fund and other entities

Second, like the staff and previous speakers, I am encouraged by the bold step the authorities have recently taken to drastically reduce the diesel subsidy, which as the staff report points out was the core structural PC of the program

Looking forward, I am in full agreement with the staff's policy recommendations. I will therefore underscore only some policy requirements, which seem to me to be essential if Yemen is to make progress in diversifying its economy, stimulating economic growth and reducing poverty

It is of paramount importance to maintain fiscal discipline inter alia by firmly resisting the mounting pressures for additional public outlays and containing the costs of decentralization.

It will be necessary to speed up the pace of structural reforms, especially through the implementation of the long-overdue reform of the tax system, the completion of the reforms of the civil service and the pension system and the acceleration of reforms intended to improve the climate for productive investment

Before concluding, I would like to raise two questions that the staff may wish to comment on.

First, I wonder whether there are any indications as to the likely evolution of Fund financial relations with the Republic of Yemen after the imminent expiration of the current PRGF and EFF arrangements

Second, I noticed from Box 1 of the staff report that an unwelcome result of the effort to streamline structural conditionality has been that two important areas of structural policy, namely bank restructuring and privatization, are no longer covered either by the Fund or the World Bank. I wonder whether staff considers this to be an important deficiency in program design at present and, if so, whether it has any preliminary thoughts as to how this issue might be addressed in any Fund-supported program in the future.

Mr. Wong made the following statement:

At the outset, I would like to thank the staff for a well-written paper and Mr. Shalaan for his helpful and comprehensive statement. The authorities of Yemen are to be commended for implementing measures aimed at bringing the economy back to a sustainable growth path. The country's recent macroeconomic performance speaks for itself. Thanks to the successful implementation of appropriately tight monetary and fiscal policies, macroeconomic indicators have improved considerably on many fronts, including inflation, fiscal and external accounts, foreign reserves, external debt, and so forth. The economy of Yemen is now definitely less vulnerable to external shocks and more resilient to minor setbacks.

However, we hasten to add that challenges certainly remain. We are glad to know that the policy stance will continue to gear toward the tight side on both the fiscal and monetary fronts. We thank the staff for their assurance that the one-off overrun in expenditures in the second half of 2001 can be accommodated without undermining the medium-term objectives of the program. The lower oil price projections will have implications for the balance of payments position and therefore for foreign reserves. The staff recognizes the need that the authorities should stand ready to accept a faster rate of nominal depreciation in the months ahead. We think that there is a delicate balance between an acceptable amount of nominal depreciation on the one hand—which will feed through to domestic price levels – and some degree of exchange rate stability on the other—which needs to be preserved through foreign exchange intervention. We trust that the authorities will strike a good balance. We welcome the authorities to continue to enhance their capacity to conduct monetary policy through refining their existing framework and developing market-based monetary instruments. We also commend the authorities for their substantial efforts made in reducing nonperforming loans.

On the structural side, in light of existing weaknesses in the economy, the authorities show no complacency during the good times. They seized the opportunity to make the most out of the oil windfall. The lifting of diesel prices by 70 percent, which is significantly higher than stipulated in the program, demonstrates very well the authorities' commitment and willingness to implement tough and unpopular reforms. Regarding the passage of various laws, we thank Mr. Shalaan for his detailed explanation of the problems and situation there. For the investment law, we appreciate the unusual circumstances. Mr. Shalaan assures that the law has already been approved by the parliamentary investment committee and will be tabled to the parliament once it reconvenes. Also, difficulties are not anticipated in the passage. We, therefore, have no problem in supporting the waiver for the nonobservance of this prior action. For the other laws, we thank the staff for providing technical assistance and removing some hurdles. The authorities are commended for not giving in to the parliament's earlier demand that the GST be implemented in phases. We appreciate the authorities' many efforts to ensure the broadest possible coverage of the tax. However, the staff, in their statement, still express concerns that the amendments, even without modifications, still contain a number of serious weaknesses in the list of exemptions. We understand that the authorities also see the problem of the current amendments possibly undermining revenue performance and will work toward a compromise with the parliament. I would appreciate it if the staff could comment a bit more on how serious those weaknesses are and how likely there will be a reasonably functional and meaningful GST coming out at the end of the day.

Finally, we are pleased to know that a full PRSP is now under way. We believe that in order to address the structural weaknesses of the economy effectively, grassroot support for the associated reforms is important. We need to have a thorough and credible poverty reduction strategy to complement the reform efforts.

With the above remarks, we support the authorities' request for waivers of nonobservance of the structural performance criteria and the completion of the reviews. We wish the authorities continued success in meeting future challenges.

Mr. Macia made the following statement:

Favorable weather conditions, increases in fisheries output, and strong construction activities have helped a sustained non-oil sector growth. Inflation remained subdued despite increases in diesel prices and the hike in electricity rates. Under consistently lean expenditure policies, oil profits have been put aside, public finances have remained healthy showing a higher overall budget surplus, and all targets and quantitative performance criteria for February, May, and August 2001 have been met. On the other hand, favorable oil prices have done their part to improve the balance of payments perspectives and, consequently, helped to strengthen foreign reserves.

We commend the authorities for their determination to pursue a healthy fiscal policy and containment of inflationary pressures. We caution on any easing of reserve requirements that could help to trigger broad money growth as it occurred in 2000, while we welcome the introduction of the central bank's certificates of deposit as a monetary tightening tool. On the appreciation of the real exchange rate, we concur with Mr. Shaalan's concern that interventions should be allowed to avoid undue fluctuations. It is our opinion, that competitiveness in the non-oil sector will have to be pursued not only in a framework of exchange rate stability, but also implementing structural reforms and pursuing macroeconomic stability. For the medium-term, these reforms could be oriented to promote a healthy competitive environment, efficient production, and flexible labor market conditions, as well as establish a legal framework to safeguard investments and sustain the strengthening of the financial sector.

The political offstage resulting from recent elections, and the restriction upon the executive to enact laws by decrees, will become new challenges towards reforms and the enactment of pending and future legislation. In that vein, we can mention Parliament's opposition to the broad coverage of the GST law, the banking and investments laws, the judicial reforms, the retaking of the privatization agenda, the civil service reforms, and the pending tasks in the decentralization effort and its potential fiscal impact.

> These issues will require resources, political consensus, and are time consuming. Though we look forward for the pension and the reformed tax laws to be submitted, we are uneasy about the political viability of future reforms. Could the staff comment on what possible political roadblocks we could expect with the pending agenda of laws and reforms, the privatization efforts, and the reasons for not including utilities in this program?
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> We praise the authorities in their determination to resist spending pressures as oil revenues materialized, their endeavor to curtail subsidies, and the efforts to bring the debt burden under control. A challenging structural reform agenda remains ahead, but promotion of the private sector participation and further development of the non-oil sector potential are crucial to growth; privatization efforts and judicial reform are a centerpiece to these objectives. In addition, we would encourage corrective measures against smuggling and custom's fraud. Both these issues represent a threat to institutionalized law enforcement, and a deterrent to attract foreign investment.
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> With these remarks, we request the authorities to persevere on the challenging agenda that lies ahead, while we concur with the request for waivers and support the completion of the review. We wish the authorities success.

The staff representative from the Middle Eastern Department (Mr. Gardner) addressed the questions on streamlining conditionality, specifically the status of privatization and bank restructuring. Parliament rejected the World Bank loan; in its view, it would be for the purpose of paying foreign advisors. Although that was the stated reason, there were also problems on arriving at a consensus on how to proceed with privatization. The authorities were not ready to set quantitative privatization targets, and it would be important that any future decisions concerning privatization be carried out in a transparent manner. There had been discussions on how to involve the private sector in electricity generation and, in particular, how to exploit domestic gas resources for that purpose. On bank restructuring, particular questions about systemic matters, bank supervision or potential contingent liabilities on the budget, were not major issues at present. As described in the staff report, the progress on nonperforming loans meant that the banking sector did not pose either systemic or budgetary risks at the moment. The problems that presently plagued the banking system concerned the credit culture and the creation of institutions to support that culture. Issues of definition and protection of property rights and the power to attach assets and collect collateral were important, but more within the Bank's domain than the Fund's. The Bank was already active in some of those areas, notably in the judicial reform process.

On streamlining conditionality, it was asked whether conditionality had been streamlined enough, and why parliamentary approval of key legislation had been included under conditionality, the staff representative said. The structural conditionality of the program focused on fiscal and monetary issues, with the exception of the investment law.

Many of the benchmarks and structural performance criteria gravitated around tax reform and were complementary aspects of the program—like the establishment of a large taxpayer unit and the GST law. Emphasis was placed on parliamentary approval, because enough groundwork had been done in preparing the necessary measures, and only legislative action was then needed to implement them.

Mr. Daïri stated that although the proposed measures were important, Fund-supported programs rarely included so many conditions over such a short period of time. That concentration would place pressure not only on administrative capacity, but also on needed political consensus-building. With the change in government, it was now even more delicate to proceed with reform on income and general taxes, pensions, and investment law—all major pieces of legislation.

The staff representative from the Middle Eastern Department (Mr. Gardner), on recent information on the investment law, noted that as of the previous day, the parliament had not yet resumed deliberations. Nonetheless, the legislation as introduced contained no controversial elements, and thus once debate was resumed, an early vote was likely.

Regarding the question of the GST, two major issues were raised, the staff representative recalled. The first was on the nature of the weaknesses still of concern to the staff. The list of exemptions was still excessively broad and contained goods and services with no obvious social objective. Also, for certain categories of goods, the draft law introduced differential treatment between domestic and imported goods, which contravened WTO rules and which, therefore, had no Fund support. The two issues were being debated and there was already progress on the latter point; the differential had been removed.

On the second major issue of smuggling, the GST law had been debated in the parliamentary financial committee for a long time, and the members were the main source of opposition to the law. Business interests were strongly represented there, and their concerns were legitimate because there was a possibility that smugglers could evade customs altogether, while a VAT or GST would introduce a tax differential between domestic and imported goods. However, at the proposed rate of taxation of 10 percent, the risk would not be severe, given that the same rate was being used for the current indirect tax system. The Fund issued a report in 2000 on how to address smuggling, and it was now the right time to begin implementing some of those recommendations in parallel to implementing the GST; there was no need for sequencing.

On the scope for future Fund involvement and the authorities' interest therein, the authorities had expressed an interest in seeing continued Fund involvement in supporting their reform and adjustment effort over the medium-term, the staff representative stated. Given Yemen's need for long-term and protracted balance of payments and fiscal adjustment to ensure long-term viability, the Fund could play a useful role. However, discussions could begin only after the staff received the PRSP from the authorities, and could verify that it contained sufficient assurances of political commitment to pending reforms and possibly new ones as well.

The staff representative from the Policy Development and Review Department (Mr. Seade) stated that Mr. Ralyea was incorrect in saying that there was evidence of an immediate balance-of-payments need. Although the price of oil could complicate the immediate balance of payments, of concern was the medium-term balance of payments, complicated by rapidly dwindling oil reserves. Another important point was that once an arrangement had been approved and a disbursement requested, the staff did not challenge the member's representation of a balance of payments need. This was because reaction to a changed need could, in some cases, amount to penalizing good performance by the government in resolving the problem. Focus on the medium-term balance of payments was appropriate in the case of Yemen.

Mr. Shaalan made the following concluding remarks:

> I thank colleagues for their constructive criticism, which I shall convey to the authorities. Most Directors, if not all, pointed to the slow pace of the implementation of structural reforms, which has admittedly lagged and has not been successful at meeting the program's quantitative targets; Yemen definitely lagged behind in the implementation of structural reforms. Why?
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> Mr. Ralyea and some other colleagues have rightly stated that Yemen lacked the institutional and implementation capacity to put in place such a complex set of structural measures. I emphasize that the delays were not from lack of commitment by the Yemini authorities. The staff has responded to most of the concerns raised by the two items not implemented on time: the amendments to the investment law and the establishment of the GST law.
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> The investment law was passed and the staff proposed some amendments which have been accepted by the committee, and which parliament is about to ratify. The reason for the delay is the unfortunate events of September, where both houses of parliament have been in session, and it is very difficult to put forward a law to parliament at this time when they are both in session. In my conversations with the Minister earlier this week, he assured me it would be only days before those measures are implemented.
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> The GST is a little more complicated. Here, I want to point out that the authorities have submitted to parliament a GST law, and that parliament has changed it radically. The staff made clear that the authorities had not approved the changes. They wanted to fully support the GST law worked out with the staff. The process now is that the government, through special committees, is trying to get those laws amended appropriately along the lines recommended by the staff. Hopefully, this process will result in a more adequate GST law. As many colleagues know, I, for one, am very much against exemptions in GST taxation, and it is my understanding that the GST law in Yemen has excessive exemptions built into it. The government would like to eliminate those exemptions, or at least reduce them radically.

Privatization is lagging behind. But, as the staff mentioned, you really need to have a political consensus to have a privatization process that can be successful. This is not new to Yemen. In many of our member countries, this has been the case. When you mention privatization to members, they do not even want to hear of it. But, sooner or later they are heavily engaged in the process. So, it is a matter of building political consensus in Yemen.

The question of decentralization must be assessed carefully, and I will communicate to the authorities the importance of their attaching this and the assistance they must seek from the World Bank to make it workable. Finally, I would like to take the opportunity to thank colleagues again, and to thank Mr. Seade, who has worked on Yemen for some years, and wish him every success in his new assignment.

The Acting Chair made the following summing up:

Directors commended Yemen's strong macroeconomic performance in 2001, as reflected in the stabilization of inflation below 10 percent and the large accumulation of foreign exchange reserves. While buoyant oil prices helped to strengthen fiscal and balance of payments performance, Directors also noted the contribution of expenditure and monetary restraint to this outcome.

Directors welcomed the authorities' determination to maintain fiscal discipline despite the strong boost to revenues from high oil prices throughout most of 2001 and the attendant expenditure pressures. They regretted that it would not be possible for the gains achieved in containing the non-oil deficit to be preserved in the latter part of the year because of the need for exceptional spending on border demarcation and electricity repairs. Directors, however, welcomed the steps taken to address the financial imbalance of the public electricity company.

Directors commended the authorities' decision to reduce subsidies on petroleum products by raising diesel prices by 70 percent, and for successfully making this change in a context of social peace. Both to improve resource allocation and as an important step toward ensuring fiscal sustainability, Directors encouraged the authorities to further close the gap between domestic and international diesel prices in 2002, while putting in place policies to contain any undesirable social impact.

Directors were disappointed by the weak implementation of much of the remaining structural reform agenda, and regretted in particular the lack of progress on tax reform. They encouraged the authorities to redouble their efforts to secure passage of a broad-based GST law, which they considered key to sustaining fiscal adjustment and financing social expenditures over the medium-term.

Directors also regretted that the authorities had been unable to secure passage of the investment law as a prior action for the reviews as intended. They recognized, however, that exceptional events had led to the disruption of Parliament's legislative agenda and to this delay. Directors underscored the importance of this law to improve prospects for foreign investment and thereby growth in the non-oil sector, and were encouraged by the authorities' assurances that the law would be adopted shortly.

Directors noted that monetary policy had been tightened considerably and was supportive of the program inflation objective. However, noting that one-sided intervention in defense of the exchange rate had contributed to continued real appreciation, they encouraged the authorities to refrain from systematic intervention, and to allow the exchange rate to move more flexibly in response to market pressures. They underscored the importance of avoiding further real appreciation in order to spur growth in the non-oil sector.

Building on the Interim-PRSP, Directors encouraged the authorities to complete the full PRSP by the end of 2001. They welcomed the steps already taken to achieve a broad participatory approach and stressed the need to respond effectively to calls from civil society for better targeted social expenditures and improved governance, as key elements of the growth and poverty reduction strategy.

Looking forward, Directors urged the authorities to protect the gains achieved in macroeconomic stability by maintaining strict budgetary discipline in 2002, particularly in view of the expected gradual depletion of Yemen's oil reserves and in the wake of the recent weakening of oil prices. Directors recognized the role that decentralization could play in improving the targeting of public spending, but were concerned at the lack of preparedness and capacity to implement this process. They urged the authorities to maintain tight control over budgetary allocations to local authorities until adequate capacity to manage these resources has been demonstrated. Directors noted that the military upgrade plan would have significant fiscal implications, and urged the authorities to ensure that these added expenditures can be accommodated within the medium-term fiscal objectives set out in the Interim-PRSP.

Directors emphasized the importance of moving ahead as fast as possible with structural reform, including in the areas of taxation and energy pricing. They noted the contribution which Fund technical assistance could play in this process.

Directors approved the authorities' request for completion of the reviews, with one abstention.

The Executive Board took the following decisions with one abstention, from Mr. Ralyea.

Poverty Reduction and Growth Facility—Third Annual Arrangement—Reviews, Modification, and Waiver of Performance Criteria

1. The Republic of Yemen has consulted with the Fund in accordance with paragraph 3(e) of the three-year arrangement for the Republic of Yemen under the Poverty Reduction and Growth Facility (PRGF) (EBS/97/172, Sup. 3, 10/31/97) and paragraph 31 of the Memorandum of Economic and Financial Policies attached to the letter dated February 13, 2001, from the Minister of Finance and the Governor of the Central Bank of Yemen.

2. The letter dated August 29, 1997, from the Minister of Finance and the Governor of the Central Bank of Yemen, together with its Memorandum of Economic and Financial Policies (the "Memorandum"), attached to the three-year PRGF arrangement for the Republic of Yemen, and the letters dated March 22, 1998, July 29, 1998, February 27, 1999, June 12, 1999, and February 13, 2001, from the Minister of Finance and the Governor of the Central Bank of Yemen, together with their respective Memorandum of Economic and Financial Policies, shall be read as supplemented by the letter dated October 10, 2001 from the Deputy Prime Minister and Minister of Finance and the Governor of the Central Bank of Yemen, together with its Supplementary Memorandum of Economic and Financial Policies ("the October 2001 Memorandum").

3. The Fund decides that:

a. the first and second reviews contemplated in paragraph 2(e) of the three-year PRGF arrangement for Yemen are completed; and

b. Yemen may request the disbursement of the second and third loans referred to in paragraph 1(b) of the third-year PRGF arrangement for Yemen, notwithstanding the nonobservance of the end-February 2001 structural performance criteria on the diesel price increase and the submission to Parliament of a reformed pension law, the end-May 2001 structural performance criteria on the transfer of tax files, the passage of a new GST law, and the passage of an amended banking law, specified in paragraph 2(b) of the arrangement, on the condition that the information provided by Yemen on the observance of these structural performance criteria and on the implementation of the prior actions specified in Box 1 of Annex II to the October 2001 Memorandum is accurate. (EBS/01/172, 10/10/01)

Decision No. 12601-(01/108), adopted
October 24, 2001

Extended Arrangement—Review, Modification, and Waiver of Performance Criteria

1. The Republic of Yemen has consulted with the Fund in accordance with paragraph 4(d) of the extended arrangement for the Republic of Yemen (EBS/97/172, Sup. 2, 10/31/97), in order to review program implementation.

2. The letter from the Deputy Prime Minister and Minister of Finance and the Governor of the Central Bank of Yemen dated October 10, 2001, with its attached Supplementary Memorandum on Economic and Financial Policies ("the October 2001 Memorandum"), shall be attached to the extended arrangement, and the letters dated August 29, 1997, March 22, 1998, July 29, 1998, February 27, 1999, June 12, 1999, and February 13, 2001, and the respective memoranda attached thereto, shall be read as supplemented by the letter dated October 10, 2001 and the October 2001 Memorandum.

3. The Fund decides:

a. that the fifth and sixth reviews contemplated in paragraph 4(d) of the extended arrangement for the Republic of Yemen are completed;

b. to waive the nonobservance of the end-February 2001 structural performance criterion on the transfer of tax files, and the end-May 2001 structural performance criteria on the submission to Parliament of a reformed pension law, the passage of a new GST law, the diesel price increase, and the passage of an amended banking law, specified in paragraph 2(b) of the arrangement, on the condition that the information provided by Yemen on the observance of these performance criteria and on the implementation of the prior actions specified in Box 1 of Annex II to the October 2001 Memorandum is accurate; and,

c. that purchases by the Republic of Yemen under the arrangement shall not exceed the equivalent of SDR 72.90 million until October 15, 2001. (EBS/01/72, 10/10/01)

Decision No. 12602-(01/108), adopted
October 24, 2001

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/107 (10/22/01) and EBM/01/108 (10/24/01).

4. EXECUTIVE BOARD COMMITTEES—NOMINATIONS

The Executive Board approves the nominations by the Managing Director of Messrs. Oyarzabal, Pickford, Wijnholds, Barro Chambrier, Bennett, Bischofberger, Djojosubroto, Mirakhor, Portugal, and Wei to the Committee on the Budget, of Messrs. Bennett, Bischofberger, and Djojosubroto to the Committee on Administrative Policies, Mr. Bennett to the Interpretation Committee, of Messrs. Kelkar and Bennett to the Agenda and Procedures Committee, and of Mr. Bennett to the Ethics Committee, as set forth in EBD/01/88 (10/16/01).

Adopted October 23, 2001

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 01/69, 01/70, 01/75, 01/76 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/01/120 (10/19/01) and EBAM/01/121 (10/22/01), and by an Assistant to Executive Director as set forth in EBAM/01/120 (10/19/01) is approved.

APPROVAL: February 6, 2002

SHAILENDRA J. ANJARIA
Secretary