DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

0450

SM/92/194

CONTAINS CONFIDENTIAL INFORMATION

October 30, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Germany - Staff Report for the 1992 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation with Germany, which is tentatively scheduled for discussion on Friday, November 20, 1992.

Mr. D. McDonald (ext. 38862) or Mr. Habermeier (ext. 38857) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 1992 Article IV Consultation

Prepared by the Staff Representatives for
the 1992 Consultation with Germany

Approved by Massimo Russo and Joaquin Ferrán

October 30, 1992

I. Introduction

Staff teams visited Bonn, Dresden, Frankfurt and Schwerin during August 31-September 11 and October 14-15 to hold the 1992 Article IV consultation discussions with Germany. 1/ German economic monetary and social union (GEMSU) took effect on July 1, 1990 and full political integration of the former German Democratic Republic (GDR) into the Federal Republic of Germany occurred on October 3, 1990. All-German elections for the lower house of the federal parliament were held in December 1990 and the new eastern Länder sent representatives to the upper house of the federal parliament following elections for new governments in those Länder. The next federal elections are due toward the end of 1994.

1/ The main mission in August-September consisted of Messrs. Artus, Habermeier, McDonald, Tersman (all EU1), Mr. Clark (RES) and Ms. Williams-Smith (EU1, staff assistant). Mr. Russo participated in the discussions in Frankfurt and Bonn during September 1-4. Mr. Goos attended the meetings as an observer. Messrs. Artus and McDonald had follow-up discussions in Bonn and Frankfurt in October and Mr. Esdar attended as an observer. In the meetings with federal authorities in Bonn and Frankfurt, Germany was represented by officials from the Ministries of Finance, Agriculture, Economics and Labor, the Chancellory and the Deutsche Bundesbank. Members of the mission met with Mr. Köhler, State Secretary in the Federal Ministry of Finance, Mr. Schlesinger, President of the Bundesbank, Mr. Tietmeyer, Vice-President and President-designate of the Bundesbank, and Mr. Issing, a member of the Directorate of the Bundesbank. In Dresden and Schwerin, the staff had discussions with officials of the governments of Saxony and Mecklenburg-Vorpommern and met with Mr. Biedenkopf, Prime Minister of Saxony. The mission also met with representatives of the Federation of German Industry and the Federation of German Trade Unions. Earlier, in May, a staff team visited Berlin and Potsdam for meetings with officials of the Treuhandanstalt, the Government of Brandenburg, and the German Institute for Economic Research.

II. Background

1. The context of the discussions

The last Article IV consultation with Germany was concluded on September 11, 1991 (EBM/91/120). At that meeting, Executive Directors commended the authorities on the remarkable speed of unification. In view of the pressure on resources and high wage awards in west Germany, Directors supported the tightening of monetary conditions. They were worried, however, that an excessive burden was being placed on monetary policy and they emphasized the need for fiscal consolidation and measures that promoted the renewal of the east German economy. In this context, Directors stressed the importance of a clearer and more comprehensive statement of the medium-term fiscal strategy--they noted in particular the dangers related to possible new claims on the budgets of the territorial authorities and borrowing by off-budget agencies, especially the Treuhand. In east Germany, it was crucial to discourage excessive wage increases. Large wage awards in west Germany were also inconsistent with labor market conditions in Germany as a whole, and it was important to deal with structural rigidities in west Germany that impeded the operation of the labor market.

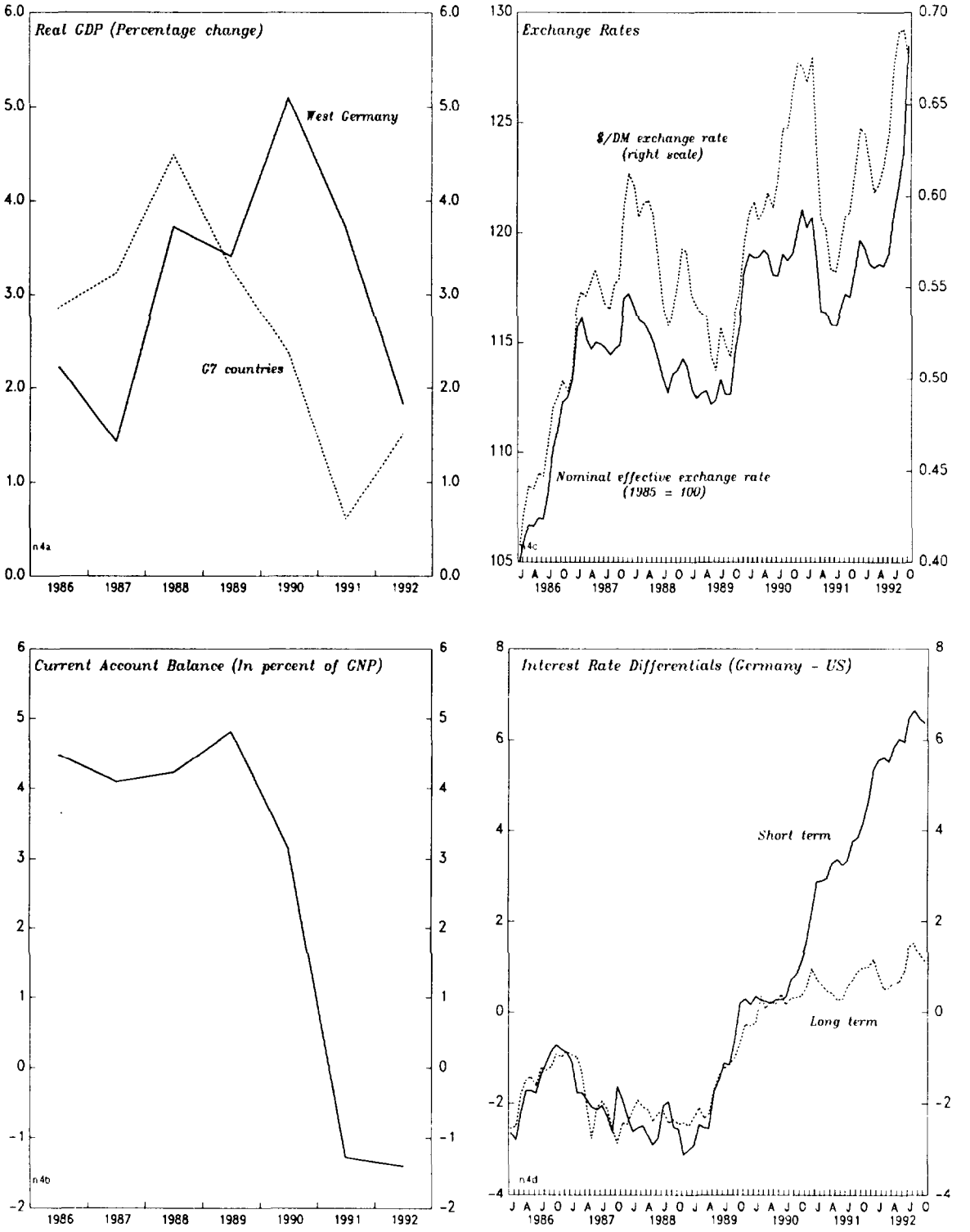
The issues emphasized at EBM/91/120 were again to the fore during the staff's recent discussions in Germany. Concerns over the medium-term fiscal outlook have not receded. While the deficit of the territorial authorities has been lower than expected a year ago, this has been offset by larger borrowing of other public entities. Wage awards in west Germany were again too high in 1992. In east Germany, the huge gap between wages and productivity has widened further. The burden on monetary policy has, thus, remained heavy--while long-term interest rates have declined, short-term rates have continued to be high in real terms.

From an international perspective (Chart 1), concerns have sharpened. With the demand impulse from unification fading, global recovery delayed, and inflation abating in most ERM countries, the consequences of high short-term interest rates in Germany for economic activity in other ERM countries have become more apparent. Moreover, with the sharp decline in short-term rates in the United States, the interest differential between Germany and the United States widened further, contributing to a pronounced appreciation of the deutsche mark against the U.S. dollar. This in turn heightened tensions already present in the ERM.

2. Recent developments

Since mid-1991, the economic expansion in west Germany has slowed (Charts 2 and 3). Initially this reflected a deceleration of domestic

CHART 1
Germany
Economic Indicators in International Context 1/

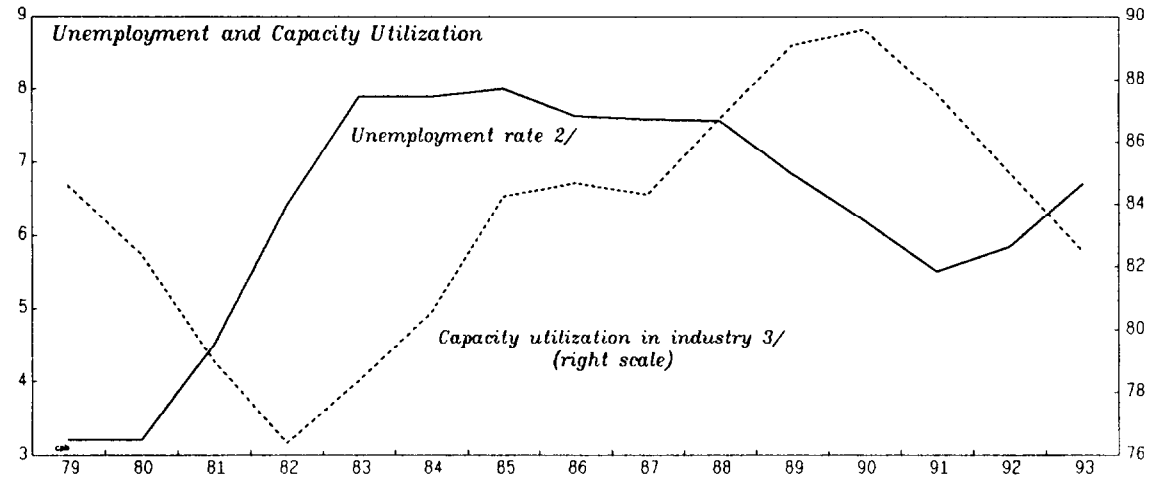


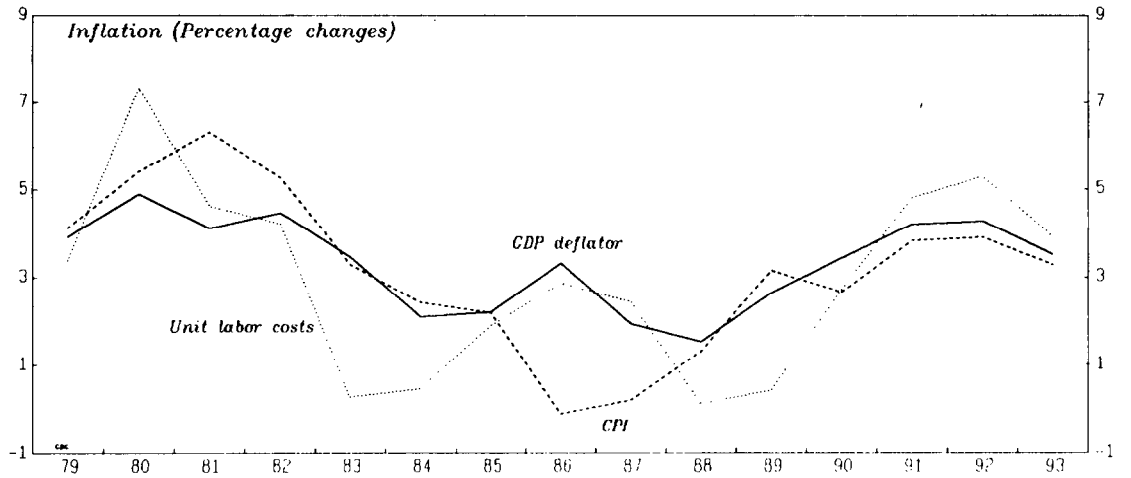
Sources: Deutsche Bundesbank, Monthly Report; and IMF Data Fund.
1/ Data for GDP and the current account balance in 1992 are staff projections.

CHART 2

West Germany

Output, Unemployment and Prices 1/





Sources: Statistisches Bundesamt, Volkswirtschaftliche Gesamtrechnungen; Bundesanstalt fuer Arbeit, Arbeitsmarkt in Zahlen; and staff projections.

1/ Data for 1992 and 1993 are staff projections.

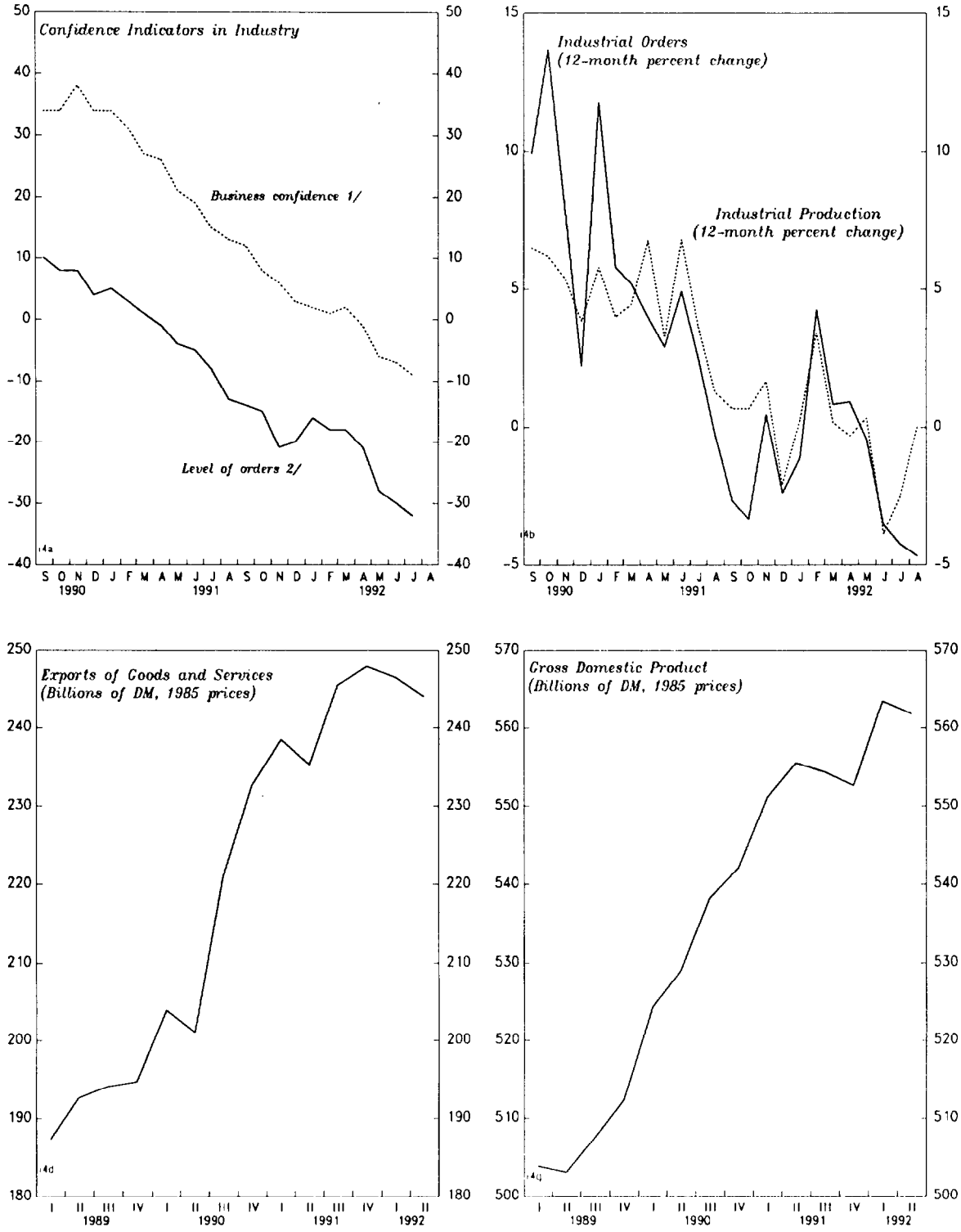
2/ In percent of labor force.

3/ In percent of full capacity.

CHART 3

West Germany

Cyclical Indicators



Source: Deutsche Bundesbank.

1/ Difference between favorable and unfavorable responses to a survey question whether the short-term business outlook would improve or deteriorate, in percent of total responses.

2/ Difference between positive and negative responses on a survey question related to the adequacy of the stock of orders.

demand in response to large tax increases. 1/ Exports lost momentum towards the end of 1991 and then fell in the first half of 1992, reflecting continued weakness in industrial country demand for investment goods, in which German exporters specialize, deteriorating cost competitiveness, and a deceleration in deliveries to east Germany. There was a surge in output in early 1992, principally due to temporary factors, including mild winter weather; however, output fell in the second quarter as these factors unwound. On balance, GDP rose by 1 percent (calendar-day adjusted) from the second quarter of 1991 to the same period in 1992. 2/ Output has declined in industry, while activity in services had continued to expand (Chart 4).

The pressure on resources in west Germany has eased, but only moderately, and capacity utilization in industry remains relatively high. Moreover, the continued strength of labor-intensive services has moderated the initial influence of the economic slowdown on the labor market. In particular, employment continued to rise in the second half of 1991 and it was only in the first half of 1992 that job creation stalled. On balance employment increased by 1 percent in the year ending in the second quarter of 1991. The unemployment rate has been edging up since the spring of 1992, and in September reached 6 percent, about 1/4 percentage point higher than a year earlier.

The tight labor market conditions in west Germany were evident in increases of 6 3/4 percent in negotiated hourly wages in 1991 and of 4 3/4 percent in unit labor costs. With the pressure on prices reinforced by increases in indirect taxes in July, consumer prices rose by 3 1/2 percent in 1991 and the GDP deflator by about 4 percent. 3/ The rate of consumer price inflation picked up further in the first half of 1992, with a 12-month rate of increase of 4 1/2 percent compared with 4 percent in the second half of 1991. The spring 1992 wage round was difficult and accompanied by the first widespread strike activity since 1984. Awards were below those in 1991 with most agreements in the range of 5 1/2-6 percent. By the summer of 1992, despite falling import prices, the 12-month rise in consumer prices of 3 1/2 percent was not much down from earlier in the year, after allowing for tax effects. 4/

1/ Increased social security contributions in April 1991, higher indirect taxes in July 1991 and a temporary (1 year) surcharge on income taxes, also introduced in July, yielded almost 2 percent of GNP on a full-year basis. These tax increases had a particularly sharp effect on consumption.

2/ The German authorities have begun to put greater emphasis on GDP as a measure of economic activity and the next WEO will also shift to GDP. GNP continues to be the variable used by the authorities to measure the size of external and domestic financial balances.

3/ For consumer prices, almost 1/2 percentage point reflected the effect of higher indirect taxes. As the tax rises occurred in mid-1991, there is a similar effect on inflation in 1992.

4/ The effects on the rate of inflation coming from the indirect tax increases of July 1991 fell out in July 1992.

The pressure on resources in west Germany reflected the enormous stimulus from east Germany, where demand was supported by sizable transfers from the west. Consumption in the east was 40 percent larger than GNP in 1991, and net imports of goods and services were over 80 percent of GNP. The output decline in the new Länder, which began in late 1989 and which intensified after GEMSU, continued into the first half of 1991 (Chart 5). There was some recovery during the second half of the year as services and construction activity began to expand and industrial output appeared to bottom out. The recovery faltered, however, in the first half of 1992. While the expansion in construction and some service activities has continued, the decline in industrial output resumed.

Employment in east Germany fell from 9 3/4 million in the last quarter of 1989 to 6 1/4 million in the summer of 1992. Moreover, of those employed in the summer, more than 3/4 million were in short-time work and job creation programs. In addition, there was considerable hidden unemployment in local government. Only part of the decline in employment was reflected in the unemployment statistics--unemployment in the summer averaged 1 1/4 million, close to 15 percent of the labor force. Most of the drop in employment was reflected in the large number of workers who moved to west Germany, commuted to jobs there, or entered retraining or early retirement programs. There was also a significant reduction in the labor force participation of women as social patterns began to adjust to west German norms.

Conditions in the east German labor market have been exacerbated by excessive wage growth. By the end of 1991, monthly wages were 70 percent higher than in the third quarter of 1990, just after GEMSU, while the nominal value of output per worker had risen by only 45 percent. Thus, the imbalance between wages and productivity widened considerably and, by the end of 1991, monthly wages were 53 percent of the level in west Germany while productivity was only 37 percent. The imbalance was even greater in manufacturing, with unit labor costs twice the west German level. Further large wage increases in the course of 1992 have pushed monthly contract wages to 70 percent of western levels across a wide range of sectors.

Prices in the east have also been rising quickly--in August 1992, consumer prices were 13 percent above their level of a year earlier. Price developments, however, have been heavily influenced by the reduction of subsidies on rents and energy; excluding these, products prices rose by less than 4 percent in the year to August. Given the large part of demand satisfied from outside east Germany, consumer prices are not a good guide to domestic price developments. The rise in the GDP deflator in the course of 1991 was 10 percentage points faster than that of the consumer price index.

3. Short-term prospects

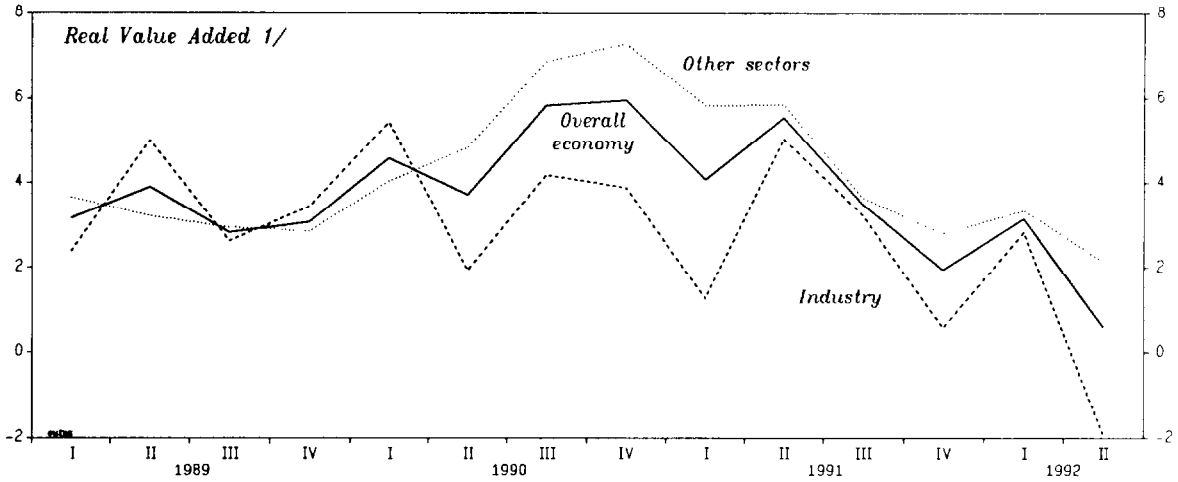
In west Germany, the economic outlook for the second half of 1992 and 1993 has weakened considerably over the past six months. Business confidence has deteriorated against the background of falling exports and

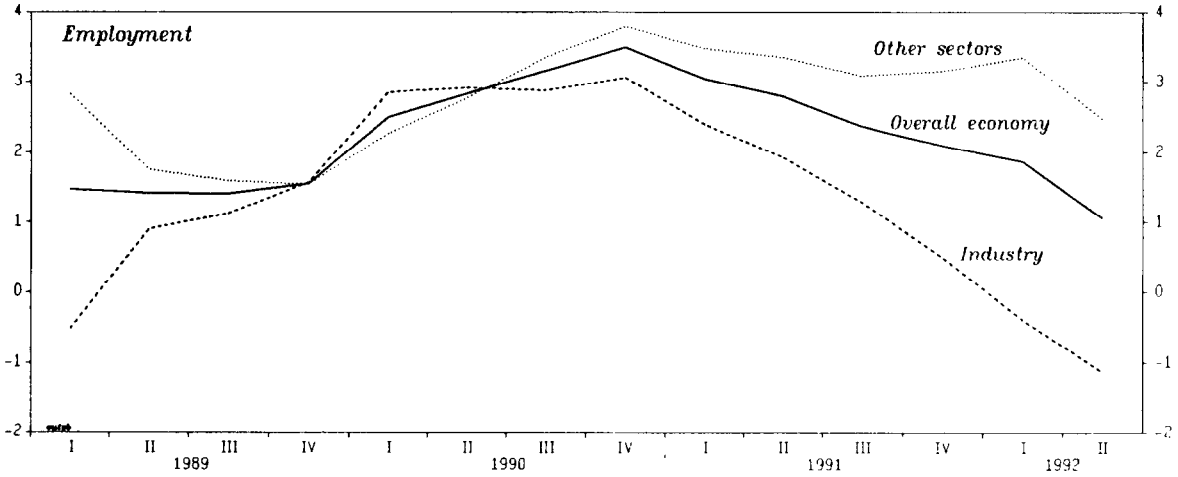
CHART 4

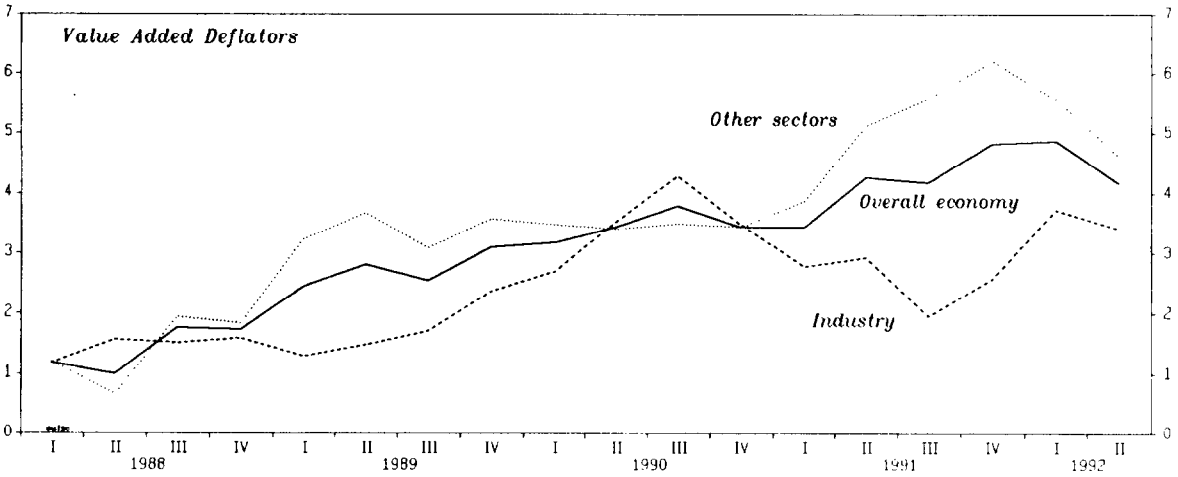
West Germany

Value Added, Employment, and Prices by Sector

(Percentage changes from the same quarter of the previous year)





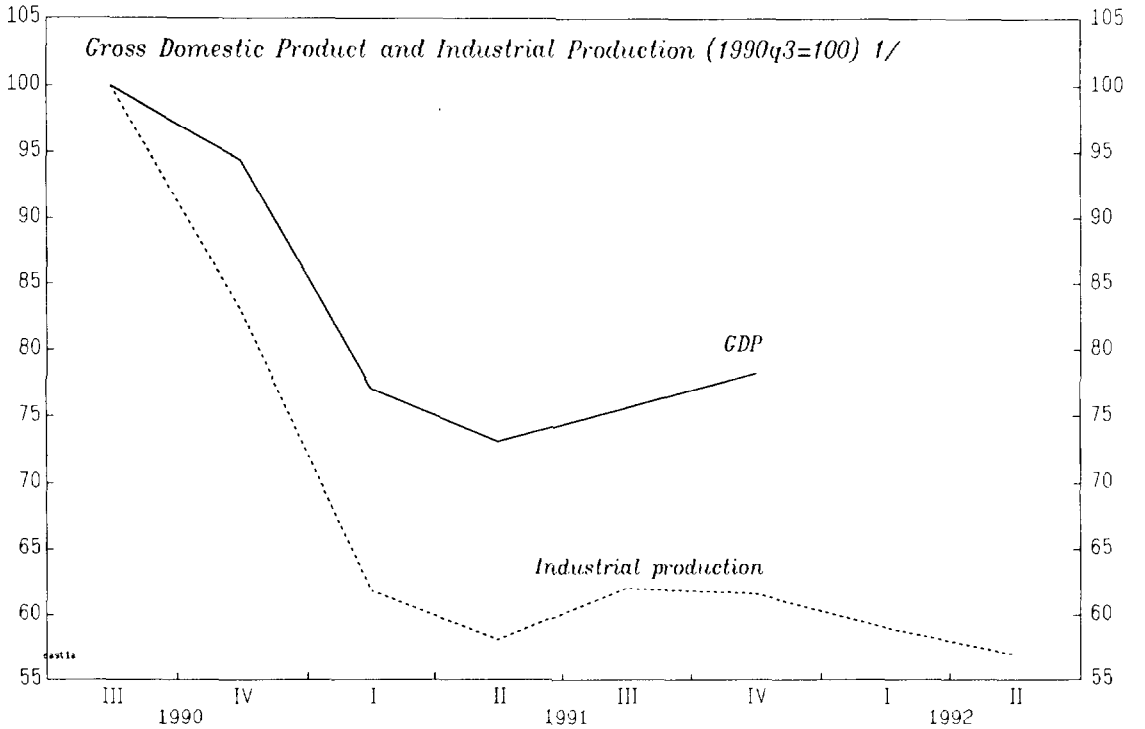


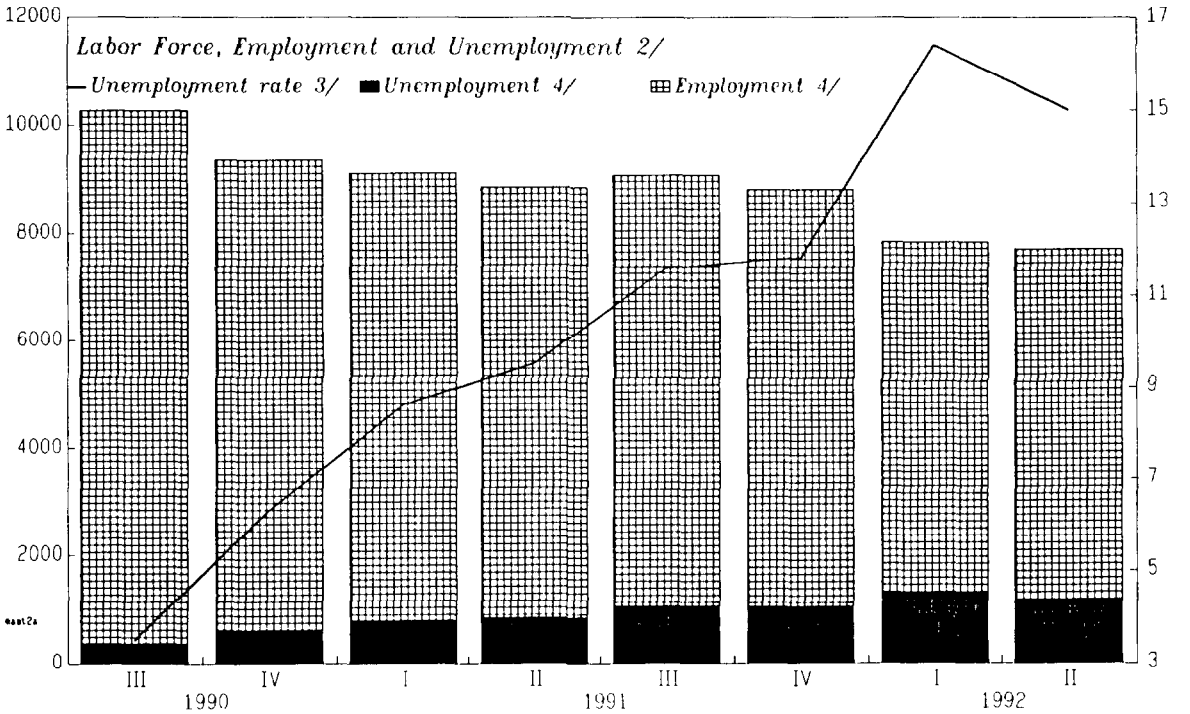
Source: Statistisches Bundesamt, Volkswirtschaftliche Gesamtrechnungen.
1/ Not calendar adjusted.

CHART 5

East Germany

Output and Labor Market Developments





Sources: Statistisches Bundesamt, Volkswirtschaftliche Gesamtrechnungen; and Deutsche Bundesbank, Monthly Report.

1/ Seasonally adjusted. National account data are not yet available for the first half of 1992.

2/ Not seasonally adjusted.

3/ Right scale, in percent of the labor force.

4/ Left scale, in thousands.

manufacturing output and declining orders suggest little respite in the immediate future. At the time of the discussions, the authorities had not yet revised the macroeconomic projections they had produced in the spring. They did expect that, for the year 1992 as a whole, GDP would grow in line with their spring forecast, i.e., in the range of 1 1/2-2 percent, with a stronger than expected first half compensating for a weaker second half. For 1993, their earlier projection of 2 1/2 percent growth in west Germany was now clearly outdated and would need to be revised downward. Subsequently, a revised projection of 1-1 1/2 percent growth in 1993 was announced.

The staff's latest projection for output growth in west Germany in 1992--a 1 3/4 percent rise in GDP--is broadly in line with the expectations of the authorities. For 1993, the staff has reduced its projection of GDP growth to about 1 percent compared with an expectation of 2 1/4 percent in the summer. 1/ The reduction reflects a small decline in output in the second half of 1992, weaker recovery in export markets in 1993 than earlier expected, and the appreciation of the deutsche mark. A rise in GDP of 2 percent is envisaged during the course of 1993, as export growth resumes and improving confidence supports a recovery in investment later in the year. Clearly, however, there are downside risks. Export prospects remain uncertain and the timing of a revival in confidence is difficult to project. Without the balance sheet problems that exist in other countries and with capacity utilization still relatively high, confidence could begin to turn up relatively quickly, but this will depend on a moderate wage round and a resumption of export growth. While the authorities are a little more optimistic than the staff for 1993, the leading German economic research institutes now project economic growth of only 1/2 percent.

In east Germany, continued problems in industry have led to downward revisions in expectations for output growth in 1992. The staff now envisages that GDP will rise by only 2-3 percent. Assessing prospects for next year is speculative. At present, the staff assumes that output will grow by about 6-7 percent, reflecting continued expansion in construction and services and some recovery in industry, supported inter alia by the coming on stream of new investments. On the basis of these assumptions, all-German GDP is likely to increase by 2 percent in 1992 and 1 1/2 percent in 1993.

The weakening of economic activity is relieving pressure on resources in Germany and rising unemployment is strengthening prospects of a moderate wage round in 1993. Working against these moderating influences will be a 1 percentage point increase in the basic VAT rate next January. On balance, the staff projects that consumer prices in west Germany will rise by 3 1/4 percent in 1993, of which 1/2 percentage point will reflect the effect

---

1/ The projections assume that short-term interest rates fall to 7 3/4 percent by the end of 1993, the wage round produces settlements of about 4 1/4 percent and there is little change in the fiscal balance.

of higher VAT, and the GDP deflator by 3 1/2 percent. By the end of 1993, consumer price inflation is expected to be below 3 percent. The German research institutes envisage higher inflation for 1993--3 1/2 percent for consumer prices and 4 percent for the GDP deflator. In east Germany, a further adjustment to rents next January will boost prices by 4 percent and for 1993 as a whole it is envisaged that consumer prices will rise by 8 percent and the output deflator by 12 percent.

The external accounts, which had swung from a current account surplus of almost 5 percent of GNP in west Germany in 1989 to an all-German deficit of 1 1/4 percent in 1991, are likely to weaken by a further 1/4 percentage point in 1992. While external transfers will not be as large as in 1991, when they were boosted by contributions to the cost of the war in the Middle East, the underlying current account position has deteriorated reflecting real declines in exports to western markets, a further weakening of markets in eastern Europe and a worsening balance on investment income. A reduction in the external imbalance--to about 1 percent of GNP--is envisaged in 1993, reflecting slowing imports and renewed export growth.

III. The Policy Discussions

The policy discussions took place against the background of an active public debate in Germany that accompanied the beginning of the 1993 budget process. This debate was fuelled by growing pessimism about the short-term economic prospects as well as uncertainty as to how policy makers would tackle the fundamental problems that now face the German economy. At the same time, tensions in the foreign exchanges and especially within the ERM underlined the international importance of this debate.

There was broad agreement on the sources of the economic imbalances in Germany. Since unification, the public sector had been absorbing resources on an unsustainable scale. In east Germany, large transfers from the west and huge wage increases unmatched by productivity gains had failed to satisfy the unrealistic expectations formed at the time of unification. In west Germany, resistance to paying the costs of unification had grown as the initial elation subsided and the estimates of those costs increased. The staff stressed that unless substantial progress was made soon in fiscal consolidation and wage pressures began to recede, the policy mix would remain unbalanced, short-term interest rates would be kept high to control inflation, confidence would continue to be weak, and the danger of recession in Germany would loom larger. This would be costly both for Germany and the international community. On the other hand, clear evidence that policies were coming to grips with inconsistent resource claims in Germany would foster recovery throughout Europe by providing room for a marked decline in short-term interest rates and by underpinning a renewal of confidence in Germany.

The authorities acknowledged the short-run dangers but maintained that Germany was not close to recession. While many cyclical indicators had been

declining, the underlying situation in the business sector was robust, profit levels were satisfactory and capacity utilization, while falling, was still relatively high. Moreover, the weakening of domestic demand was largely related to deteriorating confidence and this could change quickly. They stressed that higher public borrowing in the wake of unification had been unavoidable, in view of the unexpected nature of the challenge. In addition, it was only recently that the full extent of the costs of rebuilding east Germany and the time it would take had become apparent.

German officials recognized that the question of the policy mix was important for Germany's ERM partners. They pointed out that given the priority attached to price stability in Germany and the stable nominal exchange rates within the ERM, it had been inevitable that some of the pressures from German unification would spill over on neighboring countries. They added, however, that in assessing the experience of the past two years, one should also not lose sight of the substantial boost to demand in Europe from the surge in German imports. Moreover, while the stimulus from German imports had receded, long-term interest rates in Germany had now fallen below their historical average. Officials also stressed that difficulties being experienced by some countries in the EC were principally home grown.

The authorities said they were determined to come to grips quickly with the prevailing macroeconomic imbalances. Their resolve in the area of the budget was reflected in the medium-term fiscal program, and the decline in long-term interest rates was an indication of the market's confidence in the program. On wages, they were hopeful that the next wage round would see significant moderation, with at most only a small rise in real wages. They stressed that there was little that the government could do directly to ensure such an outcome, given the constitutional independence of the wage bargaining process (Tarifautonomie). It was actively working however to achieve a consensus in the form of a social compact between the principal groups in the economy.

1. Fiscal policy

Transfers to east Germany from the west have dominated budgetary developments; in 1991, they amounted to some DM 110 billion, about 4 percent of all-German GNP and are expected to rise further to DM 130 billion in 1992. To finance these transfers, public borrowing has risen sharply. The deficit of the territorial authorities increased from DM 27 billion in 1989 to DM 123 billion (4 1/2 percent of GNP) in 1991 but is expected to decline to DM 113 billion (3 3/4 percent of GNP) in 1992 (Chart 6). 1/ The rise in the territorial authorities' deficit between 1990 and 1992 has been smaller than originally feared, due to stronger than expected revenue growth associated with the buoyant economic conditions in western Germany. The

---

1/ The rise in the deficit between 1989 and 1991 was attenuated by tax increases in 1991, which more than offset the revenue loss from the final stage of the 1986-90 tax reform.

financial plan announced in the summer of 1991 had envisaged deficits of 5 1/2 percent of GNP in 1991 and 4 1/4 percent in 1992.

Outside the territorial authorities, imbalances have risen in 1992. 1/ Owing to rapid growth of pension and labor market expenditures in east Germany, and throughout Germany of health expenditure, the finances of the social security funds have weakened significantly; as a result, in 1992, the general government deficit is expected to decline by only 1/4 percentage point of GNP to 3 percent. Moreover, the borrowing of the Treuhand, whose activities are described in the next section, is expected to rise from 3/4 percent of GNP in 1991 to about 1 percent in 1992.

In May of this year, the Federal Minister of Finance outlined a medium-term program designed to reduce the deficit of the territorial authorities to below 2 percent of GNP in 1995 (Table 1, baseline scenario). Expenditure restraint was to be the focal point of this plan. Spending of the Federal Government was to increase by less than 2 1/2 percent a year on average over the next few years, that of lower levels of government in the west by no more than 3 percent a year, and that of governments in the east by up to 7 percent a year. The plan envisaged an uneven pattern of expenditure growth, with larger allowances budgeted for 1994, an election year, offset by relatively slow growth in 1993 for lower levels of government in the west and in 1995 for the federal government. 2/ In 1993, spending restraint was to produce a decline in the deficit of the territorial authorities by 1 percentage point to 2 3/4 percent of GNP. The 1 percentage point rise in VAT, compensated for the revenue loss from the expiration of the income tax surcharge.

Potential future claims on the budget have been an important concern in assessing the medium-term fiscal outlook. 3/ The authorities stressed that the medium-term plan contained clear and credible allowances for the debts and contingencies related to the unification process as well as other uncertainties. For example, the plan assumed that the territorial authorities would take over debt from the Treuhand amounting to some

---

1/ The territorial authorities include federal, land and municipal governments. In addition, analysis of the public finances needs to take into account the social security funds and the Treuhand, the agency charged with privatizing and restructuring east German industry. While the latter is not included in conventional measures of the public finances, its debt will be taken over by the territorial authorities in 1995. In this report, data for the territorial authorities are on an administrative basis. The general government data, which include the social security funds, are on a national accounts basis.

2/ The zero growth of federal expenditure in 1995 is however a statistical artifact. Financial contributions to the eastern Länder through the German Unity Fund decline but are offset by increased revenue sharing with the east which is recorded as a deduction from revenue.

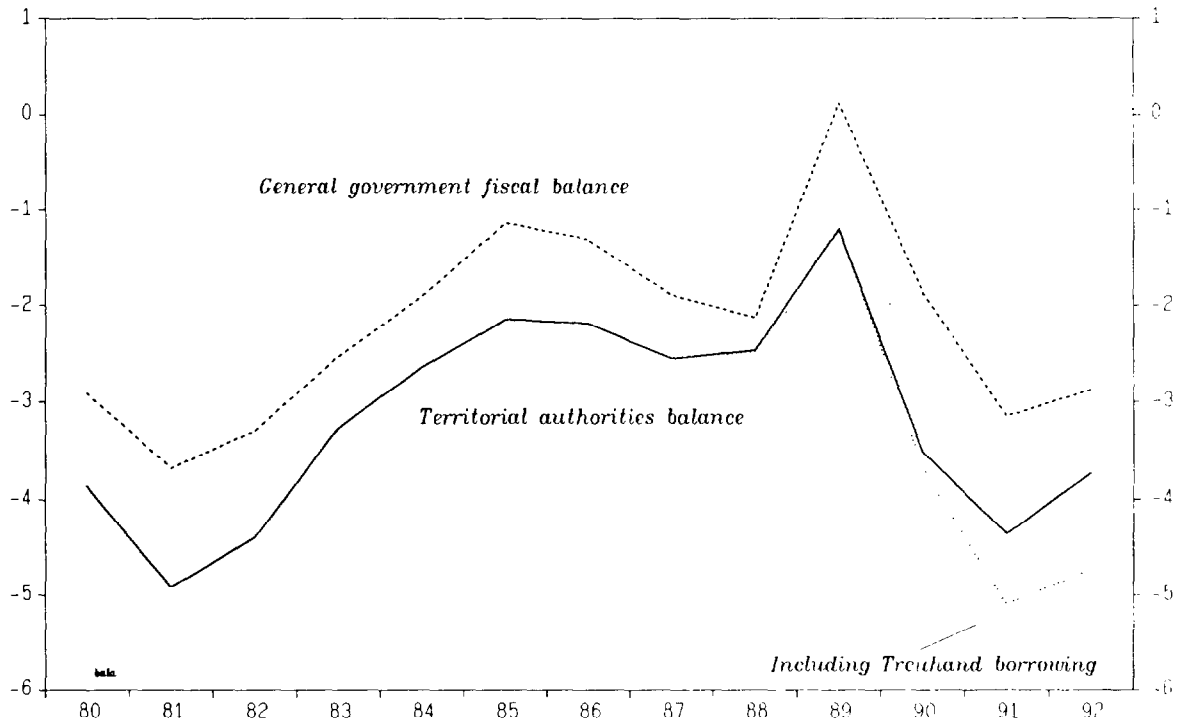
3/ See Chapter III of the paper on Developments and Issues.

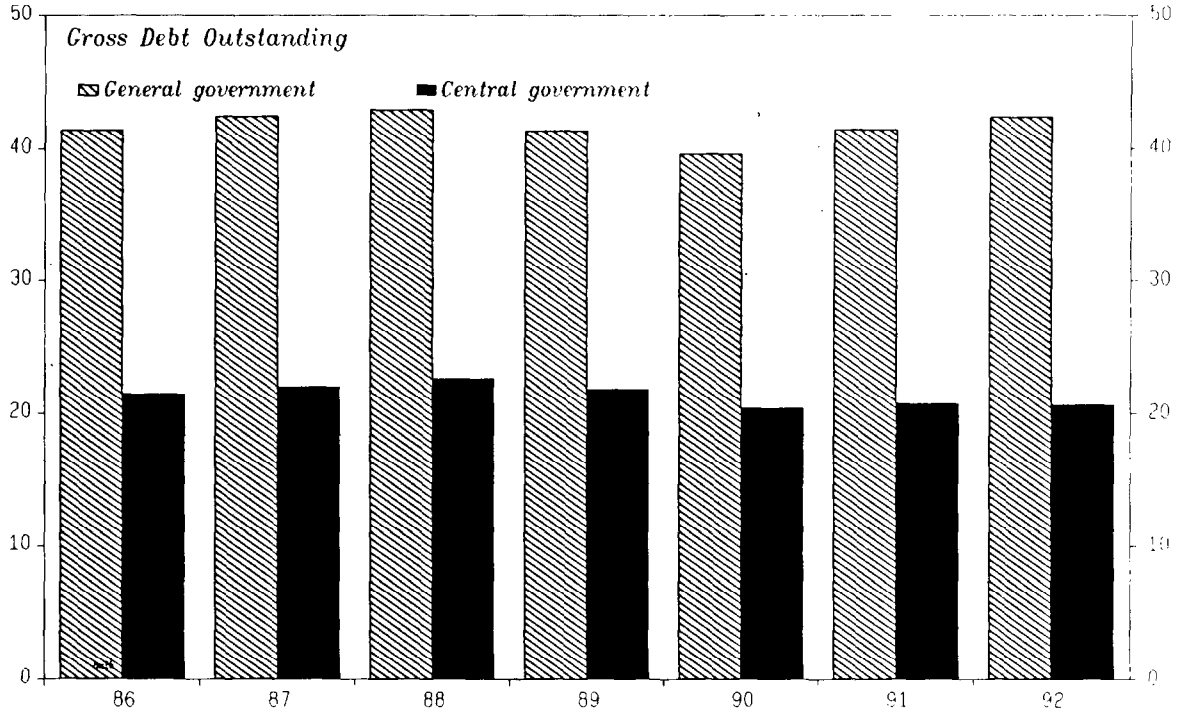
CHART 6

Germany

Fiscal Deficits and Public Debt

(In percent of GNP)





Sources: Ministry of Finance; and staff projections.

Table 1. Germany: Medium-term Fiscal Scenarios 1/

	1990	1991	1992	1993	1994	1995
Baseline Scenario 2/						
Revenue 3/	7.0	17.8	10.3	4.7	6.4	5.7
Expenditure 3/	16.3	19.4	7.9	2.4	4.5	5.3
Financial balance 4/	-3.5	-4.4	-3.7	-2.9	-2.3	-2.1
Debt 4/	39.8	41.7	42.6	42.6	45.7	51.9
Alternative Scenario A 5/						
Revenue 3/	7.0	17.8	10.3	4.7	6.4	5.7
Expenditure 3/	16.3	19.4	7.9	3.3	4.6	5.4
Financial balance 4/	-3.5	-4.4	-3.7	-3.3	-2.6	-2.5
Debt 4/	39.8	41.7	42.6	43.0	46.3	52.9
Alternative Scenario B 6/						
Revenue 3/	7.0	17.8	10.3	3.3	6.4	5.7
Expenditure 3/	16.3	19.4	7.9	3.3	4.7	5.5
Financial balance 4/	-3.5	-4.4	-3.7	-3.7	-3.0	-3.0
Debt 4/	39.8	41.7	42.6	43.9	47.6	54.8

Sources: Federal Ministry of Finance; staff calculations.

1/ All data are for the territorial authorities. Further details can be found in Chapter III of the paper on Developments and Issues.
2/ Based on the official medium-term plan.
3/ Percentage changes.
4/ End of year debt, in percent of GNP. Data for 1994-95 include debts yet to be absorbed by the KAF as well as debt to be taken over by the territorial authorities from the Treuhand.
5/ Assumes that expenditure of Länder and municipal governments in west Germany rises on average by 1 percent a year faster than in the baseline over the period 1993-95, with most of the additional expenditure in 1993.
6/ In addition to the assumptions of scenario A, scenario B assumes that output growth in Germany is 1 1/2 percentage points slower in 1993 than in the baseline.

DM 250 billion; this estimate incorporated significant sums for repairing environmental damage as well as compensation to the former owners of property expropriated by the government of the former GDR. There were proposals to fund other compensation payments, related to property outside the Treuhand's sphere, by a special levy on those to whom property had been restituted. Similarly, the projected debt of the Kreditabwicklungsfond (where debts of the former GDR government have been consolidated) already included increased estimates of claims related to the currency conversion in east Germany as well as some write-down of transferable ruble claims on former CMEA partners. In view of the situation in eastern Europe and the former Soviet Union, the plan had also increased reserves against possible future losses of export credit guarantee agencies. In addition, expenditure projections for the outer years incorporated large general reserves.

The authorities explained that other difficult questions would be dealt with in a way that did not compromise budgetary targets. At the federal level there was a moratorium on new expenditure programs that were not financed by lower spending on other programs. Reform of the railways, currently under discussion, was expected to be accompanied by a transfer of railway debts to the federal government; the budgetary costs could be financed by new revenue measures, such as road tolls or higher mineral oil taxes. It was also planned to restructure business taxes in a revenue neutral way by financing lower marginal rates through less favorable depreciation allowances.

The staff viewed the deficit targets in the medium-term plan for the territorial authorities as adequate. There was, however, no room for slippage, given the increased borrowing by other public entities, the economic risks facing both Germany and its European partners, and the large accumulation of debt that was in prospect over the medium term. The focus of the government's plan on expenditure restraint was appropriate, particularly as the changed priorities associated with unification suggested that there should be significant scope for economies, especially in the areas of spending on the military and on subsidies. If sufficient spending restraint could not be obtained, however, it would not be possible to avoid further revenue measures.

The staff observed that the medium-term plan had gone a long way toward clarifying the budgetary challenges over the years ahead. It had also made transparent, however, the budgetary risks. Some of these risks had been explicitly addressed. In particular the allowances for specific contingencies seemed to be sufficiently large given present information--although surprises could not be ruled out. 1/ Of the risks not addressed, two in particular stood out. First, lower levels of government in Germany had considerable financial autonomy. As a result, it might be difficult to contain expenditure of the Länder and municipalities in the west to the rate

---

1/ These issues are discussed in Chapter III of the paper on Developments and Issues.

of growth envisaged in the plan. Already in 1993, many Länder in west Germany had budgeted expenditure increases in the range of 4-5 percent although the Federal Government's fiscal plan envisaged an expenditure increase at this level in 1993 of well below the medium-term average of 3 percent. Second, given the present outlook for 1993, it was likely that the economic environment would be less favorable than assumed in the plan.

These risks are illustrated in Scenarios A and B in Table 1. 1/ In Scenario A, expenditure at lower levels of government in the west grows at an annual rate that is 1 percentage point faster over 1993-95 than in the medium-term plan (baseline scenario), with much of this additional spending in 1993; as a result, the deficit in 1995 is 1/2 percentage point of GNP larger than in the plan. In Scenario B, the assumptions of Scenario A are combined with slower economic growth in 1993 (1 1/2 percentage points for Germany as a whole compared with 3 percent in the plan). 2/ As a result, there is little decline in the deficit of the territorial authorities in 1993 and the deficit in 1995 is 1 percentage point higher than in baseline scenario. If the economic slowdown in Germany proves deeper or more protracted than assumed in Scenario B, the prospects for fiscal consolidation would of course be even weaker.

The staff pointed out that as far as 1993 was concerned, Scenario B seemed quite plausible on the basis of current polices and prospects. The fact that there would be no reduction in the territorial authorities' deficit under such a scenario was cause for concern; given that 1994 was an election year, a lack of progress on fiscal consolidation in 1993 was likely to raise doubts about the plan as a whole, with adverse effects in the financial markets and more generally on business confidence. Moreover, the turmoil in the ERM had underlined the importance of visible progress on consolidation. Thus, there should be a limit placed on the operation of automatic stabilizers and this should be supplemented by putting firmly in place soon measures that would enhance prospects that the fiscal targets would be met over the medium term.

The staff acknowledged that the Federal Government had included some important measures in its budget to hold the rise in its spending to 2 1/2 percent in 1993. A 3 percent cut in defense expenditure was a second installment of a multi-year cutback and reductions in transfers to other levels of government would help curtail their expenditure. There had, however, been little progress in cutting subsidies and entitlement programs. Indeed, without such progress, it would be difficult to convince other levels of government or those in the private sector that adjustment was needed on their part.

1/ See also chapter III of the paper on Developments and Issues.
2/ As noted earlier, the authorities have recently revised down their projection for economic growth in 1993.

The staff observed that subsidies in west Germany, including those at lower levels of government, were of similar magnitude to transfers to east Germany. By maintaining employment in inefficient uses, they exacerbated the pressure on resources. Some cuts in subsidies, including in tax preferences for west Berlin, had been enacted in 1991 and the exchange rate guarantee system for Deutsche Airbus had also been discontinued, but large sectoral subsidies (agriculture, coal, housing and railways) had been virtually untouched.

A scaling back of social entitlement programs was also warranted. Reform of some of these programs would eventually be needed for demographic reasons. The emerging claims from the east, however, greatly increased the case for early substantial changes. As a first step, proposed constraints on the rise of health expenditures 1/ could be supplemented with measures to economize on unemployment benefits and to slow the rise in pensions. Such measures would allow lower federal contributions to the social security system and forestall further increases in contribution rates. 2/

The staff encouraged the federal authorities to work with the Länder to reduce pressures on their budgets. A moderate outcome in the public sector wage round would be important in view of the high share of personnel expenses in budgets at lower levels of government. It would also be important to limit obligations placed on these levels by the federal parliament. Fundamentally, however, there was need for an explicit agreement that lower levels of government in the west would allocate part of their revenue to financing governments in the east. This was warranted both because the federal level had, thus far, absorbed the major portion of the costs of unification and because, given the revenue outlook, it would otherwise be difficult to contain spending of western Länder and municipalities to the targets specified by the Federal Government. A new revenue sharing system, incorporating the eastern Länder would, by law, have to be in place by 1995 and this was expected to involve significant redistribution of revenue from the western Länder to the east. Unless lower levels of government in the west began to adjust now to this likely revenue loss, they would face even more difficult adjustment in a few years time. Given these considerations, the end-1994 deadline for completing negotiations on a new revenue sharing system seemed too far off.

The staff observed that a new burden sharing agreement was also important to put in place a clear medium-term financing framework for the Länder and municipal governments in the east. Currently, these governments were in a rather difficult fiscal position with the prospect that their per-capita debts would rise to the level of their west German counterparts in the space of a few years. The own-revenue potential of these governments

---

1/ The proposed measures are intended to restrain the rise in health spending over the next few years to the rate of increase of the wages.

2/ The prospects for the social security funds are discussed in Chapter III of the paper on Developments and Issues.

would remain limited for some time and thus continued significant transfers would be required to allow adequate financing for public infrastructure in the east. However, it was important to recognize that the eastern governments had added significantly to their own problems by agreeing to rapid catch up of earnings with those in the west--public sector wages were scheduled to reach 80 percent of western levels in July, 1993 and likely to attain parity in 1995. Moreover, there continued to be significant overstaffing; in municipal governments, employment per capita was twice that in the west. Thus, any solution to the financing difficulties of governments in the east should be formulated in the context of steps to rein in their personnel spending.

The authorities maintained that the federal budget for 1993 was a strong one, with expenditure growing at a relatively slow pace. It would have been preferable to have achieved more in the areas of subsidies and entitlement programs, but this was politically difficult. Conscious of the financial difficulties being experienced by governments in the new Länder, the Federal Government had, within its tight overall expenditure constraints, decided to boost transfers to the east by augmenting the German Unity Fund in 1993-94. 1/ Discussions on a new revenue-sharing arrangement were already under way and it was hoped that significant progress could be made by early 1993, though implementation would have to wait until 1995. Measures were also under consideration to reduce the obligations in the area of welfare programs placed on lower levels by the federal parliament.

The authorities indicated that an assessment had not yet been made of the implications of weakening economic prospects for the fiscal outlook; this would await completion of revisions to the official macroeconomic projections. They emphasized, however, their commitment to the target of 2 1/2 percent growth of expenditure at the federal level in 1993. The implications of the weaker economic prospects for the social security funds and the resulting pressures for increased federal transfers to the Federal Labor Office and other funds had not yet been examined. It was, however, likely that the Federal Labor Office would have to make some adjustments to its discretionary expenditure programs in face of lower social security contributions. No decision had yet been made as to whether any measures should be taken to compensate for cyclically induced shortfalls in the revenue of the territorial authorities.

2. Structural issues and the labor market

The discussions focussed in particular on issues related to revitalizing the east German economy. A number of positive developments had

---

1/ The German Unity Fund was set up at the time of unification to provide financing to east German governments until they were incorporated formally into the revenue sharing system in 1995.

been evident--in the areas of privatization and public investment, for example--but the rapid increase in wages cast a long shadow over prospects.

The accomplishments of the Treuhand have been particularly impressive. 1/ After a slow start, the pace of privatization picked up in the first half of 1991 and over the past year has been very fast. At the end of September, 1992, 6,400 firms had been privatized or transferred to municipal governments, 1,800 firms had been or were in the process of being liquidated, and 3,400 remained to be sold. Employment in Treuhand enterprises fell from about 3 million at the beginning of 1991 to 1 3/4 million at the end of that year and the Treuhand expects it to decline to 1/2 million by the end of 1992. The Treuhand aims to complete privatizing commercial and industrial enterprises by the end of 1993. The Treuhand's activities have, however, been more costly than originally envisaged and its borrowing is expected to remain at its present level for a number of years. 2/ This reflected the much worse than expected condition of east German industry as well as large expenditures related to old debts. Future spending would also include substantial sums in compensation payments to property owners expropriated in the former GDR and for environmental rehabilitation. To prevent further weakening of its finances, the staff stressed that the Treuhand, in addition to completing industrial and commercial privatization next year, should avoid protracted involvement in enterprises which could not be sold and resist any pressures to aid firms that had already been privatized.

The staff observed that, while privatization had progressed rapidly, the level of employment in manufacturing had fallen below 900,000 in mid-1992, about 12 percent of the labor force (compared with one quarter in west Germany), and was expected to decline further in the remainder of 1992. The level of employment in industry as a whole had fallen by half since GEMSU. Enormous investment and a good deal of time would be required before industry could again provide a solid base for employment in the east. The decline of employment in sheltered sectors had been more moderate. But employment growth in these sectors would also be constrained by investment and there were clearly limits to the employment they could provide in the absence of a parallel recovery in industry. In the meantime, there was a danger that a large number of people would be left behind because of the loss of skill and the stigma attached to long-term unemployment. Calculations by the staff, assuming for illustrative purpose a 15 percent annual real growth of fixed investment in 1992-95, indicated that the economy wide capital labor ratio would, at normal employment levels, only be about half of that in west Germany by 1996. This would clearly be inconsistent with wages approaching west German levels. Thus, failure to rein back wage growth could result in prolonged large-scale unemployment or massive persistent subsidization with all the dangers this carried for the

---

1/ See also chapter VI of the paper on Developments and Issues.

2/ Parliament has granted the Treuhand an annual borrowing authority of DM 30 billion for 1992-94 (DM 38 billion in exceptional circumstances).

dynamic performance of the economy. 1/ Lower wages would not only result in more employment for a given investment profile, but would also encourage higher investment.

The authorities were concerned about the decline of the industrial base in east Germany, which although to some extent inevitable, had been made worse by the rapid increase in wages and the collapse of markets in eastern Europe. They did not think, however, that an active industrial policy would pay off in the long run. Rather, it was important to concentrate on creating the framework within which private initiative could thrive. To this end, the authorities had complemented the vigorous privatization program with large investments in public infrastructure, especially in transportation and communications. Legislation had already been passed to halve planning and approval periods for infrastructure projects and legislation would soon be introduced to allow 17 major transportation projects to bypass the usual procedures.

Important measures had also been taken to facilitate private investment. Uncertainty over property rights and the precedence given to restitution to former property owners had discouraged investors. Earlier efforts to tackle this problem had been supplemented in July 1992, when parliament adopted a new "Green Light Program" which further enhanced the position of investors. 2/ Moreover, the Federal Government had set up a program to provide administrative assistance to governments in the east in processing property claims--the federal authorities would finance 90 percent of the wages of new employees hired for this purpose. The Government had also extended until 1996 special investment grants that were due to expire in 1992. In light of the persistent weakness of markets in eastern Europe, it was also considering measures to support east German exports. 3/

On wages, the authorities indicated that senior members of the government had been urging in public the need for restraint in east Germany. It was hoped that, as part of a social pact, unions would agree to downward adjustments in negotiated wages in return for commitments from industry to invest more. But it was stressed that the principle of Tarifautonomie would not be infringed on. Action would also be taken to improve the operation of the labor market. New measures would allow a collective bargaining agreement to be replaced for a period of up to 2 years by a company contract

---

1/ The trade off between wages and employment is discussed in greater detail in Chapter IV of the paper on Issues and Developments. This trade off was also discussed in the staff report for last year's consultation (SM/91/164, 8/14/91), along with a consideration of the issue of subsidies.

2/ This program has put in place measures to accelerate the process under which the property rights of potential investors were secured. See Chapter II of the paper on Issues and Development for details.

3/ Details of these measures have not yet been fully worked out but they would include extending the coverage of export credit schemes for enterprises in east Germany.

in the event of a crisis situation. 1/ Furthermore, regulations governing wages in job creation schemes would be changed to ensure that workers had adequate incentive to move back into the regular labor market.

The mission pointed out that liberal rules on contract renegotiation would help, but underlined that there was a need also for policies that gave more influence in wage determination to the many unemployed who were now outsiders in the wage bargaining process. For example, the Deregulation Commission had proposed allowing the hiring of the long-term unemployed at below-tariff wages and restricting the right of the Government to extend contracts to employers who had not participated in the tariff negotiations.

Wages were, of course, a central issue also in an all-German context. The staff recognized that Tarifautonomie limited the direct influence of government on wage developments, but stressed that the role of government should not be underestimated. First, there was clearly a direct influence in public sector wage negotiations. In west Germany, it was critical that public employers hold the line in the wage round next spring and in the east that they take the lead in trying to achieve more rational wage levels. Second, rapid progress on fiscal consolidation, particularly in the areas of subsidies and transfers, could also send a strong signal to the labor market on the need for moderation.

The mission stressed in addition that the current imbalances in the German economy added weight to the arguments for faster trade reform as liberalization in this area would put downward pressure on prices and direct resources into more efficient uses. It therefore encouraged the German authorities to play a leading role in seeking the compromises that would help conclude the Uruguay Round. Efforts should also be strengthened to ensure that the reforming economies of eastern Europe as well as the developing countries had access to western markets. In this context, mission noted that EC association agreements with some eastern European countries had not been particularly liberal in important areas such as agriculture, steel and textiles. It also expressed concern about recent EC measures, initiated by Germany along with a few other countries, to restrict imports of certain steel products from Czechoslovakia.

The authorities recognized the importance of a prompt and successful conclusion to the Uruguay Round and they were confident that an agreement could be reached by the end of the year. The reform of the EC's common agricultural policy represented significant progress in bridging differences

---

1/ It was noted that about one third of contracts in east Germany already had revision clauses, though these could not be put into effect without the approval of the contract parties, usually at the regional level. The new proposal was likely to place any veto right below the regional level, for example the works council of the individual firm. It was also noted that many other contracts were specific to individual companies and therefore, in principle, already took into account the circumstances of the firm.

in this critical area. It was pointed out that losses to income from agricultural production would be largely compensated by direct income transfers from the EC budget and Germany did not plan to introduce any new domestic subsidies in the agricultural area. The authorities stressed that, in general, Germany had supported the reduction of barriers to trade, though clearly in some cases it had been found difficult to apply this principle. 1/ It was noted that the exchange rate guarantee for Deutsche Airbus had been terminated retroactive to January 1992. 2/ The EC association agreements were beneficial to the eastern European countries concerned, even if they had their limitations. The case of steel from Czechoslovakia was difficult as imports from that country had been priced unduly low and had been rising at a very rapid pace. The German representatives noted that the restriction was temporary and should expire at the end of 1992. They agreed that it was important that trade policies support aid policies.

On aid, the authorities observed that Germany had already committed substantial assistance to the reforming economies of Eastern Europe and the former Soviet Union for the period through 1994. 3/ Unfortunately, the scale of this assistance and the costs of unification had limited resources available for assistance to the developing countries. As a result official development assistance (ODA) was expected to rise by less than 1 percent a year over the next few years.

3. Monetary policy

The discussions took place during a period in which the context of monetary policy was in a state of flux--domestically, economic prospect were weakening, heralding a likely subsiding of inflationary pressures and, externally, heavy attention was focussed on tensions in the exchange markets and the ERM in particular. It was clear that, after a number of years of tightening monetary conditions in Germany, short-term interest rates had peaked. In mid-September, in response to the turmoil and the realignment in the ERM, the Bundesbank took a first step in lowering official short-term interest rates and followed this up over the ensuing weeks by easing conditions further in the money markets. Following these developments, the expectation of further declines in short-term interest rates over the coming

---

1/ In other cases, Germany has applied restrictions in line with U.N. agreements. Restrictions on transactions with Iraq and Yugoslavia (Serbia and Montenegro) have been notified to the Fund under Decision No. 144. Restrictions vis-à-vis Kuwait, imposed at the same time as those on Iraq, have been rescinded.

2/ In compensation for giving up the exchange rate guarantee, which had been part of a package negotiated with the Government in 1988, Daimler Benz received the remaining 20 percent government stake in Deutsche Airbus for a nominal sum.

3/ See Appendix I of the paper on Developments and Issues.

year have become firmly entrenched in the markets, with overnight money a little under 9 percent and twelve-month interest rates below 8 percent.

The representatives of the Bundesbank observed that the environment for monetary policy had remained very difficult over the past year. There had recently been some easing in the rate of inflation but this had been due largely to the falling out of the effects of indirect tax measures. The underlying rate was still much too high--even with the benefit of falling import prices, the consumer price index had been increasing at an annual rate of 3 1/2 percent. Moreover, although demand pressures had peaked, the higher VAT in January 1993 would provide an additional boost to prices.

In this environment, the Bundesbank had been especially concerned about rapid increases in money and credit. Money growth had picked up in the second half of 1991 and since then had shown little sign of letting up. Since the beginning of 1992, M3 has remained between 8 and 9 percent above the level of the 4th quarter of 1991 (at an annualized rate), compared with a 3 1/2-5 1/2 percent target range. Bank credit has been growing at an annual rate of 10 percent for well over a year. The authorities were concerned that interest subsidies, particularly in east Germany but also in the west, were stimulating credit demand and making the task of monetary policy more difficult.

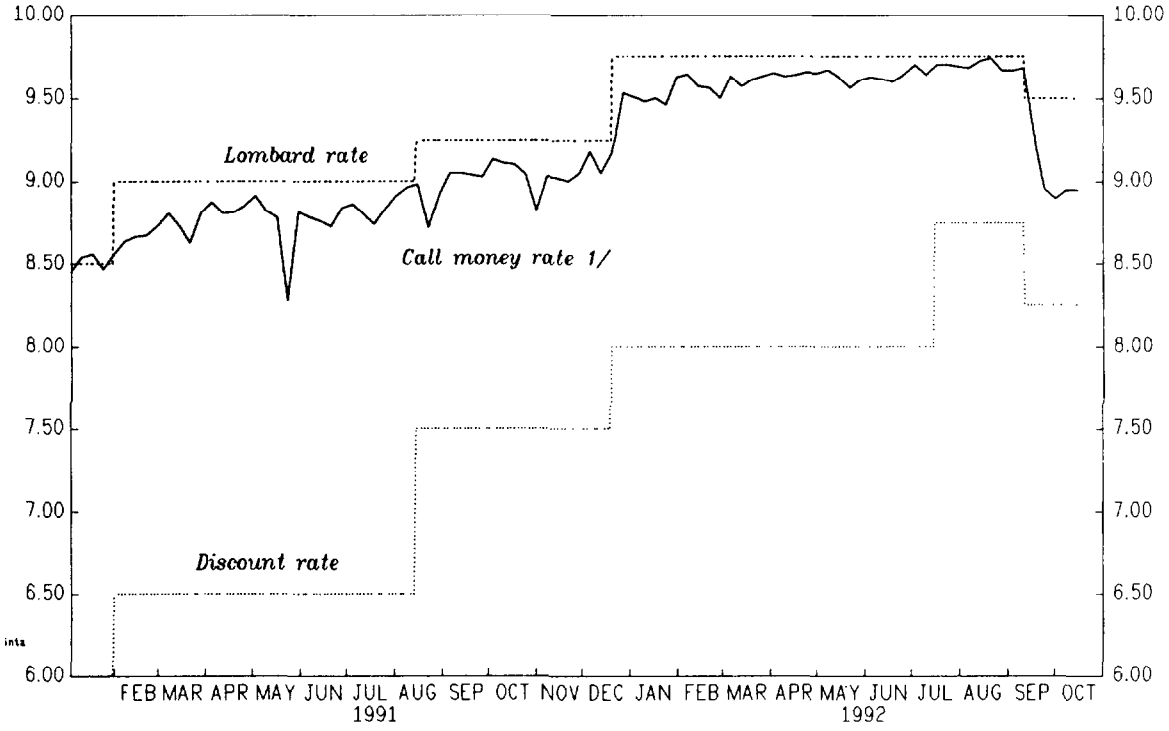
Against this background, it had been necessary to keep a tight rein on monetary conditions. The Lombard and discount rates had each been raised by 1/2 percentage point in December of last year, the discount rate had been increased by a further 3/4 percentage point in July, and short-term market rates had continue their gradual upward march, rising by about 1/2 percentage point in the year to August 1992 (Chart 7). With short-term rates in the United States declining sharply over this period, the large short-term interest differential between the deutsche mark and the U.S. dollar widened further. This, along with the increased uncertainty over the ratification of the Maastricht Treaty, after the Danish referendum rejecting the treaty and in the run up to the French referendum, had contributed to the tensions in the foreign exchanges that had emerged during the summer.

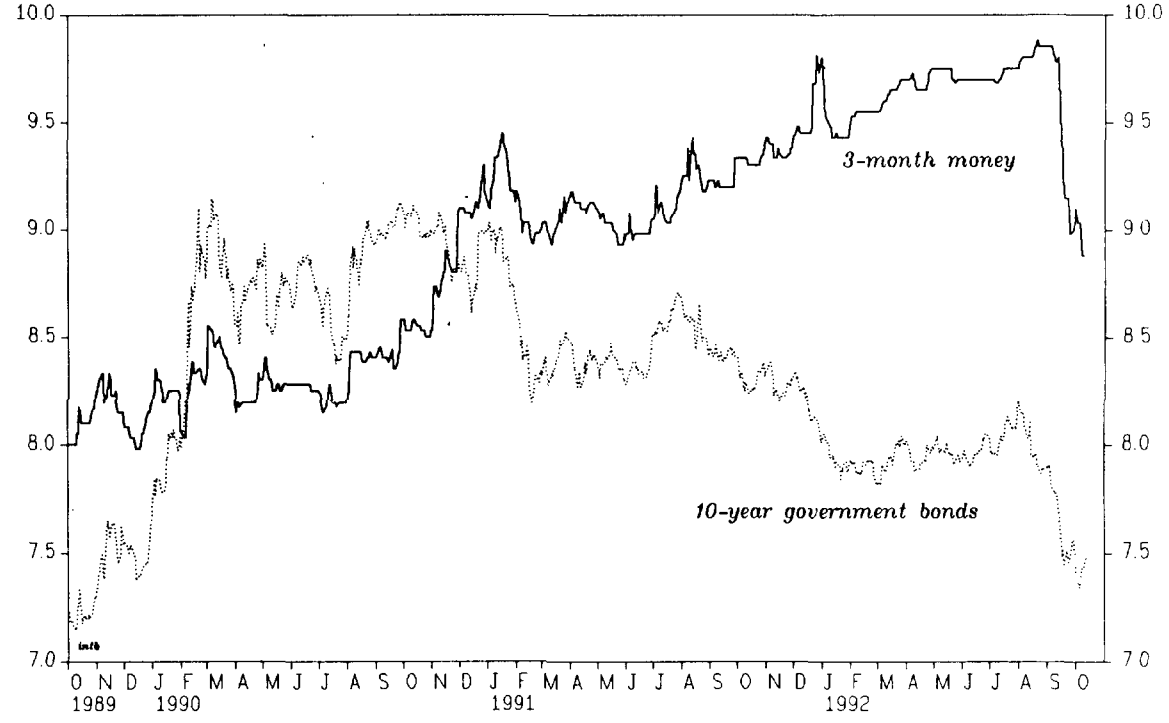
Bundesbank officials stressed that the problems that high short-term interest rates in Germany posed for its partner countries were taken into account in monetary policy decisions, although the primary consideration was domestic price stability. For example, by deciding not to raise the Lombard rate when the discount rate had been raised in July 1992, the effect on money market rates and thus on the foreign exchanges had been limited. Amidst the increasing pressures in the ERM in September, the Bundesbank had increased somewhat the weight it gave to external factors in it policy decisions. On September 14, it had decided to reduce the Lombard rate by 1/4 percentage point and the discount rate by 1/2 percentage point, as part of the package in which the Italian Lira was devalued within the ERM. In the following weeks, with continued substantial tensions in the ERM, it had allowed intervention activities to boost liquidity pushing short-term money

CHART 7

Germany

Interest Rates





Source: IMF Data Fund.
1/ Weekly average data.

market rates down to about 1 percentage point below the level prior to the mid-September cut in the discount and Lombard rates.

The Bundesbank representatives observed that the recent decline in interest rates should not be interpreted as a significant loosening of policy as the appreciation of the exchange rate had taken some of the burden from interest rate policy--between end-July and end-September, the deutsche mark had appreciated by 6 percent against the currencies of EC countries. They added that, barring unforseen events, the general tendency of interest rates over the coming year would be downward. They were, however, cautious on the speed of interest rate reductions. It was important, in particular, that interest rate actions be linked to clear evidence of receding inflationary pressures as otherwise the credibility of the Bundesbank would be damaged. The Bundesbank was conscious of the weakening economic prospects, but stressed that in assessing the response of monetary policy the focus was less on cyclical conditions per se than on the prospects for inflation. Bundesbank officials noted, however, that there were now some signs that next spring's wage round would be moderate, in part due to rising unemployment.

Bundesbank officials pointed out that the rapid pace of M3 growth was a complicating factor in assessing monetary policy actions. It was clear that unusual factors had been influencing monetary developments: declining long-term rates weakened the impact of tighter monetary conditions on money growth, by dampening incentives for portfolio shifts out of money; currency in circulation had been boosted by increased holdings in eastern Europe as well as demand from German residents uncertain as to the implications of new legislation on the taxation of interest income; and more recently, intervention activity had temporarily enlarged money holdings. It was therefore difficult to quantify the tightness of policy and advisable to look at range of indicators in addition to M3. Nevertheless, the German authorities were convinced as to the value of monetary targeting and stressed that M3 had a close relationship with nominal income developments over the medium term. The inference from monetary data that the economy was overly liquid was accurate even if it was difficult to quantify. Moreover, the impact of high short-term rates on economic activity had been exaggerated, particularly in view of the decline in real long-term rates.

The staff agreed that a tight monetary policy had been and, to a large extent, continued to be warranted. 1/ At the same time it stressed that the still rapid growth of M3 should not mislead the authorities in underestimating the current degree of tightness. Real short-term interest rates had been on a sustained basis as high if not higher than in previous periods of monetary tightening and there was nothing to suggest that the underlying inflation problem was any more severe at present. The growth of M3 had not been significantly out of line with what one would have expected

---

1/ See Chapter VII of the paper on Issues and Developments for the analysis underlying staff views on monetary policy.

given the rate of growth of nominal income in Germany as a whole, especially after taking account of some of the special influences on money demand. Moreover, in view of the lags in the influence of changes in short-term interest rates on the demand for M3, rather extreme measures would have been needed to keep money growth within its target range. Indeed, theoretical considerations, supported to some extent by empirical evidence suggested that rising short-term rates on their own might result in only limited portfolio shifts out of M3. The main effect of rising short-term rates on M3 growth was via the induced decline in economic activity and prices, but this effect normally occurred with significant lags.

Against this background, the staff emphasized that a slowdown in monetary growth should not be a precondition to further declines in interest rates. As the economy slowed, monetary conditions should be allowed to ease. Clear signs of substantial progress on the budget and wages should allow the Bundesbank to accelerate the process of interest rate reductions. Any action, however, would have to be timed carefully so as to maintain the credibility of the Bundesbank.

After the substantial overshooting that now seems inevitable for 1992, setting the monetary target for 1993 would be difficult. The staff was of the view that the increase in money following unification as well as this year's expansion had probably already been absorbed, at least to a very large extent, by higher nominal income. Thus, in setting the upper limit of the target for 1993, little correction should be made for the overshooting in 1992. At the same time, given the uncertainties involved, the authorities may want to set the lower limit at a fairly low level. The staff also thought that there might be grounds for revisions to some of the quantitative criteria on which the target was based. In particular, reassessment of the trends in velocity and in productive potential might suggest some upward adjustment to the target mid-point. 1/ Moreover, while many of the price distortions that characterized the former GDR had been eliminated, the process of adjustment was not yet complete and, in particular, significant adjustments remained in the area of rents. Some allowance might be made for such unavoidable price increases in the inflation goal on which the monetary target was based. 2/

German officials underlined that the recent turmoil in the ERM was principally due to the inadequate policies in some of the countries whose currencies came under pressure but reiterated their view that there had been no basis for the speculation against the French franc. It was also underlined that parities in the system had been excessively rigid over the past five years and that Germany had wanted a revaluation of the deutsche

---

1/ See Chapter VII of the paper on Developments and Issues for further discussion of these issues.

2/ In formulating the 1992 target, the Bundesbank did not make an explicit allowance for structural price adjustments as it judged the supply of liquidity already ample to accommodate them.

mark after unification but had deferred to the strong views of other countries against a realignment.

Bundesbank officials made two points concerning the role of intervention during the recent turmoil in the ERM. First, a country whose currency was under attack had to take interest rate action at an early stage if it wanted to defend the parity. Second, when the currency of a low inflation country came under attack for no fundamental reason, it was appropriate also that other countries in the system and the anchor country in particular took action, including on interest rates, to defend the parity. The response to the recent wave of speculation against the French Franc had illustrated how effective such a coordinated strategy could be. Such coordinated action did not compromise the system's anchor--when fundamentals were right, there was no reason to believe that changes in monetary policy would be anything but temporary.

IV. Staff Appraisal

The German economy is at a critical juncture. In the immediate aftermath of unification, the decision was taken to finance reconstruction in east Germany through public borrowing. The fiscal consolidation of the 1980s and the strong external position provided room for maneuver, while the ultimate cost of unification was still viewed as "manageable". Two years later, the situation is quite different. Rapid economic expansion in west Germany, largely due to demand from east Germany and the fiscal deficits that have financed most of it, has led to inflationary pressures, and it is now all too clear that east Germany will require large fiscal transfers for many years.

The short-run risks inherent in the present situation are obvious. The Bundesbank has accepted that some increase in the price level was inevitable in the wake of unification, but it is determined, and rightly so, that this will not be transformed into a lasting process of inflation. Tight monetary conditions in Germany, however, are having unfavorable effects on economic conditions in some other EMS countries, where activity is weak and inflation low, and are adding to tensions in the ERM. In Germany itself, the unbalanced policy mix is contributing to a marked economic slowdown which could, if the policy problems are not tackled, turn into a recession. This would bring much higher unemployment throughout Germany and postpone further a recovery in the east. These risks are underlined by the weak state of confidence in the business community and the population at large.

Unfavorable developments in the new Länder confirm the critical nature of the present situation. Certainly, there have been many achievements in east Germany these past two years. The rebuilding of administrative capacity is well underway, the privatization program is being carried out speedily and effectively, substantial resources are being channeled to the reconstruction of public infrastructure and the population has been spared much of the economic hardship that has accompanied reforms in other formerly

planned economies. Unfortunately, the pace at which wages are converging to those in the west is undermining hopes of a new Wirtschaftswunder (economic miracle) and raising the specter of yet another regional problem in Western Europe. In particular, it is difficult to see how private businesses can thrive without sufficient profits to fund their investments. And it is unlikely that an economy sustained primarily by large subsidies can provide the incentives that are needed to induce economic development.

Even from a domestic perspective, the strategy now required is one that provides room for a significant decline in interest rates at an early stage by attacking unsustainable claims on resources at their roots, that is, by acting to consolidate public budgets and to rein in expectations in the labor market in both east and west Germany. Such a strategy, set in a consistent, credible, and transparent medium-term framework, will also help rebuild confidence, which is essential to underpin a return to growth in the near term.

Fiscal policy has a pivotal role to play. All levels of government must indicate how they are going to reduce their demands on the economy's resources in 1993 and over the medium term. The new fiscal program, which envisages a reduction of the territorial authorities' deficit from 4 1/2 percent of GNP in 1991 to about 2 percent in 1995, is welcome as is the intention to achieve this goal through cuts in spending. Unfortunately, this fiscal consolidation process will coincide at least initially with a period of weakening in the economy. With elections in 1994, however, the strategy is credible only if the tough decisions are taken in the context of 1993 budgets. To ensure visible progress in consolidation in 1993, it will be necessary to limit the operation of automatic stabilizers. Such action needs to be combined with enactment of measures to strengthen prospects that the targets for 1994 and 1995 will be met.

The draft federal budget for 1993 plans economies in transfers to other levels of government, which should contribute to expenditure restraint at those levels, and important reductions in defense spending. There are, however, no major cuts in key areas such as subsidies and transfers to individuals in west Germany. Without putting in place now measures that ensure such cuts, the urgency of the present situation will not be effectively communicated. Indeed, the federal authorities can hardly expect restraint at other levels of government, or indeed the economy at large, unless they set a clear example.

Curtailing spending at lower levels of government in the west presents a particularly difficult challenge. The federal authorities can however help relieve pressures on Länder and municipal governments by working in conjunction with them to achieve a moderate wage round and by freeing them of some of the spending obligations imposed by federal legislation--for example, in the area of social and subsidy expenditures. But, fundamentally, there will have to be an explicit agreement on how the burden of unification is to be shared among the various levels of government. This would serve the dual purpose of providing a transparent financial constraint

not only on the expenditure of lower levels of government in west Germany, but also--in conjunction with a well-defined program of transfers from the Federal Government--on the expenditure of eastern Länder. Without an agreement, it is unlikely that the expenditure goals set in the medium-term program can be met. As a result, either the Federal Government would have to bear a higher share of expenditure reductions than currently envisaged, or it would not be possible to avoid further tax increases.

In its visits to the new Länder, the staff was presented with a rather bleak outlook for the public finances. To some extent, this reflected the excessive wage agreements that they have entered into. Clearly, these agreements should not be accommodated fully by transfers from the west. There needs to be a strong incentive for governments in the east to seek ways to achieve a roll back of wage increases and to reduce overstaffing. However, there should also be an early assessment of their genuine financing requirements and efforts to ensure that needed investments are funded.

Beyond 1993, the issue of contingencies assumes increased importance. The medium-term fiscal plans already take these explicitly into account but surprises cannot be excluded. Moreover, the size of debts to be assumed in the future is not outside the influence of policy makers. In the case of the Treuhand, it is important that the impressive record on privatization continue and that privatization of the industrial sector be fully completed by the end of next year. The temptation to hold on to difficult cases beyond this date should be vigorously resisted. Firms that cannot be privatized even after some rehabilitation should be closed.

The next wage round in west Germany will be crucial. A substantial reduction in wage awards from those in 1992 is needed for a return to stability. Public sector employers should set a strong example by strictly limiting the increase they are prepared to offer. This should be supplemented by efforts to educate employers and unions throughout economy as to the consequences of excessive wage growth for a third year in a row and the benefits of more restraint. They should be made aware that budgetary policy will not compensate for their failures and that budgetary goals will not be held hostage to a weakening economy. The trade-off between wage awards, on one side, and employment and profits, on the other, should be clearly visible to all.

In east Germany, more decisive action is needed to foster labor market agreements consistent with the shortage of capital and the relative scarcities of different skills. Here again, public sector employers should take the lead. In the private sector, a way must be found to allow renegotiation of existing contracts at the firm level, without the need to seek approval of tariff parties at higher levels. A clear signal should be given that the Government will not issue administrative orders preventing new employers or those that did not participate in negotiations from paying below tariff wages. More generally, there is a pressing need to have a pause of several years in the process of wage catch-up with the west.

In the face of emerging inflationary pressures, the Bundesbank has rightly stressed its primary responsibility, that is, price discipline, and monetary conditions have been tightened gradually over the past four years. Monetary conditions have in fact been quite tight for some time even though, because of lags in the effect of interest rates on the economy as well as some special factors, this has not yet been reflected in a slowing of the growth of M3. In September, the Bundesbank first reduced its official lending rates and then allowed foreign exchange interventions to induce a further decline in money market interest rates, and so ease tensions in the ERM. Given the appreciation of the deutsche mark vis-à-vis a number of other EMS currencies, it was able to do this without having to accept a significant change in overall monetary conditions. During the rest of 1992, there will be room for some further declines in interest rates as economic activity weakens, but the Bundesbank should remain cautious as long as prospects for fiscal policy and wage and price developments are unclear. The slow economic growth envisaged by the staff for 1993 should result in a continued easing of monetary conditions as the year progresses. Favorable developments over the coming months on the next wage round and on prospects for fiscal consolidation would allow the Bundesbank at an early stage to quicken the decline in interest rates, without endangering its credibility. It is the responsibility of the Government to foster these developments as they are essential to restoring confidence and promoting recovery in Europe at large.

The setting of the monetary target for 1993 will be complicated by the uncertainties surrounding the behavior of M3 and the large overshooting of the target that is now inevitable in 1992. It is important that the Bundesbank not appear to lessen the priority attached to price stability. However, it is also important that the Bundesbank be able to reduce interest rates in response to weakening inflationary pressures even if M3 growth does not slow as quickly as hoped. Thus, the target for 1993 ought to allow for more than the usual degree of flexibility. The upper limit should make little or no correction for the overshooting of the target in 1992, as much of the additional liquidity will have already been absorbed by the end of 1992. However, the lower limit should continue to allow for a relatively low rate of monetary expansion given the prevailing uncertainties and in particular the possibility that some of the factors which have kept monetary expansion high in 1992 could work in the opposite direction in 1993. In formulating the target, there may also be some justification for an upward revision of the estimates for the trend decline in velocity and the growth of productive potential and perhaps also an explicit allowance for the effects of removing price distortions in east Germany. These considerations would tend to raise the target mid-point.

Fundamentally, there is no conflict between the strategy needed to deal with Germany's macroeconomic difficulties and an active role for Germany in supporting growth and stability in the world economy. On the contrary, improving the policy mix in the German economy and strengthening the prospects for growth in Europe are quite evidently complementary goals. The staff would also urge action to reduce impediments to trade and to cut

trade-distorting subsidies; this would support domestic policy goals in Germany through beneficial effects on prices and the allocation of resources. The German authorities should therefore play a leading role in seeking the compromises that will help conclude the Uruguay Round. More generally, they should actively work for a more liberal trading framework in the EC including greater market access for the reforming economies of eastern Europe and the developing countries. Even temporary restrictions can have damaging effects. The termination of the exchange rate guarantee scheme for Airbus, which constituted a multiple currency practice, has been a welcome step toward a more transparent and liberal trade regime. On aid, Germany has been generous with its assistance to the countries of Eastern Europe and the former Soviet Union. It is regrettable, however, that only very limited increases in ODA are envisaged over the coming years.

In conclusion, there are two essential elements in a successful strategy to deal with the current situation. First, there is a need for a speedy reduction of macroeconomic imbalances and a return to price stability. Second, measures need to be put in place quickly that ensure the conditions that will foster a vigorous growth process in the new Länder. Adjustments at the margin will not suffice. The economic system needs to be adapted to the fundamental changes in the environment for economic policy--through subsidy cuts, reform of entitlement programs and measures to make the labor market more competitive. In many cases, changes were already warranted before unification. But the challenges of reintegrating the eastern Länder, while restoring the stable macroeconomic environment to which Germany quite rightly attaches a heavy weight, add urgency to action.

It is recommended that the next Article IV consultation with Germany be held on the standard 12-month cycle.

APPENDIX I

Germany: Basic Data

Area and population	
Total area	357,041 square kilometers
Total population (1990)	79.5 million
GNP per capita (1991)	US$21,286
West Germany	US$24,935
East Germany	US$7,140

West Germany	1987	1988	1989	1990	1991 1/	1992 2/	1993 2/
			(Percentage changes at 1985 prices)				
Demand and supply							
Private consumption	3.3	2.7	2.7	5.4	3.6	1.4	0.7
Public consumption	1.5	2.2	-1.7	2.4	0.5	2.0	0.6
Gross fixed investment	2.1	4.6	6.5	8.7	6.5	2.3	0.2
Construction	--	3.1	4.4	4.9	4.1	4.8	1.1
Machinery and equipment	4.9	6.6	8.9	13.1	9.1	-0.3	-0.7
Total domestic demand	2.6	3.6	2.8	4.9	3.1	1.8	0.6
Exports of goods and services	0.9	5.9	11.5	11.1	12.7	2.1	2.8
Imports of goods and services	4.2	5.8	8.4	11.9	12.2	2.9	2.0
Foreign balance 3/	-1.0	0.1	1.3	0.1	0.6	-0.2	0.4
GNP	1.5	3.7	4.0	4.9	3.6	1.4	1.0
GDP	1.4	3.7	3.4	5.1	3.7	1.8	1.0
Manufacturing output	0.3	3.9	5.2	5.5	3.0	-0.5	0.2
			(In millions)				
Employment and unemployment							
Labor force	29.4	29.6	29.8	30.4	30.7	31.0	31.2
Wage and salary earners	24.1	24.4	24.8	25.5	25.9	26.1	26.1
Unemployed	2.2	2.2	2.0	1.9	1.7	1.8	2.1
(In percent of labor force)	(7.6)	(7.6)	(6.8)	(6.2)	(5.5)	(5.8)	(6.7)
			(Percentage changes)				
Prices and incomes							
GNP deflator	1.9	1.5	2.6	3.4	4.1	4.3	3.5
Consumer price index	0.2	1.3	2.8	2.7	3.5	3.9	3.3
Average hourly earnings (industry)	5.2	3.9	4.2	5.7	7.0	5.7	4.4
Unit labor costs (total economy)	2.5	0.1	1.0	2.7	4.8	5.3	3.5
Real disposable income 4/	3.6	2.9	1.4	6.9	3.2	1.5	0.5
Personal saving ratio	(12.6)	(12.8)	(12.4)	(13.7)	(13.4)	(13.5)	(13.3)

1/ Preliminary.
2/ Staff projections.
3/ Change as percent of previous year's GNP.
4/ Deflated by the national accounts deflator for private consumption.

Germany	1987	1988	1989	1990	1991	1992 1/	1993 1/
			(In billions of deutsche marks)				
Public finances 2/							
General government							
Expenditure	949.6	990.7	1,018.9	1,118.2	1,393.2	1,529.0	1,620.0
Revenue	911.7	946.0	1,021.6	1,068.7	1,304.2	1,441.8	1,527.7
Financial balance	-37.8	-44.8	2.7	-49.5	-89.1	-87.2	-92.3
(In percent of GNP)	(-1.9)	(-2.1)	(0.1)	(-1.9)	(-3.2)	(-2.9)	(-2.9)
Deficit of the territorial authorities	-51.1	-51.8	-27.1	-93.8	-123.1	-113.2	-113.3
(in percent of GDP)	(-2.6)	(-2.5)	(-1.2)	(-3.5)	(-4.4)	(-3.7)	(-3.6)
Borrowing requirement of the Treuhand	--	--	--	4.5	19.9	30.0	30.0
Federal Government							
Financial balance	-27.9	-36.0	-20.1	-47.9	-53.2	-41.3	-42.9
(In percent of GNP)	(-1.4)	(-1.7)	(-0.9)	(-1.8)	(-1.9)	(-1.4)	(-1.3)
Public sector debt	*848.8*	*903.0*	*928.8*	*1,053.5*	*1,170.3*	*1,283.5*	*1,396.8*
(In percent of GNP)	(42.4)	(42.8)	(41.4)	(39.8)	(41.7)	(42.4)	(43.6)
Balance of payments 3/							
Trade balance (f.o.b./f.o.b.) 4/	126.8	140.4	146.4	118.1	38.4	18.6	27.1
Services balance	-15.3	-19.7	-4.7	-5.3	-12.1	-19.6	-16.2
Net private transfers	-10.3	-11.4	-10.7	-11.3	-11.4	-12.1	-12.8
Net official transfers	-18.8	-20.6	-23.1	-25.4	-47.8	-33.3	-32.0
Current account	82.5	88.7	108.0	76.1	-32.9	-46.5	-33.9
(in percent of GNP)	4.1	4.2	4.8	2.9	-1.2	-1.5	-1.1
Net foreign assets of the Bundesbank	122.5	86.3	63.3	65.1	66.7	...	...
			(Percentage changes in annual averages)				
Monetary data 5/							
Money and quasi-money (M3)	7.1	6.4	5.7	13.4	9.8	9.1 6/	...
Domestic bank lending	3.5	5.4	6.0	11.8	12.0	11.1 7/	...
Of which lending to:							
Public authorities	3.1	8.8	4.3	4.6	8.0	9.7 7/	...
Private nonbanks	3.6	4.4	6.5	13.9	13.1	11.4 7/	...
			(Period averages in percent)				
Interest rates							
Three month money market rate	4.0	4.3	7.1	8.5	9.2	9.4 8/	...
Yield on government bonds 9/	5.8	6.1	7.0	8.8	8.6	7.6 8/	...
				(Levels)			
Exchange rates							
DM per US$ (end of period)	1.58	1.78	1.70	1.49	1.52	1.53 9/	...
DM per US$ (annual average)	1.80	1.76	1.88	1.62	1.66	1.57 10/	...
Nominal effective rate (1985=100)	115.4	114.6	113.6	119.1	117.8	123.6 8/	...

1/ Staff projections.
2/ Data for the federal government are on an administrative basis and incorporate east Germany from the second half of 1990. Data for general government are on a national accounts basis and incorporate east Germany from 1991. Debt data are end-of-year data for the territorial authorities, including the German Unity Fund and east Germany from 1990.
3/ West Germany until June 1990; united Germany from July 1990.
4/ Including supplementary trade items.
5/ Monetary data include east Germany from end-June 1990; thus changes in 1990 incorporate east Germany for half of the year.
6/ September 1992; annualized growth rate seasonally adjusted relative to the fourth quarter of 1991.
7/ August 1992; annualized growth rate seasonally adjusted, relative to the fourth quarter of 1991.
8/ September.
9/ October 30.
10/ Average January-September.

East Germany	1991 1/	1992 2/	1993 2/
		(Percentage changes)	
Real gross national product	-21	5	6 3/4
Real gross domestic product	-24	2 1/2	6 1/2
Real investment	45	20	15
(In percent of GDP)	43	48	45
Employment	-16	-7	...
Unemployment			
(In percent of labor force)	11	15	...
Consumer prices	12	12	8
GDP deflator	16	19	12

1/ Preliminary.
2/ Staff projections.

APPENDIX II

Germany: Fund Relations
(As of September 30, 1992)

I. Membership status

Germany became a member of the Fund on August 14, 1952. Germany has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement.

II. General Resources Account:	SDR Million	% Quota
Quota	5,403.7	100.0
Fund holdings of currency	2,905.0	53.8
Reserve position in Fund	2,498.8	46.2
Operational budget transfers (net)	32.1	...

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	1,210.8	100.0
Holdings	1,311.0	108.3

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangement:

Since March 13, 1979, Germany has participated together with Belgium, Denmark, France, Ireland, Italy, Luxembourg, and the Netherlands in the exchange rate mechanism (ERM) of the European Monetary System (EMS). Under this agreement, spot exchange rates between participating countries are maintained within a fluctuation margin of 2.25 percent around bilateral central rates. In the case of the Italian lira, the margin was reduced from 6 percent to 2.25 percent with effect from January 8, 1990. The Spanish peseta joined the ERM on June 19, 1989, the pound sterling on October 8, 1990, and the Portuguese escudo on April 6, 1992; all maintain a 6 percent fluctuation margin. On September 14, 1992, a realignment took place involving a 7 percent devaluation of the Italian lira. In a realignment on September 17, 1992, the Spanish peseta was devalued by 5 percent. On the same day, the Italian lira and pound sterling withdrew from the ERM.

VIII. Article IV Consultations:

Germany is on a 12-month consultation cycle. The staff report for the last Article IV Consultation (SM/91/164) was discussed at EBM/91/120 (September 11, 1991).

IX. Technical Assistance: None

X. Resident Representatives: None