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Minutes of Executive Board Meeting 86/127

3:00 p.m., August 1, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	D. Saha, Temporary
C. H. Dallara	
J. de Groote	
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	
J. E. Ismael	
	H. A. Arias
	M. Foot
	I. Puro, Temporary
	L. Leonard
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	L. P. Ebrill
P. Pérez	
	G. Nguyen, Temporary
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
	L. Tornetta, Temporary

L. Van Houtven, Secretary
A. Akanda, Assistant

Also Present

Asian Department: R. J. Corker. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; B. E. Rose, Deputy Director; R. A. Feldman, A. Fidjestol, P. Fontana, H. B. Junz, L. J. Lipschitz, T. H. Mayer, S. Mitra, G. Szapary, R. G. Thumann, H. Ungerer. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Bélanger, J. T. Boorman. Fiscal Affairs Department: M. Shadman. IMF Institute: R. Alter, Participant. Legal Department: H. Elizalde. Middle Eastern Department: D. Hammann. Research Department: A. D. Crockett, Deputy Director; E. R. Borensztein. Western Hemisphere Department: H. M. Flickenschild, P. Kohnert. Bureau of Statistics: H. H. Hennrich. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, W.-R. Bengs, G. D. Hodgson, J. Hospedales, G. Nguyen, A. Ouanes, D. C. Templeman, R. Valladares, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, G. Ercel, R. Fox, Z. b. Ismail, T. Morita, S. Rebecchini, H. van der Burg, B. D. White.

1. FEDERAL REPUBLIC OF GERMANY - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/126, 8/1/86) their consideration of the staff report for the 1986 Article IV consultation with the Federal Republic of Germany. They also had before them a report on recent economic developments in Germany (SM/86/170, 7/16/86; and Cor. 1, 7/30/86).

Mr. Weitz recalled that at the discussion on the 1985 Article IV consultation with Germany his chair had stated that additional efforts would be needed in order to secure stronger and more broadly based economic growth, and that further strengthening of domestic demand by reducing the tax burden would be possible in the light of the relatively small fiscal deficit. At that time, the authorities had also been urged to permit the German economy to lead the world economic recovery and to that end to coordinate their domestic and external policies.

For the past three years, the pace of economic activity had continued to accelerate, Mr. Weitz continued. The economy was now entering a phase in which the benefits of policy efforts made earlier were becoming visible in a higher level of employment, a further reduction of the fiscal deficit, a lower rate of inflation, increased profitability of private enterprises, and a relatively strong external position. Those achievements reflected the appropriateness of the medium-term strategy followed by the authorities since late 1982, which combined fiscal consolidation with policies aimed at strengthening the supply side of the economy. Progress made thus far in fiscal consolidation was impressive, although the overall tax burden had not been reduced to sustainable levels and the structure of public expenditure did not appear to be fully consistent with the aim of improving supply conditions. A better structure of public expenditure should increase the benefits of fiscal consolidation and could be achieved by means of a major reorientation of government spending away from subsidies and other transfer payments and toward productive ends. In addition, the benefits of earlier policy efforts would be even greater if the reduced financial needs of the public sector allowed for an effective reallocation of resources to the private sector.

The authorities' decision to reduce income taxes in 1986 was consistent with the aim of strengthening domestic demand and achieving more broadly based economic growth, Mr. Weitz observed. The emphasis in the fiscal area should be on improving the quality of fiscal consolidation rather than on increasing the number of reform measures. That was particularly important if Germany was to take advantage of the favorable external environment to reorient its sources of economic growth from external to domestic demand. Such a reorientation might well serve to stimulate economic recovery elsewhere by increasing imports which might be necessary because of the deceleration in the pace of economic activity in the United States.

The increased efficiency of the labor market through the enactment of the Employment Promotion Act of 1985 was satisfactory, Mr. Weitz continued. However, there was room for further improvement, particularly in the light of the persistently high level of unemployment and the rigidities that impeded a more efficient utilization of the labor force. The increased level of profitability in corporations, together with an increase in investment in machinery and equipment and an appropriate reorientation of public expenditures should reduce unemployment, provided that the structural rigidities were removed.

Monetary policy had been prudent and should be oriented to ensure sustained noninflationary growth in the medium term, Mr. Weitz remarked. Given that the rate of inflation was very low, it was appropriate for Germany to reduce interest rates further. The country had not introduced any meaningful measures aimed at removing current trade restrictions, which would benefit Germany as well as the EC. In particular, Germany's opposition to aspects of the reform of pricing under the Common Agricultural Policy and its intention to compensate farmers for unfavorable EC pricing policies were disappointing; it was also regrettable that Germany had not supported measures that were consistent with the principles of free trade. His authorities attached great importance to the evolution of free trade, and encouraged the German authorities to reduce subsidies in agriculture.

Germany should take a leading position in the world economic recovery; it had a major responsibility to its current and potential commercial partners to implement sound domestic policies, Mr. Weitz added. If a global improvement in resource allocation was to be pursued and comparative advantages were to be exploited, a free trade system remained critical.

Mr. Mtei said that the pace of economic activity in Germany had continued to accelerate for the fourth year, with GNP growing at a rate of 2.5 percent in 1985. The inflation rate and fiscal deficit had remained low, corporate profitability had improved, and the external position continued to be robust. However, the rate of unemployment remained high at over 8 percent and recent unfavorable developments, including the weak performance of investment in exports and the less than expected increase in consumption, had led to an interruption in output expansion, thereby causing real GNP growth to be negative in the first quarter of 1986. Nonetheless, economic activity was expected to pick up substantially during the rest of 1986 and through 1987. It was encouraging to note that there was an increasing dependence on domestic demand and that continued expansion of output had not resulted in capacity restraints.

The authorities had been successful in their fiscal consolidation strategy as the fiscal deficit had been reduced to about 1 percent of GNP, Mr. Mtei continued. That success had been achieved by curtailing expenditure--the share of government expenditure in GNP had been reduced by about 5 percent over the past three years. Although expenditure had been considerably reduced, the authorities' strategy of qualitative consolidation had not been as successful, and the effort to redirect resources away from subsidies and toward productive expenditure had not met with much success. Total government subsidies in 1985 had remained at about 5 percent of GNP.

It was not clear to what extent the policy of strict adherence to fiscal consolidation was compatible with the strategy of reducing the dependence of the economy on foreign demand and relying more on domestic demand, particularly when the current government deficit absorbed a very small proportion of private savings, Mr. Mtei said. The ratio of government savings to total savings in Germany was already the lowest among major industrial countries and there was no evidence that government debt had any significant crowding out effect on private investment. Moreover, the need for countries like Germany and Japan--which had achieved considerable success in lowering inflation and the budget deficit--to adapt their fiscal policy stance without abandoning their medium-term objectives in order to pick up part of the slack in the global economy that might result from the contemplated reduction of the U.S. budget deficit, made it difficult for him to understand the rationale for Germany's plans for a large reduction in its budget deficit.

Further fiscal consolidation should concentrate on lowering taxes and on the qualitative improvement of government expenditure, Mr. Mtei observed. The tax reduction that had already been implemented was a step in the right direction and the Government's intention to undertake further tax reform was welcome. Tax reductions would encourage high consumption and investment through their favorable impact on disposable income, thereby strengthening domestic demand and enhancing the shift toward more reliance on domestic markets. The weakest point in the Government's fiscal position was possibly the existence of large subsidies, including direct subsidies and tax preferences. It was disappointing to note that the policy of qualitative consolidation had failed to reduce subsidies and that the authorities were considering further increasing subsidies for agriculture and coal in 1986. In his view, such a policy would protect economic inefficiency, adversely affect free trade, and result in a misallocation of resources. The authorities should make more rapid progress in reducing subsidies and transfers.

In the absence of a high rate of increase in consumer prices and given the continued appreciation of the deutsche mark, the current accommodative monetary stance might be justifiable and need not be a source of concern, Mr. Mtei remarked. Given the recent weakening in economic growth and the need to stimulate domestic demand, a more expansionary monetary policy might be warranted.

The persistence of a high level of unemployment might be a reflection of labor market rigidities, Mr. Mtei commented. The Employment Promotion Act of 1985, which aimed at easing regulatory restrictions in the labor market, was a step in the right direction. However, the persistence of high unemployment levels would require more measures not only to break the rigidities in the labor market, but also to expand productive capacity and increase employment opportunities.

After a fall in 1984, the increase in Germany's official development assistance in 1985 was welcome, Mr. Mtei said. However, the amount of official development assistance was rather modest, given Germany's strong economic performance and its dependence on overall international growth and trade. The authorities' commitment to increase official development assistance over the remainder of the decade by a greater percentage than the overall rate of growth of the federal budget was welcome; they should achieve the 0.7 percent UN target at an early date.

Mr. Alhaimus considered that overall economic indicators in Germany were satisfactory. It was particularly encouraging to note that the real growth rate of GDP in the second quarter of 1986 was currently estimated at 3.5 percent and that the rate for 1986 as a whole was projected at somewhat higher than 3 percent. It was significant that that improved pace of activity was due entirely to domestic demand, which had compensated for the weakening of foreign demand.

During the 1985 Article IV consultation with Germany the Executive Board had concluded that the dependence of growth on foreign demand was a major concern and that there was a need to strengthen domestic demand, Mr. Alhaimus recalled. Considerable success had been achieved in that area, and there were prospects of a large increase in consumer spending in 1986. It was important to remember, however, that although fiscal policy played an important part in achieving that increase through the reduction of income taxes, a significant part of the increase in household real income, and consequently domestic demand, was due to the large shift in the terms of trade resulting from the sharp fall in oil prices. While the terms of trade change had been projected to contribute to an increase in household real income of 2.5 percent of GDP in 1986, the contribution of reduced taxes to household real income was about 0.6 percent. Therefore, some further fiscal effort to exploit the available room for maneuver to augment demand could be recommended, and in this respect he shared the staff's doubt that a tax reduction would be limited by the need for further reducing the government deficit. A substantial reduction in subsidies might also have a favorable impact on growth and employment, as indicated in the Kiel Institute simulations.

A policy measure that would be helpful in maintaining high domestic income and low inflation was to ensure that the gains from the significant improvement in the terms of trade, especially oil, would be passed through rapidly and fully to households, Mr. Alhaimus remarked. The authorities had undertaken policies in that direction and should be encouraged to maintain that stance.

The shift in the terms of trade was expected to considerably aggravate the problem of current account surplus, which was expected to rise from 2.1 percent of GDP in 1985 to 3.3 percent of GDP in 1986, Mr. Alhaimus continued. The authorities considered that a surplus of such magnitude was undesirable and that it had been exogenously determined through the sharp change in terms of trade. Clearly, that change had been due to the lack of progress in stabilizing international oil prices and its undesirable impact on Germany's external position--and on the position of other major surplus countries--had not been adequately analyzed in assessing the diverse impact of the sharp rise in oil prices. The large current account surplus should encourage the authorities to make more comprehensive efforts, together with the EC, to remove trade barriers, especially on commodities exported by developing countries--including petrochemical products. Further efforts to expand official development assistance should also be in keeping with both the external and fiscal position of the country. An official development assistance level of only 0.5 percent of GDP was far below the potential of the economy and far short of the needs and expectations of many developing countries.

Mr. Jayawardena recalled that Germany's prudent economic management had been commended by Executive Directors during the previous Article IV consultation. However, although prudent economic management might be required to achieve domestic stability in a world where economic factors did not move freely, it might not be the most desirable strategy in the context of global adjustment needs. Meeting those needs might require good economic managers to undertake policies that were not called for solely on the basis of national requirements.

The continuing health of Germany's economy was of paramount importance, Mr. Jayawardena observed. Hence, the recovery of domestic demand and the diminished influence of foreign demand on economic growth were welcome. Domestic demand in 1986 would apparently have a positive impact on growth, due to improvement in the terms of trade arising from the fall in oil prices, the appreciation of the deutsche mark, the reduction in income taxes implemented in January 1986, and wage increases in 1986. However, it was not clear to what extent those factors would help sustain domestic demand at a high level. Consumer demand was increasing, and investment was expected to improve. The authorities had emphasized capacity expansion over labor replacement and modernization; the capacity utilization in 1985--84 percent--had been the highest achieved since 1979. However, the trend in capacity utilization seemed to have almost flattened toward the end of 1985. There were no generalized production bottlenecks, which might indicate that there was scope for further utilization of existing capacity. Nonetheless, it was not clear that substantial new investment in capacity expansion would take place in the near future unless there was a definite demand stimulus. He wondered whether the envisaged domestic demand pull arising from the terms of trade improvement and fiscal measures would be sufficient to attain the authorities' medium-term objectives.

The fiscal deficit had been a little over 1 percent of GDP in 1986, Mr. Jayawardena noted. The deficit was expected to rise in 1987, owing to the first-stage reduction of personal income taxes in early 1986. It was not clear how the stimulus to domestic demand generated by the tax cut and the consequent small rise in the fiscal deficit would be sustained in the years to come if the policy of fiscal consolidation and public expenditure restraint were maintained. The authorities clearly did not want any increase in the share of public expenditure in GNP. It could be argued that such a restrictive fiscal stance would be conducive to price stability and would create confidence in the ability of the economy to maintain steady growth. However, it was debatable whether that policy would help sustain domestic demand at a level that would provide a rate of growth that would cut the unemployment rate to one half of the present rate over the next five years. He wondered whether those growth and employment goals could be achieved by further tax cuts or by general tax reform. There was general concern as to whether the restrictive fiscal stance would lead to increased prices, despite a significant increase in investment activity due to tax cuts. The staff should make a more comprehensive analysis of that issue.

There was some doubt about the sustainability of the adjustment process, especially in the medium term, which was the major concern from the international point of view, Mr. Jayawardena said. Medium-term balance of payments scenarios would have enabled him to form a better judgment on the adjustment process. Structural reforms represented a vital source of durable growth. Germany should reduce some of its well-known structural rigidities.

The current account surplus in relation to GNP had been rising since 1982, Mr. Jayawardena remarked. In 1986, the surplus would increase further owing to a sharp improvement in the terms of trade. It was desirable that Germany should be a capital exporter and that its savings should be efficiently intermediated to the rest of the world; current account surpluses should be used to help the development of the developing world. The international adjustment process could be improved with appropriate intermediation and imaginative methods of channeling the surpluses of the industrial world. The Fund should make efforts to promote resource flows to developing countries.

Germany's record of official development assistance had been excellent, Mr. Jayawardena observed. Net absolute official development assistance had declined continuously since 1980 in U.S. dollar terms; however, that decline must have been due largely to currency value changes; the ratio of net official development assistance to GNP had risen to about 0.5 percent. The authorities should be commended for their commitment to increasing the ratio in the future. It was important for major economies such as Germany to keep their official development assistance flows at a high level, especially in view of the declining resource flows to developing countries. Germany's lead role among industrial countries that advocated free trade should be commended. Most of the trade impediments that persisted had originated from structural rigidities in the industrial economies. Further progress by Germany in the trade area would be welcome.

Mr. Salehkhou said that the improvement of the German economy, now in its fourth year, was expected to accelerate during the remainder of 1986 and to continue into 1987. Although real GNP growth had fallen by 1.5 percent in the first quarter of 1986, it was projected to rise considerably during the rest of the year at a rate of about 3 percent and to continue at the same rate in 1987. However, during the past three years the sustained growth had been the result of both strong foreign demand--which in 1985 accounted for 1 percentage point of the 2.5 percent increase in real GNP--and the consolidation of fiscal and price stabilization policies.

Two distinct features characterized the current economic situation in Germany, Mr. Salehkhou continued. First, the earlier economic cycles had usually lasted for no more than two to three years; in contrast, the current cycle was in its fourth year. Second, unlike the earlier upswings--which had relied more on domestic than on foreign demand--the current recovery had relied mainly on strong foreign demand, although it had initially been influenced by domestic demand; that trend had been a source of concern to Executive Directors during the 1985 Article IV consultation with Germany. Despite some friction in the reorientation of the pattern of growth stimuli, there had been a shift during 1986 toward less dependence on foreign demand and greater reliance on domestic demand as the principal stimulus to growth. From another perspective, the sustainability of the economic expansion was partially attributable to new developments in the external environment--the fall in oil and other commodity prices, together with the appreciation of the deutsche mark, which had improved with the country's terms of trade. The stronger trade balance was reflected in the increase in the current account surplus from 1 percent of GNP in 1984 to 2 percent in 1985.

With respect to structural developments, a relative rise in employment--the first since 1980--had been offset by an increase in the supply of labor, Mr. Salehkhou observed. The unemployment rate, therefore, had remained unchanged at a little over 8 percent. Although the unemployment rate was relatively low compared with some EEC countries, it was still considered high, as the country was in its fourth year of recovery. The rate of inflation--about 2 percent--continued to be low, which was attributable largely to the maintenance of strict financial policies. The projected rates of inflation and unemployment in 1987 were 1-2 percent and 7.5 percent, respectively.

Although the Government's policy with respect to reducing the ratios of public expenditures and taxation to GNP was welcome, it should make efforts to correct the uneven progress between the qualitative and quantitative aspects of fiscal consolidation, Mr. Salehkhou remarked. In that context, he was disappointed that the authorities intended to raise subsidies in 1986, particularly for commodities that would adversely affect developing country exports.

Although monetary growth had substantially exceeded the upper limit of a generous target range during the first four months of 1986, interest rates on the three-month money market had fallen from 6.5 percent in March 1985 to 4.5 percent in May 1986, Mr. Salehkhou noted. Furthermore, over the same period, average bond yields had fallen to the lowest levels in the past 25 years--from 7.75 percent to about 5.75 percent. If after some time, the high rate of monetary growth could not be explained by identifiable transitory factors, it might become necessary to take measures to contain the rates of increase.

Although the appreciation of the deutsche mark in 1985 had contributed to the reduction of balance of payments imbalances among major countries, that adjustment could not rely solely on changes in the exchange rate, Mr. Salehkhou said. The correction of the large external imbalances among major industrial countries would require complementary macroeconomic policies in both deficit and surplus countries. With respect to structural issues, although the Employment Promotion Act of 1985 was a step in the right direction, more action should be taken to decrease labor market rigidities and to improve the market's efficiency.

It was disappointing to note that despite the introduction of liberalization measures in 1985, there was continued resistance to aspects of the reform dealing with the pricing of commodities that were in the interest of developing countries, Mr. Salehkhou commented. That stance was inconsistent with the principles of free trade. In addition, despite a modest increase in official development assistance, the total resource flows to developing countries had fallen. Although the Government's commitment to increasing official development assistance during the rest of the decade by a greater percentage than the overall federal budget growth was welcome, he hoped that the level would soon reach at least the UN target.

The Deputy Director of the European Department noted that it had been very difficult to make forecasts for Germany since the changes in a number of important variables were very large and there was little or no historical experience to rely on. The changes in exchange rates had been unusually large and although there had been large increases in oil prices in the past, symmetrical responses by the economy to large declines could not be assumed. Hence, a cautious approach should be taken in analyzing Germany's economic prospects.

It had been clear at the time of the staff mission that there had been a pause in Germany's economic growth--in fact, output had fallen in the first quarter of 1986, the Deputy Director continued. The staff position was that many fundamental strong points in the economy were still present: Germany had introduced a tax cut at the beginning of 1986; and there had been an increase in real income of 2.5 percent resulting from the change in the terms of trade, which had provided the authorities with an opportunity to attempt to restore growth.

Responding to some Directors who had questioned the strength of the economic recovery, the Deputy Director pointed to the fact that in the second quarter of 1986 industrial production had been 3.5 percent higher than at the same time in the previous year. Export orders had declined; however, that decline had been offset by an increase in domestic orders, in particular domestic orders for investment goods. Retail sales figures had shown a welcome increase in the second quarter of 1986. Although the evidence was not conclusive, it suggested that the economy could achieve

3 percent growth in 1986. The growth forecast had been revised downward from the world economic outlook estimate in April 1986 because of the weakness of the construction industry and of exports. In order to achieve a 3 percent growth rate in 1986, GNP in the second half of 1986 would have to be 3.5 percent higher than the second half of 1985. The staff assumed that the positive effect of the terms of trade on demand would continue through 1987, though this would be difficult to quantify. In addition, since private savings had increased in the first quarter of 1986, a faster growth of consumption would be possible in the ensuing period. With profits much higher than previous levels, it would not be surprising if unions pressed strongly for larger wage increases, thereby adding to the increase in consumption. The projected rise in consumption of 4 percent would have multiplier and accelerator effects, which would further boost investment. Although the trends were difficult to quantify, the outlook for growth was moderately optimistic.

There had been modest progress in increasing employment, the Deputy Director remarked. However, there were two obstacles to bringing about a rapid increase in employment. One problem was that of the real wage overhang. At a time when profits were rising, it was extremely difficult to hold down nominal wage increases, which was essential for increasing employment. Another problem was the rising participation rate. The increase in employment in 1985-86 had been offset by an almost equal increase in the labor force, thereby leaving the unemployment level unchanged; however, the rising participation rate was not something that could be directly tackled by the Government. The staff believed that strong investment performance was the key to faster growth of production potential. In that context, although the construction industry had been weak, there had been a strong increase in investment in machinery and equipment.

The tax cut at the beginning of 1986, together with the large improvement in the terms of trade, had provided a stimulus to economic growth, the Deputy Director observed. As to the possibility of bringing forward--to the beginning of 1987--the 1988 tax cut, which was already on the statute books, there were parliamentary and political constraints. Looking to 1987 and beyond, the staff would like to see speedy action but could not provide a timetable. Since the marginal rates of income tax in Germany were very high on relatively low and medium incomes, any reduction in taxes should have much greater effects in Germany than in other countries. The authorities also had room for maneuver in reducing subsidies.

Investment by the Federal Government thus far in 1986 had been slightly below DM 8 billion, which was not a significant amount, the Deputy Director continued. In contrast, investment by the municipalities and Länder had been nearly DM 42 billion. Investment by the Federal Government was expected to increase more than overall expenditure in 1987. With respect to privatization, in 1984 the Government had reduced their holdings in VEBA, an energy conglomerate, for DM 800 million. In early 1986, government holdings in the chemical industry had been reduced by about DM 750 million. Within the next two years, the Government intended to reduce its holdings in an oil and gas exploration company, hand over control of a management conglomerate to the private sector, and sell its minority holding in both VEBA and the Volkswagen company. In total, these holdings had a market value of about DM 5 billion.

It was debatable whether a reduction in taxes--through its effect of increasing consumption and hence revenue--would make it unnecessary to undertake expenditure cuts, the Deputy Director commented. The authorities intended to implement expenditure cuts before tax cuts. In his opinion, there might be lags between a reduction of taxes and the effects on consumption and revenue, and it would be wise to be prudent in making precise calculations.

The measurement of real rates of interest was difficult, particularly at the present time, the Deputy Director noted. The inflation rate as measured by consumer prices had been -0.2 percent in May 1986. That rate had been heavily influenced by food and energy prices; if those two items had been taken out of the consumer price index, then the rate of inflation would have been 2.2 percent. Using the GDP deflator, the change in the terms of trade had pushed the inflation rate up to 3 percent. The staff believed the "underlying" rate of increase in the GDP deflator to be about 2 percent. It should be noted that real interest rates were properly measured by using an index of inflationary expectations. However, the inflationary expectations of the private sector in Germany could not be quantified. There was danger in drawing sharp policy conclusion depending on whether the real interest rate was 3.5 percent or a little more than 4 percent. In his opinion, inspection of historical series did not support the view that the present levels of real interest rates were unusually high.

The rate of monetary expansion should be seen in the light of the appropriate indicator of price inflation, the Deputy Director said. If one took 2 percent as the appropriate figure and combined it with the optimistic figure of 3.5 percent for the growth of real output, that would suggest aiming at the top or near the top of the band. The actual rate of monetary expansion was still above the top of the band and that did not imply that monetary policy was restrictive. The Bundesbank hoped that monetary growth would decline gradually at the present levels of interest rates, but was not taking steps to slow monetary growth. If the growth of central bank money continued to decelerate, he hoped that the Bundesbank would address the issue of a possible further reduction in interest rates, taking into account not only the needs of the domestic economy, but also the international responsibilities of Germany. It was difficult to determine why the rate of monetary growth had been so high in the first quarter when economic activity had been so slow. However, it appeared that some exceptional factors had been involved, such as the distortionary effect of the sale of a large industrial conglomerate, and problems relating to the role of the currency in circulation in the targeted number. In passing, he remarked that given the very high rate of monetary growth and the lower level of economic activity in the first quarter, the economy should currently be in a fairly liquid position.

The new Government--which would enter office in January 1987--would find it more difficult to tackle rigidities in the labor market than those in the financial markets, the Deputy Director observed. The authorities should make a more coordinated and serious effort to cope with structural problems, not least because of the relationship of the rigidities to unemployment.

The authorities were taking the issue of external adjustment seriously by trying to maximize the rate of growth of output and by their willingness to allow the exchange rate to respond to market forces, the Deputy Director added. The intermediation of the current account surplus should be left to the markets, with the exception of official development assistance, the level of which should be increased. As to the question of the outlook for the balance of payments in the medium term, very rough calculations by the staff showed that the current account surplus would decrease through 1988-89; lack of staff resources had prevented the preparation of a full-fledged medium-term scenario for the current account.

Mr. Grosche said that his authorities were carefully monitoring monetary expansion and evaluating the need for strong domestic growth on the one hand, and the risk of refueling inflation on the other. Germany's currency had assumed the role of a reserve currency, but only one of secondary ranking, which made it very vulnerable to erratic capital movements in an environment of free capital markets. Therefore, there was an overriding need to maintain confidence in the mobility of the deutsche mark. For political and legislative reasons, there was no plan to bring forward the tax reduction plan for 1988. It had already been decided upon by Parliament. But even if there were such a plan, it would be impossible to accelerate the process of bringing forward the tax reduction plan during the forthcoming election campaign. The trade-off between lower taxes and smaller deficits was at the heart of the debate on the medium-term fiscal strategy. However, pressures for higher deficits came not only from the intention to lower taxes. There were risks for both the expenditure and revenue sides of the budget; for example, there were calls for larger transfers to the EC. There was also the risk of having substantially lower income from profit transfers from the Bundesbank. The Bundesbank expected a reduction of profits in the order of DM 5.5 billion for 1987 because of lower yields from its assets. Moreover, there were medium-term reasons to retain room for maneuver in the budget, especially the increasing fiscal burden associated with the aging of the population. Thus, in the medium term, the deficit might not decline by a significant amount: it might even increase. Given the pressure on the deficit, it was important to maintain the objective of containing the deficit and, in that context, the tax reform would have to be financed largely from other sources, particularly from the reduction of subsidies in the form of tax preferences. No doubt there would be political obstacles in addressing the problem of subsidies. On the expenditure side, coal was subsidized quite heavily. The automatic increase in coal subsidies was the result of declining import prices owing to the strength of the deutsche mark. However, there were very few subsidies left for the steel industry.

With respect to tax legislation, the Länder had been provided with significant powers under the Constitution; the states had the constitutional right to a fixed share of revenues from direct taxes and a variable share of indirect taxes, Mr. Grosche continued. Persuading the Länder to vote for tax reductions could involve considerable costs for the federal budget. The fact that the federal budget was running higher deficits than the states and municipalities combined indicated that the distribution of tax income was misaligned; in his view that was the result of political agreements reached during previous tax legislation processes. Nonetheless, tax reform would be a priority objective for the new Government in 1987. A certain amount of frontloading could be expected, but it would be difficult to say when the tax reform would be implemented. Although January 1, 1988--when the second step of the current tax reduction program would become effective--might be too soon, there was a strong stimulus for early implementation.

Tackling the remaining labor market rigidities would require a steady and cautious approach since there were political sensitivities involved, Mr. Grosche remarked. There had already been considerable progress in reducing labor market rigidities--for example, the amendment of the provision that had restricted the eligibility of workers for unemployment benefits in situations relating to strike activities. The objective of that legislation had not been to redress the balance of power between unions and management in cases of wage disputes, but to reconstitute the neutral position of the labor agency in such disputes. The abolition of the turnover tax on transactions in financial markets would not have a significant effect because it was a small tax. Nonetheless, it will be eliminated very soon. The financial markets in Germany were probably the least regulated of the markets of all major countries. The authorities' recent decision to sell all federal government shares in Volkswagen and VEBA would raise DM 3 billion; it also demonstrated the intention of the authorities not to interfere with private business where intervention was clearly unnecessary.

The authorities were firmly committed to a liberal stance on trade policies, Mr. Grosche stated. They considered that, while it was not appropriate to give up the Multifibre Arrangement at the current time, the adjustment process in the textile industry had not been fully completed. There was more scope for liberalization and improvement of the Arrangement. The authorities would support an extended but enhanced Multifibre Arrangement aimed at market liberalization of trade in textiles over a transitional period; ultimately, there should be a progressive return to the application of GATT rules.

The Common Agricultural Policy (CAP) posed serious problems for the EC countries and the rest of the world, Mr. Grosche said. Incomes in Germany's agricultural sector had stagnated since 1975, and the average farmer's income was currently about 40 percent below that of incomes in other sectors. Germany's agricultural imports from developing countries were among the highest in the Common Market. The authorities intended to pursue the reform of the CAP through the reduction of cultivable area, provision of appropriate incentives to farmers, and early retirement schemes. The subsidies to the agricultural sector, which were costly for the budget, were not seen as compensation for the effects of the price decisions taken in the EC; rather, they constituted a form of social assistance to small and medium-sized farmers directly linked to the degree of individual need.

The authorities would continue to attach high priority to development aid, notwithstanding the demands in other areas for increasing expenditures, which were all the more pressing under the consolidation strategy, Mr. Grosche concluded. The medium-term financial plan envisaged an expansion of official development assistance along the lines of overall government expenditure. It should be noted that considerable financial assistance had been provided to developing countries by sectors other than the Government. Taken together, public assistance and private capital flows represented almost 1 percent of GNP. There was considerable potential for increasing private flows to developing countries if they created the conditions conducive to such flows.

The Chairman then made the following summing up:

Executive Directors commended the German authorities on macroeconomic policies that had helped achieve a stable financial environment characterized by virtual price stability, lower interest rates, and improved company profits leading to a high growth of business fixed investment. The financial consolidation of the past few years was thought to have provided a strong foundation for continued economic expansion in Germany without a resurgence of inflationary pressures. Directors, however, emphasized the importance of easing supply constraints and raising the rate of growth of productive potential in Germany by further encouraging investment and loosening structural rigidities. Directors noted the improved economic indicators and stressed that robust domestic demand was important at a time of slackening foreign demand in order to sustain growth and reduce the high rate of unemployment. From an international perspective, and keeping in mind also the global debt problem, it was important that Germany contribute to maintaining a reasonable rate of growth in the industrial world, to reducing the large external imbalances among the industrial countries, and to keeping markets open to international trade. Directors supported the staff's urging that the authorities give special attention to the external repercussions of Germany's policies.

Directors noted that growth in Germany in 1984 and 1985 had been heavily dependent on foreign demand and they felt that it was important to see a reorientation of the economy away from a reliance on foreign demand and toward a stronger growth of domestic demand. There were, however, expressions of disappointment that that process was proceeding less rapidly and smoothly than had earlier been anticipated and that there had been a pause in growth in the fourth quarter of 1985 and the first quarter of 1986. Despite indications of stronger demand in the second quarter, some Directors expressed concern that the boost to real incomes stemming from the sharp improvement in the terms of trade might in part be reflected in higher savings rather than greater demand. Thus, Directors stressed that developments in economic activity should be closely monitored with a view to ensuring that the projected growth did indeed materialize. It was noted favorably that a major part of the savings resulting from the fall in oil prices had been passed on to consumers.

On fiscal policy, many Directors held the view that Germany's medium-term fiscal objectives appeared too conservative. The staff's alternative medium-term scenarios which suggested that there would be more room for tax reductions deserved the careful attention of the German authorities. It was noted that there had long been support for the strategy of reducing the share of government expenditure in GNP and correspondingly lowering both taxes and the government deficit. Directors commended the authorities' successes to date on both expenditure and the deficit and thought it important that the Government proceed with its plans for a major program of tax reform and reduction in the next legislative period. They noted that the financing of the deficit now absorbed only a very small share of private savings and urged that henceforth, priority be given to tax reduction. The cut in income taxation scheduled for 1988 was welcomed, but was regarded as doing no more than offsetting fiscal drag. They emphasized that the importance of maintaining an adequate rate of growth of domestic demand warranted, in their view, a significant acceleration of the process of tax reduction. In a similar vein, a number of Directors argued that the pace and size of tax reductions could be faster and larger if they were accompanied by a bold program of reductions in subsidies which would be beneficial in itself. Many Directors expressed concern about the lack of progress to date in reducing subsidies and, indeed, some recent setbacks in this area had constituted a very substantial drain on national resources.

On monetary policy, it was noted that the growth of central bank money was still above its target range, although it had come closer to the upper limit of the range in the past few months. Most Directors believed that recent monetary trends were not a cause for concern and a question was also raised as to whether the target band might not be too restrictive. Several Directors also cautioned that a slowing of the growth of central bank money should not lead to an increase in interest rates. On the contrary, it was hoped that further reductions in interest rates would be possible and that developments within the European Monetary System would facilitate it. Directors acknowledged some difficulty in determining how high real interest rates were at present because sharp divergences between different measures of inflation rendered judgments about inflationary expectations more than usually hazardous.

Directors recognized that the large increase in the current surplus in 1986 was due in large part to the shift in the terms of trade. They believed that the substantial appreciation of the deutsche mark would facilitate adjustment and noted that developments in trade volumes indicated that this adjustment had already begun. Nevertheless, they emphasized the importance of reducing the current account surplus through policies designed to strengthen domestic demand and structural reform. Some Directors questioned the consistency of further reductions in government budget deficits with current account adjustment, and reiterated that more vigorous macroeconomic policy measures to support demand be considered if a significant upturn failed to materialize in the next few months.

Directors thought that supply-side policies should be aimed at raising the rate of growth of productive potential by improving incentives and eliminating structural rigidities. They urged that rapid progress be made in the reform of the tax system envisaged for the next legislative period so as to flatten marginal tax rate schedules, reduce subsidies, and generally strengthen incentives. Recent progress in deregulating financial markets was welcomed but a few Directors urged that priority be given to the elimination of the turnover tax on trade in financial assets and to a reform of other elements of the tax system that hindered efficient financial intermediation. Although some progress had been made in easing labor market rigidities, Directors observed that a variety of indicators, not least the continuing unemployment problem, suggested that further action was required.

On trade policy, Directors expressed concern that Germany had resisted aspects of the reform of pricing under the Common Agricultural Policy and had compensated farmers for unfavorable pricing decisions. They hoped that the authorities would be cognizant of the detrimental effects of such restrictive practices on producers in other countries. Directors generally welcomed Germany's support for a new round of GATT talks on trade. Germany was considered to be in a position to play a leading role in reducing trade restrictions and subsidies both within the EC and at a national level. Leadership was called for particularly in sensitive areas such as textiles, steel, and coal.

Directors noted that the ratio of Germany's net official development assistance (ODA) to GNP had risen slightly in 1985 but was still no higher than in 1983. It was hoped that the Government's stated commitment to aiding the developing countries would be reflected in further rapid increases in ODA in the ensuing years.

In sum, Directors favored a more forceful program of tax reform and intensified action to reduce subsidies. They also thought that clearer and more specific action was needed to reduce rigidities in the labor and financial markets and that the above mix of policies should be supported by a flexible monetary policy.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/126 (8/1/86) and EBM/86/127 (8/1/86).

2. MALAYSIA - TECHNICAL ASSISTANCE

In response to a request from the Malaysian authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/86/207 (7/28/86).

Adopted August 1, 1986

APPROVED: April 15, 1987

JOSEPH W. LANG, JR.
Acting Secretary