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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/118

10:00 a.m., August 2, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	
	H. G. Schneider
B. de Maulde	
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	
	G. W. K. Pickering
A. Kafka	H. A. Arias
H. Lundstrom	
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

African Department: G. E. Gondwe, Deputy Director; E. L. Bornemann, M. Frenkel. European Department: L. A. Whittome, Counsellor and Director; B. E. Rose, Deputy Director; B. Christensen, J. Delbeche, P. Dhonte, A. Fidjestol, L. Lipschitz, S. Mitra, D. C. L. Nellor, G. Szapary, R. G. Thumann. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; S. J. Anjaria, J. T. Boorman, A. B. Petersen, P. Pownall. Fiscal Affairs Department: V. Tanzi, Director; G. Blöndal, A. H. Mansur. IMF Institute: U Tun Wai, Deputy Director; H. F. Bauer, Participant. Legal Department: J. V. Surr. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; J. P. Horne, F. B. Larsen. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. M. Ainley, P. E. Archibong, D. Hammann, J. Hospedales, T. Sirivedhin, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, Bo T., S. de Forges, J. de la Herrán, G. Ercel, R. Fox, O. Isleifsson, Z. b. Ismail, M. Lundsager, K. Murakami, A. Mustafa, M. Rasyid, C. A. Salinas, A. A. Scholten, L. Tornetta, B. D. White, Yang W.

1. FEDERAL REPUBLIC OF GERMANY - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Germany (SM/85/194, 7/5/85). They also had before them a report on recent economic developments in Germany (SM/85/204, 7/17/85).

Mr. Grosche made the following statement:

On behalf of my authorities I wish to express my appreciation to the staff for its excellent documents and for the helpful discussions during the consultations in Bonn and Frankfurt. My comments will highlight the broad lines of our economic policies and provide some information on economic developments since the consultation on the latest forecasts and on recent fiscal and monetary policy decisions.

My authorities are in broad agreement with the staff's analysis and assessment supporting our medium-term approach in formulating monetary and fiscal policies. A shift to more stimulatory demand management policies is not the right answer to the deeply worrying problem of high unemployment. Such a shift could have only short-lived effects while hampering the ongoing fiscal consolidation and structural adjustment and endangering price stability.

Even more important, it would not help to accomplish our main objective of substantially raising potential growth. Only by attacking supply constraints will we be able to attain over the medium term higher rates of growth of output and a higher demand for labor. In order to increase potential growth, it is important to continue: to reduce progressively the share of government in the economy and to improve the scope for private initiative; to boost investors' and consumers' confidence through sound and reliable financial policies; and to lessen rigidities in the markets for capital, goods, and labor in order to make them more efficient.

The staff rightly emphasizes that the expansion in 1984 and part of 1985 relied heavily on foreign demand, and we fully share the staff's view that a more rapid rate of growth of domestic demand would be desirable.

An analysis of recent developments and short-term prospects shows that the volume and structure of demand are evolving in the right direction. Business fixed investment has picked up markedly in recent months. Moreover, there are signs that investment is shifting away from labor replacement toward capacity expansion. This process will be reinforced, as a high degree of capacity utilization in manufacturing has already been reached. Furthermore, relatively high profit levels and declining interest rates will facilitate the financing of additional investment. Recent surveys show that gross investment in the manufacturing sector of the economy could grow in real terms by 12 percent in 1985. Furthermore, private consumer demand has started to pick up. This is suggested by the sharp rise during the spring in registrations of new passenger cars, as well as by the slightly larger volume of retail sales and by comparatively high expenditure on foreign travel. During the year, private consumption will receive an additional stimulus from increasing employment and gains in purchasing power resulting from low inflation.

On the whole, it seems that the losses in production caused by the harsh weather in the first months of 1985 have been completely overcome and that the economy has returned to an expansionary path. We continue to foresee a rate of growth of real GNP in 1985 over 1984 of more than 2 1/2 percent. The economy should continue to expand at this pace in 1986, when private consumption--in the context of the ongoing process of tax reform and reduction--will get an additional boost from the first step in cutting income taxes. This step will add the equivalent of about 1/2 of 1 percent of GNP to household incomes. In 1986, private consumption is projected to grow roughly at the same rate as GNP, while the contribution of the foreign balance to growth is expected to be halved. Exports will grow at a substantially slower pace; the steep increase in imports should continue. Among the factors contributing to this development will be the downward movement of the dollar and the recent appreciation of the deutsche mark against the Italian lira.

Trends in output and employment continue to be adversely affected by the problems facing the construction industry. A lasting recovery in demand for new housing is not in view because of the easy availability--at least in some parts of Germany--of rented and owner-occupied housing. In these circumstances, attempts to stimulate construction through special policy measures would only delay the unavoidable adjustment of capacity.

The outlook for business and government construction, however, has improved somewhat. As private sector capital spending rises, more industrial construction projects are likely to be started. Moreover, the local authorities (the most important level of government for spending on construction) probably have a fairly large backlog of construction projects that can be implemented more easily now that the financial situation of many local authorities has substantially improved. In addition, the Government has introduced a number of measures that should help to support demand in the construction sector. It is proposed, for example, to cut the depreciation period for commercial buildings (started after April 30, 1985) from 50 to 25 years. In both 1986 and 1987, the Federal Government will provide up to DM 1 billion in additional financing for measures designed to rehabilitate cities. In addition, local municipalities will be able, through the "Kreditanstalt für Wiederaufbau," to borrow considerably higher amounts at low interest rates for the construction of sewage plants, the relocation of industrial parks, and other projects.

For a fairly long time, domestic price stability was threatened by the sharp depreciation of the deutsche mark against the dollar. In April 1985 import prices were 6 1/2 percent higher than a year earlier. But they have come down since then; in June they were only 3 1/2 percent higher than one year previously. The increase in producer prices for industrial products accelerated slightly at the beginning of the year under the impact of more costly energy imports, but it too has slowed since then. Consumer price increases have remained modest. In July, the cost of living index is expected to be only 2.3 percent higher than a year ago.

The growth of federal expenditure in 1985 is not expected to surpass the budgeted 3 percent. According to recent estimates, the expenditures of the Länder and municipalities will also be about 3 percent higher than in 1984. As a result of higher contributions to the pension system and measures to limit the steep cost increases in the health insurance scheme, the social security system as a whole should show a surplus of DM 500 million in 1985 and DM 2 billion in 1986.

In early July 1985, the Federal Government adopted the draft of the 1986 federal budget, which will be submitted to Parliament for approval later in the year. The government proposal limits expenditures in 1986 to DM 264 billion, an increase of only 2.4 percent compared with the current figure. With total revenues projected at DM 239 billion, including DM 12.5 billion from the Bundesbank's profits, the 1986 budgetary deficit of DM 25 billion will be about the same as this year.

The first step in cutting income taxes, which will become effective January 1, 1986; higher transfer payments to the European Community; and additional stimuli to investment activity, particularly in the construction sector, are the major factors responsible for the pause in the Government's budgetary consolidation policy, despite the modest rise in expenditures.

The medium-term fiscal plan for 1986-89 approved by the Federal Government indicates that budget deficits will remain at about DM 25 billion until 1988. A modest decline to DM 23.3 billion is projected for 1989. Federal expenditures in 1987-89 are planned to increase 2.9 percent per year. Even with this austere expenditure policy, interest payments on federal debt will keep on growing steadily from DM 27.8 billion in 1984 to DM 36.8 billion by 1989. This is one of our most serious fiscal policy problems, and it makes a reduction in subsidies even more imperative. Government subsidies are going to be reduced by DM 1 billion to DM 13.5 billion in 1986, and the medium-term fiscal plan calls for a further cutting at an average annual rate of 6.5 percent between 1986 and 1989.

Expenditures of the General Government (comprising the Federal Government, the Länder governments, municipalities, and the social security system) are expected to grow by 4 percent in 1986 on a national accounts basis, compared with 3 1/2 percent in 1985. Mainly because of the first step in cutting income taxes, revenues will grow by only 4 1/2 percent compared with 5 percent in 1985. Therefore, the overall deficit, which will be reduced by DM 9 billion to DM 30 billion in 1985 (1.7 percent of GNP), will fall only slightly to DM 27 1/2 billion in 1986 (1.4 percent of GNP). The share of overall expenditure to GNP in 1986 is expected to come down to 47 1/2 percent compared with 48.7 percent in 1984.

The Bundesbank maintained its basic monetary policy stance unchanged until midyear, despite the disturbances on the international financial and foreign exchange markets at the beginning of 1985. In July, the central bank money (CBM) stock was growing at a seasonally adjusted annual rate of slightly more than 4 percent over the level of the fourth quarter of 1984. It was therefore moving within this year's target range of 3-5 percent. At the same time, it was following a fairly steady longer-term growth trend that has hardly changed for about two years.

The basic monetary policy stance adopted by the Bundesbank created conditions ensuring that once the external disturbances at the beginning of the year had tailed off, the resultant temporary tendency toward tighter conditions in the domestic money and capital markets would also fade away. Therefore, when reviewing the target range for the growth of the central bank money stock in early July the Central Bank Council decided not to change the target. In view of actual monetary and price developments, however, it was decided to keep the growth of the CBM stock in the upper part of the range. Such a rate of monetary expansion should be adequate to support the projected rate of real growth in 1985. If the current high level of investment should result in more rapid growth of potential output than previously expected, this positive development will certainly be taken into account in the formulation of next year's target.

On the money markets, conditions continued to ease further recently with the Bundesbank's encouragement. On July 18 the Bundesbank granted additional rediscount quotas amounting to DM 3 billion effective August 1 and cut its minimum rate for securities repurchase transactions from 5.1 percent to 4.8 percent. Actual repurchase rates are likely to be somewhat higher, but the minimum rate is regarded as an indication of both the general trend in the money markets and of the Bundesbank's views on an appropriate trend. This action is another sign that the Bundesbank sees room for maneuver, particularly in view of the weakening dollar, and that it wants to have the lower cost of credit passed on to the banks' customers.

Domestic capital market rates, which are far less subject to direct control by the Bundesbank, reflected the external disturbances during the first half of the year. The yield on bonds in the secondary market, which had fallen to slightly below 7 percent around the turn of the year, rose 3/4 of 1 percent by mid-March. Since then, however, the yield has dropped back to 6.6 percent, below its level at the beginning of the year.

In concluding, I would like to stress that my authorities attach great importance to international surveillance, and, in pursuing financial stability and adjustment, they will devote special attention to the Fund's views on the external repercussions of Germany's policies. We will continue to work toward a reduction in the impediments to international trade. We are particularly pleased that the staff welcomes our support for a new round of GATT talks. We believe that the pressure stemming from a new round will contribute to carrying out substantial steps toward further liberalization of trade. With this in mind, we take seriously the staff's recommendation to do all we can to contain both national and EC restrictions and subsidies. Any such additional measures, particularly in the sensitive areas, taken by a country inside or outside the European Community would serve only to deteriorate the climate before the new round begins. We strongly support the staff's view that the liberalization of restrictions would also contribute to the growth prospects of developing countries. Liberalization and open markets are indeed the best assistance that industrial countries can provide.

Mr. Schneider remarked that the economy's performance since the onset of the recovery in 1983 had been satisfactory. Despite the withdrawal of some fiscal stimulus as a part of the medium-term fiscal consolidation effort, the recovery had continued because of several factors. Some easing of supply constraints had been achieved through the provision of incentives to private investors and a strong increase in business fixed investment. Moreover, the rate of inflation had further slowed as monetary expansion had been held steady, and public confidence had been restored and strengthened. External developments had made at least an equally important contribution to growth. Domestic demand had grown slowly in 1984 and was expected to do so again in 1985; therefore, it was not surprising that the recovery had been moderate and the rate of unemployment had remained at a record high, although the declining trend in employment had apparently been arrested.

The main tasks were to make the recovery self-sustaining and more broadly based, Mr. Schneider considered. He agreed with the staff that a policy shift to more stimulatory short-term demand management would be inappropriate; indeed, it would run the risk of rekindling inflation and inflationary expectations and of undermining fiscal and structural adjustment, as Mr. Grosche had stressed in his opening statement. However, he also agreed with the staff that the rate of economic growth in Germany was significant from an international as well as a domestic viewpoint. It was therefore important to consider whether the authorities' present policy stance would maximize the economy's growth potential without losing control over inflation. The Government's medium-term orientation of financial policies was appropriate, but there seemed to be some room in which to increase domestic demand through the tax reform recommended by the staff. There were of course still a number of problems in the fiscal area, such as the need to shift government expenditure toward investment and to reduce unnecessary subsidies, but since the estimated deficit of the Federal Government in 1985 was just 1.4 percent of GNP, it seemed that the authorities were slightly underrating the progress that they had already made as well as the room for maneuver that it had given them.

Monetary policy should be aimed at generating the liquidity needed to sustain economic growth, Mr. Schneider commented. He shared the staff's view that growth of the central bank money stock close to the lower half of the Bundesbank's target range would be a sign of an excessively restrictive monetary policy and would be insufficient to support noninflationary real economic growth. Mr. Grosche's comment that the tighter tone of monetary policy had disappeared and the Central Bank Council's decision to keep the rate of growth of the central bank money stock in the upper part of the target range were reassuring.

Structural rigidities were an obstacle to achieving broadly based and self-sustained economic expansion and a rising trend in employment, Mr. Schneider remarked. A number of measures had been introduced to reduce regulatory restrictions, but further structural measures were needed. In its appraisal, the staff had correctly underscored the serious rigidities in the labor market, and innovative steps to deal with them were required, but he felt somewhat uneasy about the following statement on page 18: "The second [rigidity] lies in the existence of numerous restrictions and regulations which limit the freedom of employers in managing their labor force, e.g., 'social plans' under which large redundancy payments have to be made to workers who are dismissed and many other regulations that confer certain rights on workers when businesses achieve a certain size." That statement gave the impression that the staff was insensitive to the humane reasons for the so-called social plans. The introduction of severance compensation for workers similar to the compensation traditionally paid to other employees was a significant recent achievement of the European labor movement and was justified by the increasingly blurred distinction between salaried employees and wage earners resulting from rapid progress in technology. If the authorities were to reduce the severance compensation, something else would have to be given in exchange, such as job training or relocation allowances; the Act for the Promotion of Employment passed in May 1985 seemed to point in that direction.

The exchange rate policies of the European Monetary System (EMS) were appropriate, Mr. Schneider stated. Economic developments in Germany had a major effect on other countries, particularly in Europe. A satisfactory and strengthened economic performance by Germany would be especially welcome given the uncertainties about future developments in the U.S. economy.

Mr. Ismael considered that in 1985, as in 1984, the authorities were to be commended for their consistent and remarkable economic management. The recovery had become more firmly established, the rate of inflation had fallen, and the fiscal and external positions had been improved. The only cloud on the horizon was the continued fairly high rate of unemployment of about 8 percent. Apparently employment had not benefited from the export-led recovery; given the expected moderation of external demand following the weakening of the dollar against the deutsche mark, domestic demand would have to take up the slack. Export growth had begun to decelerate in the first quarter of 1985, and while private consumption as well as total output were growing very slowly, there were signs that business fixed investment and private consumer demand had recently begun to pick up.

Broader-based economic growth was clearly needed to reduce unemployment significantly, but it should be achieved without either increasing the rate of inflation or undermining the authorities' medium-term goal of reducing the role of government, Mr. Ismael continued. The authorities' policy strategy and measures--which were aimed mainly at improving the supply situation--were in the right direction. The staff should comment on the implications for policy in Germany of possible developments not foreseen in the latest World Economic Outlook papers, for instance, failure by the United States to deal with its budget and external current account imbalances.

The absence of a decline in unemployment in Germany, even though investment had grown and capacity utilization had increased, suggested that unemployment was essentially structural, Mr. Ismael remarked. That conclusion was supported by the recent increase in the average duration of unemployment. While fiscal policy should encourage productive investment, structural policies were urgently needed to remove rigidities in the labor market. The measures already taken to improve labor market conditions were welcome, and the authorities should consider additional possible steps, such as rationalizing the wage structure to increase the differential between the wages of skilled and unskilled workers. To achieve that objective, the social partners would have to be fully aware of the overall consequences of their positions on labor matters. The progress that had been made in easing the regulations limiting the flexibility of employers and in reducing financial benefits for the unemployed was encouraging.

The authorities' goal of reducing the government deficit in the medium term by cutting expenditure was appropriate, but some relaxation of fiscal policy in the short run might be helpful, Mr. Ismael continued. For example, rather than reducing the deficit to the full extent envisaged, the authorities could match expenditure cuts and tax reductions. That effort could provide some stimulus to demand without undermining the authorities' medium-term fiscal objectives. The possibility that reviving growth could help to reduce the fiscal deficit should not be ruled out. Reducing expenditure and taxes to stimulate private demand and growth could also provide a stimulus to the world economic recovery, something that would be especially welcome in view of the impending slowdown in U.S. economic activity. In sum, the pause in the Government's budgetary consolidation effort referred to by Mr. Grosche in his opening statement was not alarming.

Fiscal policy could be used to stimulate both private investment and private consumption, Mr. Ismael went on. To that end, the measures that the authorities had introduced and intended to implement were encouraging. The tax proposal recently passed by Parliament provided for income tax cuts amounting to DM 10.9 billion in 1986 and DM 8.5 billion in 1988. He wondered whether the date of the cuts should have been accelerated, particularly given the fiscal drag that had already occurred. Little progress had been made in transferring public sector entities to the private sector, and, contrary to established policy, subsidies had increased. Although most of the subsidies were given to productive sectors, they increased the level of effective protection.

The authorities' policy of using medium-term monetary targets had been broadly successful, Mr. Ismael remarked. Their prudent monetary stance had significantly contributed to the present low rate of inflation and should not be altered, but the existing climate in general, and the low rate of inflation in particular, gave the authorities some room in which to maneuver. The target for the increase in central bank money had been reduced from 4-6 percent to 3-5 percent in 1985, mainly because of the lower than expected rate of inflation; the expected increase in productive potential was about 2 percent. In practice, however, central bank money had been permitted to grow at a rate in the upper part of the target range, a trend that would help to avoid stifling the fragile economic recovery and was in keeping with the objective of encouraging employment and growth without reigniting inflation.

A more liberal policy concerning the operation of the capital and money markets would be appropriate, Mr. Ismael considered. The slow pace of financial innovation in those markets had contributed to stability in the past, but reforms were needed. The financial reforms already made by the authorities had helped to improve the investment climate, and purchases and sales of bonds--especially by nonbanks--had increased in the first quarter of 1985.

The staff report contained little discussion on the appropriateness of the exchange rate, Mr. Ismael noted. Did the staff feel that the deutsche mark was undervalued in relation to the dollar?

The authorities' record in resisting protectionist pressures was commendable, Mr. Ismael said. They should continue to resist such pressures not only in Germany but also within the European Community. In addition, Germany's track record on official development assistance was good, and he hoped that the small decline in 1984 would be quickly reversed.

The authorities' responsible record in global affairs was commendable, Mr. Ismael concluded. As a major industrial country, Germany through its domestic and external policies had implications for the world at large. He hoped that the authorities would continue their good record on the trade policy and aid and would support developing countries' adjustment efforts by taking up some of the slack in demand following the slowdown in the U.S. economy and by supporting the multilateral institutions.

Mr. Polak said that he agreed with the staff that the authorities were to be commended for the main lines of their economic policy stance, which was aimed at reaching medium-term fiscal and monetary goals. The low rate of inflation achieved through that policy gave other EMS countries needed support in their struggle against inflation.

Given the steadiness of German economic policy the staff appraisal was appropriately modest, Mr. Polak continued. He agreed with most of the appraisal, including the regret expressed for Germany's protection of cereals.

Germany's economy was the third largest among the Fund membership, and the international effects of developments in Germany had a legitimate and important place in the Article IV consultation, Mr. Polak remarked. The world economy was less robust than in 1984: growth in the United States was slowing and would likely remain slow in the medium term, and there was no evidence of a pickup in growth in other industrial countries. Indeed, the growth rate in the OECD as a whole was falling and might reach a point that would make the balance of payments problems of the major debtors even more difficult to manage. The staff had correctly noted that the debt problem facing developing countries was a relevant factor in the Article IV consultation with Germany.

The staff had noted that the authorities would welcome a more rapid rate of growth of domestic demand, Mr. Polak went on. It was expected that in the near future, as in the recent past, domestic demand would rely excessively on outside factors: the external current account surplus was estimated by the German authorities to increase from DM 18 billion in 1984 to DM 25-30 billion in 1985, and the staff's estimate was even larger. External demand was neither a reliable nor a satisfactory basis for future growth. The question naturally arose what measures Germany could introduce to make a contribution--relatively modest although it might be--to maintaining world economic growth. He agreed with the authorities that little if anything could be done in that direction by reversing fiscal policy and accepting an increased fiscal deficit. Although the expansionary measures to gain that budgetary effect would in principle be temporary, the increased deficits caused by them might well be difficult to reverse, partly because of the associated rise in interest expenditure. As the staff showed on page 7, a fiscal deficit in excess of 2 percent of GNP would raise the already high debt service as a percentage of GNP. In addition, such a deficit would, as the authorities had maintained, harm the credibility of their stabilization policy and undermine the investment that was essential for future growth. Spare capacity in Germany was small; the Council of Economic Experts estimated it at 2 percent, which implied full capacity use in some areas of the economy.

Given the limitations on short-term stimulation through fiscal or monetary measures, the emphasis in promoting further growth must fall on structural reform and the removal of rigidities, as Mr. Grosche had stressed in his opening statement, Mr. Polak remarked. The authorities clearly recognized the constraints on supply described on pages 10-11 of the staff report. However, given the authorities' strong feeling that corrective measures must originate from the supply side, the meagerness of the corrective measures that they intended to introduce was disappointing. The authorities themselves had described the measures as "a small beginning." Reducing the tax burden to improve economic incentives and strengthen the supply side of the economy understandably would take time, as the authorities had claimed, but he wondered why they made the same qualification in describing their commitment to reducing rigidities in the labor and capital markets and in various other sectors of the economy. He shared the staff's view and the even firmer view of the OECD that stronger action and a higher priority for supply-side constraints were called for.

The staff had raised the question whether monetary policy might not prove to be unduly restrictive, Mr. Polak noted. The growth of the monetary aggregates had recently returned comfortably within the target range; since March 1985, short-term and long-term interest rates had fallen by about 1 percentage point. As in earlier years, there seemed to be little reason to feel that monetary policy was excessively restrictive.

Mr. Pérez remarked that the staff's analysis of the main issues concerning the German economy was a significant part of Fund surveillance; after all, developments in Germany had a strong bearing on the international economy. Most of the doubts evident in 1984 about the sustainability of the recovery of the German economy had vanished. The economy's overall performance and the adjustment already achieved in almost every area of the economy were impressive: the rate of inflation had fallen for the third consecutive year, to 2 1/2 percent in 1985, the lowest rate since the 1960s; the fiscal deficit had declined to a more than acceptable level, thereby reducing the size of the public sector; and the external current account had recorded a substantial surplus that had contributed to the growth in total demand. Moreover, the present trends were projected to continue in 1986 and in the medium term. The only unfavorable trend that seemed intractable was the rate of unemployment, which was high by German standards and in light of the adjustment in the other main variables in the German economy.

More so than any other member, Germany had followed the economic policies advocated by the Fund, Mr. Pérez commented. The most difficult part of Germany's adjustment process was over, and the Fund should encourage the authorities to give a higher priority to ensuring that Germany contributed to increasing the rate of world economic growth. The most interesting aspect of the present consultation was the opportunity that it afforded to convey to the authorities the Executive Board's confidence that Germany together with other major industrial countries could support the world economic recovery, which had not reached a number of countries whose economic and financial positions were still difficult.

The authorities' medium-term perspective on fiscal policy, particularly their goal of reducing both the fiscal deficit and the size of the public sector, was fully appropriate, Mr. Pérez considered. However, the change in the pattern of expenditure over the previous three years was inappropriate: investment expenditure had been reduced much more sharply than other kinds of expenditure, and subsidies had risen markedly, causing the share of public consumption in total expenditure to rise. He agreed with the authorities that the tax cuts would increase domestic consumption and somewhat reduce the dependence on external demands. In that connection, the main issue was the appropriate size of the cuts. An improvement in the composition of public expenditure and a reduction in taxation could help to create an environment more conducive to stronger growth of output and employment. Further cuts in taxes on household incomes, steps to maintain the public sector deficit at the current level, cuts in current expenditure, and increases in public investment seemed to be the appropriate combination of fiscal measures.

The level of wages alone did not explain the difficulty in curbing the rate of unemployment in Germany, Mr. Pérez considered. It was true that during the previous 20 years nonwage costs had risen much more rapidly in Germany than in other major industrial countries, but the staff had usefully noted that other factors apparently had played a greater role in the persistent unemployment problem, and the recently adopted New Employment Promotion Act and Youth Employment Protection Act were welcome. Experience had taught that flexible rules in labor markets were needed to reinforce the investment required to absorb the growth in the labor force. In the effort to reduce unemployment, reducing regulations was as important as setting appropriate economic targets.

Over the previous four years, the German authorities had introduced contractionary measures to offset the inflationary effects of the depreciation of the deutsche mark against the dollar, Mr. Pérez noted. In addition, the dramatic rise in net capital flows to the United States had slowed the pace of investment and productivity in Germany. In recent months, however, the external constraints on a more expansionary policy in Germany had apparently disappeared, as the value of the dollar had fallen, oil prices had declined, and the direction of capital flows seemed to have changed.

The authorities' willingness to devote special attention to the Fund's views on the external repercussions of Germany's economic policies was welcome, Mr. Pérez said. The current international economic situation called for the full cooperation of all the major countries, and economic conditions in Germany were sufficiently stable to permit that country to contribute to prolonging the world recovery begun by the acceleration of economic activity in the United States two years previously. Germany should not be asked to abandon the economic discipline that had enabled it to attain its present favorable position, but the country had considerable flexibility--owing to its price, external, and fiscal positions--to maintain a less conservative policy stance with a view to fully developing its considerable economic potential. In sum, the authorities had provided an example of excellent economic management.

Mr. Pickering stated that the authorities were to be commended for their consistent and successful economic policy management. Their restrained overall medium-term policy thrust had provided a solid foundation for the current economic recovery. Progress had been made in a number of areas in 1982-85, when the rate of inflation had been cut in half, the external current account surplus had tripled, and the general government deficit had fallen from more than 3 percent of GNP to 1 percent.

Nevertheless, the economy faced some problems, Mr. Pickering went on. The recovery, which was in its third year, had been relatively moderate, and, most important, unemployment had remained exceptionally high. At the same time, the dependence on foreign demand had increased, there was a need for continued structural adjustment--particularly in the labor market--and the appropriateness of fiscal and monetary policy was questionable.

The authorities had reduced the general government deficit and should be encouraged to maintain their efforts to alter the size and composition of government expenditures and to implement tax reductions and tax reform, Mr. Pickering went on. A reduction in the share of expenditures was clearly needed: the current ratio of expenditure to GDP significantly exceeded the figure of the early 1970s, and transfers and subsidies as percentages of GNP had been rising rapidly over the previous two years and were currently the second highest among the Group of Seven countries. Subsidies, mainly to the aerospace, railway, and mining industries, had risen by 17 percent in 1983-84. Although a moderation in the rate of growth of subsidy payments was planned for 1985, more drastic action seemed necessary in view of their distorting effects on the economy and of the need for sharper cuts in other expenditure areas.

The continuation of the process of tax reduction and reform was welcome, Mr. Pickering considered. Given the efforts to restrain and reorganize expenditure, larger tax reductions might be appropriate, even at the expense of a slight increase in the fiscal deficit above the forecast level. A further comment on the possibility of advancing the proposed tax cuts would be helpful. That step should be consistent with the authorities' medium-term fiscal strategy, which involved reductions in the deficit until 1989. The authorities should be urged to consider modifying the timeframe of their objective for reducing the fiscal deficit. Advantage should be taken of the increased room for maneuver within the overall thrust of the policy of medium-term restraint. A modification of the fiscal deficit objective not only was important from a domestic viewpoint, given the high unemployment, but would also help to sustain the world economic recovery. However, the authorities should not make any radical change in policy; any pronounced shift toward a more stimulatory policy would be wholly inappropriate.

Maintaining the medium-term noninflationary orientation of monetary policy was needed to preserve the gains that had been made against inflation, Mr. Pickering said. He shared the staff's concern that the reduced monetary targets might not be sufficiently accommodative of economic growth. The staff seemed to take some satisfaction from the possibility that monetary growth might be maintained at the upper end of the target range, but that objective implied a degree of precision that did not seem technically feasible. Moreover, given the conservative approach of the monetary authorities, it was possible that the aggregates could grow at the lower end of the range, as had happened throughout 1984. His analysis did not take into account the possible implications of a downward correction in the exchange rate for the dollar through the end of 1985. A further comment on how such a correction might affect the policy of maintaining central bank money growth in the top half of the target range would be helpful.

The stubbornness of the high rate of unemployment and of the low rate of employment growth was disheartening, Mr. Pickering remarked. Labor market rigidities should be reduced. Particular attention should be paid quickly to the problem of the narrowing of the wage differential between skilled and unskilled workers and between industries, and to the problem of the inhibiting effect of social regulations on labor flexibility.

Supply-side rigidities and the generally weak pattern of investment would have to be addressed if potential growth were to be raised from its relatively low rate, Mr. Pickering commented. That need naturally brought to mind the more technical question concerning the potential output of the German economy. The authorities had argued that, given the supply constraints in the economy, greater domestic stimulus would do little to ameliorate unemployment. The staff, however, seemed to feel that the authorities were underestimating output potential. It was clear that, as a general rule, less binding supply constraints were associated with higher estimates of potential output. It would be useful to have the staff comment on how its assumptions regarding potential output differed from those of the authorities. What measurement problems were involved? The authorities had indicated that an increase in the capital stock was necessary if the supply constraints were to be removed or eased. A comment by the staff on the prospects for such a development would be helpful.

It was inappropriate to expect the rest of the world to continue indefinitely to sustain demand in Germany, Mr. Pickering stated. That comment had been relevant in 1984 and was even more so in 1985, given both the foreign balance's large impact on Germany's GNP and the present prospects for further increasing Germany's external current account surplus. The expansion of that surplus was a major strain on the world economy, and dealing with it would require a coordinated policy response by Germany and other major industrial countries.

Mr. Lundstrom considered that the authorities were to be commended for the many favorable recent economic developments in Germany. However, some problems continued to face the economy, particularly the persistent high rate of unemployment. It was important to stress that the impetus to growth in 1984 had been provided largely by external demand, and he agreed with the staff that the rate of economic growth was unlikely to increase markedly over the coming several years. To keep real GNP growth at a minimum of 2.5 percent--which was insufficient to lower the rate of unemployment--increased domestic demand, particularly private investment, seemed to be called for, especially in view of the decline in residential construction. The staff had indicated that the Government's projection of a strong increase in business fixed investment in 1985 seemed reasonable. The conditions for such an increase had existed for some time and had created strong expectations that nevertheless might well be based on excessively optimistic assumptions, and the authorities' continued unwillingness to reconsider their short-term demand management policies was regrettable. However, their intention to pay special attention to the external repercussions of their policies was welcome.

The authorities' policy stance had been oriented toward containing inflation and inflationary expectations and toward achieving fiscal consolidation; by historical standards and in comparison with most other industrial countries, those objectives had been largely achieved, Mr. Lundstrom went on. At the same time, Germany had enjoyed moderate but stable economic growth. The problem was that the weak domestic demand in Germany had been compensated for mainly by the demand for German exports by countries that had had less success than Germany in containing inflation and improving their fiscal position. Germany's economic performance would be jeopardized if international growth rates were to decline. The slowdown in economic growth in the United States had increased the need for stronger growth in Western Europe, and it was therefore essential for Germany to seek the highest possible growth rate commensurate with the authorities' medium-term objectives.

Their policy of limiting the budget deficit as a percentage of GDP had provided a strong constraint on public sector expenditure, especially public investment, Mr. Lundstrom continued. That constraint had been intensified by the lack of progress in reducing industrial and agricultural subsidies, which had reached 5 percent of GDP. The authorities felt that a stringent fiscal policy was a prerequisite for keeping interest rates down and for achieving the desired expansion of investment, but, in the light of the prospects for 1986, his authorities agreed with the staff that the negative effects on demand of a further withdrawal of fiscal stimulus must be weighed against the positive effects on real interest rates and confidence. That conclusion was applicable to the suggestion for accelerating the implementation of the second stage of the tax reform. The contraction of private residential construction in 1985 was further evidence of the importance of a prompt increase in other components of domestic demand, particularly private demand. His authorities attached particular importance to shifting public resources toward investment, especially in the light of the limited stimulatory measures in the 1984 budget. Those measures could not be expected to have any significant positive effect, especially on private construction.

As there were no indications of a strengthening of economic developments outside Germany--indeed, the contrary seemed likely--the German authorities should reconsider their strict economic policy stance, Mr. Lundstrom considered. The real rate of interest was relatively high; considerations other than inflationary expectations and the fear of the results of a less stringent economic policy dominated decision making and held back domestic economic activity. Given the recent depreciation of the dollar, there should be some scope for a less stringent monetary policy in Germany. He hoped that the authorities would be able to maintain substantially lower nominal interest rates than those prevailing in the United States. Given the prospect of a further decline in the dollar, there was little risk that easing the stringent policies in order to improve the worrying labor market situation would prove to be inflationary. The staff had concluded that Germany's economic growth had been hampered by structural rigidities in the labor market. Thus, the regulatory changes designed to increase the freedom of employers to manage their labor force were a step in the right direction. The new regulations associated with the agreement on shorter working hours also appeared to provide increased flexibility for employers, although it remained to be seen whether the shortening of working hours would result in higher employment.

Given Germany's positive attitude toward free trade, he hoped that the authorities would continue actively to counter protectionist pressures, Mr. Lundstrom remarked. Germany's strong support of a new round of GATT talks was welcome, and he hoped that larger reductions of industrial and agricultural subsidies than presented in the last budget would be made as soon as possible.

Official development assistance as a proportion of GNP had declined somewhat in 1984, Mr. Lundstrom noted. Germany's aid performance should reflect the country's strong economy and should therefore be expected to improve.

He broadly agreed with the staff appraisal and the authorities' overall economic strategy, but he had difficulty in accepting the argument that easing the supply constraints would in itself be sufficient to increase domestic demand, Mr. Lundstrom concluded. Experience did not support that thesis. Further action would be needed to stimulate domestic demand. While the chances of reducing structural rigidities might well be enhanced in a climate of low growth and high unemployment, such rigidities were better tackled in a more buoyant economic environment. "Sound and reliable financial policies" admittedly boosted confidence, but that effect had become much weaker in Germany than in most other countries.

Mr. Nimatallah said that he generally agreed with the staff appraisal. The German economy had continued to perform well, and the authorities were to be commended for their prudent medium-term policies.

The prospects for the economy were generally encouraging, but the recovery thus far had been unbalanced, relying mainly on exports, Mr. Nimatallah continued. Domestic demand, particularly consumption, had been relatively weak and might remain so in the future. Mr. Grosche's remark in his opening statement that a more rapid rate of growth of domestic demand was desirable was correct from both a domestic and international perspective. For all practical purposes, Germany, together with other European countries, could pick up the slack in the world economy left by the slowing in U.S. economic growth.

The central policy objective was to promote and sustain a more balanced recovery, and the main policy question was how to achieve that objective without undermining the gains that had already been made, Mr. Nimatallah went on. He fully agreed with Mr. Grosche and the staff that the authorities should avoid so-called quick fixes; shifting to short-term, reflationary policies was likely to be counterproductive over the medium term. Indeed, Germany's present strong economic position was due to the authorities' prudent policies. Germany had achieved a commendable combination of price stability and external equilibrium while making remarkable progress toward achieving fiscal balance.

Germany's present position gave the authorities some room in which to maneuver, particularly in three areas, Mr. Nimatallah said. First, on the fiscal side, the authorities should strengthen their efforts to improve the composition and quality of public expenditure. Public investment had stagnated in recent years, while government subsidies had risen markedly, and at the present juncture a shift in public expenditure toward public investment could be particularly helpful in underpinning domestic growth and creating employment opportunities. The tax burden had remained largely unchanged since 1982 despite recent tax cuts, and assuming that continued progress were made in reducing public expenditure, there might be scope for further tax cuts without undermining fiscal stability. Lower taxation could help to stimulate business investment and private consumption without jeopardizing the Government's anti-inflationary stance.

Second, given the signs of strain in productive capacity in certain sectors of the economy, he agreed with the authorities that there was considerable scope--and in fact a need--to deal with the supply constraints in the economy, Mr. Nimatallah continued. He welcomed the measures recently taken to reduce rigidities in various sectors; they should help to improve resource allocation and to increase economic efficiency. However, more was needed to promote competition in the key sectors of the economy. There was a need for greater flexibility in the labor market, particularly in wage determination, and the recent legislation simplifying labor practices was a useful step in the right direction. The problem of unemployment deserved much greater attention not only in Germany but also in most industrial countries, and he hoped that the authorities would work closely with labor and business leaders to initiate measures to dismantle over time the rigidities that stood in the way of higher employment.

Third, because Germany's economic policies affected the world economy and Germany had benefited considerably from free trade, it was vital for the authorities not only to reciprocate but also to take a lead in resisting protection both nationally and within the EC, Mr. Nimatallah commented. Mr. Grosche's assurances on that point were welcome. In addition, Germany should continue to increase its official development assistance, which was sorely needed by many developing countries. Cuts in such assistance were a false economy: the efforts of Germany and other industrial countries to support development abroad had increased incomes and employment in those industrial countries.

Mr. Dallara commented that the authorities had maintained their traditionally prudent economic management. He generally agreed with the basic elements of the Government's economic policy strategy, which was designed to maintain a stable financial environment over the medium term, but the pace of economic adjustment, particularly with respect to tax reform and the elimination of labor market rigidities, was a cause for concern, and he shared some of the staff's reservations about monetary policy. The staff had raised the questions whether Germany could realistically accelerate growth in the short run and whether the recent economic recovery could be sustained over the longer run. Those questions were of interest not only to Germany but also to the international community and raised collateral questions, namely, whether the outlook for the economy and the authorities' policy stance were consistent with the desired expansion of the world economy, with the re-establishment of a better balance in the international payments situation, and with the solution of the debt problems facing developing countries.

The sources of economic growth in Germany's recent recovery had been unusual for that country, Mr. Dallara noted. In 1984, growth had depended mainly on public consumption and foreign demand; in 1985, 1 percentage point of the expected 2.5 percent growth of real GNP would come from foreign demand. The most worrying element of that pattern was the weakness of private consumption, which had grown by only 1/2 of 1 percent in 1984 and had actually fallen in the second half of that year. Given the large weight of private consumption in the components of growth, it was difficult to see how sustainable growth could be maintained with reasonable external balance over the medium term without a stronger boost from private consumption. In his opening statement, Mr. Grosche had provided some assurance in that connection, and the personal income tax cuts scheduled for 1986 and 1988 should be helpful, but a more aggressive approach to tax reform might have a favorable effect on growth. For example, would it not be possible for the tax cuts planned for 1988 to be accelerated to take effect in 1987? In contrast, the gradual resumption of business investment in 1983-84 and the outlook for 1985 were more encouraging; the substantial improvement in profitability had played an important role in that outcome. However, he wondered whether, once the catch-up investment following the 1981-82 recession had been completed, domestic consumption demand would be sufficiently strong to provide a continued stimulus to business investment.

The unemployment situation in Germany was clearly unsatisfactory, Mr. Dallara commented. Table 5 in SM/85/204 showed the contributions to growth in civilian employment in 1973-82 in the United States, Japan, France, and Germany. Total employment in Germany in that period had shrunk, while it had grown in the other countries concerned, and the failure of the services sector in Germany to generate new jobs on a scale comparable with that of the other countries was striking. He wondered whether the situation had changed since 1982.

The difficult employment situation in Germany undoubtedly was a reflection of labor market rigidities, Mr. Dallara went on. A strong and prompt effort was needed to reduce those rigidities to ensure adequate and sustainable economic growth. He wondered whether the recent reductions in the wage differentiation were sufficient; the downward inflexibility of nominal wages continued to impede further progress in that area. The high cost of dismissals and the substantial nonwage labor costs in Germany made new hiring relatively unattractive. The authorities had expressed their concern about the difficulty in effecting any substantial shift in wage differentials, and the staff papers showed that little progress had in fact been made. He wondered whether the authorities had any plans to deal with that problem. At the same time, the high unemployment "replacement ratio" remained an impediment to flexibility in the supply of labor, and the freedom of business managers to employ labor resources efficiently was still impeded by regulations governing layoffs, youth and female employment, working hours, and temporary employment. Those issues might be useful topics for the tripartite discussions that in earlier years had served as a useful means of exploring such issues. The measures that had been taken and were being implemented to address the labor market rigidities were welcome, but the pace of adjustment seemed insufficient.

He endorsed the authorities' overall medium-term fiscal objectives of reducing the size of government, cutting the fiscal deficit somewhat further, shifting the composition of public expenditures, and alleviating the tax burden, Mr. Dallara said. Some progress had been made in reducing fiscal expenditure relative to GNP, but in absolute terms the ratio was still high, and the target of 45 percent by 1989 seemed well worth striving for. Substantial progress had been made in reducing the deficit of the general government from nearly 4 percent of GNP in 1981 to about 2 1/4 percent in 1984, and a further decline to about 1 3/4 percent was forecast for 1985. The staff had estimated that a ratio of 2 percent of GNP over the medium term would stabilize the debt/GNP ratio. That estimate raised some question about the authorities' objective with respect to the ratio and about the priority given to a further reduction in the general government deficit. The question whether a lower priority might be assigned to deficit reduction could be answered only by the German authorities themselves, but the staff had made a convincing case for taking advantage of further expenditure cuts to reduce the tax burden rather than further reduce the deficit.

The medium-term orientation of monetary policy and the authorities' resistence to the temptation to fine tune the monetary aggregates were appropriate, Mr. Dallara considered. Nevertheless, the staff had reasonably raised the question whether the 3-5 percent target range for the growth of central bank money for 1985 provided sufficient leeway to permit projected economic growth to exceed the potential growth rate used by the monetary authorities in setting their target. Mr. Grosche had argued in his opening statement that growth of central bank money in the upper limit of the target range could be expected to provide sufficient monetary accommodation, but he himself was not entirely convinced that the authorities had addressed the risk of impeding continued economic growth by failing to provide sufficient monetary expansion. The financial market reforms discussed on page 14 of the staff report were welcome, and further progress in that area should be encouraged.

Germany's external current account surplus had been growing substantially, Mr. Dallara noted. There had been a 43 percent increase in German exports to the United States in 1984. The German authorities had projected a further increase in the current account surplus from nearly DM 18 billion in 1984 to more than DM 27 billion in 1985, and the staff had forecast a surplus of about DM 33 billion. In the present international circumstances, large and growing external current account surpluses in Germany complicated the efforts of developing countries to earn their way out of their debt problems; they also made it more difficult for the United States to reduce its external current account deficit. It would be useful to have a comment on the prospects for an increase in capital outflows from Germany in 1985 sufficient to cover the larger current account surplus.

The authorities' support for a new multilateral trade round was welcome, Mr. Dallara said. He hoped that, as an EC member, Germany would join the United States in seeking new GATT rules that would encourage international efficiency and specialization in agricultural commodities. In that connection, Germany's position on the recent EC cereals price negotiations was disappointing.

Movements in the deutsche mark, like movements in the dollar, seemed to be in response to a variety of factors, Mr. Dallara noted. No single factor, including relative real interest rates, seemed to provide a consistently reliable explanation of exchange rate movements. The statement on page 19 of the staff report that "the main causes of this [deutsche mark] depreciation do not lie in Germany" was odd. Even if other European currencies had tended to move in line with changes in the relationship between the deutsche mark and the dollar, exchange rate movements reflected events in both the United States and Europe.

Given the high quality of financial management in Germany, he was unwilling to urge upon the German authorities a policy designed to attempt reflation through expenditure increases, Mr. Dallara said. However, developments in the German economy had an important effect on the rest of the world--industrial and developing countries--including some that continued to face serious debt problems. As the U.S. economic recovery moderated, other industrial countries as a group should help to sustain an adequate rate of world growth. The present scope and pace of economic adjustment in Germany were not obviously consistent with that objective. Nonetheless, he was encouraged by the assurances in Mr. Grosche's opening statement that the German authorities would give special attention to the Fund's views on the external repercussions of Germany's policies.

Mr. Fujino remarked that in 1984 Germany had recorded a low rate of inflation for the second consecutive year. The authorities' commitment to managing macroeconomic policies within a medium-term framework designed to reduce the size of both the government and the fiscal deficit and to lower the rate of inflation had created favorable conditions for continued economic recovery. The authorities were to be commended for their policy consistency and for the success of the medium-term strategy pursued since 1982.

However, there were still certain weaknesses in the economy, Mr. Fujino went on. The most worrying one was the persistent high rate of unemployment--at about 8 percent in 1984--and the limited prospect for rapid improvement. The recent economic recovery had not helped to reduce unemployment significantly, suggesting that that problem should be tackled by appropriate supply-side measures and through changes in the institutional framework.

The present phase of the economic recovery had been initiated in 1983 by an autonomous increase in domestic demand, but at present some of the demand components were relatively weak, Mr. Fujino commented. The growth of consumption had been particularly slow. If it were to be sustainable, economic growth would have to be more broadly based; in that connection, the planned tax reform would be helpful. The problems facing the economy could not be solved by more expansionary demand management in the short run. The present, medium-term framework of macroeconomic policies remained appropriate.

He agreed with the thrust of the staff appraisal, Mr. Fujino said. The authorities' basic objective of reducing the public sector deficit through expenditure restraint was fully appropriate. The steady progress in reducing the share of budgetary expenditure in GNP was encouraging, but the lack of progress in reducing subsidies over the previous three years was disappointing. Indeed, the rate of increase in subsidies had been accelerating, and expenditure restraint had been achieved mainly by sharp reductions in public investment. That subsidies were to be reduced by DM 1 billion in 1986 was reassuring.

In its report, the staff had discussed the possible target for the general government deficit and the distribution of the benefits of expenditure restraint between a reduction of the deficit and a lowering of taxes, Mr. Fujino commented. The projected tax reductions and tax reform would increase the incentives for and strengthen the vitality of the private sector. He sympathized with the authorities, who believed that continued expenditure restraint was essential to reduce the share of government expenditure in GNP and to lower the tax burden, thereby encouraging private initiatives. Reducing the budget deficit to less than 2 percent of GNP would help to contain the growing share of interest payments in federal expenditure and would help to maintain the momentum of expenditure restraint.

Monetary policy also was aimed at meeting medium-term objectives, Mr. Fujino remarked. Accordingly, monetary policy management had accommodated moderate--but not inflationary--GNP growth over the previous two years. The target range for the growth of the central bank money stock had been reduced from 4-6 percent in 1984 to 3-5 percent in 1985; that reduction might have a favorable effect on containing inflationary expectations, but the staff had cautioned that growth of the central bank money stock in the lower half of the target range for 1985 would be insufficient to accommodate the economic growth expected in 1985. Monetary expansion should continue to be managed flexibly and indeed had been thus far in 1985, when the monetary stock growth had been at the upper end of the target range. The Bundesbank's decision in July 1985 to keep the growth of the central bank money stock in the upper part of the range had been appropriate.

Among the various structural rigidities in the German economy, those in the labor market seemed to be the most serious, Mr. Fujino commented. The staff had concluded that, because of the reduced wage flexibility and regulatory restrictions, the increase in unemployment in Germany since the mid-1970s had been due primarily to the decline in hirings rather than to layoffs. The Employment Promotion Act, which had become effective in May 1985, was a welcome first step toward easing the regulatory restrictions, thereby giving greater flexibility to employers in managing labor. Such measures should improve the climate for increasing employment opportunities, and further steps in that direction would be helpful.

The recent measures designed to liberalize the capital market were welcome evidence of the authorities' willingness to review and further relax existing restrictions, Mr. Fujino remarked. The liberalization measures included the repeal of the 25 percent withholding tax on interest on securities held by nonresidents and the issuance of new regulations on the German capital market in May 1985. However, he regretted that some foreign-owned banks had been excluded from the application of "lead-management rights" with respect to the issue of foreign deutsche mark bonds.

Germany's strong support for a new GATT round was essential to the effort to contain protectionist pressures, Mr. Fujino said. He hoped that Germany, which remained committed to liberal trade policies, would play an even more important role in reducing trade restrictions.

Mr. de Maulde remarked that in 1984 Germany had taken advantage of the improvement in the international environment to make remarkable further progress toward adjustment: inflation had been kept under tight control despite the impact of exchange rate movements, the fiscal deficit was the lowest among all the major industrial countries, investment had picked up, and exports had grown rapidly.

However, the staff apparently harbored some doubt about the wisdom of the authorities' intention to keep the pace of adjustment unchanged in the coming period, Mr. de Maulde continued. At the time of the previous World Economic Outlook exercise, in April 1985, the Fund would not have suggested that the authorities had room in which to maneuver. However, on page 7 of SM/85/194, the staff had asked whether it would not be more advisable for the authorities to match the savings generated by expenditure cuts with lower taxes rather than with reduced deficits. Furthermore, on page 9, the staff had asked whether present monetary policy implied a greater concern about the risks of higher inflation than about the risks of slower growth.

An obvious issue concerning Germany's policy stance in the immediate future was the respective contributions of internal and external demand to the growth of GNP, Mr. de Maulde commented. The external sector had played a decisive role in the latest cyclical upswing, particularly in 1983 and 1984; the staff and the OECD had forecast a current account surplus of about 2 percent of GNP in 1986. In his opening statement, Mr. Grosche had estimated that the contribution of the foreign balance to growth would be halved in 1986, mainly because of the appreciation of the deutsche mark against the dollar and the boost in domestic private consumption resulting from the scheduled income tax cut. Although hoping that Mr. Grosche's estimate would prove accurate, he doubted whether it would be. The impact of the exchange rate movement on demand probably would not be significant; the present high profitability of German firms gave them sufficient means to keep up with foreign competition by adjusting their prices to preserve their markets. As to the effect of the planned tax cut, it was important to remember that the rate of household savings in Germany was at a record low. There was little evidence that households would spend money made available by a tax cut rather than save it in order to restore a more normal relationship between consumption and savings. The German authorities had not voiced any such doubts; encouraging confidence was an important component of their economic policy strategy. He hoped that the authorities would prepare contingency measures that could be implemented flexibly. The measures adopted in June 1985 to provide budgetary support for the ailing housing industry had been a warmly welcome step in that direction, particularly in view of the record rate of unemployment--9.4 percent on a seasonally adjusted basis.

He harbored doubts about longer-term economic developments in Germany, Mr. de Maulde remarked. In that connection, the main question was how the German economy was preparing to meet the challenges of the 1990s. A certain number of measures had been implemented or were planned to deal with so-called structural rigidities, including the Act for the Promotion of Employment adopted in May 1985 and various initiatives aimed at liberalizing the financial markets. Those measures would be helpful in the long run even if, as the staff had stressed, more remained to be done to tackle those rigidities, and the process would unavoidably remain a slow and difficult one. The ongoing "arbitrage" between current public expenditure and public expenditure designed to prepare the country to meet future needs was worrying. The authorities had indicated that most of the cuts needed to achieve the fiscal deficit reduction target would be in programs designed to meet the economy's future needs, while current expenditures would continue to grow at their usual pace. Investment by private firms was strong, and the authorities hoped that it would remain so. The new plant and machinery would help Germany to maintain and improve its competitiveness in the short and medium term. However, public investment in basic research, higher education, and the development of advanced technology were the mainstay of the long-term adaptation of an economy to the evolving needs of the international division of labor. The present pattern of budgetary expenditure in Germany suggested that public investment designed to meet long-term needs was lagging behind shorter-term investments.

He welcomed Mr. Grosche's statement that "my authorities attach great importance to international surveillance, and, in pursuing financial stability and adjustment, they will devote special attention to the Fund's views on the external repercussions of Germany's policies," Mr. de Maulde said. The world economy had recovered strongly in 1984 but was entering an uncertain period in which imagination and a spirit of cooperation would be needed; in that context, Germany could play a substantial role.

Mr. Kafka commented that the export-oriented nature of Germany's 1984 recovery, and particularly its dependence on increased sales to the United States, suggested that the staff projection of an increase in the current account surplus from DM 18 billion in 1984 to DM 33 billion in 1985 might well be optimistic. A smaller deficit--in line with the authorities' estimate of DM 25-30 billion--would be welcome, although that estimate probably attached excessive importance to the effects of the appreciation of the deutsche mark and the surplus savings in the economy. The staff and the authorities had projected a rate of economic growth of 2 1/2 percent in 1985.

A lasting economic recovery that relied on growth in the private sector would require not only a reduction in the size of the public sector but also an increase in its efficiency, Mr. Kafka remarked. The decline in public investment over the previous four years might have undermined public sector efficiency. Moreover, Mr. Grosche had rightly stressed that labor market rigidities would have to be reduced to increase the potential growth of GDP. The authorities were to be commended for the enactment of the Youth and New Employment Acts, which were likely to reduce the barriers to employment, particularly of women and young persons. However, much remained to be done, especially with respect to work regulations, which excessively raised the long-term costs of increases in employment.

The decline in subsidies in the early 1980s had been reversed in the previous two years, and at present subsidies were equivalent to some 5 percent of GNP, Mr. Kafka noted. The staff had mentioned that federal subsidies, which were directed mainly to industry and housing, might become a serious problem.

Despite the tight fiscal policy, real and nominal interest rates had not declined in 1984; they had begun to fall only in the second quarter of 1985, Mr. Kafka remarked. The reasons for that delay were difficult to determine, but net long-term capital outflows had risen substantially following the increase in U.S. bond rates in 1984. As long as real interest rates in the United States were high, a permanent reduction in Germany's interest rates would be difficult to achieve. That fact did not mean that Germany's monetary policy should be passive; indeed, it had not been recently, although it had run the considerable risk of stifling growth. He agreed with the staff that at the present stage a reduction of taxes rather than a more rapid reduction in the fiscal deficit would be the preferable reaction to a cut in expenditure.

He welcomed the staff's more searching examination of trade and protection following the Executive Board's recommendation to that effect during the previous Article IV consultation with Germany, Mr. Kafka said. Germany's attitude toward trade was one of the most liberal of any industrial country's. A further comment on the impact of the acceleration by one year of the Tokyo Round tariff cuts adopted by the EC on items of interest to developing countries would be helpful. The authorities were to be commended for their efforts to maintain the level of official development assistance in 1984. The increase in the grant element of that assistance in 1984 was particularly welcome.

Mr. Abdallah stated that he broadly agreed with the staff's analysis. The authorities were to be commended for their impressive performance under which most sectors of the economy had recorded gains, the major stimulus having been provided by the external sector. As a result, the external current account position, which had been fairly comfortable in 1983, had recorded a significant surplus in 1984.

Despite the overall favorable performance, some areas of concern remained, Mr. Abdallah continued. Growth in Germany would not have been as favorable in the absence of increased sales to the United States and the substantial depreciation of the deutsche mark in relation to the dollar. In the circumstances, economic policy should be aimed at achieving structural reform; the measures designed to achieve such reform had been meager thus far, and the adjustment effort should be intensified.

Monetary policy had been fairly successful, particularly in curbing inflation, Mr. Abdallah commented. In 1984, the growth of the money stock had been kept within the target range of 4-6 percent, and the range itself had been further reduced to 3-5 percent for 1985. However, given the accelerated pace of fiscal consolidation and the low rate of inflation, the further tightening of monetary policy in 1985 seemed unnecessary; the authorities were tending to be excessively cautious.

Despite the relative improvement in the German economy in 1984, net official development assistance had fallen slightly to 0.45 percent of GDP, compared with 0.48 percent in 1983, Mr. Abdallah remarked. The authorities' generous aid to developing countries was commendable, but the slight cut in official development assistance was regrettable, and the authorities should be urged to increase their contribution substantially, particularly as foreign earnings of and capital flows to developing countries had been declining steeply.

Mr. Zecchini said that the authorities' medium-term financial policies had broadly succeeded in providing a stable economic environment conducive to noninflationary growth. The rate of inflation had declined from 6.3 percent in 1981 to 2.4 percent in 1984, and in the same period the general government financial deficit had been steadily reduced from 3.8 percent of GNP to 2.3 percent. However, the authorities had paid a price for that stabilization, namely, sluggish and sometimes negative economic growth together with rising unemployment. In 1984, some progress had also been made in those two areas, as the rate of unemployment had decreased slightly and GNP growth had increased moderately to 2.6 percent, although economic growth had relied excessively on foreign demand. The trends of inflation, economic growth, and unemployment evident in 1984 were likely to continue in 1985. The economic recovery continued to be narrowly based: the relatively strong external demand and the impact of the real effective depreciation of the exchange rate still played major roles in economic growth. In contrast to expectations, 1985 had not been a year of transition toward broader-based economic growth, as seemed warranted by the monetary stability, budgetary equilibrium, and the significant external current account surplus.

The authorities' apparent resistence to significant policy adjustment to changing economic conditions underscored the need to focus attention on policy issues that the authorities might feel had already been resolved, Mr. Zecchini commented. The first group of such issues dealt with the transition from the phase of economic stabilization, which had already been completed, to a phase of sustained economic growth. In that connection, a reappraisal of the present fiscal, monetary, and external policies was called for. A resumption of sustained economic growth in Germany seemed warranted for both domestic and international reasons. The stimuli provided to the world economy by the growth of the U.S. economy were decreasing, and other large economies in a position to do so should assume a greater role in sustaining world demand. The rigidities in Germany's domestic markets and in the working of other areas of the economy would be alleviated more easily if economic growth in the country were to pick up.

The second major group of unresolved issues concerned the high rate of unemployment, which, although less dramatic than in some other European countries, remained a cause for concern, Mr. Zecchini continued.

He basically agreed with the staff that, in fiscal policy, the emphasis should be on consolidating expenditure restraint rather than on further reducing the fiscal deficit, Mr. Zecchini said. However, there were significant qualifications to that conclusion. He did not agree with the staff that the public consumption over the projected level in 1984 should be regarded as disappointing. Given the weakening domestic stimulus to economic growth, temporary deviations of public expenditure growth from an already cautious path should be permitted so as to support an adequate level of economic activity and were an appropriate response that could contribute to changing business expectations. That was not to say that improvements in the structure of public expenditure were unnecessary. However, assessments of the structure of expenditure should not be based on a comparison of current versus capital outlays; an assessment of the functions of particular expenditure categories was more relevant. For instance, outlays aimed at enhancing the efficiency of the labor markets or at providing general services to the productive sectors made highly valuable contributions to improving the supply side of the economy and should not be restrained merely because they fell under the category of current expenditure.

The finances of the local authorities were another significant qualification to the general conclusion that fiscal policy should stress the consolidation of expenditure rather than further reductions in the budget deficit, Mr. Zecchini went on. The local authorities had been consolidating their financial position, and further progress might be warranted to stem the long-term expansionary trend of their expenditures. However, given the stagnation of the economic recovery, a case could be made for accelerating the program of public works by the local authorities, perhaps with the support of financial contributions from the federal budget. Such action would both support internal demand and help to strengthen infrastructure.

The OECD had noted that, on a cyclically adjusted basis, the financial position of Germany's general government had actually been in surplus in 1984, Mr. Zecchini noted. Moreover, on the same basis, the surplus was expected to increase from 0.7 percent of GDP in 1984 to 1.1 percent in 1985. Hence, he wondered whether there was as little room for maneuver as the authorities claimed. For example, the income tax reductions programmed for 1986 could be accelerated without placing an undue burden on the budget; the higher level of economic activity resulting from the tax reductions could partly offset the effects of the present cyclical fiscal trends.

The authorities had reduced their target growth range for central bank money from 4-6 percent in 1984 to 3-5 percent in 1985, Mr. Zecchini observed. Since, under current policies, both real GNP growth and the rate of inflation were expected to stay at their 1984 levels of about 2.5 percent, it was unsurprising that monetary expansion had been close to the upper part of the target range. If economic expansion were to strengthen in the second part of 1985, the monetary target might prove to be excessively constraining. In that event, the authorities should be more flexible in the pursuit of their monetary objectives. Moreover, were the rate of inflation to decelerate more than the authorities expected, owing to either the appreciation of the deutsche mark or an improvement in the terms of trade, the authorities should abstain from curtailing monetary growth in order to leave more room for real economic growth.

Germany's external current account surpluses had been growing because of the differential in domestic demand growth vis-à-vis Germany's trading partners, the strong increases in productivity in German industry, and exchange rate developments, Mr. Zecchini remarked. The deutsche mark had depreciated by 5 percent in real effective terms in 1984; it had appreciated slightly in 1985, but not enough to compensate for the depreciation in 1984. The exchange rate had been influenced by large long-term capital outflows, which had compensated for increasing current account surpluses. However, it seemed appropriate to aim at adjusting those surpluses by resorting inter alia to structural measures designed to strengthen investment further in Germany, thereby encouraging greater use of the country's excess national savings.

In sum, having achieved sizable positive results up to 1984, the authorities' policy stance had become excessively cautious, Mr. Zecchini said. Firmer support of both domestic demand expansion and improvements on the supply side could be given in 1985, in advance of the existing schedule.

The prolonged slack in economic growth had been a major factor in the growing unemployment, although the data did not suggest a strict relationship between those variables, Mr. Zecchini commented. The rigidities in the labor market had also made a significant contribution to unemployment. While the authorities could not easily influence some factors, such as the downward wage rigidity, there was certainly more scope for action in reducing the regulations that limited the flexible use of the work force by employers. To that end, the recently adopted Employment Promotion Act was welcome. There was less scope for efforts by the authorities to increase wage differentials, but appropriate reductions in marginal tax rates and a greater wage differentiation for government and public enterprise employees could have useful repercussions on the private sector. Efforts to decrease labor market rigidities could be made only in a medium-term framework, and he was confident that the authorities would be able to succeed if they displayed the same degree of determination evident thus far in the implementation of their financial policies.

As Mr. Grosche had noted at the end of his opening statement, liberalization and open markets were means by which industrial countries could assist the economy of the rest of the world, Mr. Zecchini said. However, industrial countries could provide more effective assistance by maintaining economic and monetary policies that would contribute to easing the deficit countries' external adjustment burden.

Mr. Jensen considered that the authorities were to be commended for their successful implementation of economic policies in 1984. They had contained inflation, maintained output growth within the projected range, and recorded a larger than expected external current account surplus. Those developments represented a continuation of the economic recovery, which seemed to be even better established and more sustainable than at the time of the previous consultation with Germany. However, considerable uncertainty regarding unemployment remained; although the situation had not worsened in 1984 compared with 1983, it still showed no signs of improving. He agreed with Mr. Grosche that increasing potential economic growth by eliminating supply constraints was crucial to boosting the demand for labor. That effort should be supplemented by more decisive progress in eliminating labor market rigidities. The recent marked pickup in fixed investment and the apparent shift away from labor replacement were welcome. A continuation of recent trends should result in further economic expansion strongly sustained by domestic sources, thereby reducing the heavy dependence on external sources evident in 1984.

Economic developments in Germany and in most other industrial countries were of interest from both a domestic and international viewpoint, Mr. Jensen commented. He was pleased that the issue of the international effects of Germany's domestic policies had been raised in the staff report. The achievement of a higher rate of economic growth in Germany was in the best interest of Germany and other countries. A stable economic environment and a reduction in protectionism by the major industrial countries were keys to an international environment that would facilitate solutions to the external debt problems facing a number of developing countries; at the least, debtor countries would be better placed to service their debt obligations by increasing and diversifying their exports.

There had been no major changes in Germany's trade policy since the 1984 Article IV consultation: the authorities had refrained from adding restrictions, but they had failed to reduce nontariff barriers, Mr. Jensen noted. Except for the limited movement toward liberalization within the European Communities as a whole, the German authorities had appeared uncommitted to acting decisively to ease trade restrictions. For example, they had resisted a modest reduction in cereal prices under the Common Agricultural Policy and had compensated German farmers for reductions in remuneration under that policy. In addition, no further progress had been made in reducing the barriers to textile imports. The authorities' initial conclusion that it was too early to abolish the Multifiber Arrangement (MFA) would not help to promote a more open multilateral trade system. His authorities attached considerable importance to the effective implementation of measures to reduce protection at the national level and in the context of regional agreements. The German authorities should intensify their efforts to promote a major degree of trade liberalization, particularly with respect to certain industrial sectors and agricultural products.

The medium-term orientation of fiscal and monetary policy was appropriate, Mr. Jensen said. A self-sustained recovery of the German economy should rely upon a reasonable mix of foreign and domestic sources. Even if the present trend in investment expenditure were to continue, an increase in the rate of growth of private consumption would be needed to sustain domestic demand, and he was pleased that the recent tax reform was likely to increase disposable income without damaging employment prospects.

The authorities were to be commended for the improvement in public finances, which had enabled them to reduce the general government deficit from almost 4 percent of GDP in 1981 to less than 2 percent in 1985, Mr. Jensen remarked. The authorities had also made welcome progress in progressively reducing the share of government expenditure in the economy and in reorienting the pattern of expenditure away from transfers and less productive current expenditure and toward investment. However, there was still considerable room in which to maneuver: government expenditure accounted for some 48 percent of GDP--well in excess of the 40 percent characteristic of the early 1970s--and subsidies were still equivalent to 5 percent of GDP, as no progress had been made in reducing them over the previous two years.

Sustainable and stable economic growth could make a significant contribution to maintaining the world economic recovery, Mr. Jensen commented. To that end, it was important to secure stronger and more broadly based economic growth in Germany. Policy actions should be aimed at enhancing potential growth by increasing the scope for private initiative, by restoring confidence in order to encourage greater investment, and--given the relatively small fiscal deficit--by increasing domestic demand through a reduction of the tax burden.

Mr. Clark remarked that the financial performance of the economy continued to be impressive. Over the previous year, the authorities had achieved a further reduction in relation to GDP of expenditures and the deficit of the general government. Moreover, central bank money growth had remained within the target range with no undue strain on nominal interest rates, and the rate of inflation had continued to decelerate despite the depreciation of the deutsche mark against the dollar. The German authorities' success in areas where many other countries continued to have difficulties furnished evidence of the benefits of maintaining a steady policy course over a long period and reflected the German authorities' firm resolve.

However, the authorities themselves recognized that some aspects of the real economy continued to be unsatisfactory, Mr. Clark continued. The strengthened economic growth in 1984 had not been sufficient to affect unemployment appreciably. Moreover, the base of the economic recovery had been narrow, and there seemed to have been a declining trend in the growth of productive potential.

The recovery thus far had relied heavily upon external demand, Mr. Clark said. That outcome was a reflection of two trends--the rapid upturn in economic activity in the United States and the strength of the dollar--that apparently were being reversed. Accordingly, it seemed likely that the external stimulus to economic activity in Germany would weaken. Indeed, the authorities' forecast of export growth seemed optimistic and without any full domestic substitute, output growth might also weaken. The staff had noted the importance of assessing the international impact of Germany's policies, but the extent of the staff's analysis of that issue in its report was disappointing.

The staff's analysis of the supply-side and labor market rigidities was more helpful, Mr. Clark commented. Achieving greater flexibility in wage differentials seemed to be constrained by the German system of wage determination. In many respects, that system had served the authorities well, especially in controlling inflation, but a comment on the authorities' view on the balance of the cost and benefits of the system and on their attitude toward greater decentralization of wage bargaining would be useful. Given the limited scope for direct government action in the determination of wages, efforts to make improvements on the supply side must stem mainly from deregulation, including reductions in nonwage employment costs; a further comment on the additional measures that the authorities might have in mind would be helpful.

He agreed with Mr. Grosche that more stimulating demand management policies would be unwise and, beyond the short run, ineffective, without progress on the supply side, Mr. Clark said. However, under an excessively restrictive approach to demand management, even the present moderate rate of economic growth might not be sustained.

The forthcoming personal income tax cuts should help to sustain consumption and restore incentives, but in practice they would probably do little more than offset the fiscal drag that had existed since 1981, Mr. Clark remarked. He wondered whether the authorities' success in fiscal consolidation might provide them with more room in which to maneuver on the tax side, even within the present fiscal plans, although those plans had been framed in a medium-term context.

The authorities' data included a general government surplus by 1989, Mr. Clark noted. Those data were merely extrapolations, rather than projections, and such an outcome might not be in line with the authorities' policy intentions. However, the staff had noted that the authorities did not seem to have a precise target for the general government deficit, and a further comment on the issue would be helpful.

The staff had estimated that a general government deficit of 2 percent of GNP would stabilize the stock of debt as a proportion of GNP, Mr. Clark remarked. In addition, one of the authorities' objectives was to reduce interest payments as a proportion of government expenditure, another being to reduce spending as a proportion of GDP. Those goals were certainly welcome, but a comment on the pattern of spending, interest payments, and deficits that those targets might imply in the medium term would be helpful.

The staff had noted that a disproportionate burden of expenditure restraint since 1980 had been borne by public investment, while subsidies had continued to grow rapidly, Mr. Clark commented. He was therefore pleased that, as Mr. Grosche had remarked, the improvement in the local authorities' financial situation would give them more room in which to implement necessary capital projects in the future. At the same time, the authorities should be urged to ensure that planned reductions in the growth of subsidies were achieved.

The reduced target range for the growth of central bank money in 1985 implied an increase in the velocity of money in comparison with the declining trend in velocity of earlier years, Mr. Clark remarked. One of the reasons for the new trend had probably been the effects of financial innovations; those effects were not easy to predict, but the authorities could prudently permit monetary growth in the upper part of the target range.

Over the previous year, the German authorities had again shown the skill and responsibility in economic management that observers had come to expect of them, Mr. Clark concluded. He hoped that in future they would show continuing determination in tackling the structural problems facing the economy. Sustained economic growth in Germany and throughout Europe was likely to depend upon the discovery of solutions to those problems.

Mr. Orleans-Lindsay remarked that the recovery of the German economy begun in late 1982 had been sustained and strengthened in 1984 despite the miners' strike during the second quarter of the year. That encouraging development had taken place in an environment of relative price stability, as the rate of inflation had further decelerated. In addition, the authorities had made progress toward meeting both their medium-term goal of reducing the role of government in the economy and their immediate objective of reducing the general government budget deficit. Monetary policy had succeeded in establishing a stable rate of monetary expansion, which had helped to sustain and strengthen the economic recovery. Developments in the external sector also had been favorable: the current account had registered a large surplus as a result of the strong growth in international competitiveness and despite the deterioration in the terms of trade. The continued strength of the external current account in the first quarter of 1985 was encouraging.

The authorities were to be commended for having moved the economy on to a more durable and sustainable growth path over the previous two years, Mr. Orleans-Lindsay said. Earlier doubts about the durability of Germany's economic recovery had been dispelled, but the question remained whether the projected rate of GNP growth in 1985 and the sustainability of the recovery in the medium term should depend to a considerable extent on the external sector at the expense of the domestic sector. The staff had noted that the rate of economic growth in Germany was important from both an international and a domestic point of view and had emphasized the need for the authorities to establish an appropriate balance between external and domestic demand in order to promote and sustain the maximum rate of growth over the medium term that was consistent with a relatively low rate of inflation. The staff had correctly concluded that the attainment of such an objective, "together with efforts to reduce protection, is a central element of an international environment that will facilitate a solution to the severe external debt problems of a number of developing countries."

The statement by Mr. Grosche that his authorities fully agreed with the staff that a more rapid expansion of domestic demand would be desirable was encouraging, Mr. Orleans-Lindsay went on. The search for the right policy mix to establish an appropriate balance between external and domestic demand undoubtedly posed a dilemma for the authorities. After all, the general improvement in the economic environment, the high profit margins, and renewed business confidence had not resulted in any significant reduction in unemployment. He agreed with the staff that the persistence of a high rate of unemployment--8 percent on average over the previous three years--was worrying. Progress in that area would depend upon developments in the labor market as well as upon the introduction of appropriate macroeconomic policies.

The prevailing official view was that a decisive move to stimulate fiscal and monetary policy in response to the present situation would endanger the ongoing important adjustments in the economy, Mr. Orleans-Lindsay continued. That conclusion was understandable, and he was pleased that the authorities intended to maintain their present macroeconomic policy stance. He agreed with the authorities that the objectives of higher rates of output growth and greater demand for labor could be achieved through appropriate supply-side measures, but he agreed with previous speakers that there was room in which to initiate demand management policies to stimulate the economy in the short term.

He welcomed the steps taken to ease labor market rigidities, particularly the recent legislation aimed at increasing labor market flexibility and that providing an environment in which management and labor could negotiate freely, Mr. Orleans-Lindsay remarked. Those steps went in the right direction, and he was pleased that the authorities were committed to further reducing rigidities in the labor market and other markets.

The fiscal consolidation had reduced the share of general government in GDP through cuts in civil service wages, pensions, and unemployment and health benefits, Mr. Orleans-Lindsay noted. It was however regrettable that the fiscal restraint had not extended to subsidies, which had continued to increase in 1984. The further increase in subsidies projected for 1985 was even more regrettable. The intention to reverse that unsatisfactory trend was welcome; Mr. Grosche's statement that a reduction in subsidies in 1986 would be followed by a further average annual rate of reduction of 6.5 percent through 1989 was reassuring. The steps taken over the previous two years to cut business taxes in order to improve profit margins and stimulate investment were commendable. The announced tax reform should provide tax relief to households, but there seemed to be scope to improve the conditions for investment and growth by reducing the tax burden through a more active subsidy reduction program.

Monetary policy had been greatly assisted by the authorities' non-inflationary policy orientation in general and by their fiscal consolidation efforts in particular, Mr. Orleans-Lindsay remarked. It was encouraging that the authorities intended to exercise flexibility in their effort to remain within the 3-5 percent growth target for central bank money in order to support the projected increase in real output as well as developments in the exchange markets of the members of the European Monetary System.

The authorities' policy of trade liberalization had helped to increase German imports from African countries by 14 percent in 1983-84, Mr. Orleans-Lindsay said. It was however regrettable that the authorities' progress in past years in providing development assistance had been reversed in 1984. Liberalization and open markets might well be the best assistance that industrial countries could provide in support of the growth of developing countries, but he hoped that the decline in Germany's official development assistance would soon be reversed.

Mr. Wang remarked that the authorities were to be commended for their consistent and successful economic policy management. The economy was in its third year of moderate growth, low inflation, and growing current account surpluses. Monetary policy had remained conducive to long-term price stability, and the fiscal consolidation aimed at reducing Government's share in the economy had been implemented effectively. He was particularly pleased that fixed business investment had picked up markedly in recent months and that private consumption demand had begun to rise; those developments implied that the structure of demand was shifting in the right direction, so that the heavy reliance on foreign demand could be reversed and a sustained recovery could be ensured.

Labor market developments continued to be a cause for concern, Mr. Wang commented. The authorities needed to take further steps in that area to secure a sounder basis for continued economic growth. The authorities had been diligently trying to reduce rigidities and disincentives that had impaired the smooth and efficient functioning of the labor market. He agreed with the staff that an appropriate wage policy and a further strengthening of industrial profitability were called for. Moreover, a further increase in activity in labor-intensive sectors such as services might be necessary, and the authorities' efforts to invigorate the construction sector were therefore commendable. He agreed with Mr. Grosche that the authorities should expand potential growth by attacking supply constraints rather than by stimulating demand, but, given the continued slow growth of private consumption projected in 1985, he wondered whether there was some scope for financial policies to be more supportive of real output growth.

The authorities' continued commitment to reducing trade barriers and subsidies within Germany and the European Communities was welcome, Mr. Wang said. Finally, the volume of official development assistance in relation to GNP had been slightly reduced in 1984; he hoped that it would pick up quickly and that its share in overall expenditure would increase.

Mr. Romuâldez stated that he broadly endorsed the staff appraisal. The authorities were to be commended for having maintained balance and prudent policies throughout another year. The economy's performance under those policies, although not spectacular, had certainly been solid, and it would be wrong for Germany to abandon its disciplined approach to demand management policy. Any attempt to force the pace of recovery would be fraught with hazards and could be counterproductive in the medium term.

While he did not advocate any major change in policy direction, he wondered whether further financial consolidation and gradual--albeit determined--structural reforms would be sufficient to sustain growth in 1985-86 at the improved but nevertheless modest rate achieved in 1984, Mr. Romuâldez went on. In his opening statement, Mr. Grosche had noted that the German authorities believed that their present policy stance would be sufficient to sustain growth, and it was important to remember that observers' earlier doubts about projected economic growth in Germany had proved unwarranted. Nevertheless, the authorities' present stance seemed to run some downside risks: the external sector would probably make a smaller contribution to growth as a result of the recent appreciation of the deutsche mark; meanwhile, economic activity in the United States was slowing. In 1984, Germany had increased its exports to the United States by 42 percent, and he wondered to what extent the slowdown in the U.S. economy had been taken into account in the authorities' appraisal of the immediate prospects for the German economy. The staff should comment on the extent to which recent developments in exchange rates and the growth prospects for the United States might have changed the staff's assessment of the outlook for the German economy, which was based on the latest World Economic Outlook exercise.

He also wondered whether consumption could be relied upon to pick up as strongly as the authorities had forecast, Mr. Romuáldez said. Mr. Grosche had indicated that some consumption growth was already occurring, and the staff had mentioned that consumption should benefit from the effect on incomes of the current upturn in investment and from recent export growth. However, as net export growth slowed in coming months, the stimulus to consumption might diminish.

An important question was how the authorities would respond to signs of a slowing of economic growth in Germany, Mr. Romuáldez continued. In that event, the authorities apparently would prefer to continue adhering to their well-established medium-term strategy of financial consolidation and gradual structural reform. There was much to be said for that approach, particularly its contribution to maintaining confidence in the authorities' strategy and to keeping inflation and inflationary expectations under control.

Alternatively, the authorities could take advantage of the room for maneuver afforded by the strong external asset position and the recent strengthening of the exchange rate to establish an environment more conducive to accelerating the pace of structural reform, Mr. Romuáldez said. A pause in fiscal consolidation through an acceleration of the already planned tax reforms should perhaps be considered. That approach might provide an environment better suited to making rapid progress on labor market reform. In addition, the authorities could more effectively tackle the problem of subsidies for uncompetitive industries. Subsidies designed to sustain such industries--which served only to solidify the existing inappropriate industrial structure--could be converted to subsidies to promote structural adjustment and to assist firms and individuals adversely affected by such adjustment. For example, temporary incentives might be provided for the retraining, relocation, or early retirement of workers employed in those industries. Such efforts might constitute another justifiable reason for pausing in the process of fiscal consolidation.

The much-needed pickup in private investment seemed to have begun, Mr. Romuáldez remarked. It would be unfortunate if that revival were held back by unnecessarily tight credit policies. The authorities did not seem displeased that monetary growth was running in the upper part of the target range. The Bundesbank's monetary policy record was enviable: it had consistently achieved its targets--which had invariably been ambitious by most standards--while avoiding the strains typically caused by strict adherence to monetary targets.

To facilitate the revival of investment, the authorities might wish to consider increasing the role of the value-added tax in their tax reform plans, thereby providing additional scope for direct income tax reductions, Mr. Romuáldez commented. Such a move could conceivably help to create a more favorable environment for labor market reform.

He wondered whether there was some scope--perhaps even a need, if growth were to be sustained--for the authorities to become somewhat more ambitious in their efforts to invigorate the economy, Mr. Romuâldez said. Germany had room--albeit not a great deal--in which to maneuver on the demand management side, and it could be used to facilitate more rapid progress in resolving difficult structural and supply-side issues. Continued financial consolidation together with measured progress in solving structural problems might help to contain inflationary expectations, but that approach might also limit what could be called "adjustment expectations."

He regretted Germany's recent departure from its relatively good record on trade and protectionism through its decision to resist a very small reduction in EC cereal prices, Mr. Romuâldez commented. The damage--which was severe to members of his constituency--caused by protection and overproduction of agricultural products was well known. Mr. Grosche's assurance that his authorities would make every effort to contain national and EC restrictions on subsidies was welcome. He hoped that that assurance meant that Germany would support calls for agricultural trade to be meaningfully addressed in the next GATT round. Finally, Germany had continued to provide a generous volume of official development assistance.

Mr. Salehkhou considered that the authorities were to be commended for their cautious and consistent financial policies and for their substantial progress in controlling inflationary pressures and restoring real economic growth, although at a more moderate rate than might be expected given Germany's potential. The rate of economic growth had accelerated from 1.3 percent in 1983 to 2.6 percent in 1984, as the strong performance of the foreign balance had more than compensated for the deceleration in the growth of domestic demand. Inflationary pressures, already subdued in 1983, had further abated in 1984 and in the first half of 1985 despite the significant depreciation of the deutsche mark vis-à-vis the dollar and the consequent increase in import unit values. Moreover, the external current account surplus had increased from DM 10.5 billion in 1983 to DM 17.7 billion in 1984, mainly because of the strong competitiveness of German exports.

Despite the progress with respect to growth, inflation, and the foreign balance, and although a similar outcome in those areas was expected in 1985, there had been no significant improvement in unemployment, Mr. Salehkhou noted. Moreover, as in 1984, the moderate rate of economic growth expected in 1985 remained largely dependent upon the maintenance of strong external demand for German exports to compensate for the unusually weak domestic consumption. The rate of unemployment in Germany was lower than in some of its EC partners but clearly remained excessively high for the third year of the economic recovery. More important, the rate seemed to have leveled off at about 8 percent, owing largely to labor market rigidities and possibly to the constraints of financial policies, which continued to focus primarily on the need to eliminate inflationary pressures and expectations.

The authorities' concern about the risk of reigniting inflation was understandable given the country's experience with inflation and the volatile international monetary environment that had necessitated Germany's maintenance of high real interest rates over the previous several years, which had significantly inhibited a strong recovery of output and investment, Mr. Salehkhou continued. However, Germany did not face just two alternatives, namely, low growth or inflation. There seemed to be significant room in which to improve the growth performance without adversely affecting prices, particularly in view of the rigidities and structural imbalances in the economy. The urgent need to address structural bottlenecks and to improve growth prospects significantly was dealt with in the staff report, which underscored the domestic and international importance of Germany's economic performance and policies. The policies of Germany and, indeed, all the major economies, were particularly crucial to the stability of the international monetary environment and to the ability of borrowing countries to meet their international obligations. To service their debts, developing countries depended significantly upon the expansion of external demand and the removal of protectionist barriers in industrial countries.

The structural rigidities were related mainly to the labor market and business regulations, Mr. Salehkhou noted. The authorities had only a limited ability to correct many of the rigidities, particularly those related to wage determination and social planning, but substantial progress had been achieved in reducing unit labor costs, and regulatory restrictions had been reduced with the adoption of a number of measures, including the Employment Promotion Act, the Youth Promotion Protection Act, and the Working Time Act. However, the scope of those measures was insufficient; more decisive action was needed to remove restrictions on job-creating investment and to increase the social partners' awareness of the long-term benefits of flexible labor relations.

Fiscal restraint had greatly contributed to the success in containing inflation, Mr. Salehkhou remarked. However, while the authorities had reduced the overall budget deficit and contained the share of general government expenditures in GNP, a disproportionate burden of fiscal adjustment had been borne by public investment despite the authorities' objective of reorienting spending toward outlays designed to enhance the economy's productive potential. Although one of the authorities' objectives was to restructure government expenditures, public subsidies had been allowed to increase rapidly and continued to be directed mainly at less efficient sectors, such as steel and agriculture. No significant improvement in that situation was likely to occur soon, but a welcome restructuring of taxes was expected under the tax reform approved in June 1985, which provided for significant personal income tax relief. Such reforms should enhance the supply-side effects of fiscal policy and supplement the 1983-84 tax cut measures, which had been designed mainly to increase business profits and to promote investment.

The authorities had stressed the importance of domestic considerations, particularly containing inflation and the need to maintain consistent financial policies over the medium term, in setting monetary policy, Mr. Salehkhou commented. The strength of the dollar had obviously also been a major constraint that had prolonged the tight monetary stance and high real interest rates, despite the authorities' success in controlling inflation and even though investment should be stimulated to sustain the economic recovery.

He welcomed the trade liberalization measures introduced in 1985, some of which were of interest to developing countries, Mr. Salehkhou remarked. However, there were still substantial restrictions, particularly on textiles and agriculture. Moreover, although most of the trade restrictions were maintained within the context of EC regulations, Germany's leadership in resisting further trade protectionism seemed to have weakened; Germany had opposed even a moderate reform of the EC Common Agricultural Policy. Finally, there had been a small decline in 1984 in Germany's official development assistance, and he hoped that the authorities' efforts to reach the UN aid target would be resumed.

Mr. Chatah considered that economic policy in Germany over the previous several years had obviously been generally appropriate. The fiscal and external sectors had performed strongly in 1984 and were expected to do so again in 1985, and the steady decline in the rate of inflation evident in 1984 was estimated to have continued in 1985. However, unemployment remained the economy's weak spot, and the growth performance, although improved, was not robust, particularly compared with performance during previous recoveries. In the circumstances, two questions naturally arose, namely, whether the present financial policy stance should be changed to deal with those problem areas, and whether enough was being done on the supply side to revitalize the economy and improve the employment picture.

He agreed with the staff that at the present stage a pronounced shift to more expansionary demand management would do more harm than good, Mr. Chatah went on. Such a shift would probably do little to solve the unemployment problem, which was basically structural, and the steady and transparent course of financial policies had benefited both the country's financial position and, just as important, had fostered a stable and predictable economic environment and increased confidence in the general outlook. Those advantages would make it easier for the authorities to make structural changes needed to revitalize the economy and deal with unemployment.

He agreed that Germany's financial policies should continue to be formulated in a medium-term framework and should not be used for short-term manipulation of aggregate demand, Mr. Chatah said. However, caution was required in setting the course of fiscal and monetary policy within that medium-term framework. In striking the proper balance between reducing the size of the public sector, cutting the fiscal deficit, and lightening the tax burden, the authorities had not placed sufficient stress on the need to alleviate the tax burden. The authorities apparently believed that successful budgetary consolidation through expenditure constraint was a prerequisite for providing substantial tax relief. The measures adopted thus far to improve incentives and reduce tax-induced distortions in investments apparently had not sufficiently improved the fiscal climate for investment, which was in many ways unfavorable by international comparison. Furthermore, the tax/GNP ratio had remained unchanged over the previous three years, and the announced tax cuts in 1986 and 1988 were projected to be roughly neutralized by the progressivity of the tax scale. Accordingly, another look at the desirable path of fiscal consolidation and tax reform seemed to be needed, particularly since the supply response to an accelerated tax reform might well absorb whatever increase in demand the associated tax cuts might generate.

Thus far the rate of monetary expansion had not been unduly restrictive, Mr. Chatah remarked. However, in setting the monetary aggregates care was needed to avoid depressing future potential output through the application of excessively restrictive monetary targets. The taking of that precaution did not involve any significant shift in policy, but potential output--however it was judged or estimated--was clearly a function of the success of the authorities' supply-side efforts. Monetary policy should take fully into account any improvement in the country's growth potential in the coming period.

The inflexibility of the labor market was reflected in two facts: unemployment had exceeded the slack in the capacity utilization, and employment and capacity utilization had recently moved in opposite directions, Mr. Chatah commented. Measures to reduce unemployment would have to deal with the structural causes of unemployment, namely, the weak investment performance and the substitution of capital for labor. Admittedly, the Government could do little to alter the pattern of private sector wages, but it had an important role to play in pushing for legal and institutional reforms that would reduce disincentives to employers to hire workers and would increase labor mobility in general. Tax reform and deregulation could also play an important role in encouraging growth and employment by stimulating business expansion. Excessive regulations, including those governing the business hours of retail services, for example, required thorough review. The authorities had recently taken steps in those areas, but they clearly needed to do more if the unemployment rate and the growth trend were to return to German historical norms.

The authorities had stated their commitment to reducing impediments to trade, and, as Mr. Grosche had stressed, open markets were the best assistance that industrial countries could provide to developing countries, Mr. Chatah remarked. However, as long as market access remained a problem for many developing countries and the growth performance of the industrial countries as a group remained tentative, increased flows of official external assistance would continue to be a significant factor in the international community's ability to deal with developing countries' payments problems in an orderly fashion. As the third largest economy within the Fund's membership, Germany had an important role to play in that regard.

Mr. Jayawardena said that he generally agreed with the staff appraisal. The authorities' domestic policies were exemplary. The economy had grown by 2.5 percent in 1984, and the rate of inflation had been kept at 2.5 percent, although unemployment had remained stubbornly high at 8 percent. Those trends were expected to be continued in 1985.

The question naturally arose whether, from a domestic perspective, the high unemployment rate was a price worth paying for the remarkable stability, Mr. Jayawardena commented. It was true that, given the generosity of unemployment compensation--which might be creating a disincentive for employment and encouraging a larger unofficial economy--the burden on the public of unemployment might not be great, but the compensation created fiscal problems, introduced strong labor market rigidities, and reduced the effectiveness of the allocative function of the market. Although the social costs of unemployment might well have been mitigated, the economic costs had been substantial.

From an international viewpoint, he wondered whether Germany's recent performance was adequate, given its responsibility as one of the major economies to promote sustained world economic recovery that would benefit itself as well as other countries, Mr. Jayawardena said. The dampening of inflationary expectations after the third consecutive year of adjustment suggested that the growth potential had increased substantially and that recent growth performance could have been better. The decline in domestic demand in 1984 and the predominant impetus to growth in that year given by foreign demand had been disquieting developments. Exogenous factors, such as the strength of the dollar, had undoubtedly contributed to that outcome, but the fiscal consolidation and tight monetary policies in Germany had also played a role. However, he would not go as far as some other Executive Directors in characterizing Germany's growing external surplus--together with that of Japan--as a major source of world strain. Those surpluses resulted primarily from other countries' policies; they did not arise basically from inappropriate policies in Germany and Japan.

The reduction in the share of government expenditure in GNP to 48 percent in 1985 was welcome, but for a market-oriented economy like Germany the ratio still seemed high, and he wondered whether the medium-term target of 45 percent was adequate; after all, the ratio had been at some 40 percent in the early 1970s, and even that figure had been considered high, Mr. Jayawardena remarked. The present expenditure pattern was undoubtedly determined partly by underlying structural characteristics, but a careful review of fiscal expenditure--for example, subsidies, which were equivalent to 5 percent of GDP--might help to generate savings. As German industry had little excess capacity, there was not much scope for straightforward stimulation of the economy, but flexibility enabling expenditure policy to be more biased in favor of strengthening investment, and revenue measures to promote domestic consumption, might prove useful. In that connection, the current program of tax cuts was welcome. The emphasis on reducing the fiscal deficit was excessive; reductions were clearly needed in the medium term but need not be the major policy concern in the short run.

Sluggish investment in Germany in recent months and the measures to save labor at the expense of the creation of new jobs were worrying, Mr. Jayawardena said. The labor market rigidities had made a major contribution to that situation, and the steps being taken to reduce those rigidities were welcome, although monetary policy seemed somewhat stringent: real interest rates apparently were very high and could represent a considerable handicap to investment. It could be argued that there were constraints on monetary policy resulting from the high priority given to the conduct of exchange rate policy. However, it would be unfortunate from an international viewpoint to restrain as powerful and strong an economy as Germany's because of deficient policies in other countries. That conclusion underscored the importance of policy coordination among industrial countries to improve the prospects for the world economy.

Germany had always maintained a solid commitment to free trade despite the apparently intractable pressures within the European Communities to preserve protectionist barriers, Mr. Jayawardena remarked. Germany should take firm initiatives within the European Communities to reduce those barriers and to meet its obligations under the GATT. Calling for further international action on protection and tariffs while existing commitments remained unfulfilled suggested that there was a chasm between talk and action.

Germany had been among the largest providers of official development assistance, and rightly so, given its position in the world economy, Mr. Jayawardena commented. The aid commitment was welcome, and the authorities should be urged to increase it. Their efforts would help developing countries, thereby increasing the demand for goods produced in Germany and other industrial countries. An increased aid role for Germany would be facilitated by the country's large and growing external current account surplus.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/117 (7/31/85) and EBM/85/118 (8/2/85).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director aas set forth in EBAP/85/198 (7/30/85) and by Advisors to Executive Directors as set forth in EBAP/85/200 (7/31/85) is approved.

3. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/85/203 (8/1/85) is approved.

APPROVED: May 2, 1986

LEO VAN HOUTVEN
Secretary