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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/119

3:00 p.m., August 2, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	M. K. Bush
	H. G. Schneider
	S. de Forges, Temporary
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
	G. W. K. Pickering, Temporary
A. Kafka	
H. Lundstrom	
	P. E. Archibong, Temporary
	B. Jensen
	E. M. Taha, Temporary
P. Pérez	
J. J. Polak	
	A. V. Romuáldez
	A. A. Agah, Temporary
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Yang W., Temporary

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

Also Present

European Department: L. A. Whittome, Counsellor and Director; B. E. Rose, Deputy Director; B. Christensen, J. Delbeche, P. Dhonte, A. Fidjestol, L. S. Lipschitz, S. Mitra, D. C. L. Nellor, G. Szapary, R. G. Thumann. Exchange and Trade Relations Department: J. T. Boorman, A. B. Petersen, R. Pownall. Fiscal Affairs Department: A. H. Mansur. IMF Institute: U. Tun Wai, Deputy Director; H. J. Bauer, Participant. Legal Department: G. Nicoletopoulos, Director; W. E. Holder. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; F. B. Larsen. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, J. Hospedales, T. Sirivedhin, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: W.-R. Bengs, J. de la Herrân, R. Fox, V. Govindarajan, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, S. Kolb, K. Murakami, M. Rasyid, A. A. Scholten, B. D. White, A. Yasseri.

1. FEDERAL REPUBLIC OF GERMANY - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/118, 8/2/85) their consideration of 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).

The Deputy Director of the European Department remarked that domestic consumption had been weak because the growth of incomes had been slow as a result of the long period of wage restraint and the decline in employment. The staff had noted that, on the basis of current projections, domestic demand would continue to be weak in 1985, growing by just 1 1/2 percent, but would strengthen significantly in 1986, rising by 2 1/2 percent. An important goal was to maintain the momentum of domestic demand beyond 1986.

The concern among Executive Directors owing to the size of Germany's external current account surplus was surprising: the present surplus was not large by historical standards, and the surplus in 1984 had been only a little larger than the long-term capital outflow, the Deputy Director commented. Even more important, the strength of the current account was drawn mainly from Germany's strong competitive position, which in turn was due primarily to the strict control of domestic costs. Of course, no one would wish to suggest that the German authorities should encourage an increase in domestic costs to reduce the current account surplus. Moreover, the authorities had not deliberately limited the growth of domestic demand in order to widen the current account surplus. Their principal objective was to maintain a low rate of inflation, and they were convinced that economic growth in Germany had been limited by supply constraints, not by demand management measures. In sum, the staff felt that, while the external current account surplus had been a source of controversy in the late 1970s, it was not a cause for concern at present. In fact, the increase in Germany's trade surplus with the United States had accounted for almost all the increase in the total trade surplus in 1984.

In considering the effect of Germany's current account surplus on developing countries, Executive Directors should note that Germany's current account deficit with the non-OPEC developing countries had increased by nearly DM 3 billion in 1984, to DM 6 1/2 billion, the Deputy Director continued. It could of course be argued that Germany's deficit with the developing countries in 1984 should have been increased even further, but there was no evidence that the increase in Germany's current account surplus had placed a burden on the developing countries.

The staff did not have a view on the equilibrium rate between the dollar and the deutsche mark, the Deputy Director said, but considered that the present rate was not a cause for concern. The staff would regard some further appreciation of the deutsche mark with equanimity.

The statement on page 19 that the causes of the depreciation of the deutsche mark were not to be found in Germany was a reflection of the fact that the recent developments in Germany were atypical of a country with a depreciating exchange rate, the Deputy Director observed. After all, Germany had a large external current account surplus, a very low rate of inflation, a fiscal deficit that some Executive Directors felt was excessively small, and a monetary policy that some Executive Directors considered excessively tight.

There were three main fiscal issues, namely, expenditure restraint, consolidation, and the budget position, the Deputy Director remarked. Executive Directors seemed to accept the authorities' policy of reducing the rate of growth of expenditure. As to the budget position, the staff was aware of no precise target for the position of the General Government by 1989, although in his opening statement Mr. Grosche had mentioned projections for the deficit of the Federal Government through 1989.

The political situation was a practical constraint on further income tax reductions; any proposal to advance the tax cut scheduled for 1986 would require parliamentary approval, the Deputy Director explained. Some time would be needed to call an emergency session of Parliament and consider a proposal, and by then the extent to which the cut could be advanced probably would not be worthwhile. The possibility of advancing the 1988 tax cut to 1986 had been the subject of protracted and heated debate before the 1985 Article IV consultation discussions. The present tax reduction schedule was the only one on which it had been possible to reach agreement in both houses of Parliament, and he doubted whether the political leadership would wish to reopen the debate. In that connection, it was important to remember that 42.5 percent of the cost of the agreed income tax reduction was borne by the Länder. The political makeup of the Bundestag differed from that of the Bundesrat, and a measure could not pass both houses without the support of a majority of the Länder. The staff and the authorities had not discussed the possibility of bringing forward the 1988 tax cut to 1987; presumably, it was one of the options available to the Government if economic conditions warranted its use.

The staff had not meant to imply that capital expenditure was necessarily superior to current expenditure, the Deputy Director remarked. There was of course always a danger of directing investment resources toward inefficient projects. The German authorities were trying to encourage municipal investment in projects that would enhance productive potential; they did not favor virtually any public investment merely for the sake of increasing employment. In 1984, there had been a sudden surge in public consumption due mainly to substantial overruns on health costs within the social security system. The authorities were concerned about the rapid rate of increase in health expenditures and their apparent inability to halt that trend.

The level of subsidies was high, partly because the subsidies were so transparent: they included not only expenditure subsidies, but also tax preference subsidies, the Deputy Director continued. The subsidies that in principle seemed the most likely target of an effort to cut overall subsidies were those for agriculture and declining industries such as mining, shipbuilding, and steel. A disproportionately large share of agricultural subsidies was allocated to major producers and encouraged production; the authorities might wish to find ways of supporting farm income that did not provide such encouragement. As to the steel subsidies, the German authorities were fully prepared to eliminate them by the end of 1986 provided that comparable subsidies within the rest of the EC were also removed. That matter was still being negotiated, and the outcome was unclear. On the whole, the staff preferred to see the authorities eliminate the tax preference subsidies, which were much less transparent than expenditure subsidies.

In suggesting that a fiscal deficit of 2 percent of GNP would stabilize the debt stock ratio, the staff had been aware that it was also suggesting that interest payments as a percentage of GNP would be stabilized as well, the Deputy Director commented. The German authorities usually specified interest payments as a percentage of public expenditure, and the most commonly quoted relevant figure was federal interest payments as a percentage of federal expenditure; that figure had been provided in the staff report. There were arithmetical oddities about the comparison between interest payments and public expenditure. The authorities had not wished to be tied to any formal quantitative target in the fiscal field.

The question had been raised whether fiscal policy could be used to promote domestic investment, the Deputy Director recalled. The staff would not wish to see the authorities introduce a variety of special tax schemes to encourage investment; such measures would merely encourage a misallocation of resources. Business taxes had been cut in 1983 and 1984, and the authorities had stated that, in addition to the tax cuts already scheduled for 1988, they expected to seek further reductions in business taxes.

Commenting on the potential usefulness of a restructuring of taxes, the Deputy Director noted that the authorities had not considered making greater use of the value-added tax (VAT) to increase the scope for reducing the high rates of marginal income tax. The Council of Economic Experts had underscored the important revenue role played by excise taxes on petroleum, liquor, and tobacco. The authorities apparently preferred specific taxes to an ad valorem tax because the latter was thought to have connotations of indexation. If excise tax rates were revised to reflect the inflation over the previous five years, the authorities could raise roughly DM 5 billion in additional revenues that could be used to make room for income tax cuts. That approach was acceptable to the staff but had not been discussed with the authorities.

The staff did not believe that monetary policy was excessively tight, the Deputy Director said. Nominal interest rates were falling: the long-term nominal rate had fallen from 8 percent in mid-1984 to 7 percent at the end of that year and to 6.4 percent at present; short-term nominal rates also were falling. In addition, real interest rates had declined, although still high by historical standards. One German official had noted that, assuming that inflationary expectations were 1 percentage point higher than the actual rate of inflation, real interest rates were at roughly the historical norm. It seemed safe to conclude that, in a period of steadily declining inflation, inflationary expectations followed--rather than preceded--the actual rate of inflation.

The rate of economic growth was unlikely to accelerate significantly in 1985, the Deputy Director remarked. There was no evidence suggesting that an increase of, say, 1 percentage point in the monetary growth target would cause more rapid real economic growth than the existing target. An unexpectedly large increase in the rate of economic growth presumably would be reflected rather quickly in the behavior of interest rates; in that event, it would be up to the monetary authorities to reconsider their policy stand. German monetary policy continued to be based on the same considerations that had prevailed for several years. The change in U.S. monetary policy had not yet affected monetary policy in Germany.

The staff fully endorsed Executive Directors' call for more forceful action to eliminate the labor market rigidities, the Deputy Director commented. The staff and the authorities agreed on the significance of the supply rigidities; the more that could be done to reduce those rigidities, the better. Over the previous several years, unit labor costs had fallen significantly and the formerly substantial wage gap had significantly narrowed. A number of legislative steps had been taken to deal with the supply rigidities, but additional measures were obviously needed. Mr. Schneider had correctly noted that it was important to bear in mind that while subsidies impeded economic efficiency, they were designed to meet desirable social and political objectives. However, there was some danger in giving excessive weight to the social factors. German firms that employed only six persons had to make sizable redundancy payments; even more substantial redundancy payments were required of firms that employed just 20 persons. In many cases the redundancy payments ranged from DM 10,000 to DM 50,000 per worker. Attention also should be paid to nonwage costs, although that consideration raised the larger issue of the benefits and financing of the social security system.

The staff agreed with Mr. Lundstrom that easing the supply constraints was not a sufficient condition for obtaining faster economic growth, the Deputy Director said. Easing those constraints was necessary in that connection, but it would have to be accompanied by appropriate fiscal policy measures.

As Mr. Dallara had noted, Table 5 in SM/85/204 showed that Germany's employment record in 1973-82 had been poor compared with that of the United States, Japan, and France, the Deputy Director remarked. In assessing that record, Directors should note that population and labor supply growth in the United States, Japan, and France had considerably exceeded that in Germany; indeed, the U.S. labor supply had grown by nearly a fourth while the supply of labor in Germany had grown only a little. Moreover, productivity growth in services in Germany had greatly exceeded that of France, Japan, and particularly the United States.

Germany had vetoed the proposed reduction in the price of cereals within the EC because the income of German farmers had fallen substantially--by 18 percent--in 1984 and the authorities had felt that it would be inappropriate to agree to any further weakening of German farm income in that year, the Deputy Director said. The acceleration of the Tokyo Round was welcome, although its actual impact would not be substantial. The agreement among the EC member countries would merely accelerate by one year the tariff cuts of about one third on certain items, which were being made over eight years.

Failure by the U.S. authorities to reduce the major imbalances in the U.S. economy would have unfavorable implications for Germany, the Deputy Director commented. The recent movement in the deutsche mark/dollar exchange rate had not affected German monetary policy; the Bundesbank Council had reaffirmed its stabilization course at a meeting held in July 1985. The sharp appreciation of the deutsche mark against the dollar in recent months had followed a sizable depreciation in earlier months.

One of the more important policy questions was whether Germany could make a greater effort to pick up the slack should U.S. economic growth slow and remain low, the Deputy Director commented. In his view, Germany should--for its own sake and because it was the third largest economy in the Fund's membership--always aim for the highest rate of economic growth that could be sustained in the medium run; and it should do so irrespective of growth rates in the United States or any other country.

It was difficult to estimate with any great confidence how a slackening of economic growth in the United States would affect the German economy, the Deputy Director said. As Mr. de Maulde had noted, German enterprises were quite profitable and were unlikely to suffer any significant loss in market shares in the event of a moderate slowing of growth in the United States. Nevertheless, a slow rate of U.S. economic growth over a long period presumably would adversely affect Germany through its balance of payments; the large trade imbalance between Germany and the United States suggested how significant that effect on Germany could be. However, it was important to remember that the weight--about 8 percent--of Germany's economy in the OECD area was much smaller than the U.S. economy's weight of some 40 percent. Hence, it was unrealistic to assume that Germany alone could offset the slack in the world economy owing to the slowing of growth in the United States.

There was no sign that the recent appreciation of the deutsche mark was likely to weaken Germany's external current account, the Deputy Director from the European Department remarked. The balance of payments surplus in the first five months of 1985 was in line with the staff's forecast doubling of the surplus for the full year 1985. However, in the coming period, it would be important to pay attention to average exchange rate movements; the behavior of rates in the immediate past had perhaps been somewhat deceptive.

The staff representative from the European Department commented that there were a number of ways of calculating productive potential, none of which was entirely satisfactory. One measure of the crude growth of productive potential was the sum of the trend growth of labor productivity and that of the labor force. The growth of productivity in Germany had been 22 percent and that of the labor force about 0.1 percent per annum in the decade to 1984; the sum of 2.3 percent was surprisingly close to the Bundesbank's estimate of productive potential growth--about 2.1 percent--which had been taken into account in setting the present monetary target.

The staff's rough calculation, based on production functions estimated prior to the 1985 Article IV consultation discussions, had yielded a rate of growth of productive potential in the decade to 1984 of about 2 1/2 percent, the staff representative from the European Department confirmed. It was difficult to measure the appropriate capital stock and supply of usable labor to use in that calculation; the staff estimates had not made any allowance for an increase in the proportion of the labor force that might be unemployable at current factor costs. More detailed estimates by the German Council of Economic Experts and the Bundesbank had arrived at an increase in productive potential in the range of 1.5-2.1 percent. That range was not large, and the figure used to calculate the monetary growth target was close to a central estimate.

Mr. Zecchini said that it was worthwhile advancing the date of the implementation of certain fiscal measures, even if by just one quarter. Speeding up the planned tax cuts in Germany would clearly be helpful.

The staff report could have usefully included an analysis of the functional structure of public expenditure in Germany, Mr. Zecchini considered. Such analysis should be a feature of the staff report for the next Article IV consultation with Germany for two reasons: certain demand multiplier effects should be scrutinized more carefully than they had been in the present staff report, and the supply-side impact of public expenditure should be assessed more fully as well.

Since the staff's projection of GNP growth in 1984 was more or less in line with the actual outcome, the reduction of the target for the growth of the monetary aggregates for 1985 naturally implied some tightening of monetary policy, Mr. Zecchini said. The authorities should not limit monetary expansion to the lower part of the target range if there were no basic shift in the demand for money. In addition, under the authorities' approach to monetary policy, the nominal growth of GDP was a strategic variable in setting monetary aggregates, and he was convinced that if there were a decline in the rate of inflation in Germany owing to the movement in the exchange rate--in other words, if the external impetus to domestic inflation in Germany were to decline--setting the growth target for the monetary aggregates in line with expected GNP growth would create additional room for real economic growth.

The Deputy Director of the European Department remarked that the staff agreed with Mr. Zecchini's point about the reduction of the target for the growth of monetary aggregates. One of the difficulties in discussing German monetary matters in 1985 was knowing whether to concentrate on the monetary targets or the actual rate of monetary expansion. The Bundesbank's position was in a sense paradoxical: the authorities had reduced the monetary expansion target by 1 percentage point but had also said that they intended to keep the actual rate of expansion unchanged. The likely net effect of the authorities' intentions was difficult to foresee. The authorities had mentioned that the reduction of the monetary growth target was expected to have a favorable effect on wages. The staff had responded to that argument by stressing that the most important aspect of monetary policy was the actual rate of monetary expansion. In any event, the staff fully agreed that it was obviously undesirable to limit monetary expansion to the lower half of the target range. That outcome would clearly endanger future economic growth in Germany. The staff also agreed with Mr. Zecchini that if the rate of inflation were to slow--as a result, for example, of exchange rate movements--there would be greater room for real economic growth.

Mr. Dallara said that he was surprised by the staff's suggestion that U.S. monetary policy as well as interest rate and exchange rate developments in the United States--which played a part in the functioning of U.S. monetary policy--were not taken into account by the German authorities in the formulation and implementation of their monetary policy. German officials had often said that the room for maneuver in formulating Germany's monetary policy was guided--perhaps even significantly shaped--by U.S. economic developments, particularly exchange rate, interest rate, and monetary policy developments. In early 1985, when the dollar had been appreciating strongly, the German monetary authorities had clearly given the impression that their attitude toward interest rates in Germany was affected substantially by exchange rate developments and thereby indirectly by U.S. monetary policy and interest rate developments.

The Deputy Director of the European Department responded that the recent change in U.S. monetary policy had presumably been taken into account by the German monetary authorities. However, at its midyear review meeting in July 1985, the Bundesbank Council had reaffirmed the current monetary policy course. As to the particular developments in Germany mentioned by Mr. Dallara, they were an interesting example of the complicated nature of German monetary matters. In early 1985, there had certainly been an expectation in German markets that German monetary policy would be tightened, and, as a result, there had been a sharp rise in interest rates in Germany. That rise had not been induced by policies adopted by the authorities; indeed, there had been no change in Germany's underlying monetary policy. The authorities would probably have made a policy response if the rise in interest rates had persisted; a policy response was not always forthcoming in the very short run.

Responding to a question, the Deputy Director of the European Department noted that the German medium-term bond rate had increased from approximately 7 percent at the end of 1984 to 7.5 percent on March 20, 1985; the comparable U.S. rate had risen from 11 percent to 11.5 percent. Between March 20 and June 5, 1985, the U.S. rate had declined sharply--from 11.5 percent to 9.3 percent--while the German rate had fallen back to 6.9 percent. In sum, there had been a sharp narrowing of the interest rate differential between Germany and the United States. Between early June and late July 1985, the German interest rate had fallen by a further 0.5 percent to 6.4 percent while the U.S. rate had risen to 9.9 percent, thereby again somewhat widening the differential. As to short-term interest rates, the relevant German rate in late 1984 had been 5.8 percent, compared with 8.2 percent in the United States. The differential had widened slightly by March 1985, when the German and U.S. rates had been 6.3 percent and 9.1 percent, respectively. The gap had narrowed sharply by June 1985, when the short-term rates had been 5.7 percent in Germany and 7.4 percent in the United States. By July 1985, the gap had widened again, as the German rate had fallen to 5.1 percent while the U.S. rate had risen to 7.8 percent. The fluctuations in the differential were difficult to explain. The basic pattern seemed to be a sharp movement in interest rates on dollar assets and a similar fluctuation in German interest rates for one month followed by a slight reversal of the German rates toward their earlier position; as a result, over time German rates tended to vary less strongly than U.S. rates.

Mr. Pickering commented that the external current account deficit of the United States, which was equivalent to about 2 percent of GNP, was obviously felt by the staff to be a cause for concern. He wondered why Germany's current account surplus, which was approaching 2 percent of GNP, was not also thought to be worrying. How large would Germany's surplus have to become before it was considered a problem in the eyes of the staff?

The Deputy Director of the European Department said that in financial terms a current account surplus was of course easier to handle than a deficit. Moreover, if other countries maintained adjustment policies as strict as Germany's, the German current account surplus would probably disappear; that scenario would certainly be acceptable to the German authorities. If they were to decide for whatever reason that they must reduce the current account surplus, they would have to maintain a much different policy concerning the dollar/deutsche rate with a view to achieving an appreciation of the deutsche mark. At present, the exchange rate was determined by market forces, which reflected capital movements as well as current account positions. The authorities would have to reconsider their position within the EMS, which was intended to maintain stable conditions in Germany's main markets. In addition, the authorities could inflate the economy, a course that would eliminate the external current account surplus but only at a substantial cost to the stability of the economy.

Mr. Dallara commented that the German authorities were clearly concerned about the implications of the U.S. external current account position and national debt for Germany's external position. The positions of the two countries were not fully symmetrical, but the issue of the mutual concerns about those positions was a real one.

Mr. Zecchini said that he doubted whether Germany's external current account surplus would disappear if the rest of the world were to introduce adjustment measures as stringent as Germany's. While in theory the adjustment would be symmetrical, in practice there would be a tendency toward competitive adjustment measures among countries, which would exert a deflationary pressure on the world economy.

Mr. Grosche remarked that Germany's steady although unspectacular growth in 1985 of 2 1/2-3 percent was a solid accomplishment given Germany's high level of income and lack of population growth. That economic growth had been accompanied by stable prices and had not been induced by expansionary demand policies suggested that the recovery was based on a firm foundation and was sustainable. Although Germany's economic performance was important from an international--and particularly a European--viewpoint, not too much should be expected from the effects of accelerated growth in Germany on the economies of developing countries. Even if Germany's productive potential enabled it to accelerate economic growth by, say, 1 percentage point without rekindling inflation, Germany could not offset the effects of a possible slackening of the U.S. economic recovery in general and of a slowing of U.S. import growth from developing countries in particular. Although in 1984 Germany's imports from developing countries, excluding OPEC countries, had grown by nearly 19 percent, and although Germany's deficit with those countries had increased substantially, imports from those countries represented merely 10 percent of German imports. Latin America's share in Germany's total imports in 1984 had been merely 3 percent--$4 1/2 billion--just one third of Germany's imports from France alone. Accordingly, in seeking to expand exports to deal with their debt problems, Latin American countries would have to continue to rely heavily upon the U.S. market.

He agreed that Germany's economic recovery should be more broadly based, Mr. Grosche continued. The increase in Germany's external current account surplus could be explained largely by the growth of Germany's trade surplus with the United States. Thus, Germany's surplus would likely decline as the United States reduced its trade and current account deficits. Germany accepted that such a decline as the main burden of adjusting global imbalances would have to fall on Europe and Japan; a large number of developing countries would have little room in which to expand their external deficits for some time. At the same time, Germany's domestic consumption and investment would certainly benefit from a successful effort by the United States to improve its fiscal and external position, and thereby reduce interest rates further. There were already signs that economic growth in Germany was becoming increasingly less dependent on the external sector, and lower interest rates in Germany could only foster that development.

In assessing the scope in Germany for a more expansionary fiscal policy, Executive Directors should not overestimate the country's fiscal performance, Mr. Grosche commented. After all, even though the overall fiscal deficit was still falling, the federal deficit was no longer declining. The authorities would have to make a considerable effort to reach the figures for the budget deficit projected in the medium-term financial plan that he had mentioned in his opening statement, particularly in the light of high transfer payments, especially to the pension and health insurance schemes.

The overall fiscal situation at the state and local level was excellent, but the position of individual Länder and municipalities varied considerably, Mr. Grosche went on. The Minister of Finance had had difficulty in convincing a majority of the Länder to accept a tax cut; in fact, he had been able to gain their approval only of a two-step approach to the cuts. The Länder usually asked to receive a large proportion of tax increases but asked the Government to bear the burden of tax cuts. A one-step tax cut would have required a greater concession by the Government to the Länder than the two-step approach finally agreed, which had cost the Government 1/2 of 1 percent of the VAT revenues that were given to the local governments in addition to their already high share of total revenues. Even more significant, a one-step approach would have increased the federal deficit and would have severely undermined the credibility of the Government's fiscal consolidation policy while increasing interest payments on the federal debt in the future above the already large amount. The approval of the two-step tax cut was not the last part of the new tax policy; a major overhaul of the income tax system was being prepared for consideration during the next legislative session, when economic growth and progress in fiscal consolidation should permit the authorities to take further steps affecting taxes. They were reluctant to finance the reform of the income tax system through an increase in the VAT, which was already substantial.

The authorities believed that public investment expenditure should be increased, Mr. Grosche commented. However, the share of public investment in the federal budget was fairly small, and the effort to increase total public investment would depend upon the efforts of the Länder and particularly the municipalities. In that connection, developments thus far in 1985 were encouraging: the measures recently announced by the Government to support investment demand at the local level should contribute to an increase in construction demand in coming years and showed that the federal authorities were ready to introduce appropriate fiscal measures when the need for them arose.

It was true that, although the rate of inflation had fallen to about 2 percent, unemployment still exceeded 2,000,000 persons, Mr. Grosche remarked. Reflating the economy could improve employment but only temporarily, as it would not deal with the underlying supply-side problems. Germany, like other European countries, had inflexible labor markets that kept actual wages in excess of market-clearing wages, particularly in the lower pay ranges. In practice, wages had reflected income expectations rather than the rate of unemployment. The adverse effects of excessive real wages had been exacerbated by the tendency in Germany--as in other European countries--to tax labor and subsidize capital investment. That practice had encouraged companies to replace labor with capital and to shift output to less labor-intensive items. Although business investment as a proportion of GNP had been larger in Europe than in the United States over the previous ten years, it had not been either sufficiently large or appropriately designed to boost output and employment. An excessive share of business investment had been aimed at cutting labor costs. Fortunately, those trends seemed to be gradually changing in Germany, as the decline in real labor costs and the rise in profits had encouraged job-creating investment. However, there was still a long way to go: markets must react more flexibly; and since the Government did not interfere in collective bargaining, the social partners must respond more fully to the problem of unemployment in setting market-oriented wages. The Government was encouraging that process: industry and labor had recently accepted an invitation by the Federal Chancellor to discuss the steps that government, labor, and industry could take jointly to reduce unemployment; and the Government itself had already pruned social spending, cut taxes, transfered state ownership to the private sector, and encouraged the adoption of an employment promotion law.

The Government was determined to continue its efforts to promote tax reform, help young persons to find employment, reduce rigidities in the labor market, and encourage greater wage differentiation to reflect skill, sectoral, and regional differences, Mr. Grosche commented. The authorities were convinced that the coming period would not be an easy one. The social security system would likely come under heavy strain because of demographic developments that would place upward pressure on pensions and health care expenditures. Those trends would push up labor costs and would place an additional burden on the Government and enterprises; the conflict between high labor costs and the goal of creating new employment opportunities could not be expected to disappear soon.

Responding to a further question, Mr. Grosche commented that industrial countries could--and should--assist developing countries by maintaining open markets and increasing their official development assistance as well as by achieving sustainable economic growth. But because of their small share, an increase of 1 or 2 percent in the rate of growth in Germany would trigger only a minor rise in German imports from developing countries.

The Chairman made the following summing up:

Executive Directors commended the German authorities on the steady and consistent stance of policies that had been maintained. These policies had been instrumental in reducing the rate of inflation to a very low level in 1984, at the same time as the rate of growth of real GNP had doubled. Real growth was expected, however, to remain at about the same rate in 1985, which a number of Directors felt was rather subdued. Directors voiced concerns about the structure of demand and focused on the appropriate stance of financial policies, taking into account the changing world economic outlook and the international repercussions of German economic policy. In addition, Directors concentrated on the supply constraints flowing, in particular, from labor market rigidities, which were closely related to the persistence of the seemingly intractable high unemployment.

Directors noted that domestic demand had weakened slightly in 1984 and that the acceleration in the growth of output had been due to a strengthening of the foreign balance. Similarly, in 1985, a substantial part of the projected growth in real output of 2 1/2 percent was expected to result from a further improvement in the foreign balance. Directors generally emphasized that, in the medium term, growth in Germany ought not to depend to so great an extent on foreign demand. In this context, while there was general support for the medium-term orientation of financial policies, Directors thought that, even within this medium-term framework, there was both scope and need for directing policies toward strengthening domestic demand. However, Directors did not suggest a shift to more stimulatory short-term demand management.

On monetary policy, while there were some questions as to whether the reduction in the target range for 1985 had been warranted, a number of Directors thought that monetary growth in the upper part of the 3-5 percent range would be sufficient to accommodate the projected growth of real output; it was also noted that the recent change in the dollar/deutsche mark relationship should in itself facilitate an easing of monetary conditions in Germany. It was pointed out that interest rates in Germany had fallen since the first quarter and that any lowering of interest rates abroad would continue to be helpful in reducing interest rates in Germany. Some Directors remarked that over the recent weeks there had been some widening of interest rate differentials vis-à-vis the United States.

On fiscal policy, Directors welcomed the lowering of the ratio of government expenditure to GNP that had occurred, and supported the objective of a progressive further reduction of the share of government in the economy over the medium term. This aspect of fiscal consolidation was generally thought to be essential to a durable recovery of private output and employment. Directors also supported the Government's objective of shifting expenditure into areas that will enhance productive potential and hoped that more rapid progress in this respect would be possible. Indeed, many Directors expressed their disappointment at the lack of progress in reducing subsidies, the failure to hold public consumption to the projected level in 1984, and the extent to which public investment had been reduced in recent years.

All Directors regarded the halving of the general government deficit in proportion to GNP since 1981 as a considerable achievement. They thought, however, that the size of the present deficit--less than 2 percent of GNP--was not a major cause for concern, and the strong view of the Board was that greater priority should now be attached to reducing tax rates rather than to a further reduction in the overall deficit. In this connection, Directors welcomed the planned reduction in income tax scheduled for 1986 and 1988. Most thought, however, that more could be done, for example, through an accelerated schedule, in order to strengthen domestic demand and to broaden the base of the economic expansion.

Directors emphasized the critical importance for faster growth of an easing of constraints on supply. Particular attention was devoted to rigidities in the labor market, with Directors welcoming the measures that had been taken while recognizing the need for further action. While it was acknowledged that certain labor market rigidities--such as, for example, inadequate wage differentiation--were largely beyond the limits of direct governmental action, Directors stressed that more rapid progress on this front would help to enhance productive potential and was essential to a sustainable reduction in unemployment. The recently enacted legislation on the promotion of employment was welcomed, but it was observed that more needed to be done to increase flexibility in the labor market.

While Directors recognized the importance of supply-side measures, they thought that these measures needed to be supported by appropriate financial policies, including tax reductions. Directors emphasized that such action should not put at risk price stability and the fiscal consolidation in the medium term. However, the discussion clearly indicated that Directors hoped that Germany would be willing to adjust its policies in a manner that would over time strengthen domestic demand and remain consistent with the needs of the world economy.

Directors generally welcomed the liberalization of the capital market that had occurred in Germany and German support for a new round of GATT talks on trade. It was hoped that Germany would be able to play a leading role in reducing both national and EC restrictions and subsidies, particularly in sensitive areas, such as textiles, steel, and coal. Many Directors expressed their disappointment that Germany had resisted a modest reduction in prices for cereals within the context of the Common Agricultural Policy and hoped that this did not constitute a backing away from the free-trade principles that Germany had generally espoused. It was also noted that German official development assistance had fallen slightly, and several Directors expressed the hope that this reduction would quickly be reversed.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/118 (8/2/85) and EBM/85/119 (8/2/85).

2. GULF COOPERATION COUNCIL (GCC) - TECHNICAL ASSISTANCE

In response to a request from the Gulf Cooperation Council (GCC) for short-term technical assistance in fiscal policy coordination, the Executive Board approves the proposal set forth in EBD/85/198 (7/30/85).

Adopted August 2, 1985

3. AUDIT REPORT, 1985 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the proposed letter set forth in EBAP/85/189 (7/23/85) transmitting, for consideration by the Board of Governors, the Report of the External Audit Committee for the financial year ended April 30, 1985. (EBAP/85/189, Sup. 1, 7/25/85)

Adopted August 2, 1985

APPROVED: May 5, 1986

LEO VAN HOUTVEN
Secretary