November 2000
IMF Staff Country Report No. 00/141

Germany: 2000 Article IV Consultation—Staff Report; Statement by Staff Representative; and Public Information Notice Following Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 3, 2000,** with the officials of Germany on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 2, 2000.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement **of October 23, 2000**, updating information on recent economic developments.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the October 23, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

A Selected Issues report prepared by IMF staff as background to the Article IV staff report has been separately released.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives
for the 2000 Consultation with Germany

Approved by Michael Deppler and G. Russell Kincaid

October 2, 2000

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I. Introduction, Summary, and Key Issues

1. This year's staff report on Germany focuses on the requirements for sustaining output growth and lowering unemployment—a theme shared with concurrent reports for the euro area and other associated bilateral consultations. Germany's contribution is crucial given its size and leadership role in the euro area, but its growth and labor market record for the last three decades has been discouraging and calls for policy changes to tackle structural rigidities. For the most part these changes involve specifically German institutions and must be molded at the domestic level. The consultation discussions concentrated on these issues.

2. At the conclusion of the **last consultation** with Germany (EBM/99/117), Directors agreed that in view of the improved external environment and the authorities' steps to clarify and strengthen fiscal policy, Germany's short-term economic outlook appeared reasonably bright. Some Directors considered, however, that greater attention needed to be paid to short-term macroeconomic risks from a possible sharp equity correction in the United States and associated exchange market turmoil. Moreover, most Directors cautioned that longstanding structural weaknesses—particularly in the labor market—needed to be addressed to avoid a repetition of past cyclical patterns and assure favorable medium-term prospects. They called for a strengthening of employment incentives, emphasizing increased wage and employment flexibility, lower social contributions for lower-paid workers, tighter eligibility requirements for social benefits, and a more diversified social insurance system.

3. In the past year, the economic upswing has gathered momentum, and short-term economic prospects are the most favorable in a decade. But it is an open question whether this cyclical strength will form a launch pad for sustained robust growth, or whether instead Germany's history of cyclical disappointments, rooted in structural rigidities, will reassert itself. Much depends on policies. In the discussions,[1,2] the staff emphasized the importance

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[1] The discussions took place in Berlin, Frankfurt, and Wiesbaden during June 21-July 3, 2000. Meetings were held with State Finance Secretary Koch-Weser, Bundesbank President Welteke, and other senior officials of the Ministries of Finance, Economy, and Labor, the Bundesbank, the Federal Banking Supervision Office, the Federal Statistical Office, the Council of Economic Experts, financial institutions, research institutes, and the social partners. Messrs. Esdar (Executive Director) or Donecker (Alternate Executive Director) attended most meetings. The team comprised Ms. Schadler (Head), Mr. Fetherston, Mr. Jaeger, Ms. Kodres, Ms. Kollau (all EU1), and Mr. Keen (FAD). Germany volunteered to participate in the pilot project, and the last staff report was published thereunder in November 1999 as IMF Staff Country Report 99/129. The authorities intend to publish this year's staff report; they also for the first time released the mission's concluding statement.

[2] Germany has traditionally published timely and high-quality economic statistics and provides data that are adequate for Fund surveillance (Appendix III). Germany has subscribed to the Fund's Special Data Dissemination Standard. Germany is an Article VIII

(continued...)

of using the favorable economic situation to make headway on structural reform and strengthen public finances. The authorities endorsed these broad principles and are moving ahead in some key areas, notably tax and pension reform. But their labor market strategy, which focuses on encouraging across-the-board wage moderation rather than institutional reform, is in the staff's view unlikely to be sustainable and does not tackle the rigidities that have long hindered Germany's economic performance.

II. Background

4. **The propitious current economic setting stands in sharp contrast to the disappointing growth and labor market performance of the last decade.** Since the unification boom and bust in the early 1990s, real GDP growth has averaged less than 2 percent (Figure 1). In per capita terms, this compares unfavorably to Germany's euro-area partners and, most strikingly, the United States (Figure 2). Output weakness was particularly persistent in manufacturing, where labor cost competitiveness deteriorated during the unification boom and was only restored after a prolonged labor shakeout (Figure 3). Also, construction has been plagued by the hangover from excessive building activity in the first half of the 1990s. Labor market performance—declining employment and rising unemployment for most of the period—lagged well behind not only the United States but also continental neighbors such as Denmark, the Netherlands, and (on employment growth) France (Figures 4 and 5). The 1990s performance, while clearly hurt by unification strains, was only the most anemic in a series of weak upswings attributable to structural rigidities, especially in the labor market: each cycle since the early 1970s has been marked by slow growth for much of the recovery phase, rapid expansion only briefly in the final stage of the upswing, and a massive labor shakeout in the downturn (Figures 6 and 7).

5. **Fueled by a surge in exports starting in mid-1999, activity has picked up strongly over the past year (Figure 8).** Beyond the improvement in global conditions, the weakness of the euro has played a key role.[3] The recovery has been supported more recently by investment in machinery and equipment (Figure 10). Manufacturing activity has benefited particularly and capacity utilization and business confidence are near earlier cyclical peaks[4]

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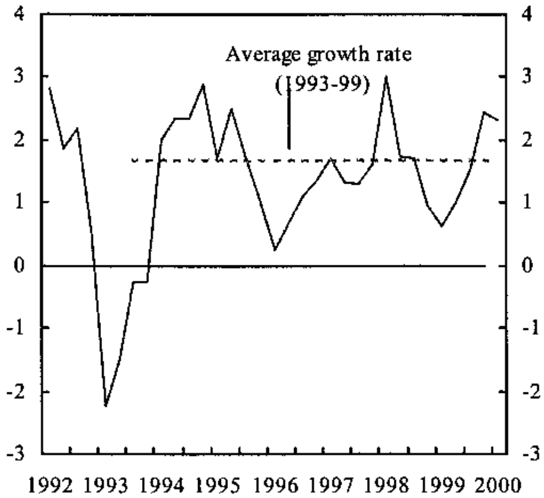
member and, apart from security restrictions noted in Appendix II, maintains an exchange system free of restrictions.

[3] As the euro weakened, Germany's real effective exchange rate (in terms of competitors both in and out of the euro area) depreciated during January 1999-August 2000 by about 9 percent to levels last seen in the early 1990s (Figure 9). Against other euro area countries, Germany's cost competitiveness has strengthened modestly in recent years, largely offsetting what the staff estimates as a small overvaluation at the time of EMU entry.

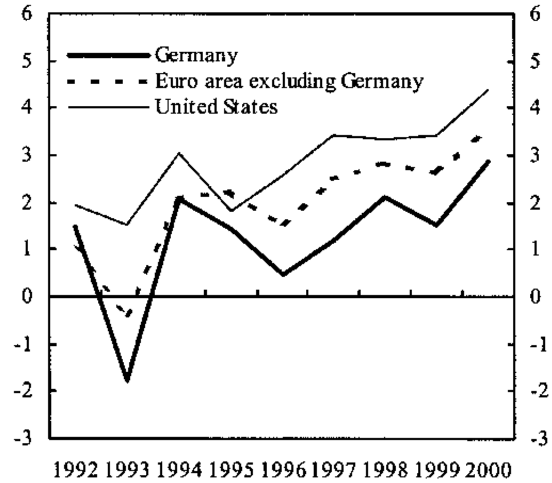
[4] In May 2000 the Ifo business climate index reached its highest level since 1991 before falling back slightly during the summer months.

Figure 1. Germany: Real GDP Growth, 1992-2000 1/



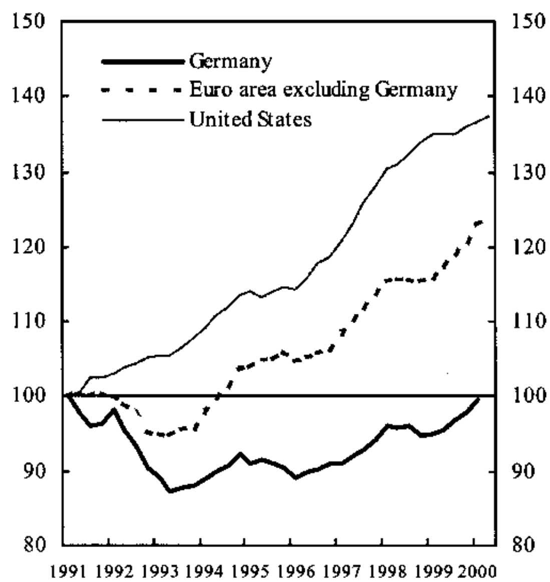
Source: Deutsche Bundesbank.
1/ Percentage change from corresponding quarter in previous year.

Figure 2. Germany: Real GDP Growth Per Capita in the Euro Area and United States, 1992-2000 (In percent)



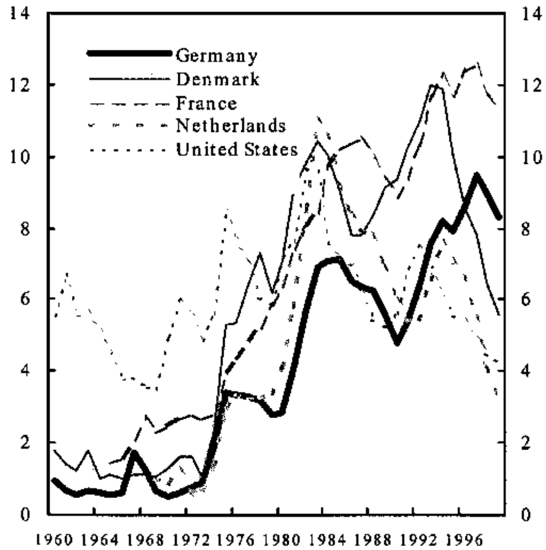
Source: IMF, World Economic Outlook.

Figure 3. Germany: Real Manufacturing Output in the Euro Area and United States, 1991-2000 (1991=100)



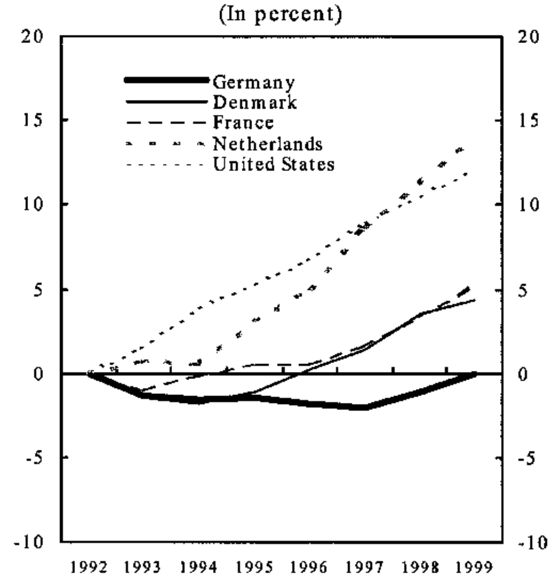
Sources: Bundesbank; Eurostat; and IMF, World Economic Outlook.

Figure 4. Germany: Unemployment Rates, 1960-1999
(In percent)



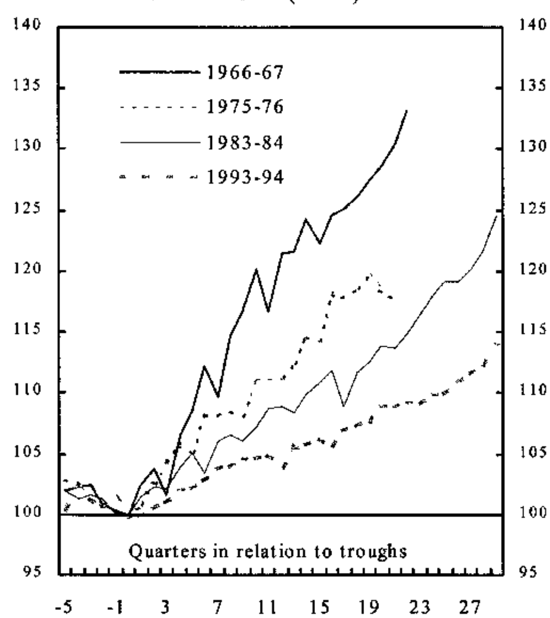
Sources: IMF, World Economic Outlook; and staff calculations.

Figure 5. Germany: Cumulative Employment Growth, 1992-1999
(In percent)



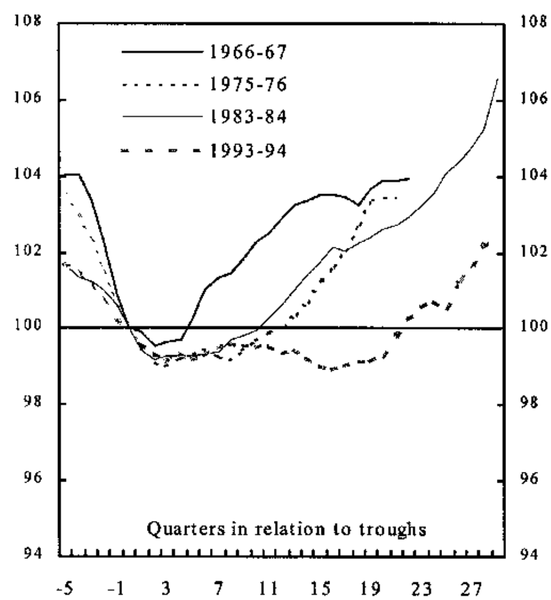
Sources: IMF, World Economic Outlook; and staff calculations.

Figure 6. Germany: Cyclical Expansions of Real GDP (Index) 1/ 2/



Source: Deutsche Bundesbank.

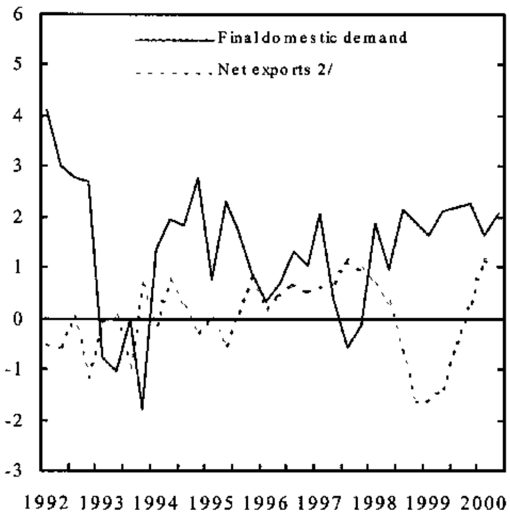
Figure 7. Germany: Cyclical Expansions of Employment (Index) 1/ 2/



Source: Deutsche Bundesbank.

1/ The troughs, calibrated at time zero, are as follows: 1967Q2 for the 1967-68 recovery; 1975Q2 for the 1975-76 recovery; 1982Q4 for the 1983-84 recovery; 1993Q1 for the 1993-94 recovery. The cyclical trough dates fulfill two criteria: (i) the annual GDP growth rate was negative; and (ii), within the year, the cyclical trough was located in the quarter with the sharpest quarterly decline in GDP.
2/ Data prior to 1991 refer to western Germany only.

Figure 8. Germany: Final Domestic Demand and Net Exports, 1992-2000 1/

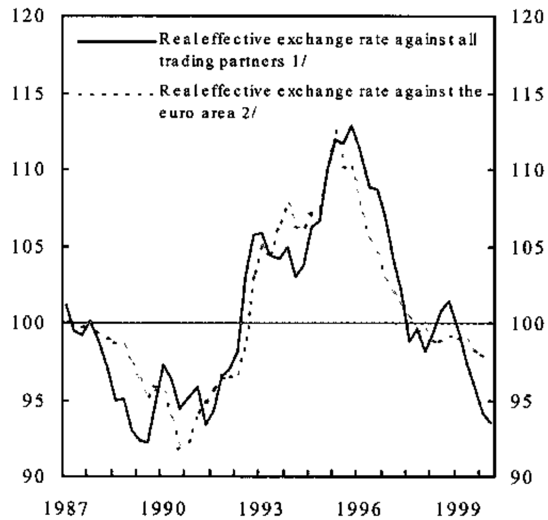


Source: Deutsche Bundesbank.

1/ Percentage change from corresponding quarter in previous year.

2/ Contribution to GDP growth.

Figure 9. Germany: Real Effective Exchange Rates, 1987-2000 (1987=100)

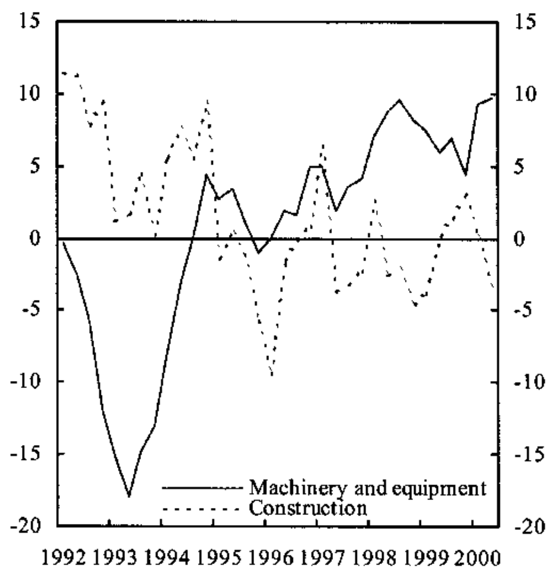


Sources: Deutsche Bundesbank; and staff calculations.

1/ Based on unit labor costs in total economy.

2/ Based on unit labor costs in the business sector.

Figure 10. Germany: Gross Fixed Investment, 1992-2000 1/

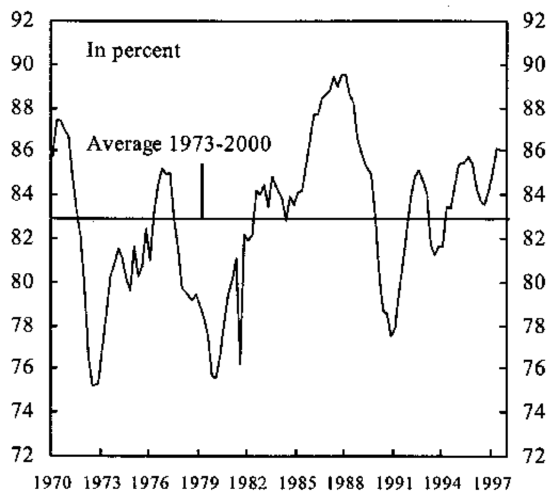


Source: Deutsche Bundesbank.

1/ Percentage change from corresponding quarter in previous year.

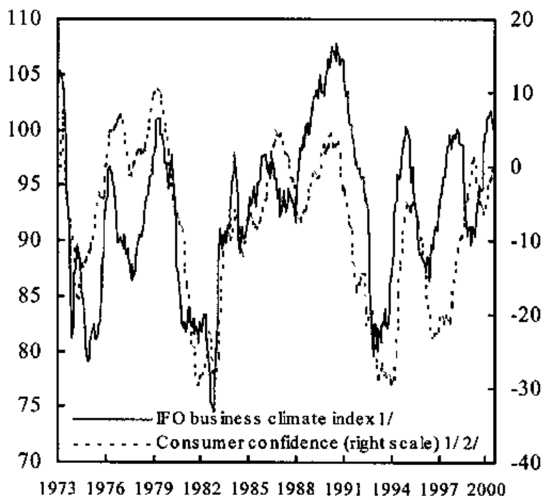
(Figures 11 and 12). The pickup has also brought gains in employment—at a pace of about 1 percent per annum since 1998—and a decline in the still high unemployment rate (to about 8 percent in mid-2000). There remain pockets of weakness, notably in the construction sector and more generally in eastern Germany where the unemployment rate is double that in the west. While the degree of cyclical slack is narrowing, the estimated output gap in 2000 (1 percent) is still one of the largest in the euro area (Figure 13): this estimate, however, is unavoidably surrounded by considerable margins of uncertainty.

Figure 11. Germany: Capacity Utilization in the Manufacturing Sector, 1973-2000 1/



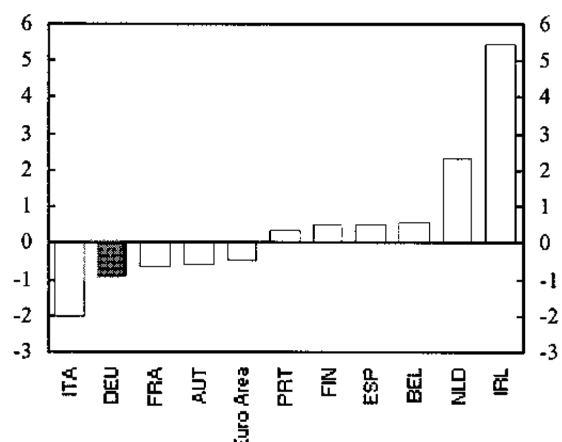
Source: WEFA database.
1/ Data prior to 1991 refer to western Germany only.

Figure 12. Germany: Confidence Indicators, 1973-2000



Sources: Deutsche Bundesbank; and WEFA database.
1/ Data for western Germany.
2/ Percentage of those surveyed expecting an improvement in their situation, less percentage expecting a deterioration.

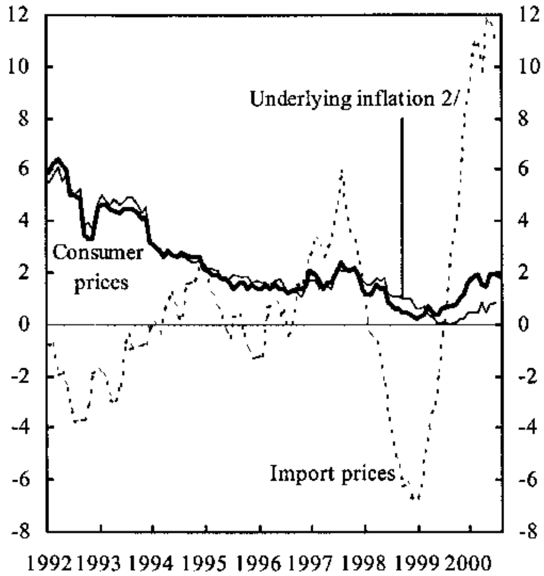
Figure 13. Germany: Output Gaps in the Euro Area, 2000 1/



Source: IMF, World Economic Outlook.
1/ Defined as the difference between actual and potential GDP, as a percent of potential GDP.

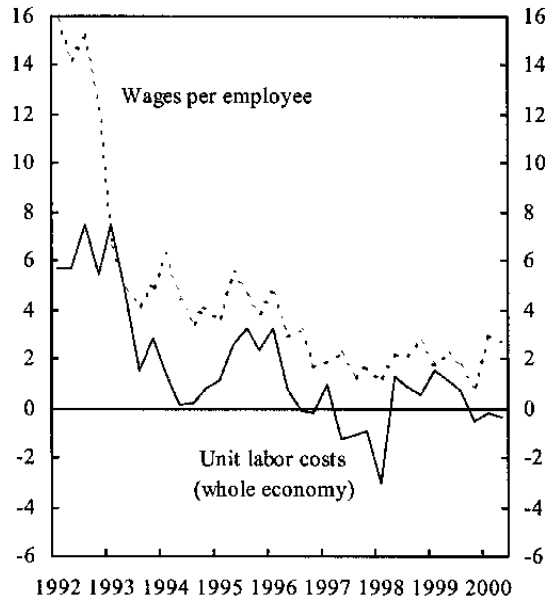
6. **Underlying inflation remains subdued.** Headline CPI inflation reached 2 percent in July 2000 (Figure 14), but this was among the lowest rates in the euro area and reflected mainly rising world energy prices rather than domestic cost pressures. Underlying inflation (excluding energy) remains below 1 percent, helped by moderate wage settlements (Figure 15) and ongoing deregulation in telecommunications and other utilities. The benchmark metal industry wage settlement reached in early 2000 covers two years and provides for increases of 2½ percent a year, a rate that on current estimates of aggregate productivity growth implies almost no increase in unit labor costs. This surprisingly moderate wage settlement appears to have been influenced by the prospect of a boost in take-home pay from the income tax cuts as well as high unemployment.

Figure 14. Germany: Price Inflation 1992-2000 1/



Source: Deutsche Bundesbank.
1/ Percentage change from previous year.
2/ CPI inflation excluding energy.

Figure 15. Germany Wages and Unit Labor Costs, 1992-2000 1/



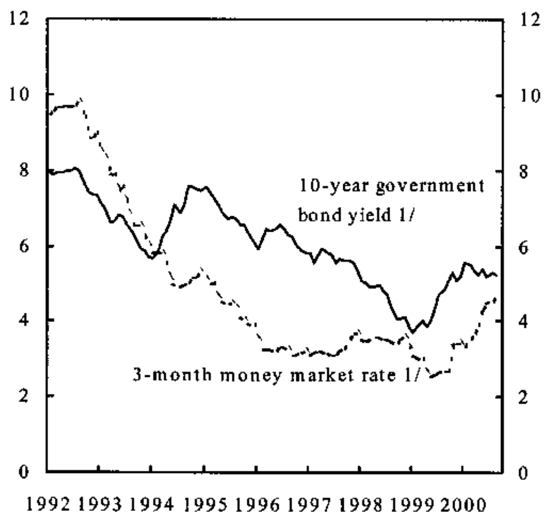
Source: Deutsche Bundesbank.
1/ Percentage change from previous year.

7. **Monetary conditions are still accommodative.** The effects of ECB interest rate increases since its tightening cycle began in November 1999—by a total of 200 basis points (Figure 16)—have been more than offset by the sharp weakening of the euro. The monetary conditions index (MCI)[5] is at a ten-year low, with both the real short-term interest rate and the real effective exchange rate below their averages for 1981-2000 (Figure 17). While the Bundesbank officials saw conditions as broadly appropriate for Germany, they did comment

[5] The MCI is constructed as a weighted average of the real short-term interest rate (weight 2.5) and the real effective exchange rate (weight 1).

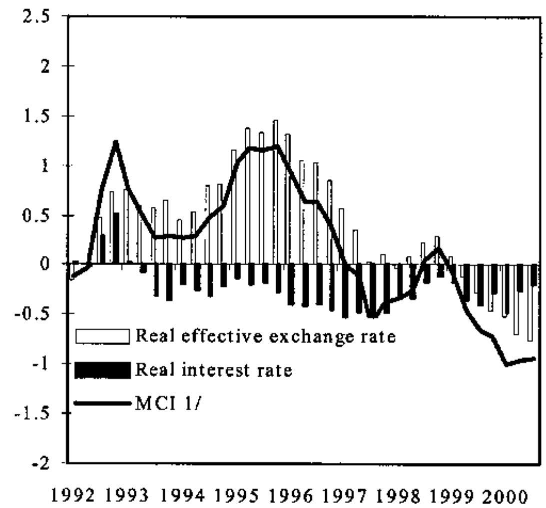
that from the perspective of the German economy alone, the ECB's interest rate increases in mid-2000 had been larger than necessary.

Figure 16. Germany: Market Interest Rates, 1992-2000 (In percent)



Sources: Deutsche Bundesbank; and staff calculations.
1/ Monthly averages.

Figure 17. Germany: Monetary Conditions Index (MCI), 1992-2000

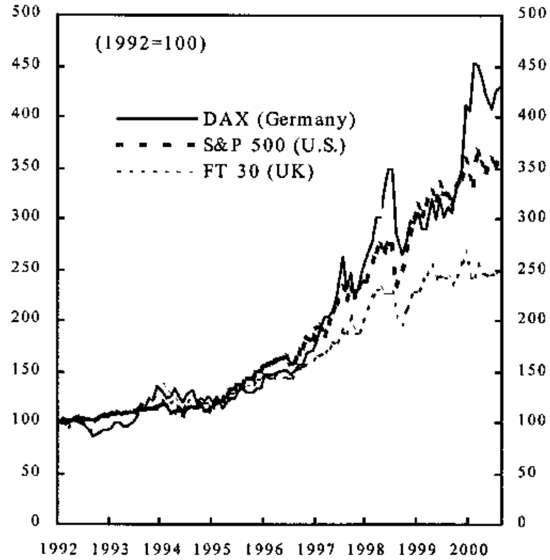


Sources: Deutsche Bundesbank; and staff calculations.
1/ Average 1981-2000=0. Calculated using as weights 2.5 for the short-term interest rate and 1 for the effective exchange rate. Upward movements denote tighter monetary conditions.

8. **Stock markets have been buoyant.** Although the Dax index of equity prices has declined by 5 percent from its March 2000 peak, in late August it remained 42 percent higher than a year ago (Figure 18). Before also experiencing a correction, the *Neuer Markt*—largely consisting of small, newly issued technology-oriented companies—skyrocketed in late-1999 and early-2000, exceeding even the rise of the U.S. Nasdaq index (Figure 19).[6]

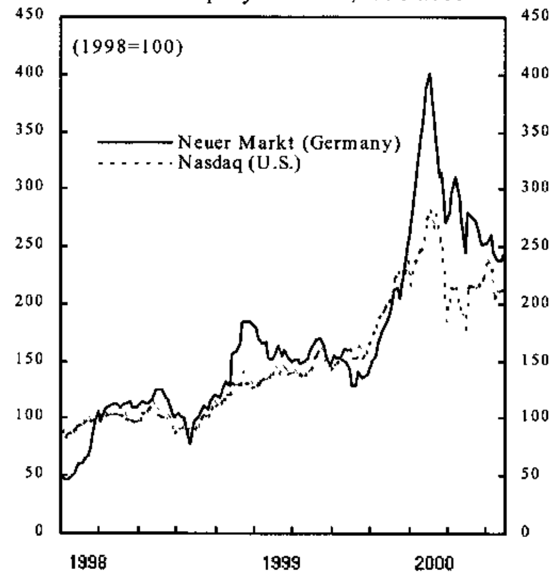
[6] The *Neuer Markt* is still small, with a market capitalization less than 5 percent that of the Nasdaq.

Figure 18. Germany: Blue Chip Equity Markets, 1992-2000



Source: Bloomberg.

Figure 19. Germany: Small Cap/High Tech Equity Markets, 1998-2000



Source: Bloomberg.

9. **Public finances have improved**. With spending tightly restrained and revenues benefiting from a favorable composition of demand,[7] the general government deficit fell to 1½ percent of GDP in 1999 while gross government debt stabilized at 61 percent of GDP (Table 1 and Figures 20-21). For 2000, the deficit in the authorities' Stability Program is targeted at 1 percent of GDP. Spending and revenue were both set to decline relative to GDP by about ¾ percentage point, reflecting the front-loaded expenditure consolidation measures announced in June 1999, personal income tax cuts, and a drop in Bundesbank profits. The fiscal outturn will be much stronger than targeted—a surplus of more than 1½ percent of GDP is projected—but this is entirely on account of unanticipated receipts (2½ percent of GDP) from the August 2000 sale of UMTS mobile phone licenses. As the UMTS windfall will be used to reduce debt, gross government debt in 2000 is projected to fall below the Maastricht debt-limit (to 59½ percent of GDP). For 2001, further personal tax cuts and a major business tax reform increase the targeted deficit to 1½ percent of GDP; the staff expects a positive fiscal impulse of close to 1 percent of GDP. For subsequent years, the Stability Program targets a reduction in the deficit to 1 percent of GDP in 2002 and ½ percent in 2003.

[7] For 1999 as a whole, the slowdown in growth was accounted for by a slowdown in exports (which are relatively lightly taxed), while growth of domestic demand held steady.

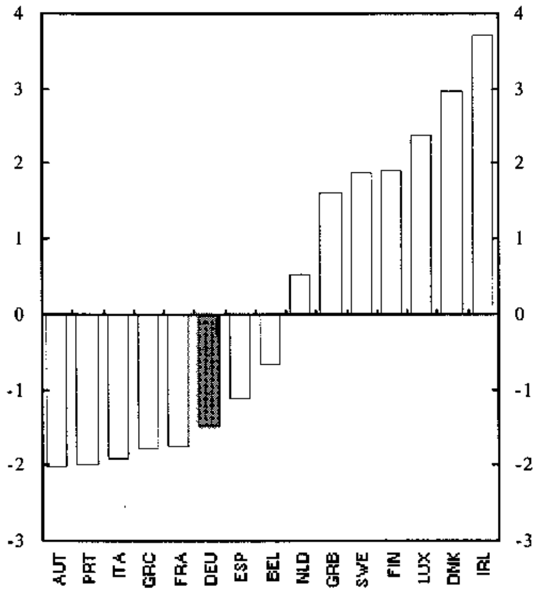
Table 1. Germany: Medium-Term Projections of General Government Finances, 1995-2005 1/

	1995	1996	1997	1998	1999	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
Official fiscal targets 2/											
Revenue	46.1	46.8	46.5	46.5	47.2	46½	45	45	44½	...	...
Expenditure	49.4	50.3	49.2	48.6	48.6	47½	46½	46	45	...	...
Balance	-3.3	-3.4	-2.7	-2.1	-1.4	-1	-1½	-1	-½	...	...
Federal government	-1.5	-1.9	-1.6	-1.7	-1.5	-1¼	-1¼	-1	-¾	...	...
States and communes	-1.4	-1.2	-1.2	-0.5	-0.2	0	-¼	0	¼	...	...
Social insurance system	-0.4	-0.4	0.1	0.1	0.3	¼	0	0	0	...	...
Gross debt	58.3	59.8	60.9	60.7	61.0	61.0	60½	59½	58½	...	...
Staff projections											
Revenue	46.1	46.8	46.5	46.5	47.2	46.7	45.6	45.7	45.6	45.7	45.0
Expenditure 3/	49.4	50.3	49.2	48.6	48.6	45.1	46.8	46.3	46.1	46.1	46.1
Interest payments	3.7	3.7	3.6	3.6	3.5	3.4	3.2	3.1	3.0	2.9	2.8
Balance	-3.3	-3.4	-2.7	-2.1	-1.4	1.6	-1.2	-0.6	-0.5	-0.4	-1.1
Gross debt 3/	58.3	59.8	60.9	60.7	61.0	59.6	57.0	55.5	54.6	53.6	53.1
Primary structural balance 4/	0.4	1.0	2.0	2.4	3.0	3.0	2.0	2.2	2.2	2.3	1.7
Structural balance 4/	-3.3	-2.7	-1.6	-1.2	-0.5	-0.4	-1.2	-0.9	-0.8	-0.6	-1.1
Fiscal impulse 5/	0.5	-0.6	-1.0	-0.4	-0.6	0.0	1.0	-0.2	0.0	-0.1	0.6
Staff; normative scenario 6/											
Revenue	46.1	46.8	46.5	46.5	47.2	46.7	45.6	45.7	45.6	45.7	45.0
Expenditure 3/	49.4	50.3	49.2	48.6	48.6	45.1	46.7	45.9	45.0	45.0	45.0
Balance	-3.3	-3.4	-2.7	-2.1	-1.4	1.6	-1.1	-0.1	0.6	0.7	0.0
Gross debt 3/	58.3	59.8	60.9	60.7	61.0	59.6	56.8	54.9	53.0	51.0	49.3
Primary structural balance 4/	0.4	1.0	2.0	2.4	3.0	3.0	2.1	2.7	3.3	3.4	2.8
Structural balance 4/	-3.3	-2.7	-1.6	-1.2	-0.5	-0.4	-1.2	-0.5	0.2	0.5	0.0
Fiscal impulse 5/	0.5	-0.6	-1.0	-0.4	-0.6	0.0	0.9	-0.6	-0.6	-0.2	0.6
Memorandum items:											
Output gap 4/	0.2	-0.9	-1.4	-1.2	-1.7	-0.9	0.1	0.7	0.6	0.4	0.0
Real GDP growth (in percent)	1.7	0.8	1.4	2.1	1.6	2.9	3.3	3.0	2.3	2.2	2.1
Real potential GDP growth (in percent)	1.9	1.9	1.9	1.9	2.0	2.1	2.3	2.3	2.3	2.5	2.5

Sources: Ministry of Finance; and staff projections.

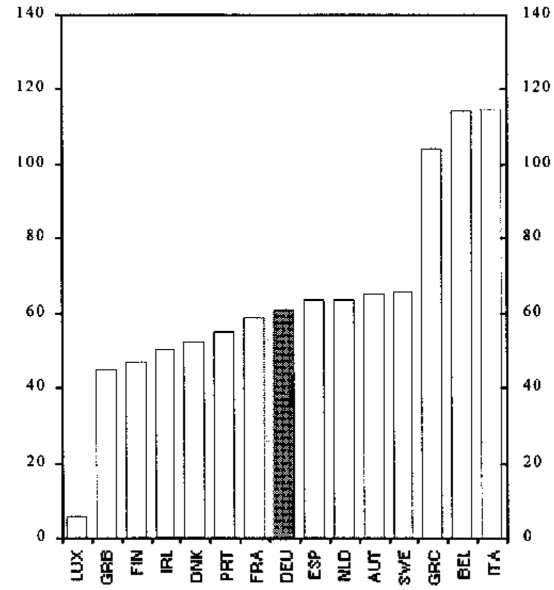
1/ Data are based on the European System of Integrated Economic Accounts 1995 (ESA95)
2/ Based on Germany's Stability Program 2000 and the revision of that, which was submitted in January 2000 to the Council of Ministers and the European Commission. Data through 1999 are the latest official estimates released in August 2000. Stability Program estimates for 2000 do not include proceeds from the sale of mobile phone licenses.
3/ For 2000 includes the one-time proceeds from the sale of mobile phone licenses of DM 99.4 billion (2.5 percent of GDP). In line with national accounting definitions, the sale of non-financial non-produced assets by government are recorded as negative expenditure rather than revenue. Revenues will be used to repay public debt; it is assumed that the buy-back of public debt will be phased over two years.
4/ In percent of potential GDP.
5/ Change in primary structural balance (excluding proceeds from the sale of mobile phone licenses); minus sign indicates withdrawal of stimulus.
6/ Assumes the same revenue path as in the staff projections, but on government spending it assumes the implementation of additional measures to keep the expenditure/GDP ratio on the path specified in the Stability Program through 2003.

Figure 20. Germany: General Government Balances, 1999
(In percent of GDP)



Source: IMF, World Economic Outlook.

Figure 21. Germany: General Government Gross Debt, 1999
(In percent of GDP)



Source: IMF, World Economic Outlook.

10. **Overall, Germany's present economic fundamentals point to relatively strong growth in the near term with no sign of domestic cost pressures.** The staff projects output growth of almost 3 percent in 2000, rising to 3¼ percent in 2001 (text table), slightly above the authorities' projections (2¾ percent in both years); consensus forecasts show 3 percent in both years. While external demand is the impetus to the recovery in 2000, domestic demand will subsequently take over as fiscal stimulus outweighs the effects of ECB tightening.[8] With moderate wage settlements already in place for 2000 and 2001, headline inflation should remain close to 2 percent, notwithstanding recent upward pressures on oil prices.

Growth Projections

(Changes in percent)

	1999	2000	2001
GDP	1.6	2.9	3.3
Domestic demand	2.4	2.2	3.3
Net external demand 1/	-0.8	0.8	0.1

Source: IMF, World Economic Outlook.
1/ Contribution to growth in percent of GDP.

[8] The staff forecast incorporates market expectations of a further increase in nominal short-term interest rates of 25 basis points by end-2000, a significant reversion of oil prices over the next two years to an average of $22 per barrel (from about $34 per barrel in September 2000), and a constant real exchange rate (frozen at the level of July-August 2000).

III. Policy Discussions

11. **The central issue in the discussions was how to turn favorable short-term prospects into robust medium-term growth.** The staff probed ways to improve the economy's resilience to shocks, to enhance supply side responses, and to exploit technological advances (the "new economy"). On many issues there was agreement: the authorities emphasized their commitment to reducing public debt while meeting the costs of a significant income tax reform; to pension reform to limit future increases in social contributions; and to deregulation and privatization to improve the functioning of product markets. In fact, in each of these areas, important actions had been taken. Differences of view arose on the role of fiscal policy over the cycle, on aspects of financial sector restructuring and supervision and, above all, on the appropriate labor market strategy.

12. **Together with the staff, the authorities saw two main sources of short-term risks to the growth outlook: a sharp appreciation of the euro, possibly associated with a "hard landing" in the United States triggered by a large stock market correction; and oil prices failing to revert to lower levels as assumed in the projections.** A MULTIMOD simulation suggests that a 30 percent appreciation of the euro (equivalent to a real effective appreciation of some 11 percent) in 2001 would reduce real GDP in Germany by some 1 percentage point below the baseline in the same year. A hard landing in the United States following a major stock market correction there would also affect German exports, but with household ownership of equities much lower than in the United States, the direct effect on households would be muted.[9] A persistence of high oil prices at $34 per barrel through end-2001 would also have a potentially large effect on output. Depending on second round effects on wages and the associated monetary policy response, Germany's real GDP could fall by up to ¾ percentage point relative to the baseline in 2001.

13. **Further out, the most important risk, in the staff's view, was posed by labor market rigidities; if unaddressed these would leave Germany vulnerable to a premature cyclical downturn, particularly in the event of shocks such as those in recent decades (Box 1).** The starting point for these episodes was typically an acceleration in wages in the upswing when higher-skilled workers with relatively rapid productivity growth sought rewards in line with their output. With Germany's uniform wage adjustment practices, these wage demands were transmitted across the board, raising the costs of low-skilled workers above their productivity, and leading to shakeouts of labor concentrated among lower-skilled workers (Figures 22-23). This process was reinforced by automatic adjustments of social contributions to balance the pay-as-you-go (PAYG) social insurance system, by the

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[9] Only about 16 percent of German households owned stock in 1997 (compared with about 50 percent in the United States), and few German households have positions in the volatile high-tech sector. Also, in contrast to the United States, financial institutions in Germany do not commonly provide margin credit to retail clients for the purpose of buying equities.

Box 1. Are Germany's Anemic Growth Cycles Passé?[1]

Since the early 1970s, each of Germany's growth cycles left a legacy of higher structural unemployment, contrasting sharply with labor market performance during the *Wirtschaftswunder* era (Box 1 Figure 1). This sequence of anemic growth cycles reflected adverse shocks, their propagation through ill-adapted labor market institutions, and procyclical fiscal policies:

- **Shocks**: Adverse shocks since the early 1970s include a shift in labor demand to relatively skilled workers (skill-biased technological change); a sectoral employment shift from manufacturing to services (deindustrialization); and German unification.

- **Institutions**: Germany's labor market institutions were ill-equipped to absorb these shocks, which inter alia called for increased wage cost differentiation across skills (in response to skill-biased technological change); occupational mobility of workers (in response to deindustrialization); and increased regional wage differentiation (in response to German unification). Instead, Germany's collective bargaining system continued to aim at across-the-board raises in wages based on average labor productivity growth; an extensive social safety net insulated reservation wages from unemployment pressures; and unification was followed by a policy to reduce wage differentials between western and eastern Germany. Finally, the structure of the pay-as-you-go pension system introduced a vicious circle into labor market dynamics: increases in unemployment leading to higher social insurance spending required raises in social contribution rates, which increased labor costs and crimped take-home pay only to start the circle again.

- **Policies**: Macroeconomic tensions were exacerbated by procyclical fiscal policy. This was in part rooted in Germany's highly decentralized fiscal system and PAYG financing for social insurance. Procyclical fiscal policy also reflected constitutional requirements to preserve fiscal stability ("golden rule constraints").

What are the chances of a repetition of past growth patterns? The adverse shocks that shaped Germany's past growth cycles may have lost some of their momentum: the share of lower-skilled workers in employment has declined sharply and deindustrialization may not continue at the past pace. But looking ahead, new challenges and shocks could test Germany: the demands of the "new economy;" regional specialization within the EU; and expansion of the EU to the east. A repetition of the past growth cycle pattern (illustrated mechanically in Box 1 Figure 1 by a "cyclical-history-repeats-itself" scenario) is a risk to be taken seriously—the more so since the buildup of underlying labor market tensions in the upswing is typically masked by the favorable cyclical environment. At the same time, institutional labor market reforms—as exemplified by the recent pension reform proposals—would hold the promise of substantial medium-term improvements in labor market performance, as illustrated by the equally mechanical "new-growth-cycle-era" scenario shown in Box 1 Figure 1.

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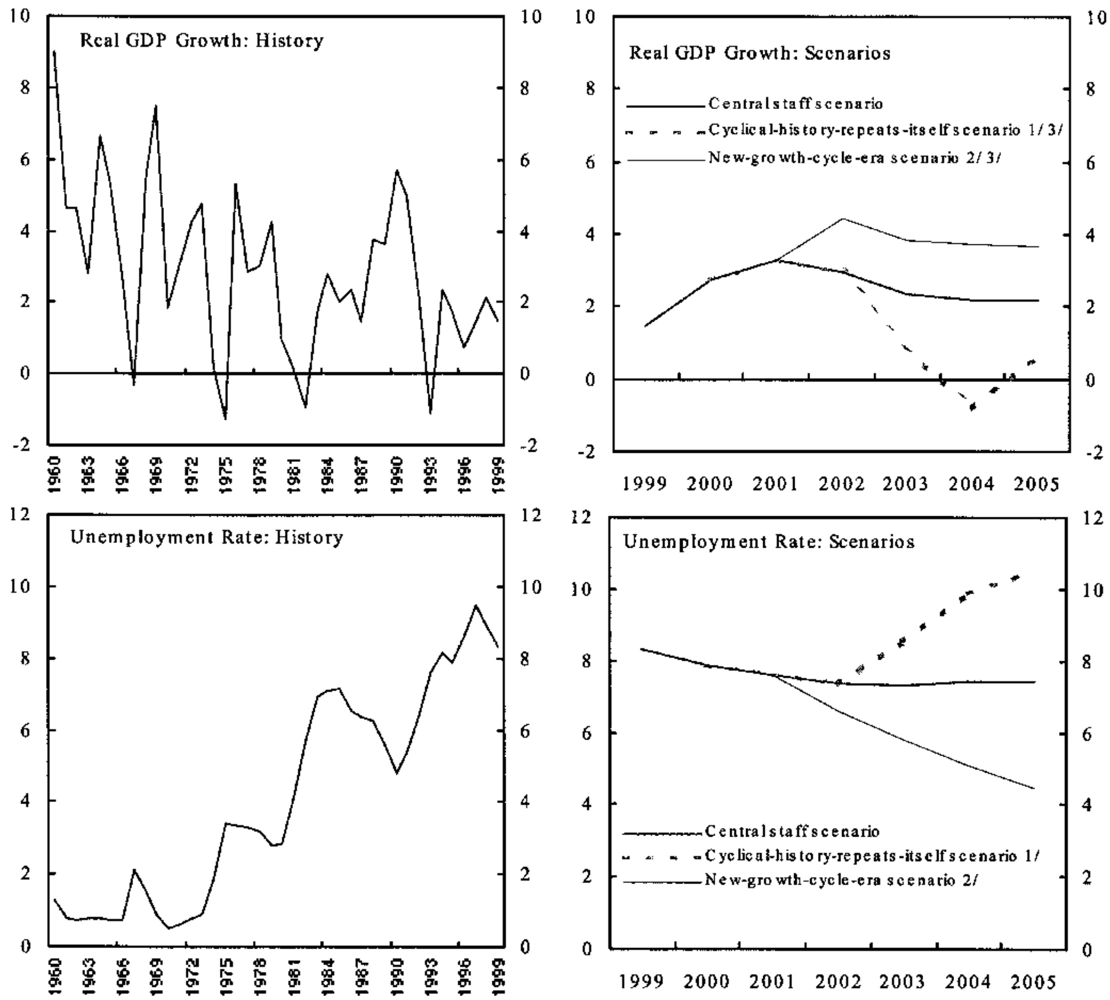
[1] This box summarizes Chapter I of the *Selected Issues Paper*.

Box 1. Figure 1. Germany: Cyclical Growth and Unemployment Scenarios, 2000-2005
(In percent)



Sources: IMF, World Economic Outlook; and staff calculations.

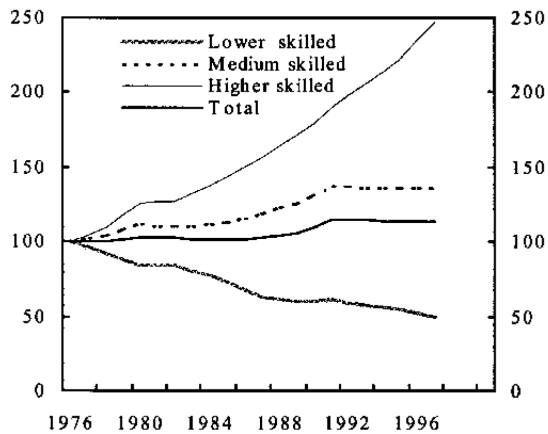
1/ Assuming an increase in the unemployment rate by a total of 3 percentage points over the period 2003-2005, broadly in line with past cyclical recession experiences.

2/ Assuming a cumulative reduction in the structural rate of unemployment by 3 percentage points during 2002-2005.

3/ A 1 percentage point change in unemployment is assumed to change real GDP growth by 2 percentage points in the opposite direction, in line with Okun's Law estimates for Germany.

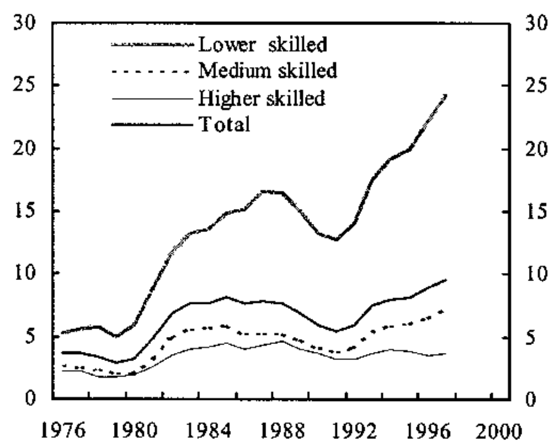
unlimited duration of unemployment assistance, and by fiscal policies geared to a nominal deficit objective. Such an episode admittedly does not now appear imminent: the 2000 wage round had locked in moderate wage increases for two years. But, beyond then, staff pointed to the risk of significant pressures—especially from higher-skilled workers—to realize wage increases consistent with their productivity growth. The authorities were less concerned about such domestic pressures but were wary that a sustained strategy of wage moderation in Germany could in the medium term result in diverging labor cost developments in the euro area countries, with attendant problems for formulating a euro-area wide monetary policy.

Figure 22. Germany: Employment by Skills, 1976-1997 (1976=100) 1/



Sources: Reinberg and Rauch (1998); and staff estimates.
1/ Data refer to western Germany only.

Figure 23. Germany: Unemployment Rates by Skills, 1976-1997 (In percent) 1/



Sources: Reinberg and Rauch (1998); and staff estimates.
1/ Data refer to western Germany only.

A. Fiscal Policy

14. **The authorities stressed their commitment to medium-term fiscal discipline within the framework of the Stability and Growth Pact.** The significant increase in the deficit targeted for 2001 did not reflect a weakening of fiscal discipline, but rather the costs of much-needed reforms to reduce the taxation of households and businesses. Indeed, the commitment to fiscal discipline was underscored by the announcement that the proceeds of UMTS mobile phone licenses sold in August 2000 would be used for reducing public debt, with the resulting interest savings (about 0.1 percent of GDP) to be allocated to spending on education and infrastructure.

15. **The cornerstone of the fiscal strategy is expenditure restraint.** The June 1999 savings package set the course with targeted and durable spending cuts focused on social transfers and public consumption: through these measures, and others to be specified for later years that would limit nominal growth of general government spending to 2 percent per annum, the authorities are firmly committed to expenditure-based consolidation over the medium-term. With nominal GDP growth expected to average 4 percent per annum, this implies a reduction in the ratio of spending to GDP of almost 1 percentage point per annum, to 45 percent by 2003. Through this spending restraint, the authorities project the general

government position to reach balance in 2004, one year after the end of the current Stability Program. The staff welcomed the commitment to consolidation through tight limits on spending. On the basis of the staff's (somewhat more optimistic) revenue projections, it would be possible, and indeed desirable, to reach budget balance sooner if the Stability Program spending limits were observed (text table).[10] With a high proportion of outlays effectively indexed to wages, it was important, given the staff's concerns about the sustainability of wage moderation, to articulate the measures for achieving these goals.

General Government Finances

(In percent of GDP)

	2000	2001	2002	2003	2004	2005
Revenue 1/	46.7	45.6	45.7	45.6	45.7	45.0
Expenditure	45.1 2/	46.7	45.9	45.0	45.0	45.0
Balance	1.6 2/	-1.1	-0.1	0.6	0.7	0.0
Fiscal impulse	0.0	1.0	-0.6	-0.6	-0.2	0.6

Source: Table 1, normative staff scenario.
1/ Incorporates income tax reductions scheduled for 2001, 2003, and 2005.
2/ Includes proceeds from the sale of mobile phone licenses equivalent to 2.5 percent of GDP.

16. **The staff inquired whether the fiscal stimulus planned for 2001 was driven by any concern that current and prospective monetary conditions could be insufficiently supportive for Germany.** The authorities said that this was not the case: while recent increases in ECB interest rates were arguably somewhat larger than warranted from a purely German perspective, estimates of present and future output gap positions were in their view much too uncertain for fine-tuning of discretionary fiscal policy settings. These should be based on medium-term requirements.

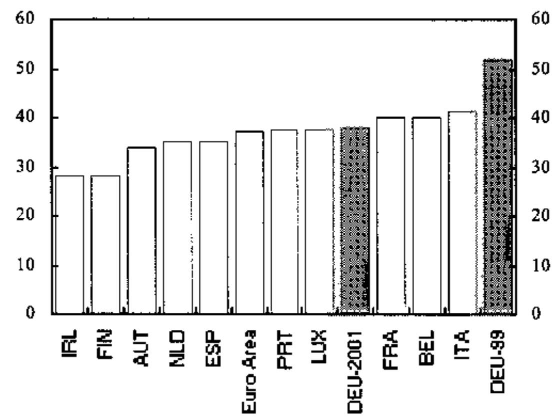
17. **In formulating policies for the medium term, the authorities focused on nominal, rather than cyclically-adjusted, objectives and were skeptical about the importance of automatic fiscal stabilizers.** The staff argued that to reduce procyclical tendencies in fiscal management and as a key element in the proper macroeconomic functioning of monetary union, medium-term fiscal goals should be formulated in structural terms that allow for the full operation of the automatic fiscal stabilizers. Gearing policy to medium-term balance would imply a deficit in the event of a negative demand shock, but correspondingly would require surpluses in the above-potential phase of the cycle. With most observers (including the staff) expecting Germany's output gap to close in 2001, the need to contemplate significant surpluses could already arise in 2003. The authorities responded that these arguments made theoretical sense, but in Germany's relatively decentralized fiscal system,

[10] The authorities' projection methodology consistently shows steeper declines in the revenue/GDP ratio than that of the staff, partly reflecting the authorities' assumption of a continuing decline in labor's share of national income.

the stabilizers were always likely to be quite weak given that governments at lower levels would aim to balance their budgets. It was also politically difficult to explain to the public goals for fiscal policy that were expressed not in actual but in cyclically-adjusted terms. They were contemplating, however, other formulations that might get round these difficulties at least at the federal level, in particular the use of medium-term norms for non-cyclical spending as the centerpiece of fiscal planning—a practice in a number of other European countries—while allowing revenues to fluctuate with the cycle.

18. **The Bundesrat's approval of the government's income tax package in July broke a decade-long reform gridlock.** The approved package—together with the *1999 Tax Relief Act*—represents a long-awaited overhaul of Germany's income tax system, slashing high statutory rates and broadening bases in a way many other countries have done since the mid-1980s. The mainspring of the reform effort is a package featuring medium-term reductions in personal income tax rates and significant reform of business income taxation (Box 2). The authorities argued that it had become essential to address two elements of the system that were problematic from an international perspective: first, statutory tax rates that are among the highest in Europe; and second, potential legal difficulties within the EU arising from Germany's full imputation system for dividend distributions. With the effective tax rate (including local trading tax and solidarity surcharge) on retained corporate profits set to average about 38 percent (down from over 50 percent previously), Germany will now have statutory tax rates at about the average for Europe (Figure 24).

Figure 24. Germany: Statutory Corporate Income Tax Rates in the Euro Area (In percent) 1/



Sources: Ministry of Finance; and KPMG.
1/ DEU-99 is Germany's statutory corporate tax rate in 1999, (including local trading tax and solidarity surcharge), while DEU-2001 is the rate that will prevail after the corporate income tax reform. Statutory rates for all other countries refer to 1999.

19. **The reforms are expected to affect growth positively.** The fiscal stimulus alone will raise domestic demand, inducing some ¼ percentage point improvement in GDP growth in 2001.[11] More importantly from a medium term perspective, the reforms are also likely to have positive supply-side effects on incentives to invest and work, although there are multiple channels for the effects and some will cancel out others. Marginal effective tax rates for most kinds of investment are likely to be little changed largely because the stimulating effect of the cut in the statutory rate of corporate taxation will be broadly offset by the adoption of less generous depreciation allowances; still, the combination of these steps

[11] This improvement is incorporated in the staff's baseline projection.

Box 2. Income Tax Reform[1]

Since the mid-1980s, the gist of income tax reforms in OECD countries has been to lower and flatten tax rate schedules while broadening tax bases. Germany's pace in reforming its income tax system has been relatively slow—the adoption of the last significant income tax package dates back to June 1988. Thus, the Bundesrat's approval of the government's income tax reform package on July 14 broke a long-standing gridlock in this area.

The approved income tax package covers the period 2001-05; cumulative net income tax relief is projected to amount to 1.4 percent of GDP. Including also the income tax measures adopted in April 1999, the overall net tax relief is estimated to amount to 2.2 percent of GDP. The size of the approved package is comparable to the more recently announced three-year tax reduction plan by the French government, which projects net tax cuts equivalent to 1.2 percent of GDP.

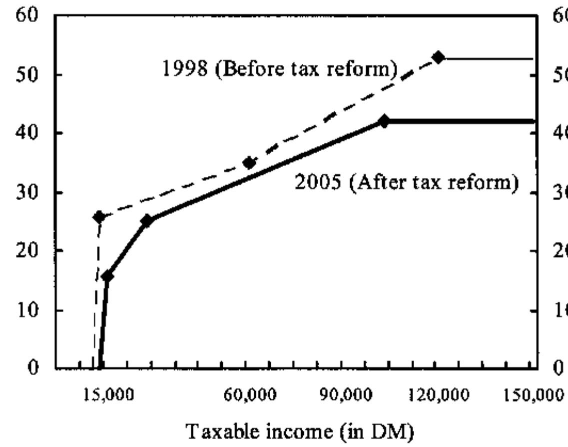
Several changes in **business income taxation** are the centerpiece of the reforms: (i) the statutory rate of corporation tax is reduced to a unified rate of 25 percent (from 45 percent for retained profits at the beginning of 1999, and 30 percent for distributions); (ii) depreciation allowances are cut significantly; (iii) in what proved one of the most controversial measures, the "full imputation" system—which eliminates double taxation of dividends by crediting the underlying corporation tax paid on distributions against personal taxation at the shareholder level—is replaced by a system in which no credit is given but personal income tax is charged on only half the dividends; and (iv) the tax on capital gains on intercorporate share holdings is, from 2002 onward, eliminated.

For **personal income taxation**, the reforms extend the reductions in marginal and average rates announced in 1999, so that the starting marginal rate falls from 22.9 percent currently to 15 percent in 2005, and the highest marginal rate from 51 percent to 42 percent.

[1] Chapter IV of the *Selected Issues Paper* analyzes tax reform in Germany. A parallel paper for the French consultation discusses tax reform in France.

should lead to a more efficient allocation of investment. Moreover, for investors deciding in which country to locate an investment project the cut in statutory tax rates makes Germany a more attractive country to choose. It also reduces the incentive to move taxable profits out of Germany by transfer pricing and other means. Eliminating the tax on intercorporate capital gains will usher in a sell-off of the substantial stock of intercorporate shareholding, with possible efficiency benefits. The structure of personal income taxes has certainly improved as a result particularly of the sizable lowering of the top marginal tax rates. But, it is noteworthy that the cuts in marginal rates are most pronounced at the highest and lowest levels and quite small over the middle ranges. (Figure 25).

Figure 25. Germany: Marginal Income Tax Rates
(In Percent)



Source: Ministry of Finance.

20. **The staff welcomed the overall reform package.** However, the staff pointed out that further reform will be needed. Specifically, the system will remain excessively complex; many exemptions mean that the personal income tax base is still subject to erosion; and the local trading tax (a business tax levied by local governments) is both complicated and, being vulnerable to tax competition, not ideal as an instrument for local governments. The authorities responded that the future of the trading tax raised issues of the fiscal relationships between the various levels of government and would need to be taken up in the context of a planned review of this issue.

B. Structural Policies

The "new economy"

21. **The authorities agreed that it was essential for Germany to position itself to take full advantage of technological advances, especially in the fast-moving information and communication technology sector.** Microeconomic policy issues related to innovation and adjustment to change were becoming increasingly important for the macroeconomy, as recognized in the Lisbon EU Council. The authorities acknowledged that there are few signs in the macrodata for Germany (or Europe generally) of a "new economy" phenomenon, in terms of an acceleration of productivity growth (cited by some observers as evidence for such a phenomenon in the United States) (Box 3). At the same time, this was not viewed as a cause for alarm given Germany's long-established tradition of excellence in the application of technology. Moreover, indications of faster productivity growth elsewhere were recent and subject to alternative interpretations. Most importantly, recent analysis by the Bundesbank of investment in information technology hardware suggested that different measurement methods—specifically the use of hedonic price indices as in the United States—account for much of the difference in reported growth in real investment in

Box 3. Does Germany have a "New Economy?"[1]

The exceptionally strong performance of the U.S. economy in the current upswing has led to speculation that the non-inflationary growth witnessed to date is related to a "new economy" and raises the questions whether similar effects can be observed or expected in Europe. Although definitions of the "new economy" vary, one view holds that there is a link between investment in high-technology equipment and the higher productivity growth. Evidence on the issue in the U.S. itself is mixed: while most studies on the topic show that the observed pickup in productivity growth in the U.S. between the first and second halves of the 1990s can be linked to a surge in the productivity of production of computers, there is less agreement about whether productivity gains are related to the spillover in the use of computers in other sectors (though even the skeptics now admit productivity gains are evident in durable goods production outside the computer industry).[2] There is also little concrete evidence so far that the productivity acceleration is sustainable. However, even if it is not long-lasting, a "new economy" effect could boost non-inflationary growth for a time.

Can similar "new economy" effects be observed in Germany? Given increasing global economic integration, one might expect that technological improvements would be quickly transmitted and adopted across national borders. But preliminary analysis of aggregate data suggests otherwise:[3] labor productivity growth in the euro area has declined, not accelerated, in recent years (from an average of 2.5 percent in the first half of the 1990s to 1.2 percent in the second). In Germany, productivity growth in the first half of the 1990s was maintained at its historical average despite sluggish output growth, reflecting the post-unification labor shakeout. It then declined in the second half. Growth of total factor productivity, in contrast, dropped to just over 1 percent in the first half of the decade and was maintained at that rate in the second. Recent work by the Bundesbank suggests that the absence of productivity acceleration, compared with the United States, could be partly attributable to different techniques for calculating price indices for computers.

With the macroeconomic data providing ambiguous signals, an examination of the circumstantial evidence of precursors to the "new economy" is warranted. However, the evidence is mixed here as well. Germany lags many of its European neighbors in terms of internet hosts and computer ownership. However, other measures show that the value added by the ITC industries in Germany is quite high—below only the U.S. and Finland.[4] Infrastructure underlying the use of IT is also considered advanced. While it may simply be that Europe is a few years behind and the "new economy" effects will come eventually, structural rigidities—in tax systems, product markets, and labor markets—and nascent equity markets in continental European economies may hinder a successful embrace of the "new economy."

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[1] This box summarizes Chapter III of the *Selected Issues Paper.*

[2] Oliner, Stephen and Daniel Sichel, "The Resurgence of Growth in the Late 1990s: Is Information Technology the Story?" *Journal of Economic Perspectives*, forthcoming, represents the view of widespread productivity gains and Gordon, Robert J., "Does the "New Economy" Measure up to the Great Inventions of the Past?" *Journal of Economic Perspectives*, forthcoming, is more skeptical.

[3] Estimates of labor productivity and total factor productivity, even when using the same data source, should be viewed cautiously since the composition of underlying series for capital stocks, in particular, differ across countries.

[4] OECD Information Technology Outlook 2000, (Paris: OECD, 2000).

information technologies in Germany and the United States. Officials responsible for statistical issues indicated, however, that there were no immediate plans to revise German national accounts data on this issue.

22. **The staff questioned whether the policy environment in Germany was sufficiently supportive of high-risk entrepreneurial activities associated with technological innovation and absorption.** Rigid labor market institutions might also lead to new labor market tensions if the "new economy" phenomenon precipitated further rounds of skill-biased technical change.[12] The authorities responded that the oft-cited heavy burden of regulation for business startups is an issue for traditional activities defined as "crafts" and for incorporated businesses (which account for about 20 percent of the total). But new high-tech activities (such as website design) were not classified as crafts and could be granted business licenses rapidly (within 2-3 hours). The financial system (especially with the advent of the *Neue Markt*) was improving the supply of venture capital and equity finance to young companies, and the income tax reform (in particular, the reduction in top marginal rates) would increase returns from successful ventures. Training and retraining issues were coming to the fore in the context of a debate on "lifelong learning" and related education reforms geared toward a modular approach. In the retail sector, e-commerce was still relatively insignificant (0.3 percent of total retail sales, although even in the United States the estimate is only 0.6 percent), but its development would challenge Germany's restricted shop opening hours.[13] More immediately, legislation was planned to liberalize existing restrictive provisions on retail discounting and gifts, which were seen as incompatible with the demands of e-commerce.

23. **The authorities were pleased with the positive impact of their deregulation and privatization initiatives in network sectors, and further moves are planned.** In telecommunications, the liberalization process (completed by 1998) has sparked strong market growth (12 percent annually), greater competition (a tenfold increase in the number of large providers to ten since 1992)[14] and sharply falling prices (for long-distance calls, by 85 percent since 1997). A third tranche of the publicly-owned Deutsche Telekom is slated for privatization in 2000, reducing the public stake from 72 percent to 58 percent. Deutsche Post will be partially privatized in late 2000, with full privatization (subject to market conditions) by 2003, when the sector will be fully liberalized (including removal of Deutsche Post's

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[12] U.S. data suggest, however, that during the last five years—the period most often associated with a "new economy" boom in the United States—the earlier marked widening of skill-based wage differentials has ceased.

[13] Ministry of Labor officials noted that a study of the previous stage of deregulation of shop opening hours in 1996 had shown no positive effects on employment.

[14] For comparison, the number of large providers of telecommunication services in selected industrial countries is: France (6); Italy (9); United Kingdom (9); and United States (27).

monopoly for deliveries of letters and small parcels). Opening up of the electricity sector has also reduced prices (by up to 10 percent for households). Market pressures are expected to lead to a decline in the number of large interconnectors (from eight currently to three or four), possibly reducing the potential for further price reductions.

Labor market and social insurance

24. **On coming to office in 1998, the Government declared reducing unemployment its number one priority.** The forum of the social partners ("Alliance for Jobs") was tasked with finding cooperative solutions and is widely credited with having fostered a moderate outcome in the 2000 wage negotiations. This despite the fact that wage policy—considered a matter for employers and employees only—is not under its remit. The Alliance has not, however, yet produced concrete proposals for addressing unemployment. The government's labor market strategy is built on the presumption that unemployment is largely structural and results from high labor costs. It focuses on promoting across-the-board wage moderation (real wage increases at or below the projected increase in average labor productivity) to contain labor costs; initiatives, including a wide-ranging pension reform, to restrict future increases in social contribution rates; and active labor market programs to improve the employability of the (especially long-term) unemployed. The authorities have also introduced experimental schemes in several states using tax/transfer mechanisms to raise employment incentives for the lower-skilled, but felt that policies (such as in France) to taper social contributions at the low end involved excessive deadweight costs.

25. **The staff questioned whether a central pillar in this strategy, wage moderation, would be sustainable.** Across-the-board wage moderation should have beneficial effects on labor demand, but over time, and perhaps even as early as the next wage round in 2002, the seeds of its destruction may be sown. Specifically, wage increases low enough to make a dent in unemployment among the low-skilled could create excess demand for the skilled, while wage increases that clear the market for skilled workers are unlikely to significantly reduce unemployment among the low-skilled.[15] In short, across-the-board wage moderation can clear only one segment of the labor market if conditions for the skilled and unskilled differ. Moreover, the risk that future technical change may again be non-neutral across skills makes the chances for success even less favorable.

26. **More generally, in the staff's view, the authorities' labor market strategy, apart from the pension reform, did not attack the roots of Germany's unemployment problems.**[16] First, labor costs are not sufficiently responsive to changes in relative labor

[15] Chapter II of the accompanying *Selected Issues Paper* analyzes the economic effects of wage moderation.

[16] These labor market adjustment problems were analyzed in detail in Chapters I, III, and IV of *IMF Staff Country Report No. 99/130* for Germany.

productivities of workers (across skills, sectors, and regions). In particular, relative labor cost adjustments are blocked by the principle of "wage growth solidarity," enshrined in the trade unions' objective to benchmark negotiated tariff wage increases on the economy's overall rate of labor productivity growth. Second, social security arrangements—particularly the interplay between unlimited duration of unemployment benefits, generous early retirement incentives, and weak re-activation requirements for the unemployed—underpin high and inflexible reservation wages relative to take-home pay offered by the markets. And third, as labor shakeouts take place, endogenous increases in the social contribution rate to the PAYG system drive an increasing wedge between labor cost and take-home pay. Each of these weaknesses has its most adverse effect on employment of the low-skilled for whom productivity growth has been relatively slow and reservation wages relatively high compared to take-home pay.

27. **From this perspective, the staff pointed to three essential directions for labor market reform.** Wage bargaining should be reformed (by removal of existing legal constraints) to allow substantially greater wage differentiation according to skills and firm-level conditions. It was also necessary to tackle the causes of high reservation wages, in particular the unlimited duration of unemployment assistance. And for the social insurance system, a downsizing of the current dominant public pillar and a move toward a more diversified system were in order. These steps would increase employment, but at the cost of greater income inequality that might not be accepted unless tax and social contribution policies for the lower-paid were restructured to provide (through graduation of contributions or an earned income tax credit) a reasonable income for those in work.

28. **There were a variety of views in Germany on these issues, but Ministry of Labor representatives were unconvinced by the staff's position on wage bargaining and reservation wages.** They argued that high unemployment had reduced trade union membership and negotiating power, and the influential IG Metall union had recently signaled willingness to consider more flexible collective bargaining structures. Moreover, a rising share of wages was being determined outside standard structures, especially in eastern Germany, where increasingly employers were given the right to pay wages below the general structure in some circumstances, and in the emerging high-tech sectors, where collective bargaining was largely absent. Regulation of fixed-term employment was more flexible than in France or Italy, but unions were pressing for the current flexible provisions to lapse at end-2000. The authorities did not consider high reservation wages to be an issue and observed that a reduction in the present replacement rate for unemployment assistance (56 percent) would be incompatible with the spirit of social security.

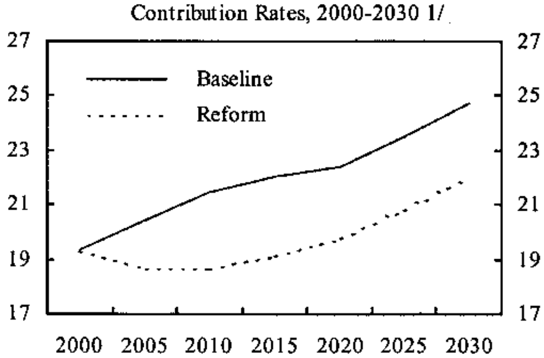
29. **Nevertheless, bold pension reform proposals have been put forward (Box 4).** The demographic profile, one of the least favorable among the industrial countries, implies rising pension outlays, and, with unchanged policies, significant increases in pension contribution rates—even on the authorities' relatively optimistic projection, from about 19 percent at present to about 25 percent by 2030. This would aggravate the vicious circle characteristics of Germany's labor market—rising labor cost leading to higher unemployment that requires

Box 4. Revamping Germany's Pension System[1]

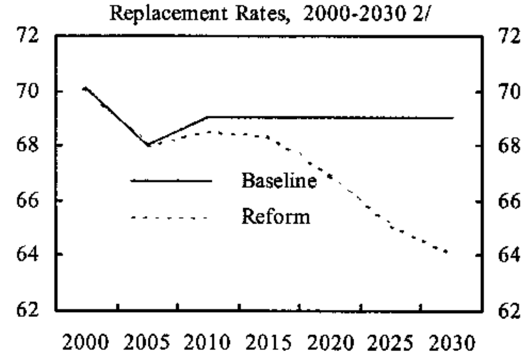
Germany's present pension system is dominated by a large-scale pay-as-you-go (PAYG) public pension pillar: public pensions account for some 85 percent of total retirement incomes; a standard pension (*Eckrente*) replaces about 70 percent of average net earnings; and public pension schemes transfer close to 13 percent of GDP to retired persons. On the financing side, the public pension pillar relies heavily on social contributions from labor—presently levied at a flat rate of 19.3 percent on wage earnings—with the remainder financed by budget transfers.

Looking ahead, Germany's largely undiversified pension system is ill-designed to handle the stresses of rapid population aging after 2010. Even on the authorities' optimistic projections, pension contribution rates would need to increase from about 19 percent to some 25 percent by 2030 to finance status-quo pension promises (Box 4, Figure 1).

Box 4. Figure 1. Germany: Projected PAYG Contribution Rates, 2000-2030 1/



Box 4. Figure 2. Germany: Projected PAYG Replacement Rates, 2000-2030 2/



Sources: Ministry of Labor; and staff calculations.
1/ Required pension contribution rate to finance pension spending (in percent).
2/ Standard pension (Eckrente) replacement rate (as percent of average net wage earnings in the economy).

The government has proposed a systemic pension reform that embraces two key elements. First, to complement the public pillar, a private funded pillar would be built with voluntary contributions underpinned by fiscal incentives aiming to increase contributions linearly from 0.5 percent of gross wage earnings in 2001 to 4 percent in 2008. Second, starting in 2011, public pension benefits of newly retired persons would be gradually reduced—the cuts in the standard pension replacement rate would cumulate to 4 percentage points by 2030—as these persons would increasingly be able to draw on income from the new funded pillar. In the projections, the reform would limit the first pillar contribution rate to 22 percent by 2030 (Box 4, Figure 2).

The proposed reform amounts to a conceptual sea change in Germany's pension system design. While in line with the recent international trend toward establishing more diversified pension systems,[2] the reform would only be a first step toward a genuine multipillar pension structure, typified in continental Europe by Switzerland's pension system. In particular, the proposed changes in the size and design of the public pillar are moderate—certainly against the background of the considerable margins of uncertainties surrounding long-run pension projections. Additional steps will likely be needed to maximize the benefits of diversifying the system.

[1] This box summarizes Chapter V of the *Selected Issues Paper*.
[2] See Fox, Louise and Edward Palmer (1999), "New Approaches to Multi-Pillar Pension Systems: What in the World is Going On?," mimeo., World Bank.

increases in social contribution rates.[17] The staff noted that the issue is ultimately one of intergenerational equity—distributing the cost of the demographic shock between future pensioners and future workers. But apart from equity considerations, an unreformed PAYG framework would be economically inefficient and risky for retirement income security.

30. **The staff, therefore, warmly welcomed the authorities' pension reform plans.** The plans, scheduled for consideration by Parliament in fall 2000, aim to diversify the pension system by encouraging current and future workers to build private pension claims in a new funded pillar, while gradually reducing replacement rates in the public pillar (the standard replacement rate would decline from 68 percent of net income currently to 64 percent in 2030). Contributions to the new pillar would not be mandatory, but certain amounts (½ percent of gross wages in 2001, rising to a total of 4 percent by 2008) would be deductible against personal tax. Those earning below the income tax threshold would receive direct support from the budget for their contributions. The cost of budgetary support is estimated to reach ½ percent of GDP by 2008. The authorities acknowledged that experience would reveal whether these incentives and the prospect of lower replacement rates in the public pillar would be sufficient to induce the envisaged flow of contributions to the funded pillar. The staff noted that the currently envisaged parametric changes in the standard pension replacement rate would still leave a dominant role for the public pension pillar, clearly so against the benchmark of countries with more diversified multipillar systems in continental Europe (such as the Netherlands and Switzerland).

Financial issues

31. **The authorities viewed the financial system as sound, with vulnerabilities having diminished as the emerging market crisis has receded (Table 2).** The construction industry remains in the doldrums, but the authorities believe the effects on financial institutions are limited because many of the more risky commercial real estate projects are undertaken by non-bank entities and are financed with equity stakes. More generally, banking systems in Europe are undergoing rapid evolution with the advent of EMU and ongoing disintermediation, globalization, and technological change (particularly in e-banking and integrated trading platforms). Yet a substantial part of the retail banking sector in Germany remains either publicly- or mutually-owned, structures that (by limiting the scope for consolidation with institutions with different legal forms) may inhibit quick responses to the changes afoot. The supervisory authorities expressed concern that the revenue base of

[17] Total social contribution rates (including also contributions for health and unemployment), which have risen from 26 percent to 41 percent since 1970, could thus rise further to almost 50 percent.

Table 2. Germany: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000 1/
External indicators					
Exports (annual percentage change, in U.S. dollars)	0.4	-2.2	5.2	-0.1	0.6
Imports (annual percentage change, in U.S. dollars)	-0.8	-3.0	4.9	1.9	1.1
Terms of trade (annual percentage change)	-0.4	-1.8	1.9	0.8	-2.5
Current account balance	-0.3	-0.1	-0.2	-0.9	-0.2
Capital and financial account balance	0.7	0.0	0.5	-1.5	...
Of which : Foreign direct investment (net)	-1.9	-1.4	-3.2	-2.2	...
Portfolio investment (net)	2.4	-0.4	-0.1	-0.9	...
Other investment liabilities (net)	0.1	1.7	3.8	1.7	...
Official reserves (in billions of U.S. dollars, end-of-period) 2/ 3/	83.2	77.6	74.0	61.0	58.7
Broad money to reserves ratio 2/ 3/	17.4	16.8	18.6	24.8	21.6
Central bank foreign liabilities (in billions of U.S. dollars) 2/	10.4	9.8	9.1	6.6	7.1
Foreign assets of the financial sector (in billions of U.S. dollars) 2/	650.3	698.7	817.6	924.4	865.4
Foreign liabilities of the financial sector (in billions of U.S. dollars) 2/	499.4	574.6	716.6	817.0	828.6
Official reserves in months of imports 2/	1.7	1.6	1.5	1.2	1.2
Total external debt 4/	59.3	63.7	74.3	72.5	...
Of which: General government debt	18.4	20.0	22.3	21.7	...
External debt to exports ratio	2.3	2.3	2.5	2.4	...
External interest payments to exports (in percent)	1.9	2.0	2.1	2.5	...
Exchange rate against U.S. dollar (period average) 5/	1.50	1.73	1.76	1.84	2.24
Financial markets indicators					
Public sector debt (Maastricht definition)	59.8	60.9	60.7	61.0	59.6
3-month T-bill yield 6/	3.3	3.3	3.5	2.9	4.9
3-month T-bill yield (real)	2.1	1.8	2.9	2.2	3.2
Change in stock market index (percent, end of period) 7/	28.2	47.1	17.7	39.1	3.7
Spread of 3-month T-bill vs. the U.S. (percentage points, e-o-p) 6/	-1.8	-1.8	-1.3	-1.7	-1.3
Financial sector risk indicators					
Total loans to assets	76.6	76.3	74.9	73.5	72.4
Total loans to deposits	115.5	115.6	113.9	112.3	110.8
Share of real estate sector in private credit (percent) 8/ 9/	22.7	22.4	22.0	23.5	23.4
Share of real estate sector in loans to nonfinancial private sector (percent) 9/ 10/	33.1	33.1	33.1	35.4	35.0
German capital asset ratio 11/	9.7	10.0	10.6	11.3	...
Profitability ratio 12/	10.8	11.0	17.7	...	...

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; and IMF, World Economic Outlook.
1/ Staff estimates and projections, unless otherwise indicated.
2/ Data for 2000 refer to May 2000.
3/ From 1999 onward data present Germany's position in the euro area.
4/ Gross external liabilities (excluding equity and liabilities resulting from foreign direct investment).
5/ Data for 2000 refer to September 8, 2000.
6/ For 2000, data are as of September 11, 2000.
7/ DAX stock market index (for 2000, December 1999 to end-August 2000)
8/ Share of housing loans in percent of total lending to private sector.
9/ For 2000, data through March, 2000.
10/ Share of housing loans in percent of total lending to nonfinancial private sector.
11/ Consolidated basis, risk-weighted, national definitions of capital.
12/ After-tax profit as percent of total surplus in operating business

these banks could, over the medium term, be undermined by other larger and more nimble institutions entering the market without the need for brick-and-mortar branches. Controversy also continued as to whether publicly-owned wholesale banks—the *Landesbanken*—should receive subsidized capital and implicit government guarantees.

32. **Financial supervisory structures in Germany are currently in flux.** The government is considering consolidation of banking supervision under the auspices of the Bundesbank or the Bundesaufsichtsamt,[18] with a later examination of the benefits of unifying financial sector supervision to include securities and insurance. Looking forward, euro-area financial markets will become increasingly interconnected, as evidenced by the discussion of mergers and alliances among equity and derivative exchanges. With a more integrated euro-wide interbank market, the staff suggested that greater harmonization of information from financial entities across the euro area would help supervisors anticipate local liquidity or solvency problems that would have potential for becoming area-wide ones. As integration deepens, consideration could be given to an institution with euro-area wide responsibility for systemically important financial institutions with a mandate to maintain financial stability. The authorities agreed that greater cooperation and harmonization would be appropriate but also noted that national structures would remain adequate, at least until more evidence for area-wide linkages was present.

ODA and trade

33. Germany's **ODA** was 0.26 percent of GNP in 1998, and medium-term budget plans do not envisage an increase. As regards trade, Germany is currently engaged, with its EU partners, in discussions aimed at bridging differences with the United States launching a new comprehensive WTO negotiating round. In this context, Germany favors ambitious commitments by all WTO members in the services negotiations and wants to ensure a commitment by all industrial countries to allow duty-free market access for essentially all imports from the least developed countries by 2003.

IV. Staff Appraisal

34. **The near-term outlook for the German economy is better than it has been for a number of years.** The external environment is strong, monetary conditions are quite supportive, and a clearer direction in domestic policies has boosted confidence. With above-potential growth in prospect, Germany should shift from being a drag on expansion in the euro area to providing an impetus for growth. The main near-term risks for Germany, as for

[18] The legally responsible entity for banking supervision is currently the *Bundesaufsichtsamt für das Kreditwesen*. The Bundesbank also undertakes many supervisory tasks, including some on-site evaluations of market-risk management systems of the largest banks, and it liaises with international supervisory organizations.

the area as a whole, are a possible sharp appreciation of the euro and the possible persistence of high oil prices.

35. **Medium-term developments, however, are likely to turn on policy changes.** Without structural reforms, most importantly in the labor market, Germany faces the risk of a premature cyclical downturn as rising demand meets inflexible supply constraints or as the euro returns to levels more in line with estimates of the sustainable structure of major currency exchange rates. The present favorable economic environment should be seized as an opportunity to address structural vulnerabilities, foremost inflexible labor markets, and secure a lasting improvement in growth prospects. The benefits of a sustained expansion would, of course, spill beyond Germany's borders.

36. **The government has already moved ahead decisively on several important policy fronts.** The commitment to fiscal discipline, tax and product market reforms, and the willingness to explore what is, for Germany, a radically new direction of pension reform bring together a strong agenda of change. But a labor market reform strategy is notably absent from that agenda.

37. **Fiscal policy has a strong foundation in the multi-year program of spending cuts, tax reforms, and deficit reduction initiated in 1999.** While the fiscal stimulus associated with direct tax reform in 2001 is difficult to justify in a macroeconomic context of strong growth, this concern is tempered by the benefits of the reform and the authorities' commitment to subsequent consolidation. Firm adherence to the global spending growth targets of the Stability Program will be needed to achieve the goal of medium-term budget balance, and will entail identifying additional specific spending measures for the period beyond 2001. These should focus on further structural cuts in social transfers and subsidies. Room will also need to be made within the overall budgetary envelope for the fiscal costs of pension and labor market reforms.

38. **Germany's focus on actual, rather than cyclically-adjusted, fiscal goals and outcomes carries the risk of rendering fiscal policy procyclical.** This risk should be avoided by allowing revenues and the fiscal balance to fluctuate with the cycle while sticking to the spending targets of the Stability Plan. The commitment to use the proceeds from sales of mobile telephone licenses to reduce debt is an important step in this direction. For the future, the authorities' interest in fiscal frameworks based on medium-term spending norms, as adopted elsewhere, is encouraging.

39. **The recent business and personal income tax reforms are a significant, and long-overdue, step in the right direction.** The reforms should increase Germany's attractiveness to foreign investors, reduce, on balance, investment distortions and yield some improvement in labor supply incentives. Attention should now shift to reform of the local trading tax, simplifying other taxes, and broadening the personal income tax base.

40. **Implementation of the proposed pension reform would constitute a major and much-needed change in the German pension system.** The planned diversification of the

pension system would reduce the burden of population aging on the public pension pillar and diminish the need for further increases in social contribution rates that harm labor market performance. In this sense, it is an important step in changing labor market institutions to raise the supply of and demand for labor. The reform's impact on national savings is less clear-cut; but the staff expects the effect on balance will be positive as younger generations make additional contributions to the new second pillar, particularly if participation in the second pillar is made mandatory. To maximize the benefits of diversification, expansion of the relative size of the new funded pillar beyond levels currently envisaged will likely be needed in due course.

41. **Germany's recent record of product market reforms has been impressive.** Further privatization of state holdings and public utility companies should be vigorously pursued. The focus on exploiting technological advances is welcome, and initiatives in the areas of education and training, internet use, and e-commerce in line with European commitments to embrace information technology should be implemented quickly.

42. **But the potential benefits of these diverse reforms will not be fully realized without a more proactive approach to labor market reform.** There are signs of evolution toward greater flexibility in working conditions and wages, trends that should be actively encouraged. But overall progress has been gradual, and this endogenous change needs to be supplemented with legal changes to allow employers and workers to reach wage agreements more in line with firm-level conditions. The problem which should be accorded highest priority, however, is the mismatch between reservation wages and take-home pay, particularly of the lowest-skilled. To make such changes—the most effective of which might be limiting the duration of unemployment assistance—consistent with Germany's social equity concerns, taxes and social charges for lower-paid workers would need to be restructured to ensure a standard of living that is attractive relative to out-of-work benefits.

43. **Short-term financial sector vulnerabilities have lessened over the last year.** Banking sector exposures to emerging markets remain large but appear to be conservatively managed. Domestically, supervisors will need to continue to watch exposures associated with the early 1990s building boom. It will also be important to move ahead promptly with proposals to put banking supervision under one roof. In the longer term, the implications of increasing financial sector integration and growth of European capital markets for the structure of supervision and regulation should be carefully examined. The benefits of establishing euro-area wide oversight of systemically important institutions should be considered.

44. **The longer-term efficiency and functioning of the financial sector pose challenging issues.** Ownership and governance structures of the publicly- and mutually-owned banks impede efficient consolidation and may hamper responses to the rapid technological change affecting the financial services industry. Moreover, the original goals and public support of the publicly-owned banks, particularly the *Landesbanken*, should be kept under review to assess whether the provision of subsidized capital or guarantees continues to be warranted.

45. Regarding **statistics**, welcome success was achieved over the past year in closing the gaps in national accounts data that had arisen in the context of the adoption of new European standards. Further adaptations will likely be needed in the future as standards evolve in response to new challenges—notably measurement issues associated with advances in information technology.

46. Germany is encouraged to raise its **ODA** toward the UN target of 0.7 percent of GNP and to use its influence toward the launch of a new multilateral **WTO** round with ambitious objectives and improved market access for poorer countries.

47. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Germany: Basic Data

Total area	357,041 square kilometers
Total population (1999)	82.11 million
GNP per capita (1999)	US$ 25,472

	1996	1997	1998	1999	2000 1/	2001 1/
	(Percentage change at 1995 prices)					
Demand and supply						
Private consumption	1.0	0.7	2.0	2.6	2.2	3.2
Public consumption	1.8	-0.9	0.5	-0.1	0.8	1.3
Gross fixed investment	-0.8	0.6	3.0	3.3	2.7	4.0
Construction	-2.8	-1.5	-1.0	0.5	-2.1	0.7
Machinery and equipment	1.7	3.7	9.2	6.7	8.8	7.7
Final domestic demand	0.7	0.3	1.9	2.2	2.0	3.1
Inventory accumulation 2/	-0.5	0.2	0.4	0.2	0.2	0.2
Total domestic demand	0.3	0.6	2.4	2.4	2.2	3.3
Exports of goods and nonfactor services	5.1	11.3	7.0	5.1	11.4	7.3
Imports of goods and nonfactor services	3.1	8.4	8.6	8.1	9.1	7.4
Foreign balance 2/	0.5	0.8	-0.3	-0.8	0.8	0.1
GDP	0.8	1.4	2.1	1.6	2.9	3.3
	(In millions, unless otherwise indicated)					
Employment and unemployment						
Labor force	40.7	41.0	41.2	41.3	41.5	41.7
Employment 3/	37.2	37.1	37.5	37.9	38.3	38.5
Unemployed 4/	3.5	3.9	3.7	3.4	3.3	3.2
Standardized unemployment rate	8.6	9.5	9.0	8.3	7.9	7.6
	(Percentage change)					
Prices and incomes						
GDP deflator	1.0	0.8	1.1	0.9	0.4	1.5
Consumer price index (harmonized)	1.2	1.5	0.6	0.7	1.7	1.5
Average hourly earnings (industry)	4.6	1.2	2.0	2.4	...	...
Unit labor cost (total economy)	0.2	-0.8	0.0	0.6	0.2	0.3
Real disposable income 5/	0.6	0.2	1.8	2.3	1.5	3.4
Personal saving ratio (in percent)	10.8	10.4	10.2	9.9	9.3	9.5

1/ Staff projections.
2/ Change as a percent of previous year's GDP.
3/ According to place of residence.
4/ On national accounts basis (ESA95); Unemployment as defined by the international labor organization (ILO).
5/ Deflated by the national accounts deflator for private consumption.

Germany: Basic Data (concluded)

	1996	1997	1998	1999	2000 1/	2001 1/
Public finances 2/ 3/	(In billions of deutsche marks)					
General government						
Expenditure	1,802	1,806	1,840	1,885	1,808	1,964
(In percent of GDP)	50.3	49.2	48.6	48.6	45.1	46.8
Revenue	1,680	1,706	1,762	1,830	1,873	1,914
(In percent of GDP)	46.8	46.5	46.5	47.2	46.7	45.6
Financial balance	-123	-99	-78	-55	64	-50
(In percent of GDP)	-3.4	-2.7	-2.1	-1.4	1.6	-1.2
Federal government						
Financial balance	-78.5	-63.5	-56.6	-51.1	55.6	-40.2
(In percent of GDP)	-2.2	-1.7	-1.5	-1.3	1.4	-1.0
General government debt	2,144	2,233	2,298	2,366	2,389	2,396
(In percent of GDP)	59.8	60.9	60.7	61.0	59.6	57.0
Balance of payments						
Trade balance 4/	93.3	110.3	124.4	118.0	120.3	133.2
Services balance	-55.3	-59.9	-67.6	-79.8	-84.1	-89.8
Net private transfers	-16.0	-15.9	-16.0	-16.7	...	...
Net official transfers	-35.3	-36.8	-37.3	-33.6	...	...
Current account	-12.0	-4.8	-8.0	-35.5	-7.7	0.0
(In percent of GDP)	-0.3	-0.1	-0.2	-0.9	-0.2	0.0
Foreign exchange reserves (e. o. p.) 5/	72.4	76.7	100.4	102.5	...	...
Monetary data	(Percentage changes, end of period)					
Money and quasi-money (M3) 6/	5.8	4.7	8.3	8.4	...	...
Domestic bank lending	7.6	6.0	6.4	5.6	...	...
Interest rates	(Period averages in percent)					
Three-month interbank rate 7/	3.3	3.3	3.5	2.9	4.9	...
Yield on ten-year government bonds 7/	6.2	5.7	4.6	4.5	5.3	...
Exchange rates	(Levels)					
DM per US$ (end of period) 8/	1.55	1.79	1.67	1.95	2.24	...
DM per US$ (annual average) 8/	1.50	1.73	1.76	1.84	2.24	...
Euro per US$ (annual average) 8/	0.78	0.88	0.89	0.94	1.15	...
Nominal effective rate (1990=100) 9/	108.9	103.9	104.1	102.1	97.4	...
Real effective rate (1990=100) 9/	119.3	111.4	108.4	104.4	98.1	...

1/ Staff projections.
2/ Data for federal government are on an administrative basis.
Data for the general government are on a national accounts basis. Debt data are end-of-year data for the general government in accord with Maastricht definitions.
3/ Government revenues in 2000 include the proceeds from the sales of mobile phone licenses of DM 99.4 billion (2.5 percent of GDP). The proceeds also affect the financial balances and the government debt.
4/ Including supplementary trade items.
5/ From 1999 onward data reflect Germany's position in the euro area.
6/ Data reflect Germany's contribution to M3 of the euro area.
7/ Data for 2000 refer to September 12, 2000.
8/ Data for 2000 refer to September 8, 2000.
9/ Data for 2000 refer to August, 2000.

Germany: Fund Relations
(As of August 31, 2000)

I. Membership Status:

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

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	13,008.20	100.0
Fund holdings of currency	9,072.72	69.7
Reserve position in Fund	3,935.51	30.3
Operational budget transfers (net)	-90.00	

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	1,210.76	100.0
Holdings	1,378.95	113.9

IV. **Outstanding Purchases and Loans:**	None	
V. **Financial Arrangements:**	None	
VI. **Projected Obligations to Fund:**	None	

VII. Exchange Rate Arrangement:

Since January 1, 1999, Germany is a member of the European Economic and Monetary Union (EMU); the deutsche mark entered EMU at a value of DM 1.95583 per euro.

Germany maintains exchange restrictions against Iraq pursuant to U.N. Security Council Resolution No. 661, and against the Federal Republic of Yugoslavia (Serbia/Montenegro) pursuant to U.N. Security Council Resolution No. 757. These restrictions were notified to the Fund under Decision No. 144.

VIII. Article IV Consultations:

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (SM/99/249) was discussed at EBM/99/117 (October 20, 1999).

GERMANY: STATISTICAL APPENDIX

Germany has a full range of statistical publications and has subscribed to the Fund's Special Data Dissemination Standard (SDDS). The Federal Statistical Office and other data compilation agencies make full use of the Internet to facilitate on-line access to data and press information.

Since the beginning of 1999, Germany's monetary and banking statistics methodology has changed to reflect the standards of the European Monetary Union. The Bundesbank has also taken steps to further harmonize the presentation of the balance of payments data, in line with the prescriptions of the fifth edition of the IMF's Balance of Payments Manual.

The adoption of the European System of Integrated Economic Accounts 1995 (ESA95) in 1999 highlighted the significant difference between Germany's official unemployment rate measure (based on a count of registered unemployed persons) and the (standardized) national accounts unemployment rate measure (based on a survey-based count of unemployed persons). For example, in 1999 the standardized unemployment rate measure was reported at 8.3 percent, but the official unemployment rate was at 10.5 percent. While the official unemployment rate dominates public discussion of the labor market situation, the standardized rate is predominantly used in international comparisons.

The adoption of the European System of Integrated Economic Accounts 1995 (ESA95) in 1999 left two significant data gaps:

- ESA95 data are only available from 1991 onward. Budgetary constraints are likely to hinder the adoption of ESA95 for pre-1991 data, thus restricting the scope for time series analysis of German data.

- The adoption of ESA95 also led to a discontinuation of the publication of separate national accounts data for western and eastern Germany. Although regional economic indicators may help to bridge some of the information gap, the monitoring of the convergence process in the new Länder will likely be impeded.

More recently, Germany's statistical treatment of investment in information technology (IT) equipment has received considerable attention. Analysis by the Bundesbank suggested that the use of so-called "hedonic" price indices—price indices that take account of large quality changes and which are used by other statistical offices including the United States, France, Sweden, and Denmark—would result in significantly higher estimates of Germany's real investment in IT equipment during the 1990s. Assessing the impact of using hedonic price measurement on other national account data—including gauging the "GDP growth effect" of alternative measures of IT investment—would require comprehensive re-calculations to other intermediate components for which IT usage is not yet recorded.

Germany: Core Statistical Indicators
(As of end-August, 2000)

	Exchange Rates	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	8/31/00	8/31/00	7/00	6/00	6/00	1999	2000Q2	1/99
Date Received	8/31/00	8/31/00	8/10/00	8/10/00	8/10/00	1/12/00	8/30/00	6/00
Frequency of Data	Daily	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Semiannual
Frequency of Reporting	Daily	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Monthly
Source of Update	Bundesbank, website	Bundesbank, website	Statistical Office, website	Statistical Office, website	Statistical Office, website	Statistical Office	Statistical Office, website	Bundesbank, website
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Daily	Monthly	Monthly	Monthly	Annual	Quarterly	Monthly

Statement by the IMF Staff Representative on Germany
October 23, 2000

This statement provides information on economic and financial developments that has become available since the staff report for the 2000 Article IV consultation with Germany (SM/00/225) was issued on October 2, 2000. This information does not alter the thrust of the staff appraisal.

1. In line with the staff report's assumptions, recent developments show that **real economic activity** in Germany remains strong but has slowed from its earlier brisk clip:

- While **manufacturing activity** was buoyant in August, with output expanding by 7½ percent, the growth rate of **manufacturing orders** eased in August to 8¼ percent (compared with average growth of 13½ percent during the previous six months). The IFO **business climate index** cooled to 98.0 in September, from 98.9 in August, but remains at a level close to previous cyclical peaks.

- **Consumer confidence** dipped in September in response to rising oil prices. Excluding car sales, which remained subdued following strong sales figures in previous years, **retail sales** were robust in August, rising 2½ percent year-on-year.

- The **construction sector** continued to be a drag on the economy, with output during August almost 9 percent lower than a year earlier.

2. In the labor market, **employment** in July was 1½ percent higher than a year ago, confirming the strong pick up in net job creation recorded during the first half of the year. The (standardized) **unemployment rate** declined to 7.8 percent in September, from 8.3 percent one year ago.

3. Owing to the run up in import prices for energy, **headline CPI inflation** rose to 2.5 percent in September (year-on-year), a marked increase from average monthly inflation of 1¾ percent during January-August 2000. However, **underlying inflation** (CPI inflation excluding energy) in September remained subdued at 1 percent.

4. Recent **wage settlements** continued to be benchmarked on the two-year pay deals reached in the chemicals and metal industries in March, which set nominal annual wage increases of around 2½ percent. In September, the social partners settled on annual wage increases of some 2½ percent for the next two years in the west German textile industry and at the car producer Volkswagen. The next important sectoral wage negotiations are scheduled to start at end-January 2001 in the retail sector followed in March-April 2001 by the banking and insurance sectors.

5. In view of the updated country information, recent financial market developments, and a new baseline for oil prices, the staff has revised its near-term **growth projections** (2000-01) for Germany in the context of a revision of macroeconomic projections for the

- over -

euro area as a whole.[1] While real GDP growth in 2000 continues to be projected at close to 3 percent, higher energy prices could dampen growth by some ¼ percentage point in 2001, reducing the staff's projection from 3¼ percent to 3 percent. These growth projections are in line with the latest (October 2000) *Consensus Forecasts.* As regards the near-term **inflation outlook**, the projection for headline CPI inflation has been revised upward to 2.0 percent in 2000 and 1.9 percent in 2001, compared to 1.7 percent and 1.5 percent, respectively, in the published WEO. However, reflecting the moderate wage cost trends, underlying domestic pressures on inflation remain subdued.

6. The government has announced **two fiscal initiatives to mitigate the cost impact of higher oil prices:** a means-tested one-time subsidy for heating costs of low income earners; and an increase in the commuter allowance from currently DM 0.7 per kilometer to DM 0.8 per kilometer; moreover, the commuter allowance will be extended to cover all forms of commuting, not just driving cars. The overall fiscal cost of the two measures in 2001 is estimated at DM 3 billion (0.1 percent of GDP). There are no plans to cut fuel taxes in response to the current run up in oil prices.

7. The federal government has clarified plans regarding the earmarking of the annual **interest savings from reducing public debt with the proceeds from the auction of UMTS licenses** (about DM 5 billion or 0.1 percent of GDP). The interest savings are planned to be spent on public infrastructure, particularly the railways, education, and energy conservation.

8. Draft legislation on the government's **proposed pension reform** is likely to be presented to Parliament at the beginning of November, with approval of the reform not expected before spring 2001. The draft proposal left open the income tax treatment of pension contributions and benefits as a Constitutional Court ruling on this issue is expected at the beginning of next year.

9. The authorities' updated **Stability Program,** which was approved by cabinet on October 11, re-confirmed the fiscal targets of the previous program.[2] It retains the commitment to medium-term budget balance by 2004 and remains underpinned by a strategy of sustained expenditure restraint.

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[1] See the supplement to the paper on monetary and exchange rate policies in the euro area (SM/00/212).

[2] Following Eurostat conventions, the Stability Program treats UMTS license receipts in 2000 as negative capital expenditures (rather than capital revenue as in the circulated staff report). The staff will adjust the presentation of Germany's general government spending and revenue data in the published version of the staff report accordingly.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/92
FOR IMMEDIATE RELEASE
November 2, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Germany

On October 23, 2000, the Executive Board concluded the Article IV consultation with Germany.[1]

Background

Germany's economy has entered a healthy expansion phase underpinned by strong external demand, a highly competitive euro, and markedly improved business and consumer sentiments. Following the Asian and Russian crisis, real GDP growth picked up to an annual pace of close to 3 percent, mainly on the strength of strong revival in exports and in investment in machinery and equipment. In the export-oriented manufacturing sector, capacity utilization and business confidence have reached the highest levels since the cyclical peak during the unification boom in the early 1990s. At the same time, private consumption has, until recently, remained subdued while construction activity is still weighted down by the overcapacities accumulated during the unification boom.

The string of anemic growth cycles in recent decades—particularly the post-unification slump of the 1990s—has left behind a labor market legacy of high unemployment and sluggish employment growth. With the labor force roughly constant, the pickup in activity led to modest employment gains, reflected in a gradual decline in the unemployment rate (on a standardized basis), from a peak of 10 percent in late 1997 to presently about 8 percent.

Headline CPI inflation has risen to over 2 percent, owing mainly to sharp increases in oil prices and the one-time effects of ecotax increases. By contrast, underlying CPI inflation (CPI

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

excluding energy and food) has remained around 1 percent, reflecting moderate wage settlements and ongoing deregulation in the utilities sectors.

Executive Board Assessment

Executive Directors were pleased to note that the near-term outlook for the German economy was more favorable than it had been for many years, reflecting a markedly improved external environment, supportive monetary conditions, moderate wage settlements, and a clearer direction in domestic policies. While Directors pointed to downside risks to the near-term outlook, mainly the persistence of high oil prices and a possible sharp appreciation of the euro, they felt that these shocks were unlikely to derail the expansion. Directors welcomed the authorities' structural reform initiatives, notably on income taxes, pensions, and product markets, noting their contribution to the present strong economic situation, but cautioned that a strong reform agenda to address rigidities in the labor market is also necessary to assure favorable medium-term growth and permanently lower unemployment. Directors were of the view that the favorable economic climate provides an important window of opportunity to address remaining challenges.

Directors noted that the medium-term orientation of fiscal policy is anchored in the authorities' multi-year program of spending cuts, tax reforms, and deficit reduction. Directors emphasized that the overall limits on spending growth in the authorities' Stability Program will need to be firmly respected to achieve medium-term budget balance. Moreover, Directors noted that room will need to be made for the fiscal costs of pension and labor market reforms, and that further structural spending cuts for the period beyond 2001 should be targeted mainly on subsidies and social transfer programs. In this context, Directors commended the authorities' commitment to earmark the full amount of the substantial windfall from sales of mobile telephone licenses for repaying public debt. Some Directors felt that—on present growth projections, and with steadfast implementation of the Stability Program's spending targets—achievement of overall budget balance would be feasible already by 2002.

Directors welcomed the recent adoption of a significant package of business and personal income tax reforms. In their view, these reforms would reduce investment distortions, improve labor supply incentives, and increase Germany's attractiveness to foreign investors. Directors observed that attention should shift to reform of the complicated local trading tax, broadening the personal income tax base, and other simplifying measures. Directors observed that there would be some fiscal stimulus in 2001 associated with income tax reform in the context of strong projected growth. Concern about such a procyclical fiscal stance is tempered, however, by the heightened downside risks to near-term growth prospects and by the likely supply-side benefits of the tax reform in the longer term.

More generally, Directors noted that Germany's longstanding focus on actual, rather than cyclically adjusted, fiscal goals and outcomes could constrain the operation of automatic fiscal stabilizers. Noting that monetary union called for an enhanced role for fiscal stabilizers, Directors welcomed and strongly encouraged the authorities' interest in medium-term fiscal frameworks based on spending norms that would allow revenues and the fiscal balance to fluctuate with the cycle.

Directors welcomed the authorities' pension reform proposal, which would constitute a major and much needed change in the German pension system, and could set an example for other European countries. Directors noted that the planned diversification of the pension system would reduce the burden of population aging on the public pension pillar, diminish the need for further increases in social contribution rates that could harm labor market performance, and possibly further increase national savings, particularly if participation in the funded pillar were made mandatory. At the same time, some Directors took the view that to reap the full benefits of diversification, cuts in the size of the public pension pillar beyond levels currently envisaged could well be needed in the longer run.

Directors took note of Germany's impressive recent record of product market reforms, notably in the telecommunications and energy sectors. Nevertheless, they urged further actions, including liberalization of shop opening hours, elimination of existing restrictive regulations on retail discounting, and privatization of financial institutions and of the remaining state holdings in public utility companies, especially at lower levels of government. Directors also welcomed initiatives in line with European commitments to embrace information technology in the areas of education and training, Internet use, and e-commerce. More generally, they observed that continued efforts to reduce structural rigidities offered the best scope for such opportunities.

Directors expressed concern that the potential benefits of these diverse reforms would not be fully realized without a more proactive approach to labor market reform. Several Directors, however, while acknowledging the need for additional labor market reforms, underscored that workable solutions would have to take into account Germany's own circumstances and institutions, and the need for careful sequencing. Although Directors were encouraged by signs of greater flexibility in working conditions and wages, especially in eastern Germany's depressed labor market, they observed that these more spontaneous changes need to be supplemented with legal changes to allow employers and workers to reach wage agreements more in line with firm-level conditions. Better training opportunities could also play a role in tackling labor market issues. Directors also attached importance to the need to tackle the mismatch between reservation wages and take-home pay, particularly by limiting the duration of unemployment assistance.

Directors were encouraged that short-term financial sector vulnerabilities have lessened over the last year. At the same time, they urged continued vigilance on exposures associated with the early 1990s building boom and with lending to emerging markets. Several Directors observed that the organizational structures of the publicly- and mutually-owned banks impede efficient consolidation and could hamper responses to the rapid technological change now affecting the financial services industry.

Directors welcomed the closing of gaps in national accounts data that had arisen in the context of the adoption of new European accounting standards, but they also commented that further changes would likely be needed as statistical standards evolve in response to new challenges, notably measurement issues associated with the economy's increased production and use of information technology. In this regard, they were interested in the possibility of comparing international growth performance on a consistent statistical basis.

Directors welcomed Germany's prominent role in strengthening the Initiative for Heavily Indebted Poor Countries and its significant support for transition economies, and—while noting that Germany's official development assistance (ODA) is above the OECD average—urged the authorities to avoid the projected declines for the coming years.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 2000 Article IV consultation with Germany is also available.

Germany: Selected Economic Indicators

	1996	1997	1998	1999	2000 1/	2001 1/
Economic activity and prices	Change in percent, unless otherwise noted					
Real GDP	0.8	1.4	2.1	1.6	2.9	3.1
Net exports 2/	0.5	0.8	-0.3	-0.8	0.8	0.1
Domestic demand	0.3	0.6	2.4	2.4	2.2	3.0
Private consumption	1.0	0.7	2.0	2.6	2.2	2.9
Gross fixed investment	-0.8	0.6	3.0	3.3	2.7	4.0
Construction investment	-2.8	-1.5	-1.0	0.5	-2.1	0.7
Gross national saving (percent of GDP)	21.3	21.4	21.6	21.3	21.9	22.4
Gross domestic investment (percent of GDP)	21.6	21.6	21.8	22.2	22.1	22.4
Labor force 3/	0.4	0.8	0.4	0.3	0.6	0.4
Employment 3/	-0.3	-0.2	0.9	1.1	1.0	0.7
Standardized unemployment rate (in percent)	8.6	9.5	9.0	8.3	7.9	7.6
Unit labor costs (whole economy) 4/	0.2	-0.8	0.0	0.6	0.2	0.3
GDP deflator	1.0	0.8	1.1	0.9	0.4	1.5
Harmonized CPI index	1.2	1.5	0.6	0.7	2.0	1.9
Public finance	In percent of GDP					
General government balance 4/ 5/	-3.4	-2.7	-2.1	-1.4	1.6	-1.2
Structural government balance	-2.7	-1.6	-1.2	-0.5	-0.4	-1.2
General government gross debt 5/	59.8	60.9	60.7	61.0	59.6	57.0
Money and credit						
Domestic credit	7.6	6.0	6.4	5.6	...	...
M3 6/	5.8	4.7	8.3	8.4	...	...
Interest rates	Percent					
Three-month money market rate 7/	3.3	3.3	3.5	2.9	4.9	...
Ten-year government bond yield 7/	6.2	5.7	4.6	4.5	5.3	...
Balance of payments	In billions of DM, unless otherwise noted					
Exports 8/	917.8	1,033.4	1,104.2	1,153.5	1,314.4	1,442.6
Imports 8/	879.8	983.0	1,047.4	1,115.3	1,278.2	1,399.2
Trade balance (percent of GDP)	2.6	3.0	3.3	3.0	3.0	3.2
Current account balance	-12.0	-4.8	-8.0	-35.3	-7.7	0.0
Current account (percent of GDP)	-0.3	-0.1	-0.2	-0.9	-0.2	0.0
Exchange rate						
Deutsche mark per US dollar 9/	1.50	1.73	1.76	1.84	2.24	...
Euro per US dollar 9/	0.78	0.88	0.89	0.94	1.15	...
Nominal effective rate (1990=100) 10/	108.9	103.9	104.1	102.1	97.4	...
Real effective rate (1990=100) 10/ 11/	119.5	111.4	108.4	104.4	98.1	...

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; IMF, World Economic Outlook; and staff projections.

1/ Staff projections, if not otherwise indicated.

2/ Contribution to GDP growth.

3/ Domestic definition on a national accounts basis; according to new integrated system of economic accounts (ESA95).

4/ On a national accounts basis; according to new integrated system of economic accounts (ESA95).

5/ For 2000 includes the proceeds from the sale of mobile phone licenses (UMTS) of DM 99.4 billion (2.5 percent of GDP). The proceeds are used to buy back public debt; the buy-back is phased over 2000 and 2001.

6/ Data reflect Germany's contribution to M3 in the euro area.

7/ Data for 2000 refer to September 12, 2000.

8/ Includes supplementary trade items and services.

9/ Data for 2000 refer to September 9, 2000.

10/ Data for 2000 refer to August.

11/ Based on relative normalized unit labor cost in manufacturing.