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Germany: 2001 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 9, 2001,** 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 September 24, 2001.** 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 supplement of **October 22, 2001** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 24, 2001 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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GERMANY

Staff Report for the 2001 Article IV Consultation

Prepared by Staff Representatives for the 2001 Consultation with Germany

Approved by Michael Deppler and Martin Fetherston

September 24, 2001

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I. Introduction, Summary, and Key Issues

1. Germany's third post-reunification growth spurt came to an abrupt end in the middle of last year. This report focuses on the factors behind the latest slowdown, probes what might be inferred about the resiliency of the economy, and examines how policies might assist recovery and improve longer-term growth prospects. Consultation missions for Germany, France, Italy and Spain pooled their efforts this year to prepare a joint selected issues paper on two issues of common interest for the countries: the employment-intensity of growth during the 1990's and consideration of rules-based fiscal policy.

2. Economic developments have contrasted sharply with expectations at the conclusion of last year's consultation with Germany (EBM/00/103) on October 23, 2000. Then, Directors agreed the short-term outlook was bright and were relatively confident the economy could weather higher oil prices. However, Directors stressed that longstanding structural weaknesses, particularly in labor markets, might once again stand in the way of sustained growth. In the event, the slowdown turned out to be already underway. Against the backdrop of the global slowdown, it has persisted at least through the middle of this year. In the meantime, the authorities have achieved notable progress in tax and pension reform.

3. In this year's discussions, the authorities and staff agreed that stronger growth would likely resume once external shocks began to unwind—although business confidence remains low.[1] In view of the projected recovery, the staff did not press for an augmented role for fiscal policy to speed recovery. The staff commended the authorities for a strong record of structural reform in the pension and tax systems and in product markets. It encouraged the authorities to rise equally to the task of reform in labor markets to reduce wage rigidities and improve incentives to work. Such reform would be a critical ingredient for raising potential output growth above present estimates of about 2 percent a year. Federal elections take place in September-October 2002.

* * *

[1] Discussions took place in Berlin, Frankfurt, Bonn, Magdeburg, Munich, Nürnberg, and Wiesbaden during June 27–July 9, 2001. Meetings were held with Finance Minister Eichel, State Finance Secretary Koch-Weser, and senior officials of the Ministries of Finance, Economy, and Labor, the Bundesbank, the Federal Offices of Banking, Securities and Insurance Supervision, the Federal Labor Office, and state and local governments. The mission also met with private financial institutions, a large industrial enterprise, research institutes, and the social partners. The team comprised Ms. Schadler (Head), Mr. Corker, Ms. Kodres, Mr. Klingen, Mr. Danninger (all EU1), and Mr. Symansky (FAD). Germany's Executive Director's Office was represented at the meetings by Messrs. Donecker, Bischofberger and von Kleist. The authorities released the mission's concluding statement and intend to publish this staff report. Last year's staff report was published as IMF Staff Country Report 00/141.

4. Reflecting new information and a weaker outlook for the global economy, staff has made significant downward revisions to the growth projection for Germany discussed with the authorities at the time of the mission. Staff will consult with the authorities closer to the Executive Board meeting and, if necessary, report any significant changes in views in a supplement to this report. The supplement would also report on any consequences for the outlook and policies of the terrorist attack in the United States, which occurred as this paper was being finalized.

II. Background

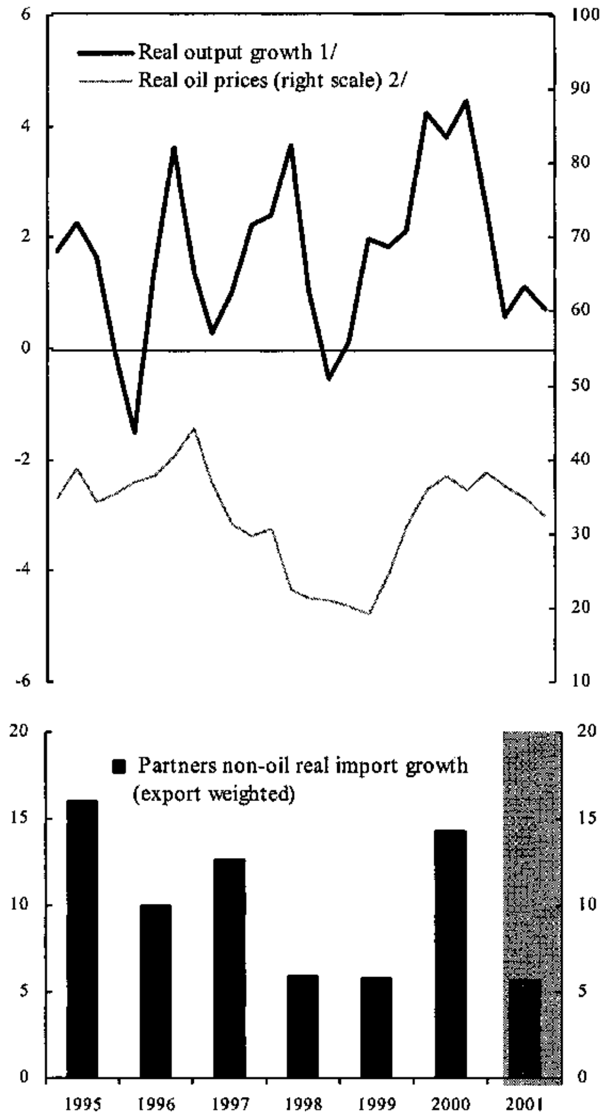
A. The Current Slowdown

5. **The rise in oil prices appears to have triggered the end to Germany's latest upswing (Figure 1).** Helped by strong global demand and a depreciating euro, real GDP growth surged to a greater-than 4 percent annualized rate in the second half of 1999 and first half of 2000, ensuring that 2000 registered the fastest annual average growth (3 percent) in nearly 10 years. But growth dropped precipitously to barely more than a ½ percent annualized rate in the second half of 2000 and remained at this rate in first half of 2001. The initial phase of slowdown was led by a contraction of private consumption, caused by the effect of rising oil prices and the depreciating euro on disposable incomes, and the end of a three-year investment boom outside of construction (Box 1). Steep declines in stock prices, particularly in the tech-heavy Neuer Markt index, probably added to the effect of weakening domestic demand growth on investment decisions (Figure 2 and Box 2).

6. **In the first half of 2001, the effects of sizable tax cuts failed to revive growth as the global economic slowdown began to take hold.** Beginning-of-the-year tax cuts[2] (amounting to 1.1 percent of GDP for the full year) helped to lift consumption growth markedly in the first half of the year despite consumers having to face further unexpected price hikes, mainly to food. But the effect of the rebound of consumption on output was offset by a sharp correction of inventories, the gradual toll on exports of the slowdown in the global economy, and falling plant and machinery investment (Figures 3 and 4). The export-oriented manufacturing sector slipped into recession in April, joining the construction sector where output has been declining since 1996 following the end of the post-reunification building boom; capacity utilization in the manufacturing sector has subsequently declined steeply (Figures 5 and 6). Business confidence continued to slide during the first half of 2001 (Figure 7).

[2] The top marginal income tax rate was lowered to 48.5 percent from 51.0 percent, the rate in the lowest bracket was lowered to 19.9 percent from 22.9 percent, and the basic allowance was increased. Corporate tax rates were also cut and the base broadened. See SM/00/229 for more details.

Figure 1. Germany: Economic Developments, 1995-2001

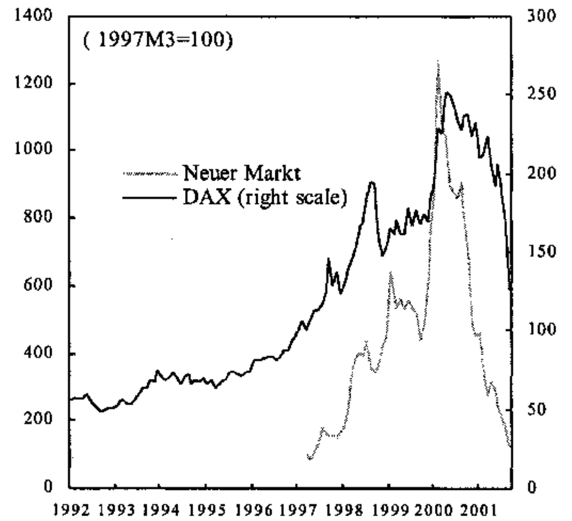


Source: Deutsche Bundesbank.

1/ Seasonally adjusted annualized growth rates over two quarters.

2/ 1980=100

Figure 2. Germany: Nominal Stock Price Indices, 1992-2001



Sources: Deutsche Bundesbank; and staff calculations.

Box 1. Shifting National Accounts Statistics and the Incomplete Story of the Slowdown

The release of second quarter national accounts data in August was accompanied by sizable revisions to the expenditure components of GDP. Compared with earlier estimates, the boom in plant and machinery investment, which had held up through the first quarter of 2001, petered out much earlier. Weak consumption growth in the first quarter was revised to strong. And a major shakeout in inventories appeared without warning in the first quarter of 2001. Some basic elements of the story remained after the revision: a downturn in consumption growth was responsible for weak domestic demand in the second half of 2000 (although the weakness was more intense according to the new data) and export and import growth still collapsed at the beginning of this year. The volatility of the data and some remaining puzzles in the finer details of the national accounts statistics suggest that more revisions may be in train.

Some puzzles, which have a bearing on interpreting the slowdown and in forecasting when recovery might occur, are:

1. **What caused the slowdown in consumption last year?** Oil prices did not, according to the data, cause a sharp increase in the consumption deflator, which grew at a modest 1.4 percent last year. Instead, higher import prices were absorbed by entrepreneurial/investment incomes and employees' compensation. That is, it was compression of disposable income rather than the erosion of consumers' purchasing power through price increases that caused the slowdown in consumption.

2. **Where is the tax cut and is it being fully spent?** Wage tax relief of 0.6 percent of GDP for the full year is hard to see in the data; the average wage tax rate in the first half of 2001 was lower than in 2000, but the decline was less than half what would have been implied by the tax relief. This might reflect taxpayers shifting income, and thus deductions, from 2000 into 2001. Despite rapid consumption growth in the first half of 2001, the savings rate ticked up, consistent with its behavior following past tax cuts. However, according to preliminary explanations provided by the authorities, the increase in the savings rate likely reflects the effect of heating bills being paid in the first half of 2001 but accrued in 2000. Thus, *on a cash basis*, the swing in consumption growth between 2000 and 2001 was even more pronounced than the new data suggest and there was no increase in the savings rate. A tentative conclusion is that none of the tax cut was saved, i.e., consumers will not have additional ammunition to support spending later in the year.

3. **What accounts for the export slowdown?** Revised national account statistics confirm that exports grew as strongly in the second half of 2000 as in the first half, at a break-neck 14 percent annualized pace. The subsequent slowdown in the first half of 2001 to an annualized growth of barely 1 percent appears to be primarily due to exports to the rest of the European Union rather than to exports to the United States or other countries. According to the latest trade statistics, nominal exports to the United States grew at an annualized rate of 11 percent in the period January-June 2001 while those to the European Union shrank at a rate of 6 percent. In other words, the most direct effects of the U.S. slowdown are not visible in the data.

4. **Was the inventory and investment decline real?** The revised plant and machinery investment figures suggest that investment turned down at a much earlier phase in the current downswing than usual. Perhaps the rapid fall reflected multinationals feeling profit squeezes abroad or facing financing constraints in foreign markets or simply cutting back investment in expectation of lower exports. For inventories the sharp correction now shown in the first quarter of 2001 is hard to substantiate because no independent estimates of stockbuilding exist and the national accounts estimate is lumped in with the statistical discrepancy between the output and expenditure measures of GDP.

Box 2. How Much Has The Stock Market Affected Activity?

Conventional wisdom that stock price movements are not very important for the German economy may be outdated. In the 1990s, there was a dramatic increase in household stock ownership in Germany—the proportion of household financial assets in equity has increased from 14 to 27 percent since 1991 and one in five Germans now own stock, double the number in 1997. Press coverage of the stock market (especially the *Neuer Markt*, devoted to high tech issues) and new equity issuance activity have grown dramatically.

Nonetheless, recent research still finds that stock market effects on consumption and investment are small, especially in comparison to those in the United States. Effects of stock prices on consumption are found to be statistically insignificant. For investment, only effects from changes in Telecommunications, Media, and Information Technology stocks (TMT) are measurably important (see tabulation below).[1] Additional research also tests whether the constant barrage of information about the U.S. stock market might have a direct effect on German consumption. However, this turns out to be basically nil.

Impact after Two Years of a $1 Increase in TMT and Non-TMT Stock Market Valuations

	TMT	Non-TMT
	On aggregate consumption	
Germany	2.8 cents	0.1 cents
United States	**1.7 cents**	**5.1 cents**
	On investment	
Germany	**5.1 cents**	-0.1 cents
United States	**8.2 cents**	**3.0 cents**

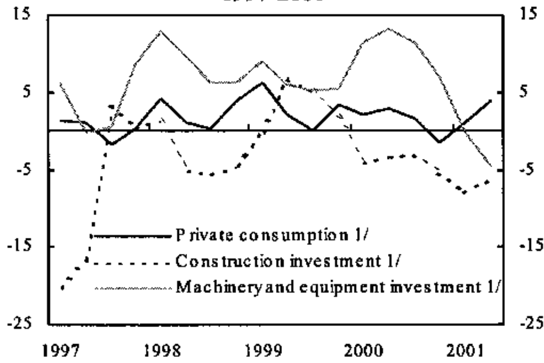
1/ Bold numbers are statistically significant. Results are expressed in U.S. dollars for ease of understanding.

Given the large swings in the prices of German TMT stocks, small marginal effects can imply large total effects. TMT stocks more than doubled (+129 percent) in the run up from March 1999 to March 2000 before giving up their entire gain (a 62 percent fall) in the following 12 months. Using the above estimates, the decline would have knocked 0.3 percentage points off consumption growth and 1.2 percentage points off investment in the year to March 2001, assuming one half of the full two-year effect would have applied. However, given the lack of statistical significance, the effect on consumption should be heavily discounted. The investment effect is corroborated by the dramatic decline in initial public offerings (IPOs) on the *Neuer Markt*—134 in 2000, versus only eleven by end-August 2001. Given that the earlier rise in stock prices would, by the same arithmetic, have been a factor behind strong investment before March 2000, stock prices thus might account for a significant portion of the swing in investment growth from its boom to its more recent decline.

Despite the tentative nature of the numbers, the analysis points to the stock market having played a role in the weakening of investment in the past year. Taking into account the share of private investment in GDP, the stock market effects on investment translate into a downward effect on GDP growth in the last 12 months on the order of 0.3 percentage points—not insignificant, but far from the entire explanation.

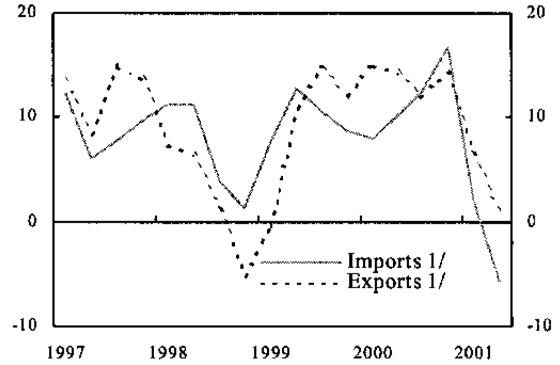
[1] See Edison and Sløk, (2001a), "Wealth Effects and the New Economy," IMF Working Paper, WP/01/77 and (2001b) "New Economy Stock Valuations and Investment in the 1990s" IMF Working Paper, WP/01/78.

Figure 3. Germany: Selected Components of Domestic Demand, 1997-2001



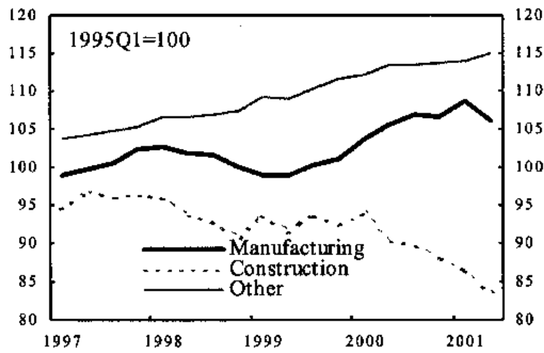
Source: Deutsche Bundesbank.
1/ Seasonally adjusted annualized growth rates over two quarters.

Figure 4. Germany: Exports and Imports, 1997-2001



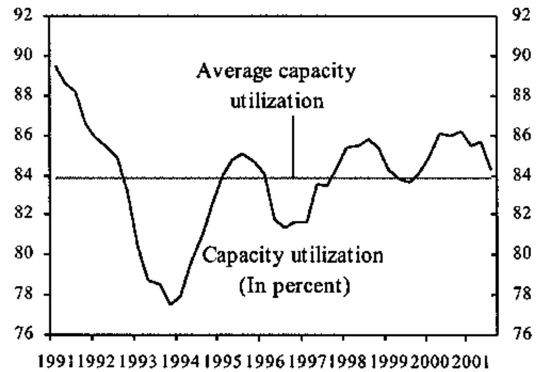
Source: Deutsche Bundesbank.
1/ Seasonally adjusted annualized growth rates over two quarters.

Figure 5. Germany: Output by Sectors, 1997-2001



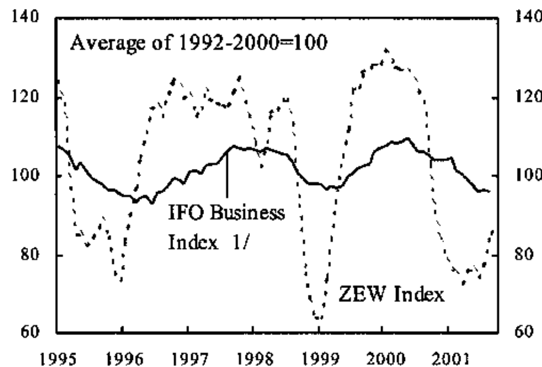
Source: Deutsche Bundesbank.

Figure 6. Germany: Capacity Utilization, 1991-2001



Sources: IFO Institute for Economic Research; and IMF staff estimates.

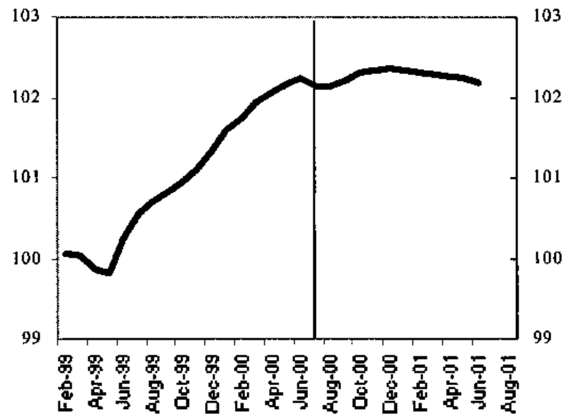
Figure 7. Germany: Business Confidence Indicators, 1995-2001



Sources: IFO Institute for Economic Research; and Centre for European Economic Research (ZEW).
1/ Data for western Germany. Composite indicator.

7. **Unemployment is inching up again.** During the preceding upswing, employment had finally begun to grow for the first time since reunification. The unemployment rate fell to 7¾ percent on a standardized measure at end-2000 from its peak of over 9½ percent in late 1997. Employment growth stopped in its tracks around the middle of 2000 (Figure 8).

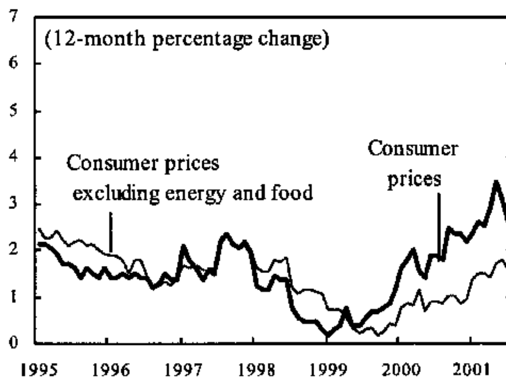
Figure 8. Germany: Employment, 1999-2001



Source: Deutsche Bundesbank.
1/ January 1999=100.

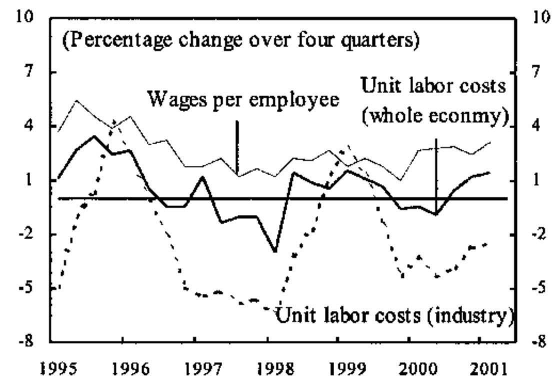
8. **Wage settlements and underlying inflation are low.** Headline 12-month inflation peaked in May when food and energy pushed inflation to 3½ percent, but by August it had eased to 2½ percent (Figure 9). Excluding the effects of steep increases in energy, food, and administrative prices, inflation is running around 1½ percent. Pay settlements have been clustered around 2½ percent, with the key deal for metalworkers covering 24 months through spring 2002 (Figure 10). A highly publicized 30 percent pay increase for airline pilots was exceptional and covers several years with increases dependent on profits.

Figure 9. Germany: Price Inflation, 1995-2001



Source: Deutsche Bundesbank.

Figure 10. Germany: Wages and Unit Labor Costs, 1995-2001



Source: Deutsche Bundesbank.

9. **The economic slowdown is likely to lead to revenue shortfalls and an overshooting of the general government deficit target in 2001.** In the first half of this year, tax collection was 3.5 percent below the level in the same period of last year; for the full year it is budgeted to decline by 2.5 percent on account of income and corporation tax cuts. However, federal expenditure is broadly on track. Assuming discipline on non-cyclical spending is maintained at all levels of government, the staff estimates the general government deficit will exceed 2 percent of GDP in 2001. In structural terms, the deficit would be 1½ percent of GDP in 2001, just over ¼ percentage points of GDP higher than in 2000, as the effect of the tax cut is not fully clawed back through planned expenditure restraint.

General Government Operations
(In percent of GDP)

	1999	2000	2001 1/
Revenue	47.4	47.1	45.9
Expenditure 2/	48.9	45.9	48.1
Balance 2/	-1.6	1.2	-2.2
Structural balance	-0.7	-1.1	-1.4
Gross debt, end-period	61.1	60.3	59.6

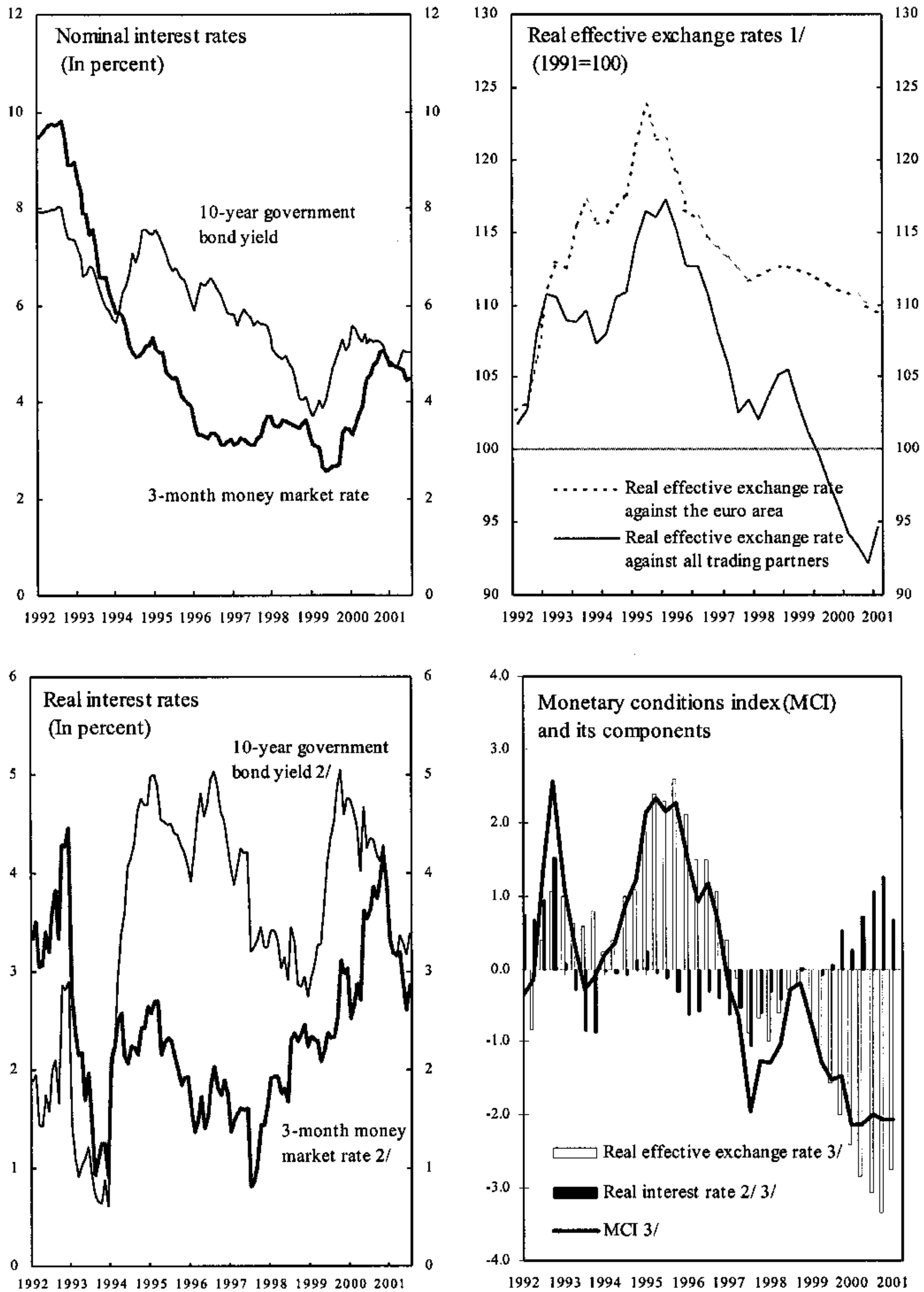
1/ IMF staff estimates.

2/ In 2000, sales of UMTS licenses are recorded as negative expenditure. The structural balance is shown net of such sales.

10. **At end-August, real interest rates were at or above average levels of the past decade, but the impact on monetary conditions was offset by the low value of the euro.** Following a partial reversal of ECB rate rises made during 2000, real 3-month interest rates were around 2½ percent if inflation is measured by its underlying level (Figure 11).[3] Real long-term rates were about 3½ percent. Nevertheless, the weakness of the euro implies that monetary conditions were still on the easy side. Mainly as a result of the weak euro against the dollar, Germany's overall competitiveness is high as reflected in a modest rise in export market share in recent years. Competitiveness with other euro area countries has also improved in the last two years, although Germany has not fully regained the competitiveness lost following reunification.

[3] Figure 11 does not reflect the effects of a 50 basis point cut in the ECB's refinancing rate made in concert with the U.S. Federal Reserve on September 17.

Figure 11. Germany: Financial Indicators, 1992-2001

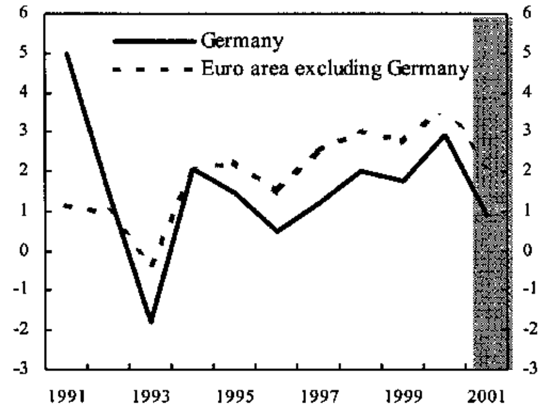


Sources: Deutsche Bundesbank; and IMF staff calculations.
1/ Based on unit labor costs in the business sector.
2/ Monthly averages; inflation expectations measured by 12-month change in CPI excluding energy and food.
3/ Average 1992-2000=0. MCI calculated using a normalized weighted average (3:1) of the deviation of real short-term interest rates and the real effective exchange rate from their average 1992-2000 levels.

B. A Longer-Term Perspective

11. **The current slowdown represents the third time since reunification that a recovery has failed to take hold.** Growth picked up during the course of the past decade. Nevertheless, average growth of only about 1½ percent a year in the 1990s was disappointing, even by European standards, and cycles were quite pronounced (Figure 12 and tabulation). In the very last cycle, 1998Q2-2000Q2, average peak-to-peak growth reached 2.4 percent a year. However, the cycle was very short—only two years—and powered by an exceptional external economic environment: very rapid world trade growth, an undervalued euro, and low real oil prices.

Figure 12. Real GDP Growth per Capita in Germany and the Euro Area, 1991-2001



Source: IMF, World Economic Outlook.

Average Annual Growth Rates of GDP
(In percent)

	1992-2000 1/	1992-1995 1/	1996-2000 1/
Germany	1.5	1.0	1.8
GDP per capita	1.2	0.5	1.7
France	1.9	0.8	2.6
GDP per capita	1.5	0.5	2.2
Italy	1.5	1.1	1.8
GDP per capita	1.3	0.8	1.7
Other euro area countries 2/	2.7	1.5	3.6
GDP per capita	2.4	1.1	3.5
United Kingdom	2.2	1.2	2.7
GDP per capita	1.8	0.9	2.4
United States	3.7	3.1	4.2
GDP per capita	2.8	2.1	3.3

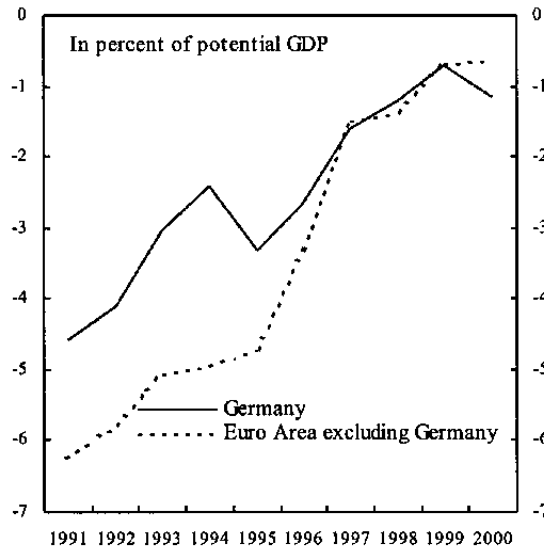
Sources: WEO; OECD; and IMF staff estimates.
1/ Start and end dates differ somewhat for each country in order to measure growth between similar points in the business cycle.
2/ Austria, Belgium, Finland, Greece, Netherlands, and Spain.

12. **Several factors related to reunification have played a significant role in holding back growth:**

- **Fiscal policy has been a continuing drag.** The general government structural deficit has been steadily reduced in the last 10 years as the authorities have worked to offset

the large fiscal cost of reunification and meet Maastricht deficit targets (Figure 13). And transfers to eastern Germany of roughly 5 percent of western GDP a year have necessitated higher taxes and social security contributions. However, most other industrial countries have also been undertaking fiscal consolidation to at least as great an extent.

Figure 13. Germany and the Euro Area: General Government Structural Balances, 1991-2000

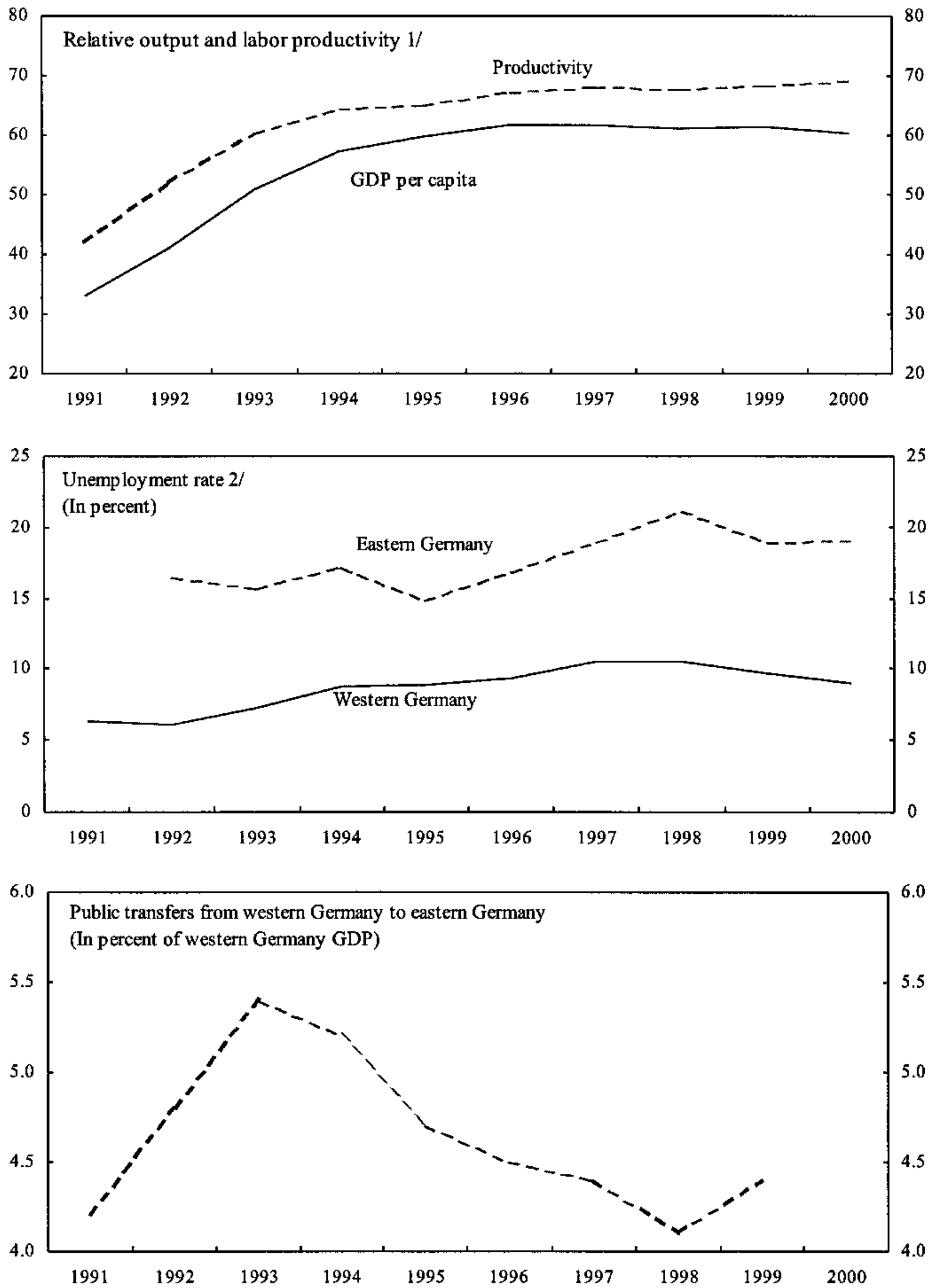


Source: IMF, World Economic Outlook.

- **Recovery in eastern Germany has disappointed.** Growth in eastern Germany rebounded sharply following a dramatic fall in output immediately after reunification. But since the mid-1990s, convergence to output and productivity levels in the west has stalled as a tentative revival in manufacturing has been masked by declining construction activity (Figure 14). Reflecting relatively high unit labor costs, registered unemployment in eastern Germany is around 17½ percent compared with about 7½ percent in the west. However, the economy in western Germany has also not been dynamic, managing growth of only 1.2 percent a year on average during 1992–2000.

- **The scaling back of the construction sector in the last five years has taken some of the bounce out of the economy.** Growth in the construction sector has been essentially following its own path—booming in the first half of the 1990s, retrenching thereafter—with little spillover onto or from other sectors (Box 3). Excluding the construction sector, the average rate of growth of output in the 1990s was still low (1.6 percent a year), but the pickup in the second half was somewhat stronger. However, while the negative contribution to growth from construction is expected to peter out in a year or two, the sector's importance to the economy is now quite small.

Figure 14. Germany: East -West Comparisons, 1991-2000



Sources: IMF, World Economic Outlook; German Economic Research Institutes; Federal Labor Office; and OECD.

1/ Eastern Germany as percent of western Germany.

2/ National definition.

Box 3. Is the Construction Sector to Blame for Low Growth?

The construction sector has been in recession for the last five to six years as the excess capacity built up during the post-reunification building boom has been scaled back. Excluding the construction sector, the rise in the average growth rate of the economy between the early 1990s and the last five years is somewhat more pronounced (see tabulation below). France also had a troubled construction sector in the 1990s, with deep recessions in 1993-94 and 1996-98, and a revival of growth only fairly recently. Thus, in the last couple of years, the growth gap between the two countries was less pronounced if construction is excluded, but comparisons are little affected if growth rates are averaged over five or ten year periods.

	Average Real GDP Growth			GDP, Excluding Construction		
	'92-'00	'92-'95	'96-'00	'92-'00	'92-'95	'96-'00
Germany	1.5	1.0	1.8	1.6	0.9	2.0
France	1.9	0.8	2.6	2.1	1.1	2.8

The independent forces driving construction in Germany are reflected in negative correlations between growth in construction and growth in other sectors in the period 1992-2000 (see tabulation below). De-trending the sectoral components of output has little effect on the correlation with private services, and flips the sign on correlation with growth in manufacturing. A tentative interpretation is that the construction sector was isolated somewhat from shocks elsewhere in the economy and vice versa. By contrast, significant positive correlations between growth in the main sectors of the economy, manufacturing and private services, are consistent with a more normal pattern of the transmission of shocks—all boats rising together to some extent—and are in line with cross-sectoral growth correlations in the French economy.

Germany: Correlation of Sectoral Growth
(detrended correlations in parenthesis)

	Manuf.	Constr.	Services
Manufacturing	1		
Construction.	-0.35 (0.36)	1	
Services	0.61 (0.46)	-0.56 (-0.40)	1

France: Correlation of Sectoral Growth
(detrended correlations in parenthesis)

	Manuf.	Constr.	Services
Manufacturing	1		
Construction	0.59 (0.53)	1	
Services	0.46 (0.28)	0.38 (0.27)	1

In the future, as reunification imbalances in the construction sector are eliminated, it might be expected that the construction sector would move more in line with the rest of the economy. This might raise average growth somewhat, although it would tend to amplify cycles as well. Nonetheless, the contribution the construction sector could make to growth is likely to be small as it accounts for less than 5 percent of value added, and is still contracting.

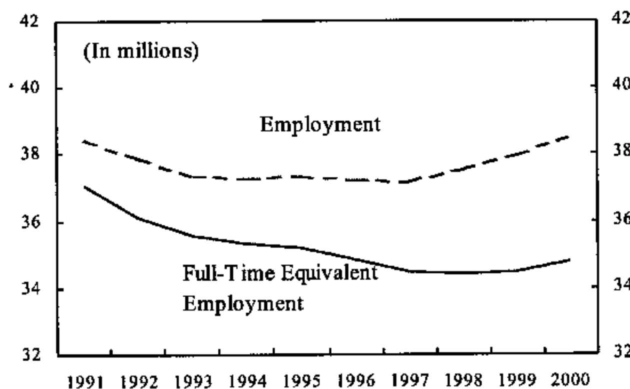
In sum, the figure for average growth in GDP excluding construction in the last two cycles 1996-2000 may be a better guide to the underlying performance of the economy, but it would still only put growth at around 2 percent a year.

13. **A further explanation appears to lie with an insufficiently supportive labor market.** Indeed, while each of the above factors has taken a toll, they cannot fully explain the comparatively weak growth record during the 1990s. A growth accounting perspective points to declining labor input. Responding to high (and, in the early part of the decade, rising) labor costs, firms laid off workers, resulting in favorable productivity increases but employment that dropped and only began to pick up with any vigor when output briefly accelerated toward the end of the decade. And because much of recorded employment growth sprung from part-time jobs (DM 630 jobs), full-time equivalent employment growth was less impressive (Figure 15). Thus, productivity and investment growth have broadly matched that in the other large euro area economies (although they have fallen well short of recent US performance), but labor input growth has been less.[4] Unemployment has remained high (Figure 16).

GDP Growth—Factor Inputs

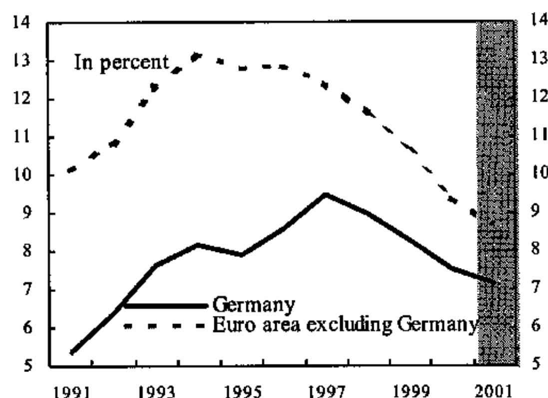
	1992-2000	1992-1995	1996-2000
GDP	1.6	1.3	1.8
Labor (hours worked)	-0.3	-0.7	0.0
Capital	0.8	0.9	0.7
Total factor productivity	1.1	1.1	1.1

Figure 15. Germany: Employment, 1991-2000



Sources: Institute for Employment Research of the Federal Employment Services (IAB); and IMF staff calculations.

Figure 16. Standardized Unemployment Rate in Germany and the Euro Area, 1991-2001

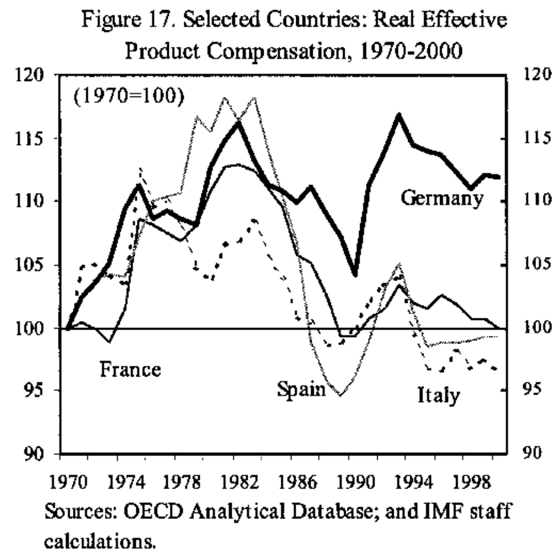


Source: IMF, World Economic Outlook.

[4] Use of hedonic pricing methods, particularly for new technology, accounts for a small part (up to 0.3 percentage points) in the difference in productivity growth between Germany and the United States.

14. **Germany's relatively poor employment performance stems from its comparatively slow progress in reducing high wage costs as well as labor market rigidities.** Other large continental European economies—France, Spain, and to some extent Italy—have enjoyed more job-intensive growth, at least in the second half of the 1990s. A staff study prepared for the mission found that a key explanation of the difference is that wage moderation has been less pronounced in Germany than in the other countries (Figure 17).[5] Wage moderation, beginning in the 1980s, has been needed to compensate for various adverse shocks to supply and demand. In Germany, wage moderation was reversed around the time of reunification, significantly widening the gap between wages and productivity and worsening competitiveness. The subsequent reversion to wage moderation more or less on a par with the other European countries has not been sufficient to compensate. Moreover the study finds that wage moderation is reflected in employment growth with a lag; hence other countries that have stuck the course for longer have been creating more jobs than Germany of late. Other aspects of the labor market have further dampened employment growth in Germany. Insufficient wage differentiation, for example, prevents markets in different regions and for different skills from clearing; restrictions on terms of employment and lay-offs may inhibit hiring; and generous benefit systems add to non-wage labor costs and reduce job-search incentives for the unemployed. Studies also suggest that insufficient wage differentiation and labor market flexibility inhibit investment in new technology and human capital.[6]

Figure 17. Selected Countries: Real Effective Product Compensation, 1970-2000



Sources: OECD Analytical Database; and IMF staff calculations.

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[5] Wage moderation is broadly synonymous with real wage growth below that of productivity, although additional adjustments are made to correct for the influences on wages of unemployment and changes in labor taxes. For details, see the forthcoming joint background paper for the consultations with Germany, France, Italy and Spain.

[6] Labor market problems have been extensively analyzed in IMF Selected Issues papers for Germany in recent years. Chapter VII of "United States, Selected Issues" (IMF 2001) provides some cross-country evidence that narrow and inflexible wage differentials in Germany have held back investment in technology.

III. Policy Discussions

A. The Growth Slowdown and the Economic Outlook

15. **The authorities and staff agreed on the immediate causes of the slowdown: the oil price shock had sparked the downturn, and food price hikes and the global slowdown had poured further cold water on activity during 2001.** Macroeconomic policies were not to blame for the slowdown: fiscal policy had supported growth in 2000 and 2001 and increases in short-term interest rates had been neutralized by the weak euro. The authorities agreed with the staff that the reasons for the sharpness and persistence of the slowdown, even in the face of considerable fiscal and monetary stimulus, were a puzzle. The authorities tended to look for the explanation in the high sensitivity of German consumers to price increases and in Germany's exposure to the U.S. business cycle. They agreed, however, with staff who also looked to structural rigidities that might have weakened the economy's capacity for resisting and overcoming the effects of shocks.

16. **The authorities felt that globalization had increased international linkages.** International financial market links were now much stronger and multinational corporations took a global perspective, scaling back investment and jobs in countries away from the epicenter of a cyclical downturn. The slowdown in the United States and declines in stock markets had thus had a large and immediate impact on Germany. Staff noted that it was hard to establish the importance of non-traditional external links. Recent analysis suggested that business sentiment was now more closely aligned across countries than in the past and this had perhaps speeded up the transmission of the global slowdown, hastening the decline in investment.[7] But other mechanisms, such as multinationals cutting jobs in Germany in response to losses in another country, remained anecdotal: indeed, Germany was likely to be relatively insulated given its comparatively restrictive regulatory environment and high firing costs. Technology sector stock prices had collapsed in line with those in other countries, but this reflected more the common technology shock than the operation of stronger linkages; in any case the sector was relatively small, accounting for about 6 percent of total business sector output.[8] Staff noted that strong competitiveness had, initially at least, shielded Germany from the direct effects of the slowdown in the United States.

17. **In exploring reasons for the abruptness and persistence of the slowdown in demand and output, the discussion turned to the influences that throughout the 1990s dampened growth and impeded recoveries.** Although the authorities were less inclined to

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[7] See Chapter III of United States—Selected Issues, IMF (2001).

[8] In a related vein, some private sector analysts thought that the high price paid by companies for UMTS licenses may have had a significant dampening effect on real investment in the telecommunication sector, but the consensus was that this was not a material explanation of Germany's slowdown.

see serious underlying influences in this cyclical downturn, they pointed to the legacy of overbuilding in the construction sector and to the fiscal burden of reunification as possible factors dampening the resiliency of the economy. Staff agreed that these influences were a drag on growth, but also placed weight on weaknesses in the labor market, which influenced not only supply conditions, but also demand, owing to the dominant effect of employment growth on incomes and consumption in Germany. Staff suggested that the tentative response of employment (at least on a full-time equivalent basis) during the upswing had not provided a solid base for disposable income growth, and that the quick halt in employment growth as soon as signs of weakness in demand appeared had played into the sudden drop in disposable income and consumption growth. This behavior, notwithstanding rather strict wage moderation, was symptomatic of labor market regulations that discouraged hiring, especially when uncertainty rose.

18. **Looking ahead, the staff projects that recovery will start in the fourth quarter of this year, provided the external environment improves**. In particular, the projection is contingent on a strengthening of world trade growth and further reversal of the earlier food and energy price hikes. While the continuing effects of the tax cuts will bolster consumption, developments in foreign demand will be key to the projected end to destocking, revival of employment growth, and recovery of investment. GDP growth is projected to pick up to 2½ percent in the year to end-2002. However, reflecting the carryover of weakness in 2001, annual average growth in 2002 would be only 1¾ percent, after ¾ percent in 2001, with the output gap averaging about 1½ percent of potential GDP (tabulation). The projection assumes that the forces for recovery will be sufficiently strong to cope with fiscal withdrawal equivalent to about ½ percent of GDP in 2002. On the basis of assumptions made before the ECB rate cuts of September 17, help from monetary easing would be modest with only a small further cut in ECB interest rate cuts assumed for the end of the year. The authorities were more optimistic than the staff about the prospects for an earlier and stronger rebound in domestic demand. At the time of the mission, the official forecast called for growth of 2 percent in 2001 and 2¼ percent in 2002. However, since then, with second quarter data showing economic stagnation and indicators pointing to little immediate sign of recovery, recent public statements suggest that the authorities now expect growth will be below 2 percent in 2001.

19. **The authorities and staff agreed that, given the weakening in economic conditions, next year's wage round would most likely produce moderate settlements**. This should help to underwrite low inflation and facilitate recovery—although there remained a risk that trade unions would seek compensation for the recent unexpected inflation. Headline inflation was expected to be under 2 percent by early 2002.

Output, Demand, Inflation and Unemployment
(Annual percent change)

	1999	2000	2001 Proj.	2002 Proj.
Real GDP	1.8	3.0	0.8	1.8
Total domestic demand	2.6	2.0	0.0	1.9
Exports of goods and services	5.6	13.2	4.9	3.9
Imports of goods and services	8.5	10.0	2.7	4.5
Output gap	-1.4	-0.3	-1.5	-1.7
Average CPI inflation	0.6	1.9	2.6	1.3
Unemployment (standardized rate, percent)	8.6	7.9	7.9	8.3

20. **The staff's projection is subject to downside risks.** Most important is the projected global recovery where the risk of delay was already significant before the terrorist attack on the United States. Exporters also remain vulnerable to a sizable appreciation of the undervalued euro—although this would not have an impact immediately—while an unwillingness to let the fiscal stabilizers play in full could crimp the recovery in domestic demand. On the upside, the speed of the adjustment in inventories and investment during the downswing might position the economy for a brisker recovery as soon as signs emerge that the global economic situation is stabilizing. While their projection implicitly subscribes to this view, the authorities did not deny that the risks to the outlook were on the downside, especially as regards the international environment.

21. **The authorities expected that medium-term growth would average about 2¼ percent, a faster pace than during the 1990s.** They pointed to the positive influence that recent tax reform and product market liberalization would have on potential growth. Staff broadly agreed, although with some qualification. Actual growth could rise to a 2½ percent pace in the next few years as the output gap was eliminated. However, the underlying performance of the economy would be less buoyant as slow growth in the working age population and projected modest progress in reducing structural unemployment would restrain potential growth (Box 4). All-in-all, the staff envisages potential growth rising to about 2¼ percent a year in the medium term from around 2 percent at present.

B. Policies

22. **The authorities pointed to the major accomplishments during the past year in structural reform.** In their view the passage of the pension reform, with its landmark introduction of a second pillar, a major tax reform, that significantly reduced marginal tax rates and broadened bases, and the steady continuation of product market liberalization would reap substantial benefits in terms of higher growth over the medium term. The authorities were concerned that a perception was growing that the reform momentum had now been lost, and that this could even have contributed to the severity of the downturn in investor confidence. They were eager to dispel this notion. They viewed the labor market as the remaining major frontier for reform, and indicated that they had begun the process of building consensus for changes in this area, particularly to address the shortage of skilled workers and insufficient jobs for low-skilled workers.

Box 4. Potential Problems

The conventional view[1] that Germany's potential growth is around 2¼ percent assumes that the underlying performance of the economy will be better than it was in the 1990s. Since 1992, real GDP growth averaged only 1.6 percent a year, though it picked up somewhat in the latter half of the decade.

Looking forward, more contribution from labor inputs and probably stronger total factor productivity (TFP) growth will be needed to increase potential growth. With the population of working age projected to grow very little, and the trend toward lower average working hours likely to continue, a positive contribution from labor will require supply side measures to increase participation and reduce the NAIRU. Structural reforms will also be required to enhance TFP growth (Germany does not appear to be blessed with a more spontaneous "new economy"—see SM/00/229).

Based on slight improvements in the underlying components, staff forecast that potential GDP growth will rise to 2¼ percent from its present level of 2 percent over the next five years. This forecast includes the following assumptions[2]: (1) the labor force grows 0.1 percent per year (in contrast to its decline in most years during the 1990s) and the NAIRU falls to 6¾ percent from 7¼ percent over the next five years; (2) the capital stock continues to grow at the rate evident from 1992-2000 of around 2.6 percent per year; and (3) TFP growth improves slightly over its performance in the 1990s to 1.2 percent per year. If the trends in the 1990s are replicated, then potential growth will be less than 2 percent for the foreseeable future. For instance, if the labor force declined by 0.4 percent per year (a conservative estimate of the actual decline in the 1990s), potential GDP growth would be 1.9 percent.

Alternatively, if labor market reforms are enacted and participation improves, medium-term potential growth could be enhanced. For instance, if the NAIRU dropped to 5.5 percent and TFP improved to 1.5 percent per year, potential GDP growth would increase to 2.5 percent per year. Increasing the growth of the labor force would also add to potential: an increase from 0.1 percent to, say, 0.4 percent would add another 0.2 percent to potential growth.

[1] E.g., OECD Economic Outlook, May 2001 and EC, Economic Papers, No. 150, April 2001.
[2] Alternative methodologies produce approximately the same outcome. For instance, using the methodology detailed in the forthcoming Euro-area selected issues paper, "Estimating Potential Output, Output Gaps, and the NAIRU for the Euro Area" for Germany, potential output growth in 2000 is 1.8 percent versus 1.9 percent using the production function methodology employed above.

23. **The authorities did not see much scope or need for further adjustments in macroeconomic policies to address the slowdown.** Most importantly, the tax reform implemented in January provided a fiscal stimulus in 2001 of over 1 percent of GDP—larger than the stimulus provided in any other major industrial country during the current slowdown. Moreover, the major impetus to the slowdown had been from supply-side shocks, to which it would not be appropriate to respond with further measures to stimulate demand. More important to ensuring that the impact of the supply shock was contained would be the 2002 wage round, where they were reasonably optimistic that the wage settlements would be moderate. Monetary policy was, of course, outside their control, but the authorities noted the considerable sentiment in Germany that interest rates were high for German economic conditions. However, they acknowledged that in light of concerns about the public acceptance of the euro in Germany, anything that could weaken the euro—such as a cut in interest rates—would carry risks.

24. **Staff inquired whether the current macroeconomic policy framework provided sufficient scope for adequate responses to economic shocks.** Specifically, with monetary policy set for the euro-area as a whole, fiscal policy tied down by the yearly Stability Program (SP) geared toward meeting the Stability and Growth Pact (SGP) goal of a balanced budget, and wages rather unresponsive to labor market conditions, output fluctuations might end up absorbing the impact of temporary shocks. Staff pointed to other large federal systems that allowed significant cyclicality in regional transfers or budget balances. While not denying that the framework may appear overly constrained, the authorities felt that this was one of the start-up costs of European monetary union: establishing credibility—for both fiscal and monetary policy—in a new system prohibited some of the flexibility that older, well-established systems can afford. Moreover, they pointed to a rather successful record of wage moderation in recent years as evidence that labor markets will play a role in adjusting to shocks.

Fiscal policy

25. **The authorities explained that having implemented a major tax reform (and absorbed much of its impact on the deficit), the focus of fiscal policy was now to eliminate the general government deficit by 2004.** To reach this goal, they intended to reduce the deficit along a pre-determined annual path, as set out in their Stability Program, which targeted a general government deficit of about 1½ percent of GDP in 2001 and 1 percent of GDP in 2002. Fiscal consolidation would rely on keeping public expenditure growth below 2 percent a year in nominal terms, implying little growth in real terms on current inflation assumptions. Spending restraint would be sufficient to accommodate two more stages of tax reform, which will lower revenue by 0.3 percent of GDP in 2003 and 0.8 percent in 2005.[9]

26. **While strongly supporting the medium-term SGP goals, staff questioned the appropriateness of adhering to the SP deficit target in 2001, in the midst of the current slowdown, and of attempting to regain the SP deficit target for 2002 in the event of a significant slippage in 2001.** Staff's projection of a sizable tax shortfall in 2001 meant that meeting the nominal deficit targets would require an untimely expenditure squeeze and impart a negative fiscal stimulus—on the order of ½ percent of GDP—which would be unwarranted in the present setting. Thus staff argued for sticking to current expenditure targets, but letting the automatic stabilizers operate, even if this meant overshooting the deficit target this year. For 2002, when growth was projected to be closer to potential, returning to the SP deficit reduction *path*, rather than the SP target for the level of the deficit, would be advised. This would imply constraining expenditure growth in line with the

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[9] In 2003, the top marginal income tax rate will be reduced to 47 percent from 48.5 percent, the rate in the lowest bracket will be reduced to 17 percent from 19.9 percent, and the basic allowance will be increased. In 2005, the top rate will be lowered to 42 percent and the lowest rate to 15 percent, along with a further increase in the basic allowance.

medium-term norm, but not attempting to recoup the revenue and deficit slippage in 2001. In the staff's projection for 2002 this would produce a negative fiscal stimulus of about ½ percent of GDP (Table 1). Assuming output returned to potential in the medium term, the target of eliminating the general government deficit by 2004 could be met with current tax and expenditure policies.

Table 1. Germany: General Government Fiscal Accounts, 1999-2004

	1999	2000	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
Revenue	47.4	47.1	45.9	46.2	46.0	45.9
Expenditure 1/	48.9	48.4	48.1	48.0	47.4	46.4
Balance	-1.6	-1.3	-2.2	-1.8	-1.4	-0.5
o/w federal government	-1.6	-1.2	-1.5	-1.2	...	...
Gross debt	61.1	60.3	59.6	59.6	58.8	57.1
Primary structural balance 2/	2.8	2.2	1.8	2.4	2.5	3.0
Structural balance 2/	-0.7	-1.1	-1.4	-0.8	-0.5	0.1
Fiscal impulse 3/	-0.5	0.6	0.4	-0.6	-0.1	-0.5
Memorandum items						
Official fiscal targets 4/						
Balance	...	...	-1½	-1	-½	0
o/w federal government	...	...	-1¼	-1	-¾	-½
Output gap in percent 2/	-1.4	-0.3	-1.5	-1.7	-1.4	-0.9

Sources: Ministry of Finance; and IMF staff estimates.

1/ Expenditure for 2000 excludes the one-time proceeds from the sale of mobile phone licenses of DM 99.4 billion (2.5 percent of GDP).

2/ In percent of potential GDP.

3/ Change in primary structural balance (excluding proceeds from the sale of mobile phone licenses); minus sign indicates withdrawal of stimulus.

4/ Based on Germany's Stability Program, October 2000 revision.

27. **At the time of the mission, the authorities did not expect significant slippage from official deficit targets and they therefore did not contemplate measures to offset possible revenue weakness.** They intended to keep to their tight expenditure targets but, if revenues were below expectations, they acknowledged that the deficit would exceed the SP target this year. According to the draft budget plans for 2002, expenditure at the federal level would grow by only 1.6 percent and the federal and general government deficits would each decline to 1 percent of GDP, in line with the SP targets. However, the authorities conceded that if 2001 revenues turned out lower than expected, the 2002 deficit target could also come under pressure. They would review their tax projections later in the year and decide then whether offsetting measures were necessary and desirable. The authorities stressed that, at the very least, the 2002 budget should build in the same degree of fiscal consolidation as in the current SP, namely ½ percentage point of GDP.

28. **Beyond allowing the automatic stabilizers to operate, the staff agreed that more active fiscal policy measures were not called for at this stage.** The staff viewed a fiscal withdrawal of ½ percent of GDP in 2002 as appropriate if the recovery based on a stabilization, or drop, in oil prices and a pick up in world demand proceeded as in staff projections. However, if developments were less favorable, the authorities might consider bringing forward the tax cuts planned for 2003. This would temporarily raise the deficit by a small amount next year without affecting long-term fiscal consolidation. While accepting that all options would need to be considered if the economic situation worsened, the authorities questioned whether bringing forward tax cuts would be effective and worth the cost of undermining its consolidation framework and its pre-announced tax strategy.

29. **More generally, the discussion turned to whether the annual SP deficit targets added to other procyclical elements of fiscal policy.**[10] The targets implicitly required tightening in a downturn when tax revenue was weak, and, in an upswing, they did not necessarily provide sufficient discipline. Indeed, as a case in point, the staff observed that although the actual deficit had remained within the target in 2000, a year of above potential growth, the structural deficit had risen. Procyclical tendencies might be mitigated, whilst not losing sight of consolidation goals, by placing more emphasis on expenditure ceilings that were consistent with a medium-term view of tax policy and public debt levels.[11] While appreciating these considerations, the authorities were reluctant for several reasons. First, deficit targets provided a simple rule that the public could understand and monitor. Particularly in Germany's federal system where norms for spending by the Länder could not be set centrally, the link between a ceiling on central government spending and the general government deficit would be too imprecise to engender public confidence in the fiscal framework. Second, they doubted the demand impact of automatic stabilizers. And third, even if expenditure targets would provide more scope for effective, countercyclical fiscal policy, public confidence in the SGP would be damaged if the framework were changed before fiscal deficits had been decisively reduced.

30. **The staff strongly supported the authorities' goals for curtailing expenditure growth over the medium term, noting the need to accommodate a further reduction in the burden of tax and social security contributions, which even after the 2001 cuts is only around average European levels (Figure 18).** These goals rely on lowering subsidies, saving on interest payments, reducing the size of the civil service (employment is to fall by 1½ percent a year), and restraining wages. Staff questioned whether wage moderation would

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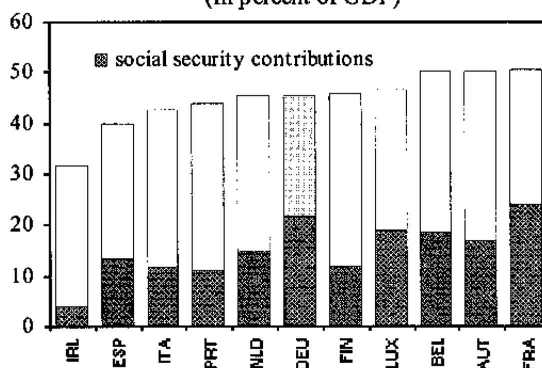
[10] The requirement to keep the social security fund in financial balance is a further source of procyclicality as contribution rates are automatically adjusted to compensate for cyclical weakness or strength in revenues. See Germany—Selected Issues (2000) for more analysis.

[11] See the forthcoming background paper to this report, which examines the operation of expenditure-rule-based fiscal policy in detail and addresses how expenditure rules might be designed for Germany's federal system with highly independent lower levels of government.

be sustainable and suggested that social transfers might also need to be trimmed. It questioned the absence of binding mechanisms to ensure that states and local authorities—which together spent about twice as much as the federal government—would contribute to the fiscal objectives. The authorities pointed to their track record in downscaling the civil service and limiting growth in the public sector wage bill. Coordinating fiscal plans of the lower levels of government through twice-yearly meetings of the Financial Planning Council had also proved effective. Still, they agreed that more regular reporting, monitoring, and assessment of fiscal projections of all levels of government would increase accountability, although the constitutionally guaranteed independence of the Länder prevented any requirements in this area. Staff welcomed recent agreement on a new horizontal and vertical revenue sharing agreement among the levels of government (*Finanzausgleich*) especially as it improved incentives for efficient revenue collection. A new Solidarity Pact committing DM 306 billion to infrastructure spending in eastern Germany through 2019 (roughly ½ percent of GDP a year) clarifies public spending commitments to the new Länder. The authorities expressed interest in undertaking a fiscal transparency review of standards and codes (ROSC).

Figure 18. Germany and the Euro Area: Revenue Ratio Excluding Interest Receipts in 2001
(In percent of GDP)



Source: IMF, World Economic Outlook.

Labor market and social security

31. **In the authorities' view the two main problems in the labor market were a shortage of skilled workers and insufficient jobs for the low-skilled.** In 2000, about one sixth of German firms reported labor shortages constraining their activity. Shortages were particularly pronounced for high skilled jobs, such as engineers and IT workers, and varied widely across regions. The "green card" initiative, through which the government offered 20,000 special work visas to foreign IT experts was addressing this problem. Despite a take up of only 8,500 visas, the government considered the initiative a success since it had catalyzed the creation of many new jobs and employers were generally pleased with the program. On low-skill job creation, the authorities were experimenting with schemes to subsidize non-wage costs of the low-skilled. But, they were skeptical that these schemes would prove successful, mainly because of what they saw as large dead-weight losses and the

low impact thus far of the pilot schemes on job creation. The authorities placed more store in actions to increase incentives for the unemployed to seek work. To this end, they were preparing legislation for introduction in 2002 that would require the unemployed to sign a contract specifying their obligations to seek work and undergo training. Looking forward, requirements to accept jobs would be tightened, and benefits reduced for those turning down job offers. Training would be better focused on basic skills and made more widely available. Most of these reforms would need to await the next legislative period.

32. **Staff welcomed these initiatives, but questioned their effectiveness if wage differentiation across skill levels and regions remained low by industrial country standards and financial incentives to seek work were not raised.** While recognizing that across-the-board wage moderation had promoted job growth, staff saw it as a blunt tool for addressing unemployment; it was likely to lead to just the types of problems seen in Germany—shortages of skilled workers and high unemployment among the unskilled. Promoting greater wage differentiation seemed an essential adjunct to wage moderation. The authorities were confident relative wage flexibility had been increasing markedly, particularly in pockets of high unemployment such as in eastern Germany, and that no policy action to push it further was needed. On the issue of low-skill job creation, staff saw little alternative to tax-based incentives to hire the low-skilled workers in the absence of a consensus to increase wage dispersion and reduce the size and duration of unemployment benefits. Staff noted that the pilot schemes with tax-based incentives had design flaws and urged the authorities to expedite better designed studies. Staff also advised closer evaluation of active labor market policies on which spending amounted to over 1 percent of GDP. The return in terms of employment creation from this spending relative to comparable spending on targeted tax cuts should be carefully assessed.

33. **Staff expressed concern about recent legislative and regulatory changes widely seen in markets as moves toward increased regulation.** Legislation had been passed granting employees the right to convert full-time jobs into part-time jobs and the scope of Germany's system of co-determination, which gives employees a say in management decisions, had been extended. Staff were concerned that these moves would reduce incentives for job creation. Also, proposals that would restrict eligibility for public contracts to firms that remunerate employees in accordance with local collective bargaining agreements would, if adopted, represent a step in the wrong direction. The authorities explained that the changes referred to were meant to promote part-time employment and to modernize the system of co-determination; they saw no negative impact on employment creation. In this vein, they had resisted pressure to allow the law permitting temporary contracts to expire. The proposal to restrict public works contracts would be studied and its adoption was far from assured. The authorities stressed that it was certainly not their intention to intensify labor market regulation—and observed that the trend in the work place was toward more flexible working arrangements, particularly in eastern Germany. A recently signed work arrangement at a major automobile producer, which makes possible the hiring

and training of up to 5,000 unemployed persons, was evidence of evolving flexibility.[12] The staff urged the authorities to continue to provide their active encouragement of such arrangements.

34. **The staff welcomed the introduction of a private pension pillar, noting that this change in approach to pension provision would be a decisive factor in containing future increases in social security contribution rates as the population aged.** Staff noted that further changes to the generosity of the public pillar would be needed to limit the burden of non-wage costs to projected levels.[13] Even, under official projections, which according to staff analysis rely on optimistic assumptions, contribution rates would still rise in the medium term to 22 percent, from 19 percent at present.[14] Emerging strains on public health care costs would also intensify as the population ages. The authorities were aware that more needed to be done to prepare the social security system for demographic pressures, although in the case of pensions, further reform could understandably not be expected at this stage. Health care reform would be a priority during the next legislative period.

Product markets

35. **The authorities and staff agreed that great strides had been made in product market liberalization in recent years.** Liberalization of the telecommunications markets had been particularly successful with prices for long-distance and international calls falling by some 90 percent since 1997. Competition in the local loop should intensify as the telecommunication incumbent divests its cable TV interests. Deregulation of the electricity market had triggered price declines for commercial users; however it remained a challenge to bring the benefits of deregulation to household consumers. The more recent deregulation of the gas industry was on track, although scope for price reductions was more limited owing to the absence of excess capacities in this sector. Postal services in the deregulated market segments were flourishing and private local railway services had established a toehold.

36. **Looking ahead, the authorities were planning to consolidate the progress made thus far and to address thornier issues such as the deregulation of public services, waste management, and water supply**. While commending the authorities on the progress to date, the staff expressed disappointment over the renewed extension of the postal monopoly for the delivery of light letters until 2007 and encouraged them to monitor closely the effectiveness

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[12] The arrangement not only permits remuneration below the established company wage contract and additional work-time flexibility, but also introduces a profit-linked pay component, increases workers' responsibility for the quality of work, and provides for extensive training that is only partly remunerated.

[13] Under the reform, the replacement rate is reduced to 67 percent of wages by 2030 from 70 percent at present.

[14] For further analysis, see Germany—Selected Issues (IMF, October 2000).

of the regulatory regime in the electricity and gas industries, which relies to a large extent on voluntary association agreements. It also argued for the liberalization of shop opening hours, which remain a serious barrier to the creation of jobs in the retail sector. The staff regretted that an agreement on an EU Directive on corporate takeovers had not been reached, as this might unduly delay restructuring and industry consolidation in Europe. The authorities explained that they would press ahead with their own legislation on takeovers, which would improve and clarify the regulatory environment. They were committed to working toward compromise with their European partners on a new draft EU Directive.

Financial sector

37. **The authorities viewed the financial sector as sound and in relatively good shape to weather the economic slowdown.** Rising insolvencies of enterprises and individuals and lower non-interest income from dampened capital market activity were expected to diminish credit quality and lower bank profitability somewhat (Table 2). But the authorities did not expect a dramatic rise in provisioning or non-performing loans as banks had been improving their credit risk management techniques, in part anticipating the application of the Basel II Capital Accord. The supervisory authorities believed that exposures to potentially risky sectors and external markets were manageable. German banks' potential credit exposures to the telecom industry were not deemed excessive (about 3 percent of outstanding credit to non-financial entities), were mostly to highly-rated corporations, and were falling as these corporations exchanged bank debt for publicly traded corporate debt or equity. The recent highly publicized real estate-related losses of the tenth largest bank in Germany were viewed as a one-off problem related to poor management.[15] And cross-border exposures to emerging markets were geographically well-distributed, with less than 1 percent of German banks' total cross-border lending allocated to Turkey and 1.3 percent to Russia. German bank exposures to developed countries currently suffering from economic downturns, such as the United States and particularly Japan, were large and needed to be watched carefully.

38. **Staff stressed that economic conditions at home and abroad, and the problems of the construction and real estate sectors in particular, required additional vigilance by the supervisors**. Although supervisors appeared to have averted potential spillover problems stemming from the losses of the above-mentioned bank, staff pointed out that its mixed private and public ownership structure had likely hindered the resolution of management problems and increased moral hazard. The authorities agreed that poor governance had been a contributing factor. Staff noted that external capital flows intermediated through Germany had increased rapidly in recent years, potentially creating new vulnerabilities for financial

[15] This bank, which is linked to a publicly-owned bank, was estimated to require a €2 billion (0.1 percent of GDP) infusion from the city-state of Berlin to remain viable and save some 16,000 jobs.

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

	1998	1999	2000	2001 1/	
External Indicators					
Exports (annual percentage change, in U.S. dollars)	5.3	0.6	0.8	3.2	projections
Imports (annual percentage change, in U.S. dollars)	5.3	2.7	2.7	1.9	projections
Terms of trade (annual percentage change)	2.0	0.4	-4.5	-0.9	projections
Current account balance	-0.3	-0.9	-1.0	-0.8	projections
Capital account balance	0.9	-1.8	0.5	0.8	May
Of which: Foreign direct investment (net)	-3.0	-2.6	6.8	-1.8	May
Portfolio investment (net)	-0.1	-0.7	-8.3	1.5	May
Other investment liabilities (net)	4.0	1.5	1.9	1.1	May
Official Reserves (in billions of U.S. dollars, end-of-period) 2/ 3/	74.0	61.0	56.9	51.2	June
Broad money to reserves ratio 2/ 3/	19.2	24.3	22.5	25.4	June
Exchange rate against U.S. dollar (period average)	1.8	1.8	2.1	2.2	
Financial Markets Indicators					
Public sector debt (Maastricht definition)	60.7	61.1	60.3	59.6	
3-month T-bill yield 4/	3.5	2.9	4.4	4.3	August
3-month T-bill yield (real) 4/	2.1	2.5	3.5	2.8	August
10-year Bund yield 4/	4.6	4.5	5.3	4.8	August
Change in stock market index (percent, end of period) 5/	17.7	39.1	-7.5	-16.2	August
Change in stock market index (percent, eop) for banks	-11.0	33.6	-0.3	-13.1	August
Change in stock market index (percent, eop) for TMT 6/	64.8	112.6	-44.6	-17.3	August
Change in stock market index (percent, eop) for construction	-7.8	8.2	-36.0	14.3	August
Spread of 3-month T-bill vs. the U.S. (percentage points, e-o-p)	-1.3	-1.7	-1.5	-0.3	August
Yield curve (10 year - 3-month T-bill)	1.1	1.6	0.9	0.4	August
Credit Indicators (percent, y-o-y)					
Total credit to non-MFIs	6.8	6.5	4.3	3.0	June
Loans	7.3	9.6	4.3	3.0	June
Lending: mortgages secured by residential real estate	7.5	29.9	6.7	1.2	June
Lending to employees and other individuals: Installment credit	3.0	-0.5	2.8	0.9	June
Lending to electrical & optical equip, telecom, computers, R&D	6.4	3.4	4.5	4.0	June
Lending to construction sector	1.2	5.6	1.7	2.1	June
Lending to other real estate enterprises	7.9	6.5	7.1	2.5	June
% lending to electrical & optical equip, telecom,computers,R&D	9.9	10.1	10.3	10.3	
Financial Sector Risk Indicators					
Total loans to assets	74.9	73.5	72.2	72.0	June
Total loans to deposits	113.9	112.3	111.1	110.5	June
Share of real estate sector in private credit (percent) 7/	21.9	22.6	22.0	21.5	June
Share of real estate sector in loans to nonfinancial private sector (percent) 8/	33.1	35.4	35.0	34.5	June
German capital asset ratio 9/	10.6	11.3	10.9	...	
Profitability ratio 10/	10.2	6.4	...	...	
Number of insolvencies of enterprises and individuals	1,341	1,316	1,549	...	
Volume of loans to insolvent borrowers (in b. DM) 11/	12.0	10.8	15.1	...	

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

1/ Staff estimates and projections, unless otherwise indicated.
2/ Data for 2000 refer to November 2000.
3/ From 1999 onward data present Germany's position in the euro area.
4/ For 2001, data are as of August, 2000.
5/ DAX 30 stock market index.
6/ TMT is telecom, media, and information technology
7/ Share of housing loans in percent of total lending to private sector.
8/ Share of housing loans in percent of total lending to nonfinancial private sector.
9/ Consolidated basis, risk-weighted, national definitions of capital.
10/ After-tax profit as percent of average capital.
11/ Only individual loans of more than 3 million DM are included.

institutions (Box 5). However, the general view was that the higher flows reflected the effects of globalization and did not, per se, pose significant new risks. The potential effects of large capital flows on Germany's financial system will be more closely examined during a Financial Sector Assessment Program (FSAP), which the authorities have agreed to participate in following enactment of a new financial supervisory structure.

Box 5. What Lies Behind the Capital Account Data?

With the current account deficit relatively small and sustainable (1.0 percent of GDP in 2000), attention is focused on the large and increasing capital account flows. In principle, analysis of the components and changes underlying these flows could be informative about potential financial vulnerabilities. In practice, however, the data tend to be difficult to interpret and provide only a broad brush picture about the risks and exposures of the German financial sector. In recent years, large and variable components have tended to reflect merger activity, changing methods of financing, the advent of EMU, and, more broadly, globalization.

The recent large gross inflows of **direct investment** reflect increased merger activity rather than new investment. In 2000, an inflow of €191 billion (9.9 percent of GDP) in large part reflected one large merger in which a German enterprise was taken over by a foreign investor. The purchase of UMTS licenses also played a major role. In addition to merger activity, the increased amounts of short-term cross-border credit flows between affiliated enterprises through their foreign subsidiaries confounds the interpretation of direct investment, as these inter-company loans are also included in this category.

The size of **portfolio flows** is also affected by merger activity, particularly in 2000. However, extrapolating from earlier trends suggests that both German investments abroad and foreigners' interest in German financial assets have increased markedly and gross flows are well over €150 billion (7.8 percent of GDP). The investment by German residents in foreign shares has more than tripled since 1997 as the U.S. stock market boom and the advent of EMU spurred interest in other countries' equity markets. **Credit transactions** have diminished somewhat in importance relative to portfolio investment in the last three years, though this may reflect increasing use of subsidiaries for borrowing.

More broadly, data suggest that Germany plays a "financial turntable" role channeling financial flows from outside to within the euro area. In 2000, net capital flows from non euro-area countries to Germany were €193 billion (9.8 percent of GDP) and flows from Germany to euro-area countries were €177 billion (9.0 percent of GDP). Though suggestive of a special role, further analysis of other euro-area countries' capital accounts would be needed to confirm this—a task inhibited by lack of comparable data.

In sum, while the larger and more variable flows through the capital account could portend some increased financial sector vulnerability, such flows are more likely a reflection of one-off transactions, increasing globalization, and the advent of EMU. German financial institutions, still the dominant players in other financial markets, appear to be hedging the currency exposures related to their holdings of foreign securities and loans. The gradual increase in the use of subsidiaries for borrowing reflects heightened price sensitivity to borrowing costs and sophisticated participants. More generally, clear trends in the capital account that could potentially be used to isolate vulnerabilities are sometimes obscured by definitional problems and large, one-off transactions. In an increasingly globalized capital market, more direct and micro-oriented methods focused on risks and exposures of large institutions will need to be increasingly employed. Aggregate data as presented in the capital account are simply too coarse and too imprecise to be relied upon for a careful examination of financial sector vulnerabilities.

39. **Looking further ahead, relatively low profitability by international standards will continue to encourage consolidation and restructuring within the banking sector**. The authorities noted that the publicly-owned savings banks and mutually-owned credit cooperatives active in the retail market were forming various cooperative arrangements (e.g., shared back office functions) to help cut costs and boost profitability.[16] However, as they are generally only allowed to merge with like institutions, cost-saving consolidation is inhibited. Staff urged the authorities to evaluate the costs and benefits of maintaining the various types of banks, particularly the publicly-owned banks. Under pressure from the EU Competition Commission, the authorities had brokered an agreement in July 2001 to phase out public guarantees to the publicly-financed institutions—guarantees that in practice enable the *Landesbanken* to tap relatively cheap financing sources to support both their private- and publicly-oriented banking activities. The staff welcomed the development, noting that it would sharpen the credit allocation process and provide incentives for restructuring.

40. **The authorities and the banking associations welcomed the Basel II Capital Accord and noted their readiness to meet the proposed standards, which would apply to all types of banks.** Anticipation of the Accord had boosted plans for common credit evaluation procedures and data collection among the savings and cooperative banks. The authorities' and banking associations' main concerns about the Accord centered on the effects of various calibrations on lending to unrated small- and medium-sized enterprises and about even-handed implementation both domestically and internationally.

41. **The government has proposed merging banking, securities, and insurance supervision within one body.** It envisages that the new agency would be 100 percent financed by the regulatees and the Bundesbank would retain its involvement in banking supervision—its consultative role for domestic regulation and in international forae, as well as its participation in routine supervision and special audits. While the government's initial proposal has been rejected by the Upper House of Parliament, the authorities assured staff that existing cooperative arrangements among the three agencies, as well as the Bundesbank, were working well. They noted that the recent merger between the second largest bank and the largest insurance company in Germany posed no supervisory concerns. The staff supported improved coordination among the three agencies and the Bundesbank, noting the increasingly blurred distinction between banking and insurance.

Other issues

42. The existing **money laundering** law came into force in May 1998, implementing the associated EU Directive. A self-assessment by the German authorities found the law to be consistent with the 40 recommendations of the Financial Action Task Force (FATF) on money laundering and, in particular, that Germany has fully implemented the 28 FATF

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[16] The savings banks and cooperatives account for some one-third of all domestic, non-bank loans and nearly one-half of all non-bank deposits.

Recommendations requiring specific action. Germany's act applies not only to domestic credit institutions and their branches, but also to their branches abroad and foreign enterprises. Germany acceded to the OECD **Convention on Bribery in International Business Transactions** and adopted implementing legislation in 1999.

43. The authorities voiced their full support for the initiation of a **new trade round** in Doha in November 2001. Within the EU, they intend to press for the liberalization of agricultural policy, along with improved market access for developing countries, as long as a multi-functional approach is taken in which the protection of consumers, animals, and environmental standards could be ensured. The level of **ODA** is 0.26 percent of GDP. Although the authorities hoped to increase this amount, significant expansion of ODA was considered unlikely for now given the existing commitment to expenditure restraint.

IV. Staff Appraisal

44. **The past year has been one of setbacks and achievements for the German economy**. Powered by an extremely favorable external environment, Germany was until the middle of last year enjoying its strongest growth spurt since reunification. Shocks to prices and confidence abruptly derailed growth, confounding hopes that the economy had put the sluggishness of the 1990s behind it. However, the slowdown should not obscure the important progress that has been made in structural reform. Pension reform has broken the mold of an unsustainable system and created a framework for addressing looming pressures on social security. Tax reform has provided significant relief from a high tax burden and improved incentives to work and invest. Liberalization in telecommunications and utilities has benefited consumers and provided new business opportunities. To be sure, plenty remains to be done; labor market reform heads the list. But the authorities have demonstrated an impressive ability to reform in sensitive areas and tackle major obstacles to growth.

45. **Growth should begin to recover by end-2001 if the external environment improves as staff projects.** A reversal of the external shocks that accounted for much of the slowdown—rising oil and food prices and the slowing global economy—should bolster consumer confidence, revive export growth and stimulate investment. Also, the speed and depth of the adjustment during the past year—especially to fixed and inventory investment—suggest the worst may be past so that growth could pick up by the end of the year and firm during 2002. However, a revival of business confidence has yet to occur, the international outlook remains fragile, and exporters are vulnerable to a snap back in the undervalued euro. These factors—plus the new uncertainties emanating from the terrorist attack on the United States—inject a sizable element of caution into the forecast.

46. **Continued wage moderation will be essential to aid recovery and get unemployment back on a declining track.** Trade unions deserve credit for putting jobs before wages increases in recent years, and until the latest growth slowdown, this was helping to lower unemployment. But progress could be undone, and the prospects for economic recovery unsettled, if in the 2002 wage round unions were to seek compensation

for recent unexpected inflation: much of this inflation reflected an external terms of trade shock that has to be absorbed by domestic incomes.

47. Even to the extent that the slowdown has resulted from demand shocks, the **room for active macroeconomic policies is limited by euro-area constraints and the sizable public debt burden.** From a purely German perspective, lower interest rates would be welcome—underlying inflation is only 1½ percent and output is below potential—but monetary policy is driven by the ECB's euro-area wide view. As for fiscal policy, the benefits for short-term activity of a larger-than-planned increase in the structural deficit must be weighed against the costs of diminished credibility of deficit and debt reduction objectives, especially given Germany's pivotal role in the Stability and Growth Pact.

48. **That said, fiscal policy should not be squeezed to hit the SP deficit target.** Through the 2001 tax cuts, fiscal policy is fortuitously expansionary this year. In the eye of the economic storm, the fiscal impulse should not be watered down in an attempt to offset shortfalls in taxes relative to targets. On current projections for 2002, the forces for recovery should be strong enough to withstand a resumption of fiscal consolidation. Yet it would be advisable not to strictly enforce the current 2002 nominal deficit target for the general government (which would involve an unusually large fiscal adjustment in a nascent recovery), but rather to aim for the change in the deficit envisaged in the SP for 2002. If demand and output growth were to remain lethargic longer than now projected, more active fiscal support—in particular bringing forward the 2003 tax cut—should be considered. In any event, as long as the authorities stick the course on expenditure restraint and output returns to potential, the medium-term target of budget balance by 2004 remains secure.

49. **The authorities' have rightly made expenditure restraint the cornerstone of their fiscal adjustment strategy.** Not only will this put public debt on a declining path, but it also will make room for further reductions in the tax burden. The medium-term expenditure growth target is appropriately ambitious. Because subnational levels of government must contribute, more regular reporting, monitoring and assessment of fiscal projections and developments at all levels of government are needed to raise the profile of spending limits and increase accountability. Going one step further and shifting some of the emphasis from nominal deficit targets to expenditure targets would mitigate the need for undue tightening in a downturn and reduce the scope for slippage in the structural deficit as occurred during last year's above-potential growth.

50. **The recent downturn in growth—the third aborted recovery in the past ten years—raises questions about the underlying resiliency of the economy.** For sure, just as they were important in the upswing, external factors have played a role in the latest slowdown. Also excess capacity in the construction sector and fiscal consolidation—both legacies of reunification—have been serious drags on the economy. But the fragility of the growth of employment points to insufficient flexibility to cope with change, diminishing Germany's growth potential—now estimated at about 2 percent per year. As recent structural reforms gestate and the construction sector stabilizes, potential growth should rise. Still,

further reforms are essential to raise employment, strengthen productivity growth, and ensure that Germany can take advantage of new growth opportunities.

51. **Labor market rigidities have proved the most intractable structural problem, but some encouraging signs have surfaced in the past year.** Wage moderation is helping to bring average wages and productivity in line, and anecdotal evidence of greater differentiation of wages in eastern Germany was borne out in a recent agreement at an automobile plant allowing deviation from established wages and employment conditions. Moreover, the authorities' first steps toward building a consensus for strengthening incentives for the unemployed to find work are welcome.

52. **The pace of change, however, does not do justice to the seriousness of the labor market problem in Germany.** And some recent regulatory changes have even moved in the wrong direction. Wage differentiation across skills and regions must rise if skilled labor shortages and high unemployment among the unskilled are to end. Given social resistance to lowering reservation wages—for example, through reductions in the level and duration of benefits—other ways will need to be found to lower wage costs for the unskilled. Schemes to provide selective tax breaks for employment at the low wage end admittedly risk deadweight losses, but have been designed and used successfully in other European countries. The authorities would be well-advised to compare the effectiveness of such schemes with that of active labor market polices on which sizable sums are now spent. Despite the breakthrough in pension reform last year, more adjustments in the parameters of the system will be needed to avoid an undue burden on labor costs as the population ages. For similar reasons, health sector reform must also be added to the policy agenda.

53. **Germany's record on product market liberalization is much more favorable and the reform momentum should be kept up.** The benefits of liberalization are visible in lower prices, notably for telephone calls and for electricity. The authorities should press on with deregulating more sensitive public services. Liberalizing shop opening hours would remove a serious barrier to the creation of jobs in the retail sector.

54. **Against the backdrop of the global slowdown, financial sector supervisors will need to remain especially on their toes.** The downturn in the telecommunications, construction, and real estate sectors need to be carefully watched for its impact on the financial system. Continued weakness in the United States and Japan could have detrimental effects on German banks' credit quality and performance, as well. More generally, regulations that prevent financial institutions from merging in order to improve low profitability, by international standards, should be reviewed. The phasing out of guarantees to public banking institutions is welcome as it will sharpen the credit allocation process and provide incentives for restructuring. The staff also welcomes proposals for greater coordination among the three supervisory agencies as well as Germany's participation in the FSAP.

55. **The quality of Germany's statistics is more than adequate for the purposes of effective surveillance. Nonetheless, recent erratic revisions to the quarterly national**

accounts data underscore that there is still room for improvement. A lack of reliable data on inventories also hampers analysis.

56. Germany's support for a new **trade** round is appreciated. The authorities are encouraged to raise spending on **ODA** to the UN target of 0.7 percent of GDP.

57. 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 (2000)	82.17 million
GNP per capita (2000)	US$ 22,630

	1996	1997	1998	1999	2000	2001 1/	2002 1/
	(Percentage change at 1995 prices)						
Demand and supply							
Private consumption	1.0	0.6	1.8	3.1	1.5	1.8	2.3
Public consumption	1.8	0.4	1.2	1.6	1.2	1.0	-0.3
Gross fixed investment	-0.8	0.6	3.0	4.2	2.3	-3.2	-1.2
Construction	-2.8	-1.5	-1.0	1.5	-2.5	-5.5	-1.8
Machinery and equipment	1.7	3.7	9.2	7.2	8.7	-1.4	-1.4
Final domestic demand	0.7	0.5	1.9	3.0	1.6	0.5	1.0
Inventory accumulation 2/	-0.5	0.0	0.5	-0.4	0.4	-0.5	0.8
Total domestic demand	0.3	0.6	2.4	2.6	2.0	0.0	1.9
Exports of goods and nonfactor services	5.1	11.2	6.8	5.6	13.2	4.9	3.9
Imports of goods and nonfactor services	3.1	8.3	8.9	8.5	10.0	2.7	4.5
Foreign balance 2/	0.5	0.9	-0.4	-0.7	1.1	0.8	-0.1
GDP	0.8	1.4	2.0	1.8	3.0	0.8	1.8
	(In millions, unless otherwise indicated)						
Employment and unemployment							
Labor force	40.7	41.0	41.2	41.4	41.8	41.8	42.0
Employment 3/	37.2	37.1	37.5	38.0	38.6	38.7	38.7
Unemployed 4/	3.5	3.9	3.7	3.4	3.1	3.1	3.3
Standardized unemployment rate (in percent)	8.9	9.9	9.3	8.6	7.9	7.9	8.3
	(Percentage change)						
Prices and incomes							
GDP deflator	1.0	0.7	1.1	0.5	-0.4	1.4	1.2
Consumer price index (harmonized)	1.2	1.5	0.6	0.7	2.1	2.5	1.3
Average hourly earnings (industry)	4.8	1.3	2.2	2.7	2.7	...	...
Unit labor cost (total economy)	0.2	-0.7	0.2	0.6	-0.1	2.2	1.9
Real disposable income 5/	0.6	0.1	1.7	2.6	1.3	1.7	2.1
Personal saving ratio (in percent)	10.8	10.4	10.3	9.9	9.8	9.7	9.4

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	2001 1/	2002 1/
Public finances 2/ 3/		(In billions of deutsche marks)					
General government							
Expenditure	1,802	1,806	1,841	1,889	1,817	1,945	2,003
(In percent of GDP)	50.3	49.3	48.8	48.9	45.9	48.1	48.0
Revenue	1,680	1,706	1,758	1,829	1,864	1,857	1,928
(In percent of GDP)	46.8	46.6	46.6	47.4	47.1	45.9	46.2
Financial balance	-122	-100	-84	-60	47	-89	-75
(In percent of GDP)	-3.4	-2.7	-2.2	-1.6	1.2	-2.2	-1.8
Federal government							
Financial balance	-78.5	-63.5	-56.6	-51.3	53.0	-53.5	-44.9
(In percent of GDP)	-2.2	-1.7	-1.5	-1.3	1.3	-1.3	-1.1
General government debt	2,144	2,229	2,292	2,359	2,389	2,412	2,486
(In percent of GDP)	59.8	60.9	60.7	61.1	60.3	59.6	59.6
Balance of payments							
Trade balance 4/	93.3	109.1	121.0	113.9	101.8	123.5	140.6
Services balance	-55.3	-58.7	-66.7	-80.4	-87.4	-90.5	-94.7
Net private transfers	-16.0	-15.9	-16.0	-16.4	-15.8	-15.0	-15.0
Net official transfers	-35.3	-36.8	-37.3	-34.0	-37.3	-35.0	-35.0
Current account	-12.0	-4.7	-11.8	-32.9	-41.1	-31.6	-20.3
(In percent of GDP)	-0.3	-0.1	-0.3	-0.9	-1.0	-0.8	-0.5
Foreign exchange reserves (e. o. p.) 5/ 6/	72.4	76.7	100.4	102.5	112.0	100.1	...
Monetary data		(Percentage changes, end of period)					
Money and quasi-money (M3) 6/ 7/	5.8	5.0	8.4	8.3	-0.2	4.6	...
Credit to private sector 6/	7.3	6.1	8.4	5.8	5.8	4.2	...
Interest rates		(Period averages in percent)					
Three-month interbank rate 8/	3.3	3.3	3.5	2.9	4.4	3.7	...
Yield on ten-year government bonds 8/	6.2	5.7	4.6	4.5	5.3	4.9	...
Exchange rates		(Levels)					
DM per US$ (end of period) 8/	1.55	1.79	1.67	1.95	2.10	2.15	...
DM per US$ (annual average) 8/	1.50	1.73	1.76	1.84	2.12	2.15	...
Euro per US$ (annual average) 8/	0.78	0.88	0.89	0.94	1.08	1.10	...
Nominal effective rate (1990=100) 9/	108.8	103.8	104.1	102.0	97.8	97.7	...
Real effective rate (1990=100) 9/	120.9	114.0	111.4	108.1	102.3	101.1	...

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 for 2001 refer to 12-month change to July 2001.
7/ Data reflect Germany's contribution to M3 of the euro area.
8/ Data for 2001 refer to September 21, 2001.
9/ Data for 2001 refer to July 2001.

Germany: Fund Relations
(As of August 31, 2001)

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	8,891.07	68.3
Reserve position in Fund	4,117.14	31.7

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	1,210.76	100.0
Holdings	1,403.33	115.9

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 has been a member of the European Economic and Monetary Union; the deutsche mark entered EMU at a value of DM 1.95583 per euro.

In compliance with the UN Security Council resolutions and EU regulations, restrictions have been imposed on payments and transfers for current international transactions regarding the UNITA movement in Angola, including its officials and members of their families, and Iraq. Effective February 14 and June 16, 2000, sanctions against the Taliban (the Islamic State of Afghanistan) were imposed. On May 22, 2000, new EU sanctions against certain individuals from Myanmar became effective. Effective November 10, 2000, EU sanctions against the Federal Republic of Yugoslavia were relaxed, except as regards the assets of some 651 persons.

VIII. Article IV Consultations:

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (SM/00/225) was discussed at EBM/00/103 (October 23, 2000).

Germany: Statistical Appendix

Germany has a full range of statistical publications and has subscribed to the Fund's Special Data Dissemination Standard (SDDS). The authorities 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 with the prescriptions of the fifth edition of the IMF's Balance of Payments Manual.

Germany adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. Three significant gaps remain:

- ESA95 data are only available from 1991 onward. Budgetary constraints are likely to hinder the timely 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.
- Primarily statistics on inventories are unavailable, depriving Germany of a key economic indicator. In the national accounts statistics inventory accumulation is derived as a residual and lumped together with the statistical discrepancy.

Following the adoption of the ESA95 standard for fiscal reporting by member countries of the European Union, Eurostat advised the IMF that the member countries would no longer report cash data for publication in the Government Finance Statistics Yearbook. The IMF Statistics Department is collaborating with Eurostat and the European Central Bank to develop a fiscal data reporting system that accords with the accrual methodologies of the ESA95 and the revised Government Finance Statistics Manual.

Germany: Core Statistical Indicators

(As of September 12, 2001)

	Exchange Rates	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	9/12/01	9/12/01	8/01	7/01	7/01	2000	2002Q2	6/00
Date Received	9/12/01	9/12/01	9/6/01	9/11/01	9/11/01	3/1/01	8/23/01	2/01
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

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2001 Article IV Consultation

Supplementary Information

Prepared by the European I Department

Approved by Michael Deppler

October 22, 2001

1. This supplement reports on information that has become available since the issuance of the staff report (SM/01/290) and on additional discussions with the authorities that took place in Washington on October 6, 2001.[1] The new information does not alter the thrust of the staff appraisal. In the discussions, the authorities and staff broadly concurred on the assessment of recent economic developments. Staff and the authorities also agreed that the terrorist attack on the United States on September 11, 2001 had considerably increased the uncertainty surrounding near-term economic prospects.

2. Recent data provide further evidence that economic activity was, as expected at the time of the staff report, weak in the third quarter of 2001 while headline inflation continues to fall:

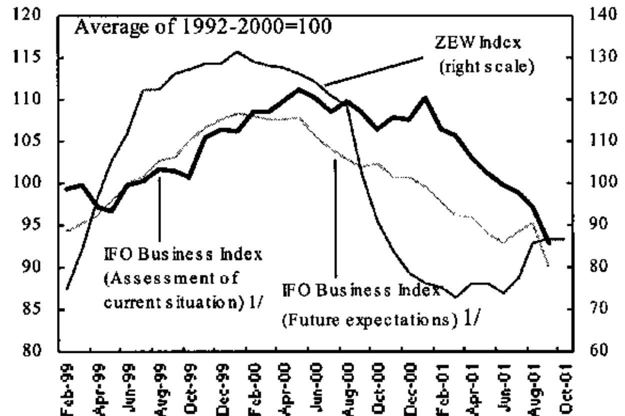
- In July-August, industrial production was 0.2 percent below its level in the second quarter on a seasonally adjusted basis. Industrial orders in July-August were one percent lower than in the second quarter.
- Unemployment edged up further in September to reach a seasonally-adjusted rate of 7.9 percent (EU-definition) and 9.4 percent (national definition).
- Imports continued to contract in August, leaving them 1½ percent lower in nominal terms in July-August than in the second quarter.
- On the other hand, exports held up well through September and retail sales indices for August suggest a moderate increase of private consumption.

[1] The staff met with Finance Minister Eichel, Bundesbank President Welteke, and Ministry of Finance State Secretary Koch-Weser.

- Consumer price inflation fell somewhat faster than the staff expected in September to 2.1 percent from 2.6 percent in August.

3. Business confidence tumbled in September, although indicators of economic sentiment suggest that a large part of the decline may be a temporary reaction to the events of September 11. The Ifo assessment for September of both the current business situation and business expectations dropped sharply, in the latter case cutting short the nascent revival of the preceding two months (Figure 1). The composite index was at its lowest level for eight years, a level consistent with falling output in the period ahead. By contrast, the ZEW indicator of economic sentiment does not show a significant deterioration in September or October when its level was above its lows of the first half of this year. Nor does consumer confidence appear to have been shaken dramatically by the events of September 11, although staff analysis suggests that consumer confidence is a poor predictor of actual consumption or economic activity in Germany.

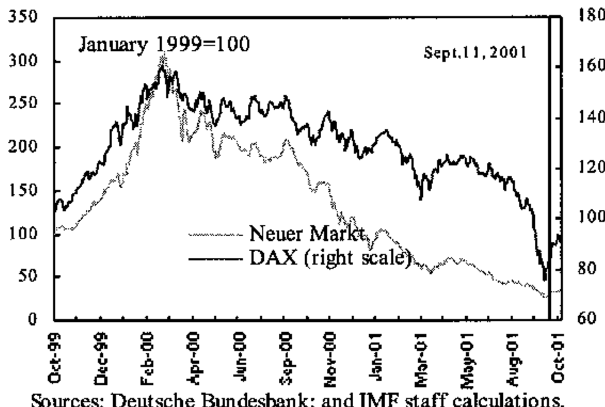
Figure 1. Germany: Business Confidence Indicators, 1999-2001



Sources: Ifo Institute for Economic Research; Centre for European Economic Research (ZEW); and European Commission.
1/ Data for western Germany.

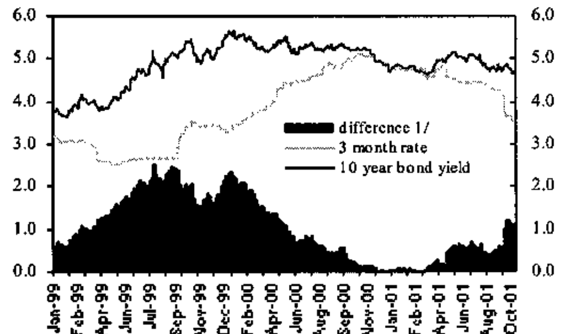
4. Germany's stock markets have broadly regained losses sustained in the days immediately following the terrorist attack (Figure 2). The DAX index nevertheless remains about 30 percent below its level at the beginning of the year. Prompt monetary easing by the ECB has led to a steepening of the yield curve as long-term bond yields have fallen only slightly since September 11 (Figure 3).

Figure 2. Germany:
Nominal Stock Price Indices, 1999-2001



Sources: Deutsche Bundesbank; and IMF staff calculations.

Figure 3. Germany: Interest Rates, 1999-2001



Sources: Deutsche Bundesbank; and IMF staff calculations.
1/ Difference between 10-year government bond yield and 3-month money market rate.

5. Even before the September Ifo survey was released, staff projected that recovery would be postponed until the first half of 2002. Based on the assessment that output will stagnate in the fourth quarter, staff estimates that annual average growth in 2001 will be 0.7 percent (0.8 percent in the staff report). For 2002, the growth projection will be heavily influenced by the duration of the setback to business expectations. Assuming it is quickly reversed—and confidence then begins to strengthen—growth would resume at a below-potential rate in the first half of the year, aided by a turnaround in global growth, recent interest rate cuts and the drop in oil prices.[2] Growth would strengthen as the year progresses. Nonetheless, average annual growth in 2002 would be well below 1.5 percent (1.8 percent in the staff report). Lower oil prices and weaker economic growth are expected to moderate inflation. Despite indirect tax increases scheduled for January to pay for anti-terrorist expenditures, the staff would see average inflation in 2002 of no more than 1¼ percent.

6. The margin of uncertainty is wide. Business confidence is highly precarious, investors and consumers are understandably nervous about the extent and consequences of further terrorist and military actions, and the path of global demand is hard to predict. The dramatic fall in business confidence in September tilts the risks, at this stage, decidedly to the downside. If confidence does not rebound quickly, the economy could experience a much more prolonged period of weakness than expected. However, uncertainty is not all one-sided, as indicated by the more sanguine ZEW business sentiment reading and the potential for the German economy to respond positively to lower interest rates and oil prices.

7. The authorities broadly shared staff's interpretation of recent developments. They agreed that the latest data and the structure of demand during the downturn highlighted that recovery depended heavily on a revival in external demand and business confidence. They also emphasized that there was very little hard data on which to evaluate the consequences of the events of September 11. On October 18, the Minister of Finance indicated that the official growth projection for 2002 would be in the range of 1 to 1.5 percent. That would be in line with the staff's projection. The official forecast will be formally released later this month.

8. The authorities agreed that the latest ECB interest rate cuts had been fully justified. From a purely German perspective, the inflationary risks of further rate cuts would appear to be very low. The additional economic weakness had further increased the likelihood of subdued wage demands in the upcoming wage round.

9. The authorities stressed that the weakened economic outlook had not changed their thinking on fiscal policy. They would shortly start to review the budget outcome for 2001 and refine revenue projections for 2002. Therefore, at this stage, they were unable to discuss

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[2] Projections are being made in the context of an interim WEO round.

adjustments to either the 2001 or 2002 budgets. Nevertheless, fiscal consolidation remained the priority in view of the high debt burden and the medium-term strains arising from population ageing. The authorities continued to place importance on meeting their Stability Program deficit targets, noting that the targets were particularly useful for instilling confidence in market participants and reassuring them that consolidation was on track.

10. Staff pointed out that the downward revision to growth would make it even more difficult to meet the deficit targets in 2001 and 2002, and reasserted its advice to stick to current expenditure plans but allow the automatic stabilizers to operate fully. According to staff projections, the general government deficit would then be about 2 percent of GDP in 2002, compared to 2¼ percent of GDP in 2001 and the Stability Program target of 1 percent of GDP. Whereas the deficit in 2002 would be larger than projected at the time of the staff report (1.8 percent of GDP), and the *decline* in the deficit between 2001 and 2002 would be less than the ½ percent of GDP envisaged in the Stability Program, the additional slippage would be entirely cyclical. With a projected drop in the general government structural deficit relative to GDP of ½ percent, fiscal policy would be contractionary in 2002.

11. With a reasonably strong recovery still projected (albeit occurring later than expected at the time of the mission), staff remains of the view that the economic outlook does not require a more active fiscal response that would, for example, overturn next year's contractionary stance. In staff's view, assuming the drop in business confidence reverses quickly and a global recovery occurs, the fundamentals are healthy enough for growth to pick up to above its potential rate in the second half of next year. Nonetheless, the next reading of business confidence will be telling. If confidence fails to recover substantially, consideration should be given to bringing forward into 2002 tax cuts that are already factored into medium-term fiscal plans. Tax cuts of the order ½ percent of GDP would still leave the general government deficit below the 3 percent of GDP Stability and Growth Pact ceiling, unless growth in 2002 were to fall to close to zero.

12. Since September 11, the authorities have taken steps to bolster the fight against money laundering and the financing of terrorism. The government has approved changes to the draft Fourth Financial Promotion Act, which, if passed by parliament, will among other things: create a central agency to track down money laundering; set up with the banking supervisory agency a central registry of bank and custodian accounts; and extend money laundering provisions to the credit card industry.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/117
FOR IMMEDIATE RELEASE
November 7, 2001

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

IMF Concludes 2001 Article IV Consultation with Germany

On October 24, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

Germany's strongest post-reunification growth surge ended abruptly in the middle of 2000 and growth has not yet recovered. The slowdown was triggered by a deterioration in the terms of trade, notably because of higher oil prices, and has been exacerbated by a sharp uptick in food prices and the weakness in the global economy. IMF staff estimate growth in 2001 will drop to ¾ percent. Headline inflation has receded from its peak of 3½ percent in May 2001 to about 2 percent. Excluding food and energy prices, underlying inflation is estimated at 1½ percent.

The ending of the growth surge has cut short progress in reducing unemployment. In the context of low trend growth since reunification, the unemployment rate rose to over 9½ percent in late 1997 before falling back to 7¾ percent by end-2000 on the back of a revival in employment growth. However, net job creation ground to a halt when economic growth faltered and unemployment began to creep up again in the first half of 2001.

Tax reform is providing support to the economy. At the beginning of 2001, income and corporate tax rates were reduced significantly, contributing to a reduction in the tax burden equivalent to over 1 percent of GDP. While the impact on the budget deficit is being partly offset

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[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. This PIN summarizes the views of the Executive Board as expressed during the October 24, 2001 Executive Board discussion based on the staff report.

by tight public expenditure control, additional shortfalls in tax collection stemming from the economic slowdown are projected to push the general government deficit over 2 percent of GDP in 2001. Another major reform during the past year was the introduction of a fully-funded, private pillar to the pension system. The new pillar will, in the medium term, deflect some of the strains on the public pension system from population aging.

Executive Board Assessment

Executive Directors noted that Germany's third post-reunification growth spurt came to an abrupt end in the middle of last year. Notwithstanding the downturn, the authorities have made important progress in improving the structural foundations of the German economy during the past year. The pension and tax reforms, and the great strides achieved in liberalizing product markets, are expected to make a significant contribution to longer-term economic prospects. Directors urged the authorities to apply equal vigor to reforming labor markets.

Directors observed that the prospects for recovery are heavily dependent on a pickup in business confidence and global growth, and that the outlook has been further clouded by the uncertain effects of the terrorist attacks on the United States. While predicting the timing of the upturn in growth remains difficult, Directors considered that, barring further setbacks, a recovery should start in the first half of 2002. They noted, nonetheless, that confidence remains precarious and that the risk of continued global weakness injects a sizable element of caution into the forecast. On the positive side, Directors noted that underlying inflation is low and that headline inflation should continue to decline in the period ahead.

Directors were encouraged to see evidence of continued wage moderation, which will remain essential in creating favorable conditions for recovery and getting unemployment back on a declining track. They commended wage bargainers for putting job creation ahead of pay increases in recent years.

While acknowledging the constraints on macroeconomic policies to stimulate growth, Directors urged the authorities to continue to explore carefully the room for supporting an early recovery. Directors considered that recent interest rate cuts by the ECB should help support growth, and, while further action on monetary policy will be determined by euro area considerations, receding risks to price stability, including in Germany, are creating additional welcome room for further monetary policy easing.

Directors noted that Germany's fiscal policy options remain circumscribed by the need to eliminate the structural budget deficit and reduce the sizable public debt burden. They emphasized Germany's pivotal role in the Stability and Growth Pact, which gives added weight to the importance of maintaining policy credibility by adhering closely to the path of fiscal consolidation. Nonetheless, Directors did not view the likely overshooting of this year's fiscal deficit target as a cause for particular concern as it simply reflects the cyclical weakness in revenues.

For 2002, most Directors agreed that the automatic stabilizers should continue to operate. They noted that, even though this could result in another overshooting of the deficit target, Germany, by sticking to the medium-term expenditure path, would still reach medium-term deficit targets on schedule. A number of Directors proposed that, absent a quick rebound in business confidence, the authorities should consider bringing forward tax cuts that are already factored into medium-term fiscal plans. Other Directors, however, cautioned against using structural tax reforms for cyclical fine-tuning.

Looking ahead, Directors emphasized that expenditure restraint should remain the cornerstone of Germany's fiscal adjustment strategy. They viewed the government's cautious expenditure growth target as an appropriately ambitious response to projected demographic strains and the need to reduce the tax burden further. Directors recommended that all levels of government develop more regular reporting, monitoring, and assessment of fiscal projections in order to raise the profile of spending limits and to increase accountability. Some Directors suggested that the expenditure growth targets should assume greater prominence within the fiscal framework, noting that a shift of emphasis away from annual deficit targets could mitigate the need for undue tightening in a downturn and reduce the scope for slippage in the structural deficit during an upturn. Other Directors, however, observed that annual deficit targets play an important role in instilling discipline and reassuring market participants that consolidation is on track.

Directors noted that the abruptness of the latest downturn raises questions about the resilience of the economy. While acknowledging that external factors have played a key role in the current slowdown, Directors also observed that trend output growth has been low in Germany for some time, and a number of them referred in this connection to the continued challenge stemming from reunification. Moreover, Directors considered that the fragility of employment growth points to insufficient flexibility to cope with rapid change and to take advantage of new growth opportunities. Directors therefore strongly welcomed the important progress that the authorities have made in implementing structural reforms, which should enhance Germany's growth potential in coming years, and highlighted, in particular, the improved business environment that will result from tax reforms and liberalization of product markets. It will, nevertheless, be important to keep up the structural reform momentum in order to further improve economic performance and resilience.

Directors agreed that a consistent and coherent set of labor market reforms heads the list of remaining structural policy priorities. They encouraged the authorities to review regulations that deter hiring and to combine wage moderation with policies that foster greater wage differentiation across skills and regions. Directors welcomed the authorities' intention to strengthen incentives for the unemployed to find work, although some Directors questioned whether they would be successful without reform of unemployment benefits. Directors also suggested that the authorities give priority to assessing the effectiveness of active labor market policies, in particular the merits of tax-based incentives for employment at the low end of the wage scale.

Directors considered Germany's financial sector to be generally sound, but stressed that, against the backdrop of the global slowdown, financial sector supervision must remain particularly vigilant. They noted that the downturn in sectors such as telecommunications, real estate, and construction, as well as bank exposures to countries in recession and to emerging markets, warrant especially close attention. Directors encouraged the authorities to take steps to facilitate further restructuring in the banking sector and improve transparency in the financial sector. In this context, they welcomed the planned phasing out of guarantees to public banking institutions and looked forward to further steps to create an open and competitive market for financial services. Directors also welcomed the authorities' recent initiatives to strengthen efforts to fight money laundering and financing for terrorism, as well as their intention to participate in a Financial Sector Assessment Program.

Directors noted that the quality of German official statistics is generally good. However, in certain areas, such as the quarterly national accounts data where revisions are frequent, they encouraged further improvement.

Directors commended the authorities for their full support for the initiation of a new trade round, and a number of them welcomed their intention to press for the liberalization of agricultural policy within the EU. Directors urged the authorities to raise their level of official development assistance to the UN target of 0.7 percent of GDP.

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. The Staff Report for the 2001 Article IV Consultation with Germany is also available.

Germany: Selected Economic Indicators

	1997	1998	1999	2000	2001 1/
Economic activity and prices	Change in percent, unless otherwise noted				
Real GDP	1.4	2.0	1.8	3.0	0.8
Net exports 2/	0.9	-0.4	-0.7	1.1	0.8
Final domestic demand	0.6	2.4	2.6	2.0	0.0
Private consumption	0.6	1.8	3.1	1.5	1.8
Gross fixed investment	0.6	3.0	4.2	2.3	-3.2
Construction investment	-1.5	-1.0	1.5	-2.5	-5.5
Gross national saving (percent of GDP)	21.4	21.5	20.9	21.2	20.0
Gross domestic investment (percent of GDP)	21.5	21.5	21.7	21.7	20.9
Labor force 3/	0.8	0.5	0.5	0.8	0.1
Employment 3/	-0.2	1.1	1.2	1.6	0.1
Standardized unemployment rate (in percent)	9.9	9.3	8.6	7.9	7.9
Unit labor costs (whole economy) 3/	-0.7	0.2	0.6	-0.1	2.2
GDP deflator	0.7	1.1	0.5	-0.4	1.4
Harmonized CPI index	1.5	0.6	0.7	2.1	2.5
Public finance	In percent of GDP				
General government balance 3/ 4/	-2.7	-2.2	-1.6	1.2	-2.2
Structural government balance	-1.6	-1.2	-0.7	-1.1	-1.4
General government gross debt 3/ 4/	60.9	60.7	61.1	60.3	59.6
Money and credit					
Private sector credit 5/	6.1	8.4	5.8	5.8	4.2
M3 5/ 6/	5.0	8.4	8.3	-0.2	4.6
Interest rates	In percent				
Three-month money market rate 7/	3.3	3.5	2.9	4.4	4.2
Ten-year government bond yield 7/	5.7	4.6	4.5	5.3	4.8
Balance of payments	In billions of DM, unless otherwise noted				
Exports 8/	1,034.2	1,106.4	1,159.2	1,348.8	1,440.7
Imports 8/	983.8	1,052.2	1,125.7	1,334.4	1,407.7
Trade balance	109.1	121.0	113.9	101.8	123.5
Current account balance	-4.7	-11.8	-32.9	-41.1	-31.6
Current account (percent of GDP)	-0.1	-0.3	-0.9	-1.0	-0.8
Exchange rate					
Deutsche mark per U.S. dollar 9/	1.79	1.67	1.95	2.10	2.13
Euro per US dollar 9/	0.89	0.90	0.94	1.09	1.12
Nominal effective rate (1990=100) 10/	103.8	104.1	102.0	97.8	97.7
Real effective rate (1990=100) 10/ 11/	114.0	111.4	108.1	102.3	101.1

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

1/ IMF staff projections, unless otherwise indicated.
2/ Contribution to GDP growth.
3/ National accounts basis (ESA95).
4/ 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.
5/ Data for 2001 refer to July 2001.
6/ Data reflect Germany's contribution to M3 of the euro area.
7/ Data for 2001 refer to September 14, 2001.
8/ Includes supplementary trade items and services.
9/ Data for 2001 refer to September 21, 2001.
10/ Data for 2001 refer to September 14, 2001.
11/ Based on relative normalized unit labor cost in manufacturing.