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Germany: 2003 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 2003 Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 14, 2003** with the officials of Germany on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 3, 2003.** 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 29, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its November 3, 2003 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
Financial System Stability Assessment

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Germany

Approved by Michael Deppler and Martin Fetherston

October 3, 2003

- Discussions took place in Berlin, Frankfurt, and Bonn during July 4-14, 2003. Meetings were held with Minister of Finance Eichel, Bundesbank President Welteke, State Secretaries Koch-Weser (Ministry of Finance) and Tacke (Ministry of Economics and Labor), and senior officials at the Chancellery, the Ministries of Finance, Economics and Labor, and Health and Social Security, the Bundesbank, and the Federal Office of Financial Supervision. The mission also met with the social partners, associations of financial institutions, and research institutes.

- The team comprised Messrs. Chopra (Head), Corker, Decressin, Brunner, Klingen (all EU1), and Petersen (MFD). Mr. Bischofberger, Germany's Executive Director, also took part in the discussions.

- A Financial System Stability Assessment report has also been prepared as part of the Financial Sector Assessment Program (FSAP), the findings of which were discussed with the authorities during the Article IV consultation mission.

- The authorities released the mission's concluding statement and intend to publish this staff report. Last year's Article IV staff report was published as IMF Country Report 02/239 following the IMF Executive Board meeting on October 23, 2002.

- A fiscal transparency ROSC was recently completed and can be found on the IMF's external website.

- Germany has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).

- Germany's statistics are comprehensive and timely, and hence conducive for effective surveillance.

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Executive Summary

Background

The economy has stagnated for the past three years and the fiscal deficit exceeds the 3 percent of GDP limit under the Stability and Growth Pact. Inflation is about 1 percent. Underlying the poor economic performance are structural rigidities, which have prolonged the adjustment to reunification-related imbalances. Recent developments have added a cyclical dimension to output weakness. Against this background, the authorities have embarked on a new, three-pronged strategy consisting of structural reforms under the rubric of Agenda 2010, more targeted public expenditure cuts, and advancing planned tax cuts.

Key issues

- **Prospects for recovery**. The authorities expected that a confidence boost from their strategy would augment the effect of strengthening global growth and low interest rates. The IMF staff was more cautious about the immediate outlook: the strategy would benefit mainly the medium term while growth in the short run might be held back by the euro's appreciation. *While a mild-paced recovery appears most likely for 2004, confidence could take a hit if implementation of the strategy faltered.*

- **Fiscal policy**. Advancing the tax cuts will interrupt consolidation in 2004. It was agreed that to preserve credibility, quality measures needed to be specified upfront to cut the structural deficit by at least 1½ percent of GDP over 2004-06. Staff thus welcomed plans to cut subsidies and entitlements, and curtail tax expenditures, but noted that total savings were as yet insufficient. *Additional fiscal consolidation measures need to be specified; further cuts in subsidies and inefficient labor market programs warrant consideration.*

- **The structural reform agenda**. To strengthen incentives to work, the centerpiece of the agenda is to reduce the generosity of benefits to the unemployed. Staff argued that they should be complemented by tougher requirements for unemployed persons to accept work and an easing of job protection laws. Absent reforms to entitlement programs, demographic aging will put considerable upward pressure on social contributions, and hence labor costs. *Reforms to unemployment benefits are well designed. Proposals to raise the retirement age and add a demographic factor to pensions would improve prospects for long-run viability of the pension system. Early implementation is a priority.*

- **Financial sector restructuring.** Declining bank profitability has been exacerbated by the economic downturn. While acknowledging that restructuring is underway, the staff noted that augmenting current efforts by lowering barriers to consolidation across public and private pillars would open new avenues for restructuring. *The financial system has proved to be resilient, but to help reverse the downward trend in profitability, work needs to begin on creating the legal framework to facilitate restructuring and attract private capital.*

I. Introduction

1. **The 2003 consultation discussions took place against a backdrop of serious concerns about the health and prospects for the economy.** Output had stagnated for three years and the budget deficit was set to remain in excess of the 3 percent of GDP ceiling under the Stability and Growth Pact (SGP) for the second year running (Table 1). In response, the authorities had just unveiled a three-pronged strategy consisting of: (i) structural reforms under the rubric of Agenda 2010, notably reductions in entitlements for the jobless and reforms to other social programs to slow nonwage labor cost growth; (ii) more structurally-based fiscal consolidation through cutbacks in subsidies and tax expenditures; and (iii) advancing scheduled tax relief from 2005 to 2004, in part to support domestic demand. At the time of the mission, many of the reforms and budgetary measures still needed to be fleshed out. Proposals have become more concrete since then and key labor market and health care reforms have been passed by parliament.

2. **The strategy leans very much in the direction supported by IMF Executive Directors in past Article IV consultations.** In particular, Directors have for many years placed the highest priority on reforming labor markets and scaling back entitlements, areas where past and present authorities have made little progress, notwithstanding the introduction of a private pension pillar in 2000. Directors have called for more concerted efforts to cut public expenditure in order to eliminate the structural budget deficit and accommodate a reduction in the high tax burden on labor. Advancing tax relief was seen as a step that might be considered if the economy were to remain mired in stagnation.

II. Background

3. **In the first half of 2003, there were good reasons to be concerned about Germany's economy**:

- Output had been static for three years;
- Unemployment was heading to a post-war high of over 9 percent—and as high as 15-20 percent in the new Länder;
- The financial sector had just endured one of its worst years on record with three of the four large commercial banks and two Landesbank registering losses in 2002.

With no upturn in sight, and inflation down to about 1 percent, it appeared possible that the price level could begin falling, generating debate about the risk of deflation.[1]

[1] See "Deflation: Determinants, Risks, and Policy Options," *IMF Occasional Paper 221 (2003)* and Bundesbank, *Monthly Report, June 2003.*

Table 1. Germany: Basic Data

Total area	357,041 square kilometers
Total population (2002)	82.48 million
GNP per capita (2002)	US$ 24,201

	1997	1998	1999	2000	2001	2002	2003 1/	2004 1/
	(Percentage change at 1995 prices)							
Demand and supply								
Private consumption	0.6	1.8	3.7	2.0	1.4	-1.0	0.8	1.7
Public consumption	0.3	1.9	0.8	1.0	1.0	1.7	0.9	0.4
Gross fixed investment	0.6	3.0	4.1	2.7	-4.2	-6.7	-1.7	3.6
Construction	-1.5	-1.0	1.4	-2.6	-4.8	-5.8	-3.7	1.6
Machinery and equipment	3.7	9.2	7.2	10.1	-4.9	-9.1	0.7	6.0
Final domestic demand	0.5	2.1	3.2	1.9	0.1	-1.7	0.3	1.8
Inventory accumulation 2/	0.0	0.3	-0.4	-0.1	-0.8	0.1	0.7	0.2
Total domestic demand	0.6	2.4	2.8	1.8	-0.8	-1.6	1.0	2.0
Exports of goods and nonfactor services	11.2	7.0	5.5	13.7	5.6	3.4	0.5	3.6
Imports of goods and nonfactor services	8.3	9.1	8.4	10.5	0.9	-1.7	3.7	5.4
Foreign balance 2/	0.8	-0.4	-0.7	1.1	1.6	1.7	-1.0	-0.4
GDP	1.4	2.0	2.0	2.9	0.8	0.2	0.0	1.5
Output gap (In percent of potential GDP)	-0.5	-0.4	-0.1	0.9	0.3	-0.9	-2.4	-2.5
	(In millions, unless otherwise indicated)							
Employment and unemployment								
Labor force	40.9	41.1	41.3	41.7	42.0	42.0	41.9	41.9
Employment 3/	37.1	37.6	38.0	38.7	38.9	38.6	38.2	38.0
Unemployed 4/	3.8	3.6	3.3	3.1	3.1	3.4	3.8	3.9
Unemployment rate (in percent) 4/	9.6	9.1	8.4	7.8	7.9	8.6	9.5	9.8
	(Percentage change)							
Prices and incomes								
GDP deflator	0.7	1.1	0.5	-0.3	1.3	1.6	0.9	0.9
Consumer price index (harmonized)	1.5	0.6	0.6	1.4	1.9	1.3	1.0	0.6
Average hourly earnings (industry)	4.0	0.0	3.8	3.7	3.6	3.4	...	...
Unit labor cost (total economy)	-0.7	0.2	0.3	1.0	1.3	0.8	1.3	0.5
Real disposable income 5/	0.1	1.7	3.1	1.9	2.0	-0.7	-0.1	1.4
Personal saving ratio (in percent)	10.4	10.3	9.8	9.8	10.3	10.6	9.8	9.6

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

1/ IMF staff projections.

2/ Growth contribution.

3/ According to place of residence.

4/ Unemployment as defined by the Eurostat.

5/ Deflated by the national accounts deflator for private consumption.

Table 1. Germany: Basic Data (concluded)

	1997	1998	1999	2000	2001	2002	2003 1/	2004 1/
Public finances 2/ 3/	(In billions of euros)							
General government								
Expenditure	923	942	965	928	1,001	1,024	1,048	1,058
(In percent of GDP)	49.3	48.8	48.7	45.7	48.3	48.5	49.2	48.5
Revenue	872	899	935	955	943	950	964	973
(In percent of GDP)	46.6	46.6	47.3	47.1	45.5	45.0	45.3	44.6
Financial balance	-51	-43	-29	27	-59	-74	-84	-85
(In percent of GDP)	-2.7	-2.2	-1.5	1.3	-2.8	-3.5	-3.9	-3.9
Structural balance	-37	-32	-24	-33	-61	-62	-51	-51
(In percent of potential GDP)	-2.0	-1.7	-1.2	-1.6	-2.9	-2.9	-2.3	-2.3
Federal government								
Financial balance	-32	-29	-26	27	-23	-33	-41	-37
(In percent of GDP)	-1.7	-1.5	-1.3	1.3	-1.1	-1.5	-1.9	-1.7
General government debt	1,142	1,175	1,210	1,222	1,233	1,283	1,346	1,428
(In percent of GDP)	61.0	60.9	61.2	60.2	59.5	60.8	63.3	65.5
Balance of payments								
Trade balance 4/	55.8	61.9	58.2	52.1	90.1	120.4	113.9	110.3
Services balance	-35.6	-38.9	-47.0	-49.9	-51.2	-38.3	-31.8	-34.7
Net private transfers	-8.1	-8.2	-7.7	-9.3	-10.5	-10.9	-8.0	-8.2
Net official transfers	-18.8	-19.1	-17.3	-19.1	-16.9	-15.6	-17.0	-17.5
Current account	-8.1	-11.1	-22.3	-28.5	1.0	48.9	51.0	45.9
(In percent of GDP)	-0.4	-0.6	-1.1	-1.4	0.0	2.3	2.4	2.1
Foreign exchange reserves (e. o. p.) 5/	39.2	51.3	52.4	0.0	49.5	40.5	37.9	...
Monetary data	(Percentage changes, end of period)							
Money and quasi-money (M3) 6/ 7/	4.6	7.6	7.2	-1.1	6.0	...	7.2	...
Credit to private sector 6/	6.2	8.4	5.8	5.8	3.2	0.9	1.3	...
Interest rates	(Period averages in percent)							
Three-month interbank rate 8/	3.3	3.5	3.0	4.4	4.3	3.3	2.1	...
Yield on ten-year government bonds 8/	5.7	4.6	4.5	5.3	4.8	4.8	4.0	...
Exchange rates	(Levels)							
Euro per US$ (annual average) 8/	0.88	0.89	0.94	1.08	1.12	1.06	0.87	...
Nominal effective rate (1990=100) 9/	103.8	104.1	102.0	97.8	98.5	99.5	103.7	...
Real effective rate (1990=100) 9/ 10/	113.3	110.4	107.0	100.8	100.0	100.1	103.2	...

1/ IMF 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 accordance with Maastricht definitions.

3/ Government expenditure in 2000 includes, as a negative entry, the proceeds from the sales of mobile phone licenses of euro 50.8 billion (2.5 percent of GDP). The proceeds also affect the financial (but not structural) balances and the government debt.

4/ Including supplementary trade items.

5/ From 1999 onward data reflect Germany's position in the euro area. Data for 2003 refer to a change from April 2002 to April 2003.

6/ Data for 2003 refer to a change from July 2002 to July 2003.

7/ Data reflect Germany's contribution to M3 of the euro area; data not shown for 2002 because of a series break.

8/ Data for 2003 refer to September 29.

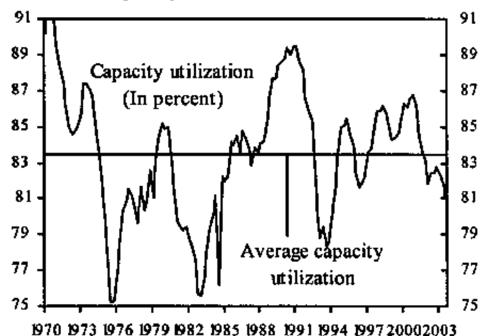
9/ Data for 2003 refer to August.

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

4. **Current problems stem from low trend growth, rooted in structural rigidities, reinforced by the global slowdown and reversal of the late 1990s surge in business investment.** Germany's economic performance in the past 10 years has lagged that of other euro area countries (Figure 1). Underlying weakness can be traced to the ongoing correction of high labor costs dating back to reunification in 1990, and to the unwinding of the building boom in the new Länder.[2] Structural rigidities, combined with a *de facto* fixed exchange rate with main continental European partners since the mid-1990s, have made adjustment a drawn out process. In particular, generous benefits for the jobless and tax and contributions increases to fund the extension of the welfare system to the new Länder softened the pressure for the wage concessions needed to absorb the unification-related increase in labor supply. Wage moderation has been evident since the mid-1990s, but the employment response has been hesitant, in part because, with high firing costs, employers must take a longer-term view about hiring decisions. As a result, incomes and domestic demand have lacked momentum and have been only partially offset by export growth as competitiveness has improved. In 2000, the bursting of the equity bubble and the downturn of the global economy removed the two remaining props to growth.

5. **Even though weak domestic demand is driven by a necessary adjustment process, three years of stagnation have left a sizeable output gap.** The degree of overheating entering the current downswing was mild: the preceding upswing was modest (growth briefly reached nearly 3 percent in 2000) and followed many years in which the adjustment process had kept output hovering below potential. Thus, although the cumulative output loss relative to trend in the current downswing has only been about 3½ percent, compared to nearly 4½ percent for the average cycle, staff estimates that by mid-2003 the output gap was 2½ percent, considerably larger than elsewhere in the euro area (Figure 2).[3] Reflecting the composition of demand, the export-oriented manufacturing sector has not borne the brunt of cyclical weakness as it has typically done in the past (Figure 3). Manufacturing has been growing strongly in the new Länder, although the effect on income convergence to the old Länder has been more than offset by the ongoing slump in construction (Figure 4).

Figure 3. Germany: Manufacturing Capacity Utilization, 1970-2003

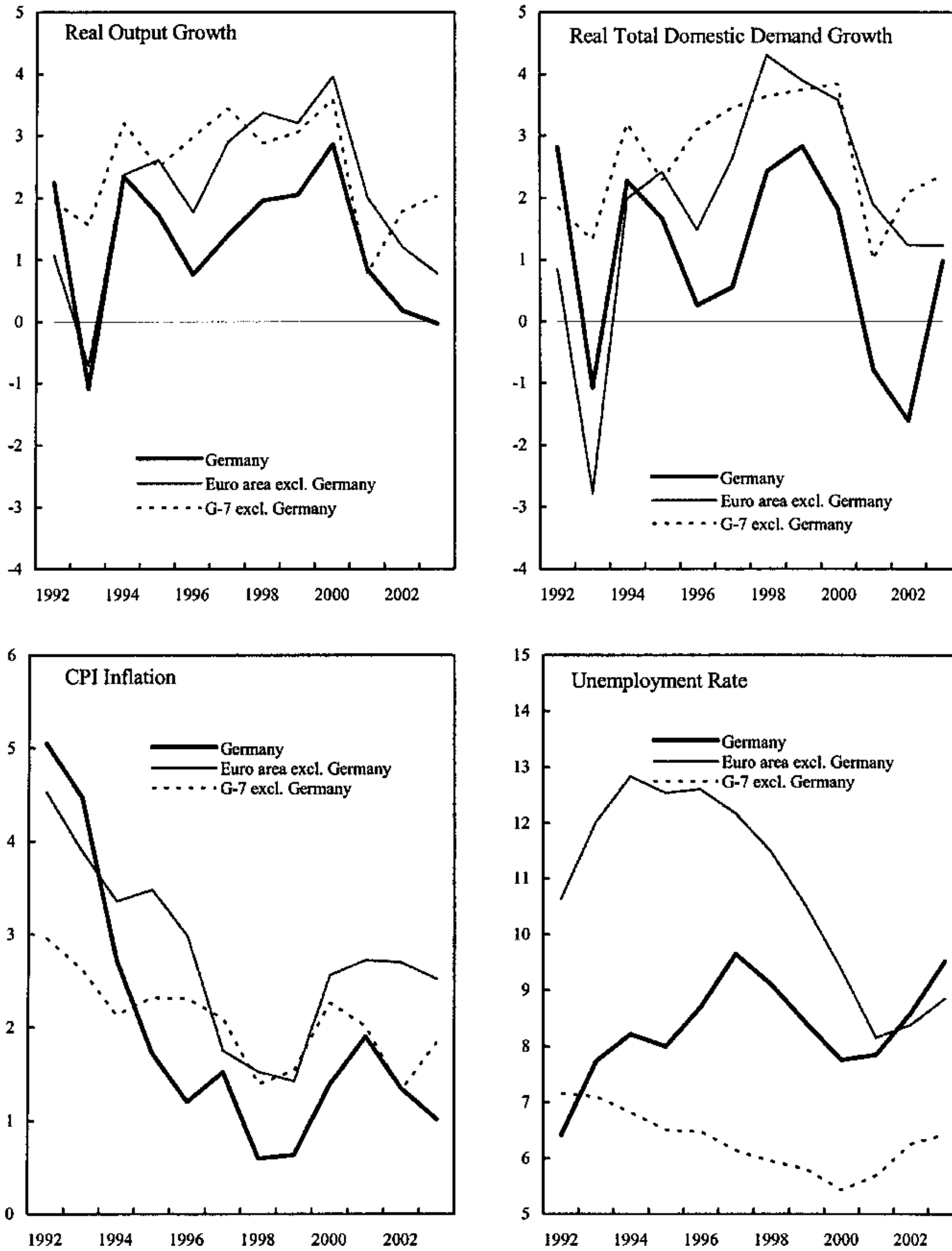


Sources: IFO Institute for Economic Research; and IMF staff estimates.

[2] IMF Country Report 02/240 (2002) provides a detailed analysis of Germany's growth record.

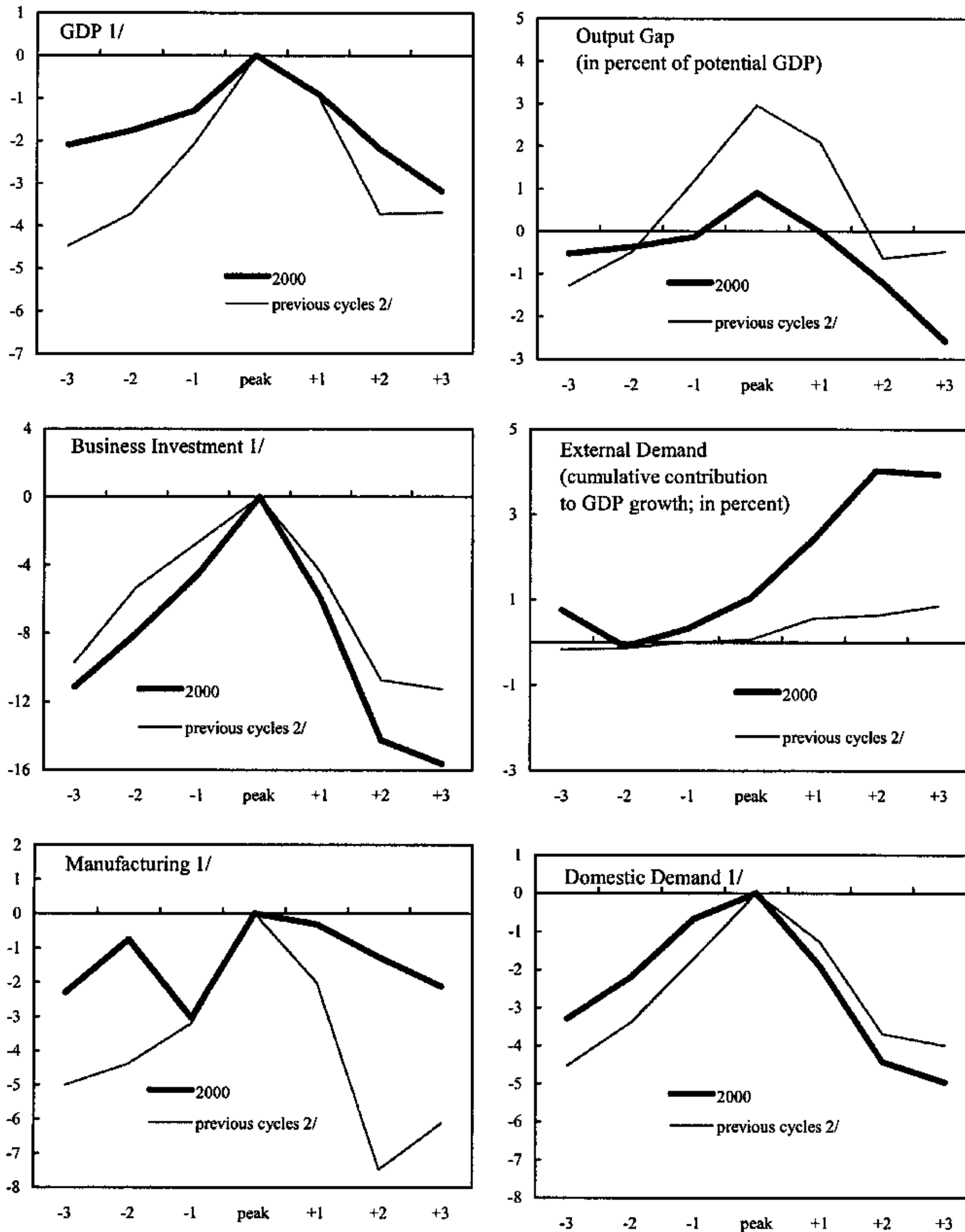
[3] The current potential growth rate is estimated at about 1½ percent, most of which stems from stable, long-term trend total factor productivity growth. Assuming zero real GDP growth, the European Commission's estimate of the output gap in 2003 would be about 2¼ percent.

Figure 1.Germany, the Euro Area, and the G-7: Economic Performance (1992-2003)
(In Percent)



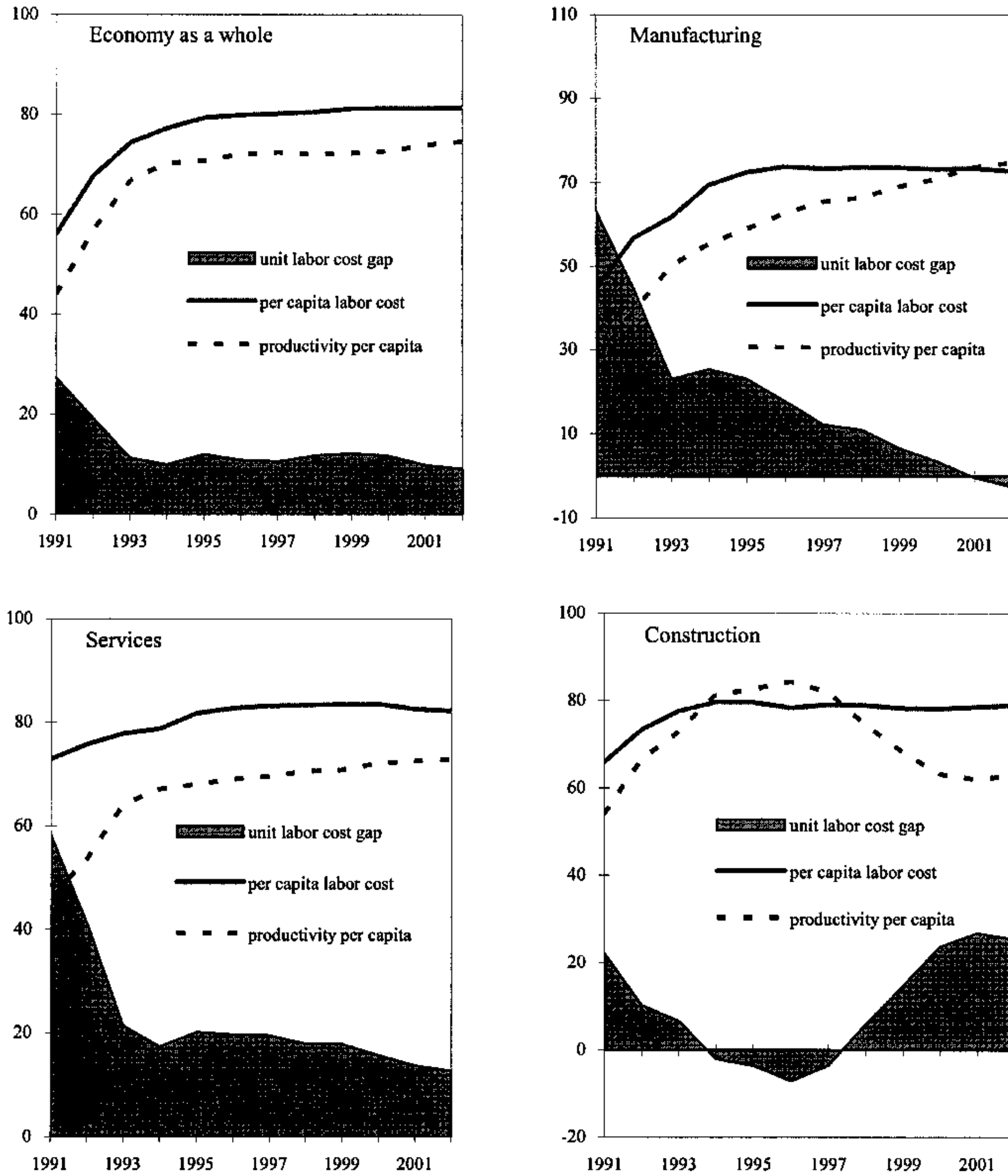
Source: IMF, World Economic Outlook.

Figure 2. Germany: Comparison of Cycles, 1970-2003
(Deviations from trends, unless otherwise indicated)



Sources: Federal Statistical Office; IMF, World Economic Outlook; and IMF staff calculations.
1/ Zero denotes the level of series at the peak of the cycle.
2/ An unweighed average of cycles peaking in 1973, 1979, and 1991. The cyclical peak of 1991 coincides with the beginning of data series for unified Germany. Trends are calculated using the Hodrick-Prescott filter.

Figure 4. Germany: Wage and Productivity Trends in the New Länder
(In percent of Old Länder level)

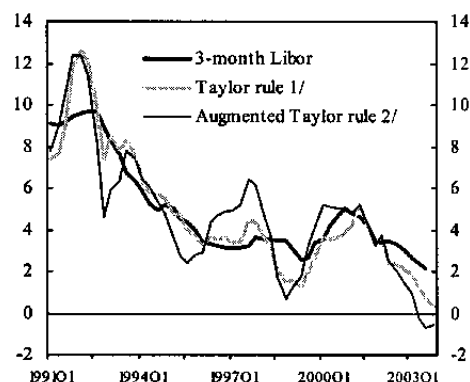


Sources: Arbeitskreis Volkswirtschaftliche Gesamtrechnungen der Länder.

6. **Correspondingly, wage and price inflation has fallen to very low levels**. Already low, unit labor cost growth dipped further in 2002 as seemingly generous wage settlements of about 3 percent were offset by negative wage drift. High unemployment has also undermined the position of trade unions: the proportion of settlements outside of collective bargains has continued to rise and the engineering and metalworkers' union suffered an unprecedented defeat in June 2003 in a strike for shorter working hours in the new Länder. Consumer price inflation has retreated to about 1 percent, which is low both relative to Germany's historical standards and to other euro-area countries.

7. **Monetary policy has been set in the light of less severe euro-area-wide cyclical conditions, implying relatively high interest rates from Germany's perspective** (Figure 5). Although nominal interest rates were cut to record lows in the first half of 2003, the effect on monetary conditions has been offset by the euro's near 10 percent real effective appreciation over the past year, tightening bank lending standards, and elevated spreads (Figure 6). Meanwhile, the volatile stock market has discouraged equity issues.

Figure 5. Germany: Interest Rate Developments, 1991-2003
(In percent)



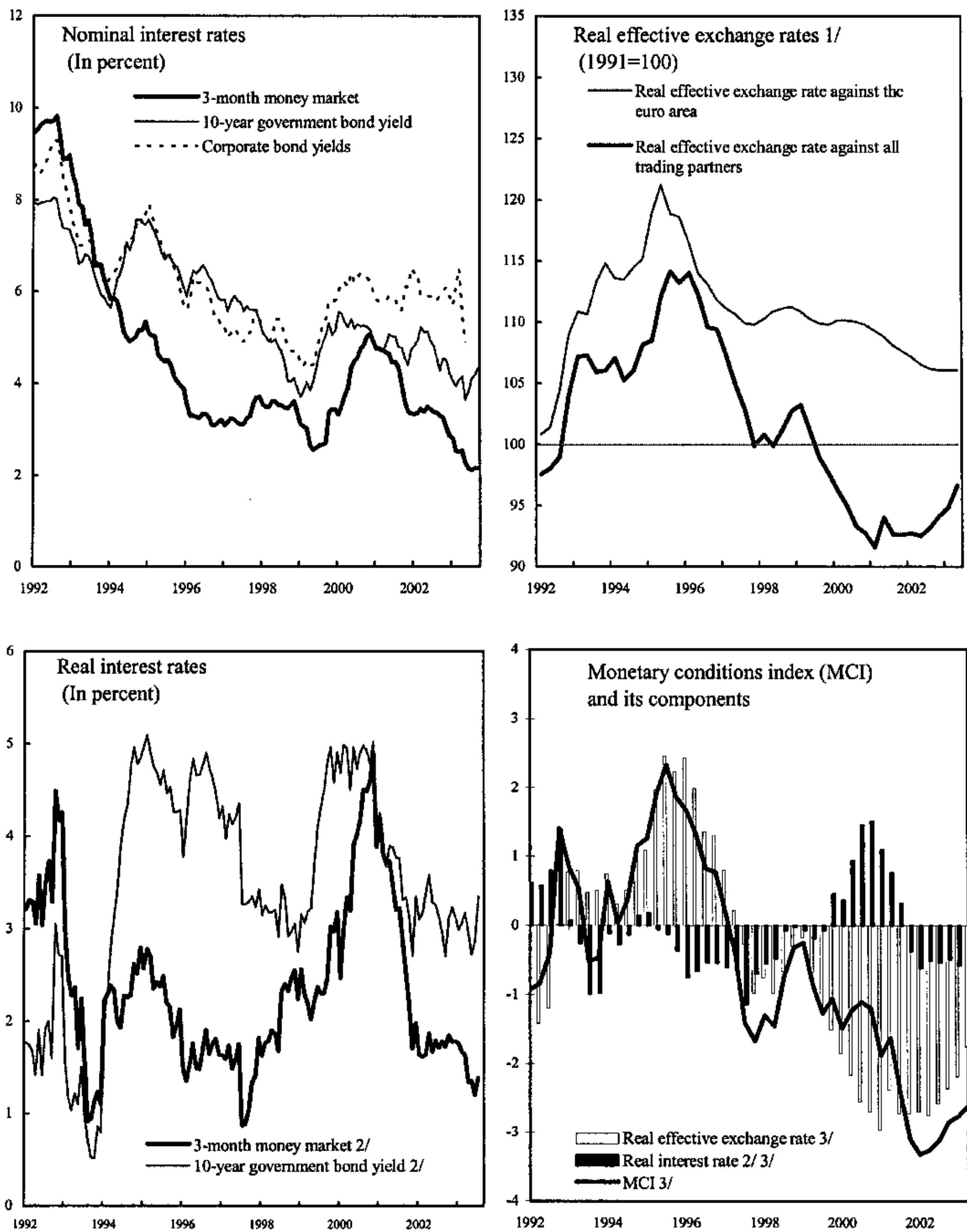
8. **A public debt ratio of about 60 percent and a relatively large structural budget deficit has restrained the use of active fiscal policy, which has been progressively tightened.** After tax cuts pushed the structural deficit up to almost 3 percent of GDP in 2001, fiscal policy turned neutral in 2002. In 2003, the structural deficit is expected to decline by about ½ percent of GDP, mainly because of a miscellany of revenue-raising measures. However, with the operation of the automatic stabilizers, the actual deficit reached 3½ of GDP in 2002 and is projected at just below 4 percent in 2003.

9. **Despite current travails, there are positive signs that adjustment is advanced:**

- The wage-cost gap with other major euro area countries has been narrowing since the mid-1990s (Figure 7);
- Profit share has risen back to its pre-unification peak;
- Improved competitiveness can be seen in a recovering export market share within the euro area;
- The external current account has shifted to a significant surplus (2.3 percent of GDP in 2002), more in line with Germany's equilibrium savings-investment balance.[4]

[4] See IMF Country Report 02/240 (2002). Earlier euro weakness and Germany's relative cyclical position have also made a temporary contribution to the surplus.

Figure 6. Germany: Financial Indicators, 1992-2003



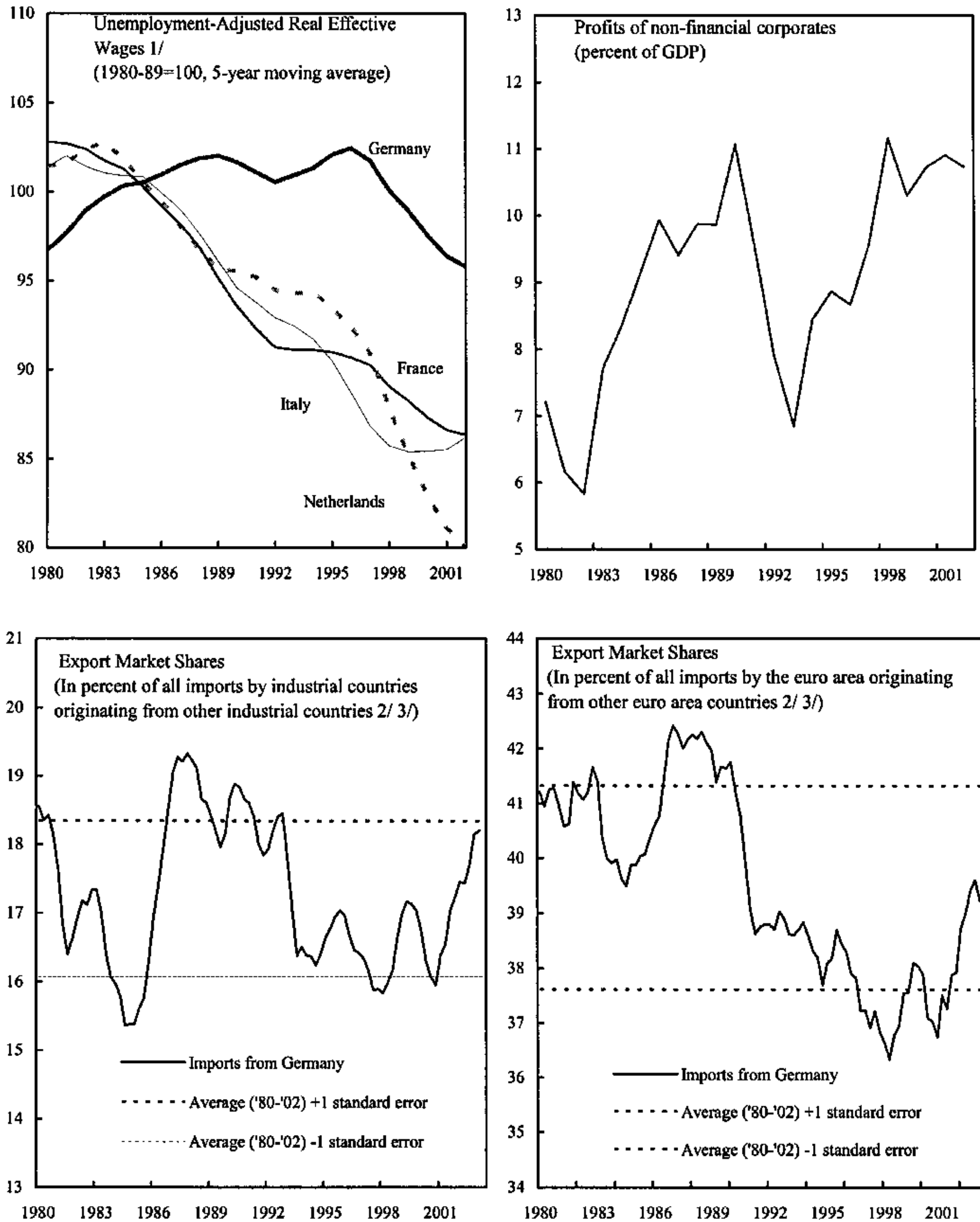
Sources: Deutsche Bundesbank; European Central Bank; and IMF staff calculations.

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.

Figure 7. Germany: Wages, Profits, and Competitiveness, 1980-2002



Sources: Direction of Trade Statistics, and IMF staff calculations.

1/ Wages that are adjusted for productivity and cyclical pressures in the labor market.

2/ Excludes Belgium and Luxembourg.

3/ Three-quarter moving averages.

10. **Furthermore, there are tentative signs that confidence may be returning and that financial imbalances are on the mend.** The economy has been in a mild technical recession since the fourth quarter of 2002. However, in recent months, expectations and confidence indicators have begun to recover (Figure 8). In contrast to elsewhere in the euro area, the nonfinancial corporate sector is running an unprecedented surplus, suggesting that balance sheet frailties—leverage rose sharply with borrowing to finance investment in the 1990s—are being repaired. And the financial sector has benefited from a rebound in stock markets from their lows at the beginning of 2003.

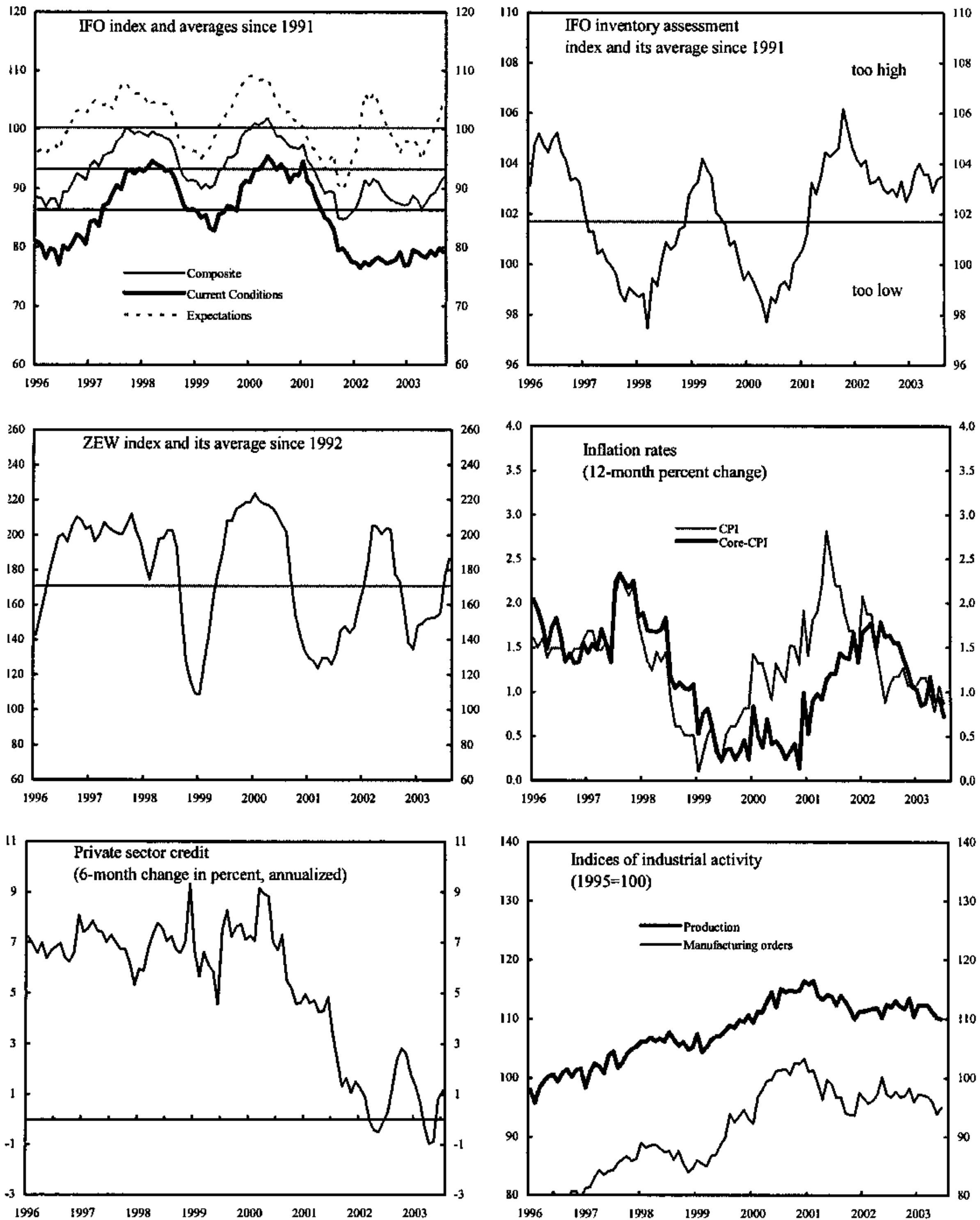
III. Policy Discussions

11. **The authorities saw the revised policy strategy as providing an important boost to confidence and the right balance of supply-side initiatives and demand-side support to revitalize growth.** They emphasized the radical nature of some of the reforms in Agenda 2010, particularly the first major cutbacks in entitlements for the jobless. Reforms to pensions and health care would also put public finances on a sounder long-term footing. The authorities underscored that the main demand element of the package—advancing tax relief—would help to spur growth in the short term as well as galvanize broad support for the policy strategy. As they were already in the pipeline, advancing the tax cuts would provide timely stimulus without jeopardizing credibility in the goal of eliminating the budget deficit in the medium term.

12. **The authorities were confident that, with rising support for change within society, the strategy would be implemented in full.** The government had already overcome initial opposition from within its own ranks and supporters, bipartisan efforts were underway covering health care and subsidies, and the opposition parties supported advancing the tax cuts. Organized labor opposed reforms to benefits and the labor market but its position had been weakening, as reflected most visibly in the metalworkers' recent strike defeat. The authorities hoped to secure agreement on the specifics of the strategy by the fall. They were determined that if any element were rejected it would be replaced by an alternative measure of equivalent economic impact. By late September, key labor market and health care reforms had already been passed, while legislation for other measures and the 2004 budget was still pending.

13. **The mission supported the strategy shift and its emphasis on structural reform.** It pointed out that long-diagnosed structural rigidities had not been confronted for many years, and this inaction lay at the heart of Germany's relatively poor economic performance and uncertain prospects. It was therefore essential to carry out the intended reforms—and, particularly, not to backtrack if the economic environment did begin to improve in the coming year. Building on the recommendations of the FSAP, it was also essential to foster restructuring in the financial sector to improve efficiency and reduce vulnerabilities in the future. The mission stressed that, considering the weight of Germany's economy in the euro area, the consequence of failing to carry through with reforms would have significant negative spillover effects on other countries.

Figure 8. Germany: Key Economic Indicators, 1996-2003



Sources: Deutsche Bundesbank; IFO Research Institute; and ZEW Institute.

14. **The key topics of discussion were**: Will the package help to restore growth in the short term? How can fiscal policy steer a successful course between competing requirements? Is the structural policy agenda sufficient and where might it be strengthened? What is the proper sequencing of measures to encourage financial sector restructuring?

A. The Economic Outlook

15. **All agreed that macroeconomic conditions should support a modest-paced recovery in 2004**. The effects of interest rate cuts in the first half of 2003 would be felt fully in 2004; income tax cuts amounting to 1 percent of GDP would stimulate consumption and investment;[5] and global demand was expected to pick up. At the time of the mission, the authorities believed their reform package would boost confidence significantly and considered the official growth forecast of 2 percent for 2004 to be achievable, even though the immediate outlook was uncertain and forecast growth of ¾ percent in 2003 would be hard to achieve. The mission was more cautious, noting that the main impact of reforms would be felt over the medium term and that the tax cuts would merely neutralize previous fiscal consolidation intentions. Specifically, fiscal policy would still be mildly restrictive in 2004, albeit less than it would have been under the consolidation path laid out in the December 2002 Stability Program (Box 1). The appreciation of the euro would also be a significant restraining factor.[6] In line with the consensus, the mission saw growth beginning to revive at the end of 2003 but not reaching the rate of potential until after mid-2004. Real GDP would therefore stagnate in 2003 and expand by 1.5 percent in 2004.[7]

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[5] Tax cuts include relief postponed from 2003 to fund flood-related damage repair (0.3 percent of GDP) as well as tax cuts scheduled for 2005 that are being advanced to 2004 (0.7 percent of GDP). After the cuts, the top marginal income tax rate would be 42 percent, compared with 51 percent in 2000.

[6] According to conventional models, the approximately 5 percent appreciation of Germany's real effective exchange rate over the past year would reduce growth by about ½-1 percentage points in 2004.

[7] An increase in the number of working days boosts growth by 0.6 percentage points in 2004. Adjusting for this, the projected underlying growth in 2004 is just under 1 percent.

Box 1. Germany: The Short-Run Effects of Fiscal Policy on Activity

According to staff estimates, fiscal intentions for 2004 are consistent with an unchanged structural deficit, compared with an implied reduction in the structural deficit of ¾ percent of GDP under the December 2002 Stability Program. However, the composition of fiscal measures might still have a mildly contractionary effect on demand in 2004: in net terms, a structural reduction in the revenue burden of about ⅔ percentage points of potential GDP is offset by a similar-sized contraction in spending. This is because short-term expenditure multipliers tend to be larger than tax multipliers—although this may not be true over the longer-term, especially if tax cuts have expansionary supply-side effects.

Staff's econometric estimates for the period 1980-2003 confirm the evidence for Germany in the literature that short-run expenditure multipliers are roughly equal to 1, while tax multipliers are much lower, typically ½ or less.[1] In broad terms, applying these estimates to the measures planned suggests the fiscal withdrawal could still amount to almost ½ percent of GDP in 2004. This would be less contractionary than the original Stability Program (see table).

Growth Impact of Fiscal Measures for 2004
(Percentage points of potential GDP)

	Current fiscal package		December 2002 Stability Program	
	Change relative to 2003	GDP impact in 2004	Change relative to 2003	GDP impact in 2004
Revenue	-0.7	+0.3	0	0
Expenditure	-0.7	-0.7	-0.8	-0.8
Total growth impact		-0.4		-0.8

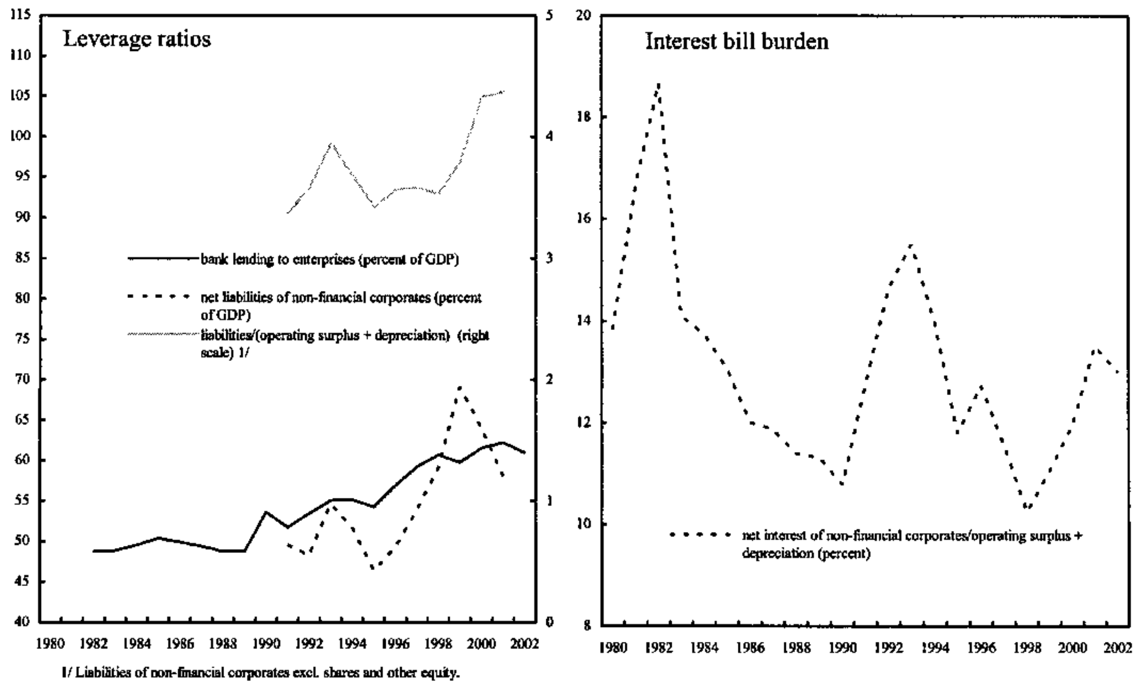
[1] See Hemming, R., Kell, M., and S. Mahfouz, "The Effectiveness of Fiscal Policy in Stimulating Economic Activity—A Review of the Literature," *IMF Working Paper* 02/208.

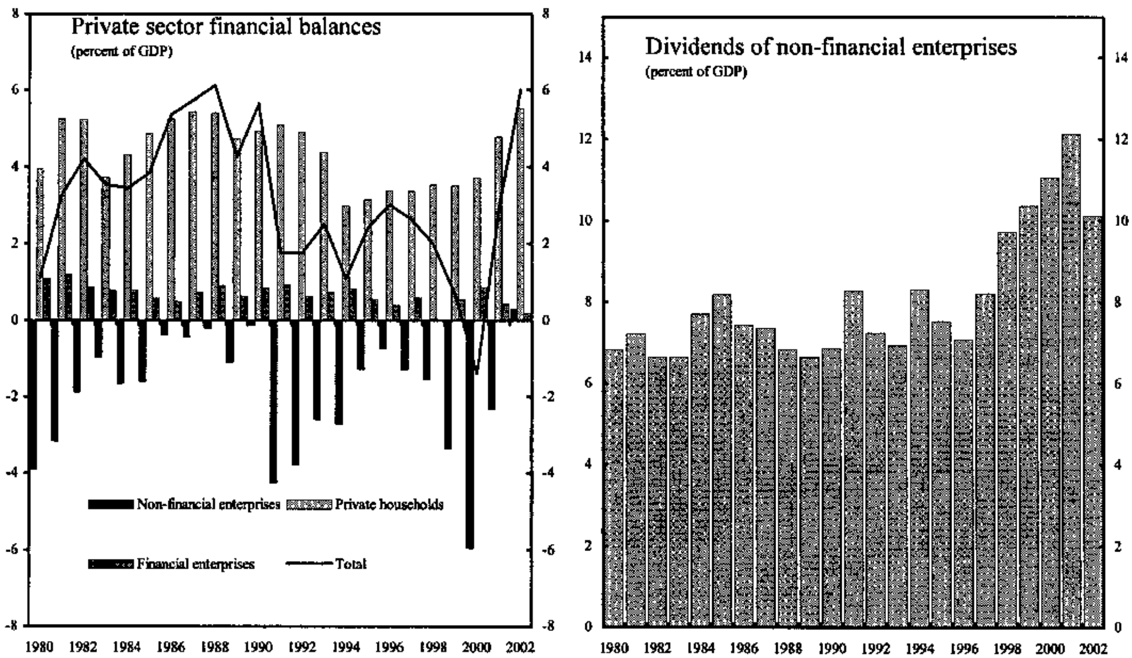
16. **Corporate financial imbalances add uncertainty to the projection, but overall the risks to the outlook seem balanced**. Outside of construction, there have been tentative signs in the last three quarters that investment is bottoming out and corporate balance sheet adjustment is well underway. Nonetheless, the authorities agreed that the recovery of investment is likely to be dampened by still-high corporate leverage (Figure 9 and Box 2). Credit growth might also be constrained to an unusual degree as banks repair their balance sheets and improve their risk management (see section D below). On the positive side, the downside bias of risks to the global outlook has eased significantly since the mission and confidence has continued to inch up. With some further widening of the output gap quite likely, a temporary period of price declines could not be ruled out. While agreeing that this would not be problematic, the mission stressed that if the economy were to take an unexpected, pronounced turn for the worse, as had repeatedly occurred over the past three years in response to external shocks, it would be important to prevent negative inflation expectations from taking a hold. In such circumstances, temporary fiscal stimulus—e.g., via an investment tax credit—might need to be considered. Its effectiveness would be considerably enhanced if a strong package of structural reforms had been implemented and there was an established pipeline of durable public expenditure cuts.

B. Fiscal Policy

17. **All agreed that a more structural approach to fiscal consolidation is key to the success of the policy strategy**. Since reunification, reliance on yearly, across-the-board restraint on discretionary spending has not delivered sufficient consolidation (Box 3). Acknowledging this, the authorities' revised strategy targets deeper and more durable savings in programs where public policy is inefficient. The goal is to achieve a reduction in the structural deficit of at least 1½ percent of GDP over 2004-06 in order to move toward underlying balance over the medium term. The mission stressed that, to ensure the credibility of the strategy, savings measures needed to be identified upfront, as it would be unrealistic to expect progress in cutting the structural deficit in 2004 with tax cuts amounting to about 1 percent of GDP. Although tax relief would be more helpful in 2004 than in 2005 from a cyclical perspective, absent a credible pipeline of measures to ensure compensating adjustment in subsequent years, the hoped-for support to demand, including through confidence effects, would be undermined.

Figure 9. Germany: Corporate Leverage and Financial Balances, 1980-2002





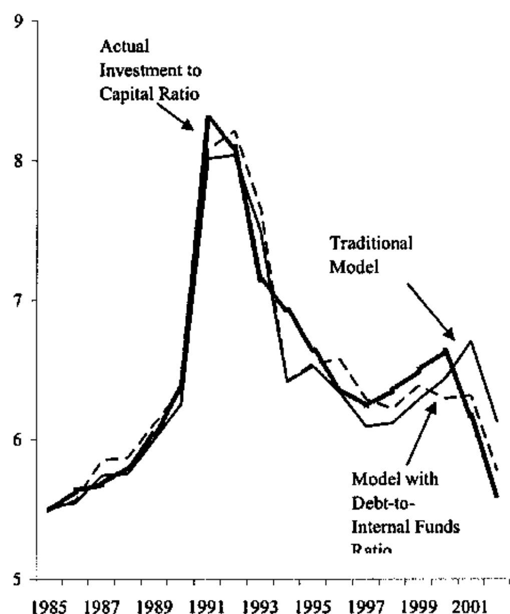
Sources: Federal Statistical Office; Deutsche Bundesbank; and IMF staff calculations.

Box 2. Germany: Corporate Balance Sheets and the Investment Cycle

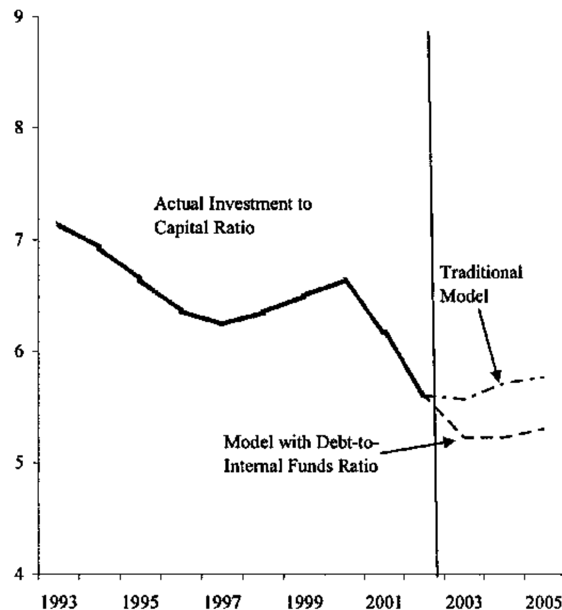
Indicators of the non-financial corporate sector's financial health during the current cycle provide a mixed picture. On the one hand, with the investment binge toward the end of the 1990s being partly financed by an expansion of corporate debt, leverage ratios—particularly the debt-to-internal funds ratio—have been pushed to historically high levels. On the other hand, corporate profitability has held up better than in previous downswings and the debt service burden remains at a manageable level.

Econometric evidence suggests that the debt-to-internal funds ratio, among other financial indicators, has a significant (and negative) impact on fixed investment. Adding this variable to a traditional accelerator-plus-user-cost-of-capital model helps to explain the sharp fall in the investment-to-capital ratio in the past three years. However, quantitatively, the dominant explanation for the investment collapse remains the slowdown in real GDP growth (compare the light solid line with the dashed line in the first panel below). Even so, a high debt-to-internal funds ratio could be a significant restraining factor on investment moving forward if corporate balance sheet adjustment were to continue at the pace of recent years (see second panel).

Investment to Capital Ratio (Actual and Predicted)



Investment to Capital Ratio (Actual and Forecasted)



Box 3. Germany: Fiscal Consolidation Since Reunification

The experience since reunification illustrates the limits of relying on across-the-board discretionary expenditure restraint to achieve fiscal consolidation.

In 1990, the year of reunification, the structural primary balance shifted to a deficit of ¾ percent of (potential) GDP from a surplus of about 2¾ percent in 1989, raising the overall structural deficit to about 3 percent of GDP. By 2002, the primary structural deficit had shrunk very little and the overall structural deficit remained close to 3 percent of GDP. Over the period 1990-2002, social transfers increased by about 3¾ percent of GDP—similar to the estimated total ongoing costs of reunification—as the extension of the welfare system to the new Länder combined with a rigid labor market to cause higher unemployment and early retirement of older workers (see table below). The increase was balanced—mainly in the first half of the 1990s—by cutbacks in discretionary spending and increases in social security contributions, each amounting to about 2 percentage points of GDP. By contrast, after tax cuts in 2001, the tax revenue ratio last year was close to its level in 1990.

Over the past twelve years, the savings on discretionary spending averaged only 0.2 percent of GDP a year and rarely exceeded 0.5 percent of GDP in any one year. Moreover, spending discipline was insufficient during 1998-2000, years when economic growth was relatively strong. Looking longer term, it is also clear that social entitlements cannot be exempt from spending cuts as the fiscal costs of aging are estimated to amount to roughly twice the costs of reunification over the next 50 years

Germany: Structural Fiscal Adjustments, 1990-2002

	1990	2002
Overall balance	-2.8	-2.9
Net Interest	-2.0	-2.7
Primary balance	-0.8	-0.2
Primary expenditure	43.0	44.9
Discretionary	21.1	19.2
Social transfers	22.0	25.7
Primary revenue	42.2	44.7
Tax revenue	22.9	22.7
Social contributions	16.5	18.4
Other	2.8	3.6

Sources: Ministry of Finance; and staff estimates.

18. **The authorities explained that they were in the process of lining up the necessary measures, which were targeted at improving the supply side of the economy**. The measures included (Table 2):

- The elimination of subsidies for owner-occupied housing purchases and construction and cuts in subsidies for industry and agriculture;
- Reductions in tax expenditures that subsidize commuters;
- A pensions package amounting to 0.3 percent of GDP aimed at stabilizing the contribution rate at 19.5 percent and cutting the support from the federal budget by 0.1 percent of GDP;
- A bipartisan health care package providing savings to the budget of about 0.4 percent of GDP by 2007.

19. **At the time of the mission, the authorities believed the general government deficit could be pushed back below 3 percent of GDP in 2004**. They estimated that the savings from the various measures would offset the cost of the tax cuts. In addition, temporary flood-related spending would cease and some improvement in the deficit could be expected on account of old measures and higher-than-potential output growth. The deficit could then be brought back under 3 percent of GDP. If the projected upturn were postponed, budgetary plans might have to be revisited and some further measures to reduce subsidies sought. Since the mission, the authorities have underscored that reducing the deficit below the Maastricht reference ratio would be difficult.

20. **The mission welcomed the emphasis on better quality expenditure adjustment but noted that identified measures so far fell short of consolidation needs**. As the tax relief in 2004 was equivalent to about 1 percent of GDP, durable savings equivalent to about 2½ percent of GDP were needed over 2004-06 to achieve the consolidation goal of 1½ percent of GDP (Table 3). At this stage, only about half of the cumulative savings had been identified.[8] For 2004, if current proposals were implemented, the general government

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[8] This calculation is based on the staff's more conservative estimates of the savings from a few measures with highly uncertain yields (e.g., the efficiency improvements at the Federal Labor Office) and those that will not deliver sustainable savings (e.g., a planned tax amnesty). It includes estimates of subsidy savings that still need to be clarified by a bipartisan commission. See Tables 2 and 3.

Table 2. Germany: Budgetary Measures for 2004-2006
(Yields in percent of GDP, relative to 2003 baseline)

	2004	2005	2006
Net budgetary savings relative to 2003 baseline	1.5	1.4	1.4
Net budgetary savings from proposed adjustment measures	0.6	0.9	1.0
Reducing subsidies and tax expenditures	0.3	0.5	0.6
Reforming social spending 1/	0.2	0.2	0.2
Cutting discretionary spending	0.2	0.2	0.2
Net budgetary savings from other measures	0.9	0.5	0.4
Measures with temporary or uncertain yield 2/	0.5	0.3	0.2
Old measures affecting budgetary balance in 2004-07 3/	0.4	0.3	0.2
Memorandum item:			
Tax cuts	-1.0	-0.9	-0.9

Sources: Unless otherwise noted, official estimates of Ministry of Finance, Ministry of Economics and Labor, or Ministry of Health and Social Affairs.

1/ Staff estimate of net budget savings; remaining yield (0.4 percent of GDP) serves to stabilize contribution rates.

2/ Authorities' estimates of revenue yield of better tax administration, a tax amnesty, and improved job intermediation by the Federal Labor Office.

3/ End of flood-related spending; savings from tax expenditures abolished previously; higher spending on subsidies for private pension pillar.

Table 3. Germany: General Government Accounts, Adjustment Scenario 1/
(In percent of nominal GDP, unless otherwise noted)

	2002	2003	2004	2005	2006
Advancing tax cuts to 2004 twinned with expenditure restraint					
General government revenue	45.0	45.3	44.6	44.5	44.5
General government expenditure	48.6	49.3	48.5	47.4	46.4
Of which: structural primary expenditure	44.9	44.6	43.8	42.9	42.1
Overall balance 1/	-3.5	-3.9	-3.9	-2.9	-1.9
Structural overall balance	-2.9	-2.3	-2.3	-1.5	-0.8
Of which: based on existing measures 2/	-2.9	-2.3	-2.3	-2.1	-2.1
Of which: measures still to be identified 3/	0.0	0.0	0.0	0.7	1.3
Memorandum items:					
Nominal GDP growth (in percent)	1.8	0.9	2.4	3.3	3.2
Real GDP growth (in percent)	0.2	0.0	1.5	2.1	2.0
Output gap (in percent of potential GDP)	-0.9	-2.4	-2.5	-1.9	-1.3
Gross debt	60.8	63.3	65.5	66.6	66.4

Sources: Ministry of Finance; and IMF staff projections.

1/ The scenario assumes that the adjustment measures in 2003 (see Table 2) are implemented and supplemented by additional measures in order to meet the goal of reducing the structural deficit by 1.5 percent of GDP in 2004-06.

2/ Measures shown in Table 2, but with the staff's more conservative estimates of savings from measures with temporary or uncertain yield.

3/ Required yield from measures that still need to be identified to achieve consolidation goals.

deficit would remain unchanged at close to 4 percent of GDP.[9] Nonetheless, in view of the tax cuts, this could be considered a credible beginning as a large proportion of the measures would be durable, with several yielding rising savings over the medium term. But broader credibility required more concerted efforts to identify savings to close the adjustment gap for 2005-06. The mission therefore noted that plans will need to be augmented, and proposed a more aggressive elimination of entire subsidy programs and reductions in active labor market programs, many of which are ineffective, be considered.

21. **Elements of entitlement reform needed to improve long-term fiscal sustainability are on the table.** The near doubling of the old-age dependency ratio over the next 50 years will add as much as 8 percent of GDP to entitlement spending in the absence of reforms.[10] With entitlements already accounting for more than 50 percent of public expenditure, the authorities acknowledged that they could not rely on a strategy of running down the public debt in anticipation of ageing-related costs through cutting spending on other items. Thus, in the case of health care, a medium-term savings plan was agreed with the main political parties in the summer and passed in September. For pensions, the authorities had charged an independent expert commission with studying the options. The commission had concluded that it was necessary to both raise the retirement age and restrain the growth of pension benefits (Box 4). The authorities planned on reaching a cabinet decision on reform measures in the fall, with a view to implementation in 2004.

22. **The mission welcomed the health care package as a good beginning and urged early enactment of pension reforms.** It pointed out that more effective competition in the supply of health care services, as well as incentives to curb demand, would be needed to ease upward pressure on contribution rates over the long term.[11] On pensions, the direction of the proposals of the expert commission was in line with the staff's analysis and it was hoped that an informed public debate and rapid implementation would ensue. Given the size of the aging problem, the mission pointed out that the proposals would not by themselves be sufficient to obviate the need for increases in contribution rates or additional new measures over the long term.

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[9] Apart from somewhat lower growth, the mission's calculations for 2004 assume a higher starting deficit in 2003 and that some measures will yield less savings than the authorities' estimate. It also assumes that general expenditure restraint, including at the lower levels of government where fiscal policy has tended in the past to be procyclical, will yield savings in 2004 of about ¼ percent of GDP.

[10] See IMF Country Report 02/240 (2002). Factoring in child-related expenditure savings, the net fiscal cost of ageing is put at 6.7 percent of GDP by 2050 and would start to bite around 2015. Nonetheless, external debt sustainability is not a medium-term concern.

[11] The health care system is described and analyzed in IMF Country Report 02/240.

Box 4. Germany: Health Care and Pension Reforms

For **health care**, the bipartisan package aims to lower the path of contribution rates by about 2¼ percentage points by 2007 (1 percentage point in 2004), or the equivalent of about 1 percent of GDP. About 40 percent of the savings would come from cutbacks in services, the introduction of co-payments, and structural changes to demand and supply. The remainder would come from an earmarked increase in tobacco taxes and the introduction of some new contributions to be paid entirely by employees.

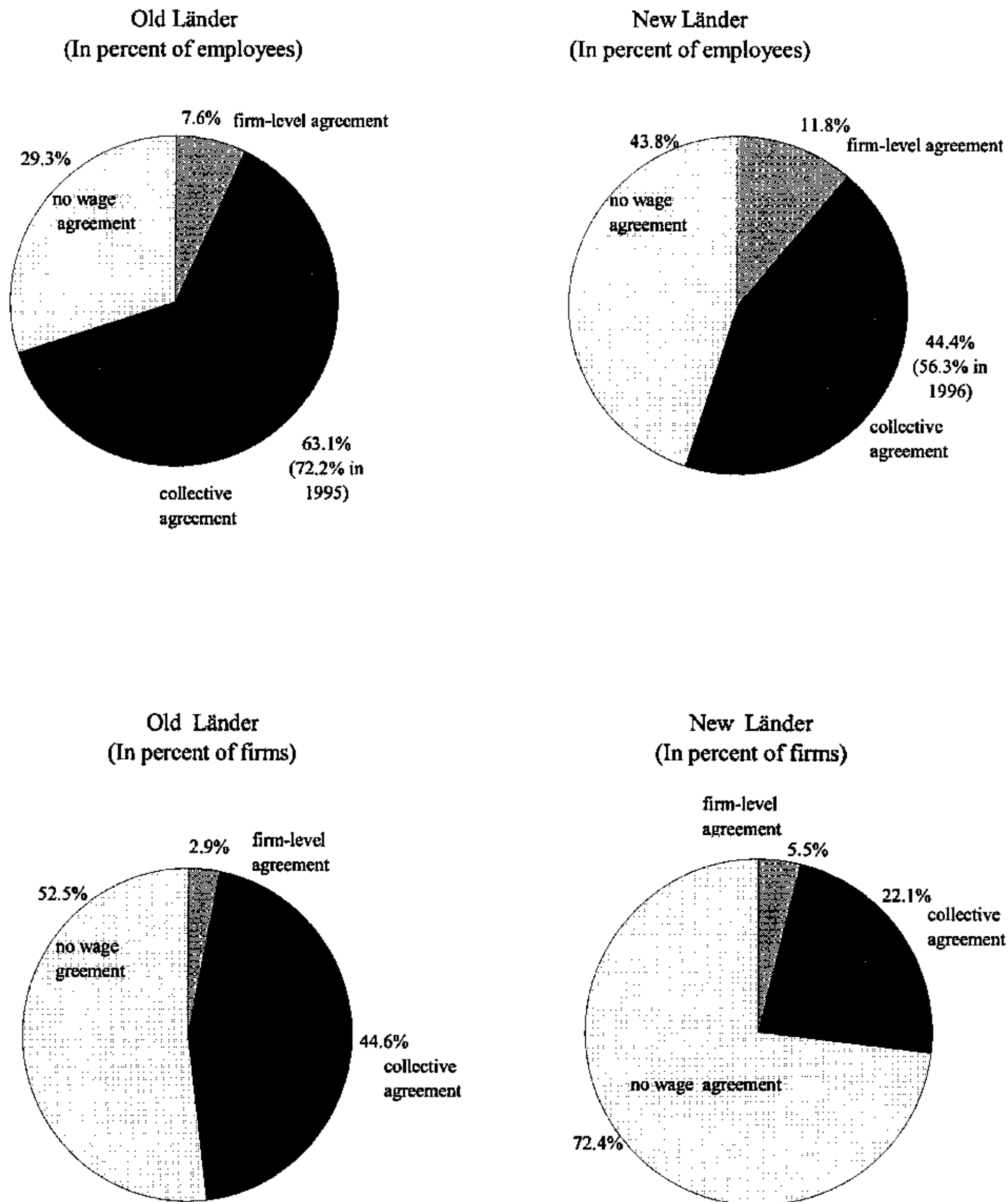
For **pensions**, the key proposals of the expert (Rürup) commission include: (i) raising the statutory retirement age from 65 to 67 years by one month a year, starting in 2011; and (ii) introducing a "sustainability" factor to the annual increase in pensions based on the relative number of pensioners and contributors. The commission estimates these reforms would take 2½ percentage points off the required increase in contribution rates over the long run, the equivalent of about 1½ percent of GDP.

C. Labor and Product Markets

23. **Progress has been made in achieving greater working time and wage flexibility.** Such progress reflected to a large extent the declining importance of collective wage bargaining agreements, notably in the new Länder (Figure 10). The latest step in this direction had been taken by the public sector: different Länder could now adopt different pay scales for their employees and many had negotiated significant wage cutbacks through reductions in various wage supplements. Furthermore, the authorities underscored that, following the recommendations of last year's expert (Hartz) commission, various steps had been taken to improve job placement services, to tighten eligibility criteria for unemployment assistance support, and to foster temporary and independent employment.[12]

[12] In particular, jobs paying less than €400 per month (up from €325 previously) are now subject to a simplified scheme of taxes and social security contributions; jobs with wages up to €800 per month are gradually subject to the standard contribution rates to avoid spikes. Those unemployed who choose to become independently employed can keep part of their benefits for a limited period.

Figure 10. Germany: Coverage of Wage Bargaining, 2001



Source: IAB Enterprise Panel and Kohaut and Schnabel (2003) "Zur Erosion des Flächentarifvertrags" ; The German Journal of Industrial Relations.

24. **Nonetheless, the authorities viewed further steps in creating a better functioning labor market as a critical part of their Agenda 2010 program.** Recognizing the need to strengthen incentives to work for the jobless, the centerpiece was a proposal to reduce the generosity of entitlements for the jobless and streamline their administration. Currently, unemployment benefit duration increases from the standard 12 months for those who are less than 45 years old to a maximum of 32 months for those who are 57 years or older, after which somewhat less generous unemployment assistance becomes available indefinitely. And beyond unemployment assistance, there is also a welfare program (social assistance). Beginning in 2004, the authorities are proposing to:[13]

- Limit benefit duration to 12 months for all unemployed, except for those aged 55 years or more, who would qualify for up to 18 months of benefits; this will ultimately affect a large number of the unemployed, although present recipients of benefits would be grandfathered.

- Merge unemployment assistance (which is related to past wages) with the less generous social assistance (which provides subsistence support) into a new scheme covering those who are able to work. Within two years following the receipt of unemployment benefits, an unemployed worker would see benefits under the new scheme cut to close to the present level of social assistance. On taking on new work, the worker could temporarily keep a larger portion of the allowance than previously.

25. **The mission viewed the reforms as well targeted, particularly those regarding unemployment benefit duration.** Germany's employment ratios lag those of high-employment countries mainly with respect to older workers and roughly one fourth of those unemployed in Germany are 50-64 years old.[14] The new support scheme for the long-term unemployed also represents a major step forward and a significant cut (the authorities estimate as much as 20-30 percent) in the reservation wage for many who would currently end up on unemployment assistance. But the mission stressed that it will also be crucial to cut support to recipients who turn down acceptable work. This requires a broad definition of what represents an acceptable job so that only the truly needy qualify for support. In the future, there is a case for lowering the reservation wage further, for example by reducing

[13] The changes to unemployment benefit duration were legislated in September. Changes to social assistance have yet to be adopted by parliament.

[14] See IMF Country Report 02/239 (2002).

benefits for the long-term unemployed below the level of social assistance while providing them opportunities to earn supplements by performing socially useful work.[15]

26. **Agenda 2010 also contains some proposals to reform the job protection legislation**. Specifically, small companies would be allowed to hire additional workers on fixed-term contracts without becoming covered by the job protection law. In the staff's view, the main cost relating to the present legislation is the judicial uncertainty about what constitutes fair dismissal. This could be remedied by allowing workers to forego protection under the law in exchange for a dismissal payment that would be agreed upfront with the employer. The authorities explained that they intended to clarify and reduce the number of criteria that determine fair dismissal.

27. **The authorities considered product market liberalization an important adjunct to labor market reform and pointed to further progress over the past year.** This included the further relaxation of shop opening hours; the sale of the remaining cable networks of the telecom incumbent; the EU-level agreement to fully open electricity and gas markets for cross-border trade for commercial customers by mid-2004 and for households by mid-2007; and the EU-level agreement on a new Competition Law. The key priority was now to monitor implementation and assess the response to past deregulation. In addition, Agenda 2010 had singled out the trades, crafts and professions for deregulation. The mission encouraged the authorities to continue to liberalize product markets and support further measures at the EU level to integrate markets, such as through the draft takeover directive.

28. **As the world's third largest exporting country, Germany has a strong interest in trade liberalization**. The authorities expected important benefits for trade from the reform of the EU's Common Agricultural Policy, owing to the decoupling of direct payments from production levels. In their view, of the many topics covered under the Doha Agenda, trade facilitation (e.g., the removal of informal trade barriers) might offer the greatest potential for welfare gains for Germany. Regarding trade with the poorest countries, the "Everything But Arms" initiative had already freed market access but the authorities would work for more liberal rules of origin. They supported EU efforts to reach free trade agreements with Middle Eastern and North African countries bordering the Mediterranean, as well as with Mercosur.

D. The Financial Sector

29. **The financial sector weathered a live stress test in 2001-2002, possibly the most difficult years in the post-war era** (Table 4). All financial companies suffered from the slump in economic activity and equity markets. The banking sector's already low profitability

[15] For example, Ifo, *SchnellDienst* 9/2002 concludes that unemployment and social assistance would need to be merged at a level one third below current social assistance to generate a significant number of jobs for the low-skilled.

Table 4. Germany: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

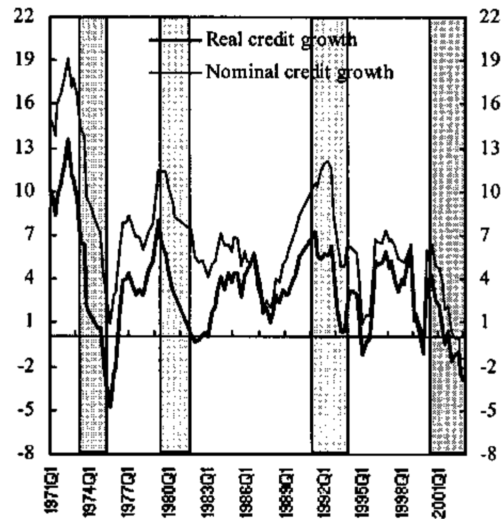
	1999	2000	2001	2002	2003 1/	
External Indicators						
Exports (annual percentage change, in U.S. dollars)	-0.3	1.3	3.8	8.7	19.3	projections
Imports (annual percentage change, in U.S. dollars)	2.0	2.9	-1.4	2.4	19.3	projections
Terms of trade (annual percentage change)	0.2	-4.4	0.1	1.9	3.1	projections
Current account balance	-1.1	-1.4	0.0	2.3	2.4	projections
Capital account balance	-0.5	2.1	-0.7	-4.0	-2.4	projections
Of which: Foreign direct investment (net)	-2.5	7.8	-0.6	0.3	-2.0	projections
Portfolio investment (net)	-0.6	-7.9	1.6	1.7	-0.8	projections
Other investment liabilities (net)	1.9	1.9	-2.0	-6.1	1.5	projections
Official reserves minus gold (in billions of U.S. dollars, end-of-period) 2/ 3/	61.0	56.9	51.3	51.2	40.9	July
Broad money to reserves ratio 2/ 3/	23.9	21.9	25.0	...	44.0	July
Exchange rate: U.S. dollar per euro (period average)	1.07	0.92	0.90	0.94	1.14	July
Financial Markets Indicators						
Public sector debt (Maastricht definition)	61.2	60.2	59.5	60.8	63.3	projections
3-month T-bill yield 4/	3.0	4.4	4.3	3.3	2.2	October
3-month T-bill yield (real) 5/	2.6	3.5	2.5	2.1	1.3	August
10-year Bund yield 4/	4.8	5.4	5.0	4.9	4.3	October
Change in stock market index (percent, end of period) 6/	39.1	-7.5	-19.8	-43.9	-6.2	8/31/2003
Change in DEU stock market index (percent, eop) for banks 7/	33.6	-0.3	-25.4	-49.9	-33.9	5/31/2003
Change in global stock market index (percent,eop) for banks 7/	2.4	2.4	-13.6	-8.5	6.6	5/31/2003
Change in DEU stock market index (percent, eop) for TMT 7/ 8/	112.6	-44.6	-30.9	-50.6	-11.1	5/31/2003
Change in DEU stock market index (percent, eop) for construction	8.2	-36.0	3.2	-36.7	-28.8	5/31/2003
Spread of 3-month T-bill vs. the U.S. (percentage points, e-o-p)	-1.8	-1.5	0.2	1.4	0.9	July
Yield curve (10 year - 3-month T-bill)	1.8	1.0	0.7	1.6	2.1	October
Credit Indicators (percent, y-o-y)						
Total credit to non-MFIs	6.5	4.9	3.4	-0.2	-0.3	March
Loans	9.6	4.9	3.5	-0.2	-0.3	March
Lending: mortgages secured by residential real estate 9/	29.9	6.7	2.7	2.5	0.7	Q1
Lending to employees and other individuals: Housing loans	24.6	4.2	3.1	3.0	0.0	Q1
Lending to employees and other individuals: Installment credit	-0.5	2.8	1.9	3.3	1.0	Q1
Lending to electrical & optical equip, telecom, computers, R&D	3.4	4.5	1.8	-5.2	-4.2	Q1
Lending to construction sector	5.6	1.7	-0.4	-4.9	-1.7	Q1
Lending to other real estate enterprises	6.5	7.1	5.3	2.3	-0.6	Q1
% lending to electrical & optical equip, telecom,computers,R&D	10.1	10.3	10.4	10.7	10.6	Q1
Financial Sector Risk Indicators						
Total loans to assets 2/	73.5	72.2	72.8	73.5	73.8	July
Total loans to deposits 2/	112.3	111.1	111.4	112.4	113.2	July
Share of real estate sector in private credit (percent) 10/ 11/	47.3	47.1	47.1	47.7	47.8	June
Share of real estate sector in loans to nonfinancial sector (percent) 11/ 12/	35.4	35.0	34.6	35.4	35.4	June
Share of non-performing loans in total gross loans (percent) 13/	4.6	5.1	4.9	5.0	...	
Non-performing loans net of provisions to capital (percent) 13/	46.3	50.9	52.2	57.1	...	
German capital asset ratio 14/	11.3	10.9	11.5	11.3	...	
Profitability ratio 15/	6.5	6.1	4.7	2.8	...	
Number of insolvencies of enterprises and individuals 16/	1,316	1,549	2,053	3,007	...	
Volume of loans to insolvent borrowers (in billions of euro) 16/	5.5	7.7	10.9	22.2	...	

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; and IMF, World Economic Outlook.
1/ Staff estimates and projections, unless otherwise indicated.
2/ Data for 2003 refer to July.
3/ Data present Germany's position in the euro area; data not shown for 2002 because of a series break.
4/ For 2003 data are as of October 2.
5/ For 2003 data are as of August. Deflated by inflation excluding energy and food.
6/ DAX 30 stock market index.
7/ DataStream indices; includes German bank stocks.
8/ TMT is telecom, media, and information technology.
9/ 1999 growth due to low mortgage interest rates and expiration of special depreciation allowances in eastern Germany.
10/ Share of housing loans in percent of total lending to private sector.
11/ For 2003 data are as of March.
12/ Share of housing loans in percent of total lending to nonfinancial sector.
13/ Non-performing loans as identified by bank auditors in line with German commercial law.
14/ Consolidated basis, risk-weighted, national definitions as under principle I of the German Banking Act, comprising all credit institutions reporting thereunder.
15/ After-tax profit as percent of average capital.

was reduced further in 2002 (to a mere 0.1 percent of assets, post-tax) due to a sharp increase in loan-loss provisioning and a fall in fee income as global financial market activity shrunk. Insurance and reinsurance companies suffered large losses on their portfolios and were also hit by a surge in property and casualty claims as well as low interest rates that depressed investment income. Nonetheless, the authorities pointed to important progress in cutting costs and reducing risky exposures, and to a declining need to provision for impaired loans. The fruits of these efforts were beginning to show in the first two quarters of 2003, with the strong recovery in the share prices of banks and insurance companies. However, they acknowledged that further adjustments were still needed to address underlying weaknesses.

30. **The sharp slowdown in credit growth reflects some supply side factors as well as demand weakness**. Although a decline in credit is usual in a downturn (Figure 11), recent studies and surveys of loan officers find varying degrees of evidence for some reluctance in bank lending.[16] The authorities explained that, in response to the difficulties in the financial sector, the pricing of credit had become more risk-sensitive, although demand-side weakness was the predominant reason for the credit slowdown. Their view is supported by still-generous dividend payouts, which suggest that firms have little demand for internal and (presumably) external funds. The authorities agreed, however, that the capacity of the banking system to sustain economic activity would only become evident once the upturn began to boost investment and credit demand. They expected Basel II to contribute to further improvements in risk pricing and hoped that the new regulatory standards would be widely adopted.

Figure 11. Germany: Bank Credit to Enterprises During Downturns, 1970-2002 1/



Sources: Bundesbank; and IMF staff calculations.
1/ 12-month growth rate in percent.

31. **The FSAP stress tests provide comfort about the resilience of the financial system**. Based on end-2002 balance sheet data, the tests suggest that with capital ratios well in excess of the Basel 8 percent floor, banks' capital levels were sufficient to absorb additional shocks at the extreme of historical experience. Subsequent developments would not appear to invalidate the results as recent stock-market driven improvements in financial companies' balance sheets likely outweigh the effect of lower-than-originally projected real GDP growth. Nonetheless, risks remain that a combination of large shocks—especially if they were to come on top of current economic weakness and negligible inflation—could pose a major challenge to the financial system.

[16] See IMF Country Report 02/240 (2002) and Bundesbank Monthly Report (October 2002).

32. **For the insurance industry, pressure on capital ratios and risk-bearing capacity from poor returns on investments are the main sources of vulnerability.** The recent rally in markets has provided some relief. Nonetheless, accumulated losses on equity portfolios could require substantial writedowns, the impact having been shielded thus far by temporarily valuing securities holdings above current market values. To reduce obstacles to attracting and retaining capital, the FSAP recommends relaxing regulations that essentially set a benchmark for the minimum rate of return that companies guarantee to policyholders (via a maximum technical rate of interest for discounting future liabilities) and also a minimum profit split with policyholders. The authorities noted that the technical rate would be lowered from 3.25 percent to 2.75 percent as of January 2004, but were not convinced of the need to abolish it, pointing out that life insurers were generally paying higher returns. The mission suggested that as these higher returns were in excess of net earnings in a number of cases, this underscored the need for strong, risk-based supervision and monitoring of capital adequacy to ensure orderly consolidation in the sector.

33. **The FSAP's assessment of financial supervision and regulation is largely positive.** Moreover, the authorities were already working to strengthen those areas identified for refinement. This included: expanding the resources of the new supervisory body, BaFin; enhancing on-site supervision and increasing oversight of bank auditors; strengthening reporting standards, notably on impaired assets; and enhancing supervision of reinsurance companies.

34. **The more complex question was how best to foster restructuring in the banking sector to arrest the trend decline in profitability and reduce future vulnerabilities.** Present weakness is concentrated among the large commercial banks and several Landesbanken, although low profitability affects all three pillars of the banking system.[17] In the authorities' view, the recent poor performance of the commercial banks reflected primarily management mistakes: these banks had moved away from retail business to engage more heavily in wholesale and investment banking, leaving them exposed to the business cycle and equity markets. For the Landesbanken, the situation was more difficult. As the government guarantees that allow the Landesbanken to compete on a more favorable footing with the commercial banks will be phased out beginning in July 2005, most of the Landesbanken faced a further reduction in their paper-thin profit margins. By contrast, the Sparkassen and cooperatives had weathered the economic downturn better because they had remained focused on their core retail business. The mission pointed out, however, that the Sparkassen would not be immune to the problems of the Landesbanken as the Sparkassen were part owners of the Landesbanken and both were related through a joint institutional guarantee scheme.

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[17] The three pillars are commercial banks, cooperatives, and public sector banks (Landesbanken and Sparkassen). The Sparkassen are local savings banks. The Landesbanken mostly engage in wholesale business. Public sector banking also incorporates various federal and regional development banks.

35. **The authorities emphasized that restructuring was underway within each of the pillars of the banking system.** The Landesbanken in particular were gearing up for change: some were already merging, others were moving closer to their Sparkassen to better integrate business, and some were being turned into joint stock corporations. Consolidation in the Sparkassen and cooperative sectors had been in train for several years primarily via mergers between neighboring institutions.

36. **The mission welcomed the restructuring efforts but argued that they would need to be taken further to foster innovation and a restoration of profitability**. So far, consolidation gains had been modest in terms of cost and capacity savings. There was no single blueprint for successful reform, but the public law structure of the Landesbanken and Sparkassen blocked some avenues for restructuring. Creating the legal framework for transforming Sparkassen and Landesbanken into private law joint stock corporations would open the door for private capital and for market forces to guide restructuring, including through mergers across pillars. Ultimately, this would require phasing out geographic restrictions on Sparkassen business (the so called regional principle) as well as joint institutional guarantees (according to which all depositors and creditors of public sector banks are protected by institutions in the sector as a whole), which inhibited the exit of weak banks.

37. **Further down the road, privatization should also be considered as it is unlikely that state ownership of almost half of the banking system (measured by total assets) can be justified**. The potential for externalities or public goods that would be incorrectly priced provide the usual rationale for public banks, but its is unlikely that market failure of this nature is exceptionally extensive in Germany. Potential welfare benefits could be attained with more narrowly targeted forms of state intervention, and with less risk for public budgets. In the meantime, measures should be taken to insulate the day-to-day management of public sector banks from local politics. To foster a debate about the pros and cons of public ownership, public sector banks should become more transparent about how they fulfilled their special mandate.

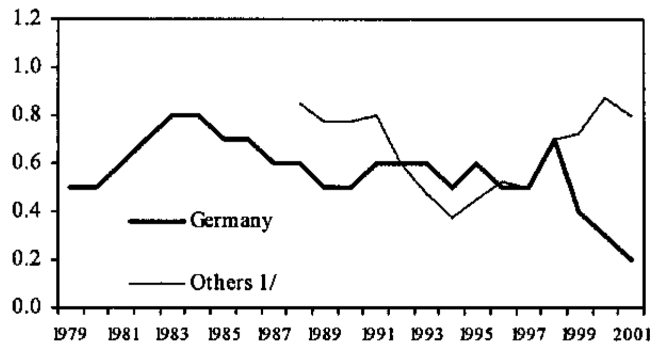
38. **The authorities preferred that each pillar of the banking system sort out its own problems before considering consolidation across pillars, arguing that a broader approach to liberalization presented greater short-term risks to financial stability**. The regional principle and the joint institutional guarantees had played useful roles in making public sector banks pillars of stability over the past decades. If they were removed—and this would in any case be a matter of Länder policy—competition might decline with adverse consequences for banking services, notably access to credit, and banks might engage in riskier lending. The mission agreed that financial liberalization came with risks—and certainly would need to be supported with enhanced on-site supervision. However, other euro-area countries had successfully reformed their public financial structures, typically lifting restrictions on banks' business before reducing public ownership (Box 5). In view of the needed legal and regulatory changes, the mission also suggested that work should begin now on fostering debate and mobilizing support for change.

Box 5. Germany: Bank Profitability and Reforms

A Selected Issues paper comparing the German banking system to those of selected EU countries with public and private banking pillars finds that:

- Germany's banking system stands out because of the large number of banks and strong presence of the public sector. Including the role of cooperatives, the system is less subject to the pressures of the capital market.
- Banks in Germany tend to be less profitable and less well capitalized, even in comparisons across similar pillars. Profitability has been on a downward trend. By contrast, banks in other EU countries managed to maintain or even rebuild profitability during the 1990s (see figure below).
- Profitability in Germany is weak mainly because of low revenues rather than high costs. Low revenues might partly reflect high competition and the fact that profit-making is not always the paramount objective of cooperatives and public sector banks. However, it might also reflect unexploited opportunities to develop non-interest revenues and under pricing of credit risk.
- Historically, the role of the public sector in banking was larger in France, Italy, and Austria than in Germany. But these countries have divested from major commercial banks. Italy required, and Austria allowed, the savings banks to transform into joint stock corporations. France transformed them into cooperatives. Spain has maintained saving banks' separate legal status but weakened the role of the public sector in governance. All countries allowed savings banks to operate like commercial banks, without a "regional principle." During the period of reforms—which took place mostly during the 1990s—bank profitability typically increased.

Cross-Country Comparison of Pre-Tax Return on Assets, 1979-2001 (In percent)



1/ An unweighted average for Austria, France, Italy, and Spain.

E. Other Issues

39. Germany has implemented the 40 recommendations of the Financial Action Task Force (FATF) regarding **money laundering** and the eight special recommendations on terrorist financing. Germany acceded to the OECD Convention on Bribery in International Business Transactions and adopted implementing legislation in 1999.

40. Germany's **statistics** are generally of high quality, but direct national accounts data on inventories should be constructed and data for the general government published with a higher frequency (Appendix II). The authorities agreed with the FSAP recommendation that more comprehensive and timely data on financial sector soundness should be made available and looked forward to the completion of the Fund's compilation guide for Financial Soundness Indicators.

41. Under the financial burden of unification, **ODA** has fallen by almost one third since the mid-1980s, to less than 0.3 percent of gross national income. However, the authorities remain committed to raising spending on ODA.

IV. Staff Appraisal

42. **The authorities' revised policy strategy, with a long-overdue focus on structural reforms, is well targeted**. Failure to address structural rigidities has contributed to more than a decade of underperformance of Germany's economy. Moreover, after three years of stagnation and rising unemployment, a confidence crisis was beginning to set in. Although they will not be the final word, the proposed measures underlying the new strategy—notably cutbacks in benefits for the jobless, reductions in tax expenditures and subsidies, reforms to health care and pensions, and advancing tax relief—provide the right ingredients to revive growth, strengthen longer-term economic performance and put public finances on a more sustainable footing.

43. **Full implementation of all elements of the strategy is essential for success and to stengthen Germany's contribution to global growth**. The package of measures begins to address many of the key problem areas, especially poor incentives to work and the spiraling costs of entitlement programs. By strengthening the supply-side of the economy and placing the structural deficit on a firm, declining path, full implementation of the package will create powerful synergies between confidence, growth, and fiscal consolidation. If the reforms are watered down and fiscal consolidation measures are unconvincing, not only would confidence be hit, but Germany's lackluster underlying economic performance will, in all likelihood, continue. In such circumstances, tax cuts will prove at best a temporary palliative.

44. **Even so, in the current fragile economic environment, the strategy may not deliver strong growth in the short term**. The announcement of the reform package is likely to have helped to boost forward-looking confidence indicators. However, several key measures still await implementation and most would raise growth mainly over the medium term. In the meantime, coincident indicators of activity remain subdued amid weak demand

in Europe and the emerging impact of the euro's rise on exports. Moving into 2004, growth should pick up as recent interest rate reductions filter through to domestic demand and the global economy revives. The tax cuts will help, although, overall, there is no net fiscal stimulus. The risks to growth appear to be balanced, but in view of the proximity of inflation to zero, the authorities should not hesitate to consider temporary stimulus if the economy were to take an unexpected and pronounced turn for the worse.

45. **Recent steps toward a more structural approach to public expenditure restraint are welcome.** The previous approach, which has relied too much on across-the-board expenditure restraint, has failed to deliver consistent budget savings. It is entirely appropriate that measures focus on making cuts in subsidy programs, tax expenditures, and entitlement programs. This not only holds out the promise of more durable fiscal consolidation but also does it in a way that will have important supply-side benefits.

46. **Durable expenditure restraint is an essential complement to the policy of advancing the tax cuts.** As the tax cuts are legislated to take place anyway, there is a good case for bringing them forward to 2004 when their support to the economy is needed most. But this will make it difficult to return the deficit below the SGP's 3 percent limit. To preserve credibility in the affordability of the tax cuts, and in Germany's commitment to underlying fiscal adjustment, the clear aim in the 2004 budget should be to prevent an increase in the cyclically-adjusted deficit. Moreover, clear assurances are needed that long-lasting fiscal consolidation is indeed in the pipeline through well-specified, durable measures, and that the structural deficit can be realistically reduced by at least 1½ percent of GDP over 2004-06.

47. **Identified budget savings so far fall short of what is required to cement those assurances.** Even assuming current proposals are legislated, the measures cumulate to achieve about half the required savings. These should not be augmented with low quality measures and tax increases in coming budgets. Rather, deeper cuts in subsidies and greater scrutiny of inefficient, but costly, active labor market programs should be considered.

48. **Health care and pension reform have rightly moved up the policy agenda in view of high and rising contribution rates and the threat to long-term fiscal sustainability from population ageing.** The health care package is a useful start, although the harder task remains to unlock efficiency gains as well as to further contain demand and scale back unnecessary services. The recent findings of the expert commission on pensions strike the right chord of realism. Delaying the inevitable need to raise the retirement age and factor demographic trends into the pension adjustment formula will make it increasingly difficult to avoid further increases in contribution rates and will undermine confidence in the soundness of the pension system.

49. **The proposals in Agenda 2010 to reform support for the unemployed are impressive and will help to reduce structural unemployment.** The reduction in the duration of unemployment benefits for older workers will significantly strengthen incentives to work as will the merger of unemployment assistance with social assistance, provided the

new program is at least as narrowly targeted as social assistance. With about 4½ million unemployed, early and undiluted implementation of these reforms is rightly a high priority.

50. **Proposals to ease labor market and business regulations also represent steps in the right direction but need to be taken further**. Agenda 2010 contains useful suggestions to free up job protection legislation and begin dismantling restrictions on trades, crafts, and professions. But there is scope to do more, particularly to encourage hiring and to support more options for wage bargaining to respond better to local economic conditions and reduce regional imbalances. More generally, Germany is encouraged to maintain its leadership role within Europe in helping complete the single market agenda and to be a strong advocate of trade liberalization.

51. **There are encouraging signs that the deterioration in the condition of the financial sector has been arrested, but it is too early to tell whether a decisive turning point has been reached.** Last year was the worst in memory for German banks and insurance companies. Nonetheless, the financial system has shown resilience and stress tests provide some comfort that it could weather additional shocks. Cost cutting and better pricing of risk have also contributed to a modest improvement in banks' bottom line. A delay in the recovery, however, would impose additional strains on a system that is already stretched. In this context, the largely positive assessment of financial supervision and regulation under the FSAP—and the authorities' plans to introduce further refinements—is welcome.

52. **The key challenge in the financial sector is to maintain a healthy balance between competition and financial stability**. The long-term decline in the profitability of all three pillars of the banking system is a major concern, to which the phasing out of guarantees for the Landesbanken adds immediacy. It is encouraging that restructuring is underway and that some public sector banks are exploring options such as corporatization and consolidation within pillars. However, restructuring efforts will need to be taken further to allow banks to adapt to ongoing changes in the financial landscape and to help address future shocks. To that end, the work should begin on creating the legal framework to reduce barriers to restructuring and facilitate market-oriented solutions within or across pillars. Down the road, privatization of public sector banks should be considered as it is far from clear that there is sufficient market failure to warrant the high degree of public ownership. Consolidation is also required in the insurance sector and the easing of regulations concerning the technical interest rate and the minimum profit split could help in strengthening the capital base of the life insurance sector, which has suffered under weak equity markets.

53. **Germany's statistics are more than adequate for the purposes of effective surveillance**. However, some improvements could facilitate the monitoring of fiscal policy and financial sector vulnerabilities.

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

Germany: Fund Relations
(As of August 31, 2003)

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	7,521.60	57.82
Reserve position in Fund	5,486.64	42.18

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	1,210.76	100.0
Holdings	1,322.72	109.25

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 accordance with IMF Executive Board Decision No. 144-(52/51), effective December 2001, the authorities put into effect a series of measures freezing the accounts of and banning payments in favor of the Taliban, listed terrorists, and persons and organizations related to terrorism. Pursuant to UN Security Council resolutions and/or EU regulations, restrictions are imposed on payments and transfers to the UNITA movement in Angola, Iraq, the Taliban, and certain individuals in Myanmar. EU sanctions are maintained against the assets of 13 persons associated with Serbia and Montenegro.

VIII. **Article IV Consultations:**

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (SM/02/309) was discussed at EBM/02/108 (October 23, 2002).

GERMANY: STATISTICAL INFORMATION

Germany has a full range of statistical publications and subscribes 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.

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

- The full set of ESA95 data is only available from 1991 onward. ESA95 data covering the period 1970-1991 have been released this year but flow-of funds data remain patchy. These shortcomings and the absence of pre-1970 data complicate time series analysis.

- 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.

- Flow-of-funds data are published on an annual basis only and with a nine month lag. More timely data would facilitate monitoring balance sheet developments.

- A bridge table between the general government data in the ESA95 classification and the public sector data on an administrative basis should be published to facilitate fiscal analysis.

In compliance with various European regulations, Germany provides Eurostat with quarterly general government revenue, expenditure, and balance on an accrual basis (ESA95), with the times series starting in 1991. It also provides the ECB and Eurostat with quarterly central governments transactions and financial assets and liabilities.

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 member states, 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. On a test basis, the *Government Statistics Yearbook 2002 Supplement* (accessible at http://www.imf.org/external/pubs/ft/gfs/manual/comp.htm) shows data for Germany using the new framework of the *Government Finance Statistics Manual 2001*: Central Government, State and Local Government, and General Government (1999-2001).

The 2003 FSAP mission found that the availability and timeliness of financial soundness indicators was relatively weak. The Bundesbank and the Banking Supervisory (BaFin) should publish relevant statistics, focusing mainly on credit institutions and insurance companies, and including at a minimum core indicators of asset quality, capital adequacy, earnings and profitability, and liquidity. It would be useful to publish more statistics on off-balance sheet activities of financial institutions, including notional amounts, market replacement values, and bilaterally netted credit exposures. It would also be helpful to consider publishing regularly a financial stability review, which has been found valuable in an increasing number of countries.

Germany: Core Statistical Indicators
(As of October 3, 2003)

	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	10/2/03	10/2/03	9/03	7/03	7/03	2002	2003Q2	12/03
Date Received	10/2/03	10/2/03	10/1/03	9/12/03	9/12/03	2/03	8/21/03	09/03
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 / Ministry of Finance	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 2003 Article IV Consultation

Supplementary Information

Prepared by the European I Department

Approved by Michael Deppler and Martin Fetherston

October 29, 2003

1. This supplement reports on information that has become available since the issuance of the staff report and on discussions with the authorities via videoconference on October 28, 2003.[1] The new information corroborates the thrust of the staff appraisal.

Economic developments and outlook

2. **Business confidence continues to strengthen, consistent with recovery beginning toward the end of this year**. In October, the Ifo composite index increased for the sixth straight month. Until October, the rise in the Ifo index had been fueled by its forward looking component, while the indicator of current conditions stagnated. By contrast, the latest reading also shows a noticeable uptick in current economic conditions. Expectations are nevertheless still running ahead of actual economic developments and will thus need to be further validated by hard evidence of reviving output in the months ahead.

3. **The newly released official forecast is in line with the consensus**. The forecast projects growth of zero in 2003 and 1½ -2 percent in 2004. The authorities see the risks to the projection as balanced. The main downside concern would be if the euro were to appreciate sharply. The authorities stressed that confidence building via implementation of needed structural reforms will be important to ensure that domestic demand provides a durable base for recovery.

- *Recent developments are consistent with staff's projection of stagnation in 2003 and mild recovery (growth of 1½ percent) in 2004.*

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[1] The principal representative for the authorities was Ministry of Finance State Secretary Koch-Weser.

Fiscal developments and outlook

4. **Recent data indicate a wider deficit in 2003 than staff had estimated in the staff report**. Although tax data contain no major surprises—in the first nine months of 2003, tax revenue was 0.3 percent above its level of the corresponding period of 2002—social security contributions have been weaker and outlays higher than expected. Overall, staff would see the deficit somewhat above 4 percent of GDP in 2003, compared to the estimate of 3.9 percent in the staff report, implying a reduction of the structural deficit of less than ½ percent of GDP. The authorities have yet to revise their fiscal projection (they will do so in the context of a supplementary budget to be submitted in November) but have a similar view of the fiscal picture for 2003.

5. **Progress has been made in reaching political agreement on the 2004 budget.** Consensus on making significant cuts in subsidy programs has emerged with a cross-party commission proposing across-the-board reductions in a broad range of subsidies by 10 percent over the next three years. The quantitative impact of these cuts would be roughly in line with staff assumptions for its baseline fiscal projection. Finance Minister Eichel continues to press for additional, targeted elimination of housing subsidies and commuter allowances. In response to the weakness in the social security funds, and with a view to holding down contribution rates, the government has also adopted an emergency pensions package that foregoes a scheduled pension increase in 2004 and makes pensioners pay long-term health care contributions in full. Passage of the budget is expected in December.

6. **The authorities now expect that the general government deficit will exceed 3 percent of GDP next year.** They remain committed to reducing the structural deficit by at least 1½ percent of GDP over 2004-06. While the authorities still aim to make progress in this regard in 2004, they acknowledged that this will be difficult given tax cuts.

- *Recent developments continue to suggest that the general government deficit is likely to remain around 4 percent of GDP in 2003 and 2004, with an unchanged structural deficit in 2004. This underscores staff's call for early identification of credible, structural savings, such as elimination of housing and commuter subsidies, to fill the remaining fiscal adjustment gap for 2004-06.*

Structural reforms

7. **The authorities have made progress in bringing key elements of their reform program closer to implementation (see table below).** On labor market reforms, the key initiative to merge unemployment and social assistance has been adopted by the lower house, albeit with some softening to define acceptable employment as a job paying the wage agreed in collective wage bargaining. The opposition-controlled upper house will now consider the reform. On pensions, the cabinet has approved adding a sustainability factor to the pension formula, which would lower pension costs by an estimated 1½ percent of GDP by 2030. Rather than raising the statutory retirement age, the government is focusing efforts on

bringing the effective retirement age closer in line with the statutory retirement age (65 years) by phasing out early retirement schemes and not allowing three years of training/education to count toward pension rights.

- *At this stage, implementation of the authorities' all-important structural reform program appears on track, although political hurdles remain ahead.*

Key Reforms: Implementation Status	
Labor market reforms Job matching: "mini-jobs"; "me plc" (Hartz I + II).	Implemented
Reform unemployment benefits (e.g., cutting duration); reform firing restrictions and facilitate hiring of temporary employees.	Adopted by lower house; now in mediation between upper and lower houses. Approval by upper house is not necessary for unemployment benefit reform. However, this reform is combined into a package with other measures that will require upper house approval.
Restructure Federal Labor Office and streamline benefit regulation (Hartz III)	Adopted by lower house; approval by upper house not necessary.
Merger of unemployment and social assistance.	Adopted by lower house and to be considered by upper house; mediation is expected.
Health care system reform Raising copayments; reducing coverage of services.	Adopted by lower and upper houses.
Pensions reform (1): no pension adjustment on July 1, 2004; long-term care insurance to be paid fully by pensioners; reducing pensions reserve.	Adopted by cabinet. To be considered by lower house in early November; approval by upper house not necessary.
Pensions reform (2): new pensions to start at end of month rather than beginning; three years of training/education no longer to count toward pension (start: 2009); introduction of sustainability factor (start: 2005); facilitate "Riester" (second pillar) contracts; reduce early retirement schemes with a view to raising effective retirement age from 60 to 63 years.	Adopted by cabinet; many measures need approval by lower and upper houses.
Budget 2004 Advancing 2005 tax cuts to 2004.	Adopted by lower house; needs approval by upper house.
Curtailing tax expenditures and subsidies; cutting public wage supplements.	Adopted by lower house; needs approval by upper house and mediation is expected.
Reform of municipal taxation	Adopted by lower house; needs approval by upper house and mediation is expected.
Reform of trades and professions	Adopted by cabinet; submitted to lower house.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/132
FOR IMMEDIATE RELEASE
November 6, 2003

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

IMF Concludes 2003 Article IV Consultation with Germany

On November 3, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

Following three years of stagnation, the government has adopted a revised economic strategy consisting of enhanced structural reforms, more-targeted budget savings, and advancing tax cuts originally scheduled for 2005. The structural reforms aim primarily at improving the flexibility of the labor market and easing demographic pressures on social security programs, which threaten to add considerably to already-high non-wage labor costs over time. A health care reform package has already been legislated. The legislative process is also well advanced regarding other key reform proposals, including reducing the duration of unemployment benefits, merging unemployment and social assistance, cutting public subsidies, and reforming the pension system.

With global growth prospects brightening, business confidence has revived somewhat in recent months, pointing to prospects for recovery in the period ahead. However, the appreciation of the euro is likely to restrain the pace of growth. Advancing the tax cuts will interrupt fiscal consolidation in 2004, making it difficult to bring the general government deficit below the 3 percent of GDP limit under the Stability and Growth Pact. The deficit exceeded the limit in 2002 and is also estimated to do so this year.

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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.

The Executive Board also reviewed the findings of an IMF Financial Sector Assessment Program (FSAP), which Germany has taken part in over this past year. Financial sector strains came to a head in 2002 when bank profits contracted sharply and insurance companies suffered losses. Improved financial market conditions in 2003 have reinforced restructuring efforts, thereby easing strains on the financial sector. Stress tests confirm the system's resilience.

Executive Board Assessment

Directors strongly welcomed the turn that Germany has taken toward addressing the structural rigidities that, along with the prolonged adjustment to reunification, have contributed to a decade of weak growth and high unemployment. Together with the more structural approach to public expenditure restraint, the government's economic strategy embedded in Agenda 2010 should help strengthen the supply-side and growth potential of the economy, put public finances on a more sustainable footing, and better equip Germany to cope with the challenges of population aging.

Directors urged the authorities to work toward full implementation of all elements of the policy strategy. This will require strong efforts to strengthen and maintain the required political and public consensus in favor of reforms. In the period immediately ahead, the authorities will need to make further efforts to ensure that fiscal consolidation will be achieved in the medium term. This should help promote confidence, without which the demand effect expected from advancing planned tax cuts would be limited. The enactment of health care reforms and the substantial progress already made in bringing labor market and pension reforms close to implementation are encouraging. These reforms should be complemented with additional steps in the future to make further headway in addressing the demographic challenge and to further enhance the flexibility of the labor market.

Directors concurred with the assessment that the prospects for a moderate recovery of the German economy in 2004 have significantly improved. Short-term GDP growth is, however, likely to remain subdued because of the appreciation of the euro, the still weak demand conditions in Europe, and fiscal constraints. The risks to the outlook appear to be balanced. Some Directors saw upside potential from a stronger-than-expected pick-up in external demand. But the dampening effects of a possible sharp euro appreciation and the still-high corporate leverage cannot be dismissed. Against this background, Directors urged the authorities to work toward further strengthening business and consumer confidence by fully delivering on their structural reforms and fiscal consolidation commitments. Although most Directors did not see the need arising, some Directors suggested that, with inflation not far from zero, additional temporary fiscal stimulus might need to be considered if the economy were to take an unexpected and marked turn for the worse.

Directors stressed that durable fiscal consolidation aimed at achieving structural balance as early as possible needs to remain a core priority on the policy agenda. They welcomed the authorities' move toward a more structural approach to public expenditure restraint, with

emphasis on targeted cuts in subsidies and the curtailment of tax expenditures and entitlement programs. Clearly, this will provide a better framework for fiscal consolidation and create efficiency gains, compared with the across-the-board approach to expenditure restraint, topped up with ad hoc tax policies, that has characterized previous efforts.

Most Directors considered that the government's commitment to reduce the structural deficit by an accumulated 1.5 percent of GDP over the period 2004 to 2006 lays out an appropriate adjustment path, taking into account Germany's still fragile economic situation. Given the planned tax cuts, however, little consolidation is expected in 2004, and some Directors regretted that a faster adjustment to bring the general government deficit below 3 percent of GDP appears to be unlikely. To retain credibility in the consolidation process, Directors urged the authorities to move swiftly in identifying the additional high-quality measures that will be needed to fully and durably meet their consolidation goals over the next three years. Expanding on the measures already announced, priority areas for additional savings are deeper cuts in subsidy programs, as well as further downsizing of expensive but inefficient labor market programs.

Directors strongly welcomed the focus of the structural reform agenda on health care, pensions, and the labor market. The health care package is a promising start, but further efforts—including efficiency gains and enhanced competition—will be needed to contain rises in contribution rates over the medium term. On pensions, Directors particularly welcomed the recent cabinet approval for adding a sustainability factor to the pension formula, and looked forward to further steps to ensure the system's long-term sustainability, including through phasing in a higher retirement age.

Directors viewed the shortening of the duration of unemployment benefits as a well-targeted measure to help strengthen incentives for unemployed workers. To further enhance work incentives, they encouraged the authorities to follow through with their plan to merge unemployment and social assistance at a level of benefits no higher than those currently available under social assistance. To complement these reforms, Directors called for tighter enforcement of benefit eligibility. They looked forward to implementation of the proposals under Agenda 2010 to reform job protection legislation and to liberalize the trades, crafts and professions. Some Directors also pointed to the need for enhanced flexibility in the wage setting process, and for broadening the reform agenda to encourage entrepreneurship and competition.

In reviewing the findings of the FSAP, Directors were encouraged that Germany's financial system has weathered considerable strains in the past two years quite well. There are signs that pressures are easing, helped by strenuous restructuring efforts. They commended the high quality of supervision and compliance with international standards, and welcomed the authorities' efforts to continue to refine the supervisory framework.

Going forward, the authorities face a key challenge in fostering restructuring in the banking sector with a view to improving its low and declining profitability. This will require maintaining a healthy balance between competition and financial stability. To further the process of bank restructuring that is already underway, Directors encouraged the authorities to take steps toward creating a legal framework that will reduce barriers to restructuring both within and

across the various public and private pillars of the system. However, a number of Directors acknowledged the need to move cautiously in this area. Directors also saw a case for privatization over the medium term of the public sector banks, which account for nearly half the assets intermediated by the banking system. In the insurance sector, Directors saw a need for consolidation and efforts to strengthen the sector's capital base. They welcomed the authorities' plan to strengthen supervision of the reinsurance sector in line with the FSAP recommendations.

Directors welcomed Germany's commitment to trade liberalization, and called on Germany to work with European and other partners toward a successful conclusion of the Doha Round. Many Directors also looked forward to Germany's leadership in working to reduce agricultural subsidies in the context of the reform of the Common Agricultural Policy, which should have positive effects both in terms of budgetary savings and for developing countries' exports. Directors also encouraged the authorities to make good on their intentions to raise official development aid.

While Germany's economic statistics are of high quality, Directors saw scope for further improvements, including to facilitate the monitoring of financial sector vulnerabilities.

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 2003 Article IV Consultation with Germany is also available.

Germany: Selected Economic Indicators

	1999	2000	2001	2002	2003 1/
Economic activity and prices	Change in percent, unless otherwise noted				
Real GDP	2.0	2.9	0.8	0.2	0.0
Net exports 2/	-0.7	1.1	1.6	1.7	-1.0
Domestic demand	3.2	1.9	0.1	-1.7	0.3
Private consumption	3.7	2.0	1.4	-1.0	0.8
Gross fixed investment	4.1	2.7	-4.2	-6.7	-1.7
Construction investment	1.4	-2.6	-4.8	-5.8	-3.7
Gross national saving (percent of GDP)	20.5	20.3	19.6	20.3	19.9
Gross domestic investment (percent of GDP)	21.7	21.7	19.6	17.9	17.5
Labor force 3/	0.5	1.0	0.5	0.1	-0.2
Employment 3/	1.2	1.8	0.4	-0.6	-1.1
Standardized unemployment rate (in percent)	8.4	7.8	7.9	8.6	9.5
Unit labor costs (whole economy)	0.3	1.0	1.3	0.8	1.3
GDP deflator	0.5	-0.3	1.3	1.6	0.9
Harmonized CPI index	0.6	1.4	1.9	1.3	1.0
Public finance	In percent of GDP				
General government balance 4/ 5/	-1.5	1.3	-2.8	-3.5	-3.9
Structural government balance	-1.2	-1.6	-2.9	-2.9	-2.3
General government gross debt 5/	61.2	60.2	59.5	60.8	63.3
Money and credit	Change in percent over 12-months				
Private sector credit 6/	5.8	5.8	3.2	0.9	1.1
M3 6/	7.2	-1.1	6.0	...	6.3
Interest rates	In percent				
Three-month money market rate 7/	3.0	4.4	4.3	3.3	2.2
Ten-year government bond yield 7/	4.5	5.3	4.8	4.8	4.3
Balance of payments	In billions of €, unless otherwise noted				
Exports 8/	592.7	693.1	741.7	764.7	765.0
Imports 8/	581.5	690.8	702.8	682.6	682.9
Trade balance (percent of GDP)	2.9	2.6	4.3	5.7	5.3
Current account balance	-22.3	-28.5	1.0	48.9	51.0
Current account (percent of GDP)	-1.1	-1.4	0.0	2.3	2.4
Exchange rate					
Euro per US dollar 7/	0.94	1.08	1.12	1.06	0.85
Nominal effective rate (1990=100) 9/	102.0	97.8	98.5	99.5	103.5
Real effective rate (1990=100) 9/ 10/	107.0	100.8	100.0	100.1	102.9

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

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

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

6/ Data reflect Germany's *contribution to M3* in the euro area. M3 data not shown for 2002 because of a series break. Data for 2003 refer to August.

7/ Data for 2003 refer to October 22, 2003.

8/ Includes supplementary trade items.

9/ Data for 2003 refer to September.

10/ Based on relative normalized unit labor costs in manufacturing.