November 2004
IMF Country Report No. 04/341

# Germany: 2004 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 2004 Article IV consultation with Germany, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 5, 2004,** with the officials of Germany on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 28, 2004.** 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 supplement to the staff report of **October 20, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 25, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

**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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**Washington, D.C.**

INTERNATIONAL MONETARY FUND

GERMANY

**Staff Report for the 2004 Article IV Consultation**

Prepared by the Staff Representatives for the 2004 Consultation with Germany

Approved by Michael Deppler and Martin Fetherston

September 28, 2004

- Discussions took place in Berlin, Frankfurt, and Bonn during June 23-July 5, 2004. Meetings were held with Minister of Finance Eichel, Bundesbank President Weber, 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 parliamentary representatives, social partners, associations of financial institutions, and research institutes.

- The team comprised Messrs. Chopra (Head), Traa, Decressin, Brunner, Braumann, and Kuijs (all EUR). Mr. Bischofberger, Germany's Executive Director, attended the discussions.

- 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 No. 03/341 following the IMF Executive Board meeting on November 3, 2003.

**Staff Analytical Work on Germany, 2000-04**

**Growth and Competitiveness**

- Investment Trends in OECD Countries: Long-Term Developments and Future Prospects. *Forthcoming Selected Issues Paper*.
- Does PPP hold in the Long Run: Evidence from Germany and Switzerland. *Forthcoming Selected Issues Paper*.
- Business Investment in the Current Cycle. *IMF Country Report No. 03/342*.
- Growth and Adjustment in Germany: Perspectives and Prospects. *IMF Country Report No. 02/240*.
- Is Germany Competitive? *IMF Country Report No. 02/240*.
- Job-Rich Growth in Europe. *IMF Country Report No. 01/307*.

**Fiscal Policy and Entitlement Programs**

- Pensions and Growth. *Forthcoming Selected Issues Paper*.
- Perspectives on Federalism and the Political Economy of Adjustment. *Forthcoming Selected Issues Paper*.
- The Fiscal Challenge of Aging: What Needs to Be Done. *IMF Country Report No. 02/240*.
- Health Care Reform in Germany. *IMF Country Report No. 02/240*.
- Rules-Based Fiscal Policy and the Fiscal Framework in France, Germany, Italy and Spain. *IMF Country Report No. 01/307*.
- Tax Reform. *IMF Country Report No. 00/342*.
- Revamping Germany's Pension System. *IMF Country Report No. 00/342*.

**Labor Markets**

- Employment, Unemployment, and Labor Supply in Germany. *Forthcoming Selected Issues Paper*.
- The Unbearable Stability of the German Wage Structure: Evidence and Interpretation. *IMF Staff Papers, August 2004*.
- On Sand and the Role of Grease in Labor Markets: How Does Germany Compare. *WP/02/164*.
- Strategies for Turning Germany's Labor Market Around. *IMF Country Report No. 00/342*.
- Declining Labor Share, Wage Moderation, and Employment Performance. *IMF Country Report No. 00/342*.

**The Financial System**

- Germany's Three-Pillar Banking System. *IMF Occasional Paper 233 (2004)*.
- Germany's Financial System: International Linkages and the Transmission of Financial Shocks. *IMF Country Report No. 03/342*.
- The Slowdown in Credit Growth. *IMF Country Report No. 02/240*.

**Main Websites for German Data**

Data in this Staff Report reflect information received by [September 30], 2004. More recent data may be obtained directly from the following internet sources:

German Federal Statistical Office...................................................... http://www.destatis.de

Deutsche Bundesbank................................................................ http://www.bundesbank.de

Ministry of Finance.................................................. http://www.bundesfinanzministerium.de

Federal Labor Agency............................................................ http://www.arbeitsagentur.de

Information on German economic statistics can be found at the Special Data Dissemination Standard website of the IMF................http://www.imf.org/external/country/DEU/index.htm

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## EXECUTIVE SUMMARY

### Background

A cyclical recovery, driven by strong external demand, is taking hold. However, a poor job market is dampening confidence and demand, while demographic pressures are beginning to affect supply. Fiscal consolidation is behind schedule and, absent further measures, the deficit would remain above 3 percent of GDP in 2005. The implementation of structural reforms under Agenda 2010 is on track despite significant popular opposition. The financial sector is recovering but there has been little progress in fostering more market-driven restructuring.

### Key issues

**The outlook**. There was agreement that the short-term outlook has brightened with a modest-paced recovery underway. The recovery remains unbalanced, with domestic demand still dormant, but the external impulse is expected to lead to higher investment and employment, and finally consumption, with a lag of a few quarters. Beyond the near term, however, the growth of potential output is constrained by poor labor utilization.

**Fiscal policy**. The authorities believed that sufficient adjustment was in train to bring the fiscal deficit below 3 percent in 2005. The staff supported the deficit objective but argued that achieving it requires further measures. Moreover, adjustment would need to continue beyond 2005 to attain the medium-run target of small structural surpluses. Consolidation should focus on cutting tax expenditures and subsidies, and inefficient and costly labor market programs.

**Entitlement and labor reform**. The authorities pointed to important strides under Agenda 2010 to strengthen incentives to work and reform entitlement programs. However, with aging-related spending projected to accelerate sharply beginning in 2010, more reforms are needed to bolster confidence in the long-run viability of the entitlement system and boost labor supply. Steps to increase the effective and the statutory retirement age and improve the efficiency of the supply of health care and funding, together with measures to improve further the functioning of labor markets and increase labor force participation, will be important. The authorities concurred that additional steps are needed, but noted that the significant Agenda 2010 reforms first had to be fully absorbed.

**Financial sector restructuring**. Financial sector strains have eased and some progress has been made in addressing structural weaknesses. Augmenting current efforts by creating the legal framework to facilitate restructuring within and across the private and public sector pillars of the banking system would help foster innovation and improve the underlying strength of the system. In the insurance sector, abolishing obstacles (e.g., mandatory profit splits) to better management of capital will give firms additional flexibility and help attract and retain additional capital. The authorities noted that banking consolidation was underway, albeit at a measured pace, but that more far-reaching reform would require changes in Länder laws.

## I. INTRODUCTION

1. **The discussions took place as a cyclical recovery of economic activity was gaining strength, but with continued concerns about longer run prospects.** On the policy front, the authorities have been implementing their three-pronged policy strategy initiated last year, as discussed by Directors in the 2003 Article IV consultation. This strategy comprises phased tax cuts, expenditure-based fiscal consolidation, and reforms laid out in "Agenda 2010" to begin addressing key structural weaknesses (Box 1). Parliament approved the last major component of Agenda 2010, a far-reaching reform of long-term unemployment assistance, in June 2004. The authorities remained committed to reduce the general government deficit below 3 percent of GDP in 2005 provided the upswing is sustained, but so far fiscal consolidation has been elusive.

## II. BACKGROUND

2. **After three years of stagnation, the German economy is showing signs of life:**

- Activity is up, albeit unevenly and at a moderate pace. The recovery is driven by export growth, as the rapid pace of world economic activity has dominated the effect of euro appreciation.

- Profitability in nonfinancial firms has picked up and has been used to strengthen balance sheets; firms remained cautious with their investment plans and again posted a financial surplus in 2003. Profitability has also improved in the financial sector, placing banks in a better position to support the recovery.

- Nevertheless, with output static since 2000, the output gap is wide and inflation is low (Table 1 and Figure 1).

3. **The latest trough followed a secular decline of the economy's potential growth, and was exacerbated by major shocks**. For many years after World War II output grew rapidly, making the generous entitlement system funded by payroll taxes appear sustainable. However, convergence and adverse incentive effects for labor then led to a considerable decline in potential output growth from 4½ percent a year in the 1960s to 1½ percent in the 1990s (see table on page 8), and overall growth is now below the rate of euro-area partner countries (Figure 2). The underlying weaknesses mainly originated in the labor market and were exacerbated by reunification. The structural rigidities made adjustment to the shocks a drawn out process that was manifested in declining labor and capital input:

**Box 1: Past Fund Policy Recommendations and Implementation**

**Fiscal consolidation**: During the 2003 Article IV consultation, Directors endorsed the government's commitment to reduce the structural deficit by 1½ percentage points during 2004-06, focused on durable expenditure cuts in subsidies and ineffective labor market programs. Although some measures have been implemented, they are not sufficient to meet these consolidation goals given cumulative tax cuts of some 1 percent of GDP.

**Structural reforms**: The Agenda 2010 reforms put forward in March 2003 were in line with longstanding Fund recommendations. Implementation status is as follows:

The **labor market reforms** have been adopted: (i) eligibility and maximum duration of unemployment benefits have been tightened; (ii) long-term unemployment and social assistance have been merged into a more narrowly targeted program with means testing (commonly referred to as the Hartz IV law); (iii) part-time work has been deregulated; (iv) job protection regulation has been streamlined; and (v) job intermediation is being improved.

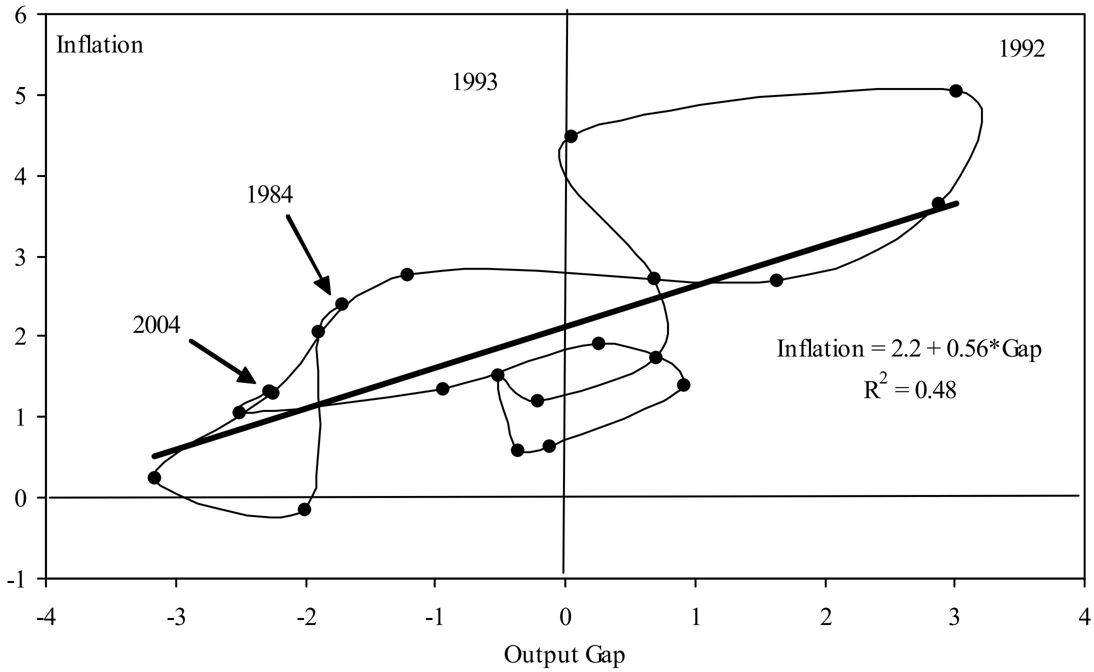
**Pension reform**s have also advanced, focusing mainly on the replacement rate. Pensions will remain almost unchanged in 2004-05. Furthermore, benefit levels were linked to the old-age dependency ratio (steady state savings: ¾ percent of GDP), and early retirement programs are being phased out. However, the Rürup pension commission's proposal to phase in a higher statutory retirement age, which Directors supported, has not yet been adopted and remains under review.

Important **health care reforms** were adopted in September 2003 and are being implemented (steady state savings: ½ percent of GDP from 2005). They include increased patient copayments; higher contributions for pensioners; cuts to some benefits; and the shifting of funding of sickness pay to employees. Directors also called for measures to boost efficiency and competition, which is now on the policy agenda.

**Financial sector:** Directors recommended a reduction in barriers to restructuring both within and across the public and private pillars of the banking system, but only limited headway has been made on this front due largely to legal impediments at the sub-national level. However, supervision is being improved in line with FSAP recommendations.

Figure 1. Germany: Output Gaps and Inflation, 1984-2003

***The current output gap and inflation are consistent with historical relationships.***




Sources: Deutsche Bundesbank; and IMF staff calculations.

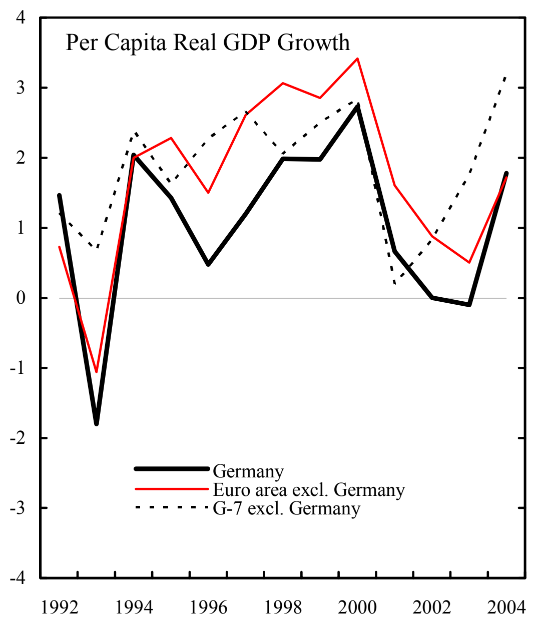
Germany: Potential GDP Growth and its Components, 1962-2009

| Average Trend Growth in: | 1962-70 | 1971-80 | 1981-90 | 1992-2000 | 2001-03 | 2004-09 |
|---|---|---|---|---|---|---|
| Real GDP | 4.4 | 2.7 | 2.4 | 1.6 | 0.6 | 1.7 |
| Total factor productivity | 2.0 | 1.5 | 1.1 | 0.9 | 0.2 | 1.0 |
| Total hours worked | -1.3 | -0.9 | 0.3 | -0.4 | -0.4 | -0.2 |
| Working age population | 0.3 | 0.6 | 0.7 | 0.0 | -0.1 | -0.3 |
| Participation rate | -0.2 | -0.1 | 0.5 | 0.3 | 0.5 | 0.5 |
| Employment rate | 0.0 | -0.3 | -0.3 | -0.2 | -0.1 | 0.0 |
| Hours per employee | -1.3 | -1.0 | -0.7 | -0.6 | -0.6 | -0.4 |
| Real capital stock | 7.9 | 4.7 | 3.0 | 2.3 | 1.6 | 2.0 |
| Memorandum item: | | | | | | |
| Labor share of income | 59.8 | 62.6 | 62.7 | 59.8 | 58.2 | 60.0 |

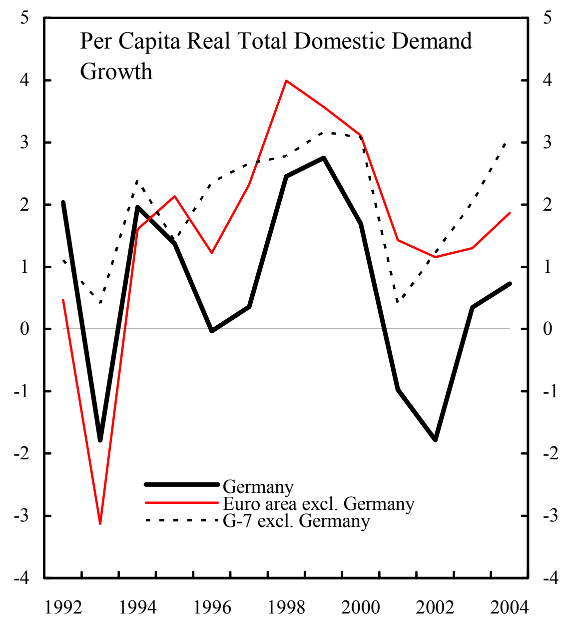
Sources: Federal Statistical Office; and IMF staff calculations.
Notes: Potential GDP growth is based on trend growth of components, where trends are derived using an HP filter.
The 2004-09 period is a staff forecast and is described in the text (Section III.A).

Figure 2. Germany: Economic Performance, 1992-2004
(In percent)

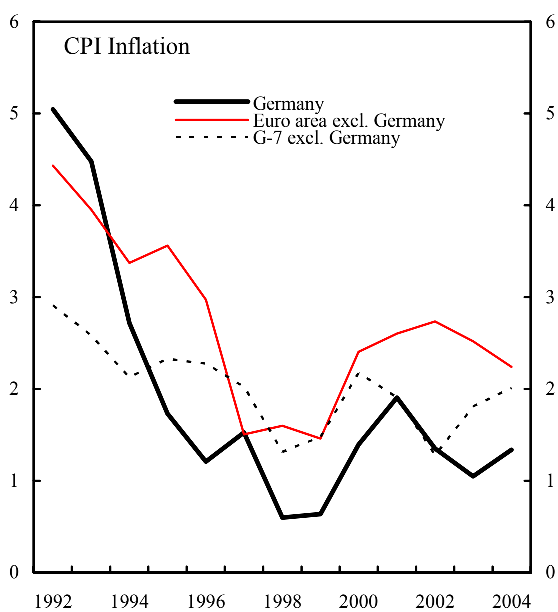
***Growth has been weaker than in partner countries...***



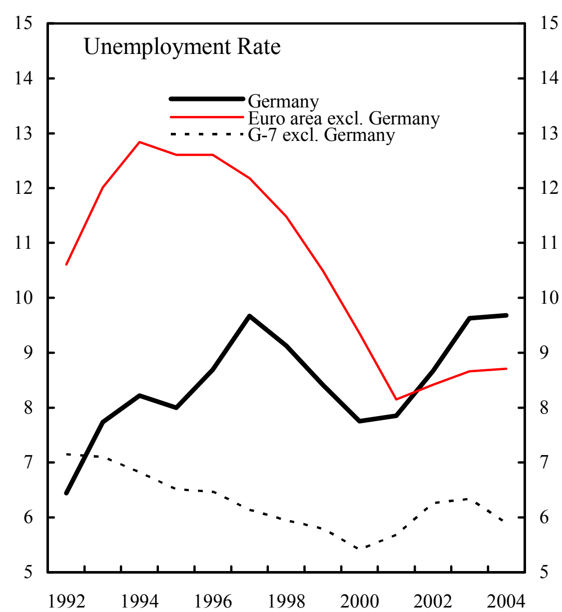

***..mainly reflecting lower domestic demand...***




***...while inflation has been quite moderate...***




***...unemployment remains high.***




Source: IMF, World Economic Outlook.

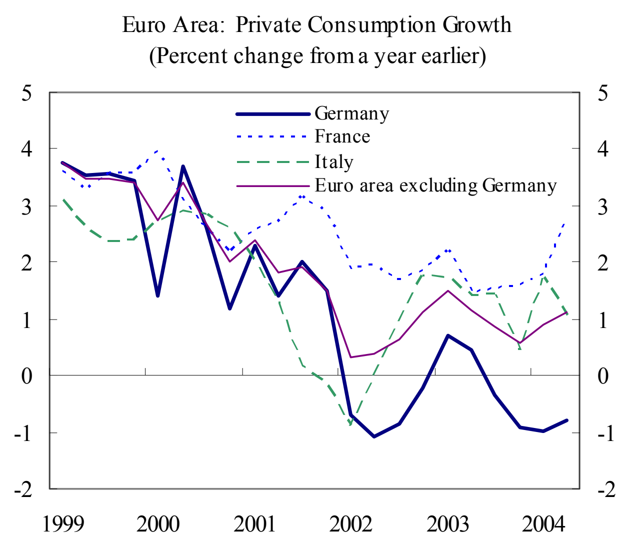
- The most troubling development in potential growth has been a decline in total hours worked.[1] High and inflexible labor costs, generous support for the jobless (high reservation wages), and deliberate policies for early retirement in response to adverse labor demand shocks played key roles in reducing labor utilization. These policies led to sustained high unemployment rates and payroll taxes when the entitlement system was fully extended to the new and less productive Länder of the former East Germany.

- Growth in the capital stock has been decelerating, following convergence after World War II—and, again, in the early 1990s after reunification—when the capital-to-GDP ratio was relatively low. However, excessive wage growth, especially in the first half of the 1990s, also played a role through its harmful effects on profit margins and disincentives to expand capacity.

- Total factor productivity (TFP) growth slowed over the past decades, a characteristic shared by most industrial economies, although some have recently managed a reversal.

4. **The economy is still in a process of adjustment, with adverse consequences for domestic demand.**

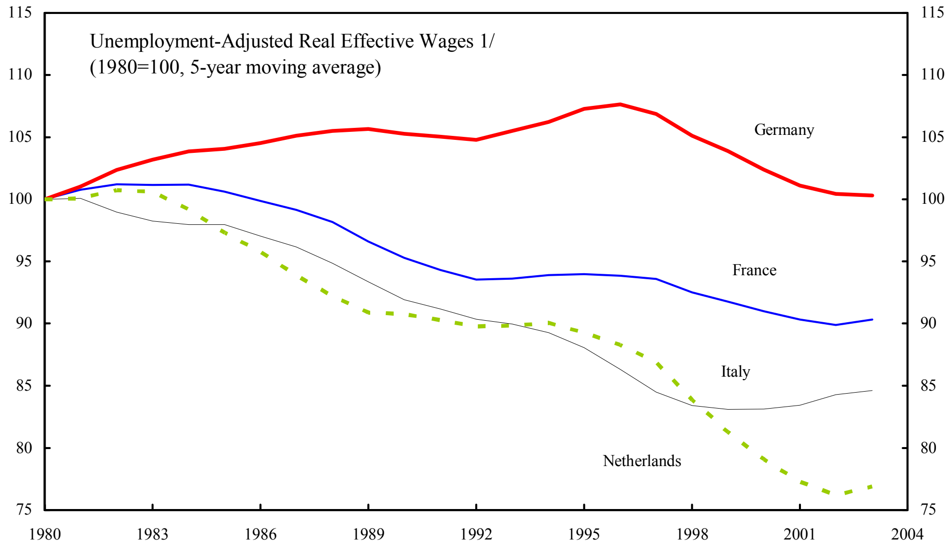
- Wage setting is becoming more flexible and increases have been moderate since the mid-1990s, which is helping to address Germany's comparatively high real wages (Figure 3). However, domestic employment growth continues to be weak, reflecting structural problems in the labor markets, including generous unemployment benefits, high payroll taxes, and tight job protection legislation. As a result, household income and consumption have lacked momentum—private consumption growth has been well below the euro area average since 2001—which has delayed the response of the job market to wage moderation.



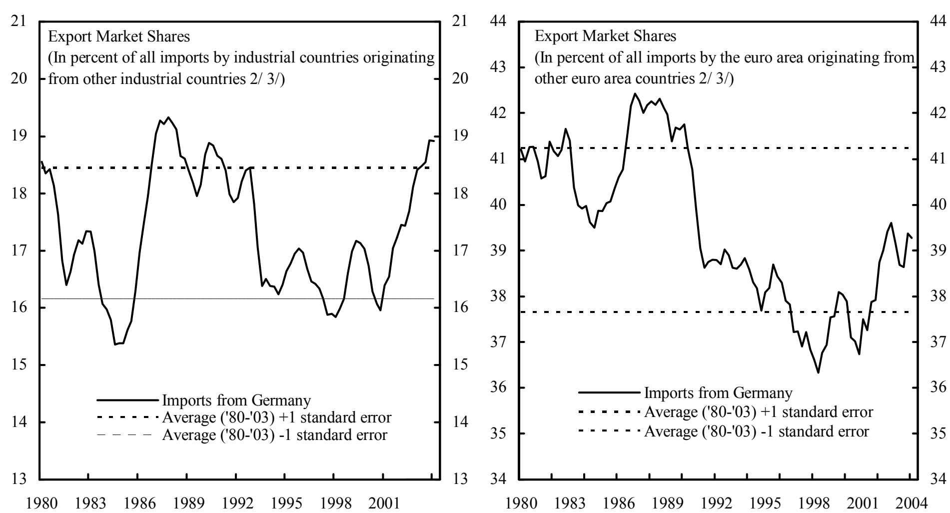

[1] In Germany, total hours worked fell by 0.4 percent a year during the 1990s, while in the United Kingdom, the Netherlands, and the United States, they increased by 0.4, 1.3, and 1.4 percent a year. Furthermore, if Germany had the same employment rate for the 60-64 year old cohort as the United Kingdom, the labor force would be larger by about 1 million workers.

Figure 3. Germany: Wages and Competitiveness, 1980-2004

***While wage moderation started late, progress is under way....***




***...and export shares are rebounding.***

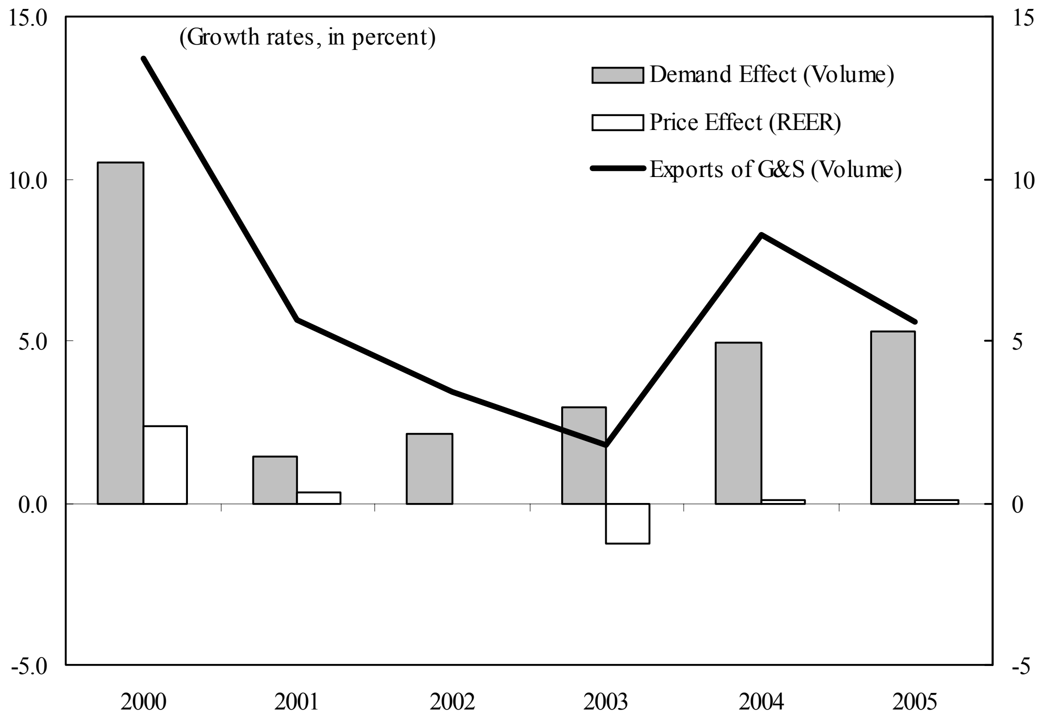



Sources: Direction of Trade Statistics, and IMF staff calculations.
1/ Wages that are adjusted for productivity and cyclical pressures in the labor market.
2/ Excludes Belgium and Luxembourg.
3/ Three-quarter moving averages.

- Nevertheless, slowing wage growth is improving competitiveness, and exports are responding well to expanding world demand (Figure 4). This is visible in strong exports of machinery and equipment, which are tied to investment spending in the global cycle, a component that was slow to recover but is now rebounding. The external current account has swung from a deficit to a substantial surplus (in line with Germany's large output gap and equilibrium savings-investment balance), and staff estimates of the equilibrium exchange rate do not point to an external competitiveness problem.

Figure 4. Germany: Export Determinants, 2000-2005

***Export demand has been strong.***




Sources: Deutsche Bundesbank; and IMF staff calculations and estimates.
Note: The demand effect measures Germany's share of world import demand, while the price effect captures changes in the share due to changes in the REER.

5. **Monetary conditions have been accommodating for the euro area, but low underlying inflation in Germany has resulted in real interest rates that are somewhat above average** (Figures 5 and 6). Loan growth has been anemic (Figure 7), reflecting a combination of weak demand as firms continue to adjust their balance sheets, and supply factors as banks tightened lending standards while rebuilding capital. Nevertheless, there is no evidence of an outright credit crunch because firms' cash flow has permitted increasing dividends alongside improving the balance sheets (Figure 8). Loan margins are now easing and asset prices have rebounded (Figure 9).

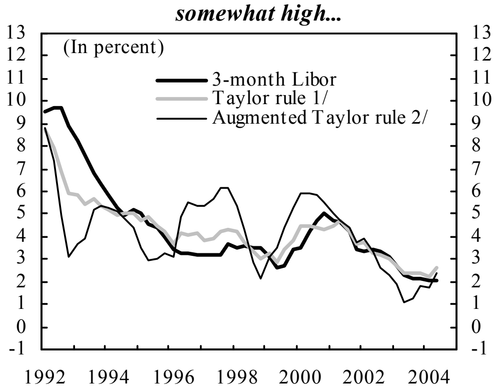
6. **The fiscal stance is not weighing on activity**. With tax cuts equivalent to 0.7 and 0.2 percent of GDP in 2004 and 2005, the structural deficit is expected to increase slightly in 2004 and decline by almost ½ percentage point of GDP in 2005 (Table 2). In any event, emerging demographic pressure, a public debt ratio already exceeding 65 percent of GDP, and a large structural budget deficit, leave no scope for expansionary fiscal policy.

7. **All in all, a modest cyclical recovery is underway, driven by external demand**. Real GDP increased at an annualized rate of nearly 2 percent in the first half of 2004, marking four successive quarters of growth. However, consumption was flat—in line with

slow growth in disposable income—and investment (in construction) remained weak . High-frequency indicators continue to show this mixed picture (Figure 10), with exports and manufacturing output holding up and orders strengthening further, but with weak confidence, retail sales, and construction spending still holding back domestic activity (Figure 11).

Figure 5. Interest Rate Developments, 1992-2004

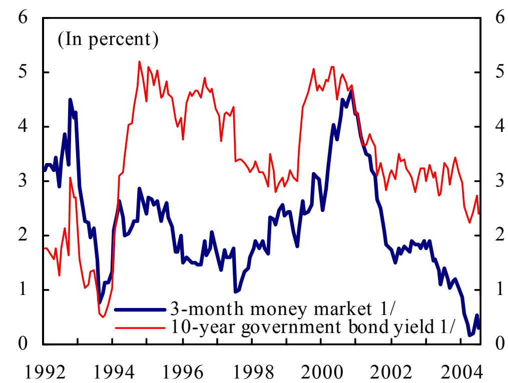
***For Germany, interest rates have been somewhat high...***




Sources: Deutsche Bundesbank; and IMF staff calculations and estimates.
1/ Assumes inflation target of 1.75 percent and equilibrium real interest rate of 2.5 percent.
2/ Subtracts percent REER appreciation in the last two quarters relative to the preceding four quarters with a weight of 1/3.

Figure 6. Real Interest Rates, 1992-2004

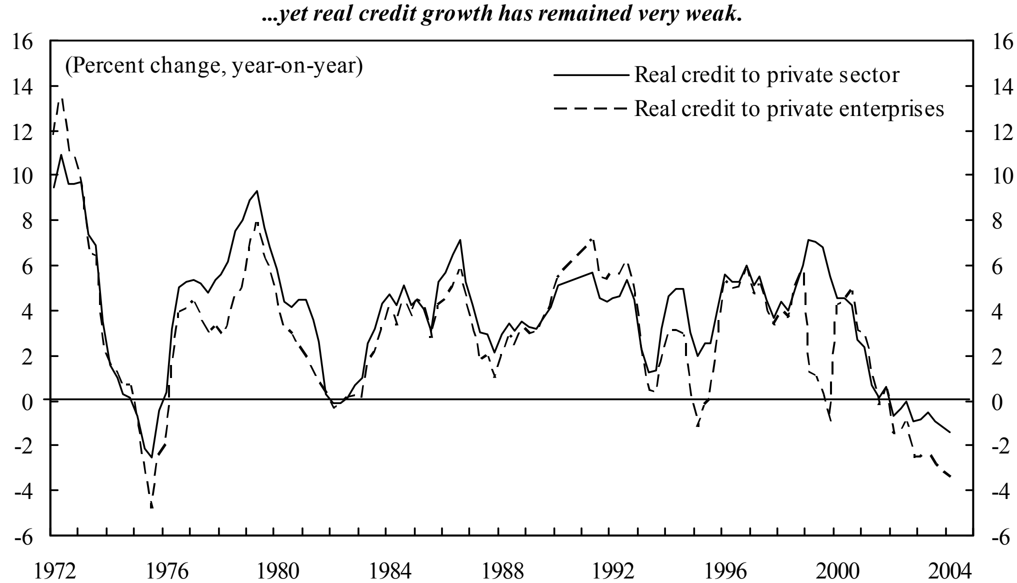
***..but are now easing in real terms...***




Sources: Deutsche Bundesbank; and IMF staff calculations.
1/ Monthly averages; inflation expectations measured by 12-month change in core CPI (excluding energy and food).

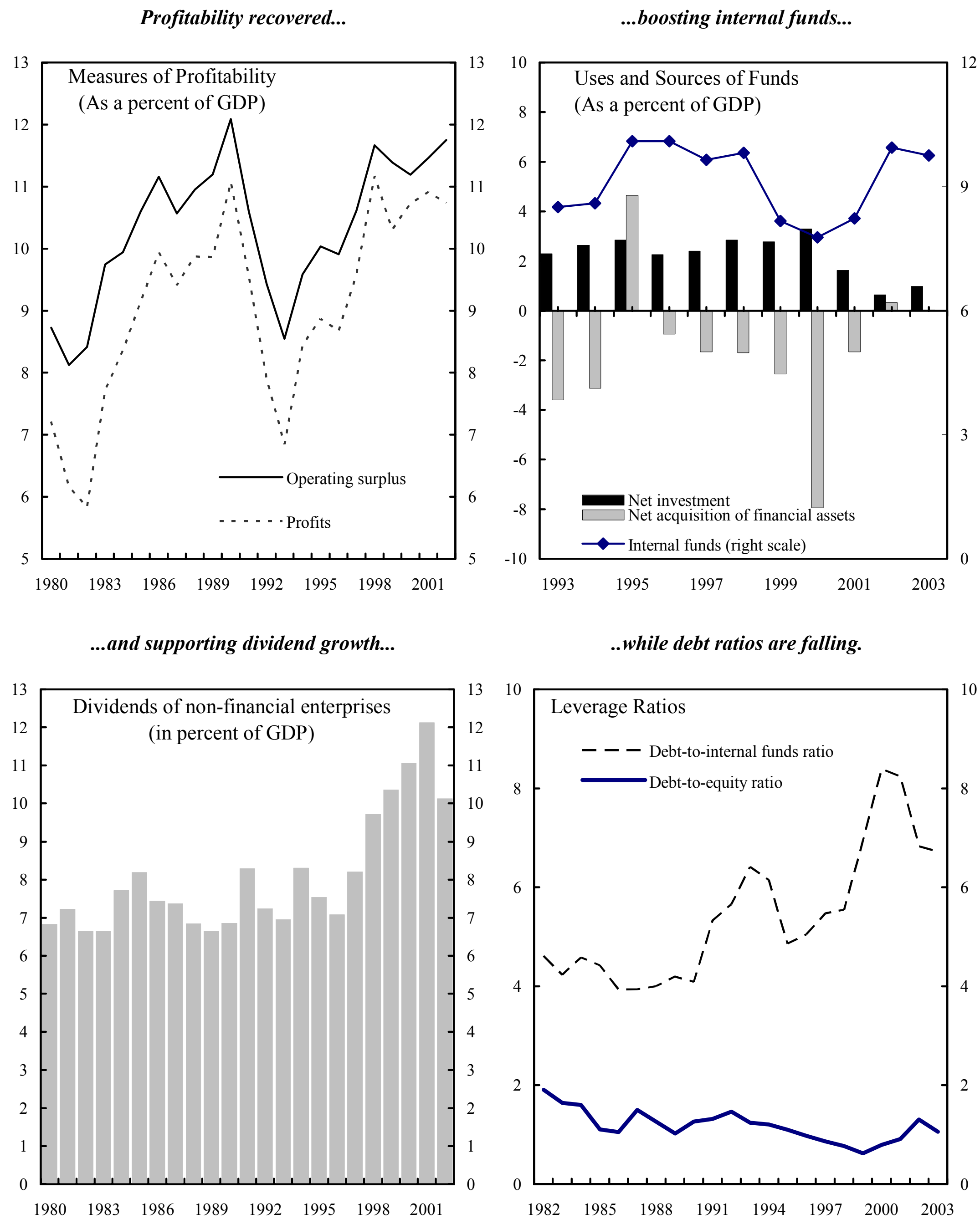
Figure 7. Germany: Real Bank Credit to the Private Sector, 1972-2004

***...yet real credit growth has remained very weak.***



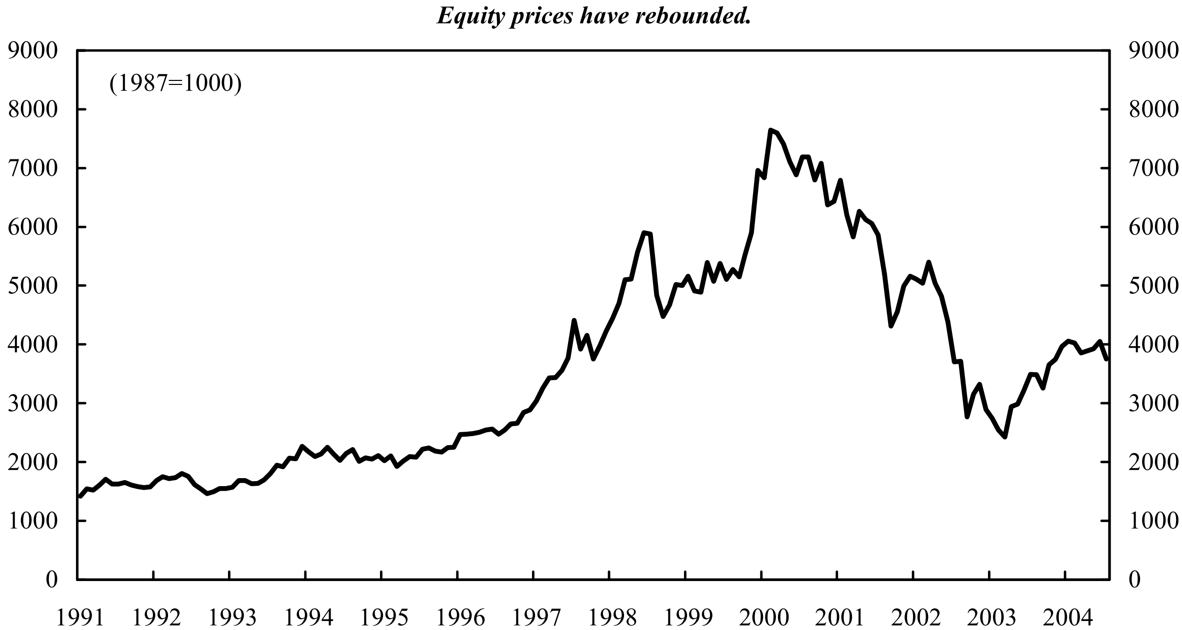

Sources: Deutsche Bundesbank; and IMF staff calculations.

Figure 8. Germany: Non-Financial Corporate Financial Accounts, 1980-2003




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

Figure 9. Germany: DAX 30, 1991-2004




Source: Bloomberg.

## III. Policy Discussions

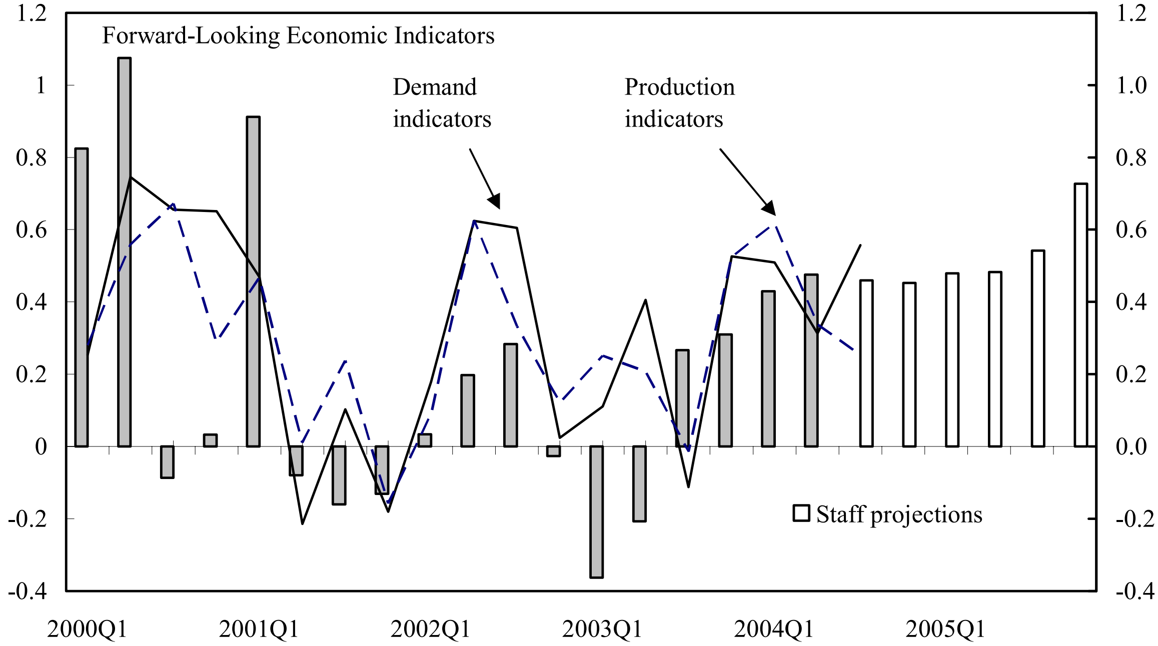
8. **The discussions took place against the backdrop of a difficult political environment**. Household confidence indicators and polls pointed to a sense of adjustment fatigue and uncertainty among economic agents, rooted also in the poor job market, sluggish wages, stagnant pension benefits, and rising health care costs. Following losses in regional elections, the government no longer controls the upper house and there is little agreement on how to proceed with fiscal consolidation. Although general elections are not due until the autumn of 2006, the political landscape is already affected by a heavy schedule of regional elections between September 2004 and May 2005.

9. **In this setting, and to avoid any risk of undercutting the recovery, the authorities were reluctant to augment Agenda 2010 or announce additional fiscal measures.** However, they underscored their commitment to the full implementation of Agenda 2010 despite popular opposition (including large street protests), pointing to the fundamental restructuring of support for the long-term jobless as evidence. The authorities viewed this as a major policy change that needed to be absorbed by the public before embarking on new reforms. They also stressed their intention to consider new budget measures later in 2004 if required to reduce the 2005 fiscal deficit to 3 percent of GDP.

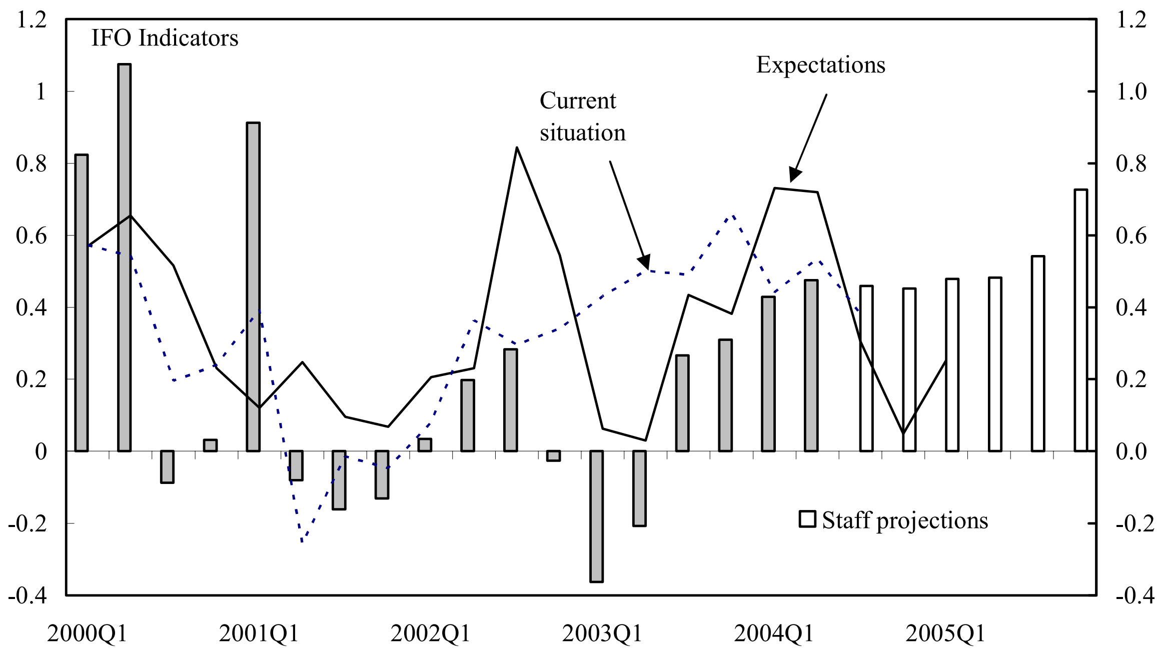
10. **The mission argued that the improved short-term outlook provided an opportunity to accelerate fiscal consolidation and deepen structural reforms.** Public debt

Figure 10. Germany: Implications of Monthly Indicators
for Quarterly GDP Growth, 2000-2005

***Demand and production indicators are broadly consistent with staff projections...***

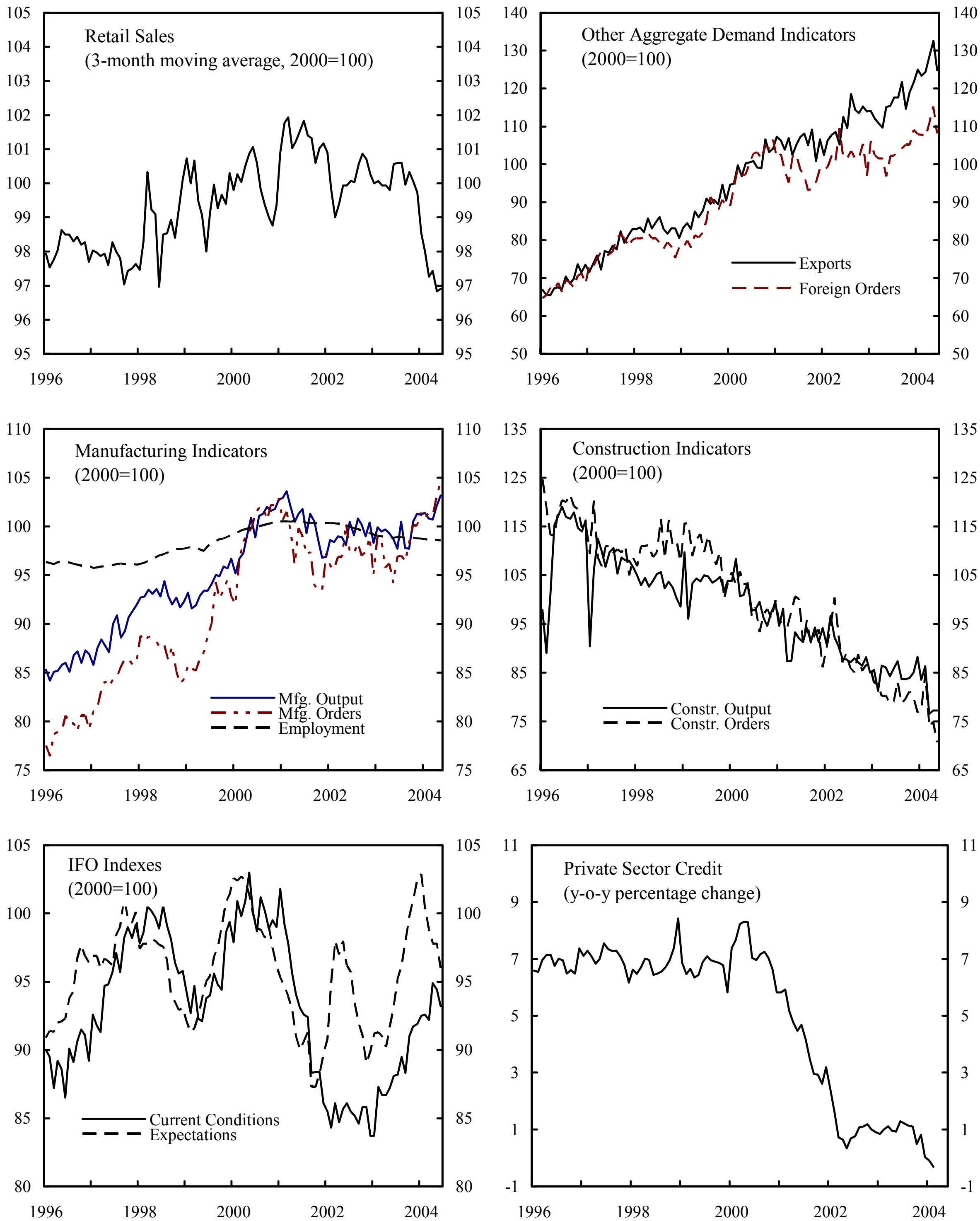



***..but IFO expectations indicators have weakened from high levels.***




Sources: Deutsche Bundesbank, IFO Institute; and IMF staff calculations. The GDP data are seasonally and calendar-day adjusted.

Figure 11. Germany: Summary of Monthly Indicators, 1996-2004




Sources: Deutsche Bundesbank; and IFO Research Institute.

is high and rising, and fiscal adjustment had already been postponed. At the same time, under German law, higher entitlement expenditure eventually tends to trigger higher payroll taxes to balance the social security system.[2] Without welfare reform, efforts to raise labor utilization, and fiscal consolidation, the impending demographic change and associated crippling payroll tax hikes will further stifle growth. Thus, the policy response needed to be forward looking to boost potential growth and deal with population aging, which will accelerate after 2010. As past policy reversals were one reason for the uncertainty among economic agents, the mission stressed the confidence benefits of casting the required policies in a coherent framework that focuses on longer-term prospects.

## A. The Economic Outlook

11. **There was agreement that the short-term outlook had improved**. The official forecast sees real GDP growth between 1½-2 percent in 2004-05, and there was concurrence that growth is likely to be at the upper end of this range in both years. Adjusting for the effects of additional working days in 2004 and fewer working days in 2005, this implies an acceleration in underlying growth of ⅔ percentage points in 2005. This scenario is built on a strong external impulse, consistent with the latest WEO forecast for global expansion, and assumes that this impulse will only gradually spill over to investment and employment, and then to consumption (Figure 12). Core inflation would remain subdued with continued wage moderation, although headline inflation would be affected by the rise in oil prices and one-off increases in health premia and tobacco taxes.

12. **However, the unbalanced nature of the recovery, with domestic demand still dormant, adds uncertainty to the projection, and there was agreement that the downside risks bear close watching.** Specifically:

- Disposable income might continue to be held back by weak employment and slow wage growth, with adverse consequences for consumption (Figure 13). The reform effort may also be causing uncertainty about future prospects, prompting households to save much of the 2004-2005 tax cut. Furthermore, construction was seen to remain weak for some time. At the same time, although the link between external and domestic demand was assumed to be weaker than in previous upswings, there was no evidence that the pass-through would not come into play and boost investment and employment. Indeed, interest rates continued to be moderate and banks were in better shape to support growth. Firms' balance sheets and profitability were also improving, which should facilitate investment.

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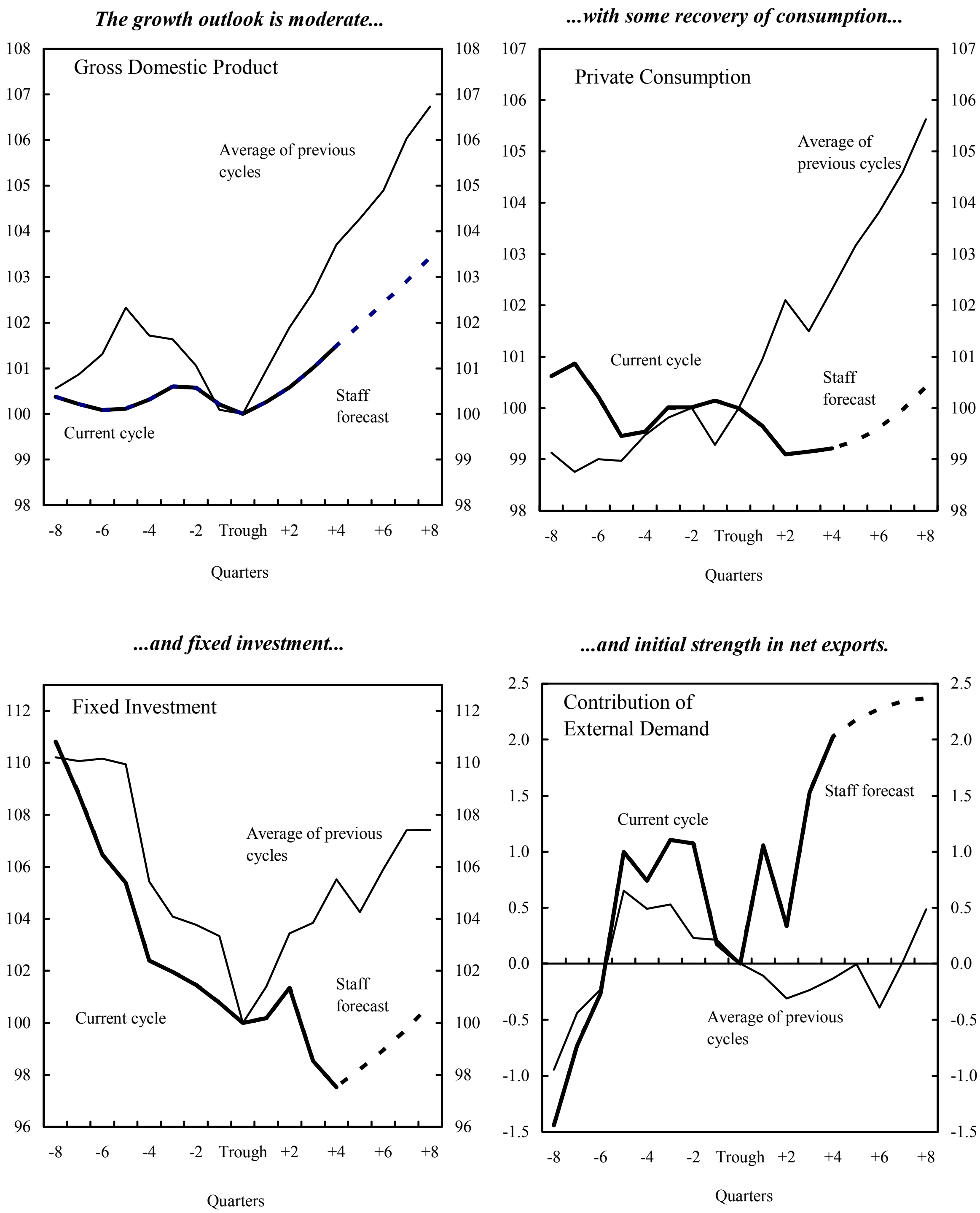
[2] By contrast, most other countries do not have this close link between entitlement spending and payroll taxes, making debt dynamics a priority in their long-term fiscal analysis.

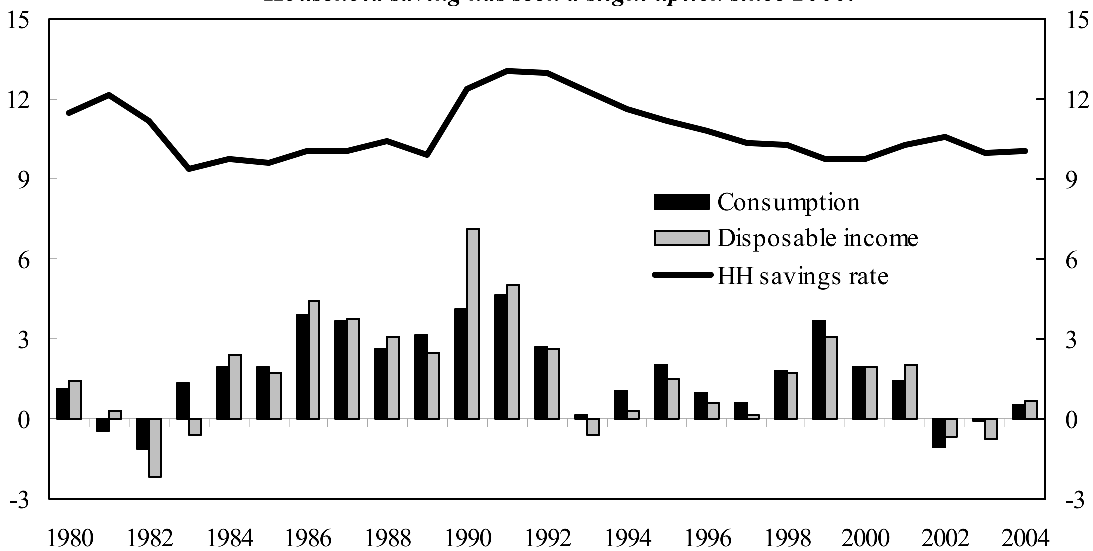
Figure 12. Germany: Comparison of Business Cycles, 1970-2005




Sources: Federal Statistical Office; and IMF staff calculations.
Note: All values are relative to trough equal to 100, except the contribution of external demand, where trough is equal to 0. The average of previous cycles is an unweighted average of troughs occuring in 1975, 1982, and 1994. The trough for the current cycle is assumed to be 2003 Q4.

Figure 13. Germany: Household Consumption and Income Growth Rates and Household Savings Rate, 1980-2005

***Household saving has seen a slight uptick since 2000.***




Sources: Deutsche Bundesbank; and IMF staff calculations and estimates.
Note: Growth rates are percent changes, and the savings rate is in percentage points.

- The authorities noted that the external impulse might subside before igniting the domestic economy in the event of even higher oil prices or new security disturbances.[3] Although the latest WEO forecast for global expansion has indeed become more cautious, it continues to point to strong world activity in 2005 (import demand growth relevant for Germany in excess of 6 percent). The staff agreed, however, that exports could slow if these risk factors were to disrupt the global upswing.

13. **Beyond the near term, however, the mission saw the upside potential for output growth constrained by poor labor utilization.** In contrast to most other European countries, Germany's working age population had already begun to decline (Figure 14).[4] After the current slack is worked off, this would impede growth unless incentives are improved and participation rates are raised to achieve better utilization of labor. The mission's analysis

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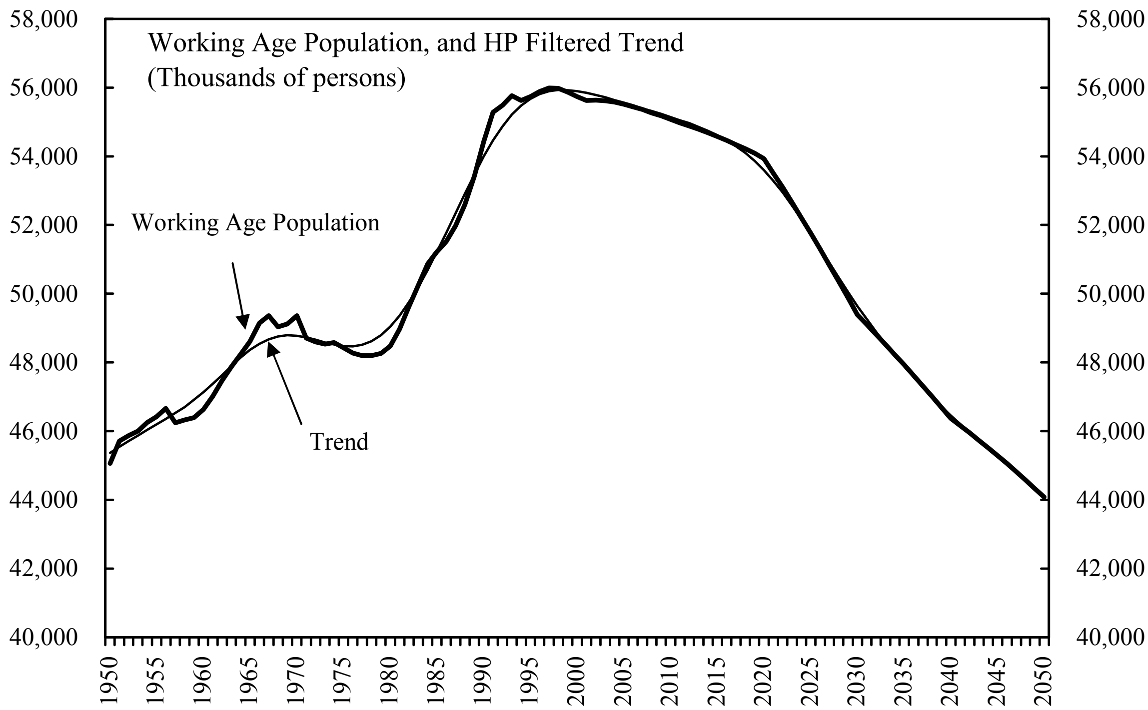
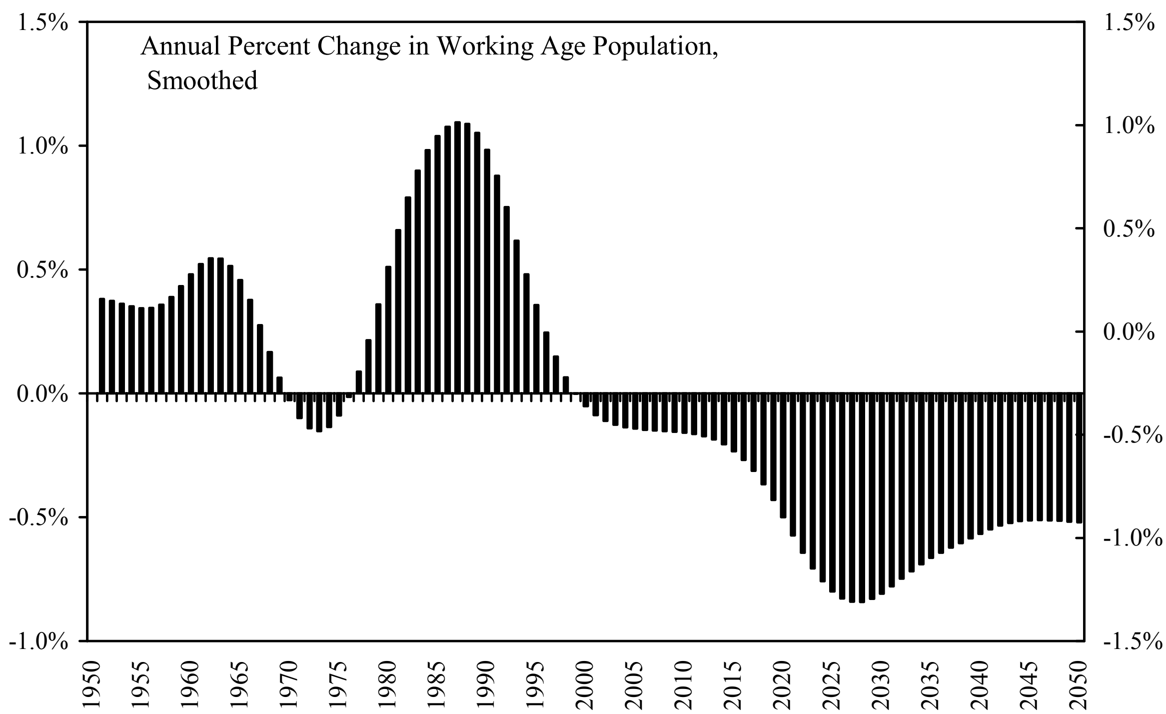
[3] Simulations suggest that a permanent US$5 per barrel price increase, at constant exchange rates, reduces real GDP growth by 0.2 percentage points a year for three years. However, so far, the euro appreciation has moderated somewhat the oil price increases in local currency.

[4] Between 1999-2004, the working age population in Germany declined by 1 percent, whereas it increased by over 2 percent in the euro area excluding Germany.

Figure 14. Germany: Dynamics of Working Age Population, 1950-2050




Source: German Authorities; Eurostat; OECD; and IMF staff calculations.
Note: Data from 1950 to 1990 for Germany as a whole have been interpolated backwards by splicing estimates for East Germany onto the available data for West Germany.

suggests that, based on the Agenda 2010 reforms so far, potential growth over the next five years or so would accelerate from only about 1½ percent to 1¾ percent a year, and this assuming that: (i) after the current cyclical slump, TFP resumes a 1 percent growth pace as in the 1980s and 1990s; (ii) the drop in total hours worked slows to 0.2 percent a year, from 0.4 percent rate in recent years; and (iii) the growth rate of the capital stock rebounds to 2 percent, consistent with improved fundamentals. Therefore, reforms beyond Agenda 2010 needed to be developed and implemented to support higher potential growth, which would also have important synergies with fiscal consolidation.

## B. Fiscal Policy and Entitlement Reform

### Fiscal consolidation

14. **There was agreement on the need to consolidate public finances as the upswing unfolds**. On real GDP growth of 1½ -2 percent in 2004-05, the authorities projected the general government deficit at 3.7 percent of GDP in 2004 and just under 3 percent in 2005. This adjustment would be driven by rising yields from past measures and tight budgeting. New measures would not make a significant contribution: savings from the proposed elimination of the subsidy for residential property—about ½ percentage point of GDP in the steady state—were small in the short run and would serve partly to fund higher spending on research and development. For 2006, the authorities targeted a deficit of 2 percent of GDP, followed by further reductions in 2007-08.

15. **The mission supported the authorities' fiscal objective for 2005 but questioned its attainability without further measures**. In 2004, the deficit would likely be somewhat higher than the authorities' estimate because of disappointing tax collections associated with sluggish wages and consumption; the structural deficit would widen slightly. For 2005, the mission's estimates of the yield from measures and macroeconomic effects on tax receipts were also more cautious than those of the authorities. Assuming a recovery of Bundesbank profits—which were unusually low in 2004—the deficit would still be lowered only to 3.3 percent of GDP. Further, on current policies, a large structural deficit would remain over the medium run.

16. **The mission recommended reducing the structural deficit by at least 1½ percentage point of GDP during 2004-06, in line with past advice.** After compensating for the 2004-2005 tax cuts (amounting to close to 1 percent of GDP), the carry-over impact of expenditure measures already implemented with the 2004 budget and one-off effects will yield a structural improvement of about ½ percentage point of GDP over 2004-06. Additional measures equivalent to 1 percent of GDP would thus be needed in 2005-06. With the adjustment in 2005 already sizable and the recovery still tentative, about two thirds of the additional adjustment could be backloaded to 2006, when growth is projected to be above potential. In any case, the automatic stabilizers should be allowed free play around the resulting 2005-06 structural adjustment path of ¾ percent of GDP per annum. Structural

Germany: Fiscal Adjustment
(In percent of GDP)

| | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| Overall balance | -3.8 | -3.9 | -3.3 | -2.7 |
| Change | | -0.1 | 0.6 | 0.7 |
| Macroeconomic effects 1/ | | -0.6 | 0.1 | 0.5 |
| Policy measures | | 0.4 | 0.3 | 0.2 |
| Tax cuts | | -0.7 | -0.2 | -0.1 |
| Health care reform | | 0.4 | 0.0 | 0.0 |
| Pension reform | | 0.1 | 0.2 | 0.0 |
| Hartz reforms | | 0.0 | 0.0 | 0.1 |
| Subsidy cuts | | 0.1 | 0.0 | 0.1 |
| Discretionary spending cuts | | 0.5 | 0.3 | 0.1 |
| One-off effects | | 0.1 | 0.2 | 0.0 |
| Bundesbank profits | | -0.2 | 0.2 | 0.0 |
| Flood related spending | | 0.3 | 0.0 | 0.0 |

1/ Impact of weaker (-) or stronger (+) growth in labor income and consumption tax bases, which differs from estimates of cyclical effects that focus solely on GDP.

Germany: General Government Balances
(In percent of GDP)

| | 2002 | 2003 | 2004 Est. | 2005 Proj. | 2006 Proj. | 2007 Proj. |
|---|---|---|---|---|---|---|
| | Staff Projections Based on Current Policies | | | | | |
| Overall balance | -3.7 | -3.8 | -3.9 | -3.3 | -2.7 | -2.2 |
| Overall balance, structural 1/ | -2.9 | -2.2 | -2.4 | -1.9 | -1.8 | -1.7 |
| | Staff's Normative Scenario | | | | | |
| Overall balance | -3.7 | -3.8 | -3.9 | -2.9 | -1.6 | -0.6 |
| Overall balance, structural 1/ | -2.9 | -2.2 | -2.4 | -1.5 | -0.7 | -0.2 |
| | Authorities' Intentions | | | | | |
| Overall balance | -3.7 | -3.8 | -3.7 | -3.0 | -2.0 | -1.5 |
| Memorandum item: | | | | | | |
| Output gap | -1.1 | -2.6 | -2.2 | -2.0 | -1.3 | -0.7 |

Sources: Ministry of Finance; and IMF staff estimates and projections.
1/ Conventionally measured, using OECD elasticity estimates and staff estimates of the output gap.

consolidation would need to continue beyond 2006, at a pace of ½ percentage point of GDP annually, to reach the structural surpluses of about 1 percent of GDP foreseen in the authorities' June 2001 *Guiding Principles of Fiscal Policy* before aging accelerates in 2010.

17. **The authorities believed that the 3 percent deficit goal was achievable in 2005 on present policies, but admitted that it would be a close call.** They indicated additional measures would be specified before the budget is passed in December if the upswing had become entrenched and the achievement of the deficit goal remained in doubt. The authorities agreed that further measures would be needed to attain the medium-run targets and move to a small surplus over the cycle.

18. **For adjustment measures, the mission proposed a continuation of the structural approach with durable expenditure cuts launched by the authorities in 2004.** Under this approach tax relief had been supported with cuts in entitlement expenditure, notably on pensions and health care. But efforts to cut tax expenditures and subsidies had not brought major savings. Using a broad definition, a bipartisan commission had estimated total expenditure on these items to be as much as € 120 billion (6 percent of GDP). However, the commission then proposed (and the government adopted) across-the-board cutbacks that cumulated to only ¼ percentage point of GDP over 2004-06. The mission felt that much deeper cuts were possible and warranted. Similarly, active labor market policies (ALMP) had proven costly (1 percent of GDP) but not very effective, and could be streamlined.

19. **The authorities agreed that the subsidies were good candidates for pruning and that across-the-board expenditure restraint was becoming increasingly difficult.** After a number of tight budgets, the room for further trimming of discretionary items had become limited. They would try again to abolish residential property subsidies, a difficult endeavor in the current political setting. Beyond that, they argued that the structural reforms to the entitlement system and labor markets might well have larger-than-presently estimated payoffs, as they might significantly alter the behavior of agents. These developments were difficult to forecast and thus prudent assumptions had been made in the budgetary projections.

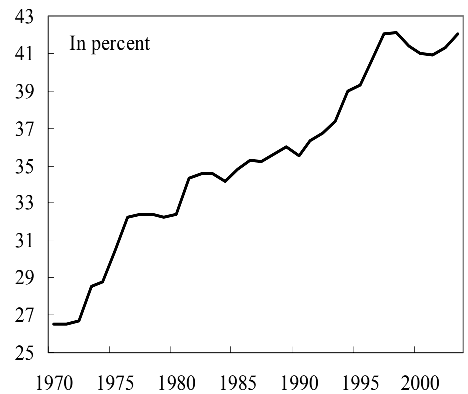
**Tax and entitlement reforms**

20. **The mission cautioned against embarking on further tax reform before the requisite expenditure cuts and fiscal consolidation are well in hand.** Several proposals are being discussed in policy circles, aimed at reducing distortions in the tax system and lowering tax rates. However, they also entail a significant risk of revenue losses in the short run, raising questions about their sustainability. Furthermore, the mission argued that, in view of

the high labor costs, limits on growth in entitlements combined with payroll tax cuts would be more effective in reviving labor markets and fostering employment and output.[5]

21. **The authorities shared the staff's position, explaining that their main priority was to limit the expansion of nonwage labor costs and improve labor utilization.** In this regard, several interlocutors saw merit in moving the funding of entitlement systems away from payroll taxes to consumption taxes but this debate was ongoing and no decision was expected soon. A specific area of discussion involved two proposals for changing the funding of health care to lessen the pressures on labor costs. This debate considers whether: (i) to replace the payroll tax with a lump-sum contribution per adult, while using the income tax to compensate those with low earnings (*Gesundheitsprämie)*; or, (ii) to widen the contribution base to include capital income and individuals presently in private health care programs to allow a lower average payroll tax rate (*Bürgerversicherung)*. However, any agreement on these proposals across the political spectrum was unlikely before the 2006 general elections.

Germany: Payroll Taxes in Percent of Gross Wages




22. **Accordingly, the authorities' efforts to slow the rise in payroll taxes were focused mainly on pension and health care expenditure**. They elaborated that:

- The recent introduction of a sustainability factor—which slows pension increases by ¼ percent for every percentage point increase in the old-age dependency ratio—would lower expenditure by about ¾ percent of GDP in the long run. In addition, efforts are underway to promote corporate and private (Riester) pension accounts, but these pillars are still small compared to the public pay-as-you-go system.

- The 2003 bipartisan health care reform, which was still under implementation, would lower spending by about ½ percent of GDP. The introduction of co-payments for doctors' visits and various improvements related to pharmaceuticals had already shown success. Moreover, limits on dental coverage would become effective in 2005. Steps to liberalize the pharmacy sector and to allow hospitals more freedom in deciding what services to offer were also under consideration.

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[5] General income tax cuts are less effective than payroll tax cuts as those in the lower income brackets pay a very small share of income tax receipts.

23. **The mission supported these reforms but argued that additional steps are needed to bolster confidence in the long-term viability of the entitlement system**. Various studies project that on current policies age-related spending would rise between 4-6 percentage points of GDP before peaking in 2050. Absent additional entitlement reform, payroll taxes would need to rise significantly to compensate, stifling growth (Box 2). Cutting discretionary spending further to offset higher entitlement outlays is not feasible either as it would jeopardize the efficiency of government.[6] Thus, further entitlement reform was inevitable to avoid unsustainable increases in the tax or debt burden.

24. **To help increase labor supply, the mission recommended linking the statutory retirement age to life expectancy rather than focusing narrowly on achieving benefit cuts.** Specifically, the 2003 Rürup pension reform commission had already recommended increasing the statutory retirement age from 65 to 67 years—by one month a year starting in 2011. Adopting this measure could contain future pension costs by another ½ percentage point of GDP. With life expectancy projected to rise by about one year per decade, the authorities acknowledged that raising the statutory retirement age would eventually be inevitable, but preferred to work first on the effective retirement age, which stood just over 60 years. Accordingly, they would gradually lift the age at which unemployed workers qualify for early retirement to 63 years, from 60 years presently. The statutory retirement age would be reexamined following the publication of sustainability reports at regular intervals, starting in 2006.

### C. Budgetary Institutions and Intergovernmental Fiscal Relations

25. **Budgetary institutions and intergovernmental fiscal relations have had a significant impact on the pace of reform and consolidation.** A background paper shows that over the past three decades all of Germany's governments faced an opposition-controlled upper house—which has to approve most economic reforms—for lengthy periods of their terms (Box 3). During such periods, little progress was made with fiscal consolidation, particularly in curtailing expenditure.

26. **Accordingly, the mission suggested measures to establish firmer commitments among different levels of government and introduce a degree of competition in fiscal federalism,** thereby improving fiscal discipline and the allocation of resources between the levels of government and among Länder. In particular:

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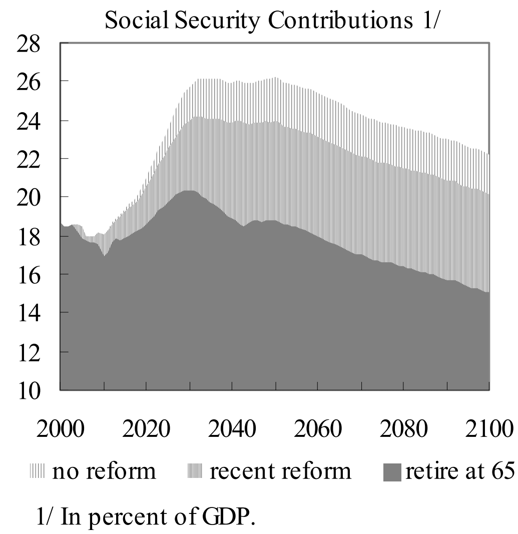
[6] Staff analysis suggests that plausible scenarios of reduced discretionary spending and interest saving would not be sufficient to absorb the future costs of aging (see, e.g., IMF Country Report No. 2/239).

**Box 2. Effects of Pension Reform on Growth**

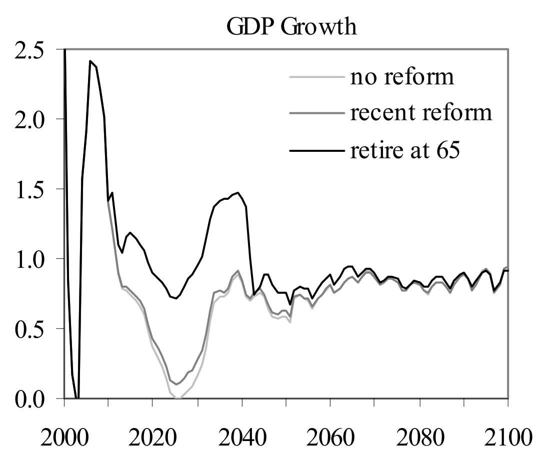
Most projections of social security finances ignore feedback effects on labor supply and capital accumulation and may hence underestimate the costs of aging. This is particularly important in Germany, where social security deficits, by law, eventually tend to lead to higher payroll tax rates. This could slow real GDP growth more sharply than currently envisioned.




Higher payroll taxes decrease real wages and reduce labor supply. Nickell (2003) estimates an elasticity of labor supply to payroll taxes of up to -0.3. This adds to the projected demographic decline of the labor force (even after allowing for immigration). With less labor input, GDP growth would slow. This would lower capital accumulation, which slows GDP growth further. Fiscal revenues would fall and require a further rise in contributions rates, leading to a downward spiral that could choke output growth after 2020.

The recent pension reform links benefits to the dependency ratio. Although this dampens the pressure on payroll taxes, it still leaves a substantial adverse growth effect, particularly from 2010 onward, when aging accelerates. The active generation still bears most of the financial burden of aging, and real wages may barely grow over the coming 20 years. Employment and GDP, and hence revenue, would be depressed, keeping pressure on contribution rates.

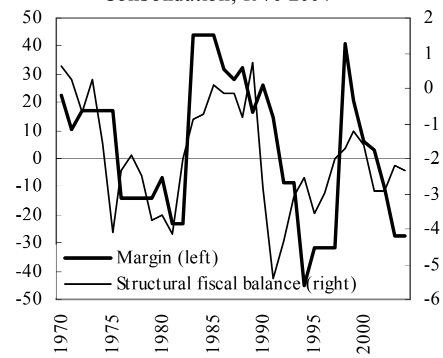
Raising the effective retirement age from currently 60 years to 65 by 2030 would support the labor force and output growth, and would distribute the financial burden more equally. Simulations suggest that with such a policy, both wages and pensions would be able to advance by about 10 percent in real terms over the coming 20 years. The employment ratio would stabilize, allowing GDP growth to be higher by about 1 percentage point per year relative to the "recent reform" scenario. The required increase in payroll taxes would be cut in half.



**Box 3: Political Economy Aspects of Fiscal Consolidation and Reform**

As discussed in the accompanying Selected Issues Paper, the structural fiscal balance has tended to be closely related to the government's combined margin of support in the lower and upper chambers of parliament. The lower chamber selects the government but the upper chamber can veto most tax laws and many structural reforms. Staggered regional elections change the majorities in the upper chamber in between the general elections. As a result, structural balances have usually improved in the early "honeymoon" years of a new administration. However, they have then eroded with losses in regional elections, as the central governments needed to accommodate a more diverse set of political interests.

Government Margin and Fiscal Consolidation, 1970-2004 1/




1/ The margin is the majority in votes for the government in both chambers of parliament.

This phenomenon puts added emphasis on ensuring that budgetary institutions and intergovernmental fiscal relations provide better incentives for fiscal management. Specific measures in this regard are outlined in Section III.C.

It was also found that since reunification structural reforms have lacked consistency. For example, new long-term care insurance was established in 1995, although the welfare state was already being stretched by reunification-related challenges. Many benefits were then cut back in 1997, including pensions through the introduction of a demographic factor. With a change in government, these cutbacks were repealed in 1999, but then re-introduced again in 2003-04 as part of Agenda 2010. Such swings in policy have likely disoriented the public about the direction and objectives of economic policy.

- The mission supported the government's plan to produce fiscal sustainability reports, but noted that the report's credibility would be boosted if it was prepared by a nonpartisan independent body that reported to the legislature. These reports should provide a comprehensive and long-run view of the general government accounts based on current policies.

- In framing its fiscal objectives, the government should make the accounting conventions and rules more consistent with the Stability and Growth Pact (as opposed to the current focus on a golden rule for the cash budget of the federal government).[7]

[7] The receipts from the Russia credit-linked note launched in July 2004 will count toward meeting the golden rule, but will not affect the Maastricht deficit.

- The Internal Stability Pact (ISP) should be bolstered by spelling out and firming up the commitments of various levels of government, including individual Länder.

- The mechanism for allocating revenue across Länder could be reformed to provide stronger incentives for fiscal consolidation by Länder.

- Länder should be given leeway to attune their regional public sector wage and welfare expenditures as well as revenues (through surcharges or discounts) to local circumstances, thereby improving the business environment for new investment.

27. **The authorities were sympathetic to these proposals and drew attention to the work of a parliamentary commission that was studying Bund-Länder relations**. Amid a perception that the federal system was contributing to reform gridlock, the commission was seeking to reduce the overlap of responsibilities between the various levels of government. Further, under the ongoing labor market reforms more scope would be given for innovative policies at the local level. The authorities acknowledged that an agreement with the Länder on how precisely to share the responsibility for conforming with the Stability and Growth Pact, including possible sanctions, would be desirable. They thought that they had taken a successful step in this direction with the ISP of 2002, and did not see much scope for further progress at this time.

## D. Labor Policies and Developments in the New Länder

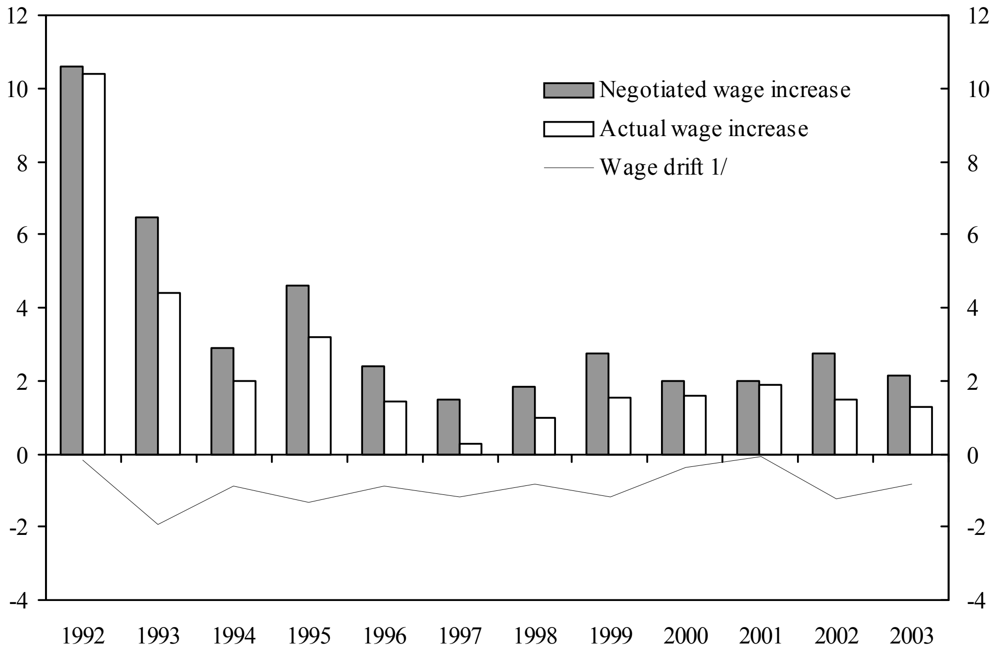
### Labor market developments and policies

28. **Rising wage flexibility has contributed to the increase in unemployment being below previous peaks, unlike in earlier slowdowns.** Continuing a trend since the mid 1990s, the vast majority of collective wage agreements concluded recently set pay increases around 2 percent, with actual pay hikes likely falling below the agreed headline number (Figure 15). The authorities observed that many collective wage bargaining agreements included clauses that allowed adjustments in working conditions to address firm- or sector-specific problems, flexibility they were actively encouraging. They also drew attention to contracts concluded recently by some large firms that stipulate an increase in the length of the workweek from 35 to 40 hours without additional pay, responding in part to intensified competition from the new EU member states. More generally, the majority of companies and close to half of all employees are no longer covered by collective wage bargaining.

29. **Combined with improved wage flexibility, the authorities thought their reforms to lower reservation wages and strengthen job intermediation would boost employment.** In January 2006, the duration of unemployment benefits would be cut, from a maximum of 32 months to 18 months for people aged 55 and over; others would continue to receive benefits for at most 12 months. Furthermore, as a key element in the Hartz IV reforms, in January 2005 open-ended unemployment assistance (UA) would be merged with social assistance into a new unemployment benefit II program (UB II). The authorities explained

that this reform entailed much tighter means tests for the 2.2 million UA recipients, probably withdrawing support from some 500,000 individuals. Those who remain eligible would receive lower benefits and would have to meet stronger job acceptance requirements. These reforms are significant, and successful implementation will require far-reaching changes by the Federal Labor Agency (FLA) and municipal agencies in charge of benefit administration and job intermediation.

Figure 15. Germany: Negotiated and Actual Pay Increases, 1992-2003
(In percent)




Source: Deutsche Bundesbank.
1/ Wage drift is the difference between negotiated and actual wage increases.

30. **The mission supported these well-targeted reforms and cautioned against their dilution, noting also that there is still an unfinished agenda**. The authorities underscored their strong commitment to the full implementation of the UB II program, dismissing calls to introduce legal minimum wages to soften the effect of tighter job acceptance criteria. Nonetheless, they thought that regions with unemployment rates above 15 percent needed special support within the framework of existing ALMPs to better manage the transition to UB II. The mission stressed that ensuring a strict, rules-based, interpretation of the job acceptance requirement—and sanctions for those who refuse a job offer—was key for the success of the reforms. This required a proper incentive structure within the FLA and municipalities. Regarding the next steps of the reform agenda, the mission noted that hiring and firing regimes are still rigid and costly, and impede flexible labor management. Further, more flexibility could be introduced in the legal framework for wage bargaining, which currently restricts the right to conclude firm-specific and collective wage agreements solely to trade unions.

31. **The mission also emphasized that labor force participation needs to be raised to mitigate demographic pressure on growth and public finances.** Labor utilization is particularly low for workers older than 55 years, women, and the young. The authorities explained that the few remaining early retirement schemes were being phased out and that the cut in the duration of unemployment benefits would make it harder to focus downsizing on older workers. The mission noted that this should be complemented by removing financial disincentives and other obstacles to working beyond the statutory retirement age. Regarding labor force participation of women, the authorities pointed to recent measures that lower social security contributions on part-time work, thereby mitigating tax-related disincentives for secondary income earners, and to programs that foster full-day schooling.

**Developments in the new Länder**

32. **Labor market problems are particularly acute in the new Länder but gradual adjustment is underway**. Union membership and collective wage bargaining are far less widespread in the new Länder. Labor costs continue to fall relative to those in the old Länder—in manufacturing they are now below western levels, fostering rapid expansion of output—and per capita incomes are catching up. However, the bursting of the subsidy-induced construction bubble is still weighing heavily on activity.

33. **Discussions focused on policies that might accelerate economic convergence**. Enterprise surveys suggest that lower wages and longer workweeks are now key reasons to locate in the new Länder, but a 2003 progress report points to public infrastructure gaps, particularly in the area of transportation. Rather than replacing old special incentive schemes for investment with new ones, the mission advocated allocating a larger share of public expenditure to investment, which is presently being rolled back by many local governments. Furthermore, in the context of the discussions on federalism, the mission also argued that more freedom for individual Länder to shape their public sector wage and welfare policies, together with some independence in setting tax rates, might allow them to improve their business environment. The authorities viewed the sluggish growth in the old Länder as a key obstacle to a better performance of the new Länder. Policies thus had to be the same across Germany, targeting lower nonwage costs through entitlement reforms and less generous support for the jobless. Ultimately, these reforms would create the room for more public investment.

The Catch-up of the New Länder

| | 1991 | 1997 | 2003 |
|---|---|---|---|
| (Old Länder = 100) | | | |
| GDP per capita | 33 | 62 | 64 |
| Labor productivity | 35 | 68 | 73 |
| Construction investment per capita | 70 | 173 | 100 |
| Unit labor costs | 141 | 112 | 107 |
| Memorandum item: | | | |
| Unemployment rate (in percent) | 10.2 | 17.8 | 18.5 |

Source: Die Lage der Deutschen Wirtschaft in Fruejahr 2004.

## E. Product Markets and Trade Policy

34. **The authorities pointed to progress in liberalizing network industries and agreed on the need to reform crafts and services to boost more labor-intensive growth.** Competition in the telecoms sector was strong; in energy, difficulties with respect to network access and high electricity prices were being addressed by moving from a model of industry self-regulation to supervision by a regulatory authority; and in the postal sector the gradual elimination of the national monopoly had created some 24,000 jobs among competitors. Furthermore, work was ongoing on adapting German to EU competition law. The key outstanding issues were (i) the restructuring of the national railway company; (ii) the liberalization of fees for services provided by selected professions; and (iii) the removal of barriers to entry in crafts. The mission underscored that liberalizing the crafts and services sector provides a promising avenue to foster more labor intensive growth. The authorities pointed to a recent reform that had opened entry into crafts that accounted for roughly 10 percent of craft employment.

Regulatory Reform in Product Markets, 1978-1998 1/
(Scale 0-6 from least to most restrictive)

| | 1978 | 1988 | 1998 |
|---|---|---|---|
| Italy | 5.8 | 5.8 | 4.3 |
| France | 6.0 | 5.7 | 3.9 |
| Netherlands | 5.3 | 5.5 | 3.0 |
| Germany | 5.2 | 4.7 | 2.4 |
| US | 4.0 | 2.5 | 1.4 |
| UK | 4.3 | 3.5 | 1.0 |

Source: Nicoletti et al. (2001).
1/ Average of indicators for 7 industries: gas, post, electricity, telecoms, air transport, railways, freight.

35. **The authorities reiterated their strong support for multilateral trade liberalization and agricultural reform.** They welcomed the EU initiative to put on the table all export subsidies, to show flexibility on various Singapore issues, and to give the poorest and most vulnerable WTO members a “round for free.” They were also pushing to liberalize the trade regime covering bananas, rice, and sugar. Regarding the CAP, Germany had strongly advocated decoupling support from production, most recently for tobacco, olives, and cotton.

36. **The authorities saw major benefits from EU enlargement, together with the full adoption of Agenda 2010 reforms to foster speedy restructuring.** Various studies found that the catch-up of incomes of the new EU members would further boost trade flows and incomes in Germany, particularly in the new Länder. Jobs in low-skill sectors faced increasing competition for many years but the authorities saw outsourcing as beneficial for competitiveness. They emphasized that the economy had to be made more flexible, notably through Agenda 2010 reforms. To help manage the flow of workers from the new member states, Germany would continue applying for now the national restrictions (i.e., work permit schemes) and provisions from bilateral agreements on labor migration with the new member states.

Exports to Poland and to Czech Republic
(Average annual growth, in percent)

| | 1994-2001 |
|---|---|
| Germany | 16.6 |
| New Länder | 22.4 |

Source: DIW Weekly Report 33/2003.

## F. Financial Sector Developments and Policies

37. **The authorities reported that financial sector strains had eased and that progress had been made in addressing structural weaknesses** (Table 3). The rating downgrades of major banks and insurance companies had ended and they had successfully tapped capital markets over the past year. In the banking sector, operating income had risen moderately within all three banking pillars in 2003, driven mainly by cost cutting.[8] Falling loan loss provisions had supported a recovery of earnings which, together with the disposal of risky assets and recovering equity markets, had boosted capitalization. However, the authorities acknowledged that raising revenue remained the "cardinal problem" for German banks.[9] Consolidation in the insurance sector was advancing too, although at a slower pace than in banking. Balance sheets had benefited mainly from the recovery in equity markets but also from lower payouts on life insurance policies.

38. The authorities also pointed to progress in preparing public sector banks for the phase-out of government guarantees in mid-2005. Although the German banking system remains highly segmented along three pillars, they noted that increased cooperation across pillars was emerging, mostly in back-office operations. The public banks (Sparkassen and their head institutions, the Landesbanken) were preparing for the end of government guarantees, which would hit the Landesbanken particularly hard, by: (i) securing more capital from

[8] However, most major banks still made large losses in 2003, partly reflecting large one-time writeoffs, and their results remained below European peers.

[9] IMF Occasional Paper 233 "Germany's Three-Pillar Banking System: Cross-Country Perspectives in Europe" found that German banks were lagging their European counterparts mainly in revenue mobilization, rather than cost control.

the Sparkassen associations of their own Land;[10] (ii) strengthening the institutional protection scheme for Sparkassen and Landesbanken; or (iii) seeking partnerships or mergers with stronger Landesbanken of other Länder. The authorities reported that these efforts had been recognized by rating agencies with shadow ratings on unguaranteed obligations in the single "A" range, except for a few institutions whose ratings were in the "BBB" range. Guaranteed obligations—which can be issued until mid-2005—typically carry a "AAA" rating.

39. **Although helpful, the mission noted that the moves by the Landesbanken were insufficient to fundamentally strengthen the banking system.** Profits from current business lines of most of the Landesbanken will be largely eliminated as their refinancing costs begin to rise in line with the lower rating on unguaranteed obligations.[11] A major restructuring of business lines is thus crucial, driven by a wide set of market forces, including greater transparency about the operations of public sector banks followed by private ownership. Hence, the mission reiterated the key FSAP recommendations to facilitate market-based restructuring by changing the legal framework so as to reduce barriers to restructuring. For example, changing the public law structure of Landesbanken and Sparkassen would permit their transformation into joint stock corporations, opening the door for private capital and consolidation within or across pillars. The authorities agreed on the desirability to open public sector banks to private capital, which also would allow more flexible responses to financial stress. They acknowledged that the restructuring process, especially cross-pillar consolidation, was constrained by legal obstacles, drawing attention to an unsuccessful attempt by one municipality to sell its Sparkasse, but said that removing these obstacles was a matter for Länder governments. The mission indicated that the Federal authorities nevertheless needed to engage the local authorities if the reforms fell short, as persistent inefficiencies in the banking system would have adverse fiscal and financial effects beyond the local level.

40. **In Germany's insurance sector, which is one of the largest in the world, strong competition and large capacity in the life segment continue to weigh on profits.** Investment income and solvency recovered with equity markets and property and casualty and reinsurance companies also benefited from rising premium income and falling claims. But in the life insurance sector, large capacity and stiff competition stand in the way of a sustained recovery of profitability, notwithstanding adjustments to the rate of return typically guaranteed to policyholders.[12] The authorities explained that the returns paid on life insurance

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[10] Together with the Land government these associations often are owners of the Landesbanken.

[11] See IMF Occasional Paper 233 for a discussion of Landesbanken ratings and profitability and other issues related to public sector banking in Germany.

[12] The officially-set technical discount rate, which typically acts as the minimum rate of return guaranteed by companies to new policyholders, was lowered from 3.25 to 2.75 percent on January 1, 2004.

policies had finally fallen to levels in line with "economic" returns of the companies. With the recovery of equity markets, the sector as a whole had moved from holding hidden losses to hidden gains in 2003; regulatory solvency was met with an adequate margin. These improvements had also been borne out by the results for the stress tests, which had been passed by companies accounting for about 90 percent of life insurance business.

41. **The mission noted that further adjustments are needed to strengthen the life insurance sector**. In particular, it will be important to abolish the mandatory 90:10 profit split (which stipulates that at least 90 percent of profits must be distributed to policy holders) to allow companies to strengthen capital and prepare for the introduction of EU's Solvency II capital adequacy scheme. The authorities said that companies were already beginning to adjust in anticipation of Solvency II, even if the related EU Directive would not be finalized for several years. In their view, the 90:10 split did not constrain capital, but they agreed that in the context of Solvency II a mandatory profit split had little rationale. Beyond work toward Solvency II, the authorities expected self-supervision of the industry to improve matters. In this context, they pointed to the introduction of Protektor AG—a joint-stock company held by the industry that had the task of taking over insurance policies of insolvent members. The authorities hoped that contributions to Protektor AG would become risk-based and assessed by industry experts.

42. **The authorities pointed to several supervisory improvements in response to the FSAP and highlighted initiatives to foster financial intermediation.** Although they had not repeated last year's stress tests for the banking sector, the Federal Agency for Financial Services Supervision (BaFin) and the Bundesbank were developing an early warning system. The Bundesbank had begun publishing a regular financial stability report. BaFin had refined the insurance industry stress tests in an effort to move toward more risk-based supervision. A major project underway was to bring reinsurance business under the umbrella of the supervisory authorities, a key FSAP recommendation. Furthermore, the authorities pointed to the introduction or development of regulatory frameworks for various new financial instruments, including hedge funds, asset backed securities, real estate investment trusts, and inflation-indexed government debt. The goal is to deepen capital markets, providing firms more financing options and allowing for better allocation of risk among market participants.

### G. Other Issues

43. A recent FATF Report on the Observance of Standards and Codes for AML/CFT concludes that Germany's system is comprehensive, effective, and efficiently implemented. However, a few deficiencies should be addressed regarding terrorist financing, including ratification of the *UN International Convention of the Financing of Terrorism (1999)*; criminalization of financing for individual terrorists who are not part of a larger terrorist organization; and specifics related to the freezing of property and wire transfers.

44. Germany's **statistics** are generally of high quality and conducive for effective surveillance. Collecting direct national accounts data on inventories and compiling quarterly

accounts for the general government would be an important enhancement. In response to an FSAP recommendation to produce more comprehensive and timely data on financial sector soundness, the authorities intend to participate in the IMF's initiative to compile Financial Sector Soundness Indicators.

45. **ODA** was 0.3 percent of GNI in 2003.

## IV. Staff Appraisal

46. **Germany has made important headway over the past year in addressing deep-seated structural problems.** However, yet more difficult reform and fiscal consolidation measures are needed if the improving cyclical conjuncture is to translate into more robust and sustained medium-term growth. Strong German leadership in economic reform is also essential because of the regional and global ramifications of its poor performance.

47. **A modest cyclical recovery, driven by the rest of the world, is taking hold, but longer run prospects continue to be of concern**. With sustained wage moderation and efforts underway by social partners to make labor markets more flexible, competitiveness has improved and exports are responding well to increased world demand. The recovery, however, remains unbalanced, with domestic demand still dormant. The external impulse is expected eventually to lead to a revival in investment and consumption, but these links may be somewhat weaker than in previous German recoveries. In any event, the longer run is of increasing concern as potential output growth is constrained by poor labor utilization compounded by population aging, which will accelerate sharply after 2010—just one business cycle away—and impose a crushing burden on the economy.

48. **Agenda 2010 represents a forceful start of needed reforms in Germany but will need to be augmented to ensure that demographic changes do not stifle growth.** Managing a redistributive state is much more difficult in a slow-growing economy with an aging population, increasing the urgency of taking action. It is encouraging, therefore, that policymakers have started to focus on the need to adapt the welfare system and increase potential growth by bolstering labor utilization through sharpened incentives to work.

49. **At the same time, with public debt on a disturbing upward trend, fiscal consolidation should be given renewed impetus**. The 2004 general government deficit will remain well above the Maastricht reference ratio for the third consecutive year. Although durable measures are being implemented to reduce expenditure, these have been offset by tax cuts. Nonetheless, the high deficit is also a legacy of insufficient expenditure restraint during previous upswings. Achieving small surpluses over the cycle will ease the pressure from debt and put Germany in a better position to face looming demographic changes.

50. **The improved near-term outlook provides an opportunity to accelerate fiscal consolidation and structural reform that should not be missed.** Complementing fiscal consolidation with labor market and entitlement reforms will not only stimulate important

synergies, but also provide the public assurance of the long-run sustainability of government finances and the welfare state. Indeed, communicating a coherent forward-looking strategy should also help revive confidence and support domestic demand in the near term.

51. **The objective to reduce the structural deficit by at least 1½ percentage points of GDP over the period 2004-2006 remains appropriate.** Measures that are projected to yield about one-third of this improvement are already in the pipeline. Hence, additional durable measures—yielding about one percentage point of GDP—still need to be implemented to meet the 2004-2006 objective. Of this, policy measures totaling about ⅓ percentage point of GDP need to be adopted before the 2005 budget is finalized to lower the deficit below 3 percent of GDP. Additional measures of this magnitude strike the right balance between putting the deficit on a clear downward path and avoiding undue strain on the recovery. After 2006, further steps of at least ½ percentage point of GDP per year would then be needed until a small structural surplus is achieved.

52. **Larger cuts in tax expenditures and subsidies are the most promising avenue to obtain durable consolidation**. Using a broad definition, these have been identified to amount to as much as 6 percent of GDP by a high-level bipartisan commission, but the agreed reductions so far have been very small. Equity and efficiency consideration call for a more far-reaching approach and the plans to abolish residential property subsidies are thus welcome. A targeted approach is also required because it will help reduce the reliance on across-the-board expenditure restraint, which will be difficult to sustain over the medium run.

53. **With the German entitlement system largely based on payroll taxes, and in view of population aging, entitlement reforms are key to creating jobs and growth.** The government's caution about additional tax reforms is thus appropriate because entitlement reforms that contain payroll taxes are the more pressing priority. Moderate budget surpluses should be accompanied by pension and health care reforms to address the impending costs of aging.

- **In the pension system,** the recent adoption of the sustainability factor that links the pension benefit replacement rate to the old-age dependency ratio, and steps to raise the effective retirement age, were necessary and important, but are insufficient to balance the system in the long run. Absent further reform, the payroll tax burden is still expected to reach onerous proportions, likely stifling economic growth. Therefore, as is increasingly accepted, the statutory retirement age will have to be raised in line with longer life expectancy. Indeed, with weak domestic demand, greater emphasis needs to be put on raising retirement ages rather than measures that reduce household income. Employees should also be allowed to work longer if they wish to do so, without being financially penalized.

- **In the health care system,** efforts could usefully focus on improving supply and funding. Progress so far has focused on transferring selected costs to users and containing demand. The next stage of reform needs to target rigidities in the supply of health care, and the measure being considered by the government, such as allowing hospitals to decide for themselves what services they provide, and liberalizing the pharmacy sector, deserve broad support. It will also be crucial to break the link between health care financing and wages.

54. **Improving budget institutions and intergovernmental fiscal relations can provide incentives for better fiscal management**. The central tenets need to focus on enhancing transparency, establishing firmer commitments among different levels of government, and introducing a degree of competition in fiscal federalism, thereby improving fiscal discipline and the allocation of resources between the levels of government and among the Länder. Valuable steps in this direction would include the adoption of accounting conventions and fiscal rules that are more consistent with the Stability and Growth Pact, and allowing lower levels of government additional degrees of freedom to raise revenue and pursue independent—but deficit-constrained—expenditure policies. The fiscal sustainability reports to be produced in the near future can be expected to further the public debate about the reform of entitlement programs; having these reports drafted by an independent body will boost their credibility.

55. **The labor market is becoming more flexible but wage moderation and longer working hours alone are not sufficient to boost labor supply.** The willingness of social partners to adopt innovative wage bargaining agreements that tailor pay and working time to local labor market conditions and global competitive pressures are laudable. Although this has undoubtedly played a role in improving external performance, high long-term unemployment, particularly among older workers and the less skilled, remains a major concern, as does the low labor force participation in general. Further labor market modifications are therefore necessary to cut unemployment and increase participation—especially relevant in view of the already declining working age population. The continued development of flexible wage and employment contracts, including for small and medium-sized enterprises, will be important in this regard.

56. **The labor market reforms under Agenda 2010 are path breaking but they are not the last word in this critical area**. The shortening of the duration in long-term unemployment benefits and the reduction of their replacement rate are well-targeted. The administrative arrangements for the program now need to be made robust so that it becomes fully functional in early 2005. Familiarity with local conditions and close cooperation among the implementing authorities will be vital to maximize the prospects for reintegrating the long-term unemployed. Strict enforcement of job acceptance requirements will be important to improve work incentives. Complementing this far-reaching reform with further pension and health care reforms that allow lower payroll taxes will encourage job creation and labor demand. Beyond these measures, it will also be important to take further steps to make hiring and firing more flexible, and to support the trend toward greater flexibility by reducing remaining central controls on wage bargaining.

57. **Germany has made good progress in liberalizing network industries and product markets, but crafts and service sectors still need far-reaching liberalization.** Improving entry and exit conditions in service industries is important to stimulate investment and employment in these labor intensive sectors of the economy. The liberalization of fees for selected professions and the removal of barriers to entry in crafts need to be accelerated. Germany's support for multilateral trade liberalization, including in agriculture, is welcome.

58. **The financial system has benefited from the cyclical recovery but fundamental reform has progressed only slowly**. Profitability has rebounded, write-offs have become less pressing, and higher asset prices have improved balance sheets. Supervision is being strengthened and broadened, notably to reinsurance companies. Furthermore, innovations are being introduced in the capital market. Nevertheless, certain key concerns noted in the 2003 FSAP exercise remain, notably the need for banks to improve their revenue efficiency through the development of new business strategies, and for further restructuring in the life insurance segment.

59. **Most importantly, legal and regulatory impediments to market driven restructuring need to be addressed to foster structural change in the financial system.** Efforts to strengthen public sector banks—notably the Landesbanken—are being guided by short-term rating concerns and narrow interests of lower levels of government. Instead, it remains vital for the Länder to create legal frameworks that transform public sector banks into joint-stock corporations, which would allow a better harnessing of market signals for restructuring and strengthen the resilience of the banking system to shocks. In the insurance sector, it will be important to broaden the supervisory focus beyond solvency margins. In this regard, the mandatory 90:10 profit split with policy holders is not consistent with the upcoming provisions of risk-based insurance supervision, and this is an opportune time to abolish this regulation.

60. **Germany's statistics are adequate for surveillance**. The steps to enhance the production and timeliness of financial sector soundness indicators are welcome. However, some improvements could facilitate the monitoring of fiscal policy.

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

Table 1. Germany: Basic Data

| | |
|---|---|
| Total area | 357,041 square kilometers |
| Total population (2003) | 82.54 million |
| GDP per capita (2003) | US$ 29, 173 |

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 1/ | 2005 1/ |
|---|---|---|---|---|---|---|---|
| | (Percentage change at 1995 prices) | | | | | | |
| Demand and supply | | | | | | | |
| Private consumption | 3.7 | 2.0 | 1.7 | -0.7 | 0.0 | 0.1 | 1.2 |
| Public consumption | 0.8 | 1.1 | 1.0 | 1.9 | 0.1 | 0.2 | 0.7 |
| Gross fixed investment | 4.1 | 2.7 | -4.2 | -6.4 | -2.2 | -0.9 | 2.6 |
| Construction | 1.4 | -2.6 | -4.8 | -5.8 | -3.2 | -1.8 | -0.5 |
| Machinery and equipment | 7.2 | 10.1 | -4.9 | -8.6 | -1.4 | -0.4 | 5.8 |
| Final domestic demand | 3.2 | 2.0 | 0.2 | -1.5 | -0.4 | -0.1 | 1.4 |
| Inventory accumulation 2/ | -0.4 | -0.1 | -1.0 | -0.4 | 0.9 | 0.3 | 0.0 |
| Total domestic demand | 2.8 | 1.9 | -0.8 | -1.9 | 0.5 | 0.2 | 1.4 |
| Exports of goods and nonfactor services | 5.5 | 13.5 | 5.7 | 4.1 | 1.8 | 10.7 | 6.3 |
| Imports of goods and nonfactor services | 8.4 | 10.6 | 1.0 | -1.6 | 4.0 | 6.5 | 6.1 |
| Foreign balance 2/ | -0.7 | 1.0 | 1.6 | 1.9 | -0.6 | 1.9 | 0.5 |
| GDP | 2.0 | 2.9 | 0.8 | 0.1 | -0.1 | 2.0 | 1.8 |
| Output gap (In percent of potential GDP) | -0.1 | 0.9 | 0.3 | -1.1 | -2.6 | -2.2 | -2.0 |
| | (In millions, unless otherwise indicated) | | | | | | |
| Employment and unemployment | | | | | | | |
| Labor force | 41.3 | 41.8 | 41.9 | 41.9 | 41.9 | 41.9 | 41.9 |
| Employment | 38.1 | 38.7 | 38.9 | 38.7 | 38.3 | 38.1 | 38.2 |
| Unemployed 3/ | 3.3 | 3.1 | 3.1 | 3.3 | 3.7 | 3.8 | 3.7 |
| Unemployment rate (in percent) 4/ | 8.4 | 7.8 | 7.8 | 8.7 | 9.6 | 9.7 | 9.5 |
| | (Percentage change) | | | | | | |
| Prices and incomes | | | | | | | |
| GDP deflator | 0.5 | -0.3 | 1.3 | 1.5 | 1.1 | 1.1 | 1.2 |
| Consumer price index (harmonized) | 0.6 | 1.4 | 1.9 | 1.3 | 1.1 | 1.8 | 1.3 |
| Average hourly earnings (total economy) | 2.0 | 3.3 | 2.4 | 2.1 | 1.6 | 1.5 | 2.0 |
| Unit labor cost (industry) | 2.1 | 0.1 | 3.3 | -0.4 | -1.2 | -0.8 | -0.3 |
| Real disposable income 5/ | 3.1 | 2.0 | 2.3 | -0.3 | 0.2 | 0.5 | 0.6 |
| Personal saving ratio (in percent) | 9.8 | 9.7 | 10.2 | 10.5 | 10.7 | 9.8 | 9.3 |

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

1/ IMF staff projections.

2/ Growth contribution.

3/ National accounts definition

4/ Eurostat definition.

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

Table 1. Germany: Basic Data (concluded)

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 1/ | 2005 1/ |
|---|---|---|---|---|---|---|---|
| Public finances 2/ 3/ | | | | (In billions of euros) | | | |
| General government | | | | | | | |
| Expenditure | 965 | 929 | 1,001 | 1,027 | 1,039 | 1,040 | 1,056 |
| (In percent of GDP) | 48.7 | 45.7 | 48.3 | 48.7 | 48.8 | 47.4 | 46.8 |
| Revenue | 935 | 956 | 943 | 950 | 958 | 955 | 980 |
| (In percent of GDP) | 47.3 | 47.1 | 45.5 | 45.1 | 45.0 | 43.5 | 43.5 |
| Overall balance | -29 | 27 | -59 | -77 | -81 | -86 | -76 |
| (In percent of GDP) | -1.5 | 1.3 | -2.8 | -3.7 | -3.8 | -3.9 | -3.3 |
| Structural balance | -25 | -32 | -61 | -61 | -47 | -53 | -43 |
| (In percent of potential GDP) | -1.2 | -1.6 | -2.9 | -2.9 | -2.2 | -2.4 | -1.9 |
| Federal government | | | | | | | |
| Overall balance | -31 | 28 | -28 | -36 | -40 | -39 | -39 |
| (In percent of GDP) | -1.5 | 1.4 | -1.4 | -1.7 | -1.9 | -1.8 | -1.7 |
| General government debt | 1,210 | 1,222 | 1,233 | 1,284 | 1,358 | 1,443 | 1,518 |
| (In percent of GDP) | 61.2 | 60.2 | 59.4 | 60.9 | 63.8 | 65.7 | 67.1 |
| Balance of payments | | | | | | | |
| Trade balance 4/ | 65.2 | 59.1 | 95.5 | 132.8 | 129.6 | 171.8 | 178.7 |
| Services balance | -46.1 | -49.1 | -50.3 | -36.4 | -34.8 | -35.8 | -34.4 |
| Net private transfers | -19.1 | -17.3 | -19.1 | -16.9 | -16.2 | -18.8 | -19.8 |
| Net official transfers | -8.2 | -7.7 | -9.3 | -10.5 | -10.9 | -8.0 | -8.2 |
| Current account | -22.5 | -27.9 | 1.7 | 45.7 | 48.1 | 97.4 | 107.5 |
| (In percent of GDP) | -1.1 | -1.4 | 0.1 | 2.2 | 2.3 | 4.4 | 4.8 |
| Foreign exchange reserves (e. o. p.) 5/ | 52.4 | 53.4 | 49.5 | 40.5 | 32.5 | 33.8 | ... |
| | | | | (Percentage changes, end of period) | | | |
| Monetary data , seasonally adjusted | | | | | | | |
| Money and quasi-money (M3) 6/ 7/ | 7.2 | -1.0 | 6.1 | ... | 3.5 | 1.7 | ... |
| Credit to private sector 6/ | 5.8 | 5.8 | 3.2 | 0.9 | 0.0 | 0.2 | ... |
| | | | | (Period averages in percent) | | | |
| Interest rates | | | | | | | |
| Three-month interbank rate 8/ | 3.0 | 4.4 | 4.3 | 3.3 | 2.3 | 2.1 | ... |
| Yield on ten-year government bonds 8/ | 4.5 | 5.3 | 4.8 | 4.8 | 4.1 | 4.0 | ... |
| | | | | (Levels) | | | |
| Exchange rates | | | | | | | |
| Euro per US$ (annual average) 8/ | 0.94 | 1.08 | 1.12 | 1.06 | 0.88 | 0.82 | ... |
| Nominal effective rate (1990=100) 9/ | 102.0 | 97.8 | 98.5 | 99.5 | 103.5 | 104.3 | ... |
| Real effective rate (1990=100) 9/ 10/ | 107.0 | 100.8 | 100.0 | 100.1 | 103.1 | 102.6 | ... |

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

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 2004 refer to June.

6/ Data for 2003 refer to a change from May 2003 to May 2004.

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 2004 refer to September 15.

9/ Data for 2004 refer to August.

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

Table 2: Germany General Government Finances
(In percent of GDP)

| | 2002 | 2003 | 2004 Est. | 2005 Proj. | 2006 Proj. | 2007 Proj. |
|---|---|---|---|---|---|---|
| **Revenue** | **45.1** | **45.0** | **43.5** | **43.4** | **43.2** | **43.2** |
| **Current revenue** | **44.7** | **44.6** | **43.1** | **43.0** | **42.8** | **42.8** |
| Tax revenue | 22.7 | 22.6 | 21.7 | 21.5 | 21.5 | 21.5 |
| Indirect taxes | 11.9 | 12.0 | 11.9 | 11.8 | 11.9 | 11.8 |
| Direct taxes | 10.8 | 10.6 | 9.9 | 9.7 | 9.6 | 9.6 |
| Social security contributions | 18.5 | 18.6 | 18.1 | 17.9 | 17.8 | 17.7 |
| Other current revenue | 3.5 | 3.4 | 3.2 | 3.5 | 3.5 | 3.6 |
| **Capital revenue** | **0.4** | **0.4** | **0.4** | **0.4** | **0.4** | **0.4** |
| | | | | | | |
| **Non-interest expenditure** | **45.6** | **45.7** | **44.4** | **43.8** | **43.1** | **42.6** |
| **Expenditure** | **48.7** | **48.8** | **47.4** | **46.7** | **45.8** | **45.3** |
| **Current expenditure** | **45.5** | **45.7** | **44.3** | **43.7** | **42.9** | **42.4** |
| Wages and salaries | 8.0 | 7.9 | 7.6 | 7.4 | 7.3 | 7.2 |
| Goods and services | 4.0 | 3.9 | 3.9 | 3.9 | 3.9 | 3.9 |
| Social transfers in kind | 7.8 | 7.9 | 7.5 | 7.5 | 7.5 | 7.5 |
| Social Transfers | 19.4 | 19.7 | 19.5 | 19.1 | 18.6 | 18.3 |
| Pensions | 12.2 | 12.6 | 12.4 | 12.1 | 12.0 | 11.9 |
| Child benefits | 4.5 | 4.6 | 4.5 | 4.5 | 4.4 | 4.3 |
| Unemployment benefits | 2.1 | 2.1 | 2.2 | 2.1 | 1.8 | 1.7 |
| Subsidies | 1.5 | 1.4 | 1.0 | 1.1 | 1.1 | 1.1 |
| Other current expenditure | 1.7 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |
| **Capital expenditure** | **3.3** | **3.1** | **3.1** | **3.0** | **3.0** | **2.9** |
| | | | | | | |
| **Primary balance** | **-0.5** | **-0.7** | **-0.9** | **-0.5** | **0.1** | **0.6** |
| | | | | | | |
| Interest payments | 3.1 | 3.1 | 3.0 | 2.9 | 2.7 | 2.7 |
| | | | | | | |
| **Overall balance** | **-3.7** | **-3.8** | **-3.9** | **-3.3** | **-2.7** | **-2.2** |
| | | | | | | |
| Memorandum item: | | | | | | |
| Structural balance | -2.9 | -2.2 | -2.4 | -1.9 | -1.8 | -1.7 |

Sources: Ministry of Finance; and IMF staff estimates based on policy measures already in place.

Table 3. Germany: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 1/ latest | 2004 1/ date |
|---|---|---|---|---|---|---|
| **External Indicators** | | | | | | |
| Exports (annual percentage change, in U.S. dollars) | 1.1 | 3.9 | 8.9 | 21.1 | 17.0 | projections |
| Imports (annual percentage change, in U.S. dollars) | 3.0 | -1.0 | 1.3 | 21.6 | 11.8 | projections |
| Terms of trade (annual percentage change) | -4.1 | 0.1 | 1.9 | 1.6 | 0.8 | projections |
| Current account balance | -1.4 | 0.1 | 2.2 | 2.2 | 4.4 | projections |
| Financial account balance | 1.7 | -1.0 | -3.3 | -2.6 | -2.5 | projections |
| *Of which* : Foreign direct investment (net) | 7.6 | -0.8 | 1.4 | 0.4 | 0.4 | projections |
| Portfolio investment (net) | -8.1 | 1.6 | 2.0 | 2.7 | 2.7 | projections |
| Other official investment (net) | -0.5 | 0.4 | 0.1 | 0.1 | 0.0 | projections |
| Official reserves minus gold (in billions of U.S. dollars, end-of-period) 2/ | 56.9 | 51.4 | 51.2 | 50.7 | 48.4 | August |
| Broad money to reserves ratio 2/ | 21.9 | 25.0 | ... | 33.0 | 36.2 | May |
| Exchange rate: U.S. dollar per euro (period average) | 0.92 | 0.90 | 0.95 | 1.13 | 1.23 | September 27 |
| **Financial Markets Indicators** | | | | | | |
| Public sector debt (Maastricht definition) | 60.2 | 59.4 | 60.9 | 63.8 | 65.7 | projections |
| 3-month T-bill yield | 4.3 | 3.7 | 3.0 | 2.0 | 2.1 | August |
| 3-month T-bill yield (real) 3/ | 3.8 | 2.4 | 1.5 | 1.0 | 0.2 | August |
| 10-year Bund yield | 5.3 | 4.8 | 4.8 | 4.1 | 4.1 | August |
| Change in stock market index (percent, end of period) 4/ | -7.2 | -19.7 | -44.5 | 39.6 | 17.8 | Sept/Sept |
| Spread of 3-month T-bills vs. the U.S. (percentage points, e-o-p) | -1.5 | 0.2 | 1.4 | 1.0 | 0.6 | August |
| Yield curve (10 year Bund - 3-monh T-bills) | 0.9 | 1.2 | 1.8 | 2.1 | 2.0 | August |
| **Credit Indicators (percent, y-o-y)** | | | | | | |
| Total credit to non-MFIs | 4.9 | 3.4 | -0.2 | -0.7 | -0.1 | May |
| Loans | 4.9 | 3.5 | -0.2 | -0.6 | -0.1 | May |
| Lending: mortgages secured by residential real estate | 6.7 | 2.7 | 2.5 | 11.7 | -0.6 | Q1 |
| Lending to employees and other individuals: Housing loans | 4.2 | 3.1 | 3.0 | 2.7 | -0.3 | Q1 |
| Lending to employees and other individuals: Installment credit | 2.8 | 1.9 | 3.3 | 3.7 | 0.4 | Q1 |
| Lending to electrical & optical equip, telecom, computers, R&D | 4.5 | 1.8 | -1.1 | -1.9 | -0.6 | Q1 |
| Lending to construction sector | 1.7 | -0.4 | -4.9 | -8.6 | -1.1 | Q1 |
| Lending to other real estate enterprises | 7.1 | 5.3 | 2.3 | -1.1 | -0.8 | Q1 |
| Lending to electrical & optical equip, telecom,computers,R&D (% of total credit to non-MFIs) | 5.7 | 5.7 | 5.6 | 5.5 | 5.5 | Q1 |
| **Financial Sector Risk Indicators** | | | | | | |
| Total loans to assets | 72.2 | 72.8 | 73.5 | 73.6 | 73.0 | July |
| Total loans to deposits | 111.2 | 111.6 | 112.7 | 112.8 | 112.2 | July |
| Share of real estate sector in private credit (percent) 5/ | 47.1 | 47.1 | 47.7 | 48.3 | 48.5 | June |
| Share of real estate sector in loans to nonfinancial sector (percent) 6/ | 35.0 | 34.6 | 35.4 | 35.9 | 35.9 | June |
| Share of non-performing loans in total gross loans (percent) 7/ | 4.7 | 4.6 | 5.0 | 5.3 | ... | ... |
| Non-performing loans net of provisions to capital (percent) 7/ | 44.7 | 46.1 | 47.6 | 52.3 | ... | ... |
| German capital asset ratio 8/ | 10.9 | 11.5 | 11.3 | 12.7 | ... | ... |
| Profitability ratio 9/ | 6.1 | 4.6 | 2.9 | -1.5 | ... | ... |
| Operating profitability ratio 10/ | 0.30 | 0.18 | 0.10 | 0.25 | ... | ... |
| Number of insolvencies of enterprises and individuals 11/ | 1,549 | 2,053 | 3,007 | 2,770 | ... | ... |
| Volume of loans to insolvent borrowers (in billions of euro) 11/ | 7.7 | 10.9 | 22.2 | 11.9 | ... | ... |

Sources: Deutsche Bundesbank; IMF, International Financial Statistics; and IMF, World Economic Outlook.
1/ Staff estimates and projections, unless otherwise indicated.
2/ Data present Germany's position in the euro area; data not shown for 2002 because of a series break (from January 2002 M3 excludes currency in circulation).
3/ Deflated by inflation excluding energy and food.
4/ DAX 30 stock market index.
5/ Share of housing loans in percent of total lending to private sector.
6/ Share of housing loans in percent of total lending to nonfinancial sector.
7/ Non-performing loans as identified by bank auditors in line with German commercial law.
8/ Consolidated basis, risk-weighted, national definitions as under principle I of the German Banking Act, comprising all credit institutions reporting thereunder.
9/ After-tax profit as percent of average capital.
10/ In percent of assets.
11/ Insolvencies of only those included in the credit register with loans of greater than Euro 1.5 million.

## Germany: Fund Relations
(As of August 31, 2004)

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

| | | | |
|---|---|---|---|
| II. | **General Resources Account:** | **SDR Million** | **% Quota** |
| | Quota | 13,008.20 | 100.0 |
| | Fund holdings of currency | 8,218.64 | 63.18 |
| | Reserve position in Fund | 4,789.65 | 36.82 |
| III. | **SDR Department:** | **SDR Million** | **% Allocation** |
| | Net cumulative allocation | 1,210.76 | 100.0 |
| | Holdings | 1,341.69 | 110.81 |
| 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.

Germany is an Article VIII member and maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for reasons related to security. 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 Iraq, Libya, Zimbabwe, and certain individuals in the Myanmar. EU sanctions are maintained against the assets of 13 persons associated with Serbia and Montenegro.

The restrictions against individuals, organizations, or countries have been modified since the last No. 144-(52/51) notification to the Fund.

VIII. **Article IV Consultations:**
Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (IMF Country Report No. SM/03/341) was discussed at EBM/03/100 (November 3, 2003).

## 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 absence of any pre-1970 ESA95 data complicates 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 for the 1970s and 1980s remain patchy. Also, 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.

As other euro-area countries, Germany does not publish quarterly general government revenue, expenditure, and balance on an accrual basis (ESA95)—such data would considerably facilitate fiscal analysis.

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 2001. 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 September 15, 2004)

| | 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 | 8/04 | 8/04 | 7/04 | 6/04 | 3/04 | 2003 | 2004Q1 | 9/03 |
| Date Received | 9/1/04 | 9/2/04 | 8/04 | 8/04 | 5/12/04 | 2/04 | 5/04 | 04/04 |
| Frequency of Data | Monthly | Monthly | Monthly | Monthly | Monthly | Annual | Quarterly | Semiannual |
| Frequency of Reporting | Monthly | Monthly | Monthly | Monthly | Monthly | Annual | Quarterly | Monthly |
| Source of Update | FIN | Bundesbank dissemination | 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 | Monthly | Monthly | Monthly | Monthly | Monthly | Annual | Quarterly | Monthly |

## GERMANY: PUBLIC DEBT SUSTAINABILITY

**Germany's general government net debt/GDP ratio is projected to increase slightly over the next five years.** The medium-term scenario is based on a moderate recovery of real activity, and a gradual consolidation of the public finances. Real growth is assumed to pick up to 2 ½ percent over the next two years as the level of GDP catches up to potential, and to slowly subside thereafter. Fiscal adjustment measures introduced in early 2004 are expected to keep primary spending constant in real terms over the coming three years. Important savings are assumed to result from reforms in pensions and unemployment insurance, yielding a slowdown in benefit growth. Staff's fiscal projections in this respect are more cautious than the those contained in the authorities' Stability Program. Finally, average interest rates on public debt are projected to decline somewhat over the coming years, as high-coupon bonds of the early 1990s are retired. Under the baseline scenario, the net debt ratio stabilizes at 63 percent of GDP from 2006 onward.

**A renewed slowdown of activity poses a risk over the medium term.** Staff's growth projections are somewhat higher than the historical average of the past 10 years, which was weighed down by the strains of German unification. However, in a stress test that assumes a two-year recession in 2005 and 2006, the net debt ratio would rise to around 77 percent. By contrast, fiscal slippages have a smaller impact on the debt dynamics, as a two-standard deviation shock to primary spending would raise the debt ratio to 67 percent. The debt ratio stabilizes soon after the shock, similar to the other stress tests.

**Germany's fundamental vulnerability stems from aging.** Spending on pensions and health will begin to soar after 2010, in particular between 2020 and 2030 when the aging trend reaches a climax. A recent pension reform helps slow the growth of benefits somewhat but will likely prove insufficient. Raising the effective retirement age in line with higher life expectancies will be paramount to ensure fiscal sustainability and healthy GDP growth.

Germany: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | | | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | |
| | | | | | | | | I. Baseline Projections | | | | | | **Debt-stabilizing primary balance 11/** |
| 1 **Public sector debt 1/** | 54.9 | 52.8 | 53.5 | 55.5 | 58.7 | | | **60.8** | **62.3** | **62.8** | **62.8** | **62.8** | **62.8** | **0.8** |
| o/w foreign-currency denominated | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 2 Change in public sector debt | 1.6 | -2.0 | 0.7 | 2.0 | 3.2 | | | 2.1 | 1.6 | 0.5 | 0.0 | 0.0 | 0.0 | |
| 3 Identified debt-creating flows (4+7+12) | 0.2 | -2.7 | 1.7 | 2.8 | 3.3 | | | 2.1 | 1.6 | 0.5 | 0.0 | -0.3 | -0.3 | |
| 4 Primary deficit | -2.0 | -4.7 | -0.4 | 0.5 | 0.7 | | | 0.9 | 0.5 | -0.1 | -0.6 | -0.9 | -1.1 | |
| 5 Revenue and grants | 47.3 | 47.1 | 45.5 | 45.1 | 45.0 | | | 43.5 | 43.4 | 43.2 | 43.2 | 43.3 | 43.4 | |
| 6 Primary (noninterest) expenditure | 45.3 | 42.4 | 45.0 | 45.6 | 45.7 | | | 44.4 | 43.8 | 43.1 | 42.6 | 42.3 | 42.2 | |
| 7 Automatic debt dynamics 2/ | 2.2 | 2.0 | 2.1 | 2.3 | 2.6 | | | 1.1 | 1.1 | 0.6 | 0.5 | 0.6 | 0.8 | |
| 8 Contribution from interest rate/growth differential 3/ | 2.2 | 2.0 | 2.1 | 2.3 | 2.6 | | | 1.1 | 1.1 | 0.6 | 0.5 | 0.6 | 0.8 | |
| 9 Of which contribution from real interest rate | 3.2 | 3.5 | 2.6 | 2.3 | 2.5 | | | 2.3 | 2.1 | 2.0 | 2.0 | 2.0 | 2.0 | |
| 10 Of which contribution from real GDP growth | -1.1 | -1.5 | -0.4 | 0.0 | 0.1 | | | -1.2 | -1.1 | -1.4 | -1.4 | -1.3 | -1.2 | |
| 11 Contribution from exchange rate depreciation 4/ | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | ... | ... | ... | ... | ... | ... | |
| 12 Other identified debt-creating flows | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 15 Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 16 Residual, including asset changes (2-3) 5/ | 1.5 | 0.7 | -1.0 | -0.9 | -0.1 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.3 | 0.3 | |
| Public sector debt-to-revenue ratio 1/ | 116.1 | 112.3 | 117.8 | 123.1 | 130.4 | | | 139.7 | 143.7 | 145.5 | 145.4 | 145.1 | 144.8 | |
| **Gross financing need 6/** | 1.5 | -1.3 | 2.8 | 3.7 | 3.8 | | | 3.9 | 3.3 | 2.7 | 2.2 | 1.8 | 1.6 | |
| In billions of U.S. dollars | 31.4 | -24.9 | 52.5 | 73.2 | 92.0 | | | 105.1 | 92.5 | 77.0 | 64.7 | 54.7 | 51.3 | |
| **Key Macroeconomic and Fiscal Assumptions** | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 2.0 | 2.9 | 0.8 | 0.1 | -0.1 | 1.4 | 1.0 | 2.0 | 1.8 | 2.4 | 2.4 | 2.2 | 1.9 | 2.1 |
| Average nominal interest rate on public debt (in percent) 7/ | 6.7 | 6.3 | 6.3 | 5.9 | 5.7 | 7.1 | 1.2 | 5.2 | 4.9 | 4.6 | 4.5 | 4.5 | 4.5 | 4.7 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 6.2 | 6.5 | 5.0 | 4.4 | 4.6 | 6.0 | 1.0 | 4.1 | 3.7 | 3.4 | 3.3 | 3.3 | 3.3 | 3.5 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | -13.9 | -7.4 | -5.3 | 14.1 | 20.7 | 1.4 | 11.7 | ... | ... | ... | ... | ... | ... | ... |
| Inflation rate (GDP deflator, in percent) | 0.5 | -0.3 | 1.3 | 1.5 | 1.1 | 1.2 | 0.8 | 1.1 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 2.2 | -3.7 | 7.1 | 1.4 | 0.0 | 1.4 | 2.7 | -0.8 | 0.4 | 0.7 | 1.2 | 1.5 | 1.7 | 0.8 |
| Primary deficit (+) | -2.0 | -4.7 | -0.4 | 0.5 | 0.7 | -1.0 | 1.5 | 0.9 | 0.5 | -0.1 | -0.6 | -0.9 | -1.1 | -0.2 |
| | | | | | | | | II. Stress Tests for Public Debt Ratio | | | | | | **Debt-stabilizing primary balance 10/** |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2005-09 8/ | | | | | | | | **60.8** | **62.5** | **64.3** | **66.2** | **68.4** | **70.8** | **3.1** |
| A2. No policy change (constant primary balance) in 2005-09 | | | | | | | | **60.8** | **62.8** | **64.3** | **65.8** | **67.7** | **69.8** | **0.9** |
| A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 9/ | | | | | | | | **60.8** | **62.3** | **62.8** | **62.8** | **62.8** | **62.8** | **0.8** |
| A4. Selected variables are consistent with market forecast in 2005-09 | | | | | | | | **60.8** | **62.3** | **62.8** | **62.8** | **62.8** | **62.8** | **0.8** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | | | | | **60.8** | **64.8** | **68.2** | **68.2** | **68.2** | **68.3** | **0.9** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **60.8** | **64.8** | **69.6** | **71.9** | **74.3** | **76.8** | **1.0** |
| B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **60.8** | **64.0** | **66.7** | **66.7** | **66.7** | **66.8** | **0.9** |
| B4. Combination of 2-4 using one standard deviation shocks | | | | | | | | **60.8** | **65.2** | **70.0** | **70.0** | **70.1** | **70.2** | **0.9** |
| B5. One time 30 percent real depreciation in 2005 10/ | | | | | | | | **60.8** | **62.3** | **62.8** | **62.8** | **62.8** | **62.8** | **0.8** |
| B6. 10 percent of GDP increase in other debt-creating flows in 2005 | | | | | | | | **60.8** | **72.3** | **72.9** | **73.0** | **73.1** | **73.2** | **1.0** |

1/ General government net debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The implied change in other key variables under this scenario is discussed in the text.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

INTERNATIONAL MONETARY FUND

GERMANY

**Staff Report for the 2004 Article IV Consultation**

**Supplementary Information**

Prepared by the European Department
(In consultation with the Policy Development and Review Department)

Approved by Alessandro Leipold and Martin Fetherston

October 20, 2004

1. This supplement reports on information that has become available since the issuance of the staff report and reflects contacts with the authorities during the Annual Meetings in early October 2004 and more recently. The new information does not change the thrust of the staff appraisal.

**Economic developments and outlook**

2. **Monthly economic indicators show some tentative signs of firming in domestic demand but a slowing in net export growth:**

- **Retail sales** in the third quarter of 2004 were up slightly from the previous quarter, but still below activity of a year earlier. Value-added taxes in real terms also increased slightly in the third quarter.

- **Business investment** in machinery and equipment has resumed growing, albeit at a moderate pace, as profitability continues to strengthen. However, construction spending is still falling.

- **Employment** on a seasonally adjusted basis increased slightly in the last four monthly observations from May to August. However, labor supply also increased and headline unemployment has risen by 0.1 percentage point to 9.9 percent (ILO definition).

- **Manufacturing output and exports** have been closely linked and have provided the impetus behind growth this year, reflecting strong global demand for German capital goods and machinery. Orders for manufactured goods, however, have slowed somewhat in recent months, alongside export orders, from high levels earlier in the year—consistent with moderating expectations for the coming months.

- **The IFO business climate index** has declined somewhat from the first quarter of the year, reflecting an easing of the expectations component of the index, while the current business conditions component has remained stable. This development is consistent with strong orders already on the books for exporters, but with increasing concern about oil prices and the pace of global economic expansion leading into 2005. Indeed, the ZEW index of investor and analyst sentiment fell sharply in October and is at a 16-month low.

3. **The rise in oil prices will affect Germany via lower external demand growth and also as a supply shock**. Through about mid-2004, the growth impulse for Germany from the global expansion surprised on the upside. However, early indicators for the third quarter showed the emergence of some softening, and the new sharp rise in oil prices to above US$50 a barrel (which has triggered an update of WEO baseline assumptions) is now causing a downward revision in output growth for 2005 in many trading partners—suggesting some slowing in Germany's net export growth next year. In addition, although the appreciation of the euro had dampened considerably the rise in domestic energy prices in the early part of the year, this effect is now receding and oil prices are also rising in euro terms. Thus, the risk factor for the outlook involving oil mentioned in the staff report is now materializing.

4. **On balance, with domestic demand still fragile and export growth likely to slow, the projections for output growth have been revised downward**. Specifically, the staff projection for real GDP growth is revised from 2.0 percent to 1.9 percent for 2004; and from 1.8 to 1.5 percent for 2005 (in line with the latest consensus forecast of the main German research institutes for 2005). Even with these revisions, the growth outlook remains within the range of 1½-2 percent for 2004 and 2005 envisaged by the authorities.[1] The underlying expansion from 2004 to 2005, corrected for the number of working days, is now just under ½ percentage point of GDP, down from an estimate of ⅔ percentage point in the staff report.[2]

5. **Inflation and wage setting continue to be moderate**. Headline inflation in the period July-September 2004 (annualized) was 1.5 percent; excluding energy it was 1.1 percent. Moreover, there has been no evidence of oil price increases spilling over into wage setting behavior so far.

**Fiscal developments and outlook**

6. **In early October, the authorities issued a supplement to the 2004 federal government budget, and obtained authorization to widen the borrowing requirement for 2004**. The supplementary budget reflects that tax revenue had been below original

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[1] The authorities expect growth to be at the upper limit of the range in 2004, as does the staff.

[2] Corrected for working days, real GDP growth is projected to be 1.3 percent in 2004 and 1.7 percent in 2005.

budgetary projections, and that expenditure on unemployment benefits had been above projections, leading to a larger deficit than was embedded in the 2004 budget. These effects were already anticipated in the staff report projection of the 2004 general government deficit of 3.9 percent of GDP, which remains unaltered.

7. **The revision to the growth outlook does not alter the key fiscal policy recommendations for 2005 outlined in the staff report**. Germany needs to take the opportunity of the upswing to bring down the structural deficit and stem the rise in debt. In the staff report, the structural deficit was projected to be cut by ½ percent of GDP in 2005 on the basis of measures already in the pipeline (implemented in the 2004 budget) and some one-time effects such as the normalization of Bundesbank profits from an unusually low level in 2004. To attain the goal of reducing the structural deficit by at least 1½ percent of GDP over the period 2004-2006, the staff recommended adopting additional policy measures totaling about ⅓ percent of GDP for 2005 before the budget is finalized. With the downward revision to growth, the overall general government deficit would then likely be 3.1 percent of GDP in 2005, reflecting the free play of automatic stabilizers.

8. **Although near-term prospects have weakened, the staff continues to believe that a structural adjustment of ¾ percentage point in 2005 is appropriate**. In assessing the tradeoffs, the staff is of the view that longer run considerations dominate the restraining effect this adjustment will have on the recovery in the short run. Further, the latest source of weakness is linked to a supply shock (oil prices) that may well be lasting. And, to the extent that the additional fiscal measures focus on corporate subsidies and tax exemptions, this would affect mainly buoyant profit income, mitigating the contractionary implications. Thus, reducing the structural deficit and bringing underlying debt dynamics under firmer control, combined with reforms to boost potential output growth, remains the priority. A clear indication that Germany is consistently tackling its long-run challenges could also have positive confidence effects. As adjustment was not pursued with sufficient vigor during the last upswing, and with 2006 being an election year, postponing the additional adjustment recommended for 2005 could lead to another missed opportunity to consolidate as the growth rate returns to potential and the economy continues to recover.

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
November 2, 2004

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

# IMF Concludes 2004 Article IV Consultation with Germany

On October 25, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

**Background**

After three years of stagnation, a cyclical recovery, driven by strong external demand, is taking hold. Profitability in nonfinancial firms has picked up and corporate balance sheets are being repaired. However, firms remain cautious with their spending plans, and a poor job market is dampening consumption demand, while demographic developments are beginning to affect supply. Further, the rise in oil prices is also having a negative impact. On balance, headline growth is projected to be 1.9 percent in 2004 and 1.5 percent in 2005, but after adjusting for a larger number of working days in 2004 this still implies a moderate expansion in underlying growth.

On the policy front, Germany has made important headway over the past year in addressing deep-seated structural problems. The implementation of structural reforms under Agenda 2010 is on track despite significant popular opposition. Combined with improved wage flexibility, reforms to lower reservation wages and strengthen job intermediation are making the labor market more competitive. Important progress has also been made in the areas of pension and health care reform. Further reforms will be needed to raise potential output growth and prepare for population aging.

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

The 2004 general government deficit will remain well above the Maastricht reference ratio for the third consecutive year. Cumulative tax cuts amounting to nearly 1 percent of GDP in 2004-2005 have been only partially offset by durable measures to reduce expenditure. In 2005, the fiscal deficit is projected to be reduced from its current high level partly on account of measures already agreed in connection with the 2004 budget and because of a normalization of Bundesbank profits, which were unusually low in 2004. However, given the still fragile recovery, and on current policies, the 2005 fiscal deficit is likely to remain above 3 percent of GDP.

The financial sector is recovering and updated stress tests confirm the system's resilience, but progress in market-driven restructuring has been slow. Nevertheless, the banking system is in a better position now to support the economic recovery.

**Executive Board Assessment**

Executive Directors commended the German authorities for their steadfast pursuit of the reforms under Agenda 2010 and the progress being made in tackling long-standing structural impediments. Notably, important strides have been made in pension and health care reform, and in reforming unemployment benefits. On the fiscal front, progress has been more limited as substantial tax cuts have not yet been fully compensated with expenditure restraint. Therefore, fiscal challenges remain large, especially as population aging will impose a substantial burden on the social security system. Indeed, with impending demographic changes, reforms will need to be augmented to ensure that Germany's improved cyclical situation translates into higher and sustained long-term growth. A few Directors noted that increasing potential output growth and stronger domestic demand would contribute to an orderly reduction of global current account imbalances.

Directors welcomed the resumption of output growth, driven by strong exports, after three years of stagnation. They concurred that the upswing is still not fully established, with insufficient support from domestic demand. Nevertheless, growth is projected to accelerate in 2005 after adjusting for working day effects, but this pick-up is likely to be subdued given oil price developments. Under this cautious prognosis, the risks appear to be broadly balanced. Many Directors saw Germany's external competitiveness position as strong, and commended efforts by the authorities and social partners to make employment conditions more flexible, which would help in transmitting the external growth impulse to employment and domestic activity.

Most Directors urged the authorities to take the opportunity of the upswing to make progress in fiscal consolidation. In view of the rising public debt and demographic challenges, they considered that the authorities should aim to reduce the structural deficit by ¾ percentage point of GDP in 2005. A few Directors, however, cautioned that additional fiscal adjustment at this juncture could have a restraining effect on the recovery in the short run. A number of Directors underscored that postponing adjustment again in 2005 would imply back-loading of the fiscal effort and would put substantial pressure on public finances in the election year 2006. Directors also supported the authorities' medium-term objective of reducing the fiscal structural balance by a cumulative 1½ percentage point of GDP over the period 2004-06, and encouraged continued structural adjustment thereafter until a small surplus is reached. Directors noted that more progress will be needed in achieving durable cuts in tax expenditure and subsidies, and felt that these items should continue to be the focus of fiscal adjustment.

Directors commended the authorities for their efforts in reforming entitlement programs, where they saw the potential for important synergies between bolstering output growth and improving the public finances. They welcomed the steps that have been implemented to anticipate the pressures on the economy from an aging population, including raising the effective retirement age and the introduction of the sustainability factor in the pension system, as well as the introduction of co-payments in the health system. However, some Directors encouraged the authorities to pursue additional steps to deepen the entitlement reforms and limit payroll taxes and other nonwage labor costs to further strengthen incentives for better labor utilization. In this regard, Directors emphasized the importance of increasing the statutory retirement age and bolstering further supply-side competition in the health care system.

Directors welcomed the authorities' efforts to improve budget institutions and intergovernmental relations, which would facilitate sound fiscal management. Several Directors agreed that a measured degree of competition between the states, including some enhanced autonomy in revenue raising and allocating resources according to local needs, could enhance efficiency and serve to stimulate accountability and budgetary discipline. Directors welcomed the authorities' intention to publish periodic fiscal sustainability reports based on calculations made by independent experts, beginning in 2006. This should raise transparency, offer pointers to strengthen long-run sustainability, and help make the public more aware of the need for reform.

Directors commended the authorities for their important efforts in labor market reform—especially to reduce long-term unemployment and increase labor force participation. These aspects of the Agenda 2010 were essential to strengthen potential output, and they would need to be complemented by additional steps to lower the costs of job protection regulations, and support the trend toward greater flexibility in the system of collective wage bargaining. Directors noted that the ultimate success of the labor market reforms, notably the Hartz IV reforms, would now depend on strong implementation that is well-coordinated with the sub-national governments.

Directors noted that Germany has made good progress in liberalizing network industries and product markets, but encouraged the authorities to proceed more vigorously in creating employment flexibility in the crafts and services sectors—including through improved entry and exit conditions.

Directors welcomed the recent improvement in the financial system's profitability, which has benefited from the cyclical upswing and increased asset prices. They also noted the continued and successful efforts to reduce costs in the system, but remarked that further progress is still needed to strengthen revenue mobilization and reduce non-performing loans. Directors encouraged the authorities to continue to follow through on the FSAP recommendations, and welcomed their intention to publish a broader range of financial soundness indicators in line with the Fund's work in this area. They were pleased that some progress is underway with restructuring in the public sector banking system in response to the impending removal of government guarantees, including through back office cooperation and some consolidation. However, although the financial system is now in a better position to support output growth, a number of Directors noted that steps taken so far have been modest and that more fundamental reforms are still needed. Directors reiterated their support for creating a legal framework that reduces barriers to restructuring, both within and across the various public and private pillars of the system. This would allow a better harnessing of market signals and strengthen the resilience of the system to shocks. For the insurance sector, Directors welcomed the broadening of supervision to reinsurance companies, and encouraged the authorities to expand the supervisory focus beyond solvency margins in anticipation of the upcoming EU-wide risk-based insurance supervision. Directors commended Germany's adherence to international standards against money laundering and terrorism financing.

Directors welcomed Germany's strong support to bring the Doha round to a successful conclusion, in particular with a comprehensive liberalization of agricultural markets and unilateral concessions by industrial countries to the poorest members of the World Trade Organization. They also welcomed Germany's intentions to increase its official development assistance.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Germany is also available.

## Germany: Selected Economic Indicators

| | 2000 | 2001 | 2002 | 2003 | 2004 1/ |
|---|---|---|---|---|---|
| **Economic activity and prices** | (Change in percent, unless otherwise noted) | | | | |
| Real GDP | 2.9 | 0.8 | 0.1 | -0.1 | 1.9 |
| Net exports 2/ | 1.0 | 1.6 | 1.9 | -0.6 | 1.9 |
| Domestic demand | 2.0 | 0.2 | -1.5 | -0.4 | -0.2 |
| Private consumption | 2.0 | 1.7 | -0.7 | 0.0 | 0.0 |
| Gross fixed investment | 2.7 | -4.2 | -6.4 | -2.2 | -1.1 |
| Construction investment | -2.6 | -4.8 | -5.8 | -3.2 | -1.9 |
| Gross national saving (percent of GDP) | 20.3 | 19.4 | 19.5 | 19.7 | 21.1 |
| Gross domestic investment (percent of GDP) | 21.7 | 20.3 | 18.6 | 17.8 | 17.3 |
| Labor force 3/ | 41.8 | 42.0 | 42.1 | 42.2 | 41.9 |
| Employment 3/ | 38.7 | 38.9 | 38.7 | 38.3 | 38.1 |
| Standardized unemployment rate (in percent) | 7.8 | 7.8 | 8.7 | 9.6 | 9.7 |
| Unit labor costs (whole economy) | 0.1 | 3.3 | -0.4 | -1.2 | -0.8 |
| GDP deflator | -0.3 | 1.3 | 1.5 | 1.1 | 1.1 |
| Harmonized CPI index | 1.4 | 1.9 | 1.3 | 1.1 | 1.8 |
| **Public finance** | (In percent of GDP) | | | | |
| General government balance 4/ 5/ | 1.3 | -2.8 | -3.7 | -3.8 | -3.9 |
| Structural government balance | -1.6 | -2.9 | -2.9 | -2.2 | -2.4 |
| General government gross debt 5/ | 60.2 | 59.4 | 60.9 | 63.8 | 65.7 |
| **Money and credit** | (Change in percent over 12 months) | | | | |
| Private sector credit 6/ | 5.8 | 3.2 | 0.9 | 0.0 | 0.2 |
| M3 6/ | -1.0 | 6.1 | ... | 3.5 | 1.7 |
| **Interest rates** | (In percent) | | | | |
| Three-month money market rate 7/ | 4.4 | 4.3 | 3.3 | 2.3 | 2.1 |
| Ten-year government bond yield 7/ | 5.3 | 4.8 | 4.8 | 4.1 | 4.0 |
| **Balance of payments** | (In billions of euros, unless otherwise noted) | | | | |
| Exports 8/ | 690.2 | 739.3 | 763.7 | 772.4 | 839.8 |
| Imports 8/ | 680.1 | 694.1 | 667.4 | 677.5 | 703.8 |
| Trade balance (percent of GDP) | 2.9 | 4.6 | 6.3 | 6.1 | 7.8 |
| Current account balance | -27.9 | 1.7 | 45.7 | 48.1 | 97.4 |
| Current account (percent of GDP) | -1.4 | 0.1 | 2.2 | 2.3 | 4.4 |
| **Exchange rate** | (Period average) | | | | |
| Euro per U.S. dollar 7/ | 1.08 | 1.12 | 1.06 | 0.88 | 0.82 |
| Nominal effective rate (1990=100) 9/ | 97.8 | 98.5 | 99.5 | 103.5 | 104.3 |
| Real effective rate (1990=100) 9/ 10/ | 100.8 | 100.0 | 100.1 | 103.1 | 102.6 |

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/ From 1999 onward, data reflect Germany's *contribution to M3* in the euro area. Data for 2003 refer to May.
7/ Data for 2004 refer to September 15, 2004.
8/ Includes supplementary trade items.
9/ Data for 2004 refer to August.
10/ Based on relative normalized unit labor costs in manufacturing.