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Germany: 2002 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

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

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 8, 2002,** with the officials of Germany on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 2, 2002.** 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 21, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 23, 2002 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

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

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INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Germany

Approved by Michael Deppler and Martin Fetherston

October 2, 2002

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Main Websites for German Data

Data in this staff report reflect information received by September 2002. In most cases, more recent data can be obtained directly from the following internet sources:

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

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

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

Federal Labor Office.......................................**http://www.arbeitsamt.de**

Ifo Institute for Economic Research...............**http://www.ifo.de**

German Council of Economic Experts...........**http://www.sachverstaendigenrat-wirtschaft.de**

Information and documentation on
German economic statistics can be
found at the Special Data Dissemination
Standard website of the IMF...........................**http://dsbb.imf.org/country.htm**

I. Introduction

1. **The 2002 consultation discussions took place at a time when the economy appeared poised for recovery after stagnation since mid-2000 and almost a decade of low growth.**[1] The strength and durability of recovery, however, remained uncertain. Moreover, with the general government deficit running close to the 3 percent of GDP ceiling, macroeconomic policy options for actively supporting recovery were constrained by Stability and Growth Pact (SGP) obligations. In recent years, the authorities have made progress in strengthening the supply side of the economy through tax reform and product market liberalization. In addition, the introduction of a private pension pillar has provided a better institutional framework for addressing looming demographic strains. However, less attention has been directed to labor market constraints on growth (Box 1). At the time of the discussions, clear directions for structural policies were awaiting the outcome of a September general election, which re-elected the SPD/Green coalition.

II. Background

2. **Low growth in Germany over the past decade has been influenced by long-standing rigidities in labor markets, which have lengthened the adjustment to the economic impact of unification.** During 1992–2001, per capita real GDP growth averaged 1⅓ percent a year, the lowest rate in the European Union (EU). The growth gap is exaggerated by cyclical factors: due to the boom around the time of unification, Germany entered the 1990s with unemployment well below the natural rate and output exceeding potential, unlike elsewhere in the EU.[2] In the following ten years, relative cyclical positions were reversed as Germany, in adjusting to the public costs of unification, undertook a larger fiscal consolidation than many

Output Gaps
(In percent of potential GDP)

	1991	2001
France	0.6	0.0
Germany	2.9	-1.0
Italy	1.1	-1.0
Netherlands	0.8	1.3
UK	-0.1	0.4

[1] Discussions took place in Berlin, Frankfurt, and Bonn during July 1-8, 2002. Meetings were held with Bundesbank President Welteke, State Secretaries Koch-Weser, Overhaus (both Ministry of Finance), and Tacke (Ministry of Economics), and senior officials at the Chancellery, the Ministries of Finance, Economics, Interior, and Labor, the Bundesbank, and the Federal Office of Financial Supervision. The mission also met with the social partners, private financial institutions, and research institutes. The team comprised Ms. Schadler (Head), Messrs. Corker, Decressin, and Klingen, and Ms. Kodres (all EU1). Mr. Bischofberger, Germany's Executive Director, also took part in 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 01/202 following the IMF Executive Board meeting on October 17, 2001. Germany has accepted the obligations of Article VIII, Sections 2, 3, and 4 (Appendix I).

[2] For details, see the forthcoming Selected Issues paper.

other countries and struggled with an appreciated exchange rate. Even so, differences in cyclical positions only explain about half of the growth gap with higher-growth EU partners, such as the Netherlands and the United Kingdom. The remainder reflects lower potential output growth owing to smaller increases in the contribution from labor.

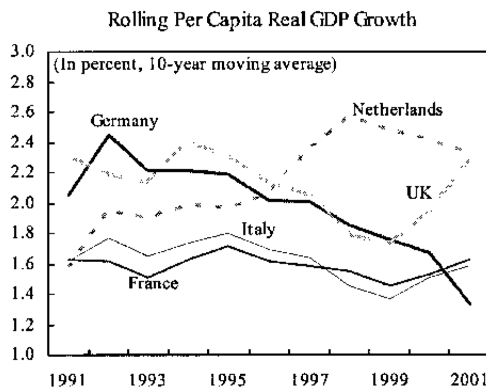
Box 1. Germany: Policy Recommendations and Implementation

Going back as far as unification, Executive Directors have strongly supported fiscal consolidation in Germany, although the authorities' efforts to achieve budget balance have been frustrated in part by low potential growth. Fiscal policy advice has been nuanced to fit specific circumstances. Thus, at the conclusion of the 2000 consultation, Directors broadly accepted a pause in deficit reduction when needed tax reform was introduced. And last year, some Directors saw a case for advancing planned tax cuts if the economy took a turn for the worse—a suggestion the authorities resisted even though growth did in fact disappoint.

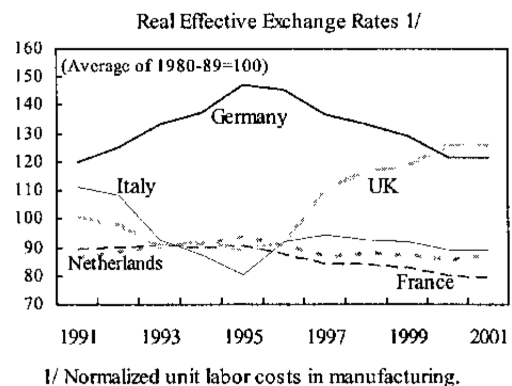
Calls for labor market reforms in staff reports and in Article IV Board meetings on Germany are at least as long standing. The authorities' approach has been to foster wage moderation through tri-partite consensus (the "Alliance for Jobs"). Measures to encourage more flexible working conditions (e.g., in part-time employment) have been modest. Generous welfare systems that dampen work incentives have been left largely untouched.

On other key policy themes, Directors have called for pension reform and reductions in the tax burden. Thus in 2000-01, they welcomed the introduction of a private pension pillar and the tax reform that significantly reduced marginal income tax rates and ironed out inefficiencies in the corporate tax code. Directors have generally recognized Germany's efforts as a leader within the EU in recent years in implementing product market reforms.

Rolling Per Capita Real GDP Growth

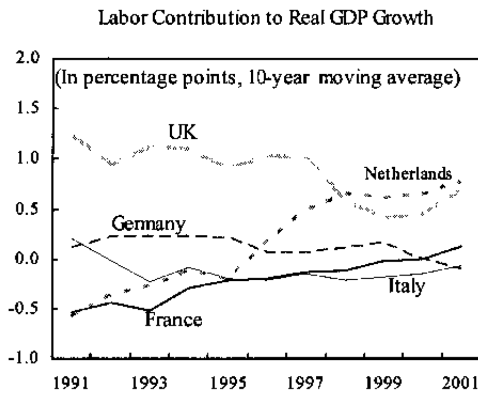


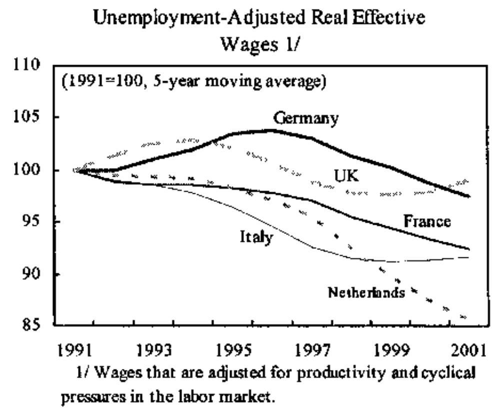
Real Effective Exchange Rates 1/



1/ Normalized unit labor costs in manufacturing.

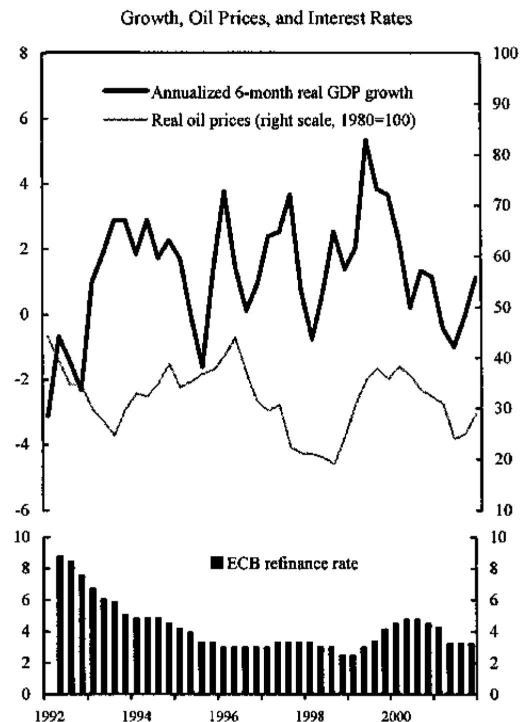
3. **Behind this slower increase in labor input has been generous assistance for the jobless, which has inhibited wage adjustment**. Wages in the west were already growing rapidly before unification, and wages in the east were set on a convergence path to those in the





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

west. With the welfare system absorbing the job losers into long-term unemployment and early retirement, wage moderation was held up in the first half of the 1990s, and the structural unemployment rate—which, at about 7 percent, is not particularly high by European standards—did not fall, as it did most markedly in the high growth countries. Unemployment is particularly severe in the new Länder, where it remains around 15 percent (EU-standardized). Since the mid-1990s, however, wage growth has moderated, albeit later than in other European economies where recent growth has been more job-rich.[3] Also, with average productivity growth generally matching European performance, Germany has not experienced the "new economy" productivity burst seen in the United States.



4. **In this environment, growth spurts could not be sustained for long and downturns have tended to be more severe than in other European countries**. The latest downturn was prompted by oil and food price shocks, as well as ECB interest rate hikes, that reduced domestic demand (Table 1). Some of the factors contributing to the relative depth of Germany's latest downturn include:

- With wage moderation less established than in other EU countries, employers have been more tentative in hiring. Accordingly, workers' real disposable incomes failed to accelerate in 2001 despite the tax cut. The impact on consumption was compounded by a reversal of the downtrend in the savings rate.

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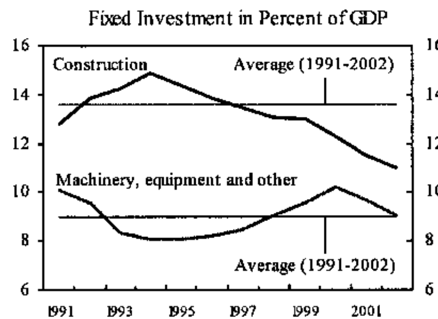
[3] See SM/01/307.

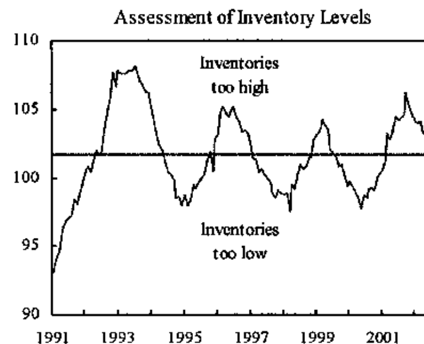
- Fixed investment had peaked earlier than in other EU countries, partly because tax changes prompted entrepreneurs to advance expenditure on machinery and equipment to a record level in 2000.[4] The contraction in investment was particularly marked because of the ongoing, post-unification slump in construction.

- As in the past, Germany was affected faster and more severely than other European countries by the U.S. slowdown. Econometric evidence for the 1990s would associate the 3½ percentage point drop in U.S. GDP growth during 2001 with an investment-led 1½ percentage point reduction in output growth in Germany, compared with less than 1 percentage point for the euro area.[5] This is consistent with Germany's greater reliance on merchandise exports.



Exports of Goods
(In percent of GDP)

	2001
France	22.0
Germany	30.9
Italy	22.2
UK	19.4



5. **Conditions for recovery have improved somewhat, but domestic and international financial strains continue to weigh on demand.** The earlier oil price-induced terms of trade losses have largely been absorbed, and high interest rates were unwound in 2001. In addition, assessments of inventory levels have been lowered toward normal levels. However, tight credit conditions, declining stock markets, euro appreciation, and fiscal consolidation are restraining conditions for strong recovery, particularly in investment:

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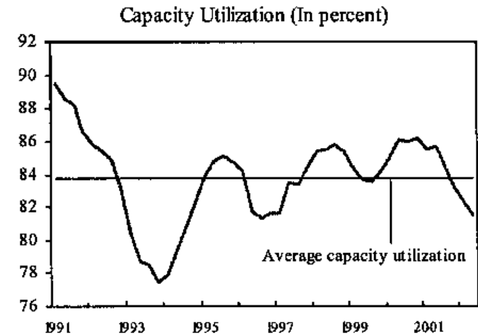
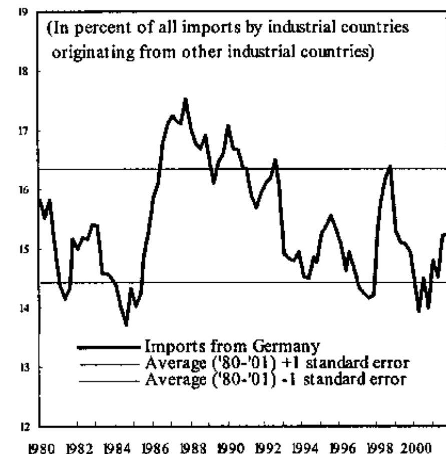
[4] Half of the gross tax relief for enterprises (totaling ½ percentage point of GDP) implemented in January 2001 was offset by lowering the general depreciation allowance from at most 30 percent (4 percent for buildings) to at most 20 percent (3 percent for buildings). This measure had been under consideration since end-1999.

[5] Sachverständigenrat, *Jahresgutachten 2001/02* reports similar results.

- Firm's financing conditions have improved by less than might have been expected on the basis of falling interest rates. Accordingly, credit growth lies below the historical relation with output and interest rates. While this may be due to an investment overhang—as evidenced by falling capacity utilization rates—it may also stem from growing risk aversion by banks, partly in anticipation of tougher capital requirements under Basel II (expected to come into effect in 2006) and the phasing out of guarantees to public banks over the next three years (Box 2).



- The decline in equity markets is casting a further pall over a revival in investment. Historically, the direct effects of the stock market have been limited.[6] But the drop in the DAX—some 45 percent since March—has been unusually large. And Germany will suffer from the second-round effects of the correction in global equity markets. While external demand has rebounded, a vigorous recovery is contingent on a pick up of investment in the United States and other countries because final consumption goods account for only 15 percent of German merchandise exports.



- The recent appreciation of the euro, which has added some 2½ percent to Germany's real effective exchange rate since March, will slow export growth even though Germany's overall level of competitiveness remains comfortable.[7]

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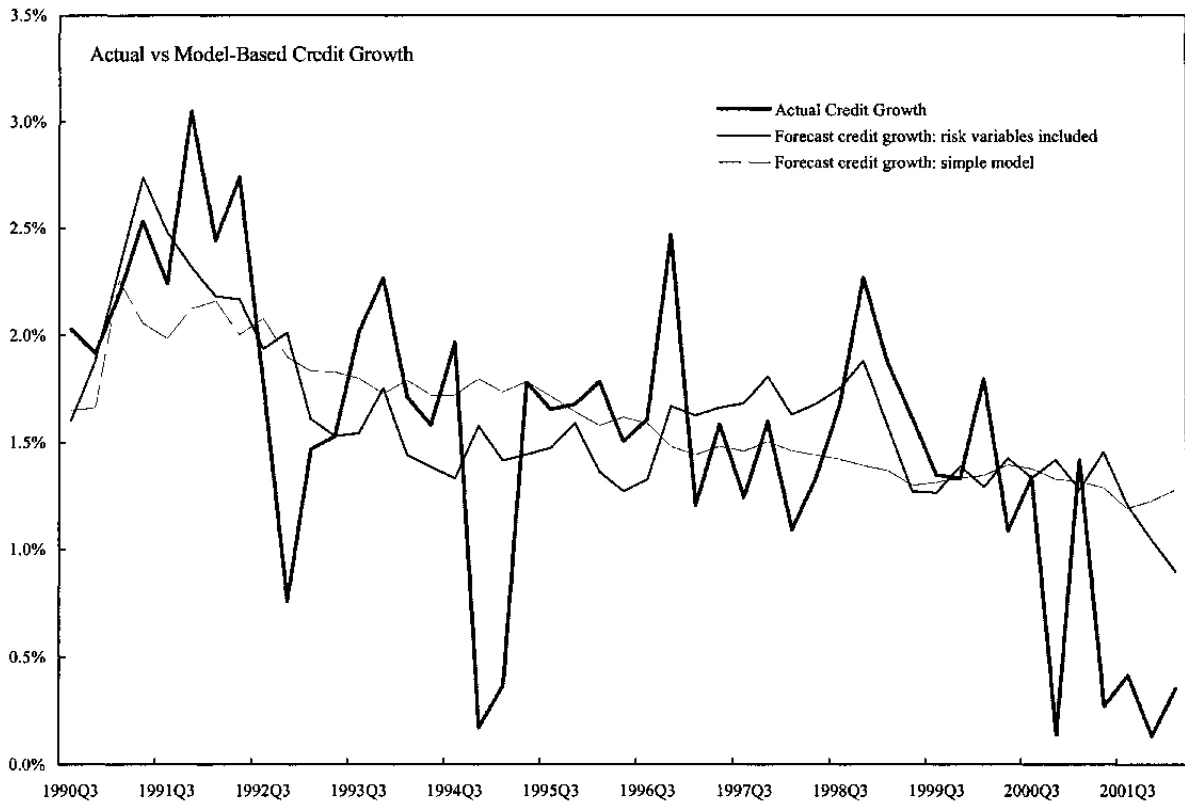
[6] See, for example, Edison and Sløk: "Wealth Effects of the New Economy" and "New Economy Stock Valuations and Investment in the 1990"—IMF Working Papers WP/01/77 and WP/01/78. During most of the 1990s, financing by firms in the stock market is estimated to have accounted for less than 5 percent of the gross change in capital.

[7] In 2001, the current account posted the first surplus since unification and the external sector made one of the largest contributions to GDP growth in the euro area. Although export growth declined sharply, it outstripped market growth by 4 percentage points. A Selected Issues paper reviews competitiveness in more detail, including within the euro area.

Box 2. Germany: A Credit Drought?

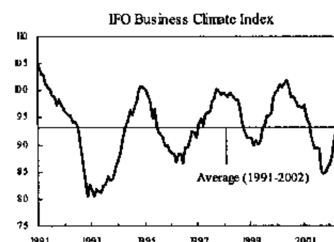
A simple econometric model linking the growth in domestic private sector credit to nominal GDP growth and lending rates overpredicts credit growth for each quarter of the year ending March 2002.[1] The cumulative shortfall amounts to 3 1/2 percent of the March 2002 credit level. Adding variables to the model that might proxy banks' risk aversion—such as the difference between lending and deposit rates and the ratio of capital plus general provisions to assets—does not substantially alter the result (see figure). Periods of unusually depressed credit growth have occurred in the past, but the duration of the current weakness is longer than the last significant episode in 1994. Cyclical factors could still lie at the root of the current credit drought as demand composition effects—and the steep slump in investment—are not captured by the model. However, it is also likely that the explanation lies with supply-side developments, such as a tightening of banks' lending standards, which are not captured by aggregate spreads, capital, and provisions.



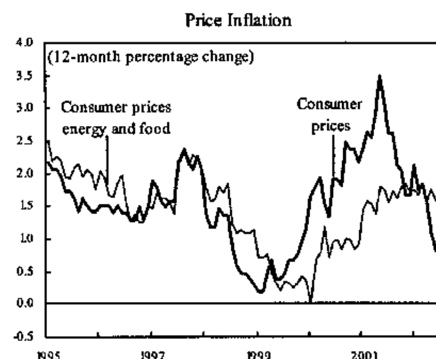
[1] A detailed discussion of the methodology can be found in the Selected Issues paper.

- Fiscal consolidation is restraining demand. Although the general government deficit in 2002, at about 3 percent of GDP, will be marginally higher than last year's level, staff estimates that the structural deficit will decline by about ½ percentage point of GDP this year. Moreover, the authorities' expenditure plans to consolidate the public finances imply, according to staff analysis, a further tightening of the fiscal stance by ¾ percentage point of GDP in both 2003 and 2004. The brunt of expenditure adjustment is to fall on public consumption and investment.[8]

6. **Consistent with this picture, business sentiment remains below its historical average level.** Business confidence revived from its low point following the September 11, 2001 terrorist attacks in the United States, but sentiment has been slipping again in the latest observations. Forward-looking indicators point to little acceleration in real GDP growth in the second half of 2002, from a sluggish 1 percent rate in the first half. Demand created by repair of severe flood damage in some parts of the country may boost growth in the fourth quarter. Nonetheless, average real GDP growth for the year is expected to be only about ½ percent. Repair of flood damage, provisionally estimated at about €15 billion (¾ percent of GDP), will continue to support demand in 2003. However, the authorities' plan to postpone next year's programmed income tax cuts to finance about €7 billion of a €10 billion (½ percent of GDP) flood-relief package will likely dampen the net stimulus.[9]



7. **All-in-all, staff projects that real GDP growth will strengthen only gradually in 2003-04, with risks that weaker global activity and ongoing stresses in financial and oil markets could weaken or delay recovery**. As past interest rate cuts feed through, earlier price shocks unwind, inventories are rebuilt, and flood reconstruction spending adds to demand, growth should pick up around the end of this year. But given tight macroeconomic policies, growth is not expected to exceed potential (about 2 percent) during 2003. Staff projects average growth will be 2 percent in 2003, and, provided that global demand firms, about 2¼ percent in 2004. Activity remains exposed to a more severe correction in global imbalances through a further strengthening of the euro, highly volatile asset and oil markets, and lower global growth. With an output gap (over 2 percent of potential GDP in 2002) persisting, and unemployment not expected to fall significantly below the current 4 million, inflation should remain at or below current levels of



[8] Conventional models suggest short-term fiscal multipliers close to unity for expenditure cuts.

[9] SGP rules would be applied flexibly in the case of unanticipated emergency relief spending.

1 to 1½ percent—notwithstanding a pick up in effective wage increases to 2½-3½ percent for 2002–03, from around 2 percent in 2001. The official forecast calls for real GDP growth of 2½ percent in 2003.

Germany and Euro Area: Staff Projections, 2001-2007
(Growth rates, in percent, unless otherwise noted)

	2001	2002	2003	2004	2005	2006	2007
Germany							
Real GDP growth	0.6	0.5	2.0	2.3	2.6	2.7	2.8
Output gap 1/	-1.0	-2.3	-2.3	-2.0	-1.3	-0.7	0.0
Unemployment rate 2/	7.9	8.3	8.3	8.1	7.6	7.2	6.8
Employment growth	0.4	-0.4	0.2	0.4	0.6	0.5	0.5
CPI inflation	2.4	1.4	1.1	1.3	1.3	1.3	1.3
General government balance (in percent of GDP)	-2.8	-3.1	-2.2	-1.4	-1.6	-1.1	-0.6
External current account balance (in percent of GDP)	0.1	1.9	2.1	2.4	2.5	2.7	3.0
Euro Area							
Real GDP growth	1.5	0.9	2.3	2.8	2.9	2.8	2.7
Output gap 1/	-0.4	-1.7	-1.8	-1.4	-0.8	-0.4	0.0
Unemployment rate 2/	8.0	8.4	8.2	7.9	7.6	7.3	7.0
Employment growth	1.6	0.5	0.8	0.9	0.9	0.8	0.8
CPI inflation	2.5	2.1	1.7	1.7	1.7	1.7	1.7
General government balance (in percent of GDP)	-1.5	-1.8	-1.4	-1.0	-0.8	-0.6	-0.4
External current account balance (in percent of GDP)	0.4	1.1	1.0	1.1	1.2	1.3	1.4

Sources: Deutsche Bundesbank; and Fund staff estimates.
1/ In percent of potential GDP.
2/ Standardized rate.

III. Policy Discussions

8. **The discussions focused on how macroeconomic and structural policies should be framed to foster a sustainable recovery**. The authorities were confident that the conditions for recovery were in place and would not be defused by financial sector strains, the appreciating euro, or fiscal consolidation. Low credit growth was seen as foremost a cyclical phenomenon; to the extent that it reflected supply-side influences, it stemmed from better risk management rather than excessive risk aversion. The euro rise was welcome as it would strengthen confidence in the new currency, lower inflation, and support domestic demand; it had not gone far enough to be a significant drag on exports. Sticking to the planned fiscal consolidation would provide policy certainty and help underpin consumer and business confidence; this was all the more so since consolidation was an essential step in preparing for longer-term demographic strains. Achieving close to budget balance was thus a key policy commitment that the authorities intended to keep even if growth were to fall somewhat short of their expectations.

9. **On structural policies, the authorities agreed that labor market reform had to be the next frontier**. Even so, labor markets had demonstrated flexibility in recent years and wage moderation had not come to an end, notwithstanding more job-neutral settlements this

year. The authorities stressed that it would take time to build consensus for reforms, particularly if it were to include the welfare system. But the high level of public debate generated by a committee of experts and representatives of the social partners (the Hartz Commission), which had been set up to recommend improvements in the Federal Labor Office (FLO), suggested that momentum for change was building.

A. Macroeconomic Conditions and Policies

10. **Macroeconomic policies are tight given Germany's cyclical position, but the authorities did not believe they would inhibit recovery**. All agreed that monetary conditions were somewhat tighter than warranted given Germany's relatively weak cyclical position. Taking into account banks' reluctance to lend and the planned fiscal consolidation, staff noted that the authorities' growth target for 2003 would be difficult to achieve.

11. **The authorities were confident that the general government deficit would stay below 3 percent of GDP in 2002 and move close to balance in 2004.** For 2002, expenditure at the federal level was being kept under tight control and almost all the Länder were operating under an expenditure freeze. Tax revenues in the first half of the year had been weak but the authorities expected income tax and VAT to pick up on account of the wage increases agreed on in May/June and the prospective revival in consumption. Similarly, corporate taxes would gain from recovering profits while nontax revenues would be boosted by larger-than-programmed transfers from the Bundesbank. Accordingly, they expected not to need further measures to stay below the 3 percent of GDP SGP ceiling.[10] Looking forward, the authorities had agreed on an "internal stability pact" with the Länder, under which spending would be slowed relative to the path in the December 2001 Stability Program, implying savings of about ⅓ percentage point of GDP by 2004. The coordination of national fiscal policy objectives across the different levels of government was also being strengthened (Box 3). On the expectation that real GDP growth would accelerate to 2½ percent during 2003–04, the target of getting close to budgetary balance—interpreted as a deficit of around ½ percentage point of GDP—would be achieved.

Germany: General Government Fiscal Accounts, 2001-2004
(In percent of GDP, unless otherwise noted)

	2001	2002	2003	2004
		Staff est.	Staff proj.	
Revenue	45.5	45.4	45.7	45.3
Expenditure	48.3	48.6	48.0	46.7
Balance	-2.8	-3.1	-2.2	-1.4
Structural balance 1/	-2.2	-1.7	-0.9	-0.2
Real discretionary spending 2/ (annual percent change)	-0.9	0.1	-0.6	-1.3

1/ In percent of potential GDP.

2/ Spending excluding expenditure on social programs.

12. **Staff felt that reaching near-balance in 2004 would be difficult and could place an excessive strain on the economy**. At the time, staff projected the deficit to come in below 3 percent of GDP in 2002, although with little room to spare: if growth failed to pick up in the

[10] Since the discussions, the federal authorities have implemented a freeze on certain expenditures, the savings from which are to fund immediate flood-related repairs.

second half of the year, weaker revenues could push the general government deficit up to around 3¼ percent of GDP. It would be important to ensure that any overshooting did not reflect lapses in expenditure control. Beyond 2002, the authorities' plans embodied, according to staff calculations, large reductions in the structural deficit and cuts in real discretionary spending in 2003-04. However, even these would be insufficient to reach close to nominal balance in 2004 if, as staff assumed, annual growth fell short of the authorities' 2½ percent target.

Box 3. Fiscal Transparency and Policy Coordination

A recent IMF staff assessment gives Germany very high marks for the openness and transparency of fiscal policy.[1] An extensive, precise, and respected body of law prevails over all aspects of public policy. Statistics and reporting are comprehensive, including in the more arcane areas of contingent liabilities, guarantees, and tax expenditures. As in many other industrial countries, transparency problems tend to stem from complexity as opposed to a lack of public information or accountability. Although well-documented, Germany's tax system and burden sharing arrangement between and across different levels of government are particularly complex. Staff recommends that simplification should remain an ongoing objective. There is also some scope to more clearly separate commercial and government activities undertaken by financial and non-financial public enterprises, although quasi-fiscal liabilities are estimated to be low.

A key area where the authorities are working to enhance transparency is in the clarification of plans at all levels of government to achieve national fiscal policy objectives, particularly given the growing importance of EU-wide obligations. Including for the federal government, staff recommends that more effort be devoted to identifying the costs of new initiatives, defining more clearly specific budget programs, and assessing structural trends in the budget. Better coordination and monitoring of plans across the federal and lower levels of government is called for, along with shorter reporting lags for the social insurance funds and sub-national governments to facilitate within-the-year analysis of developments at the general government level. Following the internal stability pact, the budget law has been amended to give the Fiscal Policy Planning Council (*Finanzplanungsrat*) a stronger coordinating role for national fiscal policy objectives.

[1] This box summarizes key findings from a draft Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency module, which was prepared for the consideration of the German authorities in September 2002.

13. **Staff stressed that, in pursuing fiscal consolidation, the quality and sustainability of expenditure restraint was more important than the precise pace of reduction in the nominal deficit.** To ensure steady progress in reducing the structural deficit, the expenditure/GDP ratio needed to be placed on a clear declining path. Expenditure restraint should aim to reduce the structural deficit relative to GDP by about ½ percentage point a year in order to achieve close to *structural* balance by 2004.[11] Ideally, spending policies should be designed to have the most favorable impact on the supply side of the economy. With expenditures on a restrained medium-term path, automatic stabilizers affecting the deficit should be given free play. The advice on the stabilizers was symmetric as it was vital to avoid past problems with spending abundant tax receipts in good times. There would be no room for tax relief other than that factored into current plans.

14. **The authorities argued that, at least for small shortfalls in growth, they did not intend to deviate from their nominal deficit targets.** In contrast to measures of structural balance, nominal targets provided an indispensable and fully transparent discipline; fine tuning would be ineffective and undermine public confidence in the SGP. Staff was sympathetic to the problems of measuring structural deficits.[12] But a very rapid adjustment might end up relying on unsustainable spending restraint, which would lack credibility. Since a key reason for pursuing fiscal consolidation was to prepare for the costs of population aging, a more credible approach might be to undertake fundamental reform of entitlements that contained future spending increases and accept a slower pace of deficit reduction.

Government Expenditure, 1999 and 2001
(In percent of GDP)

	Germany	Euro Area 1/
Expenditure, 2001 2/	48.3	48.8
Of which:		
Wage bill	7.9	11.6
Subsidies	1.7	1.3
Investment	1.8	2.9
Social spending, 1999 3/	29.6	26.5
Old age and survivor	12.0	12.3
Health and disability	10.3	8.7
Unemployment benefits	2.5	1.8
Other benefits	4.8	3.8

1/ Excluding Germany.
2/ Sources: OECD and WEO databases.
3/ Source: Eurostat; some figures are preliminary data.

15. **On the quality of expenditure restraint, the authorities explained that the federal government's medium-term budget protected productivity-enhancing outlays.** The authorities elaborated that, as part of the internal stability pact, the federal government was committed to reducing nominal expenditure by ½ percent a year over 2003–04. However, spending on education, R&D, and infrastructure would be shielded from cuts. By contrast, some savings would be sought on spending on the jobless, particularly on labor market policies that had proven ineffective.

[11] On staff projections, the general government would reach close to *actual* balance in 2006 with this adjustment.

[12] Based on historical revisions, standard errors of real GDP growth (0.5 percentage point) and of staff estimates of output gaps (0.4 percent of GDP) in 1992–2001 are large and raise problems for targeting cyclically adjusted budget deficits.

16. **Staff was nonetheless concerned that spending plans relied too much on general restraint and were insufficiently targeted at reining in entitlements and inefficient spending.** Investment and the wage bill had already borne a disproportionate share of the adjustment in spending during the 1990s, while social expenditure remained comparatively generous. The zero growth rate programmed for the federal government wage bill would encounter pressures for subsequent pay catch-up demands, and increases in federal investment spending were expected to be more than offset by investment cuts by the local governments; it was doubtful whether either would be sustainable. Staff called for a more aggressive elimination of spending on subsidies and active labor market policies than planned, as well as for cutbacks in entitlement spending, notably on the jobless. The authorities explained that subsidies were agreed on in the context of long-term programs. They hoped to manage some savings from a merger, which was under discussion, of unemployment and social assistance.

17. **The authorities' strategy to address the impending demographic challenge assumes that curbing government debt will avoid the need to make significant reductions in age-related benefits** (Box 4). The official "Guiding Principles of Fiscal Policy" of November 2000, target a gradual move to a budget surplus of 1 percent of GDP for 2009–2012. This would reduce government debt to 38 percent of GDP in 2012, from around 60 percent in 2001, assuming nominal output growth averaged about 4 percent a year. The authorities noted that the associated lower interest payments would create significant room for age-related spending. Moreover, the 2001 pension reform would greatly help to slow spending, and the demographic outlook could be expected to improve as a result of more immigration following the recent adoption of a new immigration law. A consensus existed on the need for more measures to contain health care spending. These would be designed and implemented after the elections.[13]

18. **Staff questioned whether entitlement reform could be avoided.** The pension reform had brought welcome institutional change but no significant savings. Relying only on medium-term fiscal consolidation to address the demographic problems would require a demanding compression of the relatively small share of public spending that is not demographically sensitive. Accordingly, staff advocated cutting high pension replacement rates further, raising the statutory retirement age, and shortening education periods.[14] In addition, private households' share in health care financing should be increased through co-payments. Given the lead time

[13] Some measures are already programmed, namely the introduction of a positive list of reimbursable products in 2003 and diagnosis-specific lump-sum payments in 2004. Health policy issues are analyzed in a Selected Issues paper.

[14] Under the 2001 pension reform, the minimum replacement ratio for a standard pensioner is to be cut from 70 percent to 67 percent by 2030. Each additional 1 percentage point cut in the replacement rate beyond this would reduce the contribution rate by ⅓ percentage point. A one-year increase in the statutory retirement age (currently 65) would allow contribution rates to be cut by 0.8 percentage point.

Box 4. Germany: The Fiscal Challenges of Aging

Germany's old-age dependency ratio is projected to almost double over the next 50 years, raising age-related spending by over 6½ percent of GDP. Financing these additional outlays by social security contributions would require increasing rates to a quasi-confiscatory level of 60 percent, from just over 40 percent now.

The authorities' strategy of moving to a general government surplus of 1 percent of GDP in 2009 only partly addresses this challenge. Assuming consolidation were brought about by permanent savings measures, compliance with SGP deficit and debt ceilings might be possible into the 2030s. But longer-term sustainability would require a larger fiscal effort.

Germany: Evolution of Age-Related Government Spending, 2001-50

	2001	2015	2030	2050	2001-50
	(In percent of GDP)				
Public pensions	9.7	10.0	13.5	14.8	5.1
Public sector employees' pensions	1.4	1.7	2.3	2.4	1.0
Public health care	7.3	7.8	8.2	8.6	1.3
Long-term care for the elderly	0.9	1.1	1.2	1.5	0.7
Child-related expenditure	4.4	3.9	3.5	3.0	-1.4
Total	23.7	24.5	28.7	30.4	6.7

Sources: German authorities; IMF staff projections.

Offsetting the bulk of the demographic costs through reform of entitlement programs seems essential. The base for other public expenditure, at around 20 percent of GDP, is too small to efficiently buffer the projected increase in age-related spending. Even under the government's strategy, the ratio of non-entitlement spending to GDP would have to fall by about 5 percentage points over the next ten years, despite savings on interest payments.

Staff analysis suggests that the reforms required to rein in the fiscal pressures from aging need not be drastic, provided they cover all dimensions of welfare spending and are implemented early. A Selected Issues paper examines an illustrative scenario in which the generosity of pensions, unemployment, and health programs are scaled back; future retirement ages are raised; and the length of education periods is reduced. Given the long time horizon, there would still be scope for *significant real increases* in benefits and pensions. The upfront fiscal consolidation would be smaller than currently envisaged by the authorities, but the permanent nature of the savings measures would ensure compliance with SGP limits though 2050. Moreover, reductions in non-entitlement expenditures would be more realistic (see Table).

Germany: General Government Operations, 2001-50
Entitlement Reform Scenario

	2001	2005	2015	2030	2050
	(In percent of GDP)				
Revenue	45.5	44.2	43.8	45.0	45.1
Expenditure	48.3	45.8	43.5	45.5	46.6
Age related	23.7	23.1	23.1	25.7	26.7
Unemployment support 1/	1.4	0.9	0.8	0.8	0.8
Interest	3.2	3.2	2.4	1.8	2.0
Other	20.0	18.5	17.2	17.2	17.2
Balance	-2.8	-1.6	0.3	-0.5	-1.5
Public debt	59.5	59.9	44.0	34.0	36.7

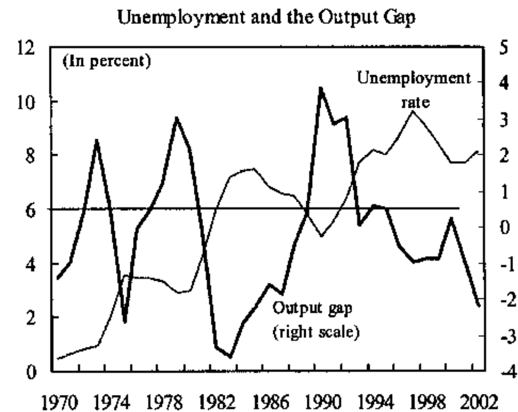
Sources: German authorities; IMF staff projections.

1/ Unemployment benefits and assistance as well as other payments to the unemployed, excluding social security contributions on their behalf.

required to phase in reforms to entitlements, staff encouraged the authorities to build consensus for change well before the demographic strains began to be felt in earnest in 10–15 years. The authorities did not rule out further pension reforms and noted that higher surpluses than those targeted under the main guiding principles scenario might also be considered if previous efforts proved insufficient.

B. Labor Market Reforms and the East-West Divide

19. **All agreed that labor markets had to be the focus of structural reforms after the elections.** The authorities observed that the unemployment rate had declined by about 2 percentage points during 1997-2001, despite below-trend output growth. Moreover, it was not expected to move much above 8 percent in the current slowdown. By contrast, in the past, unemployment had ratcheted up during years with below-trend growth. Furthermore, much of the labor market problem related to unification, as the unemployment rate in the old Länder stood at about 6½ percent in 2001 (EU standardized). In their view, progress was due to: (i) more moderate wage demands since 1996, a trend they expected to continue, notwithstanding a job-neutral catch-up for past higher-than-expected inflation in the latest wage round; (ii) more wage and working time flexibility through the incorporation of opening clauses in traditional collective wage bargaining agreements or through wage setting outside the collective bargaining framework; and (iii) measures to encourage part-time and temporary work. Accordingly, they saw no need for major changes to the wage bargaining system or job protection legislation. Instead, they intended to concentrate mainly on job matching, where they saw obvious room for improvement, through a reform of the FLO.[15]



20. **Staff suggested that better job matching should be flanked by reforms to raise the payoff from work.** Absent reforms, it was not clear how long wage moderation could be sustained—and, indeed, wage moderation was already being strongly questioned in some quarters because of its short-term depressing effect on demand. Ideally, reforms needed to be comprehensive. On the demand side of the labor market, high non-wage costs and burdensome regulations needed to be eased, notably those relating to

Germany and U.K.: Employment by Age Groups, 2001
(In percent of corresponding population)

Age	Germany	U.K.	Missing jobs 1/ (In millions)	Missing jobs 1/ (In percent)
15-64	65.7	71.6	2.6	100
15-24	46.5	55.6	0.8	31
25-49	80.3	81.3	0.3	12
50-54	74.5	77.3	0.1	6
55-59	57.7	64.7	0.4	13
60-64	20.8	37.6	1.0	38

Source: Eurostat.
1/ Additional jobs if Germany had the same employment ratios for each age group as the U.K.

[15] Against about 4 million unemployed, some 0.5 million vacancies are recorded at the FLO. Employers estimate the total number of vacancies at 1.5 million.

part-time working and temporary working arrangements, where liberalization efforts had been less bold than in some other European countries. However, if efforts had to be prioritized, they should first focus on supply-side bottlenecks. Staff pointed out that, while data suggested that the bargaining system permitted a reasonable degree of wage flexibility for job stayers, few job losers appeared ready to concede wage cutbacks or to migrate to find a new job (Box 5). As a result, about one third of the unemployed had been without a job for one year or more, with both older workers and the less skilled bearing a disproportionate burden of job losses. Furthermore, relative to the high-employment countries, Germany compared poorly on the employment ratio of older workers.[16] Staff argued that the root of these problems was overly generous benefits for the jobless: for the less skilled, these created poverty traps;[17] for older workers, benefits had been designed with the aim of facilitating a transition from work into retirement. Better job matching alone would not address these crucial weaknesses.

21. **To foster labor supply, staff advocated benefit reform coupled with an earned income tax credit (EITC) for low-income earners, perhaps targeted to older workers.** To this end, unifying the duration of unemployment benefits at 12 months and restricting a merged unemployment assistance and social assistance scheme to the truly needy should be considered. An EITC could help to reduce poverty traps, although experience elsewhere suggest that it would fail to provide a significant boost to labor supply absent cutbacks in benefits.[18] At the same time, to facilitate the transition of the unemployed into the labor market, those who saw their level of assistance reduced as a result of welfare reform could be given the opportunity to earn supplements by taking on training and performing socially useful work. Such work should substitute for many of the current, ineffective active labor market policy schemes.

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[16] The employment ratio of the young is also low, but this is related to the education system; the unemployment rate of 15-24 year olds is actually lower than in the U.K. (7.8 percent in 2001, compared with 10.3 percent in the U.K.). The overall employment ratio in Germany is above the EU average.

[17] In the old Länder, social assistance for a single worker reaches about 70 percent of the wage paid in the relatively low-paid restaurant and hotel sector; for a married worker with one child, it can reach 100 percent. Replacement rates are higher in the new Länder (see Sachverständigenrat, Jahresgutachten 2001/02, page 377).

[18] Research on the United States' welfare reform credits cutbacks in benefits with raising labor supply and the EITC with reducing poverty, but also emphasizes that the reform has not yet been tested by a large downturn in the labor market. See Blank (2002) "U.S. Welfare Reform: What's Relevant for Europe?" *CESIFO Working Paper* No. 753. The cost of the EITC might amount to ¼-½ percent of GDP (based on 2001 estimates) if schemes in either the United States or United Kingdom were taken as the model.

Box 5. Germany: Wage Flexibility

A forthcoming IMF Working Paper finds that the proportion of *job stayers* in the old Länder accepting wage cuts resembles that in the United States and the United Kingdom—although the typical wage cut is smaller.[1] The implied downward flexibility reflects a collective bargaining system that sets wage floors that typically are significantly below actual wage levels and allows exemptions in roughly one fifth of all contracts. Moreover, if employers leave their association, they can set wages outside the collective bargaining framework without the constraint of a legal minimum wage: in 2000, collective bargaining no longer covered 37 percent of employees in the west. Wage flexibility at the level of the individual worker contrasts with the rigidity of the wage structure across broad categories of education, years of experience, and tenure.[2] At the same time, few *job losers* make major wage concessions to find a job;[3] and a disproportionate number of older persons are jobless. A key reason might be that the welfare system fosters a transition from work into de facto retirement: in 1985, unemployment benefit duration was increased from the standard duration of 12 months to a maximum of 32 months for those older than 53 years, after which somewhat less generous unemployment assistance becomes available indefinitely.

Nominal Wage Growth Statistics for Individual Job Stayers in Various Panel Data Sets
(In percent, unless otherwise noted)

	Coverage 1/	Wage data	Median or Mean (*)	Wage decline (Percent of all job stayers)	Inflation rate	Unemployment rate
United States						
Mc Laughlin (1994)	1976-1986, PSID	Hourly rate	7.7 *	17.3	6.8	7.5
Card and Hyslop (1996)	1992-93, CPS	Hourly rate	3.6	20.3	3.0	6.9
Kahn (1997)	1976-1988, PSID	Hourly rate	...	17.8	6.3	7.2
United Kingdom						
Smith (2000)	1995-96, BHPS	Raw	3.7	23.4	2.4	8.2
	1991-92, BHPS	Raw	5.9	20.9	3.7	9.7
Nickell and Quintini (2000)	1995-99, BNES	Hourly rate	1.8	19.0	2.6	6.9
	1991-95, BNES	Hourly rate	2.0	17.0	2.9	9.6
	1995-96, BNES	Hourly rate	0.1	18.2	2.4	8.2
Old Länder						
	1984-99, GSOEP	Hourly rate	3.9	22.9	2.0	6.4
	1984-99, GSOEP	Raw	3.5	20.0	2.0	6.4

Sources: Forthcoming IMF Working Paper; and studies referenced in that paper.

[1] See Decressin and Decressin (2002), "On Sand and the Role of Grease in Labor Markets: How Does Germany Compare?," forthcoming IMF Working Paper.
[2] See Prasad (2000), "The Unbearable Stability of the German Wage Structure: Evidence and Interpretation," IMF Working Paper No. 00/22.
[3] See Burda and Mertens (2001): "Estimating Wage Losses of Displaced Workers in Germany," *Labour Economics* (8).

22. **Savings from reform of welfare and the FLO could be partly used to help raise labor demand through reducing social security contributions.** Total spending on unemployment, job creation, and social assistance not specifically related to sickness and disability amounts to over 3½ percent of GDP: depending on how much progress is made in improving the targeting of social welfare, budgetary savings are thus potentially significant. Efficiency considerations would suggest that cuts in contributions might, in the first instance, be limited to employers of older workers. Longer-term, sustainable cuts in contribution rates would require reform of pension and health benefits.

23. **The authorities agreed that the generosity of welfare benefits might be holding back labor supply but were against general cutbacks in assistance.** They would consider tightening eligibility for specific groups of unemployed who rejected job offers, notably the young. Also, a parliamentary commission was studying the merger of unemployment and social assistance with the main objective of removing inefficiencies. However, this would require changes in intergovernmental relations, as unemployment assistance was financed by the federal government, while social assistance was in the hands of the municipalities. If additional measures became necessary, the authorities believed the consensus would move in the direction of benefit reform. In this context, the Hartz Commission, which had initially been set up to look into the FLO's poor record in job matching, had been instrumental in launching a public debate on broader reform.

24. **Since the discussions, the Hartz Commission has published its proposals for labor market reform.** The proposals aim mainly at improving job matching through restructuring the FLO and local labor offices and merging the administration of various benefits for the jobless. In addition, they advocate: (i) personal service agencies, operating outside the public sector but with its financial support, that would aim to place the unemployed with private companies under less-regulated fixed-term contracts; (ii) incentives for the jobless to become self-employed; (iii) subsidies or special loans to employers for hiring difficult-to-integrate unemployed; and (iv) for older workers, financial incentives to accept jobs and more scope for fixed-term employment. While the authorities intend to proceed rapidly with the implementation of some measures, notably the restructuring of the FLO and the special loans program, the cost effectiveness and budgetary implications of others require further analysis as well as new laws to be drafted in the new term. The special loans program is particularly controversial because it would involve public subsidies effectively provided by the development bank, Kreditanstalt für Wiederaufbau (KfW), which is outside the general government sector.

25. **The authorities argued that existing mechanisms to correct high unemployment in the new Länder were operating sufficiently.** From various perspectives the catch-up of the new with the old Länder has been successful and is continuing (Box 6). However, as a result of overly rapid wage growth in the early 1990s, the new Länder now account for about one-third of Germany's unemployed, with unemployment rates almost 2½ times as high as in the old Länder. In the authorities' view, much of the initial job destruction had been unavoidable, owing to the lack of competitiveness of the manufacturing sector in the former East Germany. However, manufacturing had now turned into a vibrant sector accounting for about one-fifth of GDP in the

new Länder, exports were booming, and unemployment had fallen despite the phase-out of various active labor market schemes. This partly reflected wages and working conditions that were much more flexible than in the old Länder, with a large majority of employees not covered by collective bargaining agreements. Staff agreed that mechanisms to correct imbalances in labor markets in the new Länder were operating but noted that unemployment was only adjusting slowly. High benefit replacement rates in the new Länder made it all the more important to pursue benefit reform.

Box 6. Germany: The Catch-Up of the New Länder

Incomes in the new Länder have caught up rapidly with those in the old Länder. For a broad sample of countries, studies find that per capita incomes have historically converged at a rate of 3 percent per annum. For the new Länder, this would have meant that per capita GDP should have grown at least 2 percentage points a year faster over 1992-2001 than in the old Länder. In fact, it grew over 6 percentage points faster and now stands just 6 percent below the level in Portugal. Other Eastern European countries did not post similar growth. In manufacturing, productivity convergence has proceeded briskly.

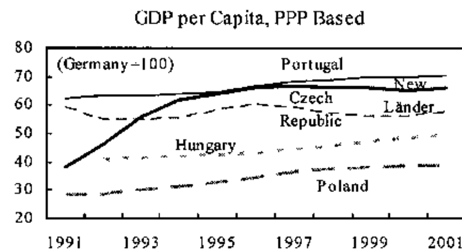
However, from the perspective of labor utilization, the catch-up has been disappointing, owing to the initial overly rapid convergence of eastern wages toward western levels. Wage moderation is now needed to cut unemployment and many of the new employers have left their associations to negotiate outside the collective wage bargaining framework.

Firms' Membership in Employers' Associations, 1993-2000

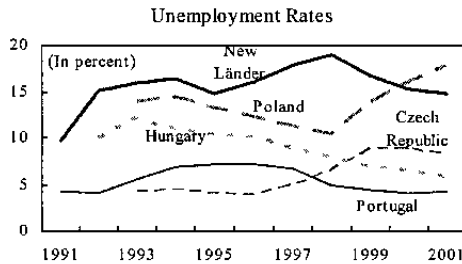
	1993	1995	1998	2000
Membership in association				
In percent of firms	36	27	21	16
In percent of employees	76	64	45	34

Source: Burda and Hunt (2001), "From Reunification to Economic Integration," Brookings Papers of Economic Activity.

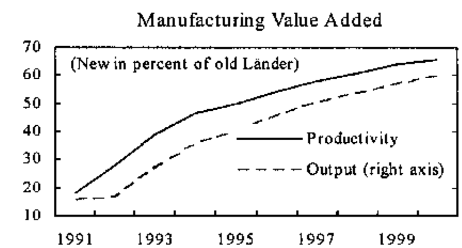
GDP per Capita, PPP Based



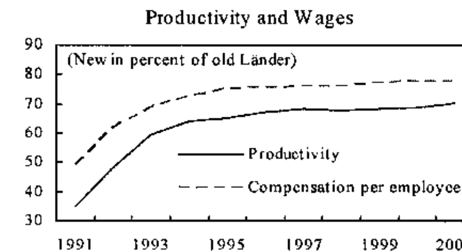
Unemployment Rates



Manufacturing Value Added



Productivity and Wages



26. **The authorities noted that the current slowdown in activity in the new Länder was largely driven by construction, which had been artificially supported by inefficient investment subsidies**. True, the overall envelope for investment by the local governments in the new Länder was programmed to decline under the pressure of fiscal consolidation. But they believed the quality of spending was more important, and they were considering a recent report on east-west convergence that proposed concentrating public support on rapidly growing clusters of activity in the new Länder, rather than spreading it thinly across the entire territory. Staff urged shielding public infrastructure from further cuts, noting that studies suggested that, on current plans, the per capita stock of eastern infrastructure covering schooling, transport, and communications would barely exceed two-thirds of the level in the old Länder by 2005.[19]

C. Product and Financial Markets

27. **The authorities explained that they would continue to press for product market liberalization but were looking for a more level playing field in Europe**. Germany had been at the forefront within Europe as regards liberalization of the telecommunications, energy, and postal sectors (the main network sectors); this had led to price declines and benefits for consumers. But while the authorities wanted to open their markets to more external competition, they were concerned that, absent better safeguards, key industries were exposed to takeovers by foreign state monopolies. This was particularly the case in energy and postal markets. Staff urged the authorities to intensify efforts with their European partners to keep the liberalization process moving forward. To foster more domestic competition in the energy sector, the introduction of specialized regulatory agencies might have to be considered as reliance on voluntary association agreements had been associated with less newcomer penetration of markets than expected. The authorities pointed out that they were currently strengthening the role of the Federal Cartel Office in ensuring competition and were considering making the association agreements legally enforceable under the Energy Industry Law. Ongoing steps to deregulate markets would be augmented by further divestiture of public assets.

28. **Staff encouraged the authorities to resist pressures for public support to SMEs**. The agreement with the EU to phase out public guarantees to the *Landesbanken* and savings banks and the coming changes from Basel II were seen in some quarters as exacerbating the cyclical problems of SMEs. With respect to Basel II, however, the authorities noted that they had reached agreement on lower equity requirements for small loans and lower risk weights on credits to smaller SMEs. This would effectively exclude many small enterprises from the new requirements, assuaging pressure for providing additional support to SMEs through subsidized loans offered by the KfW and the Deutsche Ausgleichsbank (DA). The focus of any measures would be to improve coordination and efficiency of SME support.

29. **In the wake of domestic and international scandals, the authorities were taking steps to strengthen corporate governance**. A voluntary corporate governance code

[19] See *DIW-Wochenbericht 24/00.*

establishing clear rules for the executive and supervisory boards of exchange-listed corporations had been introduced. It was expected to enhance transparency for investors and improve corporations' access to international financial markets. Companies that do not comply with the code must issue a public declaration explaining their decision. Since the discussions, the authorities have tabled further proposals to strengthen governance. These include introducing personal liability for board members for the intentional dissemination of wrongful information and strengthening the supervision of accountancy firms and their liability for negligence.

30. **The authorities viewed the financial sector as sound, with recent strains on profitability prompting improved risk management and faster consolidation.** The performance of financial institutions has been weakening since 2001, in line with economic activity and a record number of corporate bankruptcies. The correction in equity markets has further eroded banks' earnings, exposing structurally low profitability related to strong competition and high costs. While loan-loss provisions were rising and profitability was expected to continue to suffer in 2002, banks were responding by improving their risk management—a process also prompted by the phasing out of guarantees to public sector banks and the expected introduction of Basel II. Moreover, consolidation was advancing among the mutually-owned credit cooperatives, and pressures for consolidation were building for the publicly-owned savings banks. Although exposures to potentially risky sectors and markets needed to be watched carefully, they were manageable, and reserves and capital were comfortable (Table 2). Like their European counterparts, German insurance companies have suffered from falling equity prices and—even before the recent floods—unusually high claims. While some insurers have been registering negative profits, the authorities expected the insurance sector to rebound, helped by higher premiums.

31. **Staff argued that the present confluence of cyclical and structural weaknesses presented challenges for supervisors.** The authorities acknowledged that restructuring in the financial sector was an ongoing process that would take several years. They were aware of a few problems in specific banks and insurance companies but stressed that systemic risks were low. They were strengthening the complex institutions group within BaFin—the single supervisory agency under the new Law on Integrated Financial Services Supervision—to take advantage of the synergies offered by integrated financial supervision. They also intended to hire 600 new staff to implement Basel II, although the public pay scale raised difficulties that needed to be addressed. Furthermore, they planned to review the regulatory framework to ensure comparable risk-adjusted capital requirements across financial institutions. Staff urged the authorities to make publicly available more information on financial sector risks, in line with other countries. All agreed that the upcoming Financial Sector Assessment Program (FSAP) presented a timely opportunity for supervisors to review the lines of defense against financial sector vulnerabilities.

D. Other Issues

32. The authorities reported that they were strengthening further the laws and regulations covering **money laundering**. Beyond the 40 recommendations of the Financial Action Task Force (FATF), the 8 special recommendations on terrorist financing had already been implemented. Moreover, a financial intelligence unit was being built up within the federal law enforcement authority; an automatic system offering access to information on all bank account holders was being developed; and tax consultants and accounting companies would be required to combat money laundering. Germany acceded to the **OECD Convention on Bribery in International Business Transactions** and adopted implementing legislation in 1999.

33. Germany's **statistics** are generally of high quality, but to improve analysis and cross-country comparisons price deflators could better reflect changes in product quality; direct national accounts data on inventories should be constructed; data for the general government should be published with a higher frequency; and more comprehensive and timely data on financial sector vulnerabilities should be made available. Germany supports multilateral **trade liberalization**, notably the elimination of trade barriers for poor countries. Furthermore, it recently renewed its commitment to raising spending on **ODA**, which presently amounts to less than 0.3 percent of GNI.

IV. Staff Appraisal

34. **The decade since unification has been one of difficult adjustments in Germany**. The disappointing growth rate during the past 10 years should not disguise many distinct successes. Foremost among these was the integration of the new Länder with a remarkable degree of convergence of their income to western levels. But beyond this, Germany has steadily reduced its underlying fiscal imbalance, emerged as a leader within Europe in product market deregulation, and undertaken major tax and pension reforms. But the fact remains that growth for an entire decade has been low. And without a decisive break from past policies, particularly in labor markets but also in fiscal matters, Germany is at risk of another decade of painful fiscal adjustment against a backdrop of slow growth.

35. **The new government has the opportunity to make this break**. It must set its sights on putting more of the working age population to work so as to raise growth and revitalize the economy. Two priorities stand out from a macroeconomic policy perspective—increasing incentives to work and reducing entitlements, subsidies, and social transfers so as to deal with the fiscal imbalance permanently. Proceeding on both fronts will have powerful synergies: public expenditure reform will establish credibility, minimizing output costs of adjustment, and labor market reforms will raise growth, making fiscal adjustment more palatable. As the immediate outlook for growth is not strong—a stuttering recovery over the next year or so—the urgency for action is great.

36. **The conditions for recovery have improved, but major domestic and global uncertainties cloud the growth outlook**. With earlier price shocks having unwound, interest rate cuts feeding through and global activity firming somewhat, growth should begin to pick up

toward the end of the year. But in view of domestic and global financial strains and a relatively tight macroeconomic policy stance, the economy is only projected to grow at the rate of potential next year. The current wide output gap and high unemployment are therefore likely to persist.

37. **Fiscal consolidation is essential and needs to be implemented in a sustainable and credible manner**. For 2002, the deficit will likely be close to the 3 percent SGP ceiling, and the authorities will need to continue to maintain firm expenditure control. Beyond this year, ensuring that the expenditure/GDP ratio is on a clear and sustainable downward path should be the priority. With that in place, a reduction in the structural deficit of ½ percent of GDP a year should be feasible. The automatic stabilizers should be given full play—in both directions—and postponing tax cuts to pay for one-time emergency flood relief would appear to be unnecessary. It is unrealistic, on current projections, to expect budget balance by 2004, and driving for that goal would likely place undue strain on the economy. That said, further tax relief beyond that already programmed should be postponed until expenditures and the deficit have been fully reined in.

38. **It will be important to focus on the quality of expenditure restraint in order to provide the maximum boost to the supply side of the economy and reduce long-term spending pressures.** Expenditure savings centered on pay compression and cutbacks in public investment are unlikely to be sustainable. Instead, industrial and agricultural subsidies should be curtailed more aggressively than planned, and spending on social transfers and labor market programs should be scaled back. In principle, broader entitlement reform that yielded significant future savings would be at least as effective in securing market confidence and ensuring that euro area-wide monetary policy strains do not develop as would meeting medium-term nominal deficit targets.

39. **Looking ahead, the hardest fiscal task for Germany is to prepare for the costs of population aging**. Although demographic pressures are not expected to bite for a decade or so, the new government needs to take the lead in building consensus for reforms. To avoid punitive increases in social contribution rates, budget surpluses will have to be run over a substantial period and be combined with measures to reduce the generosity of entitlements. In the area of pensions, the options largely come down to raising the retirement age and lowering the replacement ratio. In the area of health care, measures should encompass higher cost-recovery.

40. **The current public policy debate on labor market reform offers a prime opportunity to push forward ambitious reforms.** Some of the Hartz Commission recommendations, notably the setting up of private placement agencies, are good and should be implemented without delay; others, particularly the special loans program, are not. But a more comprehensive package that moves toward more flexible employment practices as well as stronger incentives to work is needed. This would provide the most effective signal to employers and workers about the orientation of policies and would reap the highest response in terms of investment and job creation. But if it takes time to build consensus for such a package, at a minimum, initial reforms need to address two critical problems: the low employment rate of older workers and the high unemployment rate of the low-skilled. Particularly for these groups,

improving incentives to work through reform of the benefit system is a priority. This could be achieved by introducing an earned income tax credit for low-income earners, together with measures to target assistance for the jobless only to the truly needy. Those finding their level of assistance reduced could be given the opportunity to earn supplements by performing jobs that substitute for many of the ineffective active labor market policy schemes.

41. **To meet the challenges of intensified global competition and improve productivity growth, Germany must remain committed to product market reform.** While recognizing the difficulties of different speeds of market opening in Europe, Germany stands to benefit from remaining a leader in reform, as product market competition and productivity growth are closely related. Sufficient competition will have to be ensured in the network sectors, by carefully balancing self-regulation and intervention. The SME sector's role as an engine of growth should not be compromised by special treatment or subsidies. Germany's support for multilateral trade liberalization and the elimination of trade barriers for poor countries is highly welcome and the authorities are encouraged to raise ODA spending to the UN target of 0.7 percent of GNI.

42. **Recent developments are setting the stage for a stronger banking system, but the confluence of cyclical and structural weaknesses requires supervisors to be particularly attentive**. The phasing out of guarantees to public sector banks and the expected introduction of Basel II standards are welcome developments. These changes, together with banks' efforts to raise profitability, are already driving the processes of improving risk management and bank consolidation. Allowing the latter to continue unhindered will be important to the future health of the banking system. Moreover, it is essential that the new Law on Integrated Financial Services Supervision be implemented to ensure the latitude and resources of the BaFin are sufficient to keep abreast of financial market developments. The forthcoming FSAP will provide a timely opportunity to review supervisors' lines of defense.

43. **Germany's statistics are more than adequate for the purposes of effective surveillance**. However, some improvements could facilitate cross-country comparisons as well as the monitoring of fiscal policy and financial sector vulnerabilities.

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

Table 1. Germany: Basic Data

Total area (1999)	357,020 square kilometers
Total population (2001)	82.37 million
GNP per capita (2001)	US$ 22,324

	1997	1998	1999	2000	2001	2002 1/	2003 1/
	(Percentage change at 1995 prices)						
Demand and supply							
Private consumption	0.6	1.8	3.7	1.4	1.5	-0.3	2.3
Public consumption	0.3	1.9	1.0	1.2	0.8	0.9	0.5
Gross fixed investment	0.6	3.0	4.1	2.5	-5.3	-4.8	1.4
Construction	-1.5	-1.0	1.4	-2.6	-6.0	-3.8	1.1
Machinery and equipment	3.7	9.2	7.2	9.5	-5.8	-7.5	1.0
Final domestic demand	0.5	2.1	3.3	1.6	-0.2	-1.1	1.8
Inventory accumulation 2/	0.0	0.3	-0.4	0.2	-0.6	0.4	0.5
Total domestic demand	0.6	2.4	2.8	1.8	-0.8	-0.7	2.3
Exports of goods and nonfactor services	11.2	7.0	5.6	13.7	5.0	1.9	4.3
Imports of goods and nonfactor services	8.3	9.1	8.5	10.5	1.0	-1.5	5.7
Foreign balance 2/	0.8	-0.4	-0.7	1.0	1.4	1.1	-0.2
GDP	1.4	2.0	2.0	2.9	0.6	0.5	2.0
Output gap (In percent of potential GDP)	-1.0	-0.9	-0.7	0.3	-1.0	-2.3	-2.3
	(In millions, unless otherwise indicated)						
Employment and unemployment							
Labor force	40.9	41.1	41.3	41.8	41.9	42.0	42.1
Employment 3/	37.1	37.6	38.0	38.7	38.9	38.7	38.8
Unemployed 4/	3.8	3.6	3.3	3.1	3.1	3.3	3.3
Unemployment rate (in percent) 4/	9.6	9.1	8.4	7.8	7.8	8.3	8.3
	(Percentage change)						
Prices and incomes							
GDP deflator	0.7	1.1	0.5	-0.3	1.4	1.7	1.5
Consumer price index (harmonized)	1.5	0.6	0.7	2.1	2.4	1.4	1.1
Average hourly earnings (industry)	1.8	2.0	2.7	2.8	...	...	...
Unit labor cost (total economy)	-0.7	0.2	0.4	1.0	1.5	1.7	1.4
Real disposable income 5/	0.1	1.7	3.1	1.5	1.8	0.3	2.0
Personal saving ratio (in percent)	10.4	10.3	9.8	9.8	10.1	10.6	10.4

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

1/ IMF staff projections.

2/ Growth contribution.

3/ According to place of residence.

4/ Unemployment as defined by Eurostat.

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

Table 1. Germany: Basic Data (concluded)

	1997	1998	1999	2000	2001	2002 1/	2003 1/
Public finances 2/ 3/				(In billions of euros)			
General government							
Expenditure	923	942	965	931	1,001	1,028	1,051
(In percent of GDP)	49.3	48.8	48.8	45.9	48.3	48.6	48.0
Revenue	872	899	935	954	943	961	1,002
(In percent of GDP)	46.6	46.6	47.3	47.0	45.5	45.4	45.7
Financial balance	-51	-43	-30	23	-58	-67	-49
(In percent of GDP)	-2.7	-2.2	-1.5	1.1	-2.8	-3.1	-2.2
Structural balance	-33	-28	-19	-30	-46	-38	-20
(In percent of potential GDP	-1.7	-1.4	-1.0	-1.5	-2.2	-1.7	-0.9
Federal government							
Financial balance	-32	-29	-26	27	-23	-31	-21
(In percent of GDP)	-1.7	-1.5	-1.3	1.3	-1.1	-1.5	-1.0
General government debt	1,142	1,175	1,210	1,222	1,233	1,288	1,333
(In percent of GDP)	61.0	60.9	61.2	60.2	59.5	60.9	60.8
Balance of payments							
Trade balance 4/	55.8	61.9	58.2	52.3	89.3	123.8	128.6
Services balance	-30.0	-33.4	-41.5	-44.4	-47.4	-47.6	-48.1
Net private transfers	-8.1	-8.2	-8.3	-8.1	-9.7	-9.5	-9.5
Net official transfers	-18.8	-19.1	-17.4	-19.0	-17.0	-18.0	-18.5
Current account	-2.4	-5.6	-17.9	-22.6	2.7	41.2	46.5
(In percent of GDP)	-0.1	-0.3	-0.9	-1.1	0.1	1.9	2.1
Foreign exchange reserves (e. o. p.) 5/ 6/	39.2	51.3	52.4	53.4	49.5	44.1	...
Monetary data			(Percentage changes, end of period)				
Money and quasi-money (M3) 6/ 7/	4.7	7.6	7.2	-1.2	6.0	5.0	...
Credit to private sector 6/	6.2	8.4	5.8	5.8	3.2	0.8	...
Interest rates			(Period averages in percent)				
Three-month interbank rate 8/	3.3	3.5	2.9	4.4	4.3	3.3	...
Yield on ten-year government bonds 8/	5.7	4.6	4.5	5.3	4.8	4.3	...
Exchange rates				(Levels)			
Euro per US$ (annual average) 8/	0.88	0.89	0.94	1.08	1.12	1.02	...
Nominal effective rate (1990=100) 9/	103.8	104.1	102.0	97.8	97.7	99.9	...
Real effective rate (1990=100) 9/ 10/	113.3	110.4	107.1	100.8	100.0	100.4	...

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.

6/ Data for 2002 refer to July 2002.

7/ Data reflect Germany's contribution to M3 of the euro area.

8/ Data for 2002 refer to September 20, 2002.

9/ Data for 2002 refer to August 2002.

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

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

	1998	1999	2000	2001	2002 1/	
External Indicators						
Exports (annual percentage change, in U.S. dollars)	5.8	-0.2	1.0	3.2	7.7	projections
Imports (annual percentage change, in U.S. dollars)	5.6	2.1	2.8	-1.6	2.7	projections
Terms of trade (annual percentage change)	2.3	0.2	-4.4	0.4	1.3	projections
Current account balance	-0.3	-0.9	-1.1	0.1	1.9	projections
Capital account balance	0.3	-0.7	2.0	-1.1	-1.9	projections
Of which: Foreign direct investment (net)	-3.0	-2.6	7.8	-0.6	-1.9	projections
Portfolio investment (net)	-0.1	-0.6	-8.1	0.4	-0.7	projections
Other investment liabilities (net)	3.6	1.9	2.0	-1.2	1.5	projections
Official Reserves (in billions of U.S. dollars, end-of-period) 2/ 3/	74.0	61.0	56.9	51.3	51.9	July
Broad money to reserves ratio 2/ 3/	30.1	41.0	50.2	60.9	59.6	July
Exchange rate (euro) against U.S. dollar (period average)	1.1	1.1	0.9	0.9	0.9	
Financial Markets Indicators						
Public sector debt (Maastricht definition)	60.9	61.2	60.2	59.5	60.9	
3-month T-bill yield 4/	3.5	2.9	4.4	4.3	3.4	July
3-month T-bill yield (real) 4/	2.4	2.6	3.5	2.5	1.9	July
10-year Bund yield 4/	3.7	4.5	5.3	4.8	4.9	July
Change in stock market index (percent, end of period) 5/	17.7	39.1	-7.5	-19.8	-35.3	9/5/2002
Change in DEU stock market index (percent, eop) for banks 6/	-11.0	33.6	-0.3	-25.4	-31.3	Sept
Change in global stock market index (percent.eop) for banks 6/	4.4	2.4	2.4	-13.6	-1.2	Sept
Change in DEU stock market index (percent, eop) for TMT 6/ 7/	64.8	112.6	-44.6	-30.9	-44.2	Sept
Change in DEU stock market index (percent, eop) for construction	-7.8	8.2	-36.0	3.2	-15.7	Sept
Spread of 3-month T-bill vs. the U.S. (percentage points, e-o-p)	-1.3	-1.7	-1.5	0.2	1.1	July
Yield curve (10 year - 3-month T-bill)	0.2	1.6	0.9	0.6	1.5	July
Credit Indicators (percent, y-o-y)						
Total credit to non-MFIs	6.8	6.5	4.3	4.2	-0.8	June
Loans	7.3	9.6	4.3	4.3	-0.8	June
Lending: mortgages secured by residential real estate 8/	7.5	29.9	6.7	2.7	1.4	Q2
Lending to employees and other individuals: Housing loans	7.2	24.6	4.2	3.1	0.9	Q2
Lending to employees and other individuals: Installment credit	7.9	-0.5	2.8	1.9	1.5	Q2
Lending to electrical & optical equip, telecom, computers, R&D	6.4	3.4	4.5	1.8	1.4	Q2
Lending to construction sector	1.2	5.6	1.7	-0.4	-2.2	Q2
Lending to other real estate enterprises	7.9	6.5	7.1	5.3	0.4	Q2
% lending to electrical & optical equip, telecom,computers,R&D	9.9	10.1	10.3	10.4	0.1	Q2
Financial Sector Risk Indicators						
Total loans to assets	74.9	73.5	72.2	72.8	72.4	May
Total loans to deposits	113.9	112.3	111.1	111.4	111.7	May
Share of real estate sector in private credit (percent) 9/	11.2	22.6	22.0	21.5	21.7	May
Share of real estate sector in loans to nonfinancial private sector (percent) 10/	16.9	35.4	35.0	34.6	34.9	May
Share of non-performing loans in total non-bank loans (percent) 11/	3.0	2.6	2.2	2.1	...	
Level of risk provisioning to total non-bank loans (percent) 12/	2.2	2.0	1.8	1.8	...	
German capital asset ratio 13/	10.6	11.3	10.9	11.5	...	
Profitability ratio 14/	10.2	6.5	6.1	4.6	...	
Number of insolvencies of enterprises and individuals 15/	1,341	1,316	1,549	2,053	...	
Volume of loans to insolvent borrowers (in billions of euro) 15/	6.1	5.5	7.7	10.9	...	

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

1/ Staff estimates and projections, unless otherwise indicated.

2/ Data for 2002 refer to end-July.

3/ From 1999 onward data present Germany's position in the euro area.

4/ For 2002 data are as of July.

5/ DAX 30 stock market index.

6/ DataStream indices; includes German bank stocks

7/ TMT is telecom, media, and information technology

8/ 1999 growth due to low mortgage interest rates and expiration of special depreciation allowances in eastern Germany

9/ Share of housing loans in percent of total lending to private sector.

10/ Share of housing loans in percent of total lending to nonfinancial private sector.

11/ German commercial law definition of non-performing loans.

12/ German commercial law definition of risk provisions.

13/ Consolidated basis, risk-weighted, national definitions of capital.

14/ After-tax profit as percent of average capital.

15/ Insolvencies of only those included in the credit register with loans of greater than Euro 1.5 million.

Germany: Fund Relations

(As of July 31, 2002)

I. Membership Status:

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

II. General Resources Account:	SDR Million	% Quota
Quota	13,008.20	100.0
Fund holdings of currency	7,827.00	60.17
Reserve position in Fund	5,181.21	39.83
Financial Transaction Plan transfers (net)	751.00	

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	1,210.76	100.0
Holdings	1,400.51	115.67

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

VII. Exchange Rate Arrangement:

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

Germany maintains exchange restrictions against Iraq pursuant to U.N. Security Council Resolution No. 661, and against the Federal Republic of Yugoslavia (Serbia/Montenegro) pursuant to U.N. Security Council Resolution No. 757. These restrictions were notified to the Fund under Decision No. 144. In accordance with U.N. Security Council Resolution No. 022, the financial sanctions against the Federal Republic of Yugoslavia (Serbia/Montenegro) were suspended with effect from November 22, 1995. The sanctions against the areas of Bosnia and Herzegovina that were controlled by the Serbs were suspended on February 27, 1996.

VIII. Article IV Consultations:

Germany is on a 12-month consultation cycle. The staff report for the last Article IV consultation (SM/01/290) was discussed at EBM/01/108 (October 24, 2001).

GERMANY: STATISTICAL APPENDIX

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.

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

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

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.

Intra-annual ESA95 (national accounts) data on the general government are not available, as elsewhere in the euro area, depriving Germany of a key indicator to monitor fiscal developments. Relatedly, a bridge table between the general government data on a national accounts basis and the public sector data on an administrative basis is not published; this too hinders a full understanding of fiscal developments.

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

Germany: Core Statistical Indicators
(As of August 23, 2002)

	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	8/23/02	8/23/02	7/02	6/02	6/02	2001	2002Q2	3/02
Date Received	8/23/02	8/23//02	8/14/02	8/02	8/02	1/17/02 updated 8/22/02	8/22/02	6/28/02
Frequency of Data	Daily	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Quarterly
Frequency of Reporting	Daily	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Quarterly
Source of Update	Bundesbank, website	Bundesbank, website	Federal Statistical Office, Deutsche Bundesbank websites	Federal Statistical Office, Deutsche Bundesbank websites	Federal Statistical Office, Deutsche Bundesbank websites	Federal Statistical Office	Federal Statistical Office, Deutsche Bundesbank	Deutsche Bundesbank, website
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Fax	Electronic	Electronic
Confidentiality	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Monthly

INTERNATIONAL MONETARY FUND

GERMANY

Staff Report for the 2002 Article IV Consultation

Supplementary Information

Prepared by the European I Department

Approved by Michael Deppler and Martin Fetherston

October 21, 2002

1. This supplement reports on information that has become available since the issuance of the staff report (SM/02/309) and on discussions with the authorities that took place during the Annual Meetings and via videoconference on October 17, 2002.[1] Annex I contains additional analysis of debt sustainability, which confirms, as indicated in the staff report, that Germany's fundamental fiscal challenges are of a long-term nature. The discussions with the authorities focused on the short-term economic outlook and the policy plans of the newly re-elected government. The new information reinforces the thrust of the staff appraisal.

Short-term outlook

2. **Recent data suggest the economy is continuing to grow at a slow pace, but forward looking indicators imply a weaker growth outlook than in staff's current projections**. The latest hard data are consistent with staff's estimate that the economy expanded at a weak pace—around 1½ percent at an annualized rate—in the third quarter. Private credit may also have turned the corner after declines in the first half of the year. However, the expectations component of the Ifo business survey and the ZEW sentiment indicator have contracted further (see Figure 1), and the survey of Consensus Forecasts for growth in 2003 has been marked down by ½ percentage point in the past month to 1.5 percent. More pessimistic expectations are consistent with the continuing volatility in financial markets and the uncertainties regarding security issues in the Middle East. On the basis of the assumptions underlying the last World Economic Outlook, staff would mark down its real GDP growth projection by about ¼ percentage point in 2003 to 1¾ percent. A larger downward revision would be warranted if proposed additional fiscal measures (see

[1] On both occasions, the principal representative for the authorities was Ministry of Finance State Secretary Koch-Weser.

below) are indeed included in next year's budget, or downward risks to the global outlook were to be reflected in projections. Growth in 2002 is expected to be only marginally lower, and still about ½ percent.

3. **The authorities broadly agreed with staff's assessment, although the official forecast will not be finalized until the end of the month**. The authorities accepted that growth in 2002 and 2003 was likely to fall short of the existing official projection of about ¾ percent and 2½ percent for these years. They noted that prospects for exports in particular had dimmed relative to what had been expected in Spring 2002 when the official forecast was last updated.

Fiscal policy

4. **Recent data have led the authorities to conclude that the general government deficit will likely exceed 3 percent of GDP this year**. While full data were not available, it was clear that tax collection in September had disappointed and remained below last year's low level. At this stage, the authorities could not say how large any overshooting of the 3 percent mark was likely to be, especially with scant information available on developments in the finances of the lower levels of government. Staff now sees the deficit in 2002 being close to 3½ percent of GDP rather than the 3.1 percent of GDP in the staff report. Except for some higher cyclical expenditures, most of the upward revision stems from weaker revenue. Some of the shortfall in revenues, particularly in corporate taxes, is not fully understood and does not have a straightforward cyclical interpretation.

5. **The authorities are taking steps to ensure that the general government deficit falls back below 3 percent of GDP in 2003**. Following discussion between the coalition partners, the authorities have agreed on a package of tax measures amounting to about €7 billion (0.3 percent of GDP). These measures, which are in addition to the postponement of income tax cuts explained in the staff report, include revisions to VAT, corporate income and capital gains taxation, as well as reductions in tax expenditures and exemptions. Some of the tax measures could, however, encounter parliamentary opposition. In addition, expenditures (primarily on labor market programs) are to be cut relative to current policies by about €7 billion. An official projection for the deficit in 2003 will be available in November, according to the usual budget timetable. It will be based on assumed real GDP growth of 1½ percent in 2003, the average growth rate in the past ten years. The authorities stressed, however, that this was merely a prudent assumption and they expected actual growth to be higher. They believed that their strong efforts to bring the deficit rapidly back under 3 percent of GDP would be favorably received by their Stability and Growth Pact (SGP) partners.

6. **Looking beyond 2003, the authorities are strongly committed to reaching close to balance for the general government deficit in 2006**. The authorities agreed with the majority of EU Finance Ministers that governments that had not yet achieved budget balance should aim to reduce their structural balances relative to GDP by ½ percentage point a year. But, because tax cuts had already been approved for 2004 and 2005, the German authorities

would front-load their consolidation effort. Their fiscal plans would be based on conservative growth projections of 1½ percent in each of 2003 and 2004, and 2 percent in 2005-06.

7. **Staff noted that the front-loaded adjustment would imply a large fiscal withdrawal in 2003**. Even assuming announced expenditure cuts would mainly help to keep expenditures broadly on track with earlier plans, the additional tax measures would augment the already planned withdrawal of stimulus in 2003 of ¾ percentage point of GDP by about ¼ percentage point of GDP. Staff observed that a withdrawal of about 1 percentage point of GDP would be consistent with the intention to bring the general government deficit significantly below 3 percent of GDP, assuming the deficit was around 3½ percent of GDP in 2002.[2] The authorities did not dispute the calculations, but reiterated that budget plans had yet to be finalized.

Labor markets

8. **The authorities explained that the government firmly intended to implement all the recommendations of the recent Hartz Commission**. The budgetary cost of Hartz Commission measures would be more than offset by savings in active labor market programs. Moreover, the authorities stressed that labor market reform had been placed at center stage of the government's policy program and a merger of the Ministries of Economy and Labor would provide the bureaucratic infrastructure to implement the measures. Staff pointed out that the Hartz Commission proposals did not address incentives to work or problems with the flexibility of hiring and firing regulations. The authorities agreed that additional reforms might be needed, but stressed that the importance of the Hartz Commission measures should not be understated. Not only did they make an important contribution to job matching efforts, but, above all, they represented a major break in the labor market reform stalemate.

Financial markets

9. **The confluence of structural and cyclical strains in the banking and insurance sectors continues to merit supervisors' close attention**. Reflecting market anxieties, bank stock prices have been unusually volatile in these past few weeks, falling sharply before staging a strong rebound. Since the beginning of the year, commercial bank stock prices have fallen on average by nearly 50 percent in Germany. The authorities explained that they were continuing to monitor the situation in the financial sector carefully. Their views had not changed since the time of the mission—i.e., they did not see the current difficulties in the financial system as posing systemic risks.

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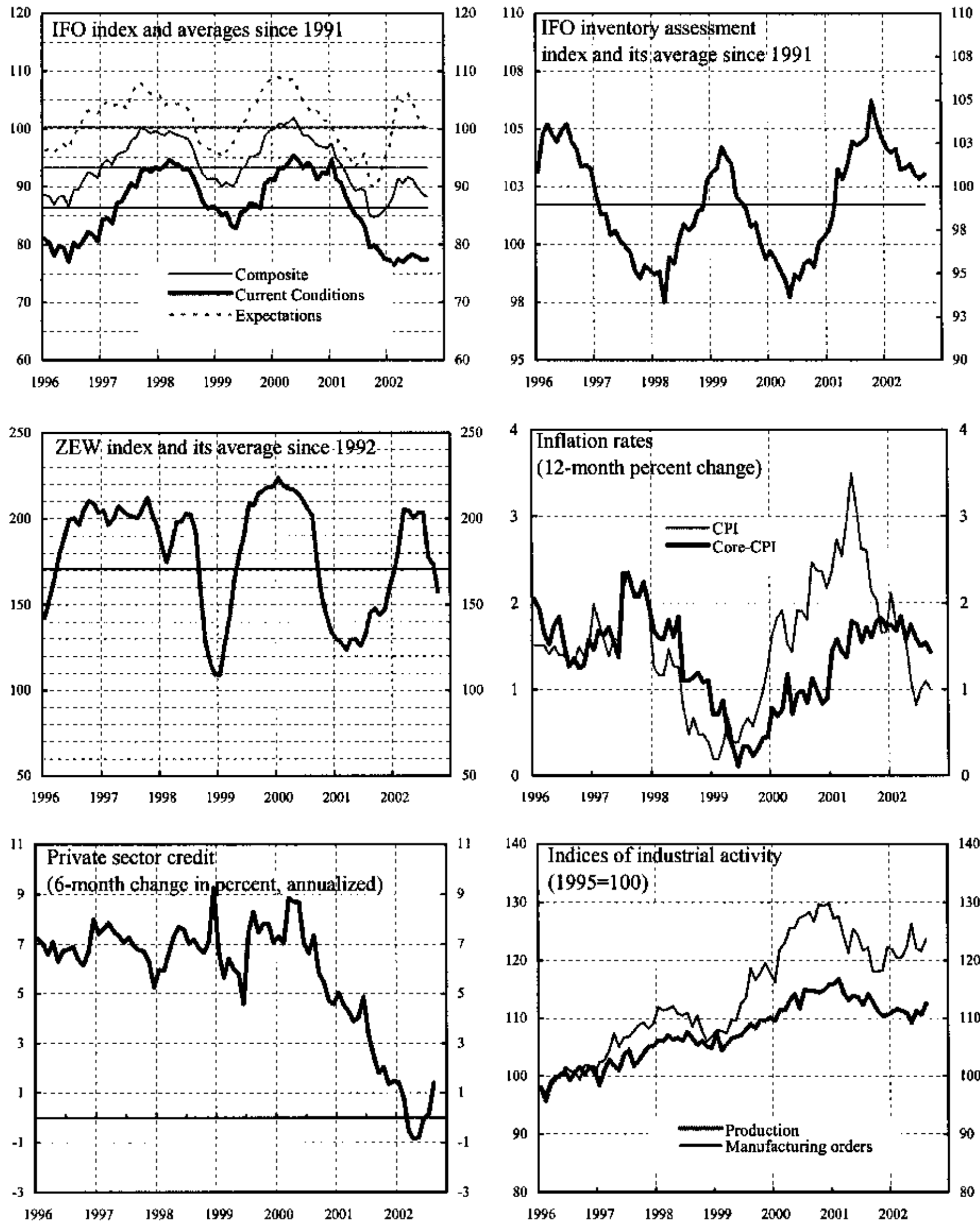
[2]With growth projected to be close to potential next year, any reduction in the nominal deficit would imply a broadly commensurate reduction in the structural deficit.

10. **In staff's view, the implied fiscal withdrawal next year will place a significant burden on the economy at a time of cyclical weakness and uncertainty**. It is commendable that Germany does not want to undermine the SGP, but the timing of a strongly front-loaded adjustment is questionable. Moreover, the implied withdrawal goes well beyond the benchmark structural consolidation rate of ½ percentage point of GDP a year that staff continues to view as appropriate. In this context, the postponement until 2004 of tax cuts (amounting to 0.3 percent of GDP) originally planned for 2003 is adding to front-loading strains as well as detracting from pre-announced medium-term tax reform plans.

11. **The quality of planned fiscal adjustment could also be improved**. As the actual formulation of the budget proceeds in the next month, the authorities should focus on putting durable and well-targeted expenditure restraint at the center of fiscal consolidation. Some of the tax measures proposed will reduce distortionary exemptions in VAT and income taxes. But, so far, the government has not indicated any intention to undertake much needed cuts in subsidies and entitlements. These will be essential for a credible fiscal consolidation with the most beneficial effects on long-term growth. Moreover, leaving fiscal consolidation to rely on continued public sector pay compression could be challenged even in the current public sector pay round where unions have put in for increases of around 4 percent.

12. **The authorities intention to move ahead quickly with Hartz Commission measures is a welcome signal of a willingness to reform labor markets**. Ultimately, however, more is needed. In particular, measures that more clearly increase incentives to work and reduce barriers to employment decisions are essential to raise the efficiency of the labor market.

Figure 1. Germany: Summary of Indicators, 1996-2002



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

Germany: Public Debt Sustainability

1. **This note reports standardized stress tests for public debt sustainability.**[3] The tests are applied as temporary deviations from a staff baseline scenario without consideration of feed-back effects and with magnitudes based on developments over the past 10 years. The baseline scenario incorporates the authorities' 2001 Stability Program, adjusted for staff's growth projections. It further assumes that income tax cuts initially scheduled for 2003 will be delayed until 2004 and that envisaged savings under the internal stability pact materialize. It does not incorporate any measures recently announced by the newly re-elected government. In the baseline scenario, the public debt ratio declines from an estimated 60.9 percent of GDP at end-2002 to 57.4 percent of GDP at end-2007 (see table).

2. **A declining public debt ratio relies on higher primary fiscal surpluses, faster economic growth and lower real interest rates than in the past ten years.** If historical averages for growth, real interest rates and primary surpluses were repeated, the debt ratio would be on a rising path. However, averages for these variables in the past five years have all improved relative to values in the early 1990s as unification-related strains have diminished and underlying fiscal consolidation has progressed.

3. **Only under fairly severe, permanent shocks would concerns about *medium-term* debt sustainability appear to arise.** According to the stress tests, the debt ratio would increase sharply if, in 2003-04, there were a significant reversal of fiscal consolidation, significantly lower growth, or much higher interest rates than in the baseline. However, in all cases—and in a composite adverse-shock scenario—the public debt ratio would subsequently move back on to a downward path. Only if the shocks proved more permanent would debt sustainability come into question. In the case of the shock to the primary surplus, this would involve prolonging an increase in the deficit relative to the baseline of over 2½ percent of GDP. In the case of the growth shock, this would require that growth, which would have averaged close to zero in 2001-2004, would not even revert to the modest path in the baseline for 2005 onward.

4. **Germany's fundamental fiscal challenge resides in the worsening demographic outlook over the *long term*.** Population aging will raise the pressures on old-age related spending, while slowing revenue growth. This challenge is discussed in detail in Chapter IV of "Germany—Selected Issues" (SM/02/318).

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[3] See SM/02/166, 5/28/02.

Germany: Public Sector Debt Sustainability Framework, 1997-2007

	Actual					Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
I. Baseline medium-term projections										
1. Public debt/revenues 1/	130.9	130.7	129.4	128.1	130.7	135.2	136.2	135.6	138.5	136.9
2. Public debt/GDP 1/	61.0	60.9	61.2	60.2	59.5	61.2	61.7	61.3	61.3	60.1
3. Change in public debt/GDP	1.2	-0.1	0.3	-1.0	-0.7	1.7	0.5	-0.4	0.0	-1.2
4. Net debt-creating flows/GDP (5+6)	1.5	0.4	0.0	-2.7	1.6	2.2	0.7	-0.6	-0.6	-1.2
5. Overall deficit, excluding net interest payments/GDP (=primary deficit)	-0.9	-1.4	-2.0	-4.5	-0.5	0.2	-0.5	-1.7	-1.6	-2.0
6. $((r-\pi)-g(1+\pi))/(1+g+\pi+g\pi))$debt/GDP (8/7) 2/	2.4	1.8	2.0	1.8	2.1	2.0	1.2	1.2	1.0	0.9
7. Adjustment factor: $1+g+\pi+g\pi$	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
8. $((r-\pi)-g(1+\pi))$debt/GDP (9+10)	2.5	1.8	2.0	1.9	2.1	2.0	1.2	1.2	1.1	0.9
9. $(r-\pi)$ times debt/GDP	3.3	3.0	3.3	3.6	2.5	2.3	2.5	2.6	2.7	2.6
10. minus $g(1+\pi)$ times debt/GDP	-0.8	-1.2	-1.3	-1.7	-0.4	-0.3	-1.2	-1.4	-1.6	-1.7
11. Residual, including asset changes, privatization receipts (negative), and valuation changes in external debt /GDP (3-4)	-0.3	-0.5	0.3	1.7	-2.2	-0.5	-0.2	0.2	0.6	0.0
Memorandum items: Key macro and external assumptions										
Nominal GDP (in billions of euro)	1,872	1,929	1,979	2,030	2,071	2,115	2,191	2,268	2,356	2,448
Real GDP growth (in percent per year)	1.4	2.0	2.0	2.9	0.6	0.5	2.0	2.3	2.6	2.7
Consumer price index (change, in percent per year)	1.5	0.6	0.7	2.1	2.4	1.4	1.1	1.3	1.3	1.3
Exchange rate (euro per US dollar)	0.9	0.9	0.9	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Nominal appreciation of euro against US dollar	-13.1	-1.4	-4.1	-13.4	-3.0	4.9	4.2	0.5	0.6	0.3
GDP deflator (change, in percent per year)	0.7	1.1	0.5	-0.3	1.4	1.7	1.5	1.2	1.2	1.2
Average interest rate on public debt (percent per year)	6.2	6.1	5.9	5.6	5.6	5.6	5.5	5.5	5.6	5.4
Average real interest rate (nominal rate minus change in GDP deflator, percent)	5.6	5.0	5.4	5.9	4.1	3.9	4.0	4.3	4.4	4.2
Growth of revenues (deflated by GDP deflator, in percent per year)	0.9	1.9	3.5	2.2	-2.5	-0.1	2.1	2.1	0.5	2.0
Growth of noninterest expenditure (deflated by GDP deflator, in percent per year)	-0.5	0.8	2.3	-3.5	6.6	1.4	0.5	-0.8	0.7	1.0
II. Stress tests										
1. If real interest rate, real GDP growth rate, and primary balance (in percent of GDP) in 2003-2007 are at average of past 10 years						61.2	61.9	63.0	64.5	65.5
2. If real interest rate in 2003 and 2004 is average plus two standard deviations, others at baseline						61.2	63.2	64.2	64.3	63.2
3. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline						61.2	63.5	65.1	65.2	64.1
4. If primary balance (in percent of GDP) in 2003 and 2004 is average minus two standard deviations, others at baseline						61.2	63.6	66.3	66.4	65.4
5. Combination of 2-4 using one standard deviation shocks						61.2	64.4	68.1	68.2	67.2
6. One time 30 percent real depreciation in 2003, others at baseline 3/						61.2	61.7	61.3	61.3	60.1
7. If debt ratio in 2003 rises by (additional) 10 percent of GDP, others at baseline						61.2	71.7	71.5	71.7	70.6
Memorandum items										
Primary deficit (percent of GDP, average of past 10 years)						-1.2	-1.2	-1.2	-1.2	-1.2
Primary deficit (percent of GDP, standard deviation of past 10 years)						1.3	1.3	1.3	1.3	1.3
Real interest rate (nominal rate minus change in GDP deflator, average of past 10 years)						5.0	5.0	5.0	5.0	5.0
Real interest rate (nominal rate minus change in GDP deflator, standard deviation of past 10 years)						0.8	0.8	0.8	0.8	0.8
Nominal interest rate (average of past 10 years)						6.7	6.7	6.7	6.7	6.7
Nominal interest rate (standard deviation of past 10 years)						1.1	1.1	1.1	1.1	1.1
Real GDP growth rate (average of past 10 years)						1.5	1.5	1.5	1.5	1.5
Real GDP growth rate (standard deviation of past 10 years)						1.1	1.1	1.1	1.1	1.1
GDP deflator (average of past 10 years)						1.8	1.8	1.8	1.8	1.8
GDP deflator (standard deviation of past 10 years)						1.6	1.6	1.6	1.6	1.6

Source: Fund staff estimates.

1/ Indicate coverage of public sector.

2/ Defined as: r = interest rate; π = GDP deflator, growth rate; g = real GDP growth rate.

3/ Real appreciation is approximated by nominal appreciation against US dollar plus increase in domestic GDP deflator.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes 2002 Article IV Consultation with Germany

On October 23, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Germany.[1]

Background

Germany's economy is poised for a fragile recovery, after having barely grown since mid-2000. The earlier price shocks and interest rate hikes that contributed to the current slowdown have now unwound. But sluggish global growth, stock market declines, weak credit growth, and the withdrawal implied by planned fiscal consolidation may stand in the way of a strong recovery. Real GDP growth this year is estimated at about 0.5 percent, with the general government deficit set to exceed 3 percent of GDP, owing largely to cyclical weaknesses in revenue collection. Inflation in 2002 is expected to average 1.4 percent.

Germany's current slowdown comes on the heels of a decade of low growth, during which the economy had to cope with important adjustments related to unification. The subdued growth performance reflects the unwinding of the boom around the time of unification, together with generous benefits for the jobless and an insufficiently flexible labor market. Although the unemployment rate is still not high by European standards, net job creation has been below that recorded in many other European countries and the underlying unemployment rate rose during

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 23, 2002 Executive Board discussion based on the staff report.

the 1990s. To improve the functioning of the labor market, the newly re-elected government has endorsed proposals of the so-called Hartz Commission to enhance job matching and strengthen incentives for job creation.

Executive Board Assessment

Executive Directors noted that the German economy is recovering from last year's slowdown, albeit slowly, due to continued weak domestic and external demand. Directors observed that although the decade since unification has been one of difficult adjustments against a backdrop of subdued real GDP growth, the authorities have also achieved a number of distinct successes. Foremost among these are the integration of the new Länder, the liberalization of product markets, and major tax and pension reforms. Notwithstanding these achievements, Directors stressed that, going forward, a considerable strengthening of reform efforts, particularly in labor markets and in fiscal matters, will be needed to create conditions for stronger, resilient growth in the context of continued fiscal adjustment.

In particular, Directors emphasized that decisive and complementary actions are now required in two priority areas: ambitious reforms to improve the flexibility of the labor market and a substantial reduction of entitlements and subsidies, which will be key to correcting the fiscal imbalance permanently. They considered that a well-sequenced and coordinated policy approach proceeding on both these fronts would have potentially powerful synergies. Credibility gains resulting from lasting expenditure reform would minimize the output costs of adjustment, and comprehensive labor market reforms would raise growth and thus make fiscal adjustment more palatable.

Directors noted that, in 2003, GDP growth is expected to pick up, but is likely to remain weaker than previously projected and subject to considerable risks. These include global uncertainties and a complex set of domestic factors. Among the latter are the continued fragility of consumer and business confidence, tighter credit conditions that have affected corporate financing, monetary conditions which—although accommodative for the euro area as a whole—are on the tight side from Germany's cyclical perspective, and the substantial fiscal consolidation in the pipeline. In view of the likely moderate strength of the recovery, the current wide output gap and high unemployment will likely persist, underscoring the need to build a broad public consensus now in favor of the structural reforms needed for boosting Germany's growth potential.

Looking forward, Directors saw continued fiscal consolidation over the medium term as essential, in particular to prepare Germany's public finances for looming demographic pressures. They commended the authorities' firm commitment to adhere to their fiscal objective of achieving and maintaining a budgetary position close to balance or in surplus over the economic cycle in line with the Stability and Growth Pact requirements, and generally supported their plan to reduce the cyclically-adjusted deficit by at least 0.5 percent of GDP annually to achieve this objective. Directors expressed more varied views on the authorities' plans for 2003 where they intend to frontload adjustment to ensure that the general government deficit falls back below 3 percent of GDP. Many Directors were of the view that such a sizeable fiscal correction in 2003 will further affect already weak domestic demand, and recommended that the

authorities opt for a more moderate pace of deficit reduction while gaining credibility from a sharper focus on medium-term fiscal priorities. A few Directors also expressed concern about the temporary postponement of tax cuts. A number of Directors, however, considered that the front loading of the adjustment effort implicit in the authorities' plans will be the best way to establish credibility and improve confidence, while securing the scope for automatic stabilizers to play fully in the future.

Directors agreed that, given Germany's still high tax burden, the sustainability of the fiscal consolidation effort will critically hinge on further permanent reductions in the expenditure-to-GDP ratio. Furthermore, they emphasized that it will be important to give high priority to the quality of expenditure reforms to provide the maximum boost to the supply side of the economy. Directors saw considerable scope, in this context, for achieving expenditure savings on subsidies, social transfers and labor market programs.

Directors commended the recent steps to improve the sustainability of the German pension system, and encouraged the authorities to prepare further pension and health care reforms aimed at addressing the future fiscal challenges raised by population aging. They noted that this will require careful consideration of measures to reduce the generosity of entitlements, which could include—in the pensions area—increases in the statutory retirement age and a lower pension replacement ratio, and—in the health care area—higher cost recovery rates.

Directors strongly welcomed the current public policy debate on labor market reform, noting that decisive progress in this area will be key to reviving Germany's growth and re-establishing high employment levels. They looked forward to the early implementation of measures under consideration that will improve job matching. Many Directors in this context cautioned against proposals to subsidize job creation. Directors considered that these initial steps will need to be followed by a more comprehensive package of reforms focusing on improving work incentives and deregulating the labor market. In particular, a reform of the benefit system should remove a key obstacle to raising employment, especially of the low skilled and older workers, and could be achieved without creating major social hardship by narrowing the targeting of benefits and offering tax credits to low-income earners. Directors also encouraged the authorities to pursue proposals to merge unemployment and social assistance programs with a view to streamlining and better-targeting benefits. A number of Directors highlighted the need for greater differentiation in wages across skill levels and regions.

Turning to the financial system, Directors urged the supervisory authorities to remain particularly vigilant in the face of the pressures on banks and insurance companies resulting from the confluence of cyclical and structural weaknesses and from the downturn in equity prices. They welcomed the ongoing developments that will ultimately strengthen the financial system, in particular the phasing out of guarantees to public sector banks and the prospective introduction of Basel II standards. Directors stressed that allowing bank consolidation to continue unhindered will be important to strengthen the future health of the banking system. They also saw the implementation of the new Law on Integrated Financial Services Supervision as an essential step ensuring that the latitude and resources of the newly created single supervisory agency are sufficient to keep abreast of financial market developments. Directors noted that the

upcoming Financial Sector Assessment Program will provide a timely opportunity to review the lines of defense against sector vulnerabilities. They commended the comprehensive measures that the authorities are taking to further strengthen their ability to combat money laundering and the financing of terrorism.

Directors commended Germany's progress on implementing product market reforms, and encouraged the authorities to build on Germany's leadership role in the EU context by pushing forward product market reforms that will better position Germany to meet the challenges of intensified global competition and improve productivity growth. A few Directors also looked for more forceful action to liberalize Germany's retail sector. Directors appreciated the recent introduction of a corporate governance code, and looked forward to further steps underway to enhance transparency and supervision.

Directors welcomed Germany's support for multilateral trade liberalization and the elimination of trade barriers for poor countries. Some Directors encouraged the authorities to work vigorously with Germany's EU partners toward an ambitious reform of the Common Agricultural Policy aimed at removing distortionary transfers that are harmful globally and costly at home. Directors encouraged the authorities to raise ODA spending to the UN target of 0.7 percent of GNP.

Directors commended Germany for the openness and transparency of fiscal policy and looked forward to the issuance of the Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency module. Germany's statistics are more than adequate for the purposes of effective surveillance. Directors suggested that further statistical improvements to facilitate the monitoring of fiscal policy and financial sector vulnerabilities would be helpful.

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

Germany: Selected Economic Indicators

	1998	1999	2000	2001	2002 1/
Economic activity and prices	Change in percent, unless otherwise noted				
Real GDP	2.0	2.0	2.9	0.6	0.5
Net exports 2/	-0.4	-0.7	1.0	1.4	1.1
Final domestic demand	2.1	3.3	1.6	-0.2	-1.1
Private consumption	1.8	3.7	1.4	1.5	-0.3
Gross fixed investment	3.0	4.1	2.5	-5.3	-4.8
Construction investment	-1.0	1.4	-2.6	-6.0	-3.8
Gross national saving (percent of GDP)	21.5	20.7	20.8	19.8	20.9
Gross domestic investment (percent of GDP)	21.8	21.6	21.9	19.6	18.9
Labor force 3/	0.5	0.5	1.0	0.4	0.1
Employment 3/	1.1	1.2	1.8	0.4	-0.4
Standardized unemployment rate (in percent)	9.1	8.4	7.8	7.8	8.3
Unit labor costs (whole economy)	0.2	0.4	1.0	1.5	1.7
GDP deflator	1.1	0.5	-0.3	1.4	1.7
Harmonized CPI index	0.6	0.7	2.1	2.4	1.4
Public finance	In percent of GDP				
General government balance 4/ 5/	-2.2	-1.5	1.1	-2.8	-3.1
Structural government balance	-1.4	-1.0	-1.5	-2.2	-1.7
General government gross debt 5/	60.9	61.2	60.2	59.5	60.9
Money and credit	Change in percent over 12-months				
Private sector credit 6/	8.4	5.8	5.8	3.2	1.1
M3 6/ 7/	7.6	7.2	-1.2	6.0	4.0
Interest rates	In percent				
Three-month money market rate 8/	3.5	2.9	4.4	4.3	3.3
Ten-year government bond yield 8/	4.6	4.5	5.3	4.8	4.6
Balance of payments	In billions of €, unless otherwise noted				
Exports 9/	566.2	593.3	692.3	736.8	756.5
Imports 9/	537.8	576.5	684.4	694.9	680.3
Trade balance (percent of GDP)	3.2	2.9	2.6	4.3	5.9
Current account balance	-5.6	-17.9	-22.6	2.7	41.2
Current account (percent of GDP)	-0.3	-0.9	-1.1	0.1	1.9
Exchange rate					
Euro per US dollar 8/	0.89	0.94	1.08	1.12	1.08
Nominal effective rate (1990=100) 10/	104.1	102.0	97.8	97.7	99.9
Real effective rate (1990=100) 10/ 11/	110.4	107.1	100.8	100.0	100.3

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

1/ IMF staff projections, unless otherwise indicated. Projections were finalized in the first half of September and have not been updated to reflect more recent developments or policy announcements.

2/ Contribution to GDP growth.

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

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

5/ For 2000 includes the proceeds from the sale of mobile phone licenses (UMTS) of about 2.5 percent of GDP.

6/ Data for 2002 refer to August 2002.

7/ From 1999 onward data reflect German's *contribution to M3* in the euro area.

8/ Data for 2002 refer to October 16, 2002.

9/ Includes supplementary trade items.

10/ Data for 2002 refer to September.

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