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

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

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 04/120
FOR IMMEDIATE RELEASE
November 2, 2004

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

IMF Concludes 2004 Article IV Consultation with Germany

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

Background

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

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

---

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

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

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

Executive Board Assessment

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

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

Most Directors urged the authorities to take the opportunity of the upswing to make progress in fiscal consolidation. In view of the rising public debt and demographic challenges, they considered that the authorities should aim to reduce the structural deficit by ¾ percentage point of GDP in 2005. A few Directors, however, cautioned that additional fiscal adjustment at this juncture could have a restraining effect on the recovery in the short run. A number of Directors underscored that postponing adjustment again in 2005 would imply back-loading of the fiscal effort and would put substantial pressure on public finances in the election year 2006. Directors also supported the authorities' medium-term objective of reducing the fiscal structural balance by a cumulative 1½ percentage point of GDP over the period 2004-06, and

encouraged continued structural adjustment thereafter until a small surplus is reached. Directors noted that more progress will be needed in achieving durable cuts in tax expenditure and subsidies, and felt that these items should continue to be the focus of fiscal adjustment.

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

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

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

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

Directors welcomed the recent improvement in the financial system's profitability, which has benefited from the cyclical upswing and increased asset prices. They also noted the continued and successful efforts to reduce costs in the system, but remarked that further progress is still needed to strengthen revenue mobilization and reduce non-performing loans. Directors encouraged the authorities to continue to follow through on the FSAP recommendations, and welcomed their intention to publish a broader range of financial soundness indicators in line with the Fund's work in this area. They were pleased that some progress is underway with

restructuring in the public sector banking system in response to the impending removal of government guarantees, including through back office cooperation and some consolidation. However, although the financial system is now in a better position to support output growth, a number of Directors noted that steps taken so far have been modest and that more fundamental reforms are still needed. Directors reiterated their support for creating a legal framework that reduces barriers to restructuring, both within and across the various public and private pillars of the system. This would allow a better harnessing of market signals and strengthen the resilience of the system to shocks. For the insurance sector, Directors welcomed the broadening of supervision to reinsurance companies, and encouraged the authorities to expand the supervisory focus beyond solvency margins in anticipation of the upcoming EU-wide risk-based insurance supervision. Directors commended Germany’s adherence to international standards against money laundering and terrorism financing.

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

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