IMF Survey

INTERNATIONAL MONETARY FUND

JANUARY 23, 2006 VOL. 35, NO. 2

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IMF Managing Director visits Brazil

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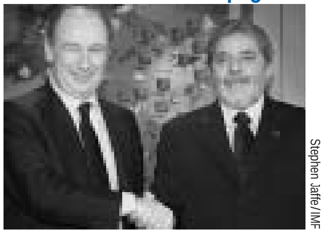

Stephen Jaffe/IMF

To recognize the early repayment of Brazil's outstanding debt to the IMF, President Luíz Inácio Lula da Silva invited IMF Managing Director Rodrigo de Rato to a ceremony in Brasilia on January 10. Effective economic policies and a favorable global environment have helped to strengthen Brazil's finances over the past three years, making the repayment possible. Brazil and the IMF pledged to remain partners in a continuing economic policy dialogue.

Reflections on the IMF's transparency revolution

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Michael Spilotro/Agency

Criticism of the IMF has been a constant through much of its history, but even harsh critics admit the organization is much more open now. Tom Dawson has guided the Fund through much of this transparency revolution. In an exit interview, he reflects on why the IMF remains relevant, what must be done to ensure that emerging market countries have a greater say in the Fund, and why formulating wise policy advice isn't enough—it must be communicated well, too.

Challenges in the Eastern Caribbean

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Index Stock Imagery

Buffeted by hurricanes, the loss of traditional markets, volatile tourism receipts, and rising debt, the Eastern Caribbean has had to cope with enormous challenges in recent years. Looking ahead, it will need to bolster macroeconomic and financial stability, create more dynamic private sectors, and deepen regional integration. The IMF, as Deputy Managing Director Agustín Carstens stressed during a recent visit, is working closely with the region and providing technical and financial assistance.

Trade, aid, and the pursuit of growth

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Henrik Gschwindt De Gyor/IMF

Why do some countries grow and others not? Integration with the global economy is often touted as a ticket to greater prosperity, but the track record has been uneven. While increased trade and aid should help countries, a recent IMF conference suggested that other steps, including developing sound macroeconomic policies and avoiding overly regulated labor and product markets, may provide the missing links between trade, aid, and growth.

IN THIS ISSUE

Germany: Is too much regulation preventing faster growth?

The headlines on the German economy are familiar: unemployment near historically high levels, a sluggish economy, and a stubbornly large fiscal deficit. Since reunification in 1990, Germany's real GDP has grown on average by about ½ of 1 percent a year less than that of its European peers. Is excessive market regulation to blame? Two recent IMF papers find that policies to increase labor participation rates offer the greatest potential for increased labor supply and output growth, and that these positive effects are largest when deregulation includes both labor and product markets.

Protecting employment

Germany's aggregate level of employment protection is not overly restrictive, but protection of regular employment is higher than the EU15 average.

Index of employment protection

	Late 1980s		Late 1990s		2002–03	
	Germany	EU15	Germany	EU15	Germany	EU15
Comprehensive index	3.2	2.7	2.5	2.3	2.2	2.1
Temporary employment	3.8	3.0	2.3	2.2	1.8	2.0
Regular employment	2.6	2.5	2.7	2.3	2.7	2.3
Collective dismissals	...	...	3.5	3.4	3.8	3.4

Note: EU15 = The 15 European Union countries prior to the 2004 expansion.
Data: Organization of Economic Cooperation and Development, and IMF staff.

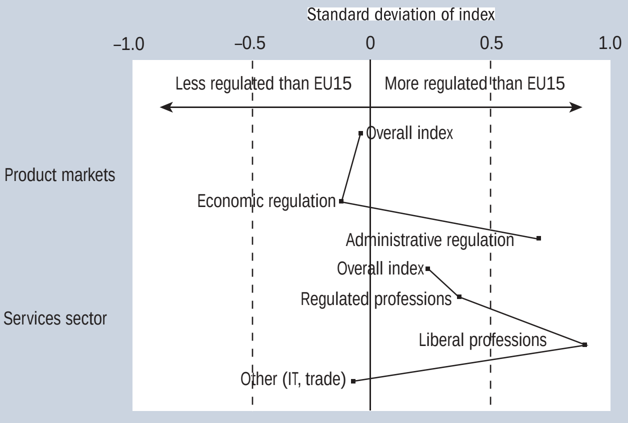
Germany's poor economic performance is not an isolated case in Europe. The economic vitality of much of the European Union (EU) has been on the minds of policymakers for some time. The Lisbon Agenda—a policy package aimed at making the EU more competitive—has called attention to the barriers to competitiveness posed by excessive market regulation. Until recently, the lack of comparable data made the empirical assessment of this claim difficult, but recent studies, based on new indicators, confirm the negative effect of regulations on growth.

A comparison of aggregate regulatory restrictiveness in product and services markets across countries (see chart) suggests that Germany's level of regulation is on par with the average of the EU15 (the 15 European Union countries prior to the 2004 expansion). Disaggregated data, however, show large differences for the main subcategories of regulation. In particular, administrative burdens tend to be higher in Germany for the services sector, where regulation is especially tight in the crafts and so-called liberal professions, including architecture, accountancy, engineering, pharmacy, and the law. Remnants of the guild system, with its extensive licensing and qualification requirements, limit market entry and competitiveness.

A comparative look at Germany's labor market regulation yields similar results. Overall, the level of employment protection does not stand out as relatively restrictive by EU15 standards. However, disaggregation shows that protection of regular employment (that is, full-time jobs) is higher than in the EU15 (see table). By contrast, regulation of part-time or temporary employment is more flexible than in other countries, in part because of reforms in the 1990s, and has its origins in attempts to fight unemployment by liberalizing temporary "entry" jobs.

Comparing measures of restrictiveness

Large differences exist between Germany and the EU15 across main subcategories of regulation in product and services markets.



Data: Organization for Economic Cooperation and Development; Copenhagen Economics; and Institute of Advanced Studies, Vienna.

Room to catch up

Being average overall does not mean that Germany can put regulatory reform on the back burner. First, the European average tends to be high compared with competitors outside the EU15. Second, countries with the lowest restrictiveness scores show the best growth and job creation. And, third, the distribution of restrictiveness within subcategories of labor, services, and product markets can make a difference. For instance, job growth in the less-regulated temporary job market is much faster than in the full-time job market. Performance of the full-time job market, however, has a greater impact on overall labor (and fiscal) conditions.

Loosening the licensing and permit system stands out as one area of much-needed reform in the product and services markets. With a large share of economic activity conducted by small and medium-sized enterprises, barriers to entry—particularly into the services sector—can constrain economic dynamism and limit output and employment growth. In this connection, the rejection of the EU services directive—which

Germany must build on initiatives to ensure durable economic improvement

Economic activity in Germany is slowly picking up, with scope for further firming of growth in 2006, the IMF said in its annual economic review. But the recovery remains unbalanced and strong export growth has yet to feed through into higher household spending. Firms are investing cautiously, and structural labor market weakness (giving rise to slow job and wage growth) is inducing cautious consumer spending.

The IMF Executive Board commended the new German government's agenda to meet the challenges of globalization and demographic change. Directors welcomed the authorities' perseverance in introducing far-reaching and politically difficult labor market reforms in 2005 that have improved incentives to work and their plans to further reform the labor market and entitlement programs. At the same time, substantial challenges lie ahead, as trend growth is low and unemployment remains high.

To secure a durable improvement in economic performance, Directors urged the authorities to build on initiatives already announced to reduce distortions and structural rigidities and achieve fiscal sustainability over the medium term. They welcomed the priority placed on fiscal consolidation, notably policies to bring the fiscal deficit below 3 percent of GDP in 2007. Several Directors considered that more ambitious fiscal adjustment could have been contemplated for 2006, especially in the current circumstances of an improved economic outlook.

Directors also emphasized the need to raise the rate of labor utilization to mitigate the impact of a decline in the working-age population on growth and public finances. To complement ongoing reforms, which have enhanced labor supply, additional steps will be needed to promote greater wage differentiation and thus help increase labor demand. They encouraged the authorities to proceed more vigorously in deregulating product and service markets to foster job creation and reinforce labor market reforms.

Financial sector soundness continues to improve. To enhance performance further, Directors recommended amending the banking sector's legal framework to support market-based restructuring in both public and private banks. ■

For more information, please refer to Public Information Notice No. 06/04 on the IMF's website (*www.imf.org*).

was proposed to provide a legal framework for the free movement of services within the internal market—appears to be a missed opportunity to infuse much-needed competition into a sector that employs two-thirds of Germany's workers.

In the area of labor market regulation, there is scope to alleviate procedural burdens and dismissal protection. For low-skilled workers, in particular, these nonpecuniary costs of employment can have a perverse effect. Instead of protecting against unemployment, they can dampen labor demand and reduce opportunities for the unemployed to find jobs. The planned extension of the probation period to two years from six months by the new coalition government could improve this situation.

Coordinating reforms

Growing evidence points to the need to coordinate reforms across product and labor markets. Reform spillovers magnify benefits that might be too small if reforms are implemented in isolation. One example of a partial approach is Germany's recent labor market reform package, dubbed Hartz IV (named after Peter Hartz, the head of the commission on reforms set up in 2002). The reform has forced some inactive people back into the labor force, but it has not yet generated strong job increases. One reason may be the lack of coordination with complementary product and services market reforms. While the Hartz IV labor market reforms are having an effect, larger gains could probably have been achieved, in the short and medium terms, if the reforms had taken place in conjunction with a reduction in regulatory constraints.

Why would policymakers forgo broader-based reforms if they appeared to be a first-best strategy? One reason may be that the policymakers are not fully aware of the benefits of coordinated reforms. Another reason is fractured decision making or the need to appease interest groups. All of these factors can hamper reforms. While there seems to be no easy remedy for these problems, some steps that may help include increased efforts to educate the public on the benefits of more comprehensive reforms and, possibly, the delegation of reform design to a nonpartisan expert group.

Deregulating labor and product markets should be a high priority in Germany. Finding a formula that allows coordinated reforms will be important to ignite job creation and bring growth back up to rates seen in other European countries. ■

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Copies of IMF Working Paper No. 05/277, *Labor and Product Market Deregulation: Partial, Sequential, or Simultaneous Reform?* by Helge Berger and Stephan Danninger, and IMF Country Report No. 06/17, *Germany: Selected Issues*, are available for $15.00 each from IMF Publication Services. Please see page 32 for ordering details. The full texts are also available on the IMF's website (*www.imf.org*).