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From the Private Secretary

9 January 1988

The Prime Minister was interested to see the attached report in Friday's Financial Times concerning the near disappearance of 1987 profits from the Bundesbank and the implications for the budget. She recognises that such calculations depend heavily on the precise dates used and that there are differences between the UK and German systems. But she would be interested to know the results of a similar calculation comparing the valuation of the UK's reserve at the end of 1987 with the rates at which foreign currencies were acquired during the period since 1 April 1987.

(PAUL GRAY)

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HM Treasury

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W Germany to raise taxes and cut spending

BY DAVID MARSH IN BONN AND ANDREW FISHER IN FRANKFURT

THE WEST GERMAN coalition yesterday decided to cut federal government borrowing by at least DM10bn (£3.36bn) next year through a mixture of increases in consumer taxes and cuts in budget spending.

The move comes in reaction to a much sharper than planned increase in the federal deficit this year. It is now expected to be DM40bn compared with DM29.5bn set down in the 1988 budget approved by parliament at the end of last year.

The tightening of fiscal policy now planned for 1989 runs completely counter to persistent calls from home and abroad for West Germany to cut taxes next year in order to bolster sluggish economic growth.

Mr Gerhard Stoltenberg, the Finance Minister, told the press after yesterday's cabinet meeting: "There is no room for further tax cuts (in 1989)."

At the same time the Bundesbank in Frankfurt announced action to reduce banking liquidity through a DM6bn cut in banks' rediscount quotas, effective February 1. The move, which will cut the amounts banks can borrow from the central bank at the 2.5 per cent discount rate, came in response to big increases in liquidity through currency inflows.

The Bundesbank said the decision did not imply any change in its basic monetary stance. However, it underlines how the central bank is reacting cautiously to ward off possible inflationary dangers from currency inflows – DM25bn since October – accompanying the latest rise of the D-Mark.

Yesterday's cabinet decision on the deficit underlines how West German fiscal policies have been severely blown off course by the fall of the dollar and the weakening economy.

The admission by Mr Stoltenberg that the 1988 deficit will be much larger than expected is likely to expose him to a fresh wave of criticism at home from both Left and Right over the consequences of rising public borrowing.

It casts a considerable question mark over whether the Government will be able to proceed with promised net tax cuts of DM20bn in 1990, conceived as a fundamental part of its economic strategy.

The immediate causes of the jump in the 1988 deficit are higher West German contributions to the European Community and the near-disappearance of 1987 profits from the Bundesbank, due to be paid over to Bonn this year. The Bundesbank profit will fall to "near zero" from the DM6bn which had been written into the 1988 budget, the Finance Minister said.

This is because the central bank will have to write off between DM6.5bn and DM7bn on the D-Mark value of its foreign exchange reserves. This is

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because of the sharp fall in the dollar to DM1.5815 at the end of last year, the value the Bundesbank will use for its 1987 accounts.

This year's federal deficit is also being driven up by DM14bn of tax cuts which came into effect at the beginning of the year. Additionally, tax revenues have fallen well below earlier, projected levels because of economic growth of only 1.5 per cent last year.

Mr Stoltenberg said a supplementary budget would be introduced before the summer to take account of the extra 1988 deficit. Additionally, around May or June, detailed decisions would be taken on finding the budgetary savings of at least DM10bn planned for 1989, Mr Stoltenberg said.

Mr Stoltenberg said the Government faced no substantial risks on the spending side for 1988, although this year's deficit could plainly be driven higher if the economic downturn eats further into tax revenues and drives up subsidies.

At present, Mr Stoltenberg is projecting a growth of between 1.5 and 2 per cent in gross national product this year, although some more gloomy private sector forecasters are predicting only around 1 per cent.