



File 81

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*From the Private Secretary*

MR. HOLROYD

CABINET OFFICE

Bf || The Prime Minister has noted from paragraph 1 of the summary of Bonn telegram no. 11 saying about the state of the FRG economy that the 1988 Federal budget provides funds for increased industrial subsidies. She wonders what these subsidies are and how they can be compatible with the EEC's competition rules. I should be grateful for advice.

I am copying this minute to Tony Galsworthy (Foreign and Commonwealth Office), Alex Allan (H M Treasury) and Tim Walker (Department of Trade and Industry).

C. D. POWELL

OA

6 August 1987



UNCLASSIFIED  
SAVING TELEGRAM

BY BAG

FROM BONN

FRAME ECONOMIC

TO FCO TELNO 11 SAVING OF 31 JULY 1987. Info. Brussels,  
Luxembourg, The Hague, Paris, Rome, UKRep Brussels,  
UKDEL OECD, UKMis Geneva, all Consulates-General in the  
Federal Republic and West Berlin, Washington, Tokyo,  
Vienna.

FRG ECONOMY

SUMMARY

1. The Cabinet approved the draft Federal budget for 1988 which will receive its first reading in Parliament in early September. Federal spending will increase by 2.4% on average to DM 275.04 billion. The largest increase in percentage terms goes to the Economics Ministry to fund increased industrial subsidies. Agriculture to receive a 7.4% increase mainly to allow for additional EC commitments. Some QUOTE investment UNQUOTE Ministries such as Education and Science and Town Planning and Construction suffer cuts.
2. Federal Borrowing set to rise to DM 29.32 billion in 1988 from DM 26.28 billion in 1987. Revenue, particularly that from taxes, forecast to rise slowly over the five year period to 1991. Federal Borrowing will peak at DM 30.9 billion in 1990.
3. Controversy about increased borrowing requirement and lower than planned Defence budget is likely to complicate the passage of the draft through Parliament and which may further confuse the decisions to be taken on tax reform. But the Government refuses to be rushed into taking decisions and the interest groups have time to plan their lobbying strategies for the Autumn.
4. Q1 public spending increased by 3.4% with the Länder and municipalities accounting for the largest rises.
5. Monetary growth recorded 8% in June, well above the target range. The increase was sufficient to cause some concern in the Bundesbank but insufficient to bring any change in policy. Emphasis on exchange rates appears likely to continue.
6. May employment and June unemployment figures were disappointing. Seasonally adjusted only 5,000 additional jobs were created and unemployment rose year on year by 0.9%. General gloom, especially over the construction sector.
7. On a year on year comparison, domestic demand in May was 4% down with foreign demand 2.5% lower. Capital goods suffered the most with orders 5.5% lower than a year ago. Provisional May production figures indicate a continuing rise in manufacturing output although the construction sector slipped back. April and May retail turnover figures indicate a marked rise in private consumption.
8. Inflation, cost of living index, was 0.2% in June but the moving annual average remains at minus 0.2%.
9. The current account surplus totalled DM 7.5 billion in May compared to DM 6.3 billion a year earlier. The visible trade surplus rose to DM 20.6 billion compared to DM 8.1 billion in May 1986.

1/DETAIL



## DETAIL

10. The month began with a day long sitting of the Cabinet which ended in the approval of the draft budget for 1988. The draft, which will be printed and released publicly during the summer break ready for its first reading in the Bundestag in the week beginning 7 September, envisages a rise in Federal spending of 2.4% to DM 275.04 billion. The figures thus far released show mixed fortunes for individual ministries. In percentage terms the Federal Economics Ministry will gain the most with a 15.1% increase to DM 6.44 billion, mainly to accommodate increased subsidies payments. Close behind come the Bundesrat budget (up 14.5% to DM 14.2 billion), Inner German Relations (up 12.5% to DM 875.6 million) and the Federal President's Office (up 11.3% to DM 22.6 million). Eight other ministries receive increases above 5%. In the main, however, the nominal value of these increased budgets is small and offset by rises of around only 2% or below in the main spending ministries. Some suffer cuts in their budgets including Post and Telecommunications (down 46.5% to DM 22.1 billion), Education and Science (down 11% to DM 3.46 billion), Town Planning and Construction (down 1.6% to DM 6.04 billion) and Economic Cooperation (down 0.4% to DM 6.85 billion).

11. The draft forecasts Government revenue in 1988 rising only slightly from an expected DM 242.27 billion this year to DM 245.72 billion next. Tax receipts will reach DM 222.45 billion after DM 216.5 billion this year, but income from the Bundesbank and from privatisation proceeds will fall (to DM 6 billion and DM 1.8 billion respectively). As a result, the Federal Borrowing Requirement is expected to grow to DM 29.32 billion in 1988 from DM 26.28 billion this year. The Finance Plan for the three years following 1988, which by law is issued in tandem with the draft budget but which, unlike the budget, does not require Parliamentary approval, makes an uncertain attempt to project the fiscal stance to 1991. Federal spending is set to increase by 2.5% in each of the three years to stand at DM 296 billion in 1991. After an initial DM 10 billion jump in 1989, the increase in tax revenue is expected to slow down to reach DM 248 billion in 1991. Privatisation proceeds are forecast to fall off completely after 1989 while the income from the Bundesbank settles at DM 5 billion. As a result, the Federal Borrowing Requirement is forecast to peak at DM 30.9 billion in 1990 before falling again to DM 26.1 billion in 1991.

12. The release of the draft caused considerable debate which is likely to lead to a stormy passage for the draft through Parliament. The Federal Finance Minister called on the Länder and municipal authorities to follow the Federal Government's lead in restricting spending. He reaffirmed the Government's commitment to budgetary consolidation and described the expected higher Federal Borrowing Requirement as unavoidable. Controversy also centred on the defence budget, which was one of the last to be settled and which is increased by 2.1% mainly to take account of higher personnel costs. Defence spokesmen claimed that the true increase is closer to 1.7% or 1.9%, some DM 1.8 billion lower than planned, and amid press speculation about trimmed projects the Ministry instituted a review of medium-term programmes. While the Federal Finance Minister insisted that his defence opposite number completely agreed with the Finance Ministry's medium-term aims, it was rumoured that Wörner had settled with some dissatisfaction. Referring to the increased borrowing requirement, opposition political parties denounced the draft as precipitating a financial crisis. The President of the Bundesbank repeated his warnings of the dangers of higher Government spending and criticised the continuing large-scale use of industrial subsidies.