

UNCLASSIFIED
SAVING TELEGRAM

FROM BONN
FRAME ECONOMIC

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Federal Republic and West Berlin, Washington, Tokyo,
Vienna.

FRG ECONOMY

SUMMARY

1. The latter part of the month was dominated by the Government's announcement of measures to raise finance for the tax reform package, and by the worldwide stock exchange collapse. Before that, however, wide coverage was given to Mr Lawson's suggestion at the IMF/IBRD meetings in Washington on managing exchange rates including commodity indexes. Speculation that remarks by Mr Lawson and Mr Baker were aimed at the FRG. Some scepticism that a commodity index would be an effective indicator.
2. Agreement between the Federal authorities and the Länder on the financial equalisation system intended to compensate financially disadvantaged Länder. Agreement will give the Länder an additional DM 600 million. The apportionment of VAT revenue to stay at current levels - 65% for the Federal authorities and 35% for the Länder - for the next two years.
3. Long awaited Government proposals to raise finance for the 1990 tax reduction package leaked prematurely on 9 October. The most controversial measure is the introduction of a 10% withholding tax on certain savings and investments. Mishandling of confirmation of the measures caused confusion on the financial markets. General dissatisfaction with the package from all sectors of the financial and business community.
4. The sharp decline on international financial markets also affected the eight German stock exchanges, though there is a general feeling that they have escaped the worst fluctuations. Most German commentators agree that the collapse was caused in part by criticism by the US Treasury Secretary of rising German interest rates. A limited cut following a meeting with Mr Baker in Frankfurt. Market rates have since fallen following signals from the Bundesbank.
5. Monetary growth continuing above target. Central Bank Money grew by 7.8% in the third quarter. M3 rose at an annual rate of 5.5% in the six months to August. Some fears of the inflationary effects and debate about the need for tightening monetary policy.

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6. The business climate recorded a slight fall in September though the majority of firms expect increased production in the next three months. New orders rose strongly in August by 7.5% compared to July, mainly because of renewed activity in the capital goods sector. Foreign orders increased by 5%. Production also rose in August by 4.5% compared to July. Construction activity rose by 4% in August compared to the previous month but remained 3.6% below August 1986.

7. Inflation, cost of living index, rose by 0.4% in September after 0.8% in August. Provisional figures for October show an increase to 0.9%. The moving annual average remains at 0.1%. Retail turnover recorded a 2.5% real increase in July/August compared to May/June.

8. Unemployment fell by 57,500 to 2.11 million but that was 61,000 higher than the same month last year, a rate of 8.4% compared to 8.2% in September 1986. The increase in the number of employed continued to slow.

9. Due to seasonal influences the current account surplus fell to DM 2.6 billion in August from DM 4.7 billion in July but in seasonally adjusted terms it remained almost the same. The accumulated surplus for the first eight months of the year stands at DM 46.6 billion compared to DM 45.6 billion in the same period last year. Foreign trade figures for September indicate a visible trade surplus of DM 11.5 billion following DM 6.5 billion in August. Exports rose by 3.1% while imports rose by only 0.7%.

DETAIL

10. The German press gave wide coverage to the IMF/IBRD meetings held in Washington from 29 September to 1 October and especially to the Chancellor of the Exchequer's suggestion that leading currencies should develop exchange rate margins and adopt commodity indicators. There was some speculation that Mr Lawson had coordinated his comments with similar ideas attributed to the US Treasury Secretary. Some newspapers suggested that the proposals were aimed at the FRG while others linked them with the EMS style of exchange rate management. In a speech in Berlin on 7 October, the President of the Bundesbank welcomed the development of objective indicators, including an index of commodity prices, but warned that no automaticity should be attached to them such as might deprive Governments and central banks of their right to autonomy of action. Pöhl also expressed doubts about the inclusion of gold in any index, fearing that such a speculative commodity might distort the indicator.

11. With an eye on the tax reduction programme, negotiations continued in Bonn between the Federal authorities and the Länder to amend the financial equalisation system (Finanzausgleich), the arrangement by which financially disadvantaged Länder are compensated for their low revenue. The system is based on a per capita tax revenue equation. Certain Länder, discontented by Lower Saxony's refusal to allow receipts from mineral oil refining to be included in the equation, last year successfully challenged the system in the

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