

UNCLASSIFIED
SAVING TELEGRAM

FROM BONN
FRAME ECONOMIC

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MY TELNO 414: FRG ECONOMY: FIVE INSTITUTES SPRING REPORT

SUMMARY

1. Report of the five leading economic institutes published on 2 May. Growth in all major industrialised countries forecast to slow in 1989. Real growth of 2% GNP expected for the German economy this year but decreasing to between 1% and 1.5% in 1989. Imports expected to continue to grow strongly, by 5% this year, while exports will stage some recovery, rising by 3% on the assumption of more stable conditions on the foreign exchanges.
2. Concern about continued low corporate investment attributed to the risk differential between the return on capital assets and the yields on financial investment. Criticism of the Government's fiscal policy which is seen as being potentially contractive if further reductions in taxation are left until 1990, as planned, and if proposed increases in consumer taxes are implemented next year. No significant changes expected in monetary policy.
3. Call for more deregulation and reductions in subsidies to boost economic growth and to assist a less contractive fiscal stance. Concern about the combination of progressive moves towards shorter working time coupled with increases in real wages. Unemployment expected to rise slightly in 1989.
4. The Government has dismissed the criticism contained in the report and it is unlikely to be persuaded to change its policies.

DETAIL

5. The five leading economic institutes in the Federal Republic released their Spring report on 2 May. The institutes, the Institut für Weltwirtschaft an der Universität Kiel (in the chair this time), the Deutsches Institut für Wirtschaftsforschung, Berlin, the HWWA-Institut für Wirtschaftsforschung, Hamburg, the Ifo-Institut für Wirtschaftsforschung, Munich, and the Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen, traditionally produce two forecasts every year.

INTERNATIONAL

6. As is usual the report opens by setting the scene on the international economy. The worst effects of the turbulence on financial markets in October have been largely neutralised by quick and concerted action by central banks. Imbalances between the US economy and those of Japan and Germany have been further reduced, though worries remain regarding the US budget deficit.

7. Growth in most industrialised countries is forecast to falter this year and to slow further in 1989. The US can expect a real increase of GNP of 2.5% this year and 2% in 1989; Japan will experience growth of 4.5% this year and 3.5% next year; the UK will drop from 3% growth this year to 2.5% in 1989; Italy can expect a similar fall from 2.5% real growth to 2% in 1989; and the French economy is expected to grow by only 2% this year and 1.5% in 1989. The main reason behind the institutes' pessimism for 1989 is an expected reduction in the rate of real growth of domestic demand in all industrialised countries. They forecast increases of 1.25% in the US, 4% in Japan, 3% in the UK, 2.5% in Italy and 1.5% in France. Inflation is expected to increase in the US from 4% this year to 5.5% next year; in Japan from 1.5% this year to 2.5% in 1989; in the UK from 4% this year to 5% next year; in Italy from 5% this year to 5.5% next year; and in France from 2.5% this year to 3% in 1989.

FRG ECONOMY

8. Turning specifically to developments in the German economy, the institutes agree with many other analysts that overall growth was not affected by the events of October. Private consumption remained strong. Production and demand have continued to expand, though the uncertainty created by fluctuations on the financial markets did little to boost confidence in industry and gave no incentive to revive already flagging investment. The report says that investment in machinery stagnated during the second half of 1987 and that it has failed to pick up since. The construction sector, helped by mild winter weather, performed better than expected. On the labour front, the institutes note the continued improvement in employment but that recent figures for seasonally adjusted unemployment have not been as good as expected. They also note continued progress in all sectors towards a shorter working week.

9. Monetary policy in 1987 was oriented further towards exchange rate stability. Official interest rates fell to historically low levels but the institutes note with concern the unnaturally large market rate differential between long and short-dated investments, up to 3 percentage points in March this year, which indicate continued investor preference liquid assets. Fiscal policy in 1987 remained broadly neutral. Unforeseen additional expenditure will lead to a higher than expected Federal budget deficit this year, compounded by the growing gap between revenue growth and growth in income.

10. On foreign trade, the report says that the continued growth in private consumption together with the reduction in import prices through exchange rate movements, benefitted imports, particularly consumer durables such as furniture. Exports were afflicted by the strengthening of the D-Mark, by the slow-down in world trade and by competition from South-East Asian countries.

FORECAST FOR 1988 - ASSUMPTIONS

11. The institutes make the following assumptions:

- demand and production in industrialised countries will continue to grow but at a lower level than in the second half of last year;