UNCLASSIFIED
SAVING TELEGRAM

FROM BONN
FRAME ECONOMIC
TO FCO TELNO 11 SAVING OF 27 OCTOBER 1988. 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.

THE FIVE INSTITUTES' AUTUMN REPORT

SUMMARY

1. The latest report of the five leading German economic institutes was published on 24 October. It presents an optimistic outlook for the world economy this year with strong growth in the major industrialised economies and some improvement in world trade imbalances. It stresses the dangers of instablility posed by rising inflation, exchange rate volatility and the threat of tighter monetary policy. Lower growth forecast for 1989.

2. For the FRG economy, the report confirms forecasts of strong growth this year, particularly in investment and foreign trade. GNP is expected to grow by 3.5%. Some complaints about continued increases in Government spending at the regional level, due mainly to higher costs of social security commitments and industrial subsidies. Agreement that monetary policy is on the right lines.

3. The forecast for 1989 expects lower growth of 2%. Private consumption will be affected by higher inflation and consumer tax increases. Investment will remain strong, including construction which is expected to grow by 2.5%. Foreign trade will provide the main impulse for growth. Little change in the labour market.

4. Criticism of "zig-zag" fiscal policy. A call for increases in indirect taxes next year to be shelved and/or the cuts in direct taxes planned for 1990 to be brought forward. A majority view that the Bundesbank should tighten the target range for monetary growth in order to combat inflation. Ritual call for deregulation and for greater privatisation.

5. Good but standard press coverage. Growth forecast for next year generally considered too low. Concern about fiscal policy reflects wide-spread disquiet with Government plans. Dismissive reaction from Government which rejected calls for change of policy.

DETAIL

International developments

6. The five leading economic institutes in the Federal Republic - Munich (whose turn it was in the chair), Berlin, Essen, Hamburg and Kiel - published their latest bi-annual report on the German economy on 24 October. Opening with an overview of international developments, the report notes that the world economy had not suffered as much as was feared from the events of last October. Economic growth in western Europe, the USA and Japan had been stronger in the second half of last year than had been realised. Some progress had been made in the adjustment of world trade imbalances. There had also been an improvement in the US budget deficit. But the report notes the dangers to continued economic growth in the world economy posed by inflation, exchange rate volatility and unnecessary tightening of monetary policy.

7. Looking to the future, the report forecasts 4% growth of real GNP in the USA this year, falling to 2.5% growth in 1989; 3% real growth in domestic demand this year and 2% in 1989; inflation accelerating from 4% this year to 5.5% in 1989. The current account deficit is expected to fall to US$ 135 billion this year but there will be little change next year. For Japan, the report forecasts real GNP growth of 5.5% this year slowing to 4% in 1989; domestic demand will rise by 7% in real terms this year and by 4.5% in 1989; inflation will increase slightly next year in line with proposed changes in Japanese taxation. The current account surplus will reduce marginally. In western Europe, real GNP is forecast to grow by 3.5% this year and by 2.5% in 1989, within which UK GNP will grow by 4% and 2.5% respectively, France by 3% and 2.5% and Italy by 3.5% and 3%. Private consumption, which remains strong this year, will slow in 1989. Domestic demand will average 4% real growth in 1988 and 2.5% growth in 1989, though the UK is expected to exceed this with 6% growth this year and 3% growth in 1989. The labour market will see little improvement. Inflation will average 3.5% this year, rising to 4% in 1989.

The FRG economy in 1988

8. The report says that at the beginning of the year financial markets were faced with a weaker dollar, strong expansion of the money supply and lower interest rates. As attention turned from the dollar, the D-Mark lost ground against other currencies. This combined with the lower exchange rate risk tempted domestic and foreign investors to look outside Germany for investment. Strong growth in the domestic money supply helped neutralise the effect of large capital outflows which resulted. The situation changed during the course of the year as central banks intervened to halt a strong surge in the dollar's value. In parallel the Bundesbank also increased interest rates thereby rectifying an imbalance in interest rate structure.