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FM BONN
TO PRIORITY FCO
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INFO ROUTINE EC POSTS, WASHINGTON, TOKYO, OTTAWA, UKDEL OECD
INFO SAVING CONSULATES GENERAL IN THE FRG AND BERLIN, BMG BERLIN

FRG ECONOMY: DECEMBER REPORT.

SUMMARY.

1. A BULLISH END-OF-YEAR OUTLOOK. GNP EXPECTED TO GROW BY AROUND 3.5 PER CENT. INVESTMENT AND EXPORTS STRONG BUT PRIVATE CONSUMPTION WEAKER THAN EXPECTED.
2. FORECASTS FOR 1989 INDICATE CONTINUED GROWTH AT A LOWER LEVEL. EXPORTS ONCE AGAIN EXPECTED TO PROVIDE A MAJOR STIMULUS AND A FURTHER RISE IN THE VISIBLE TRADE SURPLUS FORECAST.
3. BUNDESBANK MAINTAINED A TIGHT MONETARY POLICY BY RAISING ONE OF ITS MAIN INTEREST RATES AND DRAINING LIQUIDITY FROM THE MARKET. TARGET OF AROUND 5 PER CENT GROWTH IN MONEY SUPPLY M3 SET FOR NEXT YEAR.

DETAIL.

THE ECONOMY IN 1988.

4. THE GERMAN ECONOMY HAS ENDED 1988 ON A HIGH NOTE. REAL GROWTH AROUND 3.5 PER CENT IS CONFIDENTLY EXPECTED - THE HIGHEST GROWTH RATE SINCE 1979 - DRIVEN MAINLY BY A MARKED INCREASE IN OVERALL FIXED CAPITAL INVESTMENT AND THE CONTINUING STRENGTH OF EXPORTS. THIS BULLISH TONE IS APPARENT IN THE REAL ECONOMY, NOTABLY IN THE CORPORATE SECTOR. THE BUSINESS CLIMATE, AS MEASURED BY THE IFO MONTHLY INDEX, HAS MAINTAINED FOR SIX CONSECUTIVE MONTHS LEVELS HIGHER THAN THOSE LAST SEEN THREE YEARS AGO. DESPITE A SLACKENING OFF TOWARDS THE END OF THE YEAR, NEW ORDERS, MANUFACTURING OUTPUT AND CONSTRUCTION ACTIVITY ARE ALL RECORDING SIGNIFICANT INCREASES COMPARED TO 1987. STOCK MARKETS HAVE RESPONDED WITH ACTIVITY INCREASING STEADILY THROUGHOUT THE YEAR AND ALL THE MAIN INDICES REACHING RECORD LEVELS FOR THE YEAR IN THE LAST WEEK OF 1988. AND, ALTHOUGH IMPORTS HAVE RISEN SHARPLY, EXPORTS HAVE KEPT PACE RESULTING IN AN EXPECTED NEW RECORD VISIBLE TRADE SURPLUS APPROACHING DM 125 BILLION (COMPARED TO DM 117.5 BILLION IN 1987).

5. OTHER INDICATORS TELL A DIFFERENT STORY, HOWEVER. WHILE EMPLOYMENT HAS RISEN THROUGHOUT THE YEAR, THERE HAS FOR MAINLY DEMOGRAPHIC REASONS BEEN LITTLE OVERALL DECLINE IN THE NUMBER OF UNEMPLOYED. INFLATION, LOW BY INTERNATIONAL STANDARDS, HAS RISEN FROM 0.2 PER CENT LAST YEAR TO 1.2 PER CENT FOR 1988, SLIGHTLY ABOVE THE GOVERNMENT FORECAST. MORE WORRYING HAS BEEN THE LACKLUSTRE PERFORMANCE OF PRIVATE CONSUMPTION. ALTHOUGH IT IS EXPECTED TO RECORD A 2 PER CENT INCREASE IN REAL TERMS OVER THE YEAR AS A WHOLE, THIS IS THE LOWEST INCREASE SINCE 1985. WITH TAX INCREASES DUE TO COME INTO EFFECT ON 1 JANUARY 1989, THERE IS SOME CONFUSION AMONG ECONOMISTS ON THE DIRECTION OF CONSUMER SPENDING NEXT YEAR.

FORECASTS FOR 1989.

6. END OF YEAR FORECASTS FROM MAJOR INSTITUTIONS SUGGEST A SHARP SLOWDOWN OF GROWTH WITH A CONSENSUS RANGING BETWEEN 2 PER CENT AND 2.5 PER CENT RISE IN REAL GNP. THE GOVERNMENT'S OWN FORECAST IS AT THE UPPER END OF THIS RANGE. THE PRESIDENT OF THE BDI (CBI EQUIVALENT) HAS ALREADY BROKEN RANKS EXPRESSING THE VIEW THAT A STRONG CORPORATE SECTOR WILL DRIVE GROWTH OVER 2.5 PER CENT. EXPORTS ARE EXPECTED TO REMAIN STRONG AND THE VISIBLE TRADE SURPLUS IS FORECAST TO RISE - TO DM 135 BILLION ACCORDING TO ONE ESTIMATE. LITTLE CHANGE IS EXPECTED IN THE LABOUR MARKET. INFLATION IS EXPECTED TO RISE FURTHER TO BETWEEN 2 PER CENT AND 2.5 PER CENT.

MONETARY POLICY.

7. THE BUNDESBANK CONTINUED TO MAINTAIN A TIGHT MONETARY POLICY DURING DECEMBER, DRAINING LIQUIDITY FROM THE MARKET THROUGH ITS REGULAR SECURITIES REPURCHASE TRANSACTIONS. MARKET INTEREST RATES ROSE AS A RESULT AND THE BUNDESBANK RESPONDED ON 15 DECEMBER BY INCREASING ITS LOMBARD RATE FROM 5 PER CENT TO 5.5 PER CENT. AS INTEREST RATES SETTLED ONCE MORE, THE BUNDESBANK ABANDONED ITS POLICY OF AUCTIONING FUNDS AND REVERTED TO A FIXED RATE ALLOCATION OF 5 PER CENT AT ITS SECURITIES REPURCHASE TRANSACTION ON 21 DECEMBER. DESPITE DENIALS FROM THE BUNDESBANK, THESE MOVES HAVE BEEN GENERALLY INTERPRETED AS A TIGHTENING OF MONETARY POLICY.

8. THE PRESIDENT OF THE BUNDESBANK ANNOUNCED ON 15 DECEMBER A TARGET OF QUOTE APPROXIMATELY 5 PER CENT UNQUOTE GROWTH IN MONEY SUPPLY M3 FOR 1989. THE TARGET REPLACES THE RANGE OF 3 PER CENT TO 6 PER CENT THIS YEAR WHICH IN THE ELEVEN MONTHS TO NOVEMBER HAS CONSISTENTLY BEEN EXCEEDED.