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17 February 1989

Charles Powell Esq
No.10 Downing Street
London SW1

Prime Minister

A useful background paper for your discussions at the Anglo-German Summit. CDP 17/2

Dear Charles

In your letter of 23 January to Nigel Wicks about the Paris Economic Summit, you asked if we could let you have a note on our economic and trade relations with the Federal Republic of Germany and on what we might do to reduce the trade imbalance between the UK and Germany.

I enclose a paper covering the overall German current account surplus and their bilateral surplus with the UK. Our conclusion is that it would be a mistake to press the Germans to expand their domestic demand any further since first, the world at the present time positively needs the high savings which Germany is generating; and second the German economy is already operating close to full capacity so that additional demand could well carry inflationary risks. We also do not think it would be sensible to press for appreciation of the deutschemark at the present time. However, we strongly believe that Germany needs to adopt structural reforms in a number of areas which would improve the growth potential of the German economy, and which at the same time would increase the market for imports into Germany and might over time reduce the current account surplus. We have picked out four areas of reform which we believe particularly need pushing: agriculture, industrial subsidies, transport and financial services.

? but it would substitute 'home' for export demand

The Chancellor has endorsed the paper and intends to press the Germans in his contacts with them over the coming months on the four reform areas as suggested in the paper. He hopes that the Prime Minister will draw on it likewise in her meeting with Chancellor Kohl next week.

I am sending copies of this letter to Stephen Wall (Foreign and Commonwealth Office), Neil Thornton (Department of Trade and Industry), Roger Bright (Department of Environment), Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Carys Evans (Chief Secretary's Office) and Roger Lavelle (Cabinet Office).

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

ANGLO GERMAN SUMMIT: NOTE ON GERMAN CURRENT ACCOUNT SURPLUS AND STRUCTURAL REFORM

Introduction

1. Germany has been in surplus on its current account in all but five of the last thirty five years. Japan has also run surpluses, but not so persistently. Since 1986 German surpluses have averaged about 4 per cent of GDP compared with under 1 per cent over the previous 25 years. No significant early reduction is likely.

2. The Germans are high savers, partly because Germany's population will be aging rapidly over the next two decades. Furthermore, Germany's capital stock is high by international standards, and therefore the opportunities for new investment are not as great as in other countries. The net result of high savings in relation to investment is the large current account surplus. But the surplus may also be sustained by certain structural rigidities in the economy which affect savings, investment and imports.

3. The UK's interests would be served by reforms which reduce these structural rigidities. Such reforms would improve Germany's long term economic performance and provide a larger and more dynamic market for its trading partners. They may also bring about in time a lower surplus, although there can be no certainty about this.

Why?

4. It would not be sensible to press the Germans to expand domestic demand more rapidly through monetary or fiscal action for two reasons. Firstly there is, if anything, a shortage of savings in the world, and the freer capital markets of the 1980s have shown themselves well able to transfer funds from surplus to deficit countries - though this depends on the continuation of sound policies. Secondly the German economy is already running at or near full capacity and inflation has been rising (albeit from a very low base). More expansionary demand policies would increase the risks of inflation and - rightly - would be strongly resisted.

5. Appreciation of the DM at some stage seems quite likely. If this happens, it could help to moderate Germany's current account surplus. But at the present time this might imply an unwelcome depreciation of sterling. Accordingly it would be unwise to press the Germans on this point.

6. The UK had a trade deficit with Germany of £3 billion in 1983, and about £7 billion in 1988. Part of the increase was accounted for by the fall in oil prices in 1986. With domestic demand in the UK now beginning to grow more slowly, there is a reasonable prospect that our bilateral deficit will gradually decline.

7. The remainder of this paper describes four areas of structural reform - agriculture, industrial subsidies, transport and financial services and inward investment - on which we should be pressing the Germans particularly. Separate annexes A-D give further details; Annex E describes the main economic and trade relations between the UK and Germany; and Annex F sets out in more detail the arguments in this introduction. There are other areas such as labour markets where structural reform is necessary, and to which the Germans, rightly, attach importance. But it is difficult for the UK to argue that it has a direct interest in these.

Agriculture

8. German agriculture is very highly subsidized: the overall transfer from tax payers and consumers to farmers, including CAP support, is DM30bn, representing 90% of value added in agriculture and 1½ per cent of GNP. Germany is the single most important stumbling block to substantial agricultural reform in the EC, despite the high cost to its consumers and taxpayers. Agricultural reform would:-

- Increase imports;

- Lower taxes as EC and national subsidies fall;

- Lower food prices and raise real consumer incomes;

- Transfer resources from agriculture to more efficient uses elsewhere in the economy.

9. We have been trying hard for some time to persuade Germany to go further in supporting CAP reform by cutting agricultural prices. The Uruguay round is the opportunity to put this into practice.

Line to take: We should press Germany to give the Commission maximum flexibility in the GATT talks in April. If Germany wants to support its farmers for social and environmental reasons it should do so by carefully targetted subsidies - at a lower level than current national subsidies.

<u>**Industrial Subsidies**</u>

10. Coal, aerospace, steel, and shipbuilding all enjoy large subsidies. We focus on coal and aerospace since these are two industries where our record is good. ?!

(i) Coal

11. The subsidy takes the form of compensation to the principal coal users (steel and electricity) for the difference between domestic coal prices and world prices of coal and oil. This means that support is effectively open-ended. In 1987 the subsidy was about DM3.0bn. In the UK subsidies to coal have been falling quickly: in 1986/7 they were £1.5bn (DM4.5bn) and in 1988/9 they are expected to be about £0.5bn, (DM1.5bn). The German arrangements are guaranteed until 1995 at least.

plus various social payments

12. The German government intends to limit support by reducing the compensation to the electricity industry, effectively shifting the cost of subsidy to electricity consumers. There is also agreement to gradually reduce production, but the impact of this is to be softened by greater financial support.

Line to take: UK experience shows benefits of reducing subsidies to coal. Open ended support to coal should not continue. Nor should cost of support simply be shifted onto the industrial coal users who are under contract to buy German coal. Important to secure reduced levels of subsidy and of production. German industry would benefit from cheaper imported coal.

(ii) Aerospace

13. Federal support to aircraft, mostly to Airbus, was about DM4½bn (£1½bn) in 1986. Although a significant proportion of the Airbus support was in the form of loans, some of these have since been written off. The government has recently agreed to underwrite Deutsche Airbus' losses as part of the agreement to return Daimler Benz to the private sector. The UK provides support to British Aerospace, on Airbus, in the form of repayable launch aid.

14. The German government has argued that (a) support is justified by benefits to research and development (b) American competitors benefit from defence contracts and their monopoly position on world markets. These arguments reflect protectionist sentiments. The US authorities have argued that the German support for aircraft violates GATT articles.

Line to take: Important to reduce subsidies to aircraft industry. Danger that support becomes institutionalised. Increasing German support may be used to bid up subsidies all round. Must resist protectionist arguments and press for progress in reducing subsidies.

Transport

15. The German **road haulage** industry has been highly regulated. There was agreement last year to liberalize international road haulage - a major step to opening up this market. But the domestic market remains regulated. There are quotas on the number of national hauliers allowed to operate, and foreign hauliers on international routes are not allowed to take trade within Germany (cabotage).

16. On **civil aviation** Germany requires that international air fares have the approval of both national authorities concerned. Other EC countries only intervene when both authorities disapprove. A new round of EC negotiations on further liberalisation is due for November, but proposals are not yet available.

Lines to take: Continue to press for transport to be a priority area for the Single Market Programme. In particular, to urge early action on road haulage (cabotage) and the next stage of air transport liberalisation.

Financial Services and Inward Investment

17. There has been considerable freeing up of the financial markets and financial services industry over the past few years. More is to come with the likely passage of a Bill permitting a wide range of financial innovations which has recently been agreed by the German Cabinet. But over-regulation and lack of competition still hamper the development of financial services, which in turn is detrimental to the German consumer and industry. Of particular concern to the UK are the following:

(i) Insurance

18. The total insurance market in Germany is large (premiums equal 6% of GDP), but not as big as the British market where premiums amount to 8.3% of GDP. The market is, by UK standards, highly regulated: policy terms and conditions for most business are subject to approval by the Federal Supervisory Authority. This restricts the development of new products. A recent report from the German Monopolies Commission criticised these arrangements and argued that deregulation would encourage innovation and lower rates. Although there is a notional freedom for German residents to insure themselves abroad, there are a number of practical obstacles and disincentives to doing so: intermediaries are banned from placing non-transport insurance with insurers not authorised in Germany, for example, and tax relief on premiums is not available on policies abroad. The EC

directives on non life insurance services agreed in June 1988 will free cross border insurance in large commercial risks by 1990. The life services directives due shortly will free certain life risks.

Line to take: The German authorities should be pressed to consider:

- relaxing restrictions to allow a greater diversity of life insurance products; and

- eliminating fiscal and regulatory obstacles to German residents insuring themselves abroad, certainly in other EC states.

(ii) Disincentives to direct and portfolio investment

19. Explicit restrictions on inward investment into Germany are minor and few. But equity markets are small and fragmented and few public companies are quoted. There are close links between banks and industrial and commercial companies (direct shareholding and proxy voting) and cross-holdings between allied companies. It is also difficult to establish the identity of ultimate shareholders because of cross-holding.

20. The close relationship between the banks and industrial and commercial companies, and the underdevelopment of equity markets is defended by many Germans on the grounds that it encourages the long term view and contributes to high investment in Germany. Our view is that it unfairly restricts foreigners' access to capital markets and reduces efficiency.

Line to Take: Measures are needed to increase (a) the transparency of shareholding and (b) the importance and size of the stock market. These would increase access to German capital markets, and the opportunities for British firms to acquire German companies.

H M Treasury

15th February 1989

ANNEX E

THE UK'S ECONOMIC AND TRADE RELATIONS WITH GERMANY

Introduction

1. This Annex compares the economies of Germany and the UK and sets out the UK's bilateral relations with Germany. The main data source is the OECD.

Size and composition

2. German GDP is greater than that of the UK, and has been since the early 1960s, but the UK has been narrowing the gap in the 1980's.

Table 1: UK and German Economies in 1987

	Germany	UK
GDP ($ billion converted at OECD Purchasing Power Parities	815	703
Population (million)	61.1	56.9
GDP per capita ($ thousand)	13.3	12.4

Table 2: German GDP as percentage of UK GDP

	1953*	1960*	1973	1980	1986	1987	1988	1989**
Germany	73	100	114	123	119	116	115	115

Converted at PPPs, except* converted at market exchange rates.
** Forecast

3. Manufacturing produces a higher proportion of GDP in Germany than in the UK, and employs a high proportion of those in work.

Table 3: Output structure in 1985

Percentage of GDP	Germany	UK
Agriculture	2	2
Industry*	39	33
of which Manufacturing	(33)	(22)
Services (including Government sector)	59	65
	100	100

Table 4: Employment Structure

Percentage of all active persons	Germany (1985)	UK (1986)
Agriculture	5	3
Industry*	42	40
of which Manufacturing	(32)	(22)
Services (including Government Sector)	54	57
	100	100

4. In 1987, exports and investment constituted higher proportions of German GDP than of UK GDP, and consumption a lower proportion.

Table 5: Composition of Expenditure in 1987

Per cent of GDP	Germany	UK
Private Consumption	55.4	62.6
Government Consumption	19.8	20.9
Gross Investment	19.9	17.4
Exports	28.7	26.4
Less Imports	23.7	27.4

5. Throughout the 1980s, net savings have been a higher proportion of GDP in Germany than in the UK, as is shown in Table 6.

Table 6: **Net Savings in the UK and Germany**

Percentages of GDP	1987 UK	1987 Germany	1980-87 Averages UK	1980-87 Averages Germany
Net Capital Formation	5.7	7.5	4.9	8.3
Current Account Surplus	-1.6	4.0	0.6	1.4
Less Statistical Discrepancy	-1.4	-	-0.3	-
equals Net Saving	**5.4**	**11.4**	**5.8**	**9.7**

Between 1980 and 1986, the capital stock (excluding dwellings) per person employed rose by 37% in Germany and 16% in the UK. In 1985 gross capital stock per person employed was approximately 20% higher in Germany than in the UK (converted at OECD PPPs for fixed investment), but this position is changing as business investment grows more rapidly in the UK than in Germany.

Table 7: **Growth of Business Investment**

Per cent per year (Average)	**1980-87**	**1983-87**
Germany	1.5	3.5
UK	5.3	9.1

Composition of Trade

6. Compared to the UK, a higher proportion of German total exports are goods, and within that manufactures.

Table 8: **Composition of Trade, Germany and UK 1986**

US $ billion	Exports Germany	Exports UK	Imports Germany	Imports UK	Balance Germany	Balance UK
Total Goods	242	106	189	125	+53	-19
of which						
Manufacturing	(186)	(66)	(110)	(81)	(+76)	(-15)
Services	36	37	47	24	-11	+13
Total	278	143	236	149	+42	-6

Table 9: **Product composition of Trade in goods, 1986**

Percentage of Exports or Imports	Per Cent Germany	UK	Germany	UK
Food and Drink Products (SITC 0, 1, 4)	5.1	7.6	11.9	12.2
Manufactures (6-8)	76.8	61.7	58.1	64.8
Raw Materials and Fuels (2, 3)	3.4	14.6	18.0	12.8
Chemicals (5)	12.9	13.3	9.3	8.6
Other (9)	1.9	2.7	2.6	1.6
	100.0	100.0	100.0	100.0

Shares in World Markets

7. Table 10 shows the German share of world exports of goods to be about 12% and that of the UK 5-6%.

Table 10: **Shares of World Exports of Goods**

percentage	**1970**	**1979**	**1987**
Germany	11.6	10.9	12.1
UK	6.6	5.5	5.4

Current Account Positions

8. Germany has had a current account deficit in only five years since 1960. Table 11 shows German and UK current accounts as percentages of GDP.

Table 11: **Current Account Positions**

Percentage of GNP/GDP	**1960**	**1970**	**1980**	**1984**	**1985**	**1986**	**1987**	**1988**
Germany	1.6	0.5	-1.7	1.6	2.6	4.4	4.0	4.2
UK	-1.0	1.5	1.3	0.6	0.9	0	-0.6	-2

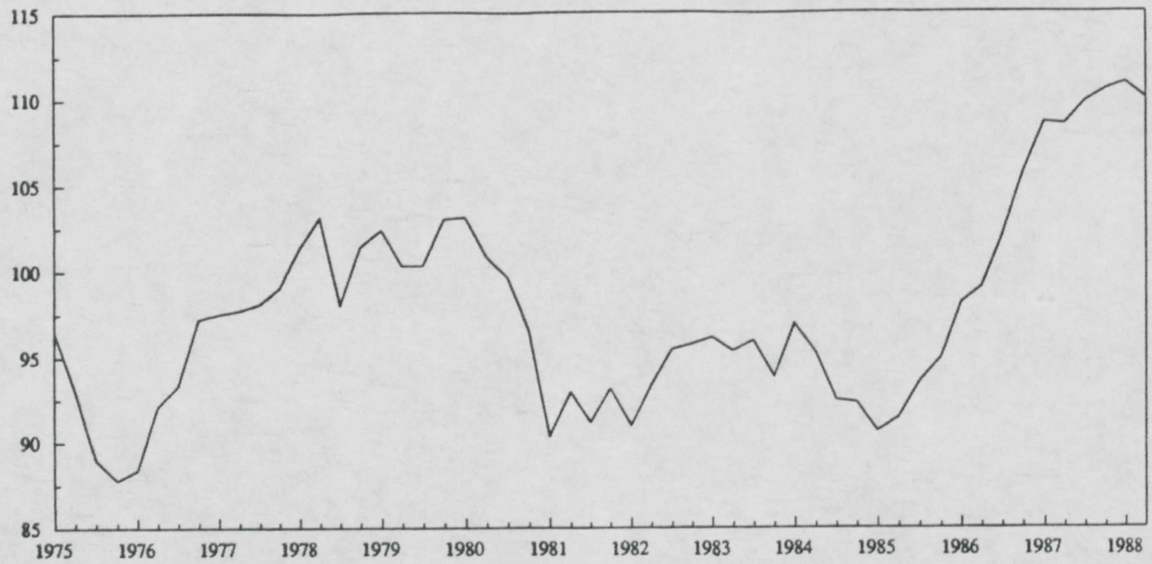
Net Overseas Assets

9. Net German overseas assets rose from $33bn in 1980 to $94bn by mid-1986. The UK's net external assets rose from $39bn in 1980 to $162bn by end 1986.

Competitiveness

10. The chart below shows some increase in German relative unit labour costs - measured in a common currency - since 1984. By most standards the German economy remains highly competitive.

GERMAN REAL EFFECTIVE EXCHANGE RATE
(DEFLATED BY RELATIVE UNIT LABOUR COST)
INDEX 1980=100



Source : IMF

Bilateral Trade

11. Table 12 shows that Germany has become an increasingly important trading partner for the UK, and that the UK's bilateral trade account has generally been in deficit. This was true even in 1983 when the UK had an overall trade surplus. The UK's bilateral trade deficit with Germany widened from 0.8 per cent of UK GDP in 1979 to 1.6 per cent of UK GDP in 1987. Possible explanations are discussed in the section C.

Table 12a: German Shares of UK Merchandise Exports and Imports

	UK Exports to Germany as % of UK Exports	UK Imports from Germany as % of UK Imports
1970	6.2	6.0
1979	10.4	12.4
1983	10.0	14.7
1987	11.8	16.8

Table 12b: UK Trade in Goods with Germany

	UK Exports to Germany (£b)	German Exports to UK (£b)	Balance (£b) % of UK GDP in brackets
1970	0.5	0.5	-0.05 (-0.1)
1979	4.2	5.8	-1.6 (-0.8)
1983	6.1	9.7	-3.0 (-1.0)
1987	9.4	15.8	-6.4 (-1.6)

Figures on UK invisible trade, with individual EC countries are not available. The UK's receipts on invisible transactions with EC countries were £22 billion in 1987, and debits were £26 billion including £1bn of payments to overseas residents in maintaining the B.A.O.R.

International Direct Investment

12. The strong industrial links between the two countries are shown by the high stock of UK direct investment in Germany and the somewhat lower level of German direct investment in the UK. UK companies held about £3 billion of assets in the form of direct investment in Germany in 1984, three times larger than the stock of German corporations' direct investment in the UK, which stood at just under £1bn. Flows of direct investment in 1985 and 1986 maintained this relative position.

German Productivity and Comparative Advantage

13. Germany has a large and efficient manufacturing sector which is a major net exporter, particularly of capital goods. The large German and Japanese surpluses on manufacturing trade are shown in Table 10.

Table 13: **Manufacturing Trade Balances 1987**

	Billions of Dollars	**Ratio of manufacturing exports to manufacturing imports**
United States	-130	0.6
Japan	164	3.4
Germany	107	1.6
France	-3	1.0
United Kingdom	-14	0.9
Italy	30	1.3
Canada	-13	0.8
Total of Above	140	

14. It is difficult to obtain reliable estimates of levels of productivity, but output per employee is probably about 20-30% higher in German manufacturing than in the UK. This picture is gradually changing as manufacturing output per employee in

manufacturing grows more rapidly in the UK than in Germany. During the 1980s this has been growing more slowly in Germany than in any other major economy.

Table 14: Output per Employee in Manufacturing

	Annual average percentage change		
	1960-70	**1970-80**	**1980-1988Q3**
UK	3.0	1.6	5.5
Germany	4.1	3.2	2.5
Major 7 Average	5.2	3.3	3.6

15. The German services sector is highly regulated. Transport and other services, and agriculture and mining are heavily subsidised. German current transfers, mainly to services and agriculture, were 4.3% of GDP in 1985, and have stayed roughly constant since. This is higher than the figure for the UK, which is declining from a 1985 value of under 4%.

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ANNEX F

THE GERMAN CURRENT ACCOUNT SURPLUS

1. This annex sets out the arguments in the Introduction in more depth.

(a) The Reasons for the German Current Account Surplus

2. Historical experience shows that individual countries have run current account surpluses and deficits for prolonged periods - decades rather than years. Britain in the year to 1914 is a good example. The fundamental reason for this is that the country has a high rate of savings in relation to its domestic investment opportunities. This is generally a question of private sector behaviour, although governments may also influence the outcome. The US budget deficit is a case in point, lowering national savings in an economy which has low private sector saving compared with other major countries.

3. In Germany we can identify reasons why, we believe, savings have been high in relation to domestic investment:

(i) Recently, Germany has been a comparatively low growth economy: in the 1980's growth was significantly below the OECD average. At the same time its capital stock is high by international standards. Together this suggests that new investment opportunities may be more plentiful overseas: hence the high level of capital outflows.

(ii) Germany's stock of net overseas assets, built up partly from its surpluses, is not unduly high as the following table shows.

Net overseas assets as a percentage of GNP

	1975	1980	1986
US	5	4	-6
Japan	1	1	9
Germany	9	4	11
France	8	14	6
UK	2	7	31
Italy	-1	9	-2
Canada	-30	-35	-36

Source: National Data and International Financial Statistics.

(iii) There are demographic reasons for expecting Germany to wish to save a high level at present. Its dependency ratio - population of over 65 year olds to 15 to 64 year olds - is expected to rise from the current level of about 22½ per cent to 30 per cent by 2010. Only Japan of the major seven industrialized countries is likely to experience a rise of this magnitude.

(iv) There are some structural rigidities, the removal of which would lead to a more dynamic economy, and, possibly, lower current account surplus.

(b) <u>Capital Markets and Investment Flows</u>

4. In the last decade, following the lead taken by Britain in 1979, many OECD countries have removed exchange controls. As financial markets have been de-regulated and financial innovation has taken place on an unprecedented scale, the nationality of individual savers and investors becomes of less significance. This greater flexibility has enabled the sustained use of Japanese and German savings to make good the shortfall of savings in the US and now in the UK. Capital markets have shown themselves able and willing to finance the current account surpluses and deficits without disruptive changes to exchange rates and interest rates. When these capital flows are used to finance productive investment

they are sustainable and may persist for considerable periods of time, provided that the appropriate policy framework is in place. Elements in this include:

- appropriate monetary policies to keep inflation under control;

- fiscal policies set within a medium term framework within which governments do not displace private sector savings;

- policy co-ordination contributes to stability in financial markets.

(c) Bilateral Trade Flows

5. Germany has a comparative advantage in manufacturing and especially of capital goods, and so runs a trade surplus in manufactures and a deficit in raw materials and services. In recent years, the UK has become a net importer of manufactures on an increasing scale. It is not surprising therefore that it has had a rising trade deficit with Germany.

6. But the increase in the deficit in the last two years has been due partly to some special factors including the fall in oil prices which halved the surplus on Anglo-German trade in fuel between 1985 and 1987.

(d) Structural Reform and the Current Account

7. Better performance through structural reform may result in either an increase or decrease in the current account. The net effect is likely to depend on the responses of national saving and the exchange rate. Thus, if a general programme of structural reform were to raise the rate of return on capital employed, one might expect to see higher investment, higher capital inflows and a smaller current account surplus. However if the effects on aggregate demand are weak, for example because policy does not

fully accommodate the increase in supply, then it is quite possible that the current account surplus might rise.

8. As the main paper has shown, in Germany outside the highly competitive manufacturing sector there are important areas which are highly regulated. These rigidities protect German producers and damage the interests of overseas producers.

9. Structural reform would therefore tend to increase the share of imports in German markets, as well as raising growth potential. Of course there would also be benefits to manufacturing industry, both by providing access to more efficient services and by allowing resources to switch from services to manufacturing. Nevertheless the net effect would probably be to reduce the current account surplus.

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