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SAVING TELEGRAM

FROM BONN

FRAME ECONOMIC

TO FCO TELNO 6 SAVING OF 31 MARCH 1987. 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.

FRG ECONOMY

SUMMARY

1. Chancellor Kohl announced his new coalition Government with changes at the Federal Ministries of Economic Cooperation and the Economy. The Government Declaration outlines the Government's intention to introduce tax reform measures but gives few details about how they will be financed. Some discussion of reductions in industrial subsidies but any decisions will be difficult to reach.

2. Further signs of a pause in economic growth. Majority of current forecasts agree that real GNP will rise by around 2% this year with domestic demand again providing the motor for growth. Industrial confidence weak mainly because of the outlook for exports. Concern over the lag in investment levels.

3. A rise in the savings ratio in 1986 is thought to indicate a shift in the debt/assets ratio as consumers adjust to the increase in disposable incomes. General assessment that this has contributed to the continued overshoot of monetary targets but that the Bundesbank will not react by tightening monetary policy.

4. Provisional new order figures for January show a drop of 2% with domestic orders down 4% on December. Industrial output also fell sharply in January over December with the construction sector suffering particularly badly. Private consumption rose by a nominal 1% in January over the same period last year. Inflation, cost of living index, stood at -0.5% in February after -0.8% in January.

5. The current account surplus fell to DM 4.9 billion in January, seasonally adjusted, after DM 8.5 billion in December and DM 4.5 in January 1986. The visible trade surplus also fell to DM 7.2 billion in January with both nominal imports and exports continuing to fall back.

6. All monetary indicators continued to grow faster than anticipated. Central Bank Money grew at an annual rate of 7.5% in February, outside the target range of 3% to 6%.

7. February unemployment totalled 2.488 million or 10% of the working population after 10.4% a year ago. The first major settlement of the wage round was agreed at 3.4% for workers in national and local public services.

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8. The new coalition Government of Chancellor Helmut Kohl was announced on 11 March. On the economic side the main changes were at the Federal Ministry of Economic Cooperation which gained a new Minister in Hans Klein (CSU) to replace Juergen Warnke who was moved on to Transport, and two new Parliamentary State Secretaries at the Federal Ministry of the Economy, Ludolf-Georg von Wartenberg (CDU) and Erich Riedl (CSU). The Federal Minister of Finance, Gerhard Stoltenberg (CDU), whose plans for a comprehensive tax reform programme for the 1990s had figured large in the negotiations preceding the formation of the new Government, retained his position despite the embarrassment of Chancellor Kohl offering that position to the Minister-President of Bavaria, Franz Josef Strauss. The liberal FDP party of which Dr Martin Bangemann, the Federal Minister of the Economy, is a leading figure, benefited from the negotiations by securing another ministerial post at Education.

9. The Government Declaration given by Chancellor Kohl on taking up office threw very little additional light on how the new Government intends to carry out its promise of tax reform. In a long passage on economic issues, but which was almost devoid of meaningful figures, the Declaration said that DM 5 billion of tax cuts will be brought forward to come into operation on 1 January 1988 at the same time as the second stage of the previously announced programme of tax cuts. This will bring the total value of the tax cuts for January 1988 to some DM 14 billion. The Declaration estimated that when the major tax reform planned for 1990 is taken into account the tax payer will have benefited by a net reduction in the tax burden of some DM 45 billion between 1986, when the first stage of the current programme was introduced, and 1990. Although a detailed announcement has yet to be made, it is thought that the measures to be introduced on 1 January 1988 will now include lower marginal tax rates for low, medium and high income brackets coupled with higher standard deductions. There will also be additional reliefs for Small and Medium-sized Enterprises. While the Government continues to refer to the new measures as tax reform, they seem not yet to have addressed the issue of a comprehensive simplification of the very complex German system and instead to have concentrated on straightforward cuts in specific areas. The programme for the 1990s will however include an attempt to iron out the fiscal drag inherent in the present income tax system by a move to a linear progressive rate.

10. It is not yet known how this programme will be financed. This aspect appears to have been glossed over in the negotiations between the coalition partners, a measure of the difficult decisions which will face the Government in the Autumn. There have been calls for cuts in subsidies to industry (which are estimated to have risen by 11% in 1986 in National Income terms), especially those to coal and steel, and there have also been hints from the Federal Finance Ministry that Government borrowing is likely to rise. The President of the Association of German Chambers of Commerce heavily criticised the Government for failing to clarify which subsidies it plans to cut. The Federal Economics Minister caused a mild rumpus when he was reported as having said in a press interview that ailing industries such as steel could not expect to be supported from Government funds, an interview which Bangemann denied having given. He then went to

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