

CONFIDENTIAL

062623
MDHIAN 3100

CONFIDENTIAL

FM BONN

TO IMMEDIATE FCO

TELNO 818

OF 280955Z OCTOBER 87

INFO IMMEDIATE WASHINGTON, TOKYO

INFO PRIORITY PARIS, ROME, OTTAWA, UKDEL OECD

INFO SAVING CONSULATES-GENERAL IN THE FRG AND BERLIN

FRG ECONOMY: REACTIONS TO DEVELOPMENTS ON THE FINANCIAL MARKETS

SUMMARY

1. SATISFACTION THAT GERMAN FINANCIAL CENTRES HAVE THUS FAR ESCAPED THE MORE VIOLENT FLUCTUATIONS OF THE STOCK MARKETS. SOME DIVISIONS APPEARING OVER DOMESTIC ECONOMIC MANAGEMENT WHICH MAY IMPINGE UNHELPFULLY ON THE INTERNATIONAL SITUATION. A RISK THAT THE GERMANS, UNIMPRESSED BY THE DEBATE WITHIN THE US ON THE BUDGET DEFICIT, WILL NOT FEEL INCLINED TO MAKE A SIGNIFICANT REDUCTION IN INTEREST RATES IN THE FORESEEABLE FUTURE.

DETAIL

2. THE GYRATIONS IN THE WORLD'S FINANCIAL CENTRES HAVE BEEN FOLLOWED WITH INTEREST IN GERMANY, BUT WITH LESS INTENSITY THAN HAS BEEN SHOWN BY BRITISH PRESS AND RADIO. THE STOCK MARKET IS NOT PERCEIVED HERE AS AN ESPECIALLY IMPORTANT INDICATOR OF ECONOMIC HEALTH. THE GERMAN FINANCIAL COMMUNITY HAS SUPPORTED THE CONTENTION OF THE BUNDESBANK AND THE GOVERNMENT THAT THE FALL IN SHARE PRICES WAS PRECIPITATED BY INTEMPERATE CRITICISM BY THE US TREASURY SECRETARY OF RISING GERMAN INTEREST RATES. SUPPORT HAS ALSO BEEN GIVEN TO SUGGESTION THAT IN INCREASING ITS REPURCHASE INTEREST RATES TO 3.85 PERCENT, THE BUNDESBANK WAS REACTING SOLELY TO MARKET FORCES WHICH STEMMED FROM INCREASING US INTEREST RATES. THE PRESS AND FINANCIAL ANALYSTS HAVE ACCEPTED THE VIEW THAT THE INHERENT STRENGTHS OF THE GERMAN ECONOMY HAVE BEEN SUFFICIENT TO PROTECT GERMAN FINANCIAL CENTRES FROM THE WORST FLUCTUATIONS OF THE INTERNATIONAL MARKETS. THE COMMERZBANK INDEX, FOR EXAMPLE, HAS FALLEN BY ONLY 16.4 PER CENT SINCE 16 OCTOBER. THE UNDERLYING FEELING IS ONE OF CONFIDENCE THAT GERMAN MARKETS WILL SURVIVE THE STORM BETTER THAN OTHERS AND THAT WHEN THE RECOVERY EVENTUALLY COMES GERMAN EXCHANGES WILL START FROM A SOLID BASE. COMMENTATORS HAVE BEEN QUICK TO EMPHASISE THE ROLE PLAYED BY PROGRAMME TRADING IN THE DECLINE IN OTHER MARKETS WITH SOME SATISFACTION THAT THERE IS NO SUCH TRADING IN FRANKFURT OR DUESSELDORF.

3. DESPITE THIS COMFORTABLE AND SOMEWHAT SELF RIGHTEOUS ANALYSIS, THERE ARE SIGNS OF ANXIETY ABOUT THE FUTURE AND DISAGREEMENT OVER ECONOMIC MANAGEMENT. THE DIFFICULTY IS TWOFOLD: INSTITUTIONAL AND POLICY. THE BUNDESBANK HAS A RIGHT, THROUGH ITS MEMBERSHIP OF THE WORKING PARTY ON TAX REVENUE ESTIMATES TO BE INVOLVED IN THE DRAWING UP OF THE GOVERNMENTS FIVE YEAR FINANCIAL PLAN WHICH WAS PUBLISHED IN SEPTEMBER. THIS RIGHT WAS OBSERVED, BUT THE BUNDESBANK HAS SINCE BEEN CUT OUT OF THE DEBATE WITHIN THE GOVERNMENT ABOUT HOW THE TAX REDUCTIONS WOULD BE FINANCED. MOREOVER, WHEN THE DECISION WAS MADE, THE SINGLE LARGEST ELEMENT OF THE FINANCING WAS TO BE BORNE BY THE PROPOSED WITHHOLDING TAX ON CERTAIN SAVINGS AND INVESTMENTS. ALL THIS, COMBINED WITH THE GENERAL IMPRESSION THAT THE COALITION GIVES OF NOT BEING MASTER OF EVENTS, HAS BROUGHT ABOUT A DECLINE IN CONFIDENCE IN THE CENTRAL BANK ABOUT THE ABILITY OF THE GOVERNMENT TO IDENTIFY THE RIGHT COURSE OF ACTION OR PURSUE IT.

4. SECONDLY POLICY. THE BUNDESBANK FEELS THAT THE COALITION SEES LITTLE BEYOND THE NEED TO SATISFY ITS VOTERS. THE BANK FEELS LONELY AS A RESULT. ITS UNEASE IS INCREASED BY THE FACT THAT OPINION WITHIN IT IS DIVIDED ON THE WAY FORWARD BETWEEN THOSE, LED BY DEPUTY PRESIDENT, SCHLESINGER WHOSE OVERRIDING CONCERN IS TO PREVENT DOMESTIC INFLATION AND WHO IS THEREFORE PREPARED TO ALLOW INTEREST RATES TO RISE TO THE LEVEL NECESSARY TO REDUCE LIQUIDITY AND THOSE LED BY THE PRESIDENT, POEHL WHO SEE HIGH INTEREST RATES AS ENDANGERING DOMESTIC GROWTH AND RISKING CONFRONTATION WITH THE UNITED STATES. ONE THEREFORE HAS THE SPECTACLE OF THE SPD PRESIDENT OF THE BUNDESBANK IN ALLIANCE WITH THE CDU FINANCE MINISTER AND FDP ECONOMICS MINISTER, BOTH OF WHOM HAVE THE INTERESTS OF GERMAN BUSINESS, ESPECIALLY SMALL AND MEDIUM SIZED BUSINESS, UPPERMOST IN THEIR MINDS, AND WHO DO NOT WANT TO BE ACCUSED OF STIFLING ECONOMIC ACTIVITY. ONE MIGHT HAVE THOUGHT THAT THIS COMBINATION WOULD HAVE BEEN POWERFUL ENOUGH TO ALLOW A MORE EXPANSIONARY ECONOMIC POLICY TO BE PURSUED. BUT, WITHIN THE BUNDESBANK, THE SCHLESINGER FACTION IS STRONG (AND IS RUMOURED TO BE INCREASING IN STRENGTH). SINCE IT WOULD BE A NOTABLE DEPARTURE FROM NORMAL PRACTICE FOR THE BUNDESBANK TO CHANGE COURSE WITHOUT INTERNAL AGREEMENT, THERE IS A STALEMATE.

5. INABILITY TO MOVE IS REINFORCED BY SCEPTICISM ABOUT WHETHER THE US ADMINISTRATION WILL ACTUALLY HONOUR THE COMMITMENTS UNDERTAKEN AT THE TIME OF THE LOUVRE ACCORD TO REDUCE THE BUDGET DEFICIT. PROVIDED THE DOLLAR DOES NOT FALL SIGNIFICANTLY FURTHER, THE GERMAN AUTHORITIES ARE UNLIKELY TO FEEL UNDER GREATER PRESSURE THAN THEY HAVE ALREADY WITHSTOOD TO LOWER DOMESTIC INTEREST RATES. AND EVEN IF

CONFIDENTIAL

062623
MDHIAN 3100

THE DOLLAR FALLS FURTHER, THE MOST LIKELY INITIAL GERMAN REACTION WILL BE TO INTERVENE TO SUPPORT IT OR AT LEAST MANAGE ITS DECLINE. THIS ACTION WOULD IN TURN BE LIKELY TO STRENGTHEN SCHLESINGER'S HAND BECAUSE OF THE FEAR THAT INTERVENTION WOULD INCREASE THE PROBLEM OF ADHERING TO DOMESTIC MONETARY TARGETS. IT IS NOT CLEAR AT THE MOMENT WHAT, IF ANYTHING, WILL CAUSE THE GERMANS TO BREAK OUT OF THIS CLOSED CIRCLE.

6. THERE IS NO TIDY END TO THIS STORY.

BULLARD

YYYY

DISTRIBUTION

188

MAIN 185

FINANCIAL

WED

ADDITIONAL 3

BANK OF ENGLAND
TREASURY

CABINET OFFICE

NNNN