UNCLASSIFIED
SAVING TELEGRAM

FROM BONN
FRAME ECONOMIC
TO FCO TELNO 7 SAVING OF 30 MAY 1986. Infc all EC Posts, UKDel OECD, UKMis Geneva, all Consulates-General in the Federal Republic, Washington, Tokyo, Vienna.

FEDERAL GERMAN ECONOMY

Summary

1. Although the general economic conditions in the Federal Republic are still positive (stable prices, low interest rates and good prospects for growth in private consumption), outturn in the first quarter did not record especially favourable results (production rose by only 2.2% - after 4.5% in Q1 1985; new orders fell by 1.5%, exports by 2.7% and the business climate - as measured by the IFO Institute - deteriorated further and for the fourth consecutive month). The Ministry of the Economy describe the process as a "breathing space" and attribute the causes to inclement weather, the impact of the Easter holidays and a wait-and-see attitude applied by exporters in the run-up to the EMS realignment and other exchange rate factors. All commentators are agreed that the key to further growth this year lies in private consumption and, although the outlook for this component is good, the high rate of increase needed to support the level of growth anticipated by the government is in doubt.

2. The labour market recorded a marked improvement in April. The total number of unemployed at the end of April was 2.23 million, 217,600 fewer than in March and 74,600 down on April 1985.

3. Consumer prices fell again in April and the annual rate of inflation stood at minus 0.2%. Flash estimates for May show a further fall to minus 0.5%.

4. Despite speculation of pressure which preceded the Tokyo Summit, the Bundesbank has not followed the US and Japan in further reducing discount rates.

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5. Another massive trade surplus was recorded in March givin a current account surplus in the first quarter of DM 16.3 billion compared to only DM 5 billion in Q1 1985. However, this result has been heavily influenced by lower import costs and German exports now seem to be stagnating - albeit at a high level.

Detail

6. The economic conditions for continuing growth remain good: price stability has been achieved and inflation is now at the lowest level since 1959; interest rates are low; real wages are rising and a substantial increase in purchasing power will result from low oil prices and tax reductions. However these positive factors have yet to be reflected in the real economy, a fact confirmed by disappointing first quarter figures. New orders, production exports and capacity utilisation have all declined on a year earlier or at best stagnated. Overall provisional Q1 figures show only a 1.8% (real) increase on Q1 1985 (which itself recorded a particularly disappointing result due to the worst winter for 20 years).

7. The official view on this year's Q1 outturn, as given by the Economics Ministry, is that the economy is taking a "breathing space". Oil price and exchange rate uncertainties (in the light of the EMS realignment) and the drastic fall in the dollar rate have played a role in this process as did the impact of the Easter holidays and the inclement weather experienced during the first quarter. However, other economists have concluded that the problems experienced by exporters have had a sobering influence on expectations for future foreign demand. They have also voiced concern that private consumption has yet to show the hoped-for upswing. Indeed, domestic demand, as reflected by new orders, has remained flat (at a low level) for the last six months. Thus, some commentators have already begun to call for a reappraisal of earlier forecasts of 4% real GNP growth to be revised downwards to 3%.

8. Clearly the dramatic fall in the dollar rate has been more damaging for export business than anticipated and this has had a sobering influence on expectations on the future growth of exports.

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INTERNATIONAL PERSPECTIVES

MORGAN STANLEY

May 9, 1986

Germany: Flirting With Deflation

In volatile markets, the U.S. dollar remains under downward pressure against the German mark. This trend toward dollar weakness and mark strength is likely to continue until the Bundesbank accommodates the deflation in the German economy with lower interest rates. Given this perspective, both the German bond market and the currency continue to be extremely attractive for global investors.

Consumer prices are now 0.2% below levels of a year ago. Wholesale prices are 7.1% below year-ago levels. Oil prices in German mark terms have fallen from a peak of DM 96 per barrel ($29) in March 1985, to DM 30 per barrel ($13) in April 1986, a 70% decline.

On the other hand, unemployment is at 9%, down modestly from 1985's average of 9.3%. In the last five months, industrial production has fallen four times, including a 0.5% decline for March and a 0.7% decline for February. This leaves industrial activity 1.2% below levels of a year ago. Furthermore, export demand, which accounted for much of Germany's real GNP growth in the 1983-1985 period, has slowed considerably.

In sum, current data strongly suggest that the German economy will fail to produce the 3.5% real GNP growth many analysts expect, including the Bundesbank. Also, actual deflation of 0.5% to 1.0% in consumer prices may occur, well below the 0.5% inflation forecasted by the Bundesbank and others (See Table 1, next page).

The Bundesbank's Burden

Because the Bundesbank has viewed the economy as strong and deflation as unlikely, they have maintained a cautious stance toward the interest rate reductions that have occurred around the world. From April 1985 through April 1986, there has been a 145 basis point drop in 3-month Euro-mark interest rates to 4.5% and a 150 basis point drop in 10-year government bond yields to 5.78%. As illustrated in Figure 1, this compares to a much greater drop in U.S. dollar interest rates. The 3-month Euro-dollar rate has fallen 195 basis points during this period, while the 10-year Treasury bond has seen its yield decline by 390 basis points.

Comparing these interest rate declines to inflation rates in the United States and Germany suggests that real interest rates have been rising in Germany relative to the United States. Both countries are experiencing declines in expected inflation of a similar magnitude. With nominal interest rates falling faster in the U.S., however, this means that real interest rates have been shifting in Germany's favor.

From our perspective, this shift in real interest rates is one way of measuring the relative tightness of German monetary policy. This also helps to explain the collapse of the dollar from around DM 3.35 in March 1985 to below DM 2.20 today.

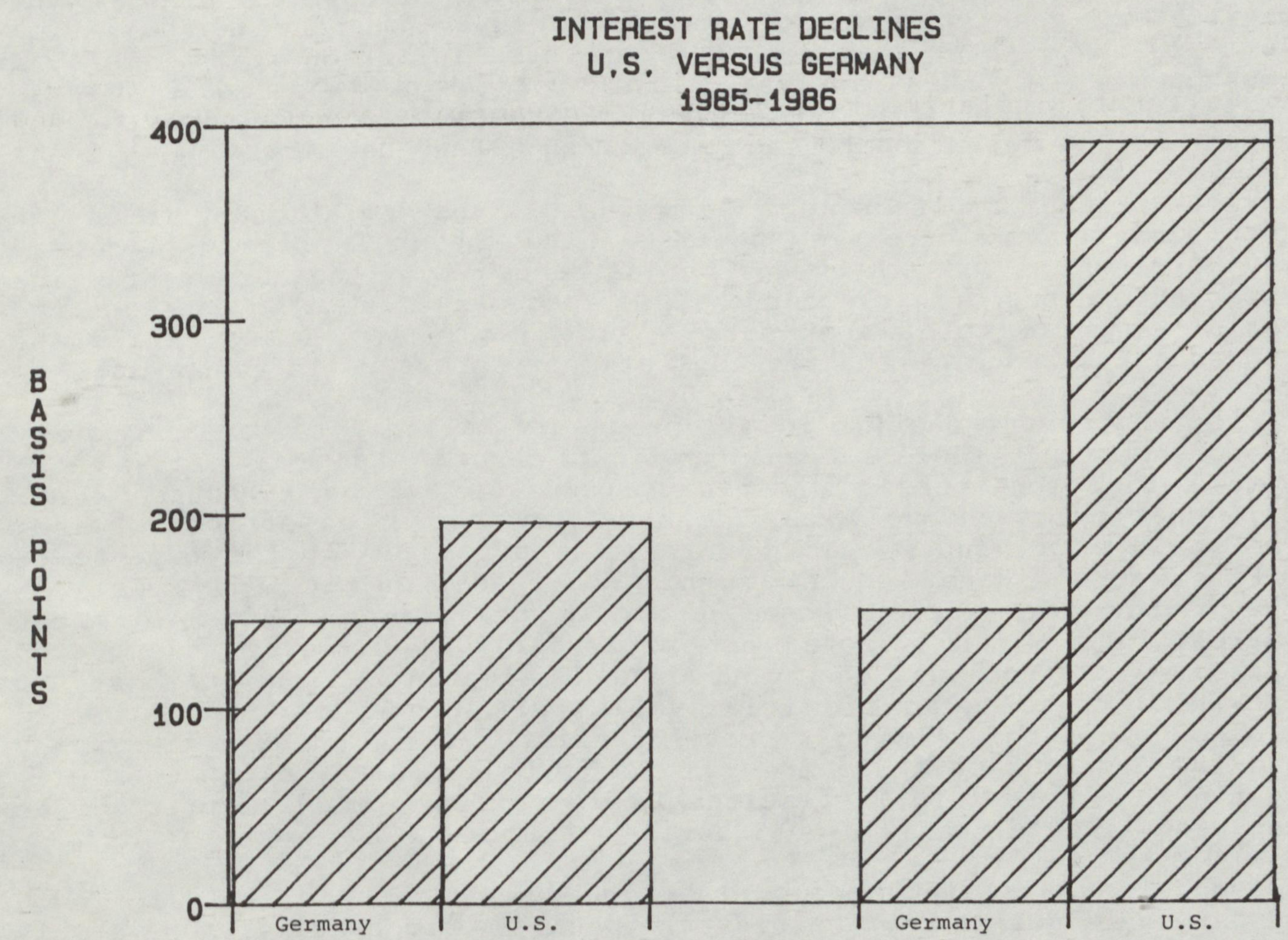
More important, this comparison indicates that the dollar may continue to fall until relative real interest rates shift toward the U.S. and become more balanced. One way this can occur is if U.S. nominal interest rates rise. Our view, however, is that U.S. policy, at the Treasury Department and the Federal Reserve, is (1) aimed at accommodating declines in interest rates that are associated with improved inflation prospects, (2) concerned about sluggish U.S. economic growth, and (3) not concerned about the weak dollar -- indeed, the Treasury Department would appear to prefer further dollar weakness. As a consequence, U.S. interest rates are more likely to fall than to rise. This places the burden of stopping the dollar's collapse and the mark's rise on the Germany authorities.

Table 1

Germany: Moderate Growth With Deflation?

				1986	
	1983	1984	1985	German View*	Morgan Stanley Economics*
Real GNP					
(Annual Average)	1.6%	2.7%	2.5%	3.5%	2.8%
Consumer Prices					
(Annual Average)	3.3	2.4	2.2	0.5	-0.2
(4Q/4Q)	2.6	2.1	1.8	0.6	-0.7

*The "German View" is Morgan Stanley Economics' interpretation of the stance taken by the Bundesbank and the Finance Ministry and is supported by private forecasters in Germany, but is not necessarily the official view.



3-Month Euro-rate Decline

10-Year Treasury Rate Decline

Why the Bundesbank is Cautious

The Bundesbank's cautious approach toward accommodating the deflationary effects of sharply lower oil prices is based fundamentally on their view that the price factors causing the deflation are temporary. The Bundesbank has argued that (1) oil prices may not stay low, (2) the oil price collapse may stimulate corporate profits and result in stronger wage settlements, (3) domestic demand may rise and increase price pressures, and (4) the extreme one-year strength of the mark causes the current inflation rate to overstate the likely long-term inflation path. As a consequence of this analysis, the Bundesbank has developed an optimistic outlook for real economic growth in Germany, while not expecting the deflation to last more than a few quarters.

Our view is quite different. We argue that the deflationary forces in the German economy are very powerful, that the oil price decline may be permanent, and that any adjustments to long-term inflation expectations based on the currently strong mark must also consider the 1981-1984 period of a weak mark. As a result, we do not share the Bundesbank's concerns that the deflationary pressure is temporary.

First, the recent decline in oil prices is unlikely to be a temporary phenomenon, and there is an excellent chance that oil prices will remain low. Long-term oil demand pressures have been reduced since 1974 due to tremendous worldwide energy conservation efforts. Also, the world's oil supply has been greatly expanded, at the expense of OPEC's market share. Much of this additional supply will remain on the market for years to come, even if oil prices fall to $10 per barrel. While it may have been very costly to discover and develop these new oil sources, once found and developed the marginal costs of operating these wells are relatively low. Hence, they will not be closed down even if low oil prices persist. Thus, on both the supply and the demand side there are reasons to believe that oil prices will return to a more normal relationship with other commodity prices than has prevailed in the 1974-1985 period.

Second, there is little doubt that the strong mark is producing some of Germany's deflationary pressure. What is more amazing, however, is the price performance of Germany during the strong dollar period. German inflation was running at 6.3% in 1981. By 1984 it was down to 2.4%. That is, during the period when powerful exchange rate effects were pushing Germany's inflation rate higher, the inflation rate fell. Why? German domestic demand was weak as a result of tight fiscal policies, and this actually reduced price pressures. The incredible price performance of Germany in the strong dollar years argues that the long-term German inflation rate may be well below the inflation rate that was prevailing in 1985 (2.2%), and that one year of mark strength brings the exchange rate effects back toward neutral.

And finally, our concerns on wage pressure also differ from that of German authorities. We agree that the oil price decline will provide a stimulus for the German economy, improve corporate profits, and lead to tougher labor negotiations. Our long-term interpretation, however, is different. Rather than worry about wage drift, the problem may be that real wages rise too rapidly and eventually depress the corporate sector and keep unemployment rates high. Remember, in times of deflation, real wages will grow faster than nominal wages. In this situation corporations will have difficulty passing on costs to consumers, profitability will be reduced, and expansion plans will be curtailed. This argument suggests that 1986 may see solid economic growth, although not quite as fast as the current market consensus suggests. More importantly, the outlook for 1987 depends on whether the deflation is temporary and mild or more severe, as we suggest.

The Empirical Test

Current economic data provide no conclusive evidence as to which of these views is more appropriate. There can be little argument, however, that the Bundesbank's caution is a major reason for the current and likely future strength of the German mark against the dollar.

For forecasters, the question is what might cause the German authorities to alter their policies and allow greater declines in interest rates. From our perspective the economic data of the next three months is crucial. If industrial production remains depressed, if unemployment stays at 9% or higher, and if consumer prices continue to tick down one to two-tenths of a percent per month, then during the summer there is a good chance that the Bundesbank will become more accommodating and lower interest rates. On the other hand, if unemployment falls toward 8%, industrial production increases suggest the possibility of further employment gains, and consumer prices stabilize and occasionally tick up by a tenth of percent, then the German authorities will remain very cautious.

The wild card in the game is the exchange rate. To date, the German authorities have been unwilling to adjust interest rate policy to reverse the course of the mark, although they have, from time to time, intervened in the foreign exchange markets. If the view here is correct, then further mark appreciation may lead directly to interest rate cuts. In terms of addressing the dollar's collapse, it is useful to think of three phases: rhetoric, intervention, and interest rate policy shifts. The German authorities are well into the rhetoric phase of trying to talk the markets into stability, and they are moving into the intervention phase. The only phase that really matters for the longer-term trend, however, is the interest rate policy phase. So far, they have been reluctant to become less cautious on interest rates, due to the domestic concerns discussed here in detail.

INTERNATIONAL INTEREST RATES AND EXCHANGE RATES

EXCHANGE RATES (A)	U.S. (B)	GERMANY	JAPAN	U.K.
1982	109.800	2.427	249.080	1.751
1983	114.200	2.553	237.510	1.517
1984	122.400	2.846	237.520	1.336
1985	127.100	2.917	236.560	1.297
1985 1ST QTR	135.100	3.256	257.680	1.115
1985 2ND QTR	131.400	3.087	250.730	1.258
1985 3RD QTR	125.100	2.849	238.640	1.376
1985 4TH QTR	117.300	2.583	207.180	1.435
CURRENT (5/9)	104.100	2.177	162.250	1.542
INTEREST RATES (MAY 9)				
EURO DEPOSIT RATES				
ONE MONTH	6.81	4.50	4.56	10.63
THREE MONTH	6.75	4.50	4.56	10.38
SIX MONTH	6.75	4.44	4.44	9.94
TWELVE MONTH	6.81	4.44	4.44	9.63
GOVERNMENT BOND RATE (C)	7.45	5.78	5.19	8.98

EXCHANGE RATES (A)	AUSTRALIA	CANADA	NETHER-LANDS	ECU
1982	1.017	1.234	2.670	1.033
1983	0.903	1.232	2.854	1.209
1984	0.880	1.295	3.209	1.411
1985	0.702	1.365	3.280	1.274
1985 1ST QTR	0.751	1.353	3.683	1.375
1985 2ND QTR	0.667	1.369	3.485	1.361
1985 3RD QTR	0.698	1.360	3.205	1.210
1985 4TH QTR	0.688	1.378	2.912	1.150
CURRENT (5/9)	0.745	1.380	2.459	1.016
INTEREST RATES (MAY 9)				
EURO DEPOSIT RATES				
ONE MONTH	15.31	8.75	6.00	7.81
THREE MONTH	14.50	8.63	5.75	7.50
SIX MONTH	13.73	8.63	5.63	7.31
TWELVE MONTH	13.61	8.75	5.50	7.19
GOVERNMENT BOND RATE (C)	12.10	9.15	6.51	7.09

(A) THE AUSTRALIAN DOLLAR AND BRITISH POUND STERLING ARE QUOTED AS DOLLARS PER UNIT OF FOREIGN CURRENCY. ALL OTHER CURRENCIES ARE QUOTED AS UNITS OF FOREIGN CURRENCY PER DOLLAR.

(B) MORGAN GUARANTY TRADE WEIGHTED INDEX VERSUS 15 MAJOR COUNTRIES, 1980-82=100.

(C) YIELDS ON GOVERNMENT BONDS ARE FOR MATURITIES OF 8 TO 10 YEARS. THE EUROPEAN CURRENCY UNIT (ECU) BOND YIELD IS FOR A WORLD BANK ISSUE.