

Part A

CONFIDENTIAL
under cover and

Begins : 7/7/81.
Ends : 20/7/81.


 PO -CH /GH/0080

 PART A

Chancellor's (Howe) papers:

BILATERAL WITH THE
GERMAN FINANCE MINISTER
JULY 1981

PO -CH /GH/0080
PART A

Disposal Directions: 25 years

J. [Signature]
26/7/95

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for briefing folder
Pl explore flight possibilities. Is there any way
Ch/Ex to go on Fri pm from Gatwick in time
for dinner (via cc
Kahn, Couzens, ...
Frankfurt?)
not time to come back
at midnight -
prac. impossible? Early
Sat am to Gatwick?

CHANCELLOR OF THE EXCHEQUER

Financial Secretary
 Sir D Wass
 Sir K Couzens (or)
 Mrs Hedley-Miller
 Mr Ashford
 Mr Bottrill
 Mr Edwards

POSSIBLE BILATERAL WITH MATTHÖFER

7/7/81.

1. As you know repeated attempts to arrange a substantial discussion between you and Matthöfer have failed for one reason or another. Matthöfer's office have now proposed that you fly to Bonn for dinner on Friday, 17 July. Your Private Office tell me that this would be very inconvenient but not quite impossible.

2. In previous advice Sir K Couzens and I have been doubtful whether we were justified in asking you to rearrange your diary in order to fly to Bonn. Certainly there is no case for doing so as part of the preparations for Ottawa. Schmidt and Schulmann are dealing with that for Germany and Matthöfer is on the sidelines.

3. On the other hand, Matthöfer has been remarkably persistent in making new proposals for a date. The fact that he has not offered to come to London may well be explained by his medical condition - I was told that his doctor had advised him not to fly. We do not wish to appear to be rejecting him.

4. The first joint meeting of the French and German governments since the French elections takes place early next week. Matthöfer is reported to be very worried about the probable consequences of the new French government's economic plans. It is natural that he should want to exchange views with you if he is genuinely worried and the 17 July would be a good date to follow up the Franco/German talks.

5. There is therefore a general case for accepting Matthöfer's invitation, namely that we want to avoid any recreation of the Paris/Bonn axis that existed under Schmidt and Giscard. Our chief specific objective at any talk with Matthöfer would be to get him to interest himself personally in the Budget restructuring issue. As the Financial Secretary remarked when we discussed this matter on the way to Brussels on Monday, we are unlikely to get a decent settlement for the UK unless the

Germans are willing to make a substantial contribution to the Community Budget. Even so, there are a number of powerful arguments for working with the Germans. In the longer run our hopes of getting a satisfactory settlement for the UK depend on ^{the} small rich countries accepting a reduction in their privileges. We are most unlikely to be able to achieve that on our own. Furthermore we are type-cast within the Community as constantly wishing to bend the rules. No one can accuse Germany of being uncomm^{un}mitaine. The admittedly precarious Anglo/German alliance is important to our tactics at this stage of the negotiations.

6. The German government is very torn on the issue. Schmidt is intermittently tough but is held back by Genscher. Officials at Under Secretary level in the Ministries of Finance and Economic Affairs are only too eager to cooperate with us in urging radical reform of the system. But, they need a political lead. Schulmann has conspicuously failed to provide that lead. Although he is Schmidt's man we have repeatedly failed to arouse his interest in the subject. All this suggests that it might help our cause if Matthöfer could be persuaded to take a serious interest in the problem himself.

Conclusion

7. Neither our Embassy in Bonn nor I believe that the above adds up to an overwhelming case for your rearranging your time-table so that you can fly to Bonn on 17 July. On the other hand one has to acknowledge that such a meeting could be useful to us and I would certainly not want to give Matthöfer the impression that we were fobbing him off.

D.H.
 D J S HANCOCK
 7 July 1981

fr Matthias briefing 3
folder

BY BAG
FROM BONN
UNCLASSIFIED
FRAME ECONOMIC

8/7/81,

TO FCO TELNO 28 SAVING OF 7 JULY 1981. Info all EC Posts, UKDel
OECD, UKRep Brussels, all Consulates-General in
the Federal Republic.

FEDERAL GERMAN ECONOMY

Council of Economic Advisers

1. The Council of Economic Advisers ("The Five Wise Men") normally produce a report on the Federal German economy every November, but can produce special reports if they think economic policy is awry. They accordingly published a report on 6 July, markedly more downbeat than in November. On the same day, it was announced that the Joint Parliamentary Arbitration Committee had reached a compromise on the 1981 Budget which will now be passed into law by the Bundesrat on 10 July without need for a special recall of the Bundestag.
2. The Five Wise Men see no possibility of an economic recovery in present circumstances. Stimulation is not to be expected soon from foreign demand, and the domestic economy will be depressed for the next few months by high interest rates and imported inflation. They agree with the Federal Government that GNP will decline in 1981 by up to one per cent. The current account should gradually improve.
3. The rise in production of 3 per cent from January to May was due to lively external demand. Even if it does not drop again there is no cause for satisfaction in the absence of prospects for a return to price stability, high employment and external balance. Unemployment should average 1.2 million this year, and there are no signs of an improved employment situation in the foreseeable future. Neither wage nor fiscal policy has given relief to monetary policy.

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4. Fiscal policy is particularly criticised, and drastic cuts in public expenditure called for. The public sector deficit (which in the absence of any consolidation will approach DM 80 mrd in 1982) has created a crisis of confidence damaging to the DM. A structural deficit of some DM 35-40 mrd must be done away with in the period 1982-85 by cutting expenditure, including in the social sector. Since this involves controversial (and probably delayed) political decisions, an across the board cut by an agreed percentage is recommended including inter alia in education, housing and family allowances, and pensions for miners, farmers and railwaymen. Restraint in Civil Service pay is required. Subsidies for unemployment benefit and health services should be reduced. The state should review its subsidies to agriculture, savings, housing and railways. Excepted should be expenditure aimed at promoting growth and structural change, eg. help for innovation, risk investment, entrepreneurs, rationalisation, energy investment and public sector infrastructure. The tax system should promote investment more efficiently.

5. The Trade Union representative (Glastetter), in a minority report, argues against the emphasis on expenditure cuts, blames the public sector deficit on tax relief programmes and calls for more taxation of wealth and the higher paid.

6. To counteract the import of inflation the Five Wise Men argue for revaluation of the DM within EMS. Again with the exception of Glastetter, who calls emphatically for a relaxation of money and interest rate policies, Bundesbank policy receives the seal of approval.

7. In reaction, the Federal Minister of the Economy saw his policies confirmed by the report, and agreed that budgetary consolidation is of central importance. Lambsdorff also agreed that Bundesbank profits should not be used as a delayed correction to public sector expenditure. The Opposition found the report positive. An SPD spokesman disliked the emphasis placed by the majority on wage restraint, but dismissed tax increases as a means of overcoming the deficit. The FDP argued against expensive employment creation programmes and hoped that high interest

rate/

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rate policies would be reviewed at the Ottawa summit. The Federation of German Industry welcomed the report which also found a sympathetic echo throughout the press with only one exception (Frankfurter Rundschau).

8. The report was produced partly in order to influence the Federal Government during preparations for Ottawa. It will strengthen the FDP and those in the SPD favouring budgetary consolidation, and encourage the Bundesbank. It is bound to be resented by the left wing of the SPD and the Trade Unions.

FCO PLEASE PASS TO EC POSTS, UKDEL, OECD (4 COPIES)

TAYLOR

FRAME ECONOMIC
ECD (I)

THIS TELEGRAM
WAS NOT
ADVANCED

-3-

[REPEATED]

ERD (1)

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Foreign and Commonwealth Office

London SW1A 2AH

17 July.

Dear David,

13/7/81.

ARREST OF GERMAN TRAWLERS

1. I understand from Nick Spackley you would like some briefing on this.
 2. Paras 1-3 of the enclosed Telno 292 to Bonn give the basic facts, while the speaking note shows the line we are taking with the Germans (David Hannay spoke to their Embassy this morning).
 3. In addition then ERIC wrote to Mr. WATKINS; we have yet to reply.
 4. We are working hard to avoid a row with the Germans, although UK ministers are upset at the lack of consultation. The Germans are likely to appeal and there ~~are~~ is yet to be full consideration of the legal aspects, which would be nasty. I hope this helps.
- Yours ever,
Jim Foster.

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GRS 400

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FRAME FISHERIES

FM FCO 131833Z JUL 81

TO IMMEDIATE BONN

TELEGRAM NUMBER 292 OF 13 JULY

INFO IMMEDIATE UKREP BRUSSELS

ARREST OF WEST GERMAN FISHING VESSELS.

1. ON 10 JULY A DEPT OF AGRICULTURE AND FISHERIES FOR SCOTLAND (DAFS) FISHERIES PROTECTION VESSEL ARRESTED TWO GERMAN FISHING VESSELS - KIEL (BX 479) AND HANOVER (NC 474) - OFF THE OUTER HEBRIDES WITH 12 TONNES OF HERRING ON BOARD. IN DAFS VIEW, THERE WAS A HERRING BAN IN FORCE IN THIS AREA, (ICES VI A). THE GERMAN MASTERS ARGUED THAT THE GERMAN MINISTRY OF ECONOMICS HAD GIVEN THEM PERMISSION TO FISH SINCE THE COMMUNITY BAN HAD ENDED AT THE END OF 1980 AND THERE WAS A COMMISSION PROPOSAL FOR A TAC OF 55,000 TONNES.

2. AFTER A SERIES OF TELEPHONE CALLS, THE VESSELS COMPLIED WITH THE ENFORCEMENT VESSEL'S (DETAILS IN MINUTE BY MOHAN, MAED OF 13 JULY: COPIES BY BAG) REQUEST AND WERE ESCORTED TO STORNOWAY. ON 12 JULY THE GERMAN EMBASSY DELIVERED A NOTE TO THE RESIDENT CLERK (TEXT IN MIFT) WHICH SET OUT THE GERMAN POSITION.

3. ON 13 JULY THE VESSELS WERE BROUGHT BEFORE THE COURT FOR PROSECUTION UNDER THE WEST COAST HERRING (PROHIBITION OF FISHING) ORDER 1981. THE MASTERS WERE FOUND GUILTY AND ADMONISHED. THEY WERE NOT FINED NOR WAS ANY GEAR CONFISCATED, SINCE THE COURT HELD THEY WERE ACTING IN GOOD FAITH ON THE BASIS OF WRONG ADVICE FROM THEIR GOVERNMENT. THEIR CATCH (A TOTAL OF JUST OVER 100 TONNES) WAS, HOWEVER, CONFISCATED.

4. MEANWHILE, MASON (MAFF), AND CORMACK (DAFS) AND OTHER OFFICIALS WILL BE IN BONN ON 14 JULY FOR TALKS ON FISHERIES AND THE ANGLO-GERMAN ECONOMIC COMMITTEE IS TO MEET IN LONDON ON 15 JULY. FOR THE MOMENT, WE ARE TAKING THE LINE THAT WE REGRET (IF THIS IS INDEED THE CASE) THAT THE GERMAN GOVERNMENT SHOULD HAVE GIVEN THEIR FISHERMEN THE IMPRESSION THAT THEY COULD FISH WITH IMPUNITY WHILE THERE WAS NO AGREED CAOUNCIL TAC OR QUOTAS FOR HERRING IN THE AREA, AND WHILE THERE IS TO BE A COUNCIL WHICH WILL PROBABLY DISCUSS HERRING IN ONLY A FORTNIGHT'S TIME. THAT SAID, WE ARE ANXIOUS TO AVOID AN OPEN ROW. WE HOPE THAT THE WAY THE STORNOWAY COURT HAS HANDLED THE MATTER MAKES THIS UNLIKELY.

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5. GRATEFUL IF YOU WOULD ARRANGE TO SEND AN ACCOUNT OF THE BILATERAL FISHERIES TALKS IN TIME FOR THE ANGLO-GERMAN ECONOMIC TALKS START AT 0900Z ON 15 JULY.
6. GRATEFUL TOO IF UKREP COULD CONFIRM THAT THERE WAS NO REACTION BEYOND THE LETTER BOOSS/FRIZELL OF 27 MAY TO OUR NOTIFICATION AND, IN PARTICULAR, WHETHER THERE HAS BEEN ANY COMMISSION INDICATION OF APPROVAL OR DISAPPROVAL OF THE ORDER.

CARRINGTON

FRAME FISHERIES
EQD (1)
LEGAL ADVISERS
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ARREST OF GERMAN TRAWLERS "HANNOVER" AND "KIEL":
SPEAKING NOTE

1. At the meeting of officials in Bonn on 14 July the matters raised in the memorandum No Wi 426.00/3 of 12 July from the Embassy of the Federal Republic of Germany were discussed in detail and the reasons for the action taken by the United Kingdom were fully explained. The main points are:-
2. In 1980 the International Council for the Exploration of the Sea advised that it was premature to decide that fishing for herring should be allowed in Divisions VIa (West of Scotland) or IV (North Sea) in 1981. In January 1981 the Council of Ministers took an interim decision to roll forward the regulations which provided that there should be no fishing for herring in, amongst others, ICES Area VIa. This interim decision was renewed at the February Council.
3. Then, at the 27 March Council, the Council reached the following decision, recorded in the minutes:-
" - noted that out of a desire to avoid a serious disruption, the Member States would take conservation measures similar to those which they had taken in previous years".
4. There have been no definitive Community measures adopted by the Council since then and so it follows that it is correct for Member States to continue to ban herring fishing in these areas.
5. When the United Kingdom Order prohibiting herring fishing was revised to remedy a minor technical defect, copies were sent on 4 May 1981 to the Commission and to all other Member States. No comments on it have been received from the Federal Republic of Germany or from any other Member States; the Commission's reaction has been confined to asking for clarification of a question of fact which we have answered. There has been no other comment.

/Against



6. Against this background we were surprised that the Government of the Federal Republic of Germany should have seen fit to issue licences to fish for herring in area ICES VIa on 29 June without consulting or even informing the UK authorities. We were the more surprised that the first information on the matter we received was the message from Herr Ertl to Mr Walker of 13 July simply notifying us, two weeks after the fact, of the issue of the licences. This was three days after the German vessels had been arrested. There was not even any consultation at official level.

7. We are frankly puzzled by the German interpretation of the legal position. The Commission have just made a TAC proposal for herring in the area in question, and the British Presidency have arranged a Council to discuss it. Are the German Government suggesting that a Commission proposal should be the proper basis for decision before the Council has even had a chance to discuss the matter?

8. When the Netherlands proposed earlier this year that their fishermen should be allowed to fish for herring in the North Sea in May or June 1981, the Commission, after establishing the views of other Member States, voiced opposition to this suggestion in its letter of 27 May arguing that such fishing could lead to 'serious disturbances'. There was therefore a clear expectation at that time that fishing would not be restarted in areas where it had been banned for several years, without at least consultation taking place between the Commission and the Member States beforehand. The United Kingdom is not aware of any circumstances that could lead to the view that such a procedure is no longer necessary. No such consultation has taken place about herring fishing at the West of Scotland.

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9. The orderly conduct of Community business requires that the Council be given an opportunity to settle the conditions for the reopening of herring fishing so as to avoid both damage to the stocks and the disturbances to which the Commission has referred. It is most important that even where there is a Commission proposal fishing should not take place before there has been full discussion in the Council taking into account the definitive scientific advice. To illustrate this point the following example is given. On 6 March 1981 the European Commission proposed a herring TAC of 41,000 tonnes for Area IV. It was the view of the United Kingdom and of other Member States that this proposal was contrary to the scientific advice available at that time, since the advice from the International Council for the Exploration of the Sea remained unaltered. As a result the Commission revised their proposals in respect of the Area IV TAC for herring downwards to 27,500 tonnes on 13 June. And the latest advice from the International Council for the Exploration of the Sea, renewed only very recently, is for a TAC of 20,000 tonnes in Area IV. It is therefore fortunate that fishing was not restarted earlier in the year on the basis of the earlier Commission proposal before Council discussion or serious damage might have been done to the stocks.

10. On 19 June the Commission formally sent the Council a proposal for a herring TAC for 1981 including a proposal for Area VIa which is where the German boats were fishing. This proposal has not yet even been discussed with Member States and the date of its submission makes it clear that it had nothing whatsoever to do with the failure of the CFP negotiations earlier this year. We have neither rejected it nor accepted it; we have not even had a chance to consider it.

11. Immediately after the receipt of the definitive advice from the International Council for the Exploration of the Sea on 6 July, the United Kingdom Presidency on 8 July called a meeting of the Fisheries Council on 27 July to consider this Commission proposal, among others, in the hope that these matters can be resolved then. The United Kingdom considers that such a Council discussion is an essential requirement before herring fisheries are reopened. In our view there is no basis to change UK legislation enforcing a zero



TAC until the Council has had an opportunity for discussion and decision.

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FM BONN 151700Z JUL 81
TO IMMEDIATE FCO
TELEGRAM NUMBER 546 OF 15 JULY
INFO IMMEDIATE UKMIS NEW YORK (FOR PRIVATE SECRETARY)
INFO PRIORITY PARIS
INFO ROUTINE UKDEL NATO WASHINGTON UKREP BRUSSELS
INFO SAVING DUBLIN ROME LUXEMBOURG COPENHAGEN THE HAGUE BRUSSELS
ATHENS

MIPT: FRANCO-GERMAN SUMMIT: DETAILED POINTS.

1. WE HAVE GLEANED THE FOLLOWING ON INDIVIDUAL SUBJECTS DISCUSSED.

SECURITY POLICY AND ARMS CONTROL.

2. THIS WAS A MAJOR SUBJECT OF DISCUSSION BOTH BETWEEN SCHMIDT AND MITTERRAND, AND BETWEEN GENSCHER AND CHEYSSON. THE TWO SIDES WERE IN VIRTUAL AGREEMENT. MITTERRAND WAS ROBUST, AND ENDORSED THE CONCEPT OF MILITARY BALANCE. THERE WAS HOWEVER A SIGNIFICANT DIFFERENCE OF EMPHASIS, THE FRENCH BEING CHIEFLY CONCERNED TO RE-ESTABLISH THE BALANCE, AND LESS INCLINED TO FAVOUR ARMS CONTROL NEGOTIATIONS FOR THEIR OWN SAKE OR TO ENDORSE THE NEED FOR URGENCY. MITTERRAND MADE IT CLEAR THAT THE FRENCH NUCLEAR DETERRENT WAS NOT TO BE INCLUDED IN ANY ARMS CONTROL NEGOTIATIONS BETWEEN THE SUPER POWERS.

DEFENCE.

3. ACCORDING TO GENERAL TANDECKI, APEL AND HERNU GOT ON WELL TOGETHER. THE FRENCH, WHILE STANDING FIRM ON NON-INTEGRATION INTO NATO AND THE RETENTION OF SOVEREIGN CONTROL OVER THEIR NUCLEAR FORCES, INDICATED READINESS TO EXTEND THEIR MILITARY COOPERATION BOTH WITH NATO AND BILATERALLY WITH THE FRG. TANDECKI EXPECTED JOINT PLANNING TO BE EVEN MORE INTENSIVE THAN BEFORE AND TO INCLUDE NUCLEAR MATTERS. BUT THE POSSIBILITY OF JOINT NUCLEAR TARGETTING HAD NOT BEEN RAISED.

4. THERE WAS NO ADVANCE OVER THE FRANCO-GERMAN TANK DESPITE PRESSURE FROM HERNU. COOPERATION WILL CONTINUE: THE TWO SIDES AGREE OVER THE TURRET, BUT THE DIFFERENCES OVER THE HULL REMAIN. TANDECKI COMMENTED THAT IT WOULD BE DIFFICULT TO GET THE TANK PROJECT THROUGH THE BUNDESTAG, WHERE ALL THREE PARLIAMENTARY PARTIES WERE AGAINST IT.

OTTAWA.

5. ACCORDING TO GERMAN ECONOMIC OFFICIALS, THE FRENCH WERE SHARPLY CRITICAL OF AMERICAN AND JAPANESE POLICIES. MITTERRAND SAID THAT IF THE AMERICANS EXPECTED THEIR ALLIES TO DEVOTE MORE TO DEFENCE THEN THEY SHOULD ALSO HAVE THE CONSIDERATION FOR THEIR ECONOMIC DIFFICULTIES. HE AGREED HOWEVER NOT TO PRESS TOO HARD AT OTTAWA,

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AT LEAST UNTIL THE AMERICANS AND THE JAPANESE HAD HAD THE CHANCE TO SHOW WHETHER THEY PLANNED TO RECOGNISE EUROPEAN DIFFICULTIES. BOTH SIDES AGREED THAT FOR THE TIME BEING THERE WAS LITTLE POINT IN TRYING TO PRESS THE AMERICANS TO CHANGE THEIR POLICY ON HIGH INTEREST RATES.

EUROPEAN COMMUNITY.

6. THE FRENCH AGREED ON THE NECESSITY FOR STRICT ADHERENCE TO THE 1 PER CENT CEILING FOR 1982 BUT WOULD NOT COMMIT THEMSELVES BEYOND THIS. ON THE QUESTION OF BUDGET RESTRUCTURING, AND CAP REFORM, THE FRENCH MADE A NUMBER OF POINTS, SOME CONTRADICTORY. MITTERRAND AND DELORS UNDERSTOOD THE GERMAN NEED FOR A LIMIT ON THEIR NET CONTRIBUTION BUT MADAME CRESSON DID NOT SEE ANY POSSIBILITIES FOR SAVINGS, ASSERTING INDEED THAT THE CAP REQUIRED NEW RESOURCES. MITTERRAND ECHOED THIS, PROPOSING THE INTRODUCTION OF DUTIES ON TAPIOCA AND MANIOC AND, POSSIBLY, SOYA TOO. THE FRENCH SAID THEY WOULD NOT WELCOME THE INTRODUCTION OF BUDGETARY REFORM BEFORE THE 1983 BUDGET AND DOUBTED IN ANY CASE WHETHER IT WOULD BE POSSIBLE TO AGREE REFORMS ANY EARLIER. MITTERRAND WANTED TO SEE AN INCREASE IN FRENCH AGRICULTURAL PRODUCTION, LONG-TERM SUPPLY CONTRACTS WITH THIRD COUNTRIES, AND ARRANGEMENTS WITH MAJOR PRODUCERS SUCH AS ARGENTINA, CANADA AND THE USA ON PRICES: AS ONE GERMAN OFFICIAL PUT IT, AN AGRICULTURAL OPEC. AS DEMONSTRATED ON MONDAY IN BRUSSELS, THE DIFFERENCES OVER ENLARGEMENT AND THE MULTIFIBRE ARRANGEMENT WERE AS LARGE AS EVER. THE FRENCH APPROACH TO THE MFA LED THE GERMANS TO BELIEVE THAT THERE WERE POWERFUL PROTECTIONIST INFLUENCES BELOW THE SURFACE IN THE FRENCH ADMINISTRATION.

NORTH/SOUTH.

7. THERE WAS A GOOD DEAL OF DISCUSSION ON THIS. BOTH SIDES AGREED THAT THE NORTH/SOUTH RELATIONSHIP WAS OF HIGH PRIORITY: AN ESSENTIAL ELEMENT IN THE BALANCE OF WORLD POWER AND NOT AN OPTIONAL, HUMANITARIAN EXTRA. GENSCHER AND CHEYSSON APPARENTLY ALSO AGREED THAT BOTH IN THE PREPARATIONS AND AT THE CANCUN SUMMIT THERE SHOULD BE CLOSE COORDINATION AND COOPERATION BETWEEN FRANCE, THE FRG AND THE UK.

THE SOCIAL DIMENSION.

8. SCHMIDT LISTENED CAUTIOUSLY TO MITTERRAND'S AND MAUROY'S LENGTHY AND IMPASSIONED PRESENTATIONS: BUT THOUGH WISHING THEM WELL, HE MADE IT CLEAR THAT HE REMAINED SCEPTICAL. WORKING HOURS AND WAGES IN THE FRG WERE DEALT WITH BY EMPLOYERS AND EMPLOYEES: THE GOVERNMENT WOULD NOT INTERVENE AND COULD NOT AFFORD EARLY RETIREMENT PLANS. THE GERMANS FOUND DELORS RATHER MORE REASSURING.

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9. THE EMS DID NOT FEATURE LARGELY IN THE TALKS. BOTH SIDES AGREED THAT IT WAS WORKING WELL AND THAT THEY SHOULD WORK TOGETHER TO IMPROVE IT. THE FRENCH REITERATED THEIR DETERMINATION TO MAINTAIN THE PRESENT VALUE OF THE FRANC.

NATIONALISATION.

10. THE FRENCH OFFERED IMMEDIATE GOVERNMENT TO GOVERNMENT TALKS ON NATIONALISATION OF FIRMS WITH GERMAN CAPITAL. THE GERMANS WERE HESITANT, FEARING TO IMPLY ENDORSEMENT OF THE NATIONALISATIONS. THEY POINTED OUT THAT GERMAN ENTREPRENEURS COULD HARDLY BE ENCOURAGED TO INVEST IN FIRMS AFFECTED BY FRENCH NATIONALISATION PLANS, AND SUGGESTED THAT TECHNOLOGICAL COOPERATION BETWEEN GERMAN AND FRENCH FIRMS MIGHT ALSO BE AFFECTED.

EXPORT CREDITS.

11. ON THE OECD EXPORT CREDIT CONSENSUS THE FRENCH WERE PREPARED TO AGREE TO AN INCREASE IN INTEREST RATES OF THE ORDER OF ONE-AND-A-HALF TO TWO PER CENT. FOR THEIR PART, THE GERMANS WOULD ACCEPT AN INCREASE IN THE RANGE ONE-AND-A-HALF TO TWO-AND-A-HALF PER CENT.

COMMUNISTS IN FRENCH GOVERNMENT.

12. THIS WAS NOT RAISED BY SCHMIDT WITH MITTERRAND (ALTHOUGH IT WAS APPARENTLY RAISED AT OFFICIAL LEVEL BY LAHNSTEIN). BUT MITTERRAND VOLUNTEERED A LENGTHY EXPLANATION OF THE POLITICAL LOGIC UNDERLYING HIS DECISION TO BRING THE COMMUNISTS IN. THE CHANCELLOR REMAINS A GOOD DEAL MORE WORRIED ABOUT THE CONSEQUENCES THAN HE ALLOWED TO APPEAR. WE SHALL REPORT FURTHER BY BAG.

FCO PASS SAVING ADDRESSEES

GOODALL

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[PASSED AS REQUESTED]

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- 1. MR HANCOCK
- 2. CHANCELLOR OF THE EXCHEQUER

- cc Sir Kenneth Couzens
- Mrs Hedley-Miller
- Mr Mountfield
- Mr Kemp
- Mr Ashford
- Mr Edwards
- Mr Bottrill
- Mr Fitchew
- Mrs Gilmore
- Miss Peirson

DISCUSSION WITH HERR MATTHÖFER, FRIDAY 17 JULY 1981

I attach briefing for your discussion with Herr Matthöfer. You will receive a separate note from Mr Hancock on the main issues and the handling of the discussion.

2. The attached briefs cover the following subjects;

- Brief No. 1 : German budgetary and economic problems
- 2 : UK public expenditure problems
- 3 : EC Budget restructuring
- 4 : Implications of policies of new French Government
- 5 : US interest rates and Ottawa
- 6 : Global negotiations etc. and Ottawa
- 7(a) : CAP reform
- 7(b) : 1981-82 Community Budget
- 8 : Community staff pay
- 9 : Insurance
- 10 : Poland

3. The brief on German budgetary and economic problems is a background note only. All the other briefs contain points to make as well as background.

M. C. Mercer

M C MERCER
16 JULY 1981

16/7/81.

THE GERMAN BUDGET PROBLEM

In its own terms, Germany has a serious budgetary problem. The Federal budget deficit in 1981 will be around 25 per cent more than originally planned. And the prospects for the 1982 budget have coalesced into the main politico-economic issue facing the Government.

2. The core of the problem is familiar. The 5 year finance plan to reduce the budget deficit (not unlike the MTF5) has been blown off course by the impact of recession. In 1980, the federal deficit was DM 27 billion, DM 3 billion more than planned. The general Government borrowing requirement rose to $3\frac{1}{2}$ per cent of GNP compared with 3 per cent in 1979.

3. The initial (December 1980) target for the federal deficit in 1981 was also DM 27 billion, entailing expenditure growth in nominal terms of 4 per cent, ie a fall in real terms. But expenditure is now expected to grow almost twice as fast as this and the federal deficit target has been raised to DM 35 billion (implying a general government borrowing requirement of around $4\frac{1}{2}$ per cent of GNP). In relation to the original spending plans the main areas of overshoot have been: unemployment and social security benefits - 10 per cent (DM 5 billion) more; debt interest - 6 per cent (DM 1.1 billion) more; and defence (notably the Tornado project) - 2 per cent (DM 0.9 billion) more.

4. Attempts to cut this year's public expenditure have, predictably perhaps concentrated on capital spending. This has only served to fuel the political row. The basic law on Stability and Growth, which has guided German economic policy for the last ~~two~~ decades, states, inter alia that in any year the level of public investment should exceed new borrowing. This year, for the first time, it will not do so.

5. The problem over the 1981 Budget is regarded as merely a foretaste of what is to come next year. The Government intends to return to the path laid down in the 5 year plan, and the federal deficit target for 1982 has accordingly been set at DM 26 billion. This is very ambitious, even if the economy turns up quite sharply and interest rates fall. Herr Matthofer recently told our Ambassador in Bonn that feelings of alarm about the 1982 budget work "irresponsible". But he has also said that tax increases were ruled out. So severe cuts in current public spending seem inevitable. As the Bundesbank said last month, these cuts are "bound to affect statutory rights" (ie

entitlement to unemployment and social security benefits).

6. Herr Matthofer, however, remains philosophical. To paraphrase his remarks during the June debate on public expenditure: "if you think we have problems with borrowing at 4½ per cent of GNP, look at the British, they are at 6 per cent".

OTHER GERMAN ECONOMIC PROBLEMS

7. The current account deficit. In 1980, the deficit amounted to \$16 billion, the highest in any OECD country. In the first quarter of this year it reached an annual rate of around \$20 billion. The OECD and the German Government forecast a longer deficit in 1981 as a whole than in 1980. This may be unduly pessimistic. Competitiveness has improved markedly over the last year. And in April the current deficit was very small and the trade surplus the largest for over two years.

8. Interest rates are very high. 3 month rates are now a bit under 13 per cent (an implied real rate of around 7½ per cent). There has been a perceived conflict between the level of interest rates required for external reasons and the level appropriate to the domestic economy. But there is growing recognition that high interest rates are necessary because of the budget problem and to prevent imported inflation spilling over.

9. Sluggish activity and growing unemployment
In the first quarter of 1981, GNP was over 2 per cent lower than a year earlier. Output is expected to fall in 1981 as a whole, perhaps by up to 1 per cent. But there are clear signs that the trough has been passed. Industrial production increased by 8 per cent (annual rate) in the first five months of this year, and new export orders are particularly buoyant. Unemployment increased by almost 350,000 in the 12 months to May; the rate is now 5 per cent.

10. Inflation. In May, the year-on-year inflation rate was 5.6 per cent. This is the same rate as in May 1980. However, the rate has fallen a bit since the early months of the year, despite the impact of DM depreciation. Wage settlements have been moderate, averaging 4½ per cent in the spring wage round.

2. UK Public Expenditure Problems

1. The Government has from the outset been committed to reducing both public expenditure and taxation. But both have risen.

2. Since the Government came into office (May 1979) public expenditure has risen in real terms, both absolutely (by around 2% between 1978-79 and 1980-81) and as a proportion of national income from 41½% in 1978-79 to an estimated 44½% in 1980-81. A further real rise, both absolute and relative, is expected in 1981-82, the current year. The tax burden (excluding the effects of the North Sea) has risen from 35% of national income in 1978-79 to an estimated 39½% in 1981-82.

3. The need for reductions is as great as ever. In particular, reductions in public expenditure are needed to permit worthwhile reductions in the tax burden on companies, in order to improve the position of the corporate sector and the prospects for employment; and on individuals, especially the lower paid, in order to improve the prospects for pay restraint. But the pressures are all for increases in expenditure.

4. Recessionary pressures are severe. Unemployment has risen from around 1½ million in 1979-80 to around 2¾ million now, and is still rising. Largely as a result, social security is 28% of total public expenditure in 1981-82 compared with 25% in 1978-79, and will probably be 30% in two years. This is despite difficult decisions by the Government to phase out some benefits and reduce others in real terms, involving cuts of some £1½ billion.

5. Unemployment, particularly youth unemployment, has also meant a far higher call for employment support measures. Instead of falling, expenditure has almost doubled in real terms since 1978-79, and the pressures for further increases continue, especially following the recent riots.

6. The nationalised industries also (like private industry) have been severely affected by the recession. The March 1980 public expenditure plans envisaged the NIs' aggregate external financing requirements falling from over £3 billion (net, at today's prices) in 1978-79 and 1979-80 to a net repayment of over £½ billion by 1983-84. But the recession has hit their revenue: their total financing requirement in 1980-81 stayed at well

over £3 billion and it will be difficult to reduce this significantly in 1981-82 and 1982-83. 17

7. Support for private industry has also had to be increased, notably for BL.

8. Besides the immediate recessionary pressures, there are considerable difficulties in constraining public expenditure in the longer term. The Government is keen to support the NATO aim of real increases in defence expenditure; rising numbers of elderly patients in particular mean pressure for real increases in health expenditure (including personal social services) as well as pensions; rising crime and violence require increases in expenditure on the police and other law and order services.

9. The Government has taken decisions to reduce in real terms spending on housing subsidies and investment, on education (where numbers of school children are falling), and on many other services such as road construction and overseas aid. But difficult though these decisions have been, the total of public expenditure remains high and the Government is committed to reducing it.

10. The UK's net contribution to the EC Budget is an important element in the public expenditure problem. It rose from a negligible quantity in the early years of membership to some £900 million [over £1 billion in today's prices] in 1979-80 (equivalent to more than DM4 billion at current exchange rates). Thanks to the special refunds, the UK's net contribution has now been reduced substantially, but it is still running at around £400-500 million a year. It is extremely hard to justify, to public opinion in Britain, this large and continuing slice of public expenditure. Few people can see any reason why the UK, as one of the Community's less prosperous countries, should be a net contributor at all.

EC BUDGET RESTRUCTURING

1. UK must have permanent and satisfactory Budget settlement. Essential for both economic and political reasons.
2. Britain naturally shares interests with Germany as the other main contributor.
3. Our two countries must stand together. No good shifting burden between ourselves; have to persuade others - we hope politely - to accept a fairer share.
4. One purpose of Hague Speech was to contribute to that persuasion. Has Matthöfer any comments on it?
5. Commission report a little mealy-mouthed. Downplays German problem. Stops well short of direct and general approach to Budget equity, such as Chancellor Schmidt's suggestion of limits on net contributions and receipts. How will Germans react? Will they just argue that the mechanism the Commission suggest for the UK should also apply to Germany? Or will they propose something different, such as a limits scheme?
6. Hope we and our officials can continue to keep closely in touch. Although it would be unwise for our representatives or the Special Group to be seen to be acting in collusion, they should at least know what the other is going to say.

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BACKGROUND

You are familiar with the issues. On figures:--

- a. the Germans expect their net contribution in respect of 1981 to be some DM 6-6½ billion. They point out that this is about a fifth of their current account deficit.
- b. The public expenditure White Paper put the British net contribution in respect of 1981 at about £1 billion, after refunds. (Later estimates are somewhat lower, but these are not public.)
- c. Without refunds, the UK has the largest net contribution, and it is rising - despite the fact that we are one of the poorer countries of the Community, and our living standards are falling.

IMPLICATIONS OF POLICIES OF THE NEW FRENCH GOVERNMENT

Points to make

1. (i) Interested to hear Herr Matthofer's views on new French economic programme.

(ii) Welcome M Delors' assurances about fiscal and monetary orthodoxy of French policies.

(iii) But concerned that measures might have adverse impact on some already weak points in the French economy - inflation the current account.

(iv) Does Herr Matthofer see a danger of growing divergence between Community economies? Could this undermine the EMS?

Background

2. Herr Matthofer is reported to be very worried about the consequences of the new French Government's economic plans.
3. Publicly, the German Government has expressed understanding for French policies. But privately, it is said to see that results as catastrophic, not least for the future of the EMS.
4. Following the France-German Summit on 13 July a senior Bonn Government official was quoted on saying that the effect on French inflation could be "simply disastrous".
5. The new French Government has announced three economic packages. The main elements are:
 - a) support for the worst off, both in and out of work
 - b) direct job creation in the public sector
 - c) assistance to industry (including interest rate subsidies)
 - d) higher taxes on top salaries and windfall profits

6. The gross budgetary cost of these measures is around FF20 billion though their impact on the budget deficit should be rather less. The budget deficit for 1981 may be around FF60-70 billion (2½ per cent of GDP), more than twice that originally planned by the previous government.

7. The National Statistical Institute's (INSEE) latest review of the French economy assesses the impact of the measures over the rest of 1981 - it expects an extra 0.8 per cent GNP growth and a worsened current account. But surprisingly the measures are expected to have no impact on inflation or unemployment.

US INTEREST RATES AND OTTAWA

Points to make

1. (i) Discussions at the European Council and the Finance Council have been useful in producing an agreed Community position.
- (ii) Think we are all aware of the dangers of a public row in Ottawa. Two things in particular will help us to get our message across to the Americans: a) recognition of the importance of the US succeeding in the fight against inflation and of the dollar remaining strong; b) recognition that EC's economic difficulties are partly home grown.
- (iii) Main message should be that lower interest rates are possible, without relaxing the fight against inflation, provided fiscal policy is tight enough to support monetary objectives.
- (iv) Hope, in particular, that if the US budget deficit comes under control more slowly than the Administration expects corrective action will be taken to ensure no extra pressure is put on interest rates.
- (v) Have seen reports of recent Franco-German Summit which indicate an agreement to try and achieve a stabilisation of the dollar. Would Herr Matthofer care to comment?

BACKGROUND

2. The need for a united Community approach to the interest rates issue was accepted at the European Council on 29/30 June: and the main lines of the approach were agreed at the Finance Council on 6 July. The Presidency conclusions of the European Council stated that: "important monetary policy objectives are shared with the US, but the US should be urged to take due account of the significant international consequences of its domestic policies. The Community itself should do its part to relieve the strain on monetary policy".

- 3. The Finance Council agreed that EC representatives at Ottawa should be guided by this conclusion and should also take account of the reports commissioned by the Monetary Committee and the Committee of Central Bank Governors. The former concluded that interest rates (both in the US and elsewhere) could be reduced, without relaxing anti-inflation policy, by substantially reducing government deficits. On the volatility of interest rates, the Committee said that US techniques should pay more attention to trend movements in monetary aggregates rather than short term deviations. The Central Bank Governors report urged a cautious approach to the Americans: suggestions that they should radically alter their policy mix "would risk a rebuff".

- 4. Press reports of the Franco-German Summit of 13 July contained a puzzling reference. The two Heads of Government are said to have agreed that, at Ottawa, they would set out to achieve a stabilisation of the dollar exchange rate either through unilateral measures by the US or through a common initiative by the central banks. You might want to seek clasification of this. (The US authorities have not intervned in the foreign exchange markets since their policy of minimal intervention was announced in March).

TALKS WITH HERR MATTHOFER, FRANKFURT, 17TH JULY 1981Global Negotiations, etc and Ottawa1. Background

The Canadians, supported by the French, will press strongly at Ottawa for a 'forward' line at the Mexican Summit and in the GLOBAL Negotiations. Over the past year the FRG have shown a scepticism about the purpose and value of such a line and we have been in close touch with them. Last autumn in Brussels and in New York the UK and the FRG stood firm - with the US - against the G77's attempts to subject the IMF/IBRD statutes to debate in the UN. In Geneva the FRG has taken a similarly firm line in negotiations on international commodity agreements (vis tin and cocoa).

2. But Herr Genscher has always exerted himself in favour of a more accommodating role, and a more sympathetic response to, for example, the Brandt Report. The FCO affect to believe that the FRG may soon move to a much softer line on North/South issues including notably official flows for development assistance, thus greatly embarrassing the UK's position, particularly in view of our tenure of the EC Presidency.

3. Unfortunately, the communique of the EC Council in Luxembourg on 29/30 June committed the Community to work for resumption of the Global Negotiations at an early date and emphasised 'the crucial importance of a positive impetus' to be given to this effect by the summit conferences in Ottawa and Cancun'. This has effectively cut the ground from under the feet of the sceptics, at least for the time being.

4. Line to Take

It would be wasteful and unwise for the West to think of launching new programmes involving additional aid or other 'concessions' in order to try to win goodwill at the Mexico Summit. Twenty-two countries will attend at Mexico and the meeting will last for only two days. The number of participants and the short time available will not allow of more than very broad statements of intention and approach. Quite apart from the constraints on additional expenditure, the occasion will be quite inappropriate for any considered and effective development policy.

5. We are now hooked on the Global Negotiations, and must make the best of a bad job. Our purpose should be to underline the importance of the private sector for development, trade and finance; to encourage the OPEC countries to carry more responsibility for development; to emphasise the proper function of aid, rather than the importance of its sheer volume; to uphold and enhance the roles of the GATT, IMF and IBRD; to welcome initiatives in favour of the poorest countries and in aid of the financing of energy resources.



J F SLATER
14 July 1981

CONFIDENTIAL

CAP REFORM

Line to take

Crucial for the Community to get to grips with the problems of the CAP during the budget restructuring exercise otherwise an opportunity will be missed which may not arise again. Believe there is much in common in views of the UK and German Governments on CAP. We both agree that we must reduce the size of the surpluses and their cost. Other major elements in the solution must include reducing real support levels for products in excessive surpluses, giving greater play to market forces, and subjecting agricultural spending to financial disciplines. We can support each other in continuing to pursue these themes. In addition, we are concerned by the Commission's proposals for promoting agricultural exports through long-term contracts. This inconsistent with the objective of reducing surpluses and could be very costly. Also concerned by Commission's intention to propose new spending schemes in the Mediterranean. Costs of the Mediterranean regimes must be reduced in advance of enlargement.

Background

2. It is desirable to keep reassuring the Germans that we are seriously interested in CAP reform and not just a budget mechanism. (Though it is fair to say that the Germans themselves are more assiduous in proclaiming their commitment to CAP reform than implementing it). You will recall that at the Anglo/German Summit in May you were able to reach a reasonably close identity of views with Herr Schulmann on the guidelines for CAP reform. You could remind Herr Matthoefer of this.

3. The section in the Commission's Mandate report on CAP reform is pretty much a curate's egg. Although it contains laudable references to the need for price restraint and for limiting the present open-ended system of intervention spending, the wording is often imprecise, weak and in parts contradictory. Moreover, it contains extremely unwelcome references to a more active export policy and more expenditure on Mediterranean structures. There is nothing in the paper about imposing a financial restraint on CAP expenditure other than a pious hope that the other measures proposed will lead to agricultural expenditure growing more slowly than own resources.

4. We should certainly continue to urge the Germans to maintain a common front with

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CONFIDENTIAL

us on CAP reform, since we have no other potential allies. That said, it is clear (see next section on 1982 budget) that their priorities for reducing CAP expenditure are often different from our own.

1982 Budget: provision for FEOGA guarantee expenditure

Line to take

Both our Governments committed to the view that rate of growth of FEOGA guarantee expenditure should be "markedly lower" than that of own resources. Understand that our officials have already been in touch about possible reductions in the 1982 preliminary draft budget needed to achieve this objective. Understand, however, that there is a risk that the positions of our two delegations may be drifting apart on question of where the reductions should be made. Can our officials try to sort this out before the Budget Council next Thursday?

Background

6. The UK German and Dutch Governments at the 1 April Agriculture Council made a declaration to the effect that the rate of growth in agricultural expenditure from 1982 onwards should be markedly lower than the rate of increase in own resources. The Commission's 1982 budget implies an increase in agricultural spending over 1981 of 12.8% compared with an increase in own resources of around 11.5%. MAFF and ourselves have identified savings totalling some 700m^{ecu} which we think could realistically be made in the provision for FEOGA guarantee to bring the rate of increase down to around 8½%. We have been seeking to coordinate a common line with the Germans to achieve these reductions at the Budget Council on 23 July. Unfortunately, although the German Finance Ministry have been reasonably cooperative and, left to themselves, would have gone along with a large proportion of our savings, it looks as though they have been overborne by the German Agriculture Ministry. Present indications are that the Germans will be seeking reductions of only 500m^{ecu} and that about half the cuts they propose are unacceptable to us. These include cutting the provision for continuation of the UK butter consumption subsidy after April 1982 and providing for the continuation of the linear coresponsibility levy in agriculture to which we are strongly opposed. These issues are to be discussed at the Budget Council on Thursday 23 July under the Chairmanship of the Financial Secretary. We think it would be worth making a further attempt to see if we can get the Germans to come more closely into line with our views before Thursday's Council. Hence the line to take. We will try to arrange for news of any later developments on this issue to be passed to Mr Hancock in Frankfurt on Friday evening.

1981/2 COMMUNITY BUDGET EXERCISE

The Germans have suggested that Herr Matthofer and the Chancellor should have a few words about the current exercise leading to the Budget Council on 23 July.

The most important issue before the Council is provision in the 1982 Budget for FEOGA Guarantee. A Speaking Note on this is included in Brief 7A.

Attached is a Speaking Note on other issues arising on the Budget.

[Handwritten signature]

SPEAKING NOTE ON 1981/2 COMMUNITY BUDGET EXERCISE

The Financial Secretary will chair next week's Budget Council, and I am glad to learn that he will meet Herr Schulmann in Brussels shortly before it begins.

2. Much progress has been made in discussions at official level on preparing for the Council; I am encouraged to learn that over a wide area the approaches of the German and UK representatives have been very much in line.

3. Member States certainly need to bear very fully in mind the need throughout the Community to exercise the most stringent control of public expenditure. It is essential that great restraint should also be shown in expenditure at the Community level.

4. Furthermore, both the Council and the Parliament must be very conscious of the approach to the 1% VAT Own Resources ceiling which is the one thing imposing a real financial discipline on the Community Budget. HM Government will continue to insist on maintaining the ceiling.

5. The most important issue before the Budget Council is the provision to be made in the 1982 Budget for FEOGA Guarantee expenditure. For Speaking Note on this see Brief 7A.7.

6. No doubt there will also be a number of other areas causing some difficulties between Member States, among them the level of non-obligatory expenditure where the European Parliament has powers to increase considerably the levels decided by the Council. I hope that it will be possible to reach agreement without further disputes over the validity of the Budget.

7. The United Kingdom attaches particular importance to ensuring that adequate payment appropriations are entered in the Budget to enable previously agreed commitments to be

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honoured. This need has been more fully recognised in the pre-Council discussions this year than was previously the case.

8. I hope that agreement can be reached on the content of the Amending Budget for 1981, and that this will also be acceptable to the European Parliament so that its adoption will provide a political solution to the Budget dispute dating back to the end of last year.

16/7/81

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir D Wass
Sir K Couzens
Mrs Hedley-Miller
Mr Bottrill
Mr Ashford
Mr Edwards
Mr Hawtin
Mr Peretz
Mrs Gilmore

BILATERAL WITH MATTHÖFER

1. Your talks with Matthöfer in Frankfurt tomorrow will be, I think, important. The Germans are showing distinct signs of concern at the emerging policies of the new French Government - see Bonn telegram No 546 attached - and this naturally inclines them to attach more importance to their relations with us. Matthöfer originally suggested this meeting with you on the grounds that he had been unable, through ill-health, to accompany Schmidt's party to Chequers. Attempts to find a suitable time have run into all sorts of difficulties. Despite these, Matthöfer's office have been persistent in suggesting new dates. The inference clearly is that he really does want to talk to you. This week is a particularly good time because the impressions created by his talks with Delors earlier in the week will be fresh in his mind.
2. Your main objective should, I think, be to establish a closer relationship with Matthöfer personally. I think that is more important than any of the substantive items that are to be discussed.
3. The briefing is attached. The most important item of substance from our point of view is Budget restructuring. The negotiations have not yet begun in earnest. It is too early to start talking details to Matthöfer. What we need to secure is an assurance from him that the Germans will work closely with us.
4. The present German position is a reconciliation of various conflicting interests within the German Government. Schmidt is publicly committed to having a limit on the German net contribution. Genscher does not like this talk because he thinks it is uncommunautaire. Matthofer's main interest is the cost to his Budget. The agreed formula produced by the German machine is that

"if a correction is to be made to the position of the UK, then a corresponding correction must be made in favour of Germany".

5. Given the nervousness of the German Foreign Ministry (which reflects concern about antagonising the small rich countries), there is a distinct risk that the chemistry of inter-departmental negotiations in Bonn will work out in a way very unhelpful to us - namely that the focus of German policy will be on curbing the cost to the Budget of refunds to the UK and not on leading the Community towards a rational system on the lines of your Hague Speech.

6. It would therefore be very helpful to arouse Matthöfer's interest in the Hague Speech. He told you last time you met that he would read it. A number of points you can make in talking to him are listed in the brief. I would stress two points:-

- (i) The Community must look at this problem in a broad and longer term perspective. A short term ad hoc solution applying only to the UK and Germany would merely postpone the crisis either to the time when FEOGA runs out of money because of the 1% ceiling or to the time when the costs of further enlargement cause the system to break down. Acting together, Germany and the United Kingdom can help the rest of the Community to see the problem in a true perspective.
- (ii) Germany and the United Kingdom will each be in a stronger position if we act in concert. The German case has been denounced on the grounds that Germany is rich and gets all sorts of extra unspecified benefits from membership of the Community for which it is quite natural that Germany should pay. The British are suspect for constantly wishing to change the rules in our favour. Such attacks could not be made on a joint position. No one can accuse the Germans of being uncommunautaire; and no one can accuse the British of being rich. Together we can prevent the rest of the Community evading the issue.

D.H.

D J S HANCOCK

16 July 1981

20/7/81.

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MRS HEDLEY-MILLER

cc - The Principal Private
Secretary (or)

Sir D Wass
 Sir K Couzens (or)
 Mr Battishill
 Mr Lavelle
 Mr Mountfield
 Mr Ashford
 Mr Bottrill
 Mr Edwards
 Mr Fitchew
 Mr Peretz
 Mr Wicks
 Mr Scholes
 Mr Phelps, C&E
 Mr Franklin, Cabinet
 Office
 Mr Hannay, FCO
 Mr Reid, DoT
 Mr Unwin, British
 Embassy, Bonn

CHANCELLOR'S BILATERAL WITH MATTHÖFER, 17 JULY

Matthöfer

1. The Chancellor of the Exchequer had talks lasting 3½ hrs with/ at a hotel near Frankfurt on 17 July. The Private Office will circulate a record after the Chancellor's return from Ottawa. In the meantime, here are the main points.

Commission Report on the Mandate

2. Matthöfer said several times that German and British interests were very similar. He revealed that there is a joint committee of senior French and German officials who are working through the Commission document to concert the Franco-German line. One of the French officials is Haberer. The others were not named. Matthöfer suggested that we should set up an equivalent Anglo-German committee. I think this is a Ministry of Finance committee but I am not certain. Our Embassy in Bonn are following up the proposal. The Chancellor feels it important to consolidate the relationship in this formal way even though the development is unlikely to make much practical difference to the frequency of contact and the content of the talks.

Insurance

3. Matthöfer made it quite clear that he knows nothing about the Insurance issue. The responsibility was apparently transferred from the Ministry of Economic Affairs to the Ministry of Finance almost by accident. The Ministry of Economic

Affairs retain an interest in the subject and Lambsdorff is from the Insurance industry. Matthöfer therefore suggested that the Chancellor should talk to Lambsdorff. The Chancellor said he would do so in Ottawa. (Both Matthöfer and Lambsdorff are going). Matthöfer said that he would prepare Lambsdorff for this as they were flying to Ottawa together .

Cooperation over 1982 Budget

4. Matthöfer was keen that we should cooperate over the 1982 Budget. He told Heck to fly to London on Monday. I had a brief word with Heck afterwards. We agreed that it was not necessary for Heck to come to London but that contact would be maintained via our Embassy. I put to Heck the proposition that we should seek the maximum amount of agreement between our propositions on the entries on the line and put any disputed points into Chapter 100. He agreed. Matthöfer spoke at some length about the need to remove a series of exemptions from taxation of the uses of fuel. He said that his motive was chiefly fiscal but he was clearly seeking to exploit concern about energy in order to increase his revenue. He said the Commission were doing some work but their document would be useless when it arrived. The main points he made were:-

/Energy
New para.

- (i) Aviation fuel. He cannot tax Lufthansa on their own, so he is seeking an agreement between all European countries to tax fuel used in internal European flights. He specifically mentioned the need to include Spain and Switzerland if this scheme were to be viable.
- (ii) Air force. He would like to tax the air force in order to force them to assess the costs of their operations. But he had apparently decided that it was not worth the trouble. For some reason the Federal Government would only get 18% of the yield.
- (iii) River transport. He wants to do away with the Treaty that exempts Rhine barges from tax on fuel.
- (iv) Oil consumed by the oil industry. This exemption was quite anomolous in his view.
- (v) Agriculture. Politically difficult but justifiable on merits.

New Community Instrument

6. Matthöfer told Delors at their talks in Bonn that the Germans will vote for the NCI next time. But there is no Franco-German agreement on the figure. Matthöfer said 1 billion ecu; Delors wanted a lot more. There would have to be a compromise.

Poland

7. It was confirmed that the Bundesbank will not provide the requested deposit without a Government guarantee and the Federal Government have no powers to guarantee a "risky" loan (which a loan to Poland undoubtedly would be). They have raised their export credit cover percentage to 95% instead.

Stabilising exchange rates

8. Matthöfer explained what lay behind the rather mysterious reference to the ecu-dollar rate in the Bonn Summit communique. Delors had said that interest rates need not necessarily affect exchange rates when there is a policy of intervention. Matthöfer thought this was nonsense and the most he was prepared to acknowledge was that we should confirm the IMF agreement to prevent excessive fluctuations.

Commission pay

9. Matthöfer said he could not understand the UK position on Commission pay. I explained it. Matthöfer changed the subject.

D.H.

D J S HANCOCK

20 July 1981

21.7.81

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With the compliments of
THE BRITISH EMBASSY

A J Beamish

BONN

20/7/81.

RECORD OF CONVERSATION HELD AT SCHLOSS HOTEL KRONBERG,
FRANKFURT, 17 JULY 1981

Present

Herr Hans Matthöfer,
Federal Finance Minister

Sir G Howe,
Chancellor of the Exchequer

Dr Pieske,
Deputy Secretary, Federal
Finance Ministry

Mr D J S Hancock,
Deputy Secretary
HM Treasury

Dr Heck,
Under Secretary, Federal
Finance Ministry

Mr John Wiggins,
Assistant Secretary,
HM Treasury

Herr Schmitt,
Assistant Secretary,
Federal Finance Ministry

Mr P Unwin
Minister (Economic)
British Embassy, Bonn

Mr A J Beamish,
Counsellor Economic
British Embassy, Bonn

1. Herr Matthöfer reported on the recent Franco-German Summit. He said the atmosphere had been very good and the Germans and the French had agreed once again that by working together they could be much more effective.

FRANCO-GERMAN CONSULTATIONS

2. Community Affairs

Herr Matthöfer said that the French side had agreed to adhere to the one percent ceiling without qualification. They had also agreed that agricultural expenditure in 1982 should be reduced but would not agree to the "markedly lower" formula though they raised no objection to German support for it. The French had not yet worked out a position on reform of the CAP but had no confidence that 1982 would give enough time for that or budget restructuring.

/They were,

They were, however, prepared to continue the practice instituted under the previous Government of cooperating with the Germans in a six-man high-level official committee to work out a common position on budgetary and agricultural questions. With regard to the dispute with the European Parliament over the 1981 budget, M. Delors said that he was determined to improve relations with the European Parliament. He had agreed with the Germans that a political solution to the problem should be found.

3. Herr Matthöfer went on to say that, for his part, he had told the French how dissatisfied German Government was with the Commission document on the 30 May mandate in particular, because it offered no solution for the FRG's problems. Greater Community solidarity was needed. There could be no solidarity when only two member countries were net contributors, and while the wealthier countries were making no contribution at all. He had told M. Delors that the German Government wanted an arrangement similar to that agreed last year for the British. The French had shown understanding and said that they would consider the question carefully. It should be pursued in the high level committee.

4. Referring to the New Community Instrument, Herr Matthöfer said that the French were very keen, that the Germans had said they would vote for it but had not decided on the amount. He thought that they would settle for something between 1 billion and 2 billion ecu.

5. Herr Matthöfer then outlined his long held views, on environmental and general economic grounds, of the desirability of extending further the taxation of petroleum products. There were 4 categories of use that he thought ought to be covered:

- i) aviation spirit - it ought to be possible to secure European agreement to the taxation of aviation spirit consumed on intra-European flights. Flights outside Europe would have to be exempted;
- ii) fuel for river transport, especially on the Rhine. The exemption dated from the time, he thought, of Napoleon and would need the agreement not only of France and Switzerland but of other countries too;
- iii) oil consumed by the oil industry in, eg. refineries;
- iv) petroleum products used by the agricultural industry.

/The French

The French side had shown no enthusiasm for the last point but had agreed to look at it.

6. Ottawa Summit

Herr Matthöfer said that on US interest rates they had agreed that the text recently approved by European Finance Ministers would serve as a good basis for the European position at Ottawa. M. Delors said how much he would welcome it if it were possible to break the link between transatlantic interest rates and European exchange rates. The Federal Chancellor while sympathising repeated the familiar German position that the market should be allowed to operate, but M. Delors had not been deterred and would probably raise the question at Ottawa. Herr Matthöfer said that high interest rates in America were also awkward for the FRG. A strong dollar made the job of turning round the German Balance of Payments position more difficult but any attempt to de-link would result in large capital movements out of Germany which could only exacerbate the situation. He did not see the balance of payments position being turned round for at least two to three years.

7. Herr Matthöfer reported that the French side had been very keen to see progress on the establishment of an Energy Affiliate at the World Bank. For his part he did not think that the Arabs would agree but the Germans would nevertheless press the Americans at Ottawa on this point. Sir Geoffrey Howe said that he had had conversations recently with the Kuwaiti Finance Minister and was now more favourably disposed towards the idea than he had been earlier. There seemed to be something in the point that if the Energy Affiliate had a separate personality there was a better chance that it would work well and not conflict with other parts of the World Bank system. However, he thought that the Americans were still firmly opposed.

EMS

8. As regards the EMS, both sides had agreed that it functioned well and had sustained a heavy load. Herr Matthöfer said that he was convinced that experience showed that the EMS did help, by maintaining a degree of stability within the European region, to promote trade and that it also provided an extra discipline on Governments to align their policies with those of their partners.

DEREGULATION OF AIR FARES

9. Sir Geoffrey Howe, referring to Herr Matthöfer's hopes in relation to the taxing of petroleum products, said that he thought that Community Governments had currently the opportunity and possibility of making a very great contribution to the welfare of the European consumer by deregulating air fares and permitting

/greater competition.

greater competition. Last year the British Government had de-regulated road transport fares with the result that traffic had increased by 150% and prices had gone down by 50%. The consumer was the clear beneficiary. Herr Matthöfer thought there had been similar experience in Germany with the amalgamation of bus systems in country districts. He found Sir G Howe's point very interesting and would talk to Graf Lambsdorff about it.

1982 Draft Preliminary Budget

10. In the course of a short discussion on the 1982 budget, Sir Geoffrey Howe said how important it was to try to make the "markedly lower" formula a reality. Herr Matthöfer agreed but said that Herr Ertl was a problem and opined that the summer, as far as agriculture was concerned, was going to be long and hot. Herr Matthöfer went on to say that although the German and British Governments seemed to be agreed on the size of the cut to make in the 1982 budget they were not yet able to agree on the details. Ought they not to try to get together and work something out? They had, after all, a blocking majority. He wondered whether it would make sense to get together, as the Germans did with the French in a high level committee of officials. Sir G Howe said he greatly welcomed this suggestion which the British side would be happy to accept. Mr Hancock drew attention to the urgent need to try to achieve a meeting of minds for the Budget Council on 23 July. Herr Matthöfer accepted this and instructed his officials to get together with the Treasury as soon as possible.

11. In reply to a question from Herr Matthöfer about the British attitude toward non-obligatory expenditure for 1982, Mr Hancock said that he thought the German and British positions were, in fact, very close. The British aim was to ensure that expenditure rose by no more than 7.5%. Herr Matthöfer suggested that in matters of personnel and management in the Community the Germans were the only ones prepared to take a tough line. Mr Hancock pointed out that in the recent dispute on pay for the higher grades, the British had taken the line that the important thing to do was to preserve the two main criteria for establishing pay at the end of the present quinquennium. That was exactly what had been achieved. At the end of the present period comparability and economic and social factors would have to be taken into account. That seemed the best way of achieving control over the salaries.

Insurance

12. Over dinner, Mr Hancock raised the question of insurance. He said that just as progress seemed to be within grasp it always moved out of reach. New technical objections of one sort or another were found every time. The current proposals dealt with the industrial and commercial side of the market. Whereas individuals might not always be able to take a well-informed view about alternative possibilities that would not be the case in respect of firms who, in general, would be qualified to inform themselves and would stand to benefit from wider choice. Herr Matthöfer said that insurance

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was not strictly speaking his affair but that of Graf Lambsdorff. He suggested that Sir G Howe talk to Graf Lambsdorff at Ottawa and asked his officials to ensure that Graf Lambsdorff was briefed. He said that Graf Lambsdorff was a believer in competition, would give a straight answer but had, before joining Government been in insurance and might not expect to be staying in Government for ever.

The Mandate

13. Sir G Howe, referring to his speech on budget restructuring and CAP reform at The Hague, urged that the Germans and the British should continue their close technical cooperation on these matters. He went on to say that the budget was the most obtrusive issue as far as Britain's membership of the Community was concerned and that it would, increasingly, become a problem for Germany too. But it was not simply a British problem. It seemed to him and to HMG that from the Community point of view it would be infinitely preferable, instead of the existing arbitrary mechanisms, to have arrangements that consciously determined the distribution of resources. Mr Hancock said that the Commission document was not all that bad but that the parts dealing with agricultural exports and Mediterranean products needed to be treated with considerable caution. Herr Matthöfer, in reply, said that the Germans had told the French that they were prepared to remain the largest net contributor but that Community solidarity demanded that others should share the burdens. But, Herr Matthöfer went on, the French would be difficult and a solution without them was impossible. As far as Germany was concerned, the net budget contribution amounted, at the moment, to DM10 billion. This was a very considerable part of the German Balance of Payments deficit. If he had no Balance of Payments problem and if US interest rates were 3 or 4 points lower the Community budget would not be a problem for Germany. He agreed that the Commission proposal on agricultural exports and Mediterranean products needed careful looking at. M. Mitterrand had, at the Franco-German talks, proposed the introduction of duties on tapioca, manioc and soya.

14. In a brief discussion on sterling and the EMS, Mr Hancock questioned the assumption that large fluctuations in the sterling rate were over. He drew attention to the way the inflation rates in the UK and the FRG had developed over the past year or so and suggested that the evolution of the exchange rates bore very little relationship to these trends. Sir G Howe referred to the tensions that sterling's presence in the EMS could set off. At the outset HMG had been influenced by the unhappy experience of British membership of the "snake". Herr Matthöfer

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observed that the Germans had never looked at things from that point of view. They had rather looked at the wider political elements and "taken the plunge". On Poland, Herr Matthöfer confirmed that the Bundesbank was unwilling to participate in the French proposal for a \$500 million package without a Government guarantee. The difficulty was that the Federal Government could only give a guarantee if the probability of risk was not high. That was not the present case. The Federal Government would probably have to consult the Bundestag. They wanted to make the Delors proposal work. Returning to the subject of the Ottawa Summit, Sir G Howe, referring to Japanese trade policy, said that HMG objected to what he described as the Japanese "laser beam" technique. It was discouraging to discover that the British Government had been giving the same message to the Japanese about the need to open up their markets for the past 8 years, at least, without any noticeable result. It seemed important that the European countries should cooperate in their attempts to persuade or frighten the Japanese into opening up their market. Herr Matthöfer said that the Japanese were just much more energetic and enterprising in their marketing techniques and thought that the Germans and other Europeans had a good deal to learn from them.

15. Referring to steel, Herr Matthöfer said it was vital for European steel prices to rise. There was room for at least a 20% increase.

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