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Lawson

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PO -CH /GH/0141

PART A

Begins: 6/5/83

Ends: 12/12/83

DD: 25 years

CHANCELLOR'S PAPERS ON THE FEDERAL REPUBLIC OF GERMANY (FRG)

PO -CH /GH/0141

PART A

PROF. DR. DR. H.C. ROLF RODENSTOCK
PRÄSIDENT DES BUNDESVERBANDES
DER DEUTSCHEN INDUSTRIE

GUSTAV-HEINEMANN-UFER 84-88
5000 KÖLN 51
TELEFON: 37081

6 May 1983

The Rt. Hon.
Sir Geoffrey Howe, QC, MP
Chancellor of the Exchequer
HM Treasury
Parliament Street

London SW1
GROSSBRITANNIEN

Mrs Hedley. FMHy.

N. 12.5.

11/v.

My dear Chancellor,

May I thank you again very sincerely, on behalf of the delegation of industrialists and bankers from the Federal Republic of Germany which was so kindly received by you at HM Treasury on Monday, 25 April and the most stimulating discussions we had with you about the British economy.

It was very good of you to spare so much of your time for us and we deeply appreciate all your valuable comments.

Yours faithfully, R. Rodenstock

GRS 440

CONFIDENTIAL

CONFIDENTIAL

FM BONN 291512Z JUN 83

TO PRIORITY FCO

TELEGRAM NUMBER 661 OF 29 JUNE

INFO PRIORITY BMG BERLIN EAST BERLIN MOSCOW WASHINGTON UKDEL NATO

AMENDED DISTRIBUTION 30/6/83

FRG LOAN TO GDR

1. TODAY'S GERMAN PRESS REPORTS PROMINENTLY THAT THE FEDERAL GOVERNMENT HAS PROMISED TO GUARANTEE A LOAN OF DM 1 BILLION TO THE GDR ORGANISED BY A CONSORTIUM OF LAENDER BANKS HEADED BY THE BAVARIAN LAND BANK. STRAUSS HAD BEEN PERSONALLY INVOLVED, AS WELL AS THE CHANCELLOR AND FINANCE MINISTER. THE LOAN WOULD BE PAID IN TWO INSTALMENTS AT AN INTERVAL OF 3 MONTHS. THE GDR IS SAID TO HAVE GIVEN ADEQUATE GUARANTEES OF REPAYMENT, BUT NO DETAILS ARE REPORTED. THE REPORTS SAY THAT THE LOAN IS NOT TIED TO ANY SPECIFIC PROJECTS OR CONNECTED WITH ANY POLITICAL CONDITIONS.

2. IN ITS LEAD EDITORIAL THE RIGHT OF CENTRE FRANKFURTER ALLGEMEINE ZEITUNG COMMENTS THAT MANY PEOPLE WILL BE FLABBERGASTED BY THIS MOVE, AND ESPECIALLY AT THE APPARENT ABSENCE OF ANY QUID PRO QUO. THE CDU/CSU HAD CRITICISED THE FORMER GOVERNMENT FOR NOT BARGAINING HARD ENOUGH WITH THE GDR. SINCE BECOMING CHANCELLOR KOHL HAD PROCLAIMED THE PRINCIPLE OF A BALANCE OF GIVE AND TAKE IN INNER GERMAN RELATIONS. THE ARTICLE SPECULATES THAT THERE MAY HOWEVER BE SOME SECRET UNDERSTANDING AND THAT THERE MAY SOON BE SOME GDR CONCESSIONS, EG ON THE MINIMUM EXCHANGE RATE FOR VISITORS TO EAST BERLIN AND THE GDR, ON THE AGE LIMITS AT WHICH EAST GERMANS CAN OBTAIN PERMISSION TO VISIT WEST BERLIN AND THE FRG, OR ON THE PROCEDURES FOR BORDER CROSSINGS.

3. THE RESPONSIBLE HEAD OF DEPARTMENT IN THE AUSWAERTIGES AMT HAS CONFIRMED TO US THAT THE STORY IN PARA 1 ABOVE IS ESSENTIALLY CORRECT. HE CLAIMED TO HAVE KNOWN NOTHING OF THE PREPARATION OF THIS LOAN WHICH WAS HANDLED BY A SMALL CIRCLE OF TOP MINISTERS AND OFFICIALS ON THE FRG SIDE. A CONTACT IN THE GDR PERMANENT REPRESENTATION HAS ALSO CONFIRMED TO US THAT THE REPORT IS CORRECT.

COMMENT

4. IT HAS LONG BEEN RECOGNISED THAT THE GDR WAS LIKELY DURING 1983 TO HAVE GREAT DIFFICULTY IN MEETING INTEREST AND REPAYMENT OBLIGATION FROM HARD CURRENCY DEBTS, DESPITE ITS SUCCESS IN BOOSTING EXPORTS IN 1982 AND SO FAR THIS YEAR. SOME WEST GERMAN BANKERS AND OFFICIALS HAVE BEEN READY TO SPECULATE THAT THE FRG WOULD STEP IN WITH CREDITS RATHER THAN ALLOW A FINANCING CRISIS WHICH COULD DAMAGE INNER-GERMAN TRADE, PRODUCE NEW TENSIONS IN POLITICAL RELATIONS AND CREATE HARDSHIPS FOR FELLOW GERMANS IN THE GDR (FOWLER'S LETTER OF 24 JUNE TO WILLIAMSON ESID - NOT TO ALL - GIVES MORE BACKGROUND).

15.

CONFIDENTIAL

5. NONETHELESS THE PRESUMPTION, ESPECIALLY GIVEN STRAUSS' APPARENT INVOLVEMENT, MUST BE THAT GDR COUNTER CONCESSIONS HAVE BEEN PROMISED AT LEAST IN PRINCIPLE. GIVEN GDR RELUCTANCE TO SEEM TO MAKE CONCESSIONS UNDER PRESSURE, THE FRG MAY HAVE BEEN READY NOT TO INSIST ON DIRECT PUBLIC LINKAGE. ON THE FRG SIDE THE TIMING OF THIS NEWS MAY BE CONNECTED WITH KOHL'S VISIT TO MOSCOW. THE HOPE MAY BE TO INDICATE TO THE RUSSIANS THAT A GENERAL WORSENING OF EAST/WEST RELATIONS IN CONNECTION WITH INF DEPLOYMENT WOULD ALSO HURT THE EASTERN SIDE.

TAYLOR

MONETARY
WED
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GRS 125

AMENDED DISTRIBUTION 30. 6. 83

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FM EAST BERLIN 291348Z JUN 83

TO PRIORITY F C O

TELEGRAM NUMBER 084 OF 29 JUNE

AND TO PRIORITY DOT, ECGD, BANK OF ENGLAND

INFO ROUTINE BONN, BMG BERLIN.

FRG CREDIT TO GDR

1. TODAY'S FRANKFURTER ALLGEMEINE ZEITUNG REPORTED THAT THE FEDERAL AUTHORITIES WERE TO GUARANTEE A DM.1 BILLION CREDIT BY A CONSORTIUM OF FRG BANKS TO THE GDR. THE FRG MISSION HERE HAD NO FOREKNOWLEDGE OF THIS AND WERE SURPRISED TO READ THIS MORNING'S PRESS REPORT. THEY HAVE SINCE CONFIRMED THAT HIGHLY CONFIDENTIAL CREDIT NEGOTIATIONS HAVE BEEN TAKING PLACE. BUT THEY DISMISS AS ''PURE SPECULATION'' ANY ATTEMPT TO LINK THIS CREDIT WITH POLITICAL OR HUMANITARIAN QUESTIONS.

2. THE LOCAL BBC CORRESPONDENT HAS SINCE TOLD US THAT A SPOKESMAN FOR THE ECONOMICS MINISTRY IN BONN HAS CONFIRMED THAT THE CABINET HAVE DECIDED TO SUPPORT THE LOAN, WHICH WILL BE AT 1% ABOVE LIBOR.

3. THE MISSION HOPE TO BE IN A POSITION TO TELL US MORE NEXT WEEK. IN THE MEANTIME ANY ADDITIONAL INFORMATION BONN COULD ELICIT WOULD BE WELCOME.

BALLENTYNE

MONETARY

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B.7

FROM: ADAM RIDLEY
1 July 1983

CHANCELLOR

cc Mr Page

MEETING WITH GERMAN JOURNALISTS: JULY 4TH

1. The following may be of some help.

2. These influential German economic journalists were originally invited to come to London by the CDU's Liaison Office here, following an admirable initiative by its Director, Ludger Eling, whom you may know. His purpose was to draw to the attention of these newspapers and their readers - all of whom are somewhat insular and unaware of what has been going on here - the good things that have been happening recently, and which are in prospect. It is a consciousness-raising exercise, if you like. They will also be intervewing Cecil Parkinson, Norman Tebbit, Gordon Pepper, Walter Goldsmith, and representatives of the CBI and TUC. Their particular interest, as well as ours, is in determining how far one can talk of a recovery or rebirth of the UK economy. In the background there is, of course, the parallel issue of the extent to which economic policy in Germany and the UK can be seen in the same light, and cooperation between the two governments is growing.

3. It is unfortunately impossible to obtain the normal detailed biographical information on those who will be talking to you - it appears that the Germans do not make a practice of preparing such details as we do, though Mr Page may be able to extract some useful information from our Embassy. I shall be dining with them on Sunday night, and will use this opportunity both to give them as much background information as possible, and also to establish where their interests lie. I will let you know on Monday of anything important which I discover.

Line to Take

4. Since you only have half-an-hour, I would imagine the best thing, after the exchange of pleasantries, (in which you might like to underline what a pleasure it is to see such a large and distinguished group), you might like to say a few words as a prelude to the necessarily rather short period of discussion which is available. In so doing one might touch on the following themes:

(i) Our basic objective since '79 has been to reverse the UK economy's long-term decline. This would have been a massive task even without the oil crisis, and an inheritance of a simultaneous explosion in public spending, the money supply and wage costs. While we have'nt done very well on GDP if one compares '83 with '79, the position is nonetheless an encouraging one under the circumstances.

(ii) The economy since '81 - when our recession ended and the worst of our problems had been conquered - has seen quite significant growth, at a higher rate than in most OECD countries. Productivity has grown exceptionally, particularly in manufacturing, in circumstances when it would normally be expected to have fallen. Our exports have done surprisingly well, particularly considering that the level of sterling was widely considered to be so uncompetitive. Investment has remained remarkably buoyant, with a relatively poor performance in manufacturing being offset by a strong performance elsewhere. Again a favourable comparison can be made with developments elsewhere. Had we not had the American interest rate shock in the autumn of '81 and the sudden collapse of world trade prospects in '82, we should have had very substantial growth since the '81 Budget.

(iii) At the level of detailed policies, we have already achieved a remarkable amount. Though the level of public spending has not actually been brought down in real terms below what it was, there can be no country in the industrialised world where it has been kept down so effectively for so long. We have made enormous progress in the area of privatisation. The myth of the "natural monopolies" has been largely detonated. We have not only achieved a good deal in the disposals already completed, but won the political argument hands down, and are now approaching the remaining state industries in a much more radical way than other countries. We have introduced a vast array of measures to help enterprise. There is no other major country which has abolished exchange controls. While the tax burden has sadly risen, we have managed to do a great deal to improve its

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incidence, in particular to relieve the pressure on industry, even if that was at the painful and undesirable expense of loading more on the person.

(iv) The Government's achievements are just as great at the level of attitudes and expectations. As with the real economy, there is a massive task to be undertaken here, involving the reversal of the orthodoxy of 20 or 30 years. Our success in that enterprise was demonstrated very clearly in the election and the associated opinion polls. Those voters who supported us and most of those who supported the Alliance demonstrated their clear conviction that our approach was right, and the old Keynesian corporatist philosophy undoubtedly wrong.

(v) The prospect for the future cannot be discerned clearly - we are sceptical of long-term forecasts. But we see a clear path to lower inflation in the years ahead; a GDP growth rate which, unless the world goes mad, should continue to be in the 2%-3% zone, if not more. And we are already enjoying not only substantial growth in consumer demand, but in capital expenditure this year.

(vi) On the policy front, there may have been some surprise or disappointment at election time over the fact that the Manifesto was relatively unglamourous. That surprise was totally misplaced. The last thing that one should have sought was a dramatic change of course, sudden radical gimmicks or a squalid exercise in marketing. What the Government promised to do, rather, was to carry on with the tried and proven policies it had already introduced. That should be and is very reassuring. It was notable how little our Manifesto was an issue, or was attacked during the election. The path to economic success, like achievements of genius, consists of 99% hard work and determination, and only 1% inspiration!

(vii) The international dimension is also very important. As soon as we had got our own domestic economy under some sort of control, we did not hesitate to turn our minds to the important problems of the international economy. The previous Chancellor played a major role as Chairman of the IMF Interim Committee, and we are working hard wherever we can to build on that initiative. The problems of the international economy are rather like

those of the UK. There is no single simple answer. Much hard work and countless individual decisions are needed, and in that connection the opportunities of collaborating with a like-minded government in the Federal Republic of course is particularly important and welcome.

AR

A N RIDLEY

Chancellor.

I suggest you speak on the record. But if you wish to speak on a non-attributable basis at some point of the interview you would indicate the change of terms, at that point.

S.P. 4/7

FROM: J PAGE
4 July 1983

CHANCELLOR

c c Mr Hall
Mr Monaghan

BRIEFING FOR W GERMAN ECONOMIC JOURNALISTS

I attach a telex received from Bonn this morning together with some notes from the Adenauer Foundation office in London.*

J PAGE

[* To follow]. (below)

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297711 PRDRME G

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BONN/FCO 001/04

BONN NO 1381

FROM BIS BONN (CAMARA)
TO MR JOHN PAGE, CHIEF PRESS OFFICER, TREASURY 262405

IMMEDIATE
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GRPS: 200

SUBJECT: BRIEFING FOR W.GERMAN ECONOMIC JOURNALISTS

ALL JOURNALISTS INVITED ARE HIGH LEVEL, VERY INFLUENTIAL ECONOMIC JOURNALISTS, WELL-DISPOSED TOWARDS US, FROM IMPORTANT CONSERVATIVE PAPERS. THEY HAVE BEEN INVITED TO LONDON BY THE KONRAD ADENAUER STIFTUNG SPECIFICALLY TO FIND OUT ABOUT CONSERVATIVE ECONOMIC POLICIES AND THE STIFTUNG HOPE THAT THEY WILL WRITE FAVOURABLE AND ENCOURAGING ARTICLES PUTTING ACROSS OUR ECONOMIC POLICIES IN A GOOD LIGHT. THEIR POSITIONS ARE AS FOLLOWS:

DR HANS DIETMAR BARBIER (SUEDDEUTSCHE ZEITUNG): HEAD OF THE ECONOMIC DEPARTMENT OF THE BONN OFFICE,

HERR HEINZ BECK (DIE WELT): AS ABOVE

HERR PETER HORT (FRANKFURTER ALLGEMEINE ZEITUNG): AS ABOVE

HERR DR DIETER PIEL (DIE ZEIT): SECOND ECONOMIC MAN IN TEAM OF TWO IN THE BONN OFFICE, ALSO WRITES FOR THE BOERSEN ZEITUNG,

HERR HORST SCHMITZ (CAPITAL): HEAD OF DEPARTMENT FOR BANKING AND INSURANCE MATTERS,

HERR HANS-HENNING ZENCKE: WRITES FOR 13 REGIONAL PAPERS ON ECONOMIC MATTERS.

ENDS
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SENT AT 04/0803Z DM

262405 TRSY G
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N/A

GERMANY: BACKGROUND ECONOMIC BRIEFING

1. Recovery prospects have improved considerably since late last year. GNP may have risen ½ per cent and industrial production by 2 per cent in the first quarter after falling sharply in 1982. Business confidence has picked up. As a result forecasts of growth this year have been revised upwards to around ½ to one per cent. Official projections still show only ½ per cent growth for 1983. But the pace of domestic improvement has slackened as orders (which were affected by temporary factors) and other indicators have not maintained earlier trends and their are doubts over the strength of the recovery, and particularly over the future path of investment. Output is however now expected to grow by 2 per cent in 1984.

2. With such a modest recovery the rise in unemployment will not be checked and could reach 9½ per cent by the end of next year. Consumer price inflation, now running at around 2½ per cent, may fall a little further this year despite the one percentage point of VAT increase in July. Modest wage growth should help prevent any rapid upswing next year.

3. After three years of deficit the current account was a surplus in 1982. It is expected to increase this year though how much depends on the strength of the export recovery.

4. German money supply (CBM) grew at an annual rate of 15 per cent in the first quarter - well above the Bundesbank's 4-7 per cent target. This rapid growth, however, reflected at least partly upward pressure on the deutschmark before the EMS realignment. Growth slowed in April and we have assumed this continues in the rest of the year to bring CBM back close to its target range, followed by a growth of about 5-6 per cent a year for the rest of the forecast period which would be closely in line with nominal GDP growth. In these circumstances, German interest rates might be able to remain around the present 4-5 per cent level - particularly if other factors are strengthening the DM.

/5. The Kohl Cabinet

5. The Kohl Cabinet agreed the draft 1984 budget at the end of May. Within a medium term plan to reduce the Federal deficit progressively from DM41bn this year to DM40bn in 1984 and DM24bn by 1987, the budget maintains the policy of restructuring expenditure in favour of the corporate sector (particularly investment) at the expense of the personal sector. It plans to limit total expenditure to 2 per cent nominal growth and makes substantial cuts of around DM6.5bn in social expenditure.

6. We share the Government's desire to reduce the deficit of the medium term but accept both the OECD's and IMF's concern over the speed with which this is achieved. They argue that too rapid a reduction could impair the strength of domestic recovery.

7. After a sharp fall in output last year the German economy, despite some uncertainties, appears to be recovering though growth next year remains below that expected in either US or Japan.

8. Summary table of selected economic indicators is below:

	Germany (percentage changes unless indicated)			
	1982	1983	1984	1985
GDP growth	-1.1	0.4	1.8	3.0
Contributions: Domestic Demand	-2.4	1.1	1.8	2.0
External Sector	1.3	-0.7	0.0	1.0
Consumer Price Inflation	5.3	2.7	2.1	2.2
Current balance ($bn)	-7.8	3.3	3.3	5.6

NOTE OF AN INTERVIEW GIVEN BY THE CHANCELLOR OF THE EXCHEQUER ON MONDAY 4 JULY, AT 11 DOWNING STREET, TO A GROUP OF GERMAN ECONOMIC JOURNALISTS (LIST ATTACHED)

The Chancellor opened the session by outlining briefly the Government's policy both in the past and in the future. In 1979, the Government found itself set with the task of reversing many years of relative economic decline, compared with the rest of the industrial world. Broadly speaking, they had embarked on a two-pronged policy:

(a) macro-economic They had re-emphasised the importance of a financial discipline as the framework of the economy. This discipline took the double form of restricting the growth of the money supply and reducing the Budget deficit.

(b) micro-economic The Government had set out to restore market forces to a more prominent part in the economy, by the abolition of controls on pay, prices, dividends, hire purchase etc and particularly on exchange control. The UK now had no exchange controls, after having had forty years of one of the most rigorous systems in the world. There had also been an extensive programme of privatisation.

2. As well as this framework of policies, there had also been the innovation of the medium term financial strategy. The importance of this was that it was intended to be pursued consistently over a period, with no more chopping and changing of policy. The consequences had more than fulfilled expectations, especially with regard to inflation. The UK was now one of the low-inflation countries in the OECD after having been for a long time one of the high ones. There had also been important gains in manufacturing productivity, as well as fewer strikes and more industrial peace. Industry had been through a very difficult time, and unemployment was very high, but the

Government had felt confident enough in its strategy to go to the country last month and the election result had justified that decision. The policy would therefore continue on the lines already planned.

3. The Chancellor then invited questions from the German delegation.

Q. Was there overmanning in British industry which was now being dealt with, and what were the prospects for the absorption of that portion of the labour force which was being made redundant?

The Chancellor said that there had been overmanning in the past but it was now being dealt with. This was one of the causes of increased productivity. It was also of course one of the causes of increased unemployment. He was however optimistic about the prospects of re-absorption. Substantial numbers of new jobs were being created all the time, even if not at quite the rate of those that were being lost. As the recovery continued, and overmanning eventually came to an end, the balance between the jobs being lost and those being created would be reversed and unemployment would begin to fall. It would not be easy, especially with the technological changes that were happening at the same time, but the rate of rise in unemployment was certainly slackening.

Q. 4. North sea oil had obviously been a great help during the period of adjustment, but was it not a limited source whose exhaustion might cause problems?

The Chancellor agreed that North Sea oil had been a very important source for the UK, but reminded the delegation that it was important to get it into prospective. North Sea oil accounted for only 5 per cent of GDP, and only a slightly higher proportion of tax revenue. Some businessmen thought North Sea oil was actually harmful, because of the effect it had on the sterling exchange rate. It was certainly true that the oil would eventually run out, but this time was some way ahead: he expected the UK to be self sufficient into the 1990s. The peak year of production was probably 1984, but decline from there on would only be gradual.

Q. 5. Was the question of UK membership of the EC now settled? Did the Chancellor agree that the UK and FRG had a special relationship in the context of the future development of the EC?

The Chancellor said that he sincerely hoped the question of membership had definitely been settled. Within the Community the UK was definitely very close to the FRG. The policies of the two Governments were very similar, and they also had a common interest in the reform of the Community budget. He was anxious to see further development of the Community but this would be impossible without reform of the budget. This would do more than anything to remove British doubts about the wisdom of continued membership.

Q. 6. Had the EMS met the hopes of its founders, and on what conditions would the UK be prepared to join?

The Chancellor said that he thought the EMS had served member States very well. The UK had no objection in principle to joining, but it was a matter of pragmatic judgement. The problem still remained sterling's position as an oil currency, which meant that changes in the oil market tended to have the opposite effect on sterling's strength in the foreign exchange market to that which it had on the currencies of the rest of the European Community.

Q. 7. Did the Government see the second phase of its economic policy as the distribution of income in favour of profits, and was there any chance of an incomes policy being introduced to achieve this?

The Chancellor said that there was definitely a need to rebuild profits, and this was happening. Incomes policy, as understood in the UK, had not historically helped Government policy at all. It had tended to impose rigidities, when the real need was for more rapid adjustment. Even those cases where an incomes policy had produced short term results, the eventual problems had far outweighed the initial benefits. He did not think there was any future in the idea of the Government determining

private sector pay, and he pointed out that it had always in the past proved politically disadvantageous; every Government with an incomes policy had lost the subsequent General Election.

Q. 8. Did the Government intend to reduce general income tax levels, or to provide selective assistance for example in the capital taxes?

The Chancellor admitted that from 1979-1983 there had been a borrowing and a budget deficit, and that taxation had been too high. The Government had however decided that the top priority must be to get borrowing down, and to do this they needed to increase taxation as well as cutting expenditure. But they had been able to reduce income tax, and also the taxes on industry, especially the National Insurance Surcharge, by increasing VAT and the yield of the North Sea oil taxes. The possibility of future tax reductions depended critically on keeping Government spending under control. Public spending had a natural tendency to increase, and there were particular difficulties with Local Authority spending.

Q. 9. Was there any possibility of high-interest policies in the US ending, or that other countries could become more independent of the US economy?

The Chancellor said that he was very concerned with the US budget deficit, which was structural rather than cyclical. He thought, however, that if the European countries could manage to maintain a conservative fiscal and monetary policy, they ought to be able to decouple themselves to some extent. Continued high interest rates and deficits in the US, he thought, might pose problems for the duration of the US recovery.

Q. 10. Was the Government using the income from privatisation to reduce deficits, or to stimulate productivity?

The Chancellor said that the main aim of privatisation was to stimulate productivity, although in the early years it was also having a beneficial effect on the former. The Government was pleased with the

progress of its privatisation policy: the Britoil sale, for example, had been the largest share issue ever made on the Stock Exchange. Plans were now well advanced for the sale of BT, which would be even bigger. There were also other projects in the pipeline, and others still under review.

Q. 11. What would the Chancellor like to see achieved or changed in EC policy?

The Chancellor said that he valued UK membership of the EC very highly. He was most suspicious of ideas that would lead to increased expenditure. All member States were trying to keep a very tight curb on their spending at national level, and he thought the same considerations should also apply to the Community budget, especially the CAP. The failure to reform the CAP was inhibiting further successful development, because it was providing a road block. The UK and the FRG had a common interest in the budget problem because they were the only two net contributors; he felt sure that if they could co-ordinate policy, they could make their influence widely felt.

JS.

MISS J C SIMPSON
5 July 1983

Circulated to:

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PS/EST
PS/MST
Mr Unwin
Mrs Hedley-Miller
Miss Court
Mr Battishill
Mr Morgan
Mr Hall
Mr Monaghan
Mr Page
Mr Ridley
West European Department - FCO

SECRET

EXCHEQUER
22 SEP 1983
ACTION Mr Littler
COPIES TO Mr Lomax, Mr Littler, Mr Bottrill, Mr Davis

C
Note on Dutch visit also below.
MCM
28/9

10 DOWNING STREET

From the Private Secretary

22 September 1983

Pl X, pse let Mr have ASAP an updated list of extraneous interviews such as these, by country (inc Italy - re Italian Budget proposals). MT.

Spoke Bottrill.

Dear Brian,

PRIME MINISTER'S VISIT TO BONN

I enclose Robin Butler's record of the conversation which took place at a working dinner between the Prime Minister and Chancellor Kohl on 21 September (I have sent you separately a record of the tete-a-tete conversation which preceded the dinner).

I am copying this letter and enclosure to John Kerr (HM Treasury), Robert Lowson (Ministry of Agriculture, Fisheries and Food), Jonathan Spencer (Department of Trade and Industry), Dinah Nichols (Department of Transport), Richard Mottram (Ministry of Defence) and Richard Hatfield (Cabinet Office). I should be grateful if you and they would restrict circulation of the record to those who have an essential operational need to know of its contents.

Yours ever

Tom Cole.

Brian Fall, Esq.,
Foreign and Commonwealth Office.

SECRET

NOTE OF A WORKING DINNER BETWEEN THE PRIME MINISTER AND CHANCELLOR KOHL AT THE CHANCELLERY ON WEDNESDAY, 21 SEPTEMBER, 1983

Present:

Prime Minister
H.M. Ambassador in Bonn
Mr. F. E. R. Butler
Mr. A. J. Coles
Mr. B. Ingham

Chancellor Kohl
H.E. the German Ambassador to London
Herr Boenisch
Herr Lautenschlager
Herr Starbreit

****

European Airbus

Chancellor Kohl said that a decision would have to be taken next winter about Germany's participation in further development of the European airbus. He was not proposing a substantive decision on this occasion but would like to ask the Prime Minister to look at the matter and have a further discussion when they next meet, before a decision had to be made. His own provisional view, without having access to the detailed financial conclusions, was that if Britain and Germany decided not to participate in the airbus project, it would peter out and this would be the effective end of a European aircraft industry. This might be a decision which would be regretted in the long term, and his provisional view was that it would be worth going ahead on these grounds, even if the financial prospects looked unpromising.

The Prime Minister said that she would be prepared to have a further discussion about this with Chancellor Kohl. The view of the British Government had hitherto been that the project should only go ahead if the aircraft would have a commercial future. It would not be worth building an aircraft which required substantial public funds, could not be sold and had to be imposed on national airlines, which would then require a subsidy to run it. She agreed in principle that it was desirable to retain both an air frame and an aeroengine industry in Europe, but she reminded Chancellor Kohl that there was already European co-operation on the Tornado and consideration would have to be given to a new combat aircraft.

/Chancellor Kohl

Chancellor Kohl said that he was asking no more than that the Prime Minister should look at the matter with an open mind. He agreed that a careful market analysis should be undertaken, but was inclined to think that a military European aircraft industry would not be viable unless it was underpinned by a civil aircraft industry.

Economic Developments

In reply to a question from Chancellor Kohl about the development of the economy in Britain, the Prime Minister said that growth was probably running at a rate of about 2 per cent this year. There were continuing difficulties in certain industries, particularly shipbuilding, steel (especially special steels) and coal. In the medium term, exports were likely to be depressed by the debt problems of the developing countries, the disappearance of surpluses among the oil producers and increasing competition from the newly industrialised countries. The electronics industries were flourishing and creating new jobs, but these were still not quite keeping up with the decline in jobs in the older industries and the underlying rate of unemployment was continuing to rise slowly.

Chancellor Kohl said that the problems in Germany were very similar. Unemployment was declining slightly at present but was likely to increase again next year, which would be the first of a three year peak of school-leavers as a result of a bulge in the birth rate. He had had to appeal to the employers and trade unions to find an extra 30,000 training places next year. This appeal had been successful and 45,000 new places have been produced. Another problem for Germany was an excessive number of people coming out of universities. Unless there was a reduction, which the Government were now seeking, there would be 100,000 excess teachers by the end of the decade. Germany too was facing problems through the decline in shipbuilding, steel, coal and fishing. The prospect for exports was not bright, and the only industries which were doing well were those which catered mainly for export demand, notably building, chemicals and motor vehicles. He felt that the United States' economic policy, through its effect on interest rates, was doing

/more

more to create an anti-American feeling in Europe than the deployment of missiles; but he saw no prospect of achieving a change before the United States presidential elections.

The Prime Minister commented that President Reagan would agree on the desirability of reducing United States interest rates. But he had been faced with a problem because his predecessor had neglected defence expenditure and boosted social programmes. President Reagan had restored the defence programmes but had been unable to persuade Congress to make any further cuts in social expenditure. He had also relied on a belief, which she considered fallacious, that growth would generate revenue which would subsequently reduce the budget deficit. She thought that the United States' economy might run into problems even before the United States elections, through a resurgence of inflation. She drew Chancellor Kohl's attention to the measures taken by Mr. Lubbers to contain wage and pension costs in the Dutch budget, while increasing VAT and reducing the tax on companies.

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Chancellor Kohl said that he had himself frozen civil service pay until mid-1985, and had spread the uprating of social security benefits so that one year's uprating had been removed. These measures were affecting more than half the population. The provision of jobs for school leavers in Germany was impeded by the high rates which the unions had negotiated for them: the Government did not make any contribution towards training places at present, but he was planning to introduce a contribution in the following year. A considerable problem for the German Government was the State Railway system, in which the deficit was expected to increase by some £600,000 in the current year: considerable reductions would have to be made in the network, and these would be very controversial.

?

/European Budget

European Budget

The Prime Minister said that she had been worried by indications given by the Italian Foreign Minister during Signor Craxi's visit to London that the Italians were not expecting a solution to the European budget problem in December. She would deplore it if the impetus imparted by Chancellor Kohl at Stuttgart was lost. Much would no doubt depend on the date at which the European budget ran out of funds, but she was in no doubt that a fundamental reform had to be made, since the Common Agricultural Policy was now ridiculous and the system of financing was grossly unfair both to Germany and to Britain.

Chancellor Kohl said that he had not changed his position on the budget. The European Community was politically essential to Germany, but it was no good having the European Community as a roof to Germany if the roof was leaky. It was absurd that milk was now subsidised by 120 per cent. In his view, the sorting out of the CAP and the system of financing took priority over the development of new policies. He was not opposed to new policies provided that these problems were first solved.

At Chancellor Kohl's invitation, Herr Lautenschlager reported on the progress of discussions so far. He suggested that it would have been wrong to expect much progress to be made before now. In Brussels this week the positions of the various countries had been clearly stated, and negotiations would begin in earnest in October. The German Government regarded the expansion of the budget as linked to enlargement, since they did not believe that it would be possible to enlarge the Community without an increase in own resources. The Prime Minister questioned this view. Herr Lautenschlager continued that the Commission's proposals on agriculture created problems in relation to external trade, the proposed milk quotas and the tax on oils and fats. But, since eight countries out of ten were not even prepared to accept the Commission's proposals, Germany was inclined to think that proposals on the lines of those put forward by the Commission were the most that were likely

/to be

to be achieved. They would have the advantage that a subsequent change in the agricultural regime could only be authorised by a special meeting in which Finance Ministers would take part. The Prime Minister commented that she regarded the Commission's proposals as unacceptable in certain respects. There would no doubt be pressure to exempt small farmers from quotas. It was unlikely that a fundamental solution would be found, unless funds to finance the policy were no longer available.

Chancellor Kohl said that he sympathised with the Prime Minister's view that the Common Agricultural Policy would only be reformed through pressure on its funds. He regarded the problem over milk in Germany as being one about dairy factories rather than farmers. He wished to continue to support, for social, ecological and political reasons, those who relied on farming for their main income. They were essential to the stability of German society. He did not believe that small farmers were inefficient. Whereas 18% of the German population had been full-time farmers in 1950, the number had now diminished to about 5%. But a result of the CAP was that industrialists had set up milk factories containing cows which never saw the light of day, were fed on imported fodder and kept entirely to produce the milk which attracted subsidy: this was not farming, and he did not wish to support it.

The Prime Minister commented that she did not dissent from what Chancellor Kohl had said about the case for maintaining a healthy agricultural sector: she too saw a healthy farming sector as essential on economic and social grounds. But she did not believe that this justified the current CAP. Help for small farmers who faced special problems in particular areas should be provided through the national aids. But she saw no reason why small farmers should have a right to sell their produce at a guaranteed price, when no-one would think of giving such a guarantee to other small businesses. It would be essential to take this opportunity to devise a policy which was basically sound and was not merely a patched-up compromise. Chancellor Kohl commented that there did not appear to be much between the British and the German positions in principle; but there would clearly be problems in working out the details.

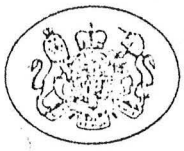
/ Concluding remarks

Concluding remarks

Chancellor Kohl said that he warmly welcomed the Prime Minister's visit to the British Forces in Germany. This demonstrated confidence in Germany also, and solidarity at a time when fateful decisions would have to be taken. The British Government could rely on the pledged word of the German Government, and in their will and resolution to do what was right. The reform of the European Community was important but was secondary to the maintenance of peace and freedom. The Prime Minister said that she would only want to add one thing to what Chancellor Kohl had said. She regarded the European Community as a major factor in the maintenance of peace and freedom: that was why she was committed to membership of it and why she regarded it as essential to find a fair and lasting financial basis.

E. E. R. BUTLER

21 September 1983



BRITISH EMBASSY
BONN

21 October 1983

Miss R S Langley Judd
Department of Trade and Industry
ECIP Division
Branch 2A
1 Victoria Street
London SW1

WRG 027/3
26 OCT 1983

Dear Rosalie

COUNT LAMBSDORFF'S VISIT TO LONDON, 1 NOVEMBER

1. Our telno 926 to the FCO set out German ideas for Count Lambsdorff's discussions with Mr Walker, Mr Tebbit and Mr Lawson. For those preparing briefing it may also be useful to have the following account of Count Lambsdorff's present personal position.

2. One must begin with the so-called Spenden Affair. Our last report was Peter Torry's letter of 10 October to Colin Munro (not to all) but for newer readers the essentials are these. There is a suspicion that Lambsdorff, together with other senior politicians (some now in opposition), may have used their ministerial authority to grant the favour of tax exemption to companies in return for donations to party funds. Lambsdorff strenuously denies any wrong-doing. Investigations have been continuing for a long time and the next significant step will be the announcement of a decision by the public prosecutor in North Rhine Westphalia whether to lay charges against Lambsdorff or not. If he does Lambsdorff may well have to resign immediately. Such developments may come as early as the end of October. But no one really in the know is telling.

3. This is not Lambsdorff's only problem. He has also been under attack for failing to take a proper grip on economic problems, in particular those of the steel, shipbuilding and coal mining industries. Such assaults have come from the trades unions and management, above all in the steel industry (our telno 893). Lambsdorff's political rivals also reckon they have found a weakness here which they have been keen to exploit, Franz Josef Strauß of the CSU for one. Some of these critics, for example in the steel industry, are passing the buck of course. But there is no doubt the criticisms are made with feeling; Lambsdorff's own tough and direct style will not have won him much kindness in return.

4. Lambsdorff has responded to these attacks with typical forcefulness and courage. It was noteworthy that he was prepared shortly before the Land elections in Bremen to enter the bear pit of one of the affected shipyards and tell the work force straight that further aid from Bonn could not be expected. In this he earned the respect, if not the liking, of those present but he was also running the risk of being blamed for any failure by his party, the FDP, at the polls. As expected, the party did indeed do badly in Bremen and were voted out of the Landtag. But any weakening of Lambsdorff's personal position was in the event countered by the success which his party achieved at the same time in the more important Land of Hessen.

5. Officials to whom I have spoken in the Economics Ministry admit to have detected no slackening of Lambsdorff's grip, rather the contrary. The only proviso, and this may be something of an indication of the stresses on Lambsdorff at the present time, is that he seems to be showing more than his usual liking for foreign travel, and this can take him away when decisions need to be made.

6. Much the most striking indication of Lambsdorff's own attitude, however, is the speech which he gave earlier this week at the opening of the major food trade fair in Cologne, ANUGA. He took this task over at short notice (in fact from his party boss, Genscher) and used it as an opportunity to deliver a particularly hard-hitting and impressive speech. His targets were his present critics and those who advocated the false policies of greater government intervention rather than less. He gave a good account of his present mood and general approach and I attach some extracts. The only caveat I should enter is that this was a speech rather than a detailed exposition of actual policy. It will continue to be of greater practical interest to see the extent to which political expediency or failing courage lead the Federal Government to compromise in following the free market ideals which Lambsdorff represents.

Yours
Michael

R E Escritt

cc: J Graham Esq, HM Treasury
J Arnott Esq, D/Energy
C Munro Esq, WED/FCO
A R Paul Esq, ECD(I)/FCO

EXTRACTS FROM THE SPEECH BY THE FEDERAL MINISTER OF THE ECONOMY, COUNT LAMBSDORFF, AT THE OPENING OF THE ANUGA FOOD FAIR IN COLOGNE ON 15 OCTOBER.

I am confident that the world economy is beginning to recover and that this process will continue. The tempo of inflation has clearly declined. The oil market has eased. The process of adjustment is continuing.

There are still serious risks - the crisis of indebtedness, high real interest rates, the inclination to resort to protectionist or interventionist measures. We all know that the breakthrough to a lasting economic upturn has not yet been achieved. It is therefore all the more important that all countries follow policies which support the process of convalescence for the world economy which will in turn have a positive effect on their own efforts.

The situation differs from country to country but in general economic problems are essentially structural. They cannot be tackled by conventional economic policy instruments. They might perhaps be successful in the first instance. Thereafter the impulse would not be carried over to the private sector and this above all because the fundamental causes had not been addressed. Nothing at all is achieved simply by the Government collecting money and using it for public investment or employment promotion programmes. At the end one is worse off than before. The task of structural adjustment requires a patience which many people do not have. It can be supported by social measures particularly with regard to youth unemployment.

Our main task remains to strive for a new economic structure. The call for more government is wrong. Experience shows that public involvement in companies can lead to everything except better economic performance. Therefore it is not a question of providing companies with "concepts" for solving their problems as is time and again being demanded for the problem branches of steel, coal mining and shipbuilding here. Were we to do this for the steel industry, then why not also for its customers and for the steel working industries which are affected in their own way by the steel crisis?

In the Federal Republic we are following just such a policy of positive structural adjustment and it has been successful. After almost two years of stagnation and a sharp decline in production, both production and capacity utilisation have clearly improved since the beginning of the year.

How is it possible then for people to claim on the one hand that the Government's policies are wrong while economic developments are positive - and not as it happens just based on a somewhat volatile export demand which has formerly often been the case and which has only improved in recent months, but of a revitalisation of domestic demand.

/We will

We will pay attention in making all our decisions to the consistent application of market economic principles because such policies are the best way of strengthening the basic economic structure. We will follow policies which strengthen small and medium sized companies for they are the heart and motor of progress and competitiveness.

I am accused of lacking an overall concept of economic policy and of inactivity. If one looks more closely, usually behind such accusations lies the call for more subsidies or more involvement of the state in the economy. I confess that I am guilty of this form of inactivity.

The Government will be successful, but we shall need stamina.

Annex 4

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TO PRIORITY FCO

TELEGRAM NUMBER 952 OF 26 OCTOBER

INFO SAVING PARIS EMBASSY BRUSSELS ROME THE HAGUE ATHENS COPENHAGEN DUBLIN LUXEMBOURG UKREP BRUSSELS UKDEL OECD CHCC(G) CGS IN FRG BMG BERLIN

ESCRITT'S LETTER OF 21 OCTOBER TO MISS LANGLEY JUDD, DTH. LAMBSDORFF TO RESIGN?

1. THE FEDERAL ECONOMICS MINISTER, GRAF LAMBSDORFF, WILL BE VISITING LONDON ON 1 NOVEMBER AGAINST A BACKGROUND OF GROWING SPECULATION HERE THAT HE MAY SOON HAVE TO RESIGN BECAUSE OF HIS ALLEGED INVOLVEMENT IN A LONG-RUNNING SCANDAL INVOLVING THE FINANCING OF THE POLITICAL PARTIES. THE FRANKFURTER ALLGEMEINE ZEITUNG OF 26 OCTOBER HAS REFUELLED SPECULATION BY REPORTING ON ITS FRONT PAGE THAT THE QUESTION OF A SUCCESSOR IS UNDER ACTIVE CONSIDERATION.

2. FOR ALMOST TWO YEARS, THE BONN PUBLIC PROSECUTOR HAS BEEN INVESTIGATING ALLEGATIONS THAT A NUMBER OF LEADING POLITICIANS FROM THE THREE MAIN PARTIES, INCLUDING LAMBSDORFF, IMPROPERLY ACCEPTED FINANCIAL CONTRIBUTIONS FOR PARTY PURPOSES FROM A LEADING GERMAN COMPANY, FLICK. IN ADDITION, LAMBSDORFF, IN HIS CAPACITY AS ECONOMICS MINISTER, IS ALLEGED TO HAVE GRANTED FLICK A HUGE TAX EXEMPTION IN RETURN FOR DONATIONS TO THE FDP. LAMBSDORFF AND THE OTHERS INVOLVED HAVE CONSISTENTLY DENIED THESE ALLEGATIONS.

3. THE CHANCELLOR'S PRESS ADVISER ACKERMANN, WHO IS ONE OF HIS CLOSEST CONFIDANTES CONFIRMED TO US THIS WEEK THAT THE PUBLIC PROSECUTOR HAD DECIDED TO BRING FORMAL CHARGES AGAINST ABOUT 6 PEOPLE INVOLVED IN THE AFFAIR, INCLUDING LAMBSDORFF AND TWO FORMER SPD FINANCE MINISTERS, MATTHOEFER AND LAHNSTEIN. THE PRESS ARE SPECULATING THAT THE PUBLIC PROSECUTOR WILL MAKE KNOWN HIS DECISION BY THE END OF THIS WEEK, BUT THE FEDERAL CHANCELLERY EXPECT THIS TO SLIP UNTIL THE END OF NOVEMBER. IF THE PUBLIC PROSECUTOR DOES BRING CHARGES, THE NEXT STEP WILL BE FOR THE COURT CONCERNED TO DECIDE WHETHER TO PROCEED WITH A TRIAL. THERE COULD BE SEVERAL WEEKS BETWEEN THE PUBLIC PROSECUTOR'S DECISION AND A DECISION BY THE COURT.

4. THE GENERAL VIEW HERE IS THAT LAMBSDORFF COULD REMAIN IN OFFICE IF THE PUBLIC PROSECUTOR BROUGHT CHARGES BUT THAT HE WOULD HAVE TO RESIGN WERE THE COURT TO OPEN THE TRIAL. BOTH ACKERMANN, AND THE MINISTER OF STATE AT THE FEDERAL CHANCELLERY, WHO IS ALSO A KEY MEMBER OF THE CHANCELLOR'S KITCHEN CABINET, HAVE HOWEVER TOLD US THAT THE PUBLIC PROSECUTOR EVIDENCE IS FLIMSY

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/AND

AND THAT IT IS THEREFORE NOT CERTAIN WHETHER A COURT WILL DECIDE TO TRY THOSE CHARGED. THEY MAY WELL BE RIGHT. BUT THE CRITERIA USED BY THE PUBLIC PROSECUTOR IN BRINGING CHARGES AND BY THE COURT IN OPENING PROCEEDINGS ARE BROADLY SIMILAR, AND IT IS UNUSUAL FOR THE COURT NOT TO OPEN PROCEEDINGS IF THE PROSECUTOR BRINGS A CHARGE.

5. AT THIS STAGE, NO-ONE REALLY KNOWS WHETHER LAMBSDORFF WILL HAVE TO RESIGN. BUT BOTH CDU AND FDP PARTY HEADQUARTERS ARE TAKING THE POSSIBILITY INCREASINGLY SERIOUSLY. FOR ALL THE CONFIDENCE ON THOSE AROUND THE CHANCELLOR THAT LAMBSDORFF WILL BE ABLE TO HANG ON, IT IS ALSO CLEAR THAT THEY ARE GIVING INCREASING THOUGHT TO POSSIBLE SUCCESSORS. STRAUSS MIGHT LIKE THE ECONOMICS MINISTRY, AND THE CSU HAVE ALREADY LAID CLAIM TO IT SHOULD LAMBSDORFF GO. BUT THE CHANCELLOR WILL WANT TO KEEP STRAUSS AT BAY AND SHOULD IT EVER COME TO THE POINT, IS LIKELY TO PREFER AN FDP SUCCESSOR.

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TAYLOR

(ADVANCED AS REQUESTED)

FCO/WHITEHALL D
WED

Annex E.

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CHANCELLOR
ECONOMIC SECRETARY } Separate copies

From: A J C EDWARDS
28 October 1983

cc Chief Secretary
Mr Middleton
Mr Littler
Mr Unwin
Mr Fitchew
Mr Bostock
Miss Court
Mr Matthews
Mr Peet

EC FUTURE FINANCING : TALKS WITH TIETMEYER, 31 OCTOBER

Here Tietmeyer has agreed to come to London on Monday. The programme is as follows (provisionally):

4.15 pm	Discussion with Chancellor and Economic Secretary
5.00 pm	Discussion continues with Economic Secretary
6.30 pm (at latest)	Herr Tietmeyer leaves for Heathrow.

Mr Fitchew and I will be in attendance.

Objectives

2. Treasury Ministers' primary concern should be to persuade Herr Tietmeyer to accept the points in the Chancellor's letter of 27 October (annex A) and to frame the forthcoming German paper for the Preparatory Group accordingly.

3. Ministers will also wish to leave Herr Tietmeyer in no doubt as to the strength of the British Government's determination to obtain an arrangement which will genuinely, reliably and permanently solve the problem of budgetary imbalances.

German proposals

4. The Germans were all set on Monday to table a damaging paper setting out a German 'model' for solving the imbalances problem (annex B). Herr Tietmeyer was persuaded by the Chancellor and the subsequent message from No 10 to postpone tabling the paper. He did however make an extended oral

presentation in this week's Preparatory Group meeting at Luxembourg in which he committed himself unequivocally to tabling a paper for the next Preparatory Group meeting beginning next Wednesday. His oral presentation covered most of the material in the suppressed paper, including the proposal that the problem should be measured as a receipts deficiency problem, as proposed by the Danes. He did however leave open the possibility of using a formula like the UK's safety-net formula to limit the burdens so measured.

5. The main points in Herr Tietmeyer's oral exposition were:

- The solution should have two elements - the Commission's modulated VAT plus an amended version of the Danish expenditure/receipts mechanism, implemented by deductions from VAT contributions.

- The Commission's modulated VAT could be regarded as dealing with the problem of the UK's relatively large share of gross contributions.

- For the rest, the measurement of burdens to be corrected should be based on the so-called 'expenditure gap' or ' receipts gap', as measured by the Danes: ie the difference between member states' actual receipts from the budget and what their receipts would have been if their share in total Community expenditure/receipts had been the same as their share in Community GDP.

- The German Government had still to decide between two ways of correcting the burden so measured. One would be to limit it as in the UK's safety net formula to a small percentage of the GDP of the country concerned, that percentage being a function of relative prosperity. But benefitting member states would be expected to bear in addition a proportion of any excess of their receipts gap over this limit (one-third for countries with less than 120 per cent of Community average prosperity and two-thirds for more prosperous countries).

- Another possibility would be to rebate to member states with unfavourable receipts gaps a percentage of those gaps which would reflect relative prosperity - (say) 60 per cent for countries with 90 per cent of Community average prosperity, falling to 15 per cent for countries with 128 per cent or more of Community average prosperity.

- Under both approaches, the reliefs would be financed by all member states in accordance with the shares-key proposed by France (a key which would reflect shares in Community receipts and relative prosperity as well as VAT shares). Benefitting member states would have to contribute, under this key, to their own reliefs (and those of others).

German motives

6. From our recent exchanges with the Germans, the following points have emerged:

i. Tietmeyer seems to be very much in the lead on this question in the German Government: the 'German model' seems to be his own creation.

ii. He is much less concerned than the UK about obtaining a genuine upper limit on net contributions. His main stated concern is to alter the Community's arrangements so that other member states will have a financial incentive to join Germany and the UK in resisting proposals for expenditure increases. His unstated judgment may be that Germany will gain more by minimising the reliefs given to the UK than by going for a real limit for Germany.

iii. In common with his colleagues in the German Foreign Office, he seems unwilling to pursue a tactic of insisting on a really satisfactory system of safety-net limits in return for agreement to an increase in own resources. Instead, he is much concerned about 'negotiability' and unwilling to go too far in opposing the wishes of France and the low countries. His instinct is to respond to criticisms by offering concessions and compromises.

Other member states' views on German proposals

7. Tietmeyer's proposals attracted both praise and criticism from other member states in the preparatory group. The German retreat from the concept of net contributions was warmly welcomed; but the following criticisms were made:

i. the proposals were too generous to the Germans themselves - compensating them three times over, through modulated VAT, the receipts mechanism and the financing key. In fact, as Tietmeyer pointed out, Germany would not benefit in all years from modulated VAT.

ii. All member states who would be net losers from modulated VAT declared their firm opposition to it - France, Italy, the Netherlands and Denmark.

iii. Most member states also expressed firm opposition to the French financing key, which would help only Germany and the UK.

The German proposals (especially variant 2) would be particularly unfavourable to Italy (see tables 1 and 2 below, column 7). Italian opposition may therefore be expected to harden once the Banca d'Italia have done their sums.

Implications for UK

8. From the UK's point of view, the main problems with Tietmeyer's oral version of the German proposals are those set out in the Chancellor's letter - use of the receipts gap to measure the problem instead of the net contribution; the high marginal rates of contribution which we should have to make to increases in our measured burden over the defined limit; and the idea that benefitting countries should contribute to their own reliefs. A further problem is the unnecessary concession on administrative expenditure. As tables 1 and 2 below show, both variants of the German scheme would have relieved the UK of less than half of our net contribution for 1982.

9. As a tactical matter, the Germans's decision to table such proposals at this stage is most unfortunate. But they are committed to doing so. The task has therefore tobe to limit the damage as far as possible by persuading them to leave the door open to solutions which the UK might be able to accept. The Chancellor's letter suggests four ways in which this might be achieved: leaving open other possibilities for measuring the burden to be corrected; dropping or criticising the second formula variant; dropping the suggested surcharge percentages from the first variant; and dropping the idea that beneficiary countries should contribute to their own reliefs. Ministers will wish to go through these possibilities

with Herr Tietmeyer. It would also be useful to suggest the possibility of a less expensive concession on the treatment of administrative expenditure.

10. If the German paper were amended in the above ways, it would leave open the possibility of a scheme under which the burden to be corrected would be measured on the basis of the difference between shares in receipts and own resources (a roundabout way of defining the net contribution) and a safety net limit applied to this burden, with a provision whereby beneficiary countries would make a small contribution to excesses in their burdens as defined over their limits. Something on these lines could be a reasonable outcome for the UK.

11. The Chancellor has asked about the possibilities for excluding levies and duties from the calculation of net contributions and compensating for this by higher rates of compensation. I will, if I may, comment on this and related possibilities in a separate note. So far as the discussion with Tietmeyer is concerned, the main points are:

i. It is important for the UK to stand by its attachment to net contributions as the best measure of the problem: the point is that the problem consists precisely in the fact that the gross contributions paid by taxpayers in Britain are so much larger than our gross receipts from the budget, with the result that we have to transfer huge sums of money across the balance of payments every month to other member states.

ii. If Tietmeyer is unwilling to mention the possibility of comparing receipts shares with own resources shares, Ministers could say that if he could even mention VAT shares as an alternative to GNP shares in measuring the burden, that would be an improvement.

Line to take

12. Ministers may like to begin by thanking Herr Tietmeyer again for postponing circulation of his paper and for including in his oral statment the possibility of a limits formula closer to the UK's own conception. They may like to suggest that the simplest structure for the discussion might be to go through the points in the Chancellor's letter in turn.

General approach (paragraph 2)

Emphasise that German paper could help the negotiation enormously if points way to (or at least leaves open possibility of) a solution which UK can accept. If paper does not do this, it could set the negotiation back.

Our fear about Germans' earlier paper was that it would not meet our criterion. Much relieved by more flexible position which Tietmeyer took in preparatory group discussions. UK's particular concern is to obtain agreement to arrangement which will genuinely solve imbalances problem on lasting basis. This implies in particular -

i. measuring problem correctly
ii. setting limits at reasonable levels and
iii. adequate protection if underlying problem gets worse over time.

German proposals do raise difficulties for us under each of these headings. Principles doubtless more important than numbers at this stage. But note that, on our calculations, both variants of German scheme would have rebated to the UK less than half of our uncorrected net contribution for 1982. Final deal will have to be much more favourable to UK than this.

(b) Measurement of burden (paragraph 4)

15. As we see it, problem consists precisely in the net contribution - that taxpayers in UK contribute so much more to budget than beneficiaries of Community policies in UK receive from budget, so that UK has to make large transfers across balance of payments every month to other member states. Net budget contribution not a perfect measurement but better than anything else and has provided basis for ad hoc arrangements of last few years. Others find it convenient to criticise concept as incommunautaire: this is an obvious tactic for net recipient countries. Net contributor countries should not be put off by such tactics.

16. Appreciate that difficult for you to return to your earlier position in your paper next week. But difference between GNP and receipts shares definitely understates the UK's problem. For reasons explained in letter, cannot rely on modulated VAT to solve problem. It does not focus on problem directly. And it is anyway highly unpopular with other member states. So hope you will leave open possibility of measuring burden by difference between receipts and own resources shares. Appreciate that this

will give result similar to net contribution. But this has to be a feature of any satisfactory arrangement. Measurement could be called budgetary indicator. Possibility of one or two other adjustments which would distinguish new indicator from existing net contribution.

17. [If Tietmeyer declines to mention share of own resources as an alternative to GNP shares, useful if paper could even mention share of VAT own resources as an alternative to GNP shares. Also useful to underline that correction based on Danish receipts gap cannot solve problem on its own.]

(c) Second limits formula (paragraph 5)

18. Very worried about dynamic properties of your second formula (the one illustrated in your draft paper). As we see it -

(a) If allocated budget doubled in real terms, with same distribution of expenditure and receipts shares as now, UK's corrected net contribution would approximately double too even if our ability to pay as measured by GNP and relative prosperity had not changed.

(b) UK would bear about 56 per cent of any marginal increase in receipts gap, and Germany about 85 per cent - after allowing for our contributions to our own reliefs.

Doubt very much whether scheme with such high rates of marginal contribution by net contributor countries would achieve your objective of giving other member states financial incentives to oppose increases in budget total.

19. Hence our hope that you might be willing to drop this variant - or at least indicate a strong preference for the GDP-related variant.

(d) First limits formula (paragraph 6)

20. Very grateful to you for including this formula. But fear that, from UK's point of view, you have rather spoiled the effect by suggesting that countries benefitting from reliefs should themselves bear one-third or two-thirds of the amounts by which their burdens exceed their limits. We calculate that, after allowing for contributions to our own reliefs, UK would in fact be expected to bear no less than 43 per cent of any increase in its uncorrected net position, and Germany 74 per cent. This raises all the same difficulties as arise on your second formula.

21. Accept that it is quite reasonable to air the ideas (a) that benefitting countries should make some contribution to increases in their uncorrected net positions above their limits, and (b) that the scale of this contribution could reflect relative prosperity. But UK could not possibly accept more than a very low marginal rate of contribution on excesses over limits. So far as your paper is concerned, problem could be solved easily by simply dropping the one-third and two-thirds marginal contribution rates which you mention.

(e) Contributions to own reliefs (paragraph 7)

22. With best will in world, cannot see how one can justify expecting benefitting countries to contribute to own reliefs. If development of budget is such that German and UK reliefs both rise, consequences for our marginal rates of contribution to increases in our underlying net contributions potentially formidable.

23. Appreciate your point that, without this provision, French would do too well from your scheme. But do feel that some other solution should be sought.

(f) Administrative expenditure

24. UK not convinced that present treatment, which assigns all administrative expenditure in Belgium to Belgium, and similarly with Luxembourg, is unfair. Enormous advantages to host countries, which are not fully reflected at all in the budget figures. Would much have preferred not to offer concessions at this stage.

25. If you feel bound to offer something in this area, suggest two possible changes in your proposal:

i. The principle of allocating administrative expenditure to member states in accordance with GDP shares should be applied to administrative expenditure in the unallocated budget as well as 50 per cent of administrative expenditure in the allocated budget.

ii. Such expenditure would preferably be allocated in relation to receipts shares rather than GDP shares, as providing a better reflection of the benefits to member states resulting from the administrative expenditure by the Community.

Other matters

26. If there is time to spare, it would be useful to discuss with Herr Tietmeyer the future course of the negotiations, as he sees it.

27. Other subjects which he is likely to raise are German MCAs and the strict financial guideline for agricultural expenditure. Mr Gray will be submitting notes on each of these on Monday morning.

A J C EDWARDS

TABLE 1

GERMAN MODEL : VARIANT 1 (GDP-based limit plus surcharge)

ROUGH ESTIMATES BASED ON 1982 FIGURES

The amount of their receipts gaps* which member states would bear themselves would be limited to zero for member states with 90 per cent of Community average prosperity or less, rising to 0.35 per cent of GDP at 140 per cent of Community average prosperity, but member states would also (a) bear one-third or two-thirds (depending on their relative prosperity) of any excess of their receipts gaps over their GDP related limits and (b) contribute to their own reliefs (and those of others). This system would be combined with the Commission's modulated VAT.

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	Uncorrected net contributions and receipts	Expenditure/receipts mechanism: Gross reliefs	Expenditure/receipts mechanism: Financing by French key	Expenditure/receipts mechanism: Net reliefs	Modulated VAT (gains and losses)	Total net gains and losses	Percentage shares in financing net reliefs
	1	2	3	4	5	6	7
B	253		31	-31	17	-14	1.4
DK	295		21	-21	-101	-122	12.7
D	-2086	24	105	-81	-13	-94	9.8
GR	685		14	-14	17	3	-
F	-19		130	-130	-184	-314	32.7
Irl	732		17	-17	-1	-18	1.9
It	1616		71	-71	-162	-233	24.3
L	256		7	-7	7	-	-
N	304		48	-48	-117	-165	17.2
UK	-2036	498	78	420	537	957	-

Comments on figures

1. Column 2 calculations use average GDP per head 1980-82 in a Community of 12 at current market prices and exchange rates. Column 3 figures use 1982 figures in a Community of 10 at current market prices and exchange rates. Column 5 is taken from the Commission's recent paper and uses an average of GDP per head at purchasing power parities and market exchange rates in a Community of 10.

2. For 1982, receipts mechanism would have provided gross reliefs of some 500 mecu for UK and some 25 mecu for Germany.

3. In terms of net outcome, scheme as a whole would have relieved UK of less than half our uncorrected net contribution for 1982.

4. Effects on other member states: Germany would receive no net relief but would contribute fairly modestly to UK's net relief. France, Denmark and Netherlands would bear main burden of financing UK's net relief.

5. Dynamic properties:

(a) if allocated budget doubled in real terms, with same distribution of expenditure and same receipts shares as now, UK's corrected net contribution would rise by less than 100 per cent but still substantially.

(b) UK would bear 43 per cent of any increase in its receipts gap; Germany 74 per cent.

*The receipts gap is defined as the difference between member states' actual receipts from the allocated budget and what their receipts would have been if their share of total expenditure/receipts had been the same as their share of Community GDP.

TABLE 2

GERMAN MODEL : VARIANT 2 (per cent of receipts gap rebated)

ROUGH ESTIMATES BASED ON 1982 FIGURES

Member states with 90 per cent of Community average prosperity would be expected to bear 40 per cent of their receipts gaps, rising to 85 per cent at 128 per cent of Community average prosperity, but the value of the corresponding reliefs would be reduced because member states would have to contribute to their own (and others') reliefs. This system would be combined with the Commission's modulated VAT.

	Uncorrected net contributions and receipts	Expenditure/receipts mechanism			mecu and per cent		
		Gross reliefs	Financing by French key	Net reliefs(+) & financing(-)	Modulated VAT(gains and losses)	Total net gains and losses	Percentage shares in financing net reliefs
	1	2	3	4	5	6	7
B	253		-70	-70	17	-53	4.7
DK	295		-48	-48	-101	-149	13.1
D	-2086	416	-240	176	-13	163	-
GR	685		-31	-31	17	-14	1.2
F	-19	156	-297	-141	-184	-325	28.5
Irl	732		-39	-39	-1	-40	3.5
It	1616		-162	-162	-162	-324	28.4
L	256		-15	-15	7	-8	0.7
N	304		-109	-109	-117	-226	19.8
UK	-2036	616	-177	439	537	976	-

Comments on figures

1. Relative prosperity based on 1982 figures for EC10. Column 4 taken from Commission's recent paper.

2. For 1982, receipts mechanism would have provided gross reliefs of some 600 mecu for UK, some 150 mecu for France and some 400 mecu for Germany.

3. In terms of net outcome, scheme as a whole would have relieved UK of less than half our uncorrected net contribution for 1982.

4. Effects on other member states: shares of Belgium, Greece and France in financing net reliefs for UK and Germany would be held down, but only at expense of very heavy shares for Italy (about the same as for France), Denmark and Netherlands.

5. Dynamic properties:

(a) if allocated budget doubled in real terms, with same distribution of expenditure and same receipts shares as now, UK's corrected net contribution would approximately double too.

(b) UK would bear 56 per cent of any marginal increase in its receipts gap; Germany 85 per cent.

* The receipts gap is defined as the difference between member states' actual receipts from the allocated budget and what their receipts would have been if their share of total expenditure/receipts had been the same as their share of Community GDP.

ANNEXES

A. Chancellor's letter of 27 October to Tietmeyer.

B. German paper for Preparatory Group which Tietmeyer agreed not to circulate.

C. Telegram reporting Chancellor's discussions with Tietmeyer last Monday.

D. Telegram reporting Tietmeyer's discussions with Sir Michael Butler and Mr Edwards on Tuesday.

E. Telegram reporting Mr Ridley's discussions with Tietmeyer in Bonn earlier this month.

F. Description and assessment of German schemes.

ANNEX A

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GRS 990
CONFIDENTIAL
FRAME ECONOMIC
DESKBY 271500Z
FM FCO 271330Z OCTOBER 83
TO IMMEDIATE BONN
TELEGRAM NUMBER 529 OF 27 OCT
RPT IMMEDIATE UKREP BRUSSELS ROUTINE OTHER EC POSTS
LUXEMBOURG TELNO 274 EC FUTURE FINANCING LETTER FROM THE
CHANCELLOR TO TIETMEYER

1 PLEASE DELIVER THIS AFTERNOON THE FOLLOWING LETTER FROM THE CHANCELLOR OF THE EXCHEQUER TO HERR TIETMEYER. SIGNED ORIGINAL WILL FOLLOW. FOLLOWING IS TEXT

BEGINS

'I WAS GLAD TO HAVE THE CHANCE OF DISCUSSING THE FUTURE FINANCING NEGOTIATION WITH YOU ON MONDAY. I AM PARTICULARLY GRATEFUL TO YOU FOR DECIDING TO POSTPONE CIRCULATION OF YOUR PAPER UNTIL THE 2 NOVEMBER MEETING OF THE PREPARATORY GROUP. THIS GIVES US AN OPPORTUNITY TO DISCUSS THESE MATTERS FURTHER TOGETHER, AND I UNDERSTAND FROM MICHAEL BUTLER THAT YOU AND HE HAD A VALUABLE PRELIMINARY DISCUSSION ON TUESDAY EVENING. I WOULD LIKE TO INVITE YOU TO THE TREASURY IN LONDON ON THE AFTERNOON OF MONDAY NEXT 31 OCT FOR FURTHER DISCUSSIONS WITH MYSELF AND WITH MR IAN STEWART, WHO HAS TAKEN OVER NICHOLAS RIDLEY'S EUROPEAN DUTIES. I THOUGHT IT WOULD BE USEFUL TO SET OUT IN THIS LETTER THE MAIN POINTS ON WHICH I WOULD LIKE OUR DISCUSSIONS TO FOCUS.

I CONTINUE TO BELIEVE THAT THE FEDERAL REPUBLIC AND THE UNITED KINGDOM, AS THE TWO MAJOR NET CONTRIBUTOR COUNTRIES HAVE THE STRONGEST POSSIBLE INTEREST IN WORKING TOGETHER ALONG WITH OUR FRENCH COLLEAGUES, FOR A SUCCESSFUL OUTCOME AT ATHENS. IT SEEMS TO ME THAT YOUR PAPER COULD MAKE AN IMPORTANT CONTRIBUTION TO ACHIEVING SUCH AN OUTCOME. IT IS ALL THE MORE IMPORTANT TO ME THEREFORE THAT THE PAPER SHOULD LEAVE THE DOOR OPEN FOR A SOLUTION WHICH THE BRITISH GOVERNMENT COULD ACCEPT IF THE PROPOSALS WERE SUCH THAT WE HAD NO ALTERNATIVE BUT TO REJECT THE

THAT WOULD SET THE NEGOTIATION BACK RATHER THAN CARRY IT FORWARD

THAT BEING SO, I THINK I OUGHT TO LET YOU KNOW ABOUT FOUR POINTS TO WHICH WE ATTACH PARTICULAR IMPORTANCE.

THE FIRST IS THE MEASUREMENT OF THE BURDEN TO BE CORRECTED NOTWITHSTANDING THE CRITICISMS OF IT THE NET BUDGET CONTRIBUTION HAS IN THE END BEEN ACCEPTED BY THE COMMUNITY OVER THE LAST FOUR YEARS AS THE ONLY REASONABLE WAY TO MEASURE THE BUDGETARY BURDEN. I DO NOT RULE OUT THE POSSIBILITY OF MINOR CHANGES OF DEFINITION OR OF A NEW NOMENCLATURE. BUT THE IMBALANCES PROBLEM CONSISTS PRECISELY IN THE FACT THAT OUR OWN RESOURCES CONTRIBUTIONS ARE SO MUCH LARGER THAN OUR RECEIPTS FROM THE BUDGET I HOPE THEREFORE YOU MAY BE WILLING TO INCLUDE IN YOUR EXCELLENT INTRODUCTION A STATEMENT THAT THERE IS A NEED FOR AN OBJECTIVE AGREED AND FULL BURDEN-SHARING INDICATOR AND POSSIBILITY OF BASING THAT INDICATOR ON RELATIVE SHARES IR EXPENDITURE AND OWN RESOURCES (RATHER THAN EXPENDITURE AND GDP). I APPRECIATE YOUR POINT THAT ADOPTIO OF THE COMMISSION'S MODULATED VAT WOULD HELP TO SOLVE OUR EXCESSIVE GROSS CONTRIBUTIONS PROBLEM. BUT IT DOES NOT MEASURE THE EXCESS CONTRIBUTION DIRECTLY AND COULD NOT THEREFORE BE RELIED UPON TO PROVIDE A CONSISTENT SOLUTION TO THAT PART OF THE PROBLEM. MOREOVER THERE MUST BE SERIOUS DOUBTS UNDERLINED BY THE ATTITUDE OF A LARGE NUMBER OF MEMBER STATES IN THE PREPARATORY GROUP, WHETHER THIS PART OF YOUR PROPOSAL WOULD BE NEGOTIABLE.

SECOND, THERE IS THE QUESTION OF THE CORRECTION OR LIMITS FORMULA. I HOPE VERY MUCH THAT YOU WILL FEEL ABLE TO OMIT THE SECOND OF THE TWO VARIANTS MENTIONED IN YOUR ORAL PRESENTATION IN WHICH RELIEFS WOULD BE EXPRESSED AS A PERCENTAGE OF THE MEASURED BURDEN VARYING WITH RELATIVE PROSPERITY. THIS VARIANT CLEARLY CANNOT REFLECT A MEMBER STATE'S ABILITY TO PAY AND THE UK CANNOT ACCEPT AN ARRANGEMENT UNDER WHICH, IF OUR UNCORRECTED BURDEN WERE (SAY) TO DOUBLE, THEN OUR CORRECTED BURDEN WOULD DOUBLE AS WELL. SUCH AN ARRANGEMENT WOULD NOT CONSTITUTE THE EQUITABLE SHARING OF BURDENS WE WOULD NEED IN A LASTING SOLUTIO IF YOU FEEL UNABLE TO DROP THIS VARIANT ALTOGETHER I HOPE YOU

WILL BE PREPARED TO INDICATE A STRONG PREFERENCE FOR YOUR FIRST VARIANT (WHERE A MEMBER STATE'S NET BURDEN AFTER RELIEFS WOULD BE LIMITED TO A SMALL PERCENTAGE OF ITS GDP DEPENDING ON ITS RELATIVE PROSPERITY).

MY THIRD POINT RELATES TO THE GDP-RELATED VARIANT ITSELF I UNDERSTAND YOUR ANXIETY THAT NO MEMBER STATE SHOULD CEASE TO HAVE AN INTEREST IN HOLDING EXPENDITURE DOWN. FOR OUR PART WE CERTAINLY DO NOT NEED A HIGH MARGINAL RATE OF NET CONTRIBUTION TO ACHIEVE THIS PURPOSE. I SEE NO PROSPECT WHATEVER THAT EVEN IF THE UK WAS TO AGREE TO MAKE SOME CONTRIBUTION AT THE MARGIN TO INCREASES IN OUR NET BURDEN IN EXCESS OF OUR GDP-RELATED LIMIT WE COULD ACCEPT A RATE OF MARGINAL CONTRIBUTION ANYWHERE NEAR YOUR SUGGESTION OF ONE-THIRD. THIS AGAIN WOULD NOT CONSTITUTE AN EQUITABLE OR LASTING SOLUTION IN WHICH BUDGETARY BURDENS MUST BE CLOSELY RELATED TO CAPACITY TO PAY. YOUR IDEA THAT THE RATE OF MARGINAL CONTRIBUTION SHOULD RISE WITH RELATIVE PROSPERITY SEEMS TO US A REASONABLE ONE BUT A MORE APPROPRIATE RATE FOR MEMBER STATES WHO ARE CLOSE TO COMMUNITY AVERAGE PROSPERITY WOULD BE ABOUT 5 PERCENT. I APPRECIATE THAT IT WOULD BE DIFFICULT FOR YOU TO SUGGEST DIFFERENT MARGINAL RATES IN YOUR PAPER, BUT WE WOULD HAVE TO OPPOSE ANY SUGGESTION THAT OUR MARGINAL RATE SHOULD BE ONE-THIRD. IT IS CLEAR THAT THIS WILL BE A KEY ELEMENT IN THE NEGOTIATIONS. I HOPE VERY MUCH THEREFORE THAT YOU WILL NOT MENTION SPECIFIC RATES IN YOUR PAPER.

MY FINAL POINT IS THAT I AM TROUBLED BY THE POSSIBILITY WHIC SEEMS TO BE ENVISAGED IN YOUR PROPOSAL THAT COUNTRIES ENTITLED TO RELIEF MIGHT HAVE TO CONTRIBUTE TO THEIR OWN RELIEFS (AND THOSE OF OTHERS). THIS WOULD SUBSTANTIALLY REDUCE THE REAL VALUE OF THE RELIEFS, ESPECIALLY IF TWO OR MORE COUNTRIES WERE RECEIVING RELIEF AND I CANNOT SEE ANY JUSTIFICATION FOR IT I HOPE THAT IN YOUR WRITTEN PROPOSALS YOU WOULD MAKE IT CLEAR THA MEMBER STATES SHOULD NOT CONTRIBUTE TO THEIR OWN RELIEFS.

I HOPE VERY MUCH THAT WE CAN MEET NEXT MONDAY AND I LOOK FORWARD TO DISCUSSING THESE MATTERS WITH YOU THEN.'

ENDS

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FRAME ECONOMIC

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ANNEX B

Financing the Community: Securing equitable financial conditions for all Member States.

Note from the German delegation

1. According to the statement made by the European Council in Stuttgart on 18.6.1983, the problems of certain Member States in regard to the budget form part of a package of questions which should ultimately be decided together.

The negotiations that have meanwhile begun have the aim, according to the European Council's statement, of arriving at a more balanced and equitable situation, in financial matters also, from the standpoint of the interests of the individual Member States and the Community as a whole.

According to the guidelines for these negotiations laid down by the European Council, the aim is to agree on measures which, taken as a whole, will avoid the constantly recurring problems between Member States on the financial consequences of the Community budget and its financing. All suitable ways and means of achieving this were examined, especially the proposals of the Commission and the ideas of certain Member States on securing equitable financial conditions for all Member States.

2. General application

It is generally recognised in the Community that the distribution of the /financial/ burdens among the Member States, which arises from the financial consequences of the EC budget, is unbalanced. Ad hoc measures taken up to now have been merely temporary solutions with obvious disadvantages. In terms of integration policy and financial policy it is now high time that an arrangement be made, in connection with the reorganisation of Community finances, which will provide a permanent solution to the problem for all Member States.

An arrangement of this kind will have to be sufficiently flexible in view of its objectives: on the one hand, it is necessary to create a mechanism to correct burdens on a Member State which are considered unreasonable; on the other hand, this mechanism should at the same time give a certain security, in the form of an upper limit, against any Member State bearing an excessively one-sided burden. Both objectives fall within the well-understood interests of the Community. An arrangement of this kind should become an integral part of the future system of own resources. It must bear the future development of the Community sufficiently in mind and for this reason the upper limit should not be fixed. In calculating the upper limit, distinctions will have to be drawn according to Member States' economic productivity.

3. Possible elements of a "system of Community balance"

In view of the factor of constant budgetary imbalances, a single instrument to alleviate the situation does not appear to be sufficient on its own. A solution will therefore have to be sought through a combination of two instruments which - going on past experience - should apply to the revenue side /of the budget/. Such an arrangement would allow the expenditure side of the EC budget to be kept free for genuine Community policies.

a) An appropriate component part in an overall solution would appear to be the idea put forward by the Commission for an agricultural "modulator" which, as it would be applied degressively, could at the same time introduce an element of flexibility into a combined solution. The agricultural "modulator" is necessary to an overall solution, but not sufficient.

b) As the second element in an overall solution, an arrangement concerning upper limits could be considered, with the following features:, as proposed by the Danish delegation, the difference between a Member State's percentage share in payments from the EC budget and its percentage share in the EC GDP could serve as a suitable criterion of the /financial/ burden /on that State/. The proportion of Community budget expenditure flowing back to the Member States (allocated expenditure) should also be taken into account in this formula.

It seems appropriate to allocate only a certain percentage of the administrative expenditure to the Member States in which the Community institutions are situated. The remainder of the administrative expenditure could be distributed among all the Member States in accordance with their shares in the EC GDP.

In the event of a Member State's share in the return flow being less than its share in the EC GDP (a negative balance), an upper limit would be set on the level of the negative balance, along hte lines of the British delegation's proposal. The upper limit would be defined as the percentage of that negative balance which is the best and most appropriate for a Member State, in keeping with the sum of its per capita GDP as a percentage of the EC average, from the point of view of a balanced distributi of the /financial/ burdens among all the Member States. This upper limit could be designed to increase linearly with increasing per capita GDP as a percentage of the EC average, up to a final limit to be determined.

The Member State concerned would be relieved of its burden on the revenue side /of the budget/ to the amount of the negative balance lying beyond the upper limit; the amount of that relief would be the product of the negative balance falling beyond the upper limit as a percentage and the allocated expenditure in the EC budget.

c) The loss in revenue that would result from such relief could be made up by all the Member States net for net on the revenue side of the EC budget in the following year. In this connection, a modified VAT deduction key taking into account the return flow position and the relative prosperity of Member States, more or less as proposed by the French delegation, appears to be worth considering.

4. The attached diagram may serve to make clear the German delegation's ideas. The figures given in that diagram are hypothetical and given purely by way of illustration.

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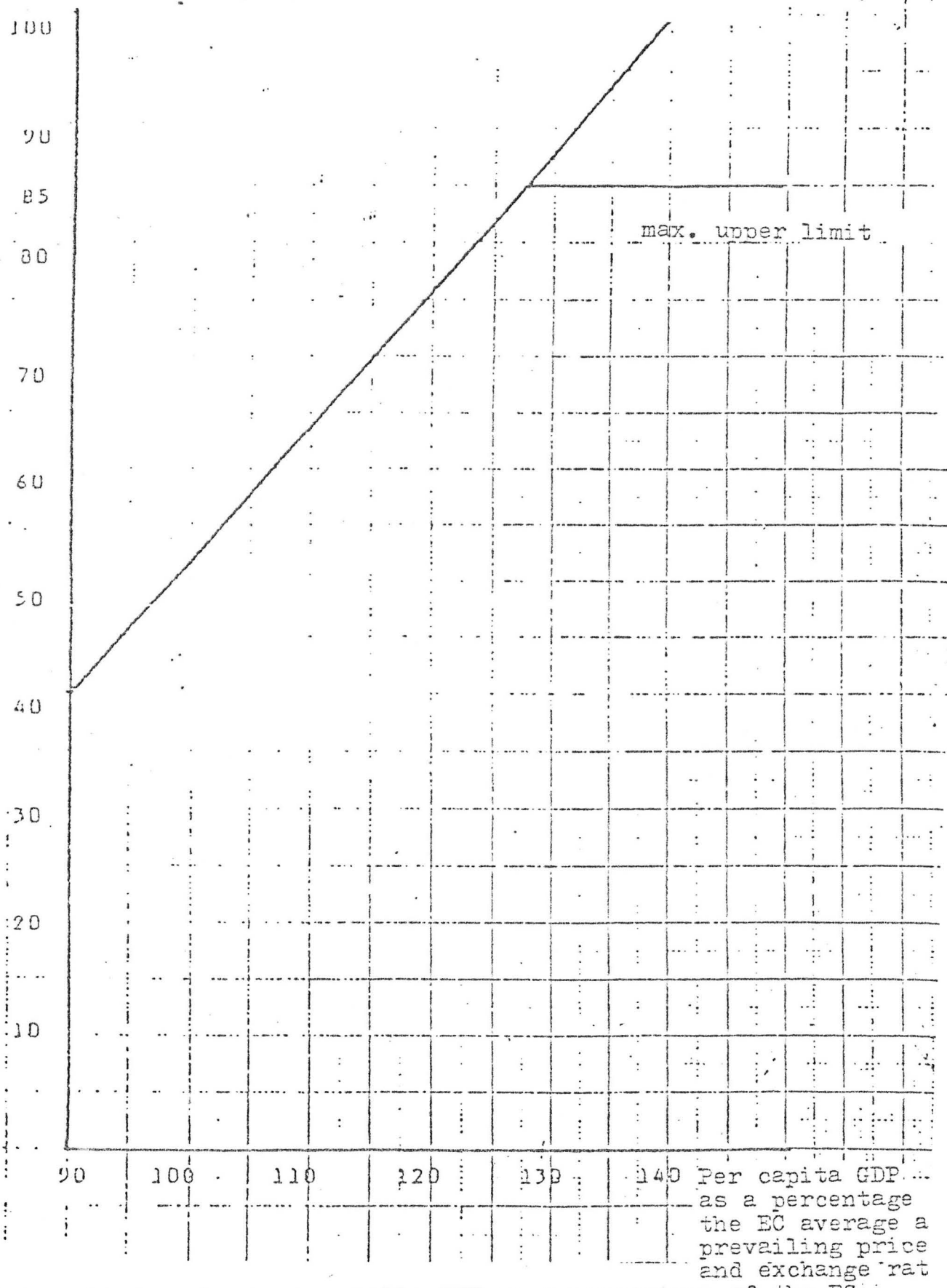
Hypothetical suggested model for the Community of Ten

Upper limit in % applied to the negative balance between GDP and % share in return flow.



Model: Member States whose per capita GDP as a percentage of the EC average is higher than 90 will have an upper limit of 40% + 1.2% for every percentage point by which their per capita GDP exceeds 90% of the EC average; the maximum upper limit is 85%; the percentage of the upper limit is applied to the negative balance between the percentage share of GDP and the share in return flow as a percentage of allocated expenditu

Wire Dept.

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Budget Cont.

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FM LUXEMBOURG 241521Z OCT 83
TO FLASH FCO
TELEGRAM NUMBER 253 OF 24 OCTOBER
INFO FLASH BONN
INFO PRIORITY OTHER EC POSTS AND UKDEL STRASBOURG

ANNEX C

FM UKREP BRUSSELS

GERMAN PAPER FOR PREPARATORY GROUP : CONVERSATION BETWEEN CHANCELLOR OF THE EXCHEQUER AND TIETMEYER

1. CHANCELLOR SPOKE TO TIETMEYER AND SCHMITT AT LUNCHTIME ABOUT GERMAN PAPER FOR PREPARATORY GROUP (SEE MIPT). COPY OF PAPER IN GERMAN TO LONDON THIS AFTERNOON BY HAND OF INGHAM.

2. CHANCELLOR TOLD TIETMEYER THAT IDEAS IN GERMAN PAPER WERE UNACCEPTABLE TO UK. THEY WOULD INVOLVE ABANDONING NET CONTRIBUTIONS CONCEPT AT TIME WHEN SIGNS WERE THAT FRENCH AND OTHERS MIGHT BE MOVING IN OUR DIRECTION. THEY WOULD NOT PROVIDE DEGREE OF PROTECTION WHICH UK AT ANY RATE WOULD NEED AS PART OF OVERALL AGREEMENT. IF RECEIPTS ELEMENT IN OUR UNCORRECTED NET CONTRIBUTION WERE (SAY) TO DOUBLE, THAT ELEMENT IN OUR CORRECTED NET CONTRIBUTION WOULD DOUBLE AS WELL. ANOTHER BAD FEATURE WAS THAT MEMBER STATES WOULD HAVE TO CONTRIBUTE TO THEIR OWN RELIEFS. IT WAS SURELY MUCH TOO EARLY IN ANY EVENT, AS A MATTER OF TACTICS, TO BE MAKING SUCH CONCESSIONS. CHANCELLOR ASKED TIETMEYER ACCORDINGLY NOT TO TABLE PAPER IN ITS PRESENT FORM BUT TO PROVIDE COPY OF DRAFT AND HAVE FURTHER BILATERAL CONSULTATIONS WITH US BEFORE TABLING ANYTHING. TABLING PAPER NOW WOULD BE VERY SERIOUS STEP, WHICH WOULD SET BACK THE NEGOTIATION BADLY AND LARGELY REMOVE CHANCES OF PROGRESS AT ATHENS.

3. TIETMEYER PROMISED TO REPORT WHAT CHANCELLOR HAD SAID TO STOLTENBERG, WHOM HE WAS DUE TO SEE AT 8 AM TOMORROW (TUESDAY). HE WARNED HOWEVER THAT STOLTENBERG HAD UNDERTAKEN TO GENSCHER THAT HE WOULD TABLE THIS PAPER.

FCO ADVANCE TO:
FCO : PS HANNAY WALL
CAB : WILLIAMSON DURIE
MAFF: ANDREWS
TSY : PS/CHANCELLOR UNWIN FINTCHEN

UKREP DIST : ECON/FINANCE

(ADVANCED AS REQUESTED)

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ANNEX D

FM LUXEMBOURG 261445Z OCT 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 287 OF 26 OCTOBER
INFO IMMEDIATE PARIS, BONN
INFO OTHER EC POSTS AND UKDEL STRASBOURG

EC FUTURE FINANCING : TALKS WITH GERMANS, 25 OCTOBER

1. OVER DINNER LAST NIGHT, EDWARDS AND I HAD A LONG DISCUSSION WITH LAUTENSCHLAGER, TIETMEYER AND SCHMITT ABOUT FUTURE FINANCING AND THE GERMAN PROPOSALS. TIETMEYER SAID THAT GERMANY WAS COMMITTED TO CIRCULATING A PAPER BEFORE THE 2 NOVEMBER PREPARATORY GROUP MEETING AND AGREED THAT THERE SHOULD BE FURTHER BILATERAL DISCUSSIONS WITH THE UK BEFORE THEN (SEE BELOW).

2. IT WAS CLEAR FROM THE DISCUSSION THAT TIETMEYER IS IN THE LEAD ON FUTURE FINANCING IN BONN: THE LATEST GERMAN POSITION SEEMS TO BE LARGELY TIETMEYER'S OWN CREATION. LAUTENSCHLAGER CONTRIBUTED LITTLE TO THE DISCUSSION AND LET TIETMEYER MAKE ALL THE RUNNING.

3. ON SUBSTANCE, TIETMEYER VIGOROUSLY DEFENDED THE GERMAN POSITION. HE WAS CONVINCED ON THE BASIS OF FRANCO-GERMAN TALKS THAT THE FRENCH WOULD NEVER ACCEPT A SOLUTION BASED ON NET CONTRIBUTIONS, AND THE GERMAN IDEAS HAD BEEN FRAMED ACCORDINGLY. GERMANY'S AIMS IN THE NEGOTIATION WERE NOT THE SAME AS THE UK'S. THEIR PRINCIPAL CONCERN WAS NOT TO HAVE AN ABSOLUTE OR RIGID UPPER LIMIT ON THE GERMAN NET CONTRIBUTION, BUT TO PRODUCE A NEW SET OF ARRANGEMENTS WHICH WOULD GIVE SOME OTHER MEMBER STATES, AS WELL AS GERMANY AND THE UK (PARTICULARLY FRANCE) A FINANCIAL INCENTIVE TO CONTROL EXPENDITURE. TIETMEYER THOUGHT THAT GERMANY'S LATEST IDEAS OUGHT ALSO TO COVER UK'S INTERESTS ADEQUATELY. ALTHOUGH FORMALLY THE NET CONTRIBUTIONS CONCEPT DID NOT APPEAR, ACCEPTANCE OF THE COMMISSION'S PROPOSAL FOR MODULATED VAT SHOULD TAKE CARE OF THE UK'S PROBLEM OF EXCESSIVE GROSS CONTRIBUTIONS (IT DID NOTHING FOR GERMANY), AND EXPENDITURE MECHANISM SHOULD TAKE CARE OF OUR DEFICIENCY OF RECEIPTS FROM THE COMMUNITY BUDGET. TIETMEYER EMPHASISED THE CRUCIAL IMPORTANCE OF KEEPING THE INCREASE IN THE OWN RESOURCES LIMIT AS LOW AS POSSIBLE AND NOT ALLOWING IT TO TAKE EFFECT UNTIL 1986 OR 1987.

4. I EXPRESSED REGRET THAT THE GERMAN PROPOSALS ABANDONED THE NET CONTRIBUTIONS CONCEPT IN FAVOUR OF THE DANISH MEASUREMENT, BASED ON GDP AND RECEIPTS SHARES. WE DID NOT ACCEPT THAT THE ADDITION OF MODULATED VAT, WHICH MANY MEMBER STATES DISLIKED, GAVE THE SYSTEM THE EFFECT OF A NET CONTRIBUTIONS SYSTEM. OUR IMPRESSION (WHICH TIETMEYER DISPUTED) WAS THAT THE FRENCH WOULD NOT IN THE LAST ANALYSIS PRESS THEIR OBJECTIONS TO NET CONTRIBUTIONS OR A BUDGETARY INDICATOR CLOSELY RELATED TO NET CONTRIBUTION. IF THE GERMAN IDEA WAS AMENDED TO APPLY TO THE DIFFERENCE BETWEEN RECEIPTS AND OWN RESOURCES SHARES, THAT WOULD MEET THE UK'S CONCERN.

/5.

5. I THANKED TIETMEYER FOR ADDING TO THE EARLIER GERMAN IDEAS A VARIANT BASED ON SETTING A GDP-RELATED LIMIT AND URGED THEM TO INCLUDE THIS VARIAN IN THE FORTHCOMING GERMAN PAPER. I EXPRESSED CONCERN, HOWEVER, AT THE GERMANS' PROPOSED RATE OF SURCHARGE ON EXCESSES IN THE EXPENDITURE GAP OVER THIS LIMIT - ONE THIRD FOR COUNTRIES BELOW 120 PER CENT OF COMMUNITY AVERAGE PROSPERITY AND TWO THIRDS FOR MORE PROSPEROUS COUNTRIES. I SAID I COULD NOT SEE HOW BRITISH GOVT COULD POSSIBLY ACCEPT SUCH A HIGH RATE OF MARGINAL CONTRIBUTION ON AMOUNTS IN EXCESS OF THE LIMIT. WITH MARGINAL RATES ENVISAGED BY GERMANS, I DOUBTED VERY MUCH WHETHER THERE WOULD BE ANY DECISIVE IMPACT ON THE FINANCIAL INCENTIVES OF OTHER MEMBER STATES AND THEIR ATTITUDES TO CONTROLLING EXPENDITURE. THE NET BENEFICIARIES, INCLUDING SPAIN AND PORTUGAL, WOULD CONTINUE TO DEMAND BIG INCREASES IN COMMUNITY EXPENDITURE AND WOULD ACCUSE BRITAIN, FRANCE AND GERMANY OF BEING UNCOMMUNAUTAIRE IF WE REFUSED IT. BRITISH MINISTERS MIGHT JUST POSSIBLY BE PERSUADED TO CONSIDER SYMPATHETICALLY THE IDEA OF MAKING A SMALL CONTRIBUTION AT MARGIN TO INCREASES IN OUR UNCORRECTED POSITION OVER THE LIMIT - PERHAPS 5 PER CENT FOR THOSE CLOSE TO AVERAGE PROSPERITY, RISING TO A HIGHER PERCENTAGE FOR THE MOST PROSPEROUS COUNTRIES: BUT A MARGINAL RATE OF ONE THIRD WAS OUT OF THE QUESTION. I URGED TIETMEYER ACCORDINGLY NOT TO MENTION THE ONE THIRD AND TWO THIRDS FIGURES IN THEIR PAPER AT THIS STAGE. UK WOULD BE BOUND TO OPPOSE THIS, AND GERMAN SUGGESTION COULD BE INTERPRETED AS THEIR OPENING POSITION. FURTHERMORE, SINCE THE UK WOULD CERTAINLY NOT ACCEPT THE PERCENTAGES PROPOSED FOR THE UK, GERMANY WOULD HAVE EXPOSED ITSELF TO BEARING AN ENORMOUS SHARE OF ANY INCREASE IN THE NET BENEFITS OF THE NET BENIFICIARIES. NATURALLY THE UK WOULD HAVE NO OBJECTION AT THE END OF THE DAY IF THE GERMANS WANTED TO BEAR SUCH A BURDEN. BUT THEY SHOULD SURELY HOLD BACK UNTIL THE NEGOTIATING CRUNCH CAME.

6. WE LEFT WITH SCHMITT SOME ROUGH CALCULATIONS OF HOW GERMANS' ORIGINAL SCHEME WOULD AFFECT UK AND OTHER MEMBER STATES, WITH ACCOMPANYING COMMENTS.

7. ON MCA'S, TIETMEYER UNDERLINED IMPORTANCE OF SOLVING THE PRESENT PROBLEM. HE HAD THE IMPRESSION THAT THE UK HAD BACKED THE COMMISSION PROPOSALS AND EXPRESSED REGRET AT THIS. I TRIED TO PUT THE RECORD STRAIGHT BUT TIETMEYER (AND LAUTENSCHLAGER) CONTINUED TO COMPLAIN THAT WE HAD PUT THEM IN A NINE TO ONE SITUATION. IT WOULD BE USEFUL TO RETURN TO THIS SUBJECT WITH HIM.

8. ON THE STRICT FINANCIAL GUIDELINE, TIETMEYER REGRETTED THAT GERMANY HAD NOT TAKEN A STRONGER LINE BUT POINTED OUT THAT FINANCE MINISTRY HAD TO RESPECT VIEWS OF FEDERAL CHANCELLOR AND MINISTER OF AGRICULTURE.

/9.

3. ON NEXT STEPS, TIETMEYER SAID HE WOULD BE WILLING TO HAVE FURTHER DISCUSSIONS WITH US EITHER THIS SATURDAY OR (PREFERABLY) ON MONDAY AFTERNOON. STOLTENBERG WOULD BE IN BDP FOR NEXT FEW DAYS. I RECOMMEND THAT CHANCELLOR OF EXCHEQUER (IF HE IS WILLING) SHOULD SEND MESSAGE TO TIETMEYER TOMORROW, SETTING OUT UK'S VIEWS ON ABOVE LINES AND INVITING HIM FOR TALKS IN LONDON ON MONDAY AFTERNOON. WE WILL SEND DRAFT MESSAGE THIS AFTERNOON. OFFICIALS SHOULD ALSO LOBBY GERMAN OFFICIALS VISITING ON MONDAY FOR ANGLO-GERMAN ECONOMIC COMMITTEE.

FCO ADVANCE TO:

FCO : HANNAY WALL
CAB : WILLIAMSON STAPLETON DURIE
TSY : PS/CHANCELLOR UNWIN FITCHEW

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ANNEX E

DESKBY 071100Z

FM BONN 070950Z OCT 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 903 OF 7 OCTOBER

INFO IMMEDIATE UKREP BRUSSELS PARIS ATHENS

INFO SAVING EMBASSY BRUSSELS COPENHAGEN DUBLIN LUXEMBOURG ROME THE HAGUE

POST STUTTGART NEGOTIATION: ANGLO/GERMAN CONSULTATIONS

SUMMARY

1. FINANCIAL SECRETARY TO THE TREASURY HAD USEFUL DISCUSSIONS WITH TIETMEYER, STATE SECRETARY IN GERMAN FINANCE MINISTRY, YESTERDAY AFTERNOON. TIETMEYER REPEATED GERMAN CONCERNS ABOUT UK'S VERSION OF SAFETY NET, BUT SAID THAT GERMANS WERE NOT WEDDED TO THEIR VERSION AND WOULD STUDY ALTERNATIVE WAY OF MEETING GERMAN CONCERNS DISCUSSED BETWEEN SCHMITT AND EDWARDS TWO WEEKS AGO, IN HOPE OF REACHING COMMON POSITION WITH US AS SOON AS POSSIBLE. SCHMITT SAID AFTERWARDS THAT GERMANS DID NOT INTEND TO ADD AT ATHENS SPECIAL COUNCIL TO WHAT TIETMEYER HAD ALREADY SAID IN BRUSSELS. ON MCAS, TIETMEYER SAID GERMANS COULD NOT ACCEPT COMMISSION'S PROPOSALS BUT WERE NOT WEDDED TO THEIR OWN PROPOSALS EITHER AND WOULD BE READY TO DISCUSS OTHER POSSIBILITIES. GERMANS COULD NOT GO ALONG WITH UK IDEAS FOR STRICT FINANCIAL GUIDELINE BUT WERE WORKING UP IDEAS OF THEIR OWN WHICH WENT WELL BEYOND COMMISSION'S LATEST PROPOSALS.

DETAIL

2. FST EXPLAINED THAT UK WAS CONCERNED TO OPEN WAY FOR COMMUNITY TO PROGRESS AND DEVELOP NEW POLICIES. GERMAN AND BRITISH INTERESTS COINCIDED CLOSELY, EVEN IF NOT FULLY. IT WAS MOST IMPORTANT THAT THE UK AND GERMANY SHOULD STICK TOGETHER IN THE NEGOTIATIONS. BUT IT WAS VITAL FOR THE UK TO SECURE THE TWIN OBJECTIVES OF REMOVING BUDGETARY IMBALANCES AND ACHIEVING EFFECTIVE DISCIPLINE ON AGRICULTURAL EXPENDITURE. THE SCOPE FOR COMPROMISE IN THESE AREAS WAS NECESSARILY LIMITED.

3. TIETMEYER SAID THAT IF OWN RESOURCES WERE TO BE INCREASED, THE INCREASE SHOULD NOT BECOME OPERATIVE BEFORE 1987, IN CONTEXT OF ENLARGEMENT. THAT MEANT THAT FOR THE NEXT THREE YEARS IT WAS ESSENTIAL FOR THE COMMUNITY TO STAY WITHIN ITS OWN RESOURCES. THEY WANTED NEW POLICIES TO BE DEVELOPED, BUT NOT NECESSARILY ONES THAT COST NEW MONEY. BUT THEY ACCEPTED THAT SOME REALLOCATION OF FUNDS FROM EXISTING POLICIES WOULD BE NECESSARY, HENCE THEIR INSISTENCE ON THE NEED FOR ECONOMIES. HOWEVER, GERMAN AGREEMENT TO AN INCREASE IN OWN RESOURCES COULD ONLY BE GIVEN IF TWO CONDITIONS WERE SATISFIED:

/(A)

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(A) A LIMIT WOULD HAVE TO BE IMPOSED ON THE RATE OF INCREASE OF THE FRG'S NET CONTRIBUTION

AND (B) THE FRG WOULD NOT CONSENT TO BE THE ONLY NET CONTRIBUTOR.

THEY DID NOT WANT TO BE IN THE POSITION OF HAVING TO VETO NEW POLICIES. THE CHANCELLOR WAS NOT READY TO INCREASE OWN RESOURCES FOR THE EXISTING COMMUNITY BUT WOULD DO SO FOR A ''REBUILT AND ENLARGED'' COMMUNITY. IT WAS BAD FINANCIALLY AND POLITICALLY FOR THERE TO BE ONLY ONE OR TWO NET CONTRIBUTORS.

4. ON MODULATED VAT, THETMEYER SAID THAT GERMAN GOVERNMENT FAVOURED THE COMMISSION'S PROPOSAL BUT WOULD PREFER TO BASE THE NEW OWN RESOURCE ON AGRICULTURAL PRODUCTION ALONE, IE TO EXCLUDE THE NET OPERATING SURPLUS. THE DANISH IDEAS WOULD NOT SOLVE THE PROBLEM AND WERE UNACCEPTABLE. THE GERMAN GOVERNMENT COULD NOT ACCEPT A COMBINATION OF MODULATED VAT AND THE DANISH IDEAS EITHER.

SAFETY NET

5. ON THE SAFETY NET, THETMEYER SAID THAT THE GERMANS HAD GREAT SYMPATHY WITH OUR PROPOSAL. IT HAD, HOWEVER, ENCOUNTERED SEVERE CRITICISM FROM SEVEN OR EIGHT MEMBER STATES, AND THEY DOUBTED WHETHER ABSOLUTE LIMITS ON NET CONTRIBUTIONS WOULD BE NEGOTIABLE. FROM A FINANCIAL POINT OF VIEW, THE UK SYSTEM WOULD BE FIRST RATE. FROM A NEGOTIATING POINT OF VIEW, MORE FLEXIBILITY WOULD BE NEEDED. THE ARRANGEMENT SHOULD BE SENSITIVE TO THE GROWTH OF COMMUNITY SPENDING AND NET TRANSFERS. UNDER UK'S SYSTEM A COUNTRY PROTECTED BY ITS LIMIT WOULD HAVE LITTLE INCENTIVE TO CONTROL INCREASE OF COMMUNITY EXPENDITURE. THE GERMAN GOVERNMENT DID NOT LIKE THIS FEATURE. HERR KOHL AND HERR GENSCHER WOULD BOTH BE CONCERNED THAT NEW FINANCIAL ARRANGEMENTS SHOULD DE COMPATIBLE WITH A DEVELOPING COMMUNITY, WHICH THE GERMANS WANTED.

6. THE FINANCIAL SECRETARY SAID HE UNDERSTOOD GERMAN CONCERNS. BUT WE MUST NOT BE DETERRED BY THE OPPOSITION EXPRESSED BY OTHER MEMBER STATES: THIS WAS ONLY TO BE EXPECTED. THE GERMAN VARIANT OF THE SAFETY NET HAD THE DRAWBACK THAT IT WOULD NOT GIVE SUFFICIENT PROTECTION TO NET CONTRIBUTOR COUNTRIES AGAINST A SUBSTANTIAL WORSENING IN THEIR UNCORRECTED NET CONTRIBUTIONS. IF UNCORRECTED NET CONTRIBUTIONS WERE TO DOUBLE, THEN CORRECTED NET CONTRIBUTIONS WOULD DOUBLE AS WELL. THE GERMAN SYSTEM, BEING BASED ON THE LEVEL OF UNCORRECTED NET TRANSFERS, DID NOT MEASURE ABILITY TO PAY. WOULD IT NOT BE MORE PROFITABLE TO EXPLORE OTHER WAYS OF MEETING GERMAN CONCERNS WITHOUT REDUCING SO DRASTICALLY THE PROTECTION WHICH THE SAFETY NET LIMITS WOULD PROVIDE? SCHMITT AND EDWARDS HAD ALREADY DISCUSSED ONE POSSIBILITY IN THIS AREA. THE FINANCIAL SECRETARY HANDED OVER AN ILLUSTRATIVE TABLE.

7. THETMEYER SAID GERMAN GOVERNMENT HAD NOT REACHED FIRM VIEW ON FORM WHICH SAFETY NET SHOULD TAKE. THE ALTERNATIVE APRROACH WHICH THE FINANCIAL SECRETARY HAD SUGGESTED SOUNDED INTERESTING, AND HE WOULD STUDY IT CAREFULLY. THE GERMAN GOVERNMENT DID NOT HAVE IT IN MIND TO PUT FORWARD PROPOSALS IN THE NEAR FUTURE BUT MIGHT POSSIBLY DO SO AT END OF OCTOBER.

/8.

8. THE FINANCIAL SECRETARY WELCOMED TIETMEYER'S WILLINGNESS TO LOOK AT OTHER WAYS OF MEETING THE GERMAN CONCERNS AND EXPRESSED HOPE THAT GERMANY AND UK COULD FIND AGREED WAY FORWARD BEFORE GERMANS FLOATED ANY NEW PROPOSALS PUBLICLY. TIETMEYER AGREED.

9. TIETMEYER SAID IT WOULD BE NECESSARY TO FIND A SOLUTION WHICH FRENCH TOO COULD ACCEPT. HE THOUGHT THE KEY TO THIS LAY IN GOING SOME WAY TO MEET FRENCH CONCERNS ABOUT DEFINITION OF NET CONTRIBUTIONS. TRILATERAL DISCUSSIONS WITH THE FRENCH WOULD BE USEFUL.

10. THE FINANCIAL SECREATARY AGREED ON IMPORTANCE OF BRINGING FRENCH ALONG. IT MIGHT BE USEFUL TO HAVE DISCUSSIONS WITH THEM AS SOON AS FRG AND THE UK HAD SORTED OUT THEIR OWN IDEAS. THERE WAS ONE CONCESSION ON DEFINITION OF NET CONTRIBUTIONS WHICH MIGHT BE CONTEMPLATED: VIZ SCORING ADMINISTRATIVE EXPENDITURE AT ONLY 50 PER CENT OF ITS ACTUAL AMOUNT. THIS SHOULD NOT, HOWEVER, BE CONCEDED UNTIL A MUCH LATER STAGE. THE OTHER CHANGES SUGGESTED BY FRENCH WOULD NOT BE ACCEPTABLE TO THE UK. FRENCH IDEA FOR REALLOCATING AGRICULTURAL RECEIPTS, IN PARTICULAR, WAS NOT ACCEPTABLE. IT WAS MAINLY BY THIS MEANS THAT THE FRENCH SUCCEED IN REDUCING THE UK'S NET CONTRIBUTION FIGURE BY ONE HALF. THE KEY AREAS FOR FINDING A (NEXT WORD UNDERLINED) RAPPROCHMENT WITH FRENCH WERE LIKELY TO BE THE FINANCING OF SAFETY NET RELIEFS AND THE PERCENTAGE RATE OF PROTECTION FOR NET CONTRIBUTOR COUNTRIES BEYOND THEIR LIMITS. TIETMEYER SEEMS TO ACCEPT THESE COMMENTS.

11. ON MCAS TIETMEYER STRESSED IMPORTANCE FOR GERMANY TO FINDING A SOLUTION WHICH DID NOT INVOLVE REDUCTIONS IN NOMINAL PRICES RECEIVED BY GERMAN FARMERS. GERMAN GOVERNMENT COULD NOT ACCEPT REDUCTIONS IN INCOME FOR GERMAN FARMERS IF FARMERS ELSEWHERE IN COMMUNITY, PARTICULARLY MEDITERRANEAN PRODUCERS, WERE ENJOYING INCREASES IN THEIR INCOMES. THEY HOPED THAT THEIR PROPOSED ARRANGEMENT ON MCAS WOULD ENABLE ANNUAL PRICE INCREASES TO BE LOWER THAN THEY WOULD OTHERWISE HAVE BEEN.

12. THE FINANCIAL SECRETARY SAID THAT THE GERMAN GOVERNMENT KNEW OF THE DIFFICULTIES THE GERMAN PROPOSAL CAUSED FOR UK GOVERNMENT. IN OUR VIEW IT WAS LIKELY TO LEAD TO HIGHER SUPPORT PRICES AND HIGHER BUDGETARY EXPENDITURE. THE FINANCIAL SECRETARY HANDED OVER THE NOTE BY MAFF, SHOWING ESTIMATED BUDGETARY EFFECTS. THERE COULD BE NO CERTAINTY OF ACTUALLY ACHIEVING THE COMPENSATING REDUCTIONS IN THE GENERAL PRICE LEVEL.

13. TIETMEYER SAID THAT GERMAN GOVERNMENT WERE NOT WEDDED TO THEIR PRECISE IDEAS AND WOULD BE READY TO LOOK AT OTHER POSSIBILITIES. BUT COMMISSION'S IDEAS WERE UNACCEPTABLE. SOLUTION TO THIS PROBLEM WOULD FORM KEY ELEMENT IN PACKAGE.

14. ON STRICT FINANCIAL GUIDELINE TIETMEYER SAID THAT FRG COULD NOT GO ALONG WITH UK'S PROPOSAL. THEY COULD ACCEPT THE COMMISSION'S PROPOSAL. BUT IT DID NOT GO FAR ENOUGH. HE THEN OUTLINED FINANCE MINISTRY'S IDEAS IN SAME TERMS AS HECK IN LONDON LAST WEEK.

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HE ADDED THAT FINANCE MINISTRY WERE ALSO CONSIDERING THE IDEA THAT, AS IN NATIONAL ADMINISTRATIONS, ALL DECISIONS BY THE COMMUNITY'S POLICY COUNCILS WHICH INVOLVE SPENDING MONEY WOULD HAVE TO BE CONSIDERED ALSO, OR POSSIBLY APPROVED BY THE BUDGET COUNCIL OR POSSIBLY ECOFIN. THE FINANCIAL SECRETARY SAID WE WOULD BE GLAD TO THINK ABOUT THIS IDEA.

15. TIETMEYER AGREED THAT IT WAS IMPORTANT FOR THE TWO FINANCE MINISTRIES TO KEEP IN CLOSE TOUCH. HE ACCEPTED THE FINANCIAL SECRETARY'S POINT THAT WE OUGHT TO SEE IF WE COULD REACH AGREEMENT ON FORM OF SAFETY NET, POSSIBLY ON LINES DISCUSSED EARLER IN MEETING, BEFORE HAVING TRILATERAL DISCUSSIONS WITH FRENCH. THIS SHOULD BE DONE QUICKLY. TIETMEYER ACCEPTED THE FINANCIAL SECREATARY'S POINT THAT THE TWO GOVERNMENTS SHOULD CONSULT EACH OTHER BEFORE MAKING NEW PROPOSALS OR OFFERING NEW CONCESSIONS IN THE FUTURE FINANCING NEGOTIATIONS. SCHMITT SAID AFTERWARDS THAT GERMAN GOVERNMENT WERE VERY UNLIKELY TO ADD AT ATHENS SPECIAL COUNCIL TO WHAT TIETMEYER HAD ALREADY SAID IN BRUSSELS.

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ANDREWS, ATTRIDGE: MAFF.

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ANNEX F

GERMAN PROPOSALS FOR FUTURE FINANCING AND REFUNDS

This note sets out a preliminary assessment of the German ideas presented on 24 and 25 October. The main elements of the German's proposals appear to be

(a) the Commission's modulated VAT proposals under which part of VAT own resources would be revised on the basis of a special key reflecting shares in Community agricultural production and "net operating surplus", modified to take some account of relative prosperity;

(b) some modifications to the allocation of budget receipts between member countries;

(c) a receipts gap mechanism for refunds. The Germans are considering two schemes where refunds are based on a country's "receipts gap" (ie the shortfall between its actual receipts from the allocated budget and what those refunds would have been had the country's share of budget receipts been the same as its share of Community GDP). At present only three countries have such a receipts gap: the UK, Germany and France;

Variant 1 - the formula from the UK's safety-net proposal would be applied to set a limit for the receipts gap. Up to this limit a country would have to bear the entire burden of the shortfall of receipts. Above it, the country would be entitled to a refund of two-thirds of the excess amount if its per capita GDP was below 120% of the Community average, and one third if per capita GDP is above 120%.

Variant 2 - the proportion of any receipts gap refunded in this case would be a function of relative prosperity.

(d) refunds would be deducted from contributions the following year, but would appear to be a gross rather than net amount;

(e) financing these refunds could be on the basis of a special key which took account of relative prosperity and the gap between receipts and GDP shares.

Modulated VAT

2. Our previous analysis and the Commission's recent figuring on the effects of their proposal for a modulated VAT key suggest that it would have reduced the UK's net contribution by about a quarter over the years 1980 to 1982 if it had been used to substitute for normal VAT. However, if its introduction were part of an overall increase in own resources, the gain for the UK would depend on how the Communities spent their additional funds. For 1982, the Commission estimate that the modulated VAT key would have reduced the UK's uncorrected net contribution by about 540 million ecus and we have used this figure in the present note. It is still, however, a forecast figure as outturn data for agricultural production and net operating surplus are not yet available.

Allocation of administrative expenditure

3. The reallocation of the 948 mecu of administrative expenditure included in the 1982 allocated Budget that the Germans propose would increase the UK's receipts by about 95 mecu. Our receipts gap - the proposed basis for correction - would be reduced by the same amount. Allocating half of administrative expenditure between countries on the basis of GDP shares would increase the receipts of France and Germany by similar amounts (ie around 100 mecu); and reduce the receipts of Belgium and Luxembourg by some 250 mecu and 150 mecu respectively. We assume here that the Germans envisage no other changes to the present Commission methodology for calculating receipts from the allocated budget.

Receipts mechanism based on the safety-net (Variant 1)

4. If the safety-net formula shown in the diagram in the UK's paper, which was designed for a Community of Twelve, were used to set a "limit" on the receipts gap, we should have:-

"limit" as % of GDP = 0.007 (y - 90) where y is the relative prosperity index

5. For the UK in a Community of Twelve in 1982 this would have given a "limit" of 440 mecu (where average relative prosperity for 1980-82 is used for y and the formula is applied to 1982 GDP). The Germans, however, envisage that the UK should be compensated for only two thirds of the exess of its receipts gap over this amount and that this refund should be paid gross. This case is illustrated for 1982 in the

TABLE 1: REFUNDS TO UK PROVIDED BY GERMAN RECEIPTS MECHANISM BASED ON SAFETY NET (VARIANT 1) APPLIED TO 1982 BUDGET

1.	Allocated Budget, mecu	17940
2.	UK uncorrected net contribution, mecu	2036
3.	UK receipts gap on German definitions, mecu	1184

EC10 relative prosperity figures throughout

4.	"Limit" set on receipts gap, mecu	235
5.	Excess over this "limit", mecu	949
6.	Gross UK refund if compensation for this "excess" is ⅔, mecu	633
7.	Total refunds (including France and Germany) - mecu	829
8.	UK financing share of refunds, %	14.9%
	mecu	124
9.	UK net refund, mecu	509
	as % of UNC	25%

EC10/12 hybrid

10.	"Limit" set on receipts gap, mecu	437
11.	Excess over this limit, mecu	747
12.	Gross UK refund (⅔ of 11) - mecu	498
13.	Total refunds (including Germany) - mecu	522
14.	UK financing share of refunds, %	14.9%
	mecu	78
15.	UK net refund, mecu	420
	as % of UNC	21%

Note: Tables 3 and 4 show the calculation of these figures in more detail

bottom part of table 1. (The case is described as a hybrid since EC12 figures for relative prosperity are used to determine the limit, but EC10 figures are used in deriving financing shares of refunds - see paragraph 10 below for more details in the financing key).

6. In a Community of Ten the UK's relative prosperity index is lower and so a lower "limit" is set by the safety-net formula and total refunds are larger - see the middle part of table 1. Fuller details of the calculations are shown in tables 3 and 4.

Receipts mechanism based on Danish convergence fund - variant 2

7. According to the graph attached to their draft paper, the Germans propose that at 90% of average GDP per head a country would have to bear 40% of its receipts gap. That is the rate of refund applied to a receipts gap would be 60%. With each 1 point increase in a country's relative prosperity index above 90, its rate of refund would be reduced by 1.2%. A minimum rate of refund of 15% would be set and this would be reached at 127.5% of average prosperity. These relationships may be expressed algebraically as follows:

Percentage of receipts gap that a country must bear itself =

$$40 + (y - 90) \frac{(85 - 40)}{(127.5 - 90)} = 40 + 1.2\,(y - 90)$$

where y is its relative prosperity index

and percentage rate of refund $= 60 - (y - 90) \dfrac{(85 - 40)}{(127.5 - 90)}$

$$= 60 - 1.2\,(y - 90)$$

8. In 1982 the UK's relative prosperity index for a Community of Ten was 97 giving us a 52% rate of refund, or some 620 mecu in absolute terms (see tables 2 and 5). This refund, however, would be a gross amount and would translate into a net refund of about 440 mecu (see below for more details on the financing of refunds). This amounts to only just over 20% of our net contribution (although it should perhaps be noted that the contributions gap formed an unusually large part of our total net contribution in 1982, principally because of the effects of exchange rate movements on VAT contributions).

TABLE 5: REFUNDS TO UK PROVIDED BY GERMAN RECEIPTS MECHANISM DERIVED FROM DANISH CONVERGENCE FUND (VARIANT 2)

1982, EC10

1.	Rate of refund where UK relative prosperity index = 97	52%
2.	Gross refunds to UK, mecu	616
3.	Total refunds (including France and Germany)	1188
4.	UK financing share of refunds, %	14.9
	mecu	177
5.	UK net refund, mecu	439
	% of UNC	21.6

The financing key for refunds

9. The Germans have incorporated in their proposals the French suggestion for a special key for financing refunds. Table 6 illustrates the derivation of such a key, whereby VAT shares are modified by relative prosperity and ratios of receipts to GDP. Relative prosperity (column 1) is measured by a country's GDP per head at current prices and exchange rates for the year in question as a proportion of the Community average. Column 2 represents the ratio of receipts from the allocated budget (as defined by the Germans) to GDP for the country in question to the average for the Community. These two modifiers are given equal weight by simply multiplying VAT shares by both figures. Since there is no guarantee that the resulting figures will sum to 100, it is likely to be necessary to scale them (as in column 5) to ensure that they do.

Overall effects

10. For 1982 in a Community of Ten the two variants of the German proposals would have produced the following results for the UK.

		Variant 1 (safety net)	Variant 2 (convergence fund)
1.	Gain from modulated VAT	537	537
2.	Gross refund	633	616
3.	Contribution to financing refunds	124	177
4.	Net refund	509	439
5.	Net reduction in UNC (1-4)		
	- mecu	1046	976
	- %	51%	48%

11. Further work will be required to see how large a reduction in the UK's net contribution these proposals would produce with different budget sizes and structures from that of 1982.

S MATTHEWS

TABLE 3 GERMAN REFUNDS SCHEME BASED ON SAFETY NET LIMITS FORMULA APPLIED TO RECEIPTS GAP

EC10

	GDP share (%)	Receipts share on German basis (%)	Gap where applicable mecu	Gap where applicable %	Safety net Limit* mecu	Receipts Gap above limit mecu	Gross Refunds mecu	Financing Share (%)	Payments to Refunds mecu	Net refunds mecu
Belgium	3.5	5.5						5.9	49	
Denmark	2.4	3.6						4.0	33	
France	22.9	20.0	520	2.9	962	-	-	25.0	207	
Germany	28.1	15.9	2189	12.2	1600	589	196	20.2	167	29
Greece	1.6	5.7						2.6	22	
Ireland	0.7	5.1						3.3	27	
Italy	14.7	21.0						13.6	113	
Luxembourg	0.2	0.8						1.3	11	
Netherlands	5.8	8.9						9.2	76	
UK	20.1	13.5	1184	6.6	235	949	633	14.9	124	509
							829		829	

*Using formula (y - 90) 0.07 Y where y = GDP per head and Y = GDP in billion of ecus

TABLE 4: GERMAN REFUNDS SCHEME BASED ON SAFETY NET LIMITS FORMULA APPLIED TO RECEIPTS GAP

EC 10/12 hybrid

	GDP share (%)	Receipts share on German basis (%)	Gap where applicable (%)	Gap where applicable Mecu	Safety Net Limit* mecu	Receipts gap excess over limit mecu	Gross refunds mecu	Financing share (%)	Payments to Refunds mecu	Net Refunds
Belgium	3.5	5.5						5.9	31	
Denmark	2.4	3.6						4.0	21	
France	22.9	20.0	2.9	520	1385	-	-	25.0	130	
Germany	28.1	15.9	12.2	2189	2118	71	24	20.2	105	-81
Greece	1.6	5.7						2.6	14	
Ireland	0.7	5.1						3.3	17	
Italy	14.7	21.0						13.6	71	
Luxembourg	0.2	0.8						1.3	7	
Netherlands	5.8	8.9						9.2	48	
UK	20.1	13.5	6.6	1184	437	747	498	14.9	78	420
							522			

* Using formula $(y - 90)\ \frac{0.07}{1000}\ Y$ where y = GDP per head and Y = GDP

TABLE 5: GERMAN DEFUNDS PROPOSAL: VARIANT BASED ON DANISH CONVERGENCE FUND

Net + Gross Refunds in 1982

	GDP share (%)	Receipts shares as presently measured (%)	Receipts shares on German basis* (%)	Receipts Gap ((1)-(2)) (%)	GDP per head	% of Receipts Gap expected to bear/ it	Gross Refunds % of receipts gap	Gross Refunds mecu	Financing Share (%)	Payments to refunds mecu	Net refunds mecu
Belgium	3.5	7.0	5.5						5.9	70	
Denmark	2.4	3.5	3.6						4.0	48	
France	22.9	19.5	20.0	2.9	115	70	30	156	25.0	297	-141
Germany	28.1	15.3	15.9	12.2	124	81	19	416	20.2	240	+176
Greece	1.6	5.6	5.7						2.6	31	
Ireland	0.7	5.1	5.1						3.3	39	
Italy	14.7	20.6	21.0						13.6	162	
Luxembourg	0.2	1.6	0.8						1.3	15	
Netherlands	5.8	8.8	8.9						9.2	109	
UK	20.1	13.0	13.5	6.6	97	48	52	616	14.9	177	+439
								1188			

* 50% of administrative expenditure is allocated according to GDP shares

/ Calculated on formula 40 + 1.2 (y - 90) % where y = GDP per head

Table 6

Financing Key for Refunds (1982 figures)

	① Relative Prosperity EC average = 100	② Receipts/GDP as a proportion of EC average *	③ 1982 VAT shares	④ ① × ② × ③	⑤ Scale to sum 100 = Financing Share
Belgium	97	155	3·8	5·71	5·9
Denmark	127	150	2·0	3·81	4·0
France	115	87	23·9	23·9	25·0
Germany	124	57	27·4	19·37	20·2
Greece	44	356	1·6	2·51	2·6
Ireland	58	686	0·8	3·18	3·3
Italy	70	143	13·0	13·01	13·6
Luxemburg	112	538	0·2	1·21	1·3
Netherlands	111	152	5·2	8·77	9·2
UK	97	67	22·0	14·30	14·9
				95·77	

* Using German proposal for receipts of Administrative expenditure.

Annex 5

From: R B SAUNDERS
Date: 28 October 1983

MR KING-EF2

cc Mr Monck o/r
Mr Gordon
Mr Pirie o/r
Mr Ilett
Mr Perfect

VISIT OF COUNT LAMBSDORFF - ALLIANZ VERSICHERUNG-AG BID FOR EAGLE STAR

While I would not recommend the Chancellor to raise this question himself when he meets Count Lambsdorff next Tuesday, some background briefing may be useful.

2. In June 1981, Allianz, the biggest German general insurance group with some 16% of the market, took 28% of the shares of Eagle Star in a dawn raid. Eagle Star is a major UK insurer - fourth in the life league table and sixth in general business - with about 4½% of the total market.

3. Allianz has recently increased its shareholding to 29.99% which has automatically triggered an offer to all shareholders under the City Takeover Code. The offer, at 500p, is thought to be too low at this stage to attract much interest from shareholders; the current market price is 535. The main question is whether the bid should be referred to the Monopolies and Mergers Commission. No reference was made in 1981 and the Secretary of State is expected to take a decision about a reference this time before the present offer expires on 12 November. There is no clear indication yet what line he will take. The Foreign Secretary has asked him to take account of the implications for relations with the German Government in considering a possible reference.

4. The lead responsibility is with DTI, given their responsibilities both for the MMC and for supervision of the insurance industry. The main Treasury interest is in whether a successful bid could have repercussions for the banking sector. At present, our policy in dealing with any hypothetical future overseas bid for a UK bank is uncertain, and the question is whether the decision in the Eagle Star case might be seen as a precedent for such circumstances. Our view is that it should not, for two reasons. First, the insurance and banking sectors are quite different, both domestically and Community-wide. Secondly, in terms of importance and market share, Eagle Star is of very much less significance than either one of the clearers or, in Scotland, one of the Scottish clearers. One difficulty with the policy on the takeover of clearing banks is that, as it happens, there are no clearing banks whose takeover would not have major implications for either the English or the Scottish economies.

5. As further background, I attach a copy of Count Lambsdorff's telegram of 19 October to Sir Geoffrey Howe and of the DTI briefing on this for Mr Tebbitt, who is seeing Count Lambsdorff the same day as he sees the Chancellor.

Line to Take

6. It will be for the Secretary of State for decide on reference to the MMC. The Chancellor has seen Count Lambsdorff's telegram to the Foreign Secretary and is sure that the German Government's view will be taken fully into account.

R B SAUNDERS

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SECRETARY OF STATE
FOR FOREIGN AND COMMONWEALTH AFFAIRS

SIR GEOFFREY HOWE
LONDON

DEAR GEOFFREY,

I UNDERSTAND THAT ALLIANZ VERSICHERUNGS-AG, THE LARGEST GENERAL INSURANCE GROUP IN THE FDR, HAS TODAY ANNOUNCED AN OFFER FOR THE SHARE CAPITAL OF EAGLE STAR HOLDINGS PLC WITH THE OBJECTIVE OF DEVELOPING A CLOSER ASSOCIATION TO THE BENEFIT OF BOTH GROUPS AND THEIR SHAREHOLDERS. ALLIANZ (WHICH ALREADY OWNS 28 PERCENT OF E.S.) HAS CLEARLY STATED THAT IT IS NOT SEEKING TOTAL CONTROL OF E.S. AND HAS ALSO INDICATED THAT:-

1.
ALLIANZ WOULD WISH E.S. TO CONTINUE TO BE A BRITISH COMPANY LISTED ON THE STOCK EXCHANGE WITH ITS HEADQUARTERS IN LONDON(SEMI)

2.
ALLIANZ BELIEVES IT DESIRABLE FOR A SIGNIFICANT PART OF E.S.'S SHARE CAPITAL TO REMAIN IN THE HANDS OF THE U.K. PUBLIC(SEMI)

3.
ALLIANZ WILL SEEK TO HAVE APPROPRIATE REPRESENTATION ON THE E.S. BOARD BUT WOULD WISH THE MAJORITY OF THE BOARD, INCLUDING CERTAIN OF ITS REPRESENTATIVE MEMBERS, TO BE OF BRITISH NATIONALITY(SEMI)

4.
ALLIANZ WOULD NOT SEEK TO BE INVOLVED ACTIVELY IN THE DAY TO DAY MANAGEMENT OF THE E.S. GROUP.

I BELIEVE THE PROPOSED STRENGTHENING OF THE ASSOCIATION BETWEEN THE TWO GROUPS BRING CONSIDERABLE MUTUAL BENEFITS AND WOULD BE A SIGNIFICANT STEP IN THE DEVELOPMENT OF CLOSER COMMERCIAL TIES, IN AN IMPORTANT SECTOR, BETWEEN THE U.K. AN THE FDR. CLEARLY THE APPROPRIATE AUTHORITIES WILL UNDERTAKE FORMAL REVIEWS OF THIS MATTER. NOTWITHSTANDING SUCH REVIEWS I WOULD BE GRATEFUL IF YOU AND YOUR COLLEAGUES COULD GIVE THIS MATTER YOUR SUPPORT.

WITH KIND REGARDS
OTTO LAMBSDORFF
FEDERAL MINISTER OF ECONOMICS BONN=

VISIT OF COUNT LAMBSDORFF, 1 NOVEMBER 1983

BRIEF ON INSURANCE

Points to Make

1. Read with interest Count Lambsdorff's message of 19 October to Sir Geoffrey Howe. Assure Count Lambsdorff that his points - as of course the Allianz bid - will be given full and fair consideration.

2. Not able to go any further at present. Awaiting consideration by and recommendation from the Director General of Fair Trading on whether the bid should be referred to the Monopolies and Mergers Commission for its consideration.

3. UK favours free movement of capital generally and freedom in insurance markets. UK's probably freest insurance market in the world. Many in UK market argue that unfair that foreign companies can purchase share stakes in UK insurers when their national markets are largely closed to foreign insurers either for selling insurance or buying into domestic insurers. Welcome hearing Count Lambsdorff's comments on such arguments.

4. On freedom of services in the European Community, UK very disappointed that no agreement after 8 years discussion. UK raised at ECOFIN last Monday. How does Count Lambsdorff see the way forward? Any hope of progress in foreseeable future?

Background

The Finance Minister is responsible in the Federal Republic for insurance supervision. However, Count Lambsdorff takes an interest in insurance as a service industry: as an insurance company board member before he became a Minister he is also knowledgeable about it. He telegraphed the Foreign and Commonwealth Secretary in support of the Allianz Versicherung AG bid for Eagle Star Holdings, simultaneous with the Allianz announcement.

2. There is little to be said about the handling of the Allianz bid. The Director General for Fair Trading has to recommend to the Secretary of State whether or not it should be referred to the Monopolies and Mergers Commission (MMC) for report on whether it may be expected to operate against the public interest. The Allianz offer, unless extended, expires at 15.00 on Saturday 12 November, after which time Allianz can resume buying shares in the market. The Director General will be making his recommendation with a view to Ministerial decision and announcement by 11 November at latest.

3. Count Lambsdorff should know that the MMC would take into account a range of considerations, including notably the maintenance and promotion of effective competition, in any assessment. It is best not to go beyond a brief reference on these lines. But given the reference in his telegram to the proposed takeover being a significant step in the developing Anglo-German commercial ties in insurance, it would be of interest to hear any elaboration he may have on this theme. It is, for example, very difficult for a UK insurance company to obtain a significant stake in a German one: there is no legal bar but the complex pattern of cross holdings between banks and insurance companies means that opportunities seldom arise.

4. The Federal Republic is restrictive in insurance supervision. The effect is that an insurance buyer, however strong, is limited to the domestic market. Foreign insurers - but not Lloyd's with its unique constitution - can establish branches there but building up business in this way is a slow process. The Commission 8 years ago proposed a directive to facilitate the freedom of services, ie the ability to sell across a frontier without having an establishment in the recipient market. This draft directive is completely bogged down by opposition from restrictive Member States, notably the FRG and France. Our only consistent support for a liberal directive has come from the Netherlands. Count Lambsdorff has stoutly defended the German system as for the protection of the consumer rather than the German insurance industry (the biggest in the Community). The Commission is now exerting legal pressure on the Germans and others to open up their markets. Count Lambsdorff may have something to say on the current position of the draft directive and how he sees discussion developing on insurance in the Community.

For Lambsdorff folder

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FRAME ECONOMIC

FM BONN 281715Z OCT 83

TO PRIORITY FCO

TELEGRAM NUMBER 962 OF 28 OCTOBER

INFO SAVING ATHENS UKREP BRUSSELS EMBASSY BRUSSELS COPENHAGEN DUBLIN LUXEMBOURG PARIS ROME THE HAGUE DUESSELDORF

FRG ECONOMIC POLICY: PRIVATISATION

1. THE DECISION OF THE FEDERAL GOVERNMENT TAKEN ON 26 OCTOBER TO REDUCE ITS SHARE HOLDING IN THE GIANT ENERGY CONCERN VEBA MARKS A FIRST STEP IN THEIR DECLARED POLICY OF PRIVATISATION. SINCE COUNT LAMBSDORFF WILL BE IN LONDON SEEING BRITISH MINISTERS ON 1 NOVEMBER, YOU MAY FIND THIS BACKGROUND USEFUL.

2. THE PRESENT GOVERNMENT SHARE HOLDING OF 43.75 PER CENT IS TO BE REDUCED TO 30 PER CENT. THE SHARES WILL BE SOLD EARLY NEXT YEAR THROUGH A BANK CONSORTIUM. THE GOVERNMENT HAS SAID THAT VEBA ITSELF MAY PURCHASE A PROPORTION TO SELL AT A DISCOUNT TO EMPLOYEES, AND HAS POINTED OUT THAT THE PROPOSED AMENDMENT TO THE LAW ON EMPLOYEES' TAX-FREE SAVING FROM INCOME (VERMOEGENSBETEILIGUNGSGESETZ) WILL MAKE IT MORE ADVANTAGEOUS FOR LOWER EARNERS TO PURCHASE SHARES.

3. THE SALE OF THE SHARES, WITH A PAR VALUE OF DM 232 MILLION, IS EXPECTED TO RAISE AROUND DM 700 MILLION WHICH THE GOVERNMENT STATE WILL BE USED TO REDUCE THEIR NET BORROWING REQUIREMENTS AND PRESS COMMENT HAS SEEN THIS LAST CONSIDERATION AS PARAMOUNT. BUT OFFICIALS HAVE BEEN AT PAINS TO STRESS TO US THE IMPORTANCE OF THE PRINCIPLE OF DISENGAGEMENT FROM ACTIVITIES WHICH NEED NOT BE THEIR CONCERN (SUBSIDIARITY).

4. NEVERTHELESS, THE DISENGAGEMENT ONLY GOES A CERTAIN WAY. THE GOVERNMENT HAS NO INTENTION OF FURTHER REDUCING THEIR SHARE HOLDING BELOW A LEVEL WHICH, AFTER A PLANNED INCREASE BY VEBA OF ITS SHARE CAPITAL, WILL BE 25 PER CENT. THIS, AS THE CHANCELLOR'S OFFICE HAVE ADMITTED TO US, WILL ENSURE THAT THE FEDERAL GOVERNMENT WILL RETAIN A SEAT ON THE SUPERVISORY BOARD AND A VIRTUAL RIGHT OF VETO ON IMPORTANT DECISIONS, AND WILL REMAIN BY FAR THE LARGEST SHARE HOLDER.

RESTRICTED

/5. THE

5. THE COMPANY (WHOSE CHAIRMAN HAS WELCOMED THE GOVERNMENT'S ANNOUNCEMENT) IS THE LARGEST BY TURNOVER IN THE FRG. IT WAS FORMED IN 1974 AS A COUNTER-WEIGHT TO OIL MAJORS IN THE FRG MARKET AND AS A POSSIBLE PARTNER FOR OPEC COUNTRIES WHICH PREFERRED TO DEAL WITH A ''NATIONAL'' OIL COMPANY. THE COMPANY'S OIL AND CHEMICAL INTERESTS, IN LINE WITH THE GENERAL TREND, HAVE NOT BEEN DOING WELL, THOUGH THE SALE OF HALF ITS OIL REFINING INTERESTS IN THE FRG TO THE NATIONAL VENEZUELAN OIL COMPANY AT END 1982 EASED THE SITUATION CONSIDERABLY. OVERALL THE BALANCE SHEET IS BUOYED UP BY ITS PROFITABLE POWER GENERATION INTERESTS. THERE IS LIKELY TO BE CONSIDERABLE INTEREST WHEN THE SHARES ARE SOLD.

6. STATEMENTS BY FINANCE MINISTER STOLTENBERG AND HIS STATE SECRETARY TIETMEYER HAVE MADE CLEAR THAT THE GOVERNMENT ARE DETERMINED TO CONTINUE ON THE PATH OF PRIVATISATION ACCORDING TO AN OVERALL PLAN, THE DRAWING-UP OF WHICH WILL BE COMPLETED NEXT YEAR. THEY STRESSED THAT THE PROCESS WOULD PROCEED WITH CARE AND WITH FULL REGARD TO THE INTEREST OF EMPLOYEES.

7. THERE IS SPECULATION BUT NO CONFIRMATION THAT THE NEXT CANDIDATE MAY BE LUFTHANSA.

FCO PLEASE PASS SAVINGS TO ABOVE ADDRESSEES EXCEPT DUESSELDORF

TAYLOR (REPEATED AS REQUESTED)

FRAME ECONOMIC
ECD(I)

AJ

FROM: J GRAHAM
DATE: 31 October, 1983

1. MR LAVELLE
2. CHANCELLOR

cc Mr Fitchew)
Mr Bottrill o/r)
Mrs Case)
Miss Court) Without
Mr Edwards)Attachments
Mr Pirie)
Mr Denison)
Mr Ingham)
Mr Saunders)

I think you are familiar with most of the material from your meetings with Dr. Kuhfus, Herr Tietmeyer & Mr Tugendhat. The steering brief provides both an index and annotated agenda. B.

MEETING WITH COUNT LAMBSDORFF 1 NOVEMBER

You have agreed to meet Count Lambsdorff, Federal German Economics Minister, at 4 pm on Tuesday 1 November 1983. He will be accompanied by Dr Mueller Thuns and Dr Witt, who are both senior officials from the Economics Ministry, and Dr Kudlich, the Economic Counsellor from the German Embassy in London. Some time ago you also agreed that Miss Katherine Pestell, the Economics Minister at the British Embassy in Bonn, should attend.

2. Count Lambsdorff's visit is in preparation for the Anglo-German Summit on 8-9 November 1983. He will have already seen the Secretaries of State for Energy and Trade and Industry. The Germans envisage the discussion with you will cover the world economic prospects and the outlook for interest rates, international debt particularly that of Poland and Community finances in advance of the Athens Council.

3. World prospects are improving. The recovery in the industrial countries, which has been most marked in North America, is forecast to continue next year. Inflation is likely to pick up slightly but will remain moderate. World trade is expected to recover more strongly next year.

4. The interest rate outlook, as ever, is uncertain. US monetary growth has been on target since August though both the M1 and M2 targets have been rebased. The recent jump in M1 raised interest rates slightly (short term rates rose 1/4 point to 9 1/4 and long

rates rose to over 11½ per cent) though last week's fall has virtually cancelled the increase. However despite improving monetary conditions, without some agreement to cut the US budget deficit, lower interest rates look unlikely. Continuing rapid growth, renewed inflation or undue weakness of the dollar could put renewed upward pressure on interest rates. A brief on world economic prospects is at Annex A.

5. The German economic recovery has been rather uneven. The respected Five Institute's report, published last week, was critical of government policy and expressed concern over the sustainability of the recovery. The Embassy's reporting telegram and a general brief on the economy is at Annex B. The brief notes that we share the IMF's and OECD's concern that German policies should take full account of the pace of domestic recovery.

6. For the debt discussion, the latest detailed assessment from the Bank at Annex C provides useful background. Annex D contains a brief provided by AEF which deals particularly with Poland and the FRG/GDR loan.

7. On Community finances, Count Lambsdorff may wish to follow up the talks you had today with Herr Tietmeyer for which EC provided full briefing. You could draw on this material for your meeting with Lambsdorff though if any supplementary material is needed it will of course be supplied. (Annex E).

8. Although the EMS has not been listed, it could come up in discussion. For ease of reference the brief for your meeting today with Mr Tugendhat is at Annex F.

9. You will be aware of Count Lambsdorff's representations to the Foreign Secretary over the bid by Allianz (the largest German insurance group) for Eagle Star. We doubt if this will be raised but in case it is Annex G explains some of the background and suggests a line to take.

10. Finally Count Lambsdorff's own political future is in some doubt over allegations that he accepted political donations in return for granting tax exemptions to the company involved. Charges could be brought by the end of November. The Embassy's assessment of Lambsdorff's prospects, (letter of 21 October and telegram no 952) which notes that possible successors are already being discussed, is at Annex H together with a personality note. The letter also contains extracts from a speech Lambsdorff made in mid-October criticising those who call for greater government intervention which gives some further insight of his views.

11. To achieve some continuity for the budget discussions Mr Edwards will provide support. I will also attend

J GRAHAM

c/ There is also a telegram giving details of FRG's first foray into privatisation immediately below.

Annex A

CHANCELLOR'S MEETING WITH COUNT LAMBSDORFF: 1 NOVEMBER 1983
WORLD ECONOMIC PROSPECTS

Points to make

(i) Recovery now underway led by rapid growth in North America. Elsewhere upturn in output is not as strong. World trade slowly beginning to turnround. Prospects are encouraging but higher interest rates or renewed inflation could jeopardise recovery.

(ii) Remains essential to maintain prudent monetary and fiscal stance. Policies should contain inflationary pressures as activity recovers and thereby help ensure upturn develops into durable growth. Important for all to reduce structural budget deficits but US has particular responsibility.

(iii) International debt scene calmer. Developing countries have cut external deficits. But problems persist and further ones cannot be ruled out. Renewed growth, firm adjustment and adequate finance all needed to solve debt problems. Important for IMF quota increase to be ratified soon. Resisting protectionism essential for global recovery.

(iv) See no case at this stage for an international monetary conference. Root of past difficulties was imprudent policies rather than the system. Welcome G10 study to identify areas where improvements to existing system can be made. Convergent and responsible policies for monetary stability and sustained growth offer best prospects.

Background

GDP in the major industrial countries as a whole rose at an annual rate of 2½-3 per cent in the first half of 1983. Output growth was concentrated in North America, elsewhere the upturn was weaker. Slower destocking, higher personal consumption and housebuilding have been the major sources of growth. Business investment has yet to recover strongly. US recovery is expected to moderate from now on.

2. World trade fell last year for the first time since 1975 and recovery this year has been slow. Industrial countries' imports have risen rapidly but imports by oil producers and non-oil developing countries appear to have fallen though they should recover next year. Trade growth is likely to be slower than in previous upturns.

3. Most forecasts see recovery continuing next year with the US economy growing by 4½ per cent after 3½ per cent in 1983. The Japanese reflationary package has not so far led the government to revise the 3½ per cent growth forecast for this fiscal (our financial) year suggesting growth would have been lower without it. Private forecasts estimate it could add ½ per cent to next year's growth raising it to around 4-4½ per cent. Growth in the Community is put at only 1½ per cent next year with French output falling as a result of austerity measures though Germany and the UK are expected to grow by around 2 and 3 per cent respectively.

4. Modest recovery and labour market measures have helped stabilise unemployment in the major countries and reduce it in some cases, over recent months. Next year it should continue to fall in the US but European unemployment is expected to deteriorate further though at a slower rate than previously.

5. Inflation in the major countries has more than halved since 1980 and is now down to 4 per cent though the underlying rate (adjusting for statistical distortions) is marginally higher. Inflation differentials remain wide. Both French and Italian governments are expected to miss their inflation targets this year. Some fear rapid monetary growth since mid-1982 will cause an acceleration of inflation. But both OECD and IMF see inflation remaining moderate and rising only slightly next year to around 5 per cent.

6. After declining last year US interest rates picked up over the summer as the Fed tightened policy in response to rapid monetary growth earlier this year. Short-term rates reached 10 per cent

in August but have eased back to around 9 per cent now. Other countries took advantage of lower US rates last year to reduce their own but this year rates in Europe and Japan, until recently have remained broadly stable. Lately, German rates have edged up as the Bundesbank sought to rein back rapid monetary growth. The stronger yen has allowed the Japanese to cut the discount rate, unchanged since December 1981, as part of its reflationary package.

7. As a result of lost competitiveness and rapid domestic recovery the US current account is growing rapidly and may approach $40 billion this year and $60 billion next. This dominates the forecast improvement in the Japanese and German surplus. Further improvement in the French current account is expected as austerity bites.

8. Co-ordinated intervention against the dollar in early August by the US, France, Japan and Germany may have had some slight temporary effect but the dollar continued upwards thereafter. It peaked in September and has fallen back since then particularly against the deutschemark and the yen. A rising deutschemark against a weak franc is already provoking speculation over another EMS realignment. On balance the emerging US current account deficit should put downward pressure on the dollar in the absence of higher US interest rates. While timing remains uncertain most expect the effective dollar rate to fall modestly in the short-term.

9. Non-oil developing countries' (NODCs) financial position deteriorated last year due to declining terms of trade, weak OECD demand and higher debt service costs. In some cases inappropriate domestic policies also contributed. Growth of net new bank lending to NODCs fell markedly to 7-8 per cent last year, compared to over 20 per cent previously. The need to adjust has cut imports and reduced their current account deficits but no further improvement is expected as renewed exports are offset by higher imports. Domestic recovery also depends on their continuing access to new borrowing.

10. Debt prospects generally should be improved by recovery now underway in OECD countries. Details of Brazil, Poland, Yugoslavia are covered in the debt brief.

Policies

11. Interpretation of monetary trends has been complicated by continuing effects of distortions and shifts in velocity. In the US this led the Federal Reserve earlier this year to rebase both M1 and M2. In response to rapid monetary growth the Fed tightened policy over the summer. Recently monetary growth has slowed and all the aggregates including M1, are now back within their (revised) target ranges. In Europe, monetary growth is still towards the top, or slightly above target.

12. Recession has thwarted most governments' efforts to reduce budget deficits though expansionary policies have been pursued by the US and until recently, France. The OECD estimate that general government deficits as a share of GDP for the major countries have risen steadily since 1979 to 4½ per cent this year but should fall slightly next year as a result of fiscal restraint. Many European countries including France and Japan are taking action to reduce underlying budgets though the US has yet to do so.

13. The Japanese reflationary package (increased public works expenditure and income tax cuts) is less of a stimulus than first appears. It is spread over 18 months and includes the acceleration of expenditure that would have occurred anyway. The income tax cuts are the first adjustment to the non-indexed system since 1977 and only offset a small part of the fiscal drag since then. The effects on the general government deficit (which OECD expected before the package to fall to 2½ per cent of GDP next year) will be smaller than the broad figures suggests.

14. Concern has focussed on the failure by the US Administration and Congress to agree how the large Federal deficit should be reduced. Both Feldstein (CEA Chairman) and Volcker have repeatedly stressed their concern over its effects on interest rates and the sustainability of recovery.

15. Large prospective US deficits combined with rising private credit demand carries the risk of higher inflation, interest rates or both. The US authorities are concerned to avoid much higher interes rates due to the effects on international debtors and recovery

generally. So far the Fed has avoided sharp increases in rates but without some fiscal agreement lower interest rates seem unlikely. Slower US GDP growth ahead and the prospect of continued modest inflation should allow monetary growth to be kept close to (if slightly above) target and short-term interest rates close to their current levels of around 9-10 per cent. But continuing rapid output growth, renewed inflation or undue weakness of the dollar could put upward pressure on interest rates again.

16. Most industrial countries are against the idea of new international monetary conference. In response the G10 have agreed to consider how the existing system can be improved without completely ruling out a conference at a later stage. Work for the G10 is at a preparatory stage - the first meeting is to be in mid-November. It is likely to consider: the role of exchange rates, and the effects on trade, investment; etc, the multi-currency reserve system and the effect of the major countries' financial policies on world liquidity; strengthening IMF surveillance and longer-term debt solutions such as (lengthening debt maturities, greater private direct investment, enlarged World Bank role).

31 October 1983

Annex B

CONFIDENTIAL

CHANCELLOR'S MEETING WITH COUNT LAMBSDORFF 1 NOVEMBER 1983

THE GERMAN ECONOMY

Points to make

(i) World recovery now getting underway as benefits of lower inflation and reduced interest rates feed through. A sustainable German recovery is vital if continental Europe as a whole is to share in recovery.

(ii) Welcome reduction of inflation and signs of recovery in Germany but progress has been rather uneven. How does the government judge the pace of recovery this year and the prospects for next?

(iii) The UK shares Chancellor Kohl's fiscal objectives of reducing structural budget deficits over the medium-term. Criticism of fiscal stance being too tight (from IMF and OECD) suggests policy should be implemented flexibly taking account of pace of recovery. What of plans for tax reform to reduce fiscal drag?

(iv) Note German Government's stress on business investment recovery. Agree it is crucial for sustained growth but unusual for it to lead recovery. So far benefits of policy of restructuring private expenditure towards investment have yet to appear. Important that domestic activity, both consumption and investment, should contribute to the recovery as slow world trade growth ahead may limit external sector's contribution.

(v) The deutschemark has recently recovered from its summer trough against the dollar. It has risen particularly against the French franc. How would the Government react to further upward pressure on the deutschemark and possible EMS tensions?

Background

GDP which was flat in 1981, fell by more than 1 per cent last year. This reflected a sharp decline in domestic demand which was only partly offset by net external demand. Towards the end of the year, exports too began to fall. German industrial production fell through 1982 to a level about 9 per cent below its 1980 peak.

2. GDP recovered by about 1 per cent in the first half of this year but several temporary measures have helped support output. Consumer spending rose sharply in the early months as the savings rate fell and real incomes were boosted by the maturing of bonus-carrying savings schemes. Investment, too, has fluctuated partly reflecting the ending of temporary tax incentives. Doubts over the strength of the investment recovery have been heightened by the fall in orders in recent months. The underlying pattern, however, seems to be of a rather modest domestic upturn. Signs of sustained recovery are few.

3. Germany has relied traditionally on a strong boost from exports to aid recovery but many of Germany's markets in the rest of Europe and among both oil and non-oil developing countries are depressed. Exports may not therefore recover strongly at least in the short-term. GDP is expected to have fallen in the third quarter but to show a modest rise in the final quarter. The current official view is that growth for the year as a whole could be around 1 per cent.

4. Opinions differ about the likely strength of recovery next year. The German Government's official forecast, published with the Budget, is for 2½ per cent GDP growth next year. This is above most other assessments as both the IMF and the Commission see only 2 per cent growth. The Five Institutes' Report published last week was critical of government policy and forecast only 2 per cent growth next year. A slow growth of real incomes coupled with a rising tax burden may be expected to restrain consumer spending and in the absence of a strong rise in domestic demand, the recovery in investment could also be muted.

5. Unemployment has more than doubled since 1980 but has flattened off recently at around 8½ per cent. The relatively slow recovery expected over the next 15 months is unlikely to be sufficient to prevent unemployment continuing to rise. The OECD expect that the rate will increase to 9½ per cent by the second half of next year.

See also attached piece from the tapes.

6. Consumer price inflation has fallen from 6 per cent in 1981 to 3 per cent in September this year. It has been increased by the July VAT rise which OECD estimates has added ¾ percentage point to the price level. Modest wage settlements around 4-5 per cent should help to keep inflation to low levels.

7. Short-term interest rates have fallen from their 14½ per cent peak in 1981 to around 6 per cent now. Long-term interest rates have fallen also but to a lesser extent. Official rates remained unchanged until recently despite the growing weakness of the DM against the dollar. The Bundesbank tightened policy over the summer raising interest rates to curb the rapid monetary growth in the first half of the year. The rise in the Lombard rate on 9 September confirmed this trend.

8. The DM has recovered from its lows against the dollar in August. It has risen particularly against the French franc provoking renewed speculation of another EMS realignment. The Bundesbank would probably prefer to see further upward pressure reflected in the exchange rate while the Economic and Finance Ministries would prefer lower interest rates.

9. The DM may now start to reflect the growing external current surplus. After three years of deficit the current account was in surplus by $3½ bn in 1982 helped by a rising trade surplus. The current surplus for the first nine months of this year is now provisionally put at DM5 billion (or $2 billion). The Five Institutes now expect it to reach DM10 billion next year.

Policies

10. The German authorities have combined a relatively accommodating monetary policy with a stringent fiscal policy. The overall effect has generally been to keep both interest rates down and the DM weak until recently, but the effects on activity have been disappointing so far.

11. The target growth rate for Central Bank Money (CBM) was set at 4-7 per cent for the year to the fourth quarter of 1983. In the early months of this year, however, the money supply grew at an annual rate of 11 per cent. This was blamed partly on capital inflows ahead of the March EMS realignment and partly on the maturing of large savings schemes. Monetary growth slowed considerably over the summer, as policy tightened, but by September had still risen at an annual rate of 8 per cent since Q4 1982, ie still above target.

12. The German Government remains committed to reducing structural budget deficits and switching private expenditure away from consumption towards investment. Their medium-term plan seeks to almost halve the Federal borrowing requirement to DM23bn by 1987. It has already been reduced to under DM40bn for 1983 and Stoltenberg is committed to next year's reduction to DM37bn. However, prospective budget cuts may not have made adequate allowance for additional coal and steel subsidies on which Kohl is suspectible to pressure.

13. The 1984 budget provides further incentives for investment, aimed at smaller firms. These are being financed partly by the increase in VAT, but expenditure cuts of DM6½bn are being sought mainly on social benefits. The principal savings include lower unemployment benefits for certain claimants, cuts in maternity and other social security benefits, lower pension entitlements and postponed public-sector pay awards. Total planned expenditure is to rise by 2 per cent against an inflation rate of 2-3 per cent.

14. Despite the Government's plan to adjust personal income tax scales in the medium-term, no adjustment has been made since 1981 and fiscal drag has risen sharply. The OECD estimates that direct tax payments will rise twice as fast as incomes from employment next year.

15. This tight fiscal stance has been criticised by domestic sources including the German Institute for Economic Research and not surprisingly by Germany's European partners, eg France

and the OECD. It has also been criticised by the IMF. A measure of the stringency of recent fiscal policy is that between 1980 and 1984 the underlying general government deficit, which includes the Lander, will have been reduced by about 4 per cent of GDP, tougher than the Japanese.

16. The IMF comments in its August World Economic Outlook:

> 'The appropriate stance of policies in Germany and Japan is one involving continuous prgress toward the medium-term objective of reducing fiscal deficits and monetary growth, but moderating the speed of such progress in the light of the continued weakness of domestic demand'.

This seems the right note to strike, reflecting concern that the German recovery is not held back by excessively tight policies.

28 October 1983

Annex C

INTERNATIONAL FINANCIAL SCENE

General situation

Two major developments since the last Report have created much uncertainty on the international debt front. First, Congress has not yet endorsed the USA's higher contribution to the Fund which, together with the related delay in the BIS' credit facility to the Fund, threatens to restrict the IMF's ability to lend at a critical stage. Second, prospects for the Brazilian package - on which much else hinges - now depend essentially on the Fund's reaction to the recent decree on wage indexation. With the Philippines having entered the emergency ward and the long anticipated Argentine elections imminent (30 October), the general atmosphere is highly tense, and confidence in current case-by-case techniques of debt management will be severely tested in the months ahead. The run-up to the IMF Board discussion of Brazil on 18 November will be a crucial period.

Economic background

Economic recovery is continuing in the major industrial countries. In particular, there have been encouraging signs during the third quarter of further non-inflationary growth in the United States. This industrial revival should benefit indebted countries in terms of export demand and has already given some impetus to commodity prices, thus improving the terms of trade for some ldcs - although a number of others continue to suffer from weak prices for their main exports. Recent declines in US short-term interest rates from their peak in August should also bring some relief, but they still remain well above the level obtaining for much of the past year. Moreover, the future course of US interest rates remains highly uncertain. While these developments are on the whole encouraging, there is no general confidence that the recovery in industrial countries is yet broadly or firmly based.

International lending

Recent figures confirm the marked slowdown in international bank lending. The latest BIS statistics show that international banks'

total net lending rose by $15 bn in the second quarter, compared with $30 bn in the corresponding period of 1982, and a quarterly average of $24 bn last year. Data for the third quarter from the London market suggest that the downward trend has continued. Within the total rise in the second quarter, net lending to non-oil developing countries increased by $4 1/4 bn, bringing the rise in the first half-year to some $6 bn. So new bank borrowing by ldcs in 1983 is likely to be much less than was expected at the beginning of the year; and the IMF, for example, have reduced their projection from $20 bn to $15 bn. Managed borrowing will predominate, and could "crowd out" other borrowers, who might then face severe balance of payments financing problems. For the most part, only prime borrowers are at present able to raise funds in the market.

Problems of this kind have already arisen for the Philippines, which has been forced to call a 90-day moratorium on its debts (estimated at $25 bn), pending a rescheduling. For the present, the market is responding calmly to this development, with no signs yet of any tendency to link the Philippines with other Far Eastern borrowers such as South Korea, Thailand and Indonesia, since these countries are considered to have managed their economies, and their external debt, extremely well. Indeed, some of them have already reacted swiftly to the situation in the Philippines by cutting back borrowing programmes and making the necessary adjustment to their economic policies. Nevertheless, there is still a risk that a further general cutback in lending would produce cash flow problems, even for these previously relatively creditworthy borrowers.

In contrast, minor OECD countries, over some of which question marks have been raised in the past, continue successfully to be able to raise funds. Moreover, the market is still prepared to lend, though modestly and at a price, to Latin American borrowers such as Panama, Paraguay and Colombia, which have not experienced debt servicing problems.

Current problems

The whole process of international rescues for problem countries is currently being severely tested on a number of fronts simultaneously.

In the key country, Brazil, rejection by Congress of law 2045 on wage determination, and two subsequent replacement decrees - the latest of which reduces its severity - has created renewed uncertainties, after the encouraging response to the "roadshow". It remains to be seen how the IMF and the banks will react to the latest decree. Meanwhile, efforts are being made to assemble the components of a financial package within the next three weeks. De Larosiere has asked for written assurances by 14 November that $6 1/2 bn will be available from banks, and $2 1/2 bn from governments, to enable him to recommend the Brazilian programme to the IMF Executive Board on 18 November. The sheer size of the bank credit, its softer terms and the need to muster a quorum of committed banks to make the syndication viable, make selling the loan package to the banks a formidably difficult task. In particular, the banks will watch closely for assurances that the official contribution is fully subscribed and represents genuine new money. Such contributions will be seen not only as a signal of confidence in the recovery programme, but may also influence the degree of bank commitment to the present and prospective packages for Brazil (and other countries).

In many ways, Argentina is even more worrying than Brazil, because domestic political uncertainties make breakdown more likely. The political will to tackle the debt problem seems to be lacking, and the IMF programme could be on the verge of collapse, while the central bank's liquid assets are dangerously low. By itself, the uniquely difficult domestic political situation in Argentina, combined with its essentially favourable balance of trade, should make it an isolable problem; but a breakdown in Argentina at this rather delicate stage elsewhere could lead to a damaging deterioration of confidence. Developments in Mexico, on the other hand, remain encouraging, with a government willing and able to undertake appropriate adjustment; and there is unlikely to be much difficulty in securing the requisite new funds for next year, even though the authorities seem certain to demand, and might well be thought to deserve, better terms.

Role of the IMF and BIS

The effectiveness of the IMF in providing leadership, as well as credible adjustment programmes, could be impaired by apparent lack of official support. Latest expectations are that the IMF bill, which is crucial to the Fund's ability to take part in rescues, should ultimately be passed by the US Congress before the Thanksgiving recess beginning 19 November. In the meantime, agreement on a special BIS credit facility of SDR 3 bn to the IMF (which will next be discussed on 7 November in Basle) has been delayed, because some central banks - notably the Bundesbank - will not give their approval until it becomes clear that the American quota increase will be forthcoming, and partly because some central banks have still to swallow more fundamental reservations about the tenor of the loan and the USA's non-participation in it. This has already obliged the IMF to restrain the granting of new commitments.

Conclusion

The next few weeks will severely test the informal coalition between borrowers, banks, creditor governments and the IMF, which has so far managed to contain the debt crisis. A successful outcome, especially on Brazil, will be vital if considerable knock-on effects are to be avoided, and if confidence in present case-by-case techniques of crisis management is not to be seriously weakened. Without such confidence, the outlook for next year will be bleak.

The following sections assess the current position in major debtor countries in rather more detail.

Brazil

Brazil is still the largest single problem country on the international debt scene, and prospects are now even more uncertain after the Brazilian Congress' rejection of the crucial wage de-indexation Decree (No 2045) on 19 October. Although the

government lost little time in issuing a new substitute Decree (No 2064), this in turn has now been replaced by a further, and less severe, decree (No 2065): it is not yet clear whether the IMF will consider this adequate. The provisions of Decree 2045 were at the heart of the revised IMF programme, for which the Brazilians signed a letter of intent on 15 September. Indeed, the IMF Managing Director not only required sufficient finance to be committed in support of the programme, but was also not prepared to recommend the programme to the Executive Board until the Decree had passed into law. A financing gap of $11 bn has been identified for the remainder of 1983 and 1984, which it is proposed to fill through a $6.5 bn new commercial bank loan, a $2 bn Paris Club rescheduling, and $2.5 bn from export credit and other official sources. The bankers' Advisory Group has agreed to market the new money loan on significantly better terms than for earlier funds, which is likely to set a precedent for other Latin American countries to follow. (Indeed, the Argentines have already sought similar concessions, both for the 1983 debt currently being discussed and for 1984 debt to be rescheduled). Initial reaction from banks, who have been asked to commit themselves to the new money loan by 14/15 November, has been one of philosophical resignation. Although political uncertainties within Brazil may create nervousness abroad, bankers' general attitude to the defeat of Decree 2045 and its subsequent amendments, will doubtless be determined by the IMF's reaction.

Prospects for raising $2.5 bn from official sources also remain uncertain. The USA, through the Eximbank, has indicated a willingness to provide $1 1/2 bn export credit facilities, on condition that other countries also contribute. But we are not aware that any other firm commitments have yet been received, while HMG remains opposed to putting up further official money for Brazil (over and above rescheduling of Paris Club maturities).

The latest wage decree improves prospects of early Congressional approval; but if this were not forthcoming before mid-November, the IMF Executive Board meeting (scheduled for 18 November) would be delayed, and further increases in arrears (already nearing $3 bn)

would result. Such a development would be of concern to many US banks, in view of the regulatory requirement to classify loans as non-performing when interest arrears reach 90 days.

Other problem countries

(i) Latin America

Foreign banks' debt negotiations with Argentina have been bedevilled in the last month by increasing political interference ahead of the Presidential elections on 30 October, and by continuing build-up of payments arrears. However, having overcome an attempt by an Argentine federal judge to freeze the rescheduling talks, the Government has now reaffirmed its intention of finalising all rescheduling agreements by 30 November. Disbursement of the long-delayed first tranche of the $1.5 bn medium-term credit is now unlikely before 30 November at the earliest. The further delay reflects continuing payments arrears and a decision by banks to await the outcome of the elections in order to test the authorities' commitment to the refinancing package. The banks' Working Committee is currently seeking to reach final agreement with the Argentines on revised conditions attaching to the disbursement, which will primarily be used to make a repayment under the $1.1 bn bridging facility. Meanwhile, the IMF programme appears to be on the verge of collapsing, and the central bank's liquid assets are now dangerously low.

Relations between the Venezuelans and the banks continue to be soured by the steady accumulation of interest arrears, now totalling around $600 mn. Several default suits are reported to be in the pipeline. Meanwhile, the banks have had no option but to agree to a further extension of the 90-day moratorium which expired at end-September. The Government had sought a 120-day extension, but the banks, conscious of the need to adopt a hard line if progress in rescheduling negotiations was to be made, have granted only 30 days.

If, in the Advisory Committee's view, the Venezuelans have made significant headway towards paying off interest arrears and negotiating an IMF economic adjustment programme, it will recommend a further 90-day extension until the end of January.

In sharp contrast to the other major problem countries, Mexico's position continues to provide grounds for optimism. Agreements to reschedule virtually all public sector maturities up to end-1984 have now been signed, and commitments to Mexico's private sector debt rescheduling scheme have risen rapidly in recent weeks. The authorities are soon to begin negotiations on new money requirements for next year, which are reckoned to be $4 bn from banks and $1.5 bn from official sources.

Elsewhere, Peru has been obliged to approach the IMF for a conditional waiver of the EFF performance targets for September and December. The breakdown of the programme will delay the next scheduled drawing from the Fund in November, and hold up the remaining $200 mn to be disbursed under the $450 mn new money loan from banks.

More encouragingly, the Chileans have reported that their standby arrangement returned to its original path by the end-September deadline, although the authorities are now seeking easier terms under the second year of the programme; and Ecuador's commercial bank refinancing package was signed on 12 October.

(ii) Far East

The liquidity crisis in the Philippines has now obliged the authorities to seek a 90-day moratorium on repayments of debt principal to banks. During this period, a new SBA is to be negotiated with the Fund and a financing plan agreed for the remainder of 1983 and 1984, which will no doubt include a formal rescheduling package. Continuing concern about political stability makes the situation even more delicate. However, there has been no evidence that the problems in the Philippines have weakened confidence elsewhere in South East Asia, although one report indicates that Indonesia may wait for more settled conditions before coming to the market again. Otherwise, both that country and South Korea appear to be making further progress in adjusting their economies in the light of lower oil prices.

(iii) Eastern Europe

Official contact with Poland (albeit still on a conditional and technical basis) has been renewed: the creditors' group sent a fact-finding team to Warsaw in early October and will meet on 26 October to review its report and decide whether to invite the Poles to Paris in November to resume rescheduling negotiations. The US position remains unclear. Meanwhile, the commercial banks are expected to sign their agreement in Luxembourg on 3 November to reschedule 1983 maturities. Although the 1983 support programme for Yugoslavia has for the most part still to be implemented, preliminary soundings are being taken by the IMF on the possible format for 1984.

(iv) Southern Europe

Although the external positions of Portugal, Spain and Greece are likely to remain under strain for some time, no debt servicing difficulties are expected in the short term. Indeed, there are positive signs of improvement from both Portugal and Spain. In Portugal, the fairly rigorous programme recently agreed with the IMF for a standby facility worth $475 mn over 18 months - approved in conjunction with a compensatory financing facility worth $275 mn - lays the basis for a staged return to a more sustainable external position, while the current account showed a strong improvement in the first half of 1983. The announcement of the IMF programme also seems to have improved market sentiment: the reception for Portugal's request for a seven-year $300 mn euro-credit was so favourable that it was raised to $350 mn. Meanwhile, Portugal repaid $300 mn of the $700 mn BIS facility arranged in two tranches earlier this year, and a further credit of $300 mn was advanced in August. The Spanish current account deficit has also improved somewhat this year, and faster progress seems likely in 1984. Foreign exchange reserves, however, have been severely depleted, and it will be some time yet before Spain is able to stabilise its external indebtedness, let alone reduce it. Even so, there are no signs of serious resistance to Spain's very considerable financing demands from the

market. In Greece, on the other hand, with foreign exchange reserves already low (less than 1 1/2 months' imports at end-June), the current account deficit is expected to worsen slightly this year, reflecting a poor export performance and reduced invisible earnings. Nevertheless, the debt service ratio (including short-term debt) was only 24% in 1982 and should not be much higher this year. Borrowing on the international markets still appears to be well received, and $1 bn was raised in the first eight months of this year, compared with $1.7 bn in the whole of 1982.

Annex D

INTERNATIONAL DEBT - POINTS TO MAKE

General

1. Any durable solution to country debt problems must depend above all on economic adjustment by debtor countries. Developed countries best contribution is non-inflationary growth and avoidance of protectionism.

2. Support the role of the IMF and World Bank in promoting sound adjustment policies by ensuring they have the necessary resources and by supporting such policies in the Board.

3. Governments stand ready to contribute through the IMF World Bank, BIS bridging operations and official rescheduling. They should not normally be expected to make further contributions either direct or indirect to the financing burden. To do so could weaken the disciplines on debtors and private creditors and involve unacceptable increases in Government spending or financial exposure.

4. Generally debtor countries are not a homogenous group. Their difficulties are properly dealt with on a case-by-case basis, not by generalised and costly schemes.

Poland

5. Welcome the agreement at last week's Paris Club to invite the Poles to talks about debt rescheduling. Glad that the Americans now seem to accept, at last, that this is the best way forward.

6. Note that the Poles are unlikely to be able to make significant net repayments for many years. Essential nevertheless to make such recoveries as we can and to secure properly negotiated agreements for the future.

7. Inappropriate at this stage to be considering Polish requests for new credits, as part of the rescheduling agreement.

8. The Polish application to join the IMF is also irrelevant to the discussions of the Creditors group. The issues will not be decided in that forum.

East Germany

9. Interested to know how the West Germans assess the debt service difficulties of East Germany. Note the new credit given by West Germany in the summer. What are the prospects now? And will another loan be necessary?

Brazil

10. Note that prospects of agreement on the IMF programme appear to be deteriorating, particularly because of problems getting Decree Law 2064 through on wage deindexation. Stress the need for a sound programme and support the Managing Director's current insistance that Congress must approve the latest austerity package before the programme can be approved. Enquire about West German attitudes.

11. Note the G10 commitment to provide an official support package, despite HMG's refusal to participate. Danger that pressures will be relaxed if it came to be thought that official creditors were willing, as a matter of course, to provide additional support to fill postulated financing gaps over and above the substantial support being provided through the Fund and through official debt restructuring. Enquire about West German response to the American appeals.

Yugoslavia

12. It would be in the interests of Western creditor governments if next year's IMF programme involved more realistic economic adjustment and governments' direct contribution concentrated on debt restructuing, thereby avoiding a repeat in 1984 of the exceptional financial support operation arranged earlier this year. Hope this will be the consensus at the meeting of officials in Berne in mid-November.

BACKGROUND - FRG/GDR LOAN

The West Germans are anxious to maintain, or even improve, their special relationship with East Germany despite the general deterioration in East/West relations elsewhere.

2. East Germany is facing serious debt service problems, and last June the West Germans announced they would guarantee a loan of DM 1,000 million (about £250 million) as balance of payments support. We believe the West Germans were hoping to secure in return some political concessions, especially in terms of human contacts. Such conessions as we are aware of have been relatively minor, and debt service difficulties remain. So the exercise does not appear to have been as successful as was hoped in securing either the financial or the political objectives.

3. A financial deterioration in East Germany could affect other countries in Eastern Europe, already facing similar debt service difficulties, and would affect creditor countries, including the UK. Accordingly it would be helpful to know the West German assessment of prospects and their willingness to contemplate continued financial support, if they believe it to be necessary.

BACKGROUND - POLISH DEBT RESCHEDULING

Commercial banks and official creditors both negotiated rescheduling agreements in respect of debt service payments due in 1981. Following the declaration of martial law in December 1981 Western Governments refused to resume talks on rescheduling debt service payments due subsequently. The Polish response was to stop making any debt service payments, thereby effectively gaining the advantage of 100 per cent relief on both principal and interest. Commercial banks have continued to negotiate rescheduling agreements in successive years.

2. Western creditor governments originally in NATO imposed 3 conditions on any resumption of talks:-

a. the lifting of martial law;
b. the release of internees, and
c. the resumption of talks with Solidarity and the Church.

Of all creditor governments, the US have had most difficulty accepting that sufficient political progress has been made to allow negotiations to resume, but now seem to accept the view of the UK and other creditor countries that the refusal to negotiate is no longer a sanction and is actually working to the Poles advantage.

3. A meeting of the creditors group in Paris last Wednesday 26 ~~November~~ October agreed that the Poles should be invited to a meeting with creditor countries in Paris in the week beginning 14 November. The Americans concurred, ad referendum.

4. The aim of the negotiations will be to reschedule Poland's outstanding debt service payments over a number of years so that creditors will receive some net repayments each year with the prospect of full recovery in due course. But our assessment is that the Poles do not have the resources to make significant net repayments. What little there is has been scooped to a large extent by the commercial banks leaving little for Western Governments. There may not even be enough to cover fully the existing arrears and the

payments that would fall due under even a comprehensive rescheduling of other debt service payments. Moreover, the Polish Government appear unwilling or unable to take the economic adjustment measures necessary to restrain domestic consumption and/or increase production for hard currency exports.

5. It will be necessary, in the absence of an IMF programme (Poland is not a member) for the Creditor countries to establish with the Poles a future economic programme and performance criteria against which it can be monitored.

6. These are all matters for the negotiations which are likely to be long and difficult.

7. The Poles are seeking to negotiate concessions on two points: the granting of new credits; and acceptance of their application to join the IMF. Agreement seems unaminous within the creditors group that it is inappropriate to be discussing any resumption of new credits at this stage.

8. It is inappropriate, too, to try to link IMF membership with these negotiations. The application is being held up (primarily by the Americans) following the declaration of martial law. But we accept the current stalemate. Membership might involve a substantial call on IMF resources for Poland, which would be unwelcome to the IMF in the current circumstances. Generally, though, we support the principle of Polish membership in due course.

Annex E

BRIEF ON MR TUGENDHAT'S SPEECH

The speech was made to members of the Irish Stock Exchange in Dublin on Friday, 21 October. It has received little, if any, press coverage. The main part of the speech was about EMS and the role of the ECU and the key points he made are listed below. In addition Tugendhat spoke about:

(a) strengthening the links between national stock exchanges and revealed that the Commission might be able to fund computer links between European stock exchanges;

(b) the need for well balanced and harmonised tax systems together with relaxations/lifting of capital market restrictions;

(c) the hope that Ireland's exchange controls are "temporary and will be withdrawn as soon as circumstances permit".

Key points from speech

(i) Exchange rate stability

EMS has been a "remarkable success" in stabilising exchange fluctuations despite the second oil shock, fluctuations in US monetary policy and the dollar, and the most severe recession since the 1930s.

(ii) Co-ordination and convergence

EMS "has also entailed the co-ordination of economic policy and with it some convergence of economic performance ..." though he recognises the EMS's record on this score has been mixed. "Some Member States have too readily seen changes in parities as a soft alternative to changes in policies". He goes on to argue that too few Member States "have framed their monetary policies with sufficient reference to those of their Community partners". Not only does this weaken the EMS but "prevents Europe from making its full weight felt in ... international monetary negotiations".

(i) Role of ECU

ECU has "now emerged as a significant currency for private investors ... Yet the reaction of some Community governments to the ECU, particularly the German Government, has sadly been very much less positive than the attitude taken by most private banks and investors." Tugendhat goes on to urge the German authorities to overcome their objections to the ECU otherwise, by not playing its full part, this "will considerably impede the development of the EMS as a whole."

(iv) UK participation in EMS

Tugendhat urges Britain to become a full member of EMS by joining the exchange rate mechanism (ERM). In particular he argues that the absence of sterling from the ERM:

- denies British industry the chance of a more stable pound in the Community;
- upsets the stability of the ECU since Britain does not participate in the intervention mechanism;
- prevents the full development of the EMS.

He therefore welcomes the call by the House of Lords Committee on the European Community for full British participation in the EMS.

Comment

Most of the points raised by Mr Tugendhat are covered in the EMS brief prepared for your meeting with M Ortoli (copy attached). However, some additional Q and A briefing is given below on various specific points that were raised in the speech.

EMS contributed to exchange rate stability? /House of Lords Committee report contains evidence that EMS has contributed to greater exchange rate stability for its members, despite the number of realignments which have occurred./

Some evidence that exchange rates of ERM members have been more stable than those of the US, UK and Japan over period

since 1979. But this is not conclusive evidence that it was ERM itself which contributed to this greater stability. Sterling and dollar have fluctuated over that period for rather special reasons. And the narrowness of Japanese capital markets may well be behind the volatility of the Yen.

British industry being denied the chance of a more stable pound in the Community?

CBI agree that exchange rate volatility is major problem for industry but do not believe that joining the ERM would cure it. Perhaps reflects concern that joining ERM would substitute interest rate for exchange rate instability. Also membership of ERM would not help, for instance, those more concerned with stability of sterling-dollar rate or those who use the forward market.

Britain's non-participation in ERM upset the stability of ECU?

No. Need to remember that four major realignments in past two years have affected stability of ECU. Premature UK membership of ERM would not assist stability. Lasting exchange rate stability best promoted by sound financial policies leading to sustainable non-inflationary growth. In any case stability of ECU itself cannot be prime consideration in determining timing and appropriateness of Britain's entry into ERM.

Britain's reticence preventing full development of EMS?

No. HMG fully supports objectives of EMS but need to weigh up changing balance of risks, advantages and disadvantages of joining the ERM. To enter at the wrong time in the wrong conditions would harm development of EMS and objectives it seeks.

SPEAKING NOTES ON EMS

- Government takes seriously question of EMS membership and supports its objectives. We already play responsible role in several aspects of EMS

- Government always accepted that sterling's eventual successful and continued membership of the ERM would mark a major European achievement, and is to be desired.

- No immediate plans for entry into the ERM but question under review. Important to wait until conditions are right. Problems remain (petro-currency and international trading status of sterling) and EMS objectives would not be served by premature UK membership of ERM

- Sustainable non-inflationary growth is main priority. By itself, intervention not effective in controlling sterling, Joining ERM could lead to interest rate instability and shifts in monetary policy inconsistent with overall economic objectives. CBI disagree that ERM is solution to exchange rate volatility.

- Government content with rapid growth of ECU business. UK places no restrictions on ECU business. But development needs to reflect market demand - counter-productive to give artificial incentives. Agree that Germans should recognise that ECU is now a bona fide banking instrument.

BRIEF 2 THE EUROPEAN MONETARY SYSTEM

Background

(i) UK is founder member of EMS and participates in negotiations on its modification and in realignment conferences, and we deposit 20% of our gold and dollar reserves with the EMCF (by way of a rolling 3 month swap), even though the pound does not participate in the exchange rate mechanism.

(ii) The Commission have proposed that the Athens European Council make some kind of declaration of intent on EMS membership and development.

(iii) At their Council meeting on 19 October the CBI voted against the UK joining the exchange rate mechanism (there had been a disagreement between the European Committee who had favoured joining and the Economic Committee who had not). Sir Campbell Fraser said that exchange rate volatility had been one of the biggest problems facing UK businesses in recent years, but this could not be cured by joining the ERM.

(iv) A report by the House of Lords European Communities Committee on EMS was published on 22 September. The Committee believed that "though exact timing must depend on general government policy, the balance of advantage lies in early, though not necessarily immediate entry" into the ERM. The report is to be debated on 14 November.

(v) You will have seen Mr Littler's minute of 19 October about opinions in the German Finance Ministry on the possibility of sterling's early participation in the ERM.

(vi) After enjoying a relatively tranquil two years from its inception in 1979, the EMS has in the last two years encountered more difficult conditions with major realignments taking place in October 1981, February and June 1982 and 21 March 1983. Since the

EMS was established sterling has appreciated by 2½ per cent against the deutschemark, by 35½ per cent against the French franc, and by 21% against the basket of EMS currencies.

Line to take

(i) Government continues to keep the question of sterling's participation in the ERM under review, but has no immediate plans for entry.

(ii) Government has always accepted that sterling's eventual successful and continued membership of the ERM would mark a major European achievement, and is to be desired. But important to wait until conditions are right both for ourselves and for the system as a whole. Reasons why premature membership likely to cause problems well known [see defensive points below.]

(iii) Main priority (for us and other member states) is to get inflation down and keep it down, as a basis for continued sustainable economic growth, through sound financial policies. That is the only way to promote lasting exchange rate stability.

Defensive points

(i) Unlike the other EMS countries, the UK is self sufficient in oil. Sterling therefore tends to rise and fall in line with oil prices while other continental currencies do the opposite. Although oil markets have been relatively settled recently, cannot be certain that such stability will continue - as recent events in the Middle East demonstrate.

(ii) The pound and the deutschemark are both widely used in international finance and hence particularly vulnerable to large speculative flows between them (eg following a possible sharp movement in the dollar). [House of Lords Committee recognised that sterling's entry might place a strain on the ERM not comparable with other European countries.]

(iii) Intervention on its own is not an effective method of controlling exchange rates for widely traded currencies such as the £ and DM. Policy action, on interest rates in the first place, is needed. Joining the ERM would thus risk substituting interest rate for exchange rate instability. And it could require shifts in monetary policy not justified by monetary conditions where (cf Mansion House speech) the exchange rate was moving for reasons "quite unconnected with fundamental developments here or abroad."

(iv) House of Lords Committee Report perhaps assumes too readily that above difficulties have eased. Even so, the Report's argument for UK participation is negative rather than positive:

> "Many reasons given in the past for not entering seem no longer valid, but no single overwhelming reason can be given to advocate immediate participation into the ERM." (para 84).

2.54

NOTE OF A MEETING BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND COUNT LAMBSDORFF, FEDERAL GERMAN ECONOMICS MINISTER, AT NO.11 DOWNING STREET ON TUESDAY 1 NOVEMBER

Present

The Chancellor of the Exchequer
Mr Edwards
Mr Graham

Count Lambsdorf

Dr Mueller Thuns

Dr Witt

Dr Kudlich

Miss K Pestell

The Chancellor asked Count Lambsdorff how he saw the prospects for the West German economy. Count Lambsdorff said that the economy was improving. It was on course for 1 per cent real growth in 1983, and growth was expected to reach 2.5 per cent in 1984. Other economic indicators were also promising; inflation was now less than 3 per cent, current account was in surplus, interest rates were below 1981/82 and even the unemployment figures were less bad than had been feared, although 1984 was likely to be a difficult year in this respect. The Federal Government had been working hard, with some success, to reduce its budget deficit and this now amounted to some 2 per cent of GNP. There was still a great deal to be done in the field of deregulation, to make German industry more flexible and adaptable but it was hoped to take decisions on this early in the new year. He also hoped that there would soon be an opportunity to introduce tax reforms, and reduce the burden of taxes on income and corporations. Increases in the former had been particularly high in recent years, because it had not been possible to increase tax thresholds. He hoped that the budget that would take effect on 1 January 1986 would achieve this. At the moment, the marginal rate of tax for the average employee (including social benefits as well as income tax) was 60 per cent. This made collective bargaining on wage increases very difficult, because the net result of any agreed increase was so small. The mood in the country towards the new Government was still rather difficult, but this was not particularly worrying at present and there was plenty of time to make up the ground. Like the UK, the new Federal German Government was working on at least a medium term policy.

2. The Chancellor, in response, said that the recession in the UK had started earlier, and therefore so had the recovery. From its nadir in the first half of 1981, the UK economy had shown very low growth in 1982 but in 1983 the growth was likely to reach up to 3 per cent. Most of the momentum for this had come from rising consumer spending and the end of destocking, and it looked as though this pattern was likely to be much the same in 1984. Our employment, at nearly 13 per cent, was higher than in the Federal Republic, but the rate of growth had slowed considerably and should be leveling off in 1984. Inflation was now 5 per cent, and he expected that this also would fall slightly in 1984. The budget deficit would unfortunately overshoot the planned £8.25 billion, but it would still be low by the general standards of the civilised world; including the nationalised industries it would probably be slightly greater than 3 per cent of GDP, which was about average for the last 3 fiscal years. There had been, and would continue to be, a difficult struggle with public expenditure but the Government's intention was to hold the total constant in real terms for the next three years, which with an improving economy would reduce it as a percentage of GDP. The UK's problems with marginal tax rates on income were not so serious as the Federal Republic's - income tax and insurance contributions amounted to about 40 per cent - because the thresholds had been indexed in every year but one of the Conservative Governments. Because of the high budget deficit that had been inherited, however, it had been necessary to increase the total burden of taxation; this had been done by increasing indirect taxes, national insurance, and north sea oil taxes. Like the Federal Republic, the UK industry needed a large amount of deregulation to make it more flexible and adaptable. A considerable amount had already been done in this field, and the Government had also made a good start in its programme of privatisation. £2 billion worth of assets had already been transferred to the private sector and virtually every privatised company had improved its performance.

3. Count Lambsdorff said that the Federal Government had just decided to reduce its holding in the Veba energy concern from 46 per cent to something under 30 per cent. Dr Stoltenberg had been somewhat reluctant to do this, as stock prices were historically high and it was not therefore a good time to try to market the company, but the political pressure to show some hard evidence of the Government's intention to introduce its declared policy had proved irresistible. The Chancellor sympathized with the difficulties the Republic were likely to face in pitching the price, and related to Count Lambsdorff the difficulties he himself had experienced with Brit-oil. He advised him that criticism of the Government's actions was very much less if the concern were sold by means of a tender

offer, because it was at least possible to demonstrate that the Government was getting the best price available on the day of the sale.

4. Count Lambsdorff asked the Chancellor what the UK's attitude was likely to be to the ideas floated by Herr Tietmeyer in the last ECOFIN about progress on the insurance directive. The Chancellor admitted that his initial reaction was very sceptical. Herr Tietmeyer had expressed his ideas only in a very general term, and the UK Government would certainly look at any specific proposal on its merits. But his initial reaction was not in favour of the idea of two different categories of insurance. He still felt that the better idea was an across-the-board liberalisation of insurance services. Dr Thuns explained that the German's intention had been to pick up the previous UK concentration on the need to liberalise insurance regimes for the big industrial risks. Count Lambsdorff explained that the general problem with a broader liberalisation was its conflict with the political philosophy of consumer protection. It would be quite impossible to abandon the latter for the smaller, individual consumers in Germany, even if it were eventually accepted that large companies should be sufficiently well aware of the situation to look after themselves. The present regime in the Federal Republic did not in any case prevent foreign participation in insurance. There were German insurance companies that were 100 per cent foreign owned and there would be no objection to others passing into foreign hands, if those anxious to enter the market could find companies who were willing to sell.

5. The Chancellor also raised the question of the progress of negotiations on the European budget. He emphasised once again that the UK would find it impossible to accept any solution that did not solve permanently the problems of both the financial mechanism and the CAP, and that without this they could not agree to any increase in own resources. He also repeated that the UK had looked at every possible combination of answers, and could see none that did not relate to net contributions. He was sorry therefore to see the German proposals that were to be tabled the following day, because they suggested the Federal Republic were leaning towards a different approach, and one moreover that the UK could not possibly accept. He appreciated that the German paper had been designed in good faith to help solve the problem, but he was very much afraid that it would entirely miss this target. He understood the Germans' unwillingness to be the only net payer into the community, and to have their contributions uncontrolled, but the UK safety-net plan in fact provided a much better solution to this problem than that which the Germans themselves had proposed. The UK plans were obviously open to marginal amendment, for example in

introducing a dynamic element rather than an absolutely rigid ceiling to net contributions, but it was essential to stick basically to the net contributions point.

JS

MISS J C SIMPSON

2 November 1983

Circulation

Those present
PS/Economic Secretary
Mr Fitchew
Mr Lavelle
Mr Bottrill
Mrs Case
Miss Court
Mr Pirie
Mr Denison
Mr Ingham
Mr Saunders

PERSONAL AND CONFIDENTIAL

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B.7

A N Ridley
Special Adviser

12 December 1983

Robin Butler Esq
10 Downing Street
London S W 1

Dear Robin,

Here are some minutes of the discussions to which the Special Advisers were invited with Herr Teltschik and his German colleagues last Friday. They are not yet complete, as John Houston has not yet had an opportunity to let me have his record of the "economic" part of the morning. But they do cover the key session on foreign policy, and records all the key points as accurately as possible, even at the cost of length and repetition; and the preliminaries, in which both sides spoke about their central administration framework and modus operandi - whose key aspects I touch on immediately below. It may be helpful if I attempt to summarise the most interesting points to emerge from the whole affair.

First, there were a number of significant hints and concerns which we were made aware of at the buffet dinner to which I invited all participants on Thursday night:

- concern that Prime Ministers/Heads of State were being forced to go into so much detail to make Summits work;
- a sense of relief that the Germans now had a good line on the Elysée staff, even if they at times behaved like a bunch of socialist ideologues;
- a great desire to get closer to the UK.

Second, in the discussion of the organisation of both sides at the centre (referred to above), with which Friday's more formal exchanges began, the following became clear. On the one hand the Germans found it difficult to imagine a way of running things in which the PM/President and his/her staff were noth both the solitary power-house and sole agents for coordination - as are the Elysée

/and....

and Bundeskanzleramt. We had to underline to them repeatedly the fact that in our system, with Chancellor, Foreign Secretary and PM sharing the same priorities and liaison well established between No 10, Cabinet Office, Treasury and Foreign Office, we did not have need for a comparable staff. On the other hand they were implying that given an inexorable pressure pushing more and more detailed issues onto Summit agendas and all this entailed, we should find some way of joining in the kind of contacts made possible by large central staffs such as the Elysée and Bundeskanzleramt. Our arrangements might be ideal from a normal point of view, but would they enable us to help our masters play the increasingly vital and complex game of summitry in the way our partners found necessary?

Third, in the foreign policy discussion on Friday afternoon, they (in practice mainly Teltschik himself) touched pretty deliberately on a number of important points (paragraph references are to my fuller minutes, which are attached):

- the need for an early Western initiative to resume dialogue with the USSR, to pre-empt an embarrassing Soviet effort with the same purpose (§3-6);
- Mitterrand's proposal for another Franco-German Summit, and the suggestion we should join the game (§8-10);
- concern that we should sustain, widen and deepen consultations with the Americans on key issues (§4);
- the need to respond to third-world expectations of the EC as in effect potential third power bloc (§12-14), and the suggestion we should in particular respond to Hussein's desire for an Anglo-German role in the Middle-East (§13);
- a warning that we should all consider now how to respond to a new Soviet disarmament initiative involving French and British nuclear weapons, and extending also to countries such as China;
- a general message that the German door was very emphatically open to deep and early discussions about the future of the Community; coupled with the hidden but clearly implicit thought that Franco-German contacts would pursue such goals even if we stayed out;
- a warning about US assumptions of allied support if the USA had to intervene to protect the Straits of Hormuz.

X

/Fourth...

Fourth, there was a point or two worth recording in relation to the economic discussion, even if we do not yet have a proper record of it. Much of what both sides said dealt with the relatively satisfactory pattern of domestic economic development in both countries. But at the end of his presentation the main German speaker, Herr Ludewig, turned to the development of the EC's economic policies in the longer term. It was striking that within Germany success and restoration of confidence in recovery hinged on confidence that they had a stable Government committed clearly to cutting the structural public deficit (to zero in '85), lowering taxes, strengthening the market and curbing inflation. Looking at the EC there were in fact at least three major Governments on broadly the same, right lines - one had to grant that to the French now.

Y1

Looking ahead, did we not need to

- run our domestic policies with more awareness of their impact on each other, as we were urging the US to do?
- make it really clear to the business community that we were really committed to further effective progress towards united markets in the longer term?

What, therefore, were the elements in our vision of what the EC should be or become over the next ten years?

/In my reply I stressed needless to say that we had all sorts of ideas about the EC's long term future, but until the Athens agenda had been dealt with, there were limits to the objectives to which we could be expected to give high priority. That said, we would probably be absolutely committed, with Germany, to more united markets/.

I had the impression the Germans are not yet quite clear what economic aims they are after, but convinced of the need for committed discussion with us and the French as to where the Community should go.

If there are any points on which you or others would like clarification, Peter Cropper, John Houston or I can probably dig up more detail from our notes. I am sending copies of this letter and attachments to both of them, as well as to the Chancellor and Economic Secretary's offices here, and to Geoff Littler; also to Stephen Sherbourne.

Yours ever
Adam

A N RIDLEY

INFORMAL ANGLO-GERMAN DISCUSSIONS

DECEMBER 9 1983

PRESENT:

From the German Side

Federal Chancellor's Office

Min Dir Horst Teltschik: (Foreign, Security and related matter
Dr Walter Neuer: (Political matters Europe, Near East, EC)
Dr Anton Rossbach: (US, E. Europe, E-W Relations, Disarmament)
Capt. Ulrich Weisser: (Alliance and Military)
Dr Johannes Ludewig (EC Economic)

From the Foreign Office

Dr Michael Jansen (Personal Adviser to Herr Genscher)

From the CDU

Herr Peter Radunski, Secretary-General CDU Central Office.

From the British Side

Peter Cropper, CRD
John Houston, FCO
Robert Ramsey, EDG
Adam Ridley, Treasury
Stephen Sherbourne, No 10
- - - - - - - - - - - - -

Robin Butler, No 10 (for lunch only).

PERSONAL AND CONFIDENTIAL

FOREIGN POLICY, NATO AND SECURITY ISSUES

Teltschik opened the discussion with a relatively long and carefully prepared presentation, which gave every sign of containing many of the key points which the discussions were intended to convey to us.

2. He began with an aside, expressing surprise that consideration of Foreign policy in the UK seemed to attract relatively low priority and that it was to some extent a field for non-experts at that. He hoped that it would be getting more serious attention soon. /In so doing he was demonstrating misunderstanding of points made earlier, when John Houston had explained that till recently foreign policy issues here had, as a rule, had a relatively small party political content because of a broad consensus embracing the main issues and most public opinion; and misinterpreting (perhaps) the significance of the very light staffing of No 10 in Foreign Policy matters/. He then developed four major themes.

1. INTERMEDIATE MISSILES, AND THE FUTURE INTERESTS OF W. GERMANY AND THE UK

3. The key issue was and is not so much how many Cruise missiles would be deployed and how quickly, as the fact that we had held to our decisions to do so. Had we not, the repercussions would have been very serious in the wider international arena. Those many countries which were anxious about the USSR, and in many cases (over-) dependent on the USA had long been anxiously wondering whether Germany and the UK would resist Soviet pressure, stick to the two-track decision and deploy. In essence it constituted a test of whether we could be relied on at all.

4. That issue of principle and our countries' credibility both now having been restored, there was now an opportunity for a better dialogue with the USSR than in the immediate past. It would in any case be wrong to think the Russians would stay out of contact indefinitely and in a huff. They would take an initiative, perhaps quite soon.

5. There were plenty of examples of such moves by them. Only four months after their invasion of Czechoslovakia in 1968 they had made a major démarche at the European Security Conference - to which Willy Brandt had, significantly and importantly, been the first to react. Unless they have suddenly changed and if we

do nothing, they will blame the West for the failures at Geneva, with some success, and then come up with a new initiative. If they do, the West could be put in disarray, with some Western countries seeking ways of reacting constructively while others denounced the whole exercise as Soviet propaganda.

6. Therefore we should both be considering taking some kind of pre-emptive initiative; keeping doors open; and continuing to talk. For that reason Germany was naturally pleased with the conclusions of the NATO Council, and was delighted Mrs Thatcher planned to visit Hungary. /It transpired that Herr Kohl has the same idea in mind/.

7. Teltschik added, almost en parenthèse, that he and others were hoping for a Reagan-Andropov Summit in due course. This could be a basis for a breakthrough, particularly on disarmament.

2. GERMANY AND EUROPE

8. The two-track decision had produced strains inside Germany which we might well be aware of - a peace movement and an SPD in turmoil were two major ones. It was absolutely vital that outsiders should appreciate their nature. It was important that we should note to what extent Adenauer's 1964 decision to "integrate with the West" was far from self-evident; and certainly a unique event in Germany's history. The peace movement was in a sense challenging that historic move. It was, of course, true that the "Hot Autumn" the Peace Movement had promised had not occurred. In truth the activists do not now know quite what to do. But it was quite possible that those seeking to "disintegrate" would in due course grow in number, and even prevail at some point.

9. This risk the French were very aware of. There had recently been a big change not only in the French Government but also on the part of the Gaullists. This was already leading to much more intensive relations, and greater interest in the "European idea", perhaps particularly in security matters.

10. Thus Mitterrand had just proposed a "working summit" with Kohl in January, and the preparation of a "common paper on European Perspectives". Neither Teltschik nor any others had yet much idea what agreements on policies or objectives were thus being pursued. But it was absolutely certain that the proposal was both an expression of France's security interests and a reflection of the importance of the double track decision. It was also, come to

that, another aspect of a growing Continental tendency /Teltschik very deliberately said "continental" in the English sense/ towards greater cooperation, "particularly amongst the EC's founders". Such progress would, of course, demand a solution of the Athens problem. But

> "the Conservative Party and British Government should pay very close attention to these developments. Should the UK not be part of the debate? Or should Britain keep its head pointed elsewhere? "

3. A MAJOR PREOCCUPATION OF GERMANY'S FOREIGN POLICY

11. A further issue, or rather conviction, arising from the double-track decision concerned relations with the US Government. There had been no other matter over which liaison and discussion with the USA had been so close and continuous. Our country's success in holding to our purpose was directly attributable to the effective maintenance of such excellent contacts, as well as to the fact that not only did the key NATO states have a common position from the outset, but so did France and, even, Spain. It therefore followed that we should seek equally effective and constant coordination and consultation in other areas. This effort should extend to consultation with the Alliance generally, and not just a few narrow security issues.

4. THIRD WORLD EXPECTATIONS OF THE COMMUNITY

12. When travelling abroad, Kohl and his staff were constantly being impressed by the fact that countries like Saudi-Arabia, Japan, China, Indonesia and many others were seeking a more influential EC and to escape from the "either/or" embrace of the USSR and USA. This was, most importantly, particularly true of the Arabs and the Middle East. The Arabs did not think we could solve all their problems, but they did think and hope we (the EC) could make a major impact on some areas.

13. Thus with the PLO now knocked out, Hussein was considering a new initiative. He knows its success would require the support not only of the US, but also of Kohl and the Prime Minister, given his particularly good relations with them. Hussein had recently written to Kohl about the idea. Kohl had discussed it with Mitterrand, who was dismissive because "Hussein is too weak".

14. This was a matter on which the UK and Germany should work very closely, and concert vis-à-vis the USA.

15. Rossbach then enlarged on Teltschik's first theme of re-developing relations with the USSR. The Russians' main strategic purposes would remain to prevent the USA from continuing the modernisation of their weapons, and to encourage them to withdraw from Europe. But the Russians' immediate priority was saving face (Gesichtswahrung), and extracting themselves from a mess of their own making. The decision to station medium-range weapons was now being implemented, and they would wish to limit it as far as possible. They would have no interest in seeing the Iron Curtain become a curtain of rockets (Raketenvorhang). They were well aware that they had made advances with public opinion in the West by being willing to take positive and apparently constructive initiatives, and would not wish to jeopardise these gains.

16. It was striking that in those classes of Russo-German contacts where Germany was still maintaining "business as usual", the USSR remained very open and responsive. They were all set to do so at the forthcoming Stockholm Conference, too.

17. This suggested that the western nations should follow a two-fold strategy:

(1) some kind of secret contacts, part of whose purpose would be to explore suitable face-saving devices;

(2) some kind of positive public Western posture, which would prevent public suspicions that we were simply crude spectators, who were awaiting the USSR's return to its senses and dialogue.

18. Such a positive posture did not need to be founded on specific proposals. What mattered was a stress on willingness to resume talks, and procedural moves to restart them; and that the West should not insist on the Russians paying a substantial price for resuming the dialogue.

19. John Houston then underlined some aspects of British policies for arms control, etc. Amongst the points he made were the following.

20. The position was indeed depressing. It was important that the deployment of Cruise was now taking place. Four years of Soviet pressure had not prevented it. There must be doubts both

about the Soviet leaders and what they would now wish to do. It was quite possible that they might choose to wait for a while to make our flesh creep in the West, and build up new pressures. If that was a defensible assessment, we would need to be careful about how we responded. As far as public attitudes went, it appeared that opposition was for the moment diminishing, perhaps because people have a tendency to fall in with the status quo, which is now deployment. This pattern could, however, change if tension were to increase. All this calls for unity in the Alliance; and being wary of possible initiatives which might curry public favour, but raise false hopes on the Soviet side. We shared the German judgement that the Russians needed a way of saving face, and we needed to get back in conversation with them.

21. Teltschik then offered further observations about disarmament problems. The INF talks had ended because of Soviet insistence on including French and British weapons. Germany had agreed with us and the French in our refusal to see them brought in. But we (all of us - i.e. UK, France and Germany) should now consider how we would react to a proposal which embraced third country systems. For example a Soviet proposal of altogether broader scope than hitherto, involving all major weapons systems, and bringing into the discussion the Chinese as well as Britain and France. Such an initiative could well constitute a very embarrassing offer we could not refuse.

22. In sum, the UK and France needed to consider very soon if, when, where and how we should involve our weapons in such negotiation.

23. John Houston recalled that "we've never said 'never'". We had open minds, and were always prepared to consider new proposals seriously.

24. Rossbach observed that the long time required for full deployment gave the USSR big opportunities for changing public attitudes. The pre-emptive initiative commended earlier needed to involve the whole Alliance and the US, with whom contacts would have to be as close as over the INF.

25. Viewed from a German perspective, the faltering consensus over defence matters which the SPD's state was aggravating called for "a political impulse in Europe, and more action and effort in the framework of political cooperation".

26. Jansen (Auswärtiges Amt) intervened to make two points. He had been much struck on the margins of the Athens Summit by peoples' fear of being dragged into US concerns when Europe could not even deal with its own.

27. He also recalled his Department's statement after the INF collapse, stressing the case for a broader approach to East-West problems. There was something to be said for paying more attention to the 2-pillar approach of the original Harmel report.

28. After some minor interventions from Neuer and Weisser, Ridley asked Teltschik if he could shed any further light on Mitterrand's objectives in proposing the working summit and joint paper on Common European Perspectives. At least three different, non-exclusive, private goals were conceivable, however the proposal might be presented and worded:

- closer agreement and cooperation on fairly specific defence matters;
- a more effective independent European voice in foreign affairs matters generally; which could mean an attempt to mobilise the largest EC members as an inner group. echoing ideas current a while back;
- a more effective decision-making framework in the EC, in view of the difficulty of making any progress at all at them, the threat of even greater centrifugal tendencies after enlargment, and the implications of such insights for the French Presidency. All of which might lead one back by a rather different route to the idea of an "inner-group" of dominant large countries.

29. Teltschik repeated that the French had only made a very vague proposal. It was quite certain that closer cooperation in security matters was one goal; and almost certain that greater cooperation over high technology industries was another. But the political aims Mitterrand had in mind were still quite obscure. The Germans would be both studying the proposal carefully and seeking to find out the answers to these questions directly after the weekend.

30. He went on to underline that Kohl and the German Government were interested in using any opportunity to develop the Community. They would look at any sensible ideas, if humanly possible in partnership with the UK. There was a deep desire in his country

to do so, and the pressures to do so were growing.

31. He then turned briefly to non-EC problems. George Schulz had just visited Bonn and discussed the Middle East and the Iran/Iraq war. It seemed likely that, if there was the obvious crisis there, culminating in the closure of the straights of Hormuz, we would all be likely to wait for the USA to intervene militarily. Schulz had made it clear that, if they had to do so, they would "expect the Europeans to respect their interests too", i.e. act conjointly or support.

187/12

British-German Consultation for Special Advisers

London 8/9 December 1983

Notes on First Session concerning role of political advisers in Government.

1. Adam Ridley introduced the UK team and described the structure of government at the political centre.

2. Stephen Sherbourne described the organisation of government as seen from the Political Office at No 10.

3. Mr Horst Teltschik welcomed the opportunity to meet opposite numbers face to face. He also underlined the increasingly close links between European governmental machines.

4. Mr Teltschik described his own experience in local and central government as Head of Section 2 of Bundeskanzleramt, concerned with foreign affairs.

5. Mr Radunski - party manager of the CDU at headquarters. Was for some years deputy head of Konrad Adenauer Foundation. He stated that Dr Kohl was both head of government and leader of party - but the two posts do not have to be held by the same person.

6. Mr Ludewig - in department 4 of Bundeskanzleramt, dealing with questions of economic and financial policy. Formerly served in Department of Energy. Work includes relations with EEC on economic matters.

7. Mr Neuer - works in Teltschik's department, on relations with West European states - including political relations with EEC. Started in Foreign Service.

8. Mr Rossbach, also in section 2, working on North American Affairs, East West Relations, Disarmament. Also formerly in Foreign Service.

Mr Weisser - Naval Officer, reporting to Mr Teltschik on defence and security matters.

Mr Jansen - Personal Adviser to Mr Genscher, Foreign Minister. In the Ministerial office we have four secretaries, all career officials. In Mr Genscher's ten years in office there has only been one political adviser.

Mr Teltschik described Bundeskanzleramt. 400 people. Six sections. The political leadership consists of:

1. Secretary of State responsible for administration.

Three MPs concerned i) with relating with parliamentary party; ii) with the Upper House; iii) with Berlin matters.

Dept 1. Administration/Legal

2. Foreign Policy

3. Internal and Social Policies

4. Economic and Financial Policies

5. Public Relations and Communications

6. Security Departments

The officers of these six Departments were all political appointments and can be replaced on a change of Government.

Within the Bundeskanzleramt the rest of the staff are on attachment from government departments.

Work of the Bundeskanzleramt: prepares all issues for decision by the Bundeskanzler.

Members of the BKA are primarily concerned with political success of the government - not only party political success.

Mr Radunski - how the Party works:

Secretary General of the Party is also a Minister in Cabinet.

In the last ten years the CDU has become a highly organised members party.

The Party also has many more multilateral and bilateral contacts.

The Party is responsible for the electoral campaign.

The most important link government/party is the executive committee of 11, under chairmanship of the Federal Chancellor.

Policy planning. Research System. Departments, Party, Konrad Adenauer Foundation have to be co-ordinated. Also Government.

Mr Houston - In our system, the idea that foreign affairs are political is a new one.

Important to realise that all officials are expected to be concerned with the success of the Government.

Mr Teltschik - the Bundeskanzler must have around him team committed to the political success of the Government.

Mr Sherbourne described how officials were expected to be impartial. Referred to Sir John Hoskyns' thesis, that the Civil Service had impeded the progress of the Government since the last war.

Mr Ridley introduced another debate, particularly on foreign affairs, describing how Community matters had gone back to departments. No central entity yet.

Mr Teltschik said he was the first head of Foreign Policy Department who was not a career official. It is vital that members of the Bundeskanzleramt must be both loyal and creative.

Mr Ludewig pointed out that foreign affairs had been the controversial side of German post war affairs - whereas on home affairs there was a broad concensus.

Mr Teltschik pointed out that the Federal Chancellor spends very much time on foreign affairs and is not pinned down in the same way as the British Prime Minister at Question Time.

Mr Jensen asked what could be done to save the matters of key detail having to be dealt with by Heads of Government.

Mr Ridley emphasised the fact that in the British system the Head of Government has to deal with detail.

Mr Neuer pointed out how the European Council had degenerated - it was now almost a council of experts.

Mr Teltschik asked how the different organisations at the centre are weighted when it comes to preparing policies for EEC negotiation.

Mr Telaschik said he was the first head of Foreign Policy Department who was not a career official. It is vital that members of the Commonwealth Public Service be both loyal and creative.

Mr Lussey pointed out that foreign affairs had been the controversial area of German post war affairs - whereas on home affairs there was a broad consensus.

Mr Tatschik pointed out that the Federal Chancellor spends very much time on foreign affairs and is now planned down in the same way as the British Prime Minister at question time.

Mr Jensen asked what could be done to save the matters of key detail having to be dealt with by Heads of Government.

Mr Hodges explained the interaction in the Cabinet system and the need of Government use to deal with detail.

Mr Hodges pointed out how the Foreign Council had degenerated - it was no longer a council of experts.

Mr Lussey spoke on the different organisations at the Foreign Ministers level and the complex consultations which go on at this level.

Mr Sherbourne - First Mr Coles, the Foreign Office man at No 10. Then key officials.

Mr Ridley - The private secretaries probably carry 30 per cent of weight.

The cabinet office will concentrate on matters of procedure.

The Policy Unit is growing gradually in status and power.

Otherwise power tends to be concentrated in Ministers.

T L Gropper.
10 Dec 83.