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RECORD OF A CONVERSATION BETWEEN THE PRIME MINISTER AND THE CHANCELLOR OF THE FEDERAL REPUBLIC OF GERMANY AT SCHLOSS GYMNICH ON THURSDAY, 1 MARCH 1973 at 10.55 p.m.

Present:

Prime Minister	Herr Willy Brandt
Mr. D.J. Mitchell	Herr Poehl
Mr. J.J.B. Hunt	Herr Weber
Mr. R.T. Armstrong	Herr Schilling
	Herr Fischer

Foreign exchange situation

The Federal Chancellor said that the Prime Minister and he had agreed to resume their discussion of the exchange situation with monetary experts present.

The Prime Minister invited Mr. Mitchell to open the discussion.

Mr. Mitchell referred to the Prime Minister's speech at dinner, in which he had said that this was possibly a time for big political decisions on European monetary affairs. The problem was that markets could not stay closed indefinitely. It might be possible to keep them closed until the middle of next week; but between now and then a statement would have to be worked out, which would have to meet two requirements: it would have to contain the inflow of dollars, and it would have to entail an element of European union or cooperation comparable to the joint Community float which had been discussed. This would clearly require discussion at a meeting of Community Finance Ministers over the week-end, though this would present particular difficulties for the Chancellor of the Exchequer who was due to open his Budget on Tuesday 6 March. In preparation for that meeting, there would need to be a note of possible Heads of Agreement on a joint

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Community float and on other elements necessary to that. These elements had not been worked on either by individual Community countries or by the Commission. These would clearly incorporate some of the elements on which the European Commission had now been asked to report by 30 June. That was the measure of the acceleration of decisions required. It would be necessary to decide about the details of methods of intervention and settlements, about methods of support for the weaker currencies (sterling and the lira) about the implications of reserve pooling, and about the need for acceleration of work on other aspects of economic and monetary union. What was envisaged meant a substantial acceleration of the timetable proposed in the Werner Report.

Herr Poehl said that the German Government had taken their decision to close the exchange market on the following day. It was now necessary to look at the various possible courses of action. One possible course was to reopen the markets without any parity changes but to introduce a stiffer regulation of capital movements. Their experience of such regulations was not good; they did not believe that they could avoid speculative movements by these means. A second possible course would in theory be the introduction of a two-tier market. But that course was not open to the Germans because of the structure of their balance of payments. A third possible course for Germany was to float in isolation. If they were looking only to their own interest, this course would have considerable attractions and would enable them to reinforce their attempts to contain inflation. But it would be a great shock to the European Community. The German float in 1971 had brought the Community near to breaking point. For the Germans to float again now on their own could spell the end of progress towards European monetary union at least for several years.

So the German Government were more in favour of a joint monetary float on the lines proposed three weeks ago. On that occasion all the arguments against such a plan had been considered. Central Bank Governors had discussed the matter in Basle and had concluded that Britain could not take part in a joint Community float. Then it had not been necessary to pursue the possibility, since Mr. Volcker had arrived with a different solution to the problem. That solution had not lasted, and now we had a new situation in which another dollar devaluation was simply not possible.

One of the reasons which was given for Britain being unable to join a joint Community float was the existence of the sterling balances. It was said that, if a new parity was fixed for sterling, there would be a considerable movement out of sterling into the Deutschemark: perhaps as much as $5 to 6 billion. So this was already as much Germany's problem as Britain's. If Germany was ready to recognise that and to contemplate the consequences, perhaps Britain could think about that.

Herr Poehl recognised that the practical problems of a joint Community float would require a lot of further study and discussion. But in the end there had to be a political decision. If we now decided against a joint float, the prospect of European monetary union would be postponed for a long period of time.

A joint Community float would be only a first step. The next step would be harmonisation within the Community on monetary policies, interest rate policies and perhaps even fiscal policies. The main problem was whether the Community was ready to take such a step. Once the first step was taken, it would be an encouragement to follow it up with others. We had reached a crisis situation which contained the seeds of a great adventure. Perhaps that was the direction in which the logic of the situation compelled us.

In the subsequent discussion Herr Poehl said that markets would be closed the following day in Belgium, the Netherlands, Luxembourg and Denmark. Mr. Mitchell thought that London was likely to close too. It was agreed that there would need to be a meeting of Community Finance Ministers. It would be for the Commission to convoke such a meeting, which might well be held in Brussels. Herr Poehl said that it would be perfectly possible to keep the exchange markets closed until the end of next week or until necessary. The real point was whether the Community should move to a joint float or not. Before a decision was taken, all concerned would have to know what it meant. It might be easier to reach a solution if it was not actually called a joint float, in view of the French objections to the concept of floating.

Herr Poehl said that the German Government had done a good deal of work on the possibility of a joint Community float in 1971, and therefore knew what it meant for Germany. From a technical point of view it was very simple: it simply meant that there was no intervention in dollars, while between Community countries intervention was maintained rather on the lines of the snake. But that was only a first step. It would also be necessary to pool at least part of national reserves, and there would be problems to consider here, particularly (for the French) in relation to gold reserves. It might well be necessary to move fairly quickly to the harmonisation of interest rate policy; in the not too distant future, a European Central Bank would be required - and (Mr. Mitchell added) a European Treasury.

Mr. Mitchell drew attention to the difficulty of deciding the parity at which sterling should be fixed, given the uncertain prospects for the balance of payments in the next year or two. It might be that the kind of parity which we should wish to fix would be lower than some of our partners would welcome. Herr Poehl made it clear that, if we fixed a parity which we subsequently found we needed to adjust, we should be free to change the parity. Mr. Mitchell commented, and Herr Poehl accepted, that this would be a necessary element in the proposition.

Herr Poehl contemplated that other countries besides the Community countries would join the bloc created by a joint Community float. It would mean that more than 50 per cent of the Community's trade was done at fixed exchange rates, and it would give strong backing for the weaker currencies.

Mr. Mitchell said that a joint Community float would not of itself correct economic imbalances between members of the Community. It would however make harmonisation of economic policies very important. It was for question how soon it would be possible to create Community institutions to take this much larger load of responsibility.

The Chancellor commented that, even if it was not possible to get a full Community solution, it might be possible to work out one with some other European partners, though this course had potentially dangerous implications. Herr Poehl said that it had been clear in Paris that the French would not agree to any solution that did not include all nine Community countries. Signor Malagodi had talked about the possibility of a general float for all Community countries except Britain and Italy. Monsieur Giscard d'Estaing and Herr Schmidt had both said that they could not contemplate that. If the Deutschemark, the guilder and other currencies went up while sterling and the lira went down, it would be the end of European co-operation.

Mr. Mitchell recalled that, at the last round of discussions in Basle, it had been agreed that any arrangement of this kind would require a considerable amount of support for the weaker currencies, including sterling, without limit of period and probably without interest. His impression had been that the Bundesbank was less than enthusiastic about this possibility. Herr Poehl said that Central Banks looked at their reserves as misers looked at their treasure. This was a decision for the German Government, not for the Bundesbank. Herr Schmidt had said in Paris that Germany was ready to pay a high price for a solution of this kind, for political reasons. The Chancellor reminded the Prime Minister that he had indicated as much in their telephone conversation three weeks ago.

The Chancellor and the Prime Minister agreed to resume their discussions the following morning.

B.

5 March, 1973