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RECORD OF THE PRIME MINISTER'S DISCUSSION WITH THE CHANCELLOR OF
THE FEDERAL REPUBLIC OF GERMANY, HERR SCHMIDT, AT 10 DOWNING STREET
ON 10 MAY AT 1815

Present:

The Prime Minister
Foreign and Commonwealth
Secretary
Mr. B. G. Cartledge

The Federal Chancellor
Herr H-D Genscher
Dr. J. Ruhfus

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Welcoming Chancellor Schmidt, the Prime Minister said that she was very glad indeed that soundings had been taken at an earlier stage to ensure that his visit would take place whatever the result of the British Election. Chancellor Schmidt said that the six-monthly Anglo/German consultations were now firmly established and it was quite natural that this appointment should be kept. Not least from the point of view of the FRG public, it was a good thing that business should be seen to be going on as usual.

The Prime Minister said that the Chancellor would find some differences in the new Government's approach to foreign policy issues: it would be more positive in its attitude to defence, its approach to Europe would differ from that of the last Government, and it would take a different line on Rhodesia. But foreign policy as a whole could not change with every change of Government. There might be changes of attitude and approach but the fundamental issues remained the same. There would, however, be a total change in the UK's domestic economic strategy. Chancellor Schmidt told the Prime Minister that his own Government's economic policies were in fact of a rather Conservative nature and concentrated on improving the effectiveness of economic management. The main difficulty was to convince the trade unions that the Government's policy was right; in order to do this, he had to spend two hundred hours a year talking to trade union leaders, who needed stiffening against the pressures exerted on them from lower down in the Labour movement. The Prime Minister asked whether the infiltration of the unions by the extreme Left posed a threat in the FRG. Chancellor Schmidt replied that there was a certain amount of infiltration, among the younger / elements

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elements in the trade unions; but there was not a single Communist on any of the Executive Councils of the unions in the FRG.

Chancellor Schmidt went on to say that, having witnessed the difficulties which M. Raymond Barre had been having with the trade unions in France, he was more than ever convinced of the necessity of maintaining a dialogue between Government and unions. M. Barre had very little contact with the unions, but contact was necessary in order to convince the man in the street that the Government was pursuing the right course. Chancellor Schmidt said that in M. Barre's position, he himself would talk and listen to the trade union leaders endlessly, but at the same time act vigorously. His own practice was to give periodic working dinners, which were not publicised, for trade unionists, industrialists and bankers. Sometimes he met the trade union leaders tête-à-tête. The Prime Minister said that she could see the value of this. In the UK, the prosperity which had to be achieved could not be won with tax incentives alone; it was also essential to reduce restrictive practices in industry.

Europe

The Prime Minister said that she was very concerned about the state of the UK's relations with Europe. Chancellor Schmidt said that in this area the FRG had real complaints about the policies of the Labour Government, although these had been to some extent muted for the sake of Mr. Callaghan. The Prime Minister told Chancellor Schmidt that the Labour Party had put it about that the Conservatives would be more pliant on such issues as fisheries policy, the CAP and the Community Budget. In fact, the Government's approach was that Britain belonged to Europe for the big reasons: in order to work together and to cooperate with her partners and contribute to a strong, free Europe. But the Government would in no way lack determination to change what was unjust or unreasonable, especially on such issues as fish, agricultural surpluses and the EEC Budget. But the new Government would tackle these problems against the background of a more positive approach to Europe than that of its predecessors.

/ The Prime

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The Prime Minister went on to say that it would help the Government to "re-sell" Europe to the British people if they could secure cooperation from their European partners. The Prime Minister said that she saw the EEC as the economic structure of liberty; some political structures designed to protect liberty failed to touch the economic strata which was what really mattered. The Foreign and Commonwealth Secretary said that the Government's firm intention was to make Europe work.

Chancellor Schmidt recalled that, despite his deep commitment to Europe as a young man, he had abstained in the Bundestag on the ratification of the Treaty of Rome because he had thought it wrong to go ahead with the European Community without the United Kingdom. He had been very glad when the UK had eventually joined the EEC, but then disappointed by the results. He had always believed that it should be possible, by working together, to correct what needed changing in the CAP; but the Labour Government had insisted on taking a stand on principle and its tactics had been simply to bang the table. Chancellor Schmidt said that the Prime Minister's approach was the only one which could succeed. The Chancellor noted that there was a certain tendency in the Community to lapse back into nationalistic attitudes - this was true in France, was detectable in the FRG and had certainly been a feature of the Labour Government's European policies.

The Prime Minister said that she thought that the Community had tended to concentrate on small matters, such as the promotion of standardisation, because it had failed to make progress on the large issues. Some of the Commission's efforts at harmonisation were simply absurd. She was also concerned by tendencies towards protectionism in the Community and, particularly, by M. Davignon's activities over steel. Chancellor Schmidt said that he was also losing his trust and confidence in M. Davignon on this question; he seemed to be promoting a new version of Colbert's mercantilism and this was a dangerous development. The Prime Minister then gave the Chancellor an outline of the speech which she intended to make at her dinner in his honour later in the evening.

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Turning to the CAP, the Prime Minister said that it had never been intended to bear the weight of current price levels or of present currency differentials. Chancellor Schmidt said that there was more wrong with the CAP than that: the whole idea of enforcing price levels from above was misguided. It was impossible to guarantee both a steady growth of production from the farmers and, at the same time, the maintenance of a proper supply and demand mechanism. This error was built into the CAP. Herr Ertl, however, would find it very difficult to accept any reduction in Deutschmark prices. The Prime Minister said that she understood the FRG's problems. But food prices in the UK had increased by 150 per cent over the last five years and it was difficult to get the Green currency issue right. It was essential that the Government should be able to point to some progress on the CAP very quickly.

On the Community Budget, the Prime Minister said that it made no sense that the third poorest country in the Community should pay the largest, or according to another calculation, the second largest, Budgetary contribution. Chancellor Schmidt said that the Prime Minister should not be too quick to believe her briefs. The Prime Minister replied that she was quoting, not from her briefs, but from those of the Bundesbank. Chancellor Schmidt said that only a very few people in the FRG really understood the finances of the CAP and the Bundesbank was not among them. The Chancellor suggested that the Prime Minister should ask the President of the Commission for his views on the Budgetary problem, since he took an objective approach to this issue.

The Prime Minister said that despite the three problems of fish, agricultural policy and the Budget, she still believed that she could go before any audience in the UK and win their assent to the view that Britain's membership of the Community was worthwhile. The basic issue was that the free countries of Europe should live together and cooperate. If a fresh referendum were to be held on the UK's membership, the result would still be positive.

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On the EMS, the Prime Minister said that the Government was anxious to show willing, although the high level of the pound posed problems. For the time being, the Government wished to maintain the value of the pound in view of the switch they proposed to make from direct to indirect taxation; they would not favour a reduction in the exchange rate for the time being. Chancellor Schmidt commented that Mr. Callaghan had said that he did not wish to join the EMS because the value of the pound would fall but in the event the reverse had happened. The Prime Minister said that this was a consequence of North Sea oil and the effect of the situation in Iran on the value of that resource. High interest rates in the UK was also a factor. Chancellor Schmidt said that the UK's interest rates were not high if one took the rate of inflation into account. The FRG had an interest rate at present of 8 per cent; given that the inflation rate was 3.3 per cent, this gave them a rate of interest in real terms of 5 per cent. The Chancellor went on to express the view that the state of the British economy was considerably better than was generally realised, largely because of North Sea oil.

Turning again to the EMS, the Prime Minister said that the Government would be considering exercising its option to swap 20 per cent of the UK's gold and dollar reserves for ECUs and would then consider its position on the EMS as a whole. Chancellor Schmidt said that if the UK were to join the EMS by, say, August this year and then proceed to negotiations on the three issues - fisheries, the CAP and the Budget - which were of concern to the UK, the Prime Minister would then find that the UK's partners would be much more responsive to UK views than might otherwise be the case. The Foreign and Commonwealth Secretary said that he had already concluded that the UK's attitude towards the EMS would be regarded as the touch-stone of her attitude towards the EEC in general.

Turning to the UK economy, the Prime Minister said that inflation would probably increase by 11-12 per cent by the end of 1979. Chancellor Schmidt said that the FRG's inflation rate would rise too, partly because of oil prices and partly because of the measures which President Carter had taken to stabilise the dollar.

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President Carter had not, it was true, gone far enough but he had made a beginning which had increased confidence and put a halt to the continuous rise in the value of the deutschmark. Germany's imports were therefore no longer so cheap and inflation had begun to rise. If the US let the dollar go, the FRG's rate of inflation would fall again. The Prime Minister said that the value of the pound was affected not only by the rate of domestic inflation but also by capital inflow and outflow. The Prime Minister said that she thought the UK could now afford to relax her exchange controls in conformity with EEC regulations. Chancellor Schmidt commented that it might be difficult to do this in time for the European elections.

The discussion ended at 1915.

JH;

Distribution:

PS/FCS

/Chancellor of the Exchequer

/Minister of Agriculture, Fisheries and Food

Sir John Hunt

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Extract - Euro. Policy - CAP - May 1979

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