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By JR NARA Date 3/30

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MEMORANDUM OF CONVERSATION

PARTICIPANTS:

The Secretary
Mr. Ed Yeo, Under Secretary for Monetary
Affairs, Department of the Treasury
Mr. Sonnenfeldt, Counselor
Mr. Rogers, Under Secretary for Economic
Affairs
Jock Covey, Notetaker

CONFIDENTIAL
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DATE & TIME:

November 3, 1976; 5:50 pm

CLASSIFIED BY FRANK WISNER
SUBJECT: British and Italian Economic Situations
SUBJECT TO GENERAL DECLASSIFICATION

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Yeo: I will tell you there is one man greatly disappointed by the results of this election -- Schmidt. And Callaghan said that he feared that international economic problems would not be dealt with because of the election.

The Secretary: Did you tell Schmidt that I will be coming back to the one place where I am eligible for the country's highest office? And if that fails, I can go to Israel where I have the right of return.

Yeo: We had a good meeting.

The Secretary: Who is we?

Yeo: Schmidt, Perle, and Appel. It was all very enjoyable and very stimulating. Schmidt explained his view of the British situation. Callaghan is the only one who can govern. He has a terrible view of Margaret Thatcher. He says that she is a bitch, she is tough, she lacks scope and cannot lead. There are only two people who can govern England -- Heath, who failed, and Callaghan, who he says is on the brink of resignation. The Cabinet is all trying to hang him. He is terribly concerned about the instability of sterling.

The Secretary: You know Pamela Hartwell says that Healey cannot possibly last out the year. She says he is totally discredited.

Yeo: After that I gave some of our views -- that we shared their desire to stabilize sterling; that we had already spent \$9 billion over the last 18 months to do so and couldn't keep it up

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The Secretary: You know I didn't realize before how staggeringly high the British interest rates are. How is it possible to have any investment at all?

Yeo: If you want to have investment, you have to reduce the budget deficit. If you have a budget deficit you must have punishingly high interest rates.

The Secretary: Why can't they have our system?

Yeo: They could but it can't change immediately. Given the situation either they reduce public sector borrowing -- which is their name for the deficit -- or they sell long-term bonds to finance the deficit.

The Secretary: What was the exchange rate when we were in Puerto Rico? It was over 2 wasn't it? And you guys said that it might go down as low as 1.8 if they weren't careful. And Callaghan went through the roof!

Yeo: So the British have to keep growth down. Either they do it by design -- maybe get a stronger sterling out of it -- or they do nothing and let it deflate itself.

The Secretary: Why do they have to go slow? Remember, I am just using you as my economic tutor. Give me the idiot lecture. Why can't they grow fast as long as they are increasing their productive capacity? Shouldn't their top priority be to modernize?

Yeo: The top priority is to reduce consumption and increase.

The Secretary: But the standard of consumption is already below Germany and Italy. Do you see what I mean? I am trying to get at the political factors.

Yeo: The problem is that income is not growing, but the share of income devoted to consumption is growing. Therefore, the share devoted to investment is decreasing

The Secretary: Where do you go from there?

Yeo: You slow consumption down and hope you can begin to feel progress within a year.

The Secretary: Suppose you just let it deflate itself?

Yeo: It is too destructive a process in both political and economic terms.

The Secretary: What are the politically destructive terms?

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Yeo: A total lack of sense of direction. The two-party system itself might suffer.

The Secretary: When they get through devolution, they will have to contend with parties that are not anything like the Westminster parties and then they will be in deep trouble. David Harlech thinks that if they do not go to proportional representation, the whole British system of government could collapse. You could have under devolution a Scottish parliament in Edinburgh making continuous demands on the parliament in London where the Scots are wildly under-represented. But the Scots there would join any opposition group and would make the balance very volatile. Labor would end up becoming the conservative party.

Rogers: They would be the balance of power.

The Secretary: You could have a French parliament. And the only way you could buy these groups off would be by giving them more power.

So do you think that the IMF stricture should be eased?

Yeo: No.

The Secretary: All my British friends are saying that they are not so sure that the conditions should be eased. They just do not want to be driven against the wall.

Yeo: I told them I did not intend to drive them against the wall. Lever was the one saying that was what we were trying to do. In the end we agreed to three things. One, the Fund is the key. Two, level should stay far away from what we are doing. And three, if they want to talk about funding the sterling balance, I would do so but only after the work with the Fund is completed.

The Secretary: What did the Germans say?

Yeo: They said there must be a reduction in public sector expenditures.

The Secretary: What kind of public sector expenditures? Welfare expenditures . . . defense . . . ?

Yeo: Payments to local authorities. . . .

The Secretary: You think you will ever get them to put up money for Rhodesia now? (laughter)

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Rogers: But all in all, that was good.

The Secretary: That was your mission. You got it done.

Yeo: I think Schmidt clearly sees the problem.

The Secretary: Oh yes! He sees the problem, but will he then stick us with the British? I think we ought to meet with Ramsbotham. You and Yeo and Sonnenfeldt. Tell him we want to be helpful and tell him what Schmidt told us.

Sonnenfeldt: Then you should tell Schmidt so that he won't fudge.

The Secretary: What have we got to lose? I will call Ramsbotham and say you are back and I want to give him some of your conclusions.

Yeo: I just wonder how well he understands these things some times and how accurately he reports it back to London.

The Secretary: Well, maybe you could go over there. But here we can back you up.

Sonnenfeldt: If you go over there what you say has to get back to Callaghan through too many prisms. With Peter Ramsbotham, if you burp, he reports it!

Yeo: If Healey goes out, all the rest of that crew will go out too.

The Secretary: You know Crosland wants it. That poor child believes that when I leave, he can become the leader of the Western World. He doesn't understand that I have been carrying him. (laughter)

Rogers: You are much too nice to him.

Yeo: There is terrific intrigue in the Cabinet. They are chopping each other to pieces.

The Secretary: I am glad that is one thing we do not have to contend with over here. But you know, down at Ford Headquarters last night there were people wandering around with buttons saying: "Don't blame me, I voted for Reagan." Can you believe it?

No, I expected this. I don't know if Labor can handle major cuts in public expenditure though.

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Sonnenfeldt: They did put a wage stop on -- which was against their principles.

The Secretary: But does each broken principle make it harder to break another one?

Tell me, why won't import controls help?

Yeo: They are deflationary but they don't lend much to long-term stability. They are simply a reduction in consumption by fiat. They don't change the basic situation. You have to improve investment and to do that you must reduce consumption. The question is "Do you do it in terms of a free trade nation interacting with other countries, or do you do it as a Fortress Britannia?"

Rogers: And besides, the export industry depends on those imports. It is definitely a less desirable alternative.

The Secretary: Somewhere along the line part of Labor's left wing will drop out. They would rather have the Conservatives impose this program on them than be a party to it.

What happened to bring Britain to this state?

Yeo: In the first place, Heath made his "dash for growth" and lost control of the money supply and, secondly, Labor lost control of the budget. . . .

The Secretary: . . . because of increased public expenditures?

Yeo: Yes.

The Secretary: Why did they lose control of the money supply?

Yeo: Because Barbour printed too much money!

The Secretary: You mean there are no constraints on printing money?

Yeo: Under the British system, he can order the Bank of England to just print money and he did it. That is now why it is a walking cadaver.

The Secretary: I don't understand why Wilson didn't see it coming. He was supposed to be a pretty good economist.

Yeo: I was always under the impression he was more of a tactician than a strategist.

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The Secretary: You don't have to be very brilliant in order to see this. Putting aside the IMF for now, this really is a battle for people's minds. People have to understand and they have to support. You know they are about to lose two by-elections and they are going to lose the majority. Apparently they don't need the majority to run parliament but they need it in the committees. Otherwise the legislation bogs down. I didn't realize that before. They cannot run parliament with a majority, but they can run the committees.

Yeo: They will definitely lose one of them but . . .

The Secretary: How is the Italian situation?

Yeo: Better than the British. Andreotti is making extraordinary progress with the IMF.

The Secretary: They are willing to accept their restraints?

Yeo: Yes.

Sonnenfeldt: And they are getting the communists to hold off.

The Secretary: Oh yes! But wait until our boys come in.

Rogers: He is cutting public subsidies and raising taxes like mad and he is getting away with it.

Yeo: Only because the public understands and supports it. If the British had public support . . . I just wonder if in the Italian situation the IMF might have been a little bit too tough.

The Secretary: You guys should talk to Peter Ramsbotham. I will call him and say I am sympathetic, that you are back and have come to some conclusions which I would like for him to pass on to Callaghan only. Then maybe they will want you to come over.

Yeo: That is good.

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