f.a. Rud
2/XI

ANGLO-GERMAN CONSULTATIONS:
BONN 31ST OCTOBER 1979

The Chancellor of the Exchequer's bilateral discussions

MORNING SESSION

Present:

Chancellor of the Exchequer	Herr Matthofer, Federal Minister of Finance
Sir Kenneth Couzens	Herr Lahnstein, State Secretary Federal Ministry of Finance
Mr. H. Overton, H.M. Embassy	Senior officials, Federal Ministry of Finance

---

EEC Budget Contributions

Herr Lahnstein opened the discussion. Since the last Finance Council the Federal Government's position on the Budget issue had not changed. He stressed three points. First, it was not realistic to look for a complete answer to the UK's problem at Dublin. The first step was important; but a solution of the Community's expenditure problems was for the medium term. There would have to be some compromise. Second, it was important to maintain the 1 per cent VAT ceiling: the Federal Government would welcome firm UK support for this. Third, in their view the existing Dublin mechanism should form the basis for a solution. The idea of a brand new mechanism would cause the Federal Government some difficulty. He hoped the UK would not feel the need to press that.

2. Herr Matthofer said that he had had a long talk with Chancellor Schmidt the previous day. The Chancellor's view, which he shared, was that the West would be faced with weak Soviet leadership over the next few years because of Mr. Brezhnev's ill health. Because of that, and because of disenchantment with US leadership, it was

all the more important to ensure cohesive leadership within the Community: this would need to be founded on common understanding between France, Germany and the UK. His Government would do all it could to foster a common position. This might mean facing internal difficulties over the CAP; the French Government's difficulties in moving on agriculture before 1981 could not be ignored. It also required a determination to hold the 1 per cent VAT ceiling on own resources as a means of exerting pressure for changes in the CAP.

3. The Chancellor said he agreed on the importance of maintaining cohesion within the European Community. But his Government had to give priority to the economy if the UK was to be able to fulfil its economic and defence obligations. This involved difficult and unpopular decisions. Our GDP had fallen in ten years from just under 90 per cent of the EEC average to little over 70 per cent. In contrast, the German GDP was growing faster than in the rest of the Community. The German economy was likely to grow by 4 per cent this year; the UK economy by less than 1 per cent. Public expenditure had been reined back to the level of 1978/79, and would have to be kept at that level in real terms if government borrowing and interest rates were to be held at manageable levels. Against that background, the UK contribution to the Community budget was a matter of great political importance. We shared the Federal Government's wish to maintain the ceiling on own resources and to see a re-structuring of CAP expenditure. But these issues deserved attention in their own right: the problem of the UK budget contribution required a separate and urgent solution. We required a broad balance in the UK's financial relationship with the Community. This compared with a forecast net contribution on present arrangements of £1-1¼ billion in 1980, rising to £1.6 billion in 1983. To expect the UK to continue paying sums of that amount was unreasonable.

4. The Chancellor went on to draw a number of comparisons. The UK net contribution in 1980 would exceed the whole of our overseas aid programme, which already absorbed a larger percentage of GDP than in Germany. UK expenditure on defence was already larger in relation to GDP than that of any other Community member; and defence expenditure outside our territorial limit relative to GDP exceeded that of all other NATO members. Our net contribution was equally a major element in eliminating the surplus on invisibles; it represented more than 10 per cent of the UK public sector borrowing requirement; was equivalent to the proceeds of a 2 per cent rate of VAT; and represented an additional 2p on the basic rate of income tax. Arguments advanced by some of our partners against a satisfactory solution were not compelling. The flow of North Sea oil would not last indefinitely; in any event oil did not offset our low GDP. Nor was it right to attribute our net contribution to failure to increase our trade with the rest of the Community: imports from the EEC had risen from 26 per cent of the total in 1968 to 38 per cent in 1978, and even more sharply in relation to manufactured goods. The FRG's trade with the rest of the Community had meanwhile begun to fall. (At this point the Chancellor handed over a copy of the note on UK trade patterns annexed below. Herr Matthofer complained that paragraph 2 overlooked Germany's increasing imports from non-oil LDCs and her greater dependance on imported crude oil. The Chancellor replied that no criticism was intended of the Federal Republic: the facts were directed primarily at mistaken French criticism of UK trade patterns. The Germans appeared to accept this.)

5. Continuing, the Chancellor stressed that the growing size of our net contribution was a factor inhibiting economic recovery in the UK. It was not a situation which had been expected when we joined the Community. Assurances of a diminishing share of Community resources going to support the CAP had proved mistaken. The broad balance which we looked to the Community to provide

was not something plucked out of the air: it was a principle to which the UK Government attached highest importance. A solution based on removing the restrictions in the present Dublin mechanism would not be sufficient to achieve this.

6. Herr Lahnstein intervened to say that on German calculations, the UK's gross contribution would be reduced by 600 MEUA, or 500 MEUA after allowing for our proportionate share in the cost of financing our own relief. It would turn the French into net payers: this would raise a difficult political problem. Sir Kenneth Couzens replied that the size of the UK net contribution also posed a political problem. Herr Lahnstein said he recognised that, but the UK was the "demandeur", whereas the French were not. He added that his Government did not feel that they were in the centre of this argument: although they were net payers, this caused no difficulty for German public opinion. Frankly speaking, he could not see any prospect of reaching an agreed solution at Dublin if the UK wanted to go beyond removal of the present restrictions from the Dublin mechanism. Their own soundings of Community partners indicated that the French would be joined by the Danes and the Benelux countries in opposing demands on that scale. The Chancellor said he did not underestimate the problem for our partners in having to pay more: their difficulties in meeting a share of the UK net contribution merely served to underline the size of the total burden which the UK was assuming on its own account. Sir Kenneth Couzens said that the German figures appeared to be fairly close to our own. They showed all to clearly that only two-fifths of our present net contribution derived from our excess gross contribution to the budget, and three-fifths from our low receipts. It was reasonable to start with the Dublin mechanism, provided the exercise was not limited to removing the present restrictions: why should one not go on to introduce new conditions? One could still call this the Dublin mechanism. Herr Lahnstein said that he was bound to advise that if the UK took that line it would be overplaying its hand. We should not have a single friend at Dublin. And he begged us to

step down from such an extreme position. The Chancellor replied that for the Prime Minister to return with less than half a solution from Dublin might be worse than facing united opposition from our partners to a more equitable solution. Herr Lahnstein wondered whether that was so. Surely the UK could accept immediate help on the scale suggested, with the prospect of further improvement in the medium-term as the Community adjusted its expenditure pattern to the 1 per cent VAT ceiling and our trade continued to shift in favour of the Community. Would that not provide a sufficient basis for a solution?

7. The Chancellor said the trouble was that we had received such assurances twice before. This time, we were resolved to have a solution which addressed itself directly to the size of our net budget contribution. Sir Kenneth Couzens added that there would be difficulty in containing the present level of agricultural expenditure, let alone reducing it as a proportion of the Budget. Herr Lahnstein said there was an important difference between present and past attempts to remedy the situation. The approaching limit on own resources was bound to impose a squeeze on agricultural expenditure. Sir Kenneth Couzens thought this ignored the range of possible accounting devices (co-responsibility levies; national contributions; negative expenditure) which could be used to circumvent the ceiling. Surely even the Federal Government had its political divisions on this subject?

8. Herr Lahnstein said that, in that case, he foresaw the prospect of total deadlock in Dublin. Even to achieve agreement to reduce the UK net contribution by 500 MEUA would require considerable perseverance. Herr Matthofer added that the French would see the UK demands as confirming their fears about lack of commitment to the Community. Contacts with Paris had shown the French firmly resolved in their position. They thought the British were "playing chicken". He too foresaw great difficulty in establishing an agreed position. He had spoken to M. Monory only the previous week. The latter had tried to recruit the Federal Government to a strong common position. It was clear that the French Government

feared criticism from the "Gaullists" if they moved very far. There was no problem for Germany: public opinion accepted the legitimacy of their position as large net payers to the Community - they got their money back in other ways. Both he and Herr Lahnstein repeated several times that they wished to be as helpful as possible. They did not regard themselves as directly involved in what was essentially an argument between the UK and other members of the Community, especially France.

9. Herr Matthofer said he wanted to be clear: was the Chancellor saying that a reduction of 600 MEUA in our gross contribution from modifying the Dublin mechanism would not be enough? The Chancellor said that was so.

1980 EEC Budget

10. Herr Lahnstein then went on to probe the UK attitude towards the European Parliament amendments to the draft 1980 Community Budget, related to the maximum rate of increase on non-obligatory expenditure. The Federal Government, along with France and Belgium, had already indicated a wish to keep the rate of growth as close as possible to the 13.3 per cent maximum derived from applying Article 203. He hoped the UK would support them in trying to get a reasonable compromise between the Council and the Parliament.

11. The Chancellor said that he was not wholly familiar with all the details. But our attitude to this, as to other matters, would be influenced by the overriding requirement to reduce our net contribution. He could not give unqualified support to the German position, but he was inclined to their view, so long as this did not prejudice any possible improvement in our net contribution position. We had made it clear that we did not want to see our budgetary problem solved by simply increasing Community expenditure. Herr Lahnstein said he understood the UK position. Perhaps there could be further contacts before the issue came up for decision by the Budget Council? He agreed that it was awkward for the Budget Council to precede the Finance Council; but this was a treaty requirement which could not be avoided.

Exchange Control

12. Herr Lahnstein spoke approvingly about the decision to end UK exchange controls. He wondered what this meant to the £ and why downward pressure had been delayed until this week. The Chancellor replied that he had no reason to think that the pressure on sterling the previous day was especially due to the announcement on exchange controls. There could be many reasons, including relative interest rates. The Chancellor went on to explain the reasons behind his decision, stressing the wisdom of acquiring income bearing assets overseas to offset the depletion of North Sea oil. But it was bound to mean that sterling would face a period of more than average uncertainty until the market had absorbed the consequences of this decision. This, plus recurrent pressures as a petro-currency, made it difficult to forecast the likely movements of sterling over the next six months or so.

EMS

13. Herr Lahnstein asked whether that effectively also settled our attitude to EMS. The Chancellor said the Government's position on EMS remained unchanged. The exchange control decision provided another factor which made it difficult for sterling to join the exchange rate mechanism for the time being. Herr Matthofer said that the Federal Government would certainly not insist on UK membership just at the moment. Herr Lahnstein said he was sure the answer was to have a UK representative at meetings of EMS members. Without sterling, it would mean extending the initial phase of EMS, but he saw no difficulty in that. The move to a full European Monetary Fund would have to be delayed. Sir Kenneth Couzens said he hoped any blame for lack of progress on setting up the EMF would not be laid at the feet of the United Kingdom. Herr Matthofer said that would not be done. In his view, the initial stage of EMS had worked better than he had expected and he saw no difficulty in going on as they were.

14. As a separate matter, Herr Matthofer apologised to the Chancellor for the misunderstanding which had led to the absence of a UK

representative at the re-alignment meeting in October. Steps had been taken to ensure that this would not be repeated.

15. The morning session ended at approximately 12.30 p.m.

AFTERNOON SESSION

Following lunch, at which the German team was joined by Graf Lambsdorff, Federal Minister for Economics, and State-Secretary Schlecht, Ministers resumed for a second bilateral discussion at which Graf Lambsdorff took the lead.

Community Steel Policy

16. Graf Lambsdorff, recalling that the Davignon regime was due to expire at the end of December, said that, whilst the Federal Government were in favour of an entirely free steel market, they recognised the necessity to continue some more limited protection. The Federal Government wanted to see minimum prices abolished, and had so informed the Commission. It was not yet known whether Commissioner Davignon had settled his own preference between outright abolition and suspension. He understood the United Kingdom Government favoured an Italian exception for steel coils. The Federal Government were anxious about this. The maximum price arrangements had a disruptive effect on the market, by giving North Italian producers the opportunity to undercut prices and threaten the industry in Southern Germany. He could not see any advantage for the UK in prolonging the present arrangements and asked if Her Majesty's Government would be willing to re-consider the possibility of a compromise. As regards the external regime, the Federal Government wished to see significant reduction in the restraints on imports from third countries - both as to the number of agreements and the number of products covered by them. The Federal Government's view was that only some 30-40 per cent of steel products needed now to be included within such agreements; this would cover most of those which the UK regarded as sensitive.

17. Replying, the Chancellor explained that the questions raised by Graf Lambsdorff were not within his direct Ministerial responsibility. He had a good deal of sympathy with the general desire to abolish protective measures of this kind. At the same

time, the steel measures were part of an established Community framework within which the steel industry was seeking to reorganise itself; and he hesitated to espouse too extensive a liberalisation whilst substantial structural changes were in train in the British steel industry. The industry was still losing money heavily. His personal view was that this might not be the time to countenance significant changes in the present regime. However, he would certainly report Graf Lambsdorff's views to the Secretaries of State for Industry and Trade.

GATT

18. Graf Lambsdorff expressed a good deal of anxiety at the French decision to hold up Commission signature of the MTNs agreement on behalf of the European Community. He was particularly worried that the agreement might not now be signed before 20th November when the US waiver on countervailing duties ran out. He thought that if the French position was to be changed it was essential to convince Monsieur Deniau personally.

19. The Chancellor replied that he would be seeing Monsieur Monory on 6th November and would take the opportunity of raising the matter with him. Graf Lambsdorff said this would be helpful, though he thought that Monsieur Barre and Monsieur Monory were already favourably disposed towards the matter.

Energy

20. Graf Lambsdorff spoke in rather critical terms of what he called our "lack of flexibility" in using North Sea oil to ease the EEC's difficulty in meeting the 1985 import targets agreed in Tokyo and subsequently confirmed at the meeting of Energy Ministers held in Paris. The UK net export figure of 23 million tons a year at the time of Tokyo had subsequently been reduced to nil, and only recently increased to 5 million tons a year, US interpretation was that UK production gave no flexibility in meeting the overall EEC import target. The Federal Government had told Secretary Duncan that they did not accept that interpretation.

Graf Lambsdorff said he would be grateful if the Chancellor would relay his anxieties to the Secretary of State for Energy, and seek a reconsideration of the position by Her Majesty's Government. He found it difficult to advise his own colleagues to be more flexible in other fields if the UK was not prepared to be more flexible on this.

21. The Chancellor said he was less familiar than the Secretary of State for Energy with the details of this subject. He noted, without prejudice, what Graf Lambsdorff had said and undertook to see that his views were relayed to the Secretary of State for Energy. Sir Kenneth Couzens mentioned the decision to cut back on gas-flaring as a factor limiting North Sea oil production: he hoped the Federal Government would recognise the wisdom of that decision. Graf Lambsdorff acknowledged this; but persisted in pressing for greater flexibility on the 5 million tons figure. British North Sea oil represented the only flexibility available to the Community.

22. The discussion ended with Herr Lahnstein making some ritual noises about the spot market, and about reports which reached him on a visit to Pittsburg of fears about the price of BNOC forward sales. The Chancellor replied that BNOC were following, not leading the market; the prices they were charging properly reflected the value of security of supply. Prices had certainly not been fixed in a hostile way.

23. The afternoon session ended at approximately 3.40 p.m.

Distribution

Cheif Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Jordan Moss
Mr Barratt
Mrs Hedley Miller
Mr Monck (pages 9-11)
Mr Michell
Mr Turnbull (para. 18-19)

Mr Alexander, No 10.

(A.M.W. BATTISHILL)
1st November, 1979