BREAKFAST DISCUSSION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND U.S TREASURY SECRETARY, THE HONORABLE WILLIAM MILLER, AT NO.11, DOWNING STREET ON THURSDAY, 29TH NOVEMBER, 1979

US Treasury Secretary Miller called on the Chancellor this morning on his way back to Washington after his Middle East tour. He was accompanied by Mr. Mundheim, General Counsel to the US Treasury, Mr. Bergsten of the US Treasury and the US Ambassador and Mr. Ammerman. The Chancellor was accompanied by the Financial Secretary, Sir Kenneth Couzens, the Deputy Governor of the Bank of England, Mr. Hosker, Treasury Solicitor and Mr. Hancock.

2. The discussion, which lasted about an hour and a half, covered five main topics:

- the international oil situation;
- the US domestic oil situation;
- his Middle East tour;
- North Sea oil prices and BNOC forward sales; and
- events in Iran.

The International Oil Situation

3. Secretary Miller said that his Middle East tour had been planned some time; and he had seen no reason to alter it in the light of events in Iran. It had taken place against the background of a tight balance of demand and supply for oil (with Iranian production still some 3 mbpd below the pre-revolution level); exceptional oil price increases, going far beyond world expectations, which

had damaged US counter-inflation policy and extended the timetable for bringing inflation under control (oil prices accounted for 4 per cent, nearly one third, of current US inflation); and a situation in which capacity of the developed countries to help the LDCs had, in consequence, been seriously curtailed. There was in the present situation a risk of further deterioration leading to world recession, increased protectionism and severe economic disruption. Secretary Miller said that he personally did not expect that situation to come about, but the stakes were high and the risks apparent. The sequence could be triggered by a 30 per cent increase in oil prices.

4. Against that background, Secretary Miller described the aim of his Middle East tour as to convey the message that the oil producing and oil-consuming countries shared an interest in restoring and maintaining a balanced world oil situation, for which all countries should be prepared to make sacrifices. As its contribution the US was willing to accept a period of economic recession. Above all, world demand for oil needed to be reduced. As a high energy user the US had a special responsibility to help in this respect.

US Domestic Measures

5. Secretary Miller then went on to describe the measures taken by the Carter Administration to improve the US domestic oil situation. He began by repeating the familiar historical reasons for the present US high energy consumption and consumer resistance to change. US public opinion was only beginning to acquit the oil companies of total responsibility for conspiring to raise oil prices. More efficient use of energy was coming to be accepted as a legitimate objective. Consumer resistance was slowly being broken down. The present Administration had achieved more in this respect than all its predecessors.

The President's energy legislation alone accounted for a half billion bpd reduction in energy consumption. The US Administration were putting a major effort into energy conservation through mandated standards for energy use in a wide range of industrial, transportation and building operations; through individual and corporate tax incentives for insultation; and through application of temperature controls. Increased production of conventional energy sources was being encouraged. The President's firm initiative on de-regulation would reverse the long tradition of oil-price controls and stimulate greater exploitation of the massive US oil resources. The phasing programme to October 1981 was a legitimate price to pay for this necessary reform. A programme of renewable energy sources was being developed: although having some impact in the next decade, this would not come to full fruition until the turn of the century. A major effort was being made to harness unconventional sources of domestic energy: US oil deposits in shale exceeded Saudi Arabian oil reserves. Secretary Miller also mentioned US methane deposits and interest in gasification and liquifaction of coal.

6. Secretary Miller described the progress of US policy in this area as "going fairly well". The Administration had other proposals to make if the current legislative programme was successfully enacted this year. The results were encouraging. Domestic oil consumption showed a drop of 2½ per cent in the first half of 1979; and this had risen to 4.4 per cent by the third quarter. This was not due, as some alleged, to any economic downturn. It continued a trend, reflecting the success of earlier policies; the onset of the recession would provide further reinforcement.

Middle East tour

7. Secretary Miller said that it had not been the intention of his Middle East tour to secure public commitments from the countries he visited either on oil prices or on output

levels. Rather, he had aimed to get an appreciation of the mutual interest of oil-producers and consumers in at least maintaining present levels of production, which in the case of the Saudi was higher than their perceived optimum. He described the attitudes he had met as "very responsive". Middle East opinion was generally in accord with the aim of containing production levels sufficient to produce a disciplined price structure again. There was some expectation that present excess demand might be due in some degree to temporary factors. Partly this was a matter of hoarding. But it also reflected reduced reliance for supply on the international majors inducing more customers to come into the market on their own account. This led the US to think that the market situation might be reversed in the coming quarters, with supply again out-running demand.

8. On <u>production</u>, the Saudis had not been prepared to give any commitment, but seemed ready probably to maintain current levels. The UAE had given a public commitment to maintain the present levels next year (despite a temporary cut of 60,000-80,000 bpd whilst they remedied technical abuse of one of their existing fields). The Kuwaitis had been the most hawkish publicly. But in private discussion they had been more forthcoming, though faced with difficult internal pressures to maintain oil in the ground rather than replace it with potentially less secure financial assets. Their public statements stressed an unwillingness to increase production. Privately he thought they might cut back next year to the level existing before the Iranian troubles. But they wanted to maintain flexibility over timing.

9. As to <u>prices</u>, having stuck to $18 a barrel, the Saudis were most upset at the price increases by other OPEC countries and by the oil companies' failure to pass on the benefit of Saudi price stability to consumers. Both Kuwait and the UAE recognised the dangers to their own self interest from an

undisciplined spot market. There were fears both about their own growth prospects in a world recession and also (in the light of experience after 1974) about the security of their own financial assets. Both wanted to return to a single price system, but were doubtful of success at Caracas. But there was some expectation that emerging excess supply would begin to dry up the spot market, not least because of high storage costs of oil. The Saudis had expressed the most moderate price objectives but the Kuwaitis, whilst the most hawkish, had been less ambitious than Secretary Miller had expected.

North Sea oil and forward sales

10. Secretary Miller then made some critical remarks about BNOC's forward oil sales and about UK price leadership and disposal of North Sea oil. Speaking frankly, he thought that the UK's actions were contributing to, and exacerbating, an already difficult situation. It was not in the interest of the developed countries, nor he thought of the UK, that North Sea oil was realising higher average price than the rest of world supply. Forward sales by BNOC were a harmful precedent which risked emulation by the more militant sections of OPEC.

11. In reply, the Chancellor said he shared Secretary Miller's concern about the potential dangers to the world economy from any further deterioration in the oil situation. But he could not leave the remarks about the UK unchallenged. North Sea oil had to be seen in perspective. It was true that we were approaching self-sufficiency in oil; but that would not be sustained for many years. North Sea oil brought a direct advantage to the UK balance of payments, but indirect disbenefits to our competitiveness through an appreciating petro-currency. At its peak North Sea oil would add only 4 or 5 per cent to GDP. But it also aroused false expectations among our own people. If anything, national self-sufficiency increased difficulties of sustaining a sensible energy policy: the Government were currently grappling with the need to raise

the real price of gas. The Chancellor said it had to be understood that the Government did not directly control the price at which North Sea oil changed hands. This was a matter for the operating companies, who had been given explicit assurances that they would be allowed to dispose of oil from the North Sea at the ruling world price. Without this assurance the development of North Sea oil could not have been assured. The UK certainly was not a price leader: we followed the prices for equivalent high-quality crude set by countries like Libya, Algeria and Nigeria. Nor could the UK be accused of setting a precedent over forward oil sales: others had done so before us. The Chancellor said he fully recognised the dangers in competitive energy pricing. The UK would lend no encouragement to this. We were bringing all our influence to bear in the direction of moderation and, in this spirit, welcomed the discussions Secretary Miller had been having with Middle East suppliers.

12. Secretary Miller retorted that he found it sad to hear the UK spoken of in the same terms as Libya and Nigeria. Such a comparison would not be well received in the US. He did not believe it added to UK esteem. UK oil was selling at a price above the average of Saudi and Kuwaiti oil. Sir Kenneth Couzens said that it was not realistic to compare the price of Saudi crude with the higher-quality crude obtained from the North Sea. North Sea oil was changing hands at world prices. This recognised the assurances given to the oil companies. Secretary Miller said he did not believe that prices were not under Government control. How was it then that North Sea oil came to be sold at a uniform price? If that was the position the message was certainly not getting across in the US. Reverting to BNOC forward sales, Secretary Miller said this had done irreparable harm to the United States. Distinctions could not be drawn on grounds of security of supply. The US could not question the reliability of Middle East suppliers, if faced with demands for similar arrangements. The Financial Secretary said that he had seen no evidence that

BNOC forward sales had altered the world position at all.

13. Secretary Miller said that the impression created by the UK's actions were not favourable. Whatever the reality, perceptions were important. The Chancellor replied that the matter could not be left there. He must ask Secretary Miller to correct any misunderstanding of the UK position. This was not state-owned oil; it was market-produced oil extracted by world-wide trading companies, with strong US interests. Sir Kenneth Couzens added that the proportion of North Sea oil going to the spot market was very low indeed, only a couple of per cent of total production. This was a better record than many Middle East suppliers. It had required a great deal of leaning on the companies to achieve. Mr. Hancock quoted the example of Tricentrol which had recently been on the point of taking BNOC to arbitration to enforce its right to dispose of North Sea oil at the ruling world price. Other companies could do likewise. Secretary Miller said that these considerations did not deal with the question of forward sales.

Iran

14. Secretary Miller described the Iranian action over the US Embassy hostages as a violation of recognised international law and convention; it was without precedent in modern times. Nevertheless, the US Government's response in banning imports of Iranian oil and in blocking official Iranian financial assets had been calculated not to inflame the situation. Removal of deposits to other banks would have posed no great problem. But the Iranians had been thought to be bent on humiliating the US by leaving US claims unsettled and unloading large quantities of dollars in the market; this would have been considerably more damaging. US actions had therefore been designed to hold the Iranian authorities accountable for their financial relations.

15. Secretary Miller went on to say that the US was appreciative of the help given by the UK Embassy in Tehran and the support provided by the UK Government and the Bank of England. The UK authorities had behaved commendably in holding that Iranian claims on UK branches of US banks should be settled by the due process of English law. He had to say, however, that there were increasing doubts as to whether the US was any longer dealing in Iran with a responsible authority of whom the normal standards of international behaviour could be expected. Attempts to secure the return of the Shah by blackmail were wholly unacceptable.

16. Reverting to the blocking of Iranian accounts, Secretary Miller said that immediate action had been taken by the US authorities to unfreeze non-dollar assets and to release funds for normal diplomatic expenditure. This demonstrated the intentionally limited nature of the action. Subsequent events culminating in the declaration of a default on the $500 million Iranian loan had been unpredictable. It would be sad if earlier international concern for the welfare of the US hostages was to begin to be subordinated to commercial interests. Secretary Miller referred to a court hearing later in the day over an application to release funds by a UK branch of the Bank of America. The branch in question was backed by a U.S cover account and would not have sufficient funds to meet the application on its own account. Since the US account could certainly be blocked difficult and important questions of jurisdiction would arise. It was important, therefore, that the matter should be looked at against the wider background.

17. The Chancellor, in reply, expressed total sympathy with the US in its refusal to accept the Iranian breach of the normal concept of diplomatic behaviour. The US had to look at all ways of influencing the situation. The UK had tried

to respond helpfully, whilst holding firm to the principle that claims on branches of US banks in this country had to be settled by reference to UK law. However, if the present situation deteriorated there was bound to be a risk of disturbing confidence in the international financial order and in the trust which other OPEC countries now enjoyed in the western banking system. The Deputy Governor also expressed anxiety over the possible repercussions. Suggestions of possible public disclosure of the liquidity position of the Bank of America's branch in London made him particularly uncomfortable. No more damaging statement could be made about a bank than that it had insufficient funds available to meet a claim. Mr. Mundheim thought this pointed to recognising the Bank of America as a special case: that might be the best way out of a difficult situation. Secretary Miller said that the exceptional circumstances of the Iranian action needed to be stressed. The US was not asking the UK to share its initiative by blocking funds in the UK banks. But he submitted that in cases of concurrent jurisdiction the purpose of the acting nation, and the actions of the hostile nation, should be carefully considered. He could not see any risk to the UK banking system in that approach. The Deputy Governor replied that he had been concerned for future confidence in US banks. Secretary Miller said that he was ready to face that risk in the interests of defeating international blackmail. He personally believed that refusal by the Atlantic Alliance to continue normal commercial relations with Iran would reinforce, not reduce, confidence in the western financial order.

18. The Chancellor said that no conflict of purpose arose between the UK and the US. We were struggling, with the US to reconcile important conflicting principles in our mutual interest. Secretary Miller recalled that the US had last blocked the accounts of a foreign sovereign state to

prevent Norway and Denmark from being looted during the German occupation in the last war. Arguably swift action of this kind would reinforce confidence in the western world's ability to safeguard legitimate national assets from threat by revolutionary factions in temporary control of a country. The Chancellor acknowledged that the growth of international lawlessness threatened to undermine established financial principles: this increased the need to find ways of proceeding without resort to unprincipled action.

19. Secretary Miller then spoke about the risks to continued oil supplies from Iran. A total shutdown could come about as the result of economic mismanagements and a progressive decay in Iran's physical capacity to keep the oil flowing; or as the result of a counter-revolution shutting down the oil-wells again. Both risks were present. However the situation developed, Secretary Miller said that he hoped that handling of the financial situation would not imperil the present good relations between the US and the UK. The Chancellor said Secretary Miller would understand that disputed claims would have to be settled in accordance with the law in their respective countries. It was also right that others should reflect long and hard before making any move to participate in the US actions. In emphasising this the UK was not asserting the precedence of commercial interest; rather we were acknowledging the supreme importance of maintaining a framework of international financial confidence.

20. Before the meeting closed, there was a brief discussion of what Secretary Miller would say at his press conference later in the morning. He would report on his Middle East tour; say that he and the Chancellor had exchanged information about the US energy programme and the world energy situation, including prospects for prices and production; say he had brought the Chancellor up to date on the Iranian situation. He would not say that he had put any pressure on the UK to go further than it had done.

21. The meeting ended at 10.00 a.m.

AB

(A.M.W. BATTISHILL)
29th November, 1979

Circulation

Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Barratt
Mr. Hancock
Mr. Peretz

Mr. Hosker, Treasury Solicitor

Deputy Governor, Bank of England

Mr. Bayne, FCO