

PRIME MINISTER'S MEETING WITH CHANCELLOR SCHMIDT AT CHEQUERS ON  
SUNDAY 23 APRIL 1978 AT 1945

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| <u>Present:</u> | The Prime Minister             | His Excellency<br>Herr Helmut Schmidt |
|                 | The Rt. Hon. Denis Healey      | His Excellency<br>Herr Hans Matthöfer |
|                 | The Rt. Hon. Harold Lever      | Dr. Otmar Emminger                    |
|                 | The Rt. Hon. Gordon Richardson | Mr. H. Heick                          |
|                 | Mr. K.E. Couzens               |                                       |
|                 | Mr. K.R. Stowe                 |                                       |

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The Prime Minister, after an exchange of courtesies, said that he had, as requested by Chancellor Schmidt, confined to a very few people the Chancellor's ideas about European monetary reform. He would like to discuss these further at this meeting with the Chancellor. He said that he had approached it as a political problem because it was essential that the Bonn Summit should not be a failure - the consequences of failure would be very grave indeed - and he did not believe that any European initiative could either pre-empt the Summit or appear to be directed against the United States.

Herr Schmidt said that some of his ideas had evidently leaked into the press from London, but he still wanted discussion to be confined to the very few people gathered this evening. As regards the Bonn Summit, the fourth in a row, it differed from the other three in that the press were creating substantial expectations and this was regrettable. The Summit should be of the same kind as the present meeting, where Heads of Government could consult freely, learn from each other and understand each other's difficulties. The United Kingdom and United States had proposed five sectors for discussion with a view to getting constructive decisions. He was

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not sure, however, what a "decision" was. The Downing Street Summit had taken decisions on the nuclear fuel problem, on economic targets and on inflation but these decisions had been overruled or not implemented or even reversed. Meanwhile the volatility in exchange rates continued and if it persisted would give rise to even greater economic problems. In that context, the decisions of the Downing Street Summit did not look so good if they were now reviewed. Nevertheless, if the Bonn Summit wanted more of these decisions, the FRG would not stand in the way. But he would be cautious.

Herr Schmidt said it was worth spending time to ask why we were in this mess; why was there so little growth in the United Kingdom, the FRG and the United States? We needed to know the reasons; we needed to know the role of monetary factors; and we needed most of all to know how to make growth. Keynes' demand management no longer produced growth: it could push up wages and prices but not create growth; the United States had, by Keynesian policies, produced negative growth. Why? What are the decisions that will create growth? How?

At this point Herr Schmidt handed over the preliminary draft of a "non-paper" setting out his ideas on European monetary reform. Most of the substance of this paper was substantially reproduced in discussion by Herr Schmidt and it is not therefore recorded in detail.

Continuing, Herr Schmidt asked, could we have got into this mess without inflation?

Mr. Healey replied by saying that the present mess of "stagflation" undoubtedly derived substantially from the United States' printing money to pay for the Vietnam war. This was followed by the oil price rise and by other such inflationary decisions. He noted that Herr Schmidt said that the problem was not one of demand. The IMF disagreed, and so did he: the IMF said that the problem was lack of demand. And he noted that in this connection Japanese and FRG surpluses now equalled in size the OPEC surpluses.

/Japanese growth

Japanese growth had been export-led, and so too had that of the FRG. Because of stagflation the rest of the world could not now buy FRG capital goods. The Five Point Plan was conceived as being based upon the need for an increase in demand. The FRG was working at only 80 per cent of capacity and the United Kingdom at less than 70 per cent. The under-utilisation of resources in the surplus countries had the effect of reducing growth elsewhere. The IMF and the EEC were each working towards agreement on growth policies and he thought it was valuable that the Copenhagen Council had agreed on a 4½ per cent growth target: he hoped that the pre-Summit Council at Bremen would agree to work for a further 1 per cent. Herr Schmidt interjected that the Bremen Council and the EEC growth targets were irrelevances, and he had opposed the 4½ per cent as meaningless.

The Prime Minister said that he agreed that the reason why we were in this mess was the US financing of the Vietnam war, which led to excess liquidity, which itself facilitated the oil price rise. His own chief worries were firstly unemployment, which concerned him deeply, and secondly the super-competitives who were compounding the unemployment problem.

Herr Schmidt said both the Prime Minister and Mr. Healey had agreed that the Vietnam war financing had exported the United States own inflation, which had been exploited by the oil cartel: the effects were enhanced by the world's reserve currency - the dollar - ending its gold convertibility and then its fixed parity. In other words, our present mess was due to fiscal and monetary errors. Nobody had decided to diminish growth or demand or investment. So it was not a simple matter of taking opposite decisions which would enhance growth, demand and investment. He did not think it was possible to take decisions to have growth as such and he did not see how you could enhance growth if you left out the very monetary and fiscal issues which had led to the lack of growth. As regards the United States' position, of course it was the strongest economy, which had the world's reserve currency; but it had a relatively small proportion of its GNP involved in world trade - only 12 per cent. What was

/good for

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good for the United States was not necessarily good therefore for countries depending upon world trade. Only the United States could afford to have a deficit: the rest of the world could not. He did not himself fully understand the Japanese economy: it was not fair to say that the Japanese did not want to do anything about their large surpluses: they did not know how to. If he knew how to create growth he would certainly do it in the Federal Republic because he wanted to win elections too. But he really did not believe that spending money on pensions, railways, or steel would create growth. Capital formation and the savings ratio were both high in Germany and there was absolutely no shortage of money. That was why he asked the question, "what is demand?" which everybody wanted more of. Mr. Healey interjected that it was money that people were prepared to spend, which could be given to them by tax cuts or could be spent for them by public expenditure.

The Prime Minister said we were not here to wrangle over whether the FRG policy was right or wrong on growth but to ask why the world economy was in the state it was: he would like to take further the Chancellor's question of "what is demand?"

Mr. Lever said that the problem was structural. The FRG, for example, had been structured over a very long period for growth based upon exports and therefore they required buoyant world trade and without it could not sustain their growth. The United Kingdom had a different structural problem in that because of its industrial weaknesses it could not expand the economy without running into balance of payments problems. The problem was thus structural in the sense that the industrial countries could not grow; the OPEC surplus countries could not absorb more imports; while the rest could grow only by generating exports which required a demand in world trade which did not exist.

The Prime Minister said that he agreed with this. But there was no one factor which determined growth or its causes. Nevertheless, lack of confidence was at the heart of the matter and this had been Herr Schmidt's own phrase when they met in Bonn.

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/ The UK view

The UK view was that we should take as many factors contributing to lack of growth as we could find - maybe we had not got them all, or the right ones - and work out how we could tackle each of them together. That was the origin of our approach to the United States, which Herr Schmidt had encouraged him to make. It was clear that President Carter would not act except on the basis of a concerted plan. What else was there to do but to try such a plan? He could not tolerate 16 million unemployed. Nevertheless, he agreed with Herr Schmidt that we had to start with an analysis of the problem.

Herr Schmidt said that one solution was that those with deficits should get rid of them!

Mr. Richardson said that the oil price rise had affected all the heavy importing economies and their consequently deflationary policies had been repercussive. We would need to use conventional instruments to restore confidence.

Dr. Emminger said he agreed that the FRG economy had been too export-dominated, but this was changing: most recently growth had increased because of the increase in domestic demand. But such a change needed time. One of the present constraints was the low profitability in Germany (excepting cars): the average FRG profitability was less than 50 per cent of that of the United States. They must have better profit prospects before they could achieve significant growth, and to produce this would take time. He was in fact happy with what would have been achieved in 1978 - growth of, in effect, 4 per cent. But we must be patient if we were going to bring about the necessary structural changes. There was a very large elasticity of demand for imports in the FRG. Last year they had achieved 2½ per cent growth nationally but imports had risen by 5 per cent. This year he thought the ratio would be 3½ per cent - 6 per cent. He would plead for patience during structural change. Mr. Healey interjected that this would be more acceptable if the Germans were to give more on demand.

/ Herr Schmidt

Herr Schmidt said that he agreed that in a package at the Bonn Summit each country would have to do something and he would have to take a political view about that, but it must make sense economically and he was still asking what demand was, and whether anybody could recover if the United States was running a \$30 billion<sup>p.a.</sup> deficit. If we assumed that the FRG and Japan could get rid of their surpluses, who would then have them? The answer was three or four OPEC countries would retain large surpluses and 130 plus countries would have a deficit - ldc's, dc's and advanced countries, only the Arab rogues would keep surpluses.

Mr. Couzens questioned this and said why should the oil countries have surpluses - they arose only if the FRG would continue to import oil while the OPEC countries would not import German manufactures?

There was a confused discussion about what were the consequences of a deficit. But agreement was reached that the OPEC surpluses were reducing as import absorption became more practicable.

Herr Schmidt said that the fate of the ldc's depended on the Shah of Iran and Crown Prince Fahd and the fact was that if those two decided, as he thought they might, on a 16 per cent oil price increase, there would be a major disaster. The Prime Minister said that he agreed with that. He then asked Herr Schmidt what he thought would happen if we could assume, as the Chancellor had suggested, that the United States managed to wipe out its deficit. Herr Schmidt said that he would be prepared to pay a very high price if the United States, to remove its deficit, took action on energy and inflation. Action on the first would lead to a lower growth in oil consumption and would have a stabilising effect, while action on the second would give the world a big shot of confidence, because it would put an end to the decline. He was looking for some decisive action on the part of the United States Government and if they would commit themselves to these two

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proposals he would, in consequence, commit the FRG to decisions which were in all other respects "errors". He doubted very much if President Carter's words could measure up to the needs. He had read carefully the statement on inflation and did not find much in it. Action on the two fronts on energy and inflation was essential, and if President Carter either said he could not take it or would not, or if Congress objected, then any other kind of action by anybody else made no sense. We had to put the positive factors together. Mr Richardson agreed that it would have a great effect on world confidence if the US President were decisive on these matters. The Prime Minister asked what decisions they were looking for from President Carter. Herr Schmidt said that the United States oil imports were now \$47 billion per annum, in 1973 they had been \$5 billion per annum: the United States had <sup>more than</sup> doubled the volume at a quadrupled price and this was the heart of the matter. President Carter would have to make the American consumer pay a lot more for his gas at the pump and only by so doing would everybody see that he was serious, even if the global effect of such a matter was small. If, on the other hand, he tried to deal with the oil import problem by "gadgets", this would be seen for what it was and valueless. The test was whether the United States Government was willing to stand the automobile drivers' outcry against the gas price increase. He did not believe Congress would. But President Carter had power himself to deregulate Texas oil prices and by so doing tackle the problem at the source. If President Carter would only do that, he would go on his knees and praise God.

Herr Schmidt then returned to his earlier question: what kind of decision was it that we could take. The FRG had already printed more money than it needed. Its General Government Deficit (GGD) was bigger than the UK (disputed by Mr. Healey) - what did the Prime Minister want him to do? The Prime Minister replied that the Chancellor had said, most significantly and very encouragingly, that if the United States would act then he would too. He thought this was a significant statement but it was not for the United Kingdom Government to say what Chancellor Schmidt's action's should be.

/Herr Schmidt

Herr Schmidt said he really did not know what to do so far as tax cuts were concerned. The fact was that the German consumer already had everything that he wanted and if he were given tax concessions he would simply spend the money in services in Italy, Yugoslavia and Spain. This would have beneficial outward effects but the inward structural problem would not be touched.

Mr Healey said that it was not possible to do economic restructuring by demand management measures. Herr Schmidt said that he could not agree more! And what he wanted to do was to remedy the structural weakness. He asked pointedly how much effect would Mr. Healey's recent tax measures have on the United Kingdom unemployment problem? Mr. Healey agreed that they would not have much effect at all. Herr Schmidt said that he agreed. It would be better if he were to give the tax concessions not to individuals but to the corporations to improve profitability and encourage investment. The SDP would not like it but it made more sense. Mr. Lever said that these structural changes needed more time and could not be corrected in one package. Herr Schmidt said that this was true and in that context he pointed out that the FRG was not, as commonly supposed, a surplus country if account was taken of all its expenditure on services, i.e. including holidays abroad. The fact was that the FRG was importing services and exporting capital and by so doing was not a surplus country.

Mr. Healey said that we could all agree that we all needed more time and that was certainly true of the United Kingdom, but in the meanwhile there were very strong pressures for protectionism. The Prime Minister agreed and said that the Bonn Summit would, as he saw it, be a turning point on this issue of trade restrictions. Herr Schmidt said that the FRG too were resisting protectionist measures. The important thing however was to deal with the consequences of the transfer of capital and technology to the super-competitives - Taiwan, Korea and Hong Kong - for any increase in demand for, e.g. steel, ships and textiles, would simply be met by those countries. If we were



not careful we would, by our present policies of transferring capital and technology, produce exactly the same situation with other members of the Group of 77. He accepted that the FRG steel industry would never be used again; nor would their textiles and shoes, or their radios and cameras. Japan was beginning to suffer from the same effects of "differential costs". There were two answers: one, stop the transfer of capital and technology, which he regarded as wrong both politically and morally and/or to restructure your economy by replacing the industries which the super-competitives were competing with with new industries. But which new industries? He did not know and in any case how do you bring 300 years of shipbuilding history to an end? What were the shipbuilding workers going to do? The State would not be able to give them new industries because it could not do so. The boards of the industrial corporations who could do so would only move if they saw sufficient prospect of profit to ensure that any new capital they invested would be amortised over a reasonable period. So, if we want to restructure our domestic industries to deal with the super-competitives of today and with the new super-competitives in the Group of 77 tomorrow, we needed something more and quite different from a half per cent increase in "growth" brought about by tax cuts designed to benefit housewives. If the Bonn Summit pressured him into tax cuts then he would make them but they would not solve the problem.

The Prime Minister said that it would not be the Bonn Summit but the German people who would pressure the FRG into stimulating the economy because they would not accept a continuing loss of jobs. This was a political fact which was leading more and more people to seek restructuring of the kind Herr Schmidt was describing behind a tariff wall of protectionism. Herr Schmidt repeated that output on steel and coal would in no way be increased by tax reductions but those industries were the centre of unemployment.

/The Prime Minister

The Prime Minister said that it was necessary to talk about this politically. The Tories would approach this pragmatically and would certainly take measures to protect the UK economy. Unless positive steps were taken in the next 12 months which made it unnecessary, the moves to protectionism would be irreversible. In the UK the Government had already reduced the steel industry by a half and it might have to be reduced further. The same problem was facing the Government over shipbuilding but he was not prepared to see the UK shipbuilding capability destroyed. The UK was an island and a maritime nation and his own policy, which he had not yet discussed with his colleagues, would be to maintain the shipbuilding capability by building a bigger Navy for the purpose of keeping open the sea lanes, e.g. to Faslane for the Polaris submarines. For this purpose we needed ships like mine sweepers and hunter killers to balance the Soviet Navy's presence across our sea routes. Herr Schmidt said that may be the UK could sustain these industries at 50 per cent but the position was the same in all the Western economies, that the traditional industries were declining: it was the same everywhere: what were going to be the industries for growth? Mr. Lever said that it would be the industries that the Koreans wanted to buy and what were they? Technology and services. Herr Schmidt agreed and said that the consequence of this was that we had to change supply and not demand and that it was the restructuring of our supply industries which we had to focus on: by creating the capital for the new and restructured industries, you would create the demand but how was this to be done? If he were a Conservative politician he would say simply a matter of incentives. Herr Matthöfer said that the solution lay in a combination of all three kinds of measures: generating demand by increases in income; changing the structure by giving business incentives to invest where they could see and meet new demand; and changing the structure of demand in another sense by more public services. Mr. Healey agreed and said that we would not create employment by high technology. Mr. Lever commented that what would happen eventually would be that we

/would pay

pay for the super-competitives' goods by producing the high technology services that they needed, but those services which could be created would require a smaller labour force and as a result we should be able to afford and operate more public services with what we earn.

The Prime Minister said that he would now like to hear what Herr Schmidt thought about the prospects of work-sharing as a solution to the problems of unemployment, e.g. by way of a move to a 35-hour week. Herr Schmidt said that he favoured this development but the trade unions must understand that if this comes about they must hold back wages in consequence. The Prime Minister explained the background to his request (the trade union leaders dinner at Downing Street on 10 April when the trade union leaders had said that they saw advantage in pursuing the work sharing approach this year as a means of assisting in pay restraint). The Prime Minister said that he had told his trade union colleagues that they must consult in Europe on this issue and encourage progress there too. He himself took these ideas very seriously and had asked for work to be done urgently to see what prospects there were for progress. Herr Matthöfer said that they had moved on this in Germany quite recently by giving the public services two days extra holiday, by giving the miners four days extra holiday and by reducing the retirement age to 63. The Prime Minister asked whether there had been any effect on wage demands and Herr Matthöfer replied not yet. The Prime Minister said that he was confident that the United Kingdom trade union leaders would trade-off work sharing against pay increases. In further discussion it was pointed out that the labour force trends in the UK and the FRG showed some dissimilarities: the total number of people in work in the FRG had decreased in the last three years (partly by foreign workers leaving but by no means wholly on that account) whereas in the United Kingdom the total<sup>employed</sup> had remained constant while the number of unemployed had risen; there was no problem of youth unemployment in the FRG and indeed, at 180,000, their youth unemployment was proportionately lower than that

/for all

for all adults; there was a high proportion in the FRG of women, the elderly and the disabled among the unemployed. The Prime Minister said he was sure we must encourage people to look at the possibilities of a shorter working week. Herr Schmidt agreed and said that in the FRG they were retiring at 62 now on the same pensions and if a 60-year-old man had been unemployed for twelve months he would now retire on his full pension. Herr Matthöfer commented that what worried him was that the proportion of workers to non-workers was going wrong.

The Prime Minister then asked Chancellor Schmidt: "What is your big problem? If it is not inflation nor prices, what is it?" Herr Schmidt said undoubtedly unemployment. Three years ago it was inflation and prices but now it is unemployment and had been for these past three years: if only he could secure a reduction of 200,000 in the number of unemployed! The problem now was certainly not inflation but growth and unemployment.

The Prime Minister said that he had concluded from the discussion so far that we must regard the Bonn Summit as a critical occasion (the decision-making aspects of which had perhaps been over-emphasised) because what it must do was to ensure that the world leaders looked as though they were in command of events so that world confidence could be generated. Herr Schmidt said that if one looked ahead over a three-year period he would feel confident, but he had no doubt that the trade union leadership, the entrepreneurs and the SDP were not confident. But he was. Mr. Lever commented that he expected currency stability to improve but unemployment to remain the same. The Prime Minister said that he did not see how we could reconcile in one operation the restoration of confidence with the requirement to restructure Western European industry. Chancellor Schmidt said that we could at least put the brake on capital and technological transfer to the Koreas of this world. What we ought to do to help the under-developed world was to export our food surpluses for nothing! Herr Matthöfer said "and destroy their agriculture!" Herr Schmidt said we should give the surpluses away, to which

/Mr. Healey

Mr. Healey retorted that we ought to stop producing them in the first place. Herr Schmidt said he agreed, and had hoped that one of the benefits of the United Kingdom entering the Community would have been to end this absurd policy.

#### CURRENCY STABILITY

Herr Schmidt referred to the paper which he had handed to the Prime Minister earlier. He gave a brief account of his ideas for achieving new monetary relationships in Europe by fixing parities which allowed a variation of 1½ per cent either side of a target rate.

Herr Schmidt said that we must try for greater stability to overcome lack of confidence in Switzerland, Japan and Germany and also in New York. Ultimately we would have to restore fixed parities but as a first step we could get a near-fixed-parity system with target zones and with a fixed relationship between other/<sup>European</sup> currencies and the dollar. We should attempt to do this first in the EEC and establish confidence there, both in EEC trade and in the relationship of EEC currencies with a stable dollar. He said this can and would happen and it would happen with or without Britain. But it was up to us whether we participated in it. The Prime Minister said that whether we/<sup>would</sup> participate depended upon the consequences. He had from the outset/<sup>publicly</sup> said that he was going to take a sceptical line and would continue to do so until he could clearly see the consequences. What were they? Herr Matthöfer said that the consequences would be more trade for all because of currency stability and he cited the growth in German/Dutch trade as a result of a stable currency relationship.

The Prime Minister said that one effect would presumably be a devaluation of the deutschemark and an upvaluation of the pound and he could not see that in the United Kingdom's present position that could in any way help us. How did they think it

/was going

was going to help us? Herr Schmidt said that it would over a period of five years because it would strengthen trade, facilitate quicker growth in exports and imports in a stable currency zone, and it would be more stable because it had two pillars not one: within four to five years the EUA might evolve as a new reserve currency. The solution that he was proposing was the one that they had been about to follow in 1973 but had withdrawn from because of external pressures. He disclosed that on one day at that time they had spent \$2.7 billion to try to defend the DM before they had decided to decouple from the dollar. A return to fixed parity with the dollar was impossible and the Americans would not themselves make the dollar more stable, unless perhaps this could be achieved at the Bonn Summit.

The Prime Minister said that the considerations which the United Kingdom Government must bear in mind were: first, we would have to enter a relationship at a lower level than the present exchange rate because we could not afford, given our trading position, to commit ourselves to an uncompetitive rate. This therefore was a political act and with an election in 12 to 18 months it simply was not feasible for him as Prime Minister to go to the country saying that we had decided to enter the Snake again with a 20 per cent devaluation; secondly, a devaluation of the pound on entry would result in a rise in the price index. Mr. Healey explained that a 1 per cent fall in the effective rate of the pound against the basket of currencies was a half per cent rise in the price index within six months. Giscard had gone in and out of the Snake twice because France could not stand an over-valued franc and Heath had tried it but had withdrawn after 10 days because we could not stand the high value of the pound on entry.

Herr Schmidt said that he understood these domestic political considerations. The Prime Minister said that they really were very difficult because, as American experience showed, a single currency for a wide geographical area carried no certainty of a single level of prosperity in that area and many small areas, including the United Kingdom, would on this basis suffer badly.

/Herr Matthöfer

Herr Matthöfer said that there would be a very big market in one currency and while it was true that prosperity would be unequal within the big market, this was no different from the present situation even in Germany where there were unprosperous areas. The Prime Minister interjected that at present the United Kingdom transferred resources from England to Scotland and Wales: he was quite sure that the people of the FRG would not be prepared to pay for transfers to Wales.

Herr Schmidt said that we had to recognise that, so far as transfers of currency were concerned, the public did not understand anything about it or even know about it. This was something that bankers did. The poorer areas, to which the Prime Minister had referred, would benefit from having a European currency which would enable transfers of resources to be made: he did not think this would be much of a problem so far as the United Kingdom was concerned but he thought it would be a big problem in relation to South Italy, Spain and Greece. He noted that so far in the EEC we had:

- (1) national schemes of tax differentials and budgetary measures to assist poorer areas;
- (2) EEC schemes of regional development, but these had nothing to do with currency schemes.

He did not envisage the currency scheme as being simply a device whereby European SDRs could subsidise the poorer areas. We could, however, identify the EIB and Fecamp with the currency scheme by putting them into affiliation with it and funding them so that they could float loans. He would, nevertheless, want to distinguish clearly between (a) the currency system and the need for stability which justified it; and (b) subsidisation schemes which might result from it. The Prime Minister pointed out that, with regard to loans etc., the FRG owned its reserves and could deploy them accordingly, whereas the United Kingdom's were borrowed. If we were now to borrow from the new reserve pool this would add enormously to the problems. Herr Schmidt said that if we all put 15 per cent of our dollar reserves into the

would pool the consequence of the scheme /be that no-one would want to borrow dollars. But if they did so they would loan them on the three bases of short, medium and long-term loans. We could in fact add a new five to ten year loan. He emphasised that the more credible the scheme was, the less likely that any of the transferring countries would call upon the pool for loans. He commented also that we should not present the scheme as something which would deal with the unemployment problem - it might ultimately, in five to ten years time.

Herr Schmidt said that he was ready to take on the risk of Italy being a burden under this scheme because he was passionately determined to do all that he could to avoid Communist governments in Italy and France. We should recognise that we could quite easily by now have had Communist governments in Italy and France. If this had happened NATO itself would have been under threat.

Mr. Lever said that he was not clear how it was proposed to stabilise the Euro currency vis-a-vis the dollar.

Herr Schmidt said the scheme itself would do it because if the dollar had to relate to six linked currencies then the United States authorities would stabilise it.

The Chancellor said that there were attractive elements in what Herr Schmidt was proposing, the most attractive being that it was aimed at preventing excessive fluctuations world wide. He was sure that it was desirable to limit these extreme fluctuations, although problems arose over defining the levels at which fluctuations were tolerable. We could have too big or too little a range. We would also need to know on what terms the weak and strong currencies within the agreement would borrow or lend. There was certainly a case for looking deeply at the proposal but it would need to be done thoroughly because, if the terms were not thought through, it could do much damage.

Herr Schmidt agreed with this last point. Mr. Richardson said that we should not call this a Snake. Herr Schmidt agreed: he said it was not a Snake neither was it target zones. He said

/that he



that he had spoken to the French Government and there had been less than enthusiasm for it among M. Barre, M. Clappier and among the technicians. But he himself was a political leader and thought that the technical problems could be overcome. He recognised, of course, that within the "compound" there had to be scope for revaluations and these had in fact been done in the Snake. He recognised also that the United Kingdom might want a lower rate for the pound on entry. He also thought that we might want to aim at a band which was less than the band of  $\pm 1\frac{1}{2}$  per cent which he had referred to earlier. There was no need for this to distort UK economic policy. Denmark had devalued three times in one year within the Snake. He did not like either the Denmark devaluation or the German upvaluation. But what they had in common was that they all wanted to avoid fluctuations. By so doing, they would produce more harmonious relationships between their currencies without the Commission in Brussels interfering. He did not want to give more power to the Commission but to keep it all in the hands of Finance Ministers and Governments. He suggested that the Prime Minister should talk to Anker Jørgensen who, according to Herr Schmidt, had been greatly assisted by the incentive to stay in the convoy. Such a scheme would make for "more harmonious relationships" although President Giscard had said that there were additional risks. But, if it does happen, and the United Kingdom stays outside, what were the risks then? Mr. Lever said that the risk was that the UK currency would become more exposed and that in turn meant that we could become more protectionist. Herr Schmidt commented that the UK could also be attacked by people wanting their dollars. The Prime Minister asked why we had only stayed in the Snake for 10 days? Mr. Richardson said that it was because we went in it at too high a rate. Herr Schmidt said that the UK should have borrowed. The FRG had offered France \$5 billion at that time to help them to stay in the Snake but President Pompidou had turned it down because it was German money. But on the proposal that he was now making, such offers of help to remain in "the compound" would come from the pool, not from Germany.

/Mr. Richardson

Mr. Richardson said he assumed that the pool would be made up of dollars and other currencies and the pool could be designated in European Units of Account (EUAs) as well as in pounds or deutschemarks. Mr. Lever asked what Herr Schmidt thought the balance of payments effect of this scheme would be. Herr Schmidt said that that would depend on the level of entry. He went on to say that other currencies outside Europe might be interested in the scheme, in particular the Third World countries for whom a Lomé-type relationship might appeal (he said in parenthesis that he was very pro-Lomé and much approved that approach for the Third World to that of the Common Fund).

The Prime Minister asked what size of fund was in mind. Mr. Richardson repeated that it would be a fund containing two kinds of currency, dollars and the European currencies. Herr Schmidt said: "A dollar fund would be safer!" Mr. Couzens commented that on this basis intervention could be in dollars or in one's own currency or in deutschemarks. Dr. Emminger said he did not want the deutschemark to become a reserve currency but the Prime Minister commented: "It will". Herr Schmidt responded that it was less likely if they were all in the compound. Mr. Lever said that the fund might in fact attract dollar funds. The Prime Minister said that it appeared to him that we should all become part of a reserve currency under Herr Schmidt's scheme and this could not be stopped. Mr. Lever agreed and said that people would want to buy EUAs, not only for dollars but for other currencies as well, and he thought it called for close collaboration with the United States. Herr Schmidt said that the management of the fund would be for the central authority of bank governors or presidents and would meet every four weeks. The United States would, in fact, see this as a friendly and generous gesture of support.

Herr Schmidt said that the proposal had not so far been discussed outside a very small circle. The Prime Minister asked him how he envisaged carrying on the discussions from here. Herr Schmidt said that he now understood the Prime

Minister's electoral problems, but he would still think that the right kind of linkage would be narrower than the Snake after the necessary processes of adaptation. The Prime Minister said that he was very cautious still about this and Mr. Healey emphasised the danger of leaks - the Prime Minister commented that the leaks/<sup>which</sup> had already taken place had partly, and perhaps helpfully, discounted the scheme. He would continue to be sceptical and would keep it under tight control. Herr Schmidt said that no-one should do anything more until they had the real paper. Outside the circle in the room, the only people who really knew about it, apart from President Giscard, were M. Clappier in France, Graf Lambsdorff and Herr Schulmann in the FRG. Herr Schmidt said, returning to the matter of the Bonn Summit, if his European colleagues went along with a monetary stabilisation scheme of this kind, then the growth decisions at the Bonn Summit would be that much easier because the monetary conditions for growth will have been stabilised. The turbulence in the monetary markets was a very real factor - it was not insignificant that the deutschemark had appreciated 60 per cent against the dollar in five years.

The Prime Minister then turned to the question of relative profitability and asked what the German position now was. Dr. Emminger said that it used to be much better than it is now. The Prime Minister said that he wanted his Five Point Plan to deal with short-term threats to trade by protection. Mr. Lever commented that the effect of the super-competitive countries had been enhanced by the world slump and it may be that we should promote more trade in the world if we went in for more transfers of capital and technology, and it would be worth doing this as a means of getting world trade moving again.

Herr Schmidt said that in the matter of the North/South Dialogue, the concept of the Common Fund was rubbish. Supposing there were a Common Fund for copper, then it is true that Zambia might gain some benefit, but the United States and the USSR would gain infinitely more, similarly with iron ore and similarly with cotton. He was going to Jamaica to tell Michael Manley so, and to tell him that it

/was a Lomé-type

was a Lomé-type solution that offered the only key to the problem. In this connection, he asked what was meant to be covered by the heading "Capital Movements" in the Five Point Plan. The Prime Minister said that this referred not just to the North/South Dialogue but was intended to deal with the problems of surpluses, e.g. in Japan and OPEC and how to finance the "benign" deficits. Herr Schmidt said: "What then is your aim? Could we have a paper on capital flows so that we can understand what you want to do? You seem to be talking only of the problem and not of the solution." Mr. Healey commented that we wanted a more positive position on this whole question, with better aid terms, and Mr. Couzens explained that the Preparatory Group for the Bonn Summit had already commissioned a paper, now with the Canadians, about this aspect of the Five Point Plan.

At this point, Herr Schmidt asked why we had not helped Turkey from our reserves as they had done. (The Prime Minister was not aware of the background and asked to be given a note of what it was all about.)

The Prime Minister said he wanted to talk for a moment about the European Summit. Mr. Healey said that preparations for the next <sup>European</sup> Summit were going well. They had established momentum and he thought that the Finance Ministers Council would soon state recommendations for Bremen. Herr Schmidt said that Bremen was totally superfluous and people were getting involved in this in the Commission and the Council of Ministers simply in order to flatter themselves. The Prime Minister said that he himself never understood why we needed three Councils a year, nor so many people at them.

The discussion then moved rapidly over a number of issues which were more fully taken up in the Prime Minister's further meeting with Herr Schmidt where they are recorded separately. These items covered:

- (a) Soviet relationships with the FRG and the US;
- (b) SALT II, CTB, MBFR and SS-20;
- (c) The NATO meeting