VISIT OF CHANCELLOR SCHMIDT OF THE FEDERAL REPUBLIC OF GERMANY 10TH-12TH MAY 1979

NOTE OF A DISCUSSION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE MINISTER OF FINANCE, OF THE FEDERAL REPUBLIC OF GERMANY, AT 11, DOWNING STREET AT 18.00 ON THURSDAY, 11TH MAY 1979

Present:

Chancellor of the Exchequer
Mr. K.E. Couzens
Mrs. M.E. Hedley-Miller
Mr. M.J. Michell

Herr Matthoeffer, Federal Minister of Finance
Herr M. Lahnstein, Under Secretary of State
Dr. V.W. Heck, Assistant Under Secretary, Federal Minister of Finance
Dr. G. Massion, Embassy of the Federal Republic of Germany

After an initial exchange of courtesies, Herr Matthoeffer opened the discussion by asking about the Government's economic priorities. The Chancellor in reply emphasised Ministers' total commitment to reductions in both the uniquely high level of United Kingdom personal taxation and in public expenditure and the public sector borrowing requirement. Lower direct taxation and improved incentives were required to regenerate the supply side of the economy and reverse the decline in industrial performance.

Herr Matthoeffer asked how far the Government's policies allowed for some Government support for industry and more general incentives to encourage investment. Government help in the FRG had given a good deal of encouragement to successful medium and smaller sized companies. Also, schemes like the coal gasification programme could not have succeeded without Government initiative. The Chancellor said that schemes for industrial support were liable to waste large amounts of public money and the Government preferred to concentrate on motivating the private sector in other ways.

The Chancellor then turned to performance of the monetary aggregates. The UK money supply was running very close to the top of the 8-12 per cent range, which had remained unchanged for two years. Herr Matthoeffer replied that in the FRG the money supply was well within the 6-9 per cent target. Interest rates paid by industry for long term borrowing were little over half those prevailing in the UK.

Discussion then moved on to Community matters. The Chancellor began by recalling a conversation he had had with Herr Willy Brandt some years previously when the latter had suggested that the most significant contribution to be made by the UK to the vigour of the EEC lay in improving the performance of its own economy. The Government were determined to see that improvement come about.

Herr Matthoeffer then invited the Chancellor's views on UK participation in the European Monetary System (EMS). The Chancellor said that the Government would naturally wish to re-examine this whole question: whilst our partners should not expect early decisions, he recalled that in the debate in the House of Commons in December he had indicated a greater disposition than the Labour Government to see the UK participate more fully in the new arrangements. His expressed doubts had been of a mainly technical kind, relating to the adequacy of machinery for making parity adjustments within the EMS and to whether sufficient progress had yet been made towards economic convergence in the participant countries. Taking up the first point, Herr Matthoeffer suggested that parity adjustments, with goodwill, were no more difficult in the EMS than they had been in the snake. Since December the exchange rates of the EMS countries had shown remarkable stability even before the system formally came into operation. The unexpected feature had been the strength of sterling. If the UK joined the exchange rate mechanism in due course would the Government want the usual $2\frac{1}{4}$ per cent margin for sterling or the wider margin allowed to the Italian lira? The Chancellor said it was too soon to be firm about details, but he reaffirmed the Government's willingness to look sympathetically at the whole question of UK participation in the exchange rate mechanism.

Discussion then turned to the Regulation to be discussed at the meeting the following Monday of the EEC Finance Council covering the interest rate subsidy for Ireland and Italy. Herr Lahnstein recalled the history of the discussions of this subject since December. The United Kingdom, though regarded as a "less prosperous country", was not included in the provisions of the present Regulation which applied only to those participating fully in the EMS, including the exchange rate mechanism. The Italians and the Irish were anxious to see the Regulation approved and he hoped the Chancellor would be able to acquiesce in it. Replying, the Chancellor said he naturally did not want to take up a rigidly hostile position on the matter. He understood why the Regulation had to be confined at this point to Italy and Ireland. Nevertheless, he would expect the Finance Council to record its explicit recognition that there was room for further consideration of our access to interest rate subsidies in the event that the UK joined the exchange rate mechanism. Whilst this could not form part of the Regulation, it would need to be formally recorded.

Replying, Herr Lahnstein assured the Chancellor of the general recognition that the UK could not be excluded for all time from access to the facility. He suggested that when the Finance Ministers meet informally in Brussels on Sunday night proposals should be put to the French Presidency for a formula which would safeguard the UK position. Mr. Couzens suggested that this would need to include an undertaking to reconsider the total financial provision for interest rate subsidies if the prospect of future UK participation were not to imply a reduction in the available help for the Italians and the Irish. Herr Lahnstein, whilst expressing German sympathy, felt that the French would not depart from their entrenched opposition to accepting the UK as a "less prosperous country". It might be better to look for a flexible formula which would satisfy everybody.

The Chancellor then turned to the problems presented by the transfer of Community resources. Recalling his participation as Solicitor-General in a previous administration in drafting the UK Treaty of Accession, he had been surprised to discover how the position had worked out in practice. Whatever the reason for the present imbalance, the present and prospective scale of the UK net contribution to the EEC budget threatened the Government's public expenditure plans, burdened the balance of payments and could not be justified any longer to the British people. It was, moreover, a serious impedement to the Government's plans to regenerate the British economy. Our present £800 million net contribution was simply not commensurate with our relative economic prosperity. Replying to an intervention by Herr Lahnstein, the Chancellor disagreed that the argument turned essentially on the treatment of MCAs. Whatever the basis of calculation, the United Kingdom remained a large net contributor both in terms of national accounts and in resource terms when the cost of imported food was properly included. Compared with the size of our contribution, the total provision for interest rate subsidies was very small. Moreover, he had been struck by the inconsistency between the aim of stability underlying the EMS and the persistent tendency of the EEC budget to increase economic divergence. A solution was needed which was compatible with the well-being of the Community.

Herr Matthoeffer's response was to stress the importance of holding firm to the 1 per cent ceiling on the "VAT tranche" of contributions to the Budget. This might well be reached early in the 1980's and providing the ceiling was maintained this would act as a strong incentive to restructure the Community's expenditure. The Chancellor, whilst acknowledging this, suggested that maintaining the 1 per cent ceiling would of itself do no more than prevent the present imbalance from getting worse. Even with that, and assuming progress on the CAP, the UK still finished up with a large disproportinate net transfer of resources, to which it was essential to find a solution. Herr Matthoeffer interjected to say that he had always been critical of the CAP, especially in regard to milk production. But in Germany, this was a coalition problem. The French were intransigent: the CAP was essential to President Giscard's position. The Chancellor replied that the budget problem was quite separate from the CAP and needed to be addressed as a separate issue. Mr. Couzens added that maintaining the 1 per cent VAT ceiling could arguably make it more difficult to restructure Community expenditure away from the CAP and towards the Regional and Social Fund. Herr Lahnstein said that his Government were convinced that any readjustment had to come from the expenditure and not from the contributions side of the Budget. That is why they placed such importance on holding to the 1 per cent VAT ceiling. A budgetary squeeze would be bound to put a brake on farm price policies. However, he agreed that restraining CAP would not automatically provide more resources for disbursement through the Regional and Social Fund.

Concluding this part of the discussion, the Chancellor said that he could not see any means of removing the present disproportionate UK contribution unless the Community were prepared to undertake some more fundamental reconsideration of its financial structure. This was not a question of renegotiating the terms of membership; any more than it was a claim to establish a "juste retour". It could involve looking again at the financial mechanism which applied at present only to the member-countries' gross contributions and not to their net contribution.

Herr Matthoeffer then turned predictably to the level of the UK contribution to Turkey, contrasting it unfavourably with the very much larger contributions offered by France and the FRG, and with those of the smaller countries like Austria and Belgium. In reply, the Chancellor expressed a common anxiety with Herr Matthoeffer to contribute to the help for Turkey. But this was coupled with a similar anxiety that offers of help had so far singularly failed to persuade Turkey to follow a disciplined economic programme to put its own house in order. The Chancellor said Ministers would naturally look at the position again, but would have to have regard to their commitment to reduce public expenditure. He assured that Chancellor Schmidt would also be raising this subject with the Prime Minister in their discussions. Herr Matthoeffer and Herr Lahnstein both acknowledged the importance of Turkish acceptance of a proper financial discipline. The FRG contribution would certainly not be pledged before there was an assurance that Turkish discussions with the IMF were proceeding satisfactorily. Whilst that still seemed some way off, he hoped it would be possible for swift and adequate action to be taken once progress had been made. In this respect, he emphasised that other potential contributors would take their lead from the UK.

The meeting ended with a brief discussion in which Ministers agreed upon the value and importance of close collaboration among the major industrialised countries on international economic and monetary affairs.

The discussion ended cordially at about 19.15 p.m.

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(A.M.W. BATTISHILL)
11th May, 1979