

NOTE OF A CONVERSATION BETWEEN THE PRIME MINISTER AND
CHANCELLOR SCHMIDT IN CHANCELLOR SCHMIDT'S BUNGALOW

AT 20.15 ON 15 JULY 1978

Present

The Prime Minister
Sir John Hunt

Chancellor Schmidt
Note-taker

The Economic Summit

Chancellor Schmidt said that President Carter's visit to Berlin had been a great success. He had talked to the President about the Summit and had made it clear that Germany would be unable to move on growth unless the United States could act on energy and the balance of payments. He remained unconvinced of the case for stimulating the German economy but would nevertheless do this in order to achieve concerted international action. If, however, President Carter was to act on oil prices he would probably have to use his executive powers: and if he was to declare his intention now of doing this it could provoke action in Congress to block this. The President realised this and might therefore decide that he could make no firm commitment at the Bonn Summit. Chancellor Schmidt repeated that he would act on growth if the President acted on energy despite the considerable political and legal difficulties which would be involved in Germany. President Carter for his part wanted a commitment at the Summit against protectionism and he would support President Carter over this. He doubted whether it was worth pressing Japan further on growth but it was vital that real action should be taken to reduce the Japanese surplus and open the Japanese market to imports. The Prime Minister said that he had hoped Chancellor Schmidt and President Carter would already have come to some agreement on the trade off between growth and energy. What would happen to the

deutschemark and the dollar if the Summit ended without any agreement on this matter? Chancellor Schmidt said that he did not know. The Bundesbank had already had to intervene to a considerable extent. The Prime Minister reiterated that it was important to reflect upon the consequences for confidence and the markets if the Summit failed. Chancellor Schmidt replied that he appreciated the need for a successful Summit and that this was why, despite his intellectual reservation about the case for German action on growth, he was nevertheless prepared to act provided - and this was essential - there was a satisfactory response from the Americans about energy. The Prime Minister then asked about German interest rates. The Chancellor replied that at the long end they were $6-6\frac{1}{8}$ per cent and mortgage rates were $6\frac{1}{2}$ -7 per cent. The Prime Minister asked whether a higher rate would be needed to finance a higher public deficit. Chancellor Schmidt said rates were already too high with inflation at only $2\frac{1}{2}$ per cent. The Prime Minister said that we had a similar excess (though at a higher level) of long interest rates over inflation. Chancellor Schmidt again emphasised the borrowing problem which any addition to demand would cause for the German Government.

The Prime Minister then asked the Chancellor how he envisaged handling the meeting. Chancellor Schmidt replied that, having been in Berlin with President Carter, he had not yet studied his own briefing papers. He envisaged however that the meeting would start with a general discussion covering the five key areas. The Prime Minister asked how this could be done in a way which would avoid a haggling-type of discussion with each country making demands upon another.

/Chancellor Schmidt

Chancellor Schmidt suggested that initial discussion might be more general and that the haggles might take place among Heads of Government only over lunch. The Prime Minister referred to the American and German wish to see a condemnation of protectionism. There were considerable protectionist pressures in Britain but he would like to be as forthcoming as possible in the context of a successful Summit. The world reaction to failure would be very serious. Chancellor Schmidt said that he would lose either way. If the Summit failed he would be criticised by world opinion. If it succeeded he would be criticised by his own business and banking community who were urging him strongly against any further stimulation of the German economy. The Prime Minister asked what they were primarily worried about. Was it the fear of inflation? Chancellor Schmidt replied that different interests had different worries. His own view was that the additional borrowing requirement was the major problem. He repeated however that he was willing to act on growth to improve international confidence provided there was satisfactory action by others. In reply to a question by the Prime Minister he also confirmed that he would not say publicly that he did not believe that additional stimulation would lead to additional growth in Germany.

The Prime Minister and Chancellor Schmidt then discussed the arrangements for press briefing at the Summit and the Prime Minister suggested that at the end of the first day the only formal briefing of the press should be by Chancellor Schmidt as chairman of the meeting. Chancellor Schmidt said that he would be willing to do this if others suggested it.

/Chancellor Schmidt

Chancellor Schmidt then said that he had a difficult timetable. He had called a meeting of his Cabinet on Sunday evening in order to decide whether what others had offered on the first day of the Summit would justify German action on growth. He suggested that the Prime Minister should telephone President Carter and say that if the latter was going to be able to say something forthcoming on energy it was essential for him to do so on Sunday. He had made his position clear to President Carter but the latter had been evasive to him. He understood his Congressional problem but the plain fact was that United States oil imports were ridiculous. The Prime Minister replied that they must be given credit for making some progress in reducing them. In reply to a subsequent question as to whether he had made clear to President Carter the minimum commitment on energy required as a condition of German action on growth, Chancellor Schmidt said that he had not done so. He was not worried about the particular wording. He did not necessarily want the President to commit himself to particular dates or particular figures. He must however indicate a clear intention to take action.

European Monetary Co-operation

The Prime Minister and the Chancellor then discussed European monetary co-operation. At Chancellor Schmidt's request no notes of this were taken, but the main points made were as follows.

Chancellor Schmidt:

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- (a) expressed concern at the briefing which the Treasury had given the press following the Bremen meeting.
- (b) stressed his genuine belief that a scheme of this kind would be of benefit to Britain.
- (c) emphasised that the timing for further consideration of the scheme had deliberately taken into account the possibility of an autumn General Election in Britain.
- (d) said that President Giscard might not be reluctant to proceed without British participation, but that he would greatly regret it.
- (e) said that he would face political and financial opposition in Germany to this scheme but was confident he could carry it.
- (f) agreed strongly that serious action to remedy the abuses of the CAP was necessary in parallel but for German electoral reasons would prefer no action to be taken on this before the end of September.
- (g) said that one of the things which had motivated him in putting forward his scheme had been the German loan to Italy. Such bilateral arrangements affronted national pride and it was far better that support should be arranged on a European basis.

The Prime Minister said that:-

- (a) he hoped the Chancellor would note carefully his statement to the House of Commons. It was this that reflected the position of HMG.
- (b) there were of course political difficulties for the Government in advance of a General Election but it should
/not be thought

not be thought that this was the only or indeed the real problem. We had yet to be convinced that a scheme could be produced which would benefit us and which would not result in increasing the industrial strength of Germany and weakening the countries with regional problems. We would nevertheless continue to consider the matter constructively.

Aircraft Industry

The Prime Minister referred to the fact that Mr. Varley would shortly be seeing Count von Lambsdorff. It was important to continue these discussions urgently. We intended to take a commercial decision, but if this enabled us to co-operate in Europe we would welcome it. Chancellor Schmidt said that the airbus was now doing well. Initially orders had been heavily subsidised but they were now coming in on a commercial basis. The French claimed however that the B10 would be delayed if it were fitted with a Rolls Royce engine and he had a feeling that someone in France would not be unhappy if Britain did not participate. The Prime Minister replied that Rolls Royce was one of the three best engine manufacturers in the world. In taking our commercial decision it would be essential for us to safeguard Rolls Royce technology. Chancellor Schmidt said he did not understand why if we joined with Airbus Industrie Boeing would cease to buy Rolls Royce. The Prime Minister explained that Boeings did not sell customers a particular engine but offered them a choice. If however British Airways placed an initial order and stipulated a Rolls Royce engine this would become the launch engine for Boeings and would influence other customers. As regards participation in Airbus Industrie and the

B10 it would make a lot of difference to our decision if the French would agree to a Rolls Royce engine in the B10.

Chancellor Schmidt said that the French claimed that it was too late to make this switch but thought that they might have a political motive for saying this. He instructed his aide to let him have a note for a discussion he would be having during the Summit with President Giscard about the French claim that a Rolls Royce engine could not be put into the airbus.

The Prime Minister then referred to the attraction of three-way co-operation with McDonnell Douglas which would have the effect of squeezing Boeing out. Chancellor Schmidt said that he thought the B10 would take a lot of beating. The Prime Minister again emphasised Rolls Royce's capability with the larger engines and the fact that they were now moving into the medium range.

East/West

The Prime Minister and Chancellor Schmidt then discussed possible topics for the four-power discussion saying that President Carter wished particularly to talk about Africa, SALT, human rights and detente. He said that he was worried about the posture of the American Administration and it was clear that the Russians did not understand it. President Carter seemed to think that he could talk privately to the Russians on a co-operative basis and be rude to them publicly. The Russians did not understand which was the true American position and were very sensitive about the attacks being made on them. They had recently sent a Bulgarian emissary to see him in the hope that he
/would talk

would talk to President Carter during the Summit about Soviet concern lest sensitive technology be transferred to China. He had told the emissary that the Russians were being too sensitive about this. The Prime Minister said that we were considering selling the Olympus engine to China. The Chinese were also interested in the Harrier but we had reached no decision about this. Chancellor Schmidt said that both of these were defensive weapons. He referred also to the French intention to sell the Chinese an anti-tank missile.

16 July 1978