Michael ~~f.a.~~ [illegible]

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NOTE OF A MEETING AT THE MINISTRY OF THE ECONOMY, PARIS ON FRIDAY, 19 SEPTEMBER, 1980 AT 10.00 A.M.

Present:

M. Rene Monory, Minister of the Economy (in the chair)
M. Haberer
M. Rigaud

Chancellor of the Exchequer
Sir Kenneth Couzens

Mr. L.V. Appleyard (British Embassy, Paris)

CHANCELLOR'S DISCUSSION WITH FRENCH MINISTER OF THE ECONOMY

Monory welcomed the Chancellor, referring to the increasingly important role the UK was playing in Europe, and to the desirability of good understanding between the British and French Governments. He was glad to have the opportunity of an exchange of views at a time when there were not too many pressing bilateral questions; in particular, he was interested in the courageous economic policy the British Government were pursuing, and in the Chancellor's reactions to the present strength of the pound sterling.

2. The Chancellor said he was glad of the opportunity to talk about longer term questions; he thought it would be worth devoting some attention to policy in the aid field (including the role of the international financial institutions) and to evolution of the European Community Budget. On aid, he thought the most important objective was to provide more effective help for the very poor; and he accepted that the role of Governments in this was irreplaceable. But he was struck by the increasing share of the private sector in the flow of resources of developing countries during the 1970s; this was a healthy and natural development, and helped to avoid undue emphasis on the

creation of an "international tax system". During the 1970s private flows to the developing countries from France, Germany and Italy had doubled as a proportion of GDP, while those from the UK had quadrupled. The transfer of resources through this mechanism avoided the political problems of financing aid through national budgets, and also offered some prospect that the resources so transferred would contribute to more effective development.

3. Monory was more preoccupied by the failure of private resources to flow to the poorest countries. The forty worst off countries had experienced an actual economic regression in recent years, and clearly needed more official aid. In particular it was desirable to support investments which would not pay off for many years, for example the improvement of communications for backward land-locked countries. In each case he wanted to look for the key to a radical improvement, whether this was the development of agriculture, or the exploitation of mineral deposits, or the installation of communications to the sea. Nevertheless he agreed that there was no particular advantage in concentrating aid flows through Governments (étatiser). The Chancellor remarked that even the poorest countries should not do anything to discourage flows of private sector resources; this was a lesson which a number of countries like Sri Lanka and Mozambique were now learning. And even China was showing increasing interest in the development of aspects of the market econony, like workers' participation in the profits of their enterprises.

4. Haberer noted that the French Government were intending to increase the size of their official aid flows. Public finance was essential for the development of infrastructures, while efforts needed to be made to reduce the extent to which aid flows from the industrial countries fell off during periods of recession when the need for them was greatest. The Chancellor pointed out that total public expenditure in the UK was now planned to fall somewhat in real terms; within this declining total it had been necessary to prevent further growth in the aid programme which

had been increasing at 6 per cent a year. However, this was a levelling off, rather than an actual cut-back. Meanwhile it was desirable to encourage developing countries to take every opportunity to secure flows of private resources, which now made up about two thirds of the total flows from the OECD area to the developing countries. Efforts would be needed to help the international banking system to play its proper role in this task. Haberer pointed out the possible difficulty that some developing countries might be induced to borrow too much; inflation meant that the banks had plenty of money to lend, but too much reliance on loans could produce "disorder" (like that in Turkey, Zäire and perhaps in Brazil).

5. The Chancellor referred to the need for OECD countries to keep effective control of the international financial institutions, and prevent them from being turned into organs of taxation which the industrial countries would be obliged to pay. He and Monory agreed that it was misleading to divide the world into "North" and "South"; Monory preferred to think of a "trilogue".

The Economic Conjuncture

6. The Chancellor noted that the imbalances in the UK economy had been exacerbated by the international recession; but at the same time these international pressures provided a discipline which could help to achieve necessary changes in economic behaviour. He had found it very hard to restrain the burden of public spending, and the re-structuring of older industries (notably steel) was proving very expensive. Meanwhile the private sector complained of having to bear too much of the burden through high taxation and a high exchange rate. The Government saw no reason to change their medium-term approach of mastering inflation through monetary control - rather they needed to intensify their efforts. It was essential to reduce people's expectations and aspirations for higher real earnings, especially in the public sector; given that manufacturing would be obliged to hold pay increases to, say, 8 per cent over the coming year, a prolonged battle would be needed to achieve a comparable outcome

in the public sector. Despite present difficulties, the Chancellor was confident that substantial changes should be visible in the structure of the UK economy within two to three years; and the rate of inflation was already improving quite rapidly, partly as a result of the high exchange rate.

7. Monory noted that France was expecting to get her inflation rate down to 13 per cent by the end of the year, and then to about 12 per cent early in 1981. The hope was to get inflation down to about 10 per cent by the end of 1981. Whereas 1979 had been a relatively good year for industry, some sectors were now encountering serious difficulties, partly as a result of their previous failure to achieve necessary changes. Only a fairly small current account deficit (about 25 billion French francs) was expected for 1980, and this was helping to strengthen the franc and restrain inflation. Meanwhile the Government deficit was being financed without recourse to the banks; the bond market was strong, and monetary growth should be less than inflation. Unemployment, however, remained a problem; 1.4 million people were now out of work, and with rapid growth expected in the labour force over the next four years, the difficulties were likely to continue.

8. The Chancellor remarked that the UK also was experiencing large increases in the labour force in 1980 and 1981; unemployment was now above 2 million, and was unlikely to fall for a considerable period - indeed in the short run it was likely to get higher. But this high unemployment nevertheless coincided in particular areas with substantial employment vacancies - unemployment benefit at too high a level in relation to wages apparently reduced people's willingness to take less attractive jobs. The problem was to find a way of sharpening incentives to take employment without at the same time being unfair to workers in declining industries.

9. Monory asked about the impact of North Sea oil in putting up the exchange rate. The Chancellor said the present exchange

rate was due in part to the high interest rates required for the purposes of monetary control; in part to business confidence in the Government's policies; and in part to North Sea oil. The Government could not alter the state of confidence of the fact of North Sea oil, and there were bound to be problems for producers of tradeable goods and services as a result of the stronger real exchange rate. Altogether the present situation increased the need for substantial change in UK industrial performance. Meanwhile the instability of the world economy made it hard to lock sterling into an exchange rate parity with other European currencies. This was a reflection of the fact that sterling tended to move in the opposite direction to other hard currencies when oil prices changed; if oil prices increased, sterling strengthened relative to European currencies, while if oil prices fell, the movement was reversed. Although there had originally been UK worries about joining EMS, on the ground that the exchange rate for sterling would be pulled up by that for the DM, in practice sterling, if it had been a member of the EMS, would have proved a great embarrassment through its strength.

10. Sir Kenneth Couzens noted that the UK current balance and inflation prospect were not only improving because of North Sea oil, where output had generally lagged behind previous expectations. But the observe of the improvement was the sharp rise in unemployment which had followed the run-down of stocks. The question now was how far consumption would fall, so reinforcing the recession. The monetary target was far below the rate of inflation, and although it now appeared that the target could well be exceeded, monetary growth would still be well below the rate of inflation - and this factor had been important in producing the squeeze on stocks. The fall in stocks and in output had in turn been reflected in lower imports. In general the UK approach to the exchange rate was much like that of M. Barre; industry had to adapt to the exchange rate, rather than the exchange rate to the needs of industry. There was a fair chance

that the increase in unemployment would be associated with a significant improvement in productivity enforced by the high exchange rate - there had been a big change in the industrial climate, and this should sharpen the competitiveness of UK industry in the eventual world recovery. Unemployment had attracted less public concern than might have been expected in the past, and it was probably a price worth paying to achieve greater productivity and competitiveness. Effective control of public sector pay was a key ingredient in securing these desirable developments.

Problems of Mediterranean countries

11. Monory mentioned the need for a common attitude to the problems of Turkey and Yugoslavia. The Chancellor noted that the UK had co-operated in international efforts to help Turkey, subject to the overall limits on UK resources. But there was inevitably difficulty in reconciling bids for additional bilateral aid with commitments to the multilateral institutions. Monory thought more would have to be done for Turkey, and the Chancellor noted that if the army followed sensible policies, Turkey's claim to help would be strengthened. Haberer recalled de Gaulle's judgement on Turkey in 1968 - "la Turquie, c'est une armee et une dette".

12. So far as Portugal was concerned, Monory thought it important not to limit the European Investment Bank's (EIB) capacity to lend outside the Community. France had therefore proposed that pre-accession assistance to Portugal should be half in the form of aid and half in the form of EIB loans, and had suggested a figure of 115 MUA for the EIB contribution. The Chancellor explained that the UK favoured a larger contribution from the EIB, both because of the limits on total UK funds available for aid and because there was a better prospect of EIB money being spent on desirable projects. Haberer was concerned that nothing should be done to upset the operation of the EIB, which of all EC institutions worked the best. He was concerned that the French

Foreign Ministry were inclined to see the EIB as a black box which produced money painlessly - but in practice the EIB had to raise its money in the markets and maintain the highest credit rating. All its borrowers were already in current deficit, and if more EIB funds were advanced for Portugal, additional claims could be expected from Spain and Greece. (It was noted in further discussion that this objection to additional EIB loans to Portugal applied also to additional aid.)

Restructuring the European Community Budget

13. The Chancellor noted that Government expenditure as a proportion of GDP had a tendency to rise in every country. The present 1 per cent VAT ceiling was a help in containing EC expenditure, but the problem of the differential increase in agricultural expenditure as compared with the rest of EC expenditure meant that there would at some point be a collision with the ceiling. Sir Kenneth Couzens commented that it was just possible we might get through 1981; the VAT rate in the draft Budget was 0.95 per cent. But we should have to face up the problem of an irresistable force (agricultural expenditure) meeting an immovable object (the VAT ceiling). The Chancellor pointed to the need to design a system of agricultural support which did not generate limitless surpluses; could any use be made of the concept of "standard quantities"? It was essential to find a durable system in which agricultural expenditure did not grow faster than own resources receipts (i.e. about 8 to 11 per cent a year) if the 1 per cent ceiling were to be maintained.

14. Monory stated the French determination to maintain both the VAT ceiling and the integrity of the Common Agricuultural Policy. He accepted the Chancellor's overall objective; but he was concerned that some French regions (notably the Loire Valley) would be hard hit by imports of Spanish and Portugese agricultural produce when the Community was enlarged - indeed, there were already very substantial problems during 1980.

There was a need to discourage surpluses, but small farmers would need different treatment from the very large producers. Whereas large scale French cereal producers could prosper at present world prices, the smaller farmers in his constituency (with holdings of 150 acres or less) could not do so. Trying to move such farmers off the land too quickly would impose heavy costs in the national budget, and would be politically unacceptable. Some way had to be found to stop large agri-business cashing in on Community help given to smaller farmers. Monory - unlike the UK - did not rule out the use of co-responsibility levies to restrain milk production, but he insisted that the main culprits in the production of the milk surpluses were Dutch rather than French farmers. He admitted he was personally very concerned about sales of Community butter to Russia, with a cut going to the French Communist Party; it would be much better if EC consumers were enabled to buy more.

15. The Chancellor recognised the strong social case for effective support for small farming; it was equally important to help small farming in rural Wales, where such farms were the backbone of the local community. He saw a large measure of agreement of the two countries' objectives for the reform of the CAP, and suggested that possible steps might be further explored in discussions between officials of the Treasury and the Ministry of the Economy.

Article 235

16. The Chancellor pointed to the need to get the Article 235 arrangement settled quickly; it was undesirable for them to be linked with other extraneous issues. Monory noted that the last obstacles to completion of the arrangements were in process of being removed. He referred to the German budgetary problem, and to a possible "calender problem" in 1981 arising out of the agricultural price review in relation to French political developments. Rigaud noted that the outstanding issues were the type of majority required and the duration of programme

approvals. The Chancellor observed that the outcome of any linkage between this issue and agriculture was very problematical, and urged that a final settlement be reached at the Foreign Affairs Council on 7 October.

17. The discussion concluded at 11.50 a.m.

JW

(A.J. WIGGINS)
22 September 1980

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