

SUBJECT
re Mark

SECRET

Note of a Meeting between the Prime Minister and Chancellor Schmidt
at Chequers at 1100 on Friday, 19 March, 1982

Present:

Prime Minister

Chancellor Schmidt

Mr. C.A. Whitmore

Herr Otto von der Gablentz

World Economy

Chancellor Schmidt said that he was very concerned about the effect of the United States economic policies on the economies of the rest of the world. The American economy was vital to the well-being of the international community, but the United States did not seem to be ready to do anything about the problems facing the world economy today.

The Prime Minister said that she agreed with the Chancellor about the key role of the American economy. Despite the difficulties which that economy was going through at present, she believed that it remained fundamentally very strong. President Reagan should seek to cover more of his expenditure with taxation than he was doing at present. If he were to move in this direction, confidence would rise very quickly. She believed that it would not prove impossible to persuade President Reagan to do this.

Chancellor Schmidt asked who could persuade President Reagan to move in this way. The Europeans had attempted to do this at the last Economic Summit in Ottawa and had failed. He was pessimistic about the chances of getting President Reagan to change his economic policy. The President had listened to what he and President Mitterrand had said to him during their visits to Washington about the need for lower interest rates, and he had appeared to be ready to respond to their urgings. But nothing had happened subsequently. The total saving rate in the United States was running at about \$165 b a year. The Federal deficit was about \$120 b. If one added to that the borrowings of the States and the big cities, the

SECRET

/ American

American PSBR was probably about \$150 b and so would absorb almost the whole of the saving rate. The American Government was pursuing Keynesianism in the worst possible way, and calling it supply economics. At the same time, the Federal Reserve Bank was carrying out monetarist policies. In short, the United States was trying to follow simultaneously two different economic policies which were fighting against each other to the detriment of the people. He did not believe that the American Government understood the situation they were in. He did not believe that President Reagan would change his economic policy in the near future, for he was bound to be inhibited by the approach of the mid-term elections later in the year.

The Prime Minister said that she fully agreed that President Reagan should be persuaded of the need to change American economic policy for the sake both of the United States and of her allies like the Federal Republic and ~~the~~ United Kingdom. She thought that one or two of the European Heads of Government should put this to him. She was more sanguine about the likelihood of a positive response from the President. Nine months had passed since the Ottawa Summit Meeting, and President Reagan must have drawn a number of political lessons from developments during that period. Nor were his European allies a lone voice in seeking to persuade him to alter his policies. There were many influential figures in the United States who were saying precisely the same thing.

More narrowly, the British economy was beginning to recover. As a result of the Government's policies, industry was becoming more efficient, and in particular was having some success in keeping down unit labour costs. She had come into power wanting to secure lower taxation, and that of course still remained her aim. But so long as it proved impossible to reduce public expenditure, it would be correspondingly difficult to bring down taxation. She would like to see more capital reconstruction since this would create more jobs. But some of the money that could have gone into investment of this kind was being absorbed by wage increases. But even here she was optimistic: last year the general level of

wage increases had been lower than inflation, and she had every hope that the same would be true of 1982. But she did not know how long it would be possible to sustain a trend of this kind. She also found it difficult to evaluate what the precise effect of falling oil prices would be on the British economy. This development ought to help bring about an expansion of world trade. On the other hand, it affected most immediately those markets in places like the Middle East and Nigeria to which we exported so much of our national product: those countries' incomes would now be reduced and they would presumably import less. On balance, she believed that the drop in oil prices would be helpful to world trade and Britain's share.

Chancellor Schmidt said that if President Reagan could not be brought to see the need to change his economic policy, he could envisage a theoretical alternative which would make it possible for the Europeans to isolate themselves from the effects of American interest rates. The United Kingdom already had a surplus on its balance of payments. The Federal Republic was moving in the same direction. If, in addition, France and Italy could bring their balance of payments into surplus, it might be possible to create a European monetary area which did not need American or Arab money to cover its deficits as it did now. We would therefore not be competing with American interest rates to attract this money. Instead, we should have an independent European area setting its own interest rates and sustaining itself internally from its own money markets. A development of this kind, which would of course require a system for the coordination of monetary policies, would help the Europeans and would neither help nor harm the Americans.

The Prime Minister said that she was not at all sure that the system which the Chancellor had been sketching out was a practical proposition. The steps which would be needed in some countries to bring their balance of payments into surplus were the kind of action which Parliamentary democracies frequently found it difficult to accept. The United Kingdom had had a big surplus on its current account last year, both because of North Sea oil and a

very good export performance. But every time the interest rates in Britain came down, she anxiously watched the exchange rate of sterling against the dollar for fear that if it dropped, inflation in the United Kingdom would rise again. She liked to see an exchange rate somewhere between \$1.80 and \$1.90. So long as our balance of payments position remained strong, she saw no objective reason why the exchange rate should fall below \$1.80. But this might happen if interest rates in New York were very high.

Chancellor Schmidt said that he acknowledged the Prime Minister's point about persuading public opinion in democracies to accept desirable but difficult economic decisions. President Mitterrand, for example, would not like the steps that would be necessary to bring the French balance of payments into surplus because of the effect this would have on his domestic programmes. In the Federal Republic he thought that the trade unions would accept the required measures for perhaps a couple of years, but not much longer. What would be essential if public acceptance of the steps he had in mind was to be secured, would be a common European system which would convince people that their Governments were working together to try to solve the problems facing their countries.

The Prime Minister said that it was for reasons such as her concern about the effect of American interest rates on the sterling exchange rate that she agreed that it was necessary to try and persuade President Reagan to modify his economic policies. The question was how best to approach him and when. If he were to be offered powerful criticism of his present policies, it would have to be done by a friend. One possibility was to do it at the Economic Summit at Versailles, but that might be too far off. She was particularly concerned that there would be big differences between President Reagan and President Mitterrand, and she thought that it would be difficult to bring the two of them together.

Chancellor Schmidt commented that President Mitterrand would see the benefits for the rest of the world if American interest rates came down, even if he did not applaud it. As to who should speak to President Reagan about the need for a change in American economic policy, Mr. Tom Claussen of the World Bank was one possibility, and another was Mr. George Schultz. Both of them were Californians, a not unimportant point. He and Mr. Schultz were old friends, and if the Prime Minister agreed, he would like to write to him to let him know about his conversation with her. He did not rule out the possibility that President Reagan would have to change his economic team before long, and if that happened, it was possible that Mr. Schultz would enter the Administration. But because of the forthcoming mid-term elections, he did not believe that President Reagan would correct his course, if he ever did, before the late winter of 1982/83. The question then was when the effects of such a change would be felt in the rest of the world.

The Prime Minister said that she would be very happy for Chancellor Schmidt to write to Mr. Schultz as he proposed. The American economy responded to developments much faster than the European economies, and she believed that an improvement in the United States would begin to be felt in the rest of the world quite quickly.

Chancellor Schmidt said that he was not sure that the American economy would recover as fast as the Prime Minister believed. While he accepted that the reasons for unemployment in America now were different from its causes in the pre-war years, the United States now had a degree of unemployment which resembled that of 1931, and it had taken President Roosevelt until the Second World War to deal with it.

Unemployment

The Prime Minister said that even if world trade did increase in the near future, she did not believe that this would have much effect on present levels of unemployment because most Western economies had plenty of spare capacity. She often wondered whether

fundamental action would need to be taken. in the longer term to deal with unemployment, or whether the problem would be solved by the ingenuity of people creating new jobs in response to new industrial and technological developments.

Chancellor Schmidt said he thought that, while it would be slower to appear than it had been in the 1930s, political unrest in response to unemployment would surely develop on a widespread scale. We were seeing it now in Belgium, and it would spread. With technological change there was likely to be less work available. Logically people should then work shorter hours in order to share the available work, and so reduce the number of people who were idle. But if working hours were cut, wages would have to be cut too. This would be bound to give rise to political difficulties since people would not want to accept lower pay. And if, in order to reduce the number of unemployed, people were given pensions earlier than now, the level of those pensions would have to be lower than it was today, since he doubted whether it would be possible to increase any further the burdens on the average wage earner for whom taxation was already high enough.

World Population Explosion

Chancellor Schmidt said that he was becoming increasingly concerned about the world population explosion. The earth now sustained 4½ billion people, and by the year 2000 the number would have risen to 6 billion. The vast majority of these people were ~~to~~ to be found in the developing countries. The demand on the industrialised world to help these countries would become enormous. The present levels of aid programmes would be totally inadequate to meet the new situation, but the Western world could not possibly provide the additional finance that would be necessary. Yet we all gave the developing countries the impression that we would be ready to try to help them.

The Prime Minister said that at Cancun she and Herr Genscher had made it absolutely clear that the international finance institutions like the IMF and the World Bank must be governed by those who had to find the money.

Sixth International Tin Agreement

The Prime Minister asked whether Chancellor Schmidt had, like her, received a message from the President of Indonesia about the proposed new International Tin Agreement. The point was that Indonesia was an enormous market for the West, and she was making it clear that she would exclude from her market any countries which refused to participate in the Sixth International Tin Agreement. On the other hand, she would favour those who did join the Agreement. At the moment it appeared that the Americans were ^{not} ready to join the Agreement, but there would be no point in an agreement without the United States. Both the United Kingdom and the Federal Republic were still considering what their attitude should be.

Chancellor Schmidt confirmed that he too had had a message from the President of Indonesia. The Federal Economic Ministries were against participation in the new Agreement, whereas the Ministry of Foreign Affairs was in favour. He understood that the position was the same within the British Government.

Nuclear Energy

In response to a question by Chancellor Schmidt, the Prime Minister said that the British Government was continuing to pursue vigorously a policy of expanding its nuclear power programme. We were building two AGRs at present, and we hoped to go ahead with more nuclear power stations next year.

Chancellor Schmidt said that there was a strong movement against the use of nuclear energy in Germany. At present there was no facility for ^{reprocessing} spent nuclear fuel in the Federal Republic, and the French did some reprocessing for them now. He was anxious to diversify the facilities available to the Federal Republic for reprocessing, and he wondered whether the United Kingdom would be ready to reprocess nuclear waste from Germany at Windscale. He would like to know what the reprocessing capability of Windscale was.

The Prime Minister said that she would gladly arrange for Chancellor Schmidt's request to be considered, and she would let him know whether, in principle, we could offer the Federal Republic help with reprocessing. She would also let him know the answer to his question about our reprocessing capability at Windscale.

NATO Summit

Chancellor Schmidt said that the idea of a NATO Summit in the summer of this year had come from the Americans. He suspected that originally they had not had anything in mind for the Summit apart from a great demonstration of unity. But he believed that developments over the last few weeks had now led the Americans to understand that the Western world did not function by one of its members shouting and the rest clicking their heels. He wanted the meeting in Bonn to be routine and businesslike. He was prepared to have a sensible communique, but he did not want the meeting to issue a dramatic declaration which nobody subsequently lived up to.

In reply to a question by the Prime Minister, he said that President Mitterrand had not mentioned the possibility of a European Defence Policy in his talks with him, and they had spent some time discussing defence matters. He believed that stories of such a policy were inventions of the Press. Advocacy of a European Defence Policy would not correspond to President Mitterrand's basic Gaullist attitude to defence which was that France should be able to defend herself by her own means, even while acknowledging the need for the German glacis and the United States nuclear umbrella. If anything, President Mitterrand was slightly more Gaullist than President Giscard. One should never forget that President Mitterrand had been a member of the entourage of M. Mendès-France, and it was M. Mendès-France who had killed the idea of a European Defence Community.

The Prime Minister said that she was glad to hear what Chancellor Schmidt had said about President Mitterrand and a

European Defence Policy. When she had been asked about this in the House, she had said that the worst thing that could happen to European defence would be for Europe to be divided from its United States ally. We had the North Atlantic Alliance, and we should make full use of that.

Chancellor Schmidt said that his answer to that was "Yes, but". By that he meant that the Alliance would not work if the United States thought that they could give the orders and all the rest would do as they said. He thought that the Americans were now learning the need to consult their allies before they made public pronouncements of new policy.

The meeting ended at 1205.

Jan.

19 March, 1982.