Prime Minister

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RECORD OF A CONVERSATION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE FEDERAL GERMAN FINANCE MINISTER AT 11.15 A.M. ON FRIDAY, 19 MARCH 1982 IN 11, DOWNING STREET

Present:

Chancellor of the Exchequer	Herr Matthofer, Federal Minister of Finance
Sir Kenneth Couzens	Dr. Heck, Federal Finance Ministry
Mr. Littler	Herr Hansland, Federal Finance Ministry
Mr. Kerr	Dr. Kudlich, German Embassy, London

UK and German Economies

The Chancellor welcomed Herr Matthofer, and asked about the progress of the Federal Government initiative on measures to stimulate employment. Herr Matthofer explained that he had been opposed to these measures. The bonus for investment would do little to stimulate any extra investment. The measures had been taken in order to secure the co-operation of the unions. The unions had come together to propose a common initiative, whereby they would deliver wage moderation if the Bundesbank lowered interest rates and the Federal Government introduced an employment programme. The unions had delivered the goods on the wages front. Had he still been a trade union economist he would not have recommended their participation in such a programme. Interest rates had since fallen, by a further ½ percentage point on 18 March, and the differential between the Federal Republic and the United States now stood at 5½ percentage points. But the Government was running into problems over the VAT increase which was intended to finance the additional expenditure. VAT was a "common" tax, which meant that the Bundesrat had the right to block it. The CDU who control the Bundesrat were adamant that they would not permit the increase. The FDP had said that they would not accept an increase in any other tax. It is an unpromising background against which to start the planning of the 1983 budget.

It would normally be completed in June, but there was now talk of delaying it until August. The Federal Government faced State elections in September, which could leave the CDU, if they won, with a two-thirds majority in the Bundesrat, which would mean effective stalemate, as the Government did not have the two-thirds majority in the Bundestag necessary to override any CDU blocking vote.

2. Herr Matthofer said that he found the Chancellor's Budget very impressive. The Chancellor commented that there had been a narrow balance to strike, but the outlook on inflation was certainly improving and the year-on-year increase should be below 10 per cent by mid-summer. Unemployment remained much the most difficult issue, but he very much hoped that by the end of the year it would have turned down. It was now on a plateau.

World Economic Questions

3. The Chancellor noted that the outlook on inflation was improving world-wide with the easing of energy and commodity prices. Herr Matthofer noted that it was essential to keep oil consumption falling. If it came down by a further 20 per cent it might be possible to envisage a fall in the real oil price of some 30 per cent. A fall in oil consumption would benefit Germany through improving the current account and thus the exchange rate. Lower oil prices would boost confidence in the Germany economy. He had supported the idea of a large tax on energy consumption, the proceeds of which could be devoted to energy saving investment. If that had been implemented the German economy would be better off now. Last year his 7 pfennig tax on gasoline had been controversial, but had gone through, and despite it the price at the pumps was now 2 pfennigs lower than it had been then. But the deutschemark remained undervalued. Despite the inflation differential with the United States over the past two years the dollar had appreciated from a rate of \$1 = DM 1.70 to a rate of \$1 = DM 2.37. If the dollar fell to DM 2.20 he would want to see interest rates lowered. That would allow German exports to remain competitive, while boosting activity at home.

4. The Chancellor commented that pressure on the Americans over their deficit would have to be sustained, up to and if necessary at the Summit. This could best be done in private, rather than in public speeches. Herr Matthofer doubted whether there was any effective way of getting the message across to President Reagan. Secretary Regan was clearly in a very difficult position: he knew what should be done, but was unable to do it. Action to reduce the US deficit was crucial.

5. The Chancellor referred to imbalances in the world economy created by Japan. The closed nature of the Japanese domestic economy, their non-tariff barriers and their reluctance to buy imported goods; their skill in targeting their exports to capture specific sectors of overseas markets, killing indigenous industries; and the acutely unsatisfactory balance of their monetary and fiscal policies: all created major problems. This monetary/fiscal balance was the obverse of the United States': in Japan fiscal policy was very tight and monetary policy was very lax. The result could be seen in the 8 per cent fall in the effective value of the yen over the past year. There must be concerted pressure on the Japanese. Last year he had argued this point in Ottawa, but had been alone in doing so: the point had not been reflected in the communique. But he (and the French Finance Minister) thought that something must be done. He would value German support. (The Chancellor handed Herr Matthofer x the attached note on Japan.) Herr Matthofer said that he thought the Germans might be in a privileged position to speak to the Japanese in private. And he might consider visiting Japan. But he would certainly study the UK paper, and he fully accepted the objective need for action.

Turkey

6. Herr Matthofer said that the Germans were most concerned about the provision in the Turkish/EC Association agreement that would give the Turks free movement of labour within the Community. Germany already had 1.5 million Turks, and there were 165,000 wives with a legal right of entry, and 300,000 children. The problem with Turks was that, unlike Spaniards, they did not integrate in Germany. They

did not learn the language. Herr Matthofer would welcome the Chancellor's support within the EC on this subject.

European Monetary System

7. The Chancellor mentioned the current weakness of the franc, which was disturbing. Sir Kenneth Couzens said that the French had spent $1.3 billion in a week in defence of their currency. Herr Matthofer did not think the French would be able to resist for long, although they would want to avoid a realignment coinciding with the second round of local government elections on 21 March. Sir Kenneth Couzens doubted whether a realignment could be confined to the franc, as the Irish punt, the Italian lira and the Belgian franc were under related pressure.

8. Sir Kenneth Couzens asked whether, if there were to be another realignment, the Germans would agree that there should be no MCA changes while the agricultural price negotiations were going on. Herr Heck said that the Germans did not see this as a matter of principle and would be prepared to see MCA changes.

9. The Chancellor said that the 15 March ECOFIN discussion suggested that little progress could at present be made on the non-institutional development of the EMS. Herr Matthofer said that he did not see any reason to relax disciplinary features until there was some convergence of economic performance. But he saw no difficulties over ECU accounts, or the abolition of restraints on flows.

EC Mandate

10. The Chancellor noted that the next discussion on the Mandate would be at the 22/23 March Foreign Affairs Council. Not much had changed since his talk with Herr Matthofer in January. Our position remained that the most we could accept was a modest net contribution: 150 million ecus, the figure mentioned in our paper, was the absolute maximum. He did not understand the concept of degressivity: it would be wrong to pretend that a problem disappeared when one constructed a disappearing solution. And, though Finance Ministers

agreed on the need for agriculture to take a lower proportion of EC resources, Herr Ertl sang a different tune at Agriculture Councils.

11. Herr Matthofer said that the German Government's first objective was to prevent the 1 per cent "own resources" limit being breached. Secondly, they would wish any refunds to the UK to be made retrospectively, so that the problems that had arisen in the past two years would not arise again. Thirdly, degressivity, which had been accepted in 1980, was essential. The UK had now been a member of the European Community for 10 years and had to get used to the implications of full membership. The Chancellor said that when the UK had joined the Community it had been promised relief if unacceptable situations emerged, and had been assured that the balance of Community spending would tilt away from agriculture. Sir Kenneth Couzens pointed out that the UK was perfectly prepared to accept degressivity arising from policy changes, but objected to arbitrary degressivity. The UK was the only country asked to pay a contribution to the Community totally out of proportion to its relative real income.

12. Herr Heck said that at the Agriculture Council the Germans had supported the Commission's proposals. And Herr Matthofer added that this was against the background of real income losses (of some 12 per cent in the past year) to German farmers. The Chancellor pointed out that British farmers had suffered too, but that the UK Government were arguing for lower price increases than those which the Commission had proposed. It was very difficult to reduce inflationary expectations when each year's bids for the agricultural price fixing came in at levels much higher than expected inflation. Sir Kenneth Couzens pointed out that the continual battle over the UK's budget share meant that we were perforce obliged to use agriculture as a bargaining counter. If the Germans really wanted to restrain the growth of agricultural spending, they should fight harder for it, and help free us from the budget difficulty which held us back.

13. Herr Matthofer pointed out that the Germans were not prepared to pay more than 25 per cent of any budget refund to the UK. And they would like to be paid back some 600 million ecus, two-thirds of their shares of refunds to the UK over the last two years. The Chancellor said that this would not be acceptable. The form of the 30 May agreement had not been of the UK's devising. It had been imposed on us against our wishes. The French had gained most from it. Were the Germans thinking of sending a bill to them too?

14. The meeting ended at 12.25 p.m.

JKR

JILL RUTTER

22 March 1982

Distribution

Those present
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Mr. Burns
Mr. Ryrie
Mr. Lavelle
Mrs. Hedley-Miller
Mr. Bottrill
Mr. Edwards
Mr. Peretz
Mr. Garside
Mr. Bailey
Mr. Peet

PS/No.10
PS/Foreign & Commonwealth Secretary
PS/Secretary of State for Trade
PS/Minister of Agriculture

Sir Jock Taylor: Bonn
Sir Michael Butler: UKREP EC
Sir Hugh Cortazzi: Tokyo
Mr. D.J.S. Hancock: Cab. Office

EC/JAPAN RELATIONS

Japan has survived the second oil price shock more successfully than other industrial countries - with higher output growth, and lower unemployment and inflation. GDP growth has averaged 4 per cent in each of the past two years, compared with only 1 per cent in other major economies. Unemployment is about 2 per cent compared to 8 per cent in other OECD countries. Inflation was 3.3 per cent in the twelve months to the end of January, and has been virtually nil since October.

2. The recovery, however, has been biased heavily towards external demand. Net external demand has accounted for about three-quarters of Japan's GDP growth in the past two years, and, despite the deceleration of export growth in past months, it is expected to contribute significantly again this year. Indeed since 1974 the contribution of the external sector to growth in Japan has been far more than was necessary to compensate for the effect on Japanese import costs of the two oil price increases. It is right that we should consider the implications of this situation both for our own economies and for the general equilibrium of the world economy and the health of the open trading system.

3. The emergence of large Japanese surpluses is not a new problem. It has occurred at roughly the same point in previous cycles, contributing significantly to trade and exchange rate tensions in the world.

4. We must of course acknowledge the efficiency of the Japanese economy, and must in turn continue our own adjustment efforts. But Japan's success has been built to a significant extent upon a relatively closed non-market economic system, supported by macro-economic and exchange rate policies which give undue weight to external rather than domestic demand.

5. We are by now all familiar with the barriers to imports into Japan - both formal and informal - which have resulted in imports being only a sixth of GDP compared with almost double that, for example, in Germany and the UK. Imports of raw materials, fuels and food into Japan are, as a proportion of GDP, broadly in line with those of the

/UK and Germany.

UK and Germany. But imports of manufactures into Japan account for only 3 per cent of GDP compared to 10 per cent in other major economies.

6. We are also all familiar with the way in which Japan's tightly-controlled industrial strategy, involving government, industry and banks, results in a narrow concentration of export products with disruptive effects in particular markets in other countries. In addition to the impact of the excess of their exports over manufactured imports, the speed of attack on particular markets creates havoc in individual sectors.

7. Underlying all these difficulties is the high level of Japanese savings which are not matched by domestic private investment or public borrowing. The Government's present stringent fiscal policy should be seen in this light. A recent Commission paper shows that Japan's budget deficit is expected to be reduced to about 2 per cent of GDP - below the average for the Community or for the United States. With inflation now reduced to 3 to 4 per cent and a current account surplus, the Government is seeking further economies to balance the current budget by 1984. Yet personal savings account for 18 per cent of incomes in Japan compared to about 8 per cent in the other major economies. Japan's scope for fiscal manoeuvre, therefore, should now be larger - not smaller - than that of other countries. The excess of savings over investment is producing the current external surplus to which the rest of us are having such difficulty adjusting.

8. The Japanese are at the same time pursuing a policy of accommodating monetary growth and low interest rates. Monetary growth (M2) has been about 10-11 per cent over the past year and three-month interest rates have been reduced to 6½ per cent, well below those in other countries. A major effect of this, however, has been to prevent the yen appreciating to reflect fully the underlying strength of Japan's competitive position and the emerging current surplus. On the contrary the yen's effective rate has fallen by about 8 per cent since February 1981.

9. As a result of pressure from overseas the Japanese have recently introduced a number of trade liberalisation measures. Though welcome,

these rather limited steps will not by themselves restrain the growth of the surpluses which pose problems for their trading partners. In these circumstances it is appropriate that Community governments should consider whether, while maintaining pressure on the trade front, it would not also be appropriate to encourage the Japanese to alter the mix of their macro-economic policies.

10. It is no part of our thinking that we should urge net expansionary measures on the Japanese at a time when we are concerned to consolidate the gains that we have made in the world as a whole in reducing inflation. But we should ask the Japanese to pay more attention to the structural aspects of their situation which, if reinforced by their policies, tend to make them an uncomfortable partner in the open trading system and so encourage protectionism. This should lead them to cut back less in the fiscal field where they are effectively increasing taxation and to rein back their relaxed monetary stance so that the yen can rise to reflect its true strength. This would help to restore a better balance in the international economy as a whole.

11. It would also be entirely consistent with our approach to the United States, whose policies are also threatening to disrupt the world economy but from the opposite direction. The present mix of Japanese and U.S. fiscal and monetary policy is a powerful threat to the open trading system because of the bilateral imbalance and protectionist pressures it is likely to generate.