subject a master.

RECORD OF A MEETING BETWEEN THE PRIME MINISTER AND THE SECRETARY OF STATE FOR FOREIGN AND COMMONWEALTH AFFAIRS AND THE US SECRETARY OF STATE AND US CABINET OFFICIALS AT THE RESIDENCE OF THE BRITISH AMBASSADOR, WASHINGTON, AT 8 AM ON THURSDAY 21 FEBRUARY

Present:

Hon George P Shultz,
Secretary of State

Hon James A Baker
Secretary of the Treasury

Hon William E Brock,
US Trade Representative

Hon John R Block
Secretary of Agriculture

Hon Malcolm Baldrige,
Secretary of Commerce

Ambassador Charles Price,
US Ambassador to UK

Mr W Allen Wallis,
Under Secretary for
Economic Affairs

Mr J Holmes,
State Department

Rt Hon Margaret Thatcher MP,
Prime Minister

Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign
and Commonwealth Affairs

Sir Oliver Wright GCMG, GCVO,
DSC
British Ambassador

Mr F E R Butler,
Principal Private Secretary
to the Prime Minister

Mr N Wicks,
Minister (Economic)

Mr Brian Crowe
Minister (Commercial)

Mr C Powell,
Private Secretary to the
Prime Minister

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US Fiscal Deficit and Level of the Dollar

The Prime Minister referred to the morning's news about new record highs for the dollar. The consequences were serious. There was not much that could be done other than intervention from time to time to burn the speculators' fingers. But UK interest rates would have to stay high and above US interest rates for some time. This affected small businesses and the construction industry. Yet other economies like Germany, Japan and Switzerland - and allowing for the miners strike the UK - were doing well. When would the rise of the dollar stop?

Mr Baker said he shared the Prime Minister's worry. He agreed that there was little that could be done. The US could not reflate, nor did they want an import surcharge. But reducing the fiscal deficit would be helpful.

The Prime Minister said that the effect of decisive action on that front would help. The alternative was a substantial problem of indebtedness for the US.

Mr Shultz said that if the deficit went down, in the short term the dollar could even rise. But overall a deficit reduction would lead to greater stability, with US savings going into US industry. The dollar would go down. So that was the main thing the US could do. But other countries must make themselves more attractive to capital inflow especially LDCs. They must realise that there was no prospect of increased aid - they must make themselves attractive to equity investment.

The Prime Minister thought that the Latin Americans were doing better on that front. Mr Shultz said South East Asia was doing well. Intervention in the exchange market did not work. The Prime Minister said that intervention could only work if it were sudden and in order to stop surges. She did not understand why people were moving out of the deutschmark. The Foreign Secretary agreed with Mr Shultz. At Williamsburg and at the recent G5 meeting it had not been visualised that intervention would happen more than occasionally. There was no going against the underlying causes. Mr Shultz said that the Smithsonian Agreement of 1971 had been hailed at the time but it had been the worst agreement made in international finance, since it had tried to fix rates at the wrong levels. It had done immense damage and been partly responsible for the subsequent rise in world inflation. The Prime Minister said that she would not wish to defend any particular sterling rate. Mr Baker said that $4½ billion had been spent on intervention since 17 January to no noticeable effect and all countries had lost money.

Mr Block said that if the high dollar continued, US export industry and agriculture "would die". The Prime Minister said that the high dollar was fine for European exports to the US, but there were two effects. First, industry slackened off on efficiency and, second, inflation increased, not least because of commodity prices in dollars. Mr Shultz said that the US could not go on running a trade deficit. That was an unstable situation. But things could be done. Ways of discouraging capital imports to the US could be explored. The present situation was killing industry.

The Prime Minister asked how capital imports to the US could be discouraged. Mr Baker thought that Mr Volcker's testimony the previous day on the Hill had been responsible for the current surge in the dollar: he had made clear that the US was not going to adopt an easy money policy. The Foreign Secretary said that a high fiscal deficit with a tight monetary policy produced high interest rates, compelling higher interest rates still in other countries. The Prime Minister said that the situation was inherently unstable. Mr Baker thought there could be no action out of Congress within the next 60 days. This was the minimum period because of the inherent difficulties Congress saw in the Administration's proposals. They would prefer an import surcharge. The Prime Minister said that that would be the very opposite of liberalisation. When introduced in Britain it had betokened the mentality of the siege economy. Mr Baker said that the approach in Congress tended to be protectionist. The Prime Minister said that members of Congress had denied this to her the previous day. Mr Baker said that many in Congress would alternatively want to see taxes raised to reduce the fiscal deficit. The Foreign Secretary said that that was something the UK had had to do at its most difficult moments: bridging the gap by increased tax on expenditure when everything possible had been done on reducing public expenditure.

Mr Baldrige was not convinced that the dollar would stay high throughout the year. There was a chance of a down turn in mid year arising out of the convergence of growth rates in the US and Europe. Where the gap had been 6.8 per cent against 1.8 per cent, it was coming down now to 4 per cent against 2.75 per cent. This would have its effect on the dollar. Mr Shultz agreed. The rise in share prices in Europe showed an expectation of better rates of return and that should reduce capital flows to the US.

Mr Baldrige said that the generally satisfactory macro-economic picture for the US hid very real problems. The growth in the US economy had come from small firms. Out of 20 million jobs created here over 15 years, 9 out of 10 had come from companies employing fewer than 100 people. 2 out of 3 had come from companies employing fewer than 50 people. None had come from the Fortune 500 companies. Many older companies were failing but there were 600,000 new ones every year. Policy makers must not ignore this. New companies covered a wide range of activities including services and high tech (10 to 15 per cent) but the effect of the high tech companies was much more important than the percentage because of their wider effect through manufacturing and the economy. The Foreign Secretary said that Europe had a similar perception. It was difficult to identify the obstacles in Europe.

Mr Brock said that in the US the biggest factor stimulating growth had been the reduction in capital gains tax in 1979 from 50 per cent to 28 per cent and then to 20 per cent, leading to a great increase in venture capital. The Prime Minister said the problem was less capital, of which there was plenty, but rather people. Mr Baldrige thought the crucial factor was the ease with which new companies could be started up in the US. In a conversation with a senior German official it had emerged that whereas two people leaving IBM could start a new company in two months, in Germany a similar process would take between one and two years: the prospective entrepreneurs would run out of capital first. The Prime Minister recognised the importance of the rate of formation of new businesses. In the UK they got tax advantages even though this created difficulties for us in the European Community. The US was much freer and much less union ridden. But times were changing as lack of support for the NUM was showing.

The Prime Minister said that it was important that agricultural prices should not increase. Mr Brock said that they should be reduced. The Foreign Secretary said that in real terms they would be. The Prime Minister said that what people saw was the change in cash terms. The Foreign Secretary said that the right cut for cereal prices in the Community should be 5 per cent. The Commission had proposed 3.6 per cent. This was still important. The Prime Minister said the Commission had proposed a nil increase across the board, although this disguised an unjustifiable increase in the price of milk. The UK wanted no increase in prices and strict financial discipline. The Germans agreed but then said that their farmers needed to have their incomes preserved. It was the Germans who were the engine of price increases in the Community.

Mr Block explained that the debt problem affecting US farmers was a short term one relating to this year's planting season. In the long run the Administration planned to reduce farm support subsidy, phasing it out over five years. The farm programme had cost $3 billion in the 1970s, had risen to $18 billion, had been $7 billion in 1984, would be $12 billion in 1985 and $10 billion in 1986. The big expense was the loan programme and buying dairy surpluses.

Mr Baker said that reduction in the farm programme was central to the budgetary strategy. Over the last four years the cost had been $63 billion. It would be reduced to $35 billion over the next few.

Mr Brock said that this was an area in which we needed to think together. The efforts of the Administration were sincere but tough. They could not succeed while subsidised exports of surplus products by the EC continued. The Prime Minister commented that the US too had subsidies. But the British were continuing to fight against the policies which produced surpluses in the Community. Unfortunately we were outvoted in the management committees on export subsidies. British housewives were not used to high food prices and we still had to make provision for New Zealand exports. The problem was the German farm lobby which was dragging up European farm prices. Mr Brock asked how the US could help. The Prime Minister said that the Americans should convey their views firmly to Delors and Andriessen in the Commission and also to Chancellor Kohl. Things were going in the right direction but were taking time. Mr Brock thought that the Europeans did not realise the urgency of the situation. The Prime Minister commented that Britain with Germany and the Netherlands had prevented restrictions on imports of oils and fats and soya. Mr Brock appreciated that but asked that Britain tell its partners of American determination. As American farm support declined, so their farmers would insist on firm access to world markets.

Sir Geoffrey Howe said that there was a perception in Europe of American farm subsidies. There must be common US/European understanding of what we were trying to do. Delors, Christopherson and Andriessen, as former Finance Ministers, understood the problem. The Prime Minister commented that Lord Cockfield would also press for expenditure cuts. But it was important to get at Germany and France. Mr Brock said that if they could be got into agricultural negotiations, an agreement should be possible. The problem was getting them to the table. The Foreign Secretary thought the right line was that of the Catherwood Report: mutual and balanced subsidy reductions. The Prime Minister said that Britain shared many of the United States' objectives. The Americans should get their views over to Chancellor Kohl.

New Zealand

Picking up the Prime Minister's reference to New Zealand, Mr Shultz asked about the Prime Minister's reaction to Mr Lange's decision on US naval visits. The Prime Minister confirmed that Britain had no intention of telling anyone whether or not British naval ships were carrying nuclear weapons. Mr Shultz welcomed this. New Zealand had taken themselves out of the number of countries prepared to protect freedom. It would feel the effect of this through not continuing to get the special consideration it had had by virtue of its role. The Prime Minister said that unfortunately Mr Lange was due to make a speech at the Oxford Union on nuclear disarmament. He had been impaled on the electoral hook but she had thought he would get himself off it. Mr Shultz said he had thought so too and he had said so, but Mr Lange had got even tougher. He swung with the political weather.

Oil Market

Mr Shultz asked the Prime Minister's opinion on the price of oil over the next year. The Prime Minister thought it would be vulnerable through the summer. It was up at the moment and stockholders were waiting to see if the price fell. She would be concerned by the prospect of a sharp fall. This was not because of its effect on the UK economy (which was only 5% of the GNP, 8.5% of revenue), but more because a rapid fall would be far worse for countries like Nigeria which owed a lot of money. Mexico was also in this position, although unlike Nigeria it had made a real effort with its economy. The oil price was about 20 cents above the official price at the moment. She would like to see it stay there and not move up or down. The Foreign Secretary said that other oil producers were also indebted to the world banking system. A stable price was therefore very important. The question was whether this was possible.

Mr Wallis said that oil producers were starting to sell finished products. This was generating protectionist measures and new problems in international trade. The Prime Minister said that producers could afford to reduce production. The Saudis had been as low as 2 mbpd. Mr Baldrige said that in the case of Mexico oil price reductions had been offset by lower interest rates. They were still growing at 3½%. The Foreign Secretary pointed out that this was at the cost of a tremendous internal adjustment. Mr Shultz commented that Mexican capital was still moving to the US. This reinforced his earlier remark that other countries must do better at attracting capital.

The Prime Minister said that an oil levy would greatly damage oil price stability as well as being contrary to GATT. Once oil prices started to fall the result could be disastrous. Everyone would increase production. No large new oil deposits were being discovered. In consequence the West would again become heavily dependent in the 1990s on the Middle East. So she hoped the Administration would not contemplate an oil levy. Mr Baker indicated that the Administration would not favour such a levy. Mr Brock said that there was a lot of support for one in Congress. The Prime Minister pointed out that with consumption at 13mbpd and production at 8.5mbpd and falling, and only 10-12 years of US reserves, there was a high risk for the US of being thrown back into dependence on the Middle East. Mr Shultz said that there was plenty of gas coming forward. Mr Brock questioned whether petrol taxes were high enough in the US. He thought not. The Foreign Secretary drew attention to the difference between a tax and an import levy. Mr Baker said that if there were talk about a domestic tax, this would increase pressure for a levy instead. The Prime Minister pointed out that the oil price would have to rise very substantially to make new sources like shale economical. Mr Brock and Mr Baker thought that new oil would be found and was being found. The Prime Minister pointed out that the results so far in China had been disappointing and other finds were in the

Middle East. Mr Shultz said that one of the biggest mistakes of the last ten years had been the maintenance of price controls. Consumption would have declined sooner in their absence. The lesson was to let the market work. Mr Baker pointed out that gas was still controlled in the US. US industry was split on the issue.

Laker

The Prime Minister referred to her conversation the previous day with the President. If the litigation could be got out of the way through Eximbank agreeing to settle out of court, this would give a much better framework for liberalisation.

Mr Wallis said that he was aware of the problem with Eximbank. He and Ambassador Price would see what could be done. But the Americans had been disappointed at the lack of reaction to the President's decision last year. This diminished their enthusiasm. But he thought something could be done.

The Prime Minister said the American disappointment was not justified. If there were no settlement, there would be a great row over the discovery of documents which would end up affecting trans-Atlantic air traffic. That was in neither country's interest. Mr Wallis agreed. The Prime Minister said that Britain could claim to be disappointed over the absence of right for British airlines to serve US domestic routes, or over the lack of access to US coastal shipping (which in the UK was free). Mr Wallis said that aviation was particularly controlled. The Prime Minister said that Britain was seeking greater competition in Europe. We would not mind American competition in Britain if the Americans would allow British competition inside the US. The threat now arose out of the discovery process, the application of the PTI Act, the impounding of aircraft etc. Mr Price said that the treble-damage suits would hit US, not foreign, carriers because of blocking legislation.

Mr Shultz said that Britain had asked for changes in US anti-trust laws. The Americans had emphasised that that was not necessary nor likely to be possible; but that there were procedures giving immunity from potential anti-trust action. The Prime Minister said that that did not stop individuals bringing vexatious suits. Mr Shultz said the procedure had a good track record. Once the procedure had been followed there had been no successful claims. The Prime Minister said that the airlines had followed Bermuda to the letter, getting British and American Government approval, and had therefore thought they were in the clear.

The Foreign Secretary said that one step should be taken at a time. The outstanding liquidator litigation was close to a solution, with only one creditor holding out. Mr Shultz said that nobody liked Sir Freddie Laker and the lawyers getting substantial sums at the expense of a government agency. The Prime Minister said that if there were no settlement, there would be serious consequences within three months. And she would not be able to denationalise British Airways. Mr Wallis could not see why she could not follow the American example and offer BA for sale with a contingent liability. The Prime Minister made it clear that that was not possible in British conditions. Mr Wallis agreed that it was desirable to see the matter settled. The Prime Minister said that it was more than desirable: the consequences of not settling would be disastrous. Mr Wallis said that all were convinced of that.

Unitary Tax

Mr Brock said that the Governor of California was working on this. Mr Wallis said that British and Japanese tactics had been very effective. Successful pressure had been brought to bear in Florida by British withdrawal from a trade fair, and was being brought in California by the Japanese reducing investment and business activity. Mr Brock thought that British companies should make representations in California.

The Prime Minister said they were: a CBI mission had gone there in the previous week.

Trade Round

The Foreign Secretary welcomed US pressure for a new trade round. The French and Italians were being difficult. Mr Shultz hoped that the British Sherpa for the Economic Summit would be instructed to press ahead on a new round. The Prime Minister said one problem was Japan: everyone wanted the Japanese to take steps to open their market but when the time came at economic summits, the word became that we must be nice to the Japanese. Mr Wallis said that only the US, Canada and Germany had strongly advocated a trade round at the last Sherpa meeting. The British and Japanese had made friendly remarks but had not been vigorous. The Prime Minister said she would make sure that the British Sherpa had instructions. Mr Wallis said that the French had made clear they would not consider one if it covered subsidies. Mr Brock said that Mr Declercq was in favour but the French were blocking a Community mandate. This created a difficult position for the US. Could Britain help with the French? The Prime Minister thought this unlikely.

The discussion ended at 9.30 am.

F.E.R.B.