



Prime Minister
 You may care to consider these

Foreign and Commonwealth Office

London SW1A 2AH

4 March, 1983

messages.
 Our Embassy in Bonn will advise when
 it is safe to transmit a message. I
 shall be in touch on Sunday evening.

Your truly,

A-J.C. $\frac{4}{2}$

The FRG Election, 6 March: Prospects and Messages of Congratulation

You may find it helpful to have a brief assessment of the situation in the FRG on the eve of the elections. Paragraph 5 overleaf contains recommendations about messages of congratulation. I shall be showing this letter to Mr Pym on his return, together with a suggested message to Herr Genscher.

In the final stages of the FRG election campaign the odds are narrowing in favour of a return of the CDU/CSU and FDP coalition. A second but less probable outcome is a two-party Bundestag with the CDU/CSU governing alone and the SDP in opposition. A hung Parliament with the FDP out and the Greens holding the balance of power is unlikely. Although the polls continue to suggest that support for both the FDP and the Greens is hovering around the 5% of the second vote required for representation in the Bundestag, most pundits believe that on Sunday the FDP should make it, and that the Greens might just fail at the 5% hurdle. The chances of Herr Vogel becoming Chancellor must now be reckoned slim. The present Government will in any case continue in office until the new Bundestag has convened and elected a Chancellor. This might not happen before Easter.

We are likely to be faced next week with the prospect of the mixture as before, or at least as since October 1982. This would be comfortable and safe for British interests, even if not exciting. But if the CDU/CSU rule alone (one late poll suggests all four parties will be in the next Bundestag with the CDU/CSU enjoying an absolute majority over the other three) we can expect Herr Strauss to come to Bonn as Vice-Chancellor and Foreign Minister. This could provoke some turbulence in Germany's relations with Eastern Europe and the Soviet Union, and there are those who fear that his efforts to put his personal stamp on affairs may cause us difficulties in other areas too. But we are reasonably confident that Herr Strauss would not draw Dr Kohl into policies damaging to British and Allied interests.

/Dr Kohl



Dr Kohl is likely to continue to pursue sensible policies. With or without the FDP he would if necessary deploy Pershing and possibly Cruise too in due course; maintain a balance between Paris and London; and do his best to conduct an orderly relationship with Washington. At home his economic policies would be cautious and realistic although he will be under great pressure to get unemployment down. Difficulties might arise later, particularly if the SPD retained its cohesion in opposition and moved to the left. A strong and united SPD opposition could show up Dr Kohl's ponderousness and lack of imagination. In the unlikely event of Sunday's poll producing an irresolute SPD Government, INF deployment would almost certainly be the main and disastrous casualty, even though Vogel is a clever man, whose personal commitment to the Alliance and the Community is not in doubt.

If the result is already clear on the evening of Sunday, 6 March, the Prime Minister may wish to send a message of congratulations to the winner. Alternatively, she may like to telephone him on Sunday evening (in October 1980, the Prime Minister telephoned Herr Schmidt to congratulate him). Colin Munro of our Western European Department would be available if necessary to interpret. We could perhaps have a word later today about the practical arrangements.

The first computer predictions of the final result are usually available about an hour after the polls close (6.00pm our time) and are accurate to within a few percentage points. They will show whether or not either Dr Kohl or Herr Vogel has won a clear victory. There are obvious advantages in sending congratulations quickly, but if the final outcome is still in doubt on 6 March it might be wiser not to send messages until we have all had the chance to evaluate the result. I enclose draft messages of congratulation/commiseration to Dr Kohl and congratulation to Herr Vogel.

We shall be recommending that Mr Pym should himself send a message to Herr Genscher in any event: congratulations if he gets 5% and looks like keeping his job; commiseration if he fails.

[Handwritten signature]
 (R B Bone)
Private Secretary

MESSAGE OF CONGRATULATIONS FROM THE PRIME MINISTER TO
CHANCELLOR KOHL

Please accept my warmest congratulations on your personal triumph in the elections and on the outstanding success of the CDU/CSU. I am greatly looking forward to continuing our work together on the many problems we face in Europe, in the Alliance, and elsewhere.

MESSAGE OF COMMISERATION TO CHANCELLOR KOHL

We have worked together to good effect during your period as Chancellor, and I am grateful to you for all you did to foster the relationship between our two countries. I am sorry that the result of the elections was so disappointing for you.

MESSAGE OF CONGRATULATIONS FROM THE PRIME MINISTER TO
HERR VOGEL

Please accept my warmest congratulations on your victory in the elections in the Federal Republic. I am greatly looking forward to working closely with you on the many problems we face in Europe, in the Alliance and ~~elsewhere~~, in the world at large.

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MR. SCHOLAR

HELMUT SCHMIDT'S PRESCRIPTION

There is much in Schmidt's argument that is correct, relevant and indeed powerful. Although there is nothing new, he puts the old arguments quite cogently. On the other hand, there are quite a few things that are just plain wrong. Occasionally the analysis comes unstuck, and some of the policy proposals leave us hanging in the air wondering whether our feet will ever touch the ground.

Real Interest Rates

This is particularly true with respect to his "most important need is to get real interest rates down". But it's certainly not clear that real interest rates, even on long term bonds, are extraordinarily high. In Britain, for example, index gilt yields about 2½%. And he says "in the present situation a long term real interest rate of 2% would be appropriate". Well we've near enough got it in Britain. And in the United States I am far from convinced that real interest rates are extraordinarily high. With treasuries yielding a little over 10%, who can be sure that the average rate of inflation over the next seven years or so is not going to be 7% or 8%?

Schmidt, of course, argues that the Federal deficit should go down. So do we all. That will reduce inflationary expectation. It is certain to reduce nominal interest rates, but not necessarily real interest rates.

Budget Deficits and Expansion

Schmidt puts forward the steady money growth policy as appropriate for all countries. But he argues some countries which have small budget deficits should be encouraged to expand by having larger deficits. (These are Japan, Britain and West Germany together with some other smaller countries.) This seems to be a version of the old convoy theory. Yet he does not seem to have taken into account the fact that a budget deficit is not a basis for sustained expansion. Record, indeed massive budget deficits, have been achieved in countries which have run rapidly into a most deep depression; examples are the United States, Canada and Italy. In fact the countries that are in the worse mess have the largest budget deficits; why should Britain, Japan and West Germany, together with

/Switzerland

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Switzerland and Austria, be called upon to join them in this mess? Also Schmidt does not reconcile his belief that higher deficits will induce higher real interest rates with the proposition that budget deficits expand income. Does that therefore mean that higher real interest rates are expansionary? This is a yawning gap in the logic of his argument.

A New Monetary System

Schmidt by implication, if not explicitly, clearly argues that the world needs greater exchange rate stability, but with more flexibility than Bretton Woods, on lines similar to those which prevail in the EMS. The monetary authorities should intervene, not to offset fundamental shifts in the exchange rate, but to counter the behaviour of the "flocks of sheep", ie foreign exchange dealers.

Although Schmidt would clearly like to see an EMS developed for all the OECD countries, I think realistically he knows that this will never come about. There is indeed considerable opposition from the Bundesbank, who regard the EMS as largely a failure. The only hope is, as he says, that the Americans will change their minds and take a leadership role here. I doubt very much if we shall see any attempt by the United States to set up an OECD or BIS wide form of EMS. (I return to this below.)

Protection

In my view this is by far the best part of Schmidt's prescription. If the Williamsburg Summit could agree to the minimum requirement as a "formal binding undertaking by the seven major industrial states not to impose any additional restrictions on trade in the next two years", that would be a great step forward. But Schmidt is realistic here and points out that there are severe divisions within the Community.

North/South

The argument in this section is particularly deficient, and it has a Brandt-like quality. He seems to regard Government official aid as a pre-requisite for development, in spite of the obvious evidence against such a proposition. He also wishes to stabilise developing countries' export earnings, in spite of the appalling performance of expropriation by the many export boards that litter the Third World.

/Finally,

Finally, he supposes that the greatest obstacle to economic health of the South remains population growth, again in spite of the arguments showing that in many, indeed most, developing countries there is a problem of under, not over, population. P.T. Bauer has "convincingly shown that the earth's resources can cope with population explosion".

A Policy for Schmidt, Brandt et al

We can readily embrace much of Schmidt's prescription including the need for the US Federal deficit to be reduced, the prescription of steady money growth policies for all countries, the spirit of the anti-protectionist resolution, and other more detailed policies. However, it is not clear how far we can or should go in implementing these elements of the Schmidt prescription. We can ourselves determine our steady monetary growth. But we can do little to change the Federal deficit in the United States.

There are some aspects which I believe we should definitely reject. First and foremost is the new version of the old convoy theory, namely that countries such as Britain which have solved their budget deficit problem should thereby promptly slip back again into substantial budget deficit. This is clearly absurd and obviously inconsistent with Schmidt's view that budget deficits cause high real interest rates which inhibit expansion.

Similarly, we should have no truck with his vague and unsubstantiated notions about development. Only Governments and politicians in the South, together with the aid establishment in the North, will profit from an expansion of official aid.

Similarly, we should not support Schmidt's proposals for the Americans to provide the lead for a world EMS. But what we can do is to suggest that all countries adopt a policy of steady monetary growth combined with a trend reduction in budget deficits. This will then provide the convergence which has so eluded those countries in the EMS arrangement. The United States might well be induced to join a world MTFS.

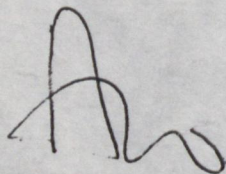
It is possible to develop this international version of the MTFS to enable expansions of particular currencies, such as the Deutschemark, when there is some exogenous expansion of demand for it, at the

/expense

expense, let us say, of the French franc. Then one could set up a rule that would enable the Deutschmark supply to expand and the French franc supply to contract, all in an institutional international MTFS arrangement. Aggregate world money would be under a broad control.

These ideas of an international MTFS are, of course, nebulous at this stage. But they would provide a positive initiative and a way of going forward with a programme of convergence on the low inflation rates that we are managing to see now in the major Western countries. Until a degree of convergence and stability is achieved it is useless to imagine that we can, by intervention or by domestic monetary policies, peg exchange rates in any way.

In May 1983 the United States may well be in the process of, or at least contemplating, the reduction in monetary growth that is necessary to remove the excess expansion of the last eight months. A world MTFS initiative may be associated with a reassertion of monetary stability in the United States.



ALAN WALTERS
1 March 1983