102. Memorandum of Conversation[1]

Washington, May 15, 1982, 12:15 p.m.

SUBJECT

President's Meeting with George Shultz

PARTICIPANTS

President Ronald Reagan
George Shultz
Donald Regan, Secretary of the Treasury
Walter J. Stoessel, Acting Secretary of State
Michael Deaver, Assistant to the President
Richard Darman, Assistant to the President
Robert McFarlance, Deputy Assistant to the President for National Security Affairs
Norman Bailey, National Security Council
Marshall Casse, Office of the Under Secretary of State for Economic Affairs (NOTETAKER)

After an exchange of greetings the President asked Mr. Shultz for his report on the trip that Mr. Shultz had just completed on the President's behalf.[2]

Mr. Shultz handed the President a memorandum summarizing his conversations[3] and also handed the President a speech given by Helmut Schmidt which Shultz said was particularly impressive.

Mr. Shultz reported that all of his interlocutors were looking to the June Summits for an expression of Western unity, in particular as President Mitterrand and Prime Minister Suzuki said the Summits must demonstrate unity and strength to "the other side." The Summit

[1] Source: Reagan Library, Douglas McMinn Files, Summit Files, France—Preparatory Meeting (2). Secret; Sensitive; Not for the System. Drafted by Casse on May 17. The meeting was held in the Cabinet Room. Also scheduled for publication in *Foreign Relations*, 1981–1988, vol. XXXVI, Trade; Monetary Policy; Industrialized Country Cooperation, 1981–1984.

[2] In telegram 121638 to Ottawa, Tokyo, and multiple European diplomatic posts, May 5, the Department indicated that Shultz would be planning a "private trip" to Ottawa, Paris, Bonn, Rome, Tokyo, London, and Brussels, departing Washington that day. The Department noted in response to speculation regarding the trip that press guidance had been prepared. That guidance read, in part: "As you know, Mr. Shultz is the Chairman of the President's Economic Advisory Board. In view of the difficult economic problems to be discussed at Versailles and on other stops during the President's European trip, the President has shared his thinking on the economic summit with Mr. Shultz and, at Secretary Haig's suggestion, asked him to meet with the leaders of some of our major economic partners." (Department of State, Central Foreign Policy File, Electronic Telegrams, D820235–0765)

[3] Reference is to a May 14 memorandum from Shultz to the President. (Reagan Library, Stephen Danzansky Files, Summit File, Toronto Summit 1982–1987; NLR–733–17–1–1–7) The memorandum is scheduled for publication in *Foreign Relations*, 1981–1988, vol. XXXVI, Trade; Monetary Policy; Industrialized Country Cooperation, 1981–1984.

meetings must also display a sense of realism recongnizing that serious economic problems exist but that the Western societies are capable of dealing with these problems.

Mr. Shultz reported that Mitterrand clearly wants to place the emphasis on the meetings of principals alone over meals. Mitterrand was reported to be holding a competition to find the five best French chefs under the age of 45 to prepare the five meals during the Summit as a demonstration of the importance he attaches to the private discussions at the meals. Mitterrand expects hard, candid conversations during the meetings but intends that the communique show unity and a sense that the leaders are constructively grappling with the problems. Mr. Shultz reported that the other heads of state and government are looking to the U.S. and to the President for leadership at Versailles. He quoted Helmut Schmidt as saying that while the President must act as one among equals ("as he so well does") he is more than that. He must be the leader and Schmidt pledged to follow that lead.

Mr. Shultz reported successively on the major topics for the Versailles Summit:

—*High U.S. Interest Rates*: In Europe, Japan and Canada Mr. Shultz encountered great concern about the level of U.S. real interest rates. He found a common line of reasoning which begins with high interest rates slowing U.S. growth, influencing interest rates abroad because of the limited room for maneuver on exchange rates; thus slowing growth outside the U.S. causing a general economic slowdown and higher unemployment on a global scale. This chain of events is universally ascribed to U.S. budget deficits. How to address U.S. deficits however varies even within governments, Shultz reported. He said that Thatcher welcomed the President's emphasis on cutting expenditures and his refusal to raise taxes to promote budget balance whereas Chancellor Howe felt that balance was most important, leading him to advocate "whatever is necessary" to eliminate the deficits. Mr. Shultz told the President that while he felt there was an element of truth in the foregoing line of reasoning there was also a serious weakness. Differing economic conditions as reflected in Italian inflation rates triple those in the U.S. and German rates half those in the U.S., indicate that all economic problems for others will not disappear when U.S. interest rates come down. He urged the President to make the point at Versailles that lower U.S. rates will not be a panacea for the world. He also told the President that his colleagues at Versailles will be especially interested in the President's views on the budget battle and on the U.S. economic outlook.

He added that all of the other leaders want to fight inflation but that they desperately need growth. He reported that Trudeau was clearly the most worried of all the heads of state that he met. He described a three-way conversation between himself, Trudeau and Ian Stewart (Deputy Finance Minister) in which Stewart described Canada as moving toward economic catastrophy with rampant bankruptcies and Trudeau asked if the same conditions did not exist in the U.S. and elsewhere. Trudeau said that Canada has no more time to wait, the economy is in desperate shape and he is led to ask the question "are my policies at fault?" Based on this conversation Shultz suggested that Trudeau may be the most difficult leader to handle at Versailles.

Mr. Shultz reported that as he got further into his trip he identified a growth theme that could bring some of the various participants together. Nothing that Suzuki had made a proposal in the area of technological cooperation, that Mitterrand would make a report to the Summit on technology and that the President's program was focusing on increased savings and investment in the U.S., Shultz felt that a theme promoting higher growth and lower inflation through investment and technology could be useful in addressing the various concerns at Versailles. He cited two dangers with this approach: (1) high interest rates damage investment, thus drawing more attention to U.S. interest rates and (2) a debate over the relative merits of public versus private investment would be inevitable.

—*Policy Coordination*: Mr. Shultz reported that the President's initiative on policy coordination (as indeed his letter on the Versailles and NATO Summits) was well received. Although the Europeans see the limits to coordination as a result of their frequent efforts in this area within the Community, they also understand the usefulness of greater knowledge and frequent communication to get the message "into the gut, not just the head." Mr. Shultz felt that this better understanding can soften the edges during a period of difficult international economic relations.

For the Europeans and the Japanese the number one topic on coordination is exchange rates. Mr. Shultz reported that U.S. policy is uniformly perceived opposing intervention in all circumstances. This has resulted in an impression that the U.S. "doesn't care about" the exchange markets. The Europeans above all are pleading for a different rhetoric. Mr. Shultz added that there was much to commend a different tone in stating our intervention policy.

Mr. Shultz described three schools of thought on exchange rates. The first, subscribed to by Schmidt, Spadolini, Thatcher and Thorn, agrees that intervention cannot counteract basic market trends but that smoothing operations are useful to show the interest of governments in well-functioning markets. The second, subscribed to primarily by Mitterrand, goes much further and believes that basic values can be influenced by intervention. Mrs. Thatcher remarked that such an approach would "simply throw money to the speculators." The third view, subscribed to by Suzuki (reportedly on the basis of a plan developed by Miyazawa), suggests bilateral efforts to influence exchange markets by means not limited to intervention. Suzuki has written to the President proposing joint study of such efforts. Mr. Shultz reported his own impression that the Japanese seem to be able to influence the value of the yen when they decided it should be done. At the moment they have in mind a yen rate of 210 to the dollar and Shultz wonders whether they are looking to put a "political face" on a decision they have already taken. Mr. Shultz urged that the President pursue the Suzuki proposal in part because Shultz has great admiration for Miyazawa.

—*Trade*: Mr. Shultz reported that all of his interlocutors were concerned about rising protectionism. He added that he personally thought this was the most threatening thing on the horizon. Shultz outlined two possible strategies: One, expressed most clearly by Mitterrand, called for putting all the protectionist measures on the table and developing a plan to deal with current problems and to reverse the trend toward more protection. The other, more in keeping with the U.S. initiative, takes a more aggressive approach to extend the principles of free trade to areas not adequately covered. Mr. Shultz told the President that the second approach would require his vigorous personal leadership but would receive the support of Schmidt and perhaps Thatcher.

Mr. Shultz reported that much of the European commentary on trade issues was aimed at Japan. On the other hand, the Japanese complain that they are being "picked on." Mr. Shultz noted that after hearing for 15 years the usual Japanese "small country" approach he had been shocked by Suzuki's opening commentary acknowledging the responsibility of Japan in the global economy. He told the President that Suzuki is very much looking forward to his bilateral at Versailles and counselled the President against joining in any European effort to gang up on Japan. Mr. Shultz noted that most of the world's population is in Asia and that the U.S. would do well to find "common cause" with the Japanese and provide a little "TLC" for Suzuki. Mr. Shultz expressed the opinion that a public rebuke against the Japanese at Versailles would be devastating.

—*Credits to the Soviet Union*: Mr. Shultz reported his distinct impression that the President had made head-way with the Europeans on the issue of credit subsidies to the Soviet Union. Each of the European leaders acknowledged that they are spending large amounts of money on arms largely because of the threat from the Soviet Union. Why then are they subsidizing the Soviet economy? At the Head of State level, all agree that this is foolish but they continue to do so. Several of them, particularly Thatcher, noted, however, the tendency for others to backslide on agreements; thus the need for some form of machinery to police any eventual agreement on limiting credits. Shultz also conveyed Thorn's impression that sentiment in Europe was swinging toward the U.S. position on credit to the Soviet Union.

Mr. Shultz added that the Europeans differentiate between the Soviet Union and the satellites. On credit issues, however, they all feel that the West is currently over-extended in Eastern Europe and that prudence argues against more lending to Eastern Europe at the present time.

—*North/South Relations*: As a result of his conversations, Shultz feels that the United States is on one side and everyone else is on the other in dealing with the less developed countries. He said that the leaders with whom he met felt the U.S. is unjustly getting a bad name in the third world. This perception is largely attributable to the U.S. position on global negotiations. All agree that the integrity, independence, etc . . . of the specialized agencies must not be prejudiced but they say that the U.S. is crazy not to go along with global negotiations. Shultz added that he detected a fair degree of cynicism in the European approach to this issue.

Mr. Shultz reported that several leaders, particularly Schmidt and Thorn, cited the value of the Lome Convention[4] and its commodity agreements as a useful device in dealing with a major LDC problem. Shultz told the President that he felt this issue needed more study in the U.S. Government and had so indicated to Larry Eagleburger.

—*Energy*: Mr. Shultz said this was a subject that no one wanted to discuss expect Schmidt, who was concerned that we were getting "too relaxed" on energy and will get "blind-sided" once again. Shultz suggested that the President be prepared with a list of synfuels projects that are going forward on a market basis and a package of energy alternatives for Europe among his briefing materials for Versailles.

On other issues, Shultz noted the *Falklands* problem as one which particularly concerned Spadolini since about one half of the Argentine population is of Italian descent. More generally, there is widespread concern in Europe that the Falklands will be divisive of the movement toward European unity since it is unlikely that the Community can continue to give full support to the British as the hostilities worsen.

Mr. Shultz informed the President that his proposals on the *START* negotiations were well received by all, except Trudeau, who has his own ideas on nuclear weapons.

On the *NATO Summit* agenda, Shultz had only discussed the question of strengthened conventional defenses. It was clear that budgetary considerations would be the primary determinant of European

[4] Reference is to the Lomé Convention, signed by 46 LDCs and the EC on February 28, 1975. Its provisions included an earning stabilization fund for LDC primary commodity exports.

reaction to this proposal. Shultz relayed Thatcher's comment that we be careful not to underrate the Russian technical competence while Schmidt was primarily worried about statements citing Western weaknesses in conventional defense. Schmidt said that, for a front line state, it is demoralizing to hear repeated contentions that the West could not withstand a conventional attack. He added that the German Army was up to the task.

In summary, Shultz told the President that the leaders he had met wanted unity and strength, not confrontation at Versailles. They recognize the need to fight inflation but also desperately need growth. They acknowledge that it is foolish to subsidize the Soviet Union but realize they are doing so. They recognize that the world trading system is deteriorating and that each of them is contributing to its deterioration. In short, they need someone to lift their sights toward a more constructive and positive approach to policy in the future. Shultz told the President that he was elected.

The President thanked and commended Mr. Shultz for his excellent report. He said that in his view most economic problems in Europe were the result of government intervention, and none except Mrs. Thatcher was moving to correct the basic problems. The challenge is to convince the Europeans that the old French king was right when he said: "Laissez faire." Shultz replied that Mitterrand repeatedly referred to De Gaulle in describing his own policies, placing himself in the mainstream of French economic thinking.

In a closing exchange, The President said that Shultz' report "scared him a little." Shultz retorted that he did not want the President to think that Versailles would be "a piece of cake."

Action items: On the basis of Shultz' report, the following action items are indicated:

1. *Macroeconomic Policy*: Development of a growth theme drawing on the Mitterrand/Suzuki initiatives on technology, and the recognized need for heavy investment activity to facilitate structural adjustment. This theme would be consistent with the Administration's emphasis on growth through private savings, investment and higher productivity.

2. *Exchange Rates*:

(a) Exploration of a change in the tone and rhetoric of U.S. exchange market policy, to reflect more positively our willingness to intervene to counter disorderly markets;

(b) Follow-up on Prime Minister Suzuki's suggestion to President Reagan that we establish a bilateral group to inquire into factors influencing the value of the yen.

3. *Trade*: Determine whether we could accept President Mitterrand's proposal to "lay all our protectionist practices on the table", and determine jointly how to back away from them.

4. *Energy*:

(a) Develop a list of market-based synfuels projects;
(b) Provide briefing material for the President on energy alternatives for Europe.

5. *North/South*: Analyze the STABEX provisions of the Lome Convention, with an eye to an expanded income stabilization scheme.

6. *East/West Issues (Soviet credits)*: Pay careful attention to the problem of backsliding on a credit arrangement, by insisting on a mechanism to police the arrangement.

7. *Japan*: "Think long and hard" before joining in any effort to gang-up on Japan, or submit it to a public rebuke.