PRIME MINISTER

MEETING WITH KARL-OTTO POEHL

The Governor and Brian Griffiths will also be present at your meeting with Herr Poehl.

The purpose of the meeting is mainly social. Herr Poehl has not met you before, and he very much wanted to do so as a personal matter rather than for business reasons. But you are bound both to want to discuss economic affairs.

There are briefs below on the German economy and an interesting note about the latest position on the US budget deficit. (I imagine Herr Poehl may comment on the increasing risk that Congress may not take action to reach the Gramm-Rudman figure. I also understand that Congress has today declined to vote the necessary appropriations to keep government in business another 24 hours and all federal employees have been sent home.)

On German macro-economic policy, I suggest you should be sympathetic to the German reluctance to take action at present, in view of the rapid growth of the monetary aggregate which they watch and of the prospects for quite substantial growth in domestic demand (3½-4 per cent in 1987). But you could ask what their response would be if the growth forecast proves optimistic, and you could also point to the need to support the Administration in fighting off protectionist pressures.

I suggest there is no real need for you to mention the swop with the Bundesbank. Herr Poehl could well expect you to be above that kind of detail and there is no real need for you to thank the Bundesbank: the intervention on our behalf has cost them nothing.

Temporarily retained
29/11/16

DRN

(DAVID NORGROVE)

17 October 1986

DCA.03

NW to see

DN to see

F

CONFIDENTIAL

PRIME MINISTER

PM has seen & agreed
CDP

ANGLO-GERMAN OFFSET AGREEMENTS

I understand that this subject came up at your Chequers Seminar yesterday and that you said you might raise it today with Herr Poehl.

I think you would be fully justified in underlining to Herr Poehl the very heavy financial and balance of payments burden we incur from maintaining British Forces Germany.

But I think it would be an error to raise with him the specific issue of Offset, for three reasons:

i. I showed you the other day a background note about Offset arrangements, which reflected the German Government's very strong determination not to negotiate another agreement. If we want to try again we must prepare the ground carefully. Rushing in with Herr Poehl will simply alert the Germans before we have any properly worked out plan.

ii. anyway, Poehl would not be the best person to raise it with, since he would have no say in the matter; and

iii. its not really the moment, post-Reykjavik, to relaunch a controversial proposal which will be very divisive in Anglo-German relations.

So I recommend that while you could reasonably draw attention to the problem, you should not refer specifically to Offset as the solution. He will get the point anyway.

CDP

Charles Powell

20 October 1986

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CCBG
CCPG
CCB/UP

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15 October 1986

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

PRIME MINISTER'S MEETING WITH KARL-OTTO POEHL

... I attach some briefing on the German economy, a suggested line to take on German economic policy and a background note on Herr Poehl for the Prime Minister's meeting with him on 20 October.

I am copying this letter to John Footman in the Governor's office at the Bank of England.

Yours ever,

Tony

A W KUCZYS
Private Secretary

GERMAN ECONOMY

Suggested line-to-take

- Share view that macroeconomic policy should be set in a medium-term framework to achieve sustainable non-inflationary growth.

- Welcome shift in Germany to growth led by domestic demand. Forecast growth for 1986 and 1987 looks satisfactory and should help reduce current account surplus. What would German authorities' response be if growth forecast proves optimistic?

- Support German view of importance of US actually implementing planned cuts in budget deficit. Problem of imbalances cannot be solved solely by faster growth elsewhere. But note that US Administration might need some support in quelling protectionist pressures in Congress, particularly after November elections.

- UK membership of EMS exchange rate mechanism (ERM) kept under constant review. Arguments in favour and against joining ERM. UK would not want to join unless and until balance clearly in favour of doing so.

Background

(i) GNP growth in Germany has averaged 2¼ per cent per annum since 1983. In both 1984 and 1985 growth of net exports, helped by the boom in the US and the appreciation of the dollar, boosted GNP growth by over 1 per cent and domestic demand grew by only 1½ per cent per annum.

(ii) Output fell in 1986Q1, but recovered strongly in Q2. GNP in 1986 is likely to be about 3 per cent above its 1985 level and a similar growth rate is forecast for 1987. Domestic demand growth in 1986 could reach 4½ per cent and official forecasts, which are supported by the IMF, say domestic demand could increase by 3½ - 4 per cent in 1987. This would be a satisfactory rate.

(iii) Together with a terms of trade improvement (due to the collapse of oil prices, lower commodity prices etc), this export performance is expected to produce a current account surplus of around $30 bn, 3½ per cent of GNP, in 1986.

(iv) The annual inflation rate, which had been reduced to around 2 per cent in 1985, has been negative since April this year. Though this is unlikely to be maintained once the effects of the oil price fall have worked through, inflation should remain very low by international standards.

(v) Unemployment has remained a persistent problem, though at around 8 - 8½ per cent of the labour force it is below the EC average, and a slight fall is expected in 1987.

(vi) The General Government deficit has been cut from 3¾ per cent of GNP in 1981 to an expected ¾ per cent in 1986, largely through reductions in expenditure as a percentage of GNP. The Government has said it will now switch the emphasis to reducing taxation, though not at the expense of increasing the deficit, and has promised to present proposals to reform and cut taxes if re-elected next year.

(vii) Monetary policy centres on the control of the constructed monetary aggregate Central Bank Money (CBM), though it has been growing faster than its 3½ - 5½ per cent target throughout 1986. By September growth over the target base was 7½ per cent, at an annual rate. The Bundesbank has expressed concern at this excessive growth and has used it to justify its decision not to make a further cut in the discount rate, which has been at 3½ per cent since March.

	1984	1985	1986[1]	1987[1]
Real GNP Growth (per cent)	3	2½	3	3
Unemployment rate (as a percentage of the labour force)	8½	8¼	8	7½
Inflation (CPI) (per cent)	2½	2¼	-¼	1½
Current balance ($ billion)	7	14	30	25

1 IMF WEO estimates/forecasts

IF2

H M TREASURY

15 October 1986

PÖHL, KARL OTTO

President of the German Federal Bank (Bundesbank) since 1980.

Born 1929 in Hanover. Studied economics at Göttingen. Member of the SPD since 1948. Worked at the IFO Economic Research Institute in Munich, 1957-60. 1961-68 economic journalist in Bonn. 1968-70 on the board of the Federation of German Bankers. 1970-71 at Federal Ministry of Economics. 1971 appointed State Secretary for economic affairs in the Federal Chancellery. Appointed State Secretary at the Federal Ministry of Finance in 1972. Vice President of the Bundesbank 1977.

A protégé of former Chancellor Schmidt, he went to the Bundesbank against the wishes of the banking community who objected not only to his lack of banking experience, but also to the apparently political nature of the appointment. Initially maintained a low profile but has now fully established himself as President and as a banking personality. Pöhl's professionalism as President of the Bundesbank makes him, despite his political background, acceptable to the Coalition.

Protestant. He has a son and a daughter. His first wife was killed in a motor accident in 1973. He married a much younger woman in 1974. Speaks English well. Convivial company.

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Please keep on file CDP 3/x.

MR POWELL

Anglo-German Offset Agreements

Paragraphs 1 and 4 of the note below by FCO Research Department and the underlined parts of the chronology attached to it should provide the bare facts. Let me know if you want more.

C L G Mallaby

3 October 1986

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CCPC.

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ANGLO-GERMAN OFFSET AGREEMENTS

Flag A 1. The last Anglo-German Offset Agreement expired on 31 March 1980. It was concluded in October 1977 (backdated to 1 April) and provided for a total payment of DM 475m (about £120m at 1977 exchange rates) spread over three years to be spent on barracks and other facilities for British Forces Germany (cf. Articles 2 and 3 of text).

2. The 1977 Agreement was <u>expressly</u> the last of its kind (Article I: "bilateral Offset arrangements shall be terminated after the expiry of the present Agreement"). In a confidential minute, however, the UK reserved the right to pursue "alternative solutions, including a multilateral solution, the problem of the burden of maintaining British Forces on the mainland of Europe". The Germans replied - also confidentially - that however we went about it, the answer would be no, and that included "the idea of a multi-lateral solution".

3. Nevertheless, we have given thought to a successor to the 1977 Agreement under our "alternative solution" reservation". After much deliberation, however, we concluded that the multi-lateral avenue was closed (I attach a note on various possible forms considered); and that the only alternative - a new Host Nation Support Agreement (covering part of the costs of such things as the civilian payroll, maintenance of buildings and installations) suffered from similar problems, although it remained a theoretical option. In fact, in December 1983 we renegotiated the Anglo-German Host Nation Support Agreement (text attached) on the new model established by the 1982 Agreement between the US and the FRG. But this appears only to provide for increased support - and then only material - from the FRG in the event of emergency reinforcement of BFG from the UK.

Flag B

Flag C

<u>Earlier Anglo-German Offset Agreements</u>

Flag D 4. Support has taken various forms over the years (see attached chronological Note). Government-to-Government cash payments have predominated. But some agreements have provided for purchase of military and civil goods, of UK Government debt, or - in one case for a non-interest bearing deposit in London.

1 October 1986

CONFIDENTIAL

WSRG 061/1 1978 July 1978

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ANNEX D

CHRONOLOGICAL HISTORY OF OFFSET AGREEMENTS FOR THE COSTS OF BRITISH FORCES IN GERMANY (BFG)

From 1945 to the end of the Occupation Regime

1. From the end of World War II to 1952 the United Kingdom, along with the other Allied Governments, obtained from the Germans payment of all her expenses in Germany without limitation.

2. From 1952 until 1955, when the occupation regime finally ended, the Germans paid occupation costs to all the Allies at a rate not exceeding DM 600 million per month.

From 1955 to 1961

3. During this period the UK continued to receive direct financial contributions from the Germans under agreements made in 1956, 1957 and 1958. These provided also for arms purchases by the Germans and for the accelerated repayment of post-war economic assistance. Nonetheless, the UK felt obliged to seek relief under the terms of the Brussels Treaty (see Appendix 1) from the burden of stationing costs.

4. In February 1957 the UK proposed to the WEU Council substantial reductions in the size of BFG as part of a general reduction in the size of the UK Armed Forces. The reasons given were economic; the UK representative spoke of the need to "achieve a substantial reduction in the burden that Defence at present imposes on our economy". The WEU Council recommended to the North Atlantic Council (NAC) that it should review the resources of the Alliance covering, among other things, "a common solution of currency problems arising from the stationing of troops in other member states".

5. The NAC's response is contained in its Resolution dated 25 July 1957 which stipulated that:

> "1. The NATO member countries which can invoke currency difficulties resulting from the stationing of their troops in other member states and for the solution of which they request the assistance of their partners are those countries:
>
> (i) which are required, in accordance with NATO plans, to station forces on the territory of other member states;
>
> (ii) which are at any given time experiencing serious balance of payment difficulties;
>
> (iii) for which the cost of stationing forces represents at such time a heavy additional burden on their balance of payments."

6. The Resolution goes on to say that any countries which fulfil, or consider they will fulfil within the succeeding 12 months, simultaneously the 3 conditions specified above "shall submit to the Council a detailed

memorandum containing all appropriate explanations to justify that there are good grounds for their request for assistance". Any memoranda submitted would be forwarded to "2 or 3 independent experts of recognised competence in the field of international finance", who would "advise the Council whether in their judgement the countries involved do or will fulfil simultaneously the 3 conditions specified above".

7. Pending a decision on its proposals for force reductions, the UK had with the agreement of NATO and the WEU reduced the size of BAOR from 77,000 to 63,500. Applying now under the terms of the NAC resolution, the UK had its economic position confirmed by the experts and was granted a Certificate of Need by the NAC. BAOR was then cut to 55,000.

The 1960s

8. A second appeal in accordance with the 1957 Resolution was made in 1961. Once again a Certificate of Need was granted with a view to bilateral negotiations between the UK and the FRG. These negotiations took place during the winter and spring of 1961-62, the UK's opening bid being that the Federal German Government should take over responsibility for civil labour, movements, food, fuel, accommodation, equipment, works, lands and other miscellaneous services required for the maintenance of BFG. The Germans refused to consider any such proposition; and the bilateral offset agreement signed in June 1962 provided for payments of DM 600 million (about £54M) a year for 2 years in respect of military and civil procurement contracts, the utilisation of services, participation in military research and development projects and commitments in the field of development aid. The outturn of this agreement was far from satisfactory and disputes with the FRG were only settled when the latter made advance payments on military and civil account to the value of DM 313 million (£29M) in March 1964.

9. A second 2 year agreement was signed in July 1964. The Germans, basing themselves on projected figures of DM 500 million (£47M) for military purchases, refused to commit themselves to a minimum acceptable payment figure and undertook only to offset "insofar as possible" our foreign exchange costs (now totalling about £85M a year). Following the change of Administration in UK, this agreement was partly re-negotiated and extended by 1 year to 1967. Under the re-negotiated agreement, the Germans agreed to a level of offset of DM 600 million (£54M) for 1966-67 and to deposit £43M in sterling in a non interest bearing account in London.

10. In 1966 the UK warned the WEU Council that the maintenance of BFG was a contributory factor of our balance of payments deficit and that we would have to consider force reductions if it proved impossible to secure adequate cover for their costs. The 1967-68 offset agreement involved a German commitment of DM 550 million (about £50M) in respect of military and civil procurement and an American redeployment of USAF units to the UK worth some £20M in offset. These financial arrangements were expected to cover some 90% of the foreign exchange costs of BFG. Nonetheless, the WEU Council was told that it was proposed to withdraw 1 Brigade Group of BAOR and 1 Helicopter Squadron of RAF(G) to the UK, though these units would remain under the operational control of the UK CsinC in Germany and would be earmarked to SACEUR. In December 1967 the NATO Defence Planning Committee approved

the UK force plans for 1968 to 1972, which took account of the redeployment. The WEU Council then acquiesced, though it was SACEUR's view that there was military justification for the withdrawal and though the NAC resolution and its attendant procedures had not been invoked.

11. The 1968-69 offset agreement provided for payments of DM 510 million (£53M) in respect of military and civil purchases and for a DM 200 million (about £21M) Bundesbank investment in a medium term UK Government Bond. These arrangements, together with continuing income from USAF units transferred to the UK the previous year, were expected once again to cover about 90% of BFG's foreign exchange costs in 1968-69 (estimated at about £90M). A further agreement covering the two financial years 1969-70 and 1970-71 comprised a loan by the Federal German Government of 125 million US dollars (approximately £54M) repayable over 10 years, plus offset payments totalling DM 1,020 million in respect of military and civil procurement. This agreement was supplemented by further offset arrangements in respect of the return of 6 Brigade to the FRG, which increased the military procurement target by DM 24 million and provided separately for up to DM 13 million for the Brigade's settling-in-costs.

The 1970's

12. 1971 saw a return to the principle of direct financial payments. The agreement concluded in that year was to run for 5 years (1971-72 to 1975-76) and involved payments of DM 110 million each year (worth some £13M at the outset but about £20M at its expiry). Military and civil procurement was to continue but on a "best endeavours" basis and with no target figures.

13. There was no offset agreement in respect of 1976-77. The current agreement, concluded in October 1977, provides for payments totalling DM 475 million (about £118M at autumn 1977 exchange rates) spread over the 3 years from 1977-78 to 1979-80 in respect of local works services for BFG. As a result of the late conclusion of the agreement, no payments were received in 1977-78; but there is provision for carry-over from one year to the next and the latest estimate of receipts in 1978-79 is DM 343 million (about £85M at autumn 1977 exchange rates), which includes a substantial backlog from last year. The Germans have made it clear that they regard the current bilateral offset agreement as the last of its kind.