chex.jp/dsl/66 **RESTRICTED**

CC/

AO

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

8 June 1989

R N Peirce Esq
PS/Secretary of State for
Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

C
3/6.

Dear Robert,

MEETING WITH M STRAUSS-KAHN, CHAIRMAN OF THE FINANCE COMMISSION OF THE FRENCH NATIONAL ASSEMBLY

M Dominique Strauss-Kahn, Chairman of the Finance Commission of the French National Assembly, paid a courtesy call on the Chancellor and the Economic Secretary yesterday at No 11 Downing Street. He was accompanied by M Jean de Rosen, Financial Counsellor at the French Embassy, and a representative of the Central Office of Information. Mr Lankester (HM Treasury) was also present. Although the tone of the discussions was relaxed, the line of M Strauss-Kahn's questioning suggested that he was uneasy about the UK's sincerity in wanting improved economic and monetary co-operation in the European Community.

UK Monetary Policy

M Strauss-Kahn asked for how long UK interest rates would remain at their present level, indicating that this had some bearing on French monetary policy. He wondered whether there was a danger, when UK interest rates eventually did come down, that consumer spending would pick up and there would be a further worsening of the trade balance. The Chancellor explained that controlling inflation was the primary objective of macroeconomic policy and that interest rates played a crucial role in achieving this objective. He said he expected interest rates would have to remain at around their present levels for some time yet (this seemed to surprise M Strauss-Kahn) but he foresaw no untoward consequences for the trade balance when interest rates were reduced in due course.

M Strauss-Kahn asked whether the Chancellor shared his analysis that the recent resurgence in inflationary pressures in Europe was due primarily to price increases in the services sector. The Chancellor said that in the UK the strength of domestic demand was the main factor. He also reminded M Strauss-Kahn of the anomalous and unhelpful inclusion of mortgage interest payments in the UK retail prices index.

EC Issues

M Strauss-Kahn said that France had a number of difficulties with reducing its taxation of savings in advance of full capital liberalisation next year. These concerned the scale of the adjustment France was having to make (he implied that other member states should help out by raising their taxes on savings) and the relatively short timescale for implementing it. In addition, lower taxation of wealth was contrary, in French minds, to notions of fiscal justice. He suggested a link between harmonising taxation of savings and the Delors proposals, implying that French progress on the former might be faster if other Community countries were willing to move forward with the latter.

The Chancellor said he saw no connection between the two sets of issues. On the taxation of savings, there was now no prospect of agreement on an EC withholding tax. The proposal made no sense in the global context of "footloose" capital; it would just drive savings overseas. The Chancellor said that, in any case, he believed it implicit in the Lebegue report that France stood to gain by reducing its taxes on savings; M Strauss-Kahn was thus wrong to see lower taxation of wealth as a sacrifice except possibly in immediate revenue terms. He pointed out that the UK had enjoyed complete freedom of capital movement since it abolished exchange controls ten years ago and had not found the experience problematic. He also noted that only the previous day the Swedes had announced that they were abolishing exchange controls; in view of the high level of taxation in Sweden, France should find this decision reassuring.

M Strauss-Kahn asked when the UK would be joining the exchange rate mechanism of the EMS. The Chancellor said that the UK was extremely interested in improving economic and monetary co-operation within the Community; with the exception of the ERM, the UK already played a very full part in the Community's monetary arrangements and had been instrumental in promoting the development of the ECU and already had free movement of capital. As for joining the ERM, only the timing was in doubt. (At this, M Strauss-Kahn shrugged Gallicly.) It would not be appropriate for the UK to join until our rate of inflation was closer to the EC average. The UK Government had, however, very serious reservations about the Delors report's recommendations for monetary union. He did not believe that the proposals had been properly thought through; monetary union as envisaged by Delors required new political institutions for which the UK and other member states were not ready. Instead, the UK wanted to improve co-operation within the framework of the existing Treaty. The Chancellor very much hoped that the French would not try to force the pace of reform; more discussion was required and impatience would only cause unnecessary divisions between member states.

In reply to a question by the Economic Secretary, M Strauss-Kahn said France wanted UK participation in the ERM for two reasons. First, it was not possible to establish the EC bloc as a key third player in world monetary arrangements if sterling remained outside the ERM. Secondly, the essentially bilateral nature of the ERM at present, by which he meant the overwhelming importance of the DM/FF nexus, was not ideal for French purposes. The British and French philosophies of monetary policy were much closer than those of France and Germany. The French thus saw the British as an ally in their dealings with the Bundesbank.

M Strauss-Kahn concluded by emphasising that once the single market had been successfully completed the French were convinced that European monetary union was the next logical goal. He was evidently troubled that the UK did not appear to share this aspiration.

Public Sector Pay and Efficiency

Finally, M Strauss-Kahn asked how public sector pay was determined in the UK and how the Government was attempting to increase efficiency in the public sector. He remarked that for the past six years the French Government had controlled the public sector payroll very tightly but had now got to the stage where further economies were difficult to secure. The Economic Secretary elaborated on the situation in this country.

I am copying this letter to Charles Powell (No 10) and Paul Tucker (Bank of England).

Yours sincerely,

Duncan Sparkes

DUNCAN SPARKES
Assistant Private Secretary