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Dear Richard.

ANGLO-GERMAN SUMMIT, 30 MARCH: CHANCELLOR'S BILATERAL WITH DR WAIGEL

Dr Waigel called on the Chancellor at No.11 this morning. He was accompanied by Herr Koehler, Dr Heck, Frau Aschenbrenner, Dr von den Driesch and Herr Wokalek. Mr Wicks, Mr R I G Allen and Mr O'Donnell were also present. Nearly the whole of the time available was spent on GEMU.

GEMU

After an opening exchange of courtesies Dr Waigel described recent developments on German Economic and Monetary Union (GEMU). He had been travelling extensively in order to keep colleagues abreast of developments. He would be doing so again at the Informal ECOFIN over the weekend. He assured the Chancellor that he would continue to do so and would consider any advice which was offered. He was grateful for the helpful and expert discussions he had had with fellow Finance Ministers in other countries.

Continuing, he said that with hindsight the decision to offer GEMU to the GDR had been the right one. Speed was of the essence: with each additional day the expense and difficulty increased. The GDR economy was in a state of collapse and the GDR no longer had any identity. Its leaders had no capacity to effect change and its people did not trust their own political authorities. The recent election showed a desire for democracy, freedom and a social market economy. The sooner this could be achieved the better for both the FRG and for Europe as a whole. If the GDR remained independent for several years and only later applied to join the EC that would be far more expensive for all concerned than early GEMU and accession to the FRG under Article 23 of the Constitution.

Continuing, Dr Waigel said it was very important that Economic Union should occur simultaneously with, or preferably before, Monetary Union and the adoption of a common monetary policy. The GDR needed to move to a free market, which meant not only freeing prices but free movement for enterprises and free collective bargaining.

The GDR's external position was not easy, but nor was it a dramatic problem. When it had been borrowing it had done so with some restraint. However, the position was worse than the GDR had hitherto admitted. He estimated that there was $18 billion of external debt. This would be a tolerable burden - there was no need to repay the principal, but the debt would have to be serviced.

Internal indebtedness was, in contrast, a big problem. After GEMU, enterprises in the GDR would have to service higher interest rates. So the choice of a conversion rate - which was still to be decided - was important. Among the major conglomerates, there were parts which were simply not competitive, even if de-centralised. He was having to reconstitute industry divisions in the Federal Finance Ministry!

The major problem with a 1:1 conversion rate - which was preferred by those concerned with social policies - was its effect on commercial debt. The Finance Ministry, Economic Ministry and Bundesbank favoured a 2:1 conversion rate (please protect).

The Chancellor said he was grateful for Dr Waigel's frankness. He agreed that the sooner GEMU could take place the better. He concurred in Dr Waigel's analysis. He was reassured by his determination to see a rapid transition to a market economy in the GDR, and the elimination of subsidy. He was following developments with interest and admiration.

Continuing, the Chancellor said that his concern was with the external implications. Reunification would give rise to higher public spending in Germany. Chancellor Kohl had indicated reluctance to put up taxes in an election year. The Bundesbank were reluctant to put up interest rates, given the views of their Community partners. But the spending pressures in the German economy might translate into higher inflation.

Dr Waigel said he thought that higher taxation was not an appropriate response. In their experience tax reduction had stimulated growth - 3½ per cent in 1989 and a projected 4 per cent for 1990. This was a helpful background to GEMU.

Continuing, he said that since 1983 the FGR had been successful in consolidating its budget. The Federal deficit was now 2 per cent of GDP. Local Government finances were even stronger, in some cases showing a surplus, and public expenditure overall showed a surplus. The Federal Government would be asking for a greater share of total revenues for 1990 and 1991, which would allow a margin for manoeuvre. This would enable a standstill in the reduction of borrowing without endangering financial stability.

There would of course have to be changes in future budgets. But it should be remembered that it currently cost DM 40 billion a year to keep Germany divided. These costs would gradually disappear, allowing some reordering of priorities, and would release funds for investment in the GDR's future.

The Chancellor asked Dr Waigel how he intended to prevent a rise in consumption in the GDR following GEMU.

Dr Waigel recognised the problem. However, the savings rate in the GDR (10,000 to 11,000 Ostmarks per capita) was far lower than in the FGR - DM 40,000 per capita. He wished to protect savers. He was considering a limit of, say, DM 2,000 on the 1:1 conversion rate above which a 2:1 conversion rate would apply, and there might need to be other restrictions (please protect). He did not think that, if savers thought their savings were secure, they would change their savings habits. However, he would not want to convert larger personal savings or company savings at this rate. However, he did not see this as the major problem. GEMU would add only one-tenth to the FGR's money stock, which could be easily accommodated. The major problem, he reiterated, was the uncompetitiveness and indebtedness of the company sector.

EMU

The Chancellor said that in his view the timetable for work on EMU should not be affected by GEMU. He was concerned that decisions on Stages 2 and 3 should not be taken before there was sufficient experience of Stage 1. How long should Stage 1 be? And what should be the conditions for movement to Stages 2 and 3?

Dr Waigel agreed that movement should be step by step: we should learn through experience. If this was successful, then the IGC in December would be able to make progress. The two key principles were stability and independence. Herr Koehler added that the conditions for moving to Stages 2 and 3 were very important. Convergence in economic performance would be a particular problem for some countries.

Insurance and Financial Services

As this stage the meeting was joined by Mr Ridley, Herr Haussmann and Mr R Mountfield (DTI).

The prepared announcement on Insurance and on Directives in the financial services area was agreed without discussion, subject to confirmation of the detailed drafting by officials. The meeting broke up at this point to allow Ministers to attend the Plenary Session in No.10.

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

Tancred Tarkowski

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