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10 DOWNING STREET

From the Private Secretary

26 February 1980

Visit of Chancellor Schmidt: Economic Issues

I enclose a brief extract from the record of that part of the Prime Minister's talk with Chancellor Schmidt yesterday dealing with world affairs. You already have the record of their discussion of the Community budget.

I did not include in the main records any account of a brief discussion between the two Heads of Government about the performance of the British economy. The Prime Minister described the course of events since the final removal of exchange controls last autumn and the subsequent rise in the sterling exchange rate. Chancellor Schmidt expressed some scepticism both about the consequence of the rise in the value of sterling and about the possibility of controlling it. He said that the rise had been predictable and in the long run would do Britain no harm. The German Government had been told repeatedly by their own industrialists that an increase in the exchange rate would be disastrous. They had ignored the advice and had never regretted it. In any case it would be impossible for the British Government to resist the rise for long. We would have to accept the consequences of being oil rich. Devices such as negative interest rates might help for a short period but in the end the market would prove stronger. Chancellor Schmidt agreed however that it was important to hold the domestic money supply down. The German Government professed to control the country's monetary base although there was, perhaps, more pretence than reality in this policy. It was designed to keep the trade unions in line (Chancellor Schmidt noted ruefully that in Germany the Government had more difficulty in controlling the entrepreneurs than in controlling the trade unions).

The Prime Minister said that the rise in the exchange rate had a very damaging effect on British exports. Unlike German manufacturers, who sold on the basis of quality, design and delivery, the British manufacturers sold primarily on price. Chancellor Schmidt said that in the long run it was essential to make manufacturers sell on the basis of quality. Those who did not do so would go to the wall. The Prime Minister said that she agreed where private

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sector manufacturers were concerned. For her the difficulty lay with the large nationalised sector. Chancellor Schmidt admitted that this was indeed a "bad heritage".

Chancellor Schmidt then returned to the question of British membership of the EMS. You already have a record of this part of the discussion. Arising from that conversation, the Prime Minister has asked that a re-appraisal of our attitude towards the EMS should be put in hand in the light of developments since the autumn in the domestic and international economic scene. Such a re-appraisal might conveniently cover the question of participation within the narrow and wider bands; and policies short of outright acceptance or rejection of membership e.g. a declaration of intent coupled with an invitation to the other members to discuss the timing and conditions of British membership or a discussion of modifications to the existing scheme which would make it easier for us to participate

No doubt in preparing such a note you will consult the FCO, the Cabinet Office and the Bank. I think it would be helpful to the Prime Minister if your paper described the full spectrum of views on the question of full participation in the EMS.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office) and David Wright (Cabinet Office).

Yours sincerely

Richard Alexander

A.J. Wiggins, Esq.,
HM Treasury.

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