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CONFIDENTIAL



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8 May 1981

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Dear Michael,

ANGLO GERMAN CONSULTATIONS: 11-12 MAY 1981

TMV(81)3 refers to the possibility that Chancellor Schmidt may complain to the Prime Minister about US interest rate policy. Since TMV(81)3 was prepared there have been two developments which may increase the possibility that Chancellor Schmidt will raise this question. There has been a renewed rise in US interest rates which has caused a fall in European currencies against the dollar, and the US Treasury has told Congress that it intends to intervene in the exchange markets much less than the previous Administration.

We know that Chancellor Schmidt feels strongly about US interest rate policy. He would argue that it must be wrong for US interest rates to have risen sharply and then fallen again three times in a little over a year, given that the dollar is the world's main reserve currency. He feels that it is wrong that a low inflation country like Germany should have to face high interest rates mainly in order to defend the DM exchange rate against the dollar; and is being obliged to import deflation and to see investment damaged by high interest rates at a time when interest is particularly needed. This situation has produced differences of opinion between Chancellor Schmidt and the German Finance Ministry on the one hand and the Bundesbank on the other. Moreover there has been some tendency for FDP Ministers (Lambsdorff) to side with the Bundesbank. There are links with Chancellor Schmidt's wider political problems.

Some other Community countries naturally support Chancellor Schmidt's view but there has been no readiness to make concerted representations to the United States. We for our part have attached first importance to supporting the United States in their fight against inflation. We also think that high US interest rates are by no means the only cause of the recent weakness of the DM. In contrast to what has happened with Japan, the German current account deficit has not been reduced yet and the market is conscious

/of German



of German vulnerability to oil imports. Unrest in Poland has also played a part. The table attached shows how the DM has fluctuated against the dollar this year.

However, our main concern during Chancellor Schmidt's visit must be to avoid any difference which might mar the agreement we hope to achieve on other issues. It would be best if the subject were not raised. If it does come up however the Prime Minister may like to turn it by referring to what the UK has itself done. She might say that we all sympathise with the US efforts to reduce inflation which are in everybody's interest, not least in relation to the oil price. We can see that interest rates have to play a part in reducing inflation. They have had to play a part in the UK. However, in the UK we have managed to avoid a switchback movement of interest rates. We have had to be cautious about reducing rates until the trend towards falling inflation was firmly established. But we have also made great efforts to see that interest rates do not have to bear too much of the burden. We endured a Budget which we could not expect to be popular precisely in order to be able to reduce interest rates. We would hope that the United States also would put an appropriate part of the burden of fighting inflation on to fiscal policy and not put too much of the burden onto interest rates. From that point of view we were glad to see that Congress had approved a programme of public expenditure reductions which if anything went beyond what the new US Administration had first proposed.

We would hope that this approach would appear sympathetic to the Chancellor's preoccupations, while avoiding criticism of US policy. We would also hope that the subject could be avoided or turned at the press conference. If necessary the Prime Minister could say that she hopes the US will be successful in turning back inflation, so making it possible for dollar interest rates to be brought down substantially and quickly.

I am copying this letter to George Walden and Michael Franklin.

*Yours sincerely*  
*John Wiggins*

A.J. WIGGINS  
 Principal Private Secretary