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MEMORANDUM OF CONVERSATION

SUBJECT: Working Lunch with Chancellor-elect Gerhard Schroeder of Germany (~~S~~)

PARTICIPANTS:

The President
Robert E. Rubin, Secretary of the Treasury
William S. Cohen, Secretary of Defense
Samuel R. Berger, Assistant to the President for National Security Affairs
Gene Sperling, Assistant to the President for Economic Policy and Director of National Economic Council
John Kornblum, U.S. Ambassador to Germany
Thomas Pickering, Under Secretary, Political Affairs, Department of State
James Steinberg, Deputy Assistant to the President for National Security Affairs
Leon S. Feurth, National Security Advisor for the Vice President
Donald K. Bandler, Special Assistant to the President and Senior Director for for European Affairs, NSC Staff, (Notetaker)

Gerhard Schroeder, Chancellor-elect
Juergen Chrobog, Ambassador to the U.S.
Joschka Fischer, Member of Parliament
Gunther Verheugen, Member of Parliament
Ludger Volmer, Member of Parliament
Uwe Karsten Heye, State Secretary and Government Spokesman of Lower Saxony
Alfred Tacke, State Secretary of the Ministry for Economy, Technology and Transportation
Interpreter

DATE, TIME AND PLACE: October 9, 1998, 11:45 a.m. - 1:20 p.m. Old Family Dining Room

~~SECRET~~
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The President: We had a good conversation in the Oval office focused largely on Kosovo. Perhaps you can start here by telling us what you are doing to put your governing coalition together and what its policy priorities will be. I'd like to hear about your plans for Germany's domestic economy and how it will be affected by factors beyond German borders -- Russia and the financial crisis in particular. (U)

Chancellor-elect Schroeder: I will begin next week building our new coalition. Chancellor Kohl has been personally very helpful during the transition. His attitude and demeanor have been positive, and he has shown great statesmanship in dealing with change. The new Bundestag will come into session on October 26 and my government will start working on the 27th. (U)

Our three foremost challenges are unemployment, training and jobs for youth, and tax reform. Now all of these issues will be affected by the framework of our overall budget and finances. So it is clear that I will have to proceed in stages. By lowering the costs of doing business and reducing social subsidies, we hope unemployment can be brought down. I am optimistic about this. I will also try to reduce unemployment through an "alliance for work" that is an alliance of unions, employers and the state. (U)

In the foreign policy area I expect lots of continuity. The international problems facing us are challenging and will require new levels of cooperation. On the European level, I will be working very closely with other governments -- especially France and the United Kingdom -- and with the leaders of the social democratic parties to cooperate in the fight against unemployment. Action will be required on the European level -- not as a replacement to national policy but as an essential supplement. (~~C~~)

Another key issue will be enlargement of the European Union toward the east. We hope to maintain momentum but expectations do seem quite excessive. We will have to explain to the candidate countries that differences in national economies mean that some candidate countries will take longer to enter the Union than others. This should not erode the candidates' efforts nor those of existing members to bring them in, but more time will be required. (~~C~~)

Now concerning international economic cooperation, I hope we can pool our strengths even more in the future. I read your September speech at the Council on Foreign Relations. My own thinking is very much along the lines as yours concerning a so-called third way. There are three points I would like to make. First, we have to find better ways to control banks, financial markets and capital flows. Second, we have to find out how it will be possible to involve the private sector in finding solutions to international crises. Third, we have to adapt the IMF and World Bank and improve the way they function. (~~C~~)

Now one of our best tools for economic cooperation is the G-7/8. This was a very useful instrument but it has degenerated and shows signs of wear today. Summits are delving into a vast array of issues. We should refocus them on the core purpose, which is how to improve international economic cooperation and performance. (~~C~~)

The President: I would like to make three observations. First, there is a real opportunity now that you have been elected to build consensus among Germany, the United Kingdom, France and the United States on how to grow our economies and decrease unemployment. With the right policies and tools in place, we will certainly be able to make rapid progress in the West and more gradual progress on the eastern half of the continent. (~~C~~)

Second, it is obvious that developments in some regions threaten overall international economic health. This is fundamentally a problem of liquidity: there is just not enough money given worldwide levels of international loan exposure. We need to articulate clearly that the problem is not the risk of inflation but the risk of contraction. In other words, there is not enough liquidity to spur growth. (~~C~~)

Third, the international financial institutions have serious problems to deal with in the short-term. The U.S. and Germany could put up $50 billion tomorrow to deal with some of these problems and it would all be gone within a week -- in many cases, the money would simply be expatriated. So, we need the IMF with backup from the G-7 to increase liquidity. Otherwise, anything we could do would just end up hurting our own economies. (~~C~~)

We will have our IMF contribution freed up in the coming days and will then focus more on decisions ahead involving liquidity and the IFIs. The problem with the IMF and World Bank is that they were designed to build a world trading system and a social safety network for the poorest countries. They are not equipped to construct a world financial system with hundreds of billions of dollars in overnight flows. (~~S~~)

In our national economies, we have built regulatory systems that limit the risks of leveraging, market abuses and fraud. Regulation by our Securities and Exchange Commission has helped us deal with huge increases and decreases in our equity markets. When large decreases come we are faced with enormous financial/liquidity needs -- like those affecting Asia, Russia and Latin America today. The effects eventually hit our financial institutions due to their overseas exposure. (~~S~~)

In the short run, we need more liquidity in the system and we have to be disciplined enough not to throw good money after bad. At the same time, we have to be sure that key countries like Brazil, Mexico and Thailand do not fail. In the long run, we have to deal with the entire range of international capital movements by developing an effective global regulatory system. Our finance ministers in the G-7 have been working with 15 or 16 developing countries along exactly these lines. There is no consensus yet on a mechanism to solve the problems. Without such a mechanism, my opinion is that today's international problems will only be repeated. (~~S~~)

Secretary Rubin: I agree. The problems are very complex, the worse we have seen in 50 years. Alan Greenspan told me recently that he has never seen anything quite like the situation we are facing. It is important that we engage right away; Germany and the United States should provide a lot of leadership. (~~S~~)

Sometimes we get the impression in our G-7, World Bank and IMF discussions that the continental Europeans are less concerned about the problems than are the United States and United Kingdom. A high level of German involvement and initiative will be critically important in resolving the problems we face. (~~S~~)

Looking at Asia and Latin America, Europe has been more restrictive in certain -- but not all -- respects in accepting exports from these countries. They are looking for help in order to come back, and that would be in all of our interests. We need to ensure also that we have up to date global financial architecture. A lot of that but not all has already been done. (~~S~~)

The President: Over the years I have had lots of ideas on training, on investment in the areas that haven't had it before on education. I was reminded of that when I visited Eisenach in eastern Germany not long ago. There is no doubt about the impact of the modern industrial investments that have come in there, but there are 20, 50 or 100 other places that haven't yet had that kind of investment. (U)

I realized at a certain point that none of the micro strategies will work in the absence of an overall macro economic strategy. In our case, I realized we needed to drive down the budget deficit, which would in turn bring interest rates down, create jobs and stimulate private sector-driven growth. That approach has worked. (U)

You face a similar dilemma. If you do what is necessary domestically, your banks may still be hit hard by the situation in Russia and the general financial crisis. Whatever our domestic improvement or international successes like Latin America, the weight of the huge international market will weigh down on us. Prosperity based on justice will be impeded by an international crisis regardless of how well we do with third way ideas. (~~C~~)

Frankly, I was somewhat taken aback at the World Bank/IMF meetings here in Washington last week when the German and French central bankers emphasized a desire not to overstate the problem because not all developing countries are hurting. This may be true of Poland and Hungary. Moreover, I recognize that Germany and France have moderate growth prospects for the year ahead. But, it's also true, and it wasn't mentioned by these same bankers, that France has 12 percent unemployment and Germany has a similar problem. It bothered me that we have only a 10 percent risk of inflation damaging our economies but a 90 percent risk of deflation, and yet they suggested there was compelling reason to change policies. (~~C~~)

I have worked at getting the right policy mix for over six years. Things are going very well in the United States, but all the new prosperity could disappear. We really need an international strategy. It will be important for us to work closely with Jospin, Blair, the Italians and others. We need a consensus about how to regulate the cycle of boom and bust internationally over the long-term -- just as we have been able to do nationally. (~~C~~)

You have decided to create the Euro and a monetary union and the idea is a good one. However, there must also be a solid international system, given the degree of interdependency that comes with huge daily capital flows. The prospect for speculation on currencies and commodities, for leveraging and hedging through funds, for volatile derivatives -- all of this has become a force of nature. (~~C~~)

It is clear that those of us who do have strong economies now have to be responsible and get more liquidity into the system. This will complement and accelerate efforts by our policy experts to put measures into place to avoid a growing crisis. I don't say this publicly, but we could have a very serious problem. The risk is not small. (~~S~~)

If I had one wish for you, for all of us, it would be for you to be able to develop excellent chemistry with the Japanese government. I have had six Japanese colleagues and not been able to find a way to move them to do what is in their nation's self interest. Japan must, for example, reform its banking system. Whatever we do to fix our own economies, we will have a large weight tied on our feet unless they are with us and they have resolved some of their fundamental problems. Now, I would never say any of this publicly, but you have to look at the facts. And once again, I thought that your central bankers were much too confident and fixated on inflation. Japanese banks are not the biggest problems perhaps, but they are one hell of a problem. (~~C~~)

Chancellor-elect Schroeder: I agree there is a real problem building up in Japanese society. The country is much more hostile to reform than others. At one time, the strong consensus that existed in Japanese society was a great advantage. Now it has become an economic and political liability because they just seem unable to change. (~~C~~)

The President: The sad thing is that they have all of the resources they need. They have saved 20 percent per capita over a period of more than 20 years. They have well over $1 trillion in their postal saving system. They could refinance their bank debt and have explosive growth if they played their cards right. (~~C~~)

China is another problem. We could do everything right and still not find the solutions due to them. (~~C~~)

In any case, your election has generated great hopes. Around the world there is a lot of interest in what you will do with your new leadership. Russia is a good example: Germany has a unique opportunity to be a partner with Russia. (~~C~~)

Chancellor-elect Schroeder: But who will be our partner in Russia? (~~C~~)

The President: It is a good question and I don't have a full answer. Because you are new you can have an appropriate relationship with the Yeltsin government and still reach out to the others. The Russians have a number of different policy courses they might adopt from here to come out okay. There are also a few things over which they have no real choice -- they need to have an honest banking system, as well as an honest and effective system of taxation. We've been trying to convince them that every country needs that. Unfortunately, the last tranche of IMF assistance from our two countries disappeared in 48 hours. (~~C~~)

Chancellor-elect Schroeder: I agree that Germany does have a special responsibility for Russia but I am also asking myself who our partner will be. It is certainly not going to be Yeltsin. How stable do you think the Primakov government is? (~~C~~)

Thomas Pickering: We expect to see stability for the next 6-8 months under Primakov. In a perverse sort of way, Primakov is there because he was the least bad alternative. The problem is that he has as little economic capability as anyone you could imagine. This is the four week anniversary of his Prime Ministership and there is still no economic plan. If he had a sensible one we could all have been helping to address their problems in a step-by-step way. (~~C~~)

We have seen predictions that by now there would have been 20 to 40 million Russians in the streets. In fact, there are fewer than one million. It is a resilient society. They are always fooling us. (~~S~~)

So who might replace Primakov? My view is that Lebed would have a very good chance. In fact, we probably face a choice between a not so smart general and a crooked mayor, Lushkov. The reformers think that they will be back in six to eight months. If so, there are any number of people riding white horses. The public is looking for anyone who can lead. (~~C~~)

The President: I think you have a possibility, since you are starting fresh, to have a correct relationship and to build bridges to people like Lebed and Lushkov. Russian space scientists have not been paid for 6 months. There are enormous needs and in this sense opportunities. (~~C~~)

Samuel Berger: We are not going to give up on this government, either. It has real opportunities. It has not been able to establish a new set of economic policies yet. The President said that you can not defy the economic laws of gravity. We have to realize in the coming months we will not be able to simply bail them out. We need some sort of center position that at least connects the Russian economy to the global economy. (~~C~~)

Leon Feurth: All of this discussion touches on key issues of economy uncertainty. But it is also essential that we make progress on issues like reducing their stocks of highly enriched uranium and plutonium, eliminating their chemical weapon stocks, getting ratification of the Start II Treaty, demilitarizing weapons -- especially nuclear weapons -- among other things. The price tags on these items are large. Even before the financial crisis, it was clear that Russia could not pay. The question is that if we want to get these things done, should we consider financing these kinds of changes? This is a key issue. Beyond that, there are health issues. For example, we are finding new strains of TB developing in Russia, strains that are highly resistant. Travel will spread these new strains. Intervention may become necessary to attack what could become a common health problem. (~~C~~)

Thomas Pickering: So far they have been moving within the framework of their constitutional system. This is something we should recognize. It is very important. (~~C~~)

Joschka Fischer: I want to repeat what Gerhard Schroeder said; we really don't know with whom and on what basis we can develop our relationship with the Russian government. We don't know if we will have to work with Primakov or a new government. There is much talk about the food shortages this winter and the need for imports. What do you think? What effects would you expect on the stability of the Russian government and on our relations if we intervene militarily in Kosovo? (~~C~~)

The President: On the question of food it is amazing and a matter of concern that they import close to 70 percent of their food despite their great agricultural capacity and potential. This is a symbol of their broader problem. The west should move as soon as possible to help meet these needs. What Leon said about the nuclear threats is also absolutely true. We should do whatever we can do to help. Similarly, in the area of public health. Now on your second question about Kosovo, this is a difficult question to evaluate. I have sought to persuade the French not to push a UN Security Council resolution that Russia would have to veto. That approach would put Russian weakness into high relief, and a veto by them would draw international opprobrium. Such an outcome would strengthen extreme and nationalist elements. (~~C~~)

Samuel Berger: In fact, the Russians went twice to Belgrade and got promises which were only respected in the most cosmetic ways. This has diminished their willingness to back Milosevic. He has disregarded Russian as well as western interests and this has tempered Moscow's reaction. (~~C~~)

The President: The Russians are neither stupid nor insensitive. They know that they have been lied to by Milosevic. But we also should not underestimate Russia's interests and its special view of things. Kosovo is not Bosnia. There have not been as many deaths. Moscow sees Kosovo against the backdrop of Chechnya as a kind of autonomous region looking for independence, with lots of Muslims that need to be brought to heel. A large percentage of Russian opinion sees and feels it that way, but we have reduced the risk of this situation breaking out. Let's return to the economics. (~~C~~)

Joschka Fischer: As you said, liquidity is at the root of the problem. How can we envision a solution for Russia? This is important to Germany. If Russia was left to us it would over burden our resources -- it's like what we call a "cat biting its tail," a vicious circle. Problems that they have could have disastrous impact on their ability to regain stability and to do reform. (~~C~~)

The President: We need to get through a viable IMF package and a reasonable World Bank social safety network. The funds will never stay inside Russian borders unless the government is successful in collecting taxes, in building a viable banking system and offering investment protections. Both of our countries need to make sure that we are clear with Russia: unless you adopt certain rules of the road, we will not be able to help you. (~~C~~)

Chancellor-elect Schroeder: I think we have to be frank here. It's possible the Primakov government can't even make use of an economic blueprint because they don't have a state. That is the real problem. That is why all economic progress has failed. Under the circumstances all that we can really foresee is to focus on project-oriented assistance. This is the only way to ensure that the assistance funds will not get eaten up or end up in numbered accounts in Cyprus, Switzerland and elsewhere. (~~C~~)

The President: I would like to raise a few other topics. We have devoted an awful lot of time in the past years to lessening tensions between the Greeks and the Turks over Cyprus and the Aegean. This is one of only a couple of foreign policy areas where I have made absolutely no progress in my six years. India-Pakistan is another one. You and I discussed this once before. I recognize the complexity of the issue for Germany, but we won't get a fix for Greek-Turkish-Cyrus and Aegean problems on their own terms. Solutions are more likely to flow from something that Europe or the U.S. does with Greece or that Turkey does with the EU. We have different factors in play to resolve some of the basic issues. If we can find a way to handle these problems right, including the problems of Islam to the east and the Balkans to the northwest, this could have a huge positive impact for the next 25 years. And Germany is uniquely poised to play a very positive role with Turkey. (~~C~~)

Joschka Fischer: This will not be simple. The third generation of Turks will integrate into German society. They have a positive perspective. We have to keep the EU door open for Turkey, but this is only in a very long-term perspective. The EU is now addressing enlargement to our east. This is a very different kind of project. On human rights, I am not very positive about Turkey. Moreover, the Greek-Turkish problem is very serious, so any European solution can only be considered in a long-term perspective. (~~C~~)

Chancellor-elect Schroeder: Well, I need 40 percent of the voters. He only needs 6 percent. (~~C~~)

Joschka Fischer: Next time, that will be 8 percent. (~~C~~)

The President: I know that this is a big problem. I've been thinking about it and working on it for 6 years. And without really finding a solution. It is a big problem that will shape the dangers and opportunities over the next 30-40 years. (~~C~~)

Joschka Fischer: The Kurds, Turkey's domestic situation, and its problems with human rights all create real problems for us. (~~C~~)

The President: We understand that. But if Germany were to make a gesture to clarify that there is no risk of European Union bias against letting a Muslim country be part of Europe in the long-run, this would remove Turkey's excuse for not dealing with its own problems. Over a period of years it might reduce the dysfunctions of their living under a one party government and they wouldn't have their easy comebacks in dealing with Europe. (~~C~~)

Chancellor-elect Schroeder: I want to remind you of what I said last time we met: the European Union is not a religious society but a values society, so Turkey must address its domestic problems. We understand what you are interested in but it is also true that it didn't help when the United States declared that Turkey should be an EU member. I don't share Helmut Kohl's view of the religious issues involved in Turkey and the European Union but we do have to be careful. (~~C~~)

The President: We will have to try to meet again soon in the future. There are a number of other things I would like to talk to you about. We have a big NATO Summit coming up next year. I wish we could discuss the global environment. This is one of the great intellectual challenges of our age, to convert people from the idea that there is no longer an iron bond between economic growth and energy use. This is a big problem around the world. (~~C~~)

There are important things that we can and should do together and we will need more time soon to talk about this agenda. (~~C~~)

Chancellor-elect Schroeder: Mr. President, thank you very much. (~~C~~)

-- End of Conversation --