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PRIME MINISTER

You asked me how the French had kept up the value of their currency within the exchange rate mechanism.

The answer in one very important sense is that they haven't. The franc has depreciated against the D.mark by 45 per cent over the past ten years in a whole series of re-alignments. I attach a table which shows this. Depreciation has closely followed the rise of French relative to German unit labour costs, offsetting the loss of competitiveness in bilateral trade.

Italian adjustment has been similar. Over the period the lire has fallen against the mark by 60 per cent. Depreciation has again closely followed the rise of Italian relative to German unit labour costs pointing to similarly smooth adjustment within the mechanism.

Our position has been different in two main respects. First, our unit labour costs have moved in step with Germany's since 1981. Second, sterling appreciated sharply in the beginning of the period because of North Sea oil and 1979. No doubt our policies played a part. Recently in 1987 our unit labour costs performed better than Germany's, and the pound later rose against the mark: in 1988 the trend was reversed and the pound subsequently fell back this year. Graphs showing movements between 1979 and 1988 for the French, the Italians, and ourselves are also attached.

Despite adjustment, both France and Italy have run substantial trade imbalances with Germany. The main reason seems to have been French and Italian industries seeking to modernise with German equipment. I suspect such private investment has helped competitiveness, especially of late when the French unit labour cost position has even improved relative to Germany. It must also have made more of French industry independent of Paris.

Over the period French interest rates have run pretty steadily around 3 to 4 points higher than Germany's. In this respect Mitterand has followed similar policies as Chirac, no doubt with the mechanism in mind. To this extent there has been a policy of holding up the franc by monetary means.

The result of lifting the bulk of French exchange controls was a net inflow into France as foreigners adjusted their portfolios to take advantage of the new freedom to move out as well as in. A similar effect has been observed in Italy. It happened here in 1979. The resulting impact on exchange rates does not, however, appear to have been all that great.

All this said, there is no doubt that the French have mechanisms whereby they can and do influence trade and payments. I have to say, however, that I do not think that their effect on the franc has been all that significant. We know for instance that the French have been prepared to spend heavily to win overseas capital export business and to support parts of their industry. The impact on their overall trade performance of subsidies of this kind is much more difficult to judge. Given the burden of financing the subsidies elsewhere in France, I suspect that over the years they have not helped. Nevertheless these heavy French subsidies not only distort competition, but they must influence their trade figures from time to time.

Second, French banking is still dominated by three large institutions, two of them still in state hands. They clearly retain the capacity to influence individual transactions across the exchanges. We know, for instance, of a £150m financial investment in a company operating here and in Eire dti

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that was stopped from Paris in August. However, the reason is not known: it could have been to restrict the exit of foreign currency, but it is thought that it was probably commercial.

The figure is hardly significant compared with monthly flows across the French exchanges - but it is a device which could be used on occasion to help the franc.

It may not be irrelevant that the French have reserve requirement rules which they use in conjunction with interest rates in monetary policy. This is a matter of choice. For instance, following the recent Bundesbank 1 per cent increase in short term rates, the French increased rates by 3/4 percent and tightened reserve requirements producing a similar overall affect.

The French retain a particular attachment to nationalized industries and industrial subsidies for distorting trade. All these are used to get round the coming Single Market. One of our objectives for the future must be to have a campaign to get these devices "liberalised" in due course.

The conclusions must be

1) that the ERM has not produced exchange rate stability over the 10 year period.

2) that the much greater stability which has taken place over recent years is due to improved performance by France and Italy in controlling their unit labour costs relative to Germany's - and through operating a successful monetary policy.

3) that although the French retain significant "devices" for affecting their exchange rate, they are not being widely used at present. It is

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unlikely that their removal will result in any great pressure on the franc.

4) the apparent recent "success" of the ERM is due to the recent success of France and Italy in pursuing policies designed to keep their unit labour costs close to those of Germany.

While much remains to be done in the interest of the Single Market in both countries, it may well be that when final elements in their exchange controls are removed next year there will not be a significant impact on their exchange rates.

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N R
6 November 1989

DEPARTMENT OF TRADE AND INDUSTRY

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## FRANCE AND WEST GERMANY

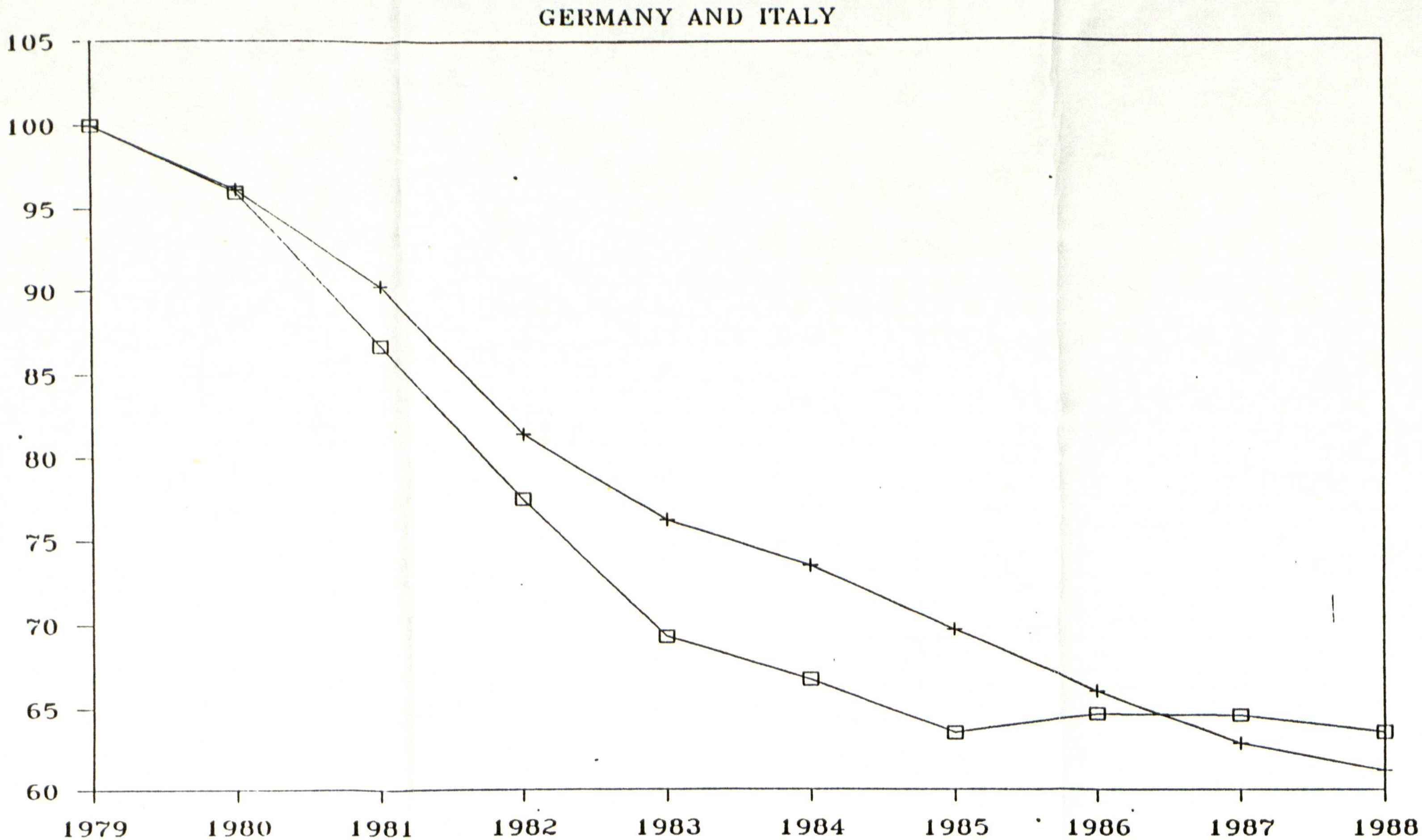
## UNIT LABOUR COSTS AND EXCHANGE RATES

| | Unit Labour Costs in domestic currencies (annual % change) Fr | WG | Difference | Exchange Rate (DM/10 FFr)[1] | Percentage Change in Exchange Rate |
|---|---|---|---|---|---|
| 1979 | 8.3 | 2.7 | + 5.6 | 4.31 | - 3.4 |
| 1980 | 14.3 | 7.8 | + 6.5 | 4.31 | 0 |
| 1981 | 12.5 | 4.8 | + 7.7 | 4.17 | - 3.2 |
| 1982 | 12.1 | 3.4 | + 8.7 | 3.69 | - 11.5 |
| 1983 | 6.3 | - 0.7 | + 7.0 | 3.35 | - 9.2 |
| 1984 | 7.2 | 1.1 | + 6.1 | 3.26 | - 2.7 |
| 1985 | 6.2 | 1.9 | + 4.3 | 3.27 | + 0.3 |
| 1986 | 1.9 | 4.3 | - 2.4 | 3.13 | - 4.3 |
| 1987 | 0 | 2.5 | - 2.5 | 2.99 | - 4.5 |
| 1988 | - 3.0 | - 0.4 | - 2.6 | 2.94 | - 1.7 |
| 1989Q1 | [2] +0.3 | + 0.6 | - 0.3 | 2.95 | 0 |

1 A fall in the exchange rate indicates a depreciation of the franc against the mark. Over the period 1979-1988 the DM has appreciated against the franc by 45%.

2 Percentage change on year earlier

# RELATIVE ULC INDEX & XCH RATES




□ GER/IT REL ULC IND

(a fall indicates a decline in Italian competitiveness)

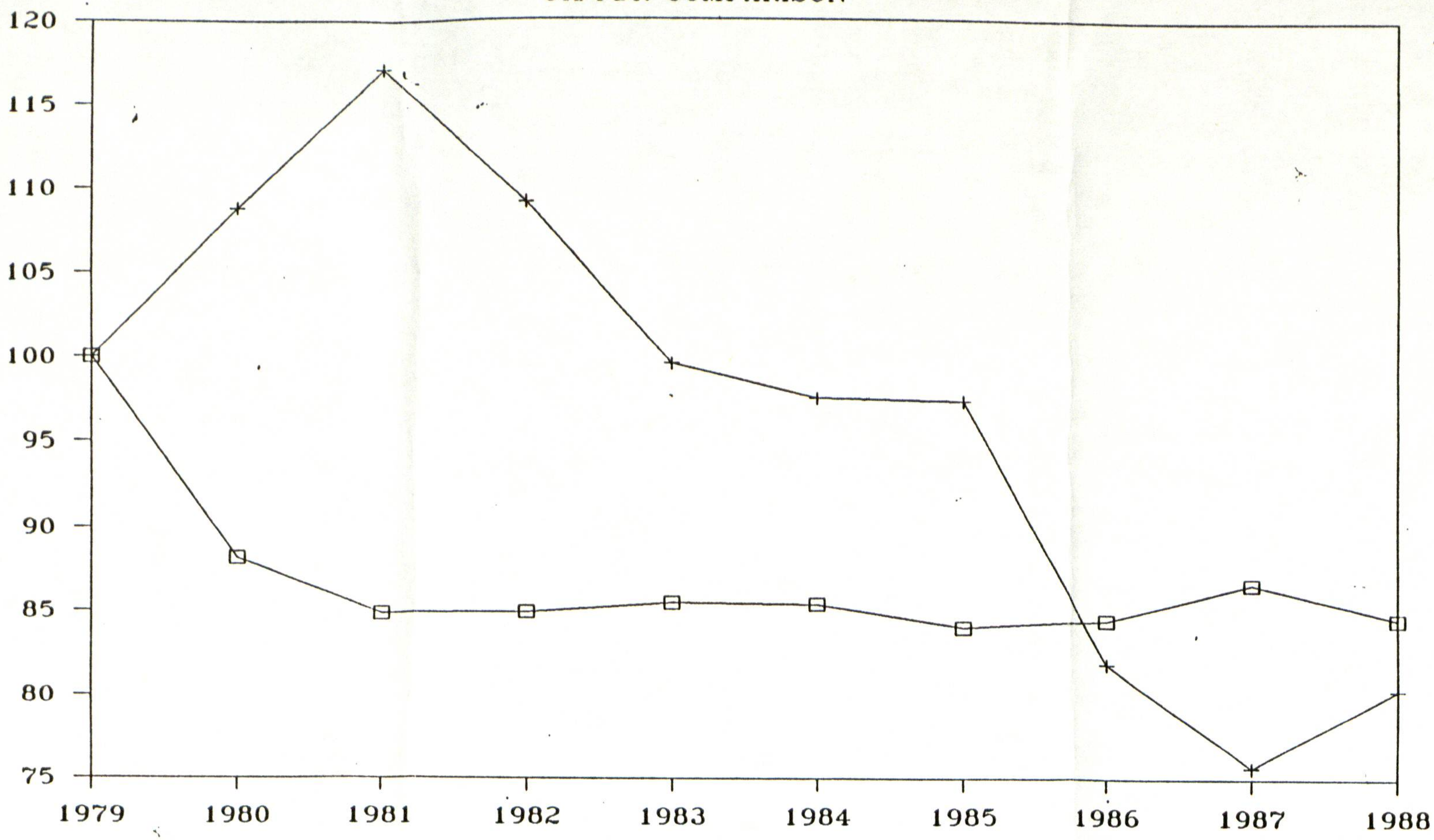
\+ DM/IL INDEX

(a fall indicates a depreciation of the lira against the mark)

The graph shows that the lira has depreciated roughly in line with the relative movements in unit labour costs in Italy and Germany over the period.

# REL ULC & EXCH RATES

## UK/FDR COMPARISON



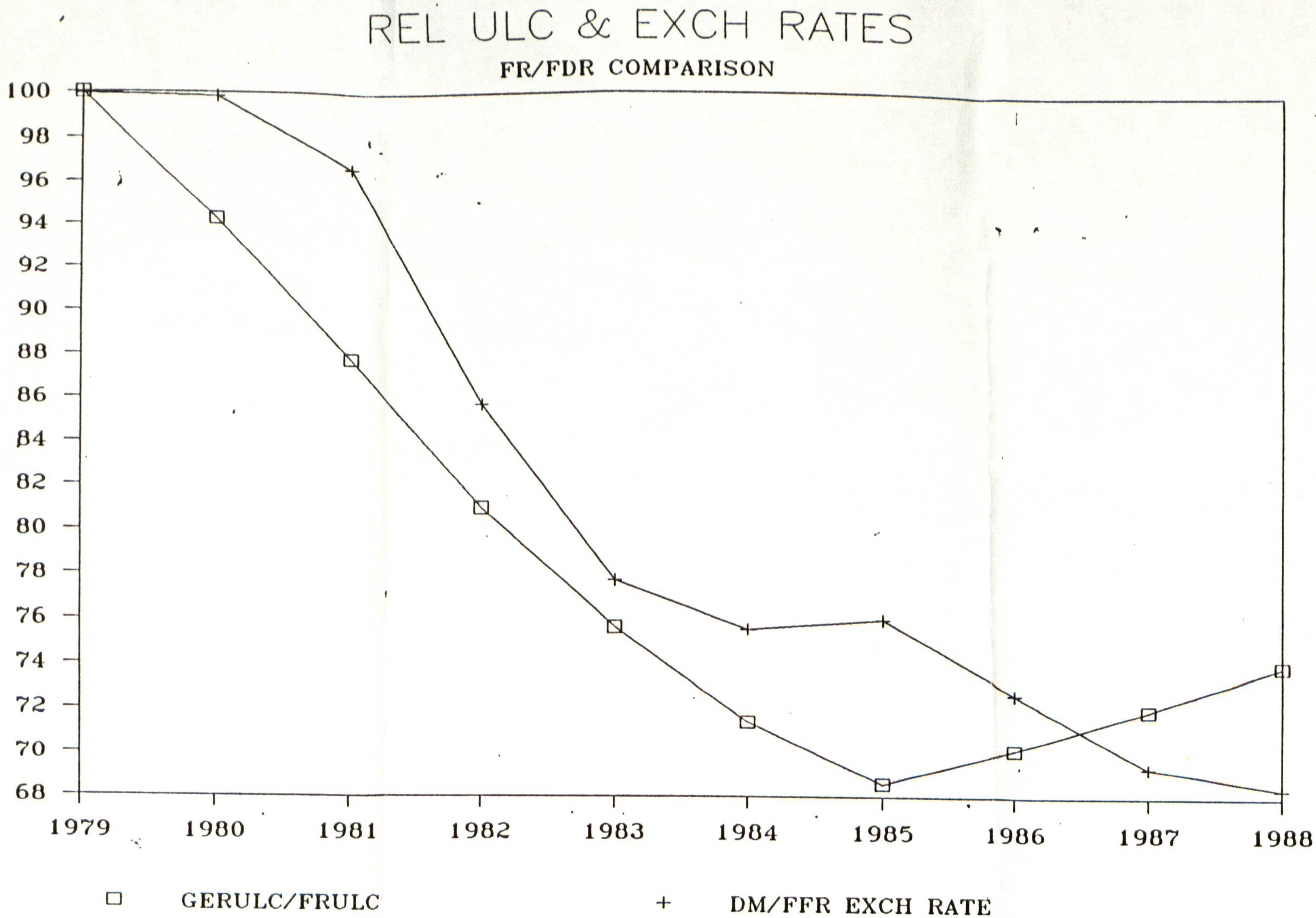

□ GERULC/UKULC

(a fall indicates a decline in UK competitiveness)

\+ DM/£ EXCH RATE

(a fall indicates a depreciation of sterling against the mark)

Movements in the sterling - DM exchange rate have been only loosely related to movements in relative unit labour costs.

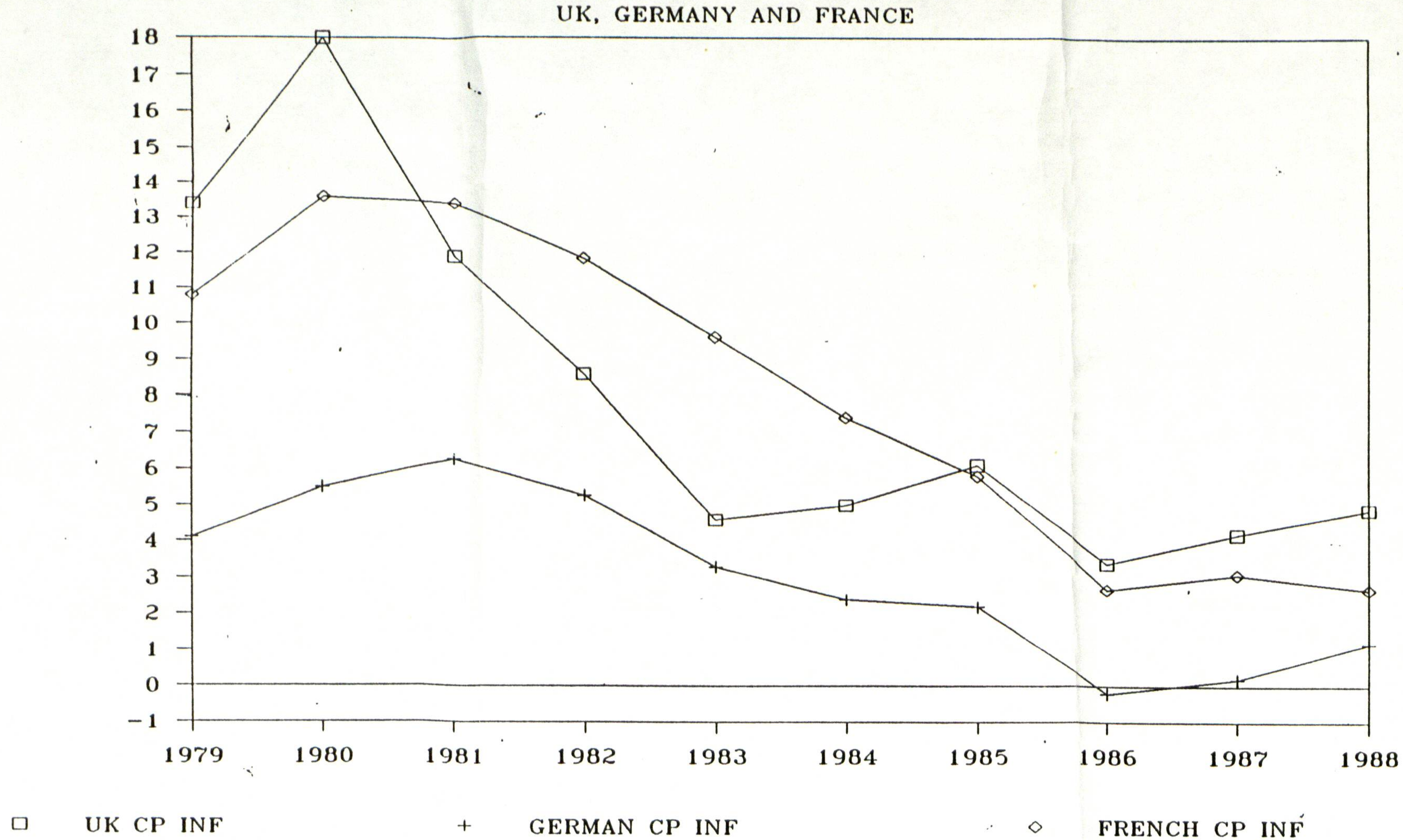



(a fall indicates a decline in French competitiveness)

(a fall indicates a depreciation of the franc against the mark)

The graph shows that the franc has depreciated broadly in line with the relative movements in unit labour costs in France and Germany over the period.

# CONSUMER PRICE INFLATION




Inflation has fallen over the period and the differential between France and Germany has diminished.

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