

CONFIDENTIAL
FM PARIS
TO DESKBY 201100Z FCO
TELNO 1568
OF 200942Z DECEMBER 90
AND TO PRIORITY BONN, UKREP BRUSSELS
AND TO SAVING OTHER EC POSTS

THE FRANC IN THE EXCHANGE RATE MECHANISM (ERM)

SUMMARY

1. THE FRENCH FRANC CLOSE TO RECORD LOW AGAINST THE DM AND APPROACHING BOTTOM OF ITS ERM BAND. ONLY FRENCH REACTION SO FAR IS TO BLAME GERMAN AND AMERICAN POLICIES AND TO HOPE STORM WILL BLOW ITSELF OUT. BUT UNPALATABLE INTEREST RATE INCREASE MAY BE INEVITABLE, POSSIBLY TODAY. GROWING PUBLIC ANNOYANCE WITH GERMANY.

DETAIL

2. AT PARIS FIXING LAST NIGHT THE FRENCH FRANC STOOD AT 3.4157 TO THE DM, CLOSE TO ITS LOWEST EVER LEVEL. IN TWO MONTHS IT HAS DECLINED OVER 2 PERCENT AGAINST THE DM, AND WITH FEW SIGNS THAT THE SLIDE IS SLOWING DOWN, IT IS RAPIDLY APPROACHING THE BOTTOM OF ITS ERM BAND.

3. FRENCH RESPONSE TO THE UNPRECEDENTEDLY STEEP FALL OF A CURRENCY WHICH ONLY YESTERDAY BEREGOVY REPEATED WOULD REMAIN "FIXED TO THE DM" HAS BEEN TO BLAME GERMAN AND US INTEREST RATE POLICY. THEY ALSO CLAIM THAT WIDE MOVEMENTS OFTEN TAKE PLACE IN THIN YEAR-END TRADING. THEY ARGUE THAT THE DM IS TEMPORARILY BECOMING A "FALSE STRONG" CURRENCY AND THAT IT IS THIS, RATHER THAN ANY INTRINSIC WEAKNESS OF THE FRANC, WHICH IS CAUSING STRAINS WITHIN THE ERM. CONSEQUENTLY THE BANK OF FRANCE HAS SO FAR TAKEN LITTLE ACTION EITHER THROUGH INTERVENTION ON THE EXCHANGES OR THROUGH AN INTEREST RATE INCREASE. THEY MAINTAIN THAT THE PROBLEM SHOULD BE SOLVED BY GERMAN BUDGETARY RESTRAINT RATHER THAN THE BUNDESBANK'S MONETARY RESPONSE TO THE DEFICIT. BEREGOVY SAID YESTERDAY THAT THE GERMANS SHOULD IMPLEMENT THE ACTIONS THEY HAD BEEN URGING ON OTHERS FOR SO LONG. US INTEREST RATE POLICIES ARE ALSO BLAMED FOR THE CURRENT DIFFICULTIES.

4. THIS POLICY OF BATTENING DOWN THE HATCHES IN THE HOPE THAT THE STORM WILL PASS WAS REAFFIRMED AS RECENTLY AS MONDAY AT THE MONETARY COMMITTEE. AND THE FRENCH CLEARLY HOPE THAT STRAINS

ELSEWHERE IN THE SYSTEM (INCLUDING ON STERLING) WILL CAUSE MEMBERS TO PUT COLLECTIVE PRESSURE ON THE GERMANS. BUT IN PRACTICE THEY WILL ALMOST CERTAINLY BE OBLIGED TO TAKE DIRECT MEASURES TO KEEP THE FRANC WITHIN ITS BAND. THE MOST LIKELY IS A REVERSAL OF THE 30 OCTOBER BASE RATE REDUCTION OF 0.25 PERCENT (WHICH, COMBINED WITH THE ALMOST SIMULTANEOUS GERMAN INCREASE, OVER-NARROWED THE FRANCO-GERMAN INTEREST RATE DIFFERENTIAL AND TRIGGERED THE FRANC'S DECLINE). A LOWER-PROFILE ALTERNATIVE WOULD BE TO PUSH UP RATES THROUGH RESTRAINING LIQUIDITY. ANY SUCH ACTION WOULD BE HIGHLY UNWELCOME SO SOON AFTER PUBLICATION OF A GLOOMY FORECAST FOR ECONOMIC GROWTH NEXT YEAR: BUT THE AUTHORITIES HAVE ALREADY LEFT THIS TOUCH ON THE TILLER DANGEROUSLY LATE, AND IF THEY FAIL TO ACT SOON (POSSIBLY TODAY), THEY MAY HAVE TO MAKE A LARGER COURSE CORRECTION SHORTLY AFTERWARDS.

5. ANOTHER OPTION, WHICH IS NOT MUTUALLY EXCLUSIVE, IS JOINT INTERVENTION BY THE BANK OF FRANCE AND THE BUNDESBANK.

COMMENT

6. FRENCH RESENTMENT AT HAVING THEIR OWN MONETARY POLICY BLOWN OFF COURSE BY WHAT THEY SEE AS GERMAN NATIONAL ACTIONS IS PALPABLE (THERE IS OF COURSE A SEPARATE US DOLLAR CONCERN). THEY ARE LOOKING FOR SUPPORT TO THE UK AND OTHERS MOST AFFECTED BY THE DM'S RISE WITHIN THE ERM. IN SPITE OF BRAVE TALK ABOUT THE INDISSOLUBLE LINKAGE BETWEEN THE DM AND FRANC, ONE OR TWO VOICES OUTSIDE GOVERNMENT ARE BEGINNING TO ASK IF A REALIGNMENT OF THE FORMER WITHOUT THE LATTER CAN OR SHOULD BE EXCLUDED.

7. IN ALL EVENTS, THE CURRENT SITUATION WILL ONLY STRENGTHEN THE GROWING STRAIN THAT IS CREEPING INTO FRANCO-GERMAN RELATIONS.

8. FCO PLEASE PASS IMMEDIATELY TO WICKS (HMT) AND CROCKETT (BANK OF ENGLAND).

FERGUSON

FCO PASS SAVING TO OTHER EC POSTS

YYYY