

7 September 1982

Memorandum for: Deputy Director of
Central Intelligence

VIA : Deputy Director for Intelligence *J*

SUBJECT: Response to Questions on French
Economy

John:

The attached is in response to McFarlane's
1 September question concerning whither France.
We promised to attempt delivery
to you by c.o.b. today.



DDI-7118-821

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Director,
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E U R A

Office of European Analysis

Attachment: As stated

D/EURA: jes/7Sep82

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Implications of Mitterrand's Economic Policies

Francois Mitterrand took office in May 1981 committed to halting a rapid rise in unemployment and reviving the recession-ridden economy. His gamble that France could buck international economic trends failed, however, and the government has been obliged to undertake an economic retrenchment that is both severe and politically risky.

The austerity program launched this June brings French economic policy more into line with the OECD mainstream: stricter limits on public sector deficits, closer attention to monetary growth targets, a bold attempt to end wage indexation, and some shifting of income to the corporate sector. If the government's new resolve does not falter because of union wage demands or electoral considerations, we believe the French economy has the capacity to bounce back.

The question remains, however, how the longer-term structural changes implemented by the Socialists, such as the nationalization program and increased worker participation in company management, will affect the economy's performance in the competitive international environment. The effects of these changes are likely to be felt long after Mitterrand's -- and perhaps the Socialists' -- term ends in 1988. The push toward state control of the economic machinery and the increasing bureaucratization of economic decisionmaking may have set in motion a process of secular deterioration.

On the other hand, the program could turn out to be less damaging than might be assumed. Important aspects of Mitterrand's program resemble or extend actions taken over the past several decades by conservative

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governments. They also are consistent with patterns of French political and economic behavior.

The Short-Run: Sticking With the System

The Socialists' initial strategy was conventional: stimulate consumption by increasing transfer payments and creating public sector jobs if necessary. To finance this program while maintaining other priorities, such as defense, they opted for more government borrowing and a package of tax increases directed at the wealthy and higher-income wage earners.

The increased domestic demand generated by the recovery program predictably resulted in an increased trade deficit. This deterioration of the French trade balance -- in combination with stagnating receipts in the normally-surplus services account, large capital outflows prompted by nervousness over Socialist intentions, and pessimistic financial market appraisals of the future -- led to two devaluations of the franc. The devaluation of October 1981 was accompanied by half-hearted measures intended as much to bolster financial market confidence as to begin fighting inflation in earnest. Although responsibility for this first devaluation could be shared with the Giscard government, the second devaluation in June 1982 demonstrated how badly the Mitterrand government had miscalculated in trying to push ahead with its stimulus program. A world-wide recovery, which would have spurred French exports, lagged; for a variety of reasons, including a generalized lack of confidence and increased business costs deriving from government measures to promote hiring, private investors showed no inclination to step up capital spending.

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By June, when the need for remedies could no longer be avoided, the Socialists rejected the opportunity to carry through with a total "break with the system." Such a break probably would have meant giving up on fighting inflation, resorting to outright protectionism and, in the process, condemning France to a declining standard of living and lesser influence internationally. Their acceptance, instead, of external constraints argues strongly that they take seriously their commitment to keep France in the European Community, participate in an open world trading system, and maintain a mixed economy.

Even if the current policy orientation is maintained, the price paid for the Socialists' expansionary policies will be the loss of nearly two years in the fight to reduce inflation to the level of France's principal trading partners. This task has been complicated by the franc's depreciation against the dollar and EMS currencies since Mitterrand's victory and by some increased difficulty in obtaining foreign loans and investment to balance the current account.

These are not, however, irremediable problems. If the government maintains its present course, the economy can probably be restored in a couple of years to its pre-1981 condition. In effect, the experience of the first years of the Giscard presidency would recur. Prime Minister Jacques Chirac's 1975 stimulative program, similar in magnitude to that of Mitterrand and Mauroy, led to essentially the same results after about 18 months. It fell to Chirac's successor, Raymond Barre, to institute an austerity program to bring the budget and current account deficits back into line and to restore the franc.

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The Long-Run: Has the Balance Finally Been Tipped?

Socialist economic doctrine holds that the state should use its power to direct resources toward "broader" goals than mere profit. The nationalization program is thus more than a bow to Marxist principle. It is also an attempt to give the state control over a part of French industry large enough to serve as the "locomotive" for the rest of the economy. Most of the banks remaining in private hands were included in the program so that the government could more freely allocate credit toward priority activities and sectors. The government intends to define these areas through a planning process reminiscent of the successful multi-year plans of the post-war years.

In the French context, much of Mitterrand's program is not especially new. The wave of nationalizations in 1981 was the third in this century. Government involvement in the economy -- referred to as "dirigisme" -- has been building up steam since the Bourbons. French governments since the war have used their extensive control of the economy to promote high technology or prestige ventures, such as the Concorde, the nuclear energy program, and various schemes to develop an indigenous, top-of-the-line electronics industry. Some of these have been successful, some have not. The Mitterrand government intends nonetheless to try again by picking international "winners" of its own.

On the labor front, changes in labor relations tend to be spasmodic -- an upheaval of sorts followed by a protracted period when everybody gets back to work. Under the present government, higher labor productivity and better labor-management relations are to be promoted by means of legislation increasing worker participation in decisionmaking.

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At this point, France remains an open economy. Accession to the European Community in 1959 lowered some of the barriers that once made the French economy something of a closed system flourishing at the expense of competition. Thus, there is a danger that the Socialist program could lead history to repeat itself. The increases in state control and worker participation could produce a bureaucratized, inflexible economy that is both inefficient and cumbersome. The effect would be a slow process of deterioration likely to leave France less and less able to compete internationally. It is too early, however, to draw conclusions concerning the possibilities for such a process getting under way -- and once under way for stopping it.

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