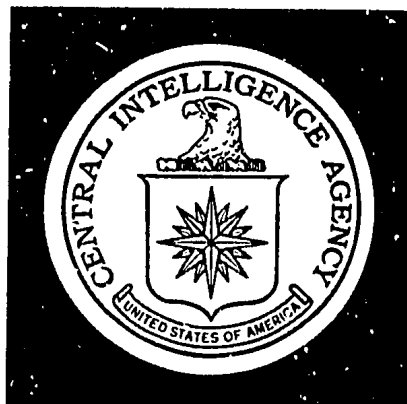


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Economic Effects of the French Crisis:

A Preliminary View

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
7 June 1968

INTELLIGENCE MEMORANDUM

Economic Effects of the French Crisis:
A Preliminary View

Summary

The general strike will probably result in a substantial weakening of France's balance of payments. This in turn will reduce the ability of the French government to pursue independent policies and may force France to adopt more conciliatory attitudes toward international economic and monetary problems.

The strike has cost France about \$2½ billion, at least 2 percent of its annual Gross National Product (GNP). A considerable part of this loss may be made up during the remainder of the year because wage settlements and other concessions to labor will increase incomes and thereby stimulate the growth of production. But the increase in incomes will also create inflationary pressures and strongly increase the demand for imports. Although exports should continue to do well this year, the foreign trade balance will worsen and there will be a substantial loss of earnings from tourism. A small balance-of-payments deficit had been expected in 1968; now the deficit may rise to at least \$700 million and could be considerably larger if there is a substantial outflow of capital. To cover such deficits, France has already drawn

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on the International Monetary Fund and may have to reduce its very large gold reserves, which amount to more than \$5 billion.

Whatever the result of the forthcoming election, the French government is likely to be less able to control inflation. Should a left-wing government come to power, there is the additional danger of a large capital flight.

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Economic Developments During the Crisis

1. The general strike that has paralyzed France for the past three weeks is apparently petering out. At its peak, it involved about 10 million workers (both strikers and others prevented from working), or about two-thirds of the labor force. The strike started with sporadic walkouts on 14 May, grew to general strike proportions the following Monday, reached its highest level from 27 May through 1 June, and began declining on Tuesday, 4 June. By the weekend of 8 June the full-time equivalent of nine working days of the entire French labor force will have been lost because of the strike. Most manufacturing plants were shut down, some because of lack of materials rather than walkouts or seizures by labor. Almost all banks were closed and public services, such as transportation, mail, and most telephone exchanges, were shut down completely. Most water, gas, and electric utilities were kept in operation, although their unions were actually on strike. Hotels, restaurants, and tourist facilities continued functioning, but tourists were rare. Newspapers continued to publish. By Sunday, 9 June, the total loss of output during the crisis will have been 2½ billion dollars -- roughly 2 percent of the estimated GNP for 1968.

2. The crisis had a severe impact on foreign exchange markets. Heavy speculation led to a rapid flight from the franc into other currencies, and on 30 May the government imposed strict exchange controls. On 4 June a French drawing on the International Monetary Fund (IMF) of \$745 million was announced. This drawing will be used principally to meet the immediate effects of the unrest on the French reserve position. The French have announced that they lost some \$307 million from official reserves as a result of the weakness of the franc during the crisis. This estimate probably covers only expenditures to support the franc's exchange value -- support undertaken on behalf of France by other central banks, including the Federal Reserve Bank of New York and the Bank for International Settlements in Basle, Switzerland. It probably does not include such short-term capital flight

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as occurred during the crisis or the value of export receipts not repatriated before imposition of exchange controls by the French authorities. Together, crisis-related losses of funds may approximate the value of the IMF drawing, or some \$700 million.

3. Apart from the union leaders' stated goals of bringing down the present government, most of the main strike issues center on the question of wages. The final settlements probably will not greatly exceed the original offers made by the government. Most of the wage increases will probably range between 10 and 15 percent, including those granted since the beginning of the year. For the year as a whole, the average growth of wages is likely to be 9 to 10 percent, compared with 6 percent expected before the strike.

4. The government's offer to raise minimum wages by 35 percent would affect only about 2½ percent of the labor force, mostly agricultural and service workers. The effect on costs and income, therefore, will be small. The nature of any future link between wages and the cost of living index is still unknown, but such a link probably would have little or no effect on wages this year. Similarly, the proposed shortening of the standard workweek from an average of about 47 hours to an average of about 40 hours with no reduction in wages would come into effect over the next three years; thus the short-term effect will be slight. Tax reforms have been called for by the workers, but so far no definite demands seem to have been formulated. Part of the one billion or more dollars in wages not paid during the strike will probably be disbursed after the settlement or made up in the form of guaranteed overtime.

5. Other strike issues appear to be more political than economic in nature. The workers' resentment over cutbacks in social security medical coverage and increases in worker contributions probably stems as much from the government's high-handedness in last year's reform of

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the entire system as from diminutions of actual benefits. A return to higher medical benefits will cost little (probably less than \$15 million this year). The government most likely will have to postpone the reforms without actually having to give them up. Token increases also can be expected in family allotments and old-age pensions. Recognition of full union rights to organize and presumably to bargain collectively has already been offered by both the government and private employers, and the offer has been acknowledged by the unions. The demand for a greater union voice in management, however, is not likely to be pressed, because French workers have been traditionally more interested in more tangible gains such as increases in wages.

Short-Term Economic Effects of the Crisis

6. The settlement package will have two main effects: (1) it will pump more purchasing power into the economy, and (2) it will increase production costs. Both effects will be inflationary and will have serious repercussions on the balance of payments. The full extent of the inflation will depend on many variables. Perhaps the most important is the extent to which the economy can increase its output in response to increased demand. Before the strike, the French economy had been recovering from the 1966-67 slowdown, but there still was considerable unused capacity and unemployment was high for France (about 2½ percent of the labor force). Excess capacity and unemployment were mainly the result of unusually large investment during 1965-67 in new plant and equipment, much of which was of the labor-saving variety.

7. The strike settlement will increase purchasing power for the rest of 1968 by at least \$3 billion, or about 2.5 percent of GNP at an average annual rate. This rise in purchasing power will stimulate the growth of production (especially of consumer goods). Growth of real GNP in terms of an annual rate could rise from the 5 percent reached just before the crisis to around 7 percent during the second half of the year. Such an acceleration of growth would offset about half of

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the output lost during the crisis and, for 1968 as a whole, the growth of GNP would be about 4 percent, compared with about 5 percent expected before the strike. Higher output, however, will not absorb all of the increase in purchasing power, part of which will force up prices, while part will be used to buy more imports.

8. Increased wage costs also will create an upward pressure on prices. In the second half of the year, wage costs probably will be some 4 to 5 percent higher than they would otherwise have been. Inasmuch as labor productivity is unlikely to increase more than it would have in the absence of the strike, much of the gain in output during the second half of the year will come about through an increase in employment or in overtime work. For the most part, French businesses can be expected to pass on cost increases in the form of higher prices because profit margins in most industries have been quite small. Price controls could be imposed, but there is actually little leeway where profit margins are low.

9. Overall, retail prices could increase at an annual rate of 8 to 10 percent in the second half of 1968, compared with about 3 percent before the strike. As usual, wholesale prices will rise more slowly than retail prices. The higher retail prices will cut sharply into the workers' newly acquired gains, but real incomes will be boosted by more rapid growth in output and imports.

Effects on the Balance of Payments

10. Rapid economic expansion and inflation will have severe effects on the French balance of payments. Even before the general strike, a balance-of-payments deficit of about \$200 million to \$300 million seemed likely for 1968. The present crisis may increase this deficit to about \$700 million and quite possibly much more if there is a large capital drain.

11. The trade balance will suffer for several reasons. Greater price increases in France than

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abroad will tend to stimulate imports and restrict the growth of French exports. The main effect in the short run will be on imports -- especially consumer goods, which are highly sensitive to a rise in domestic prices relative to foreign prices. Even apart from price changes, imports will tend to rise at an increasing rate as the economy approaches full capacity output.

12. Despite some cancellations of orders resulting directly from the strike, French exports are unlikely to be greatly affected in 1968. The larger, more efficient firms that probably account for most of the exports are in a relatively good position to absorb cost increases. Demand for French exports elsewhere in Western Europe grew rapidly during the first quarter of this year and is likely to remain strong through 1968. Nevertheless, the increase in domestic demand may cut into the quantities available for export.

13. The elimination of the remaining intra-EEC tariffs and the imposition of the Common External Tariff on 1 July will further stimulate imports. These changes will permit an increase in prices received by French exporters and thus will at least compensate for the effect of rising costs on their profit margins. The French have announced that they will go along with the tariff adjustments as scheduled.

14. Tourist receipts will be especially hard hit because revenue lost now cannot be made up later in the season. Because of the crisis, the higher prices in France relative to other European countries, and the unwillingness of many American tourists to travel in France, the loss in receipts from tourism could reach \$100 million in 1968.

15. Capital movements may have the most important effect on the 1968 balance of payments. For several years, the inflow of long-term capital had been leveling off while the outflow was increasing. The surplus on private capital transactions this year would have been smaller than in any of the past three years even without the general strike. Now the balance on these transactions may become

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negative, which could increase the balance-of-payments deficit to \$1 billion or more. Outflows of short-term capital will remain a danger, particularly if a left-wing government is elected. Exchange controls will probably be maintained as long as the danger exists. These controls can greatly limit, although not completely prevent, capital flight.

16. France has huge reserves with which to combat this weakening balance-of-payments situation. Before the crisis began, these reserves amounted to about \$6 billion in gold and foreign exchange, \$5.2 billion of which were in gold. The 4 June drawing of \$745 million from the IMF replenished the foreign exchange reserves and thus avoided, at least temporarily, the necessity of selling gold. France can borrow at least \$1.1 billion more from the IMF -- \$138 million of which can be drawn unconditionally. But the Bank of France would probably have to use some of its gold reserves before it could obtain conditional loans from the IMF. Because French reserves and borrowing capacity are so large, France could run balance-of-payments deficits for a long time without being forced to devalue the franc.

Outlook for the Longer Term

17. Whatever the results of the coming elections for the National Assembly, the government probably will be less able than in the past to resist inflationary wage demands and price increases. Furthermore, in order to cope with such problems, investment and possibly military programs may have to be cut. France's external payments position also would suffer.

18. Since its coming to power in 1958, the de Gaulle government has established an excellent record of economic growth and stability, but this was not achieved without political and social costs. De Gaulle's aloofness and authoritarian methods have polarized and united the left to a degree it could not have achieved by itself. As a result, a less-than-decisive victory in this

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month's parliamentary elections would force the regime to pay much greater attention to the views of the opposition parties and of other pressure groups.

International Implications

19. Inflationary developments in France will tend to stimulate small increases in both output and prices in other countries, especially those with which France trades most heavily -- the EEC countries, the United Kingdom, and Sweden. A faster growth of French imports will directly increase incomes and purchasing power in these countries, although the impact will be small. Indirectly, the French crisis could lead to demands in other countries for higher wages, shorter hours, and greater use of overtime.

20. Perhaps more importantly, French foreign economic policy will no longer have its former strength and independence. Some benefits could accrue to both the United States and the EEC because France probably will be forced to adopt more conciliatory attitudes on international monetary reform and various internal EEC problems. Whether or not France sells some of its gold or borrows abroad to finance its balance-of-payments deficit, one source of pressure on the dollar will be removed. This in itself, however, will do little to resolve the weakness in the US balance-of-payments position or the weakness of Sterling. The basic French commitment to European economic cooperation will not change, and France may even feel compelled to become a more cooperative Common Market partner.

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