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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

20 March 1987

Charles Powell Esq
10 Downing Street
LONDON SW1

Please bring forward
to 25 March
CDP

Dear Charles,

flap

M. BALLADUR

You wrote to Alex Allan on 15 January asking for briefing for the Prime Minister's meeting with M. Balladur on 26 March.

As you probably know, M. Balladur will be participating in a symposium on that day, organised by the Economist, on the liberalisation of the French financial system. The Prime Minister might like to invite him to say something about the symposium themes - he will have just been speaking about financial deregulation - or his proposals for the French economy more generally.

Time will be fairly short but we think it would be very useful if the Prime Minister could herself then say something about our community of interest in the ex novo review.

Briefing on these two areas is attached plus a personality note. The Chancellor is seeing M. Balladur earlier in the morning and will hope to cover other topics of bilateral interest.

At the moment, we do not see any need to provide the Prime Minister with briefing on other current international economic issues. We will be receiving reports on the latest round of G7 deputies' discussions at the weekend and if there is anything there the Prime Minister needs to know we will send you a separate note.

I am copying this letter to Lyn Parker (Foreign and Commonwealth Office) and David Williamson (Cabinet Office).

Yours sincerely,

Cathy Ryding

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PRIME MINISTER'S MEETING WITH M. BALLADUR

COMMUNITY FINANCING

Line to take

Ex novo review

- Important that Britain, France and Germany should **work together** in the discussions now engaged in Brussels on Community financing.

- We are not satisfied with the Commission's report. Their **proposals are far too ambitious** and loaded towards the Mediterranean. No question of our agreeing to doubling of the structural funds or an increase in own resources to 1.4 per cent of GNP (equivalent to a 2.2 per cent VAT rate).

- First essential is to **reform CAP.** It is because CAP has produced surpluses whose storage and disposal take up half of total budget that Community faces financial crisis. Glad that Commission paper includes **number of ideas** on this.

- Recognise sensitivity of CAP in France. But hope can agree that cannot continue like this. Essential that **improved stabilisers** should be introduced. Intervention should return to original role of safety-net, not an alternative market.

- Also essential that **expenditure controls** should apply to **all parts of budget.** Cannot accept that control should not apply to expenditure resulting from SEA.

- For **non-obligatory (non-agricultural) expenditure,** we must ensure that the **maximum rate** of increase (which is what the Community can afford) is **not exceeded.** We have worked together to achieve this in the 1987 budget and **must ensure that this becomes the rule for the future.**

- Only when necessary changes in CAP and expenditure control have been made can we judge if any increase in own resources is needed.

- Fontainebleau Agreement stipulates that the maximum rate **may** be increased to 1.6 per cent on 1 January 1988 by **unanimous** decision of the Council and after approval by national parliaments.

- We shall not put a proposal for any further increase to the present British parliament. Decisions will not be reached at the June European Council. But we should use that meeting to get greater realism into these discussions, and to pave the way for solutions later, based on more effective expenditure control.

- Even with the Fontainebleau correction, we remain the second largest contributor to the Community budget. We will not agree to any solution that would leave us worse off than Fontainebleau. Indeed, we should like to see some improvements.

COMMUNITY FINANCING

BACKGROUND

Ex Novo Review

1. The Delors paper on implementing the Single European Act (COM(87)100) and the accompanying Commission paper which is supposed to be the response to the Fontainebleau remit (COM(87)101) are now being discussed COREPER with a view to presenting an interim report to the Foreign Affairs Council at the end of April. We have already suggested that the May ECOFIN should also look at the dossier. The FAC will then prepare the subject for the June European Council. Serious negotiation is not likely to start until after then.

2. The Commission proposals are a mixed bag. In one aspect or another they offend against almost every member state's interests and are probably not likely to survive long once serious negotiations begin. There are, however, a number of ideas which we would like to see developed, most notably on the need for reform of the CAP and for genuine controls on other budgetary expenditure. The FCO judge that if we are to have a real chance of progress, it will be necessary to make common cause with the French and Germans.

3. The French attitude, from what we know of it, is reasonably encouraging. In the past they have been reluctant to face up to any need for reform of the CAP. Now, however, even though they still regard the principles of the CAP, including its protectionist mechanisms ("Community preferences"), as sacrosanct, they have apparently recognised that things must change. They are, for example, apparently prepared, unlike the Germans, to face up to the implications of a realistic pricing policy.

4. The French are likely to support our demand that all budgetary expenditure should be subject to proper control. They have always been wary of any approach that seemed to single out the CAP. They are therefore likely to back our line that doubling the structural funds and exempting 'expenditure resulting from the SEA' from budgetary discipline are both unacceptable. On the proposals for reforming the structural funds, they are likely to join us in opposing increased geographical concentration for the Social Fund and agricultural guidance. Their attitude to the ERDF is more equivocal; their receipts from it are very low and they may be prepared to write them off as the price of achieving other things of more importance.

5. The French have given little indication of their attitude to the revised financing system. We have not pressed the issue because showing interest in it would be inconsistent with our attitude that no increase in own resources is required. It seems, anyway, unlikely to survive much detailed discussion.

FRENCH ECONOMY

General

(i) Government recently reduced its GDP growth forecast for 1987 to 2 - 2½ per cent. Latest OECD and EC Commission forecasts 2.1 per cent and 1.8 per cent respectively. 1987 ~~could~~ should, therefore, be the fifth successive year in which growth in UK exceeds that in France.

(ii) Unemployment continues to edge up and reached 10.9 per cent of labour force in January. OECD's latest forecast shows unemployment in France exceeding that in the UK in 1988H1.

(iii) Inflation, after hovering just above 2 per cent throughout most of 1986, rose to 3 per cent in January and 3.4 per cent in February. Government has revised its target for inflation, over the year to December 1987, up from 1.7 per cent to 2.4 per cent.

(iv) Foreign trade recorded small surplus in 1986, largely due to terms of trade gains from lower oil prices. But exports continue to grow only slowly and prospect is for return to a small trade deficit in 1987.

(v) Government now facing demands from all sides, including own supporters, for selective reflation of economy, e.g. through tax concessions to encourage investment. M Juppe, Minister responsible for budget, reported as favouring programme of public works to stimulate activity, though this would be offset by cuts in planned expenditure elsewhere. Budget for 1987 incorporated rise in expenditure of only 1.8 per cent (implying fall in real terms). Planned reduction in central government deficit from 3 per cent of GDP in 1986 to 2½ per cent in 1987. The Social Security budget came under some strain in 1986 because benefits were uprated by the expected rate of inflation, which was rather higher than the outturn. Increases in contribution rates are expected to put the budget on a sounder footing in 1987.

(vi) Monetary policy: target ranges set for growth of two monetary aggregates, M3 and M2, in 1987 of 3 - 5 per cent and 4 - 6 per cent respectively. But policy also directed at maintaining franc's exchange rate in ERM. French authorities kept interest rates high in January, when ERM was under pressure, and have reduced them only gradually since then.

(vii) Present Government has initiated programme to privatise most public enterprises that do not provide a public service. The first such privatisations were those of Saint-Gobain last year and Paribas earlier this year. Credit Commercial de France and Compagnie Generale d'Electricite are among the enterprises due to be sold in 1987.

Liberalisation of French Financial System

(i) Programme of liberalisation started by Socialist Government in 1985, continued by present Government.

(ii) Main features of unreformed system were predominance of bank intermediation, automatic refinancing of banks by Central Bank, compartmentalisation of financial markets, credit ceilings, subsidised interest rates for privileged borrowers, and restrictions on capital movements.

(iii) Main objectives of reform are limiting the monetary financing of public deficit, encouraging the efficiency of banking system, and increasing the role of Paris as a major financial centre.

(iv) Main measures taken so far include creation of new financial instruments (e.g. negotiable certificates of deposit) to encourage decompartmentalisation, removal of credit ceilings and elimination of interest subsidies for favoured borrowers.

(v) Reform has had consequences for monetary policy. Monetary aggregates have had to be re-defined. More importantly quantitative credit controls have been abandoned. In future authorities will rely on short-term interest rates and controls on bank liquidity to control monetary growth.

(vi) Government have also begun to dismantle French exchange controls. But M. Balladur has stated that complete abolition must await a lasting improvement in the trade balance. French residents still unable to hold foreign currency accounts.

BALLADUR, EDOUARD

Minister of the Economy, Finance and Privatisation.

Born 1929. Graduate of the Ecole Nationale d'Administration. 1963-74 worked for Pompidou, first as social affairs adviser (alongside Chirac) when Pompidou was Prime Minister; and later as Assistant Secretary-General at the Elyée in 1969, and Secretary-General in 1973. After Pompidou's death in 1974 he became head of a subsidiary of the CGE electronics and engineering group, but continued to move in political circles and by the late 1970s had become an increasingly influential adviser to Chirac. Elected to the Assembly in March 1986 (the first time he had stood for office) he became the only Minister of State (Ministre d'Etat) in the new government, and therefore clearly the most important figure after Chirac, for whom he deputises when occasion demands.

Almost unknown to the general public before becoming a Minister, he nevertheless has a reputation for being intelligent, discreet, and highly efficient. Despite having little previous experience of the Ministry he now directs, he has been quick to impose his authority on it; so much so that his juniors ministers show signs of resentment at the comparatively small scope he allows them and at his alleged failure to delegate. His approach to economic affairs so far suggests that he is prudent and pragmatic, rather than out and out liberal. He is tipped as a strong candidate for the premiership if Chirac becomes President.

Has shown himself to be approachable and openminded in his dealings with British officials.

Married. Four children.

FRANCE: Relations Pt. 4