exports starting in the third quarter of 1975 and extending through the first half of 1976. Exports rose by 14 per cent during this period, and the proportion of income due to the exterior balances was higher in 1975 — and grew further in 1976 — than in all but one of the preceding 20 years. However, most of this increase was stimulated by the relative competitiveness of British industry due to the collapse of the pound. The general collapse in world trade in the middle of 1976, in addition to a leveling off of destocking in British industry and the concurrent need to import relatively more expensive raw materials, indicates that without the special export arrangements between Arab, East bloc and Third World countries of the kind the government is now contracting for, an improvement in the trade balance is extremely unlikely.

Industry: Production and Investment

The latest estimates of the Gross Domestic Product (GDP) show that there was little change in the level of economic activity between the second and third quarters of 1976, and that there has been no growth in output during 1976, following the improvement in the last quarter of 1975. Industrial production fell by 0.3 per cent in the third quarter after rising slightly by 1.0 per cent in the second quarter. Industrial output in November was at 102.5 (1970 equals 100), only marginally up from 102.4 in October.

Those sectors which stand to benefit most from the government's export push show the best production and investment levels. As can be seen from the accompanying table, steel production registered its highest level for 20 months in November, up a full 7.5 per cent from October. There has been a similar increase in metal manufacture and vehicle production, especially tractor production, following major trade deals with Poland, Iran and Egypt.

There was a period of heavy destocking during 1975 and early 1976, with a drop-off in the level of destocking in late 1976. The volume of stockbuilding fell by £27 million in the third quarter compared with a fall of £118 million in the second quarter. A continuing decline in the level of stocks held by the construction industry was the principal factor behind the third quarter fall; manufacturers and retailers both increased their level of stock marginally by £5 million. This is deceptive however, since the manufacturing industry in particular will hold raw materials as a hedge against the pound when it is falling on the markets. In addition to financing trade on the expectation of further pound collapse, it is likely that the increase in bank lending to the private sector went to finance the build-up of these stocks.

Capital expenditure in industry rose by nearly 4 per cent in the third quarter of 1976, but this was due primarily to a sharp increase in North Sea oil investment. As indicated above, bank advances to industry in October were not used primarily for investment. Similarly, although the mini-boom of 1975 added to overall company profits, these funds were used to improve cash flows after massive accumulation of liquid liabilities (mainly bank borrowing). Fixed investment by manufacturing, distributive, and service industries (in 1970 prices) was in the neighborhood of £4,300 million in early 1974, but had plunged to £3,300 million by early 1976.

A recovery is expected, given the ability to improve exports — the latest estimates from the Department of Industry forecast a rise of 10-15 per cent in the volume of new investment by manufacturing industries and 5 per cent growth for the distributive and service industries — but the government's raising of the MLR raised severe questions about the ability of industry to borrow. Although the level of private industrial fixed investment in the first quarter was smaller than at any time since 1968, it is estimated to have risen 2.5 per cent in the second quarter and .75 per cent in the third quarter. Metal manufacturing (spurred by export prospects) showed a 10 per cent rise in the level of investment in the first three quarters of 1976 over 1975, but large falls in investment levels were recorded in textiles (29 per cent) and paper, printing, and publishing (21 per cent).

Consumer Spending

According to government estimates, virtually the entire rise in consumer spending from 1975 to 1976 is accounted for by a wave of buying by continental and other foreign shoppers.

France Outlook Grimmest in Europe

French Prime Minister Raymond Barre's severe deflation program, inaugurated last September, has succeeded in giving the coup de grace to an already faltering French economy. By the end of first quarter 1976, the rapid upswing in French industrial production, kicked off by the fall 1975 pump-priming program and the cyclical rebuilding of rundown inventories, had already begun to peter out. This showed up initially as a flattening in industrial orders during the second quarter, followed by a plunge in the third quarter and an increase in unsold inventories. Hardest hit was private capital investment, which tapered off sharply in the spring; order books in the critical capital industries dwindled from that point on.

Then, in September, Barre's "anti-inflation" gambit — taken in the context of an already flagging internal consumption and the onset of austerity programs in France's European and Third World trading partners — threw the French economy into a virtual tailspin. In October, industrial production dropped 4.7 per cent from the previous month; unemployment soared nearly 30 per cent from the 1976 low of 808,000 reached in July to

1,041,000 in November, and the government is expecting the jobless total to hit 1,200,000 by February.

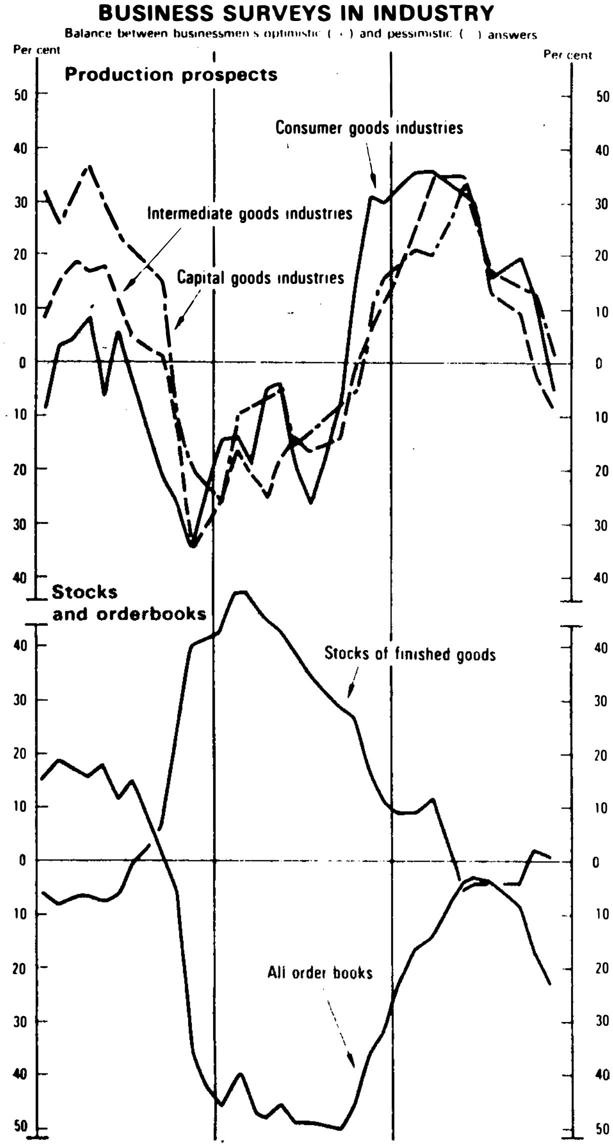
While Italy, and to a lesser extent Britain, should be able to stabilize their economies, at least temporarily, through a number of large-scale triangular trade deals, involving Comecon and OPEC countries, French President Giscard d'Estaing's pro-U.S. orientation and known aversion to the new world economic order precludes an aggressive French triangular trade policy.

The $1 billion deal concluded last week between a group of French and Italian engineering firms headed by Technip, a French government-controlled company, and the Soviet Union, in which Technip will build the Soviets two petrochemical plants in exchange for petrochemical products, is one of a few exceptions.

Moreover, British Prime Minister Callaghan has made the regeneration of basic industry his first priority; Giscard's government is undertaking the *liquidation* of the French steel industry — beginning with this week's announcement that the 3 billion francs to be injected into the Lorraine steel region in 1977 will be used *primarily* for phasing out 14,000 jobs.

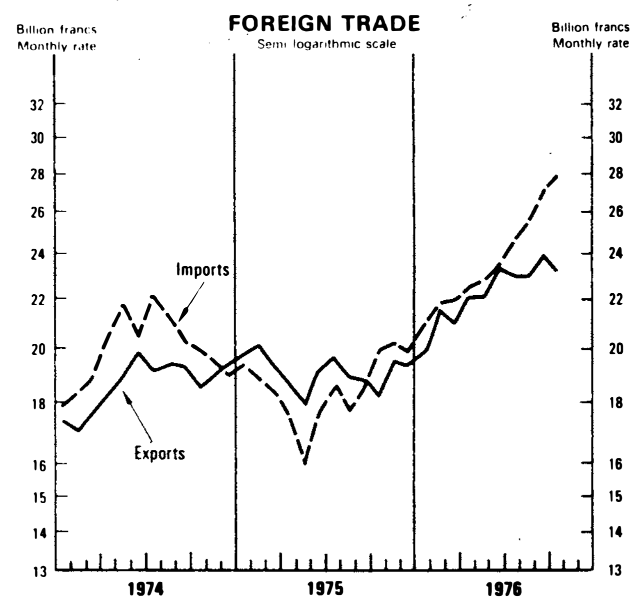
For all the above reasons, French economic prospects are more grim than for any of the other leading Western European economies. The country ran a record $4.25 billion trade deficit in 1976: any further deterioration will leave the country to the whims of the foreign exchange markets, eventually forcing Giscard to go hat in hand to the IMF for a bail-out loan. A French IMF application would, in fact, be welcomed with glee by members of Carter's economic "team," such as Treasury Under-Secretary appointee and former Brookings Institution economist C. Fred Bergsten, who has been pushing for still greater French deflation as part of an overall "de-synchronization" policy (i.e., "strong" countries reflate "weak" countries deflate). The crisis scenario developed by certain New York commercial banks of mass capital flight from France followed by a collapse of the franc has so far failed to materialize, mainly due to the even greater weakness of the U.S. dollar.

BUSINESS SURVEYS IN INDUSTRY



The French economic upswing ran out of steam by the second quarter of 1976, as indicated by the above survey of business opinions concerning production prospects, orders and stocks. (Source: *National Institute for Statistics and Economic Studies*)

France ran up a record $4.25 billion trade deficit in 1976. Imports soared, reflecting manufacturers' efforts to restock raw materials and fuel needed for further expansion, and a 30 per cent jump in the prices of imported raw materials. Exports fell off due to depressed conditions in France's European and other trading partners, and a severe drought which reduced the supply of agricultural products available for export. (Source: *National Institute for Statistics and Economic Studies*)



Barre's Deflation — More to Come

The next phase of Barre's "anti-inflation" policy should prove even more onerous than the last. In 1976, the government budget deficit was slashed by 40 per cent, from 35 billion francs in 1975 to 22 billion in 1976, representing a large cut in real government spending and a tax hike. In 1977, the Giscard government aims for a "balanced budget." In 1976, money supply (M-2) growth was reduced from an annual rate of 17 per cent in the first quarter to a mere 6.6 per cent in August and September (the latest months for which figures are available). In 1977, the government will hold money supply growth down to 12.5 per cent, while allowing only a 5 per cent expansion in credit supplied to the economy by the largest French banks.

These tight credit conditions have already made borrowing costs prohibitive for French corporations, many of which are already dangerously illiquid. The bellwether "day-to-day money" rate, the rate at which banks acquire funds in the money markets (comparable to our "Fed Funds" rate), soared from 6.36 per cent in January to 10.75 per cent in December, compelling the banks to jack up their prime lending rate to 11.65 per cent (at a time when the U.S. prime rate was falling to 6 per cent and the Fed Funds rate to under 5 per cent!). French firms have been forced to borrow on the Eurodollar markets instead, hiking their total outstanding foreign debt to a whopping 20 billion dollars.

Meanwhile, the government will attempt to ban "excessive" wage increases — defined as increases greater than the rise in the cost of living — and has threatened to penalize companies through cut-offs of bank credits, the suspension of state financial aid, and blockage of price increases.

Capital Goods and Steel

Capital spending has clearly not thrived under this austerity regimen. The volume of new investment in plant and equipment rose by a meager 3 to 4 per cent in 1976, and even this was mostly in the public industry sector; the latest government survey indicates a 4 per cent *cut* in 1977.

Most indicative is the plight of the French steel industry: Crude steel production dropped 5 per cent in October, following a substantial climb earlier in the year. Orders are running 40 per cent below the 1974 peak, and the country has been turned into a *net-steel importer* as the result of cut-throat price competition with Japanese, West German, Italian and British producers.

At least 23,000 steel industry layoffs are slated to go into effect in 1977. The government has allocated 3 billion francs to the Lorraine industry — half of which must be used to cover retirement and unemployment benefits for the phasing-out of 14,000 workers. So that the program will not be a financial burden, Giscard has proposed that the remaining workers repay the 3 billion francs by buying shares in their bankrupt companies!

"Consumer Confidence" Collapse

With the surge in unemployment and continued double-digit inflation rates, French household consumption dropped off in the third quarter. The latest government survey indicates that, by November, "consumer confidence" had ebbed to a very low level indeed. Thirty-seven per cent of those interviewed expected a fall in living standards in the coming months; 43 per cent foresaw a further rise in unemployment.

Although inflation had moderated to an annual rate of "only" 9.6 per cent of November — down from 11 per cent — the OECD projects another price surge in the first quarter of 1977 due to the lifting of the government's price freeze and heavy increases in wholesale food prices due to the European drought.

Auto Decline

The end of the consumer spending "upswing" has already taken its toll on the auto sector. Although French auto production rose 10 per cent over the depressed 1975 level, for a total of over 3 million vehicles, November production levels of 268,000 represented a substantial drop from the 310,000-plus monthly levels achieved earlier in the year. Auto orders dropped off markedly, starting in July, with the simultaneous decline in domestic registrations and in exports. Auto imports into France jumped 40 per cent over a year ago, reflecting Japanese "dumping" and the greater competitiveness of Italian and British models due to the depreciation of their currencies.

The chemical and textiles industry show even greater stagnation; only the electrical sector has shown a continuously-rising pattern in production and order, due to nuclear power plant and other energy-related projects.

The most decimated sector is residential housing construction. Housing starts dropped 6 to 7 per cent in 1976, recording a total of only 364,000 units in the first 3 quarters — the lowest level since 1970. Lower-income housing was hit worst, showing an 18 per cent drop. Further declines are projected in 1977 due to government spending cuts and the credit squeeze.