INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/91

10:00 a.m., June 13, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
A. Donoso	
	M. K. Bush
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
A. Kafka	C. Robalino
	G. Grosche
G. Lovato	N. Coumbis
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	H. Alaoui-Abdallaoui, Temporary
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

J. W. Lang, Jr., Acting Secretary
C. J. Fairbairn, Assistant

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2. Sudan - Stand-By Arrangement - Postponement of Effective Date . . . . Page 41
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Also Present

Asian Department: J.-P. C. Golle, L. Mendras, J. Thornton. European Department: L. A. Whittome, Counsellor and Director; T. R. Boote, P. Dhonte, D. Gros, H. B. Junz, A. Leipold, G. A. Mackenzie, V. Marie, K.-W. Riechel, J. S. Van 't dack, M. Xafa. Exchange and Trade Relations Department: C. D. Finch, Director; G. G. Johnson, N. Kirmani. Fiscal Affairs Department: P. S. Heller. IMF Institute: G. Teyssier, Director. Legal Department: S. A. Silard. Research Department: A. K. McGuirk. Secretary's Department: B. J. Owen, P. D. Péroz. Treasurer's Department: D. Berthet, D. S. Cutler. Bureau of Statistics: Y. Gisse, K. W. Nahr. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, K. A. Hansen, W. Moerke, G. E. L. Nguyen, Y. Okubo, D. I. S. Shaw. Assistants to Executive Directors: I. Angeloni, R. Bernardo, Chen J., L. E. J. M. Coene, C. Flamant, I. Fridriksson, V. Govindarajan, D. Hammann, N. U. Haque, H. Kobayashi, J. A. K. Munthali, G. W. K. Pickering, T. Ramtoolah, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, Wang C. Y., M. A. Weitz.

1. FRANCE - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with France (SM/84/109, 5/15/84; and Sup. 1, 6/11/84). They also had before them a report on recent economic developments in France (SM/84/123, 5/29/84).

The Director of the European Department, commenting on the forecasts for the 1984 current account in the light of the disappointing April trade figures, said that wholly accurate forecasts could not be obtained. The forecast of a current account deficit of F 10 billion for 1984 had assumed that all fiscal, monetary, and financial policies would be implemented, but more recent trade figures and first quarter estimates suggested that it would be more accurate to forecast a deficit of F 20 billion. However, because of the currently favorable seasonal impact on the trade account, the original estimate of F 10 billion had not been changed.

Mr. de Maulde made the following statement:

> At this time last year, the Fund's Executive Board was informed, as part of the annual consultation with France, of the overall program adopted by the French Government at the end of March 1983 aimed at restoring economic equilibrium on a lasting basis.
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> In the course of the discussion, all my colleagues approved the principles and measures in the plan; a number of them nevertheless expressed skepticism that the stated objectives were attainable.
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> The consultation report before us today comes in good time to dispel these doubts. It clearly demonstrates that the initial targets have been reached, that adjustment is proceeding at the planned pace, and that significant structural changes, designed to ensure the lasting character of this adjustment are under way.
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> Two priority objectives were set in March 1983: to restore the equilibrium of the balance of payments on current account within two years, and to reduce the inflation rate to 5 percent by the same deadline. The Government also indicated that France should be halfway to both objectives within the first 12 months.
>
> The deficit of the balance of payments on current account in 1983 was F 29 billion, less than half of the F 79 billion recorded in 1982. The consumer price index rose by 9.3 percent during 1983; while this figure exceeds the official intermediate objective of 8 percent, the rate of increase in the final quarter was down to 7.9 percent.
>
> Thus, French performance has been better than anticipated in the balance of payments area, less good in the area of prices.

We believe these differences are due largely to accidental and seasonal factors and do not put the program off track.

Our objectives for 1984 remain unchanged. The independent forecast by the Fund staff (page 21 of SM/84/109) is that the current account may still show a slight deficit (F 10 billion) and that inflation (at 6.5 percent) may slightly exceed the target. It is our belief that the Fund's forecast this year, like last, may be overly pessimistic.

The assessment made in the consultation report of the policies implemented clearly shows the important differences between the strategy adopted by the French Government and conventional adjustment programs. The latter seek to change the behavior of enterprises and households, through indirect measures in the areas of taxation, interest rates, and prices. The thrust of the French policy package, on the other hand, is on face-to-face involvement in contractual incomes policy, with supportive monetary and fiscal measures.

Today, setting future incomes on the basis of the targeted inflation rate is well integrated in the nation's economic system and has become an accepted component of the French social fabric. This policy has now spread from the public sector to the private sector and from wages to other income. It has demonstrated its ability to change the relative shares of domestic and foreign demand and of household and enterprise incomes. Thanks to this policy, the disindexation of the French economy, repeatedly recommended in the past by the Fund's reports, is well under way. The incomes target set for 1984 is 5 percent. Practically all wage agreements reached thus far respect this target figure, which is consistent with the price target mentioned above.

Fiscal policy was very strict in 1983, when expenditure grew at only half the rate of the previous year. This has not been quite enough to hold the deficit, which reached 3.3 percent of GNP, down to the target of 3 percent, as actual revenue was lower than anticipated. The objective for 1984 is again to hold the deficit to 3 percent of GNP. Therefore, in addition to the restrictive measures already enforced, other measures aimed at canceling or freezing certain budget allocations have been prepared, and will be implemented should the target appear in danger of being exceeded.

In the monetary area, the consultation report views as reasonable the 5.5 percent to 6.5 percent growth range set for M-2R in 1984. The French monetary authorities are determined to keep to this target, relying primarily on the regulatory instruments available to them for credit control. The Government intends at the same time to further promote the dramatic growth of long-term savings and of the bond market; the active interest rate policy followed in 1983 will be pursued in 1984 as well.

There is no ideal policy mix. Some aspects of the French approach can be criticized, but at least one must recognize that it is achieving its overall objective of restoring equilibrium both without recession, since the GNP grew by almost 1 percent in 1983 and should grow by the same amount in 1984, and without resorting to protectionist measures. Despite the disruptions experienced on the foreign exchange markets, France has scrupulously observed its commitment made in Williamsburg last spring.

In addition to the disinflation of the French economy and the restoration of its external equilibrium, important structural changes are under way which will determine the medium- and long-term future. Some of these changes result from overall economic policy, while others have been brought about by deliberate, specific actions of the Government.

Overall, business profitability, which had been falling steadily since 1979, improved markedly in 1983. This reversal reflects both an improvement in export margins and the relative stabilization of wage costs. It must be protected and strengthened. It has already led to a recovery of industrial investment significantly stronger than anticipated just a few months ago. The benefit of this development is twofold: it supports the overall activity level right now, and it strengthens the future competitiveness of French enterprises both domestically and internationally. In both respects, it can be expected to maintain and create employment.

In the area of industrial policy, the French Government is not confining itself to macroeconomic adjustment. Here, as in the incomes policy area, it has chosen the direct approach of tackling problems face to face, in keeping with the Colbert tradition of national economic management. Broadly speaking, French industrial policy combines three main types of action: efficient management of public sector enterprises, restructuring of declining economic sectors (such as coal, shipbuilding, steel, and automobiles), and accelerated development of advanced technologies (especially in electronics and data processing). The actions undertaken entail difficult choices at present, including the elimination of plants and jobs. They are justified by our belief that, in the medium term, a comprehensive modernization of the industrial structure is required in order to create and maintain new jobs in productive, competitive industries.

Another modernization effort--more modest but still significant for the future--has been pursued in the banking sector. The same regulations now apply to all financial institutions, regardless of their type (commercial, cooperative, mutual, etc.). The anticipated results include greater efficiency of the various financing channels and greater flexibility of credit policies.

Finally, in order to alleviate the excessive burden being placed on the economy by the public sector levies (i.e., contributions to central and local governments and to the various social welfare systems), the Government has decided to reduce such contributions by 1 percentage point of GDP as of January 1, 1985. Concrete measures to that effect, involving severe cuts in expenditure, will be incorporated in the next budget, to be submitted to Parliament in the autumn of 1984.

The path of the French economy through the end of this year thus appears well marked out; forecasts for the subsequent period are, of course, more uncertain.

The consultation report forecasts growth of about 2 percent in 1985, rising to 3 percent the following year, with inflation holding steady at 5 percent and a moderate current balance of payments surplus; this is consistent with the middle scenario in the World Economic Outlook exercise.

The price and external balance figures are close to those projected by the French authorities, and indeed are their targets. The growth rate, by contrast, will result from the combined efforts undertaken by them and their major partners to bring about a broader and more vigorous world recovery than currently anticipated. The French Government's decision to continue raising the level of its official development assistance is a step in this direction.

Mr. Lovato said that he was in broad agreement with the staff appraisal. The French authorities had been successful in 1983, particularly in improving the external accounts, and, to a more limited extent, in bringing down inflation. The challenge was now to consolidate the progress through the continuation of wage and monetary restraint, and to strengthen control of public finances in order to ensure the credibility of monetary policy. He welcomed the French authorities' emphasis on the compatibility of medium-term economic policies and a structural revitalization of the industrial sector, since that was an aspect of economic policy of central importance to Europe as well as to France itself. The recent improvement in industrial profitability provided an important prerequisite for lasting modernization.

The French economy had undergone a number of substantial changes in recent years, Mr. Lovato continued. In the monetary and financial fields, there had been a marked disintermediation in the banking sector and an enlargement of the bond market, leading to a greater potential for diversification and efficiency in the public's portfolio choices. The process had been stimulated by the constraints imposed by the credit ceilings, allowing greater short-run freedom in the conduct of interest rate policy, which would otherwise have been inhibited by the need to finance the public sector deficit and by international financial conditions. In the longer run, however, the credit ceiling was likely to become less effective, and to create distortions that could undermine the efficiency of the financial system. Moreover, it tended to segment the asset market and reduce the degree of substitutability in the private sector's portfolio, thereby reducing the effectiveness of the traditional market instruments of monetary policy. As a result, the reliance of monetary policy on administrative instruments should decrease in favor of a greater degree of flexibility in interest rates, although the underlying conditions could create problems, requiring gradual adjustment. The Italian monetary authorities had faced, and successfully overcome, a similar transition between 1982 and 1983.

In the realm of fiscal policy, Mr. Lovato went on, there had in recent years been a gradual increase in the public sector deficit relative to GDP. The deficit was largely the result of the social security system, whose net expenditures had constituted about 40 percent of the central government deficit in 1983. The upward trend in social security payments in France was a reminder of the serious impact of demographic trends on the public finances of many industrial countries. Pension systems organized on a pay-as-you-earn basis were affected by changes in the population's age structure, such as a fall in birth rates, producing deficits that could partially nullify the benefits of the system by causing inflation, or could shift the burden of payment onto future generations. He looked forward to reading the results of the survey on demographic trends that was being made by the Fiscal Affairs Department.

Industrial policy was another basic aspect of current economic policy in France, Mr. Lovato said, and one on which more detailed background information would have been useful, particularly in the report on recent economic developments. The French authorities appeared to have followed a market-oriented approach, relying on increased profitability in the medium term to raise efficiency and productivity. Two instruments gave the French authorities power in the industrial sector; first, the strong public participation in the productive sector, and second, a large network of subsidized credit. The problem was to determine how to use the two instruments, and which sectors to favor. Only if they were implemented according to a far-sighted view of comparative advantage and world trade developments would the temptations to impose trade restrictions be resisted. Worrying indications of France's degree of protectionism had emerged from the staff papers. Increased profitability was not sufficient to induce efficient investment, particularly in the context of intense protectionism and restrictions on interest rates; on the contrary, it might induce, in some cases, a relaxation in efforts to improve efficiency.

France was now emerging from the recession, Mr. Lovato continued, and, having put itself back on a balanced growth path, was able to take advantage of the removal of some institutional rigidities and a more productive economic structure. He encouraged the authorities to continue their adjustment efforts, and to strengthen their reliance on the market, in the implementation of both financial policies and policies relating to the foreign trade sector. France's increased official development assistance was a welcome initiative whose importance was fully appreciated by the Italian authorities.

Mr. Grosche said that the staff papers, as well as Mr. de Maulde's statement, showed clearly that the program adopted in March 1983 had produced remarkable results, which were evident in stronger external accounts, a notable degree of wage restraint, and improvements in the competitive position of French industry. Despite a difficult international climate, France had not taken recourse to increased protectionism. As a member of the European Monetary System, it had taken advantage of the System's drive toward convergence in economic policies in formulating its own policies. A converging path of economic policies through more coordination on the European and international level should avoid the need for further substantial exchange rate realignments. France's last realignment had borne witness to the argument that only devaluations accompanied by a tightening of domestic financial policies would reduce external imbalances and inflation. In addition, the staff report made it clear that, in view of the persisting inflation differential in favor of France's major trading partners and its foreign indebtedness, a change in policies was not yet warranted despite the increasing rate of unemployment.

In order to preserve existing achievements and to lay the foundations for sustainable growth, Mr. Grosche continued, the authorities should persevere in their efforts. He endorsed the staff appraisal and the recommendations presented in the staff report, and he welcomed Mr. de Maulde's confirmation that the objectives for 1984 remained unchanged.

On fiscal policy, Mr. Grosche noted that the French authorities had not succeeded in limiting the central government deficit to 3 percent of GDP in 1983. Despite a series of expenditure cuts, the deficit had grown from 2.8 percent to 3.3 percent of GDP, a figure that was even higher on a cash basis. It was regrettable that the public sector continued to absorb a large part of domestic savings and was therefore competing with private demand for credit.

The rising share of government-controlled expenditures was also a cause for concern, Mr. Grosche said. Social and health expenditures should be brought in line with the available funds, and losses of the nationalized industries should be further reduced. He concurred with the staff view that the general government deficit should be phased down to 2.5 percent of GDP in 1984.

Concerning taxation, Mr. Grosche went on, it was not yet clear how the intention of the French President to reduce the tax burden by 1 percent of GNP in 1985 was to be implemented. The cuts were desirable to further strengthen industrial profitability, to induce new investment that would enlarge employment possibilities, and to facilitate the application of new technologies, but they could prove difficult to execute, if they conflicted with general public expectations.

Given the persistence of high inflation, Mr. Grosche continued, wage policies should be geared to cost reduction. It had been reassuring to read in Mr. de Maulde's statement that almost all recent wage agreements had respected the target figure set for 1984. Since wage restraint had to be supported by a moderate expansion of monetary aggregates, the central bank should aim at the bottom end of the target range of 5.5 percent to 6.5 percent for the growth of M-2 held by residents (M-2R). Because inflationary expectations had not yet subsided and the monetary aggregate chosen might not reflect accurately the rate of monetary expansion, monetary policy should follow a clearly restrictive path. He shared the staff's concern about credit ceilings and other administrative procedures for allocating credit to the private sector. The authorities should consider replacing the complex and rigid system, which was a permanent source of distortion in the economy, with a more market-oriented approach that would facilitate the use of monetary policy and enhance the overall efficiency of the French economy. The French authorities had argued that high real interest rates were the main factor behind the decrease in credit demand, and that the credit ceilings had not impaired the functioning of the credit market. However, the banking sector was able to circumvent the existing restrictions by granting a credit in foreign exchange which was refinanced abroad, thus eroding the effectiveness of monetary policy and contributing to short-term external debt, indicating the disadvantages of a bureaucratic approach to monetary policy.

Concerning external policies, Mr. Grosche said that he hoped that France would intensify its efforts to adjust the balance of payments, particularly since the current account deficit in the first quarter of 1984 had been higher than planned. That outcome suggested that the F 10 billion current account deficit predicted by the staff for 1984 would be difficult to attain, as the Director of the European Department had noted; nevertheless, he hoped that by 1985 the staff's forecasts would again appear to have been too pessimistic.

The high volume of foreign debt emphasized the need to rectify the current account imbalance, Mr. Grosche continued. According to the staff report the medium- and long-term external debt had amounted to $54 billion at the end of 1983. In May 1984, the French Senate had published a report, in which total outstanding debt was estimated to be about $74 billion at the end of March 1984; the figure included short-term debt of about $18 billion and gross debt contracted in the first quarter of 1984 of about $3 billion. Future staff reports should take account of the large short-term debt component, a large part of which was revolving and medium term in character. The foreign indebtedness was not yet unmanageable, but as the largest part of the foreign debt was not denominated in French francs, the debt service was highly dependent upon exchange rate changes; action to overcome the current account deficit was therefore urgently required.

The measures taken to promote adjustment in the industrial sector were welcome, Mr. Grosche said, since they would help to open up new opportunities for the export industry and would, in general, enhance the degree of supply-side flexibility. Experience had shown that an inadequate supply response following increases in domestic demand led to a worsening of the external accounts. However, while appreciating the threefold "direct approach" to industrial adjustment advocated by Mr. de Maulde, he urged the authorities to recognize the contribution of private investment, since only an expanding economy founded upon private investment offered a long-term solution to the serious problems of unemployment. In addition, nationalized enterprises should be exposed to the same degree of competitive pressure as private enterprises.

He concurred with the view of the French authorities that it was crucial to expand industrial investment, Mr. Grosche said. Significant capital formation was a precondition for the necessary modernization of industry, improvements in competitiveness, and higher employment. That capital formation was dependent on reasonable wage settlements, supported by constrained financial policies that inspired confidence.

Mr. Suraisry said that he was in general agreement with the staff analysis and could endorse the main points in the staff appraisal. The authorities had made commendable progress toward stabilization of the economy during 1984; the current account deficit had been halved, the rate of inflation had been reduced, and industrial profit margins had improved considerably. The achievements were impressive and owed much to the authorities firm adjustment efforts. Looking ahead, it would be important to consolidate the gains and to create the right framework for sustained growth, which, as recognized by the authorities, would require a combination of continued demand restraint and supply-side measures to correct structural weaknesses.

In particular, the authorities had been highly successful in devising and implementing an effective incomes policy, Mr. Suraisry continued. It was encouraging that their policy was being maintained in 1984 and that recent wage settlements in both the private and public sectors had been in line with the official target. Moderate wage increases were essential to reduce inflation and to further restore profit margins in industry. Lower inflation and higher profits should in turn encourage new investment and create new employment opportunities over the medium term. He welcomed the current discussions aimed at reducing rigidities in the labor market, reinforcing the authorities' present adjustment efforts.

Successful adjustment also depended on appropriate financial policies, Mr. Suraisry said. He therefore supported the authorities' intention to limit the fiscal deficit to the equivalent of 3 percent of GDP in 1984, requiring strict control of public expenditure, which had risen sharply in relation to GDP in recent years. Expenditure restraint would assume even greater importance in 1985, when the authorities intended to reduce the burden of taxes and social security contributions. Comments from the staff or Mr. de Maulde concerning the authorities' plans for lightening the tax burden would be interesting.

Monetary policy also had an important role to play in the adjustment effort, Mr. Suraisry continued. The monetary targets for 1984 had appeared consistent with the authorities' external objectives, but the effectiveness of the present system of quantitative credit controls was doubtful; he welcomed the recent steps, such as the new banking law, designed to encourage greater competition in the financial system.

Externally, the trade account had already benefited from the effective depreciation of the French franc and from the world recovery, Mr. Suraisry noted. The authorities should attempt to maintain competitiveness and to eliminate the trade deficit in view of the heavy burden of interest payments on external debt. The recent moves to improve industrial productivity and to modernize and restructure the industrial base were important steps in the right direction. It was commendable that the authorities had not resorted to notable protectionist measures, and had eliminated, as planned, the restrictions on foreign exchange for tourists. However, as noted by the staff, there was clearly scope in France, as in other industrial countries, for dismantling trade barriers both bilaterally and within the European community.

It was noteworthy, Mr. Suraisry added, that the authorities had been able to increase the level of official development assistance (ODA) in 1983, despite budgetary constraints. He hoped they could meet their target of expanding ODA to the equivalent of 0.7 percent of GDP by 1988.

Mr. Hirao said that he was in broad agreement with the staff report, and commended the French authorities for their achievement of the important goals that had previously seemed excessively ambitious. The halving of the current account deficit of the balance of payments between 1982 and 1983 was indeed an impressive accomplishment, and the authorities' success in reducing inflation, although not by as much as originally targeted, was also encouraging. Particularly welcome was the positive growth in GDP in 1983 resulting from an unexpectedly strong response of economic activity to improved competitiveness.

He was particularly struck by the success of incomes policy in France, Mr. Hirao continued. As noted by the staff, the policy had broken the former pervasive system of de facto indexation. The key to success appeared to have been the new approach adopted by the authorities in which wage supplements had been based on the official price target, providing a good example of a well-administered and forward-looking incomes policy. The scheme had initially been intended for the civil service sector, and the reason for its wide acceptance by the private sector as well would be interesting to learn. He was also interested in the specific changes contemplated for the administration of the scheme in 1985 to allow more room for differentiation between sectors and firms. He endorsed the authorities' intention to achieve such flexibility through administrative changes in technique in order to ensure the scheme's continued success.

Another major achievement, Mr. Hirao went on, had been the improvement in the profitability of French industry in 1983, due largely to the suppression of wage costs and a significant widening of export profit margins following the March 1983 devaluation. However, Chart 3 of the staff report (SM/84/109) indicated that the level of profitability in 1983 seemed to have recovered only to the 1980 level, emphasizing the need to reinforce the current upward trend in profitability. On the other hand, the rate of unemployment had resumed its rise in mid-1983, and was estimated to have reached 9.5 percent in March 1984. While the development was a source of immediate concern, he took a more medium-term view, stressing that modernization of the industrial structure would offer the best prospects for employment.

Concerning fiscal policy, Mr. Hirao noted that the central government budget deficit in 1983 had been significantly higher than originally planned, rising from 2.8 percent of GDP in 1982 to 3.3 percent in 1983. To limit the central government deficit to the equivalent of 3 percent of GDP in 1984 would require a major effort to restrain expenditures. The authorities' commitment to the objective was encouraging, as exemplified by the cancellation of some capital expenditures as well as their decision to replace only one third of employees leaving the civil service. In 1985, it would be particularly important to restrain expenditure, since the authorities were intending to reduce the burden of taxes and social security contributions by 1 percent of GDP while simultaneously containing the budget deficit. Since there was a continuing need to raise industrial profitability, a cut in corporate taxation would be welcome. He agreed with the staff that reductions in personal income tax should favor the lower income brackets.

He endorsed the staff assessment which suggested that the financing of the budget deficit at its currently targeted level would crowd out an excessive share of available financial resources, putting at risk the Goverment's external and price objectives, Mr. Hirao said. It would therefore be preferable to further reduce the deficit to 2.5 percent of GDP in 1984 and thereafter.

In the area of monetary policy, Mr. Hirao noted that the 10.2 percent growth in M-2 at the end of 1983 had overshot the target of 9 percent. However, it was encouraging that preliminary figures for the early part of 1984 confirmed that the growth of the money supply was continuing to decelerate, and that the authorities were confident that the target growth range of 5.5 percent to 6.5 percent could be attained. He endorsed the authorities' view that the high level of interest rates would play a major role in containing the growth of the money supply through a further expansion of the capital market. As regards the main operational instrument for the achievement of the monetary target, a more market-oriented credit allocation system and a more active interest rate policy would be preferable to the credit ceiling approach. However, he shared the views of the French authorities that the transition should be gradual.

Concerning external debt, Mr. Hirao noted from Appendix III (SM/84/109) that the debt service ratio was projected by the staff to rise from 5 percent in 1983 to a maximum of 8.2 percent in 1990, and to decline to 5.7 percent in 1995. Given that projection, it was essential that the policies prescribed for 1984 be fully implemented and sustained during 1985 and 1986, in order to restore a viable external position.

On industrial and trade policies, Mr. Hirao welcomed the authorities' commitment to an open trade system.

Mr. Wicks said that he was in broad agreement with the staff report. The policies that the French authorities were now following were undoubtedly bearing fruit. Particularly encouraging were the substantial reduction in the current account deficit and the sharp improvement in the competitiveness and profitability of French industry.

Nevertheless, Mr. Wicks continued, inflation had fallen only very slowly, so that the French inflation rate remained substantially higher than that of France's major trading partners in Europe, particularly Germany, perhaps its key trading partner. The authorities' target of 5 percent inflation in 1984 appeared optimistic given that inflation was running at an annual rate of about 8 percent in 1984. The actual inflation rate was likely to be much higher, underlining the need to maintain firm monetary and wage policies, particularly if further devaluations of the franc were to be avoided.

Concerning fiscal policy, Mr. Wicks remarked that the overshooting of the authorities' target for the central government deficit was a cause for concern. Despite a series of measures taken by the authorities, particularly the restraint on public sector wages and the removal of a number of items from the budget altogether, the share of public expenditure in GDP had continued to rise and was projected to rise still further in 1984. Further pressures would result from the decentralization of responsibility for expenditure decisions to local authorities, and from the absence of a contingency fund to absorb unexpected increases in expenditure. Nonetheless, it was essential that the authorities should maintain firm expenditure control in order to meet the target of a deficit of 3 percent of GDP in 1984 and 1985, and to implement tax cuts of 1 percent of GDP in 1985. Since the central government budget deficit now accounted for nearly one fifth of gross private savings, double the figure for 1981, it was important to meet the targets if the expected expansion in business investment in 1984 was not to be crowded out, or monetary targets endangered. It was worth noting that the public sector borrowing requirement, which was a more appropriate measure of the pressure on financial markets than the budget deficit, stood at nearly 5 percent of GDP, suggesting that a budget deficit of 2.5 percent of GDP in 1984 and 1985 would be preferable; the authorities' suggestion to bring forward certain measures to reduce public expenditure from 1985 to 1984 was therefore welcome. His authorities had been particularly pleased that the staff had attempted to construct the financing requirement for the total public sector; the staff should provide similar estimates for other major countries, particularly for the United States, since it was the broad concept of public borrowing, rather than the central government deficit alone, which was appropriate to the assessment of the total financing requirement of the public sector.

Concerning monetary policy, Mr. Wicks welcomed the authorities' decision to target M-2R, rather than M-2, since it was a closer measure of domestic credit expansion, and to lower the target in line with their inflation objective. It was important that the monetary targets should be met, so that monetary policy would reinforce policy in other areas. Furthermore, as noted by the staff and previous speakers, the targets should be achieved through a more active interest rate policy rather than through the imposition of direct controls on credit, which led to widespread inefficiency. The new banking reform law and the emphasis of the Ninth Plan on transition to a more market-oriented credit allocation system were therefore welcome. He wondered if Mr. de Maulde or the staff had further comments on the authorities' plans for the financial system.

Commenting on external policy, Mr. Wicks noted that the reduction in the current account deficit in 1983 had been impressive; even allowing for the deferred payment for oil imports, the authorities had achieved their target of halving the deficit. However, although the substantial improvement in export competitiveness and the reversal of the losses in market share in 1982 were encouraging, performance in 1984 had been less promising, and the staff's projections suggested that the authorities' target of current account balance by the end of 1984 might not be achieved, highlighting the importance of maintaining competitiveness and restraining domestic demand.

Furthermore, the buildup of external debt projected for 1984 remained substantial, Mr. Wicks added. The French Finance Minister had been reported as saying that further borrowing of roughly the same magnitude would be required between 1984 and 1989, with outstanding debt beginning to decline only in 1987-88. He wondered whether that was reflected in the staff's projections for the balance of payments. Also regarding external policy, he had been disappointed by the lack of substantive analysis in the staff reports of the effects of controls on the capital account, which were potentially as distortionary as current account controls. Indeed, the staff had noted, in the report on recent economic developments, the sharp divergences between Eurofranc and domestic interest rates; Fund surveillance of major industrial countries should clearly aim at a more comprehensive view of the external sector in future consultations.

With regard to structural policy, Mr. Wicks welcomed the substantial improvement in company profitability achieved in 1983. It had been due to the success of both the new wage indexation system, which had directed the surplus from increased productivity toward enterprises, and the depreciation of the franc, which had allowed a significant increase in corporate savings and, by enabling firms to finance themselves more easily, had offset the pressures on domestic savings created by the expanded government deficit. Nevertheless, as Table 9 of SM/84/123 showed, the ratio of gross saving to value added remained well below that of the late 1970s, underlining the need for continued wage restraint. The authorities' intention to relax industrial price controls further should also contribute to a higher savings ratio. Their efforts to reduce excess capacity in declining industries and to improve productivity in structurally weak sectors of the economy were also welcome.

France, like other industrial countries, continued to face structural problems in the labor market, as indicated by the continuing rise in unemployment and the low level of vacancies, Mr. Wicks remarked. The present wages policy had made a substantial contribution to reducing relatively high costs of production, on which considerable attention had been focused during the 1983 Article IV consultation with France. Since then, there had been a deceleration of the rate of growth in real hourly wage rates in industry from 3.1 percent in 1982 to 1.4 percent in 1983, and a decline in real wages in the first quarter of 1984, implying an overall decline in the rate of increase in unit labor costs from 10.7 percent in 1981 to 5.9 percent in 1983, a rate which was expected to decline still further to 2.4 percent in 1984. As a result, value added in the corporate sector was growing faster than the wage bill, thus permitting a restoration of the gross operating surplus ratio to its 1977-79 level of 25.2 percent.

There had also been a weakening of all the components of aggregate demand, Mr. Mtei went on, resulting in an overall decline in total domestic demand of 0.3 percent in 1983, thus freeing more goods and services for export than would otherwise have been possible. Due to the worldwide revival in economic activity, the March 1983 devaluation of the franc, which had been the result of exchange rate realignment within the European Monetary System, and the continuing effective depreciation of the franc in terms of the U.S. dollar had increased the competitiveness and profitability of exports, aided by the declining rate of unit labor costs. Consequently, France had been able to increase its share of export markets even in traditionally U.S.-dominated export markets, including those in Latin America, while at the same time the weakness in domestic demand had tended to reduce import volume. If the trend continued, the prospects for equilibrium in the current account for 1984 and surplus in 1985 and thereafter, as envisaged by the authorities, appeared good.

Underpinning improvements in competitiveness were the government policies adopted in mid-1983 aimed at reducing rigidities in the economy, Mr. Mtei continued. The retailoring of fiscal policy to fulfil anti-inflation and external balance objectives and to maintain the stability of the franc within the EMS was also important. The rigidities in the labor market were particularly significant, as indicated by the dramatic impact of the change in wage indexation practices on competitiveness, profitability, and the share of labor in value added. Overtime regulations, lengthening of the legal duration of fixed-term contracts, and the introduction of greater flexibility in manpower decisions at the corporate level had also had positive results that would be further strengthened by the policy of gradually decontrolling industrial prices, adopted in 1984. Although the speed of decontrol would depend on the success of the anti-inflation effort, the authorities should not desist from carrying the decontrol policy to its logical conclusion in the near future in order to avoid unnecessary economic distortions.

The abandonment of the expansionary fiscal policy of the 1981-82 period in favor of the introduction of austerity measures was understandable, Mr. Mtei remarked. Under the new measures, the government deficit would be limited to 3 percent of GDP and inflation reduced to 5 percent in 1984 through a series of revenue-raising and expenditure-cutting policies. France had discovered that a country could not embark on a unilateral expansionary economic policy while its major trading partners and competitors were pursuing austerity measures. However, it was clear that, under the new strategy, labor would have to bear the brunt of the burden of adjustment in the foreseeable future, although it was possible that the Government's training program and job subsidies would result in a fall in the unemployment rate as the recovery strengthened. The impact of economic management on labor could not be overemphasized, since its ultimate objective was the promotion of human welfare. Unemployment insurance and social security funds had been fast depleted, replenished only through increased contributions by employees and employers. Excessively high contributions by the latter could prove counterproductive in terms of employment, profitability, and competitiveness, highlighting a need for a reduction in the unemployment rate to render future increases unnecessary.

Capital formation in competitive public industries had been accorded high priority, Mr. Mtei noted, and the bulk of state equity transfers in 1984 would go to them. If the guidelines requiring public enterprises in the competitive sector to achieve financial balance by 1987 were met, it would be possible to contain the financing requirement of the entire public sector, amounting to about 5 percent of GDP in 1983, to a level that would neither risk the external balance and price objectives, nor crowd out private sector investment.

Concerning the monetary sector, Mr. Mtei said that he agreed with the staff that the M-2R target growth range of 5.5-6.5 percent and net domestic credit growth of 7 percent could not be exceeded without endangering price and external balance objectives. The prolonged reliance on direct control as the main instrument of monetary management in France since 1972 was intriguing. He was also puzzled by the authorities' explanation that the relatively limited scope for an active interest rate policy was due to the narrowness of the domestic money market, the heavy public sector indebtedness, and the dichotomy between lenders and borrowers within the financial system, since it did not differ from the explanation offered by developing countries. He wondered whether Mr. de Maulde could comment on the reasons for the pervasiveness of the constraints in the French financial system.

The French authorities were to be complimented, Mr. Mtei remarked, on their dedication to economic development in the developing countries, whose real needs, aspirations, and problems France had always understood and supported. Despite France's own economic problems, the authorities remained firm in the 1981 resolve to increase official development assistance to independent countries to 0.7 percent of GNP by 1988, an objective which had been included in the country's Ninth Plan (1984-88). Meanwhile, official development assistance as a percentage of GNP had increased from 0.38 in 1980 to 0.49 in 1983. He hoped that other countries would join France in increasing their ODA to the internationally agreed target of 0.7 percent of GNP as early as possible.

Mr. Kafka observed that the staff's skepticism concerning the feasibility of French targets for 1983 had clearly been unfounded. The main objectives for 1983--to halve the external account deficit and to reduce inflation substantially--were essentially attained despite all difficulties. Mr. de Maulde had praised Colbertism as superior to the neoclassical approach in both macroeconomic and microeconomic policy, and evidence that "direct action," the essence of Colbertism, could be successful was a healthy reminder to the Board, although it was unlikely that the results could be generalized.

Whatever the technique, Mr. Kafka continued, French policy had been impressively successful so far. Furthermore, renewed growth had been achieved without intensified protectionism, and could be expected to continue given more favorable world conditions. Appropriate domestic conditions and firm determination by the French Government were also necessary, particularly in the fiscal field.

Developments in France had taken place against a background of important structural change, Mr. Kafka commented. By 1982, there had been notable improvements in the industrial sector, evidenced by the increase in the share of nonlabor income in manufacturing and in the share of gross operating surplus in value added; such trends should be strengthened. The courageous 1983 wages policy, which related the goal for wage settlements to desired rather than past inflation was, of course, a decisive break with tradition; in the context of the devaluation of the franc, it reinforced the international competitiveness of the French economy. The continuation of a forward-looking wage policy, in conjunction with the Government's industrial, fiscal, and financial policies, was to be commended.

Concerning financial policies, Mr. Kafka remarked that the current system of achieving monetary targets through the use of credit ceilings was inefficient and was connected with subsidization of interest rates. The new banking law should reduce the excessive segmentation of the financial system and increase the scope and flexibility of monetary policy. However, there would probably be limits to its impact, deriving from the ownership structure of the financial sector.

He commended the French authorities for their continuing efforts to expand official development assistance, Mr. Kafka continued; it had reached 0.52 percent of GDP in 1983, representing an increase of 6 percent from 1982. He had been pleased to note that France had the lowest absolute intensity of nontariff barriers against developing countries compared with other EC members. Nevertheless, the weighted incidence of all nontariff barriers in France indicated that there was scope for reduction, and he requested that the staff elaborate on the subject of protectionism in the 1985 Article IV consultation with France. Nor should it be forgotten that France bore a share of the responsibility for the protectionist policies of the European Communities, a factor which tended to be overlooked during individual country consultations.

Mr. Polak recalled that the 1983 consultation with France had been preceded by a far-reaching decision by the French authorities to adopt a comprehensive domestic adjustment plan. The staff report under discussion presented welcome evidence of the implementation and success of the adjustment policies, as well as further testimony to the commitment of the French authorities. The staff paper gave a clear indication that the French Government was firmly committed to the convergence of economic conditions among the major industrial countries, as well as within the European Monetary System. In particular, the authorities were determined to achieve a current account surplus in 1985 and beyond, in order to reverse the rapid accumulation of foreign debt, even though such action would require a continued negative growth differential compared with their main trading partners. Moreover, the authorities sought convergence of the French inflation rate with that of Germany, rather than the aggregate rate of EC members. The statement of commitment was perhaps the most important result of the consultation; he strongly endorsed the government targets, particularly as the implementation of adjustment policies during 1983 had enhanced their credibility.

In choosing its policies, Mr. Polak considered that the Government was walking a narrow path between attaining its targets and meeting the self-imposed constraint of sustaining the level of economic activity. In 1983, they had been successful in achieving a positive GDP growth rate of 0.7 percent; it appeared safe to assume that strict monetary, fiscal, and incomes policies would continue to be compatible with sustained growth at a moderate rate of 2 or 3 percent over the next few years.

On fiscal policy, Mr. Polak said that he supported the intention to bring forward implementation of the 1985 economic measures to 1984. It was essential that there should be some reduction in the fiscal deficit in 1985, rather than mere containment, which sounded ambitious in terms of the policies required and the proposed tax reductions, but was not ambitious enough in terms of longer-run requirements, such as the need for an appropriate reduction in monetary expansion without crowding out private investment. In accordance with the staff appraisal, a budget deficit of 2.5 percent in 1985 with a further reduction thereafter would be desirable.

It was essential that inflation should be reduced to the original 5 percent target in 1984, Mr. Polak said. The failure to cut inflation had been disappointing, particularly as the recession should have facilitated a reduction. If inflation were again higher in 1984 than the official target, wage earners and unions might seek the restoration of full indexation or aim for a high official wage target for 1985; either outcome would be equally undesirable.

He would like further clarification of the workings of the present incomes policy, Mr. Polak remarked. On page 5 of the report on recent economic developments, it was noted that, in early 1984, government employees had been compensated for the loss in average purchasing power in 1983 with a lump sum payment, and yet it was also noted that the payment conformed to the 5 percent guideline for 1984. Since the present system did not provide full indexation, he wondered whether there would be a period of catching up when the system was abolished, and, if so, whether the French authorities believed that a real wage cut was unnecessary in France despite high and rising unemployment and a clear need to increase corporate profitability. It should be recalled that the staff appraisal in the report for the 1983 Article IV consultation had stated that, in view of the urgent need to restore profitability and reduce unemployment, it was unlikely that real wages could be maintained.

The Government's plan to compensate for higher budgetary outlays on civil service salaries by replacing only two out of every three vacant posts in civil service employment was also a case of high wages leading to lower employment, Mr. Polak said. The continuing rise in the real minimum wage rate was a cause for some concern, since it put upward pressure on wages and reinforced labor market rigidities. The plan for a further reduction in average working hours was also open to criticism, since it had inflated costs in 1981.

With regard to monetary policy, Mr. Polak remarked that he shared the staff view that net expansion of domestic credit and not of the money supply should be the main target of monetary policy. The high priority accorded to external adjustment required that unexpectedly large outflows from the current account should not be compensated. He wondered whether the recent reduction in the rate of monetary expansion was perhaps the mirror image of the current account deficit in the first quarter of 1984.

The new practice of including a page on statistical data at the end of the staff report pointed up the delay in the provision of French statistics, Mr. Polak remarked. According to recent information from the Bureau of Statistics, the most recent data in the July issue of International Financial Statistics would be for December 1983 for international liquidity, the Banque de France, and the commercial banks, despite the fact that more recent data were available in France, namely, for May for international liquidity and the Banque de France, and for March or possibly even April for the commercial banks. The explanation given by the staff was that the data were reported to the Fund only after their publication in the Bulletin of the National Council of Credit. It seemed to be a case of tangled bureaucracy which he hoped Mr. de Maulde would be able to unravel.

Concerning external policy, Mr. Polak noted the substantial improvement in the current account. However, as regards the capital account, the argument that the net autonomous capital outflows could not be significantly reduced, as suggested in SM/84/123, was not tenable. Although it perhaps applied to gross outflows, it should be possible to attract more autonomous capital inflows via different policies on capital restrictions and interest rates. If freedom of international movement in the goods sector had been complemented by freedom of international capital transactions, the interaction between the goods and capital markets could have prevented so large an accumulation of foreign debt.

He welcomed the discussion on French trade policies in SM/84/123, Mr. Polak went on. In particular, the well-documented statement indicating that France applied more restrictive protectionist measures than any other country should have appeared in the staff appraisal. In that connection, Mr. de Maulde's statement that Colbert's mercantilist spirit lived on in Paris was not reassuring. The last remnant of mercantilism should be abolished in France and elsewhere.

He welcomed the abolition of exchange restrictions for tourists, Mr. Polak said. It was also encouraging that, according to the 1984 currency budget, the Fund would shortly be able to call upon France once again for the financing of Fund lending, a sign of the considerable progress that had recently been made.

Mr. Tvedt said that he was in general agreement with the staff appraisal. Recent developments in France indicated that economic performance had improved substantially in important areas, particularly with respect to the current account deficit, which had been more than halved between 1982 and 1983. Although the improvement was partly due to certain special factors, there had been substantial gains in both international and domestic market shares. According to the staff report, the current account had continued to improve, and could possibly be in equilibrium by the end of 1984, although the Director of the European Department had said that the estimate might be overoptimistic. Nonetheless, the concern of some Directors expressed a year ago, that the structural weaknesses in the competitive position of parts of French industry and the J-curve effect following the March 1983 devaluation would make it difficult for France to achieve its objectives, had proved unwarranted. It should be noted, however, that the marked improvement in the current account balance was to an extent related to the cyclical position of the French economy. Thus, it was essential to preserve the competitiveness of French industry and stimulate investment. Although public sector investment played a greater role in France than in many other industrial countries, the depressed level of business fixed investment between 1981 and 1983, with the prospect of a further decline in 1984, was not encouraging.

With respect to incomes policy, Mr. Tvedt continued, the authorities should be commended for their success in breaking with the tradition of automatically adjusting wages for past price increases. A much better balance appeared to have been achieved between actual wage developments on the one hand and productivity and terms of trade changes on the other. Moreover, following a substantial decline in the rate of increase in unit labor costs in recent years, and with the prospect of a further improvement in 1984, manufacturing unit costs measured in a common currency seemed to have reached a level more compatible with that of France's major trading partners. However, given France's participation in the European Monetary System (EMS), bilateral comparison with Germany's economic performance was also relevant, as noted by the authorities. Given the significant difference in cost and price inflation between France and Germany and the importance attached to the smooth functioning of the EMS, more emphasis should be placed on reducing inflation at a faster rate than had been suggested by the authorities. In addition, the unexpectedly high inflation in 1983 and the prospect of a further overshooting in 1984 could refuel inflationary expectations.

Against the background of the inflationary experience of recent years, and the apparent difficulties in interpreting monetary data, Mr. Tvedt said, he agreed with the staff that the growth of M-2R and domestic credit expansion should be tightly constrained.

France, like many other countries, had encountered structural problems and rigidities in its economy, Mr. Tvedt remarked. In the labor market, the authorities had recognized that their former policy of minimum wage adjustment had become a source of rigidity, and they had reacted courageously by increasing the flexibility of the wage settlement system. Concerning industrial policy, structural changes were scheduled to take place gradually owing to their social implications, a policy with which he fully agreed. Also encouraging was the authorities' commitment to an open trading system. Structural change and improved competitiveness should be achieved by stimulating labor mobility and by improving the conditions for profit and investment in competitive industries, while maintaining free trade across the borders.

With respect to the staff report itself, Mr. Tvedt commented that, given recent developments in the French economy and its general importance, the staff should have elaborated further on the outlook for France, including more detailed projections for 1985. It would also have been useful if the staff had discussed the implications of the supplementary information, which had been received on June 11, for the outlook of the French economy as presented in the staff report. The authorities were to be commended for continuing their development aid despite their economic difficulties.

Mr. Joyce commended the French authorities for the good performance of their economy, which had been significantly better than expected. Particularly beneficial had been the important measures implemented in 1983 to stabilize the economy. The self-imposed targets set by the Government in the spring of 1983 had been the elimination of the current account deficit by the end of 1984 and the significant reduction in the rate of inflation. The objectives had been appropriate, and the Government's firmness in pursuing them had produced a more sustainable external balance, a marked improvement in price performance, and a partial recovery in business profitability. However, the French economy continued to face a number of difficulties; in particular, unemployment was high and rising, profitability, while improving, remained weak, and, while the fiscal excesses of 1981-82 had been reduced, the sustainability of the fiscal deficit remained in doubt. It was therefore vital for the authorities to maintain the momentum achieved, and to implement the measures required to keep the adjustment process on track. However, it should now be possible to move away from "crisis management" and to take a more forward-looking approach, with a greater emphasis on structural reform.

Concerning fiscal policy, Mr. Joyce continued, the size of the budget deficit as a proportion of GDP had grown substantially in recent years, despite the authorities' welcome restraint. The increase in the deficit was understandable given the sluggish growth of output, but its absorption of an increasingly large share of domestic financial resources was a cause for concern, since, within the context of a tight monetary policy, it could crowd the private sector from the capital markets, adding to upward pressure on interest rates.

He agreed with the staff observation that the current method of calculating the central government deficit was too narrowly based, Mr. Joyce said, and that it would be preferable to include the financing needs of other government agencies and public sector enterprises in assessing the public sector's overall financing requirement. Indeed, it was important for the authorities and the staff in future Article IV consultations to continue to monitor fiscal developments according to the broader measure.

He was concerned about the implications of the planned reduction in the tax burden for 1985, Mr. Joyce added. Although an easing of the tax burden was always to be welcomed, the sluggish economic growth expected for 1985 would require that the authorities maintain very firm control over government spending. Furthermore, as noted by the staff, the tax reductions should be concentrated on lessening the corporate tax burden so as to increase profit margins, strengthen private investment, and improve employment opportunities.

The success in restraining monetary growth during the early part of 1984 was highly encouraging, Mr. Joyce commented, particularly given its acceleration in the fourth quarter of 1983. However, the higher rates of inflation expected in 1984, compared with those forecast for France's major trading partners, suggested that the authorities should keep the growth of M-2R in the lower end of the target range of 5.5-6.5 percent. While that might constrain domestic demand, it would have a beneficial impact on French competitiveness, particularly if it led to a sharper reduction in domestic inflation. He shared the hesitancy of the staff concerning the usefulness of credit ceilings in the French case, since, as a policy instrument, they appeared a cumbersome tool for the restraint of M-2R; the authorities would be well advised to adopt more market-oriented techniques.

The incomes policy pursued by the authorities since 1983 had probably helped to reduce the growth of unit labor costs, Mr. Joyce said. Both the staff and the authorities estimated that nominal hourly wage increases had been approximately 4 percentage points lower than they would otherwise have been in the absence of the wage freeze and the new system of wage settlement. However, given the data in Table 1 of the staff report, suggesting that wage increases continued to outpace price increases, he wondered whether the new policy of basing wage negotiations in 1984 on a price target of 5 percent was likely to be viable, particularly since both the staff and the authorities appeared to agree that an inflation rate of nearly 7.5 percent was more likely. He requested from the staff a fuller description of the practical determination of wage rates under the new system, and an indication of possible wage flexibility should price increases exceed expectations.

The current effort to improve the economic efficiency of public sector enterprises was commendable, Mr. Joyce said. Furthermore, the restructuring of ailing industries and the accelerated expansion of growth sectors would benefit employment over the medium term. The French experiment of attempting to strike an appropriate balance between state objectives and market incentives in the nationalized industries was interesting, but had undoubtedly led to a more complex system of incentives and higher managerial overheads than would otherwise have been necessary, perhaps leading some Executive Directors to argue that the authorities should aim at greater reliance on market forces. The view was justified in principle, but each country should exercise its own judgment concerning industrial policy, and accept its consequences.

Commenting on external policies, Mr. Joyce noted that, although the growth in external debt was projected to slow in 1984, the ratio of external debt to GDP was expected to rise still further. In view of the possible unsustainability of the debt, the authorities were correct in aiming for a current account surplus in 1985. In addition, France's longer-term interests would best be served by the pursuit of free trade policies, both inside and outside the European Communities. France's apparent reluctance to support initiatives for a new and early round of multilateral trade negotiations and its attempts to tighten European trade policy within the European communities were appropriate only in the short term, and were incompatible with the leadership position expected of France within the EC.

The overall progress and, in particular, the improvement in French competitiveness were noteworthy, Mr. Joyce added. The authorities had begun to deal with some of the rigidities in the economy, but it was clear that many distortions existed. If France were to become more efficient and to achieve a rate of inflation and a balance of payments position that were in accord with its desire for the stability of the franc within the European Monetary System, continued economic adjustment was necessary. He congratulated the French authorities on their intention to increase further their official development assistance.

Mr. de Groote stated that the French authorities were to be commended for their economic pragmatism. They had not hesitated in devising a new approach to deal with their economic imbalances once it had become clear that the international environment would not permit them to pursue the expansionary policies they had originally intended. Their achievements could therefore be judged very differently depending on whether present policies were compared with pre-election commitments, or present successes with the dangers that alternative policies would have entailed.

The originality of the French adjustment policy, which had been adopted to correct the economic imbalances common to most industrial countries, lay in the priority accorded to the medium-term objective of restoring the profitability of entrepreneurship, Mr. de Groote continued. At the same time, demand had been constrained through fiscal policy and the short-term use of incomes policy for decelerating inflation and for restoring the competitiveness of the economy in the longer term. The approach to the correction of imbalances and the revitalization of economic growth was predominantly structural, and therefore had to be gradual.

Indicative of the authorities' distinctive blend of policies, Mr. de Groote said, was the March 1983 decision to supplement the exchange rate adjustment by a tightening of fiscal and monetary policies and the introduction of a courageous and innovative incomes policy. Moreover, the application of the various policy elements had been calibrated to minimize their negative effect on employment. Although the approach had not permitted full attainment of their goals, the authorities had nonetheless achieved remarkable progress, particularly given the experience of the past and the uncertainty surrounding the economic forecasts. That the present situation was not yet satisfactory was admitted by the French authorities, and the staff's choice of language had been overcritical in parts of its appraisal. For example, the staff considered the expected improvement in the inflation rate from 9.3 percent in 1983 to 6.5 percent in 1984 to represent a "disappointing rate of progress," and stressed that the results, both those achieved and expected, were "still far from establishing a satisfactory situation." In fact, the current rate of inflation was consistent with the performance of the price level since 1960, and it was continuing to fall. Although the price target had not been reached, progress in the balance of payments had exceeded expectations, and had done so in the absence of intensified protectionism.

In the future, Mr. de Groote commented, France should consolidate the progress made in reducing the current account deficit and containing the public sector deficit, in order to ensure the sustainability of the improvement in economic performance. Incomes policy had played a crucial role in the improvement; the authorities should therefore continue to reduce the inflation rate in order to moderate wage costs. It had been particularly encouraging to learn from Mr. de Maulde's statement that the policy of setting future incomes on the basis of the targeted inflation rate was now a well-accepted component of the French social fabric, a development that reflected the Government's firm resolve to use the present political circumstances to restore better conditions for the economy. However, to preserve the necessary wage differentiation, the Government would need to moderate its demands for real increases in a national minimum wage, since wage moderation would remain essential as long as the inflation differential between the franc and the stronger EMS currencies continued to erode the competitive position of the business sector. The recovery of business profitability was still insufficient, since only part of the deterioration which had occurred since the early 1970s under the previous Government had been offset. That the centerpiece of the medium-term structural adjustment pursued by the French Government was the improvement of business profitability as the motor for further employment generation had sometimes been overlooked.

He shared the staff's doubt that France's monetary policy was fully consistent with the overall economic strategy, Mr. de Groote said. The compartmentalization of financial markets and administrative controls over the creation of domestic credit had led in recent years to a larger injection of liquidity than had been warranted by the external situation, providing a possible explanation for the slowness in the deceleration of inflation in recent years. Although the rate of expansion of credit had slowed in 1983, it had been accompanied by a rapid increase in the share of long-term financing in the financial markets. France also had special credit circuits, designed to ensure the financing of investment, that were not included under the credit ceilings; total financing flows were therefore larger than the figure for credit expansion indicated. Similarly, M-2 understated the actual liquidity in the economy, particularly since the recent structural changes in the financial market had caused a shift to other financial resources as liquid as M-2, although formally of a long-term nature; if nonmonetary liquid resources and M-2 were treated as counterparts to net domestic credit, the growth rate for domestic liquidity was calculated to be over 13 percent, as opposed to 11.2 percent, for 1983.

Despite the existence of special financing channels and preferential interest rates, in the tradition of Colbert, the rate of investment, particularly in the business sector, had been sluggish since 1981, Mr. de Groote continued. He therefore wondered what purpose was served by the fragmentation of the financial market, apart from the protection of heavily indebted enterprises. In addition, interest rates had not been set in conformity with the 1984 goals, and indeed, the limitations imposed on M-2 for 1984 would require a large contribution of long-term financing, the source of which was uncertain since long-term interest rates were fixed at the same level as short-term rates. By suppressing long-term interest rates, the Government might find it necessary to abandon its credit objectives in order to maintain an adequate level of economic activity, gravely undermining the credibility of the Government's strategy.

In the domain of public finances, Mr. de Groote noted that the authorities had succeeded in preventing further deterioration of the fiscal deficit, the present level of which should create few difficulties as long as domestic credit demand remained subdued. He therefore agreed with the French authorities that maintaining the present deficit would sustain an adequate level of domestic demand in the near future, although the Government should be prepared to reduce the public sector's claim on resources once economic activity revived. While containing public expenditures, the authorities had continued to give priority to France's overseas responsibilties and had further increased their official development assistance, most of which was bilateral, for which they were to be commended.

The French Article IV consultations had always evolved in an atmosphere of historical and ideological controversy, Mr. de Groote remarked. Mr. de Maulde had traced the roots of the current industrial and incomes policy back to Louis XIV's Finance Minister, Colbert, and his system of national economic management. However, Mr. de Maulde's precedessor on the Executive Board, Mr. Mentré de Loye, did not regard Colbert as a patron saint of effective economic management. In a recent book, Gulliver in Chains, and in some controversial interviews published in French periodicals, Mr. Mentré de Loye had urgently pleaded for a rejection of the influence of Colbertism on French economic policies. He doubted whether those policies were as Colbertist as they might seem; it was unlikely that the market alone could ensure the restructuring of declining economic sectors such as coal and steel. It was, however, the Government's intention to give special incentives to private enterprise in potential growth sectors; the treatment of businesses under current economic policies appeared already to have had a favorable impact on the Paris Stock Exchange.

France had been relatively successful in following an adequate adjustment path, Mr. de Groote stated. The external balance had been improved and inflation reduced without incurring a major recession and without recourse to protectionist measures. Although the results might be viewed by some as less than satisfactory, the French approach had the merit of limiting the cost of adjustment in terms of lost output and employment, although some elements of the package--monetary policy in particular--should be strengthened to ensure the credibility of the Government's strategy. Given that the skepticism expressed in the 1983 consultation concerning the viability of the French adjustment program had been unfounded, the authorities should be accorded the benefit of the doubt to pursue their adjustment strategy further in 1984.

Mr. Alfidja said that 1983 had marked a decisive change in French economic policy, which, in response to past years' experience, had been directed at reinforcing the competitiveness of French enterprise through two simultaneous actions: first, the devaluation of the franc in March 1983, and second, the introduction of a wage policy compatible with improved industrial competitiveness. The successful outcome of the new policies, particularly the improvement in the current account, provided the best support for the appropriateness of the decision to change course.

The growth of 1.2 percent in industrial production in 1984 after several years of decline was encouraging, Mr. Alfidja continued. Although that expansion was below the average for the 1977-79 period, it had to be placed in the context of European growth, which had been moderately high in the late 1970s, as well as in the context of current deflationary domestic policy. That real GDP had grown by 1.6 percent during the first quarter of 1984, from a rate of 0.7 percent in 1983, was an indication that recovery was under way. It was also satisfying to note that from 1983 onward there had been a recovery in industrial investment; furthermore, it was evident from recent studies that there had been a change in the type of investments, implying a possible reduction in the rate of unemployment, which was still high despite government efforts to reduce it.

The success of French policy in the future rested critically on a reduction in inflation, Mr. Alfidja said. Lower inflation would increase the competitiveness of French products, and the stability of the European Monetary System could be assured only if there were a reduction in the inflation differential between France and its European partners. Furthermore, falling inflation would serve to dampen inflationary expectations. The progress in the field of inflation during 1983 was encouraging and would facilitate the introduction of a realistic and equitable wage policy. The break from the rigid system of wage and price indexation had been an important achievement; during the 18 months prior to the end of 1983, the increase in real wages would have been 4 percent less if it had been based on the official price index. He congratulated the authorities on their new system, especially as they intended to maintain it during 1984 and thereafter.

However, Mr. Alfidja continued, the anti-inflation objectives were perhaps overoptimistic, although it was in the interests of France and its partners that they should not be. The lowering of the inflation differential between France and its commercial partners from 3.7 percent in 1983 to 1.7 percent in 1984 would be highly beneficial for the reasons he had mentioned earlier.

The public sector deficit of 3.3 percent of GDP had only slightly exceeded the objective of 3 percent fixed by the authorities, Mr. Alfidja noted. The staff report indicated that the deficit was due not to lack of control but rather to an unexpected shortfall in revenue. The authorities intended to limit the deficit to 3 percent of GDP for 1984, which would require a strict control of expenditures. He was pleased to note that the financing of public sector enterprises in 1984 would be limited to 1.2 percent of GDP, compared with 1.6 percent in 1983. The reduction was made possible by, among other things, improved stability in real wages and better productivity. The authorities' decision to aim at financial equilibrium for some of the public enterprises in 1984 was welcome.

On the financial sector, Mr. Alfidja agreed with the authorities that their monetary policy was highly restrictive. Nevertheless, the target growth range of 5.5-6.5 percent for M-2R in 1984 appeared overambitious, taking into account the projected growth of GDP. The authorities' intention to use an active interest rate policy to encourage savings was notable, while the new banking legislation, effective from July 1984, should improve competition and hence facilitate effective monetary policy.

The authorities were to be congratulated for reducing the trade deficit in 1983, Mr. Alfidja said. The March 1983 devaluation, together with the authorities' wage policy, had improved the competitiveness of French products, with tangible results. In 1983, the volume of exports had grown by 3.6 percent while the volume of imports had falled by 2.0 percent. He hoped that the authorities would reach their goal of a current account surplus in 1984.

He thanked the French authorities for the increase in their official development assistance, Mr. Alfidja continued, which represented 0.52 percent of GDP in 1984, compared with 0.49 percent in 1982. Despite their economic problems, the authorities intended to bring the ratio to 0.54 percent of GDP in 1984.

Mr. Feito commented that the French authorities' commitment to development assistance was commendable. In a difficult economic environment it was encouraging to note that France, as a large and important industrial country, had not changed its development aid policy.

The French Government had significantly modified its financial policies, Mr. Feito continued. During 1983, a successful effort had been made to arrest the inflationary trend and to correct the balance of payments problems, which had been accompanied by growing unemployment since the beginning of the decade. The policy package had corrected the monetary imbalances between France and its major trading partners; but additional corrective measures were required to buttress the progress already made and to ease further the balance of payments constraint in order to establish a firmer base from which to ensure growth of output in the future.

Concerning external developments, Mr. Feito noted that, although the 1983 objective of reducing the current account deficit had been met, the outcome had been far from satisfactory, and the observed improvement could prove to be temporary should domestic activity and employment levels eventually rebound. The improvement of the current account had been due primarily to a decline in overall investment, since flows of savings had remained broadly constant, while the lagged effects of the earlier real depreciation of the franc had also contributed to the strengthening of the current account. However, in quantitative terms, the main cause of the improvement had been the lower growth rate of real demand in France compared with that of partner countries. Moreover, the results had been positively influenced by gains in the terms of trade of about 2.5 percent, which were unlikely to be repeated in the near future. In addition, as noted by the staff, as long as there were permanent autonomous capital outflows, the only sustainable trade position was an offsetting current account surplus. Indeed, given France's high volume of external debt, it was desirable to set a current account surplus target greater than the expected net autonomous capital outflows. In sum, it was clear that the improvement in the current account should not be interpreted as an indication of adequate levels of competitiveness in French industry. On the contrary, further advances in competitiveness should be sought if the external balance were not to be secured at the expense of domestic investment and employment.

The inefficiency of the labor market and current high levels of unemployment were another major area of concern, Mr. Feito continued. There was a consensus that inefficient pricing of labor services and rigidities in the labor market were the major factors behind the labor problem in France as well as in most other European countries. The problem was not only that the average wage rate was too high but also that the distribution of wage rates was wrong. Unemployment appeared to be the result of wide discrepancies between the demand profile of different sectors on the one hand and the allocation of labor and other resources on the other.

He shared the staff's view that the mix of incomes policy and tight financial control adopted by the Government, as well as the more cautious stance toward real minimum wages and the intention to reduce other labor market rigidities, were welcome developments, Mr. Feito said. However, there were indications that labor costs should be further restrained and that the introduction of more flexible labor legislation should be accelerated. There was a need to arrest the steady fall in private investment rates by increasing profitability. It was clear from Appendix I of the report on recent economic developments that some measures of corporate profitability were meaningless, but once the indicators were adjusted for real interest rates, which represented the opportunity cost of allocating investable funds to productive purposes, they all showed a negative rate of profit. That result gave cause for concern, particularly since, given French monetary policy, interest rates did not capture fully the degree of credit rationing to which the private sector was subject, due to the increasing claims of the public sector on financial resources.

Investment should be encouraged, either by reducing real labor costs, particularly in low-productivity growth industries, or by lowering real interest rates from their current levels, Mr. Feito added. The latter option did not seem feasible given the current and prospective financial borrowing needs of the public sector. In fact, based on current trends in public expenditure, further increases in real interest rates or in taxes could be expected, both of which would be equally detrimental to private investment. As a result, there was a trade-off between the growth of the public sector deficit and real wages, in that the larger the public sector deficit, the lower real wages should be in order to preserve industrial profitability and to achieve internal and external balance. Further fiscal action, preferably on the expenditure side, was clearly vital to narrow the public sector deficit as rapidly as possible.

Moreover, further wage moderation might also be necessary, Mr. Feito said, should a partial reversal of past exchange rate movements take place between the EMS currencies and the U.S. and Canadian dollars. It was disappointing that the unemployment problem in France had worsened despite the real devaluation of the franc against the U.S. and Canadian dollars, owing perhaps to the real wage gaps between the countries, which should be narrowed if a coordinated stance of macroeconomic policies among industrial countries and a stable world economic environment were to be achieved. He invited the staff or Mr. de Maulde to comment on the probable consequences and the requisite changes in French policy that would arise should past exchange rate trends among major currencies be reversed.

The French authorities were well aware of the possible threats to economic prosperity in the medium term, Mr. Feito concluded, but there was no doubt that they would again show the necessary flexibility to tackle unforeseen developments.

Mr. Ismael commented that the strategy followed by the French authorities since 1983 was likely to succeed in achieving current account equilibrium in 1984, which was one of the two immediate objectives set for the current economic program. Concerning the reduction of the inflation rate, which was the other objective, the staff appeared to be less optimistic than the authorities, a difference which was due to disagreement on the required dosage of each policy element, rather than their relative merits, particularly with regard to incomes, monetary, and fiscal policies. The gradual approach of the authorities certainly had its own merit in minimizing the side effects of the adjustment policies on economic growth and employment, but there was a real risk of missing the inflation target under the current fiscal and monetary policies. The strategic importance of suppressing inflation in order to implement a sound incomes policy and to improve the competitive position of the economy could not be overemphasized.

Concerning fiscal policy, Mr. Ismael remarked that the increase in the central government budget deficit from 2.3 percent of GDP to 3.7 percent in 1983--on a cash basis--was a cause for concern in the light of its impact on inflation and interest rates. Of equal concern was the current high level and upward trend of government expenditures in relation to GDP. The 1984 target of a budget deficit of 3 percent of GDP, although still not low enough, did not appear feasible in view of the anticipated lower revenues, the projected depletion of social security funds, and the increasing trend in the real expenditures of local authorities. Consequently, the preparation of measures to cancel and freeze certain budget allocations was appropriate. He also supported the staff's suggestion that the implementation of decisions planned for 1985 should be brought forward to 1984 to provide more ambitious targets than were currently being sought by the authorities.

The sharp reversal in the upward trend in the rate of expansion of M-2R in 1984 was another vital element of the current program's implementation that needed close monitoring, Mr. Ismael continued. In 1983, the Treasury's claim on monetary resources to finance budget deficits had been the major factor behind the high rate of monetary expansion, emphasizing the importance of reducing the fiscal deficit in 1984 and 1985. The authorities should adopt the definition of public sector financing requirement as that resulting from administrative decisions--rather than that arising from market actions--since that definition would be consistent with the government policy of granting full autonomy to the management of most public enterprises. In the conduct of monetary and credit policy, the Government should begin to rely more on a flexible interest rate policy than on credit ceilings, which were a relatively crude instrument of monetary policy, particularly since, at the current time, credit ceilings were not constraining domestic credit expansion. The banking reform law to be introduced in July 1984 was welcome, as it would provide a more favorable competitive environment through ensuring equal treatment for various types of banks.

On the supply side, efforts to introduce high technology into the industrial sector were encouraging, Mr. Ismael said. Investment in technology was consistent with the principle of comparative advantage and would develop more competitive industries capable of sustaining a high level of output and world trade. Elimination of the remaining price controls over industrial commodities and the extension of full autonomy to the management of nationalized companies were essential to strengthen the finances and operation of industrial enterprises. However, the high instance of nontariff barriers in France relative to other major members of the European Communities was a cause for concern; the authorities should act to create a free trade system. He too welcomed France's continued commitment to increase official development assistance to 0.7 percent of GDP by 1988.

Mr. Abiad said that he was in agreement with the staff appraisal. While the policy package of March 1983 for a structural reorientation of the economy had been fully implemented, the results had been mixed. Noteworthy developments were the reduction of the external deficit in 1983 to one half of that in the previous year, the resumption of export growth, and further gains in the attempt to restore both domestic profitability and competitiveness. However, weaknesses in other areas, as manifested by higher than targeted inflation, a larger than planned budget deficit, overshooting of the monetary target, and the rising level of foreign debt, clearly underlined the need for the continued pursuit of restrained policies. The extension of the 1983 policies into 1984, with increased emphasis on the restructuring of the industrial sector, was therefore encouraging.

The authorities' approach to incomes policy, which aimed at introducing longer-term flexibility into wage negotiations rather than focusing only on the achievement of real wage reduction, seemed both reasonable and pragmatic, Mr. Abiad continued. Monetary policy could clearly play a useful role in reinforcing incomes policy in the fight against inflation. However, on page 10 of the staff report it was noted that the relationship between monetary growth and inflation in France was weak in the short run, although monetary growth had affected inflation through the balance of payments and exchange rate behavior. The finding was interesting, and he requested the staff to elaborate on the special factors underlying it in the case of France and on its policy implications. Concerning the effectiveness of monetary policy, the staff repeatedly suggested that it would be enhanced by reduced reliance on quantitative credit ceilings and a more flexible interest rate structure, but the authorities' gradual move toward the new policy direction was also reasonable considering the institutional factors specific to France. The sharp decline in the "derestriction premium" (prime de désencadrement) and the increase in interest rates in France were also notable, and it would be interesting to learn from the staff whether the credit ceilings had been less effective as a result of interest rate developments.

A slower growth of government expenditure in 1985 would be necessary to control the growing deficit, Mr. Abiad said, inasmuch as a reduction in the tax burden was envisaged. Also noteworthy was the staff view that to continue financing the deficit at its currently targeted level could adversely affect private investment and output growth.

Concerning trade policies, Mr. Abiad noted the authorities' restated commitment to an open trade system. However, he had some difficulty in reconciling that statement with the qualification on page 18 of the staff report that, under certain conditions, "some temporary protection was necessary" and with France's recent initiative to tighten EC trade policy. Moreover, he wondered whether protectionism affected developing and industrial countries with the same intensity since the latter countries enjoyed a more diversified production base and wider export markets than the former.

Despite France's budgetary constraint, official development assistance had been increased in 1983 and was expected to be further increased in 1984, Mr. Abiad noted. Since many ODA recipients were undertaking major adjustment efforts in a difficult international economic environment, the maintenance of adequate levels of assistance would be crucial to the success of their endeavors.

With regard to the contents and coverage of the report on recent economic developments, Mr. Abiad pointed out that, although SM/84/123 contained a new appendix on the measurement of corporate profitabilty, it did not discuss France's energy policies, in spite of the importance attached to them by the authorities. In recent years, the energy sector in France had undergone a number of structural changes. According to unofficial sources, one aspect of more recent developments had been the difficulty associated with the efforts to achieve an economically viable energy mix involving a fundamental shift toward nuclear-based electricity generation. However, the viability of the approach necessitated a scale of production that seemed to be well above present and prospective domestic consumption needs, while the marketing of the resulting electricity surplus in neighboring countries would require considerable additional investment. To the extent that the public utility concerned no longer received budget subsidies--and given the reported levels of its current indebtedness--the required investment would have at least to be partially financed through high prices, a development that could frustrate efforts to promote electricity consumption and export. Developments in the electricity, coal, and gas industries could have been usefully analyzed and could perhaps be incorporated in the 1985 report on recent economic developments. Meanwhile, he asked the staff to comment on recent developments in the domestic pricing of oil products; no information had been provided in the staff papers.

In terms of labor market developments, Mr. Abiad noted that the relevant section of SM/84/123 made no reference to either the immigrant component of the labor force or immigration policies; he asked the staff to comment on recent changes in those policies. Furthermore, the staff suggested that work-sharing schemes had been pursued with less vigor in 1983. The staff's view on France's experience with such schemes and the associated reduction in the workweek would be welcome; it could be helpful to policymakers in other countries, particularly those where there had recently been demands for similar arrangements.

Mr. Morrell said that an important start had been made in correcting the financial imbalances that had recently beset the French economy, as well as in reversing some longer-standing weaknesses. The outcomes for the balance of payments and the rate of inflation had been closer to the authorities' expectations than the staff's original outlook, and had been achieved through a resolute implementation of the French financial program. It was regrettable but unavoidable that such progress could be achieved only at the expense of output growth and employment at a time when recovery in some other industrial countries was producing the opposite result.

He could generally endorse the staff appraisal contained in the latest report, Mr. Morrell said. There was little disagreement between the authorities and the staff on the basic agenda for future action. Clearly, to obtain sustainable growth, the authorities would need to consolidate the gains made in 1983 in reducing the external deficit and in slowing the inflation rate. Incomes policy would play an important role in achieving the latter objective. The economic measures intended for 1984 appeared appropriate.

Concerning public sector finance, Mr. Morrell agreed with the staff assessment that a reduction in the central government deficit to 3 percent of GDP in 1984, although requiring a major effort, was a necessary condition for the achievement of the financial objectives. It was notable that there was no aggregate information available on the borrowing requirement of the nationalized industries, and he wondered whether the Government was responsible, through guarantees or additional equity contribution, should they fail to service their debt. The authorities did, however, maintain that the nationalized industries were individually responsible for their own financial management.

The rising ratio of public expenditure to GDP was a source of concern, Mr. Morrell said, since it was expected to rise from 38 percent in 1974 to 50 percent in 1984. Table 3 of the staff report, on selected indicators of public sector claims on resources, showed a trend toward crowding out, although a large part of expenditure growth had arisen from items where control was limited, such as social transfer payments and interest payments. The intention to reduce such payments by 1 percent of GDP in 1985 was welcome, but over the medium term the Government should examine means of reducing the deficit, not only for macroeconomic reasons, but to bring the Government's fiscal burden in line with its efforts at structural adjustment, with particular emphasis on improving industrial profitability. He asked the staff for an assessment of the burden imposed on the economy through the transfers of resources in favor of certain sectors, such as agriculture, either directly through the fiscal system or indirectly through price distortions and resource misallocation.

The staff and the authorities agreed on the need to continue the tight monetary policy, although not on the means for executing it, Mr. Morrell noted. He shared the view of the staff and many other Executive Directors that a more market-oriented credit allocation system and a more active interest rate policy could improve the efficiency of the French economy. The new banking legislation was welcome.

On the balance of payments, Mr. Morrell said that he hoped for further improvements in the current account for 1984, although the less optimistic comments of the Director of the European Department at the opening of the meeting were noted. He welcomed the expected reduction in the growth of external medium-term and long-term debt, which was expected to slow in 1984 from its formerly unsustainable level. The removal of exchange restrictions in 1983 was commendable.

The staff report noted that the authorities recognized that French industry had fallen behind competitor countries in the process of structural adjustment as a result of its low profitability, resulting from wage rigidities and high interest rates, as well as the drain on resources from inefficient sectors such as steel, textiles, and agriculture, Mr. Morrell commented. It was therefore discouraging to read of French initiatives to tighten further the protective trade posture of the European Communities, even though it appeared to be a defensive response to protectionism elsewhere. The so-called new commercial policy instrument, understood as reciprocal action against the United States, represented an escalation in the use of a sophisticated protective apparatus among the major economies to the detriment of the multilateral trading system and the smaller trading countries which lacked comparable leverage. He hoped that there would be a return to more obvious and less distortionary devices for protection, such as tariffs.

On the agricultural sector, Mr. Morrell welcomed the changes agreed upon in the Common Agricultural Policy, and hoped that they would lead to a decline in surplus production, a more balanced price structure and a reduction in export restrictions. Regrettably, further protective measures against specific imports, such as cereals, butter, sheep meat, and beef, seemed likely.

He joined other Directors in commending France for its commitment to official development assistance, Mr. Morrell added, and for its intentions to increase its assistance in the future.

Mr. Zhang said that it was clear from the staff report that the French authorities had made significant progress toward the correction of financial imbalances and long-standing rigidities and weaknesses in the economy. The key element of the French policies had been the implementation of an incomes policy, aimed at keeping the rise in nominal incomes in line with the targeted rate of inflation, while supported by a tightening of financial policies. The course taken by the French authorities was in striking contrast to the policies in some other major industrial countries that had not sought a disinflationary policy of nominal income growth. Instead, they had chosen to moderate demand through drastic financial restraint, which had sharply reduced activity, profits, and private investment, and had greatly increased unemployment.

The breaking of the previously pervasive de facto indexation of wages and salaries appeared to represent a major gain, Mr. Zhang continued. To have broken the system of indexation without a severe reduction in private investment, as had been encountered elsewhere, attested to the advantages of such a policy mix. However, judgment of the success of an incomes policy greatly depended upon the importance attached to disindexation, which had not been achieved without cost. The measures taken to mitigate the effects of high unemployment and the consequent increase in social security payments had meant that lower wage settlements had not been associated with a corresponding slowing of hourly labor remuneration, thus preventing wage and price inflation from decelerating rapidly.

To consolidate and extend the gains, Mr. Zhang commented, the French authorities must continue to avoid the economic and political hazards that could wreck their policies, as indeed they recognized. On the one hand, the success of the incomes policy could be impaired if the inflation target were not met due to insufficient financial restraint. On the other hand, excessively vigorous financial constraints could lead to a sharp fall in private investment and a rise in unemployment, which should be avoided since support for the incomes policy would thereby be undermined, provoking political pressures for palliative measures, such as high public spending and industrial subsidies, increased trade protectionism, and further direct protection of jobs.

The staff was, of course, correct to emphasize that, if incomes policy was to be successful, it should be supported by "adequately constraining financial policies," Mr. Zhang said. Consequently, the staff recommended a shift toward a more market-oriented credit allocation system and a greater reliance on interest rates for the curbing of demand. However, the view of the French authorities that such a shift could be realized only gradually should be endorsed, especially given the high indebtedness of French industry and the narrowness of the domestic money market. The experience of other industrial countries, notably the United Kingdom, indicated the uncertainty and considerable short-term costs associated with a rapid relaxation of long-standing credit controls. A major change in the French system of financial control would be ill-advised if the French authorities were to consolidate and extend their existing achievements.

The staff also suggested that French policies should be aimed at securing more rapid convergence between the French and German rates of inflation, Mr. Zhang continued, and at achieving a current account surplus. To achieve the goals, the staff advocated the adoption of a more ambitious disinflationary incomes policy, and the enforcement of rigorous monetary restraint by shifting from credit allocation toward a market-oriented system to strengthen central bank control over the financial system. The suggested policy raised the general question of whether it was preferable to aim for a feasible but only partial realization of an ideal goal, or to strive for a more ambitious target, ignoring the greater risks of falling short. With specific regard to incomes policy, he agreed with the French authorities that "it would be of greater long-term benefit to introduce flexibility into wage negotiations than to impose a severe, and thus possibly reversible, one-time restraint" (page 10 of SM/84/109). In the monetary sector, a major change in the financial system would inevitably have severe repercussions on the industrial sector, the level of investment, and unemployment, thereby undermining the present basis for French policies, although a greater reliance on interest rates could ease the balance of payments problem. Given the political and industrial uncertainty, tighter monetary control would not necessarily strengthen the French franc and lessen the inflation differential.

He welcomed the French authorities' decision to increase further their official development assistance, Mr. Zhang said. He commended the staff on Appendix I (SM/84/123) reviewing various measures of corporate profitability. He requested the staff to clarify the meaning of the statement on page 5 of the staff report (SM/84/109) that recent research "found evidence of a changing pattern of investment behavior, with a higher and rising weight for profitability, perhaps because of a pent-up demand for replacement investment."

Mr. Jayawardena said that he was in broad agreement with the staff appraisal. Emerging particularly strongly from Appendix II of the report on recent economic developments was the extent and intensity of protectionism in France. It had resulted in a substantial misallocation of resources, and threw doubt on the effectiveness of efforts to achieve financial balance within the economy since the financial sector merely reflected the real sector.

He recalled a recent EC decision to make the costs and benefits of protection explicitly known to allow people to make informed judgments, Mr. Jayawardena remarked. If the French authoritites publicized the facts relating to protectionism, he was certain that the people would exorcize the ghost of Colbert. He welcomed the commitment of the French authorities to increase official development assistance.

The Director of the European Department said that he would first answer questions on France's external debt position. The staff had been asked to construct scenarios based on medium-term and long-term debt, and that had been done; it was certainly true that other elements of debt were also important in making a full comparison of France's position with those of other industrial countries. Comparison on a broader basis was difficult for several reasons. First, there was the accounting problem of how to deal with short-term debt in any forward-looking scenario. Second, despite recent improvements, there were still gaps in the available information on external debt. That being said, it was clear that by most established criteria, France was high on the list of industrial countries in terms of external indebtedness, with the proviso that it was difficult to judge the relative debt position of countries such as the United States and Germany, where much debt held by nonresidents was expressed in domestic currency.

Another problem in making a full assessment of France's external debt position, the Director continued, concerned the extent to which the debt of the private sector should be included in measurements of the total debt of the French economy. A main difficulty was a lack of data, as had been noted in a recently published Senate report. The report had also included in the total debt figure about F 150 billion of short-term debt, but the methodology used was questionable. In particular, one third of the F 150 billion represented money borrowed in the Eurofranc market by French banks, and would not have been included as external debt by many observers. It was also questionable whether borrowing by French banks for on-lending to French residents should be included.

With regard to the statement by the French Finance Minister that further borrowing of roughly the same magnitude as that projected for 1984 would be required over the next five years, the Director explained that the staff's estimates of France's external borrowing requirements were somewhat higher than those advanced by the French authorities. Of course, future estimates depended partly on the assumptions made regarding the future of the current account and of net autonomous capital flows. Mr. Polak was correct in stating that net autonomous capital flows should not be regarded as being irreducible, particularly since they were heavily influenced by the amount of export credit extended by France. Both gross and net figures could be affected by the interest rate policy pursued within France, which had for long been influenced by the desire to keep the rate of interest as low as possible without risking the stability of the French franc within the European Monetary System.

There had been a notable change in the attitudes of the French authorities to monetary control, the Director remarked, as was evident in references to a gradual reduction in the reliance to be placed on credit ceilings and the increased reliance to be placed--and already being placed--on interest rate policy. Those points were underlined in a recent report by the Governor of the Banque de France and also in the report on the Ninth Plan. The degree of interest rate subsidization inherent in the present system was often exaggerated; the average interest rate premium was equivalent to no more than a little over 1 percentage point. As emphasized by the French authorities, the recently prevailing high level of interest rates had relieved some of the strain on the credit ceilings.

Several questions had been asked about the prospective tax cuts in 1985, the Director continued. Mr. de Maulde had stated that they would take effect from January 1, 1985. At the time of the consultations, the French authorities had scarcely begun to consider what taxes should be reduced and what means should be used to contain the public sector deficit within the target of 3 percent of GDP.

The incomes policy had been widely accepted for several reasons, the Director commented. First, trade union power in France had been exaggerated in earlier years; the unions were not rich and had been in no position to finance their members in prolonged strikes. Second, political factors, such as the present political composition of the Government and in particular the inclusion of communist party members, had played a role. Third, the growth of unemployment and realization of the severity of the French economic problems had contributed to the acceptance of the incomes policy. If the French authorities had been asked to comment, they would probably have given more weight to the role of a gradual approach to adjustment in securing conservative wage settlements.

On wages, Mr. Polak had requested clarification of the comment in the report on recent economic developments that in early 1984 government employees had been compensated for the loss in average of purchasing power in 1983 with a lump sum payment, although it was also noted that the payment took place in conformity with the 5 percent guideline for 1984, the Director recalled. The F 500 award to civil servants in early 1984 had been on a per capita basis, regardless of salary, and was regarded as compensation for the discrepancy between public sector salary increases and the inflation rate in 1983. Clearly, the approach adopted had overcompensated some while others had been undercompensated. The F 500 bonus had not been incorporated permanently into the pay scale. In addition, civil servants had received a 1 percent wage increase in April 1984. It was uncertain whether the increase should be regarded as additional compensation for 1983 or an early down payment on the 1984 wage increases; the ambiguity was most probably deliberate. Other Directors had questioned whether the 5 percent target wage increase would be viable if the inflation rate were to differ markedly from official projections. Certainly, the French authorities' intention was to avoid a catch up, since full compensation for inflation would severely dilute the achievements of the present approach to incomes policy.

The price target was to ensure that the rate of inflation in France should be no more than that in Germany, the Director said. On the delay in the submission of monetary statistics in France, the staff had attached a note to its supplementary report which specified the delays in the publication of money and banking statistics. The delay clearly presented a problem to external observers of the French economy; the French authorities themselves had earlier estimates, based on a preliminary sample, but they had always been reluctant to publish until the coverage was complete.

A number of questions had been raised on the issue of banking reform, the Director said. Its basic purpose was to put all France's banking institutions on the same basis; it was expected that that would lead to a more active money market policy and would over time blur the distinction between those banks whose debt base was especially strong and those in a less favorable position. The results of the reforms would not be apparent for some time, and the authorities had no intention of pushing too rapidly.

One speaker had asked about future changes in the exchange rate for the franc vis-à-vis other currencies, the Director remarked, and had also suggested that despite the real effective depreciation of the franc, the persistent high level of unemployment implied that real wage rates in France were still too high. Some studies done by the staff had pointed to a similar conclusion.

Another speaker had noted that monetary growth was thought to have affected inflation in France through the balance of payments and exchange rate behavior, the Director recalled. The strength of the relationship between the behavior of the monetary aggregates and that of inflation was related to the degree of competitiveness of the economy and the prevailing level of capacity utilization. In practice, the willingness of the French authorities to alter the exchange rate when it became necessary had led to a relatively close correlation between the behavior of the monetary aggregates and inflation.

Referring to immigration policy, the Director stated that the French authorities had attempted to incorporate illegal immigrants within the labor force, by gradually according them legal status. However, the authorities were still concerned by the high proportion of foreign workers in certain sectors of French industry, particularly the automobile industry. The problem had been exacerbated since foreign workers were often concentrated in those sectors that were in the process of shedding labor. Consequently, a number of schemes had been introduced to facilitate the return of unemployed immigrant workers to their own countries.

Domestic oil prices in France were set under a formula agreed in 1982, which laid down the speed at which increases in dollar oil prices could be reflected in domestic prices, the Director of the European Department said.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/90 (6/8/84) and EBM/84/91 (6/13/84).

2. SUDAN - STAND-BY ARRANGEMENT - POSTPONEMENT OF EFFECTIVE DATE

1. The Government of Sudan has requested a stand-by arrangement for a period of one year for an amount equivalent to SDR 90 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/83, Supplement 2, subject to paragraph 3 below, and waives the limitation in Article V, Section 3(b)(iii).

3. The stand-by arrangement set forth in EBS/84/83, Supplement 2 shall become effective on the date, but not later than June 15, 1984, on which the Fund finds that satisfactory arrangements have been made to finance the uncovered gap in Sudan's balance of payments in 1984. (EBS/84/83, Sup. 4, 6/8/84)

Decision No. 7728-(84/91), adopted
June 8, 1984

3. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1984

The Executive Board approves the Annual Report on Exchange Arrangements and Exchange Restrictions, 1984, together with a letter transmitting the Report to the Board of Governors. (SM/84/93, Rev. 1, 6/1/84)

Adopted June 11, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/84/125 (6/7/84) is approved.

APPROVED: January 28, 1985

LEO VAN HOUTVEN
Secretary