FOR AGENDA

SM/83/69

CONTAINS CONFIDENTIAL
INFORMATION

May 6, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: France - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with France, which has been tentatively scheduled for discussion on Friday, June 3, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion they should contact Mr. de Schaetzen, ext. 75168.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

FRANCE

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with France

Approved by L. A. Whittome and C. David Finch

May 6, 1983

I. Introduction

Article IV consultation discussions were held in Paris from March 23 to 31, 1983. The French authorities were represented by officials of the Ministry of the Economy, Finance, and the Budget; the Bank of France; and other government agencies. The staff team consisted of Messrs. L. A. Whittome (EUR), S. Anjaria (ETR), P. Dhonte, Ms. D. Ripley, Mr. B. de Schaetzen, Ms. M. Xafa, Mr. V. Marie (all EUR), and as secretary Ms. S. Wright (TRE). Mr. B. de Maulde, Executive Director for France, attended the meetings as an observer. France accepted the obligations of Article VIII Sections 2, 3, and 4 of the Fund Agreement as from February 15, 1961.

II. Economic Background

1. The level of activity

Economic conditions in France changed sharply over the course of 1982. Initially, policies supported private consumption in the expectation that this would bolster employment and investment without serious adverse effects for the external sector. By midyear, the upturn in world demand that had been one of the assumptions underlying these policies had failed to materialize and a further rapid rise in labor costs stymied the response of domestic output. Both the rate of inflation and the rise of real hourly wages (of 12.4 per cent and 4.2 per cent, respectively, at annual rates during the first half year) contrasted with the substantial moderation being achieved in France's main partner countries. Strong domestic demand was reflected in a sharp deterioration of the external balance; the current account deficit of F 28 billion in the second quarter exceeded that for 1981 as a whole.

Following the June 1982 EMS realignment, a reduction in inflation and the external deficit became the primary policy concerns. Prices and wages were frozen through October, and measures were taken to curb the deficit of the social security system. In the second half of the year, as policies became less stimulatory, domestic demand fell slightly in contrast to its strong increase in the previous half year. Real disposable income of households during this period declined by 1 per cent but was still, for the year as a whole, 3.5 per cent above its level of 1981. Reversing its earlier recovery, the volume of private nonresidential investment declined in the second half year and for the year as a whole was 1.4 per cent above the level of 1981: investment in industry declined by 5 per cent, compounding a reduction of 4 per cent in the previous year. Stockbuilding, which had been strong in the first half year (partly, it would seem, in anticipation of an exchange rate adjustment), eased markedly. With the retrenchment in domestic demand, imports of goods and services in real terms declined from the high level reached in the first half year, while exports recovered.

For the year as a whole, GDP increased by 1.7 per cent over 1981. While this compared favorably with the outturn in other industrial countries, output rose mostly in the services sector while manufacturing production stagnated. GDP growth fell substantially short of the 3.8 per cent increase in domestic demand, and the current account deficit widened to the equivalent of 2.2 per cent of GDP from the equivalent of 0.8 per cent of GDP in 1981.

Activity remained subdued in the first months of 1983. While domestic demand firmed slightly (although household surveys suggested that this trend might soon be reversed), business surveys reported a further weakening of foreign demand and continued pressures on competitiveness. At the same time, pressure on the exchange rate was intensified by the continued large trade deficit and by the expectation of a stronger deutsche mark.

Notwithstanding the weakening in activity in the second half of the year, registered unemployment only rose by 5.8 per cent through 1982, to an estimated 8.7 per cent in the fourth quarter, as public employment was increased, working hours were reduced, vocational training was expanded, and early retirement was encouraged. Unemployment even declined toward the end of 1982 and in the early months of 1983.

2. Prices and costs

The inflation target of 10 per cent through 1982 was markedly lower than the increases of close to 14.0 per cent recorded during each of the preceding two years. The target was met, but again developments over the course of the year were uneven. Despite a substantial moderation of import prices, the rate of increase in consumer prices declined only marginally during the first half year, and remained well in excess of the rates recorded in most partner countries. The price freeze reduced inflation to 4.5 per cent at annual rate in June-October. From November, the freeze was replaced by an extensive system of controls, but over the next five months inflation averaged 11 per cent at an annual rate.

Wage increases during the first half of 1982 were particularly sharp as the statutory workweek was reduced with little change in pay, and hourly wages rose by 17 per cent at annual rate during that period, compared with 16.5 per cent during 1981. The wage freeze of July-October, which did not apply to minimum wages, was successful. Extensive negotiations prevented a strong catch-up when the freeze expired, and hourly wage increases were restrained to 7.1 per cent at annual rate during the second half year.

It is difficult to isolate the effects of economic policy on the formation of hourly wage costs in the 18 months to end-1982. An analysis by INSEE compares actual developments with predictions based on historical developments. This analysis suggests that hourly wage increases in the 12 months to mid-1982 exceeded by 2.9 per cent what could have been expected on the basis of past relationships, which would reflect the large increase in the real minimum wage in June 1981 and reductions in working hours in February 1982. In addition, increases in employers' social contributions added about 0.5 per cent to labor costs in that period. On the basis of this study, the impact of economic policy on labor costs from mid-1981 to mid-1982 could therefore be estimated at 3.4 per cent.

The study also suggests that, with the wage freeze of July-October, hourly wage increases in the second half of 1982 were 1.3 per cent less than would have resulted from historical relationships. However, during the same period, the financing of the social security system resulted in additional charges on enterprises and added 1.8 per cent to hourly labor costs. Altogether, economic policies may have increased labor costs by a further 0.5 per cent during the second half of 1982 even though this was a period that included a freeze on wages.

3. Competitiveness and profitability

According to the usual indicators of relative unit labor costs, the overall cost competitiveness of French manufacturing industry improved steadily from the end of 1980. This improvement, however, was in large part related to the appreciation of the U.S. dollar vis-à-vis EMS currencies. Relative to other members of the EMS, French labor cost competitiveness, which had been markedly eroded over the first two years of operation of the system, was not significantly modified by the October 1981 realignment and did not improve until the second half of 1982, when the realignment of June was supported by a wage freeze; even then, it was only restored to its level of the first quarter of 1979. By the end of 1982 labor cost competitiveness was again beginning to deteriorate.

The gains in export price competitiveness which had been recorded in the year to mid-1981--partly again in reflection of the appreciation of the U.S. dollar--were not continued in the following year. Domestic suppliers found themselves unable to compete successfully with foreign competitors as domestic demand picked up in late 1981. Moreover the gains in price competitiveness stemming from the October 1981 devaluation were gradually eroded as export prices were raised to reflect costs and to offset the pressure on margins in the domestic market.

The lack of competitiveness was reflected in the absence of recovery of profitability from the very low level recorded in 1981, and the gross operating surplus of the nonfinancial corporate sector remained below 24 per cent of value added (Table 1). The saving rate of nonfinancial companies moreover fell further, to 9 per cent, on account of a sharp rise in corporate interest payments. Altogether, in the three years since 1979, gross savings of the nonfinancial corporate sector increased by 41 per cent less than the deflator for investment expenditures. Over the past three years, gross corporate savings have fallen short of depreciation, resulting in cumulative net dissavings of about F 210 billion or 2.2 per cent of GDP.

Table 1. France: Indicators of Profitability in the Nonfinancial Corporate Sector

(Period averages in per cent)

	1977-79 Average	1980	1981	1982
Gross operating surplus ratio 1/	25.4	24.4	23.4	23.6
Savings rate 1/	12.3	11.5	9.6	9.1
Self-financing ratio 2/	66.7	59.6	51.4	48.4
Financing requirement 3/	3.8	5.4	4.4	5.2

Sources: INSEE, National Accounts; and Fund staff estimates.

1/ Per cent of value added of the corporate sector.
2/ Ratio of gross savings to gross fixed investment.
3/ Including the financing of stocks; in per cent of GDP.

4. The external balance

In addition to the current account deficit of F 78.7 billion, autonomous long-term capital outflows, including direct investment, net export credits, and public sector transactions amounted to F 38.6 billion in 1982. Altogether, the external financing requirement rose to F 117.3 billion (3.3 per cent of GDP), compared with F 61.4 billion in 1981.

A substantial part of this amount, or F 78.6 billion (compared with F 33.6 billion in 1981), was financed by net external borrowing, either directly by the Government or through authorized loans; nevertheless, net official foreign assets declined by F 34.3 billion. By year-end, gross medium- and long-term external liabilities contracted for balance of payments financing were estimated at F 294 billion, or 30 per cent of exports of goods and nonfactor services, of which F 231 billion was public or publicly guaranteed debt. The debt service ratio on medium- and long-term debt including nonguaranteed debt could be estimated at 3.8 per cent in 1982, and was expected to rise to 4.3 per cent in 1983 on the basis of liabilities outstanding at the end of 1982.

The French franc depreciated by 9 per cent in nominal effective terms in 1982, and by 4.7 per cent in real effective terms, as a result of the strength of the dollar against European currencies and of the EMS realignments. On June 12, 1982, following a period of heavy intervention, the franc was devalued by 5 3/4 per cent against the Belgian franc, the Luxembourg franc, the Danish krone, and the Irish punt, while the guilder and deutsche mark were revalued by 4 1/4 per cent against these currencies. After heavy intervention, the central rate of the French franc was again devalued by 2.5 per cent on March 21, 1983 while the deutsche mark appreciated by 5 1/2 per cent. This adjustment resulted in an effective depreciation of the central rate of the French franc of about 4.3 per cent vis-à-vis the central rates of the other EMS currencies.

III. Report on the Discussions

The evolution of economic policies over the last two years has been most evident in the public finances. Fiscal policy was expansionary through mid-1982; in the next three quarters stress was placed on the stabilization of the public sector deficit; and at the end of March 1983 fiscal policy became deliberately restrictive. Incomes policy was gradually strengthened. Continued emphasis was put on direct measures to stem the rise of unemployment, while credit policies remained accommodating.

The main objectives of economic policies at the beginning of 1983 were to reduce the rate of inflation to 8 per cent through the year and to limit the public sector deficit to the equivalent of 3 per cent of GDP. These objectives were thought to be consistent with a small increase in real domestic demand and a gradual reduction of the current account deficit. However, following the March 21 realignment of the EMS, a more ambitious external target was set. The current account deficit was to be halved to F 36 billion in 1983, and to be eliminated by the end of 1984, in order to contain the buildup of foreign debt and, with it, of debt servicing obligations.

1. The exchange rate

The authorities consider that the stability of the franc within the EMS requires a major reduction of the current account deficit together with a reduction in inflation differentials. The 8 per cent devaluation of the central rate of the French franc against that of the deutsche mark in March 1983 was regarded as the minimum that would be considered credible by the markets, but also the most that could be consistent with the Government's anti-inflationary policies. It was also thought to have re-established a competitive position compatible with the achievement of the current account target.

Intervention was considered an effective instrument for smoothing day-to-day fluctuations, and has been used generally to keep the franc well above its lower intervention limit within the EMS. Intramarginal intervention has typically taken place in U.S. dollars. During the period immediately preceding the March 1983 realignment, the franc was allowed to fall to its lower intervention point, which both necessitated intervention in EMS currencies and gave access to the system's credit facilities.

Interest rates have also been used in an attempt to stabilize the exchange rate, and, in spite of the very poor profits of enterprises, money market rates in France have been allowed to decline less rapidly than in other countries. The positive short-term differential with the deutsche mark money market rate rose from 6 per cent in July 1982 to 7 per cent in February 1983, a margin which proved insufficient to offset the effects of adverse exchange rate expectations. In early 1983 the Bank of France intervened on the Eurofranc market in a successful effort to raise the cost of borrowing in French francs by nonresidents to prohibitive levels.

Capital controls were intensified in 1982, and yet further in early 1983, to reduce the scope for speculative pressure on the exchange rate and increase the autonomy of monetary policy. In March 1983 rules on forward transactions for commodity traders were tightened, and annual ceilings were imposed on foreign exchange purchases by residents for foreign travel purposes. The authorities considered that exchange controls, although costly in economic terms, have proved to be an effective instrument to curb capital outflows. As evidence, they pointed to the 1982 turnaround in portfolio transactions and in short-term nonmonetary capital.

2. Monetary policy

Monetary policy in France is designed to support the authorities' objectives for prices and activity by gradually reducing the growth rate of the money supply. The policy instrument is the setting of quantitative controls on credit to the private sector so that interest rates may have somewhat greater freedom to respond to external considerations. Since 1976 annual targets have been set for the growth of M2; in recent years there has also been an effort to adjust yield differentials in order to encourage savings to move into longer-term instruments. As the external balance deteriorated during the course of 1982, increasing attention was also paid to the domestic credit aggregates. The authorities, however, considered that the deterioration of the external balance was essentially a result of cyclical and competitiveness factors which could not be adequately controlled by monetary means at an acceptable cost. They also considered that a reduction in the rate of inflation must primarily depend upon such actions as changes in wage settlement practices, and that monetary policy should be viewed as being supportive of such actions rather than as a primary means of achieving the inflation goal.

The target growth range for M2 was set at 12.5-13.5 per cent during 1982. In the event, monetary expansion was stronger than targeted in the first half of the year but later decelerated sharply and, at 11.4 per cent, was below the target for the year as a whole. While the official target was thus undershot, the authorities did not consider the outturn to be satisfactory, as both the loss of foreign assets through the external account and liquidity creation through domestic credit expansion were substantially larger than contemplated. They emphasized that the effectiveness of the system of quantitative controls on total credit expansion had been weakened by several developments. First, the controls did not cover all credit to the private sector, but allowed for important exemptions, though most of these were subject to special norms. Indeed, the coverage of the controls had been reduced from 72 per cent of credit to the private sector (excluding credit backed by nonmonetary resources) at the end of 1980 to 66 per cent at the end of 1982; during 1982 credit extended outside the controls rose by 27.6 per cent, compared with a rate of 12.6 per cent for controlled credit. Second, the deterioration in business profitability and notably the losses experienced by public enterprises had contributed to a strong demand for credit. Third, the sustained increase in credit to the private sector had been compounded by a sharp expansion in credit to the Treasury.

While the authorities agreed that these developments were potentially destabilizing, they did not believe that existing arrangements should be replaced by an alternative approach, e.g., a control over the monetary base. The interest rate adjustments required under such an approach could be sharp, especially given the importance of the privileged lending circuits, and could endanger the position of the more heavily indebted among the private firms. They preferred that existing arrangements should be made more compatible with the external objective by reducing the monetary financing of the Treasury, by improving the profitability of enterprises and notably of the public companies. By these means and with a further extension of the bond market they would hope to prevent any future overshooting of the credit ceilings.

The initial M2 target for 1983 had been set at 10 per cent, and the quantitative ceilings on credit had been correspondingly tightened. Following the March realignment, the authorities decided to lower the M2 target to 9 per cent, implying a reduction in the permissible credit expansion of the order of F 20 billion. Most of this would be obtained from a reduction in the monetary financing requirements of the Treasury, but some further tightening of credit to the private sector would also be necessary.

The volume of issues on the bond market rose sharply in 1982 and again in the early months of 1983, as interest rates on new issues, while declining gradually, remained high both in real terms and in comparison with the yields on short-term instruments. This development was considered desirable, and it was intended that long-term bond yields should remain positive in real terms by some 2 to 3 per cent.

3. Fiscal policy

The initial budget for 1982 continued the policy of stimulating domestic demand that was adopted in the supplementary budget of mid-1981. Ordinary budget expenditures were to rise by 28 per cent and revenues by 19 per cent over the 1981 initial estimates, although the increase in each case was only 12 per cent when measured against the outturn for that year. The deficit (including net loans and advances) was projected to rise to F 95.5 billion or 2.6 per cent of projected GDP, compared with an outturn of 2.1 per cent in 1981.

The stance of fiscal policy, however, changed gradually over the year. In the wake of the October 1981 EMS realignment, a "reserve fund" was instituted by freezing capital spending appropriations of F 14.4 billion. In the spring of 1982, the authorities emphasized their determination to hold the public sector deficit to 3 per cent of GDP, and to stabilize the central government tax burden at 18.3 per cent of GDP in 1983. During the year, increasing concern over the financial condition of enterprises was reflected in a reduction of the business tax, increased equity funding for public enterprises, and an announcement that the rates of business contributions to the general social security scheme would not be increased through 1983. Additional outlays in the two supplementary budgets were offset by cancelling F 19 billion of appropriations (including F 8 billion from the reserve fund) and by a 1 percentage point increase in the value-added tax rate. These measures, and the impact of the wage freeze, kept the realized deficit on an administrative basis very close to the initial forecast.

The initial budget for 1983 further emphasized the intention of the authorities to contain the growth of expenditure which was set at 11.8 per cent over the initial budget for 1982. The deficit was projected at F 118 billion which was calculated to be equivalent to 3 per cent of GDP. Moreover, a F 20 billion reserve fund was created. The budget provided for comparatively strong increases in transfers to the social security and the unemployment funds, to the public enterprises and private industry, and for research and development outlays. In contrast, the State's own current expenditure was to increase comparatively slowly.

Financial trends for the social security institutions were similar to those of the state budget. By mid-1982, a strong increase in social transfers (which, year on year, increased by no less than 7 per cent in real terms), and the revenue impact of weaker-than-anticipated economic activity, led to the prospect of large imbalances in the financial position of the general fund and of the unemployment fund. At the end of September, comprehensive measures were introduced to balance the accounts of the general fund, including a revision of the informal indexation practices for pensions and other cash benefits, an effort to control the cost of health care, and an increase in excise taxes which would become effective in 1983. Similarly, steps were taken to balance the unemployment fund; these included some restrictions on eligibility, the imposition of a "solidarity" tax on civil servants, and an increase in the rates of contributions of both employers and employees. As a result, the cash deficit of the two institutions was estimated at about F 16 billion for 1982 and, assuming no increase in unemployment, it was forecast that their accounts would be balanced in 1983.

In connection with the March 1983 EMS realignment, additional measures were introduced to reduce domestic demand so as to secure the Government's external objectives. These included notably the cancellation or postponement of F 15 billion in state spending (of which F 10 billion is from the reserve fund); an increase in gasoline taxes estimated to yield F 4 billion, and the levy of a compulsory loan, estimated to amount to F 14 billion. In addition to the planned increase in excise taxes (which was, however, partly postponed because of its incidence on the CPI), the social security fund would be buttressed by a 1 per cent surcharge on taxable personal income. This surcharge was expected to yield F 14 billion, and was intended to provide a margin of safety against the possibility that the program's effect on activity would depress receipts. Finally, as mentioned below, investment outlays of public enterprises were reduced by F 12 billion.

4. Industrial policy and the public enterprises

Industrial policy in France seeks the modernization and adjustment of the traditional sectors and encourages investment in new high technology sectors which seem to hold out particular promise for the future. The sectors regarded as having a large future potential include electronics, communications, aerospace, and bioengineering.

Public support for private industry is mainly provided by extending long-term funds, mostly through a variety of specialized financial institutions, with the benefit of state subsidies, of partial state guarantees, or of exemptions from the applicable credit ceilings. With the nationalization of large industrial groups in 1982, public enterprises now include, next to a group of companies having a near-monopoly position, mainly in the fields of transportation and energy, a group of companies in the competitive sector. Both groups recorded large losses in 1982, and their external financing requirement was augmented by investment programs of almost F 113 billion or 3.2 per cent of GDP. The authorities held that both groups must return to financial balance by 1984 or 1985. The "monopoly" companies were to achieve financial balance as a result of tariff increases and improved efficiency; meanwhile their investment program for 1983 had been reduced by F 11 billion from initial plans in connection with the March austerity measures. The group of competitive companies, on the other hand, was to be managed according to market standards and the companies were expected to achieve an adequate self-financing ratio. In their case, the State's obligation as a shareholder was to assure adequate equity financing, and F 12.5 billion had been appropriated for this purpose in 1983.

Increased long-term financing would be forthcoming from the financial institutions, thus allowing the State's own lending to be reduced. This was regarded as an appropriate consequence of the 1982 nationalization of the banking system which reduced the need for the State to act as a banker. For this purpose, the access of the financial institutions to the domestic bond market had been enlarged, the structure of their external borrowing had been shifted to longer-term maturities, and an elaborate system of state guarantees had been put in place.

Another aspect of French industrial policies was the promotion of energy saving and the development of domestic energy sources, notably from nuclear reactors. Total primary energy use dropped by 2.2 per cent in 1982, and the share of domestic energy rose to 34 per cent. The authorities indicated that energy conservation would continue to be furthered by various programs and that nuclear electricity production would increase by 21 per cent in 1983, representing an estimated reduction in oil import requirements of almost 5 million tons.

5. Prices and incomes policy

The authorities considered a deceleration of inflation to be an essential objective. Target rates had been set at 10 per cent during 1982, and 8 per cent during 1983, with the objective of moving down to 5 per cent by 1984. Detailed administrative arrangements are to limit the rise in the prices of services and in trade margins through 1983. Arrangements for the industrial sector are more liberal, and take account of the need to improve profitability and of the pressure from foreign competition.

Starting in early 1982, the authorities sought to end the traditional automatic adjustment of wages for past price increases. Settlements were to specify preannounced wage increases for extended periods, reflecting the targeted rate of inflation and the specific economic conditions in each sector, and allowing for a relative improvement of the lower paid. After exceptionally extensive negotiations in late 1982, the social partners adopted these guidelines for almost all the 6.1 million public sector employees through 1983, and, less formally, for the private sector as well.

The authorities stressed that there would be no automatic catch-up at the end of the year should the inflation target be overshot, despite the general references made to such a possibility in a number of wage agreements. The evolution of real wages in the public sector would be reviewed in early 1984 as stipulated in the relevant agreement, bearing in mind the general economic situation. The private sector arrangements did not, they stressed, provide for a formal review. The authorities expected that these arrangements would hold for they were based on a strong social consensus. While it was acknowledged that a significant rise in inflationary pressures beyond those foreseen would pose difficulties, the recent EMS realignment was not expected to feed through to domestic prices in a way that would jeopardize the wage strategy and the support package announced in March would have little impact on the cost of living. The administered price increases of 8 per cent had already been foreseen, and excise tax increases had also been largely planned for.

6. Employment policies

The authorities had implemented a number of programs to reduce unemployment; these included increases in public sector employment, employment subsidies in the industrial sector (notably in the textile industry), and the promotion of reduced working hours and early retirement. Registered unemployment had risen by 117,000 through 1982, whereas historical relationships would have led to an estimated increase of 300,000. Wide-ranging training programs were also offered to new entrants in the labor market.

The authorities estimated that the reduction in statutory working hours in early 1982 had been mostly compensated for by productivity gains. Further general reductions in the workweek were not contemplated in the short run, although preliminary work on the Ninth Plan (1984-1988) suggested that it would be necessary to reduce working hours by an average of 2.5 to 3 per cent a year over the period of the Plan. This reduction, however, would not be effective in curbing unemployment if it increased unit labor costs or if it reduced the operating time of plant and equipment.

7. Other external policies

The authorities emphasized their intention to slow the increase in external debt resulting from the widening current account deficit. For this purpose, they were determined that the current account deficit should be halved in 1983, and that it should be eliminated altogether by the end of 1984.

The current account deterioration experienced in 1982 was related in part to structural inadequacies in the industrial system, which could only be corrected over time; to a strong rise in relative production costs, which would be corrected by the exchange rate realignment, and whose future containment would be assured by domestic anti-inflationary policies; and to the cyclical demand imbalance, as domestic demand in France had been much stronger than in neighboring countries. This imbalance had to be eliminated, or even reversed, so as to achieve the current account target. Accordingly, the package of supporting measures introduced on March 25 had been calculated to bring about a reduction of domestic demand by 1 to 1.5 per cent in volume below previous projections.

The March 21 realignment of exchange rates had also confirmed France's commitment to an open trading system. The authorities drew a clear distinction between French commercial policy and more broadly defined sectoral policy designed to promote employment, modernization, and restructuring, which had to be judged in the light of French industrial policy objectives. These objectives included the maintenance or establishment of a French presence in a broad range of industrial products, including, in particular, consumer durables. Sectors benefiting from assistance included steel, textiles and clothing, electronics, and agriculture. In certain sectors, most notably steel, the trade restraints were a part of a broader policy designed to cut capacity and ensure future competitiveness through restructuring and modernization.

In agriculture, the emergence of the European Communities as a net exporter of many temperate zone products had to be considered in the context of the objectives for farm incomes and employment. In the view of the authorities, arrangements to organize international markets in agriculture and possibly other sectors should on balance benefit all countries, given that the alternative seemed to be that of unilateral import restrictions.

As in other industrial countries, bilateral and sector-specific trade restraints had tended to multiply in the past 18 months. Most direct commercial policy actions fell within a European Community framework. In the Community context, a broad French policy objective was to encourage more effective surveillance over intra-Community nontariff barriers, while developing adequate commercial policy instruments to counter "unfair" competition from outside the region.

At the national level, quantitative restrictions applied to some 80 items covering 3 per cent of total French imports (excluding energy). French policy sought to ensure that the intent of the national measures was not diluted by unrestricted imports from other common market members. Late last year, the French authorities had announced certain additional measures at the national level. The French authorities felt that these were not protectionist. The requirement to channel video tape recorders only through the customs port at Poitiers was considered a reasonable response to the perceived difficulties of French exporters in gaining access to the Japanese market; the obligation to use the French language in documentation relating to goods passing through customs was applied in such a manner as not to exclude imports when this requirement was not met; and the marks of origin labels were required for only two product categories although a decree to expand this requirement was under preparation.

Annual ceilings on foreign exchange purchases for tourism expenditures had been introduced with effect from March 28 to complement the package of measures aimed at curtailing domestic demand. The basic exchange allocation for tourist travel to foreign countries by residents was reduced from F 5,000 per person per trip to an annual limit of F 2,000, and other means of payment (e.g., credit cards) were restricted. The authorities were of the view that the effects of these measures would not be large in relation to total expenditures on tourism (about F 30 billion in 1982).

France remained committed to increase its official development assistance to a level equivalent to 0.7 per cent of GNP, in addition to aid to overseas departments and territories of approximately 0.25 per cent of GNP. In 1981, total ODA had reached 0.73 per cent of GNP, or 0.46 per cent excluding the overseas departments and territories; the initial budget law for 1983 raised the latter amount to 0.52 per cent.

IV. The Economic Outlook

The initial budget and monetary projections for 1983 assumed a 9 per cent year-on-year rise in the GNP deflator and a rise in real output of 2 per cent. It was expected that foreign markets would strengthen during the course of the year, and that the dollar price of oil would decline markedly. This would have allowed a modest improvement of the current account together with a small increase in domestic demand.

In view of the disappointing trade deficit recorded in the first two months of 1983, and of mounting speculative pressures on the franc, a marked improvement of the external balance has been given a high priority and measures to restrain domestic demand were introduced on March 25, after the franc had been devalued. These actions will affect growth prospects, but the authorities expect that they will not significantly affect wages and prices. If this were not to be so, the ambitious external targets as well as the price targets would clearly be placed at risk.

At the time of the consultation, the details of the measures of March 25 had not yet been finalized, in particular, as regards credit policy. However, the staff believes that the authorities would very broadly concur with the following summary of the likely outturn in 1983. While household disposable income will be weakened by the restrictive measures, real consumption expenditure is expected to remain constant as a result of a decline in the savings rate. The rise in current government expenditures will just keep pace with the rate of inflation. Sluggish demand should lead to a further modest decline in gross fixed investment and a leveling off of stocks. Total domestic demand is expected to decline by nearly 1 percentage point (in sharp contrast to its 3.8 per cent growth in 1982), and with an expected positive contribution of the foreign balance, real GDP would stagnate.

With only a weak growth of industrial output, a further fall in employment is expected, and the average unemployment rate may rise by about 1 percentage point to 9.5 per cent. The increase of wages through 1983 is expected to be held to about 8 per cent, for a year-on-year increase of just under 9 per cent and an increase in unit labor costs of perhaps 8 per cent. It is anticipated that many producers will seek to take advantage of the recent exchange rate change to improve their profit margins, and the GNP deflator will rise by 10 per cent.

On the external side, exports will strengthen with a recovery from the unfavorable agricultural performance of 1982, and with a revival of demand abroad. The forecast assumes that a fall in the price of oil and the measures taken to reduce dependence on imported oil will substantially reduce the energy deficit, while the volume of other imports will be restrained by cyclical factors. Some of these developments will be offset by a deterioration in the non-oil terms of trade, and by increased outflows on investment income. All in all, the current account deficit will be markedly reduced, especially if credit policy is fully supportive of the thrust of the March 25 measures.

In 1984 the Government is determined to secure a further deceleration of the rate of inflation; a precondition is that there should be no catch-up for a probable overshooting of the CPI target in 1983. If this condition is met, and is supported by credit policy, the acceleration of foreign demand expected in 1984 would allow for a moderate upturn in domestic demand while permitting further significant progress toward the objective of balancing the current account.

France's external debt of F 188 billion at the end of 1981 (equivalent to some US$33 billion) rose to an estimated F 294 billion (US$44 billion) at the end of 1982. The Government's targets for the current account in 1983 and 1984 imply a deceleration of this rate of increase, and by the end of 1984 debt outstanding may have risen to F 430 billion or the equivalent of 35 per cent of exports of goods and nonfactor services.

V. Staff Appraisal

One year ago it was already clear that the policies to strengthen activity by providing an initial boost to consumption implied a risk to the balance of payments. In the event, the deterioration of the balance of payments has been sharp, much sharper indeed than most had feared. In 1982 the deficit in the current account rose to the equivalent of 2.2 per cent of GDP from a ratio of 0.8 per cent in 1981.

Although the deterioration in the external position has attracted much attention, it is important, especially for the longer run, to emphasize that a good start was made in what will undoubtedly prove a long and difficult task of breaking inflationary expectations. An unprecedented effort has been made to abolish the de facto indexation of incomes which had sustained real household incomes even at times when the terms of trade were deteriorating markedly, and had limited the effectiveness of exchange rate adjustments. Moreover, unemployment rose relatively less than in most of France's main competitors. However, this relative performance rested more on a stimulation of demand, which could not be sustained, and on the introduction of a variety of employment support schemes, which have contributed to the rise in labor costs, than on a durable improvement in employment conditions in the market sector.

Nevertheless, the economy has continued to be beset by recurrent bouts of weakness of the French franc, not unassociated with an excessive rate of domestic credit expansion. In order to support the franc, extensive external debt has been incurred at a rate which, if maintained, would most certainly pose problems for the future. Of equal concern, the deeper weaknesses of the economy thwarted the response of domestic industrial production and of employment to the rise of domestic demand.

The immediate objectives of economic policy after the March 1983 realignment of the EMS are to halve the current account deficit in 1983 and to eliminate it by the end of 1984, and to cut the rate of inflation to 8 per cent during 1983 and less than 5 per cent during 1984. These objectives are regarded as ambitious, especially given that three months of 1983 had already passed when the targets were set, and that the price consequences of the March devaluation would adversely affect the current account outturn in 1983. In the staff's opinion they are nevertheless, from a wider perspective, about the minimum that is required. Continuing large autonomous outflows of capital (around US$6 billion per annum) make it essential that the current account deficit be sharply reduced if France is to regain control of the buildup of its external debt. Similarly, the target for inflation is the least that must be achieved in view of recent price developments in some of France's main trading partners. Moreover, the achievement of these objectives is essential to set the stage in which the deeper weaknesses of the economy can be tackled.

Wide-ranging measures were announced in late March in order to secure the achievement of the external target. Although the measures are intended to result in a significant fall in domestic demand, the authorities hope that by putting particular emphasis on incomes policy the costs of securing a marked deceleration in inflation may prove to be less in France than has been the case in some other industrial countries. In the staff's opinion these measures and a more favorable international climate will certainly lead to a reduction in the current account deficit but on balance, it is unlikely that either the price or the current account target will be met in 1983. The degree of success that is achieved will depend upon the extent to which a number of conditions that are within the control of the authorities are fulfilled. The staff would emphasize four areas of importance.

First, the measures must be fully and rapidly implemented. This is the more important as they were taken well into the year and as their initial impact may well be partly cushioned by lower savings.

Second, the present preannounced wage settlements must hold absolutely during 1983 without any catch-up in early 1984 even though prices may well have risen somewhat more than was envisaged when the settlements were made. If these arrangements were not to hold, it is clear that the price objectives would become unachievable and that the prospects for the current account would be weakened even in 1983.

Third, it is essential that monetary policy be fully supportive of other policies. Recent developments provided a dramatic illustration of the fact that excessive credit expansion can quickly lead to a deterioration of the balance of payments. Domestic credit rose rapidly in the 18 months from September 1981 to March 1983, namely, by an estimated 28 per cent, whereas nominal GDP rose by 17 per cent. The staff suspects that the credit expansion planned under the revised monetary target for 1983 is still on the high side and would therefore strongly argue that it must be regarded as an upper limit and be rigorously and continuously monitored. Moreover, the system of quantitative credit controls as it now functions does not appear to be an effective instrument to regulate total domestic credit in the short run. Therefore, if the evolution of prices or the external account during 1983 indicate that credit expansion were to be excessive, then the authorities would have to be prepared to quickly reduce the public sector's demands for credit and at the same time allow a rise in interest rates. Given the institutional setting, the staff believes that to be effective the most weight would need to be put on a reduction in the public sector's deficit.

In this context, the staff suspects that for France the financing of a central government deficit equivalent to 3 per cent of GDP has been shown to be excessive, given the financing requirements of the business sector and of other parts of the public sector, and would, therefore, strongly urge that lower percentage targets be set. The restoration of the external balance requires a reduction in the imbalances that have arisen in the public finances. The staff also considers that in circumstances which require a tight fiscal policy, a budget target expressed as a percentage of GDP is too loose a formulation and that the effective control over expenditures that has been a feature of French economic policy would be helped if the target were expressed in nominal terms. In any event it is crucial that for 1983 the target deficit of F 118 billion not be exceeded and that financial balance be achieved in the social security accounts, including the unemployment fund. Furthermore, the borrowing requirements of the public enterprises must be kept at most within the limits now foreseen even if this were to necessitate a further increase in tariffs later in the year.

The measures announced in March to achieve the immediate objectives do not per se correct the deeper weaknesses of the economy. The failure of French industry to respond more than marginally to the growth of domestic demand from mid-1981 is a matter for deep concern, as there could be some risk that output and employment may prove equally unable to respond to an increase in international activity. The fact that this failure in 1982 may be partly related to the particular circumstances of the period should not obscure its more fundamental causes.

There are several views of the causes for this weakness and probably none has a monopoly of the truth. One view is that the stimulus provided from mid-1981 was largely used for the purchase of consumer durables, which is a sector of industry in which France is relatively weak. At the same time, foreign demand for a few highly technical industries, such as nuclear power stations, electronics, or the aerospace industries, in which a high proportion of investment has been concentrated, has been relatively subdued. Labor disruptions in specific sectors, e.g., the automobile industry, would have been yet another circumstantial factor.

A suspicion of a somewhat different nature is that a part of the sharp deterioration in the current account in 1982 may be attributable to disguised capital transactions in view of the tight exchange controls. While this factor may have accounted for some of the stockbuilding in the months preceding the June 1982 and March 1983 EMS realignments, there is no evidence that it clearly affected the services account, and capital flight can at most only explain a limited part of the current account deficit in 1982.

In the opinion of the staff the weaknesses manifested by French industry stem primarily from more direct lack of competitiveness. Since 1979, real disposable income of nonfinancial corporations declined by 41 per cent in sharp contrast with a 7 per cent increase in real disposable income of households. Over the past three years, disposable corporate income has increasingly fallen short of compensating for economic depreciation and the cumulative shortfall over that period is of the order of F 210 billion. Low investment has caused equipment to age, has hampered the adjustment to new products and markets, and undercut growth and employment.

The capacity of industry to respond to an increase in demand was further compromised in the year to mid-1982 as the very increases in wages and social transfers which initiated the increase in demand also increased production costs so undermining the capacity of domestic producers to achieve adequate operating margins at a competitive price.

While these factors must have contributed to the unresponsiveness of output in 1982, it is important to recognize that they are not the reflection of inflexible structural constraints, but that they result from economic conditions which can be altered by economic policy. In the opinion of the staff, employment creation depends directly on an improvement in profit margins, and therefore urgently requires an improvement in competitiveness. In contrast with the EMS realignment of October 1981 which was quickly offset by a strong rise in labor costs, the realignment of June 1982 restored cost competitiveness within the EMS to the level of early 1979. However, this level, together with the prospect of a further deterioration in relative costs, was still clearly insufficient to ensure adequate profitability conditions and the usual cost projections suggested that a renewed deterioration would have to be experienced through 1983. The staff therefore welcomes the realignment of the franc within the EMS that was agreed upon last March, and the fact that the supporting measures avoid adding a further burden on enterprises. However, past experience shows that this realignment cannot be effective unless it serves to restore the financial position of industry; for this reason also it is very essential that it be supported by a strict observance of the preannounced wage settlements.

Even so, the recovery of business income will at best be modest. Therefore, a sustained attempt must be made to reduce the costs falling on industry, including the burden of nonwage labor costs. Indeed, in view of the urgency of restoring the growth potential required to close the foreign balance and to provide adequate employment opportunities, the view that real wages can be maintained in the face of high unemployment needs to be urgently reconsidered. At the same time, great caution will need to be exercised in regard to changes in work practices that can adversely affect labor costs.

The staff welcomes the fact that the package of March 1983 eschews the introduction of new protectionist measures. Any proliferation of bilateral and sector-specific trade restrictions or subsidy practices distort trade and pose no less a risk of proliferation and retaliation than the across-the-board protectionist measures that have so far been largely avoided.

The emphasis in French commercial policy on obtaining "fair" treatment in foreign markets where access is perceived as being limited seems to overemphasize a bilateral approach to trade issues. The staff welcomes the determination of the French authorities to secure the benefits of an open and orderly trading system, and believes that, as a key trading nation, France should play a leading role in coordinated moves toward reversal of recent trade restrictions and achievement of a broad-based trade liberalization.

The imposition by France of comprehensive limits on the provision to residents of foreign exchange for tourism, with authorization beyond these limits in special circumstances, gives rise to restrictions on the making of payments and transfers for current international transactions. The staff notes the costs of these restrictions, and their adverse consequences for some members. It believes that the balance of payments support provided by the measures could realistically be supplanted at a relatively early date by other policies. In these circumstances, Executive Board approval of the exchange restrictions is not being proposed.

It is recommended that the next Article IV consultation with France be held on the standard 12-month cycle.

France - Fund Relations

Status:	France formally accepted the obligations of Article VIII, Sections, 2, 3 and 4, of the Fund Agreement as from February 15, 1961.
Quota:	SDR 2,878.5 million.
Fund holdings of French francs: (measured in SDRs)	SDR 2,010.3 million or 69.8 per cent of quota as of February 28, 1983.
France's holdings of SDRs:	SDR 802.5 million or 74.3 per cent of net cumulative allocation, as of February 28, 1983.
Gold distribution:	1,283,718 fine ounces.
General Arrangements to Borrow:	The maximum commitment of France is F 2,715.4 million (SDR 394.7 million); as of February 28, 1983, F 2,715.4 million remained available.
Last consultation:	The staff report for the 1982 Article IV consultation with France (SM/82/63, 4/5/82) was considered by the Executive Board at EBM/82/64 (5/3/82).
Exchange system:	Since March 13, 1979, France has participated together with Belgium, Denmark, Germany, Ireland, Italy, Luxembourg, and the Netherlands in the exchange rate mechanism of the European Monetary System (EMS). Under this agreement, France maintains spot exchange rates of the currencies of the other participants within margins of 2.25 per cent (in the case of the Italian lira, 6 per cent) above and below cross rates derived from central rates expressed in ECUs. On March 31, 1983 the exchange rate of the French franc against the SDR under Rule O-3 was F 7.8414 = SDR 1.

Basic Data

Total population (mid-1981 estimates)	54 million
GDP per capita (1982)	US$9,900

	1981	1980	1981	1982 Estimates	1983 Projections 1/
	In per cent of GDP	Volume changes; in per cent			
Demand and supply (volume)					
Household consumption	65.0	1.7	2.1	3.5	0.2
Public consumption	13.1	1.3	2.3	1.7	0.5
Gross fixed investment	20.8	2.4	-1.1	-0.4	-1.8
Public	2.6	1.4	1.0	0.6	-1.0
Residential construction	4.9	-3.8	-1.0	-6.0	-2.5
Other private	13.3	5.0	-1.5	1.4	-1.8
Final domestic demand	98.9	1.8	1.4	2.4	-0.1
Stockbuilding 2/	0.1	0.3	-2.0	1.4	-0.6
Total domestic demand	99.0	2.1	-0.6	3.8	-0.8
Exports of goods and services	24.4	2.4	5.4	-3.7	3.5
Imports of goods and services	23.4	7.2	1.6	4.8	0.3
Foreign balance 2/	1.0	-1.0	0.8	-2.2	0.8
GDP	100.0	1.1	0.3	1.7	--
Manufacturing output	...	0.2	-2.9	0.3	0.5
Memorandum item:					
GDP in current francs	...	2,765.3	3,106.1	3,549.7	3,897.6

	1980	1981	1982	1983 1/
	(In millions; annual average)			
Employment and unemployment				
Labor force	23.2	23.3	23.4	23.6
Unemployed	1.5	1.7	2.0	2.2
(In per cent of total labor force)	6.3	7.3	8.6	9.5

	1980	1981	1982	1983 3/
	(Annual changes in per cent)			
Prices and income				
GNP deflator	11.8	12.0	12.8	9.8
Consumer price index				
Average	13.6	13.4	11.8	10.0
Through the year	13.6	14.0	9.7	9.0
Terms of trade	-6.5	-4.5	1.9	2.9
Average hourly compensation (manufacturing)	15.3	14.4	15.3	10.2
Unit labor cost (in manufacturing)	12.1	11.3	10.1	7.7
Real disposable income of households	-0.1	3.2	3.5	-0.9
Personal savings ratio	14.7	15.6	15.8	15.2
	(In billions of francs)			
Public finance 4/				
Central Government				
Expenditure	579.6	702.5	797.8	881.5
Revenue	544.4	626.9	705.7	766.1
Special accounts (net)	0.1	0.1	0.3	0.2
Loans and advances (net)	11.3	11.2	-7.1	-2.6
Financial balance	-23.8	-64.3	-98.9	-117.8
(In per cent of GDP)	(-0.9)	(-2.1)	(-2.8)	(-3.0)
	(In billions of francs)			
Balance of payments				
Trade balance	-55.0	-55.0	-103.9	-57.0
Services and private transfers (net)	44.7	39.9	42.6	41.5
Official transfers	-7.3	-10.7	-17.4	-20.5
Current account	-17.6	-25.8	-78.7	-36.0
As a per cent of GDP	-0.6	-0.8	-2.2	-0.9
Long-term capital	-24.0	-54.6	-49.7	...
Treasury authorized loans	18.0	33.6	78.6	...
Short-term capital 5/	51.8	18.2	15.5	...
Net changes in official reserves	28.2	-28.6	-34.3	...
	(Annual changes in per cent)			
Exchange rates				
US$ per FF (end of period)	-11.0	-21.5	-14.4	-14.1 6/
US$ per FF (period average)	0.7	-21.9	-17.3	...
Effective rate (MERM, end of period)	-4.6	-11.2	-7.0	-10.2 6/
Effective rate (period average)	1.1	-10.6	-9.2	...
Adjusted relative unit labor costs (period average)	3.6	-6.4	-4.7	...

	1980	1981	1982	1983 3/
	(Annual changes in per cent)			
Monetary data (end of period)				
Money and quasi-money (M2)	9.8	11.4	11.4	9.0 7/
Net foreign assets	40.0	-7.3	-61.0	...
Domestic credit	11.2	9.7	14.9	...
Claims of the Treasury (net)	-4.5	26.2	19.6	...
Claims on the economy	13.0	16.2	14.4	...
	(End of period; in per cent)			
Interest rates				
Three-month money market rate	11.56	15.26	12.71	12.13
Prime lending rate	12.25	14.00	12.75	12.25

Sources: Data provided by the French authorities; and staff estimates and projections.

1/ WEO projections.
2/ Changes as a per cent of previous year's GDP.
3/ WEO projections except for public finance data.
4/ Administrative basis, and initial budget law for 1983.
5/ Including errors and omissions.
6/ March 1983.
7/ Official target (the target for 1983 is formulated as the change in a three-month average centered on December).