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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 99/118

10:00 a.m., October 22, 1999

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
A. Barro Chambrier	
	J. Nelmes, Temporary
	J.L. Pascual, Temporary
	M.J. Fernández, Temporary
R.F. Cippà	
B. Esdar	W.-D. Donecker
	A.G. Zoccali
	J.A. Costa, Temporary
	J. Spraos
	D. Nardelli, Temporary
K.A. Hansen	
K.-T. Hetrakul	
V. Kelkar	A.G. Karunasena
	S.K. Keshava, Temporary
W. Kiekens	S. Zádor, Temporary
K. Lissakers	
J.-C. Milleron	G. Bauche
	I. Mateos y Lago, Temporary
A. Mirakhor	M. Daïri
J.P. de Morais	J. Mafararikwa, Temporary
	A. Lushin
	S. Vtyurina, Temporary
S. Pickford	S. Collins
	D. Taylor, Temporary
	R. Junguito
A.S. Shaalan	A.F. Al-Faris
	S.A. Bakhache, Temporary
	I.M. Woolford, Temporary
	W.C. Mañalac, Temporary
Wei Benhua	
J. de Beaufort Wijnholds	
	M. Takeda

A.S. Linde, Acting Secretary
G. Nkhata, Assistant
S. Soromenho-Ramos, Assistant

East Timor—Technical Assistance
Staff representative: Valdivieso, APD

France—1999 Article IV Consultation
Staff representatives: Artus, EU1; Lipschitz, PDR

Cambodia—Enhanced Structural Adjustment Arrangement
Staff representatives: Puckahtikom, APD; Leddy, PDR

Also Present
ECB: G. Grisse. IBRD: R.S. Newfarmer, East Asia and Pacific Regional Office. Asia and Pacific Department: W.S. Tseng, Deputy Director; M. de Zamaroczy, R. A. Elson, K. Ishii, H. Liang, C. Puckahtikom, T.R. Rumbaugh. European I Department: M.C. Deppler, Director; J.A. Artus, Deputy Director; L.D. Everaert, H.M. Flickenschild; R.P. Ford, A. Gagales, K. Hviding, A. Jaeger, T. Krueger, A. Leipold, M.-O. Louppe, M. Pani, A.J. Ubide, A. Zanello. European II Department: G.C. Pastor. L.M. Valdivieso. External Relations Department: N.V. Shastry. Legal Department: F.P. Gianviti, General Counsel; D.E. Siegel, B. Steinki. Monetary and Exchange Affairs Department: M.T. Jones, C.S. Lee. Policy Development and Review Department: T. Leddy, Deputy Director; L.J. Lipschitz, Deputy Director; N.R.F. Blancher, N.L. Happe, I. Kapur, A. Masuda. Research Department: F. Larsen, Deputy Director; G.J. Schinasi, A.J. Tweedie. Secretary's Department: S. Bhatia, P. Gotur, M. Schulte. Technology and General Services Department: B.C. Stuart, Director. Treasurer's Department: N.J. Rawlings. Western Hemisphere Department: M. Guerguil. Office of the Managing Director: J.A.P. Clément, D.A. Citrin, S. Tiwari. Advisors to Executive Directors: J.A. Chelsky, B. Couillault, E.J.P. Houtman, N. Jadhav, M.E. Kandil, B. Konan, M.F. Melhem, W. Merz, H. Mori, A.R. Palmason, J.N. Santos, G. Schlitzer, M. Sobel, S. Thiam. Assistants to Executive Directors: A.S. Alosaimi, P.A. Brukoff, M. Budington, P. Cabezas, G. De Blasio, K. Harada, C. Josz, D.H. Kranen, T.-M. Kudiwu, S. Le Gal, Y. Moussa, J.A.K. Munthali, K. Ongley, L. Redifer, S. Rouai, M.M. Salvador, J. Schaad, U.F. Seyidzade, R.J. Singh, Siti Mariam Mohd. Yusof, Sugeng, M. Walsh, Wang X., P. Winje.

1. EAST TIMOR—TECHNICAL ASSISTANCE

The Executive Directors considered a request from the United Nations for the Fund staff to field a mission to East Timor, concurrent with a Joint Assessment Mission led by the World Bank, and for the Fund to provide whatever follow-up technical services might be requested by the United Nations.

The Acting Chairman made the following statement:

> The Fund has received a request from the United Nations to field a mission, concurrent with a Joint Assessment mission led by the World Bank and including a wide range of experts from UN agencies, to assess and make initial recommendations on the state of the East Timorese economy and the institutions needed to support economic activity and economic management. The mission will take place during the period October 27 to November 15. The mission's findings and initial recommendations will form a part of a more comprehensive assessment to be prepared jointly with the UN and the World Bank and provided to potential donors. The joint report is expected to provide initial recommendations and guidelines to the UN Transitional Administration for East Timor (UNTAET), which it is expected to be established shortly. Similar to the case of Kosovo, Executive Board approval is required for such assistance to a non-member country. May I take it that the Board approves this mission and whatever follow-up technical services that are requested by the United Nations? We are proceeding this way in light of the desirability of fielding a mission quickly.

Mr. Wei wondered whether a press release would be issued on that matter. If so, he felt that the comparison to Kosovo in the Acting Chairman's statement should be deleted. Kosovo was not a non-member country, since it was not an independent country.

The Acting Chairman replied that Mr. Wei was right. Kosovo was a part of a country that was not a member of the Fund, while East Timor, having been granted independence, was in fact a new country, though without membership in the Fund.

Mr. Nelmes wondered how large the mission would be.

Mr. Sobel wondered whether the staff could elaborate on the mission's intended work agenda.

The staff representative from the Asia and Pacific Department replied that the mission would comprise six staff members—including two from the Monetary and Exchange Affairs Department, two from the Fiscal Affairs Department, one from the Asian department, and one from the Tokyo office—plus himself, as mission head.

The mission's work would focus primarily on setting up some form of arrangement to ensure fiscal management and to restore the payments mechanism, the staff representative

noted. The staff would also make recommendations with regard to what currency might be used as the legal tender, and on the issue of commercial policy and the tariff structure, which was likely to become the main source of revenue, since most of the economy was paralyzed. The World Bank was going to address issues concerning sectoral developments. Notably, Bank and Fund staff would be cooperating very closely in setting up basic economic institutions and in developing a very rudimentary legal framework. All of that work would be provided to the UN Transitional Administration for East Timor (UNTAET), which was expected to be set up very shortly, to assist it in developing a strategy that would be part of a request for financial assistance presented to donors, most likely in the month of December.

Mr. Wijnholds welcome that initiative, which was very timely.

The Acting Chairman confirmed that the Board approved of sending such a mission.

The Executive Board took the following decision:

> In response to a request from the United Nations, the Executive Board approved the proposal for Fund staff to field a mission to East Timor, concurrent with the Joint Assessment mission led by the World Bank, and for the Fund to provide whatever follow-up technical services might be requested by the United Nations.

Adopted October 22, 1999

2. FRANCE—1999 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the Article IV consultation with France (SM/99/250, 10/1/99; and Cor. 1, 10/21/99). They also had before them a background paper on selected issues in France (SM/99/260, 10/8/99).

The staff representative from the European I Department submitted the following statement:

> This statement provides information on economic and financial developments and on the year 2000 draft budget, which has become available since the issuance of the staff report for the Article IV consultation (SM/99/250, 10/1/99). This information does not alter the thrust of the staff appraisal.
>
> After the slowdown of late 1998 and early 1999, real GDP grew at an annual rate of 2.4 percent in the second quarter of 1999, in line with the staff's projections. Domestic demand continues to support activity: private consumption and investment grew at annual real rates of 2.4 percent and 5.2 percent, respectively. The external sector has recovered as well, with exports growing at an annual real rate of 10.4 percent.

The latest cyclical indicators show that, in September, consumer sentiment reached a record high and business confidence continued to improve. Consumption of manufactured goods was 3.6 percent higher in August than a year earlier. These developments are in line with the growth outlook presented in the staff report (GDP growth of 2.5 percent in 1999 and 3 percent in 2000, as in the latest Consensus Forecast).

In the labor market, employment expanded strongly in the second quarter of 1999, at a rate of 1.8 percent year-on-year, while unemployment was stable at a seasonally adjusted rate of 11.3 percent in August 1999. Wage inflation remains contained, as hourly wages increased at an annual rate of 1.9 percent in the second quarter of 1999. Price inflation continues to be low, with the September harmonized price index 0.6 percent higher than a year earlier.

Recent interest rate developments have paralleled those in other euro-area countries: the 10-year government bond yield rose in mid-October to about 5.5 percent, a 21-month high, while the short-term interest rate increased to about 3.3 percent. To put these changes in perspective, the spread with respect to comparable (10-year) U.S. Treasury bonds has fallen to 60 basis points from 150 basis points in mid-June. The yield on the 10-year inflation-indexed bond reached 3.5 percent, up from 2.8 percent in June 1999.

The authorities' most recent projection for the 1999 general government deficit is 2.2 percent of GDP, 0.1 percentage points less than anticipated in the budget, reflecting better-than-expected revenue collection that was only partly offset by slippages in health care spending.

The recently announced draft 2000 budget for the general government projects a deficit of 1.8 percent of GDP, which implies a reduction in the structural deficit of about 0.3 percent of GDP under the assumption of 2.8 percent real GDP growth (compared to 3 percent in the Staff Report's projection). The draft budget envisages real growth of total expenditure of about 1.3 percent, and a reduction in the tax burden of 0.5 percentage points of GDP. If these targets are attained, the fiscal deficit would be reduced by about 0.9 percent of GDP in 1998–2000 (with half of the reduction owing to cyclical factors), the ratio of public spending to GDP would decline by about 1 percentage point, and the revenue ratio would be cut by about 0.2 percent of GDP over the same period. With a primary surplus of about 1.4 percent of GDP, the debt ratio is projected to decline for the first time since 1980.

At the level of the central government, total state expenditures are projected to be stable in real terms, while primary spending will increase in volume by 0.3 percent, with priority given to the areas of employment, education, justice, and environment protection. The two main tax measures in the budget are the reduction of the value-added tax rate on home

improvements and the elimination of the 1997 surcharge on corporate taxes (already legislated in 1998). A reduction of the income tax has been postponed to 2001.

As regards the social security system, real expenditure is expected to increase by about 2.2 percent (after an estimated 2.7 percent growth in 1999), and the general fund is projected to achieve balance for the first time since 1989. The major features of the draft 2000 social security budget are: the establishment of new taxes to partially finance the 35-hour workweek initiative (namely a tax on profits of large enterprises and an ecotax), an allocation to the pension reserve fund; and a 2.5 percent ceiling on the growth of health care spending.

The 2000 draft budget is broadly in line with the authorities' 2000–02 Stability Program: it implements the strategy of cutting the deficit by about 0.4 percent of GDP each year over the medium term, and gradually reducing the tax burden. However, in the staff's view, the draft budget does not go as far as had been hoped in addressing structural issues in the public finances, in order to allow for a sizable decline of the government's weight in the economy. In particular, it does not appear to make meaningful inroads into streamlining the civil service (where staffing is expected to remain constant) or curbing healthcare spending (which is projected to be 4.1 percent greater than the initial 1999 objective).

Mr. Milleron submitted the following statement:

Staff underscores that France's short-term outlook is favorable—notably thanks to policies implemented during the last two years, which have promoted employment creation and fostered consumer confidence. Indeed, much is going well in France, thanks both to an appropriate policy mix and to structural improvements, including in labor markets and employment creation. France has resisted the external shock caused by the emerging market crisis better than its main partners in the euro area as is stated in the very useful Appendix I ("Why has France been growing faster than Germany and Italy?").

Staff forecasts a 2.5 percent growth for 1999 followed by 3.0 percent in 2000. The latest projections associated with the 2000 budget draft law and published on the 8th of October, point to growth of 2.3 percent in 1999 and 2.8 percent in 2000. Beyond this renewed growth, the situation is improving in many areas, notably the labor market. Indeed, French growth is accompanied by a significant and rapid increase in job creation. Despite this sustained activity, inflation remains very low and competitiveness good, as witnessed by our export performance. In this context, fiscal consolidation is proceeding at a faster pace than in many European countries. In 2000, the share of public debt in GDP should decrease for the first time since 1980.

Of course, despite this improved picture, several policy challenges must still be addressed. But I disagree with Staff's contention that front-loaded structural reforms, undertaken with insufficient social consensus, are more appropriate than carefully sequenced, gradual reforms. The government's reform strategy is, first, to build on improving growth prospects in order to develop a consensus for structural change; second, to emphasize the need for fairness in the distribution of the benefits of reform; and, third, to involve relevant social actors in the preparation of restructuring programs. Public support is key to the success of reform, and income growth is a necessary ingredient to gather a reasonable degree of social and political consensus. This applies particularly to the welfare and social security systems and to the quality of public service. In addition, I have the feeling that staff somewhat underestimates the dynamics of innovation and structural change taking place in France, which is aimed at promoting employment. The French business sector has undergone considerable change in recent years, as exemplified by the current rapid pace of mergers and acquisitions. State-owned companies were often leaders in this movement. The French government has also taken important steps in opening former monopoly sectors to competition and enabling innovation. Measures were targeted at labor and financial markets. INSEE estimates, inter alia, that the contribution of information technology to GDP growth has jumped from its previously low levels (0.2–0.3 percentage points) to a significantly higher level (half a percentage point in 1997 and 1998). There is also ample evidence that measures aimed at developing new services (especially personal services) have increased job creation. Altogether, these measures have helped workers return to the labor market, increasing the available workforce and thus potential growth.

Finally, I do not agree with Staff on its definition of the reform agenda. While the French government clearly shares Staff views on the need to address several weaknesses of the French economy, to improve public sector efficiency, to reduce the tax burden, and to prepare for the upcoming demographic shock, it does not consider, for example, that the divestiture of public services, drastic reductions in civil service manpower or decrease in the minimum wage are legitimate policy objectives.

I will focus my comments on issues where I differ with Staff, sometimes strongly, or where updates are necessary.

Fiscal Policy

Staff recognizes that the general orientation of the 2000–2002 stability program is sound, yet considers its objectives unambitious. This judgment is highly questionable.

First, we must acknowledge that qualifying for the euro has greatly bolstered the credibility of France's economic policy stance. The fact that the deficit should amount to 2.2 percent of GDP in 1999, slightly lower than the initial 2.3 percent GDP target, serves to vindicate their resolve. In 2000, the public deficit will be 1.8 percent of GDP at most, indicating a structural deficit of not more than 0.9 percent of GDP, by Staff calculations. Let me just remind you that the 1993/1994 public deficit reached a record level of 5.5–6.0 percent of GDP.

Second, these reductions, which will decrease the annual public sector borrowing requirement by 0.4 to 0.5 percent of GDP, illustrate appropriate control of public expenditures, as well as great consistency of purpose on the revenue side.

In terms of control of public expenditure, the 2000–2002 stability program sets the course for an evolution of General government expenditure by 1 percent per year in real terms over the three years of the program. This should be compared with an average real expenditure growth of 1.6 percent during 1993–1997. The new fiscal strategy imbedded in the program represents a major policy change for France: it implies that additional tax receipts arising, for example, from higher than expected growth, must be allocated to deficit or tax reduction, but not to higher spending.

In terms of revenues, the tax burden should be significantly reduced in FY 2000, with taxes lowered by FRF 39 billion (0.5 percent of GDP). This would push the tax burden below 1997 levels as a percentage of GDP.

Last but not least, Staff should have put more emphasis on my authorities' commitment to the restoration of long-term sustainability of public finance, through reduction in the weight of public debt to GDP from 2000 onwards. Indeed, since 1997, the general Government has generated a primary surplus, although, until 1999, it was less than required to stabilize the weight of debt in GDP. In 2000, the weight of public debt to GDP is expected to be lowered by 0.6 point to 59.9 percent of GDP: this would be its first decrease since 1980.

Structural Issues in Public Finance

a. Healthcare Reform

The primary goal of policy in this field is to maintain the solidarity that forms the basis of the French social security system. In fact, one should not forget that health care is a public good characterized by the availability of a performing health system, open to any citizen in the country. However, my authorities are also well aware that there is a potential for efficiency gains in this sector and that it is both necessary and feasible to continue determined

efforts to slow down health expenditure, in a manner that should remain compatible with a high quality health service. This is the reason why some reforms to reduce rent-seeking behavior in the health care system and to improve the quality of medical services are being implemented.

b. Pension Reform

Staff rightly points out that between 2005, the date at which the first baby boom cohorts will reach retirement, and 2010, demographic changes will put particular pressure on pension financing and on public finances.

A public dialogue is currently going on in France which should enable the Government to propose, by the end of the year, a set of general guidelines for pension reform. In doing so, the Government will be guided by three principles: (1) consolidate the pay-as-you-go scheme, thus strengthening the intergenerational solidarity at the heart of the French social contract, (2) lay the groundwork for further significant unemployment reduction, so as to ease future financing difficulties; and, (3) undertake reforms in consultation with social partners. Therefore, I will limit my comments and give some details on two points of the Rapport Charpin, which has been analyzed by Staff.

- Staff indicates in footnote 19, page 15, that the annual financing gap of the public pension program will be about 5 percent of GDP in 2040, but omits to say that this estimate is linked to a structural unemployment rate of 9 percent. The Rapport Charpin has also made alternative assumptions, and in fact has privileged the intermediate scenario of a structural unemployment rate of 6 percent, which would lead to an annual financing gap of 4 percent of GDP in 2040. Realization of the most favorable assumption—a structural unemployment rate of 3 percent—would result in an annual financing gap of just 3 percent of GDP in 2040.

- Staff presents in section E, paragraph 22, and in Appendix II, some useful—but sometimes incomplete or not fully accurate—elements of comparison in pension rules between the private sector and the civil service. For instance, the table included in paragraph 22, provides the distribution of 1997 retirees in terms of initial age at which pension rights are exercised, without taking into account the existence of early retirement programs in the private sector, which undermines the accuracy of the comparison.

I have forwarded to Staff further comments from Mr. Charpin, dealing with other technical points in the report that should also be addressed.

c. Civil Service Reform

Civil service reform is a continual process dating back to 1997, initiated by the Government in a spirit of consultation with social partners. France wants to modernize the civil service without sacrificing its quality. The main aspects of the agenda include:

- forward-looking management of human resources, taking into account the demographic characteristics of the French civil service;
- an improvement of civil servant training, both at the initial level and through various forms of on-the-job training;
- a better familiarity with the new technologies of information and communication, including a reorganization of the methods of work where necessary;
- a strengthened transparency in public interventions with a special emphasis on timeliness of the public service;
- and, a new approach to control activities, associating them, to the extent possible, with the idea of an adequate assessment of the content of public policy.

The Implementation of the 35-Hour Workweek Initiative

I welcome Staff's assessment that the 35-Hour Initiative is likely to revive discussions between the social partners—which have languished and sometimes halted in the past—while fostering a better work organization in a context of negotiations decentralized to the company or industry level. Let me, however, note that this pragmatic approach is hardly consistent with the view that the 35-Hour Initiative risks distracting attention from "fundamental" labor market issues.

Of course, we are still at a preliminary stage in an ongoing process, since the Loi d'orientation et d'incitation à la réduction du temps de travail of June 1998, is at present under discussion in the French Parliament and since the initiative will be fully rolled out only in 2002. Therefore, I will limit my comments to the few points on which I believe some update may be useful, especially in page 19, box 4:

- Second bullet point: from 2001, 10 percent—rather than 15 percent as is stated in the report—of the overtime premium will go into the employment fund if the workers are part of a firm that has not adopted a 35-hour workweek;

- Fourth bullet point: the report states that "2.2 million minimum-wage earners will maintain their monthly income in spite of a reduction in statutory work time." In fact, this figure includes minimum-wage earners in sectors, such as the public sector, not currently affected by the law. For now, implementation of the law will involve 1.75 million minimum-wage earners.

Labor Market Reforms

From the beginning, the French Government has granted priority to employment. The latest labor market figures for salaried employment in the private sector speak for themselves: 1998 was marked by a sharp year-on-year increase in employment (+ 300,000); in 1999, despite the deferred impact of the cyclical slowdown in the fall and winter of 1998, 220,000 jobs will be created; in 2000, economic growth can be expected to boost jobs (close to 300,000). These figures are of course encouraging. In that respect, I would like to emphasize that, counter to Staff opinion, our job market is less rigid than it is segmented. Most adjustments in our labor market primarily affect certain types of wage earners: young people, for whom it takes longer to join the workforce; elderly people, who are prematurely excluded from the labor market; and, the long-term unemployed and the unskilled, whose deficiencies make them ineligible for recruitment.

In its report, Staff questions policies centered on employment subsidies—even while rightly acknowledging that these policies have contributed to job creation in the recovery. But, earmarking public funds for the integration or reintegration of these categories of unemployed is not only fair, it is also effective, since jobs for such people bring a collective gain—a sort of investment by society in individuals by encouraging their return to the job market instead of locking them in the trap of exclusion.

Let me give you one example, centered on the exemption of low wages from social security contributions. This is an effective form of redistribution, since it makes it possible to provide jobs for workers who would otherwise be excluded (present evidence indeed suggests that the exemptions associated with the "ristourne degressive" alone should contribute to some 200,000 job creations). This is the necessary complement to a policy of preserving and increasing the purchasing power of the guaranteed minimum wage. Refusing to lower the minimum wage does not mean refusing to admit that the cost of labor, especially unskilled labor, may have an impact on employment. It means adopting a consistent solidarity policy vis-à-vis workers with low wages. Moreover, there is some conflict between two Staff proposals: it seems inconsistent, on the one hand, to advocate a lower minimum wage, and on the other, to recommend maintaining a gap between this wage and social allowances in order to give incentives to work. This

would automatically lead to a sharp decrease of minimum social allowances, which is clearly unacceptable to my authorities.

Developments in the Financial Sector

The financial sector provides a significant case-in-point for the reform strategy which I outlined in the introduction to this statement. In the last two years, state-owned companies have been restructured and privatization has proceeded at a rapid pace in order to prepare the sector for increased competition within the Euroland. Furthermore, the legislative framework has been especially adapted to increase cooperation between supervisory bodies. Capital markets have also been given incentives to channel savings towards long-term investment and innovation financing.

Staff points out what they call "anachronisms" and explains that these can undermine the potential benefits of consolidation. It is, on the contrary, our view that the main interest of the French experience is to provide an example of a country where national specificities have not presented obstacles to the modernization of the financial sector.

- On financial supervision and regulation and as summarized by Staff, the system "performs well." Thus, the Staff's reference to an integrated structure is inappropriate since no international institution has expressed any preference for a special model. As most G-10 countries, France has opted for a network of specialized independent authorities, working in close cooperation.

- On mutual and savings banks, Staff argues that the ownership structure is a major competitive advantage which has biased their behavior at the expense of profitability (p. 26). But, Staff also points out that commercial banks have consistently underperformed cooperative banks in terms of profitability (p. 30). I do not concur with this view. First of all, I wish to recall the recent remarks by Alan Greenspan, which pointed out that complementarity of financial structures is a significant factor in resilience. More specifically, mutual and savings banks face specific limitations in terms of access to stock markets, which in some respects balance the competitive advantage mentioned by Staff. Finally, recent mergers between banks in both categories have reduced the relevance of this traditional distinction.

- As far as the system of administered interest rates is concerned, my authorities recall that the evolution of those rates is no longer subject to purely political decisions independent of the evolution of market rates: in June 1998, the Government established a corridor for the rate of the "Livret A" setting its floor at the inflation rate plus 1 point, and its ceiling at the EURIBOR rate minus 0.5 point. Furthermore, such a

system has made it possible for all French savers, especially the more modest, to earn on their savings while ensuring the democratization of home ownership.

Other Matters

I regret Staff's wording on ODA. Despite the decrease in 1998 to four-tenths of 1 percent of GDP, France—being the first country within the G7 in terms of ODA's share of GDP, and the third in the world in absolute terms—clearly remains one of the countries most involved in financing ODA and in serving the cause of development. Beyond this, France's share in enhanced HIPC initiative funding will by far exceed the efforts of other G-7 countries.

Finally, I am pleased to report that France is participating in the pilot project for release of Article IV staff reports.

Extending his remarks, Mr. Milleron stated that he had a series of technical and factual remarks on the staff report, as well as the selected issues document. Notes on those points had been sent to the staff prior to the meeting. Failing any response from the staff, he understood that those points would be properly taken into account.

Mr. Takeda submitted the following statement:

We would like to thank staff for an informative and stimulating paper. We are pleased to note that France has treaded a steady path of economic growth over the past year, and that its short-term outlook is favorable. While accommodative monetary conditions have underpinned growth, fiscal policy has been contractionary, but only modestly so. We share the authorities' view that the current recovery that hinges on consumer confidence is still fragile, and sympathize with their cautious attitude toward fiscal consolidation described in the staff paper as "gradualism," especially in view of the uncertainty surrounding the prospects of the U.S. economy. Also, the euro has rebounded a little since the consultation discussion took place, and the ECB's policy stance seems to be shifting in the direction of tightening, both of which suggest that monetary conditions may not continue to be as accommodative. This provides another reason to be cautious about fiscal tightening.

At the same time, in view of the medium-term fiscal concerns, the authorities should pay serious attention to staff's point that the cyclical window of opportunity for fiscal consolidation that is currently available should not be missed. To the extent that external conditions remain stable and domestic recovery continues, the authorities should utilize any windfall improvement in the budget balance to overachieve their fiscal targets this year and next, which staff termed as "unambitious."

Staff not only recommend smaller budget deficits, but also argue that France's high revenue/GDP ratio should be brought down substantially in order to strengthen the supply side. While we see merit in staff's latter recommendation as well, the problem is that for these to be achieved simultaneously, a large cut in expenditures would be necessary. This would probably be the first-best solution in the medium term, but may be somewhat unrealistic in the short term. If so, some balancing between cutting deficits and reducing revenue would be needed, and staff's policy assessment that focuses primarily on the medium term is not clear on this point. The question is what is the right balance at this juncture between progress toward fiscal consolidation and the supply side effect of revenue cuts. We would welcome staff's comments on this, as well as their evaluation on whether the authorities' current policy should be more tilted in one direction or the other.

Turning to structural issues, we find it particularly interesting to compare France's approach with that of Germany's to the major structural problem they share, namely extremely high structural unemployment. For this purpose, that staff paper (and the one on Germany) provides ample food for thought. In fact, there seems to be an extra benefit—a sort of positive externality—in holding the Board meetings on France and Germany close together. Also, Appendix I that discusses why France has been growing faster than Germany and Italy over the past five years presents a nice comparative study of the three countries' economic conditions and policies. Here again, a marked difference in labor market performance is cited as a possible reason for France's faster recovery. In what follows, therefore, we would like to focus our attention on the labor market, and comment on this critical aspect of the French economy.

Unlike financial markets, institutional elements play an important role in the labor market. In the case of Germany, the traditional concept of "solidarity" upheld by unions has led to a paralysis of market mechanism in the determination of lower-skilled workers' wages. This has brought about the ironic consequence that these workers are exposed to a disproportionately higher probability of unemployment, although if they are lucky enough to be employed, they are able to receive a real wage exceeding their productivity. Unfortunately, this adverse consequence is reinforced by the authorities' policy action to strengthen taxation on "DM 630" jobs, which has had the effect of stifling the dynamic niche of the labor market that has provided scarce job opportunities to lower-skilled workers.

Obviously, high unemployment among lower-skilled workers is not just the result of particular institutional or policy factors, but has much deeper roots, as summarized succinctly in the staff paper (Box 3, para 1). This is why the same problem is seen in France and some other Western European countries. However, the French labor market seems to be much more decentralized, and the authorities' attitude more proactive in enhancing labor

market flexibility, which no doubt explains the remarkable difference in job creation between France and Germany in the 1990s, as depicted in the chart in Appendix I (p. 32). We welcome the authorities' recent reform to cut social charges for lower-paid workers, which should further facilitate employment of this segment of the labor force.

However, the reform measure we just mentioned has been introduced in the context of the 35-hour workweek initiative, so that a careful examination of the latter is necessary to make an overall assessment. We have to confess that this initiative, at least at first sight, gives us the impression that a government intervention in the labor market of truly alarming proportions is being made in the name of job creation. The description of the new system given in the staff paper (Box 4) indicates that it is very restrictive, complicated, and likely to require a large amount of resources for administration, both private and government. In particular, the additional monetary and human resources necessary in the government sector to enforce this system properly seem to run totally counter to the objectives of fiscal consolidation and civil service reform.

These problems may be easier to live with if the initiative successfully achieves its primary objective, namely, job creation. We are somewhat disappointed that the staff paper is shy on this critical aspect of policy assessment, which only cited an outside work presented earlier this year (OECD Economic Outlook). Admittedly, it is still early to make a firm judgment on this, but the assessment made so far seems to be rather negative. For example, one source (Economist, April 3, 1999) states that "one thing that almost nobody pretends any more to believe is that the new law, however amended, is likely to create a stack of new jobs, as the Socialists' manifesto two years ago claimed it would," and goes on to quote one minister confessing that it is likely to create "relatively few jobs for a lot of mess." This was before the new law, and we wonder if staff have any updated assessment of their own.

It is encouraging to note, however, that the private sector is adapting to the new system in order to minimize its distortive effect. Namely, taking advantage of the new system, firms are "annualizing" their employment so that seasonal demand for production can be better accommodated through, for example, a temporarily longer workweek. What is not entirely clear is, if this type of work reorganization "creates mutually beneficial opportunities" as staff point out, why didn't such a Pareto improving arrangement occur without the help of the government initiative which, unfortunately, also contains various other elements that are fairly distortive? Perhaps, due to institutional constraints, the labor market is not flexible enough to exploit all Pareto improving opportunities. Alternatively, the initiative may have inadvertently strengthened the bargaining power of employers. This view is found in the Economist article we cited earlier, which says: "Trade union leaders are

understandably glum. They demanded a shorter working-week when the Socialist government took over, so they can hardly now complain if the result is not—to put it mildly—entirely what they had in mind."

It should be noted that, in either of these interpretations, "annualization" could decrease, rather than increase, employment in the short term because employers have less incentive to hoard workers to meet peak demand for labor. However, a pragmatic view to which we subscribe would be that, as long as the private sector can utilize the new system to their advantage and can increase efficiency, it can be regarded as a successful policy, whether it creates new jobs or not. And in the end, such an increase in efficiency should lead to expanded production and more jobs. In this regard, we fully agree with staff's assessment in paragraph 49 that the authorities should refrain from rigidly implementing the framework and from stifling private sector efforts to adapt to the new system. This seems to be essential for France to continue to enjoy the benefits of a relatively flexible labor market and to outperform neighboring countries in terms of job creation.

Extending his remarks, Mr. Takeda asked for elaboration on the 35-hour week initiative. It seemed that the initiative was facing widespread criticism in France.

Mr. Shaalan and Mr. Bakhache submitted the following statement:

The French economy continues to benefit from sound macroeconomic management and progress in key structural reform areas, particularly in privatization of public enterprises and reform of the financial sector. This, along with the increase in job creation over the past few years which appears to be promoting consumer confidence, have been major contributing factors to the buoyant economic performance. Indeed, with the recovery of economic activity in the second quarter of 1999, non-inflationary growth is expected to be at 2.5 percent for the year. We commend the French authorities for this performance, which points to favorable medium-term prospects.

We are in broad agreement with the analysis in the well-written and rather candid staff report. The report is appropriately and mainly focused on both short and medium term fiscal challenges as well as on factors underlying labor market rigidities.

We concur with the view that, at this juncture, downside risks to this favorable outlook are exogenous and would arise mainly from a sharp decline in activity in the United States or a less than robust pick up in economic activity in other major partners' economies. However, we consider that the strength of the current economic expansion as well as the ability of the economy to withstand external shocks can be enhanced by addressing two issues in two key areas. In particular, a more aggressive approach to public finances aimed at strengthening fiscal consolidation beyond what staff terms

unambitious targets would appear to be appropriate. Furthermore, in spite of the recent gains on the employment front, structural unemployment, remains, as in many other European countries, a major problem whose root causes need to be dealt with decisively.

The authorities' preference for a gradual approach to fiscal consolidation is based on the importance they attach to preserving social stability and consumer confidence. The specter of macro tightening and the associated deterioration in household confidence of the mid 1990s may well be behind the authorities' cautious strategy. While we appreciate these concerns and in fact agree that they cannot be ignored, we find the staff's recommendation for a speedier pace of consolidation to be rather convincing. The necessity of undertaking deep fiscal adjustments, which not only would render fiscal consolidation more durable, but also enhance the supply responsiveness of the economy, points to the need to proceed expeditiously with fiscal consolidation. We concur with the staff that delays would only increase the economic costs of adjustment.

The accommodative monetary conditions prevailing in France along with the ongoing upswing in economic activity represent an opportune time for accelerating the pace of fiscal consolidation. It is important at this time, especially in light of what, admittedly, represent the main downside risks to the economy, i.e. external shocks, to create enough room in the fiscal accounts not only for the operation of automatic stabilizers, but also for taking discretionary measures to support economic activity if needed. We hope that the fiscal targets for the current year will be achieved and that any overruns in health outlays will be compensated for. Here we would note that, for the first time in four years, state expenditures are budgeted to increase by about 1 percent in real terms. Hopefully, this does not represent a departure from the expenditures restraint of the past.

For the medium term, the guiding principles of the Stability Program as stated in paragraph 16 of the staff report appear appropriate. However, within this transition period to long-term fiscal sustainability, more adjustment especially through lasting and significant reductions in public spending is called for. Setting a fiscal plan with more ambitious targets would, in addition to addressing the increasing claims of the aging population on the budget, pave the way for more meaningful tax cuts. While the scheduled reduction of the local business tax and the reform of employers' social security contribution rebate are encouraging, more should be done in this area. In fact, at around 51 percent of GDP, the revenue to GDP ratio in France remains and, even with the programmed tax cuts under the Stability Program is expected to remain the highest among the G-7 countries. We believe that a clear and well-articulated plan for a more ambitious path of fiscal consolidation, which highlights the objective of reducing taxes, would indeed strengthen the public's confidence.

In recent years, the French authorities have made major strides in reforming the economy. Implementation of the privatization program, including the significant progress in 1998 and 1999, is particularly praiseworthy. Given the still high degree of state involvement in the economy, we very much welcome the authorities' intention to proceed with the trend of selective transfer of public enterprises to the private sector. The financial sector has also seen welcome transformation, which can only serve to improve French financial institutions' competitiveness in the more integrated European market. We are of the view that, among the remaining issues that need to be tackled in the financial sector, reforming the still extensive system of administered interest rate needs to be reassessed with the aim of liberalizing interest rate determination.

Recent progress in reforming the labor market has been beneficial as evidenced by the decrease in the unemployment rate. Indeed, active labor market policies have yielded significant gains mainly in the form of higher subsidized employment contributing in 1998 to the best employment performance in over two decades. However, the graph on page 23 of the staff report, which confirms these gains, also reveals the limitation of the active labor policies. In particular, non-subsidized employment, which seems to have only increased for the first time in 1998 over the past decade, appears to be at its lowest level since the early 1970s. This clearly points to the need to directly address the structural rigidities which mainly lie at the low end of the skill distribution, as described in paragraph 29 of the report. More generally, in spite of recent decline in unemployment, at 11.3 percent it is still very high even by European standards and represents a constraint on France's long-term growth potential. While we do not intend to enter the debate on the 35-hour workweek, we would note our concern regarding its fiscal implications and its limitations in reducing unemployment. Furthermore, given that the introduction of the 35-hour workweek will not address the above-mentioned structural rigidities, we feel that the focus placed on it may be diverting attention from the more pressing issues.

Finally, we would like to reiterate our commendation for the authorities' success in reinvigorating France's solid growth performance. We are confident of their ability to sustain this performance and wish them success in tackling the remaining challenges in the period ahead.

Mr. Barro Chambrier submitted the following statement:

The strong performance of the French economy during the past year has been remarkable. With a strong industrial production, and increased households confidence, as shown by the high de-saving ratio, the sustained efforts of the French authorities are producing positive results in 1999, despite the spillover effects of the Asian crisis. Indications are that GDP growth may reach 2.5 percent in 1999, and 3 percent in 2000, which should be a

consolidation year after the overheating of 1999. Increased domestic and foreign manufacturing orders, high domestic demand evidenced by increased private consumption, and the low level of stocks at end 1999 have and will continue to contribute to this positive outcome. In addition, an environment of price stability, notwithstanding the recent increase in long-term interest rates, has also undoubtedly contributed to the strengthening of business and consumer confidence, and in the more recent period to significant employment creation. These are positive achievements for which the authorities should be commended.

However, while the current outlook provides a window of opportunity to consolidate the already positive results achieved, policy challenges, as noted by the staff, remain. Despite progress achieved in the fiscal sector, over the past years, as noted in Mr. Milleron's informative preliminary statement, we are of the view that a more ambitious targeting of deficit reduction may be appropriate and would allow room for significant tax break. The indication by the French authorities of actions already taken or to be implemented to gradually balance the budget and reduce sharply the unemployment rate over the medium term are welcome steps.

Fiscal Policy

In the fiscal area, while we concur that continued economic expansion by yielding more revenue, and the reduction of the public debt will contribute to the reduction of the fiscal deficit, the achievement of this objective will be better served by a sustained reduction in public expenditure, especially as the authorities recognize the importance of reducing the tax burden, particularly with regard to the income tax. The already scheduled cut in the business tax and reform of employers' contribution relief are in the right direction. We also welcome the steps being taken to implement reforms in the health and pensions systems, in the face of the demographic pressures stemming from the aging of the population, and for their relieving impact on the budget. In this context, incentives to contain costs are essential, and we wonder whether, as proposed by the staff private pensions funds scheme should not be explored as a complement to the structural imbalances of the social security fund. In the same vein, we welcome and encourage the pursuit of the dialogue between the authorities and the social partners in order to foster further pension reform, in particular with regard to early retirement programs.

In this context, we concur with the broad strategy outlined by the authorities, and aimed at reducing the budget deficits, to provide for a possible tax cut of about 2 percent of GDP by 2003. This ambitious strategy, including the signature of "contrats de gestion" with various ministries for expenditure control purposes, will provide the framework for a comprehensive program of fiscal consolidation.

Employment Policy

Although declining from 12.5 percent in 1997 to 11.3 percent in 1999, the success achieved on the unemployment front remains limited, despite the decline in labor costs, the increasing productivity, and the continued surpluses registered by the external current account. This seems to indicate that beyond growth, a more ambitious approach is needed to achieve significant reduction in the unemployment rate. Over the past few years, the French authorities have made serious efforts to address the unemployment problem, but the existing overly generous system of unemployment benefits and the high minimum wage have acted as a disincentive to work. We welcome steps already taken by the authorities to improve the training of low skilled workers, streamline some unemployment benefits and reduce the cost of hiring. While one must regard the combination of these measures, together with the economic recovery as powerful means to reduce the unemployment rate, they are reaching their limits and will likely continue to impact negatively on the budget in the medium term. We therefore welcome the measures taken to foster durable employment prospects by gradually withdrawing social benefits.

In combination with a policy of wage discipline and other fiscal incentives, the introduction of the 35-hour week has certainly helped to improve social dialogue and work reorganization through the annualization of the work time. Nevertheless, the success of the challenging 35-hour week in increasing employment opportunities will depend on the modalities that will guide the implementation of the new draft Law, by relieving constraints on labor supply, particularly with regard to small-scale enterprises. Some clarifications will still be welcome on the impact of the 35-hour week on public finance. While it is stated that those impacts will be manageable, firm estimates are not available. In this context, we wonder what are the views of the staff and the authorities regarding the OECD's modest projections of the impact of the 35-hour week on employment (estimated at between one quarter of 1 percent and 2 percent after five years).

Financial Sector

We commend the authorities for their prudent and supportive monetary policy in 1998, which has resulted in price stability and also enabled a smooth transition to the Euro. On another area, it is encouraging to note that the Euro transactions are increasing and that confidence in the new system is gaining strength. With regard to the financial system, in an integrated Euro area, we welcome the consolidation and profitability of banks sector, as well as the gradual state divestment from the sector, and encourage the authorities to eliminate the administrative setting of some interest rates.

Structural Policies

With regard to structural issues, we welcome the continued progress in the privatization agenda established in 1993. However, we note that in the areas of telecommunications, transport and postal services, progress has been less than expected. Notwithstanding the strategic position of these sectors, we wonder whether particular social situations in these sectors do not constitute bottlenecks to the needed openness of these sectors in light of the increased international competition and globalization of markets.

Finally, I would like to ask Mr. Milleron to convey the appreciation of the countries in my constituency for the important financial and technical assistance that France has provided and continue to provide to them. This assistance is making a significant contribution to the fight against poverty, alleviation of the debt burden and more generally to the development of these countries. We also commend the French authorities for their generous support and contribution to the HIPC Initiative, and are hopeful that France will continue to maintain the high level and quality of its assistance in the future. Despite budgetary constraints, we would like to convey particularly, the appreciation of my Zone Franc authorities to the French Government for its commitment to the zone and for its support, which has led to the smooth peg of the CFA Franc to the Euro in January 1999, while preserving its fundamental operating mechanisms.

Mr. Bernes submitted the following statement:

To begin, I would like to thank the staff for producing a good paper, and note that I fully agree with the paper's analysis and policy recommendations. The tone of the report is somewhat more critical than that of last year, however, in my view the criticisms are both constructive and well placed, and I commend the staff for their frankness. If I were to make one suggestion in this context, it would be to extend the candid nature of the analysis to include a more explicit and forward-looking discussion of the prospects for monetary conditions in the euro area, with a view to assessing the implications for individual euro-area economies. Such an approach would enrich the discussion of fiscal and structural policies, by highlighting their possible congruence, or dissonance, with prospective monetary conditions.

Returning to France, the economy performed well in 1998 and the outlook for the remainder of 1999 and 2000 is also positive. Nevertheless, as the staff makes clear, the major policy challenges of fiscal consolidation and structural expenditure and tax reform, and labor market reform, are pressing issues that need to be addressed. In all cases, I share the staff's concern about the gradualist approach the authorities have adopted.

With respect to fiscal policy and the public finances, the slow pace of deficit reduction and structural fiscal reform is disturbing. Indeed, I find it paradoxical to argue, as the authorities effectively appear to do, that the recent strong growth performance limits the scope for further fiscal consolidation and reform. The authorities reason that the cyclical upturn is underpinned by strong consumer confidence, and they do not want to undermine this confidence with tough policy decisions. The 2000 budget plan provides evidence of this.

In response, I would tend to argue, as the staff does, that France's good growth performance provides a window of opportunity for the authorities to commit to more ambitious targets for fiscal consolidation, and to move more expeditiously in terms of structural fiscal reform. To state it simply, now is always the best time to begin implementing reforms. But perhaps more importantly, this window of opportunity is unlikely to be slammed shut at the first sign of reform. As the staff points out in Appendix 1, the recent growth performance in France has been driven at least in part by supply-side factors that include a relatively favorable competitive position and structure of production. Supply-side factors are unlikely to be significantly adversely affected by fiscal consolidation and reform, and as a result, one could expect economic activity and confidence to hold up reasonably well under fiscal adjustment. Indeed, a positive supply-side response to fiscal reform would tend to boost economic activity and confidence, although admittedly this could arise with a lag.

In any event, more ambitious progress has to be made in terms of fiscal consolidation now, in the context of an expanding economy, in order not to detract in the future from the usefulness and flexibility of fiscal stabilizers in the event of downturns. Moreover, as the analysis in Box 1 starkly shows, there is a pressing need to act early in order to smooth out the inevitable budgetary strain stemming from population aging. Due consideration must be given to intergenerational equity. Indeed, even the results of the "delayed policy adjustment" simulation can be considered optimistic, given that it assumes that financial markets would be willing to finance rising government deficits continually over the decade between 2003 and 2013 without demanding higher risk premia.

I would also underline the sense of urgency with which the staff advises reforming the tax structure and reducing the overall incidence of taxes. To some extent, the differing levels of taxation that already exist across euro-area countries provide incentives that affect employers choice of location, and as a result, their use of that country's available supply of labor. France is clearly not gaining competitiveness in this respect. Tax reform in the wake of public spending reductions has to be undertaken so that labor costs are not overly burdened by overly high tax and social contribution rates.

Turning to labor market issues, while I recognize the potential benefits that might have arisen as a result of the 35-hour workweek initiative, in my view, the overall macroeconomic effect is regrettably not likely to be positive. There is a clear cost to the government budget, and I worry that the initiative is unlikely to reduce the still-high rate of structural unemployment. Rather than relying on a complex system of regulated quotas on working hours, in my view, the best way to increase employment is to allow the price of labor more freedom to move to clear the employment market, and through enhanced competition that promotes productivity gains, wealth, and economic growth. In this sense, it is unfortunate that the prominence of the 35-hour workweek initiative has diverted attention away from the much-needed reevaluation of the root causes of France's high structural unemployment rate.

As noted above, I found the discussion of monetary conditions to be overly brief, particularly with respect to the prospects for monetary conditions in the near term. In my view, from France's perspective there is little need for a tightening of monetary conditions in the near term. Inflation is hovering below one percent, and a significant degree of excess capacity in product markets is projected to remain in 1999 and 2000, implying that underlying price pressures are unlikely to emerge next year. Moreover, monetary conditions have firmed since early summer, as evidenced by the rise in long- and short-term interest rates and the firming of the euro. (On a technical note, it is worth observing that the calculation of the French MCI would be of greater use if it were calculated with weights that are specific to France rather than to the overall euro area. Such a calculation could then be used to determine the appropriateness of the common monetary policy from the perspective of the individual country).

Finally, I noted with interest (and dismay) that an extensive system of administered interest rates remains, and the authorities have no intention of overhauling the system. I wonder whether or not this effectively wrestles a significant part of the control of the monetary-policy transmission mechanism away from the ECB, and whether or not it is consistent with the ECB's view of a market driven monetary-policy transmission mechanism. Comments would be welcome.

Mr. Hansen submitted the following statement:

The French economy is currently performing relatively well, particularly in comparison to other major European partners. Employment creation has been outstanding, business and consumer confidence remains positive, and the near-term economic outlook is for growth above potential. Moreover, the economy was remarkably resistant to contagion from the emerging market crisis in recent years, and there continues to be room for containing inflation and wages as the output gap tightens in the medium term. The staff has clearly recognized this in the report and I agree with the thrust of

their positive assessment. But, I can also agree with staff that the challenges ahead are considerable, and that the gradualist policy response may not suffice to address the underlying problems of high unemployment and the heavy tax burden. Nonetheless, we must not forget that "public support is key to success of reform," as stated by Mr. Milleron in his illuminating preliminary statement.

In spite of the current upturn in output and employment, there appears to be considerable slack in the economy. The report indicates that the output gap was around 3.5 percent at the start of the recovery but that it is projected to have narrowed to 2.1 percent in 1999. Inflation is projected to reach a low of 0.5 percent in 1999 (CPI average) and increase to only 1.1 percent in 2000. Yet, monetary conditions are determined to be adequately supportive at present. Unemployment is expected to reach a new low of 10.7 percent in 2000, while productivity (GDP over total employment) is expected to increase to 1.5 percent in 2000 from a low of 0.9 percent in 1999. Wages (average hourly earnings in manufacturing) are expected to grow at a modest rate of 1.8 percent in 1999 and 1.9 percent in 2000. Moreover, the net effect on labor cost from the 35-hour workweek initiative should be contained if plans for rebates on employers' social security charges are carried out in concert as envisaged.

Fiscal Issues

The present cyclical environment is ripe for using the current expansion to promote further fiscal consolidation. In my judgment, there is a need for a more ambitious program for budgetary consolidation and public expenditure reform.

The budget deficit leaves little room for maneuver under the conditions of the EU Stability and Growth Pact framework. This has its roots in the fiscal adjustment envisaged under the French stability program, submitted in 1998, which placed the deficit-to-GDP target not particularly near the Stability and Growth Pact objective of "close to balance or in surplus," even in the medium term. Nonetheless, the general government deficit is projected to decline at the end of 2002 to 0.8 percent of GDP under the more favorable scenario (assuming 3 percent growth on average in 2000–02) and to 1.2 percent under the cautious scenario (assuming 2.5 percent growth on average 2000–02). While the targeted deficit minimum in the high-growth scenario is based on relatively optimistic assumptions regarding medium-term GDP growth, the low-growth scenario may be more closely aligned with growth potential and past performance. Moreover, I fear that the same factors which contained negative effects on growth during the recent emerging market crisis, such as relatively low exposure of cyclically sensitive goods in exports and weak trade linkages with emerging markets, might

present a constraint on growth as those markets recover, at least relative to other major EU partners.

The recently presented budget for 2000 does not appear to be more ambitious than the stability program with respect to the medium-term objectives. Nonetheless, there is enough room to let the automatic stabilizers function without substantial risk of exceeding the 3 percent reference value under both macroeconomic scenarios, including in 2002. However, the safety margin provided by the projections of the stability program and the budget should preferably be wider in order to accommodate unforeseen developments in the coming years, such as, for example, the uncertain budgetary impact of major structural reforms. Strengthening fiscal consolidation will not endanger the credibility of the medium term fiscal orientation. I support staff's recommendation to further reduce public spending in order to reach a budget balance by 2003. In that context, I welcome Mr. Milleron's encouraging comments on lower than targeted deficit to GDP ratio in 1999 despite lower growth projections.

Structural Issues

Structural unemployment remains high, and the need for pension reform is, in fact, speedily approaching. Since the last Article IV consultation, there has been remarkably little progress in these areas. The same goes for health care expenditure overruns, and the need for rationalizations in the civil service. Instead, the authorities have focused attention on the 35-hour workweek initiative. My inclination is to agree with staff's concerns regarding the fiscal implications of the 35-hour workweek, particularly as I suspect they are right about the fiscal costs being "nontrivial." Perhaps staff could aid us with more thorough and less anecdotal evidence of this very important phenomenon.

I welcome the introduction of measures aimed at creating favorable conditions for employment and enhancing economic efficiency by promoting innovation, risk-taking and the modernization of the public sector. At the same time, I encourage the authorities to proceed further in implementing the necessary reforms in order to enhance the performance of the economy. It is time to tackle directly the root causes of France's unemployment problem. With reduced labor supply from the 35-hour workweek initiative, high medium term growth presupposes a significantly lower NAIRU, which again calls for more flexible labor markets.

I agree with staff's concerns about the effects of reducing the labor supply just ahead of a major demographic shock, which is bound to boost the dependency ratio, which already is relatively high in the French economy. In this context, I am skeptical as to the effects of the 35-hour workweek initiative on employment creation. A more flexible approach to working hours and

overtime would be preferable, not the least to avoid negative effects on employment due to increased labor costs.

Financial Sector Issues

Although I cannot but be impressed with the thorough analysis of the financial sector in the Selected Issues paper, I wonder if the exercise is all that useful, given that the staff does not seem to place those issues near the center of their analysis. At first glance, one could get the impression that all is well in the financial sector and that there is no urgency with respect to further advancing financial sector reform.

In elementary economics students are led to believe that market determination of interest rates is central to efficient and well functioning financial markets; we encourage program countries to install such institutional arrangements for the sake of economic efficiency. But, why is it that a major market economy like France retains an extensive system of administered interest rates and social clauses in their contracts? In staff's own words "the large-scale regulation of savings products is another characteristic of the French banking system with no parallel elsewhere in Europe." It is no minor issue that interest rates on saving instruments, accounting for about 60 percent of total deposits, are set by the Ministry of Finance. It is all the more serious that "the hierarchy between risky and non-risky assets of comparable quality" is altered by the system. According to staff, Banque de France argues that "one of the main reasons for the positive spread of deposit interest rates with respect to the euro area is the rigid system of administered rates, which prevents them from adjusting to market developments. Because of its link with the housing market, it may also be responsible for the higher cost of mortgages in France." Hence, in the present market environment, real interest rates are kept unduly high by official intervention and it does not seem to benefit average homeowners. But it gets even more puzzling, for at the same time, remuneration on a class of deposits, sight deposits, is prohibited by law—the so-called "Ni-Ni clause." It effectively keeps real interest rates on sight deposits negative by law and, to complicate matters further, some deposit accounts are taxable while others are not. I appreciate that staff has raised the point with the authorities but the report does not convey any sense of urgency in this regard.

I would also note that the high level of concentration in the French banking system, with the five largest credit institutions servicing almost seventy percent of total deposits (68.6 percent in 1997 compared to 14.2 percent in Germany), is not a trivial issue. It probably would not be much of a concern if it were not for the government's policy of influencing the privatization process, even to the extent of attempting to create "national champions" in banking. I note staff's account of three major features of the latest privatization strategy: that the government retains a certain type of

golden share; that large stakes of shares are sold to what is labeled as reliable shareholders who are deemed capable of fending off foreign takeovers; and the more general desire to preserve jobs, which is conditional on the post-privatization business environment. Although it may well turn out that this strategy is sustainable, it cannot be excluded that the increasingly competitive global environment, in addition to the squeezed domestic profit margins, may eventually put pressure on the banking system, and this could potentially have severe consequences on the fiscal side. Could staff please elaborate?

Finally, let me note that I found the reference to French banks' exposure to the Asian crisis countries in the Selected Issues paper rather alarming, yet there were no red flags in the staff repot. Staff claims that French banks expanded significantly abroad prior to the Asian crisis "in 1996 foreign branches and subsidiaries of French banks abroad represented about 30 percent of total domestic assets...In 1998, some major French banks...had net exposure to the Asian crisis countries amounting to 50 percent of their equity." It appears, in this respect, that the French economy was rather open to spillover effects from the Asian crisis in contrast to the limited exposure on the current account side. Staff's comments would be appreciated.

Extending his remarks, Mr. Hansen remarked that the staff report and the selected issues paper seemed to arrive at different assessments as to the health of the financial system.

Mr. Faini submitted the following statement:

At the outset, I would like to congratulate the French authorities for the remarkable economic achievements over the last year. Growth has been sustained and is at one of the highest levels in the Euro area. Inflation has been subdued and unemployment is declining, albeit from relatively high levels.

In the spirit of the new format for discussions of Article IV reports I will focus my comments on a few selected issues.

Why has France's output grown fast (-er than that of Italy and Germany)? According to staff, France's more rapid growth can be attributed mainly to a relatively strong competitive position, a positive employment performance, and a more moderate pace of fiscal retrenchment. I must confess that I remain somewhat unconvinced. Let me focus on the comparison between France and Italy. First, it is important to stress that the differential in the employment performance largely reflects differences in population growth. Indeed, between 1994 and 1998 the employment/population ratio was virtually unchanged in Italy and shows only a modest increase, around one percent, in France. It is easy to show that, corrected for population growth, the average annual increase in employment was 0.4 percent faster in

France than in Italy. This is not negligible, but is unlikely to be the main factor behind the difference in the overall economic performance. Let us turn to the second factor highlighted by staff, namely competitiveness. Staff take 1993 as the basis for comparison. This is not a fortunate choice, since the lira was somewhat undervalued at that time. Even so the comparison does not lead to any clear-cut conclusion. Moreover, if we take 1991 as the basis for comparing Italy and France (Germany's cyclical position in 1991 was quite different), we see that the real exchange rate based on unit labor costs depreciated substantially faster in Italy than in France. Overall, I would tend to conclude that the substantially milder effort in the run-up to EMU largely accounts for the superior performance of France during the nineties. In the latter part of the period (1998–99), France also benefited from having more limited trade links with the crisis countries in Southeast Asia.

What is the appropriate stance for fiscal policy? Staff take a somewhat critical attitude with respect to the fiscal stance in France, arguing that the window of opportunity allowed by the favorable cyclical position should be more fully exploited. It is indeed true that the need to make adequate provisioning for the demographic shock should not be underestimated. However, if one accepts that France's output performance can be largely attributed to the milder fiscal adjustment, excessive retrenchment could easily bring the recovery to a premature end. Staff's repeated emphasis on the ability of French authorities to maintain consumer confidence and spending also calls for a continuation of the gradual approach pursued so far. Moreover, as noticed earlier, France is likely to benefit relatively less from the recovery in Southeast Asia. Finally, it is worth stressing that the French approach to fiscal consolidation, namely predetermining the course of public spending in real terms, will also allow for a much needed reduction in taxes. The decline in the tax burden is also likely to trigger positive non-Keynesian effects on consumption, adding therefore to the confidence effects. The main factors of concern remain, I believe, the large fiscal impact of labor market policies and, in particular, of the 35-hour workweek initiative.

What is the outlook for further unemployment reductions? Let me add a few remarks on a topic that has been thoroughly analyzed by Mr. Takeda. French authorities have been relatively successful in reducing unemployment through a well-designed policy aimed at reducing taxation of unskilled labor. Much of the discussion between staff and authorities focused on the 35-hour workweek initiative. According to the OECD, the employment effect should be small but positive. I would like to add a note of pessimism, however. The employment impact of the initiative will be a function of the relative weight of overtime costs (the higher such costs, the higher the impact on employment) and fixed employment costs (the higher such costs, the more likely that firms will try to rely on overtime rather than on higher employment). In this respect, it is somewhat surprising that the staff report does not make any mention of the employment protection legislation (EPL), a crucial component of fixed

employment costs. According to the OECD, the strictness of employment protection in France is relatively high for temporary jobs and close to the median for regular employment. Moreover, on both accounts the ranking of France within the OECD has markedly deteriorated between the late eighties and the late nineties. Tight EPL will make it more likely that the 35-hour workweek initiative will have only limited effects on employment. Staff's opinion on this point would be highly welcome. In this regard, it is surprising that staff, in listing the priorities for labor market reforms, rightly mention the large supply of unskilled workers, the minimum wage level, and the system of social assistance. However, no reference is made to the need to liberalize the employment protection legislation. This omission is somewhat puzzling and again I would like to hear staff views on the subject.

To conclude, let me again congratulate French authorities for their remarkable economic achievements. I wish them continuing success in their future endeavors.

Mr. Mirakhor submitted the following statement:

We thank Mr. Milleron for his comprehensive and very helpful statement. The staff has produced a well-written set of papers. We appreciate, in particular, the format of the staff report, with focus on the policy discussions where the views of the authorities and the staff are clearly spelled out. We welcome the common positive assessment of the present economic situation, the short-term outlook, as well as the common view on downside risks to growth. We appreciate the Selected Issues paper focusing on the financial sector. Particularly useful and instructive are the sections on the sequencing of financial reform and on the French experience with capital account liberalization within this context. We wish to encourage this single-issue approach in the background papers for major industrial countries.

The French authorities' skillful management of the economy in recent years has brought them rich rewards with the successful participation in Phase III of the EMU and an above average growth performance. We welcome, in particular, the significant progress in employment creation through a combination of well-targeted fiscal incentives and wage moderation. In this respect, it is difficult to dispute the authorities' assessment of the significant contribution of their labor market policies and consensus-building approach in recent employment and growth performance, which has outpaced those of other large Euro countries. Appendix I of the staff report confirms the relevance of the authorities' position. The economy's strong resilience during the recent market crisis is also noteworthy. However, with resumption of growth in emerging markets, the factors that have partly shielded France from the spillover effects of the recent market crisis, including the lower share of manufacturing in GDP and of exports to emerging markets in total exports, could have opposite effects on the economic performance in France in the

period ahead relative to other European countries. The staff may wish to comment.

In some of the recent Article IV discussions with Euro countries, the staff have expressed the view that the medium-term fiscal objectives of the Growth and Stability Pact (GSP) were unambitious and did not make sufficient room to accommodate the effects of the upcoming population aging, and to supplement, when needed, the operation of automatic stabilizers. The staff may wish to indicate whether these considerations were overlooked at the time the GSP was negotiated, or if new developments have made these issues more obvious. We share the staff's views on the need to improve the health and pension systems, to streamline the civil service, and to reduce the high rates of taxation and the extent of exemptions. However, in view of the progress achieved so far, we see considerable merit in Mr. Milleron's argument that durable and successful reforms cannot be undertaken without a broad-based public support, particularly when reforms involve a few, but organized and politically powerful, losers and many disorganized and politically weak gainers. The power of a strategy of relying on improved growth to expand the size of stakeholders in the economic progress and thereby establish a solid constituency for the reform process cannot be underestimated; nor should the need for building a consensus among the social partners on sensitive reform issues—such as the pension system reform, civil service retrenchment, and reduction of tax exemptions—be taken lightly. Incidentally, it is gratifying that a large industrial county would come around to a point that developing countries have been trying to make. What may be a do-or-die proposition in a first best world is neither desirable nor practical in a world of compromises and consensus politics.

While we note the staff's view that the focus on the 35-hour workweek initiative may have detracted attention from other labor market issues, we share the authorities' assessment that it has revamped the social dialogue and highlighted productivity issues in the context of decentralized negotiations. We are of the view that this initiative should be implemented flexibly to increase the chance of maximizing its effect on employment and improving social relations. Like the staff, we believe that addressing decisively the root causes of unemployment would require reforming the educational system and training programs, enabling closer link between wages and productivity, and reorganizing unemployment and welfare assistance to enhance work incentives. On the issue of minimum wages, we agree with Mr. Milleron that while efficiency considerations are key, it is also important not to overlook equity considerations.

We commend the authorities for the successful implementation of their privatization program and encourage them to seek a further retrenchment in government's involvement in the economy. The authorities should also be commended for their achievements in liberalizing the financial sector. The

Selected Issues paper details the systematic, determined and successful efforts of the authorities to transform the financial sector and achieve a high degree of liberalization and modernization. The authorities are encouraged to build on recent progress to further improve the efficiency of this sector.

Finally, despite its recent decline, the level and quality of France's ODA is commendable. We encourage the authorities to avoid a further decline and to reverse this trend toward achieving the UN goal. We appreciate the authorities' role in strengthening the HIPC Initiative and their generous contribution to ESAF/HIPC financing. Their active role in the Paris Club to seek innovative responses to the needs of the heavily indebted middle-income countries is also commendable.

Mr. Cippà submitted the following statement:

Within the Euro area, the French economy seems to have joined over the last three years the fast-growing league. In 1998, growth remained robust, reaching the highest rate in a decade, while inflation was subdued. Behind this good economic performance lie several factors. Favorable monetary conditions and a revival of consumer confidence have triggered a pick-up in private consumption. This demand seems to be underpinning growth in non-manufacturing, labor-intensive, sectors, implying job creation. With the resulting increase in disposable income, consumption is further boosted and thus a kind of virtuous circle seems to be effectively at work.

Looking at the future, the near-term economic outlook remains optimistic. Further employment growth can be expected, consumer spending should remain buoyant and France still benefits from a strong competitive position. All these elements are expected to contribute in achieving a real growth rate averaging 3 percent per annum over the medium term. I view, therefore, the economic situation as more robust than the French authorities seem to think. An acceleration of the pace of reforms should therefore be possible. The opportunity offered by the current favorable conditions should be resolutely seized to address long standing structural issues. In this context, particular attention should be given to reforms in public finances and in the labor market.

As regards public finances, I share the Banque de France's opinion that more ambitious targets should be possible. The ongoing fiscal consolidation has mainly been brought about by higher tax revenues stemming from strong economic growth. In order to ensure long-term fiscal sustainability, bolder fiscal adjustment and a series of public expenditure reforms are still necessary. These efforts should include both spending cuts and control mechanisms which would allow to supervise and correct spending slippages more efficiently. These control mechanisms are particularly

important as far as healthcare is concerned, given the recurring overruns this sector has experienced in the past.

A stronger fiscal program would be justified on several accounts. Considering France's heavy tax burden, tax cuts are a priority. So far, the authorities have taken a number of measures, in particular concerning labor and corporate taxation. These measures represent a first step toward reducing the weight of the state in the economy. Well-conceived and more fundamental reforms, however, are necessary. The French tax system is still overly complex and costly to administer. Greater spending restraint would have provided the necessary room to start the undertaking of more comprehensive tax reforms, aimed at a more transparent and simple system.

The long-term viability of the pension system will also depend on greater fiscal efforts. However, I agree that the political and social sensitiveness of this issue does not allow for any quick fix. For instance, recourse to early retirement should be tightened. The number of years of contributions should be increased. Moreover, since the sustainability of the pension system will remain problematic as long as it relies almost exclusively on pay-as-you-go schemes, pension funds should be reintroduced. All these changes are not easy to carry through. This should not prevent, however, the authorities from taking advantage of the current renewed public awareness of this issue to press their case. They will have to convince the public of the necessity of such reforms. The faster a general consensus on these matters can be reached, the earlier the reforms can be implemented.

On the issue of pension funds, I would just like to stress here the important contribution they can make as complement, and not as substitute, to a pay-as-you-go system. The Swiss experience shows that, by introducing pension funds and by reducing the burden on the pay-as-you-go scheme, the whole pension system can be made more sustainable. The Swiss pension system is based on three pillars. The function of the first, based on the redistribution principle, is to guarantee a basic insurance to every contributor. With the second pillar—the private pension funds based on the capitalization principle—contributors are forced to build up private savings. These two pillars are complemented by voluntary savings.

Let me turn next to labor market policies. Despite the well-documented rigidities hampering the French labor market, France experienced in 1998 the fastest growth in employment among the three largest euro-area countries. This favorable development stemmed partly from the authorities' actions, centered on employment subsidies. These interventions do not address, however, the root causes of the problem and imply high budgetary costs. Social charges and the minimum wage remain high and hamper the employment of the low-skilled and the inexperienced. A significant and durable reduction in unemployment will only be achieved,

therefore, through a combination of greater wage differentiation, improvement of the educational system and vocational training and greater market flexibility in general.

Finally, concerning the 35-hour workweek initiative, I welcome the authorities' efforts to be more pragmatic in its implementation, notably through the annualization of work time. Despite these efforts, however, I fear that the effects on employment of this initiative may only be limited, while implying considerable budgetary costs. For instance, concerns remain that the use of overtime and the working time of professional staff may be excessively constrained. I would therefore join the staff and renew my call for a flexible implementation of the initiative.

Mr. Morais submitted the following statement:

The broad-based economic upturn that became evident in 1998 despite the dampening effect of the financial crisis in emerging markets, has been sustained in 1999 and the short-term prospects are significantly more favorable than its European Union partners, after France posted its fastest rate of growth in ten years. The authorities deserve to be congratulated for the mix of policies, aimed at promoting employment creation and bolstering consumer confidence. France now finds itself in the enviable virtuous circle where the sustained growth has helped to lower unemployment, in turn, reinforcing consumer confidence. It is all the more encouraging that all this is taking place against the background of continued price stability and strong external competitiveness.

However, growth projections for 1999 which indicate less robust prospects than in the previous year, serve to underline two important considerations: first, consumer confidence remains basically fragile and has forced the authorities to take a more cautious approach to policy formulation in order to avoid undermining the ongoing upturn. Second, the structural reforms already underway need to be reinforced so as to bolster the medium-term vitality of the economy and underpin its growth and employment prospects. In this connection, it is encouraging to note that there appears to be a meeting of the minds between the authorities and the staff on the need to use the opportunity presented by the current upturn to address more forcefully the long-standing challenges that have confronted the French economy namely: the reduction in the structural unemployment, especially among the youth and the low-skilled; the reduction in the burden of taxes and social contributions; and the continued fiscal consolidation designed to achieve a budget balance in the medium term.

The authorities acknowledge the validity of the argument for steering the economy in a position that would enable France to cope with the impending demographic shock and to create room for automatic stabilizers to

work within the context of the Stability and Growth Pact. To this end, we note that the authorities have taken steps, albeit cautiously, which have gone a long way toward achieving the desired results. Noteworthy among these is the overall soundness of the stability program, designed to achieve a budget balance in the medium term with ceilings being placed on certain key areas of public spending. Besides, efforts to reduce the burden of taxes and social contributions have also been initiated. Like the staff, however, we also believe that there is scope to reinforce these efforts, especially through a more ambitious fiscal consolidation program.

There can be no doubt that the cautious approach to policymaking has served the authorities well in their efforts to implement politically difficult reforms. However, it is also becoming increasingly evident that the efforts already underway, including the 35-hour week program may not have gone far enough. For example, it is generally felt that the incentives under the 35-hour week program, while increasing employment in the short term, will not be strong enough to substantially reduce the unemployment rate in the medium term. In the circumstances, the authorities are well advised to implement policies that promote flexible labor and product markets in order to place the economy on a robust growth path. It is important that the authorities should make a headstart as economic conditions remain propitious.

Finally, we would like to commend the French authorities for their continued commitment to strengthen their partnership with low-income countries, especially the poor sub-Saharan African countries, in their fight to eradicate widespread poverty. This commitment continues to be expressed in the form of generous efforts in bilateral and multilateral development assistance, including contributions to the HIPC Initiative. We would encourage them to continue with their leadership position in the service of the cause of development.

Mr. Wei submitted the following statement:

At the outset, I would like to thank staff for the well-written and informative papers, and Mr. Milleron for his helpful preliminary statement. Developments in 1998 have demonstrated the French economy's resilience to external shocks—a measure of the effectiveness of the authorities' structural reforms and sound macroeconomic policies over the past few years. The favorable growth outlook— above potential growth rate in a low inflationary environment, even if it can only be applied confidently for the near term— is welcome. As staff points out in the statement, domestic demand continues to support growth, and we fully share the authorities' view that consumer confidence, significantly bolstered by job creation, is essential for economic recovery, and any policy change should pay sufficient attention to the implications for consumer confidence.

This being said, however, as staff points out, the cyclical upswing will not erase the twin legacy of high unemployment and a heavy tax burden, and there is a window of opportunity provided by the current short-term virtuous circle—job creation has bolstered consumer sentiment, triggered an economic upswing and further reduced unemployment—to make meaningful progress in breaking the vicious circle of the twin legacy. Mr. Milleron's preliminary statement indicates clearly the difference of opinion between the authorities and staff on the course of action to cure these chronic problems.

In this regard, we fully support Mr. Milleron's view in disagreeing with staff's contention that front-loaded structural reforms, undertaken with insufficient social consensus, are more appropriate than carefully sequenced gradual reforms. Therefore, we support the authorities' three-point reform strategy, and fully agree that public support is the key to the success of reform. Mr. Milleron rightly points out that staff might be underestimating the dynamics of the innovation and structural changes taking place aimed at promoting employment. However, after many years of effort, the current unemployment rate—11.3 percent of the labor force—provides no room for complacency and more decisive action is required. The advent of the Euro at the beginning of the year was not only a big event for EMU countries, but also for the rest of the world, which will benefit from a more dynamic and flexible economy in the Euro area. The institutional changes induced by the Euro require accelerated fiscal consolidation and structural reforms providing the mechanism for economic adjustment when needed. From this point of view, we encourage the French authorities to take effective measures that are tailed to French situation to meet the requirement of the changed (EMU) regime. Now, I would like to turn to my comments to specific issues.

Fiscal Policy

The reduction in the general government deficit from its peak level of 5.5–6.0 percent of GDP in 1993/1994 to the estimated 2.2 percent of GDP in 1999 is commendable. We share the staff's view that the general orientation of the 2000–2002 stability program is sound, and welcome the expected decrease in the public debt to GDP ratio in 2000—the first time since 1980. However, staff argues that a more ambitious consolidation program aimed at a balanced budget in 2003 and a 2 percent GDP tax cut financed by sustained reduction in public expenditure, is more desirable taking the impact of demographic development on the budget into consideration, and the merit in having some room for discretionary fiscal support, besides the operation of automatic stabilizers, when needed. However, the authorities' current fiscal program is already in line with the requirements of the Stability and Growth Pact, besides, as Mr. Milleron pointed out in his preliminary statement, the new fiscal strategy imbedded in the authorities' program implies that additional tax receipts must be allocated to deficit or tax reduction rather than

higher spending. We encourage the authorities to give full play to the new strategy, and use any windfall gains in revenue for deficit or tax reduction.

Structural Reform

Over the past few years, progress has been made in the structural reform area, particularly with the implementation of the privatization program in 1998 and 1999, and we commend the authorities for their efforts. However, much more needs to be done. The recurrence of slippages in health care expenditure clearly indicated that effective incentive systems to contain costs have to be put in place. For the pension system, since it concerns everyone, we believe that broad public consensus is necessary for a sustainable reform. From this point view, it is encouraging to learn that there is heightened public awareness of the financial imbalance in the current system, and believe that it offers a valuable opportunity for a new headstart to tackle the problem. Among the recommendations made by staff, we believe that appropriate attention should be given to the idea of establishing private pension funds.

As staff points out in the paper, the 35-hour workweek initiative must be credited for revamping the social dialogue and catalyzing work reorganization. However, we have some concerns about the fiscal cost of this initiative, and its lower-than-expected contribution to the reduction of unemployment—the original purpose of this initiative.

Turning to other labor market reform issues, we commend the authorities for their progress in creating jobs over the past few years. For the future course of action, we tend to agree with staff that the limits of the employment subsidy might have been reached, and consideration should be given to the measures targeting the root causes of unemployment. Successfully addressing the three issues highlighted by staff in paragraph 50 is critical to the sustained reduction of unemployment, particularly, for lower-skilled workers, and we encourage the authorities to give serious consideration to staff's recommendations.

Great changes have taken place in the French financial sector, and we commend the authorities for their progress in making the sector more solid, competitive, and profitable. As for the administered interest rate system, we tend to share staff's view, and encourage the authorities to give an overhaul of this system.

Finally, we appreciate France's contribution to the enhanced HIPC Initiative, and its leading position in ODA's contributions among the G-7 countries. We encourage the authorities to strengthen their efforts in ODA contribution according to UN standard.

With these remarks, we wish the authorities further success.

Extending his remarks, Mr. Wei said that he agreed with the authorities' views, particularly concerning the pace of reform. Without broad support, such reform would be unlikely to succeed.

Ms. Lissakers made the following statement:

I must say, the comprehensiveness of the statements by lead speakers and by many other chairs gives me the luxury of being fairly limited in my comments, even though I am a lead speaker. It is clear that the Article IV for France has stimulated a lot of interest in the Board, quite rightly. I give the staff a lot of credit for that, because I have to say, European I, in general, based on the German Article IV, as well as the French Article IV, seems to have taken on board the Board's pleas for more focused, tightly written and forceful Article IVs. And greater selectivity in selective issues papers. I hope we will see more Article IVs like these.

I welcome the fact that the French authorities, like the German authorities, are volunteering to publish the Article IV. It will be interesting to see how these documents are received in Germany and France, because they are pointed and because they go right at the heart of the most intensely debated economic and social issues in these two countries. These two documents lay to rest, at least for now, the concerns many expressed that publication would lead the staff to water down and tone down their comments. On the contrary, it seems to have inspired them to be more pointed, and that is, as I say, very welcome. It will be very interesting to see how this experiment with publication goes.

On the general issue, the other reason for interest in the French Article IV, of course, is the transition and the fact that one has a government that like the German Government has acknowledged that these are the big problems that need to be tackled and has developed a plan to do so. There is a lot of disagreement about the plan and whether it is going to work over time. Just looking at the numbers in the performance of the French economy, it is very welcome, indeed, to see a large European economy with a fairly high rate of growth and that is domestic demand-led growth, with at least some new job creation at the same time that the budget is staying within the parameters of Maastricht, and the trajectory is toward reduced deficits. And, there are clearly many things happening on the structural front.

There is disagreement between the French authorities, as expressed by Mr. Milleron, and the staff, about the pace, and, indeed, many colleagues suggest that the pace is too slow. On the one hand, I have some sympathy for the argument that moderation in fiscal consolidation makes sense while one is still uncertain about the growth trajectory. If you can ensure strong, sustained growth, the fiscal consolidation will be much easier and more sustained. But, France, like most industrial countries, confronts this demographic time bomb

and also the very big problem of rising health care costs, and it is very clear from the numbers and from the very useful graphs the staff presents that there is a huge cost in delaying. Addressing these issues forcefully, and in a period of high growth and optimism makes sense, and there should be scope for moving faster than the French authorities appear set to move now.

I am most concerned about the pace of structural change rather than the budget trajectory, per se. If the structural changes are not carried through rapidly, and I think tax reform is particularly important there, as well as pension reform, it is unlikely that the strong growth will be sustained. And, while investment has picked up in France, it is still pretty modest, and certainly not what is needed to close the output gap and bring down unemployment and put the economy on a sustained high growth path for an extended period. The lack of ambition or even intent on civil service reform is somewhat puzzling, as well, given the very large size and apparent inefficiencies on the public sector.

I am as puzzled as everybody else by the 35-hour workweek. A 35-hour workweek does have a lot of appeal, representing about half of the average workweek for a Washington public sector employee. And, it appears to be a rather clever backdoor way of getting at some structural rigidities in the employment market, and getting more flexibility in wage negotiations. Also, perhaps it may be a real stimulus to productivity. Still, like others, I am very doubtful that it is going to generate more jobs per se, and indeed the whole concept of a 35-hour work week, as well as the German discussion about reducing the pensionable retirement age from 65 to 60 seems rooted in the assumption that the number of jobs in the economy is finite, and you have to figure out some way of sharing them.

Coming from an economy that has created 15 million new jobs in the past couple of years, this seems odd. It does not seem to us to be a sensible way to approach unemployment, nor really is a solution to unemployment. And there is the question of whether this 35-hour work week is loaded with so many rules and fiscal costs, that you are taking away with one hand what you are adding with the other in terms of stimulus and loosening of the jobs market.

On the approach to low income unemployment, the proactive approach the French Government has taken recently, fiscally costly, can have large social benefits, and indeed, has had economic benefits as far as one can see. There is an enormous social cost to having long-term unemployed and having a high rate of youth unemployment. I was troubled by the stated position of the previous French Government which was that the French people are perfectly satisfied to have 12–13 percent unemployment; as long as there are social transfers, it does not matter. It does matter, as we know, in terms of the social fabric. I think this government has been quite right in tackling that,

even though there have been fiscal costs. Again, it is not a long-term solution to the unemployment problem. We all struggle with the question, as President Clinton says, how we equip our population for knowledge-based economies. Education and retraining, as many have said in their statements, is a very important element as well as flexibility in the pricing of labor, and reduction in the non-wage cost, particularly on the low end.

On the financial sector, I agree with Mr. Hansen up to a point, that the staff could have pulled in a little more of what was a very interesting treatment of the financial sector into the body of the main text, but I understand that it is also a contradiction with our plea to have a very focused and narrow central staff paper.

Just a general comment on what is happening in the financial sector in France. It seems that the Asian model applies to more than just our approach to the Article IV discussion today. The very intensive reliance on administered interest rates does seem highly anachronistic. I am interested in the question Mr. Bernes posed, which is, is this taking away from the ECD's control of its monetary policy instruments?

Secondly, I wonder how this structure of administered interest rates is consistent with the effort to liberalize and expand the capital market in France, where there has been considerable effort. At some point, the two are just not going to be reconcilable. Third, the nationalistic approach to privatization and consolidation in the banking sector strikes me as very remarkable. It seems France is intent on having a common market, with everything except the financial sector.

Finally, a point which is not central to the macroeconomic issues, but is an important point that I had intended to raise and I had, indeed, told Mr. Esdar I would raise in the German Article IV, which is a long-standing debate that has gone in this Board about corruption and bribery. Many program country representatives have suggested there is a double standard. We have discussed in this Board the fact that there are those who are bribed and those who are bribing. Many industrial country governments have a contradictory policy when they complain about official corruption in developing countries, but turn around and subsidize their corporations who are major contributors to that corruption. The OECD has recently adopted an anti-bribery code which tries to get at that. As we do address the corruption issue in Article IVs and program documents for many program countries, I think we should also address it in the industrial country Article IVs, and I would suggest that we should note in the industrial country Article IVs whether or not the OECD members, at least, have, in fact, implemented the anti-bribery code that they have signed on to. I will ask today whether that is the case for France and I will continue to ask it in all the other OECD member countries' Article IV discussions.

Mr. Esdar commented that Germany had implemented the OECD guidelines on bribery in 1997, and so an appropriate legal framework was now in place.

Ms. Lissakers remarked that many industrialized countries allowed their companies to deduct, as legitimate business costs, bribes paid to foreign officials. Such policies seemed to be inconsistent with the international community's stance on corruption.

Mr. Artus, the Deputy Director of the European I Department, made the following statement:

> I would like to comment on three key points raised by Mr. Milleron. Firstly, Mr. Milleron is criticizing the staff for advocating "one, divestiture of public services; two, drastic reductions in civil service manpower; and three, a decrease in the minimum wage." This is somewhat of a caricature of the measures recommended by the staff, but let me take the three issues one at a time. On public services, the only point made by the staff, in paragraph 34, was that the liberalization of electricity and gas distribution was being pursued in line with European directives, but at a slow pace. We also noted, in paragraph 52, that there is considerable scope for additional liberalization beyond the minimal threshold set by EU directives. Our comments fell somewhat short of advocating the general divestiture of public services.
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> On civil service reform, the staff report notes that there is scope for a significant reduction in the manpower of the civil service. Similarly, the staff notes that streamlining the public sector will be unavoidable if, as expected, the central government is forced to bear a significant part of the expenditure restraint needed for fiscal consolidation. There appear to be clear instances of overstaffing, where an appropriate use of attrition might be useful. Again, we did not advocate a "drastic reduction" of the civil service.
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> On the authorities' minimum wage policy, the staff argues in paragraph 51 that the first priority should be to enhance vocational training and broaden programs that provide effective on-the-job training for unskilled workers. Those efforts should proceed regardless of age, and at a level of remuneration that, given the low productivity of the trainee, will often be below "the minimum wage." We did not recommend that the minimum wage should be reduced across the board. In fact, the issue of a minimum wage cut is not mentioned in the staff report. However, the fundamental issue is how to avoid a massive increase in the minimum wage resulting from the 35-hour initiative—on 1 January 2000, the hourly minimum wage will be increased by 11 percent owing to the initiative. It is true that subsidies will be provided to offset part of the cost, but the 11 percent increase comes at a time when the inflation rate is slightly less than 1 percent.
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> On the second point, which concerns the tax burden, Mr. Milleron stressed that progress is being made and that the burden in 2000 should be

below its 1997 level. This is true, but the decline will amount to one-tenth of 1 percent of GDP, and the amount will still be more than 1.5 percentage points greater than in 1992–93.

The third point concerns issue of administered interest rates. Mr. Milleron has pointed out that there is now a corridor which is linked to short-term market interest rates, on one side, and the inflation rate, on the other. Unfortunately, the administered interest rates do not actually have to be within this corridor. The system specifies that a committee will make recommendations on the administered rates, taking this corridor into account. The recommendations are then followed, or not, by the ministry of finance. In fact, the ministry failed to follow the first recommendation of the committee—it recommended a cut in the interest rate which was three-quarters of 1 percentage point above the upper limit of the corridor, but the finance minister decided to make no adjustment. For the second recommendation, in July 1999, the ministry partly followed the advice of the committee and adjusted the level of administered interest rates, but it set them at a level which was still above the upper limit of the corridor. In fact, the past 3–4 weeks have been the first time that the administered rates have been inside the corridor, not because they have been adjusted downward, but because short-term market rates have increased sharply.

On monetary policy, Mr. Bernes had asked for a forward-looking discussion of monetary conditions in the euro area, along with the implications for France. Currently, each Article IV staff report on a euro-area member is composed of two parts. One part addresses fully and explicitly the issue of monetary policy in the euro area. For the second part, we then look at the implications for the country concerned. France is in a middle position—activity is weaker than in Ireland, the Netherlands, or even Spain, but is stronger than in Germany or Italy. Therefore, given that the euro-zone monetary policy is appropriate for the average of the euro area, we consider that it is broadly appropriate for France. Looking ahead, that is unlikely to change over the next 12 months, as we would expect France to remain more or less in this central position.

On fiscal policy, the staff is only advocating a small further reduction of the deficit, about half a percentage point over 3–4 years. This is unlikely to affect the pace of economic recovery. However, we believe strongly that there should also be a more ambitious reduction in the tax burden, compared to that envisaged by the authorities. We consider that reducing the tax burden and expenditures at the same time will not have much of an impact on the pace of recovery, even in the short run. The impact may even be slightly positive. Our main point is that fiscal policy needs to be addressed from a medium- to long-run viewpoint.

Mr. Takeda also asked about the issue of sequencing, and whether we should focus first on deficit reductions or tax reductions. This is a point of contention between the European Central Banks and the finance ministries. Our view is that, in the case of France, it is best to do both at the same time, as a reduced tax burden is probably needed to get political support for other less-popular measures.

The 35-hour labor market initiative was a key element in the electoral platform of the socialist party. From a political standpoint, therefore, the authorities probably had little choice but to deliver on their election commitment. However, it is not possible to predict the likely effect on employment. First, if the only outcome is that overtime is paid after 35 hours, rather than 39 hours, and the market adjusts relatively quickly—over a couple of years—the basic real wage rate will decline in relation to productivity, so that average labor costs will remain unchanged. This will have a positive effect on employment, simply because there will be a slight tendency to use less overtime and more employees. However, the effect could be very small.

Unfortunately, this is not the only force at work. In addition, there will be increased flexibility in the organization of working schedules. In particular, we are seeing a widespread shift to annualization which is also having an influence on the short-run demand for labor. On the one hand, there is less need for labor hoarding in periods of slack demand to meet labor requirements during periods of peak demand. This will reduce the demand for employment. On the other hand, increased flexibility means a general increase in productivity and efficiency that will, over the medium term, increase the demand for employment. It is difficult to know which one will dominate. Still, this is not the end of the story. The authorities have introduced legislation that sets a limit on the use of overtime—not only will overtime be paid more, but there is a fixed limit on the amount that can be used. This limit will reduce productivity and efficiency, reduce firms' freedom in organizing the work schedule, and reduce the demand for labor.

In addition, the minimum wage (the SMIC) is an hourly rate. As the authorities have decided that there should not be any reduction in the monthly wage bill at the level of the SMIC, the move from 39 to 35 hours will means that the hourly SMIC will increase by 11 percent. Although the Government is introducing a number of subsidies to offset this cost, those subsidies are conditional, the conditions are vague, and it is difficult to know how effective they will be. The conditions require: one, having an agreement at the industry or firm level on how the 35-hour initiative will be implemented; and two, a firm-level commitment that this initiative should be used to increase employment, or at least to avoid reductions in employment. It is impossible to know what will happen to average labor costs at the level of the SMIC.

I have only been speaking about the effect on the short run demand for labor. Over the medium term, the average level of unemployment is related to various rigidities and constraints on the functioning of the labor market. To some extent, if we believe that there is such a thing as a NAIRU, then there is no reason to expect that the 35-hour initiative is going to have a positive effect. Anybody who says that they can provide a quantitative estimate of the medium-term effect is not really very serious.

Mr. Hansen asked about the initiative's cost on the budget. The gross estimate is about FF100 billion, which is 1.2 percent of GDP. We do not know the net cost, as it all depends on what happens to employment and unemployment. The authorities argue that the unemployment rate is going to fall sharply, so that they will save money on unemployment compensation and use those funds to pay for the subsidies to firms. Without the reduction in unemployment, I am afraid the gross cost may become a net cost.

Ms. Lissakers asked a question concerning the OECD anti-corruption conventions. France has ratified the OECD conventions to combat bribery in international transactions. Legislation will be submitted to parliament in the next few weeks, and is expected to be adopted by the end of the year. France has also signed the anti-corruption recommendations on aid-funded procurement. Furthermore, the authorities have stated their preference for conventions that will be more legally binding than the recommendations. The first evaluation of the Financial Action Task Force on money laundering found that "France has created a real model for fighting against money laundering. Furthermore, France's system goes beyond the Financial Actions Task Force recommendations in many areas."

Ms. Lissakers said she was concerned at the staff's approach to France's monetary policy. It seemed that the approach taken was not sufficiently forward looking, in that the monetary stance of the ECB was considered to be given. There had been no attempt to outline the authorities' likely response in the event that the ECB decided to raise interest rates. In contrast, the Mexican authorities had been asked explicitly during their recent Article IV consultation to consider a scenario in which the U.S. authorities raised rates.

The Acting Chairman noted that Board members were not constrained by the approach taken in staff papers. If they wanted to discuss particular aspects of European monetary policy, they were free to do so.

Ms. Lissakers commented that her concern related mainly to the nature of the staff's Article IV consultations with individual European countries. Those discussions should be forward looking, but the staff seemed constrained from asking about the authorities' reaction in the event that Europe-wide price developments forced the ECB to raise rates.

The Deputy Director of the European I Department pointed out that the staff was not constrained from asking such questions. Discussions with European authorities frequently

covered the implications of a possible increase in interest rates, particularly for fiscal policy. However, the staff was somewhat constrained in discussing whether the ECB monetary stance was appropriate from the perspective of the euro area as a whole.

Mr. Pickford made the following statement:

Let me join Ms. Lissakers at the outset in saying that the staff seems to be taking the lead in advancing the content and format of the Article IV reports. The next Article IV discussion on the United States should be interesting. Let me also say that Directors' statements were helpful, and I particularly agree with the sentiments of Messrs. Hansen and Takeda, as well as those of Ms. Lissakers. Perhaps I can touch first on the pace of reform. To quote Mr. Hansen, "a gradualist response may not suffice to address the underlying problems." I also agree with Ms. Lissakers that it is more important to move ahead on the structural side than on the fiscal side. As the Board noted in the case of Germany, at some point the search for consensus has to be balanced against the need for progress. I suspect we may be nearing that point in the French case.

On fiscal policy, I agree that a somewhat more ambitious program is appropriate at this stage. The circumstances are favorable for a faster consolidation, and I am not persuaded by the argument that confidence may suffer as a result—the staff supplement shows that confidence is at an all-time high, and they feel that it would be appropriate, at this time, to capitalize on the economy's unexpectedly high growth performance to improve the fiscal position. On that same subject, the staff questions Mr. Milleron's statement about the divestiture of public services. I wanted to ask a slightly separate question. I am gratified that the Government sees the need to address weaknesses in the economy, improve public sector efficiency, reduce the tax burden, and prepare for the forthcoming demographic shock. It would be interesting to know what alternatives the Government has in mind to address some of these issues.

While it may be appropriate for the Government not to consider drastic reductions in civil service manpower, it should be kept in mind that the civil service accounts for 25 percent of the working population. Moreover, the staff have identified significant inefficiencies. It would be interesting to know if the authorities' reform agenda contains more than contained in paragraph 2(c) of Mr. Milleron's statement. Many of these items are clearly welcome, but I wonder whether they address the underlying issue.

On the 35-hour week initiative, I agree very much with the comments and analysis of the staff. On the financial sector, my main concerns were on the issue of the administratively-set interest rates. Mr. Hansen had some valuable observations in this regard. It would also be interesting to know the answer to Ms. Lissakers's question on the impact on ECB operations.

On the extent to which globalization and the EMU is likely to increase competitive pressures on the French banking system, and hence impact its profitability, it is appropriate to consider whether the authorities should instead put more weight on the potential vulnerability of the financial system. Finally, on the issue of monetary policy, I agree that the current monetary stance is adequately supportive. The only thing I would like to add is that the link from monetary policy to fiscal policy in France reinforces the need to take advantage of any windfall cyclical improvements in the fiscal situation to reduce the deficit more quickly than currently planned.

Mr. Esdar made the following statement:

The French authorities should be commended for their prudent macroeconomic policies and diligent economic management, thereby encouraging France's remarkable positive economic performance over the past two years. This outcome is also based on favorable supply and demand conditions, on accommodative monetary conditions, and on a remarkable wage moderation. All of this has strengthened the French economy against the negative effects of the recent emerging market crisis. It is important to have these points in mind when we discuss the situation in France, and this should be reflected in our summing up.

The crucial question is the extent to which this economic environment should be used to speed up the pace of reform. In my view there two different aspects: one concerns the structural side and the other concerns the fiscal side. On the structural side, I agree with Mr. Milleron that a difficult balancing act will be required. There is much wisdom in the French authorities' argument that successful reforms in sensitive areas, such as health care and pensions, cannot be undertaken without broad public support and due regard for national macroeconomic policy principles, structures, traditions, and sensitivities. This is particularly true in the continental European context. As we discussed during the German Article IV consultation, people in European countries have been accustomed to comprehensive, generous, and costly public safety nets, within the framework of a social-market economy model. We do not have to give up this guiding principle, but we need to adjust its content to the demands of an increasingly globalized economy. We also need to get rid of some excesses that are placing an increasingly heavy burden on government finances. There can be no doubt on the general need for urgent and far-reaching reforms, particularly in view of demographic developments. It will take time, courage, and perseverance to educate our citizens on the need for substantial changes to the health and pension system; last not least, in the interest of greater intergenerational solidarity. Nobody easily gives up the right to financial and other entitlements one has worked for, possibly over many years.

Therefore, I sympathize with the authorities' argument that successful reform of public spending would be best assured by careful sequencing, as there is a danger of weakening the necessary political consensus, hastening the risk of social unrest and a drop in consumer confidence. As history has shown, the French people are quick to resist forcefully anything that they regard as unfair or as an unduly strong government interference in their lives. The authorities' intended sequencing—giving priority to reform of the health system, while following a more gradual approach for the reform of the pension system and the rationalization of the civil service—seems sensible and appropriate.

I would like to comment on some of the staff's recommendations. We should be more careful in making rather sweeping statements. On the issue of generic drugs, for instance, I am somewhat reluctant to accept the wisdom of this institution. Perhaps we should leave such issues to the medical experts. Also, the civil service system has an important role in France and the pension rules are part of a comprehensive life-long public sector contract. While there may be a number of problematic aspects and inefficiencies, we need to be careful with our judgments and recommendations. After all, our French neighbors have developed a capable civil service that continues to attract the best minds in country, and which has been a role model for other countries.

On the fiscal front, some Directors expressed the view that we should be cautious about further fiscal tightening in the short term, in light of uncertainties surrounding the prospect of the U.S. economy, a possible rebound of the euro, and the possible tightening of the ECB's policy stance. I am not fully convinced by this argument. In Germany, at least, we have taken a somewhat different road. However, if short-term growth turns out to be more robust than projected by the authorities, they should seize the opportunity for further deficit reduction. The latest cyclical indicators suggest that such a scenario is not unrealistic. Any windfall improvements in the budget balance should be used for further consolidation and tax reductions.

Turning to the labor market, it is encouraging that France's active labor market policies have been successful in job creation during the past few years. However, this success has a fiscal cost. The overall unemployment rate, despite its declining trend, also remains uncomfortably high. The French authorities have launched some promising measures, such as a substantial reduction of the VAT for labor-intensive services, but there is room to do more. In this regard, I agree with the staff's analysis and recommendations. The previous active labor market policies should be supported by a review of both unemployment benefit schemes as well as employment protection legislation. Such a review should aim at removing any impediments to accepting employment. It should also encourage participation in active labor market measures, and enhance incentives to create jobs.

Finally, with regard to the implementation of the 35-hour workweek initiative, the staff made a convincing statement, and I have nothing to add. We follow developments in the French labor market with great interest as we are confronted with similar problems. In this regard, Mr. Takeda's observation that the French labor market is more decentralized than in Germany, may explain the differences in job creation over the past few years. We hope that we can learn some of the lessons of the French authorities' measures, although probably not from the 35-hour initiative. Bringing both economies back on track in this area may further promote European integration, which both countries have successful pursued over past decades. It is not only for this reason, however, that we wish our French friends much success.

Mr. Shaalan said that he agreed on the importance of public support in the successful implementation of reform. However, the authorities should take active measures in gaining such support, which might take the form of a balanced reform package that is acceptable as a whole. Also, he asked Directors to keep in mind the current discussion on the need for public support when they considered similar problems faced by less-industrialized members.

Mr. Wijnholds made the following statement:

It is always a pleasure to discuss the French economy, and this was a good staff report. I also appreciated the statements and interventions of the lead speakers. This experiment is going well. First of all, on the relative performance of France vis-à-vis some other large economies in Europe, there is a demographic aspect to be considered in the case of Italy which makes comparison difficult. However, the growth performance in France has been better than in Germany. An important element is that the French competitive position has been stronger—if we look at the development of the trade balance in recent years, it is striking how strong the French performance has been. France has entered the EMU at a relatively favorable rate. This has been good for the EMU, and although Germany has been at a disadvantage, I trust it will soon catch up. I am not so sure, however, whether France will be able to continue to perform better than Germany if it does not do more in the area of structural policy. In fact, in this realm French plans have not been much better than German performance. I doubt structural employment will go down much unless more is done here.

On the issue of fiscal policy, I would not have minded more detail on the policy mix. In my view, the relatively favorable cyclical position in France provides a great opportunity to do somewhat better on fiscal policy, and I agree with the staff that French fiscal policy could have been more ambitious. Even if European short-term interest rates were to increase slightly, that would not have much affect on the cyclical position—we need to keep in mind that long-term rates have already increased, and that usually long-term rates are more important for investment and other key variables. I do not think there is any real problem with the policy mix at this moment.

For those who are advocating gradualism with regard to French fiscal policy, such an approach is not the best way to have France contribute to world economic growth. If we take a medium term perspective, further consolidation now would be appropriate and useful, and may even generate increased confidence in the short run. Also, it would provide more room in the future for the working of France's automatic stabilizers—the current scope is still somewhat limited. If we have a downturn in the future, France would then be better placed to address its problems through use of the automatic stabilizers.

Much has already been said on the labor market. The recent improvement in job creation has been heartening. However, the question is whether this improvement is sustainable without further strong structural measures. I will not add anything on the 35-hour workweek, as it is an extremely difficult issue. However, I do believe that this initiative may have diverted attention from some other important matters in the French policy debate. That debate is now over. Laws have been passed, and the authorities should operate on that basis. I would even venture that, contrary to the opinion of some, the exercise is not without merit. However, I see the initiative more as a social tranquilizer, rather than a real solution. The job-creating effect is, as the staff explained, hard to predict, but it may be there. We will have to see. Anyway, the decision has been made and I would encourage the authorities to retain as much flexibility as possible in this area, and move on to other important issues where structural reform is needed.

On the financial sector, I share Mr. Hansen's concerns regarding administratively-determined interest rates. I look forward to a government action plan to phase out this institution, as it is an aberration. Privatization in the financial sector should continue. The first results are encouraging, and the French banking system is in much better shape. There is room for further consolidation, and I would also mention that the authorities should do what they can to remove any informal obstacles to the entry of foreign banks, either through merger or competition with French banks.

As a final, more general remark, the different views of the staff and the authorities are not so much differences of principle, but more a matter of political economy. I have some sympathy for the authorities' problems as explained by Mr. Milleron. It is one thing to outline optimal economic policies in a vacuum, but it is another thing to have to deal with social and political priorities. This is the problem that France is facing, perhaps more than some other countries. This is not to say that political and social objectives are immutable. If I may recall the situation in my own country about 15 years ago, when we really started to work on structural reforms, touching the social security system was considered to be impossible. However, gradually it became something that could first be discussed and finally an area in which the need for action was agreed. We have not done enough yet, and to be

realistic, that will take time. In general, it may be desirable to tackle structural reform in Europe quickly, but we have to have an understanding of the constraints. That is not to say that we should not continue to encourage the authorities to move forward. It is just that we also have to realize that the process will be gradual. I would not advocate gradualism in fiscal policy, but I expect it.

Finally, in terms of the overall handling of the economy, the authorities have a good grasp of the situation. We congratulate them for France's economic performance, and we encourage them to move boldly ahead in the future.

Ms. Lissakers said that she agreed with Mr. Wijnholds about the political economy aspects of reform. However, the main concern was not the pace of reform, but the fact that some key issues did not seem to be on the agenda. In the areas of tax and civil service reform, the authorities did not seem to intend any significant changes. The staff had pointed out that there was significant scope for civil service reductions and efficiency improvements. Similarly, tax reform was an essential part of any effort to foster increased investment and a dynamic private sector. As for the financial sector, the nationalistic approach to restructuring seemed to reflect the mindset of the authorities, rather than the population at large.

Mr. Milleron pointed out that the 35-hour workweek initiative was an ongoing process. A draft law had been presented to the parliament and was currently under discussion. Also, for the time being, it would not affect any firms with less than 20 employees. The full effect would not be felt until 2002, which left time for further discussion during future Article IV meetings.

Mr. Al-Turki made the following statement:

France's favorable short-term economic outlook is welcome. Growth has picked up in the second half of the year, inflation is low, and employment is growing. The authorities' strong push in the fiscal area and their efforts in structural reform have paid off. More efforts are still needed on both fronts, however, to address the medium-term challenges. Here, I will make a few comments.

I agree with Mr. Milleron that carefully sequenced, gradual structural reforms will likely yield better overall results than front-loaded reforms undertaken with insufficient social consensus. I also agree with him that income growth is a necessary ingredient to gather a reasonable degree of social and political consensus. In this regard, the current environment provides an opportunity to push the structural reform agenda forward.

On the transition to the 35-hour workweek, I remain of the view that without maximum flexibility at the implementation stage, this initiative could prove counterproductive. I also agree with staff on the need to enhance

training, increase wage differentiation to better reflect productivity differentials and improve incentives for job search. That said, I am not clear on where staff stands on the policies surrounding employment subsidies. In the report on France, staff appears to question those policies, while in the report on Germany, staff advocated such policies and used their success in France as an argument (paragraph 26, page 15).

On healthcare, I agree that this is a difficult and sensitive issue but every effort should be made to enhance efficiency and contain the rising costs. Let me add here that I commend staff for acknowledging that these are issues beyond their expertise.

On the fiscal front, substantial progress has been made in reducing the deficit since the mid-1990s. The 2000–2002 stability program which focuses on further reducing the deficit by cutting expenditures is also welcome. While a more ambitious fiscal consolidation will provide greater room to maneuver during a cyclical downturn, one has to be careful not to undermine the recovery. Indeed, too much fiscal tightening may pose risks, especially at a time when the rise in Euro interest rates and the increase in volatility of stock markets could weaken consumer confidence.

Finally, I agree with Mr. Milleron's remarks regarding the staff's wording on ODA.

With these remarks, I wish the authorities further success.

Mr. Pickford observed that the French economy had displayed an impressive performance in terms of job creation. Some of that success may have been the result of employment subsidies. He asked the staff to comment on the effect of those subsidies in the medium term—over 2 million workers received some form of subsidy, which raised the question of dead weight loss and whether such job creation was sustainable.

Mr. Kelkar made the following statement:

We would like to commend the French authorities for prudent macroeconomic and structural policies implemented in the last two years in the face of the emerging market crises of 1997–98. These policies have not only been instrumental in building resilience in the French economy but have also contributed substantially in promoting employment creation and boosting consumer confidence leading thereby, to a steady path of economic growth, low inflation and robust export performance. This has been succinctly brought out in Appendix I (p. 30) where a useful comparison has been made with other major euro-area countries such as Germany and Italy. It is also heartening, though hardly surprising, to note that France's short-term outlook is favorable as documented in the staff report and its update in the statement by the Staff Representative.

Trite as it may sound, the present situation in France lends itself to somewhat banal characterization that "much has been done, but much remains to be done." There is little disagreement between the staff report and the exceedingly lucid and thought provoking preliminary statement from Mr. Milleron regarding the policy challenges that need to be addressed. However, Mr. Milleron's definition of the reform agenda seems more comprehensive. One the other hand, there are sharp differences as regards timing, pacing and sequencing of the future course of reforms. We would like to focus on these differences and offer our comments.

In the arena of public finance, the staff feels that the 2000–02 Stability Program is "unambitious" in terms of objectives which Mr. Milleron finds "high questionable." There is hardly any doubt about the staff's contention that the cyclical window of opportunity for fiscal consolidation that is currently available should be not missed. Yet, the authorities' accent on "gradualism" premised on the view that the current recovery hinges on consumer confidence that is still fragile, thus warranting a cautious approach to fiscal consolidation, is also understandable. The details provided by Mr. Milleron, such as contrasting the targeted public deficit of 1.8 per cent of GDP in 2000 with the peak levels of 5 to 6 per cent of GDP in 1993 and 1994 and the fact that in 2000, public debt to GDP ratio is expected to come down for the first time since 1980, certainly do not point in the directions of a fiscal agenda that could be characterized as "unambitious." The critical question is whether there is any merit in attempting to overachieve the fiscal targets using the window of opportunity currently available, given the demographic shock that lies ahead.

We would appreciate Mr. Milleron's comments.

There is also a problem of reconciliation of two distinct recommendations of the staff report, viz reduction of overall deficit and lowering revenue/GDP ratio. While there is no tension between these two objectives over the medium term, their simultaneous pursuit in the short term would necessitate a very large cutback in expenditures, which as noted by Mr. Takeda, may be unrealistic.

Staff comments are welcome.

As pointed out in Appendix I (p. 32), France stands out among the three major euro-area countries; i.e., France, Germany and Italy, as the most successful employment promoter. Even in time-series sense, for France, 1998 marked the best employment performance in 25 years, with employment growth exceeding 2 percent—the highest rate among the three largest euro-area countries. Yet, the unemployment rate at 11.3 per cent in June 1999 remains high and the youth unemployment rate at 21.7 per cent by mid-1999 remains worrisome.

We fully agree with the staff assessment that the problem of high and persistent unemployment holds the key to the future evolution of the French economy. In this regard, we feel that some useful lessons could be drawn from the experiences of other developed countries, such as the United States and the Netherlands. We would also like to highlight that labor market policies in the industrial countries have important international implications—especially in curbing the protectionist tendencies.

We agree with the staff assessment that fiscal incentives to support labor demand at low wages and promote temporary and part time work as well as wage moderation have played a significant role in increasing the dynamism of the French labor market. It is not clear however, why the staff seems to feel that the employment subsidies may no longer be effective. In this regard, we fully share Mr. Milleron's view that earmarking public funds for the integration or re-integration of the unemployed is an investment by society in individuals facilitating their return to the job market instead of locking them in the trap of exclusion.

Box 4 (p. 19) presents a useful summary of the evolving perspectives on the 35-Hour Workweek Initiative which, along with corrections indicated by Mr. Milleron in his preliminary statement, succinctly indicate the current state of this centerpiece of France's recent labor market initiatives.

While it is being widely acknowledged that the Initiative is having some positive effects on the social dialogue and productivity—especially in view of the reorganization of work in the context of decentralized "35-hour negotiations" at the firm or industry level, full implications of the Initiative are far from being clear.

The budgetary impact of the Initiative remains unclear while the ultimate employment effect of a shift to a 35-hour workweek has been regarded as "very difficult to predict" (para 28, p. 21). There is also some merit in the staff's criticism that the revised draft bill still imposes an excessively rigid framework—unduly restricting the choices freely made in bilateral negotiations between employers and employees. Another valid concern is regarding the potentially damaging effect of overtime limitations on small enterprises (which would come under the ambit of the Initiative from 2002), given their limited maneuverability in reorganizing production processes. We would appreciate further clarifications from Mr. Milleron.

Finally, we would like to draw your attention to an issue which appears to be conspicuous by its absence in the staff report, the reforming agricultural policies in the broader context of the EU. In view of the forthcoming trade dialogue in Seattle, it would have been quite useful to cover this important issue at least in the Selected Issues paper. It may be recalled that the Report of External Evaluation of Fund Surveillance had emphasized

the need for dilating on international implications of domestic policies in industrialized economies. We would like to emphasize the importance of international implications of these issues for developing countries, especially those in the African continent.

With these comments, we wish the French authorities every success in their future policy endeavors.

Mr. Woolford made the following statement:

The Article IV staff paper on France is frank and lays out the policy challenges facing the French authorities. The short-term outlook is favorable, with low inflation, accommodative policy conditions, and improving growth prospects. However the challenges of fiscal consolidation and structural unemployment remain unmet. We agree with the staff's advice on both of these issues. I would like to limit my comments to the issues of reform and confidence, although I would like to associate myself generally with Mr. Bernes's statement.

This chair has often argued for the need for ownership of programs and policies. In his preliminary statement, Mr. Milleron stressed that the Government's strategy for reform is to build on France's improved growth prospects to develop a consensus for structural change. The experience of my country, and I am sure we are not alone, is that when times are good, people are not interested in hearing about change. However, through engagement, communication, and education, the public can be convinced of the need for reform—the figures in box I on debt dynamics are somewhat convincing. In this regard, I agree with the staff and others that the cyclical window of opportunity should not be missed, especially given the currently high levels of overall confidence. Although I also agree with the authorities that confidence can be fickle, now seems to be as good a time as any for decisive action. Therefore, like the staff and others, I would question the authorities' gradualist approach, and suggest that the staff's recommendations could more effectively support consumer confidence and provide a more balanced growth profile, compared to the authorities' gradualism.

At this point, I would like to present a view that has been held by my authorities. I am not advocating that this is necessarily the correct approach for the French authorities, but it does illustrate a different view about the interaction between reform and confidence. The finance minister who put the New Zealand 1980s reform program in place, Roger Douglas, wrote an interesting paper in 1990 on the generalizable lessons from successful structural reforms. OECD studies show that authorities tend to avoid structural reform until it is forced upon them by economic stagnation, the collapse of their currency, or some other adverse economic or social event. Also, politicians tend to dismiss the need for structural reform as long as they can,

as they believe decisive action will bring political calamity upon their governments. Obviously, France is not in such a dramatic situation—growth is robust, and the transition to the EMU is a success. However, I would like to convey one or two other points made by Mr. Douglas. The conventional view is that consensus must exist for reform before it is implemented; otherwise the actions taken will prove to be politically unsustainable at election time. The tendency is to seek consensus in advance by compromising the quality of the decisions—bringing the benefits up front by ignoring the costs or by pushing them further down the track. He goes on to argue that consensus does not arrive before the quality decisions are implemented, but instead develops progressively afterwards, as the decisions deliver actual outcomes to the public. With this in mind, he developed a number of principles for successful reform: (i) implement quality reform in quantum leaps using large packages; (ii) speed is essential; (iii) it is impossible to go too fast; (iv) once you start the momentum rolling, never let it stop; (v) consistency and credibility amount to economic confidence; (vi) get the fundamentals right; and (vii) trust, respect, and inform the public. Having said all this, I appreciate that there are large differences across countries in terms of the practicalities of rapid reform, and of the public reaction to such reform. This is just one view. I wish the French authorities bon courage.

Mr. Donecker remarked that Mr. Douglas had a positive influence on economic policy in New Zealand, and that he had brought about a major change in public and government attitudes to reform. However, the situation was not entirely comparable. In France, the prevailing attitude was that "if it isn't broke, don't fix it." In the case of New Zealand, however, it had been clear to all parties that some type of reform was necessary. Moreover, the New Zealand Government had been removed during the following elections, owing to its courageous reform efforts.

Mr. Woolford pointed out that, in New Zealand, there had only been one change in government since 1984, despite the pace of reform. Moreover, he had not intended to focus the discussion on New Zealand. Instead, the key point was that confidence could be maintained once reforms started to deliver improved outcomes, which then provided momentum for further reform. Confidence in New Zealand had been at an all-time high during the reform process.

The Acting Chairman commented that there were two different views on the role of the Board in such situations. One view was that the Board should concentrate on outlining the most appropriate policy measures for the country concerned, without concerning itself on which measures might be politically feasible. It had to be noted, however, that many of the "politically unacceptable" recommendations by the Fund and the Bank, in the developing country context, had eventually served as a focus for an evolving political consensus. The other view was that the Board should not let the best become the enemy of the good, and should instead focus on practical measures that had a realistic chance of implementation in the short term. It was not clear which approach was preferable. However, at some point the

Board should at least outline what it considered to be the optimal policy stance. Perhaps it might then moderate its statement by recognizing certain practical realities.

Mr. Kelkar stressed that, whichever approach the Board decided to take, it should be consistent across different countries. All members, both industrialized and developing, faced political realities which shaped their policy choices.

Mr. Donecker remarked that the duty of the Board was to recommend the best possible policy options for the country concerned, and then to let the authorities decide on which measures were feasible. As for the issue of consistency, it had to be kept in mind that different countries had different priorities and approaches. For instance, the European social market economy model might be less acceptable in the United States.

Mr. Junguito made the following statement:

> The staff report, as well as Mr. Milleron's statement, clearly indicates the excellent progress registered in the French economy.
>
> In the fiscal policy area, we welcome the authorities' determination to meet the 1999 general government deficit target. The authorities and the staff believe that this target is achievable—without additional measures—provided that the authorities continue correcting the slippage in healthcare spending. In fact, the most recent deficit projection indicated a better-than-expected fiscal outcome for 1999, mainly due to better revenue collection.
>
> For the medium term, however, while supporting the policy approach underlying in the Stability and Growth Pact, the staff noted that the fiscal adjustment envisaged in the 2000–02 program does not appear ambitious. In view of staff arguments, we also believe that the upcoming multiyear fiscal revision provides an opportunity for the authorities to improve the medium-term fiscal scenario.
>
> On structural issues in public finance, we support the authorities' view that health care reform should take priority, and welcome the progress already achieved to contain health expenditures, and the recent agreement signed with the pharmaceutical industry. However, as the staff have emphasized, much remains to be done to control such expenditure.
>
> For the authorities, the reform of the pension system is important to prevent a medium-term increase in the financing gap of the public pension system, and its solution represents a political challenge. Therefore, we agree with them that further consultation among the social partners is necessary, while understanding the urgency for reform measures. We welcome the public dialogue currently taking place in France which would allow the Government to propose shortly a set of general guidelines for pension reform.

On balance, in terms of the benefits of a gradualist approach, as Mr. Milleron has said, front-loaded structural reforms, undertaken with insufficient social consensus, are not necessarily more appropriate than carefully sequenced, gradual reforms. The authorities, however, should adopt more front-loaded decisions without adequate consultation either when opportunities arise or when the economic balances are so large or growing in a form that immediate adjustment becomes recommendable.

According to the authorities, the newly proposed 35-hour workweek initiative offers a viable framework, but we share the staff view that the outcome of the 35-hour initiative is difficult to predict in areas such as its incidence on job creation; its net impact on labor costs and on the flexibility of the labor market.

We welcome the improvement in employment creation and unemployment reduction. There is no doubt, however, that structural unemployment is still one of the main problems in France. As the staff said, the causes, and therefore the solutions, are complex. We support all initiatives and particularly the structural reforms that the authorities undertake to tackle this major problem.

Finally, we wish to express our concern about the slight decline observed in France's official development assistance (ODA), while acknowledging that France is the first country—within the G-7 countries—in terms of ODA as a share of GDP, and the third in the world in absolute terms.

Mr. Lushin made the following statement:

Over the past several years, the French authorities have managed to achieve substantial progress in various areas. They have succeeded in obtaining strong economic growth against a backdrop of very low inflation, a sound external position and improving public finances. Significant results have been obtained in promoting employment, which has grown rapidly over the last two years. Still, as indicated in the staff report, many challenges lie ahead, especially in the structural area. I will limit my intervention to remarks on the fiscal and labor market policies.

The authorities have achieved a substantial fiscal consolidation in the run-up to EMU, having decreased the general budget deficit from almost 6 percent of GDP in 1994 to 3 percent in 1997, or, on average, by 1 percentage point of GDP a year. Since then, the pace of fiscal consolidation has somewhat decelerated, to approximately 0.4 percentage points of GDP per year. The authorities' intention is to keep this pace unchanged in the next three years, based on the wish not to jeopardize the much-needed recovery of domestic demand. We think that, from this point of view, their preoccupation with short-term goals may be justified. The staff consider the authorities'

plans to be "unambitious" and call for a higher pace of consolidation with the aim to achieve a balanced budget by the year 2003. We agree with the rationale behind the staff's approach, namely, the necessity to decrease the excessively high revenue ratio and thus to catalyze meaningful supply-side responses, and the need to provide adequate margins to provision for the demographic shock ahead. It is also true that there is, at least theoretically, ample room for expenditure reduction through the optimization of healthcare and pension systems and the rationalization of the civil service. However, we wonder whether the staff's proposal may be "overambitious," since to achieve simultaneously a balanced budget and a lower revenue level, a large cut in expenditure will be necessary, of the amount of approximately 5 percentage points of GDP between now and the year 2003. The fact that the scale of the proposed adjustment is really ambitious is evident from past experience, when between 1994 and this year, public expenditures in France have been decreased by only 2 percentage points of GDP. Therefore, like Mr. Takeda, we think that a right balance should be found between further fiscal consolidation and the supply side effects of the revenue cuts.

In the area of labor market policies, we welcome the recent reorientation of emphasis towards streamlining employment and training support programs, and addressing unemployment traps. Some of these measures are already bearing fruit, which is evident from the growing job creation. However, much has to be done in this area. Like the staff, we think that pushing employment upward through public subsidies, although socially important, does not fully address the root causes of the problem and implies a high budgetary cost. We also agree with the staff that to tackle directly the root causes of structural unemployment, three issues are critical, namely, enhancing the educational system, greater wage flexibility to reflect differentials in productivity, and strengthening work incentives through a more rational system of unemployment and welfare assistance. This said, we concur with Mr. Milleron that any reforms in these areas, and also in the areas of healthcare and the pension system, are unlikely to succeed without broad public support, especially when deeply-rooted vested interests are involved. Therefore, here the French authorities are facing the delicate task of balancing the need for economic efficiency with the existing social realities. We hope they will be successful in this undertaking.

With these remarks we wish the authorities every success in their endeavors.

Mr. Kiekens made the following statement:

Before turning to the Article IV consultation proper, I would like to comment the two general issues you have invited Directors to discuss, namely: Should monetary policy be discussed during consultations with individual euro

area members? Should the Fund give policy advice that is economically optimal even though it may not be politically feasible?

On the first question, Mr. Artus, speaking for the staff, has given the right answer. Whether the ECB's monetary policy is appropriate for the euro area should not be discussed in national consultations. This is the subject matter of the consultation with European institutions. But how a country's fiscal policy mixes with the ECB's single monetary policy is part and parcel of the Fund's consultations with that individual country.

Ms. Lissakers has insisted that the staff should have discussed, with the French authorities, the implications of a possible interest rate increase by the ECB, just as the staff discusses with the Mexican authorities the implications of a rise in U.S. interest rates. However, I would like to call for some pragmatism in this matter. Obviously, one cannot compare the case of an emerging market economy that is affected by a spillover of U.S. monetary policy, with the case of a euro area country affected by the monetary policy of the ECB. The Fed's policy is decided on the basis of its domestic effects; the ECB's policy is decided on the basis of its effects on the euro area, of which France is a major member. The consultation before the Board today was held in June and early July. At that time, it was not foreseen that the ECB would raise interest rates anytime soon. Even today, the Fund staff considers such a rise unnecessary. Compared with other euro area countries, the French business cycle is neither ahead nor behind in its advancement. Therefore any adjustment in the monetary stance of the ECB is unlikely to be inappropriate for France. One should not assume that any adjustment in monetary policy necessarily calls for adjustment of countries' fiscal policies as well. The latter is not an instrument of fine-tuning, and should certainly not be used to offset the effects the ECB intends to achieve. For all these reasons, it was appropriate that monetary policy, and the effects on the French policy mix if the ECB should raise interest rates, was not discussed this time.

In principle, the Fund should give policy advice that is optimal in economic terms, even if it is likely that it would be politically difficult or impossible to implement in the short term. At the same time, the Fund should point to the intermediate steps that may be more feasible, and indicate the benefits of progress and the costs of delays in implementing the optimal policy. In this way, authorities have full information when they decide. What is economically optimal, and how to achieve it, should not be decided in the abstract, without regard to the social and political context. For example, it is now well accepted by the European I department that the optimal route to a better functioning labor market in continental Europe is different from that followed in the United States or the United Kingdom.

France's macroeconomic fundamentals improved remarkably during the approach of EMU accession. Consistent pursuit of stability oriented policies and

structural reforms are bringing broad-based growth and employment. Now the challenge is to make the most of these improved conditions. Fiscal consolidation and structural reforms must be continued in order to substantially lower unemployment. Care should be taken not to underestimate the magnitude of this challenge, since an economic upturn tends to mask structural weaknesses.

The monetary policy stance, which is based on conditions in the euro area as a whole, is the most accommodative France has seen since the establishment of the European Monetary System in 1979. The relatively advanced stage of the business cycle in France, compared to the euro area, calls for a somewhat tighter fiscal policy in France than in euro-area countries where growth is lagging. This does not seem to be reflected in the draft 2000 budget, which targets a reduction of the structural deficit by 0.3 percent of GDP. Germany, whose growth is weaker than the rest of the euro area, is seeking to reduce its structural deficit by 0.5 percent of GDP reduction. The short-term policy mix requires that France's 2000 budget should be tighter than Germany's.

Next year, spending discipline seems to relax. Total expenditures will grow by 1.3 percent in 2000, up from 1.0 percent this year. The relaxation of spending discipline brought on by the present comfortable stage of the business cycle is unwelcome. I wonder how this rate of expenditure growth can be reconciled with the 1 percent annual real growth of state spending called for in the 2000–02 Stability Program (see footnote 15 of the staff report).

It is necessary to curb spending growth in the medium-term to make room for lower taxes. This is what France intends to achieve. The only question is whether the government is moving fast enough in that direction, given the favorable outlook. French domestic demand was remarkably strong in 1998 despite a deteriorating external environment, in contrast to the much weaker domestic demand in 1995 and 1996 under the previous government with its ambitious plans to reform social security and improve the public finances. It was probably wise for the new government to approach further fiscal consolidation and structural reforms more gradually in the beginning. Now that growth is solid and broadly based, it seems unlikely that the slightly larger cuts in public revenues and expenditures proposed by the staff would impair the recovery. Following the staff's advice would establish a desirable policy mix combining an accommodative monetary stance with budgetary rigor.

It is appropriate that health care reform is high on the agenda. Health care spending is a recurrent source of budgetary slippages. Health care spending in 2000 is budgeted to increase by 2.5 percent in real terms over this year's expected outcome, and by 4.1 percent over this year's budget. Clearly, the goal of bringing health care spending under control has not yet been achieved. Universal access to high quality health care must be preserved, but ways must be found to contain the costs. Some other European countries have found ways to meet this objective at a lower cost.

I doubt whether the government's plan to address the fundamental reforms of health care, the pension system, and the civil service one after another, is the best approach. Delaying reforms, especially of the pension system, will be costly. The charts in Box 1 clearly show that such a delay will have a devastating effect on the public finances. Population aging will render the pay-as-you-go system unsustainable. Raising the retirement age to extend the system's sustainability makes sense in many ways. First, age 65 was chosen as the retirement age at a time when life expectancy was much shorter than now. Second, it is a sensible way of increasing the economy's potential output, since many younger retirees have a great deal of valuable experience and energy that is presently being lost. Third, it is a very powerful way of decreasing payroll taxes that help push up high cost of labor and the high level of unemployment.

I suggest that future staff papers dealing with pension reforms should include information on the actuarial balances or imbalances of the existing pension system. This will make it clear that not correcting such imbalances will leave an unfair and heavy burden on the shoulders of future generations.

A systematic review of the justification and effectiveness of many public programs would result in substantial savings of public monies. Dramatic reforms would be easier to carry out if there were more private sector job opportunities for former civil servants. Further progress in reforming the labor and product markets will thus make pubic sector reform easier.

Wage moderation and active labor market policies have contributed to 800,000 new jobs in the last five years, of which almost 600,000 were in the private sector. This is an impressive outcome. But the cost of France's active labor market policies is not negligible. It amounts to 4 percent of GDP and covers 30 percent of the labor force. With unemployment still over 11 percent of the labor force, despite exemplary wage moderation and energetic labor market policies, the current strategy has probably reached its limits.

The efficiency of France's active labor market policies could be significantly increased by streamlining the more than 50 different programs that have been layered on one another by a succession of governments over the years. France's educational establishment should study Germany's successful apprenticeship system to learn how equip youth with the skills sought by employers. The eligibility requirements for social security assistance should be tightened, and effective training provided to increase migration from public assistance to work. The labor cost of unskilled workers must be brought in line with their productivity.

Despite considerable efforts to minimize the cost effects of the mandatory shortening the workweek to 35 hours, I still feel that a mandatory 35-hour workweek is difficult to reconcile with the objective of employment creation. At the beginning of today's meeting, Mr. Artus explained how difficult

it is to judge whether the 35-hour workweek will create employment. From his exposition, I retain that it is unclear whether the positive employment effects of the accompanying measures that introduce greater flexibility will fully offset the negative effects of the compulsory shortening of the workweek. In any case, I join the staff and other Directors in advising that this legislation be implemented flexibly.

In Europe in general and France in particular, the barriers for entrepreneurs seeking to create their own businesses are still much too high. Administrative procedures must be simplified, tax pressures lowered, and access to the distribution sector liberalized. This will create job opportunities, especially for unskilled workers. The French investment climate will eventually benefit from the EU-driven liberalization of electricity and gas distribution, but later than elsewhere in the EU because the French authorities are determined to liberalize more slowly than other EU countries.

In France, the interest rates on various savings instruments are still administratively set. Increased competition and ongoing financial integration will make these administered interest rates increasingly distortive.

Mr. Schlitzer pointed out that the Board, during Article IV discussions, generally considered two alternative scenarios—an optimistic one and a pessimistic one, on each side of the baseline scenario. In the case of France, some Directors seemed to be asking for a single pessimistic scenario only; i.e., the consequences for France if European interest rates were to increase. Given that the staff reports were to be published, such a one-sided approach might suggest to market participants that the Fund placed a high probability on a future increase in rates. Alternatively, the report might be seen to imply that the Fund was recommending an increase in interest rates, which was not the case. The Fund needed to be cautious when discussing such issues in public.

Mr. Donecker said that he shared Mr. Schlitzer's concerns.

Mr. Zoccali made the following statement:

I join other speakers in acknowledging the high-quality set of papers presented by staff for today's discussion and Mr. Milleron for his frank and helpful preliminary statement. Given the widespread interest in the French economy, allow me, Mr. Chairman, to make a few comments on the general environment as well as on the specific issues identified for discussion.

At the outset, it should be recognized that the French authorities' comprehensive strategy of fiscal consolidation, coupled with gradualism and careful nurturing of the social consensus in their pursuit of structural reforms, has successfully led to the return of consumer and business confidence and helped to trigger, albeit in the context of a comparatively strong competitive position, a virtuous circle of more dynamic internal demand and the most

significant employment growth in 25 years. We sympathize, therefore, with Mr. Milleron that faster front-loading of structural reforms could erode development of the social and political consensus needed to support the process of structural change and risk social conflict at a time when the current strategy is seen to be delivering income growth and in some respects reconciling solidarity objectives with some efficiency gains. Additionally, I concur with the view expressed that the Board is in no position to second-guess the authorities as to what is politically feasible. The issue that remains is how best to help sell, implement and sustain "best" policies over time and for this there is no hard and fast rule. Mr. Kiekens has made a constructive suggestion as to how to refine staff's role in this domain and I would hope that it will be given a chance.

Second, notwithstanding France's relatively favorable near and medium-term prospects, this Chair concurs with the view that supporting household confidence remains critical for sustaining its growth trajectory, keeping in mind the expected cyclical slowdown of the U.S. economy, the lingering doubts regarding the strength of economic recovery in other large trading partners and the tightening bias in the ECB's policy stance. In this context, we agree with Mr. Takeda that a cautious attitude toward fiscal consolidation going forward would be appropriate without missing the cyclical window of opportunity that staff rightly underscore.

The priority attached by the French authorities to ensuring the credibility of the 2000–2002 Stability Program relates directly to the pace of medium-term fiscal consolidation and labor market policies. To save the Board's time, allow me to share, in particular, Mr. Takeda's nuanced remarks on both fronts, including on the implications of the implementation of the 35-hour workweek initiative, which, as Mr. Artus has noted, will be more clearly felt in the medium and long term.

Striking the right balance between additional fiscal consolidation and the desired supply-side response, given the size of the output gap and the prevailing external uncertainties, boils down to fine judgment. While reducing taxes and reaching a budget balance by 2003, as advocated by staff and other speakers, would certainly be desirable in anticipation of the demographic shock, what is important in our view is that the window of opportunity provided by France's good growth performance, to borrow the words of Mr. Bernes, not be slammed shut before the process for more ambitious fiscal consolidation and structural reform is firmly established. Moreover, growth may not be a sufficient condition for reducing joblessness. However, the effort to ameliorate the prospects for the disproportionately the low-skilled and inexperienced, in the context of the authorities' comprehensive strategy to address the interaction of rigidities at the low end of the wage distribution, and the effects of increasing wage differentials due to skill-biased technical progress and a shrinking employment base in labor intensive sectors, will

certainly not be facilitated by a decline in domestic demand. In this regard, the automatic stabilizers, which are well within the 3 percent margin of the Stability and Growth Pact framework, should be allowed to function in the near and medium term. In any event, I agree with Mr. Pickford and Mr. Esdar that making explicit the implication of the authorities' fiscal strategy, that all unforeseen tax receipts will be allocated to faster deficit or tax reduction and not to higher spending, can only add to the credibility of the fiscal consolidation effort and to the sought after supply-side response.

Having said this, the quiescence of inflationary expectations in France and the near term firming of monetary conditions in the eurozone provide an additional argument in favor of the envisaged path of fiscal consolidation, as it is unclear how much of the improved confidence from fiscal consolidation will be reflected in lower interest rate levels across the maturity spectrum. More generally on the monetary and financial sector policy discussion, we share Mr. Bernes' comments regarding both the possible conflict with the near term tightening of monetary conditions from France's perspective and the implications of the extensive system of administered interest rates, inter alia, for the control of the ECB's monetary policy transmission mechanism. The more forward-looking approach to the discussion of monetary policy in the eurozone suggested by you, Mr. Chairman, for future relevant Article IV consultations would seem most appropriate.

Finally, on other structural issues, the brief paragraph devoted in the staff paper to France's trade policy clearly downplays its significance for domestic welfare gains and fiscal consolidation as well as for global adjustment. The reference in paragraph 37, of SM/99/250, to the factors that would shape any reform of the EU's common agricultural policy heightens our concerns regarding the motives behind the proliferation of new "multifunctional" issues. The improved export position of the European farm sector in recent years and the costs of extending present CAP benefits to other agriculturally intensive prospective EU partners generally argue in favor of a more resolute liberalization of the current framework of price and domestic supports and of other restrictions affecting net trade flows. Just as France has been able to make substantial inroads into privatization and liberalization of some product markets, it is to be hoped that this effort will also carry cover to the agriculture sector, and give added meaning to the country's significant contribution in the field of ODA and to the cause of international development.

Mrs. Hetrakul made the following statement:

I would like to thank the staff for its comprehensive set of papers, and Mr. Milleron for his informative statement. We would also like to commend the authorities for their skillful management of the economy, which has resulted in high growth, employment creation, and the resilience of the

economy. Second, we share the authorities' view on the importance of public support, and agree that France's improved growth prospects should be used to help develop a consensus for structural reform. Carefully sequenced reform should avoid unnecessary shocks to the economy.

I share fully the comments of Messrs. Esdar, Donecker, Wijnholds, and Kiekens regarding the consideration of the best policy options for the country.

At this point, France has an ambitious target for fiscal policy, but it is encouraging to note the authorities' commitment to overachieving that target. Like Mr. Esdar and others, I agree that if economic performance is better than projected, the authorities should try to use the improved environment as a window of opportunity too accelerate the reform agenda.

France still faces the twin challenges of high unemployment and a heavy tax burden. The authorities need to embark on more determined policies to bring down the unemployment rate, which threatens to continue to burden the economy and society. We appreciate France's leading role in contributing generously to the ESAF-HIPC Initiative and to ODA. Nevertheless, like Mr. Wei and others, we would like to encourage France and other G-7 countries to strengthen their ODA efforts in accordance with the UN standard. With these remarks, we wish the authorities further success in their endeavors.

Mr. Pascual made the following statement:

The papers before us today give us the opportunity of discussing one of the very interesting cases France is used to provide the western world in modern history. In fact, they provide an approach on how to deal with common problems to other European countries. This fact and the weight of this country in the European economy make the case especially important and the discussion most appealing.

Economic prospects remain in general favorable after a temporary slowdown during late 1998 and early 1999. Growth is balanced and job creation steady. Monetary conditions are supportive while the fiscal stance is expected to be slightly restrictive. This could be the general picture of an economy well managed and the staff agrees with this perception. But it is also true that some important problems lie under the calm surface as the staff points out. On balance, I believe the authorities have done well their task in preserving the incipient recovery although they could have advanced more in pending challenges, mainly in the structural front. Under this light, I must recognize that the general tone of the staff report is a little too tough. I can understand, and even share, the view that supports a tough role for the Fund. We must be like the old priests who yelling from the pulpit preached the virtues of sanctity even when few listened and even fewer put it into practice.

However, I believe that in this case the severity is excessive and we risk, like the same old priests, of defending so demanding a position to be non credible. I would like, therefore, a more balanced message in the summing up to compensate for this excess.

This being said, I must admit nonetheless my agreement with most of the staff's positions. I believe that gradualism could be an euphemism for some degree of inaction, and the search for social consensus an excuse for the lack of effective leadership, but these are common features in most European countries and the authorities don't deserve to be particularly blamed for it. There are, however, some fields where the lack of ambition or commitment could have real negative effects to the economy. I would underscore two: fiscal sustainability, especially in the medium term, and labor market regulation.

Concerning the fiscal issue, I concur with the staff in considering the program unambitious under the present circumstances. Indeed, the positive economic outlook, the improvement of internal conditions, the unfunded future liabilities stemming from demographic development, and the structural deficiencies of future spending call for more decisive actions in the fiscal front. Short-term economic conditions could justify the more moderate correction supported by the authorities, but medium-term considerations warrant a more aggressive approach focused on restraining expenditure, reducing the tax burden, and implementing effective mechanisms of control.

Aside from the fiscal costs of current and future active labor market policies, the issues raised by the staff deserve close attention. Health care expenditure requires a tighter regulatory framework to put its evolution back on track. It is difficult to understand the reasons why such slippage can occur repeatedly without immediate corrective actions. I welcome the measures already adopted by the authorities mentioned in the staff report, but their results, assessed by this year budgetary outcome, seem disappointing. Pension reform is also warranted. I understand and even share the authorities' social concerns in this matter. But if staff's forecasts are correct, decisive front loaded actions are required to preserve the sustainability of the system. Even considering the more auspicious figures of the simulation, the budgetary burden will be too heavy. Civil service reform is also imperative. Public employment figures are extremely worrisome, especially when examined under efficiency criteria. I am sure the French administration, always known for its high quality, can do it better than this.

All these issues are impairing the appropriate consolidation effort most needed to reduce the high tax burden the economy is now shouldering.

As far as the labor market regulation is concerned, I must recognize that I have mixed feelings. On the one hand, I truly share the authorities'

views on the need for a more flexible dialogue among social actors. And in this sense, their strategy, the 35-workweek included, could have positive results in opening a more comprehensive review of the entire social system if it is implemented with the appropriate dose of realism. But on the other, it is a strategy that risks making the authorities hostage of the social actors.

The results are so far positive, although it is difficult to assess its real impact due to the temporal nature of some measures and because of the uncertain fiscal cost.

In any case, one conclusion can be drawn. There are too many regulations and contractual figures. This impairs a clear understanding of the framework and increases the administrative cost. A comprehensive reform is needed to simplify and streamline this regulatory jungle. I am sure that the country that once was able to code all branches of law will be able to do it now in this specific subject without much effort.

The representative from the European Central Bank made the following statement:

On the issue of administered interest rates, I thank the staff for making clear that there are significant differences remaining across the European area, which tends to complicate the work of the European Central Bank. I am concerned, however, that the report might give the impression that European policy-makers do not know what they are doing. For instance, the question might be asked as to how could they set up a new central bank while allowing administered interest rates in France, which may distort the transmission mechanism. Theoretically, I agree that such predetermined interest rates do weaken the transmission mechanism. However, the impact is somewhat limited. We are confident that the efficiency of ECB monetary policy is not materially affected by such measures. Nevertheless, this issue raises an important question of substance. When creating the common currency, the banking systems of member states were accepted as they were—in fact, many governments might object if the ECB provided strong proposals on how to change their national banking systems. At this stage, therefore, the ECB does not interfere in the structural banking sector policies of its members. In the future, at least some of these questions will have to be addressed, and the ECB has also already asked for a bigger say in the question of banking supervision.

Turning to the French case, I would like to mention that there are some areas in which the French banks are performing particularly well. They are actually ahead of most European competitors in terms of money market management. So, the picture is complicated. On the question of the political role of the saving banks and cooperative banks, we have to take into account the historical aspects of the French case, as many speakers have pointed out. However, I would like to focus on another issue. Suppose that the fragmented banking structures that exist in Germany and France are somewhat costly. In

an evolving world, where customers can be serviced easily by electronic devices, such costly structures are less attractive opportunities for foreign banks wishing to takeover or merge with their French/German counterparts. These structures, therefore, might be seen partly as hindering competition.

As far as monetary policy is concerned, I can associate myself with the staff. The short-term outlook for the French economy has benefited from accommodative monetary conditions. In fact, conditions at the moment are the most accommodative since the establishment of the European Monetary System. Therefore, as for the prospect of future interest rate increases, we should not exaggerate such fears.

On fiscal matters, I would like to associate myself with the position of the staff, and congratulate them on their balanced approach in this area.

The Deputy Director of the European I Department commented that Directors needed to be cautious in drawing the distinction between structural reform, on the one hand, and fiscal consolidation, on the other. Fiscal consolidation in the French case mainly concerned: tax reform; streamlining the civil service; and pension reform. Those items were also areas of structural reform.

The staff had not focused on the issues of agricultural and trade policy, the Director continued. However, those policies were now largely determined by the EU, and would therefore be covered within the context of the Fund's regional surveillance efforts. On the issue of employment subsidies, the staff had recommended a reduction in social security contributions at the level of the SMIC. The staff had pursued a consistent approach on this issue, as similar advice had been presented within the context of the German Article IV consultations. In the French case, the fall in social security contributions had been implemented at the same time as the 35-hour week initiative, which would increase the SMIC. Rather than decrease labor costs, therefore, the net effect at the SMIC level would be muted. Also, employment subsidies in France entailed a wide variety of different programs. Some programs had been useful, some had not. Therefore, it was somewhat difficult to arrive at an overall assessment of their effectiveness. The key recommendation of the staff was that those subsidy programs should be simplified and streamlined.

About 200,000 jobs had been created in the non-commercial sector, the Director noted. Those jobs had varied widely, and some would remain permanently. For example, some of the jobs that had been created involved neighborhood policing by members of the local community. Such activity was useful, and would probably be maintained. As a different example, the authorities were paying individuals to help elderly citizens do their shopping. Some of these positions would probably become permanent, as shopping assistance became a commercial activity. Many of the positions, however, would probably disappear without government support.

As for the vulnerability of the French banking system, there was no real conflict between the conclusions of the main staff report and those of the selected issues paper, the

Director remarked. The selected issues paper contained much more detail, and so captured various aspects that were not apparent from the main report. The report, on the other hand, provided an overall assessment. In general, the French banking sector was in good shape, and bank profitability had increased significantly. It was true that many banks had been highly exposed to emerging markets. However, they had made substantial provisions during the recent crises, and the staff considered that their exposure was no longer an issue. Bank supervision in France had also been strengthened significantly.

In response to a query from Mr. Hansen on why the staff report had only contained 18 lines on financial sector issues, whereas the selected issues paper had contained 17 pages, the Director pointed out that the Board usually favored relatively brief staff reports. The staff, therefore, often had to form a judgment as to how much space they should devote to summarizing the selected issues paper.

Mr. Hansen pointed out that the staff report on the Article IV consultations for Germany had contained a number of boxes that had outlined the findings of the selected issues paper. Such an approach might have been useful in the French case.

The Executive Board recessed at 1:00 p.m. and reconvened at 3:00 p.m.

Mr. Milleron made the following concluding statement:

> I must say that I was very interested in this debate, which was useful and well prepared thanks to staff. Let me begin by warmly thanking staff, the European team, and in particular Messrs. Artus and Zanello, who devoted so much time and energy to examining our problems and going deep into the analysis of the French economy as it is today. I would like also to thank my colleagues. I had sometimes the impression of being in a hospital bed with 23 medical doctors around me, with diagnoses that were not perfectly convergent.
>
> In listening to the interventions of my colleagues, I cannot fail to conclude that the main issue in today's discussion is the question of gradualism. That is why I shall focus my points on this specific issue.
>
> If one tries to formalize the economic analysis of gradualism, one realizes that it is not an easy issue; but let me try to dig a little deeper. The problem we face is a kind of optimal control problem, in which the speed of adjustment—whether one talks about fiscal adjustment or structural adjustment—may be defined as the basic control variable. Something like the accelerator peddle when you drive. Now, there are risks of a crash that are highly correlated with speed, just like driving on an icy road. The behavior of the driver, if he or she is rational, will depend on two elements: first, an assessment of the risk of a crash and its costs and, second, driver's preferences, whether he or she is a risk-averse person.

In such a conceptual framework, I think staff is not in the right tone when they say that my authorities should drive faster. My authorities are aware of the high possible cost of a crash. They know that the French society sometimes behaves like a geyser, and the cost of a crash may be heavy, as much as several weeks of social turmoil. Considering this cost, and taking into account the fact that the driver has a certain degree of risk aversion, you cannot criticize him for careful driving.

Now, there is the question of the window of opportunity, which was called the French windfall by my British colleague. Something like: for the time being it's fine, but you may soon have to confront a big snowstorm, so that it could make sense to drive faster in order to get home as early as possible. I agree that it makes sense to put it this way, but I say that it doesn't change the nature of the problem. It remains a question of risk evaluation and a risk-taking behavior. You can mention that there are various strategies; you can help our authorities realize that there are alternatives; but you cannot make a categorical judgment on an issue like that. The only case, in my view, in which criticism is justified would be the case of survival. If there is a 100 percent probability of being killed by the snowstorm, then it makes sense to say that it is fully rational to rush. But I don't think we are facing this situation.

There is another point I would like to mention on this issue of gradualism. It is a fact that the state of the French society should not be considered as a given and unchanging. In fact, it is changing, and I would not hesitate to say, the changes are in the right direction. The danger of social turmoil in my country is the creation of destabilizing radicalization. When, as has been the case during several periods of cohabitation, it is clear that our institutions can work properly, new forms of tolerance emerge. For instance, the foundations of a market economy are now fully accepted by a comfortable majority of my fellow citizens. More interestingly, the proportion is not so different in the moderate Left and Right wings of the political landscape. In the same spirit, globalization is now considered as progress, and the proportion of positive answers is higher in the Left than in the Right. I could also mention similar results on the question of privatization. When assessing the consequences of what I called a possible crash, one should not forget that such a crash could ignite new conflicts, new tensions in a society that is steadily improving its ownership of a more modern approach to economic life. This asset must be protected.

Consequently, I will not hesitate to convey to my authorities the following message: in our discussion, various strategies to address fiscal and structural problems were envisaged. These strategies are characterized by various degrees of risk taking. But staff and my colleagues were wise enough not to make any definite judgment on this matter. They are fully respectful of the attitude towards risk of those who are in the driver's seat, so they

recognize that they should not address in a definite manner the question of the best decision to make.

Overall, Mr. Chairman, I think the discussion on gradualism about the case of my country has been very useful. What I shall keep in mind is that it is so important, on such delicate matters, to avoid simplistic approaches.

I would like to comment on a second dimension not fully independent of our debate. Here, I would like to say that overcoming the taboos and disseminating the proper information on sensitive issues is indeed a significant step forward and possibly a prerequisite for a serious and consistent medium-term policy.

Many speakers this morning mentioned the case of a possibly plethoric civil service in France. Staff is probably correct when mentioning that we still have a long way to go from that point of view. Let me say that the Department of Finance has taken some significant steps, even if the general public is not yet sufficiently aware of it. For instance, foreign observers often find tax collection in France a little bizarre, with its at least two parallel and relatively costly networks. This government asked the Inspection Générale des Finances to examine these specific issues starting from previously unavailable international comparisons. It is a rather difficult question and many precautions have to be taken in comparing the civil service in different countries, even industrialized ones. The way the study was conducted and the result is rather impressive since it so happens that the cost of tax collection in France is two to three times what it is in most developed countries. As you can imagine, such information can create some social turmoil in some quarters. However, the government was courageous enough some weeks ago to put this report on the net, which is per se a way to help people change what they think about civil service.

Mr. Hansen and many speakers this morning referred to the system of administered rates and did not hesitate to use the word "anachronism" to describe the French situation. It is true that this story goes back to the beginning of the 19th century and the system has resisted at least two revolutions and three major conflicts, and maybe more. A significant step forward was taken recently with the Comité Consultatif des Taux Réglementés and the creation in June 1998 of a corridor, not independent of the market situation for the rate of the Livret A. The progress is that the advice of this Committee is published and may therefore be subject to a public debate. I do not want to overexaggerate this element but, again, it must be identified as a case in which some taboos have been overcome as a result of disseminating information.

Pensions constitute a third example. In the Staff Report, one can find a fair presentation of the content and conclusions of a report which was broadly

disseminated to, and discussed by the social partners. It is not too much to say that the overall awareness of the magnitude and urgency of this issue has increased even in the general public. It is not a scoop that better information on the long-term environment can improve the general allocation of resources and that in this case such a piece of work was certainly an indispensable prerequisite in properly addressing these long-term issues, enabling a better integration of these aspects into the short-term decision making process.

Finally, Mr. Chairman, one could say that in the debate on gradualism one should not forget that the production and dissemination of proper information is itself part of the process.

Now, briefly, on another issue: I am pleased to confirm that, as I mentioned in my preliminary statement, France is participating in the pilot project for the release of Article IV staff reports.

I am aware that it is too early to draw the conclusions from this project. However, I must report, off the record, that the perspective of publication put a lot of pressure on us in the French office. In brief, the difficulty is: in case of questions coming from our Parliament, our authorities want to be able to say something like: "our representative at the Board made a strong point on this issue." I must say that I was among those who tried to convince my authorities they should join the pilot project, but I noticed today that publication per se creates perverse effects. If we continue like that, our interaction will be less candid and probably more and more polluted by political interferences of this type. I am sure it is an issue that will come back on our agenda.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for policies that had yielded a remarkable economic performance, and contributed to the resilience of domestic demand in the face of the adverse effects of weakness in emerging markets that had been felt in some European countries. Growth had been sustained at one of the highest levels in the euro area, inflation had been subdued, the budget balance had been maintained within the Maastricht requirements, and employment creation had been significant.

Directors, while supporting the policies that are being followed to reduce unemployment, encouraged the authorities to strengthen their efforts to tackle long-standing structural problems so as to promote further growth and lower unemployment. Many Directors pointed out that the favorable near-term outlook offered a propitious setting for faster fiscal consolidation and deeper structural reforms. They underscored that early implementation of structural reforms, in particular—including in the fiscal area—would be crucial to put

the economy on a path of sustained high growth. Directors generally recognized, however, that to ensure the durability and success of ambitious and socially sensitive structural reforms, it would be necessary to garner broad-based consensus. A number of Directors agreed with the authorities that a more rapid pace of consolidation and reforms could, by reducing the extent of social consensus, undermine hard-won private sector confidence. These Directors felt that the present cautious pace of reform was appropriate.

In calling for a faster pace of fiscal reform and consolidation, many Directors considered that, while the general orientation of the authorities' stability program for 2000–2002 was sound, its objectives were unambitious. They indicated that public expenditure plans should have been aimed toward achieving deeper deficit and tax cuts. Accordingly, they urged the authorities to strengthen their consolidation efforts in the upcoming revision of their medium-term plan, with a view to achieving a balanced budget and sizable tax reductions by 2003. This would be all the more appropriate if short-term growth turns out to be more robust than currently projected. They stressed that fiscal adjustment along these lines would not only help provision for the demographic shock ahead, but would also catalyze favorable supply-side responses and more satisfactory job creation. Given the planned evolution of public spending, some Directors suggested that further consideration should be given to the issue of the right balance between cutting deficits and reducing the tax burden.

Most Directors agreed that restraint in public expenditure should be sought at the level of the social security system. From this perspective, they urged the authorities to restore incentives to contain health care spending, and to address the long-term imbalances of the current pension system through further reform. In addition, they saw scope for selectively streamlining the civil service without undermining the high quality of public administration.

Directors held the view that tax cuts and tax reform should be critical elements of the authorities' medium-term fiscal strategy. In welcoming ongoing initiatives to shift the burden of taxation away from labor, they noted nonetheless the lack of progress in reforming personal income taxes, and the risk of a misalignment between France's corporate tax rates vis-à-vis those in major partners.

Most Directors acknowledged that the 35-hour workweek initiative appeared to have had a positive impact on the social dialogue, and some believed that its impact on work organization was also positive. However, they expressed concern that the initiative would not contribute much to unemployment reduction, could be costly to the budget, and would worsen the effect of the coming demographic shock. Directors agreed that the initiative should be implemented with maximum flexibility and without undue restraint

on permissible overtime or work schedules freely agreed in negotiations at the firm level.

As for other labor market policies, Directors thought that the authorities' approach—especially the reductions in social security contributions on low wages and the fiscal incentives to increase part-time work—had contributed to sustaining labor demand in recent years. In their view, however, employment support programs needed to be streamlined and, more fundamentally, major reductions in structural unemployment would require a careful reevaluation of the root causes of this problem. Crucial actions in this regard would be ensuring greater flexibility in wage determination, strengthening the educational and vocational system in order to reduce the number of low-skilled and inexperienced workers, and broadening programs that offered on-the-job training at wages commensurate with the low productivity of the trainees. In addition, several Directors advised giving high priority to redesigning the system of unemployment compensation and welfare assistance to reinforce the incentives for the jobless and the inactive to seek work. This could be accomplished through tighter eligibility requirements and more gradual reduction in social assistance upon entering employment.

Directors commended the significant progress on the privatization front, but saw further scope for reducing state involvement in commercial enterprises. Directors took note of ongoing market-driven changes in the financial system. They also observed that supervisory practices were evolving appropriately to meet the challenges of global capital markets. Nonetheless, many Directors advised the authorities to discontinue the practice of setting interest rates on some saving accounts, in order to reap the full benefits of financial integration through enhanced domestic and foreign competition.

Directors praised France's general development assistance and urged that it be kept at a high level despite budget stringency.

Directors noted that France maintains high standards of data provision to the Fund for surveillance, and is a subscriber to the Special Data Dissemination Standard and the Dissemination Standards Bulletin Board.

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

3. CAMBODIA—ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered a staff paper on Cambodia's request for a three-year arrangement under the Enhanced Structural Adjustment Facility (EBS/99/188,

10/1/99). They also had before them a policy framework paper for Cambodia for the period 1999–2002 (EBD/99/119, 10/7/99).

The staff representative from the Asia and Pacific Department made the following statement:

> This statement summarizes the information that has become available since the circulation of the staff report and request for arrangements under the Enhanced Structural Adjustment Facility for Cambodia (EBS/99/188). This information does not change the thrust of the staff appraisal.
>
> Macroeconomic developments continue to be in line with ESAF program expectations. Based on the consumer price index through August, the annual inflation rate was 3 percent compared to the pro0gram target of 5 percent for end-1999. The exchange rate has been broadly stable, and gross international reserves have increased to $414 million as of October 15.
>
> Preliminary budget data for September indicate that overall fiscal performance remains in line with the program, particularly with respect to domestic financing of the budget, which is running below program ceilings. However, spending for priority social sectors fell somewhat short of the monthly target, as in previous months. Interministerial meetings are continuing with a view to reducing administrative impediments to increased spending in these areas, and this will be a main topic of the next quarterly donors meeting in Phnom Penh scheduled for October 27, 1999 which will be attended by Fund staff.
>
> Based on preliminary information, the September 1999 indicative targets for net international reserves, net bank credit to the government, and net domestic financing of the budget were observed. Data on the net domestic assets of the banking system are not available yet.
>
> Since the staff report was issued, all prior actions have been implemented. In September 1999, discussions were initiated with the Russian and United States authorities concerning external debt rescheduling. The subdecree on forest concession management was submitted to the Council of Ministers on October 7. The Forest Crime Monitoring Unit was launched on October 7 with the signing of a memorandum of understanding between the government, UNDP, and a bilateral donor. A progress report on forest crime was released to donors and provided to the Council of Ministers on October 14, and was made available to the public on October 19. On October 15, the government announced publicly its intention and timetable for tendering for a new provider of preshipment inspection services for imports. The Financial Institutions Law was passed by the National Assembly on October 19.

In addition to the full implementation of prior actions, the authorities' commitment has been further reinforced by the October 20 letter from the Prime Minister to the Chairman and Members of the Executive Board.

Mrs. Hetrakul submitted the following statement:

At the outset, my Cambodian authorities would like to express their appreciation for the efforts made by the staff in assisting them with the implementation of policies and measures to stabilize the economic situation over the past year as well as formulation of the medium-term reform program. With the formation of the new Government in November 1998, Cambodia is now in a more stable political and social environment and in a strong position to renew its economic and structural reform efforts. The economic performance since the beginning of this year has made considerable progress. Building on these initial achievements, the government is determined to embark on the reform process with the goals to alleviate poverty and achieve sustainable economic growth. The government's overall agenda and strategy were endorsed by the National Assembly on November 30, 1998. The objectives of this agenda are: (i) safeguarding social stability; (ii) building human capacity; (iii) strengthening infrastructure and fostering an environment for private investment; (iv) fully protecting and preserving the natural environment; (v) enhancing national revenues in the context of a fully accountable and transparent fiscal policy; and (vi) encouraging the private sector as the engine of growth, investment, and employment creation. My authorities strongly believe that with this agenda and with the efforts made by the entire Cambodian population and the government, supported by the financial and technical assistance from the international community, including the Fund, the goals of the reform program could be attainable.

Since the new government assumed office in November 1998, the political and social conditions have stabilized and improved, leading to a more peaceful environment that is conducive to growth and investment. Signs of economic recovery have emerged, inflation declined from 13 percent at the end of last year to an annual rate of 3 percent in August 1999 and is expected to remain below 5 percent for the year as a whole. Tourism in the first half of the year increased by 13 percent compared with the year before, and has nearly returned to the previous peak level of 1996. With favorable weather, a good agricultural harvest is also in prospect. On this basis, economic growth is expected to recover to 4 percent in 1999 against the almost-zero growth last year. Budgetary developments, with particularly strong performance of VAT and customs duties, have largely met or exceeded expectations. The current budget balance is expected to record a surplus of 1.5 percent of GDP for 1999. The exchange rate and international reserves have been stable and a further significant increase in garment exports has helped offset the decline in forestry-related exports and an increase in imports, thus containing the

increase in the external current account deficit to 12 percent of GDP for 1999, which is better than the medium-term target.

With a view to supporting economic recovery, lowering inflation and promoting a stable exchange, since the beginning of the year, the Government has introduced several policies and measures in the monetary and fiscal areas including those to eliminate the central bank net lending to the government, reduce the degree of dollarization without recourse to administrative measures, increase collection of timber royalties, eliminate all ad hoc exemptions for tax and import duty as well as the export tax exemption for rubber and timber. A tender for pre-shipment inspection (PIS) has been launched recently. The government has also taken measures to reorient current expenditures from defense and security to basic health and education.

With regard to forestry management, illegal logging activities outside official concessions have been sharply reduced since early 1999. This was achieved through the concerted efforts of all elements of society including the military, police, provincial authorities and local communities. Key measures include the establishment of a Forest Crime Monitoring Unit (FCMU) with independent outside observers, and the cancellation of all log collection permits for illegally felled logs and of all concession contracts. The first report by the FCMU was made public on October 19, 1999. From now on, the FCMU's report will be published on a quarterly basis. With the assistance from the Asian Development Bank (AsDB), the authorities have started a comprehensive review of all 21 concessionaires expected to be completed by early 2000. No new concessions will be granted while the authorities are carrying out the review. The draft of the Sub-decree on Concession Management was submitted to the Council of Ministers for consideration and approval and the forestry management law is now under active preparation.

Regarding the military demobilization, the Government has made a strong commitment to reduce the current size of the Royal Cambodian Armed Forces (RCAF). Surveys were conducted in the two largest military regions. Based on the results of these surveys, the ghost soldiers and their dependents have been identified and removed from the payroll. Meanwhile, the government has taken measures to streamline and improve efficiency of the civil service through downsizing its scope and improving the pay scale. Other efforts include the prevention of leakages, the reduction of scope for corruption, and the enhancement of transparency and accountability in every aspect of the government activities.

In the banking sector, the National Bank of Cambodia (NBC) has taken measures to strengthen its supervisory functions by increasing its banking supervision staff with continued training from the Fund. On-site inspections by international audit firms have been underway and will be completed for all commercial banks by end-1999. The full audit of one of the

two state-owned commercial banks, the Foreign Trade Bank, by an international audit firm was completed, thus paving the way for its restructuring and its future privatization. To support the banking reform, the National Assembly has approved the Law on the Financial Institutions to provide the legal framework for the organization and operation of these institutions and for the NBC to enhance its supervisory functions.

In other words, many policies and measures recommended by the staff and the previous Board discussion and all prior actions have been implemented.

Recognizing the slippages in the implementation of the economic and structural reform policies and measures in the past two years, the government is strongly determined to put back on track the reform measures in these areas with the objectives of raising economic growth and per capita income and reducing poverty. Built on the agenda and strategy approved by the National Assembly, the government, with the assistance and collaboration from the Fund and the World Bank staffs, established a three-year program for 1999–2002 with specific elements and focus on major efforts to (i) strengthen revenue to support increased government expenditure; (ii) reduce military spending and implement administrative reforms of the military and the civil service to provide additional fund for social services and public investment; (iii) strengthen public resource management, particularly in forestry; and (iv) build the legal framework and economic institutions for the private sector. The medium-term macroeconomic framework for 1999–2002 is aimed at raising economic growth to 6 percent, lowering inflation to 4 percent, containing the external current account deficit at lower than 13 percent of GDP, and increasing gross official reserves to about 4 months of import coverage. To achieve these objectives and targets, the government will implement policies and measures on both macroeconomic and structural fronts.

In the fiscal area, the government will make efforts to raise the revenue to 4 percent of GDP during 1999–2002 by strongly implementing VAT, improving customs administration, rationalizing investment incentives and broadening the tax base. In the monetary and exchange rate areas, the authorities hope to reduce gradually the extent of dollarization and to develop an effective market-based domestic monetary policy, by enhancing the policy credibility and ensuring a stable macroeconomic environment, particularly through strengthening the fiscal position and the soundness of the banking system. The NBC will also take measures to reduce the government's net credit position with the banking system and increase bank credit to the private sector to support economic recovery. In the short run, the NBC's policy will focus on bank regulation and supervision while introduction of a treasury bill will be pursued during the program period. The NBC will also maintain its market-based exchange rate policy by allowing the official exchange rate to

be adjusted flexibly. The government will also maintain a liberal exchange system. It intends to accept the obligations under the Fund's Article VIII, Sections 2, 3 and 4, during the program period.

Regarding forestry management, the authorities have emphasized their commitments to take further actions to develop forestry as an environmentally sustainable and economically viable sector. These include overhauling concession management, formulating a legal framework for forestry, establishing a permanent forest estate, and strengthening intersectoral oversight and accountability. The authorities are in cooperation with international observers—including key NGOs—to strengthen Cambodia's efforts at monitoring and controlling logging activities. Based on the review of all 21 concessionaires, actions will be taken against the concessionaires that are not in compliance with contract terms or Cambodian law. New concessions will not be granted until the review is completed and a system of rigorous and sound forestry management is established. The Government is firmly committed to addressing the issues in forestry management.

On military demobilization and civil service reform, based on the improved security situation, under the Cambodian Veteran Assistance Program (CVAP), the authorities are committed to reducing the current size of the RCAF by about 40 percent, over a five-year period from 143,000 to about 80,000–100,000. A pilot program is expected to begin in early 2000, to be followed by full implementation of the demobilization and reintegration program after an evaluation of the pilot program. Civil service reform will aim at rationalizing and downsizing the civil service as well as improving overall efficiency. As a first step in this process, and based on a centralized automated payroll system, the number of civil servants is expected to be reduced by at least 3,600 (2 percent) through elimination of redundant workers and normal attrition by end-1999. Further reductions will be made in 2000–2002 following a civil service census and functional review of all ministries and adoption of a concrete civil reform program in consultation with the World Bank. The civil reform and improvement of the tax administration will allow for the delivery of social spending on health and education to eliminate poverty.

On the private sector development and public enterprise reform, the Government is reforming the legal and institutional framework for the private sector, with a view to enhancing transparency and creating a level playing field. For these purposes, a comprehensive Commercial Code is being prepared to strengthen the regulatory framework for business organization, contracts, intellectual property rights, and product liability. Two commercial laws will be submitted to the National Assembly by December 1999, and the remainder by the end-2000. Measures will also be taken to strengthen the rule of law and transparency, including modernizing the judiciary.

Privatization of major state-owned enterprises has proceeded satisfactorily and will continue during the program period within the context of the Law on Public Enterprises. With returning confidence, more investment from abroad and at home is expected to be increased.

In adopting this ambitious reform program, my authorities fully recognize the many difficulties and challenges ahead. However, they are confident that the reform program will be supported by the international community. In this regard, my authorities have made a request to the Board and the Management of the Fund for an Arrangement Under the Enhanced Structural Adjustment Facility and expressed their sincere hope that the Board and the Management will extend a strong support for their reform efforts. They strongly believe that the approval by the Board and Management for their request will be followed by the World Bank's Structural Adjustment Credit (SAC).

I would like once again to express our deep gratitude for the support and assistance given to Cambodia thus far by the Board, the Management and the staff of the Fund and the international community, in particular, the recent technical assistance given by the Fund in the customs, tax, and banking areas. They hope that more technical and advisory assistance will be provided to Cambodia in the course of the implementation of the program.

Lastly, in line with the Fund policy on transparency, my authorities agreed to the publication of the PIN relating to the last Article IV Consultation and this time, to facilitate a wider distribution of the PFP and the MEFP, the government of Cambodia has also authorized the Fund to publish these documents.

Mr. Mirakhor made the following statement:

I would like to commend the authorities for their "commitment to break with the past," which was demonstrated in the reforms already implemented since early 1999. I thank the staff for their comprehensive well-written papers, and Mrs. Hetrakul for a very helpful statement.

Since the 1988 Article IV consultation discussions have already taken place, my remarks will concentrate on 1999 and the proposed program. We are pleased to note that economic prospects are improving for Cambodia. Based on developments thus far, growth rate for 1999 is projected to recover to 4 percent; inflation is expected to remain below 5 percent; budget performance is set to produce a record surplus, leading to a decline of 2.5 percent of GDP from its 1998 level in the fiscal deficit; and, finally, with exchange rate and reserves being stable, the current account deficit is not projected to widen further. On the structural side, the momentum of reforms initiated in early-1999 has been maintained. These are very encouraging

developments and provide the proper springboard for the authorities' ESAF-supported program, which we strongly support.

I am pleased to note that the objectives of macroeconomic and structural policies, contained in the PFP, are to raise economic growth and per capita income and reduce poverty. This welcome emphasis is in line with the spirit of the Poverty Reduction and Growth Facility (PRGF), which, as of today and pending the consent of all contributors to the ESAF Trust, will replace the ESAF.

It is hoped that the coincidence of the dates of Board adoption of PRGF and discussion of Cambodia's program will benefit the country. In this regard, I wish to ask if the program will be recast within the context of the PRGF and a Poverty Reduction Strategy Paper (PRSP) by the time of the first review and with the objective of highlighting the contribution of the program to growth and poverty reduction, and if it will be presented to the Board. In this context, I am sure the staff will want to pay particular attention to the details of unemployment which are not covered under the proposed ESAF. The major components of the reform strategy, including a halt to illegal logging, the military demobilization, and the civil service reform will adversely impact the labor market and exacerbate the pervasive nature of poverty and the wide income distribution differential between rural and urban areas. In this connection, has consideration been given (by the authorities or in the World Bank advice to them) to small scale and micro-projects, which are generally labor-intensive and very helpful in widening the base of public support for reforms?

The proposed ESAF program rightly renders fiscal reform a cornerstone of the adjustment strategy for the next three years, and the authorities have already made a good start in this area under the 1999 budget. While the reform agenda—including broadening the tax base and improving tax administration, with the objective of raising the low revenue to GDP ratio—is ambitious, it is nevertheless necessary in view of the pressing needs to increase social spending and rebuild infrastructure.

The conduct of the wide-ranging reforms requires important contribution from the IFIs to enhance the authorities' implementation capacity, and I welcome in this connection the recent reopening of the resident representative post.

I welcome the authorities' intention to accept the obligations of Article VIII during the program period and their decision to publish the ESAF documentation.

With these remarks, I wish the authorities full success with the implementation of their program, and hope that the support of the

international community is forthcoming and commensurate with the country's reform efforts and financing needs.

Ms. Mateos y Lago made the following statement:

At the outset, I would like to commend Staff for managing to push through an agreement with the Cambodian Government on what appears to be a sound, well conceived and timely reform program.

Cambodia now stands at a crucial stage of its development. After experiencing zero growth in 1998, it is now on the path to recovery, thanks in particular to greater political stability. Inflation, as demonstrated by the latest figures circulated by Staff, is under control and the pace of economic reform since the beginning of the year has been quite remarkable. Yet, the foundations of a truly attractive business environment and healthy macroeconomic background are hardly in place, and whatever has been achieved remains fragile and reversible.

In this connection, granting Cambodia the requested ESAF-supported arrangements would be a very powerful tool in securing the timely implementation of a comprehensive medium-term reform program. Therefore, we warmly support the proposed decision.

However, it should not be overlooked that this ESAF program has a few worrisome features, which I would like to review briefly, if only to prompt Staff's comments.

First, I noticed that the planned budget deficit would reach 6 percent of GDP at the end of the program, as a minimum. Indeed, it could be significantly higher if either medium-term GDP growth or fiscal revenue targets were not met, which is not unlikely, but I will go back to that in a minute. Such a budget deficit, in itself, does not seem very wise to me, and I would have greatly appreciated it if Staff could have provided a fiscal sustainability analysis, for it would be ironic that on completion of the program, the Cambodian authorities find themselves with a level of public debt that, given their debt management skills and the limited sophistication of the domestic financial markets, ends up being a major impediment to future growth.

Also, it was not very clear from the report whether the figures of overall fiscal balance related solely to the central government budget or to a more broadly defined public sector, including in particular state enterprises. In fact, more generally, it would have been quite helpful to learn more on state enterprises, particularly those which are due to remain within the public sector for the foreseeable future: how large they are, what business they are into,

how competitive they are and why the government is reluctant to privatize them even though this additional source of revenue would be very welcome.

As for medium-term GDP growth, I find the targeted 6 percent a little mysterious. I am sure all the necessary calculations were made before such an ambitious target was agreed upon between Staff and the Cambodian authorities, but since there is no mention of them in the report, I somehow wonder what will drive growth up to that level, especially against the background of a sharp increase in tax pressure and keeping in mind that 50 percent of GDP is accounted for by agriculture and therefore subject to climatic hazard.

Turning now to tax receipts, I also have serious doubts that the Cambodian Government will manage to raise their revenue by 4 percentage points of GDP if they limit themselves to implementing the measures described in the report, which basically boil down to rationalization measures. In addition, it should be borne in mind that the commitment to further liberalize trade will curtail customs revenue, which will partially offset the efforts made by the Government to raise revenue from other sources.

Finally, there is one last thing that needs to be clarified: the program involves a jump in the investment rate by almost 7.5 percentage points of GDP. There is no doubt that infrastructure needs are huge, but how is that surge of investment going to be financed? More specifically, I would like to know what are the underlying assumptions about the respective contributions of the public versus the private sector and also of domestic investment versus foreign investment.

The second worrisome feature of the program is that, paradoxically, it does not significantly alleviate external vulnerability. Indeed, what the debt sustainability analysis shows is that Cambodia would be in a very fragile position in the event of an external shock, or even simply if for any reason, and there could be many, private investment flows fall short of what was expected. If anything, this reinforces the need to implement the microeconomic reform agenda swiftly and decisively. Similarly, a slowdown of exports due to the trade restrictions imposed by the United States and possibly by the EU on garment imports or a further drop in primary commodity prices could jeopardize external sustainability. So could a failure to reach a rescheduling agreement with the main bilateral creditors, which leads me to urge, once again, both the Cambodian authorities and the two bilateral creditors concerned to do their best to actually agree on a rescheduling scheme in keeping with the 1995 Paris Club agreement.

The third and last worrisome feature, to me, is the lack of emphasis on improving governance, whereas it should rank very high on the agenda. Indeed, since in many areas the authorities are really building from scratch,

they should use this opportunity to review procedures and practices with a view to eradicating corruption. Short of doing that, they may end up with a form of built-in corruption which would severely undermine business confidence and deter sustained private investment flows.

Finally, even though I am aware many things have changed in Cambodia over the past year or two, I would like to recall that performance under the previous ESAF was quite unsatisfactory. In this connection, staff's assessment of mixed performance (as made in paragraph 5 of the report) is a clear understatement. What it means is that the potential for internal resistance should not be underestimated and that notwithstanding the support granted by the international community, the Government will have to gather support stemming first and foremost from the civil society.

In addition, as acknowledged by Staff, implementation capacity remains extraordinarily weak, which calls for a heavy supply of TA together with a very close monitoring. In this respect, I would like to underscore that I found the strict monitoring provisions of the report extremely well conceived and the benchmarks very appropriately chosen. The only missing thing might be benchmarks regarding the reorientation of spending from defense and security to social purposes. But this can certainly be taken care of without structural benchmarks.

So, all in all, even though I deliberately focused on the weaker points of the program, I would like to once again commend the staff and the Cambodian authorities for designing this reform program and committing to it, and I wish them all the best in this endeavor.

Mr. Morais made the following statement:

Strong measures have been taken to reduce expenditures and the foreign exchange reserves have strengthened. All prior actions have now been implemented. We encourage the authorities to maintain this momentum, particularly in strengthening budgetary performance.

With respect to revenue mobilization, the strengthening of the customs administration will be critical. It will also be important to raise tax revenue and reduce tax arrears. We welcome the plans for military demobilization and civil service reform. Measures taken so far to reduce the payroll costs of soldiers and civil servants have yielded encouraging results. The next step will be to ensure that these savings are widely distributed.

The authorities are well aware that their objectives can only be achieved in a low-inflation environment. In this respect, preventing further central bank financing of the budget deficit will be critical to keeping inflation down. It is encouraging to learn that the problems in the banking system do

not yet pose a systemic risk. However, we encourage the authorities to implement the newly approved banking law.

Although Cambodia is not currently classified as a HIPC country, we note that the fiscal burden of its external debt is close to the target of the Enhanced HIPC Initiative. The funds currently spent on servicing the debt ought to be spent on the social sectors instead. In order to sustain the reform effort, we urge creditors to grant Cambodia debt relief on terms comparable to those granted to HIPC countries.

Mr. Taylor made the following statement:

We welcome the opportunity to consider the request from the Cambodian authorities for an ESAF-supported program. It is a real achievement for Cambodia and should help maintain the momentum created since the last election while rewarding the authorities for a promising start. We particularly welcome the recent strengthening in economic performance. But despite the promising start, the challenges for Cambodia remain great, in particular in the areas of fiscal reform and poverty reduction. We agree with the staff's recommendations and can approve the request for an ESAF-supported program. However, I would like to make a few points on transparency and governance, especially in light of the newly adopted Poverty Reduction and Growth Facility (PRGF).

First, on the program design itself. In recent board discussions and at the time of the annual meetings, we rightly began to sharpen the focus on poverty reduction. Now that ESAF has been renamed PRGF, it seems appropriate that Cambodia becomes one of the beneficiaries, given that its human indicators are among the lowest in the world. Accordingly, one would expect the staff report to focus on measures to promote economic growth and reduce poverty. However, the links are somewhat disappointing. The staff report does not question the fact that the growth achieved in 1999 so far has had little effect on poverty levels, nor does it question that the poverty reduction that did take place has tended to be concentrated around the capital. However, I understand that the transformation of ESAF into PRGF will take time, and I commend the staff on the work it has already done with respect to Cambodia. My comments are meant as constructive criticisms for the future.

With respect to fiscal policy, the proposed program does not list explicit conditions to address the focus of government expenditure. While the staff report rightly notes that the reliability and stability of government funding is a major problem in Cambodia, expenditure issues are not adequately covered in the Policy Framework Paper matrix. The matrix conditions with respect to social sector spending are as follows, and I quote: "Provide adequate funding and meet budgetary targets for spending on basic health and education in line with the public expenditure review, and increase

public investment in rural infrastructure." I wonder if this is not too vague. I would accordingly welcome the staff's views on whether the Policy Framework Paper is too broadly formulated to be used for monitoring the ESAF-supported program.

Defense expenditures are not even included in the policy matrix. Furthermore, the three-year proposal for demobilization has not been translated into annual commitments. Will this make transparent monitoring difficult? In a similar vein, expenditure commitments on health and rural investment do not seemed to be timed at all. How will progress be monitored and assessed in those areas? We also note the comments about ghost soldiers and ghost children in box 3 of the staff report. I wonder whether the staff could inform us about the impact on the military budget of the removal of the expenditures associated with this fraud.

With respect to the formulation of the program, it has been suggested that the design process was not sufficiently consultative. Consultation is clearly important but also difficult, as many parties are involved. However, the Fund must ensure that the consultation process is effective. I would welcome any comments that the staff may have on this issue. Again, the point is made in a constructive vein.

Finally, turning to governance, we strongly endorse the view that corruption must be eradicated. I would welcome the staff's views on how this issue will be taken forward and on the government's reaction to this critical challenge. Would it be appropriate for the Fund and Bank staffs to assist the authorities in developing an anti-corruption strategy? Such a strategy could be discussed at a consultative group meeting. I am certain that many donors would be eager to assist in that area. More specifically, we would like to raise the question of procurement. There have been a number of cases where procurement policies have created monopolies in specific sectors. For instance, a single company has been granted the contract to supply all drugs to the health sector. We would welcome the staff's views also on this issue.

Finally, with these comments, I wish the authorities the best in implementing the new program.

Mr. Nardelli made the following statement:

We welcome today's discussion on Cambodia's request for an ESAF-supported program. After years of severe political and economical strain—underlined by an unsatisfactory performance during the previous program—this country needs the support of the international community.

Two positive developments have been recorded since last year. First, a new political equilibrium now appears to have been formed, and we are

heartened by the new government's commitment to break with the past. Political stability is a prerequisite for ensuring a successful outcome and sustain the recovery of donor support that has taken place over the past few months. Second, a long-awaited comprehensive review of forestry policy has finally taken place. Hopefully, this review, coupled with governance reforms, will bring to an end the impoverishment of the country's natural resources. The new Fund program is well designed to address the major obstacles.

The fiscal correction in the program is significant, and we agree that increasing revenues will be critical. Priority should also be given to avoiding the continuation of central bank financing that took place for the first time in 1998. In this respect, we urge the authorities to proceed swiftly with the introduction of treasury bills. This measure will favor the development of a more active financial market and will help avoid a future relaxation of budget policy, which can easily occur when central bank financing is readily available.

We take note of the authorities' commitment to reduce military spending. Box 3 in the staff report shows that the number of employees in civil administration is slightly lower than it is in the military, where the wage bill amounts to 2.7 percent of GDP. This constitutes a major obstacle to improving the public sector—the current wage bill for the civil service amounts to 1.4 percent of GDP compared to 6.1 percent in other countries with a similar background. Does the staff agree that the wage bill should be allowed to exceed slightly the target of 1.6 percent of GDP in order to facilitate catching up in this area? We note that the government's plan for the size of the military over the next four years is somewhat vague, as it is indicated as being in the range of 80,000 to 100,000. Maybe a decision in the lower end of the range would offer additional savings, which could then be channeled into the public sector.

We welcome the steps that are being taken with respect to trade reform and rationalizing tariffs. In view of the importance of customs duties to overall government revenue, we urge the authorities to seek technical assistance in order to determine the adequate pace of reform so as to avoid jeopardizing fiscal consolidation.

Finally, the current account deficit is a source of concern. The staff report indicates that sustainability will not be affected because the recent widening of the deficit should be absorbed over the long term through the resumption of official long-term borrowing and debt relief. However, this assumption relies heavily on the normalization of relations with bilateral creditors and inflows of foreign direct investment. While the former can reasonably be expected in the near future, the same may not be true for the latter. Furthermore, donor assistance may vary according to political

developments. An alternative plan to smooth over the current account deficit is therefore desirable.

With these remarks, we support the proposed decision and wish the Cambodian authorities all the best in their endeavors.

Ms. Lissakers made the following statement:

Overview

In conformity with U.S. legislation, we wish to have the United States recorded as abstaining in this decision.

We remain apprehensive about the integrity of the governing regime in Cambodia, but believe that the objectives to be achieved under this ESAF (accelerate economic reconstruction, address pervasive governance/corruption problems, reduce poverty) are right on the mark for this conflict-torn country.

Based on discussions with staff, we are encouraged that the program as structured contains reasonably diligent targeting and monitoring. We advise, however, that the Board should stand ready and willing to put the program on hold if the authorities' commitment and/or implementation of program begins to waiver.

We anticipate that the rest of the donor community will be supportive of IFI monitoring efforts.

I would like to commend staff on the close collaborative effort undertaken with the World Bank, NGOs and other IFIs in structuring this program, many elements of which go outside the normal boundaries of Fund competence. We would like to request that a poverty reduction strategy paper be developed as the ESAF and the upcoming World Bank structural adjustment credit proceed.

My remarks will focus on four key areas: fiscal/military budgeting, forestry, resumption of discussions for bilateral debt rescheduling, and labor rights.

Fiscal/Military Budgeting

The cornerstone of the macro program is improving revenue collection and reorienting public spending from the military and defense to social and human needs. Key to this effort will be minimization of extrabudgetary decision-making.

We are pleased to see that staff has incorporated monthly spending targets for both military spending and social spending. We urge staff to be assiduous in ensuring that the targets are reached.

We understand from Fund staff that Cambodian authorities are looking into creating an independent National Audit Authority to implement systematic auditing of military spending. We strongly support swift action on this front to bring greater transparency and accountability to the current system of ad hoc civilian audits and annual audits conducted by the military itself.

With regard to expenditures for demobilization, we encourage the Cambodian authorities to generate a new plan for reintegration of soldiers and their families in time for discussion at the upcoming consultative group meeting on October 27.

The new plan should be structured to prevent incentives for illegal tampering with military rolls. It should also stress integrated rural development, land and housing development, and income generation projects.

Forestry

Efforts undertaken by the government so far to crack down on illegal logging activities outside of concessions are positive. But we have heard concern expressed by NGOs and others about potential backsliding in this area.

With regard to the sub-decree on concessions, we conveyed concern we heard from NGOs and USG contractors about the substance of the decree as well as the public comment process to Fund staff. The technical deficiencies reported include: a lack of environmental impact assessment of forest concessions, perverse effects of log royalty increases, and power imbalances between responsible ministries.

Staff was aware of the problems, and made quick efforts to help shape up the sub-decree somewhat before it was submitted to the technical committee of the Council of Ministers on October 7.

While it may still be theoretically possible to improve the sub-decree chances are high that without strong, immediate, and continued engagement by the IMF, World Bank, and donors, the opportunity will be lost, and the new forest policies will in fact be further weakened before adoption, and/or not implemented.

We urge staff to continue its follow up to ensure that authorities will further modify the decree, as needed, before it is approved by the Council of Ministers and sent to the National Assembly.

Resumption of Negotiations for a Bilateral Debt Reduction

Staff analysis indicates that Cambodia's debt sustainability is contingent upon conclusion of bilateral debt reschedulings still outstanding under the 1995 Paris Club agreement. Cambodian authorities were required to initiate discussions with bilateral creditors, including the United States, as a prior action for the ESAF.

In our recent bilateral discussion, Cambodian authorities appeared to be seeking non-Paris Club terms. Cambodia is not a HIPC, so bilateral agreements will have to follow the terms already agreed upon with the Paris Club. Authorities also need to provide promised information that would allow the dialogue to progress.

The United States urges the Cambodian authorities to expedite serious discussions with us, and with other creditors, to reach Paris-Club-compliant bilateral debt rescheduling agreements and complete this important aspect of their debt management efforts.

Labor

The staff report notes that growth in garment exports, which have been and are assumed to continue to serve as the main engine to growth, could be curtailed by new quota arrangement with the United States.

- The United States can increase the quota by 14 percent, if it is determined that Cambodia is in compliance with ILO core labor standards and its own labor laws in the garment industry. The ILO expects to put a monitoring mechanism in place to assess continued compliance.

- Our understanding is that the main problems revolve around the right to organize and the Ministry of Labor's ability to monitor and enforce existing labor laws. The proposed law to create a labor court would be a positive step. We will be watching for further progress on these issues, as well as on effective formation of the Labor Advisory Committee.

To conclude, I would like to commend the Cambodian authorities for their decision to publish the policy framework paper and their letter of intent.

Mr. Takeda made the following statement:

This chair highly appreciates that the authorities have committed to ambitious economic reform, and I must stress that steadily proceeding with economic reform based on the Fund program, along with maintaining political stability, would be the best future path for the growth of the economy. This chair supports the proposed decision and strongly hopes that the current admirable performance be maintained in the future.

On the fiscal side, I welcome that revenue performance in the first half of 1999 was fairly good. I hope that setting monthly budgetary targets and monitoring them closely will continue to yield favorable fiscal outcomes. According to the staff report, revenue increases of 4 percent of GDP are expected to be achieved during 1998–2002 by strengthening customs administration, expanding the VAT, and various other measures. However, considering the poor administrative capacity at present, providing intensive technical assistance would be necessary to achieve this objective. We should be actively supporting the authorities in this respect, as they are showing a willingness to improve their administrative capacity. On the expenditure side, I welcome that the authorities are shifting from defense and security expenditures to social expenditures, such as health and education. Implementation of the military demobilization program without delay is necessary to achieve this shift as expected.

The military demobilization program has a substantial impact on the prospect of fiscal balances. The authorities have committed to the ambitious target of reducing its size by 40 percent within five years. I hope this reduction can proceed as programmed under the appropriate advice of the World Bank.

Concerning civil service reform, the authorities intend to improve governance through a wage increase, and at the same time reduce fiscal costs by reducing the number of civil servants. We find this type of adjustment desirable so that the public sector can become more efficient and be transformed to a more appropriate scale.

In order to achieve sustainable growth, forestry sector reform is critical. Because the authorities made every effort to reduce illegal logging activities by utilizing various measures, illegal activities have radically decreased during this year. I welcome this development. To maintain this momentum in the future, it will be necessary for the FCMU to operate as expected. In addition, as the staff says, strengthening concession management is quite important in light of the sustainability of the forestry sector.

Finally, I welcome that the authorities have decided to publish the PFP and MEFP. With these remarks, I wish the authorities every success in economic reform in the future.

Mrs. Zador made the following statement:

Cambodia is doing better than expected, as tourist activity fuels economic growth. However, private investment continues to lag. The new government has made a good start and has promised important reforms. Cambodia needs to rebuild its economy and its institutions and will have to address governance and corruption problems. This is an enormous task, which I hope will be matched by the government's commitment and administrative capacity. Much remains to be done before investor confidence can be restored. Accountability, transparency, the elimination of corruption, and respect for human rights are all essential ingredients for sustaining economic growth and will also affect the level of future assistance from the international community.

I welcome the reform steps taken by the authorities since early 1999. The government has introduced a value-added tax, and has forbidden central bank credit to the budget. The privatization of the telecommunications sector has been announced. Pursuing these politically sensitive measures will test the government's ability to challenge vested interests in order to pass necessary reforms. However, the government's completion of all prior actions justifies a cautious optimism. Overall, the program appears sufficiently strong, although the staff should seek further assurances that spending will be channeled in a transparent manner from the military toward housing, the forestry sector, and the civil service.

The authorities must also seek to improve the quality of its statistical database, and provide more timely information on external financing of the budget and the use of FOA.

Finally, let me comment on monetary policy. Due to the high degree of dollarization of the economy, monetary policy alone cannot keep inflation under control. Most of the burden will fall on fiscal policy. Fiscal discipline and budget consolidation are therefore of paramount importance in keeping inflation down. Reducing the degree of dollarization will depend primarily on the credibility of monetary policy, and is therefore likely to take some time. A currency board system could eventually lead to stabilization and rehabilitation, though I agree with the staff and Mr. Takeda that this would not presently be feasible. In any event a currency board cannot be set up until existing deficiencies have been corrected and a prudent fiscal policy has been established. With these comments, I support the proposed decision.

Ms. Vtyurina made the following statement:

It is refreshing to see an upbeat tone in the staff papers this time. The new government's commitment to the reforms is seen not only through the ambitious agenda presented in their LOI but also through a satisfactory track record through September of this year. The return of political stability should enhance the economic prospects for Cambodia. The recent macroeconomic developments point to a potential increase in GDP of 4 percent and inflation of 3 percent for the year, numbers that are much more favorable than last year's 1 percent and 13 percent, respectively. These numbers, however, will only be realized if necessary changes continue to take place in all sectors of the economy. We agree with the thrust of the staff appraisal and, therefore, I will only comment on two areas of the program, fiscal and external.

The fact that the fiscal reform is the cornerstone of the program is no surprise to anybody. The still very low revenue ratio to GDP, as a result of continual problems with customs revenue collection and deterioration in governance, call for an ambitious revenue effort. We are pleased with the measures listed in Box 1 that have been and are going to be taken to improve the revenue collection. Especially, we noticed that Cambodia is one of the few countries where the implementation of the VAT actually has brought results that were better than expected, and we would like to congratulate the authorities on the successful implementation of this complex reform. We often see how difficult it is for many developing countries to implement this reform, and, in this case, Cambodia can serve as a very good example that timely implementation can bring results that are even better than envisaged. Conversely, the customs administration has been suffering from inadequate administration. We are encouraged, however, that recently the authorities have stepped up their efforts in addressing this problem through strict limitations of ad hoc duty exemptions. On the expenditure side, we cannot disagree with the staff's advice to re-orient public expenditure to better support development and social needs. From the staff update we have learned that spending on priority social sectors has fallen somewhat short of the monthly target, as in previous months. We urge the authorities to address this issue promptly.

The situation in the external sector continues to be difficult. The current account deficit is expected to stay in the range of 12–13 percent of GDP during 1999–2000. The external sector will continue to be vulnerable and external viability will require not only sustaining reform policies, such as prudent debt management, but also normalizing relations with the bilateral creditors. As far as Russia is concerned, recently there have been some contacts between the two sides. However, we want to state that the formal negotiations on debt rescheduling with the Russian Federation have not started yet; therefore, we believe that the assumptions regarding the post cut-off date debt of Cambodia to Russia used in the debt sustainability analysis should be used only on a preliminary basis. The external outlook for Cambodia

significantly depends on the renegotiations of this debt, and we urge the authorities to take a constructive position in their dialog with Russia in regularizing the external debt issues.

We support the decision and wish the authorities success.

The Acting Chairman remarked that Mr. Taylor's comments had underscored the formidable task that the Fund was facing in implementing the PRGF with respect to staff resources and capabilities.

The staff representative from the Asia and Pacific Department stated that the Fund-supported program had been drawn up during the period May–August 1999. In designing the program, the staff had placed the emphasis on poverty reduction in order to redress Cambodia's social indicators, which were among the lowest in the world. First, revenues must be raised in order to make room in the budget for spending on education and health, which currently amounted to only 1.7 percent of GDP. Second, defense spending must be reduced through demobilization and those resources redirected to the social sectors and to strengthening public administration. Third, a new forestry strategy must return logging to an environmentally sustainable level, while also giving the rural poor access to those resources, for example, by allowing them to use the land for cash crops.

The staff was planning, for the first time, to monitor monthly fiscal indicators under the program in cooperation with the World Bank, the staff representative continued. For that purpose, along with revenue targets, monthly social spending targets had been incorporated into the program, which would also allow for an implicit monitoring of defense spending. The staff had also been cooperating with both the government and the World Bank to improve the overall quality of expenditure by removing bottlenecks and ensuring that funds were disbursed locally. While such policy action was outside its expertise, the staff was working closely with the Bank staff to ensure that this critical component of the program was implemented satisfactorily.

Mr. Mirakhor wondered how to achieve a smooth transition from the ESAF to the PRGF. While social and demographic indicators would be given considerable weight in the future, reliable data in those areas were often not available. For instance, the latest data on access to safe water in Cambodia were from 1993, whereas the latest data on primary school enrollment rates were from 1996. The scarcity of reliable social data made it difficult to identify social benchmarks against which it was possible to measure progress.

The staff representative from the Asia and Pacific Department replied that the Bank staff was currently on mission in Cambodia, with a view to developing further the social benchmarks. The Fund staff would consult with the mission upon its return. However, the analytical basis was relatively weak, given the scarcity and unreliability of data, which was magnified by the fact that the Fund had not been operating in Cambodia until recently. However, it should be noted that it was not necessary with detailed data to ascertain progress in poverty reduction at the current stage, given the very low starting point. Furthermore, Cambodia had a vibrant non-governmental community, which played an important role in

monitoring social progress. For instance, if a school received funds but failed to improve correspondingly, the students and local non-governmental organizations would take it upon themselves to inform the international donor community.

It would be unrealistic to expect the staff to have a full Poverty Reduction Strategy Paper ready for the first review of the program, the staff representative continued. While the staff would attempt to recast the current ESAF-supported program in time for that review, it would be unrealistic to expect that process to be finalized, given the limitations of the current database.

The consultation process had also proved to be more time-consuming than the staff, the authorities, and the non-governmental organizations had anticipated, the staff representative related. For instance, with respect to the sub-decree on concession management in the forestry sector, the complexity of the issues at stake had required an extension of the original consultation period; in the event, the consultation had taken 2 months to complete. As a result, the staff had realized that more time must be set aside for consultation. Other problems that the staff had encountered included the lack of accountability and mistrust vis-à-vis the Fund of certain non-governmental organizations, which had led them to disregard information that was provided to them by the staff and the authorities, thus causing a further delay of the consultation process.

Ms. Lissakers asked whether the sub-decree on forestry management might still be modified before being presented to the council of ministers, as her chair was of the view that further changes were needed.

The staff representative from the Asia and Pacific Department replied that, while the sub-decree had been submitted to the technical committee of the council, it had not yet been adopted. The staff had been assured by the authorities that it would not be adopted until the draft had been approved by the World Bank, thus leaving scope for further changes.

Mr. Mirakhor asked whether there was a technical difficulty in approving the program, given that the ESAF had been replaced by the PRGF.

The Deputy Director of the Policy Development and Review Department replied that, while the decision to replace the ESAF with the PRGF had been approved by the Board, it would not become effective until formal consent had been received from all contributors. Therefore, the Fund would be going through a period of transition; some programs based on Policy Framework Papers would be presented to the Board in the coming months, as the negotiation process had almost been completed. Other programs would manage to complete the transition to Poverty Reduction Strategy Papers before they reached the Board. With respect to Cambodia, it might not be possible to complete the transition in time for the first review of the program, given the complexity of the consultation process. In that respect, it was important to ensure that all operational requirements were met so as to keep the program on track and prevent the Poverty Reduction Strategy Paper from becoming a superficial document.

The Acting Chairman asked whether there would be a period during which the ESAF and the PRGF would overlap.

The Deputy Director of the Policy Development and Review Department replied that, by the time all contributors had approved the decision to implement the PRGF, all ESAF-supported programs would be transformed into programs under the PRGF. While the Policy Framework Paper was likely to be replaced by the Poverty Reduction Strategy Paper fairly soon, the Board might be presented, during a period of transition, with a policy matrix that did not contain detailed information, but simply outlined a three-year framework.

Mr. Mirakhor wondered what that would mean in practical terms for a country in his constituency that was in the process of negotiating an ESAF-supported program.

The Deputy Director of the Policy Development and Review Department replied that there was a catch-all provision in the decision that had been approved by the Board, which indicated that all references to ESAF should be replaced by references to the PRGF once the change had been approved.

The staff representative from the Asia and Pacific Department related that governance was a very important issue for Cambodia. The program sought to address governance problems in two ways; first, by making key policy instruments more transparent and, second, by increasing the transparency of information on economic policies, including with respect to the budget and the forestry sector. On the revenue side of the budget, the most significant improvement in governance would come from eliminating the use of ad hoc import and tax duty exemptions, which currently amounted to almost 0.5 percent of GDP. Second, customs procedures would be reinforced through the reinstallation from April 2000 of pre-shipment inspection for imports. Third, duties on cigarette imports would be unified, thereby preventing further abuse in that particular area. Another significant—but also very sensitive—governance issue included the removal of so-called ghost soldiers from the military payroll.

While the government had announced a 30 percent wage increase for the armed forces in May 1999, the removal of ghost soldiers—which was to be completed by August 1999—would allow the wage bill to remain unchanged, the staff representative continued.

In the forestry sector, which had been plagued by widespread corruption, most of the program measures that the staff had recommended had been made public, including the list of revoked concession contracts, the staff representative related. The staff had also asked the authorities to publish plans to establish a forest crime-monitoring unit, which would include outside observers. Furthermore, the staff expected the planned quarterly donor meetings to increase transparency through enhanced monitoring.

Achieving the projected increase in revenues of 2 percent of GDP would require a strong and a sustained effort over the next two years, the staff representative remarked. A Fiscal Affairs Department mission had been planned for November 1999 to assist the

authorities in that respect. Fund technical assistance would be targeted to those areas where resources were the most needed, such as customs administration.

The staff considered a fiscal deficit of 6 percent of GDP to be sustainable, as it would not require any domestic financing, the staff representative said. Furthermore, savings amounting to 1.5 percent of GDP would be derived from reducing over the medium term the government's debt to the banking system. However, a sustained effort to increase revenues would be needed to ensure that the fiscal deficit remained sustainable.

The Policy Framework Paper and the letter of intent contained a commitment to reduce overall military spending from the current 4 percent of GDP to 2.5 percent in 2002, the staff representative continued. Savings would be realized already in 2000, as military spending according to the budget would be reduced by 0.4 percent of GDP. Those savings would subsequently be redirected to the social sectors. The staff did not yet have access to information on the planned pace of reductions over the program period, as the details of the demobilization program were currently being worked out with assistance from the World Bank and bilateral donors.

Rebuilding confidence in the domestic currency would be a very slow process, as all bank deposits were currently held in dollars, the staff representative remarked.

The staff had projected a growth rate of 6 percent on the basis of the economy's history of relatively high growth, the staff representative related. Furthermore, investment was currently quite strong on account of the rebuilding of infrastructure. While the sources of financing included foreign direct investment, most of the funds for rebuilding came from grants and loans on concessional terms.

While considerable progress had recently been achieved in bilateral negotiations with the two main Paris Club creditors, a conclusion of the talks would require more time, as there was disagreement over the data, the staff representative remarked. Once agreement had been reached on that issue, an eventual debt rescheduling should take into account Cambodia's very limited ability to service debt. Unlike the countries eligible for assistance under the HIPC Initiative, Cambodia's reliance on external grants and loans was limited. Accordingly, the country's ability to service a large debt burden would be constrained from a fiscal point of view.

Mr. Taylor wondered what the outcome would be if the authorities failed to secure a rescheduling from their main Paris Club creditors.

The staff representative from the Asia and Pacific Department replied that the debt service relative to revenue would remain very high, amounting to double the amount currently spent on the social sectors.

The staff representative from the World Bank related that average per capita income in Cambodia amounted to $290. Around 80 percent of the population lived in the countryside. Of those, 60 percent spent less than $1 per day, thus falling below the World

Bank's official poverty line. Average life expectancy was 54 years, which was below the average for all low-income countries, and infant mortality remained high, at a ratio of 102 to 1,000. In such a context, it was essential to increase growth in order to reduce poverty. With respect to the implementation of the program, Fund and Bank staffs were cooperating to ensure that the funds designed to alleviate poverty did in fact reach the poor, and that the peace dividend was realized in order to increase spending on health and education. In that respect, the mission that was currently in Cambodia would attempt to assess the effectiveness of the government programs for poverty alleviation.

The Bank staff had been cooperating with the authorities to define a national anti-corruption strategy, the staff representative continued. It was, however, important to note that the eradication of corruption was a very demanding task that required long-term planning. A first step had been taken in September 1998, when the Bank had conducted a survey among enterprises to determine the number of fees and ancillary payments that they were required to pay simply to be allowed to conduct business. The results of the survey indicated that corruption was widespread with respect to the issuance of business licenses and in customs administration. The surveyed companies also indicated that they had experienced difficulties in gaining access to government contracts.

The next step of the anti-corruption plan would be to conduct a survey among the population and in the public sector, the staff representative related. The staff planned to publicize the results of the two surveys in order to help mobilize civil society in demanding greater accountability from the government. The last step would be to combine the survey results in a national anti-corruption plan. However, the anti-corruption plan would not by itself address widespread poverty. Other elements of the program that would contribute to poverty reduction in the long run included improving financial management in the public sector and reforming the civil service.

The staff representative from the Asia and Pacific Department noted that it was also important to assist small-scale enterprises, and that the International Finance Corporation had a facility for the Mekong region that might be helpful in that respect. There were only 32 state-owned enterprises left in Cambodia as a result of solid progress in privatization under the previous ESAF-supported program, 11 of which were public utilities. Six rubber plantations had been targeted for restructuring, one of which was to be privatized by the end of 2001.

While specific targets for social sector spending over the medium term had been identified, the Bank and Fund staffs were currently discussing how progress was to be monitored in practice, the staff representative concluded. The public sector was not excessively large, but it lacked skilled employees—especially at the managerial level—because pay was very low. Therefore, it was important to restructure the public sector to ensure a more viable and efficient public administration. The Bank was currently working on that issue, and planned to have a proposal ready in time for the first review.

Mr. Wei made the following statement:

It is encouraging to see Cambodia's progress in macroeconomic management and reforms in 1999. As the staff points out, much progress has been made in the country since the newly-formed Government embarked on an agenda and strategy aimed at reinvigorating the ailing economy and alleviating poverty. The economy has shown clear signs of recovery and a 4 percent growth in real GDP is now expected for 1999, compared with virtually no growth last year. Inflation declined rapidly to only 3 percent in the first eight months of this year, sharply lower than the 13 percent registered at the end of 1998. The current account deficit is expected to be contained below the medium-term target of 12 percent of GDP for this year, while foreign reserves rose to $414 million in mid-October. In my view, these achievements are clearly attributable to the many right policies that have been put in place over the past year or so, which Mrs. Hetrakul has already elaborated in detail in her comprehensive preliminary statement and I should not repeat here.

With these promising developments in Cambodia, the authorities have therefore demonstrated their renewed commitment to reforming the economy and putting it back on a sustainable growth path. A stable political environment has already given the process a very good start. I would like to thank the staff of the Fund and the Bank for designing a three-year program that can follow through the original agenda and strategy. I welcome the key targets set for the medium-term macroeconomic framework for 1999–2002, with respect to growth, inflation, the current account, and international reserves, although given the reality in Cambodia, they look over ambitious in some areas, particularly the government's capacity to carry out the program at different levels. Needless to say, technical assistance from the international community, especially enhancing the institutional capacity, is very important. Let me say here that I look forward to seeing the program implemented and seeing the targets achieved.

This chair endorses the staff's assessment and proposal, and supports Cambodia's request for arrangements under the ESAF. With these remarks, I wish the authorities continued success in their endeavors.

Ms. Manalac made the following statement:

I wish to express this Chair's support for the authorities' request for a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF).

From a substantial deterioration in 1998, it is encouraging to note that economic performance and management have strengthened beginning this year, largely due to the attainment of political stability. However, while macroeconomic indicators currently point to further improvement and

structural reforms are underway, I agree with staff that the situation remains fragile since a number of challenges continue to face the authorities. Previous speakers have already emphasized the importance of fiscal reforms primarily through increased revenue performance and rationalization of expenditures. At this point, therefore, I would just like to focus my comments on two aspects, namely: the social sector and economic indicators.

A look at Table 9 shows that Cambodia clearly lags behind its neighbors in terms of improving the health and education sectors. Thus, the agreement between the authorities and the World Bank on the spending targets for the priority social sectors for 1999 and indicatively for 2000 is a welcome development. In this connection, the authorities are urged to keep within these targets and to deal with any problems, administrative or otherwise, that would prevent them from doing so.

Closely related to this task would be the need for authorities to address the deficiencies in compiling and disseminating economic statistics. A case in point would be Table 4 of the Policy Framework Paper, which barely enables one to compare income and social indicators over time due to unavailability of data. Also, staff had earlier acknowledged that lack of data could slow down the process of debt discussions with creditors. It is recognized that effective and appropriate policy decisions can be made only if these are based on reliable and timely information. The authorities are therefore urged to continue efforts in improving the coverage, accuracy and timeliness of economic data.

Finally, I hope that the strong commitment of the current government to achieve sustained growth is maintained, and wish the authorities success in their efforts.

Mr. Keshava made the following statement:

I join the previous speakers in commending the Cambodian authorities for addressing the key problems of the economy and developing a medium-term reform program. With the formation of the new Government in November 1998, an era of political uncertainty has ended which augurs well for Cambodia. In the past, the country has so often slipped into political turmoil that whatever economic gains that could be achieved were frittered away quickly. The new Government has shown promise to move away from the past record of weak economic performance and poor governance. We are happy to note from the comprehensive staff paper and the helpful preliminary statement from Mrs. Hetrakul that the authorities are determined to implement policies and measures on both macroeconomic and structural fronts in accordance with the medium-term macroeconomic framework. However, notwithstanding the recent signs of economic recovery, Cambodia's economic future both in the short run as well as the medium term is still vulnerable and

fragile. Therefore, the authorities are advised to adhere to their commitments towards economic and structural reform efforts.

The staff has rightly identified fiscal reform as the cornerstone of the program. The 1999 budget was a step in the right direction towards medium-term fiscal sustainability. We are encouraged to note the strong revenue performance in the current year which has primarily come from the successful introduction of VAT and improved collection of customs duties. The planned measures to improve tax administration through, inter alia, strictly maintaining the prohibition on ad hoc import duty and tax exemption will not only contribute to improved revenue performance, but also lead to a better budgetary governance. We share the concern of the staff that spending for the priority sectors fell somewhat short of the monthly target during the current year. We hope that the authorities will take remedial measures to remove the administrative impediments for realizing the target of non-wage recurrent expenditure for health, education, and social services as per the program. If the authorities are successful in their efforts for civil service reform and military demobilization, substantial resources will be freed for the priority sector which will also reorient the government spending. However, the plan for military demobilization may be a non-starter if the modalities of the safety net for demobilized soldiers are not soon worked out.

Issues relating to the forestry management has been coming up in successive reviews. It is encouraging to note that effective steps have been taken against illegal logging activity and exports which will put a check on the degradation of Cambodia's most important natural resource. The establishment of a Forest Crime Monitoring Unit with independent outside observers will aid in the efforts for controlling illegal logging activities. We welcome the submission of the draft subdecree on foreign concession management to the Council of Ministers for approval which will facilitate implementation of Code of Forest Practice for efficient and sound exploitation of forest resources. The preparation of a comprehensive forestry law, which is underway with the assistance of the World Bank, will complete the legal framework for sustainable logging and safeguarding Cambodia's most important natural resource.

The authorities should continue with their efforts to reduce the government's net credit position with the banking system and increase the availability of bank credit to the private sector to stimulate economic activity. Implementation of other structural reforms in the area of strengthening the rule of law and transparency, judicial reforms and development of a comprehensive commercial code will facilitate the growth of the private sector. The authorities should continue with their work on public enterprise reform and privatization of major state-owned enterprises.

The need for strengthening the banking supervision capacity of the National Bank of Cambodia has been recognized in the staff report. It is encouraging to note that the authorities have taken measures to address this issue. The successful implementation of the recently passed Law on the Financial Institutions will strengthen the banking sector and also contribute to increased private sector activity.

We commend the authorities for the full implementation of prior actions, which shows their commitment and determination to pursue economic reform. Our chair, therefore, supports the proposed decision and wishes the authorities success in their future policy endeavors.

Mr. Bakhache made the following statement:

The political stability that Cambodia achieved in 1998 has made it possible for the authorities to make a promising start on reforming the economy. In 1999, progress has been achieved on several fronts, as indicated in the staff report. We encourage the authorities to continue in this direction.

An ESAF-supported program aimed at supporting macroeconomic stability represents a good start, and we accordingly support the authorities' request. We agree with most of the issues raised by the previous speakers and are also in general agreement with the staff analysis—particularly with respect to the emphasis placed on civil service reform. The banking system is another area that clearly requires the authorities' utmost attention and the provision of extensive technical assistance.

Finally, I would like to associate myself with the remarks made by Mr. Mirakhor and Mr. Wei on environmental and social issues.

Mr. Costa made the following statement:

We welcome the encouraging economic and political developments that are taking place in Cambodia and hope that through the approval of this new three-year arrangement under the ESAF, the process of macroeconomic consolidation and structural reforms may find new impetus and that the objectives endorsed by the National Assembly in November last year become the guiding posts of the government's actions.

All the short-term economic indicators point to the progress already achieved during the current year and the marked improvement in relation to 1998. The annual inflation rate reached 3 percent through August and GDP growth is projected at 4 percent for the year, while international reserves have already reached the record level of US$ 414 million as of October 15.

The efforts to strengthen fiscal policies are critical in order to increase government savings so that the objectives of rebuilding transport and communication infrastructure, thus encouraging private sector investment, may become easier to attain. The need to reduce reliance on customs duties, in the context of Cambodia's commitment to trade liberalization calls for a broadening of the revenue base and for a strengthening of the administrative capacity to collect taxes. The introduction of the VAT and the projected expansion of its coverage are important steps in this regard while also contributing to enhancing transparency in fiscal policy.

On the expenditure side, we fully share the government's policies to reorient current expenditures from defense and security to basic health and education as made explicit in Mrs. Hetrakul's helpful preliminary statement. The program of demobilization of the military should go hand in hand with that of providing training and of facilitating their reinsertion in the labor force. Since the agricultural sector represents half of Cambodia's GDP and employs 80 percent of the labor force we consider important to enhance the contribution of agro-processing to economic growth and exports, particularly through the development of non-farm rural enterprises, while also helping to absorb redundant labor from the military and the civil service.

On banking system reform we welcome the passage of the Financial Institutions Law which will provide the legal underpinning for a full revamping of the system. This should raise the relatively low level of confidence of the people in the banking system thus helping to strengthen its intermediation role to better meet the development needs of the economy. Again, it is very important in this regard that special attention be paid to the development of an efficient banking network in the rural areas.

Finally it is clear that the sustainability of Cambodia's economy, which despite the good economic indicators mentioned above is operating with a current account deficit equivalent to 13 percent of GDP, hinges around the continued support of the donor community and that this is predicated, in turn, on the steadfast implementation of strong policies. The Cambodian authorities have already given proofs of their commitment to take up the challenge. They seem to clearly understand that the path of sustained reforms is the only way to ensure the needed support to achieve the ambitious objectives of promoting growth, investment, employment creation and the reduction of poverty. We therefore support the proposed decision and wish the authorities every success.

Ms. Fernandez made the following statement:

I am glad to note that since the new government assumed office, in November last year, Cambodia's political climate has stabilized and the prospects for economic recovery appear to be somewhat more optimistic.

The authorities seem to be fully committed to address the country's major challenges, that is, the economic reconstruction; the improvement of the rule of law and governance; and the reduction of poverty. As a matter of fact, to attain such goals they have already adopted and started to implement a program of reforms focused, as it could not be otherwise, on two key priorities: public finances and public resource management.

Needless to say, the situation in Cambodia remains very fragile and there are still risks and uncertainties. However, I am encouraged by two facts. On the one hand, the new government had made public its determination to carry out a broad fiscal reform as well as a decisive action against corruption and illegal exploitation of forestry resources. And, on the other, the favorable program implementation the authorities have attained since its inception at the beginning of the year. Indeed, as the staff describes in its comprehensive report, inflation has declined to 3 percent; budgetary targets have largely been met, on account of better-than-expected performance with VAT and customs duties; the overall deficit has declined to 3.5 percent of GDP; and exchange rate and international reserves have remained steady.

Taken into account the above-mentioned considerations and the thrust of the staff appraisal, I support the proposed decision to approve the authorities' request of a three-year ESAF-supported arrangement. The program the authorities are determined to implement has been well conceived; it is comprehensive, and if correctly implemented will certainly put Cambodia in the path of a more rapid and sustainable economic growth.

Being public finances, as well as public resource management, and the need to improve governance essential areas of the program, I will limit myself to make just some brief comments on them.

The fiscal reform has to be the authorities' main priority. The very weak revenue collection, which last year represented 8.7 percent in terms of GDP, and the need to support the development of the country requires from the authorities an increased effort towards revenue accrual. The measures envisaged in the program, as explained in Box 1 of the staff report, are centered in the VAT implementation; the improvement of the customs administration—notably by means of strictly not granting what traditionally have been large amounts of tax exemptions; and the build-up of non-tax revenues—whose performance have even fallen short of this year's budget projections. I encourage the authorities to comply with them since only the broadening of the tax base and the improvement of tax administration will make possible the accomplishment of the program targets. An even more so, when taking into account the progressive reduction of tariff rates that will be implemented as part of the process of opening the country to the world economy.

With regards to the expenditure side, I most welcome the overhaul in the spending composition that will imply the program reduction in defense and security and the subsequent enlargement of outlays in public investment, health, education, and social services. Noting that the achievement of such an objective will depend on the authorities' implementation of the military demobilization process, and the agreement that will have to be reached—with the World Bank and donors, on the size and modalities of the required safety net for retrenched soldiers—I encourage the authorities to spare no efforts in carrying out all necessary actions in this respect.

The public resource management and the need to improve governance, notably with regards to forestry and logging, is a second area where the authorities need to concentrate, as it appears that such an essential natural resource for the economy has been suffering a severe degradation due to the poor governance exercised since the mid-1990s. In this respect, I encourage the authorities to comply with their objectives to develop a sustainable, socially responsible and economically viable sector.

As stated in Mrs. Hetrakul's comprehensive preliminary statement, illegal logging activities outside official concessions have been sharply reduced through the establishment of a Forest Crime Monitoring Unit, the cancellation of all log collection permits for illegal felled logs, and all concession contracts. All these measures have certainly been steps in the right direction. However, much more remains to be done to successfully complete the forestry reform. Strengthening the legal framework, by means of a revised Forestry Law and the reform of the concession management—started by the halt in granting new concessions until it is finalized—will be crucial to establish a sound framework that enables managing sustainable logging.

Finally, Mr. Chairman, I would like to encourage the authorities to strengthen the efforts towards the banking sector reform and the development of a comprehensive Commercial Code, two crucial areas that will certainly help create the proper conditions for attracting the most needed private sector activity.

With these remarks, Mr. Chairman, I wish the authorities well.

Mr. Alosaimi made the following statement:

I welcome the progress made so far in Cambodia. The comprehensive reform that was adopted by the authorities early this year is noteworthy. Indeed, the authorities were able to take strong measures in many areas, especially in the forestry sector and fiscal management.

In light of improved track record of policy implementation, I join others in supporting the authorities' request for ESAF-supported arrangement,

which I believe would accelerate their efforts to restructure the economy and reduce poverty. However, given risks to the program, full and timely implementation of the agreed policies and reforms is critical for its success. Here, continued Fund technical assistance seems necessary for Cambodia.

With these remarks, I wish the authorities success.

Mrs. Hetrakul remarked that the authorities attached great importance to both fiscal and banking reforms, which they considered as central to ensuring economic sustainability. They were also committed to move ahead with reforms in the forestry sector, the military and the civil service, and would seek to raise revenues and reorient budget spending toward education and health in order to improve living conditions and reduce poverty.

The Executive Board took the following decision, with one abstention from Ms. Lissakers:

1. The government of Cambodia has requested a three-year arrangement under the Enhanced Structural Adjustment Facility in an amount equivalent to SDR 58.5 million.

2. The Fund notes the policy framework paper for the government of Cambodia set forth in EBD/99/119.

3. The Fund approves the arrangement set forth in EBS/99/188, Supplement 1.

Decision No. 12080-(99/118), adopted
October 22, 1999

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/99/117 (10/20/99) and EBM/99/118 (10/22/99).

4. TRANSFORMING ENHANCED STRUCTURAL ADJUSTMENT FACILITY INTO POVERTY REDUCTION AND GROWTH FACILITY

1. The name of the Enhanced Structural Adjustment Facility established by Decision No. 8757-(87/176) SAF/ESAF, adopted December 18, 1987, shall be changed to the "Poverty Reduction and Growth Facility."

2. The following changes shall be made to the Enhanced Structural Adjustment Facility Trust established by Decision No. 8759-(87/176) ESAF, adopted December 18, 1987:

(a) the name of the Trust shall be changed to the "Poverty Reduction and Growth Facility Trust"; accordingly, Paragraph 1 of Decision No. 8759 and the Title and Introductory Section of the Annex to that Decision, containing the Trust Instrument, shall be amended by substituting "Poverty Reduction and Growth Facility";

(b) Section I, Paragraph 1 of the Trust Instrument shall be amended to read as follows:

"The Trust shall assist in fulfilling the purposes of the Fund by providing loans on concessional terms (hereinafter called "Trust loans") to low-income developing members that qualify for assistance under this Instrument, in order to support programs to strengthen substantially and in a sustainable manner their balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty."

3. The name of the "Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF Subsidy Operations" shall be changed to the "Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations." Accordingly,

(a) Paragraphs 1 and 2 of Decision No. 11436-(97/10), adopted February 4, 1997, and the Title and Introductory Section of the Annex to that Decision containing the Trust Instrument, shall be amended by substituting "Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations" for "Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF Subsidy Operations."

(b) All references to "ESAF" in Section I, paragraphs 1(viii) and 1(ix), Section I, paragraph 2(b), Section III, paragraphs 1(a) and 1(b), and Section III, paragraph 2(c) of the Trust Instrument shall be changed to references to "PRGF."

4. References in other Fund decisions, instruments, agreements, or documents related to the Enhanced Structural Adjustment Facility, the Enhanced Structural Adjustment Facility Trust, or any of its Accounts, the ESAF, the ESAF Trust, the Trust for Special ESAF Operations for the Heavily Indebted Poor Countries and Interim ESAF Subsidy Operations, or the ESAF-HIPC Trust shall be understood to be to the Poverty Reduction and Growth Facility, the Poverty Reduction and Growth Facility Trust, or any of its Accounts, the PRGF, the PRGF Trust, the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations, or the PRGF-HIPC Trust, respectively.

5. This Decision shall become effective when all contributors to the ESAF Trust have consented to the changes. (EBS/99/193, 10/14/99)

Decision No. 12087-(99/118) PRGF, adopted
October 21, 1999
Effective November 22, 1999

5. MAURITANIA—ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from July 19, 1999, Mauritania has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/99/120, 10/13/99)

Decision No. 12081-(99/118), adopted
October 20, 1999

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBA M/99/144 (10/20/99) is approved.

APPROVAL: May 23, 2001

SHAILENDRA J. ANJARIA
Secretary