MASTER FILES

ROOM C-130 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/147

3:00 p.m., September 5, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
	M. Lundsager, Temporary
J. de Groote	
	A. H. Mustafa, Temporary
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
	O. Isleifsson, Temporary
M. Massé	L. Leonard
	P. E. Archibong, Temporary
F. L. Nebbia	
	A. Ouanes, Temporary
P. Pérez	
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	
	B. Tamami, Temporary
A. K. Sengupta	
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; M. Auberger, A. G. G. Bennett, P. Dhonte, H. B. Junz, J. Khallouf, G. A. Mackenzie, S. F. D. Powell, K.-W. Riechel. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; C. Brachet. Fiscal Affairs Department: A. H. Mansur. IMF Institute: J. H. Meyer, Participant. Legal Department: A. O. Liuksila. Research Department: F. Larsen. Treasurer's Department: D. Berthet. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: G. D. Hodgson, K. Murakami, G. Nguyen. Assistants to Executive Diretors: A. Bertuch-Samuels, J. de la Herrân, V. Govindarajan, G. K. Hodges, L. Hubloue, S. King, T. Morita, M. Rasyid, J. E. Rodríguez, V. Rousset, C. A. Salinas, G. Seyler, H. van der Burg.

1. FRANCE - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/146, 9/5/86) their consideration of the staff report for the 1986 Article IV consultation with France (SM/86/196, 8/8/86; Cor. 1, 9/3/86; and Sup. 1, 9/4/86). They also had before them a report on recent economic developments in France (SM/86/202, 8/18/86).

Mr. Nebbia made the following statement:

> This chair is pleased to note the further progress made by France in 1985 and in the first half of 1986 in reducing internal and external imbalances, in particular in those areas that were identified earlier as being cause for concern.
>
> Inflation has continued to decline, and the current trends suggest figures not much higher than 2 percent on an annual basis; business profitability has improved further, raising the nonlabor share of value added and the levels of fixed investment; the deficit of the General Government has been reduced, and the current account of the balance of payments is now expected to turn into surplus for the first time in this decade. All these developments reflect the appropriate stance of economic policies followed, since 1983, by the French authorities, as well as the improved external conditions now faced by the economy.
>
> We are also pleased to note from Mrs. Ploix's very useful statement that the French authorities have decided to take advantage of the favorable current circumstances to fully restore the competitiveness of enterprises while pursuing the fight against inflation, in order to promote growth through investment and to stimulate employment. In this regard, it is most encouraging to observe, among other measures, the recent removal of exchange controls, the price liberalization undertaken for most industrial prices, the Government's intention to privatize almost all state-owned enterprises, and the elimination of a number of rigidities affecting labor and financial markets. All these measures represent appropriate steps to further strengthen corporate profitability and to widen the scope for private sector business. This, in turn, should promote efficiency and higher levels of investment and may help in restoring a stronger foreign trade position for the economy.
>
> On the other side of the coin, unemployment remains the most worrisome aspect of the French economy, with a rate close to 10.5 percent recorded in July 1986. Together with wage moderation, increased levels of economic activity and the improved flexibility of the labor market should contribute to alleviate the situation. However, there is no doubt that given the magnitude of the problem, additional measures, or the intensification of the current ones, seem to be urgently required.

For instance, the emphasis that has been put on wage moderation should remain, so as to ensure that any increase in unit labor costs is maintained below the relevant increase in productivity. At the same time, labor mobility could be promoted toward sectors with higher productivity, and a flexibility in working hours, including fixed-term and part-time hiring, should also be encouraged. In addition to these measures, some of which have already been decided, it would be useful for the authorities to further explore the existing links between the high rate of youth unemployment in France and the existence of the minimum wage scheme. Appropriate educational programs oriented toward vocational training are certainly an additional means for fighting unemployment, although their benefits are of a longer-term maturity.

Having said this, let me now briefly turn to fiscal and trade policy issues. First, as mentioned by the staff, the main fiscal policy objective in 1985 was to contain the central government budget deficit at 3 percent of GDP. However, this target was exceeded and the deficit amounted to 3.3 percent of GDP, an outturn almost equal to that in the preceding year.

Beyond these figures we are more concerned with the appropriateness of the level of expenditures of the consolidated General Government, which remains close to 50 percent of GDP, indicating a degree of involvement of the public sector that is, in our view, incompatible with other goals pursued under current economic policy.

In this respect, we reiterate what we said in the 1985 Article IV consultation with France, namely, that there is a clear need for reducing public sector expenditures by means of reducing the size of the public sector, eliminating subsidies and other support operations, assuring public enterprises' viability, and, above all, transferring to the private sector those activities in which public sector involvement has proved to be inefficient in economic terms.

We welcome in this respect the Government's decision to privatize a large number of public enterprises, including some few banks, and we hope that the proceeds of all these asset sales will not be used to finance government spending but, basically, to redeem outstanding government debt. Such allocation will in turn reduce the interest component of the central government deficit and, therefore, will make less difficult the achievement of an effective reduction of its magnitude in the years to come.

Regarding trade and commercial practices, we share the view of the staff that France should play a major role in promoting, within the European Community, a greater liberalization of markets and trade restrictions to third countries' suppliers, and we regret the fact that many important sections of domestic and foreign trade remain subject to subsidies and trade restrictions. Some of them, particularly the ones relating to agricultural products, are having disruptive consequences in world markets and have induced severe distortions in the domestic resource allocation process.

We recognize that the French authorities formulate their trade policies within the European Community framework, but there is a perception that France is one of the most protectionist in this group. Further, and even considering that this argument may constitute an effective legal or political shield against the charges for applying protectionist policies, it does not solve the already mentioned distortions and disruptive effects on trade flows. I would agree with Mr. Massé on the "gentleness" of the staff treatment of this subject, a treatment which I find in every paper prepared by the European Department.

At the time of the Article IV consultation of another EC member country in July, this chair requested a more in-depth analysis of EC protectionism and its implications for world trade. It seems that our request was not taken into account.

My authorities are following with particular attention and concern the reluctance of the French authorities to accept a broad treatment of trade of agricultural products in the next GATT round. We urge them to review their attitude.

France has taken a very helpful approach toward a better resolution of the debt problem and to the rationalization of the international monetary system; consistency with this position should be demonstrated in the most important way to solve the debt problem, which is trade.

I should add that the current improvement in the competitiveness of French enterprises in a number of sectors, as well as the overall increased profitability of these enterprises now provides a sound basis for further efforts on the part of the French authorities to reduce tariff and nontariff barriers to imports. Finally, this chair welcomes, and continues to underscore, the fact that France's official development assistance has remained at relatively high levels.

Mr. Huang made the following statement:

The French economy has continued to improve over the past year. Most notably, inflation decelerated further; in July 1986, it was 2 percent, which presented a marked contrast from the 12 percent rate just four years ago. Fixed business investment has picked up substantially, pointing to fine prospects for future growth. The stance of economic policies has been well grounded, and the abolition of credit ceilings and the easing in labor market regulations and exchange controls, among others, are particularly noteworthy policy actions aimed at eliminating the rigidities of the economy. The determination of the French authorities to pursue such extensive liberalization is impressive indeed. Since I am in broad agreement with the staff's appraisal, I will confine myself to only a few observations.

First, as Mrs. Ploix's informative statement indicates, the French authorities have placed a high priority on restoring the competitiveness of French enterprises. This is all the more important in view of France's weak external position, unsatisfactory performance of exports, and loss in export market shares. In this regard, the devaluation of the franc and the deregulation of exchange controls are timely actions to reverse the trend. In addition to these measures, further reductions in the unit cost of export goods, in my view, may well be called for.

Second, I am pleased to see that some positive measures have been taken in the area of employment. Great use has been made of hiring fixed-term and part-time workers, and this has particularly benefited young laborers. However, prospects for employment in the industrial sector remain bleak, and I believe that a further extension of the training programs would be conducive to improving the employment situation.

Finally, I would like to express my appreciation for France's continuing commitment to a relatively high level of official development assistance, and I wish the French authorities every success in their pursuit of economic liberalization.

Mr. Archibong made the following statement:

The French authorities must be commended for successfully reducing the fiscal deficit from 2.9 percent of GDP in 1984 to 2.6 percent of GDP in 1985. Much of the burden of fiscal adjustment fell on the expenditure side of the budget, where some of the measures included abolition of numerous posts in the public sector and further cuts in subsidies to industry. The authorities have further committed themselves to eliminate the deficit by 1989, except for debt service payments, which is a fairly ambitious objective. This means persistence with restrictive fiscal policy, which might produce a contractionary effect on GDP in a period when the economy is below its potential growth. It is comforting in this connection to note the authorities' intention to accompany expenditure cutbacks with tax reductions. All cuts in personal income taxes and in the corporation tax are aimed at stimulating private initiative.

Full expression of this initiative will be somewhat frustrated so long as social security contributions continue to increase unchecked. Indeed, of the G-5 countries, France had the highest share of social security contributions in total tax revenue, and about half of the rise in the tax burden in recent years was caused by such increases. This clearly underscores the need for reforming the system. It is hoped that the ongoing study of the possibility of complementing the present pay-as-you-go pension system with a voluntary capitalization system based on a retirement savings plan would provide a better solution to the existing heavy burdens of the social security system.

Mrs. Ploix's update on recent developments in France reveals a more rapid process of liberalization of the economy than could be gleaned from the staff reports. Among other things, industrial prices have been decontrolled, while rigidities in the labor market are being tackled more imaginatively. These measures, coupled with the streamlining of industrial policies, could strengthen investment and promote competition.

So far as monetary developments are concerned, I consider the projected growth of the money supply, together with the planned reduction in the financing of the budget, appropriate and consistent with the projected growth in nominal GDP. The redefinition of monetary aggregates that has been undertaken appears to be a useful step in the ongoing process of streamlining the financial system. The monitoring of monetary developments will not be more effective, and the relationship of such developments with economic activity will become clearer. In the same context of streamlining the financial system, the authorities have abolished the detailed credit controls which, for some 15 years, had been a crucial element of French economic management, constituting a major source of distortions and rigidities. I tend to agree with Mrs. Ploix that the transformation that is taking place in the French financial sector is tantamount to "a quiet revolution" which will facilitate adjustment and enhance the competitiveness of the economy. However, the authorities should be fully aware of the uncertainties that can arise from such major changes in financial management and should do everything possible to reassure economic agents and encourage risk takers.

As pointed out on page 13 of the staff report, available evidence indicated limited responsiveness of investment in France to changes in interest rates. In the circumstances, there is merit in the staff suggestion that the formulation of monetary targets should be based on a rather broad range of indicators, which should include developments in the credit aggregates, the balance of payments, and the main monetary aggregates rather than laying too much stress on interest rates.

So far as inflation is concerned, one can note with great satisfaction the progress that has been made. As a result of declining energy prices and the various measures that have been taken, the general price level has abated such that the gap between inflation in France and that in the main trading partners has virtually been eliminated. This welcome improvement must be maintained as a necessary step toward restoring the competitiveness of French industry. In this connection, one finds good justification for the authorities' continued emphasis on wage restraint even in the face of improved profitability of enterprises. Indeed, for investment to be increased to levels that can lead to a long-term decline in unemployment (a serious problem in France), increases in real wages should be kept below increases in productivity. I therefore agree with the staff that, with the enterprise sector in France characterized by heavy indebtedness, more effort should be made to shift the distribution of income in favor of profits. Much, of course, depends on the vigorous pursuit of measures to improve flexibility in the labor market and on continued cooperation between trade unions and employers' organizations, particularly in streamlining wage negotiation procedures.

Finally, my authorities warmly welcome France's support for a new round of trade negotiations and strongly urge her to press for the elimination of trade restrictions and other protectionist practices. We also welcome the maintenance by France of official development assistance of a relatively high level of 0.54 percent of GDP. While urging the authorities to increase ODA toward the UN target, we would ask Mrs. Ploix to extend to her authorities the best wishes of this chair for total success in their determined effort to improve competitiveness and revitalize the French economy.

Mr. Mustafa made the following statement:

The trends under way in the French economy since 1983 have largely continued during 1985 and early 1986. Two positive developments that stand out are the deceleration of inflation and the recovery of business fixed investment. However, the growth of real GDP remained low and lagged behind the increase in domestic demand, thereby leading to higher imports and unemployment. The fiscal deficit as a percent of GDP recorded a further decline despite a reduction in the tax burden, and monetary expansion was also reduced. The external current account showed a further improvement, but the growth of imports and exports entailed a higher trade deficit, which reflected the inadequate competitiveness of the French economy.

Economic policymaking in France has emphasized in recent years the attainment of lower inflation and a stronger external position with some notable success. However, economic performance in terms of growth and job creation has continued to be weak. At a rate of above 10 percent, unemployment could be considered a serious problem. The challenge to economic policymaking in France in the period ahead is to strike an appropriate balance between these somewhat conflicting objectives. In an effort do so so, the authorities are emphasizing as intermediate policy objectives both improvement in competitiveness and increasing the share of investment in GDP. The general stance of policies being pursued to improve competitiveness and promote investment is by and large appropriate, but flexibility in relation to the appropriate mix of policies and the pace of policy adjustments may be warranted. As an example, improvement in competitiveness requires improved inflation performance. A good part of the deceleration in inflation that has taken place so far can be attributed to a decline in import prices and wage moderation. Further improvement in inflation would appear to require adequately restrained financial policies, but that might have a further depressing effect on domestic demand, output, and employment. Nevertheless, as competitiveness improves, faster growth in output and employment would be expected as a result of higher export growth and a shift in domestic demand away from imports.

Another example of the need for flexibility in policymaking can be shown in the area of investment. The recovery in investment has been mostly of a capital deepening nature, which might aggravate the unemployment situation before contributing to higher employment through improving competitiveness. The promotion of investment of a capital widening nature could contribute directly to job creation and lowering of unemployment. Clearly, the promotion of both types of investment is needed given the current economic situation in France.

The incomes policies pursued by the authorities have been instrumental in moderating wage increases and thus contributing to lower inflation as well as to a shift in the distribution of income in favor of profits with clear implications for improving competitiveness and promoting investment. It deserves to be noted, however, that against the background of liberalization of price controls, it would be difficult for incomes policies to achieve successes that are not supported by the stance of financial policies.

Fiscal policy is focusing on restraining expenditure to reduce both the budget deficit and the tax burden. At this level, the stance of fiscal policy appears generally appropriate. However, the specific measures of expenditure cuts include a reduction of 1.5 percent of public sector employment, no increase in public sector investment, and a reduction in subsidies to industry, including interest rate subsidies. Needless to say, these measures are likely to have a negative impact, at least in the short run, on employment and investment, though the measures in question could contribute to both higher employment and investment over the medium term by improving overall efficiency and competitiveness of the economy.

The shift in recent years toward more restrictive monetary policy has been maintained with a target of monetary expansion for 1986 set in terms of M3 at a rate slightly below nominal GDP growth. However, it may be advisable to be flexible with regard to meeting the private sector demand for credit in a manner consistent with the projected increase in investment. On a different point, the conduct of monetary policy might become more difficult in the period ahead due to financial innovation and the intended abolition of credit ceilings in favor of greater reliance on interest rate management as a tool of monetary control. The emerging transitional difficulties could be eased somewhat by the planned use of the reserve base as an instrument of monetary control to affect the liquidity of banks. It deserves also to be noted from Mrs. Ploix's informative statement that the authorities are receptive to the staff's suggestion that a range of indicators be used when setting the monetary targets.

The French authorities have continued to emphasize the importance of a number of structural reforms that are being undertaken within a framework of economic liberalization, with the objective of promoting growth at a time of financial restraint. These include liberalization of price controls, reform of the financial system, lifting of exchange controls, privatization of public enterprises, new procedures for wage negotiations, measures to increase flexibility of the labor market, and elimination of rent controls. There are clear advantages to these reforms in terms of improving economic efficiency and competitiveness of the French economy in a medium-term context. However, some of these reforms, particularly the extensive privatization program, may entail transitional costs by affecting adversely growth and employment. Therefore, efforts should be made to carry out the privatization program in a manner conducive to limiting potential transitional costs. It is also particularly important to establish a national policy that would avoid shifting enterprises back and forth between the public and the private sectors.

Regarding external policies, the responsiveness of imports to increases in domestic demand and a decline in the share of French exports in the total exports of industrial countries reflect the inadequate competitiveness of the French economy. Substantial improvements in competitiveness are expected in the period ahead as a result of the devaluation of the franc in April 1986 as well as the aforementioned financial and structural policies. In the area of trade policy, the staff has noted that the EC agricultural policy has continued to afford very substantial protection to the agricultural sector. The staff has also noted the absence of new protectionist measures since last year, but has observed that protectionist pressures have not subsided either. Finally, the French authorities deserve to be commended for maintaining ODA at a relatively high level.

The Director of the European Department recalled that questions had been raised about differences between the growth estimates of the French authorities and those of the Fund staff. Originally, the French authorities had forecast a 3 percent rate of growth in GDP for 1987 against the staff's estimate of a 2.2 percent rate of increase. According to press reports, the French authorities had recently reduced their estimate to 2.8 percent. The remaining gap seemed to be primarily due to differences in perception about the growth of export markets and about France's likely share in those markets in 1987.

In response to those who had queried the staff's choice of tools for measuring real rates of interest, the Director noted that the use of the GDP deflator rather than the consumer price index might well have produced a lower real rate of interest for 1986 than that projected in the staff report; on that basis the difference between the behavior of real rates in Germany and in France would have been sharper in 1986 because of the differences of the effects of changes in the terms of trade in the CPI indices of the two countries. The explanation was related to the greater relative weight of oil imports in Germany than in France, which was partly a result of the relatively heavy dependence of the French energy sector on nuclear production; the result of the exchange rate change of April 1986 was another part of the explanation.

Two Directors had expressed regret that medium-term scenarios--perhaps covering fiscal developments or the interrelationships between productivity, investment, and growth--had not been included in the staff report, the Director recalled. With the encouragement of the Chairman, the staff had put forward medium-term scenarios when a stand-by arrangement with Turkey had been under consideration at the beginning of the current decade and had subsequently sought to use such scenarios where it seemed clear that significant problems could arise in the medium term and the risks could perhaps be more sharply illustrated by scenarios. The staff had deliberately eschewed the use of medium-term scenarios when no such problems were anticipated, particularly when the constraints and priorities of work made the thoughtful elaboration of such scenarios very difficult.

Observing that the figures for the second quarter of 1986 gave a number of Executive Directors some pause, the Director remarked that it was unclear at present whether the figures represented only a temporary surge that would even out in due course or whether they represented a more sustained strengthening of investment and consumption. If the latter, questions could well be raised about the appropriate policy response; indeed, if consumption demand in particular remained strong, the time period over which the budget deficit was to be reduced might need to be re-examined.

He was unable to provide a satisfactory answer to the questions on the relationship between interest rates and investment in France, the Director continued. Despite a great deal of detailed econometric work, neither INSEE nor the Prevision had been able to find satisfactory econometric evidence to suggest any meaningful impact of interest rate changes on investment. Indeed, some of the calculations suggested that a 1 percentage point reduction in real interest rates would lead to only a 1 percent increase in the level of investment. The same sort of picture was painted by some of the commercial bankers in France, who professed that they saw no evidence that productive investment of the sort that they were prepared to finance was being choked off by present levels of interest rates. The Fund staff had been careful to avoid any firm judgment that interest rate changes had no meaningful impact on investment, feeling that the argument was not proven; it was fair to say that most French officials felt the same way. Common sense would seem to suggest some such relationship, even if that relationship could not be demonstrated by the econometric evidence unearthed thus far. On a related matter, Mr. de Groote had rightly emphasized the implications for the entire world economic outlook analysis if the relationship between interest rates and investment was negligible.

There had been virtually unanimous agreement that wage restraint in France must be continued, and speakers had put emphasis on the behavior of unit labor costs, the Director remarked. France was not the only large industrial country that had recently been arguing that unit labor costs were not as good an indicator of competitiveness as the Fund staff seemed to believe. One of the pieces of evidence produced in France in support of that argument was the behavior of French exporters after recent devaluations of the franc. French exporters had chosen to make no adjustment to their prices quoted in foreign exchange and, as one French official had suggested, their behavior would seem to be myopic unless it could be explained by the fact that unit labor costs gave less than a complete picture of competitiveness and that French export profit margins were under much greater pressure than was suggested by the unit labor cost figures. As to the likely outturn in 1986 for wages, it seemed reasonable--especially, given the deceleration in wages that had occurred since 1983--to expect that the deceleration would be continued, particularly if the public sector example was again as strong as it had been in the past. There remained the unexplained behavior of consumers in the second quarter of 1986 and some lurking suspicion that an easing of the wage situation might have contributed to that development. The development of wages over the short to medium term was indeed a central question. The French strategy relied upon some increase in disposable income of households, but it would be preferable if that increase were to result from a reduction in personal income tax rather than any jump in wage pressures.

On the price situation, the Director said that it was his understanding that after the end of 1986, there would be no remaining formal restrictions on the prices of industrial goods and services. That having been said, there would of course remain prices that were administered, particularly those of the utilities, and there might be some gentlemen's agreements relating, for example, to some prices in the services sector.

The notion that job sharing might be an effective way of reducing unemployment in France might be justified if earnings were commensurately reduced, the Director commented. Calculations made in France on the course of real wages that would most likely lead to a stronger investment position and thus over time, to a stronger employment position took into account both the positive accelerator effect and the negative effects of the influence of higher real wages on profitability. The authorities did not place any great weight on these calculations; they regarded them more as the basis for an interesting debate. For what they were worth, the calculations suggested that the best way of achieving sustained future growth of investment would be 18 months of a considerable degree of wage restraint followed by a small but notable growth in real wages.

In her statement, Mrs. Ploix had noted that subsidies to industry and, perhaps, to exports had diminished sharply, while the staff, in its paper, had emphasized the existence of continued subsidies to agriculture and housing, which remained significantly large, the Director said. The subsidy to housing in 1985 had been equivalent to 0.5 percent of GDP, or F 27 billion. He agreed with those Directors who had noted that the French did not have a public sector borrowing requirement concept; indeed, the authorities took the view that the notion was not a particularly useful or meaningful one in the French context.

On the tax aims of the French authorities, the Director said that the intention was to improve incentives for both individuals and enterprises. It had been asked whether privatization would have any effect on the budget by diminishing subsidies. Unfortunately, it would not, because it was the more profitable of the nationalized industries that would be sold to the private sector.

The staff had no particular suggestions to make on the ways in which a faster reduction in public expenditure might be achieved, the Director remarked. The staff had noted in its report that the social security system was particularly vulnerable, and it was clear that either the amount of the benefits or the number of beneficiaries would need to be reduced, unless contributions were to be increased again. France had been successful in the recent past in reducing expenditures on health care, despite the political difficulty of such a move. It was to be hoped that the authorities' success in cutting health care expenditures would encourage them to apply similar restraint in other areas.

On monetary policy, the French authorities were seeking to use the interest rate for exchange rate purposes while looking for some other instrument to control or rather to influence the money supply, the Director commented. The French approach posed an interesting problem, which might be clarified by a deliberate exaggeration. For instance, putting the point in the simplest terms, monetary policy in Germany was regarded as influencing domestic price behavior whereas in France, it was seen as influencing the exchange rate of the franc against the deutsche mark. Such a distinction was most probably exaggerated, but it had some logical basis. German monetary policy had over the years contributed to a successful price performance, and other members of the European Monetary System (EMS) had made the choice to gear exchange rates to the deutsche mark; given such a decision their monetary policy had to be aimed mainly at influencing the exchange rate. What the French were seeking was some instrument by which they could at the same time influence developments in their monetary aggregates, and they had centered on reserve requirements. As Mr. Zecchini had rightly noted, however, care must be taken with such an instrument, as frequent changes could pose considerable difficulties for the banking system. Moreover, if considerable amounts of reserves had to be held, that could lead to problems of disintermediation and to disparities in borrowing and deposit costs. Of course, it was precisely those disparities that the French authorities might wish to make use of at times of sizable capital flows.

It was worth noting that the French banks were facing considerable challenges brought on not only by the liberalization of the financial system but also by the sharp improvement in company profits, the Director continued. The self-financing ratio in France had been rising, and with the ability of large firms to finance themselves on the commercial market--thereby short circuiting the banking system--the banks faced a falloff in demand for loans. Faced with high fixed costs, the French banks had to find alternative uses for their deposits while at the same time attempting to cut costs. The market for consumer credit in France was relatively undeveloped and if the banks sought to develop the market, although at a time when profits were improving and price controls were ending, the effect on private consumption and on prices could be undesirable.

Remarking on the privatization of public sector enterprises, the Director noted that, at least in theory, the behavior of public and private companies could be similar. In that respect, one could point to the enviable past record of Renault as a producer of automobiles. However, as one Director had noted, the State often brought additional considerations to bear on the behavior of nationalized industries that were inimical to economic efficiency. As to the appropriate rate of privatization and the capacity of the markets to absorb it, two points were worth making. First, privatization would involve to a considerable extent a switching of securities, because it was the authorities' intention to use the proceeds of sales to redeem government debt and because the nationalized industries had increasingly issued nonvoting shares that would be able to be surrendered in exchange for equities under the proposals currently under consideration. In that respect, the effects on market capacity would be largely neutral. Second, it was important to note that equity financing played a relatively smaller role in France than in a number of other major industrial countries, a point that could lead one to the view that there might be pent up demand for equities in France, especially given the improved profit position.

On agricultural policy, the staff took the view that the support of agricultural prices, as practiced in the EEC and in other countries, led to serious distortions in resource allocation and was inimical to the play of comparative advantage, the Director commented. Certainly, the staff had sought to bring that point to the attention of the relevant authorities in EC countries and elsewhere. Of course, it was also useful to recall that there were other pressures, which had contributed to the relatively moderate adjustment in agricultural prices in the EC in 1985, and thus to a deceleration of prices in France. In fact, the French authorities calculated that about one third of the deceleration of prices in 1985 had been due to a lesser push from agricultural prices than might otherwise have been expected. Moreover, protectionism carried costs for national budgets and thus for consumers generally and that had to lead over time to pressure groups that would seek to counter the plans of the agricultural lobby. Finally, it could not be ignored that the degree of agricultural protectionism in the EC had led to some curious anomalies, including for instance, the fact that countries such as Germany and the United Kingdom had become agricultural exporters.

Remarking on exchange controls, the Director commented that the staff felt there should be no substantial additional threat to the French capital account from the abolition of the remaining exchange controls, although that view had not yet been sufficient to quell the natural psychological fears of the French authorities. There had been past occasions in France when exchange controls had been removed and had later had to be reimposed; and that experience had left scars. Moreover, the recent weakening of the French franc against the deutsche mark had to be a cause for concern for the French authorities; worries on that score could lead to concerns about the level of French interest rates. In that respect, the authorities' caution about removing controls was understandable.

Mrs. Ploix noted that her authorities remained committed to abolishing exchange controls, despite their natural concerns. As for the removal of price controls, it must be remembered that in all countries, at least 25 percent of prices were administered. In France, the liberalization effort would continue, although there were some areas--including public enterprises--where prices would remain controlled. In the services area, it should be understood that the aim was to develop competition, and the pace of liberalization would be determined with that aim in mind.

On a related matter, Mr. Fujino had asked what the French authorities understood by the term "modern management of competition," Mrs. Ploix continued. The regulation of competition in France dated from 1947, and it had been slightly expanded in 1973. However, since that time, the economy had developed considerably, and the system of distribution had been renovated. To provide better competition and to facilitate greater liberalization of price controls were the goals of the modernization of regulations currently under way.

In response to those concerned about the pace of privatization of public sector enterprises, Mrs. Ploix observed that that process would be initiated for three enterprises before the end of 1986. As for concerns about market capacity and the limited share of foreigners, she reiterated the point stressed in her earlier statement that France was open to foreign investment.

To those who had raised questions about wages, employment, and the minimum wage, Mrs. Ploix remarked, first, that the OECD had shown that the minimum wage was not an obstacle to the development of employment, despite the belief of the Fund staff that the minimum wage represented an element of rigidity in the labor market. It should perhaps be noted that since the beginning of 1986, the average hourly wage had increased faster than the minimum wage. She agreed with Mr. Massé, Mr. Lundstrom, and others that innovations in the employment area were needed, and all suggestions for innovation were welcome. In that context, the public utilities begun in 1984 had adapted to a Scandinavian model. As to whether the policy of wage moderation and the aim of achieving flexibility in determining wages were compatible, France's experience was positive. The two policies had been initiated at the same time, were conducted in parallel, and had produced encouraging results. Furthermore, it must be remembered that in France, the weight of the public sector--even after privatization--would be considerable; and it was important for the Government to give the proper signal for wage determination by playing a meaningful role in the wage negotiations in the public sector enterprises.

In raising questions on investment, Mr. Dallara had wondered whether the weight of the professional tax was not too much of a burden on the profitability of enterprises and whether it had not in some way constrained investment by those enterprises, Mrs. Ploix recalled. While the professional tax was an important one in France--bringing in some F 70 billion--it did not seem to be a decisive element in the moderate progression of investment, which had improved markedly between 1982 and 1985 and was projected to continue to improve in 1986 and in 1987. The level of enterprise savings had also increased. As to whether decreasing interest rates could promote investment, she could only agree with the staff's explanation. Her authorities were convinced that interest rates were not particularly influential, since the part of investment financed by borrowing was on the decline, with investment increasingly being determined by volume and price outlook.

The new instruments of monetary policy in France would basically be interest rates and reserve requirements, Mrs. Ploix commented. Under the reorganization of the system, the Bank of France would determine a reference rate--and publish it at the end of the day--after consulting with a number of other banks. Also, the Bank of France would continue to intervene in the market, but the intervention would be by different means, perhaps along the lines of methods used in the Netherlands.

Finally, on budgetary policy, Mrs. Ploix observed that the social security issue was under study. On subsidies, she had no precise figures for agriculture but could indicate that considerable price declines had taken place in recent years and that a quota policy had been established in the dairy industry. Subsidies on housing in the 1986 budget had been substantially reduced, as had aid to enterprises and exports. The aim was to make trading as competitive as possible. For example, the cost of export discounts had fallen from F 12.8 billion in 1983 to F 5 billion in 1986 and a projected F 4.1 billion in 1987.

Mr. Nebbia said that he continued to be concerned about the weaknesses of staff criticism of trade policies as conducted within the European Community, given the importance to world trade of agricultural products of the sort exported by France. Fortunately, others were making an effort to discourage such subsidies, but the Fund should be doing its fair share. The Fund's world economic outlook projections were rather bleak, and he believed that the staff should take every opportunity to point out to Fund members the implications of their policies.

The Executive Board took note of Mr. Nebbia's observation.

The Chairman made the following summing up:

Executive Directors commended the French authorities for the further progress that had been achieved in reducing the rate of inflation, providing profitability, and encouraging enterprise investment. They also congratulated the authorities on the introduction of a wide range of liberalization measures designed to improve the flexibility of the economy and to stimulate growth in the medium term. Nevertheless, Directors noted that, despite lower import prices, France's external current account position remained vulnerable, so that rigorous demand policies would have to be maintained. The loss of export market shares highlighted the constraints on competitiveness and capacity in French industry. While the profitability of enterprises had improved since 1982, rates of return on capital were still below the levels achieved before the first oil shock, and appeared insufficient to accommodate the sustained increase in investment that was essential to improve the supply position of French industry and to reduce unemployment.

Directors commented that the recent realignment of the franc within the European Monetary System had been useful to restore competitiveness and create the conditions for a relaxation of exchange controls. However, although progress had been made recently, several Directors noted that the continuing adverse inflation differential between France and Germany emphasized the need for domestic adjustment.

Directors observed that the greater flexibility in wage formation in recent years had been central to the progress made toward restoring internal and external balance in the economy. They emphasized that continued moderation in wages was still necessary to shift the distribution of income in favor of profits and that real wages had to grow at a slower rate than productivity.

Directors also stressed the need for strict fiscal policies. They supported the authorities' aim of reducing both the central government financial deficit and the overall tax burden over the coming years. Directors generally supported the present fiscal stance, but some of them wondered whether it was sufficiently ambitious to create room for an expansion of productive investment without endangering the external accounts, especially if domestic demand continued to show signs of buoyancy. Many Directors underscored the importance of rigorous curbs on government outlays for subsidies and transfers and noted that that was an objective of the 1987 budget. They indicated that reductions in public sector expenditures ought to play the major role in lightening the tax burden.

While welcoming the authorities' intention of reducing the overall tax burden, Directors noted that, despite the aim in the 1985 budget to reduce that burden by 1 percentage point, it had actually risen in 1985 to its highest level. Several Directors argued that the burden of taxes had to be decreased if unemployment was to be reduced and incentives were to be restored over the next few years. In that context, a number of Directors advocated that the burden of taxation be shifted away from direct taxes on labor and corporations.

Directors noted with concern that the prospective financing difficulties of the social security accounts had recently led to a new increase in contribution rates. They argued that those difficulties should be corrected by savings in expenditures rather than by increases in contribution rates. Ongoing studies on a reform of the pension system were welcomed.

Directors welcomed the decision to privatize a number of public sector enterprises and stressed the need to ensure that, once privatized, such enterprises would be subject to effective competitive pressures. Several Directors suggested the need for caution in the use of any proceeds from privatization to finance increased state aid to those enterprises still in the public sector, and took note of the assurances given by the authorities in that respect.

Directors welcomed the move away from, and the prospective abolition of, administrative credit ceilings as the main instrument of monetary control, as well as the many steps that had been taken to liberalize the French financial system. While some Directors noted the high level of real interest rates, Directors generally agreed that a prudent management of interest rates was essential to the external balance, and that a lasting reduction in interest rates could not be achieved in disregard of that constraint. Directors recommended that monetary policy remain cautious. In the light of the possible distortionary effects of financial innovation and deregulation of the monetary aggregates, they also recommended that a wide range of indicators be used to monitor monetary developments in 1987.

Directors commended the authorities on the wide-ranging measures that had already been taken or had been announced to liberalize many aspects of economic life in France. The decisions to remove almost all exchange controls as well as a wide range of price controls, including those on services, and to ease rent controls, were all noted with approval. Directors indicated that they looked forward to the early lifting of the remaining exchange controls, which appeared to be ineffective to prevent capital outflows. The abrogation of the law requiring administrative approval for layoffs of employees from the beginning of 1987 was welcomed. Directors remarked that further action to remove other impediments to labor market flexibility--for example, the minimum wage that militated against hiring, particularly of young workers; restrictions on flexible work patterns; the inadequacy of vocational training--would in any case be required and could contribute over time to the reduction of unemployment.

Directors generally welcomed France's support for a new round of GATT talks on trade, and called for action, particularly in the sensitive area of agriculture. A number of Directors expressed dissatisfaction with the protectionist thrust of the agricultural policy of the European Communities and urged France to work more actively to reduce trade restrictions and subsidies both within the European Communities and at a national level. Finally, Directors commended the authorities for the maintenance of official development assistance at a comparatively high level and for their most constructive role in furthering the debt strategy in the framework of the Paris Club.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/146 (9/5/86) and EBM/86/147 (9/5/86).

2. POLAND - REPRESENTATIVE RATE FOR THE POLISH ZLOTY

The Fund finds, after consultation with the authorities of Poland, that the representative rate under Rule O-2(b)(i) for the Polish zloty against the U.S. dollar is the midpoint of the buying and selling rates for spot delivery of U.S. dollars in the official exchange markets quoted by the National Bank of Poland. The National Bank of Poland will promptly inform the Fund of any change in the representative rate. (EBD/86/237, 9/2/86)

Decision No. 8382-(86/147) G/S, adopted
September 5, 1986

APPROVED: May 14, 1987

LEO VAN HOUTVEN
Secretary