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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/146

10:00 a.m., September 5, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
	M. B. Chatah, Temporary
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
	O. Isleifsson, Temporary
M. Massé	L. Leonard
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	G. Ortiz
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	
	H. Alaoui-Abdallaoui, Temporary
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

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, K. B. Dillon. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: G. M. Teyssier, Director; J. H. Meyer, Participant. Legal Department: A. O. Liuksila. Research Department: M. D. Knight, F. Larsen. Western Hemisphere Department: S. T. Beza, Associate Director; J. P. Pujol. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, G. D. Hodgson, K. Murakami, G. Nguyen, A. Ouanes, D. C. Templeman, K. Yao. Assistants to Executive Directors: A. Bertuch-Samuels, O. S.-M. Bethel, J. de la Herrán, V. Govindarajan, G. K. Hodges, L. Hubloue, Z. b. Ismail, S. King, M. Lundsager, A. H. Mustafa, W. K. Parmena, M. Rasyid, J. E. Rodríguez, V. Rousset, C. A. Salinas, G. Seyler, B. Tamami, H. van der Burg.

1. MEXICO - REPORT BY MANAGING DIRECTOR

The Chairman recalled that the examination of the staff report for the 1986 Article IV consultation with Mexico and Mexico's request for a stand-by arrangement had been placed on the Board's agenda for Monday, September 8. The date had been chosen for two reasons: first, it was the outside date for the completion of the Article IV consultation process; second, it had been felt in July that it might prove possible by September 8 to obtain the critical mass of financing from the bankers that would permit a full-fledged discussion of the stand-by arrangement. The first reason remained valid; the second was less so, because the discussions in July/August of the bridging finance had taken more time than had originally been envisaged and had delayed the beginning of discussions on the financial conditions for the main package. As a result, the critical mass of financing was not yet available.

The management and staff had been reflecting on the best way to deal with the situation and the possible implications for the September 8 discussion, the Chairman continued. He would propose keeping both the Article IV consultation and the stand-by request as items on the agenda for September 8 on the understanding that, since the financing for the program was not yet available, a decision on the stand-by request would have to be a decision in principle. The feeling was that, on the whole, there would be more advantages to keeping the date of the meeting as initially set than to delay the Board's consideration of the request. In fact, retaining the original schedule would encourage those negotiating the financial package to finalize their discussions as quickly as possible. If it could be shown that the Executive Board had approved the design and structure of the program--which would enable the Paris Club to deal with the matter of official rescheduling for Mexico at its meeting of September 15--then the road toward full financing would have been more fully cleared, with the Fund, the World Bank, and the Paris Club having done all they could do to bring the stand-by arrangement to fruition. That would increase the pressure on the bankers and the Mexican authorities to bring their negotiations to a successful conclusion.

If the matters in question were to be taken off the Board's agenda on September 8, the Fund might create the impression that it was stalling, the Chairman commented. The Paris Club would then be unable to deal with the rescheduling, and the Fund would have triggered a delay in the entire process that might make it impossible for agreement to be reached even on the official part of the financing before the Annual Meetings. Moreover, the Mexican authorities had indicated that a decision to delay the examination of Mexico's request for a stand-by arrangement would be interpreted domestically as a negative element in the process.

While the taking of decisions in principle was supposed to be exceptional, it was probably the appropriate course to follow in the Mexican case, the Chairman continued. On September 8, the Board could discuss the precise modalities of the procedure and what sort of timing the Board would wish to attach to the decision in principle that would be taken on the day of the meeting. The maximum period allowable under the rules was 30 days; his own feeling was that a period of about 3 weeks should be sufficient in order to conclude matters before the beginning of the 1986 Annual Meetings. In sum, he was proposing at the present meeting only that Executive Directors agree to keep the matter of Mexico's request for a stand-by arrangement and the 1986 Article IV consultation on the Board's agenda for Monday, September 8.

Mr. Ortiz considered that it was important to follow the procedure outlined by the Chairman, particularly given the mid-September scheduling of the Paris Club meetings. As his colleagues were aware, the Mexican authorities had initially been reluctant to approach the Paris Club for debt rescheduling; since they had been convinced of the necessity to do so, it was important to follow through on the matter and maintain the momentum toward attaining the full financial package. It would also be important for domestic reasons for the Executive Board to give its approval to the Mexican program.

Mr. Fujino recalled that at the time of the discussion of the "approval in principle" procedure, his chair had indicated the need for caution in applying the procedure. However, in view of the explanation provided by the Chairman and Mr. Ortiz, he could go along with the approach outlined by the Chairman, emphasizing, nonetheless, that he expected the negotiations between the banks and the Mexican authorities to be completed in a timely manner.

Mr. de Groote said that he too agreed that it would be wise to hold a discussion on Mexico on Monday, September 8. Whether or not a decision in principle was called for was irrelevant; the meeting would be the best way to show the other parties to the financing "game" that the Fund and the World Bank were doing their part and that the pressure was thus on the others to play their respective roles.

Mrs. Ploix said that she could go along with the Chairman's proposal; it was important to show that the Fund, the World Bank, and the Paris Club had fulfilled their commitments so that the commercial banks would feel the pressure to play their role in putting together the rest of the financing package.

Mr. Massé observed that the longer the discussion on Mexico was delayed, the more difficult it would be to maintain cohesion among the banks; in the circumstances, he would favor a decision in principle on the stand-by arrangement for Mexico as soon as possible.

Mr. Zecchini agreed with others that, given the stage that had been reached in the preparation of the program, and in light of the many innovative aspects of the program, it was important for the Fund to send a clear message to the Mexican authorities and to the banking community about its position on the matter. Hence, he could support discussing the stand-by arrangement for Mexico on Monday, September 8 as a way of clearing up any doubts that some might have about the Board's attitude toward the program.

Mr. Hospedales, Mr Huang, and Mr. Nebbia supported the procedure outlined by the Chairman.

Mr. Kafka said, like others, he believed there was merit in holding the discussion on September 8. Although he agreed with those who felt that caution should be employed in applying the "approval in principle" procedure, he believed that the Board should not shy away from using the procedure when circumstances warranted and when there was a clear advantage to doing so.

Mr. Dallara noted that, as the Chairman and others had stressed, the "approval in principle" procedure had been intended for use on a limited basis in particular circumstances. It had not, to his knowledge, yet been used in circumstances involving a major debtor rather heavily dependent on private commercial financing. Hence, he would approach the use of the procedure in Mexico's case with some caution, particularly given the rather slow pace of discussions between the Mexican authorities and the commercial banks in developing the financing needed to support the program. Nonetheless, given that a decision in principle by the Executive Board on September 8 might facilitate and foster those discussions between Mexico and the commercial banks, he was prepared to go along with the approach outlined by the Chairman.

Following a brief discussion it was accepted that the 1986 Article IV consultation with Mexico and the request for a stand-by arrangement would remain on the Board's agenda for Monday, September 8, 1986.

2. FRANCE - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered 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).

Mrs. Ploix made the following statement:

First, I would like to thank Mr. Whittome's team for the excellent summary of France's economic situation and for the very positive assessment of the economic measures taken by my authorities.

Recent developments in France make it necessary to analyze the results of 1985 in the light of the prospects opened by the policy of economic liberalization pursued since March 1986. Elimination of rigidities, urged by Fund staff and noted by Executive Directors during last year's meeting, lies at the core of my authorities' economic policy. The goal is to restore the competitiveness of enterprises while pursuing the fight against inflation, in order to stimulate investment, employment, and the pursuit of balance of payments recovery. The many economic policy decisions made over the last six months move us toward this goal.

During the discussions in Paris, the Fund staff noted that the weakness of French foreign trade and the weakness of investment were two sides of the same coin: the deteriorating competitiveness of French firms. The Government is setting up a framework of economic liberalization that will be completed by the end of the year. This creates a highly novel situation for our economy, which is designed to restore the competitiveness of businesses and thereby promote growth through investment.

A number of major controls are being eliminated.

- The removal of exchange controls made possible by the devaluation of April 1986 is intended to apply to all the rules in effect since 1968. Lifting of the safeguard clause in regard to Community rules has brought us back to a situation of openness that we had experienced only briefly before, in 1967-68. The staff report notes the only three restrictions still remaining.

- Price controls have been lifted for industrial prices (except for books and pharmaceuticals), commerce, and certain services. This process of liberalization also extends to rents. A reform is being prepared with a view to abrogating the ordinances of 1945. Freedom will become the norm. At the same time, modern legislation on competition will be enacted.

- The law on privatization of national enterprises has just been published. Sixty-five public enterprises will be progressively put up for sale in the financial market, including three banks that were nationalized in 1945.

Rigidities are also being eliminated in the areas of employment, wages transfer of ownership of enterprises, and allocation of financial resources.

- The requirement for administrative authorization for dismissal of workers will be abolished on January 1, 1987. Fixed-term and part-time hiring is again facilitated, and enterprises taking on young people from 16 to 25 years old are exempted from social security contributions.

- Rapid progress in the decentralization of wage negotiations (over 50 percent of wage agreements are now negotiated at the enterprise level) is making it possible to approach economic realities more pragmatically and to take into account more effectively the performance of both enterprises and individuals.

- The abolition of the wealth tax will make it easier to transfer enterprises and remodel French industry. In this regard, I would like to stress the opening up of France to foreign investment, an often unappreciated aspect of our policy.

In addition to the drastic cut in subsidies to enterprises and shipyards and in subsidized loans, the abolition of the Industrial Modernization Fund (FIM) will further the ongoing process of reducing the risk of misallocation of financial resources. Thus, there are no longer any interest rate subsidies at the Government's risk. The subsidies that remain are flat-rate ones, distributed by commercial banks and specialized institutions on resources gathered in the market and reserved for small and medium-scale enterprises in order to offset an intermediation cost that penalizes them for not being able to go directly to the market.

All these measures, in conjunction with the cut from 50 to 45 percent in the business profits tax, should reinvigorate economic activity, investment, and employment.

The economic policies implemented by my authorities are intended to support the priorities I mentioned above.

The price target for 1986 is 2.3 percent, against 4.7 percent at end-1985. At the end of July 1986, the consumer price index had already declined to 2.0 percent, despite the price liberalization and the currency readjustment of April 1986. Thus, the 2.3 percent goal seems largely justified, if the price of oil stabilizes at $15 a barrel through the end of the year.

Wage policy is an important component of overall economic policy. Although it is difficult to demonstrate in econometric studies, the formation of expectations is an essential factor in the evolution of inflation. This is why the Government chose to have the public sector play an exemplary role. Maintaining the wage level unchanged in real terms from 1985 to 1986 entails that there will be no increase at all this year. The staff report (page 8) clearly notes how ambitious and difficult, but also how justified, this goal is.

The newly defined budgetary policy aims at once to eliminate the noninterest component of the deficit within three years (page 10) and to reduce the tax burden. The budgetary deficit has been stable at 3.3 percent of GNP for the last two years; in 1986, the supplementary budget confirmed that it will be limited to 3 percent of GNP. The guidelines for 1987 call for cuts of F 40 billion in expenditure and F 25 billion in taxes on businesses and households. Accordingly, mandatory levies may decline by 0.5 percent. Moreover, local governments have been asked to impose the same kind of discipline on themselves to complement this effort.

My authorities are aware that the social security system represents a heavy burden in total mandatory levies and in the budget, but they also know that it is highly important for the functioning of French society. Thus, they are studying the possibility of complementing the present pay-as-you-go pension system with a voluntary capitalization system based on a retirement savings plan.

The same desire for strictness is also found in the use to which the proceeds of privatization are to be put. They will be used to redeem the domestic debt and to restructure balance sheets, as explained on page 11 of the report. My authorities are resolutely avoiding any use of these proceeds for budgetary purposes and find the staff's concerns in this regard difficult to understand.

As regards monetary policy, a strict target for M3 growth was set in the range of 3 to 5 percent. Nevertheless, this target seems realistic, as actual figures are close to it and also because monetary financing of Treasury needs will be reduced by half this year before being completely eliminated in 1987. As noted by Fund staff, the monetary and financial reforms are clearly generating uncertainty, and the conduct of monetary policy may become more delicate in 1987 as the credit ceilings are abolished. This is an unavoidable consequence of deregulating markets and regulating credit solely through rate and reserve policies, as advocated by Fund staff. This profound reform is made possible by the introduction of new financial instruments and a futures market for them, MATIF, with the goal of rapidly creating a broad, unified capital market. Any borrower may issue negotiable paper of any maturity on a market accessible to all lenders on terms of fair competition. Given this new environment, my authorities are receptive to the report's suggestion that a broader range of indicators be used when setting the monetary targets for 1987. We are pleased that the significance of this quiet revolution encouraged the mission chief to study the subject in greater depth as a sideline of the mission.

The devaluation of April 1986 quickened the decline in interest rates. Today, while sharing the feeling that a further fall in interest rates is needed to set the world economy on a sound footing (since the desire to overcome inflation always exerts an upward influence on interest rates), the French Government cannot take further steps in that direction except in concert with its major partners.

My authorities share the staff's concerns over the external situation in 1985 and, accordingly, have made it a priority to improve the competitiveness of enterprises by liberalizing the economy, as I noted in the introduction to this statement. To this end, the abolition of exchange controls will be implemented very rapidly. At the same time, the current balance of payments has improved steadily, from a F 6.6 billion deficit in 1984 to a deficit of F 1.3 billion in 1985 and a seasonally corrected surplus of F 9.8 billion in the first half of 1986. This appreciable improvement is essentially explained by the shrinking of the trade deficit and the increase in the surplus on services. A number of external government borrowings have been repaid before maturity; the Government's foreign debt declined from F 43 billion in March 1986 to F 17 billion at end-July 1986. My authorities intend to continue reducing the external government debt as rapidly as contractually permitted.

In conclusion, I would again stress the French Government's commitment to supporting development. This commitment is reflected in the special treatment that will be given to the budget for technical assistance and official development assistance in 1987.

Mr. Grosche made the following statement:

During the past year, France has made further commendable progress in a number of areas. I welcome, in particular, the reduction in the rate of inflation, the improvement of business profitability and the almost complete elimination of the current account deficit.

On the other hand, sluggish growth, the high level of unemployment and the need to further improve the competitiveness of French enterprises demonstrate that further efforts are needed in order to bring the French economy back on a steady and noninflationary growth path.

With the staff, I welcome the authorities' general stance of policies, designed to consolidate and extend the progress achieved thus far. The elimination of major controls will mark a big step forward in economic policy making in France.

With regard to fiscal policy, I agree with the general objective of achieving a reduction of both the deficit and the tax burden. As far as the Central Government is concerned, I feel that priority should be given to a tax reduction over an accelerated reduction of the deficit. While I have no problem with the target of reducing the deficit to 3 percent of GNP in 1986, I see the need for intensifying the efforts to reduce expenditure further in relation to GNP and to use the savings for tax cuts. Especially, corporate taxes need to be further reduced in order to improve the financial strength of enterprises and to encourage investment and innovation. I am therefore particularly pleased by the Government's intention to generate additional savings in the 1987 budget with a view to creating room for tax cuts.

Unfortunately, developments in the social security system may jeopardize the authorities' goal of reducing the overall tax burden by 1 percentage point. Given the already very high level of social security contributions in France, I had hoped for concrete plans to reduce the burden created by the social security system. As I am only too familiar with the difficulties involved in reforming this sector, I have some sympathy for the authorities' cautious attitude. Nevertheless, this is a problem which requires further attention, not only in France. I am therefore glad to note from Mrs. Ploix's statement that studies are being undertaken for reforms in the pension system.

Turning to monetary policy, I agree with the staff's endorsement of the present cautious stance. This stance seems to be the more appropriate as the low inflation rate for this year will be largely the result of lower oil prices, and inflationary expectations appear not fully broken yet.

I also welcome the abolishment of credit ceilings and credit controls. The steps undertaken in the liberalization of the financial sector have already produced positive results. During the process of financial deregulation and innovation, certain monetary aggregates will probably be somewhat distorted. Therefore, I am glad to note from Mrs. Ploix's statement that the authorities are receptive to the staff's suggestion that a broader range of indicators be used in formulating monetary targets for 1987.

Clearly, within the European Monetary System (EMS), monetary policy in general and interest rate policy in particular are constrained by exchange rate considerations. It is thus fully understandable that the French authorities are aiming at a close correlation between the interest rates of major trading partners. High real and nominal interest rates, on the other hand, have contributed to the weakness in investment activity in France. While lower interest rates would therefore be desirable, I feel, like the staff, that the authorities' room for moving unilaterally is rather limited. Nevertheless, I would caution against placing too much emphasis on differentials of real interest rates, and I would think that nominal interest rate differentials are probably more relevant. In passing, I note that in the staff report, the real interest rate for France is derived from the consumer price index. While the staff points out that in the case of France this should not produce a bias, there is a significant divergence in Germany between the real interest rates measured by the CPI and by the GNP deflator, the latter being considered more relevant. I would therefore not fully join the staff in its assessment that using the CPI definition should not materially affect cross-country comparisons.

As I mentioned at the outset, unemployment continues to be one of the most pressing problems in France. Until the end of next year, the unemployment rate may even increase. In view of these prospects, it is essential to maintain a policy of wage restraint, which should of necessity be accompanied by measures to contain the rise in nonwage labor costs. But, as in many other European countries, the unemployment problem is also a structural one. I therefore welcome the measures already taken, and those in preparation, aimed at increasing the flexibility of the labor market, improving vocational training, and easing restrictions on the hiring and layoff practices of employers. These measures constitute another important step in the right direction. They should be followed up by further measures to reduce rigidities, such as those relating to the flexibility of working hours and the minimum wage (SMIC). It may prove politically very difficult to abolish the SMIC altogether, but perhaps avenues can be found to limit its negative effects, particularly on the employment of young workers. One of these avenues was recently taken when it was decided to exempt from social security contributions those enterprises that take on young people.

Finally, on the external sector, in my view, the devaluation of the franc in April was appropriate, given the loss of competitiveness which had developed in recent years, especially with Germany. The fact that this devaluation so far has had only a limited impact on external trade can partly be explained by the stickiness of the effective exchange rate in the months following the devaluation. Moreover, business may have sought to improve profit margins rather than lowering prices. Over time, the adjustment should show up in the trade figures. But, in addition to prices, there also appears to be a need for improvement of the nonprice competitiveness, particularly in manufacturing, in order to reverse the deterioration in France's trade balance for manufacturers' goods in recent years. The latest figures provided in the supplement indicate that much remains to be done.

Against this background, I would agree with the authorities that the prospects for the French economy can best be improved if policies continue to be implemented that help to enhance competitiveness and to raise the share of productive investment. Apart from appropriate financial policies, aimed at achieving price stability and reducing the Government's share in the economy, this would require further progress in addressing structural weaknesses.

The authorities have already taken a wide range of initiatives in those areas in recent years, and the results have been remarkable. Mrs. Ploix's statement provides further encouragement in this regard. I would like to wish our neighbors and friends the great success they deserve for their policies.

Mr. Ismael made the following statement:

The generally sound policies pursued by France over the past few years, combined with a favorable external environment, have brought further progress in its economic adjustment. As a result of continued wage restraint and lower import prices, inflation has been reduced further. In addition, the wage restraint and improved terms of trade have helped the profit margin of business enterprises to recover from its low point of the early 1980s. All this has contributed to the pickup in investments by private industrial enterprises. Furthermore, additional progress has been achieved in consolidating the fiscal position and in reducing rigidities in the economy. The various liberalization measures enumerated in Mrs. Ploix's informative statement convincingly attest to the progress achieved.

Nevertheless, it is clear that much more has to be done if France is to restore its competitiveness and the supply response of the economy. As noted in the staff report, the rate of business fixed investment in 1985 was still 1.5 percent of GDP below the 1970-75 average, and a much faster pace in the growth of capital stock is, therefore, needed. In addition, the profit margin of business enterprises at the present interest rate would have to be doubled in order to reach the profitability conditions of the early 1970s. Furthermore, the lack of competitiveness in the economy has caused economic growth in 1985 to lag behind the pace of expansion in domestic demand, leading to a weakening of the trade balance. It is, therefore, essential that France continue with its prudent financial policies as well as with efforts to improve competitiveness and to increase investments.

As I am in general agreement with the thrust of the staff appraisal and recommendations, I can be brief. On fiscal policy, I note that little progress was achieved in 1985 in reducing the central government deficit. In addition, the overall tax burden, which had been targeted to be reduced by 1 percent of GDP, also turned out to be higher than in 1984. But the success achieved by the authorities in reducing the fiscal deficit at the level of the General Government and the overall public sector, I believe, deserves our commendation. I also welcome the current policy to use future expenditure cuts for reducing both the fiscal deficit and the tax burden. This policy of a more gradual withdrawal of fiscal stimulus is not only appropriate, given the relatively modest growth prospects; it is also consistent with the objective of increasing profitability and encouraging private sector investments. With regard to the social security funds, however, I share the staff's concern over the increasing gap between the growth of receipts and that of expenditure. I should underscore staff suggestions for the authorities to take early steps to ensure the financial viability of the system.

Like the staff, I consider the present monetary policy stance and the targets for domestic credit expansion as appropriate. However, in the face of the removal of price and rent controls, I would stress the importance of keeping monetary expansion within the target range, if the price objective is to be achieved. I can appreciate the authorities' cautious approach in making unilateral reductions in the interest rate. This is particularly justified in view of the less encouraging developments observed in May in the short-term capital inflows and the uncertain impact of the recent liberalization of exchange controls. This underscores the need for more policy coordination among the major industrial countries, particcularly among those within the European Communities (EC). Regarding the decision to eliminate the system of credit ceilings, I support the staff's recommendation for the authorities to move more rapidly than currently planned and to use a broader range of indicators in setting monetary targets for 1987.

In the area of external policies, I support the staff's argument for accelerated actions toward the abolishment of the remaining exhange controls. I share the staff's view that this will contribute substantially to the increase in confidence with no serious risks involved.

On trade policy, I am concerned over the lack of any significant progress in reducing protectionist tendencies, particularly at the EC level. This is not only inconsistent with the objective behind the current liberalization measures; it is also detrimental to the world economy as a whole. As suggested by the staff, despite the recent EC decision to reduce average agricultural support prices, the agricultural sector is still heavily protected, and domestic prices of agricultural products remain well above the international level. Also, discrimination against third country suppliers has continued unabated in the manufacturing sector through quota and other nontariff barriers to imports. I would, therefore, join the staff in urging France to play an active role in promoting a more liberal trade policy within the EC.

Finally, I note that, for 1987, the staff's projections on the rate of economic growth, inflation, and some other variables are generally less optimistic than the authorities' projections. Of even more concern to me are the significant discrepancies between GDP growth figures for 1985 and 1986 projected by the authorities, as presented on page 21 of SM/86/196, and those presented by the staff in Appendix III of the paper. The 1985 outturn as presented in the Appendix is well below the authorities' projection; and for 1986, the authorities' figure also appears to be much more optimistic than the staff's projection. I wonder whether the staff can enlighten us on the reasons for the significant discrepancies. I would also be interested in hearing of any possible implications such discrepancies would have for the achievement of the various policy targets now in place.

Mr. Massé made the following statement:

Considerable progress has been made in France during the past 18 months toward more balanced and consistent economic performance. We must agree with Mrs. Ploix that this is mostly due to the overall stance of government policies, which have built upon a number of favorable external factors, including the decreases in oil prices, general commodity prices, and interest rates. With this period, the external account has been brought roughly into balance, and there has been a sharp deceleration in inflation. Moderate wage increases have reinforced the trend to a lower inflation rate and have also permitted corporate profitability to improve. All of these developments are welcome.

Although the recent slowdown of inflation is partially due to factors which are not in themselves permanent, the present circumstances do provide an excellent opportunity for the authorities to consolidate gains already made while accelerating the process of liberalization and reform of the French economy, particularly with respect to the labor market and the financial system. This is an opportunity which should not be missed if the long-term growth potential of the French economy is to be improved. As the authorities fully recognize, unemployment in France remains unacceptably high and will be lowered only through a combination of faster growth and more flexible labor market conditions. France's international competitive position also needs to be strengthened, in view of the increased import penetration and loss of export market shares in recent years. We should therefore encourage the authorities to take advantage of the current favorable circumstances.

Turning to specific policy considerations, we agree with the staff assessment that the present stance of macroeconomic policies is broadly correct. Fiscal policy should continue to aim at reducing the budget deficit while easing the overall tax burden, as the authorities intend. These objectives will not be easily attained, however, since relatively weak growth may inhibit the expansion of revenues. Persistence of high unemployment may also create political pressures for the authorities to introduce job creation schemes. The authorities may therefore wish to conduct a thorough reappraisal of their spending programs in order to rationalize expenditures, and I am pleased to note that public expenditures are to be reduced by about 1 percent of GDP in 1987. I fully understand the difficulties faced by the authorities in reforming the social security system, but I would note that this issue is not restricted solely to France. Many other governments, including my own, will have to use imagination in restructuring social outlays so that receipts and expenditures are brought into better balance.

As for tax reform, we believe that reductions in marginal tax rates should be explored, as should a further easing of direct taxes, which might help the corporate sector to improve its profitability and thus encourage investment. In that regard, I can understand and support the progressive privatization of publicly owned enterprises, but the authorities should be careful that the management capacity of these enterprises is not weakened, and that receipts from sales of these enterprises are not used to finance current expenditures, as that temptation will certainly arise.

With respect to montary policy, the acceleration in the process of financial market liberalization is welcome, particularly the planned shift from credit controls to interest rate management as the main instrument of monetary policy. This move should improve the functioning of monetary policy by eliminating distortions and inefficiencies in the financial system. Of course, as the staff has cautioned, this shift may reduce the informational value of monetary aggregates, at least during a transitional period. We have experienced such difficulties recently in Canada, where financial innovations have made the monetary aggregates extremely difficult to interpret. The French authorities therefore are right to be considering monitoring a broader range of monetary indicators, including M3, while the financial system adjusts.

It is fortuitous that the shift away from interest rate controls toward greater reliance on market-determined interest rates--which had been planned for some time--is occurring during a period of falling nominal interest rates, which should ease the transition. In general, however, it is not clear to what extent interest rates in France can be further reduced at present. Although real interest rates remain high by historical standards, and further lowering of the intervention rate might be desirable from a growth perspective, the authorities have to be conscious of the interest rate differential with Germany. If Germany is able to lower its rates, however, France may well be able to follow suit.

As I have already noted, wage moderation has contributed to lower inflation during the past year. However, on a year-on-year basis, wage increases have still been in the 5 percent range and the inflation differential with trading partners, particularly Germany, remains significant. These factors suggest that continued wage moderation will be required if France's external competitiveness is to be strengthened. Furthermore, as the staff has emphasized, there is a continuing need to improve the share of profits in the national accounts, and we can support the view that wage increases should be held below the growth rate of productivity for the time being.

Improvements in labor market flexibility will be essential in moderating nominal wage increases and reducing the high rate of unemployment. Some welcome improvements have been made--such as more decentralized wage bargaining, the recent shift to forward-looking wage indexing, and liberalization of hiring and firing regulations--and this process must continue. The continued upward trend in the unemployment rate, despite a modest recovery in growth, is a perplexing problem that may well call for innovative approaches. In some countries, there has been, and likely will have to be, greater reliance on innovations such as job sharing and part-time work in order to avoid placing excessive pressure for labor market adjustment on real wage rates. These innovations may not be perfect, but they will have to be part of a range of measures to reduce unemployment. The French authorities therefore should press ahead with further structural reforms in the labor market while maintaining wage moderation, since these measures are crucial if the faster rates of investment needed for sustained long-term growth are to be encouraged.

I have two final comments. First, the staff has been extremely gentle in its assessment of agricultural support policies within the framework of the Common Agricultural Policy. While I recognize that there has been some rationalization of the agricultural sector in France in recent years, and that average support prices have been reduced slightly, the fact remains that French agriculture is not really subject to international competitive forces outside the Common Market, especially in cereals; nor does trade in agriculture proceed fully on the basis of comparative advantage, to the detriment of more efficient producers. Greater efforts to scale down and eventually eliminate such generous agricultural support and subsidies are called for, on the part of all participants in agricultural trade.

Second, we agree with the staff that the devaluation of the franc in April was necessary, and we are pleased that this devaluation has permitted some liberalization of exchange controls. Nevertheless, controls continue to exist on travel, on the opening of bank accounts abroad by residents, and on lending in francs to nonresidents. Since these controls are easily circumvented and may send the wrong signal about the authorities' commitment to liberalization, it is logical that they be soon eliminated.

In conclusion, I want to express my authorities' pleasure in seeing the changes that have been introduced by France in economic policies. We support most of the measures that have been introduced, and believe that they have led to a considerable improvement in the economic situation in France.

Mr. Suraisry made the following statement:

The performance of the French economy over the last three years has been impressive. Significant and commendable progress was made on a number of fronts. The fiscal deficit was reduced, the current account was brought into approximate balance, and the inflation rate was brought down further. Another encouraging development in 1985 was the sharp improvement in profit margins, which should stimulate domestic investment and enhance future growth prospects.

As I am in broad agreement with the staff analysis and have no difficulties with the main policy recommendations, I shall focus my comments on the fiscal adjustment and the medium-term issues.

In the fiscal area, I welcome the further tightening in the fiscal stance and the intention of the authorities to eliminate, over a three-year period, the noninterest components of the central government deficit. As I have indicated on other occasions, the speed of fiscal adjustment should take into account the absorptive capacity of the private sector and its ability to take up the slack provided by the fiscal retrenchment. In this context, I agree with the staff that, should there be signs of a significantly greater than expected spending by the the private sector, the reduction of the deficit may be accelerated. In light of the most recent information contained in the staff supplement showing a robust increase in domestic demand, the acceleration of the fiscal adjustment may be now given further consideration.

The planned privatization of publicly owned enterprises is welcome. Such privatization should improve the economic performance of these enterprises and help strengthen the overall financial position of the Government, while, at the same time, contributing to the deepening of the domestic financial market.

Turning to the longer-term considerations facing the French economy, I can see three major areas that need particular attention in the period ahead. First, while considerable progress has recently been made to promote private sector investment, savings performance has been disappointing. As indicated in Appendix I of the report on recent economic developments, the household savings ratios have continued to fall. Given the need to finance more buoyant investment activity and the objective of restoring external balance, it is important to reverse this trend. In this context, it may be time to consider an overhaul of the present tax system along the lines of the U.S. tax reform, with a view to stimulating savings and improving incentives for investment in the French economy, foreign and domestic. As we have seen in our discussion of international capital markets, financial markets are becoming increasingly integrated; and, as more and more deregulation and liberalization are introduced, national boundaries are fading in the eyes of savers and investors. It is therefore important for France and, indeed, for many European countries, to consider introducing timely and appropriate tax reforms, so as to ensure "tax competitiveness" in terms of attracting savings and investments. The intention of the French authorities to lessen the overall tax burden, and the recent reduction of corporate tax, are steps in the right direction. However, a more comprehensive reform of the present tax system may become necessary.

Second, there were a number of recent developments that helped strengthen France's competitive position. The deceleration of inflation that began in 1982 was a major factor. By 1986, the inflation differential between France and its trading partners had been substantially reduced. These developments were supported by a policy of wage moderation which helped reduce the increasing trend in unit labor costs. More recently, the April 1986 devaluation of the French franc contributed to the observed overall improvement in the French competitive position. Nonetheless, there is some evidence that despite these commendable improvements, France's overall competitive position remains somewhat unfavorable and needs to be further strengthened. As pointed out by the staff, import penetration has increased substantially in recent years, and France has lost export market shares. Further, as indicated in the staff supplement, from the second quarter of 1985 to the second quarter of 1986, imports of goods and services rose by about 11 percent against an almost 1 percentage point fall in exports. There is, therefore, a need to restore the competitiveness of the French economy so as to strengthen the performance of exports and reverse the deterioration in the foreign trade balance. There are already indications that the foreign trade's contribution to economic growth will remain negative over the medium term.

One area that needs particular attention and close monitoring is the short-run trend of wages in a context of rapid deceleration in inflation. Given the typical lag between changes in prices and changes in wages, a fairly large wage increase might surface which may erode the gains achieved so far in competitiveness. Maintaining firm control over wages and salaries with the view to reducing and bringing down unit labor costs into line with those of France's main trading partners seems necessary to avoid a loss in export competitiveness and a further adjustment in the exchange rate. In this context, I welcome the comments on this matter in Mrs. Ploix's very helpful statement.

Third, while significant progress has been made with regard to improving domestic and external imbalances, the labor market situation continues to be characterized by rigidities. Such rigidities have, in my opinion, kept unemployment high and have biased production techniques toward labor-saving techniques. As it was made clear in the staff report, in addition to leading to a misallocation of resources, the inflexibilities in the labor market have resulted in high social costs, which weigh heavily on the budget. The recent measures taken by the French authorities aimed at increasing the flexibility of the labor markets are steps in the right direction; but, as the authorities recognize, there are still some important obstacles to flexibility, notably in the areas of working hours and the employment of women in shift work. I therefore encourage the authorities to intensify their efforts in this area. In this context, I agree with the authorities on the need for emphasis on vocational training and, more generally, on the reorientation of the educational system.

Finally, with respect to trade policies, I commend the authorities for their support within the EC of efforts to rationalize European agriculture. However, as pointed out by the staff, the Common Agriculture Policy still offers very substantial protection to the agricultural sector. More generally, it is evident that there are still many protectionist measures in place that need to be removed.

France has played a leading role in helping developing countries in Africa and elsewhere in the world grow and adjust. Such a role could be greatly enhanced through a liberalization of its trade policies, both at the national and the EC level. The most recent developments in world trade, as reported in the world economic outlook, are not encouraging and make a rollback in protectionist pressures all the more urgent.

In conclusion, I am impressed by the economic performance of the French economy in 1985; and, like the staff, I find the stance of the present financial policies appropriate. Continued, prudent financial policies and intensification of structural adjustment will be necessary to restore sustainable growth, reduce unemployment, and strengthen the balance of payments position.

Mr. Dallara made the following statement:

The past few months have brought with them significant changes in the approach of the French authorities to economic policy. We are encouraged by these changes, in particular by the new trend toward liberalization of the economy with respect to both domestic sectors and foreign exchange and capital market transactions. We believe that these efforts will build on the significant progress that has emerged in recent years in a number of areas cited in the staff report and reviewed already by a number of Directors. We do believe that these efforts could, if supported by a continuation, and, in some areas a strengthening of policies, including fiscal and monetary policy, lead to a higher, more sustainable level of growth over the medium term in the French economy. This would not only have obvious benefits to France, but could contribute importantly to international efforts to generate higher, more sustainable world economic growth; to reduce external imbalances; and to suport an orderly resolution of international debt problems.

Let me say before touching on a number of particularly important areas that we broadly agree with the thrust of the staff appraisal. I would also say that Mrs. Ploix has provided us with a useful and detailed statement that helps us focus on the main issues now confronting the French authorities. We agree that the central challenge is to restore competitiveness and that the emphasis thus needs to be primarily on efforts to stimulate private investment. We note in this connection that the staff projects that private investment (excluding residential construction) will grow perhaps as much as 7 percent this year and somewhat less next year, as a result in part of the increase in business profits and the efforts to liberalize the economy. While in one respect this seems rather impressive, it nevertheless remains below what would be needed to increase substantially the capital stock, an increase which may be needed over the medium term if the rate of unemployment is to be significantly reduced and if the potential for noticeably higher levels of domestic growth over the medium term is to be realized.

It may be recalled that in the recent discussion of the U.S. economy in the Board and in the documentation prepared for that meeting, there was a rather extensive discussion concerning the medium-term relationships between productivity, investment, and growth. We found this particularly useful, and it turned out to be a point of some attention in the Board discussion. Recognizing the obvious staff limitations, we would suggest that if such an area would, in the view of the staff, merit further exploration in future in the French economy, such exploration would be of interest to this chair and might be of interest to others.

We noted that the authorities are planning to strengthen business profitability by two additional tax measures: a 5 percent reduction in the corporate income tax rate for 1987; and reductions in the "taxe professionelle" on a firm's fixed assets (levied, I believe, by each locality). This latter tax would appear, from what the staff tells us and from other information, to be a significant impediment to business investment in plant and equipment, and we wonder at this stage whether these two actions on the tax front will really be sufficient to increase the after-tax rate of return on investment, which, as the staff stresses, is really essential if investment is to increase in the period ahead. I would say that this is particularly important in light of the conclusion reached in Appendix III of SM/86/202 that the main reason for the slow recovery of investment is the low rate of return on real investment, relative in particular to financial assets, which are now earning the highest real return in three decades.

We agree with the staff that if the authorities are to continue with efforts to promote growth, wage moderation is crucial. Some progress in slowing the rate of increase in unit labor costs is evident already. Mrs. Ploix also noted that a number of rigidities in labor markets are being removed, but it still appears that firms pay excessively in one way or another for many employee-related benefits or services, including high social security contributions. We understand, for example, that on average in some sectors, employers pay as much as 77 percent of gross wages in various social charges, such as social insurance fees to the Workers' Council for planning social activities, apprenticeship training, and transportation allowances, all of which comprise quite a wide range of obligations imposed upon the employer. We believe that these obligations clearly limit a firm's ability to expand, or, when need be, diminish levels of employment; and if these areas are not tackled, this will be a serious impediment to growth in the future. While acknowledging the political implications that inevitably arise in tackling such practices, we would encourage the authorities to make every effort to do so because it is not clear to us that there will be sufficient flexibility in the labor markets without such action. I might also add that the high minimum wage still strikes us as a potentially significant contributor to unemployment in various categories and subsectors in the economy.

My final comment on the new package of growth-oriented policies relates to the welcome plan of the French authorities to privatize many publicly owned enterprises. We certainly welcome the steps that have been taken in this area and would encourage additional efforts.

Turning briefly to the external sector, we were in many respects struck by the fact that, although perhaps on a somewhat different scale, France faces a problem which is not totally dissimilar to that faced by the United States. Domestic demand has been growing at what may appear to be a reasonable rate; yet much of that demand has spilled over into the external accounts, and although there have been recent improvements in the external accounts which are helpful, we feel that this may mask continued fragility and vulnerability of the payments position over the medium term. This emphasizes and underscores the critical importance of restoring and improving the competitiveness of French industry and brings me again to stress the importance of wage restraint in this connection.

A final point on the external sector concerns the ongoing removal of exchange controls, which should help in restoring confidence in the French economy and in the French franc. We wonder, however, what prohibits at this stage total elimination of these controls. Given the current circumstances characterized by, among other things, subdued inflation, the improving fiscal position and--looking back a number of months--the relatively smooth exchange rate adjustment which took place relating to the French franc in the context of the European Monetary System, it would appear that the remaining controls could well be lifted without much risk of adverse speculation. I would welcome any comments the staff or Mrs. Ploix might have on this particular point.

On developments and general policies in the fiscal area, we applaud the authorities' aim of reducing fiscal pressures while at the same time reducing personal and corporate tax rates. Of course, at this stage these objectives have yet to be achieved, and this Government, like others, has found how difficult it is to move ahead at the same time with efforts to reduce tax rates and fiscal deficits. Nevertheless, we applaud the efforts to move ahead on both these tracks, and we hope that the authorities will succeed in their efforts. Indeed, there is some reason for encouragement. The recent trends point toward ratios of both revenues and expenditures to GDP that are flattening and starting to decline. In that connection, we welcome the emphasis on reducing interest rate subsidies on businesses, although we did note that some remain in the banking sector for small-scale firms. Finally, it appears to us in this area of continued efforts at reducing and indeed eliminating the fiscal deficit, that the very large absorption of resources by the social security system will need to be addressed aggressively in the near future.

The uncertainties created by financial sector innovation and deregulation have generated, and will continue to generate, complexities in monetary policy. In spite of this, the authorities appear to be managing rather well with monetary policy during the period of transition, uncertainty, and innovation. The planned complete elimination of credit controls is especially welcome, although we would urge an acceleration of this process if practicable. We noted Mrs. Ploix's comments that any further interest rate adjustments should take place in the framework of coordinated actions. We fully agree with this point.

Before concluding, let me turn to areas relating to trade and international cooperation. The authorities in France have continued to demonstrate a firm commitment to the strengthened mechanism for economic policy coordination among the major industrial countries, evidenced in part by the position taken by Mrs. Ploix in our earlier Board discussion relating to indicators. We certainly welcome this strong support and believe that it can, and will, contribute to enhancing the effectiveness of this exercise.

I might also note our special gratitude to the French authorities for their efforts in the Paris Club, not only in this past year, but over many years. The French, out of their own Treasury and without a large staff, do diligent work in managing and processing the increasingly heavy burdens placed on the Paris Club, and they do so in a way that we in this Board have found supportive of the Fund's activities and generally supportive of the handling of the debt strategy. I think their effort deserves to be particularly recognized and commended.

I would sound one final, less positive, note in the area of international economic cooperation. It is a note that is related not just to France but to the EC more broadly. In the trade area--and I will not belabor in detail the many issues and concerns which now exist between my authorities and trade officials in the European Community--we remain disappointed that the European Community, and France in particular, have not accepted the bold objectives for agriculture agreed to by the majority of GATT participants. It is clear from the strong and rather broadly based comments in this Board in recent months that many debtor countries are dissatisfied with the agricultural policies of my own authorities and of the European authorities, comments we have heard again this morning. But it is also clear that these matters must be resolved in a multilateral context, and we encourage the French authorities to support a bold approach to dealing with these issues in the new GATT round.

Mr. Zecchini made the following statement:

It is encouraging to see that in the current year the French economy will most likely achieve important progress in many areas. After six years of very low growth, GNP is expected to increase at a higher rate, inflation is estimated to decrease by about 3 points to 2.8 percent, and the current account of the balance of payments should record a sizable surplus, the first since 1979.

However, in spite of this favorable outlook, some intertwined weaknesses will persist: growth in 1986 and 1987 is expected to be still below the average in industrial countries; the unemployment situation remains serious; and, in spite of the sharp improvement in the external accounts, which is partly due to improved terms of trade, a further strengthening in competitiveness is needed. As discussed in the report, slow growth with its negative repercussions on employment has been caused mainly by supply and external constraints rather than by a deficiency in domestic demand. A strengthening in the pace of capital accumulation appears therefore essential to relax supply constraints, to increase external competitiveness, and to favor some reabsorption in the rate of unemployment.

The French authorities are well aware of these problems, and we can endorse the thrust of the strategies which have been devised to deal with them. Wage increases should be contained to increase cost competitiveness of the enterprise sector and to enhance employment prospects. In this respect, we share the view that there is a need for a prudent wage policy in the public sector and for measures apt to favor a moderation in wage behavior in the private sector. The abolition of backward looking wage indexation, the encouragement of decentralized wage bargaining, the increased importance given to individual merit pay increases, and the planned relaxation in rules concerning the laying off of excess workers should favor the containment of labor costs and increase the flexibility in the use of labor in production processes. These policies may also favor an increase in enterprises' profitability and, consequently, a pickup in fixed investment.

On more specific policy issues, efforts to reduce the fiscal deficit have been only partially successful. The objective was to reduce the central government deficit on an administrative basis from 3.4 percent of GDP in 1984 to 3 percent in 1985, but the deficit in the latter year eventually turned out to be equal to 3.3 percent of GDP. We share the view that further progress should be achieved in 1986 and 1987 in reducing the fiscal deficit but that, in light of the relatively modest growth prospects, the pace of fiscal consolidation should not be excessively rapid so as to avoid an abrupt withdrawal of stimulus from the economy. After all, the fiscal problem does not lie so much in the size of the deficit as in the composition of public expenditure and in the level of taxation. We believe that the authorities' plan to reduce expeditures so as to allow a reduction in the deficit and in taxes is appropriate.

However, experience in other countries suggests that tax cuts should be sought only if an agreement has been reached on the necessary expenditure reductions. Furthermore, while a decrease in fiscal pressure would appear to be the main aim of the authorities, other objectives could be sought as well. For example, a reduction in certain taxes, such as personal income taxes, could be used to revive private initiative and demand and to support wage moderation. A reduction in corporate taxes or the creation of fiscal incentives for investment could also favor a strengthening of capital accumulation. This should go together with a firm approach toward reducing the extensive array of subsidies to the enterprise sector. We would appreciate it if the staff could give us some indications on the aims that the authorities intend to pursue in these respects.

The authorities have announced that they will embark on an important privatization program, and we share the view that in the long run this will promote a better allocation of resources and will increase the degree of competitiveness in the economy. We noted the staff's concern that the proceeds of privatization should not be used to finance government spending or to continue covering the operating losses of public enterprises already in economic difficulty. In the latter respect, we noticed that companies such as Renault have recorded sizable losses in 1985 and that no improvement in profitability has been registered with respect to 1984.

We do not fully concur with the staff in stating that "the State as a shareholder ought to make as critical an assessment as any private investor of the future economic viability of an enterprise." No doubt this is necessary, but it does not fully reflect the differences between the two types of shareholder. The State shareholder incorporates in its viability assessment considerations that may not be present in the objective function of "any" private shareholder or have a different weight. These structural differences cannot be completely disregarded. Otherwise, the same motivation of the presence of a State shareholder disappears, and it would be logical to dispose of all these assets by selling them to the private sector.

As to pricing policies, we welcome the intention of the authorities to reduce price controls, as their permanence tends to give rise to distortions. However, we are not clear about the extent of controls that should remain beyond the end of 1986, and we would appreciate further clarification in this respect.

In the area of monetary policy, an important shift is being made from a system of direct controls on credit to a system of indirect controls on monetary aggregates. This shift appears appropriate as, from the experience of countries such as my own, in the long run direct credit controls tend to reduce competition in the banking system, introduce distortions in credit allocation and favor a progressive disintermediation of the banking system. An appraisal of the new system is not yet possible for France, as 1986 is a transition year in which "l'encadrement" is still in place. However, it is interesting to note that "l'encadrement" is now viewed more as a safety net rather than as a major instrument of monetary policy. In fact, in 1986 credit controls have not constrained lending by the banking system. In the future, this safety net could be disposed of if enough progress is made in refining the methods and tools of monetary management.

With respect to the main categories of monetary levers, we note that the possibility of changing the reserve requirement of banks is discussed in the report, together with open market operations and the monitoring of interest rates. We would view the utilization of the latter two instruments as more appropriate to deal with short-term management. Changes in reserve requirements should, instead, be implemented less frequently and progressively, as individual banks must be given time to adjust their liquidity position. Furthermore, high reserve requirements tend to increase the difference between interest rates paid by borrowers and those paid to depositors, thereby reducing the competitiveness of the banking system vis-à-vis other financial intermediaries. We also share the suggestion made by the staff that, in light of the financial innovations taking place in France, it might be useful to adopt not just one intermediate target for monetary policy such as the growth of M3, but a broader range of indicators.

We note that interest rates remain at relatively high historical levels in France but that, as shown in Table 3 of the staff report, they are at approximately the same level as those of other major industrial countries. This suggests that, with some caution, France could join other countries in interest rate reductions.

Finally, I would like to associate myself with a comment made by Mr. Dallara in praising the French authorities for their assistance and support to the Paris Club activities.

Mr. Alfidja noted from the staff paper that economic indicators showed a general trend toward a sustained economic expansion in France although at a relatively modest rate, and an improvement in the competitiveness of the economy. A more restrictive budgetary policy and an improvement in the financial situation of the public enterprises had had a favorable impact on the budget deficit. Although exogenous factors had contributed to budgetary performance, there was no doubt that the economic policies vigorously pursued by the French authorities had also played a role.

In her opening statement, Mrs. Ploix had shed light on the economic objectives of the authorities and on the policies aimed at achieving them, Mr. Alfidja continued. In the present circumstances the emphasis placed on the restoration of the competitiveness of the economy and on control over inflation was more than justified. On the price front, it was encouraging to note that the differentials between the inflation rate of France and inflation in France's main trading partners had been considerably reduced. The decline in the inflation rate--attributable in part to the drop in the price of oil and other raw materials--together with the uncertainty prevailing in the area of prices should lead the French authorities to continue to concentrate their efforts on a reduction of other production costs. In that connection, it was reassuring to note from Mrs. Ploix's statement that, owing to implementation of measures such as the deindexation of salaries and the decentralization of salary negotiations, progress was again being made toward reducing certain structural rigidities in the economy. Following two consecutive years of decline, private sector investments had been substantially expanded in 1985 and, according to the Fund staff, could attain a 7 percent growth rate in 1986. The measures taken to alleviate the tax burden on households and enterprises should contribute substantially to improving private sector savings and to creating the favorable conditions for the growth of investments and economic activity.

In spite of strong efforts, the French authorities had succeeded only in stabilizing the budget deficit, Mr. Alfidja noted. However, the list of the measures included in Mrs. Ploix's statement for the remainder of 1986 and for 1987 clearly showed that the French authorities were determined to pursue with vigor their objective of a rehabilitation of public finance.

On the monetary side, the innovation and deregulation of the financial markets were important changes on which the Fund staff should report in detail in future, Mr. Alfidja said. He had also noted with interest the decision of the authorities to discontinue the credit ceiling as of January 1987. In view of the changes that had been implemented, the French authorities should approach the matter of credit ceilings with caution and flexibility.

As indicated during the previous discussion on France, the high level of unemployment remained a source of concern and should continue to be the subject of particular attention by the French authorities, Mr. Alfidja commented. In conclusion, he encouraged France to continue its substantial aid efforts to countries such as those in his constituency, and he hoped that the authorities would be successful in implementing their economic and financial policy package.

Mr. Rye made the following statement:

> On the occasion of the previous Article IV consultation with France, Directors stressed that a further strengthening of financial policies was essential and that increased attention needed to be paid to removing the rigidities which affected many aspects of French economic life. It is clear that, in the past year, the authorities have made good progress in both these areas. Yet the tasks they face can still be categorized under similar broad headings.

Having done much to reduce economic imbalances and improve performance in the past year, the authorities now must seek a balance in domestic financial policies that will encourage growth in domestic production (from its present relatively low level compared with France's industrial trading partners) without rekindling inflation or putting pressure on a balance of payments, which remains fragile. There is also a need to continue efforts to dismantle government restrictions and protection so as to promote a more dynamic and responsive economy.

I will discuss the second of these matters first, mainly because of the heavy weight the authorities place (rightly, I think) on the need for liberalizing the economy. They believe that improved growth in the short to medium term will depend on the Government's success in pushing through a wide series of structural changes, which, taken together, would represent a substantial liberalization of the economy. I agree with this view. A number of measures to reform the financial system have already been taken, and more are planned. Like the staff, we welcome these measures. We would like to see the authorities aim for the rapid elimination of credit controls and remaining interest rate subsidies, particularly those still applying to the agricultural and housing sectors. I note here what seems to be a considerable divergence of view on the significance of these remaining subsidies. Mrs. Ploix, in her admirably clear and concise statement, gives the impression that the subsidies have little overall significance, whereas the staff describes them as "an important allocative distortion." Perhaps I am misunderstanding the staff comment; if so, I should be glad to be set right.

We also welcome the partial removal of exchange controls earlier this year and urge the authorities to move quickly to eliminate the remaining controls and the administrative framework used to implement them. We agree with the staff that the risks involved in so doing would be minor. Indeed, I see little logic in further delay. If the remaining controls are easily circumvented and their removal has been agreed to be logical, I cannot see why that removal should have any adverse effect on confidence. Experience in two of my own countries, where exchange controls were removed at a stroke, indeed suggests the opposite.

Also welcome are measures to reduce price controls, to privatize publicly owned organizations in the competitive sector and to introduce further flexibility into the labor markets. We do, however, share the staff's reservations about the effectiveness of the minimum wage policy and the concern that it could serve to restrict employment growth, particularly youth employment.

What is disappointing is the authorities' limited progress in reducing the degree of protection afforded sections of the

French economy, particularly the agricultural sector. Agricultural subsidies and price supports in the EC remain a significant and, for many efficient agricultural exporting countries (including particularly developing countries), a very damaging distortion.

The staff notes "that the Common Agricultural Policy affords very substantial protection to the agricultural sector and that domestic prices remained well above their international level." But we would have liked to see a fuller discussion of the effective degree of protection provided to French agriculture and of the costs of this protection for the French economy and for other agricultural exporting countries. The staff observes that, while the French authorities refer to harsher penalties for dairy production in excess of quotas (page 19), the fact is that the quota for EC milk production in 1986-87 is 98.5 metric tons compared with estimated total domestic consumption of less than 87 metric tons. That is, surplus milk production is 12 percent of the total, which is reflected in the massive stocks of butter and skim milk powder currently being held in the Community. While the levy on milk production in excess of the quota level is certainly substantial, the quota itself has been set at an excessive level and, hence, does little to relieve the surplus problem. It is therefore difficult for my authorities to accept the assertion that the dairy quota levy (and the sugar levy as well) constitute a "considerable" effort to rationalize European agriculture. The fundamental problem which has to be addressed is how to reduce the incentive to produce, which is provided by the cap support arrangements and, in the final analysis, this can only be done by reducing support levels/prices.

I turn now to the area of macroeconomic policies and performance, where progress was made in 1985 and more is expected in 1986. The forecast improvement in the current account position from near balance in 1985 to a F 50 billion surplus in 1986 is predominantly due to the fall in oil prices, as shown by movements in the oil and non-oil trade balances. Non-oil imports, both for investment--which has a 70 percent import content--and consumption are expected to remain relatively strong in 1986. The main factor underlying the authorities' forecast improvement in the external position is the assumption of moderate export growth in both 1986 and 1987, despite some further loss of market shares. In view of the uncertainties over export performance, the pace at which imports will decline, and the growth of domestic product and demand, the balance of payments should be regarded with some caution, if not concern. This caution should in my view be reflected in the stance of other economic policies in 1986.

I therefore welcome the further reduction in the general government deficit in 1985 and the authorities' proposed reduction of the central and general government deficits in 1986 and

1987. Like the staff, I do not view the envisaged reductions as particularly ambitious and believe that faster progress could be beneficial. Prevention of any overshooting in expenditure, as occurred in 1985, is a minimum requirement. Given the lower interest rate structure and the potential created by the sale of publicly owned assets, we urge the authorities to seek greater expenditure savings by the winding down and, where possible, the elimination of subsidies from the budget, an area which recorded considerable growth in 1985. A review of the social security system (given the emerging net financing requirement of F 30 billion by end-1987) would also seem desirable. Mrs. Ploix's statement suggests that a review of some kind is in train, but it is not clear to me how thoroughgoing it will be.

Despite some slippage in monetary policy early in 1985, money growth was largely contained by the end of the year. The rate of money growth for 1986 seems broadly appropriate, given other policy settings, the recent depreciation of the franc, and the authorities' inflation target. A cautious approach to further interest rate reductions in the near term also seems appropriate. As the staff suggests, following the deregulation of credit controls, it would be prudent of the authorities to adopt a broader "checklist" of indicators to monitor monetary developments.

Finally, I note that the staff expresses some doubts about the authorities' forecast decline in the rate of inflation. Much of the fall in 1985 was attributed to the decline in import prices (particularly energy prices) and a modest increase in food prices. Further help from these sources is unlikely, at best. The importance of containing inflationary pressures, particularly for the maintenance of external competitiveness, underlines the need for cautious financial policies and continued wage moderation in 1986.

Mr. Foot remarked that the French authorities had achieved considerable success in strengthening the performance of the economy in the past few years, as evidenced in particular by the improved external position and the reduction in inflation. Their efforts had also helped to lay the basis for the reasonably buoyant growth expected in 1986. More recently, the authorities had formulated and were implementing a wide range of structural policies supported by cautious demand management policies. He shared the staff endorsement of that approach and would limit his remarks to comments on various aspects of current policy.

On the fiscal side, the more prudent policies followed over the past few years had led to a significant reduction in the overall public sector deficit from about 4.5 percent of GDP in 1983 to just over 3 percent in 1985, Mr. Foot noted. In that connection, there appeared to be some deficiencies in data on the public sector. He noted from the footnote on page 5 of the staff report that aggregate data were not available on the financial position of the nationalized enterprises in the competitive sector; he would be interested in any comment the staff might have on the likely magnitude of the flows not covered due to the data gap, and he wondered whether any attempt to remedy the problem would be worthwhile.

Further reductions in the deficit might be more difficult in future, although they would be highly desirable, Mr. Foot continued. The outlook for the fiscal position was overshadowed, as the staff had noted, by the uncertainties facing the social security funds and by the prospect that the finances of those funds might need to be substantially strengthened over the medium term. As was agreed in the recent seminar on long-term social expenditures in the group of seven major industrial countries, it was reasonable, if not crucial, for the Fund to pay attention to such issues; and it would be interesting to follow the authorities' response to the problem. In any event, the authorities' resolve overall in fiscal affairs was highly commendable, as was their aim of "resolutely avoiding any use of privatization proceeds for budgetary purposes."

In the area of monetary policy, Mr. Foot said that he shared the staff's support for the measures the authorities were taking to abrogate the system of credit controls in favor of an interest-based system of monetary control. The shift would seem to be a major step forward toward achieving a more flexible and responsive monetary system. However, while a more liberalized system would bring great rewards, it would also bring problems relating to the interpretation of monetary aggregates and to prudential control. Once non-French banks were able to deal actively in France and French residents could readily hold accounts overseas, the situation would never again be the same. Nonetheless, the abolition of the exchange controls and the associated liberalization of the U.K. monetary system had undoubtedly had major benefits for the United Kingdom; and if the changes could be effected in France, the effort to make them would be worthwhile. However, the pace of change might be faster than civil servants and politicians traditionally preferred. In that regard, he would be watching with particular interest the effort to regulate broad money changes in the level of bank reserves. Such an approach, using either monetary or nonmonetary systems of reserve requirements, had been one of several considered in the United Kingdom in 1980, just after the abolition of exchange controls. He doubted whether he would be breaking any confidences in noting that those who had favored a system of mandatory controls had also favored a base of roughly the same size--2 percent of the money stock--as was favored by the French authorities. A major reason for the rejection of the approach in the United Kingdom had been the fear of disintermediation, a fear also acknowledged by the French authorities. The second reason--which might not be of as much concern to other governments as it had been to the U.K. Government at the time--was that the approach could be tantamount to the setting of a desired interest rate and the conducting of monetary market operations to support it. There had been in the United Kingdom at the time many who had wanted a more seemingly explicit market determination of interest rates. In any event, the efforts of the French authorities to regulate broad monetary changes in the level of bank reserves would no doubt be a subject of great interest in the next Article IV consultation report.

Remarking on external policies, Mr. Foot observed that the sharp increase in import penetration in recent years was a source of concern and had been one of the factors behind the devaluation of the franc within the European Monetary System earlier in the year. The depreciation itself would continue to strengthen the external position, but the relative weakness of the domestic supply response underlined the importance of the pursuit of policies aimed at increasing the flexibility of the economy, including most notably the forthcoming privatization program. The authorities' intention radically to reduce the scope of price controls would also help to improve prospects for profitability and increase the flexibility of the economy more generally.

On other aspects of structural and labor market policies, Mr. Foot welcomed the measures the authorities were taking to strengthen the structural performance of the economy. In particular, wage determination had been decentralized, and labor market restrictions had been reduced. For nearly all countries in Western Europe, continuing high unemployment--particularly among the young--was of great concern. And his chair welcomed the developing experience of the Fund staff in monitoring each country's approach to the unemployment problem and in analyzing the results. That experience could be of considerable analytical value to all the countries in the future.

Mr. Wijnholds made the following statement:

> In recent years the French economy has been characterized by slow growth, rising unemployment, and a relatively weak external position. A bright spot has been the deceleration of inflation brought on, first, by wage and price controls but increasingly by means of a tightening of monetary policy. This year, economic developments are showing a significant improvement over a broad spectrum, supported by an important change in a number of areas of policy. I join the staff in welcoming the present stance of policies. A forceful implementation of these policies will create the exciting prospect of adding a major country to the list of strong economies in Europe and the world.
>
> The staff shows, by means of some quite illustrative tables and graphs, that France's economic performance has lagged behind that of other industrial countries in recent years. In particular, it has fallen short of the performance of the German economy. The new Administration has vigorously addressed the problem of weaknesses in the French economy and is now in the process of implementing a combination of prudent financial policies, wage restraint, and potentially far-reaching structural policies aimed at significantly increasing the supply responsiveness of the economy. Furthermore, the external position has been strengthened through an adjustment of the exchange rate

within the European Monetary System. In this connection I would like to remind those who have pointed to the continuing penetration of imports and slow export response that the devaluation of the franc took place only five months ago, and that it is too early to judge its effects.

On financial policies, the planned reduction in the central government budget deficit is welcome, although it is somewhat modest. I concur with the staff's view that a more ambitious target for deficit reduction would be called for if domestic demand in the private sector turned out to be stronger than expected. I note in this connection that the latest information supplied by the staff mentions that domestic demand is increasing quite rapidly. The lowering of taxes can also be welcomed, even if France is perhaps not so clearly overtaxed as some other European countries. The social security system may also need to be revamped, however, as the staff points out. I also agree with the staff that use of part of the proceeds of sales of government assets for support of public enterprises should be viewed critically. Also, it can be questioned whether limiting foreign participation in privatized enterprises to a share of 20 percent is fully compatible with the spirit of the French and international movement toward liberalization.

Monetary policy has become stricter in France in recent years and has undoubtedly made an important contribution to the deceleration of inflation. The monetary target for this year foresees a growth of M3 somewhat lower than that of nominal GDP. A continuation of this prudent stance is appropriate in order to--as a minimum--consolidate the important gains made in lowering inflation, and preferably to push it back even further, down to the German level. While lower interest rates would be useful from the point of view of aiding investment, the authorities do not wish to compromise their monetary target or to weaken the franc's position within the European Monetary System. A delicate balance has to be struck, therefore. Unilateral interest rate action is becoming increasingly difficult within the European context. Close contacts on these matters between France and its European partners are therefore of the greatest importance.

Remarking on the switch from a system of credit ceilings to an indirect system, the staff again urges the authorities to move more rapidly than planned. I think that such a speeding up would be warranted only if it can be assumed that it will not impair the effectiveness of monetary policy. Otherwise, we should give the French authorities a little more time to devise a sound and workable new system in a financial environment that is undergoing rapid change. I would, however, have liked to hear a little more about the new instrument of monetary policy that the authorities are working on. Perhaps the staff or Mrs. Ploix could say a few words about it.

Briefly on incomes policy, I welcome the wage restraint that has been achieved. This has traditionally been a difficult area in France, and the progress on deindexation and decentralization of wage negotiations is an important achievement. Furthermore, the increased flexibility in the dismissal procedure should diminish the reluctance among employers to hire new workers as the economy picks up. The staff correctly points out that the relatively high minimum wage tends to discourage hiring, particularly of unskilled workers, and adjustment of the minimum wage (SMIC) system should therefore be seriously studied.

The devaluation of the franc in April was followed by a prolonged period of capital reflows to France, enabling the liberalization of exchange controls to take place without a hitch. A number of restrictions remain in place, however, including personal travel allowances. I agree with the staff that eliminating the remaining restrictions does not pose any substantial risks and should therefore take place soon. I take heart from the pronouncement in Mrs. Ploix's helpful statement that the abolition of exchange controls will be implemented very rapidly.

It is in the area of structural policies that the changes now being worked out and implemented should have the greatest effect on France's growth and economic performance in the medium and long term. Liberalization of the labor and capital markets, the privatization of public enterprises, and the intended liberalization of rent controls are all most welcome measures to enhance the efficiency of the French economy. Much depends, of course, on the actual regime that privatized enterprises will face and the extent to which they will encounter competition.

In conclusion, the French authorities have put in motion important and potentially far-reaching changes. A forceful and sustained implementation of policies and further adaptation as and when the need arises, should enable France to join the ranks of economies that combine good growth performance and low inflation.

Mr. Fujino made the following statement:

The French economy has continued to make progress toward achieving better balance and steady structural changes in the economy. The rate of inflation, which has generally been higher than in other industrial countries, continued to decelerate, and the difference has virtually disappeared. Reflecting the improved profit margins in the enterprise sector, private nonresidential fixed investment rose by 5 percent in 1985, which was the first substantial increase since 1980. Behind these achievements were the authorities' generally prudent management of financial policies and success in wage moderation through their unique incomes policy.

However, the growth of real GDP as a whole remained low, and the unemployment rate remained very high. While the current account of the balance of payments recorded approximate balance in 1985, the deterioration of the trade balance during the second half of the year, despite a terms of trade gain, poses renewed concern about the competitiveness of French exports.

The key to improving the competitiveness of French industry lies in the stability of prices as well as strengthened investment. It is indeed a welcome development that the past high level of inflation has now come down to a level comparable to that in other major trading partners, with the CPI increasing at 2 percent. This decline in the rate of inflation has been helped to a considerable extent by lower import prices. At the same time, the wage moderation certainly contributed to the lowering and stability of prices. Incomes policy is playing an important role in this respect. The differential approach in wage negotiation now taking place is, however, an important development. At the same time, it will be essential to maintain wage increases below productivity gains. It will also help to improve the prospects for business profits, which is a necessary condition for more active investment. The reduction of the business profits tax by 5 percent would provide further incentive for investment. In spite of progressive liberalization, price controls are still fairly widely used as a complement to incomes policy. With the progress of privatization and stability of prices, I expect that the liberalization process will be further facilitated.

Here I note with appreciation the comment in Mrs. Ploix's articulate statement that "freedom will become the norm." Like Mr. Zecchini, I would like to hear a more detailed explanation of the core area where price control would be maintained. I would also appreciate further elaboration on the modern legislation on competition, which is to be enacted and which was explained in Mrs. Ploix's statement.

A further strengthening of fiscal policies and the removal of the rigidities in the economy remain important to consolidate the gains achieved so far. Therefore, the commitment of the Government to this end is most welcome. This line of policy management will reinforce the favorable effects on the French economy expected from the recent fall in oil prices.

Since I can support the general thrust of the staff appraisal, I would like to make brief comments on specific policies. First, on fiscal policy, while the general government deficit improved somewhat in 1985, due to continued buoyancy of local authorities' taxes and other expenditure-saving factors, the central government deficit for 1985 remained at almost the same level as in the previous two years, namely, 3.3 percent of GDP. There was some spending overshoot, and particularly worrisome was the large increase in the expenditure for "intervention and subsidies," which grew 9.7 percent in 1985 over the previous year.

Against this background, I attach particular importance to the authorities' objective in the 1986 budget of reducing the central government deficit to 3 percent of GNP. It is important that this objective be achieved. In 1987 and beyond, the authorities intend to eliminate the noninterest component of the central government deficit over a three-year period. This would imply, according to the staff, a deficit equivalent to 1.5 percent to 2 percent of GDP in 1989. Then the staff questions whether the speed at which the authorities intend to proceed with the deficit reduction is ambitious enough. I myself wonder whether there is not room for a more rapid rate of reduction of the deficit.

In light of the fact that about half of the rise in the tax burden in France in recent years was the result of rising social security contributions, and, in light of the authorities' intention to reduce the tax burden as part of the effort to liberalize the economy, a comprehensive review of the level of social security benefits, particularly that of pensions, is called for as a matter of high priority. In every country, the review of the social security system is a politically difficult question. However, if it is not addressed in a timely manner, the issue could become more difficult to resolve. It is gratifying to note in Mrs. Ploix's statement that a study of reform is now going on.

Second, on monetary policy, on the occasion of the 1985 consultation, I underscored the importance of a more market-oriented credit allocation system and a more active interest policy in France. In this regard, I welcome the authorities' decision to abandon the practice of setting credit ceilings for 1987. As interest rates begin to play a more important role in credit allocation, the remaining interest rate subsidies eventually should be eliminated. As a result of the abolition of credit ceilings, and in view of the ongoing financial innovation and deregulation, the staff's suggestion of using a broad range of indicators is appropriate and to the point.

The reduction in interest rates in France since April is welcome, particularly in the context of the present state of the economy. While I fully support the cautious position taken by both the authorities and the staff against further reductions, due to external considerations, if the opportunity to cut rates further should arise, it should be seized, as appropriate. Again, however, due consideration should be given to the external situation.

I would like to express my appreciation of the quick change in the financial markets. Financial innovations, diversification of financial channels, and the expansion of capital markets begun in the past several years are now expanding in scope and dimension. These developments should certainly help to increase the efficiency of resource allocation and facilitate the integration of the French market into the international financial system.

Third, with a view to improving the flexibility of the labor market, the introduction of increased flexibility in dismissal procedures, effective from the beginning of 1987, is a welcome step. However, more needs to be done to reduce the rigidities in the labor market. Finally, on trade policy, while welcoming the authorities' general commitment to an open trade system, the staff has observed and regretted that there had been no evidence in 1985 to suggest that protectionist pressures had subsided in France. I hope that the authorities will use every opportunity to pursue trade liberalization and, particularly, to eliminate the existing restrictions.

Mr. Isleifsson made the following statement:

The staff report gives a clear picture of the present state of the French economy. Recent developments have shown some encouraging signs, including a further fall in the inflation rate, improved competitiveness, improved profitability, and some increase in employment.

Despite these short-term gains, some of which owe much to the recent decline in oil prices, the underlying problems of the French economy appear to be a low rate of investment and growth, a high rate of unemployment, and difficulties in maintaining market shares.

The French Government has proposed a far-reaching policy of structural reforms. While many of these steps are welcome, the implications of the structural measures for stabilization policy need to be carefully analyzed. The planned sale of public enterprises will, no doubt, have a great impact on many aspects of the economy. It is not clear, however, to what extent the operation of these enterprises has been subsidized by the Government, and, hence, to what extent privatization will affect price developments. As the staff points out, it is important that the proceeds from the asset sales are not used to finance government spending. I take comfort in Mrs. Ploix's statement on this issue.

The high rate of growth of unemployment is of grave concern, and a more innovative labor market policy may be needed. An increased role for vocational training seems to be of prime importance, and, in general, the authorities should be considering measures which will enhance the employment prospects of youth. I would also like to underline measures designed to facilitate the process of the job search itself. The implementation of such measures should ideally be the joint responsibility of the public and private sectors.

In an environment characterized by a high rate of unemployment and rising wage costs, an incomes policy--in the way pursued in France--could be helpful. The case for shifting the distribution of income in favor of profits is well explained in the staff report. We would appreciate comments by Mrs. Ploix on how wage restraint should be coupled with improvements in the functioning of the labor market and the tax system.

The French Government aims at combining fiscal consolidation with a reduction in the overall tax burden. Recognizing the present difficulties in cutting social security expenditures, finding the means to economize on this budget item in the future seems to be no easy task, particularly in light of the foreseeable demographic changes. We would appreciate an elaboration on this subject, especially with regard to the French view on how to approach a solution to this problem.

The current state of the French economy, however, seems to be satisfactory. The inflation rate has been brought down to a low level, and a further decline is expected. The current account is projected to show considerable surpluses in 1986 and 1987, but the unemployment rate remains high. Taking these circumstances into account, as well as the fact that, in a worldwide perspective, there is a need for industrial countries with strong external balances and low inflation to pursue a more expansive policy, a case could be made for considering a modest stimulus of demand, even if this results in a somewhat smaller reduction of the budget deficit.

The recent liberalization of the French financial system and the change in the conduct of monetary policy can be expected to render the French economy more effective. The Nordic countries will follow developments in this area with great interest.

Initially, these changes may cause some uncertainty, both in financial markets and among policymakers, especially because external developments will exert a strong influence on French financial markets. In the short run, increased reliance on prices rather than rationing in the financial markets may increase the volatility of interest rates with unforeseen consequences for the exchange market.

In a longer-term perspective, however, there will be increased maneuvering room for monetary policy to guide market participants and prevent interest and exchange rate developments from getting out of line with fundamentals such as demand, current account developments, and inflation.

The French export industry has had difficulty in maintaining its foreign market share in recent years. We hope that the recent moderate developments in labor costs, combined with the effects of the fairly large adjustment in April for the rate of the French franc within the European Monetary System, will be sufficient to increase the competitiveness of the French economy.

France is now facing a liberalization process in several fields. The liberalization of exchange controls and the strengthened role of market forces in the French economy are positive steps. However, in our view, it is equally important to focus on trade liberalization. Like the staff, we think that the French Government--within the EC as well as at the national level--should take further steps toward eliminating restrictions on foreign trade and take a positive attitude in the preparations for the new GATT round.

By determined efforts over a longer period, France has now reached a relatively high level of official development assistance. The French Government is to be commended for its generally positive attitude to development issues. We also assume that the aim of reaching 0.7 percent of GDP in ODA in 1986, excluding overseas departments and territories, will be achieved.

Mr. Sengupta made the following statement:

France has made significant progress in the effort to reduce inflation, restore external balance, and improve the performance of the economy in 1985. Even though the steep decline in oil prices helped this process, it cannot be denied that pursuit of appropriate policies by France contributed substantially to this outcome. The deceleration of inflation to about 2.3 percent in June 1986 virtually eliminated the inflation differential with France's trading partners, except that of Germany. As a result of continued wage moderation during the year, unit labor costs were reduced and gross profit margins of enterprises improved. There was a 5 percent increase in private capital formation, a record increase since 1980. The central government budget deficit at 3.3 percent of GDP, though higher than the targeted 3 percent, indicates a decreasing trend. Public sector profits have increased and their overall deficits have been reduced. Monetary policy remained quite tight, despite overreaching the upper end of the target by 0.9 percent. On the external account, France continued to have an approximately balanced current account.

We agree with the authorities that the basic objectives of policy should be increasing growth of the economy and a reduction in unemployment without endangering the achievements on the inflation front and on external account. The objectives must be achieved through increases in investment and improved competitiveness of French industries. The measures announced by the Government recently are impressive. These include a reduction of the monetary growth target to as low as 3-5 percent in 1986, a halving of monetary financing of the budget in 1986 and its complete elimination in 1987, steep cuts in public expenditure in 1986 and 1987, the elimination of the central government deficit--excluding interest payments--in three years' time, no general salary increases or public sector wage increase in 1986, abolition of all exchange controls introduced since 1981, the elimination of all industrial price controls in 1986 and service price controls in 1987, the removal of administrative constraints on declaring labor layoffs from the beginning of 1987, and a substantial program of privatization. The range of actions indicate the seriousness with which the French authorities are approaching the problems confronting the economy. Mrs. Ploix's excellent statement also makes a cogent and detailed elaboration of all these policies.

The goals for reduction of the central government budget deficit are quite ambitious. One area in which the Government and the authorities seem to differ is in the size of reduction in the social security expenditures. The social security system is deeply embedded in French society, just as in the case of some other European economies, and it may be difficult to bring about any drastic changes in that system. However, it is interesting to note that pension schemes are being reviewed so as to reduce their dependence on the budget.

In the area of privatization of the public enterprises, I find that the size of this privatization effort is extremely large, forming nearly a third of the total quoted capitalization value of the market, and I would be interested to know any further details in the progress of sales of equity issues for these enterprises. The staff has made an interesting point, namely, that the act of privatization would deepen the financial markets and increase the capacity of the markets to absorb larger volumes of share issues. This raises an empirical question regarding the elasticity of savings, and I wonder whether the staff could elaborate on this, giving the views of the French economists. I am however intrigued, like Mrs. Ploix, about the concerns expressed by the staff regarding the use of the proceeds from privatization. After all, the transfer of these proceeds to the public sector enterprises does not affect the budget outcomes, which have already been determined on the basis of expected revenues and expenditures. And I see nothing wrong in using the proceeds for captial restructuring of the remaining public enterprises. Of course, they should be based on proper rates of return calculations; but, surely there is not, prima facie, a case for suspecting that the French State as a shareholder would not make such a critical assessment of the viability of the investments as the staff seems to imply.

In the area of monetary policy, the staff has made a number of useful suggestions, especially in the light of recent financial and monetary changes that have taken place. The conduct of monetary policy in the absence of credit ceilings and in a deregulated market would have to rely heavily on the interest rate mechanism and reserves. I agree with those who feel that the growth of money targets should not be too precisely defined, for the reasons mentioned by the staff. In the area of interest rates, we can see the reluctance of the French authorities to take any steps to reduce those rates without close coordination with France's major partners.

Clearly, major structural changes are under way in France that, taken together, represent a substantial liberalization of the economy. Removal of most exchange controls recently and the large privatization program are two major steps in that direction. Changes in labor markets, and changes in the wage negotiation process are also steps in this direction. Introduction of new financial instruments and the establishment of financial futures markets in the Paris stock exchange, decompartmentalization of the financial system, and reduction of interest rate subsidies are all steps introducing needed structural reform. These reforms, it is hoped, will enable France to catch up with most other partner countries in terms of growth, which remained very sluggish in 1985 at only 1.5 percent. All the world will be watching with great interest the effects of these policies of liberalization.

France has already made significant progress, even before these policies were adopted, in reducing the inflation rate. The rate of increase in the consumer price index has fallen steadily every year since its high in 1982. During the last three years and in 1986, the low rate is an extension of that trend, complemented by the oil price decline. Similarly, the current account deficit as a percent of GDP, which was as high as 2.2 percent in 1982, came down substantially in the next three years to a negligible fraction, and the trend is expected to continue in 1986-87. While the French economy performed badly in the recent past in respect of the rate of growth of GDP and the rate of unemployment, it is in these areas that everybody will be looking for the impact of the recent policy changes. While we all wish the authorities success in their effort, we realize that the policies are very difficult to carry through, particularly the major changes in wage and labor policy, including what is called rather euphemistically "increased flexibility in dismissal procedures." As the French authorities have adopted these, we can agree that they must have been felt necessary. Many of the rigidities in the labor market undoubtedly became archaic, and some moderation in wage increases was called for. But we only hope that these quickly lead to increasing growth and a reduction in unemployment. The French authorities may, however, find it necessary to take more active steps to promote capital formation and not leave the whole matter to market forces and the so-called "increased competitiveness" resulting from "wages being held to a rate of increase below that of productivity."

France did not introduce any protectionist measures in 1985. However, the authorities should take the lead to see that the subsidies and trade restrictions which France has in common with EC countries are reduced as expeditiously as possible. I agree with the staff that given the excellent progress that has been achieved in improving the position of enterprises in a number of sectors subject to strong foreign competition, as well as improved profitability achieved by the enterprise sector as a whole, France should be able to reduce tariff and nontariff barriers to imports.

France has an excellent record of official development assistance. In 1985, ODA was increased to 0.54 percent of GDP, from 0.52 percent in 1984. However, it is disappointing that the authorities are seeking to keep ODA at 0.54 percent for 1986 also. In this context, it is necessary for countries like France to increase ODA to the agreed target of 0.7 percent of GNP at least by the end of this decade, given the severe problems faced by many developing countries.

Mr. de Groote made the following statement:

Since 1983 the French authorities have been implementing a structural adjustment program with the central preoccupation of restoring business competitiveness. So far, this program is on track and the authorities are to be commended for their continuous scrutiny of those policy areas where structural progress can be made within prevailing external and internal social constraints.

Insufficient investment performance seems to be the key factor depressing the overall competitiveness of French industry and hindering France's prospects for achieving higher growth and employment levels without jeopardizing the external position. France's inadequate competitiveness is shown both by its export industries' loss of market shares, and by the fact that the narrowing of France's cyclic differential with respect to other countries during 1985 triggered on expansion of domestic demand reflected in a significant increase of imports.

A convincing presentation of the impact of all these trends is given in Table 1 of the staff paper, which shows that real GDP growth in France has lagged behind the performance of its principal trading partners for the last five years as a result of low industrial production, while domestic demand has grown faster than in other countries. The conclusion to be drawn from this synoptic comparison is that the French economy suffers from a relatively low savings rate, which has prevented France from being able to achieve sustained growth, through higher investment demand, without endangering the external account. Often there is a kind of preconceived idea that the French are high savers. This stereotype does not seem to reflect the staff's description.

It is in consideration of the behavior of savings and investment in relation to business profitability that policy implementation in the French economy should be assessed. At the heart of economic policy in France, as is brought out clearly by Mrs. Ploix's most cartesian statement, lies the mutually dependent restoration of business competitiveness and sustained investment demand. Appropriately, these two goals are pursued, first, by establishing a sustained transfer of resources from the household and government sectors to the business sector, in order to restore the profitability of enterprises and to support investment through higher aggregate savings, and, second, by the privatization of national enterprises in order to channel investment funds to the productive sectors of the economy. The recent denationalization decree thus responds to a fundamental economic necessity, which transcends its ideological justification. It is equally clear that this adjustment must be placed in a medium-term perspective and will have to be sustained by appropriate demand policies over a long period.

Tight income policies clearly have a key role to play in such a strategy. The French authorities have made commendable efforts since 1983 to reverse long-standing patterns of inflated wage demands, and their success is demonstrated by the steady deceleration of unit labor costs and, more generally, by the narrowing of France's inflation differential with its European Monetary System partners. The Government's commitment to maintenance of a firm stance on wages into 1987 is therefore most reassuring, and I wish the authorities all success in achieving the ambitious targets they have set for themselves. However, one potential threat to achievement of the wage target, a threat of which the authorities seem fully aware, lies in the projected liberalization of the extensive system of price controls. Though I fully concur with the basic goals of this policy, which is sure to benefit the economy greatly by permitting a better allocation of resources in the medium term, the benefits must be weighed against the short-term risk of refueling inflationary expectations and excessive wage demands. In the broader context of France's internal and external adjustment, I would therefore suggest to the authorities that they refrain from implementing overdrastic liberalization schemes and seek instead ways of bringing forward their structural aims to the extent that current price and wage developments permit. In any event, their chances of success in achieving their wage and price objectives will depend greatly on the country's social climate. An important change of this climate seems to be under way, leading toward greater belief in the positive effects wage flexibility can have on labor income and output. The adoption of a new style of wage negotiations is, in my view, a marked improvement in that respect and clearly illustrates this new trend.

Another intriguing and very interesting feature of France's incomes policy stance is the simultaneous pursuit of policies supportive of wage moderation and wage differentiation: binding wage targets are set for the public sector, while, at the company level, employers and employees are encouraged to conduct wage negotiations which take account of the company's viability and the Government's recommendations with respect to wage moderation. If successful, this policy would produce important structural progress in several areas simultaneously, since it will create optimal conditions under which high external and internal competitiveness would coexist with more flexibility in the labor markets and strong prospects for higher employment. The current wage indications mentioned in the staff's supplementary paper suggest, however, that there may presently be some obstacles to getting wage demands down to the desirable level; any comment from Mrs. Ploix or the staff on their expectations for the success of the current policy, and on the conditions necessary for success, would be very welcome. My Belgian authorities, who are now engaged for the fifth year of a program that has many features in common with the present French program, find that their desire to introduce greater flexibility into wage formation is constrained by the continuous need for further wage moderation, and they therefore deem it necessary to maintain relatively firm control over the process of wage negotiation in order to consolidate and improve the competitiveness of enterprises. On the basis of this experience, I would therefore like to follow Mr. Sengupta in striking a note of caution about the merits of an unqualified laissez-faire approach to income determination.

On other policies I can be brief, since they are all clearly defined by the Government and broadly in line with our recommendations made in connection with last year's consultation. The public finances continue to be managed cautiously. Though this puts me at variance with the staff's view that the intended deficit reductions could have been somewhat more ambitious along the lines of other countries' performance in this area, I confess I am rather attracted by the more gradualistic approach of the French authorities. Since there is in fact no evidence that the public sector is likely to experience unsustainable imbalances in terms of high indebtedness or excessive tax burdens, there seems no imminent need to consider drastic policies. I therefore concur with the French authorities' decision to implement fiscal policies in a medium-term framework, focusing on the elimination of subsidies and other expenditures and giving appropriate incentives to private sector activity through modest tax decreases.

Monetary policy also has followed an appropriate course. The elimination of the credit ceilings system and the significant progress made in the reduction of interest rate subsidies are both welcome developments of major significance, which mark departures from what had come to be regarded as the French approach to the instruments of monetary policy. Both innovations will produce a better allocation of financial resources and a greater efficiency of investment. The more liberal environment emerging from the process of financial reform in which France has been engaged will of course place a higher burden on interest rate management as the main instrument of monetary policy. Even more than before, interest rates will have to be carefully defined to take account of external considerations and their effect on internal investment conditions. On this latter point, I would appreciate some further elaboration from the staff on the weak relationship which empirical evidence indicates would exist between private investment demand and interest rate behavior. This issue clearly has global implications in the present international context, where expectations of a pickup in private investment demand and higher output in the industrial world seem to depend almost exclusively on the scope for further interest rate reductions.

In conclusion, the French adjustment program is a model of pragmatism and consistent policy implementation. Having taken the lesson that expansionary policies do not, in the present international environment, provide scope for resolving imbalances through higher growth, the French authorities did not hesitate three years ago to reject the options they had initially chosen and to devise a new approach focusing on the elimination of structural rigidities from the economy and supported by prudent demand policies aimed at reallocating resources toward private investment demand. The fact that this approach has been continually reaffirmed over the last three years gives to the French experiment a historical importance, since it shows that beyond political majorities of opposing creeds, a broad consensus has steadily been growing concerning the fundamental economic options to be followed. The removal of exchange controls, the privatization of national enterprises, and the elimination of rigidities in the labor market and the financial markets are all most welcome developments, which should result in a stronger economy. I wish the authorities success with their efforts to maintain tight incomes and financial policies until these transitions have produced the expected results, results which should strengthen the unique quality of life in France.

Mr. Pérez made the following statement:

I would like to start by commending the French authorities for the economic progress achieved during 1985 and, above all, for the positive prospects for the near future that will certainly contribute to improving the world economic situation. In the case of France, the list of attainments is quite impressive, covering almost all macroeconomic indicators. The reduction of inflation to 2 percent at the end of July has been particularly remarkable, allowing a substantial reduction in the inflation differential with major partners.

An important advance has been the improvement in the profitability of enterprises, helped by the moderation in wages. The other successful development has been the takeoff of gross fixed investment that has recorded a 3.1 percent increase after two years of negative developments. The prospects for 1986 are equally optimistic on the ability not only to maintain, but even to improve, this trend in investment. While it is true that the external economic environment has facilitated these positive results, the share of responsibility that the policies implemented by the authorities have had in the process should not be underestimated. Let me say at this point that I found Mrs. Ploix's statement particularly interesting, precise, and concise.

I will devote my following comments to emphasizing a few issues related basically to fiscal, monetary, and income policies, as well as to the external sector.

On the fiscal side, the target of limiting the budget deficit in 1986 to 3 percent of GDP appears correct and feasible. This would mean the maintenance for 1986 of the main thrust prevailing in 1985, based on a curtailment of expenditures that allows for further cuts in taxes with the final objective of fostering domestic demand and creating employment. The decision to utilize the noninterest component of the central government deficit as the main indicator of the fiscal stance surprises me somehow. I could understand some advantage of using the so-called operational deficit; however, given the high level of real interest rates in France, the decision to set aside not only the inflationary amortization component of domestic interest payments but the overall interest component of the defict could hinder an appropriate evaluation of the real fiscal stance of the Government. In this regard, I would appreciate it if the staff could provide us with some figures related to the magnitude of the real component of interest expenditures. It would have been interesting to have had a medium-term fiscal scenario available, in order to evaluate fiscal policy in a more appropriate perspective.

The expenditure cuts announced in the original and supplementary budgets show the authorities' clear determination to cope with the problem of excessive outlays which occurred in the past. Such efforts are rightly concentrated in sensitive areas such as public sector salaries and transfers to public enterprises.

Social security accounts are a subject of particular relevance. Traditionally, social security has enjoyed a comfortable financial position in France. Nevertheless, some shadows seem to be clouding the prospects for the near future. More specifically, a deficit of F 20 billion for the general social security account is expected for 1986 and, what is worse, this deficit could double in 1987. The surplus attained in 1985 would offset part of the coming deficits but would still leave a financing requirement of about F 30 billion by the end of 1987. This issue poses a dilemma for the authorities. While on the one side the social security system has been budgeted to contribute to youth employment, on the other, this policy could imply an additional burden for the public deficit. The generous pension system will also add some pressure to the expenditure side of the budget.

The privatization process in which the Government has been engaged is indeed a most interesting subject, which affects not only France but also other major countries. I could go as far as to suggest that it would be interesting to have a discussion sometime on the experience that many member countries are already having with this kind of privatization policy. A more thorough treatment of this phenomenon by the staff in the papers on the next Article IV consultation with France would be welcome.

The targets pursued under nationalization policies vary from case to case. While in the case of France, budgetary purposes are absent, in some other countries the aims could be of a budgetary nature. It has been traditionally argued that privatization processes are usually aimed at opening those industries involved to the forces of competition. I would rather share the view that privatization of a pubilc enterprise should be mainly seen as a change in the mode of regulation and that privatization alone does not ensure that liberalization in fact takes place. Even more so, asset sales could be considered as a way of financing government borrowing rather than reducing it. I would appreciate it if Mrs. Ploix or the staff could elaborate on this subject, including some reference to the potential capacity of the market to absorb the amount of shares that will be sold under the privatization program.

As we have seen in recent Board discussions, a number of countries are having technical problems when choosing among the several monetary aggregates to be used as a main indicator in the behavior of monetary policy. Since November 1985, the Bank of France has been operating with redefined monetary aggregates; as a result, a redefined M3 is serving as the target aggregate for 1986. All of the financial innovations that are taking place in

France have certainly influenced the measurement of such aggregates. Actually, it has been calculated that in the absence of such innovations, the target levels reached by the different monetary aggregates would have been higher. With the elimination of credit ceilings as a monetary instrument, some uncertainty will be created. The staff welcomes the elimination of the ceilings, but I still have some doubts on whether bank liquidity could be effectively controlled in the near term without some sort of credit ceilings, given the long tradition that France has had in using this monetary instrument. As for the interest rate, the high level of real rates in France may jeopardize the recovery in investment. Like previous speakers, I would like to urge France to adhere to a concerted reduction in interest rates.

As in many other European countries, the reduction of unemployment rates ranks at the top of government priorities. The 10.5 percent unemployment rate in France is certainly worrisome. The authorities have shown their firm intention to face the problem and have already put into practice programs aimed at reinforcing job creation, particularly among first-job seekers. This effort is also being supported through a set of timely supply incentives in the form of reductions in social security contributions when young employees are hired. I note with satisfaction that the staff has tempered the negative view it held in previous cases with regard to the use of this type of incentive. As I stated on previous occasions, measures geared toward removing rigidities are essential for long-term employment growth. But they will make only a gradual contribution in the short run. Something more immediate is needed to change the course of events. In this regard, supply incentives along with a boost in domestic demand could improve employment now rather than later.

The income policies followed by the French authorities are most welcome. Measures to decentralize wage bargaining and to establish indexed ceilings for wages in the public sector will contribute to decreasing labor costs and to achieving greater wage differentiation.

On the external sector, the latest data available have reinforced our impression, shared by the staff, that official projections for exports could have been on the optimistic side. Exports in 1984 grew very rapidly; in fact French exports to the United States increased by more than 50 percent in 1984 in relation to the previous year. This trend was obviously difficult to maintain and, taking into account the rate at which exports from the main trading partner countries are growing, it would be reasonable to think that export rates will decelerate substantially. On the other hand, the effects of lower oil prices have already been felt on the trade account. In addition, the good record on inflation could provide comparative advantages for French products. Strengthening of the balance of payments could certainly benefit now from these favorable elements.

In sum, we congratulate the French authorities for their achievements and support the intention of the new Government to implement further measures to foster higher growth rates, investment, and creation of employment.

Mr. Hospedales made the following statement:

In an important public economic policy initiative in 1983, France embarked on a reorganization and modernization of its economy based on a three point economic program: a restrictive fiscal policy; strict control of monetary aggregates to reduce liquidity conditions; and an active incomes policy. The strategy was fashioned within a medium-term financial framework encompassing a variety of measures, including a number of structural initiatives, in several areas of activity with far-reaching but gradual effects. This course of action was well conceived and, in the view of this chair, was clearly preferable to the implementation of a set of drastic measures--"a shock approach"--which would have been inconsistent with the prevailing substantial internal and external imbalances and structural rigidities of the economy. It is likely that to have acted other than in a gradualistic manner and within a medium-term framework could have been self defeating; this chair is of the view, therefore, that recent French experience with issues relating to growth and adjustment has important lessons for our membership, including our developing member countries.

We are in broad agreement with the thrust of the analysis and appraisal of recent economic events in France as set forth in the perceptive staff documents and in Mrs. Ploix's thoughtful and instructive statement. The commendable accomplishments in 1985 do not bear repeating, since they have been well articulated by a number of Directors. The progress was achieved at not an altogether inconsiderable cost: growth in real GDP in 1985 has remained weak at 1-0.25 percent; and, while recent data indicate a modest pickup, unemployment has remained intractable, although significant flexibility in labor markets has begun to emerge. It would appear, therefore, that while significant progress has been made in laying the conditions for a durable improvement in economic growth in France, the French authorities should be mindful of the staff advice for maintaining, if not strengthening, corrective policies. For this reason, this chair welcomes the expressed intention of the new Government to consolidate and amplify the prevailing adjustment effort within a medium-term framework which, it is to be hoped, will bring France in line with developments with major industrial countries, in particular, growth and inflation rates. The beneficial effects for France and the world economy will be significant.

First, economic growth in France remains low not only by its own historical standards but also when compared with other industrial countries, with which a significant growth differential has emerged. The need to foster economic growth in France is, therefore, a major challenge to the authorities. Accordingly, this chair concurs with their view that a durable improvement in economic growth and a reduction in unemployment in an environment of financial stability, both internal and external, could only take place at the present juncture with a greater investment effort with capital deepening to foster competitiveness and capital widening to foster employment opportunities. Second, an improved inflation performance is critical for the competitiveness of the French economy, and in this respect we view continuing success in moderating wage behavior as a key contributing factor in the eventual erosion of the inflation differential between France and its trading partners. Prevailing initiatives to further reduce and eventually to eliminate the substantial rigidities in labor markets are, therefore, welcome and desirable. We are confident that moderation in price and wage costs will effect a return to growth, enhance already improving profit margins, and facilitate the expansion of investment as envisaged. There is no doubt that a general convergence of inflation rates with other industrial countries will be extremely beneficial for France and will also contribute to the strengthening of the balance of payments which, according to the staff, is still fragile and vulnerable.

In any event, the decline in interest rates, which have been affected by improved functioning of financial markets and international coordination, together with the devalued franc, should provide enhanced stimulus to the economy over the medium term. However, the question naturally arises whether the incipient improvement in the trade balance will be sufficiently rapid and strong to balance the likely contractionary effects stemming from the necessary process of deficit reduction over the medium term. It is to be noted that the growth of domestic demand has been stronger in France than in other industrial countries when cumulative changes since 1980 are examined. The French authorities must be appropriately alert, on the one hand, to the problem of reconciling the improved confidence in financial markets stemming from the lower franc and declining interest rates and, on the other hand, to a possible temporary decline in economic activity over the medium term stemming from the fiscal consolidation process. This chair would appreciate the staff's view of whether the deficit reduction process should be redefined if the French economy slows down further or remains below industrial countries' average and unemployment continues to rise, as we have seen in the staff's latest supplement.

I have two final points. First, while this chair is particularly encouraged that France has not implemented further protectionist measures in the past year, we are strongly of the view that France should act in concert with its partners in Europe to roll back existing barriers in many sectors of EC trade so as to avoid increased discrimination against third country suppliers. Second, this chair welcomes the maintenance of the relatively high ODA flows by France, at 0.54 percent of GDP. Like Mr. Sengupta, however, we encourage France to improve this performance.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/145 (9/4/86) and EBM/86/146 (9/5/86).

2. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/86/212 (9/2/86) is approved.

APPROVED: May 27, 1987

JOSEPH W. LANG, JR.
Acting Secretary