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June 21, 1985

To: Members of the Executive Board
From: The Secretary
Subject: France - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with France.

Mr. Mackenzie (ext. 575168) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

FRANCE

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Article IV Consultation with France

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

June 20, 1985

I. Introduction

Article IV consultation discussions were held in Paris from May 6 to May 13, 1985. The staff team, consisting of Messrs. L. A. Whittome, P. Dhonte, A. Leipold, G. A. Mackenzie (all EUR), Mr. J. Clement (ETR) and Ms. S. Durand-Jansiac (secretary-EUR), met with the Minister of Finance, the Economy and the Budget, Mr. P. Beregovoy, the Governor of the Banque de France, Mr. M. Camdessus, and officials of the Administration and the Banque de France. The Executive Director for France, Mr. B. de Maulde, attended the meetings as an observer. France has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Fund agreement as of February 15, 1961.

The previous consultation was concluded at EBM/84/91 and EBM/84/92 (June 13, 1984) on the basis of SM/84/109 (May 15, 1984) and Supplement 1 (June 11, 1984). In the discussion, Directors commended the French authorities for implementing a comprehensive set of adjustment measures. Directors also noted the need for further progress, in reducing the rate of inflation, in strengthening profitability and in improving the external current account position. Directors supported continued use of incomes policy but warned that its success would require the contribution of adequately constraining financial policies; in particular they emphasized the need to fully implement the restraint on domestic credit associated with the monetary targets, and considered that a reduction of the budget deficit to not more than 2.5 percent of GDP would be desirable. Further progress was achieved in 1984 on wage moderation and the strengthening of profitability, but inflation exceeded the target and the budget deficit remained high. The authorities intend to continue to pursue the thrust of these policies in 1985. General elections are due in early 1986.

II. Developments in 1984

As in the previous year, incomes restraint played a central role in 1984. Wage settlements were based on a deliberately ambitious price target, set at 5.5 percent through the year, 1/ compared with an outturn

1/ December to December, or fourth quarter to fourth quarter, as applicable.

of 9.3 percent through 1983. There resulted a reduction of nominal and real wage increases, and of consumer price inflation. Another consequence was a further shift in the distribution of factor incomes and an improvement in business profitability. The stagnation of real personal incomes dampened consumer demand, while the increase in profits was not immediately reflected in higher investment. Domestic demand therefore was flat, which contrasted with more buoyant activity in partner countries. 1/ The cyclical differential improved the external accounts; however, sluggish domestic demand also restrained GDP, causing losses of employment and adding to the difficulty of containing the budget deficit (Table 1).

Table 1. France: Selected Indicators

	1980	1981	1982	1983	1984	1985 <u>1/</u>
CPI (percentage change)						
December to December	13.6	13.9	9.7	9.3	6.7	5.8
Year-on-year	13.6	13.4	11.8	9.6	7.4	6.0
Total domestic demand (percentages change)	2.1	-0.5	4.1	-0.4	0.3	1.1
Mark-up rate <u>2/</u>	24.6	23.8	24.0	24.4	25.9	27.0
Current account balance (in percent of GDP)	-0.6	-0.8	-2.2	-0.9	-0.1	0.1
Relative unit labor costs in common currency, 1980=100	100.0	95.4	90.8	87.2	84.5	84.3
Cyclical differential <u>3/</u>	0.1	1.5	4.5	-1.3	-2.2	-0.9

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

1/ Staff projections.

2/ Ratio of gross operating surplus to gross value added (in percent).

3/ Difference between percentage increases in total real domestic demand in France and in her partner countries, in percent.

1/ Real domestic demand in partner countries grew by 2.5 percent.

As anticipated in last year's report, real GDP growth remained weak in 1984; at 1.3 percent, there was only a slight acceleration from the 0.7 percent recorded in the previous year, due in good part to a strong agricultural performance. Most of the additional output went to strengthen the foreign balance. Gross fixed investment was weaker than anticipated and fell by 2.2 percent; by contrast, investment in industry (which accounts for roughly a third of business investment) rose by an estimated 9 percent in real terms after three years of successive declines. Real household consumption increased less than 1 percent, despite a rather sharp drop in the household savings rate.

Consumer price inflation, at 6.7 percent through the year, was higher than targeted though about in line with the staff forecast made a year ago. Partly as a result of the strong exchange rate of the U.S. dollar, import unit values rose by 10.6 percent; however wholesale food prices decelerated sharply, and price controls helped moderate price increases in the services sector (Chart 1).

Hourly compensation decelerated more than consumer price inflation: the rate of increase dropped over 3 points to 6.6 percent through 1984. Settlements broadly conformed to the Government's guidelines, and wage increases were staggered over the year according to a predetermined schedule. Productivity growth was relatively strong, both for the whole economy and the manufacturing sector. Altogether there was a pronounced deceleration of unit labor costs; in the manufacturing sector, the rate of increase dropped from 7.6 percent in 1983 to 2.4 percent in 1984. While the CPI differential with Germany remained large (5 points) the unit labor cost differential was less (2.7 points).

Lower wage inflation, given a continued effective depreciation of the franc, helped rebuild profit margins (Chart 2). Production costs in industry rose by 5.7 percent in 1984, but production prices increased by 7.5 percent and export unit values for manufactures soared by 10.2 percent. The corporate markup rate (which is approximately equivalent to the nonlabor share of value added) rose by 1.5 points to 25.9 percent, its highest level since 1974; in part this recovery reflected a sharp increase in the mark-up rate for the public utilities (Grandes Entreprises Nationales or GEN) both as a result of rate increases and labor shedding. However, debt equity ratios remained high, and the increased profitability served more to restructure balance sheets than to expand investment.

Employment fell by 1 percent in 1984, mostly in industry and construction, while the labor force expanded at about the same rate. As the impact of previously introduced measures wore off, the rate of unemployment rose to an average of 10 percent. The unemployment compensation scheme was restructured in April 1984; the new arrangements resulted in lower benefits at most income levels and a shorter duration of benefits. There are a number of studies of the "grey" economy in France, but estimates of its size vary and are uncertain. There are no indications of changes in recent years on a scale which could significantly alter the picture for activity and incomes shown by official data.

The main fiscal policy objective in 1984 was to contain the central government budget deficit (on an administrative basis, excluding the operations of the Exchange Stabilization Fund) to 3 percent of GDP. In the event, and as in preceding years (Table 2), this target was overshoot, and the deficit amounted to 3.4 percent of GDP. The slippage in the execution of the budget could be traced to higher than anticipated interest payments on the public debt (as average interest rates were some 2-3 percentage points above initial assumptions) and to lower revenues from corporate income taxes, offset in part by advancing to August 1984 certain increases in taxes and nontax revenues that were to be introduced in the 1985 budget.

Table 2. France: Central Government Balance: Initial Budgets and Outturns, 1979-84 (administrative basis) ^{1/}

(In billions of francs; as a percent of GDP in parentheses)

	1979	1980	1981	1982	1983	1984
Initial budget	-15.1 (-0.6)	-31.2 (-1.1)	-29.4 (-0.9)	-95.4 (-2.6)	-117.7 (-3.0)	-125.8 (-3.0)
Outturn	-37.6 (-1.5)	-30.3 (-1.1)	-80.9 (-2.6)	-99.0 (-2.8)	-129.6 (-3.3)	-145.6 (-3.4)

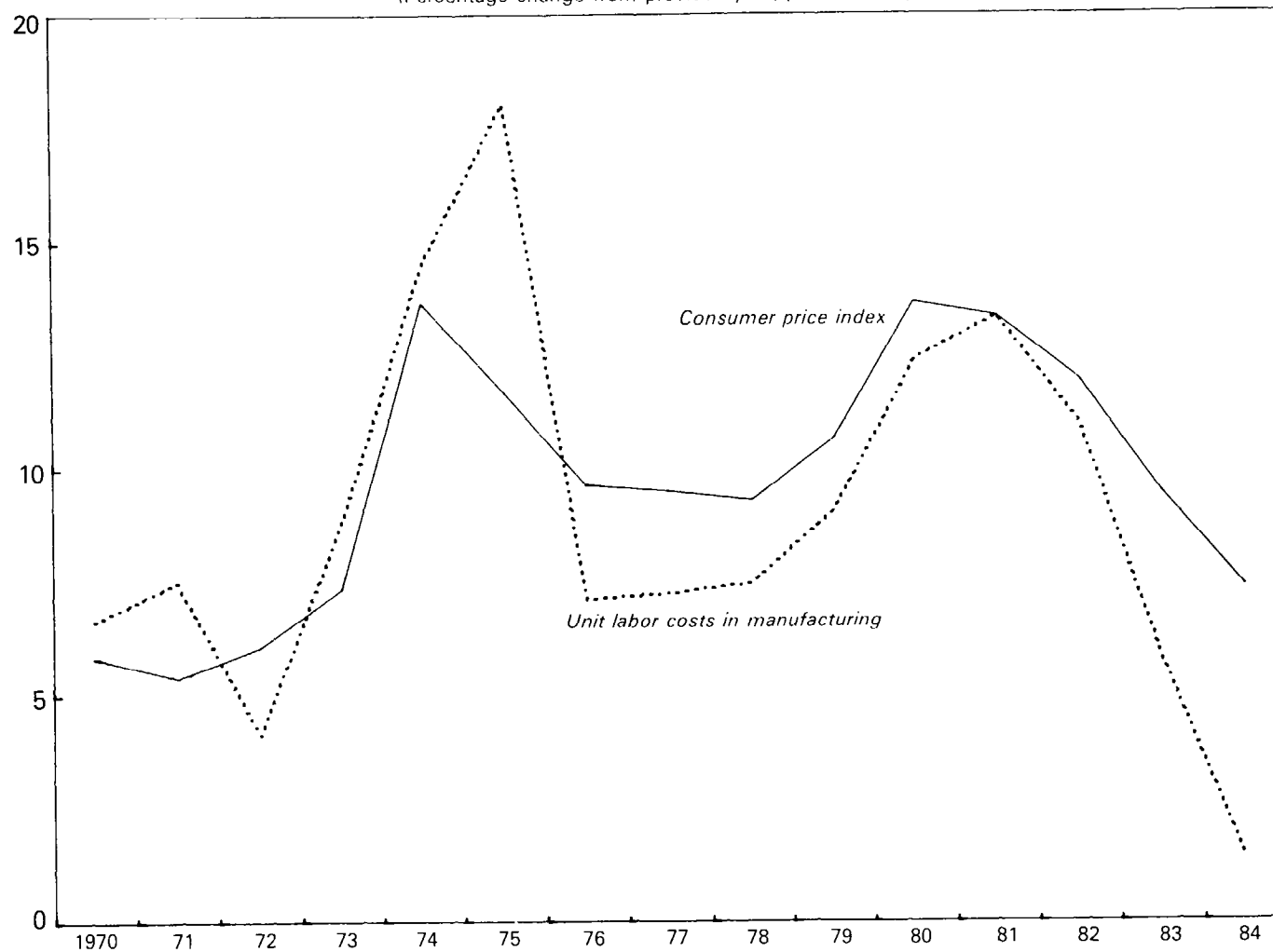
Source: Budget documents, various years.

^{1/} Administrative basis, excluding operations of the Exchange Stabilization Fund; this is the concept used for the target budget balance each year.

Despite the disappointing budgetary result at central government level, the financing requirement of the General Government (i.e., including the local authorities and the social security funds on a national accounts basis) dropped from 3.1 percent of GDP in 1983 to 2.8 percent in 1984 (Table 3). ^{1/} This improvement was largely

^{1/} The difference between the central government budgetary outturn on an administrative basis, which is used as a target by the authorities and the central government financing requirement on a national accounts basis is due to (a) the former's exclusion of the operations of the Exchange Stabilization Fund (which recorded a loss of F 11.3 billion, or 0.3 percent of GDP in 1984); and (b) its inclusion of central government financial operations (net lending and equity participations, which amounted to F 25.3 billion, or 0.6 percent of GDP in 1984). For the full reconciliation of the two concepts, see table in Recent Economic Developments, Chapter II.

CHART 1
FRANCE
INDICATORS OF INFLATION, 1970-84
(Percentage change from previous year; period average)

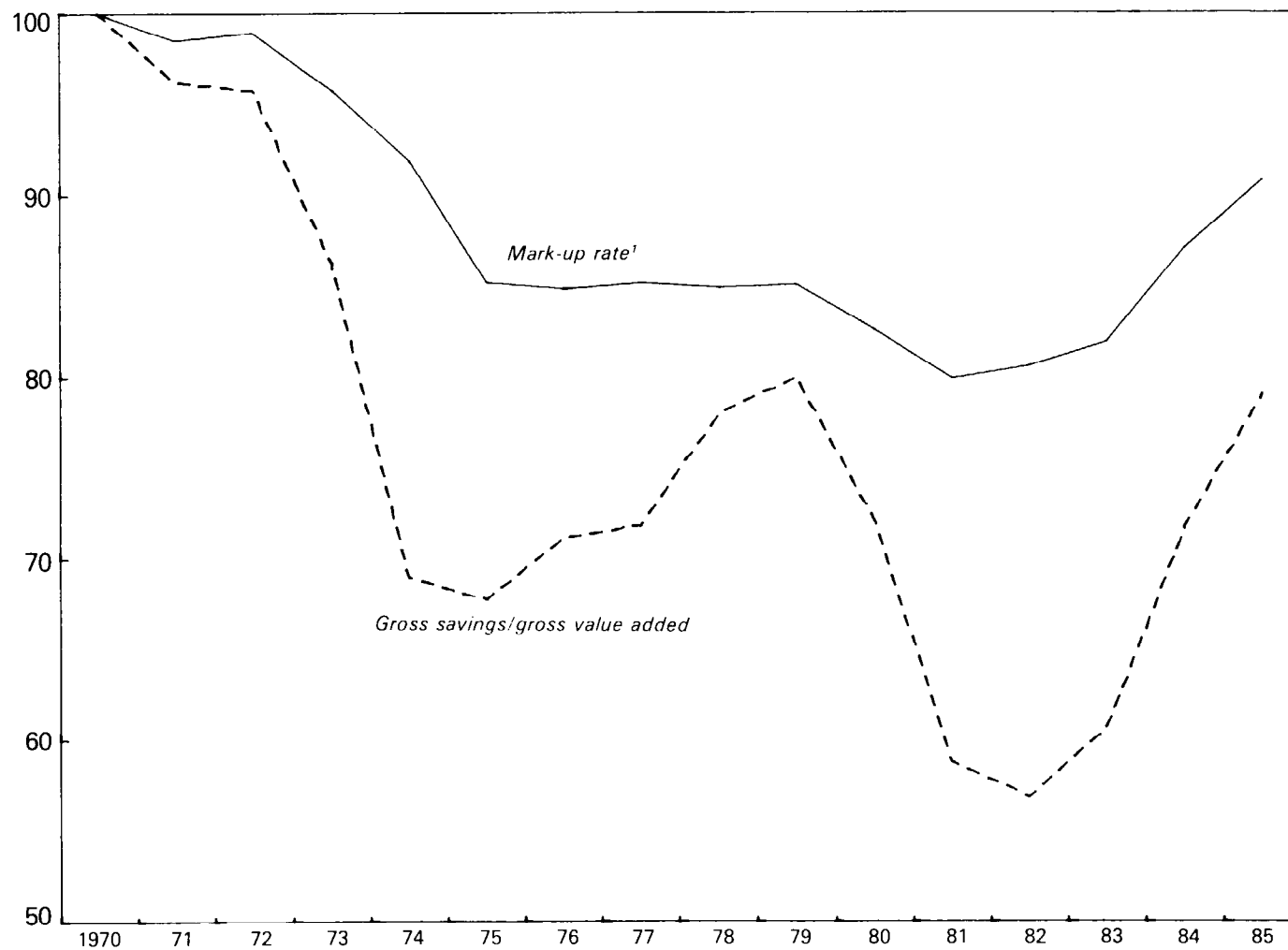


Source: IMF Datafund.

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CHART 2
FRANCE
INDICATORS OF CORPORATE PROFITABILITY, 1970-85
(1970=100)



Source: INSEE, *Comptes de la Nation*
¹Gross operating surplus/gross value added



attributable to a lower financing requirement of the local authorities, reflecting both higher local authority taxes (direct and earmarked, in connection with the process of decentralization) and lower investment in infrastructures. The social security accounts continued to record a relatively large surplus, thanks to an improved control of health costs and the full year impact of an income tax surcharge introduced in 1983 to the benefit of the family allowances fund. Although the general government financing requirement thus narrowed slightly in 1984, the overall size of government continued to grow: consolidated general government expenditure approached 50 percent of GDP and total fiscal pressure was nearly 1 percentage point of GDP above the authorities' initial projections and above the outturn for 1983.

The financing requirement of the public utilities was halved due to improved operating results and lower investment--notably in the construction of nuclear electricity plants. Equity transfers to the nationalized industries were little changed. There are no aggregate data on the financial position of the nationalized enterprises in industry. The accounts of the main enterprises record a large loss by Renault and by the steel producers in 1984 (partly as a result of write-offs), while the combined position of the other enterprises (including the oil companies) moved to a surplus.

Table 3. France: Public Sector Financial Balances, 1980-85
(National accounts basis)

(As a percent of GDP)

	1980	1981	1982	1983	1984	1985 ^{1/}
1. General Government	0.2	-1.8	-2.7	-3.1	-2.8	-3.0
Of which:						
Central Government	(-0.2)	(-1.2)	(-2.0)	(-3.3)	(-3.1)	(-3.0)
Local authorities	(-0.5)	(-0.6)	(-0.8)	(-0.6)	(-0.3)	(-0.2)
Social security funds	(0.9)	(-0.1)	(0.1)	(0.8)	(0.6)	(0.2)
2. Large public utilities (GEN)	-1.5	-1.6	-1.6	-1.5	-0.8	-0.7
3. Total public sector (1+2)	-1.3	-3.4	-4.3	-4.6	-3.6	-3.7
Memorandum items:						
4. State equity transfers to nationalized enterprises in competitive sector	...	...	0.2	0.3	0.3	0.3
5. "Enlarged" public sector concept (3+4)	...	...	-4.5	-4.9	-3.9	-4.0

Sources: INSEE, Rapport sur les comptes de la nation, 1983; and Informations Rapides; Assemblée Nationale, Projet de loi de finances pour 1985.

^{1/} Staff forecasts.

Monetary policy in 1984 targeted an increase in M2 held by residents (M2R) of between 5.5 and 6.5 percent. In the event, the target was overshot, and M2R rose by 7.6 percent, 1/ mostly because of a sharp increase in December. For most of the year, monetary growth was subdued, as bond issues rose strongly against the background of a gradual decline in long-term nominal rates. The bond market was supported by the continued popularity of short-term mutual funds whose assets are invested in that market and appear to be regarded by the public as close substitutes for money. 2/ In December, however, a flattening of the yield structure and the unexpected announcement of the introduction of negotiable certificates of deposit led to heavy withdrawals from the short-term mutual funds, a temporary suspension in new bond issues and a consequent surge in M2R.

Net domestic credit creation (bank claims on the public and private resident sectors minus banks' nonmonetary resources) came to 7.6 percent, a substantial slowdown from the 12 percent of 1983, and close to the objective of a 7 percent growth associated with the target for M2R. The administrative ceilings on credit expansion were not constraining, as demand for credit was restrained by the improvement in corporate finances, by a gradual increase in real interest rates, and by the funding of most of the Treasury's borrowing requirement on the bond market. The slowdown of credit expansion was associated with a stabilization of the external counterparts to M2R, in contrast with the experience of 1982 and 1983 which had seen a substantial deterioration of the external monetary position.

Initial external trade data for the early months of 1984 suggested a massive and puzzling deterioration in the trade account. In the event, these initial estimates were revised, and during the year the current account position improved in line with initial expectations; for the year as a whole, the current account is estimated to have recorded a small deficit (F 6 billion, 0.1 percent of GDP), well below the figure of 1983 (F 34 billion, 0.9 percent of GDP). Most of the improvement was related to the trade account and can be explained by a combination of

1/ These growth rates refer to quarterly averages centered on December, corresponding to the target period for M2R, and thus differ from the December-to-December data of Appendix II.

2/ These are short-term mutual and investment funds (fonds communs de placement-FCP and SICAV à court terme), first offered at end-1981, whose assets are invested in variable rate bonds or bonds nearing maturity, both of which are relatively immune to appreciable fluctuations in their market value. This perceived absence of capital risk, accompanied by attractive yields, high liquidity and low transaction costs, contributed to a massive shift in savings which brought these funds' assets to some F 200 billion at end-1984, from F 33 billion at end-1982. Despite the fact that they have in part a monetary character, the liabilities of these funds are not included in the definition of either M2R or M3R.

a "favorable" cyclical demand differential and of strong labor cost competitiveness. The traditional surplus on the services account declined slightly as a stronger tourism balance was offset by a deterioration in the investment income balance.

Besides the narrowing of the current account deficit there was in 1984 a marked reduction in the net outflow of long-term trade credits, as trade was redirected toward industrial countries. Recourse to compensatory external borrowing dropped by more than half to F 35 billion or 0.8 percent of GDP, which (together with exchange rate valuation effects) brought the medium- and long-term debt outstanding to F 525 billion or 12.3 percent of GDP by year-end. The banking sector's net external liabilities continued to increase as a result of nonresident demand for francs and of residents' transactions, in particular to comply with the advance surrender requirement for export proceeds; the counterpart was a further increase in reserves. Official development assistance (ODA), (excluding transfers to France's overseas departments and territories equivalent to 0.25 percent of GDP), amounted to the equivalent of 0.52 percent of GDP in 1984.

Over the year, the franc remained relatively strong within the EMS, partly because of the attraction resulting from a large positive short-term interest rate differential vis-à-vis the deutsche mark.

Policy targets for 1985 include a consumer price increase of 4.5 percent through the year; a growth range for M2R of 4 to 6 percent; and a budget deficit of 3 percent of GDP. The trade deficit widened markedly in early 1985 partly as a result of high oil imports related to the cold weather, but the franc remained stable within the EMS. Other developments continued the trends of 1984: consumer prices in April were 6.5 percent above their level of April 1984 while hourly wage growth decelerated further in the first quarter. Activity remained weak, but registered unemployment declined as a new youth employment scheme providing part-time work at reduced pay in public services came in operation.

III. Report on the Discussions

The authorities emphasized that they continued to seek the objectives described during the previous consultation. They intended to strengthen the external accounts and reduce external indebtedness; to reduce the rate of inflation further; to pursue the improvement in corporate finances; and to stop the continuous growth in the size of the public sector. The beneficial effects for growth and employment would be supported by increased emphasis on deregulation and structural adjustment; however, even with greater labor market flexibility, there could be no quick solution to the problem of unemployment. The external constraint ruled out a stimulation of demand, and continuity along a gradualist course was seen as essential.

1. Wages, prices, and labor market policies

The French representatives stressed the key role played by incomes policy in reducing inflation and contributing to a restoration of business profitability. Under the system introduced in late 1982, the Government had established an annual norm for wage and salary increases based on its target for consumer price inflation. This approach had been enforced in the public sector and had increasingly gained acceptance elsewhere. Some of the moderation of wage behavior was associated with the substantial increase in unemployment but in the authorities' view at least half of the deceleration in wages between 1983 and 1984 had to be attributed to incomes policy. The authorities also emphasized that the new procedure had shifted the focus of negotiations from branch to enterprise level, resulting in greater attention being given to the financial conditions of individual enterprises and increased differentiation in wage settlements.

As the price target for the past two years had been exceeded, the new system had reduced real wage gains. Real hourly wages had increased by 1.5 percent in 1983 but by barely 0.2 percent in 1984, well below the average of 3.2 percent recorded over the preceding 10 years. Accordingly, increases in aggregate productivity had outstripped real wage gains, resulting in a substantial increase in the share of profits in national income (Chart 2). The authorities attached importance to this development. They considered that a continued recovery of profits was a necessary condition for a strong recovery of productive investment. However, the substantial deterioration of enterprise profitability over the 1973-82 period and the accompanying deterioration in balance sheet positions could not be made good in two years.

Incomes policy in France had long favored the lower paid, by stipulating increases in minimum wages (SMIC) exceeding the rate of increase of average hourly wages, so leading to substantial gains in real terms. However, in the past year increases in the SMIC had only kept pace with increases in the CPI. The French representatives accepted that a comparison of U.S. and European experiences suggested a trade-off between real wage developments and employment, especially among young persons. There was a case for paying the young less than more experienced workers; the Government's recently introduced youth employment program, which allowed for compensation at rates below the SMIC, could be seen as a step in this direction. The minimum wage however was still regarded as an essential part of social consensus.

The staff inquired about the role of price controls. The French representatives indicated that the system of price regulation in force in France since mid-1982 had been progressively liberalized. Over 70 percent of industrial goods prices had been decontrolled to date. The prices of certain services were still controlled in areas where it was felt there was insufficient competitive pressure. Price regulation was seen as complementary to incomes policy--e.g., in the case of personal service fees--and the regulation of prices was in effect a quid pro quo for the wage and salary guidelines.

The staff observed that the deceleration in prices envisaged for 1985 seemed less ambitious than that for previous years. The French representatives said that an attempt had been made to strike a balance between ambition and realism, and that they had chosen a target for 1985 which, by standing a greater chance of being achieved, would strengthen the credibility of incomes policy. In addition, as the rate of inflation declined, it became more difficult to sustain the earlier degree of disinflation. The minimum medium-term objective was to achieve convergence of the rate of inflation with that of Germany. By the end of 1985 it was expected that consumer prices would be rising at an annual rate of about 5 percent. The differential with France's EMS partner countries would be virtually eliminated, while that with Germany would be reduced to about 3 percent. No official target had yet been set for 1986, but probably the target would be about two points below the expected outturn for 1985. The staff noted that an unambitious target might preclude a further downward adjustment of real wages even though a further decline in the labor share of value added seemed necessary. The French representatives agreed but emphasized that the system was working more and more effectively. Settlements were increasingly covering total compensation, including wage drift, so that in many cases general wage increases were less than the norm set by the Government.

The authorities had adopted a number of measures to increase the flexibility of labor markets. Legislation introduced in 1982 had facilitated hiring on fixed-term contracts and the number of fixed-term appointments had risen strongly. It had also eased restrictions on shift work and permitted more flexible working hours. Scope for further substantive progress could come from agreements for annual, instead of weekly, definitions of working hours, and from allowing night shifts for women in industry. The staff queried whether restrictions placed on firms seeking to lay off workers might not discourage employment. The authorities stressed that applications for lay-offs filed with the Labor Inspectorate were handled within two weeks for the smaller firms, and within four weeks for the larger ones, and 90 percent were approved. However, there could be delays associated with the preliminary discussions among the social partners, but these could be alleviated by decisions of the social partners themselves.

The authorities indicated that they had implemented a variety of measures to check the growth of unemployment. These had had a maximum impact in 1983, when the average number of unemployed was unchanged from the previous year. They included early retirement programs and various inducements to on-the-job training and participation in apprenticeship programs. Two substantive needs were to improve the transition from short-term to permanent employment for the young, and to provide a safety net for the long-term unemployed over age 45.

2. Public finance policies

The 1985 budget aimed to reduce the central government deficit to 3 percent of GDP, while decreasing the tax burden (total tax revenues and compulsory social security contributions, at general government level)

by 1 percentage point of GDP, which would represent the first reversal in the continuous increase of this ratio, by an average 0.8 percent of GDP per annum, since 1971. To this end, the budget included tax cuts officially estimated at F 32 billion, of which some two-thirds benefited households.

The staff team asked about the economic rationale of an approach which sought both to contain the deficit and reduce taxes. The authorities explained that the choice of policy mix rested essentially on two considerations. Firstly, it sought to halt the continuous growth in the overall size of the public sector, both on the expenditures and receipts side; the self-imposed constraint on the tax side had undoubtedly forced more rigorous expenditure control in the preparation of the 1985 budget, leading to spending cuts which might otherwise not have been made. Secondly, France had one of the highest tax burdens in the world, ^{1/} while its deficit, especially at general government level, was relatively moderate. There was thus a propensity to act on the level of taxes rather than on the deficit.

The staff team stressed that this approach needed to be complemented by two other objectives. Firstly, the size of the deficit needed to be reduced beyond the presently targeted level of 3 percent of GDP, and the staff suggested a target of 2.5 percent of GDP in 1986 with further reductions thereafter. The staff team noted that, notwithstanding the improvement in the general government financing requirement in 1984 and its projected stabilization in 1985, the public sector's claims on financial resources remained at historically high levels (Table 4). In the medium term, a situation where the financial system was required to accommodate a deficit of 3 percent of GDP would be likely to be one of insufficient capital formation and low growth potential. Secondly, while the decision to reduce the weight of taxation was to be welcomed, one could question the emphasis put on lowering household taxes at a time when heavy reliance on employers' payroll taxes for the financing of the social security system continued to weigh significantly on labor costs.

The authorities agreed that the present level of the deficit was excessive and needed to be brought down gradually. Some progress below the 3 percent of GDP threshold would be sought in 1986. The margins for maneuver were however limited by the rising charges on the public debt. More ambitious targets would require certain long established criteria to be changed, for instance the tacit understanding that real cuts in civil service wages or social security benefits were to be avoided, that the State should contribute to the pension payments of certain large public utilities, and that it would not rapidly withdraw support from some nationalized industries. If such an approach was precluded, the only possible measure, apart from action on taxes, would be to reduce civil service employment drastically. In practice the number of civil

^{1/} OECD data (including social security contributions) show France in the sixth position in 1982, after the main Scandinavian countries, Belgium and the Netherlands.

servants was being reduced by 5,000 in 1985 and by 5,000 to 10,000 in 1986, a sharp reversal of its average annual increase of 40,000 in 1981-83. Over the medium term such reductions would bring direct and indirect savings. The decision to let the 1985 tax cut benefit households more than enterprises was, inter alia, dictated by the consideration that the financial situation of enterprises had improved considerably, and that employers' social security contributions (excepting unemployment) had not been increased since 1982, contrary to earlier practice under which these had been increased in practically every year. In 1986, the design of the tax cut would remain unaltered, with the emphasis again being put on lower personal income taxes (via an across-the-board 3 percent rebate, valued at F 6 billion). There were no specific plans to shift the financing of the social security system away from contributions.

Table 4. France: Selected Indicators of Public Sector
Claims on Resources

(In percent)

	Average 1975-80	1981	1982	1983	1984	1985
1. Absorption of total domestic financial resources by the Treasury <u>1/</u>	12.2	20.5	17.6	28.4	28.7	32.0
2. Share of general government and public utilities in total gross bond issues	32.4	34.5	43.3	47.0 ^{2/}	47.1	46.0
3. General government deficit as a percent of gross private savings	4.7	10.1	14.4	17.0	15.1	16.1
4. Net private savings less general government deficit, as a percentage of GDP	9.0	5.7	4.4	4.4	5.0	5.0

Sources: Various national publications; and staff estimates and projections.

1/ Monetary and nonmonetary financing of the Treasury as a percent of total domestic credit expansion.

2/ Including compulsory loan.

The staff team queried the risks of slippage in the execution of the 1985 central government budget, noting that it required particularly sharp expenditure restraint (4 percent growth on the 1984 outturn), and that interest payments appeared once again to be underestimated. The spontaneous trend suggested that the targeted deficit would be overshoot

to broadly the same extent as had occurred in 1983 and 1984. Recent history seemed to suggest a systematic need for a large contingency fund (fonds de régulation budgétaire). The authorities replied that the execution of the 1985 budget to date was fully on track, but, while stressing the inevitable uncertainties of forecasting the budgetary outcome, recognized that the underlying trend suggested a central government deficit in the order of 3.3-3.4 percent of GDP, with possible shortfalls occurring again in corporate income tax receipts and with expenditure overruns on employment support measures. They did not however agree that interest payments had been underestimated; their containment in 1985 would owe much to the heavy recourse to issues of renewable Treasury bonds, on which interest was payable at maturity. ^{1/} No contingency fund had been provided for in the 1985 budget; to bring the deficit back to 3 percent of GDP (and below that in 1986), the authorities intended implementing, as from mid-1985, some of the savings measures that would be required in 1986. The measures would aim at a further reduction in the State's commitments for subsidized lending.

The staff team supported an early implementation of corrective action on the expenditure side and agreed with the emphasis on reducing subsidies and other support operations. The staff also pointed to the difficulties of interpreting the central government figures over time given the frequent changes in the presentation and scope of the budget. Thus, in 1985, a number of expenditure items (some F 10 billion) were transferred from the Central Government to the postal and telephone services (PTT), partly financed by a 16 percent rise in telephone charges. The authorities felt that the debate over debudgetization rested on shaky grounds. Attempts to quantify the impact of such operations, especially over time, were subject to numerous pitfalls. These changes were ultimately of scant significance to the budget outturn and were normally introduced for sound administrative reasons.

The authorities projected a general government financing requirement (national accounts basis) at around 3 percent of GDP in 1985 (2.8 percent in 1984). A very marginal improvement in both central and local authority finances would be offset by some erosion of the present social security surplus. The objective of reducing the fiscal burden by 1 percentage point of GDP rested in part on the assumption of a spontaneous decline of 0.3 percentage points in the weight of social security contributions and a stabilization of local authority fiscal pressure. The authorities were confident that the rate of increase of local authority taxation (an average 15 percent per annum in 1981-84) would at least level off in 1985-86; they were also considering altering the system for indexing

^{1/} A total F 30 billion of renewable Treasury bonds (obligations renouvelables du Trésor-ORTs) were issued in 1984, entailing a "saving" of some F 7 billion in interest payments in 1985-86, as interest is capitalized and payable after either three years (if the holder exercises the option of exchange against new ORTs) or upon final maturity (six years).

local authority tax bases to moderate their growth. ^{1/} Strains would emerge in the medium term, as the spontaneous growth of the expenditure items transferred to local authorities was definitely stronger over time than the spontaneous evolution of transferred taxes or of the decentralization grant. It was hoped that the ensuing squeeze on the finances of local authorities would induce caution in their expenditures.

The authorities indicated that the medium-term outlook for the social security funds was also a source of concern, despite the series of measures taken on both the revenue and expenditure sides since late 1982. The finances of UNEDIC (the autonomous unemployment insurance fund) would be strained in 1985, and some measures--to be decided by the social partners--appeared inevitable. The ample cash holdings of the general social security regime would tide it over its projected shortfall in 1985 (between F 3 billion and F 13 billion), but serious financing difficulties were expected to arise by mid-1986. Most affected would be the old age pension funds, as an increasing flow of retirees gained the right to full pension benefits. An annual increase in contributions through 1990 of about 1 percentage point (of wages under the maximum ceiling on which contributions are calculated) would be required. Health and family allowance expenditures, for their part, seemed to be under control. Given the strains on the social security funds, the staff team questioned the decision to grant pension and family allowance benefits, a catchup for the erosion in real per capita terms in 1984. The authorities responded that the adjustment of pension benefits was legally determined and that family allowances traditionally followed suit.

The "enlarged" public sector concept--the sum of the financing requirement of the General Government, the public utilities, and the State's equity transfers to nationalized enterprises in the competitive sector--was expected to stabilize at around its 1984 level of 4 percent of GDP, down from the peak of almost 5 percent recorded in 1983 (Table 3).

3. Monetary policy

The monetary target (M2R) for 1985 had been set at a range of 4 percent to 6 percent growth from the three-month average centered on December 1984 to the corresponding average centered on December 1985, against a normative projection for nominal GDP growth of 7.5 percent. Achievement of the midpoint of the target range was regarded as compatible with a neutral contribution of the external counterparts. Net domestic credit expansion would thus equal the change in the money supply (some F 100 billion); the Treasury itself would absorb some 30 percent of monetary resources. Bank credits to residents were set to increase by some 7 percent (10 percent in 1984). The authorities did not view this program as particularly constraining, given the prevailing weakness of

^{1/} Local authority tax bases are indexed to consumer price increases with a two-year lag, ensuring buoyant revenue growth in a disinflationary period.

private sector credit demand; they noted, however, that its achievement depended on the continued strength of the bond market, so that banks could continue to expand their nonmonetary resources and the Treasury could raise adequate nonmonetary financing.

The staff team emphasized the need for a tight monetary policy to contribute to further improvement in price behavior and in the external accounts. Judging from the rate of expansion of the monetary aggregates, and making due allowance for the strong growth of those liquid assets not included in the definition of the aggregates, the stance of monetary policy could not be considered to have been particularly constraining. The French representatives estimated that proper allowance for the liquid assets held in the form of short-term mutual funds would raise the conventional measure of the growth of liquidity by some 2 percentage points for 1984. While they acknowledged that M2R had to some extent become a less reliable indicator, they explained that account was taken of the development of short-term funds outside its definition by fixing the target range at a somewhat lower level than would have otherwise been the case. ^{1/} M2R remained the most operational indicator, given the time lags involved in obtaining data on the wider aggregates and on broad credit indicators such as total domestic credit or global credit (i.e., including the proceeds of foreign borrowing).

As from January 1, 1985, a new form of credit control replaced the system of direct ceilings on bank lending (encadrement du crédit), in application in France during most of the past thirty years. The new system ^{2/} still rested essentially on a quantitative limitation on bank credit to enterprises and individuals, enforced by the imposition of steeply progressive noninterest bearing reserves with the Banque de France whenever the rate of growth of credit rose beyond that deemed to be compatible with the achievement of the M2R target. Increases in banks' long-term resources (net bond issues and capital increases) were deducted when calculating the net credit growth subject to reserve requirements. Some loans (exports, capital equipment and housing) continued to be given preferential treatment, by assigning them a lesser weight (0.7) in the calculation of net credit growth subject to reserves. Finally, the new system shifted the reserve computation and holding periods from a lagged to a contemporaneous accounting basis (also for ordinary reserves against banks' liabilities). The staff team welcomed the lifting of direct credit ceilings, which it had long viewed as cumbersome and a source of rigidities and distortions in credit allocation. It felt, however, that more decisive progress could now be made in giving market forces a greater scope in the allocation of credit and it urged the authorities to fully exploit the potentialities of the

^{1/} Specifically, the authorities noted that the underlying assumptions for activity and prices would have justified a M2R target range in 1985 of 6-7 percent.

^{2/} For further details, see Recent Economic Developments, Chapter III, and Appendix II.

new system to move effectively and rapidly in this direction. The staff team questioned in particular the need to maintain privileged credit circuits and subsidized lending, ^{1/} noting that one effect of the lack of competition and of the segmentation of the French financial system was to make the cost of intermediation in France one of the highest among industrial countries.

The authorities stressed that the new credit control system was notably more flexible than the encadrement, allowing for example for discrete changes in the required reserve ratio in the course of the year. The system was regarded as transitional and evolutionary in nature, and it was intended to move toward a greater reliance on market-oriented monetary control procedures. The credit control mechanism had not been biting for some time and the role of restraining credit demand had fallen upon relatively high real interest rates and a positively sloped yield curve (Chart 3). This constituted a significant break from the past, when the encadrement was inter alia thought of as an instrument to maintain interest rates at artificially low levels. A form of credit control was however still seen as a necessary safeguard as the authorities were of the opinion that high interest rates alone would not always be sufficient to contain credit expansion within prescribed limits. While expressing sympathy with the staff's views, they stressed the need to prepare the ground for the shift in monetary control procedures, by gradually breaking down the segmentation of markets and innovating and modernizing the financial system, and noted that significant steps had already been taken in this direction. With respect to subsidized lending, they had substantially simplified procedures, and were relying on disinflation to render a number of the remaining interest subsidy schemes redundant, noting however that subsidized lending to agriculture would have to be maintained.

Given the persistence of the external constraint and the need to strengthen the external position of the consolidated banking system, the staff stressed the importance of controlling developments in domestic credit. The staff welcomed the greater role played by interest rates in restraining credit demand and argued that, on both domestic and external grounds, the present margin for further interest rate reductions was negligible. The French representatives agreed that interest rate reductions should follow and not anticipate the disinflationary process and that the present real interest rate differential against Germany needed to be maintained; at the same time, however, they stressed the drawbacks of the present high level of real interest rates, both internationally (on the debt servicing capacity of developing countries) and domestically (on investment, the budget and inflationary expectations).

^{1/} Privileged credit for export, housing and investment is programmed to amount to about 1/3 of credit to the private sector in 1985; some 40 percent of credit to the private sector was granted at preferential rates in 1984.

The staff team finally drew attention to the excessive time lag in the availability of French monetary statistics. The French representatives assured the mission that steps would be taken to improve the currentness of data, noting that such an improvement was imperative if interest rates were to be assigned a greater role.

4. Industrial policy

The authorities explained that the Government sought to strengthen the profitability of the industrial sector. The main instruments were the stabilization of labor costs and the rationalization of employment. The ultimate goal was the modernization of an aging capital stock and an increase in the competitiveness of French products.

In the steel sector adjustment had been completed for flat products, but further measures were required for rolled products. The revised steel plan called for a 25 percent cut in employment, to 63,000 and further financial assistance of F 30 billion. France had not formally requested a postponement of the Economic Community (EC) deadline of December 1985 for public aid to the steel sector. In the shipbuilding sector employment would be reduced from 16,900 in 1984 to 12,500 within two years. Total aid of F 3.3 billion in 1984, essentially operating subsidies, amounted to no less than F 200,000 per employee. Although textiles in the past had been regarded as labor intensive, recent developments had much changed this view. The textile plan, which had covered the 1981-84 period at a cost of F 3.7 billion (essentially through a lowering of social security contributions), had been very effective in restoring competitiveness. The plan was formally terminated at the end of 1983.

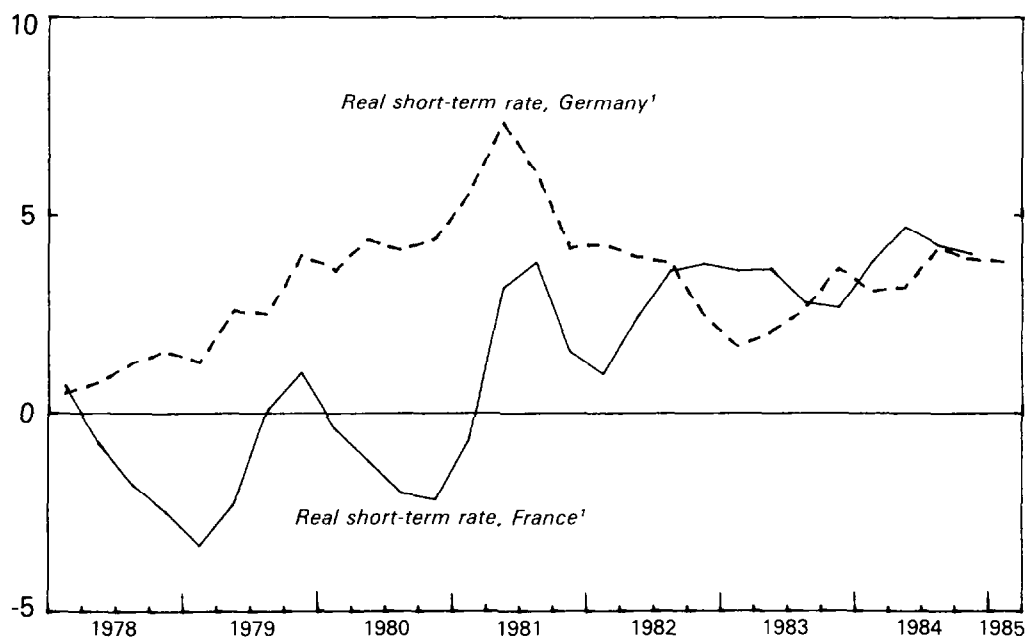
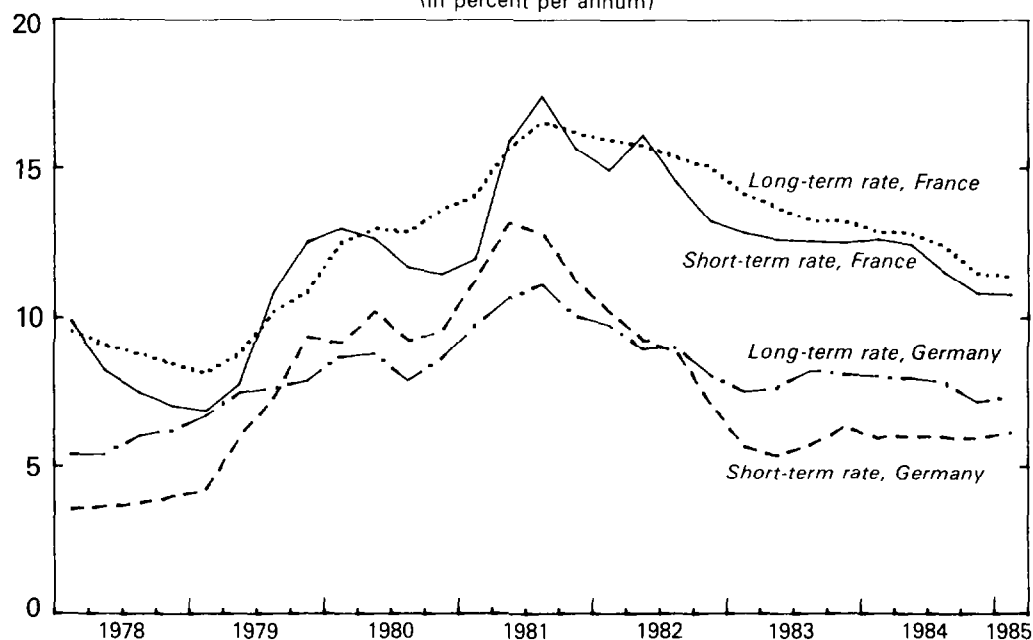
Electronics was a fast growing industry, employing 300,000 and its products were used by many sectors in the economy. Government support was extended through public procurement, research and development aid, and through the role played by the nationalized enterprises, notably in rationalizing production structures. The authorities favored "European solutions" as national enterprises were too small to compete effectively on the world market.

The authorities explained that they sought to create an environment encouraging private initiative. The newly created Fonds Industriel de Modernisation had lent F 10 billion at preferential rates to the industrial sector in 1984, mainly to small- and medium-sized enterprises. These enterprises were introducing more computer-based techniques which required a major review of their management policies.

As regards the nationalized industries, the authorities distinguished between the utilities and the "competitive" enterprises. The utilities (GEN) produced only public goods and services, and their prices were set by the Government. By contrast, the competitive nationalized enterprises

CHART 3
FRANCE AND GERMANY
INTEREST RATE DEVELOPMENTS, 1978-85

(In percent per annum)



Source: International Monetary Fund, *International Financial Statistics*.

¹Nominal rates corrected for changes in consumer prices.

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were open to world market conditions and followed profit maximization principles. Their marketing and investment policies were decided at the level of the enterprises. The authorities expected the utilities to keep their financing requirement in 1985 to the comparatively low level reached in 1984. Their investment appeared to have settled on a permanently lower plateau, with the winding down of the large nuclear energy program. The authorities considered the period of developing infrastructure to be largely over, and had consequently decided to substantially reduce capital transfers to the GEN; indeed, some had been required to make an early reimbursement of previously granted public loans.

The authorities expected the performance of the nationalized enterprises in the competitive sector to improve in 1985, with the chemicals and electronics sectors posting profits and with a scaling back of the record losses registered by Renault and the steel sector in 1984. The better financial situation of a number of the nationalized enterprises would allow them to turn increasingly to the market for their capital requirements, as witnessed by the rise in issues of nonvoting loan stock (titres participatifs) and preference shares (certificats d'investissement). Capital transfers from the State budget to these industries were put at F 13.6 billion in 1985 (equal to 0.3 percent of GDP, as in the previous two years).

5. External policies

The authorities expected the current account to strengthen further in 1985, and their initial forecast projected a current account surplus of about F 10 billion (some 0.2 percent of GDP). This projection was predicated on an average exchange rate of US\$1 = F 9.25, an average price of oil of US\$28.50 per barrel (a decline of 4 percent from its 1984 average level); export market volume growth of 4.5 percent; and import volume growth of 3 percent for manufactures. The further improvement in the cyclical position and the continued gains in labor cost competitiveness justified the expectation of some small improvement in the trade account.

The improvement in the trade balance would be somewhat offset by a deterioration in the services balance. The projected decline in the surplus on services reflected a slight worsening of the deficit on interest payments and lower net service receipts for technical assistance and civil engineering.

The staff felt that developments in 1985 to date suggested that the assumptions underlying the forecast might be too sanguine, even though the oil price projection exceeded the actual average price in the first quarter by about US\$1 per barrel. Import penetration was somewhat greater than had been assumed. The authorities felt that it was too early to revise their projection but emphasized its sensitivity to changes in the

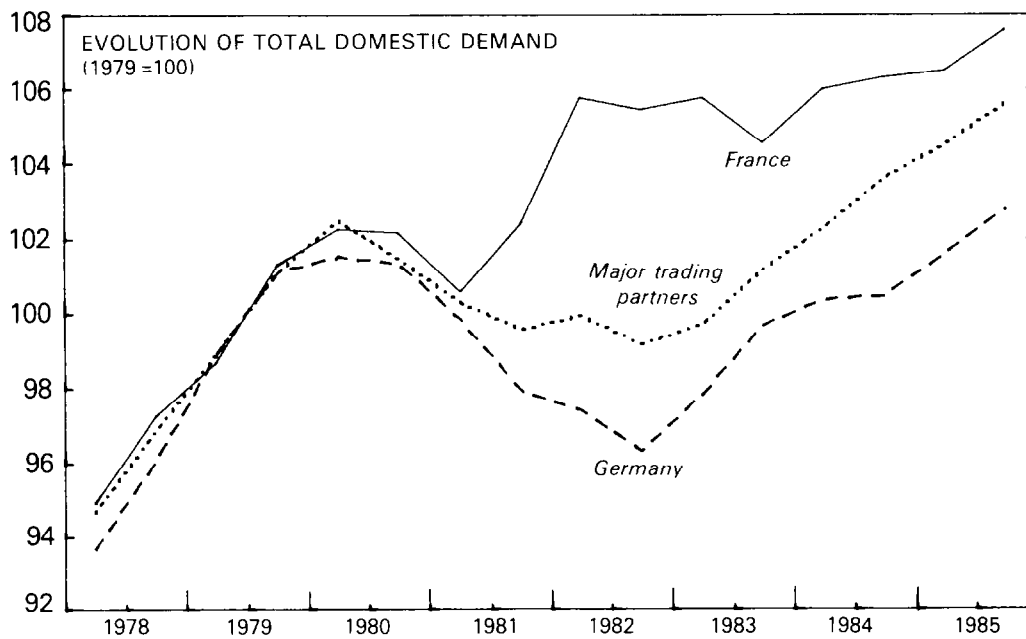
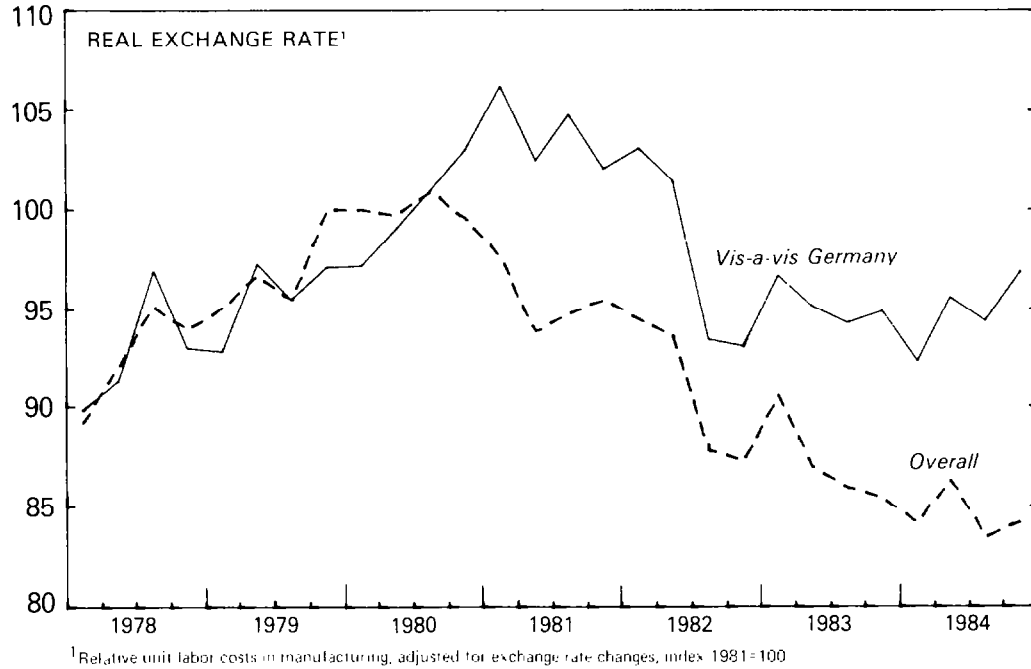
assumptions. For example, an average exchange rate of US\$1 = F 10 (the average value for the first quarter) was estimated to reduce the current account surplus by F 4 billion. A change in export market growth of 1 percent would alter the projected balance by F 7 billion.

While the usual cost comparisons showed that France's competitiveness had improved substantially since 1980 (Chart 4, upper panel) the staff observed that there were broader indications that the economy was insufficiently competitive. France's share of the industrial countries' exports had declined since 1980, and the current account was not yet in balance although the cyclical position had been favorable. Moreover, whereas French domestic growth had for long been stronger than that of Germany this was not presently the case. In short, the external constraint seemed to remain very pressing. The authorities argued that French export growth had suffered from a geographic concentration in relatively slowly growing markets. A substantial redirection of exports toward industrial countries was now taking place. Of particular comfort was the rising surplus on manufactures, which was not just the result of a few large contracts, but reflected more broadly-based developments. Furthermore, while France's current account position currently constrained domestic demand growth to a rate below that of Germany, over the previous five years (1979-84) total domestic demand had grown more strongly in France (5.4 percent) than in Germany (0.5 percent) (Chart 4, lower panel).

The authorities expected spontaneous long-term capital outflows to amount to F 34 billion in 1985, including F 18 billion in net export credits and F 15 billion in public loans abroad. Together with the projected surplus on the current account, and an assumed balance on the private short-term capital and errors and omissions accounts, this would lead to a financial shortfall in the order of F 24 billion (0.5 percent of GDP, down from 1.1 percent in 1984). Net authorized medium- and long-term borrowing was set to cover F 21 billion of this requirement, with the remainder being met by short-term bank borrowing and/or a decline in official reserves. These developments would raise France's external medium- and long-term gross debt (expressed in domestic currency, under the assumption of unchanged exchange rates) to F 546 billion (around 12 percent of GDP) at end-1985. The authorities had not updated the medium-term debt scenario made in May 1984, as they were in the process of revising the amortization schedule assumptions to reflect inter alia the impact of substantial refinancing operations (some F 20 billion) undertaken in 1984 as well as the planned early repayment and refinancing of part of the EC loan granted in 1983. They noted that spontaneous long-term capital outflows were on a declining trend and, with the improvement in the current account, the financing requirement would fall further. They took the view that France should achieve a current account surplus of F 20-30 billion, which would cover net public loans and export credits and permit a stabilization and gradual reduction in external debt. The staff team noted that this objective had yet to be achieved and argued that faster progress was important. The staff's illustrative debt projections to 1995 (Appendix IV) suggest that, in the event that

CHART 4
FRANCE

REAL EXCHANGE RATE AND RELATIVE CYCLICAL POSITION



Sources: IMF, Datafund, and staff estimates and projections.



the current account did not improve beyond equilibrium, France's gross external medium- and long-term debt would continue to rise steadily in relation to GDP and the debt service ratio (in percent of exports of goods and services) would double from slightly over 5 percent in 1985 to around 10 percent at the end of the projection period. On the other hand, a current account surplus in the order of 0.5 percent of GDP as from 1986 would succeed in gradually reducing the gross debt-to-GDP ratio (from 12 percent in 1985 to 10 percent in 1995) and would contain the debt service ratio within a maximum of close to 8 1/2 percent (in 1990). This figure is similar to that which was projected a year ago on the basis of a comparable scenario.

The staff team finally queried the policy of financing a large proportion of the balance of payments shortfall via heavy recourse to short-term bank borrowings, which covered over 1/3 of the requirement in the 1981-84 period (Table 5). The authorities maintained that this was not the result of a deliberate official policy, but conceded that existing exchange controls encouraged such inflows; they agreed that short-term bank borrowings had reached excessive levels, and said that they were taking measures to contain further indebtedness.

Table 5. France: Balance of Payments Shortfall and Financing, 1981-85

(In billions of French francs)

	1981	1982	1983	1984	1985	1/ Cumulative 1981-84
Current account	-25.8	-79.3	-33.8	-0.3	10.0	-139.2
Autonomous long-term capital	-54.8	-53.3	-46.7	-31.1	-34.0	-185.8
Short-term private nonbank capital 3/	-24.3	8.3	-5.5	-15.6	--	-37.1
Shortfall	-104.9	-124.3	-86.0	-47.0	-24.0	-362.1
As a percent of GDP	(-3.4)	(-3.5)	(-2.2)	(-1.1)	(-0.5)	--
Financing						
Authorized borrowing, net	33.6	78.1	87.9	35.4	21.0	235.0
Short-term bank borrowing	42.7	13.1	43.1	38.5	)	137.4
Change in official reserves					) 3.0	
(+ = decrease)	28.6	33.1	-45.0	-26.9	)	-10.2

Source: Ministère de l'Economie et des Finances and Banque de France, La Balance des Paiements de la France.

1/ Projections supplied by the French representatives.

2/ Provisional official estimate, likely to be revised to a deficit of F 6 billion.

3/ Including errors and omissions.

The authorities remarked that the franc had maintained a comfortable position within the EMS throughout 1984 and that they had taken the opportunity to relax certain controls on capital flows. In particular, foreign direct investment in the EC area now required foreign currency borrowing of 50 percent of the amount of the investment as against 75 percent previously. The last of the restrictions on the use of credit cards to finance individuals' expenditure abroad had also been eliminated. The Eurofranc bond market had been reactivated. The authorities agreed that capital flows remained for the most part tightly controlled, but stated that the controls were a necessary precaution against contingencies. Controls would be gradually relaxed in line with the improvement in the external position and as part of the progress toward European monetary integration. The EC Commission had recently extended for two years (to end-1986) the exemption granted France from Community regulations on the free movement of capital.

6. Trade policy

The recent reforms of the EC's Common Agricultural Policy included moderation of internal price supports and direct measures to limit production. In the cereals sector, the authorities indicated their support for continued reliance on price regulation. In their view, a gradual realignment of internal prices to world prices should moderate the problem of excess supplies and subsidization in this sector. An important development for France was the introduction of production quotas on milk for a period of five years, beginning in 1984. The authorities also remarked that the enlargement of the Community to include Spain and Portugal would create problems for Mediterranean suppliers of citrus and wine products to the Community with which there were association agreements. The EC had accordingly agreed to safeguard the share of these countries in the EC market in order to prevent disruption of their production. However, this would imply an increase in restrictions vis-à-vis other producers. At the EC level imports of steel, textile and electronic products continued to be subject to quota limitations.

At the national level, the authorities indicated that new voluntary export restraints since 1983 had been limited to two minor products and that, aside from quartz watches, France did not resort to Article XIX of GATT. The number of temporary authorizations requested and obtained from the EC Commission to limit free intra-Community circulation of goods under Article 115 of the Treaty of Rome had continued to decline (with the number of authorizations approved falling from 109 in 1981 to 39 in 1984). Concerning textiles, the French authorities favored the extension of the third Multifiber Arrangement, scheduled to expire in July 1986. The Arrangement was seen by the authorities as a guarantee of stability and predictability of the market and had facilitated access by developing countries.

The authorities were not opposed to the principle of a new round of multilateral trade negotiations, but in their view its success required a minimum consensus on the area subject to negotiation and the participation of a large number of developing countries, and a parallel progress on the question of the reform of the international monetary system. They noted that while the 1982 meeting of Ministers had agreed on a work program that included discussions of tropical products, agricultural products, quantitative restrictions and services, progress had only been made in preparing a report on agricultural products. A new round should cover the other topics, and should also include the enforcement of the GATT principles at the state level in federal countries and, centrally, the opening up of the Japanese economy. Given the above, the authorities expressed their concern that the degree of preparedness was uneven and thus felt that a new round was at present premature.

The authorities restated France's commitment to an open trade system, noting that the thrust of their policies, including particularly their emphasis on raising the competitiveness of industry, supported this commitment. The mission observed that many important sections of domestic and foreign trade remained subject to subsidies and trade restrictions.

7. Medium-term policies and prospects

The authorities did not believe that France could rely on foreign demand to pull activity sufficiently over the medium term, but thought that growth must rest on the country's own efforts. The external constraint was regarded as the main limitation on French growth. The strategy of the Ninth Plan was to curb domestic demand in order to re-establish a current account surplus, while relying on higher business investment to push back the external constraint over the medium term.

A main policy objective was a deceleration in labor costs, so that domestic consumption would bear the brunt of adjustment; the sources of demand growth would be external demand and investment growth. The authorities thought that investment had to be a key source of growth in France during the rest of the decade. They stressed that investment was necessary to modernize an aging capital stock and prevent a deterioration of labor productivity. This modernization would also contribute to the quality of French products, and thus enhance France's competitiveness in the world market.

In the absence of a buoyant domestic consumption, the French representatives explained, the accelerator would not play a powerful role, and investment would respond mainly to profitability. Profitability had deteriorated sharply until 1983. Its recent recovery had to be qualified by the high level of indebtedness of enterprises that had been built up over the last decade. Increased reliance on borrowing had been attractive when high inflation eroded the real value of debts. In contrast, with

the deceleration in inflation and high positive real interest rates, borrowing became less attractive. Thus, the French representatives thought that for the rest of the decade continued high productivity gains and lower labor and other operating costs would be essential to achieve the needed buildup of equity resources, which was a prerequisite for higher investment.

The authorities explained that, given the assumption of an annual growth rate of 2.5 to 3 percent for France's partner countries over the medium term, France's GDP growth rate could not be high enough to stabilize employment by itself. Since the labor force was still expanding, some form of worksharing--subject to very specific conditions--was seen as a necessary element of any employment strategy. The essential conditions were that worksharing should go in hand with a more flexible definition of working hours, resulting in higher rates of operation of machinery and equipment and should be compensated by adequate adjustments in monthly earnings leaving unit labor costs unchanged.

The authorities noted that the implementation of this strategy was well under way: current account developments were broadly in line with their expectations and business investment was rising strongly. They noted the consistency of their incomes and their growth policies, but observed that this strategy had to be implemented in a gradualist way. Incomes moderation had contributed to an improvement in business profitability, but at the same time had dampened demand expectations. The response of investment was held back by the high real interest rates now prevailing, and by the fact that lower inflation reduced the rate of erosion of corporate debts in real terms. There was therefore a delicate balance to be held between further improvements in profitability and a consolidation of demand expectations; fortunately, it could be expected that the incentive to invest would grow as capital stock aged and as profits improved.

The staff team inquired whether the improved profitability of enterprises had put the economy in better condition to respond to a demand stimulus. The French representatives indicated that their econometric models did not capture the supply effects of improved profitability, but saw no scope to initiate any reflation attempt on their own, although they believed such scope existed for a broader European or international concerted effort.

The staff suggested that some amelioration of the unemployment situation could result from a downward adjustment, and especially a more differentiated structure of real wages. The authorities however did not believe that employment would be very responsive to a reduction of real wages. In industry, they thought that the range of economically efficient techniques was too limited to allow relative factor prices to exert a significant influence. They accepted that lower or more differentiated real wages could support a more extensive development

of labor-intensive activities, notably in services; they thought however that European traditions would not be consistent with the degree of wage differentiation which they thought could be observed in the United States, and they noted that the development of the services sector, especially for social services, was already so extensive in Europe as to limit the prospects for a further expansion.

IV. Outlook

The staff's forecasts for 1985 differ little from those of the authorities. The staff projects real GDP growth in 1985 to lie in the range of 1.0-1.5 percent. The external sector's contribution to growth in 1985 would be lower than in 1984 because of a less buoyant foreign market abroad and a small acceleration of total domestic demand. Some modest growth in real disposable income would permit an increase in the growth of real consumer expenditures, despite a stabilization of the savings rate. While the purchasing power of wages and salaries is not projected to grow, income tax reductions are expected to make an important contribution to the growth of real disposable income, notably toward the end of the year.

The projected growth of real GDP will not be sufficient to prevent a further decline in employment and additional pressure in the labor market will result from labor force growth of 0.6 percent. However, the introduction of youth employment and of adult training schemes may contain unemployment at about its end-1984 level. The state of the labor market and the current stance of incomes policy would preclude any significant increase in the real hourly wage, and nominal wage increases should continue to decline, although probably not by as much as the official norm. Consumer price inflation is expected to be slightly less than 6 percent in through-the-year terms, and about 6 percent in year average terms. However, prices are not expected to decline by as much as the decline in unit labor costs might normally suggest, and the share of nonlabor income is expected to increase still further.

The substantial improvement in profit margins since 1982 is expected to stimulate some recovery in nonresidential private sector investment, although the growth of industrial investment is not expected to be as strong as it was in 1984. The chronic decline of residential investment is projected to end.

The average cyclical differential would decline but remain positive, and the customs trade deficit is projected to decline by about F 10 billion from its 1984 level of F 19.8 billion. The current account would then improve slightly and a small surplus would be achieved.

V. Staff Appraisal

In the spring of 1983 the French Government decided that the current account deficit, which had reached some F 80 billion in 1982, should be halved in 1983 and eliminated in 1984. At the same time, it was decided that a change in wage settlement practices could open the way to lower inflation and to an improved financial position of enterprises.

This gradual approach has been implemented with notable success, but it is the logic of gradualism that continued efforts are required to establish a basis from which sustainable growth can take place and to achieve convergence with France's main partners. The improvement in the external accounts has been virtually in line with the objectives set; however, the weight on the current account of servicing the external debt is an impediment to future growth. It is therefore necessary to achieve a current account surplus to allow for a reduction in gross debt and a consolidation of the external monetary position. It is thus all the more important to monitor and check the trade balance which has shown a marked weakness in recent months. There has been a clear improvement in price performance, but the deliberately ambitious price targets have not been met and the inflation differential remains significant. Perhaps one of the most significant recent successes has been the improvement in business profitability that had deteriorated sharply from around 1973. However, the financial condition of enterprises remains weak and, despite the evidence of some cost comparisons, there are broad indicators that the competitiveness of the economy has yet to be fully reestablished, which will not be achieved until low inflation is consistent with high profitability.

The policy of influencing the wage negotiation process to make settlements more responsive to macroeconomic circumstances and to local conditions has provided a critical contribution to progress towards the Government's objectives. It is necessary that this mechanism should continue to be used, and successfully used, so that it becomes firmly established. It is also necessary to keep setting ambitious targets in order to achieve a decisive break with the inflation-devaluation spiral. The staff believe that if incomes policy is to continue to be successfully implemented, it will need to be supported by adequately constraining financial policies. The staff also believe that progress in establishing better employment conditions can be greatly fostered by a determined attack on the rigidities that impede adjustment in many sectors of the economy.

It is inevitable that in a period of low growth it has become particularly hard to hold the budget deficit to the objective of the equivalent of 3.0 percent of GDP. But it is disappointing that in 1984, and thus for the second year running, this target was overshot. The staff therefore welcome the authorities' determination to make certain that this target is achieved in 1985 notwithstanding the reduction in

tax receipts which has been built into the budget. The proposal that the expenditure cuts that will be required in 1986 be anticipated to the second half of 1985 is entirely in line with this thinking. The staff further believe that the credibility of the Government's policies, the need to reduce the rate of growth of debt servicing, and the need to ensure that there is room available well before a revival of investment is thwarted by the external constraint, are arguments which must lead to the conclusion that reductions in the size of the deficit must be achieved despite the weakness of growth. If no progress were to be made in this direction, the risk is that France could be entrapped in a vicious circle of high deficit and low growth. Fiscal charges, which rose by nearly 1 point of GDP in 1984, constitute an important weight on the economy, and the aim of reducing fiscal pressure is welcome. The staff therefore share the authorities' view that action needs to be taken on the expenditure side. In particular, subsidies and other support operations should be reduced. There is a contradiction in continuing such expenditures at a time of rising profitability and more emphasis on efficiency. Similarly, the staff also welcome the authorities' emphasis on assuring the viability of public enterprises and on requiring them to operate in market conditions.

The stance of monetary policy has accompanied the disinflationary process, without making in itself a major contribution to this end. Judging from the rate of expansion of the monetary aggregates, monetary policy cannot be considered to have been constraining. However, the staff welcome that the external monetary position was stabilized in 1984 and that the previous sharp deterioration in the net foreign asset position of the consolidated banking system was thus halted. The need to strengthen this position underscores the continued importance of monitoring and controlling the domestic sources of monetary creation. In this respect, the staff welcome the larger role being given to interest rates in restraining the growth of domestic credit. Given this role, great care should be taken to ensure that any reductions in rates follow rather than precede the deceleration of inflation. The requirements posed by domestic monetary conditions are in line with those of the exchange markets. The position of the franc has held up well in the foreign exchange markets, but here again the uncertainties are many, the room for maneuver is small, and the risks of reducing interest rates too fast are surely larger than those associated with circumspection. The crucial test should be that real rates of interest are, at the least, in line with those ruling in Germany, and on this basis there is presently no room for further reduction in rates.

The highly administered process of interest rate determination in France and the importance of subsidized and privileged credit circuits tend to blunt the interest rate instrument and to impede prompt adjustments of rates. The staff believe that the changes initiated by the introduction of the new credit control mechanism should be promptly exploited to move more rapidly toward a more flexible system.

The attainment of external and internal financial equilibrium is a necessary condition for a more rapid and sustainable economic growth and a reduction in unemployment. The stabilization policy that has been given a priority since 1983 has unfortunately entailed a substantial increase in the number of unemployed. Real wage moderation will not immediately solve the unemployment problem, but it will encourage greater and more labor-intensive investment as well as increasing the number of workers employed with the existing capital stock. However, other changes need to be made to facilitate and speed an improvement in the employment situation. The role of the minimum wage is clearly controversial, but there is considerable evidence that high minimum wages impede the employment of the young especially in the service sector. Furthermore, there seems to be a widespread feeling that implementation of decisions on lay-offs can be unduly delayed by excessively cumbersome discussions between the social partners. The heavy reliance in the financing of the social security system on employers' social security payroll taxes adds considerably to the cost of labor, particularly of unskilled labor which may often be another way of saying young people. Present laws and regulations on labor time scheduling may also unduly impede the full use of industrial capacity.

These rigidities have their counterparts in other areas, for instance, in price and exchange regulations, and the reliance on various forms of credit controls. Given an adequate tightness of financial policies the staff believe that an abolition of exchange controls would be in France's best interest. The system of price regulations, while it may primarily play a significant if symbolic role in incomes policy, must also have harmful effects to the extent that it is effective. Lastly, the staff welcome the absence of significant new protectionist measures at the national level in France since last year, but regret that, in common with other EC members, many sectors of trade remain subject to subsidies and trade restrictions. The staff believe that France should play an active role in promoting the evolution of EC trade policy in ways that avoid increased discrimination against third country suppliers. In the international context, France should use available opportunities to press for liberalization and elimination of trade restrictions, such as those under the Multifiber Arrangement. These various mechanisms taken together have a substantial economic cost for they impose impediments to the efficient use of human, capital, and financial resources.

The staff welcome that official development assistance has remained at a relatively high level.

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

France - Fund Relations

(As of end-May 1985; in millions of SDRs)

I. Membership Status

France is one of the original members of the Fund. France accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund agreement as of February 15, 1961.

A. Financial Relations

II. General Department

- (a) Quota: SDR 4,482.8 million.
- (b) Total Fund holdings of French francs:
SDR 3,185.6 million (71.1 percent of quota).
- (c) Fund credit:
None.
- (d) Reserve tranche position:
SDR 1,297.6 million.
- (e) Current operational budget:
The French franc is included in the current budget.
- (f) Lending to the Fund (SDR millions):

	<u>Limits</u>	<u>Outstanding</u>	<u>Uncalled</u>
GAB	1,700.0	--	1,700.0
SFF	--	--	--
Enlarged access	--	--	--
Total	1,700.0	--	1,700.0

III. Current Stand-By or Extended Arrangement and Special Facilities

No use of Fund credit during the last 10 years.

IV. SDR Department

- (a) Net cumulative allocation: SDR 1,079.9 million.
- (b) Holdings: SDR 652.2 million, or 60.4 percent of net cumulative allocation.
- (c) Current Designation Plan: France is included in the current plan.

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

Since March 13, 1979, France has participated together with Belgium, Denmark, Germany, Ireland, Italy, Luxembourg, and the Netherlands in the exchange rate mechanism of the European Monetary System (EMS). Under this agreement, France maintains spot exchange rates of the currencies of the other participants within margins of 2.25 percent (in the case of the Italian lira, 6 percent) above and below cross rates derived from central rates expressed in ECUs.

VIII. The last Article IV consultation was concluded at EBM/84/92 (6/13/84). France is on a 12-month consultation cycle.

France - Basic Data

	1984	1981	1982	1983	1984	1985 1/	1986 1/
In percent of GDP							
			<u>(Volume changes; in percent)</u>				
Demand and supply (volume)							
Household consumption	65.4	2.0	3.4	1.0	0.7	1.3	1.5
Public consumption	13.3	2.4	2.5	1.4	0.3	--	0.5
Gross fixed investment	19.9	-1.1	0.7	-2.3	-2.2	1.4	2.8
Public	2.7	-1.2	9.2	-2.6	-1.7	--	0.5
Residential construction	4.2	-1.1	-7.1	-1.8	-3.9	1.0	2.0
Other private	13.0	-1.1	1.9	-2.3	-1.8	1.8	3.5
Stockbuilding 2/	0.8	-1.8	1.4	-0.8	0.2	--	0.1
Total domestic demand	99.4	-0.5	4.1	-0.4	0.3	1.1	1.7
Exports of goods and services	25.5	5.4	-2.6	4.4	6.9	4.1	4.6
Imports of goods and services	24.8	1.4	6.8	-0.6	2.6	3.0	3.5
Foreign balance 2/	0.6	0.9	-2.2	1.2	1.0	0.3	0.3
GDP	100.0	0.5	1.8	0.7	1.3	1.4	2.0
Value added in manufacturing	22.4	-2.0	--	0.8	1.9	2.0	2.5
Memorandum item:							
GDP in billions of current francs	4,277.2	3,110.6	3,567.0	3,935.0	4,277.2	4,603.7	4,937.0
			<u>(In millions; annual averages)</u>				
Employment and unemployment							
Labor force	23.5	23.8	23.7	23.8	23.9	24.1	
Unemployed	1.8	2.0	2.0	2.4	2.5	2.6	
(In percent of total labor force)	7.7	8.4	8.6	10.1	10.6	10.9	
			<u>(Annual changes in percent)</u>				
Prices and income							
GDP deflator	11.8	12.6	9.5	7.3	6.1	5.1	
Consumer price index							
Average	13.4	11.8	9.6	7.4	6.0	5.0	
Through the year	13.9	9.7	9.3	6.7	5.8	4.8	
Terms of trade	-4.6	2.0	2.2	-0.9	-0.2	0.9	
Import unit values	18.5	12.1	7.7	10.6	5.2	2.7	
Average hourly compensation (in manufacturing)	15.9	15.0	11.7	8.0	6.0	5.5	
Unit labor costs (in manufacturing)	13.3	10.7	7.6	2.4	1.8	1.4	
Real disposable income of households	2.6	2.4	-0.4	-0.6	1.3	1.3	
Personal savings ratio	15.8	15.7	14.4	13.7	13.7	13.7	

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985 1/</u>	<u>1986 1/</u>
	<u>(In billions of francs)</u>					
Central Government <u>3/</u>						
Expenditure	702.5	826.4	918.6	958.1	1,013.0	1,075.0
Revenue	626.9	737.9	783.3	812.0	865.0	925.0
Special accounts (net)	0.1	--	0.3	0.2	--	--
Loans and advances (net)	11.2	-3.4	-2.8	0.3	--	--
Financial balance	-80.9	-99.0	-129.6	-145.6	-148.0	-150.0
(In percent of GDP)	(-2.6)	(-2.8)	(-3.3)	(-3.4)	(-3.2)	(-3.0)

	<u>(In billions of francs)</u>					
Balance of payments						
Trade balance	-54.0	-103.8	-63.9	-39.2	-30.0	-18.0
Services and private transfers (net)	39.0	41.9	46.1	48.4	51.0	58.0
Official transfers	-10.8	-17.4	-16.0	-15.2	-17.0	-18.0
Current account	-25.8	-79.3	-33.8	-6.0	4.0	22.0
As a percent of GDP	(-0.8)	(-2.2)	(-0.9)	(-0.1)	(0.1)	(0.4)
Autonomous long-term capital	-54.8	-53.3	-46.7	-31.1	...	...
Authorized borrowings	33.6	78.1	87.9	35.4	...	...
Short-term capital <u>4/</u>	18.4	21.4	37.6	28.6	...	...
Net change in official reserves	-28.6	-33.1	45.0	26.9	...	...

(Annual changes in percent, except where otherwise noted)

Exchange rates						
FF per US\$ (average)	5.43	6.57	7.62	8.74	...	...
FF per DM (average)	2.40	2.71	2.98	3.07	...	...
Effective rate (MERM, end of period)	-10.4	-8.2	-10.8	-3.6	...	...
Effective rate (period average)	-10.6	-9.2	-8.7	-6.0	...	...
Relative unit labor costs (period average)	-4.6	-4.8	-4.6	-3.3	...	...

(Annual changes in percent)

Monetary data (end of period)						
Money and quasi-money (M2R)	10.4	10.8	11.2	8.3	6.0	5.0
Domestic credit (net of non-monetary resources)	14.4	15.6	13.6	8.5	5.9	5.0
Claims on the Treasury	26.1	19.7	29.0	7.3	...	...
Claims on the economy	12.3	15.7	11.9	10.2	...	...



1
2
3



(Period averages; in percent)

Interest rates

Three-month money market rate	15.26	14.73	12.63	11.88	...	...
Prime lending rate	14.00	12.75	12.25	12.16	...	...
Government bond yield	15.66	15.56	13.61	12.41	...	...

1981 1982 1983 1984 1985 1/ 1986 1/

(In percent of GDP unless otherwise noted)

Basic economic ratios

General government revenues <u>5/</u>	44.7	45.4	46.1	47.0	46.5	46.5
General government expenditures <u>5/</u>	46.5	48.1	49.2	49.8	49.5	49.5
Balance (- deficit) <u>5/</u>	-1.8	-2.7	-3.1	-2.8	-3.0	-3.0
External debt (end of year)	6.0	8.3	11.4	12.3	12.1	...
Debt service payments <u>6/</u>	3.4	3.7	4.7	6.5	5.2	...
Money and quasi-money (end of year)	47.9	46.3	46.7	46.5	45.9	44.9
Exports of goods and services <u>7/</u>	22.3	21.6	22.2	23.8	24.0	24.2
Imports of goods and services <u>7/</u>	24.1	24.5	23.5	24.2	24.3	24.1

(Period average; in percent)

Differentials with Germany

CPI	7.1	6.5	6.3	5.0	3.6	2.7
Unit labor costs (nat. curr.)	8.4	6.6	8.7	2.7	1.9	1.9
FF/DM rate (percent change)	3.4	12.6	10.2	2.9	--	--
Total domestic demand	2.0	6.2	-2.4	-1.3	0.2	-0.3

(Changes in percent)

Partner country data

Non-oil Imports in volume change	0.1	1.0	1.6	6.6	5.2	5.2
ULCs in manufacturing in francs change	16.2	15.5	9.7	5.2	2.5	2.5

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

1/ Staff estimates and projections unless otherwise stated.

2/ Changes as a percent of previous year's GDP.

3/ Administrative basis, excluding FSC operations.

4/ Including errors and omissions.

5/ National income accounts basis, consolidated.

6/ In percent of exports of goods and services.

7/ National income accounts basis.

France - Statistical Issues

1. Outstanding Statistical Issues

a. Monetary accounts

The Bureau of Statistics has commenced updating IFS monetary aggregates for France from data supplied on tape by the Banque de France, but the tapes do not contain all of the series needed to compile the IFS aggregates. The Bureau is in communication with the bank in regard to the problems of coverage and currentness of the monetary data. A number of these issues were dealt with in the report of a Bureau of Statistics mission that was forwarded to the authorities in March, 1984.

b. Government finance

The latest year for which complete data are published in the GFS Yearbook is 1981. Partial data are published for 1982 and 1983. There are no data on outstanding debt by type of holder and by type of debt instrument, as well as on supranational authorities' expenditure by function.

c. International banking

The most recently published data on banks' positions in the cross-border interbank market are for December 1983, indicating the difficulty that has been experienced in keeping current the international banking statistics for France. The authorities have reported that they are not able to provide separate returns showing the U.S. dollar value of banks' external positions vis a vis banks and nonbanks.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for France in the June 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Banque de France, which during the past year have been provided on a timely basis, other than for the monetary accounts, for which reporting has been infrequent.

Status of IFS Data

		<u>Latest Data in June 1985 IFS</u>
Real Sector	- National Accounts	Q3 1984
	- Prices: Industrial goods	March 1985
	CPI	April 1985
	- Production	February 1985
	- Employment	January 1985
	- Earnings: Labor cost	March 1985
Government Finance	- Deficit/Surplus	November 1984
	- Financing	November 1984
	- Debt	November 1984
Monetary Accounts	- Monetary Authorities	September 1984
	- Deposit Money Banks	Q1 1984
	- Other Financial Institutions	Q1 1984
External Sector	- Merchandise Trade: Value	March 1985
	: Volume	December 1984
	: Prices	December 1984
	- Balance of Payments	Q3 1984
	- International Reserves	March 1985
	- Exchange Rates	April 1985

Table 5. France: Illustrative Medium-Term External Debt 1/ Projections, 1984-95

	1984	1985	1986	1988	1990	1992	1995
Main assumptions							
Nominal GDP, growth rate (in percent)							
Scenario A	8.7	7.5	7.2	7.0	7.0	7.0	7.0
Scenario B	8.7	7.5	7.5	7.5	7.5	7.5	7.5
Current account balance (in percent of GDP)							
Scenario A	-0.1	0.1	0.4	0.5	0.5	0.5	0.5
Scenario B	-0.1	--	--	--	--	--	--
Autonomous capital flows, net (in percent of GDP)	-1.1	-0.7	-1.0	-1.0	-1.0	-1.0	-1.0
Average interest rate (in percent)	9.8	9.0	8.5	8.5	8.0	8.0	8.0
Main results							
External debt outstanding, gross (in percent of GDP)							
Scenario A	12.3	12.1	11.8	11.3	10.8	10.4	9.9
Scenario B	12.3	12.2	12.3	12.6	12.8	13.0	13.3
Debt service ratio (in percent of exports of goods and services)							
Scenario A	6.5	5.2	5.2	7.0	8.3	7.5	7.8
Scenario B	6.5	5.2	5.4	7.5	9.4	9.0	10.1

Source: Staff estimates and calculations.

1/ Covers all external borrowing with a maturity of over one year whose proceeds are sold on the exchange markets with official authorization (emprunts autorisés).

Note: The above illustrative medium-term debt projections are based on the following main assumptions: (1) a current account in line with the World Economic Outlook (WEO) forecasts in 1985-86 and moving thereafter to a surplus of 0.5 percent of GDP in scenario A (implicitly targeted by the authorities to reduce the gross external debt ratio), and remaining in balance throughout the projection period in scenario B; (2) net autonomous capital outflows (i.e., all capital transactions excluding authorized borrowings; the bulk is accounted for by net trade credits and public loans abroad) equal to 1 percent of GDP as from 1986 in both scenarios; (3) nominal GDP growth rate in line with the WEO forecasts for 1985-86 and equal to 7 percent a year thereafter in scenario A, and equal to 7.5 percent a year as from 1986 in scenario B; (4) growth of exports of goods and services consistent with the current account developments assumed in the two scenarios; (5) exchange rates are frozen at their end-1984 levels, and the average interest rate on the debt is set to decline gradually over the projection period by close to two percentage points in nominal terms (as assumed in the WEO's baseline scenario); (6) amortization payments on new debt are based on the assumption of a three-year grace period and 20 percent linear amortization.