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July 24, 1985

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

The attached supplement to the staff report for the 1985 Article IV consultation with France has been prepared on the basis of additional information.

Mr. Leipold (ext. 573743) or Mr. Mackenzie (ext. 575168) are 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
Supplementary Information

Prepared by the European Department

Approved by L. A. Whittome

July 24, 1985

Except for monetary developments, trends in the economy in the first half of 1985 have been largely in line with the projections included in the staff report.

Real GDP was unchanged in the first quarter of 1985 from the fourth quarter of 1984. ^{1/} A decline in the contributions of the foreign balance and stock accumulation offset an increase in final domestic demand. Households' consumption expenditures were boosted by large increases in expenditure on energy induced by unseasonably cold weather early in the year. Fixed capital formation increased for the first time since the third quarter of 1983 as a result of a 3 percent increase in business investment. The latest projection published by the Institut National de la Statistique et des Etudes Economiques (INSEE) foresees a 0.8 percent rate of growth of real GDP in 1985 over 1984, largely owing to less buoyant expectations as regards exports. Nevertheless, INSEE forecasts a balance of the current account of the balance of payments of about zero.

Salaried employment in the productive sector declined by 0.3 percent at an annual rate in the first quarter, after shrinking at an annual rate of about 1.3 percent in each of the two previous years. Substantial losses of employment continued in the industrial sector, but these were partly offset by an expansion of employment in services. Registered unemployment was 2.4 million in June 1985, and thus little changed from its level of December 1984. Unemployment among the young declined by about 5 percent between December 1984 and June 1985, largely as a result of the Government's Travaux d'Utilité Collective program.

The year-over-year increase in consumer prices declined slightly from 6.7 percent in December to 6.4 percent in June. Food prices moderated but there were substantial increases in the prices of energy products and in public utility rates. First quarter energy prices were boosted by the sharp rise in the dollar and by increases in the tax on petroleum products. Average hourly wages increased by 6.1 percent at an annual rate in the first quarter. Real wages declined marginally.

^{1/} All figures are on a seasonally adjusted basis, unless noted otherwise.

The rate of increase in money supply (M2R) in the first five months of 1985 remained around the 8 percent annual rate touched in December 1984. All the main counterparts contributed to this slippage from the 4-6 percent target range set for the year as a whole. First, non-monetary capital inflows more than offset the deterioration in the current account, leading to an external contribution to monetary growth in the first five months of the year equal to some F 10 billion, while the official projections had assumed a zero contribution. Sustained foreign currency lending to residents (which is exempt from the reserve requirements under the credit control system) and other, mainly short-term capital inflows--both encouraged by interest rate differentials and by the absence of exchange rate expectations--contributed to this result. Secondly, a flattening of the yield curve and weakening expectations of a further reduction in long-term interest rates restrained demand for bonds, and monetary financing of the Treasury burgeoned to F 50 billion in the first five months of the year, against a programmed F 30 billion for the year as a whole. Finally, bank credit to enterprises and individuals grew at an annual rate of some 7 percent in the first five months of the year, which was in excess of the limits compatible with the M2R target (some 4 1/2 percent). 1/ This overshooting was attributable to numerous exemptions and derogations accorded to credit institutions to facilitate the transition from the old encadrement to the new credit control system; this allowed some banks to increase strongly their loans to individuals (most particularly housing loans) as well as their loans to small- and medium-sized enterprises.

At the beginning of July, the authorities announced the following corrective measures: (a) the external contribution to monetary growth was to be restrained by cutting back on net authorized borrowings during the remainder of 1985; (b) the Treasury was to step up its recourse to the long-term capital markets so as to contain monetary financing to the programmed F 30 billion (a long-term bond issue of F 20 billion in June brought Treasury financing back on its target path); and (c) credit to enterprises and individuals was to be restrained by lowering the trigger point for the constitution of compulsory noninterest-bearing reserves with the Banque de France. 2/ However, the existing preference assigned to housing loans was reinforced, as their weight in the determination of net credit subject to reserves was further reduced.

Despite the overly rapid rate of money growth, the authorities have felt that the continued deceleration in prices, the easing of international interest rates and the strength of the franc justified a further cautious lowering of domestic interest rates. The wide range of regulated rates on savings books, CODEVI accounts and housing savings plans, were cut by between 0.5 and 1.5 percentage points on July 1, 1985;

1/ Net of increases in banks' nonmonetary resources.

2/ Only 98.5 percent of the average credit outstanding during the third quarter of 1984 is to be taken as the reference base for the calculation of the growth in net credit extended and the consequent determination of a bank's reserve requirements.

other linked rates, such as the rate on subsidized loans to industry, were reduced accordingly. Furthermore, on July 11 and again on July 18, 1985, the Banque de France lowered its key money market intervention rate by 25 basis points, bringing it to 9 5/8 percent, its lowest nominal level since 1979. Real short-term interest rates have nonetheless remained above those of Germany.

Although the final outcome of the central government budget cannot yet be reliably forecast, there would appear to be expenditure overruns with respect to interest payments and to new social expenditure arising from the decision in June 1985 to extend the youth employment scheme and to provide a safety net for the long-term unemployed. The financial strain on the unemployment fund (UNEDIC) has led to an increase of 0.2 percentage points in employees' contributions.

The seasonally adjusted trade deficit in the first half of 1985 was F 14.4 billion compared with a deficit of F 16.8 billion in the first half of 1984. The volume of exports declined by 1.4 percent from the fourth quarter of 1984 to the first quarter of 1985, but is estimated to have picked up in the second quarter. The current account balance declined from a seasonally adjusted surplus of F 1.1 billion in the fourth quarter of 1984 to a deficit of F 6.9 billion in the first quarter of 1985. The unadjusted current account deficit in the first half of 1985 was F 6.9 billion, compared with a deficit of F 10.1 billion in the first half of 1984. 1/

The franc has comfortably maintained its position within the EMS since the spring, appreciating slightly against its ECU central rate. The franc and the other EMS currencies appreciated by about 15 percent against the U.S. dollar between their March average and mid-July. The franc's position was aided by large net private short-term capital inflows. Capital inflows offset the first quarter current account deficit and contributed to an increase in net official reserves, which reached their highest level in two years in June. The EMS realignment of July 22 resulted in a devaluation of the bilateral central rate of the lira of 7.8 percent in terms of the central rates of the other EMS members. As a result of the depreciation of the market value of the lira that followed the realignment, the franc's nominal effective exchange rate is estimated to have appreciated by 0.5 percent.

1/ Seasonally adjusted data for the second quarter of 1985 are not yet available.