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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/116

3:00 p.m., July 29, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	
	M. Z. M. Qureshi, Temporary
H. Fujino	
G. Grosche	
J. E. Ismael	
R. K. Joyce	
	H. A. Arias
H. Lundstrom	
	P. E. Archibong, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
P. Pérez	
J. J. Polak	
	A. V. Romuâldez
	A. A. Agah, Temporary
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

Asian Department: L. Mendras. European Department: L. A. Whittome, Counsellor and Director; P. Beaugrand, P. Dhonte, A. Leipold, L. J. Lipschitz, G. A. Mackenzie, G. Szapary, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; J. A. Clement, B. J. Nivollet, A. B. Petersen. Fiscal Affairs Department: M. Katz. Research Department: A. D. Crockett, Deputy Director. Western Hemisphere Department: S. T. Beza, Associate Director; S. A. Silard. Advisors to Executive Directors: D. Hammann, K. A. Hansen, G. Nguyen, J.-C. Obame, G. W. K. Pickering. Assistants to Executive Directors: W.-R. Bengs, M. B. Chatah, S. de Forges, J. de la Herrân, H. Kobayashi, S. Kolb, M. Rasyid, D. A. Robinson, J. E. Rodrîguez, A. A. Scholten, L. Tornetta, B. D. White, Yang W.

1. FRANCE - 1985 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting their consideration of the staff report for the 1985 Article IV consultation with France (SM/85/175, 6/21/85; Cor. 1, 7/24//85; and Sup. 1, 7/24/85). They also had before them a report on recent economic developments in France (SM/85/195, 7/10/85).

The Director of the European Department said that the reasons for the staff position were best summarized in Table 4 in the staff report, on selected indicators of public sector claims on resources. The time perspective for reducing the central government budget deficit below the equivalent of 3 percent of GDP was one of a number of questions raised in that connection. The staff had been left with the impression that progress toward meeting that objective could be made in 1986, especially as the Minister of Finance, the Economy, and the Budget had attached priority to that objective. The underlying issue being debated in France, as well as in a number of other countries, was how much sense it made to push ahead with a reduction in the public sector deficit at a time of weak demand prospects. In emphasizing the reduction of taxation rather than of the deficit, the French authorities had no doubt had in mind that public support was more likely to be forthcoming for a policy that ostensibly sought to reduce taxation and by doing so forced cuts in expenditure on the assumption that the level of the deficit was unchangeable. The danger was that in the end the deficit might not be contained but might rather expand. An attempt had been made on page 11 of SM/85/175 to summarize the main reasons why the authorities preferred to reduce personal income taxes rather than corporate taxation, an issue being debated at present, as much for political as for economic reasons. It might be noted that although the tax burden in France was heavy relative to that in other countries, the weight of taxation fell heavily on indirect taxes and on social security contributions rather than on direct taxes, which were comparatively low.

The issue in 1984 of renewable treasury bonds would not reduce but would postpone interest payments of approximately F 3.5 billion in both 1985 and 1986, the Director added. The year in which those interest payments would actually be made would depend on whether or not the holders of such securities exercised the option of renewing them three years after the date of issuance.

The autonomous unemployment insurance fund (UNEDIC) was the social security fund that would be under the greatest financial strain, the Director noted. Measures had been taken recently to raise employees' contributions, thereby helping to contain the deficit of the fund during 1985. The forecasts for the other main funds varied, although the outlook was generally weak for 1986, and for 1987 in particular, more especially for the old-age pension fund. Unless the assumptions underlying the projections were wrong, which seemed unlikely, the deficits of those funds would not be contained unless measures were taken to reduce expenditures.

Estimates of the cyclically adjusted budget always had to be viewed skeptically, the Director of the European Department remarked. Those estimates suggested that the budget deficit of the Central Government, adjusted to take out the cyclical effects, was only somewhat lower than the actual deficit. After rising for several years, the cyclically adjusted deficit was at present running about 1/2 percentage point below the actual deficit.

There were two main reasons for the disappointing yield of corporate taxes, the Director considered. First, the carryforward of past losses for taxation purposes had been larger than the authorities had expected. Second, deductions for investments had allowed the corporate sector to pay less tax recently than had been estimated.

The provisional monetary estimates that were prepared were not given wide circulation because the authorities feared that they might lead to false conclusions, the Director explained. Even if, as the staff hoped, the Fund were to receive those provisional estimates, which became available six weeks after the date to which they applied, the problem of the lack of statistics for publication in International Financial Statistics would still remain. A solution to that problem might emerge as the French authorities came to place greater weight on monetary policy.

The emphasis of the staff in discussions with the French authorities on the need to move more quickly toward a more market-oriented banking system was justified, the Director considered. The entrenched differences in the banking system between large takers of deposits and banks that had to operate almost entirely on borrowed funds, as well as years of administrative interference in monetary matters, were not easy to overcome. Inevitably, the degree of unfreezing achieved so far in the financial system had raised genuine difficulties, as it had in the United States, the United Kingdom, and some other countries, with respect to the interpretation of the monetary aggregates. Unfortunately, it was difficult in France to fall back on the behavior of interest rates and exchange rates as good proxies, because those rates were set in conjunction by administrative control. Thus, it became all the more important to reach a conclusion in the continuing debate as to how much M-2 had to be widened to take account of the liquid nature of various funds that had come into existence in the past three or four years at a rapidly growing rate. The new credit system had had little impact so far, but it did hold out a possibility of change that he hoped the authorities would exploit. The differences between the old and the new systems had been set out in some detail in Appendix II to the report on recent economic developments. In indicating its view that more emphasis could be given to monetary restraint, the staff had in no way been implying that the emphasis on incomes policy was incorrect.

Capital/labor ratios had risen steadily in France, as they had in most industrial countries, particularly in Europe, the Director added. The high costs of labor compared with capital costs were not necessarily directly responsible. The French authorities' thinking was not that more moderation in wages would lead to the substitution of labor for capital but that higher profits would lead to increased investment, which in turn would create a stronger economic performance. A slightly different view had been expressed by the staff in its report.

The retained earnings of corporations had been rising strongly, having amounted to 75 percent of their investment in 1984 compared with 56 percent in 1983, the Director noted. The rise projected in private productive investment for 1985 was for the most part assumed to be covered by retained earnings. The credit control mechanism gave significant priority to credit extended for investment purposes. Based on the improving profit position, the authorities considered that the present high level of interest rates would not constrain investment. The staff's approach, which seemed to have been supported by Executive Directors, was that crowding out might be imminent and the productive investment needed to achieve a sustainable current account position might not be attainable without a reduction of the pressures emanating from the side of the public sector itself.

The incomes policy followed in France since late 1982 was not a de-indexed system but a different form of indexation, the Director explained. Difficult questions could arise in respect of the rate of wage increases that was desired at a time when inflationary prospects had worsened, and when the forecast of inflation for the year ahead was higher than for the current year. The system for increasing minimum wages (SMIC) seemed to work without leading to a direct link between increases in the minimum wage in real terms and unemployment in particular categories, but the issue was still open.

It was vital that sufficient emphasis be placed on resolving the unemployment problem, the Director noted. The difference between the estimates contained in the staff report and those included in the most recent World Economic Outlook survey was due to a different evaluation of the effects of the newly introduced Travaux d'Utilité Collective (TUCs) on unemployment and the fact that the end-1984 figures had been revised. Certain aspects of unemployment in France were worth keeping in mind. For instance, unemployment among women in France was higher than in other industrial countries. Women were forbidden by law to work on night shifts in textile factories, a not unimportant element in the underutilization of the textile industry in France. Unemployment also had a much greater effect on the young in France than in most other industrial countries. Lower-skilled male workers were also particularly hard hit. In addition, there was a sharp differentiation between the large public sector with protected employees and certain large private enterprises that de facto protected employees, on the one hand, and all other employers. The dualistic nature of the labor market was well understood by the French authorities but was not easy to correct. In addition, the influx of labor from agriculture into services had been greater in France than in most other large industrial countries. Furthermore, demographic developments were not favorable from the employment point of view. Those were heavy burdens at a time of adjustment, but they would be lightened insofar as real wages could be contained or reduced.

The rigidities underlying the high rate of unemployment went further than those mentioned in the staff report, the Director added. Rent control presented difficulties. Despite the claim that the construction boom in France was over, it was not easy to find reasonably priced housing in many areas where employment opportunities existed. As in many other countries, people were reluctant to move from one region to another.

To date, the TUCs seemed to have successfully fulfilled the goal of moderating the rise in recorded unemployment, the Director noted. Whether the jobs being found were new jobs or whether people were being trained for gainful and productive employment after they left the TUC mechanism was another matter.

The indicators of competitiveness were mixed, the Director explained. Unit labor costs in manufacturing were favorable, but the consumer price index and export prices were not nearly so favorable. Over the medium term, unit labor costs were, in the staff view, the better indicator; in the near term at least, exporters might wish to maintain or even to increase their profit margins. Thus, the disparity between the two sets of indicators would continue to affect the outturn of the current account in 1985. Too much attention might have been paid by the staff to early developments in the 1984 Article IV consultation report, and a rather more cautious approach had seemed appropriate for 1985. Developments in the first quarter of the current year had been weak; the second quarter had shown a marked improvement, although the first half of the year as a whole had been weaker than had been expected. Nevertheless, the prospect was for a good agricultural and tourist year. Most important, the franc/dollar rate now favored the current account, as did oil price prospects. All in all, the staff would maintain its forecast of a small surplus on current account for 1985 as a whole. However, that surplus was being achieved at a very low level of domestic demand and with a disappointing export performance, despite cyclical differentials. France had lost export market shares in 1984, but a breakdown of exports by products showed that shares of those products in existing markets had risen rather than fallen. Structural problems preventing the diversification of export lines might be responsible for that apparently unfavorable trend, which would indicate the need for more flexibility and diversification.

When the market had reopened, after the July EMS realignment, the Italian lira had depreciated against the franc by 3 percent, with an impact on the French competitive index of 0.4 percentage points, the Director said.

It would certainly become easier for the French authorities to move toward dismantling exchange controls and restrictions as the balance of payments position improved and competitiveness was no longer an issue, the Director stated. The French authorities had emphasized that their most recent request within the EC for the extension of exchange controls had, on their own initiative, been for two years only.

Finally, as to the merits of the gradualist approach, it was not clear from the adjustment in terms of the current account or prices that the French approach had been that much more gradual than, for instance, the German or the U.K. approach, the Director of the European Department remarked. France might have been slower to experience a restoration of profit margins, but the fact that France had started from a worse position had perhaps left the impression of gradualism. Moreover, the French authorities defined gradualism as avoiding any fall in GDP. In that sense, the adjustment had been gradual, but only somewhat more gradual than that of other countries over the past two years. Thus, the question of most concern was how gradual the adjustment might become over the years ahead.

Mr. de Maulde said that the statistics for the first five months of 1985 revealed a positive margin of F 10-15 billion in terms of the actual budget outcome compared with the estimates. Thus, there was some hope that the target of a budget deficit of 3 percent of GDP for 1985 would be realized. The current account balance for the first quarter had been negative, for reasons not fully understood. In fact, for the third consecutive year, there had been a large current account deficit in the first quarter of 1985, followed by a large recovery in the second quarter. An explanation had been sought in the weather, or possibly on account of seasonal imports, but the reasons remained unclear. The forecasts for the year as a whole should not be affected adversely since the improvement observed in 1984 after the first quarter had already begun to emerge in the current year's figures.

Concerning the monetary aggregates, his authorities had decided to introduce a significant innovation and to transmit to the International Monetary Fund provisional statistics, subject to revision for the period ended six weeks previously, Mr. de Maulde noted. Provisional monetary statistics were considered highly confidential in France; they were prepared by the Bank of France, which preferred to release figures only when it was sure of their full accuracy. Nevertheless, his authorities had decided to yield to the wishes of the Executive Board in that respect.

As far as the public finances were concerned, the ongoing debate was on the choice between a reduction of the budget deficit and a reduction of the public sector's share in the economy, Mr. de Maulde continued. As had been noted during the discussion, the pursuit of both targets at the same time posed, if not a contradiction, at least considerable difficulty. Obviously, his authorities would prefer to attain both objectives, but for practical reasons, they tended to put more emphasis on reducing the overall tax burden imposed by the public sector, since it led to free financial resources that were needed to finance investment. Certainly, the firm intention was also to reduce the budget deficit, the magnitude of which should not however be exaggerated. The deficit currently was equivalent to 3 percent of gross national product; the rate of unemployment was between 10 percent and 11 percent. At full employment, the budget would be in equilibrium. It might be noted that other countries with much larger deficits were achieving much better employment results. Nevertheless, the reduction of the deficit was a major objective of his authorities, who regretted having exceeded the target in the past two years.

As to the question of how to distribute the reduction of the tax burden between households and enterprises, Mr. de Maulde continued, the basic policy was that corporate taxes should be reduced most. The reason why it had been decided to begin by reducing taxation on households was that they had borne a heavier increase in their tax burden during the past two years, in the form of special social security and wage taxes, for instance. The taxes levied on enterprises had not increased at the same rate, and it did not seem unreasonable to give the household sector some prior relief. In addition, such an approach would help to convince the public of the attractions of tax reduction to stimulate the economy. The Government was considering a reduction of corporate taxes from 50 percent to 45 percent, indicating that the decision to favor households initially was only temporary.

It was hard to judge a monetary policy that had been used jointly with other instruments, such as budgetary policy or wage policy, as Mr. Grosche had observed, Mr. de Maulde went on. If monetary policy had been the only instrument used for adjustment, the authorities would have had to take a much firmer approach toward reducing monetary aggregates and toward raising interest rates. The use of several other instruments had allowed them to place less emphasis on monetary policy, without affecting the quality of that policy.

As to whether the new credit system resembled the previous one, in terms of the instruments used and in terms of the rigidity of administrative controls, the difference between the two systems might not be great at present but would definitely be of major importance in the future, Mr. de Maulde stated. The view of the staff was that it would be desirable for France to move toward a system of monetary control by interest rates and the free play of forces in the money market, a system incompatible with the selective allocation of credit and of preferential interest rates that continued to have a role in the structure of the banking system. As could be seen from Appendix II to the report on recent economic developments, mechanisms were being set up that were totally at variance with those of the past. For instance, certificates of deposit were being introduced; commercial paper had begun to be issued three months previously; and nonvoting shares of various public enterprises and entities had been issued to the public, moreover at market rates. The introduction of all those new financing mechanisms, was making life difficult for the institutions and financial networks that were profiting from the preferential instruments and rates of the past. The reform had started not with the introduction of laws and decrees canceling various categories of credit and preferential rates, but with the creation of new financial mechanisms, which would be accepted, little by little. The Executive Board could rest assured that within two or three years, important changes would have taken place in the banking system. The structures inherited from the past would give way to a framework within which freedom of action would develop; if, meanwhile, for psychological and political reasons, many of the previous structures were to remain in place, they would have to adapt themselves to the new environment in order to survive.

Finally, in response to a question by Ms. Bush, who had suggested that nationalization was linked to the budget deficit, Mr. de Maulde observed that France had public enterprises that were well managed and private enterprises that were badly managed, and vice versa. Public enterprises borrowed a great deal of private money and, as he had noted, were even issuing capital shares on private markets. Unfortunately, in France as elsewhere, there were also many private companies that used a great deal of public money, at considerable cost to the national budget. Whether shares in a company were held by a public or by a private shareholder made no difference, if the company was badly managed. His authorities were making every effort to be as restrictive as possible in extending financial assistance to both public and private enterprises, in the hope that both would adapt their management techniques to the demands of the market and perform efficiently.

The Chairman made the following summing up:

Executive Directors commended the authorities for the further progress that had been achieved in reducing the rate of inflation, improving profitability, and strengthening the external account. They observed that wage moderation had been central to the progress made in all three areas and that the new procedures for wage settlements introduced more flexibility in the economy. Directors added that the continued success of incomes policy depended upon the support of adequately constraining financial policies. In this context, they expressed concern that the rate of monetary expansion had remained above the target range but hoped that the recent corrective measures would help to bring the growth of liquidity under control. Directors also drew attention to the continued high level of the central government budget deficit, the large share of public sector expenditures as a ratio of GNP, and the public sector's growing claims on resources in the past few years.

Directors noted that despite the progress that had been achieved, further improvement in all main policy areas remained essential. Although a major advance had been made in reducing the pace of price increases, the inflation differential with France's main partner countries was still significant. The recovery in profitability was still far from complete, and this put a constraint on a strong and sustained expansion of fixed capital investment. The high and rising rate of unemployment was also of much concern to Directors.

Directors observed that despite France's relatively weak domestic growth, its current account position remained vulnerable and its export market share performance only average. In view of the importance of achieving a sustained current account surplus to allow for a reduction in gross external debt, Directors thought that rigorous economic policies needed to be maintained. There was no scope for any relaxation of the policy stance; on the contrary, many Directors believed that a tightening of policies was required.

Directors recommended that ambitious targets should be set for price performance and the growth of the monetary aggregates. The money supply target should be sufficiently tight to take full account of the continued rapid development of new financial assets that were close substitutes for money. Directors welcomed the move away from administrative credit ceilings as the main instrument of monetary control and strongly suggested that further steps be taken to liberalize the French financial system. They noted that many interest rates remained subject to administrative decisions and urged that the transition to a more market-based system be pursued resolutely. In particular, they emphasized that the still fragile external position required that any reduction in interest rates should follow rather than anticipate the deceleration in inflation, all the more so since long-term interest rates in real terms were among the lowest in Europe. Several Directors stressed the need for more timely monetary statistics.

On the fiscal front, Directors noted with concern the overshooting of the central government budget target in 1984, and added that--in the absence of early corrective action--overshooting could also occur in 1985. They noted that the overall size of the public sector had continued to grow, with the ratio of general government expenditure to GDP having reached 50 percent in 1984. Many Directors emphasized that an objective below the currently targeted 3 percent of GDP for the central government deficit should be set for 1986, so as to create leeway for a pickup in productive investment and growth. A number of Directors believed that the timing would not be appropriate for tax cuts to stimulate domestic demand. It was generally stressed that priority should be attached to reducing expenditures, particularly in the rapidly rising category of transfers and subsidies to households and enterprises. Directors also noted with concern the prospective financing difficulties of the social security accounts, which should be corrected by savings in expenditures. The authorities were encouraged to continue to require public enterprises to operate in market conditions.

Directors emphasized the rigidities that affected many aspects of economic life in France. They noted that impediments to the release of workers from firms or industries in decline reduced the efficiency of the labor markets. Directors stressed that, along with improved profitability, the reduction of rigidities, including a reduction of price controls and the restoration of market incentives, was essential to improve employment prospects. In this respect, public sector employment measures such as the youth employment program were not thought of as a permanent means of reducing unemployment. A number of Directors strongly stressed the linkages between an acceleration of structural adjustment and a liberalization of trade and noted that structural adjustment would be promoted by trade liberalization. They called on France, together with other major trading nations, to work more actively for a reduction to existing barriers to trade. Directors also called for further action toward dismantling exchange and capital controls. Finally, they commended the authorities for the increase in official development assistance.

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

2. INTERIM COMMITTEE MEETING - FORMAT AND PROCEDURES

Mr. Arias noted that the message from the Chairman of the Interim Committee to members (EBD/85/195, 7/25/85) dealt essentially with the format and procedures of the October 1985 meeting but also mentioned the agenda. In that connection, he asked whether the Chairman expected an immediate reply to his message; the wording did not necessarily suggest that he did, and it might be preferable to delay any response until the Executive Board had discussed the agenda on September 4. At that time, Directors could also comment on the format of the spring 1986 meeting.

He had no objection to the proposed format for the Seoul meeting, Mr. Arias added, but he believed that the Chairmen of the Interim and Development Committees should agree to coordinate their policy on the enforcement of the limit on attendance at the plenary sessions of seven associates. At the April meetings, the Interim Committee had enforced that limit strictly, whereas the Development Committee had not.

Mr. Polak explained that the Chairman had made tentative assumptions on the agenda simply as a basis for his suggestions on format and procedures. Although responses to those suggestions were not necessarily expected, if members had any negative reactions, they should let the Chairman know promptly. It might be useful to note that the suggestion for the format of the spring 1986 meeting, which could be discussed at a later stage, had been made to keep alive the idea of an informal afternoon session.

The Secretary stated that the Chairmen of the two Committees, in sending their individual messages to members of each Committee, had been in touch with a view to attaining some measure of coordination, but not necessarily identity at all times, on the format and procedures for the meetings. Thus, the Chairmen were fully aware that their suggestions for the conduct of the October meetings did not constitute complete identity, for which indeed they saw no need.

As for the application of the rule limiting associates to the number originally provided for in the Resolution establishing the Interim Committee, the Secretary recalled that Executive Directors had only recently made a distinct call for that rule to be respected. The Chairman was in full agreement with their view. If the Chairman of the Development Committee was not taking the same line, it was no doubt because the Executive Directors of the World Bank had not made such a call. Thus, attitudes on that matter might diverge again in the Seoul meetings.

The Chairman reminded Executive Directors that the draft agenda for the Interim Committee meeting would be discussed on September 4, 1985.

APPROVED: May 2, 1986

LEO VAN HOUTVEN
Secretary