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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/115

10:00 a.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	M. Sugita
G. Grosche	
J. E. Ismael	
R. K. Joyce	
	H. A. Arias
H. Lundstrom	
	A. Abdallah
	P. E. Archibong, Temporary
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	
	A. V. Romuáldez
	A. A. Agah, Temporary
A. K. Sengupta	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

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

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Also Present

African Department: A. D. Ouattara, Director. Asian Department: L. Mendras. European Department: L. A. Whittome, Counsellor and Director; P. Beaugrand, B. Christensen, P. Dhonte, A. Leipold, L. J. Lipschitz, J. A. Mackenzie, G. Szapary, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; S. J. Anjaria, J. A. Clement, A. B. Petersen, P. J. Quirk, M. Xafa. Fiscal Affairs Department: V. Tanzi, Director; G. Blondal, M. Katz. IMF Institute: O. B. Makalou. Research Department: A. D. Crockett, Deputy Director; F. Larson, P. R. Masson. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, G. Nguyen, J.-C. Obame, G. W. K. Pickering, E. M. Taha, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, S. de Forges, J. J. Dreizzen, J. de la Herrán, G. Ercel, C. Flamant, V. Govindarajan, G. D. Hodgson, Z. b. Ismail, H. Kobayashi, S. Kolb, M. Rasyid, D. J. Robinson, C. A. Salinas, A. A. Scholten, L. Tornetta, Yang W., A. Yasseri.

1. FRANCE - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered 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 remarked that as noted in the staff report, the absence of new protectionist measures at the national level in France was commendable. However, the restrictions and subsidies introduced under the aegis of the European Communities (EC), several of which had been increased over the past year, were surely inimical to the growth of world trade. As the fourth largest trading country in the EC, France should play an active part, together with other members, in increasing the openness of EC trade. He did not believe that the wording of the staff report carried any implication about the previous attitude of France or other EC members to measures of protection.

Press reports on the 1986 budget had been received by the staff, the Director added. First, expenditures were apparently to be held to a rate of growth of 4 percent in 1986, compared with some 6 percent in 1985 and some 6 1/2 percent in 1984. Second, the deficit of the Central Government as a proportion of GNP would be held to 3 percent, whereas the staff report had held out the possibility that it might be reduced below 3 percent. Third, the assumptions on which those projections seemed to have been made were real growth of 2 percent in 1986 and a growth deflator of 3.7 percent.

Mr. de Maulde made the following statement:

> Once again, at the conclusion of a comprehensive high-level consultation, the staff has provided us with a complete, accurate, and interesting overview of the economic situation in France. On the whole, my authorities concur with the findings of this analysis; their few reservations pertain only to nuances or questions of detail. I will therefore confine my remarks to some brief considerations along the two major lines of thought suggested by a reading of the report--namely, that balance has been restored throughout the economy and that major structural changes are well under way.
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> The basic finding emerging from developments in 1984 and early 1985 is that the credibility of France's economic policy has been established beyond question. The Government has done what it said it would do, and the results obtained are fully in line with projections.
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> Our primary objective was to bring the external accounts back into balance. My colleagues will recall what we announced in the spring of 1983: the current account deficit, which had reached F 80 billion in 1982, would be reduced by half in 1983

and eliminated in 1984. This is almost exactly what occurred. For 1985, the forecasts of both the French authorities and the Fund staff call for a small surplus. For 1986 and 1987, our target is to achieve a more significant surplus of F 20 billion to F 30 billion. It would appear that exchange markets are convinced of our ability to achieve this goal, as witnessed by the excellent performance of the franc against all foreign currencies over the past several months.

The second challenge, which bears an obvious relation to the first, was to bring down inflation to the rate prevailing in the other major industrial countries. This task has proved particularly difficult because inflation had become deeply entrenched in the collective psychology and social mechanisms of France. Here again, however, the target has been reached: from a peak of 14 percent in 1981, we have gradually reduced inflation to less than 7 percent in 1984. Our goal for end-1985 is 5 percent, which matches the projected average for the countries participating in the European Monetary System (EMS). Our policy for 1986 and 1987 will be to achieve convergence with the inflation rate of the Federal Republic of Germany, our principal trading partner.

As to the means we used to achieve these objectives, the consultation report offers a number of comments and criticisms, some of which I consider more justified than others.

We are particularly pleased that, confronted by the evidence, the Fund staff has finally managed to overcome its doctrinal opposition to incomes policy. The report notes in its conclusion that "it is necessary that this mechanism should continue to be used, and successfully used, so that it becomes firmly established." I wish to assure my colleagues that this will be the case. The French Government intends to continue using the publicly announced and contract-based incomes policy as the cornerstone of its efforts, not only because it has proved effective in the short term but also for reasons relating to the structure of our economy, to which I shall refer in a moment.

The consultaton report goes on to indicate that "if incomes policy is to continue to be successfully implemented, it will need to be supported by adequately constraining financial policies." The intent of this bit of rhetoric is to impart the notion that my authorities have not been quite firm enough in their conduct of fiscal and monetary policies. Personally, I would say instead that while they have sometimes been unlucky, they largely concur with the analyses and recommendations of the Fund.

As regards the budget, it is true that in 1984, as in 1983, the deficit exceeded the announced target of 3 percent of GDP, though by only 0.3 percentage point in 1983 and 0.4 percentage point in 1984. Still, it is natural for Fund surveillance to be more exacting in a major country. The explanation lies not in expenditure, since spending was held severely in check, but in revenue estimates that proved somewhat overoptimistic because of the impact of sluggish economic activity on tax receipts and of the effect on public debt service of higher interest rates than initially forecast. We share the Fund's view that this slight slippage must be reversed in 1985, as my Minister made quite clear to the chief of the Fund mission. We also agree that it would be advisable in the future to begin lowering the deficit target below 3 percent, even if our other major aim of continuing to reduce fiscal pressure makes this exercise particularly difficult.

As regards monetary policy, although the monetary aggregates remained within the target range set by the Banque de France for almost all of 1984, the ceiling was overshot at the end of the year as a result of an unforseen development in December 1984. The new target for 1985--a range centered on a 5 percent expansion of M-2R--is fully consistent with the inflation rate target for the end of the year, which is also 5 percent. The monetary authorities are firmly determined to meet the targets for 1985, as evidenced both by the new measures introduced about a month ago by the Banque de France (and described in the supplement to the staff report) and our cautious approach to changes in the level and profile of domestic interest rates, aimed at matching the level of savings with borrowing requirements.

I beg my colleagues' indulgence in repeating, in today's discussion of the economy's major equilibria, what I told them in this Board in 1983 and 1984: the French Government has clearly announced its objectives; it is determined to achieve them and, if need be, will take any additional measures required to do so.

Prompted by the authorities' economic policy, wide-ranging changes in structures, attitudes, and even the basic cultural framework are now taking place in France at an accelerated pace. We are too close to these changes to be able to grasp their full import. Without following any particular order, I will nevertheless try to identify some of their major aspects.

The French, in all segments of society, have discovered that a high inflation rate was not to last forever; at the same time, their perception of what enterprise, risk, and profit are has deeply changed. One need only spend a few days in my country, watching some television and reading the press, to see the many signs of this shift in attitudes.

Other rapid changes are taking place in enterprises. The wage restraint brought about by incomes policy enabled enterprises in 1984, and enables them today, to achieve spectacular turnarounds in profitability after ten years of crisis. As the Board well knows, the measuring instruments in this area are rough and inaccurate; be that as it may, balance sheets are showing that equity is increasing, that debts are being repaid, and that the recovery of nonresidential business fixed investment is gathering momentum. Should this trend continue for another year or two, reasonable prospects would appear for a growth rate tending toward the 3 percent average for the OECD countries and for beginning to move toward a more satisfactory employment level than the current one.

The findings of the consultation report on industrial policy appear to be objective and quite complete. The steel and automobile industries, to be sure, still are problem areas in the public sector, but the problems are being confronted head on, with a will to provide viable industrial solutions. The situation is generally favorable in other areas. The rule requiring that public enterprises in competitive sectors be managed autonomously, in the light of developments in their markets, is being implemented strictly and is yielding the expected results. In industry as in other fields, France strongly desires to promote the growth of international cooperation, particularly in Europe. To our way of thinking, this is one of the best ways of reaching the scale necessary to compete effectively on world markets while concretely reinforcing the bonds of all kinds that unite us with our partners in the European Community.

It was inevitable that the consultation report would deal at some length with the economy's "structural rigidities," on the one hand because the subject is still in vogue, and on the other because there is no question but that France has historically had its large share of such rigidities. I would like to assure this Board that my authorities are well aware of the problem and are taking significant action on a number of fronts.

Sweeping changes are under way throughout the Government. The continued severe budget cuts have had a beneficial impact on government agencies, which have been compelled to rethink their purposes, organization, and methods. More generally, as the report points out, the Government has made the strategic choice of reducing fiscal pressure on the French economy, the first step having been taken in 1985. Since at the same time were are regarding the ceiling on the budget deficit (3 percent of GNP) as an absolute constraint, the only way to ease fiscal pressure is to make further spending cuts that extend beyond government operations as such and affect in particular the transfers, direct subsidies, and interest subsidies traditionally provided by the central government to many sectors of society. Financial logic buttressing economic logic, France is--without fanfare--eliminating one of its traditional problems, overadministration.

At the same time, the scope of regulation is being scaled back and the role of market forces expanded. We have no fondness for price controls. They have largely been eliminated. We nevertheless consider it necessary for the time being to retain some means of action in those economic sectors where, for various reasons, it is not yet feasible to rely for rational pricing on the free play of competitive forces. We also dislike exchange controls. A number of liberalization measures have been introduced since last year. Our old habit of caution still keeps us from going as far as the report recommends, but this is a difference only of timing, not of substance. As regards administered interest rates, they too have been extensively liberalized as part of the overall reform of our credit control system described in the report and its appendices. Some pockets of regulation still exist, but my authorities do not consider the reform process complete. Financial innovation has continued to reshape the money, bond, and stock markets; new progress is under way. Finally, as regards the labor market, we note that compensation and employment conditions are tending more and more to differ depending on the situation of individual businesses. Negotiations are under way between management associations and labor unions on all the difficult questions posed by the flexibility of working hours. The Government is actively encouraging further progress in these negotiations.

I would like to conclude by reaffirming in the firmest possible terms my authorities' constant resolve to press on with the modernization of the French economy in the framework of maintaining its high degree of openness to the rest of the world. In its conclusion, the report commends France for not having introduced any significant new protectionist measures since the previous consultation, which unfortunately cannot be said for all our trading partners. In the next sentence, it is recommended that France play an active role in promoting the liberalization of EC trade policy, which is tantamount to suggesting that France is currently playing a negative role in this regard--an observation both inaccurate and uncalled for.

Finally, France will continue to meet its commitments with respect to official development assistance, as in other areas.

Mr. de Groote noted that in 1984 the French authorities once more had achieved results from the adjustment plan adopted in March 1983. They had stuck firmly to their commitments, thereby attaining most of the targets set. Two impressive results--which had not been attained easily--were the restoration of current account equilibrium and the restoration of business profitability. Domestic demand had had to be contained and strong wage discipline established, all in the context of financial policy restraints.

French economic policy was embedded in a medium-term to long-term framework and was therefore structural and gradual, Mr. de Groote observed. Thus, spectacular results could not be achieved immediately on every count. Growth had been sluggish, and inflation and unemployment rates had remained on the high side. What was important, however, was that the underlying weaknesses of the economy and the means of curing them had been identified, and that a corrective movement in the right direction had taken place.

The challenge was to consolidate the progress achieved through the continuation of wage, fiscal, and monetary restraint, although a slight loosening of the latter might be necessary to accommodate the financing of apparently strong investment, Mr. de Groote said. According to the forecast in Appendix II of the staff report, private investment other than residential construction would increase by 1.8 percent in 1985 and 3.5 percent in 1986 after two years of decline, fully in line with the intentions of the adjustment plan. The question that came to mind was how to finance that rather strong investment activity in the context of a persistently low personal savings ratio, a probable strengthening of quantitative limitations on credit, and foreseeable limitations on borrowing abroad. Enterprises might experience a further increase in profitability, but their financial situation remained precarious owing to high existing indebtedness.

The successful implementation of wage policy in France had not been expected by most Executive Directors when they had discussed the French economic situation in 1984, Mr. de Groote recalled. It had not been an easy task to limit wage increases to the targeted inflation rate, considering the highly organized nature of the work force. One of the main factors underlying the success of French incomes policy probably lay in what Mr. de Maulde had depicted as "wide-ranging changes in structures, attitudes, and even the basic cultural framework...taking place in France at an accelerated pace." The major aspect of that social mutation was certainly a fundamental change in the "perception of what enterprise, risk, and profit are." Unit labor costs in the manufacturing sector had been considerably reduced in the recent past, mainly owing to large productivity gains, although the real average hourly compensation in manufacturing had continued to grow. However, relative unit labor costs in France in 1984 seemed generally to have developed less favorably than in other industrial countries. According to the 1985 World Economic Outlook, the discrepancy vis-à-vis Germany--France's main trading partner--would remain during the two years to come. Therefore, he felt compelled to point to the necessity of the continued pursuit or even reinforcement of present wage policies, aimed at reducing and bringing unit labor costs into line with those of main trading partner countries. Such a policy seemed necessary to avoid an additional loss in export competitiveness and a possible adjustment of the exchange rate.

No less determination would have to be demonstrated by the French authorities in their efforts to curb the budget deficit, Mr. de Groote remarked. Their ambitious goals had not been fully met in the past two years. For 1985, the goals were even more ambitious, since a reduction of the deficit was being combined with a reduction of taxes. However, the staff had indicated that the threshold target of a 3 percent deficit might again be overshot, the present trend suggesting a deficit of 3.4 percent of GDP for 1985. One of the main reasons cited by the staff for that rather unfavorable development was the recurrence of a possible shortfall in corporate income tax receipts, according to page 12 of SM/85/175. That explanation seemed to contradict the many remarks in the staff report about the substantial increase in enterprise profitability. Whatever the explanation, the brunt of the fiscal adjustment would have to fall on expenditure cuts, especially subsidies, which seemed to be pervasive in the French system.

Neither the staff in its report nor Mr. de Maulde in his statement had done more than touch on the problem of unemployment, Mr. de Groote observed. A certain loss of interest was understandable in face of the persistence of the problem, but its growing magnitude in France suggested the need for caution. The staff's forecast of the increase in the unemployment rate between 1984 and 1986 was rather optimistic in comparison with that of the OECD--0.8 percent as opposed to 2 percent. Moreover, the projections in the World Economic Outlook indicated an unemployment rate of 11.6 percent in 1986, whereas the staff in its report projected a rate of 10.9 percent, although the growth prospects were found to be identical in both staff documents. Even on the basis of the more optimistic scenario, it was somewhat surprising that the performance of the French economy with regard to employment would be less favorable than that of the industrial countries on average, for which the staff had predicted a stabilization of the unemployment rate.

In conclusion, Mr. de Groote commented, the French authorities had continued to formulate their economic policies with commendable pragmatism: when the international environment had not permitted them to pursue the expansionary policies that they had originally envisaged and begun to implement, they had not hesitated to reassess the situation and devise a new approach to deal with economic imbalances. Their achievements could therefore be judged very differently depending on whether present policies were compared with pre-election commitments, or present successes with the dangers that alternative policies would have entailed.

Mr. Grosche stated that the French authorities' stabilization efforts had been notably successful. Further progress had been made in 1984 with respect to external adjustment, price performance, and wage developments, although unfortunately both the monetary and the budgetary targets had been overshot and unemployment had risen further. Some progress had been made also in reducing supply constraints and improving financial intermediation.

However, the process of structural change clearly had to be pursued further if France were to adjust its economy to the point at which satisfactory and sustainable rates of growth could be achieved. The need for a current account surplus continued to impose severe limitations on economic expansion. The information in the supplement to the staff report, pointing to renewed slippages from monetary and budgetary targets, was cause for some concern. Moreover, there were signs that overall economic performance might be somewhat less favorable than had been expected originally. Those developments underscored the need to keep policies firmly on track. Therefore, he welcomed the corrective monetary measures taken at the beginning of July in order to meet the 1985 targets, as well as Mr. de Maulde's clear statement that his Government was determined to take any additional measures that might be required to achieve its objectives.

Incomes restraint should remain one of the cornerstones of French stabilization policy, Mr. Grosche considered. At the same time, he agreed with the staff that a successful incomes policy would have to be supported by adequately restrained financial policies.

It was disappointing therefore that in 1984 the central government deficit had again overshot the announced target and that the overall size of the Government had continued to grow, with consolidated general government expenditure approaching 50 percent of GDP, Mr. Grosche observed. Fortunately, the authorities recognized the need to reduce the deficit even below 3 percent of GDP, in spite of the slow rate of economic growth. Yet fiscal pressures had increased in 1984. Moreover, the authorities' objective of decreasing the tax burden in the framework of the 1985 budget might conflict with the need to reduce the deficit. While he had the impression that the latter objective had been given high priority, the time perspective within which it would be achieved was not fully clear to him. For instance, Mr. de Maulde had mentioned that it would be advisable in the future to begin to lower the deficit target below 3 percent of GDP, although, according to the Director of the European Department, such an effort would not be launched in 1986.

The achievement of the twin objective of lowering deficits and taxes called for action to reduce expenditure, Mr. Grosche said. Cuts in subsidies and other support operations should be considered. In addition, the authorities must closely monitor developments in expenditure and take decisive corrective action if necessary. Their readiness to do so had assumed even greater importance, given the new concern about the projected financing difficulties of the social security funds.

At the beginning of 1985, a remarkable change had taken place in the implementation of monetary policy, Mr. Grosche noted. The lifting of direct credit ceilings would entail a greater role for interest rates in restraining credit demand. The new system was more flexible and aimed at reducing past distortions in credit markets due to their segmentation and lack of competitiveness. Nevertheless, while the new system was contributing to a significant break with the past, some features of the old system were being kept, in particular the elements of administrative rigidity to which the staff had referred in Appendix II of the report on recent economic developments. He hoped that further advances could be made soon to consolidate and modernize financial markets.

The adjustment of the external accounts had been impressive, but further progress seemed essential, Mr. Grosche considered. Eventually, France should achieve a stable current account surplus in order to reduce its external indebtedness. The subsequent decline in debt service payments would contribute to a further strengthening of the external position, thereby allowing a welcome further reduction of exchange controls. The achievement of those objectives would depend crucially on the implementation of adequate financial policies as well as on measures to improve France's international cost-competitiveness. Major progress had been made already in that respect, but the broad indicators showed that the economy needed to become more competitive. Further efforts should be made to contain cost pressures. Price and wage developments appeared to be moving in the right direction, and he hoped that those trends could be maintained.

Mr. Ismael remarked that the 1985 Article IV consultation with France was of great interest for two reasons. First, the adjustment program had had the intended results because despite its gradualism, it had been implemented steadfastly and consistently. The primary objective of bringing the current account into surplus and the inflation rate into line with that of major trading partners appeared to be well within reach. Also of great importance was the increase in business profitability and external competitiveness, which would serve to restore dynamism to the economy. The progress made by France was consistent with the basic strategy that the Fund had advocated for sustaining economic recovery in Europe, namely, the curtailment of inflation, the reduction of fiscal deficits, monetary restraint, and the elimination of rigidities, particularly in the labor market.

The second point of interest was that, notwithstanding the progress achieved in correcting economic imbalances and reducing rigidities, France had continued to experience weak economic growth and increased unemployment, Mr. Ismael observed. There was growing public concern about the exacerbation of that major problem, which was affecting most of the larger European countries, by the weakening of foreign demand associated with the economic slowdown in the United States and the ultimate necessity for that country to correct its large current account imbalance. The extent to which low economic growth rates and high unemployment could be tolerated in pursuit of structural adjustment and the final elimination of inflation in Europe had been debated in various economic circles. There was no doubt that recent structural improvements and the reduction of rigidities in major European countries, including France, would serve to improve the investment climate and increase the supply response of the economy. However, the favorable impact on growth and employment had been insufficient and was likely to be offset by the adverse effects of weakening external demand. A reassessment of the present strategy had been called for in order to prevent the European economic recovery from stumbling. One specific question being raised was whether European countries, particularly those having achieved a substantial degree of fiscal consolidation and price stability, should not relax their fiscal stance to stimulate their domestic economies. Such a policy was being advocated not only to offset the recessionary impact of weakening external demand but also to help reduce the U.S. current account deficit without resort to protectionist measures.

It was against that background that his interest had been aroused in certain differences of view between the staff and the French authorities, Mr. Ismael noted. Despite Mr. de Maulde's indication that those differences pertained only to nuances and questions of detail, they appeared to be rather substantive in respect of the fiscal deficit. The staff had continued to put major emphasis on reducing that deficit, whereas the French authorities seemed more concerned about the high tax burden and the growing size of the public sector. In the light of the argument that he had just advanced, and given the progress achieved in strengthening the external position, restoring price stability, and reducing the fiscal deficit, it seemed timely to shift the policy emphasis toward reducing the fiscal burden and the size of government. Such a shift was consistent with the authorities' strategy of relying on higher business investment rather than on external demand to boost domestic economic activity. Together with a continued increase in business profitability, a reduction of the tax burden would strengthen domestic demand and help to stimulate private investment without undue inflationary pressures.

The continuation of incomes policy, which had played a key role in reducing inflation and restoring business profitability, was also compatible with the stimulation of investment activity, Mr. Ismael commented. Nevertheless, a proper balance had to be maintained between a further improvement in profitability and the consolidation of demand expectations. Again, a reduction in fiscal pressure through tax cuts would serve to counter the dampening effects of wage and income moderation.

The overall stance of financial policy should remain adequately restrained, Mr. Ismael remarked. Careful monitoring and the firm control of domestic monetary creation were essential. The reduction of interest rates, which had assumed a more important role in the allocation of credit, should follow rather than precede the reduction of the inflation rate. The authorities' intention to continue to reduce the fiscal deficit, notwithstanding the planned reduction of the tax burden, was commendable. Together with incomes policy, financial restraint would ensure the maintenance of price stability and a strong external position. The present situation of weakening external demand, however, called for caution in pushing the aim of re-establishing a current account surplus to avoid deeper cuts in domestic demand and economic activity. The gradualist approach appeared to be more appropriate.

He was in general agreement with the staff's appraisal on the more specific policy issues, Mr. Ismael added. In particular, he supported its recommendations with respect to reducing subsidies and restrictions in the determination of interest rates, wages, prices, and credit allocation. Continued progress toward reliance on free-market forces in those areas could not be overemphasized.

Finally, he was concerned at the lack of progress in reducing industrial subsidies and trade restrictions, despite recent success in enhancing business profitability and competitiveness, Mr. Ismael stated. Not only would such an approach delay the development of efficient and internationally competitive industries, it would also tend to generate protectionist pressures in other countries. He joined the staff in calling on France to take the initiative in playing a more active role in the effort to roll back protectionism, both nationally and internationally.

Mr. Pérez remarked that the authorities had been trying hard, particularly since 1983, to bring their economy back into a more competitive position vis-à-vis France's major economic partners. The net result of the policies applied from 1983 to 1985 was clearly favorable: in some respects, developments had been positive since the new policy mix had first been introduced. The rate of inflation was a case in point, the slope having declined despite the tension created at the beginning of each year by very demanding targets. He had perceived a change in the attitude of the French authorities that reflected a more realistic appreciation of what was possible as well as concern about the risk of successive slippages eroding the credibility of government policies.

Another example of the success achieved had been the substantial correction in the external accounts in 1984, alleviating the pressure that the external deficit had been exerting on the economy, Mr. Pérez stated. The improved profitability of firms brought about by declining labor costs, which in turn were the result of an efficient incomes policy, was another example of the general benefits of the French authorities' policy stance.

The performance of the public and external sectors, together with the problem of unemployment, had become the three issues of major interest, Mr. Pérez observed. Fiscal developments in the past two years had been characterized by the failure to attain a central government budget deficit of 3 percent of GDP. Expenditure overruns had amounted to F 5.2 billion in 1983 and had reached F 18.4 billion in 1984; in both years, interest payments had been the main component contributing to the slippages, indicating how difficult it was to predict the financial costs of servicing debt, and at the same time explaining the major deviations from targets that could be generated as a result of the large share of financial costs in total expenditures, exacerbated by external fluctuations in interest rates. Revenue shortfalls, which had also contributed to the fiscal slippages, had been reduced in 1984 compared with 1983.

In sum, the French authorities had been forced by the overshooting of the fiscal deficit by 0.4 percent of GDP in each of the last two years to attempt once more to achieve the target of reducing the central government deficit to 3 percent of GDP, but with a different strategy from the one proposed in 1984, Mr. Pérez continued. In that year, it had been expected that the budget would benefit from social security contributions and income tax surcharges. For 1985, it should be possible to attain the target of a deficit of 3 percent of GDP together with a decline in the tax burden, for reasons that were strong enough to make the attempt worthwhile. Indeed, the greater degree of discipline implied on the expenditure side seemed appropriate, based on recent experience, and should be interpreted as a strategy aimed at reducing the overall size of the public sector, or, to use Mr. de Maulde's words, as a way of eliminating the traditional problem of overadministration. The target to be included in the 1986 budget--expenditure growth of 4 percent--was a demanding one but at the same time was a positive signal that would help to reduce the financing requirements of the public sector.

In that context, the local authorities' accounts and the social security surplus had exerted a positive influence thus far, Mr. Pérez observed. The possibility of a reversal of the social security surplus in the medium term was cause for concern, especially as France had traditionally maintained a healthy financial social security system until 1981-82, when a deficit had been recorded for the first time in 15 years. The authorities had expressed concern about the feasibility of making several major changes that were needed, and he would welcome further information in that respect. The local authorities' accounts had shown a marked decrease in expenditures, together with a continued slowdown in financing requirements, although the French authorities were following the situation closely and with extreme caution.

The major improvements that had taken place during the past two years were probably those in the external sector, Mr. Pérez considered. The authorities had fulfilled their commitment to bringing the current account balance into equilibrium despite the constraint on the economy as a result of the external imbalance that had prevailed two years previously. Nevertheless, the deficit of F 6.9 billion recorded on current account in the first half of 1985--an improvement over the same period in 1984--constituted a threat to the goal of a surplus by the end of 1985. As the staff had noted, the assumptions underlying the authorities' projections had been too optimistic, particularly the one related to the expected exchange rate vis-à-vis the dollar. Recent trends showed a weaker dollar against other major currencies; if that movement were confirmed, France would find it rather difficult to reduce its trade deficit to the extent needed. Moreover, French merchandise exports to the United States had grown by 50.5 percent in 1984, a difficult feat to repeat, particularly given the recent lowering of estimates of economic growth in the United States and exchange rate prospects. For those reasons, France should not expect positive demand-pull effects from abroad.

Therefore, the good results obtained in 1984 in the external sector should be consolidated by means of domestic policy actions aimed at improving the external competitiveness of French products, Mr. Pérez stated, especially since the authorities had announced as part of their export promotion policies the goal of directing their exports toward industrial countries. With structural long-term capital outflows expected to amount to F 34 billion in 1985, a current account surplus was the only logical way to bring about external equilibrium. The staff was apparently right to state that the current account objectives of the authorities fell short of what they should try to achieve, taking into account the problems that might stem from servicing external debt.

He commended the French authorities for their decision to continue to increase France's contribution to official development assistance (ODA), which was already of considerable importance, Mr. Pérez remarked.

The problem of unemployment was central to the economic problems of some member countries and deserved special attention, Mr. Pérez considered. Unfortunately, he did not share Mr. de Maulde's opinion that structural rigidities in France had been mentioned in the staff report partly because the subject was still fashionable. On the contrary, those rigidities were at the heart of France's problem, yet they had not been the only factor responsible for the ills afflicting the labor market. The rising dollar had pushed European governments to follow contractionary policies in order to offset the inflationary effects of falling currencies and the dramatic rise in the flow of net capital to the United States, which had prevented higher rates of investment and productivity. While the latter problems were beyond the control of individual countries, structural rigidities were not. Moreover, it was most discouraging that unemployment in some European countries, far from being alleviated, would take a long time to reduce. Nevertheless, efforts should be made on all possible fronts.

In that connection, he supported the incomes policy implemented by the French authorities since 1982, based on the commitment of the parties concerned to respect certain agreed targets, Mr. Pérez added. The role of the Government in wage negotiations was usually a delicate one calling for cautious efforts to meet desired targets. Therefore, he agreed with the authorities that they should try to maintain credibility among the other parties involved in the negotiations by being realistic rather than ambitious. In fixing a certain target for inflation, the authorities must take account of the feasibility of reaching that target and the consequences of failure in the attempt. Experience with higher than expected rates of inflation made it more difficult to curb inflationary expectations. The counterpart of setting an inflation target must be lower labor costs and less rigidity in the process of hiring new workers and in labor markets. The whole idea was to find the factors capable of creating a favorable environment for private investment. In his view, France had already laid the foundation for the takeoff of investment and the creation of new jobs by accomplishing the difficult task of improving the profitability of firms, which should be the starting point for new investment. Labor costs in France might still be too high, and some additional steps might be necessary to bring real wages into line with other incomes, especially as wage gains--not wage losses--were still being recorded, albeit at a diminishing rate during the past two years.

Mr. Joyce remarked that, in taking stock of the progress made by France since the authorities had embarked on their ambitious program in March 1983 to restore economic equilibrium, he was certain that the primary objectives of the first two years of the program had been largely met. Important progress had been made in reducing both inflation and the budget deficit; the external current account had been virtually eliminated. The French Government had reason to be satisfied at having done what it said it would do, as Mr. de Maulde had put it.

All was not well, however, and progress had been less rapid and far-reaching than the authorities had hoped in some areas, Mr. Joyce continued. Moreover, he could not subscribe to Mr. de Maulde's view that the credibility of French economic policy had been "established beyond question." France had not participated in a meaningful way in the OECD economic recovery, and its growth prospects remained among the poorest in the OECD membership. Although advances had been made, much remained to be done to improve the medium-term outlook for the economy. In short, as Mr. de Maulde and his authorities themselves recognized, the French economic comeback had been remarkable, but sweeping changes were still necessary--in government, in public attitudes, and in the economy itself--if France were to fulfill its promise and regain a position of leadership in Europe.

A restrictive policy stance had been successful in reducing the budget deficit, though that was one area where the authorities had not done as well as intended, Mr. Joyce observed. The fiscal target for 1984 had not been met, nor indeed had that for the previous year, and the enlarged public sector deficit was expected to grow in 1985. The continuation of large government deficits increased the claims of the public sector on domestic financial markets and could inhibit the future expansion of private sector investment. Therefore, he welcomed the Government's intention to make up for any slippage to date and its determination to lower the deficit further in the future.

As for the appropriate mix of expenditure cuts and tax measures, the main emphasis clearly had to be on expenditure, Mr. Joyce considered. Government expenditures as a proportion of GDP in France were among the highest of any OECD country, and there was considerable scope for reducing them, particularly through cuts in subsidies and transfer payments. Despite the desirability of reducing the fiscal burden on the French taxpayer, it seemed singularly inopportune to be cutting taxes at a time when priority must be given to reducing the budget deficit. Moreover, tax reductions at the present moment would not be fully consistent with the objective of restraining domestic demand, a key factor if the desired external current account surplus were to be attained. If there were to be any tax cuts, the emphasis should be on reducing the tax burden of enterprises, thereby consolidating the recovery in corporate profits and stimulating more investment.

An important source of the better price performance had been the moderation in nominal wages, Mr. Joyce remarked. Incomes policies had made a major contribution but some of the progress had resulted from weak domestic demand. The continuing success of incomes policy would be contingent upon adequately constraining fiscal and monetary policies, and it was in those areas that the French authorities had fallen short of the mark. Monetary policies had not been sufficiently restrictive, monetary growth had not been effectively controlled over the past year, and the current targets were not being met. Corrective steps had been taken in July, but unless the slippage were fully reversed, the success achieved so far in moderating wage and price inflation might be at risk. In addition, so long as significant inflation differentials existed between France and its trading partners, particularly Germany, French international competitiveness could be questioned. Declines in interest rates should follow rather than precede any deceleration of inflation, and real interest rates should not be allowed to fall below those in Germany.

In welcoming the recent move away from direct ceilings on bank lending, Mr. Joyce joined the staff in urging as rapid a transition as possible toward more flexible financial arrangements under which interest rates would be able to play a larger and more direct role in the allocation of credit. As Mr. Grosche had noted, the modified system still effectively restrained bank credit to business and individuals, and preferential treatment continued to be given to certain loans without much apparent justification, at least on economic grounds.

High unemployment and the general situation in the labor market in France must be a matter of concern to all, Mr. Joyce stated. The problem of unemployment threatened all countries, and European countries in particular, but the highly regulated nature of the French economy had undoubtedly contributed to the problem in France, although by the same token the Government could make an important contribution to solving it. Recent steps had been taken to reduce rigidities in the labor market, especially in making hiring and firing practices more flexible. The recently announced employment program allowed for compensation at rates below the minimum wage. However, real wages remained high; downward adjustments, together with a more differentiated wage structure, would lead to a reduction in unemployment. He failed to understand how the authorities could argue that employment would not be very responsive to reductions in real wages.

Nevertheless, the lower rate of increase in wage costs over the past two years had contributed to a much-needed improvement in corporate profits and had helped to enhance the chances of an investment-led recovery, Mr. Joyce noted. His only concern was that profits might not have improved sufficiently to lead to as large an increase in investment as projected by the authorities, at least in the short term. Businesses had been restructuring their balance sheets and rebuilding equity positions that had deteriorated sharply over the past several years; the question was how long that process would continue.

A combination of prudent financial policies and further structural adjustments would be essential if there were to be a lasting improvement in France's competitive position and external accounts, Mr. Joyce said. Furthermore, if France were to capitalize on its competitiveness, additional steps would have to be taken to liberalize the trading system. The welcome absence of new protectionist measures presumably reflected in part the European Communities' primary responsibility for European trade policy. However, existing trade barriers in the EC, and particularly in France, were high and needed to fall if trade were to expand. For that reason, it was in France's own interest to support an early start to new multilateral trade negotiations.

The complex and long-standing nature of France's economic problems would require a continued strong commitment by the authorities to traditional methods of economic restraint, Mr. Joyce remarked. It might be harder to make progress over the few years ahead than it had been to record the successes of the past two years. But he urged the authorities not to abandon their adjustment effort in midstream.

Mr. Polak observed that the discussion by the Executive Board within one week of the economies of three large industrial countries provided a good opportunity to take into account the interaction of those economies and the appropriateness of the policies of those countries against the background of the global economy. Thus, he would look at the French economy not only from a domestic point of view but also in the light of the respective roles that large industrial countries could play to help improve world economic conditions. France was not well placed to contribute to an expansion of world demand through more expansionary policies, given its still relatively high though declining inflation, unsatisfactory budgetary situation, and rather fragile external position. An improvement in growth performance in coming years should stem mainly from an increase in exports and investment, fostered by a continuation of policies aimed at greater competitiveness and profitability.

The improvement in the current account of the balance of payments in line with the authorities' intention had taken place against the background of a severe weakening of the U.S. current account, Mr. Polak observed. Under the circumstances, the achievement of a small surplus had not been a very ambitious undertaking, and much larger surpluses would be needed to permit some reduction of external debt and remove the external constraint on growth. To that end, somewhat more rigorous policy and monetary policies, accompanied by an incomes policy, would be required. Further progress in the reduction of structural rigidities would also be essential. In sum, the progress made in 1984 had been insufficient, and a policy of restraint would continue to be necessary. The decision of the French Government not to devalue the franc against the deutsche mark on July 22 demonstrated that the internal adjustment was indeed its priority.

Incomes policy had had an important place in the authorities' arsenal of instruments in recent years, Mr. Polak remarked. A certain measure of success in moderating wages and in holding down price increases had been achieved; although inflation had been halved between 1981 and 1984, it remained considerably higher than in Germany and was projected by the staff to fall only a little further in 1985 to about 6 percent. Despite the increase in profits, the financial position of enterprises remained rather weak. The increase in real wages had slowed down considerably and had fallen below the growth in productivity. However, a downward adjustment of real wages and greater wage differentiation was called for in view of the high rate of unemployment. For that purpose, wage deindexation, which had not been specifically mentioned in the staff report, would be necessary, as the Governor of the Bank of France had underlined in a letter to President Mitterand earlier in 1985 that had later been published as an introduction to the Bank's annual report.

Like most European countries, France had suffered from major rigidities in its labor market as well as in other areas, Mr. Polak went on. The increase in the number of fixed-term appointments had introduced greater flexibility into the labor market. A further rollback of restrictions on laying off workers would foster greater willingness to hire workers. Moreover, high minimum wages, especially for young people, inhibited hiring. Some notable innovations were being introduced in industrial policy, and the authorities' stated intention of creating an environment to encourage private initiative was encouraging. However, although there was a case for selectively supporting certain promising industries, for instance, through research and development aid, there was also certainly a case for reducing subsidies and import restrictions, which remained pervasive. Sufficient progress appeared to have been made in reforming the credit system; privileged credit allocation and subsidized lending for exports, housing, and investment were still widespread, and the reform introduced in January seemed to have been partially reversed. Further liberalization of international capital movements was also desirable.

The central government deficit would have to be reduced below 3 percent of GDP through measures on the expenditure side, Mr. Polak stated. The authorities should heed the staff's warning of the risk of a vicious circle of high deficits and low growth. He had not been convinced by the authorities' standard argument that certain categories of expenditure could not be touched because of the tacit understanding that real cuts in civil servants' wages and in social security benefits were to be avoided. As he had mentioned during the discussion of the 1984 Article IV consultation, higher wages in the government sector in France led to lower employment.

As in many other countries, monetary developments in France had been difficult to judge because of the introduction of new financial assets, Mr. Polak commented. According to the staff, monetary policy had not been really restrictive in 1984. A positive feature of the monetary target for 1985 was that it took into account the growth of liquid assets falling outside the M-2 definition; the target was also lower than the projected increase of nominal GDP. In addition, the target for bank credit had been lowered. Unfortunately, it was not possible to judge actual monetary performance so far in 1985 because of what the staff rightly called the excessive time lag in the availability of French monetary statistics. He noted the assurance by the authorities that more timely data would be made available.

The replacement of the system of direct ceilings on credit by a more flexible system at the beginning of 1985 had been a positive development, Mr. Polak said. A similar attempt to change the system had been made in the early 1970s. The application of reserve requirements to the assets side of the banks' balance sheets had a more direct impact on lending than reserve requirements of the standard type. The instrument was an interesting one that could prove to be a useful halfway house between the rigid system of ceilings and a more market-oriented system of monetary control toward which the authorities could move when conditions permitted. The staff was perhaps being a little too hasty in pushing the authorities toward a fully market-oriented system.

Useful information was provided in the supplement to the staff report on monetary developments and policy, Mr. Polak noted. The expansion of the broad money supply had overshot the target in the first five months of 1985, and the Bank of France had acted at the beginning of July to bring money growth back within the target zones. The result was likely to be upward pressure on long-term interest rates, which was appropriate. In that connection, he observed that the Governor of the Bank of France had said that although French interest rates were still high in nominal terms, in real terms they were lower than in most of the major industrialized countries.

Mr. Lundstrom observed that it was evident that the economic program launched by France in March 1983 had had encouraging results. There had been a substantial improvement in the current external account and a notable degree of wage restraint; the competitiveness and profitability of French industry also had developed favorably. Despite those impressive achievements, however, the French authorities would have to persevere in their adjustment efforts because the situation was still somewhat fragile.

The success of French incomes policy had been recognized by the staff, Mr. Lundstrom remarked. When combined with appropriate financial policies, incomes policy could play a significant role, and the Fund should pay more attention to it in certain circumstances.

The public sector was expected to absorb close to one third of domestic financial resources in 1985, up sharply from the early 1980s, Mr. Lundstrom observed. Thus, given the overall size of the public sector and the authorities' emphasis on promoting private investment, it was essential that slippages in fiscal policy be avoided. As the authorities themselves recognized, the deviation from the announced target would make further action imperative on the expenditure side. He joined other Directors in recommending strongly a reduction of subsidies and other support schemes, which, having risen by 60 percent in the 1980s, had been the fastest-growing component of expenditure next to public debt. Such an approach would also be in better keeping with the authorities' aim of enhancing efficiency in the productive sector, whether public or private.

The greater emphasis on a market-oriented monetary policy was welcome, Mr. Lundstrom noted. Although he understood the authorities' preference for a gradual approach after almost 30 years of quantitative credit controls, a swifter adjustment and modernization of the monetary system might be desirable. With privileged credit schemes accounting for one third of total credit to the private sector, the scope for a more efficient financial system in France would seem substantial. The importance of controlling domestic credit expansion had been stressed by the staff, and he would be interested in having some indication of the content of the measures mentioned on page 19 of the staff report.

He had been pleased to learn from Mr. de Maulde that problems in the public sector enterprises were being confronted head on, Mr. Lundstrom commented.

Remarkable progress had been made in the external sector, and the outlook for 1985 suggested a small surplus on the current account, Mr. Lundstrom observed. Nevertheless, the authorities' strong emphasis on a strategy oriented toward the balance of payments was well warranted, in the light of the sharp rise in external indebtedness and the envisaged leveling off of improvements in relative unit labor costs and the narrowing of differentials in the growth of demand between France and its major trading partners. Thus, like many other countries, France faced the difficult challenge of maintaining restrictive economic policies while simultaneously promoting structural changes in the production and export base in an external environment of slow growth.

It might be possible for France to proceed somewhat faster in decontrolling foreign transactions, Mr. Lundstrom remarked. Numerous products--notably, steel, textiles, and electronics--remained subject to quantitative restrictions. Moreover, while some measures had been taken to alleviate exchange controls, they had been relatively modest, and capital movements were still tightly controlled. France had recently been granted a renewed derogation from EC regulations on the free movement of capital, a derogation from which it had benefited since 1968. The provisions for granting such a derogation required that a member country find itself "in difficulties or seriously threatened with difficulties as regards its balance of payments." The staff had correctly highlighted in its appraisal the question of controls on foreign transactions, and he appreciated Mr. de Maulde's assurances that further liberalization was a question only of timing, not of substance. It was also encouraging that the authorities had not had recourse to new protectionist measures since the 1984 Article IV consultation.

Finally, Mr. Lundstrom commended the French authorities for a comparatively high level of official development assistance and for their generally positive attitude to development issues.

Mr. Nebbia said that he was in broad agreement with the staff appraisal. On the whole, the French authorities had made progress, particularly in those areas that had been identified earlier as being of concern. The current account deficit, which had reached almost F 80 billion in 1982, had been virtually eliminated by 1984; there were indications that it would be in surplus in 1985 and in growing surplus in 1987. However, he asked whether that objective could still be achieved, based on the preliminary figures for the first quarter of 1985, and, depending on the likely outcome, what the implications were in terms of economic policy response. As noted by the staff, the current account would have to be in a comfortable surplus in the years ahead if the rise in the ratio of gross debt to GDP and the debt service ratio were to be contained and, moreover, gradually reduced, and if France and other European countries were to assume greater responsibility for economic growth in the world following the slowdown of the U.S. economy.

The restoration of competitiveness and the improvement of the financial position of French enterprises--through an increase in business profitability--must remain key elements in the external economic strategy, Mr. Nebbia continued. Considerable gains had been achieved in those areas, but he shared some of the concern expressed by the staff as to whether or not the competitiveness of the economy had been fully established and to what extent business profitability was being eroded by a still relatively high rate of inflation. Trade developments seemed to justify such concerns because, notwithstanding the significant improvement since 1982, the trade balance had remained negative through 1984; the improvement so far in 1985 had differed little from the original projections.

A significant reduction in the inflation rate and moderation in wage and salary adjustments, as well as a sharp decline in relative unit labor costs, had been instrumental in the further redistribution of factor incomes and the improvement in business profitability, Mr. Nebbia observed. In the short run, that process might nevertheless impede economic growth unless appropriate channels were devised for speeding up investment associated with increased profits. In that respect, it was encouraging to note that although real GDP had not increased in the fourth quarter of 1984 compared with the preceding quarter, fixed capital formation had increased for the first time since mid-1983 as a result of a 3 percent increase in business investment. It would be helpful if Mr. de Maulde or the staff were to comment further on the authorities' forecasts for business investment in 1985 and the subsequent years and also on the extent to which prevailing high interest rates might hold back investments.

Meanwhile, economic activity remained weak, Mr. Nebbia remarked; as a consequence, the unemployment rate had been increasing steadily since 1981, having exceeded 10 percent by 1984. Owing partly to flat domestic demand and partly to the wage and salary settlement system introduced in late 1982, the unemployment rate projected for 1985 and 1986 was a cause for concern. Prompt measures were called for to promote considerably greater flexibility in the labor market. Even though moderation of real wages would not solve the unemployment problem automatically, it would at least encourage more labor-intensive investment and greater use of existing capital stock.

France should play a major part in promoting liberalization of wage restrictions and opening up the markets of the European Communities to third-country suppliers, Mr. Nebbia stated. It was regrettable that so much of France's domestic and foreign trade remained subject to subsidies and trade restrictions, some of which, particularly those relating to agricultural products, were having disruptive consequences in world markets; not only developing countries but also other developed exporting countries that were efficient producers were suffering the adverse effects. Of course, the relatively high level at which France had maintained its official development assistance was noteworthy.

The main objective of fiscal policy in 1984 had been to contain the central government budget deficit to 3 percent of GDP, Mr. Nebbia noted. In the event, that target had been exceeded, the deficit having amounted to 3.4 percent of GDP, almost the same outturn as in the preceding year. A question that remained unanswered was whether, looking beyond the slight slippages, to use Mr. de Maulde's words, it was either reasonable or appropriate for the consolidated general government expenditures to account for close to 50 percent of GDP, and indeed whether the size of the public sector was compatible with the other goals of France's current economic policy. Significant progress would have to be made toward reducing public sector expenditures by reducing the size of the sector, lowering or eliminating subsidies and other support operations, assuring the viability of public enterprises by requiring them to operate under market conditions, and above all transferring to the private sector those activities that the public sector had proved itself unable to undertake efficiently in economic terms.

The decision of the French authorities to reduce the weight of taxation was welcome, Mr. Nebbia commented. However, he wondered whether tax cuts should be introduced at a time when the fiscal deficit would have to be lowered, optimally below the 3 percent of GDP targeted for 1985.

Mr. Zecchini said that the gradual adjustment process started by the French authorities in the spring of 1983 had led to some meaningful macroeconomic successes, as had been expected. In 1984, as well as presumably in the first part of 1985, France had managed to lower the inflation rate and the deficit in the current external account without slowing the pace of growth of its economy. It was even more significant that the declining trend in fixed investment in the industrial sector had been reversed sharply. Yet of the four main policy instruments that the authorities had envisaged using in their economic policy mix from the beginning of 1984, incomes and industrial policies had been more effective than fiscal and monetary policies.

In particular, efforts to contain the budget deficit had not been fully successful, and monetary growth had exceeded its target rate in 1984, Mr. Zecchini continued. The rate of increase in the money supply had remained high in the first part of 1985, having overshot the targeted range by 2 percentage points. The impact on the expansion of domestic demand might explain why, in spite of the progress registered on the inflation front, the actual price outcome might have fallen slightly short of expectations. Furthermore, the current account of the balance of payments had been brought almost into equilibrium although the external position remained fragile; a better result was possible, given the 2.2 percent cyclical differential with the growth of domestic demand abroad to the advantage of France.

Incomes policies, as well as other structural measures in the industrial sector, had been successful, Mr. Zecchini observed. Moderate wage increases and some tax cuts had favored higher business profitability, an improvement in external competitiveness, and a lower inflation rate. However, the benefits of incomes policies had not fully materialized yet. Export price competitiveness had not improved in 1984 as expected, because exporters had increased their profit margins rather than contained their prices. Did the staff consider that that trend was likely to continue, and did current developments indicate some recovery in price competitiveness? Furthermore, higher business profits had favored a pickup of investment in industry, although total gross fixed investment had remained sluggish.

In the past four years, government deficits had slowly but steadily increased in terms of GDP, Mr. Zecchini noted. Although his chair was painfully aware of the difficulties encountered in containing fiscal deficits, he wondered whether the fiscal target for 1985 was sufficiently ambitious to provide continued support of the adjustment effort. As for the Government's planned tax cut for 1985 and its intention to avoid further reductions in the size of the private sector, he believed that instead of simply attempting to reduce fiscal pressure, the authorities should pay further attention to improving productivity and the domestic supply of goods and services. In addition, fiscal incentives to increase fixed investment might be considered to enhance the economy's medium-term potential. Tax cuts aimed at increasing demand in the short run did not seem advisable at present, in view of the weakness of the external position.

A replacement of the system of direct ceilings on bank lending (encadrement du crédit) and the growing sophistication of financial markets were both major developments, Mr. Zecchini considered. The unification of regulations relating to all financial institutions should be viewed favorably, as it reduced the risks of disintermediation in specific sectors of the market and of segmentation of financial markets. However, even under the new system, monetary policy was still conducted through a series of quantitative credit controls on individual institutions. Furthermore, interest rates remained subject to administrative controls. Those two factors tended to reduce competitiveness among financial institutions and might lead to a less efficient financial system. The authorities considered the new system to be transitional and evolutionary, but recent experience in Italy and other countries showed that it was possible to pass smoothly from a system of direct controls to one of indirect controls in a relatively brief time. One way to ease the transition in France might be to make flexible use of the penalty reserve requirements that banks had to meet on excess lending. For example, foreign-currency lending to residents should be subjected to reserve requirements just as other bank credit was. Of course, once indirect controls assumed greater importance, even more timely monetary statistics would be needed.

The choice and definition of adequate monetary targets posed an additional question, Mr. Zecchini remarked. In principle, in periods of financial innovation, previously existing relationships between an intermediate monetary target and a given policy objective such as nominal GNP growth might no longer be stable. Shifts in and out of new financial assets might not be covered by the monetary target. That was particularly true of assets held by the public as opposed to those held by the Fonds Communs de Placements (FCP) and the Sociétés d'Investissement à Capital Variable (SICAV), which had accounted for 4.2 percent of M-2R in 1984. From Chart 1 in the report on recent economic developments, M-2R appeared to have exceeded its target, namely following a shift in December 1984 away from short-term mutual funds, which were relatively new instruments not included in M-2R. Therefore, in periods of financial innovation, it seemed advisable to use broader definitions of money in order to avoid sharp fluctuations in their value. In addition, more narrowly defined aggregates might bear a less definite and clear relationship with policy objectives because rapid increases in new financial activities might not be taken into consideration and the actual growth of liquidity might be greater than accounted for.

Finally, Mr. Zecchini noted, if France were to attain its goal of a current account surplus in its balance of payments over the two years ahead, and if the French franc were allowed to appreciate in real effective terms, much tighter domestic demand management would be required.

Mr. Clark observed that the French economy had made further notable progress over the past year, with slower inflation, a smaller current account deficit, and a further strengthening of corporate profitability, although in some of those areas progress had not been as fast as originally hoped. The recurrent slippages in fiscal and monetary policy, which appeared to have continued into 1985, were of some concern. However, the authorities had recently taken measures to tighten monetary policy and to bring forward a number of fiscal measures to ensure that the 1985 targets were met.

But while there had been some structural liberalization in recent years, the French economy continued to be beset by controls on the prices of nearly one third of industrial goods, interest rates and credit allocation, capital flows, and pay determination, Mr. Clark continued. Those were all areas on which Mr. de Maulde had commented, although it did not seem right to characterize a concern for structural issues as being merely a vogue. Further progress in liberalizing the economy would be a prerequisite for growth at a rate that would hold out any prospect of tackling the unemployment problem.

Fiscal policy over time remained difficult to interpret because items had been shifted out of the budget for sound administrative reasons, according to the French authorities, Mr. Clark noted. The staff estimates of the effect, which had been set out Table 17 of the report on recent economic developments, were helpful; it would be even more useful to have a series of consistent figures over a longer time span.

The authorities certainly should aim at reducing the central government borrowing requirement as a proportion of GDP in 1986, and they should preferably have achieved that objective in 1985, Mr. Clark commented. The task would not be easy, given the authorities' objective of reducing taxes. One alternative might be to reduce subsidies, which had risen by over 20 percent in 1984, to account for over 2 1/2 percent of GDP.

Mention had been made on page 12 of the staff report of the authorities' view that the containment of interest payments in 1985 would "owe much to the heavy recourse to issues of renewable treasury bonds, on which interest was payable at maturity," Mr. Clark observed. That seemed to be more of an apparent than a real solution to the problem of expenditure control, and he asked the staff what the effect on the budget would be when those bonds matured.

The considerable progress made in reducing inflation seemed to have been due in good part to the success to date of the authorities' incomes policy, which had also allowed a substantial upturn in company profitability, Mr. Clark said. Mr. de Maulde had remarked that "confronted by the evidence, the staff had finally managed to overcome its doctrinal opposition to incomes policy" and had offered his assurance that incomes policy would continue to be used in the future. One obvious concern about such a strategy was the long-term effect on wage differentials and the institutionalization of a major rigidity in the labor market. In the short run, such effects might be hardly noticeable, but in the longer run, the cumulative effects could be substantial and could adversely affect investment decisions and ultimately competitiveness. He had taken note of Mr. de Maulde's comments about the extent of differentiation allowed between different sectors and different firms, but he would be interested in knowing whether the French authorities considered that further measures would be needed to deal with the problem of wage differentials in future.

On monetary policy, Mr. Clark remarked, he had little to add to the staff analysis. He welcomed the abolition of the encadrement du crédit system but wondered whether the new arrangement differed greatly in substance from the previous system. Interest rates seemed to remain a subsidiary instrument of monetary policy, determined largely by exchange rate considerations. He hoped that the French authorities would speed up their rather gradualist approach to reform in that area.

The successful reduction of the current account deficit had been followed by developments so far in 1985 that were somewhat disappointing if no worse than at the same time in 1984, Mr. Clark considered. However, he would be interested to know how far the performance of the balance of payments in 1985 could be attributed to special factors or whether the staff envisaged an improvement in the second half of the year similar to the one that had occurred in 1984. The information on capital controls in the report on recent economic developments was useful, although he would have welcomed a more detailed discussion of the effects of those controls in the staff report itself. In the framework of the European Monetary System (EMS), further progress in bringing inflation into line with inflation rates in Germany was likely to be necessary if competitive pressures on French exporters were to be lessened. He had noted the divergence of cost and price measures of external competitiveness, with the former improving and the latter deteriorating; he asked the staff which measure seemed best to explain the behavior of trade flows.

In conclusion, Mr. Clark stated that with the French economy continuing to register significant improvements, the need at present was for some further progress in reducing inflation combined with the necessarily longer-term effort at structural liberalization.

Mr. Fujino said that he had been pleased to note the further progress made in 1984 in reducing the internal and external imbalances of the French economy. The current account deficit had been reduced basically in line with the original target, and important progress had been made in bringing down inflation. Admittedly, the public sector financing requirement remained large, and the rising trend of the unemployment rate had not yet been reversed. However, his overall impression was that the economy was heading for better balance and steady structural change, mainly through the authorities' adjustment efforts. He had been particularly impressed by Mr. de Maulde's reference to the sweeping changes taking place throughout the French Government, and he could broadly endorse the thrust of the staff appraisal.

Incomes policy had been a central factor in redressing economic imbalances along with conventional demand management, Mr. Fujino remarked. Continued reliance on incomes policy usually met with skepticism, as Mr. Clark had mentioned, because there had been so many unhappy experiences with it. However, the strategy seemed to have been appropriate and successful in France because the serious erosion of enterprise profitability had had its roots in the steady increase in the cost of labor over the past decade. French incomes policy had been notably successful in reducing inflation and raising the nonlabor share of value added. Administered appropriately, a forward-looking incomes policy along those lines could be effective. However, despite the significant improvement in profitability, private investment had not yet picked up, and unemployment remained high. Continued wage restraint seemed essential to re-establish fully the competitiveness of the economy. He hoped that the authorities would make that possible by setting ambitious price targets.

If incomes policy were to continue to be successfully implemented, it would have to remain flexible, Mr. Fujino noted. The recent steps to increase the differentiation in wage settlements, including the one under the youth employment program, were welcome. Careful thought should also be given to the role of the minimum wage, despite the sensitivity of the issue. In order to reduce the relative cost of labor, more attention should be paid to reducing nonwage costs; the increase in labor costs since 1973 seemed to have been largely attributable to such costs, particularly to employers' contributions to the social security fund. Those contributions, equivalent to nearly 13 percent of GDP, seemed to be imposing heavy financial burdens on enterprises.

Incomes policy would need to be supported by adequately restrictive fiscal and monetary policies, and he welcomed the assurance given by Mr. de Maulde in that respect, Mr. Fujino went on. Until recently, the system of price controls in France had been used widely as a complement to incomes policy. Prices were the key to the functioning of markets, and to be effective, controls tended to proliferate and create distortions. The progressive liberalization of price controls was reassuring. Even in service sectors, where the room for productivity increases was limited, a certain element of free competition could be introduced. He would expect further progress in deregulation.

As to fiscal and monetary policies, the adjustment effort had been somewhat less successful, Mr. Fujino considered. The deficit of the central government had exceeded the original target for two consecutive years by a small but not insignificant amount, and had risen to 3.4 percent of GDP in 1984. It was rather worrisome to note that the deficit target was likely to be overshot again in 1985 by broadly the same extent as in the two preceding years. Financing a deficit of the present magnitude might pre-empt an excessive share of available financial resources and put at risk the Government's external and price objectives. Therefore, he endorsed the target suggested by the staff of a deficit of 2.5 percent of GDP in 1986 with further reductions thereafter. He welcomed the decision to reduce substantially employment in the civil service, which had grown rapidly in 1981-83, but specific measures to cut expenditures in other areas remained rather unclear. More decisive steps would be desirable in light of the authorities' intention to reduce the tax burden with the aim of revitalizing private investment. For example, a review of social security benefits might be called for, bearing in mind the prospective financial strains on some of the social security funds.

On monetary policy, the growth in M-2R in 1984 had again overshot the targeted range, reaching 7.6 percent, Mr. Fujino continued. Continued deceleration in the growth of the money supply was essential to reducing inflation, and he attached particular importance to achieving the M-2R target for 1985 of 4-6 percent. In recent years, higher interest rates had begun to take on a greater role in restraining credit demand, and he hoped that the authorities would adopt a more active interest rate policy and a more market-oriented credit allocation system. The relative importance of privileged credit availability and subsidized lending would have to diminish over the medium term if interest rates were to play the central role in credit allocation. The appearance of new financial instruments in the market with increased bond issues, which attracted funds from traditional channels, was a notable development. The new funds had been set up originally to circumvent pervasive administrative controls, such as those on deposit interest rates, and had created a problem of instability in the bond markets. But the wider choice available to the public in the placement of financial assets was a positive element. At the same time, changes in the legal and institutional framework of the financial institutions were taking place, with an overall reform of the law relating to the regulation of financial institutions and the replacement of direct credit ceilings on bank loans, which had long been in existence in various forms, by the imposition of reserve requirements. Further developments in the same direction should be made to open up the financial market further.

The French authorities' commitment to an open trading system was essential for the sustained growth of the world economy, Mr. Fujino concluded. It was reassuring to note that Mr. de Maulde had denied that France had been playing a negative role in the formulation of EC trade policy; thus, he hoped that the French authorities would use every available opportunity to pursue liberalization actively and eliminate existing restrictions.

Mr. Nimatallah observed that he had no difficulty in agreeing in general with the staff's main policy recommendations, in particular with its statement that the attainment of external and internal financial equilibrium was a necessary condition for more rapid and sustainable economic growth and a reduction in unemployment. Since 1983, the authorities had made consistent progress toward the attainment of external and internal financial equilibrium, had eliminated the current account deficit, had kept the fiscal deficit at about 3 percent of GDP, had reduced the rate of inflation, and had devised and implemented an effective incomes policy that had contributed to the improvement in business profitability.

He had also been reassured by Mr. de Maulde's statement that his authorities were aware of the need for major structural changes and that those changes were actually under way, Mr. Nimatallah went on. The recent moves toward dismantling controls on prices and on interest and exchange rates should lead to a more efficient allocation of resources and improve the long-term prospects for employment. Structural changes in various sectors of the economy, including both the reduction in the size of government and the scope of deregulation in the economy, were also commendable. The authorities should put special emphasis on several areas. First, more vigorous attempts must be made to dismantle the many rigidities in the labor market, including the effect of the minimum wage, restrictions on layoffs, social security payroll taxes, and regulations governing shift work. Unfortunately, such chronic rigidities were to be found in Europe and in industrial countries more generally, and unless the social partners--business and labor leaders, as well as the Government--sat down together and made serious and unselfish efforts to deal with those rigidities, unemployment might well impair the free-market system. Obviously, the problem was a long-run one; the solution would not be found overnight and might have to be an innovative one. For instance, if working hours were too long, they should be reduced to provide more leisure time.

Trade barriers were another problem calling for more serious consideration by the French authorities and perhaps by those of other European and industrial countries, Mr. Nimatallah said. Such barriers were self-defeating; the longer they were left in place, the more serious the problems at a later stage, particularly in restructuring industrial production to reflect comparative advantage. Despite the best efforts of France to reduce trade restrictions within the country, sectoral barriers were well entrenched and should be dismantled. France and other industrial countries in Europe should remove barriers and rigidities to encourage free trade among all trading partners. In general, however, the French authorities had refrained from introducing protectionist measures, in comparison with other countries. He encouraged them not only to stay the course but to do more.

Mr. Alfidja said that the remarkable results achieved by France since the previous Executive Board discussion on France were in line with the objectives set by the French authorities. The good performance of both the industrial and the agricultural sectors, based on the strength of the recovery experienced by France's main economic partners, had led to growth of real GDP of 1.3 percent in 1984. That rate, although relatively low, had been almost double that of 1983. In the struggle against inflation, the authorities' energetic measures were bearing fruit: the rate of price increase in 1984 had dropped by about 3 percentage points from 1983. The authorities should continue their efforts on that score with determination. Decisive success in reducing inflation would depend on both the success of the incomes policy to which the Government was attached and the strength of the franc, both inside and outside the European Monetary System, as well as on the competitiveness of French products.

The goal of achieving a budgetary deficit equivalent to 3 percent of GDP had not been met, Mr. Alfidja noted. As Mr. de Maulde had explained, the outcome was less the result of a lack of strict control on expenditure than of an overestimation of some receipts and an underestimation of interest payments on debt. The convergence of views between the Fund staff and the French authorities on the need to avoid such fiscal slippage in 1985 was reassuring, as was the authorities' determination to take steps to that end, although such a policy might not be easy to follow on the eve of a major election.

The recovery of the external accounts was impressive, Mr. Alfidja considered. The deficit on current account had been reduced by half in 1983 in relation to 1982, when it had been F 80 billion, and had been practically eliminated in 1984. In the industrial sector, the measures taken in 1983 were having positive effects on the performance of business. The active promotion of exports had contributed in many ways to those satisfactory results. The authorities would have to do everything possible to consolidate and strengthen the gains made if they were to reduce their debt burden and maintain an appropriate exchange rate for the franc.

The major monetary aggregates had moved closely in line with the objectives established for 1984, Mr. Alfidja remarked. In light of the developments in the first few months of 1985, the monetary objectives established for the year appeared to be ambitious. However, in light of the recent measures initiated by the French authorities, those objectives could well be achieved. The new system of credit control introduced by the authorities seemed to be better adapted to market requirements than the so-called ceiling on bank lending had been.

The French economy was not of course without problems, Mr. Alfidja concluded. The high level of unemployment was of grave concern; training programs and public works had enabled the authorities to tackle its more urgent aspects. However, the quasi-structural character of unemployment called for a solution of a more medium-term nature, the basis for which would have to be an even more dynamic and competitive economy and a strengthening of the changing attitudes of society to which Mr. de Maulde had alluded.

To conclude, Mr. Alfidja congratulated France for maintaining a high level of ODA. The countries that had elected him were particularly grateful for such assistance in the present time of shared crisis and austerity.

Mr. Arias said that he was in general agreement with the staff analysis and would like to commend the French authorities for the progress made toward stablization of the economy. The current account deficit had been reduced further to an insignificant level, the rate of inflation had continued its declining trend, and industrial profit margins were still improving. Also welcome was the increase--albeit small--over previous years in real GDP, which had resulted from improved competitiveness. Nonetheless, it was particularly important for the French authorities to continue the strengthening of macroeconomic management.

As shown in the staff report, the French authorities had been successful in implementing an incomes policy, Mr. Arias commented. In that context, the new system of allowing wage increases based on the official price target appeared to have had good results. The authorities should maintain the momentum achieved and aim at continuing to reduce inflation and further restoring business profitability. That was the authorities' strategy, with which he fully concurred, in the sense that it would encourage new investment and create the right track for sustainable economic growth.

On the other hand, continued adjustment would require that the central government budget deficit be contained by further efforts in public expenditures, Mr. Arias continued. That approach appeared more necessary if the authorities were determined to reduce the tax burden by another 1 percentage point of GDP. In that respect, he wondered why the tax reductions had not been concentrated on reducing the corporate tax burden so as to be consistent with the strategy of increasing profit margins, strengthening private investment, and improving employment conditions. Instead, more weight had been placed on lowering household taxes, which in turn could be counterproductive with respect to the social security funds. He would be grateful for some comments from the staff or Mr. de Maulde on the matter.

Regrettably, monetary growth had exceeded the range targeted in 1984, Mr. Arias observed. Hence, it would be particularly desirable if the authorities could keep monetary growth within the range planned for 1985 by seeking to tighten domestic demand as well as by further reducing the rate of inflation. He concurred with the authorities' view that high interest rates would play a key role in halting monetary growth and could be accompanied by innovations in the financial system. Further comment by the staff or Mr. de Maulde on the authorities' plans for the financial system would be helpful. From the results of the first five months in 1985, it appeared that the French authorities faced a great challenge if they were to comply with their monetary goals for the year as a whole. He asked the staff whether it envisaged any improvement for the rest of the year.

The major efforts of the French authorities aimed at continuing to increase competitiveness and reducing the trade deficit were commendable, Mr. Arias remarked. Nonetheless, he wondered whether they might not have considered other ways to undertake specific structural reforms geared toward providing incentives for private investment. The staff had mentioned in its appraisal that "France should play an active role in promoting the evolution of EC trade policy in ways that would avoid increased discrimination against third country suppliers." Could the staff or Mr. de Maulde elaborate somewhat on whether the French authorities were willing to take any initiatives in that respect?

Finally, Mr. Arias said, he was encouraged by the continuing increase in ODA by France, despite the country's own economic problems, and by the authorities' commitment to increase ODA further.

Mr. Wang said that the French economy had improved notably since the implementation of a comprehensive set of adjustment measures. The external accounts had been brought back, in the main, into balance. The franc had held its own, especially over the past several months. The rate of inflation had been sharply reduced and was to be brought down to the projected average inflation rate of the EMS countries. Furthermore, fixed capital formation had been on the increase, as had business profitability. In sum, as pointed out by Mr. de Maulde, "the credibility of France's economic policy has been established beyond question."

For the second half of 1985 and beyond, the authorities had expressed their determination to meet their objective of bringing down the budget deficit to 3 percent of GDP, Mr. Wang noted. In doing so, they would have to rely on revenue increases and further expenditure cuts, especially reductions in subsidies and other support operations, as well as on measures to promote the viability of public enterprises, which should be made subject to market forces.

The authorities were also determined to meet the new monetary target for 1985 by continuing to monitor and control domestic sources of monetary creation, Mr. Wang said. In that respect, interest rates should be established with great care. Incomes policy, which appeared to have been effective in tackling structural rigidities and enhancing competitiveness, would continue to play a central role. The reduction of the unemployment rate and the establishment of better employment conditions could be achieved more effectively by means of a persistent fight against the rigidities that impeded adjustment in many sectors of the economy.

The external accounts should be strengthened further so that a current account surplus could be achieved, thereby permitting the reduction of gross debt and a consolidation of the external financial position, Mr. Wang concluded. The authorities' resolve to maintain an open economy not only would be beneficial to France but would also contribute to international trade. The absence of any evidence of significant new protectionist measures in the past year was welcome, as was France's continuing commitment to a relatively high level of ODA.

Ms. Bush noted that evidence of the continued steady progress achieved by the French authorities in the past year was to be found in the acceleration of real economic growth, the deceleration of inflation, a reduction in the current account deficit, a lower budget deficit to GDP ratio, and some moderation in the growth of real wage rates and unit labor costs. At the same time, the improvement in some areas had been modest and there had been some disappointments, including the overshooting in respect of monetary targets, the budget, and prices, as well as the rise in unemployment and the fall in total employment.

The French authorities intended to persevere in their adjustment effort, as Mr. de Maulde had stated in no uncertain terms, Ms. Bush remarked. Over the medium term, the authorities intended to continue to aim at such principal objectives as lessening dependence on foreign demand for economic growth, strengthening of the balance of payments to reduce the external constraint on growth, reducing foreign debt, further decelerating inflation, creating a better environment for profit and business investment, arresting the increase in the size of the public sector, and carrying out a number of structural reforms. The successful attainment of those objectives would require firm economic management. The change in basic attitudes in France to which Mr. de Maulde had referred should help the authorities to reach their goals.

A strong defense of French incomes policy had been made by Mr. de Maulde, Ms. Bush remarked. It was true that some of the success in restraining wages must be attributed to cooperation among the social partners. However, her authorities firmly believed that incomes policy and price controls created distorting elements in the economy; as the authorities had chosen those paths, they would have to support them with firm monetary and fiscal policy, as the staff had pointed out and as Mr. de Maulde had acknowledged. Performance had been fairly good in both areas, but there was some room for improvement. Real wage restraint and more wage differentiation remained major preconditions for a revival of business investment and the resumption of employment growth, although they might not be enough in themselves. The greater shift toward more wage differentiation and toward negotiation at the individual enterprise level should be helpful in that respect. The new youth employment program would permit payment of wages below the standard minimum wage, and she would be interested in knowing whether any useful experience had been gained yet in that respect, as such a wage structure had been under debate in the United States.

She heartily endorsed the policy objectives of arresting what had been the steady growth of the public sector, narrowing the budget deficit, and lightening the burden of taxation, Ms. Bush stated. As the authorities were fully aware, that combination of objectives meant that expenditure restraint must be at the heart of the effort. That was all the more important because France had the sixth highest tax burden among OECD countries, as measured in 1982, and tax pressures had increased by a greater amount than in most other major industrial countries in recent years. In that respect, the reduction in the personal income tax rate in 1985, along with the further 3 percent reduction planned for 1986, was gratifying. However, the fact that the authorities projected little or no supply-side response from that tax cut reinforced the need for a firm policy of expenditure reduction. The figures, as well as the distortive effects, pointed to the need for making subsidies the main target of expenditure control. The authorities had indicated that they would not withdraw support rapidly from some nationalized industries, which did however have an impact on the budget. Thus, she would be interested in knowing if any plans had emanated from recent discussions in France about denationalization.

Monetary restraint had not contributed as much as it could have to the anti-inflation effort, Ms. Bush considered. Perhaps the switch from credit ceilings to reserve requirements would improve the management of monetary aggregates. A further evaluation of the possible impact on money growth of the relatively new short-term mutual and investment funds was also warranted. The introduction and market acceptance of new financial instruments in the United States had been followed by some uncertainty about their degree of liquidity, leading to questions about how to measure their effect on money growth. She encouraged the French authorities to reconsider whether the liquid nature of the new short-term instruments to which she had referred might not indicate that they should be included in M-2R or M-3R. The inflationary impact of those instruments might be fairly significant.

She had noted with satisfaction the move toward more a market-oriented system of monetary management through the greater use of interest rates as an allocative device, in addition to the greater reliance on reserve requirements to control credit rather than the old system of direct credit ceilings, Ms. Bush continued. She hoped that the authorities would move firmly in the direction of reducing such elements of the domestic monetary system as privileged and subsidized credit and move in general toward a market system of monetary management.

Major progress had been made in bringing the external accounts into balance, with the ratio of the current account deficit to GDP having fallen from its 1982 peak of 2.2 percent to about 0.1 percent in 1984, and with the prospect of a small surplus for 1985, Ms. Bush added. Cyclical differentials between France and some of its trading partners, together with improved competitiveness, seemed to account for most of that improvement. However, the past series of current account deficits and the large-scale foreign borrowing of recent years had moved France from a net creditor for loan capital as recently as 1980 to a substantial debtor by the end of 1984. Over the medium term, the staff had suggested that France needed to achieve surpluses on the order of F 20-30 billion if it were to avoid a continued rise in the ratio of debt to GDP and a substantial rise in the debt service ratio. The fact that Mr. de Maulde had mentioned such a target for 1986 and 1987 suggested that the authorities concurred with the staff assessment.

Some question remained about the adequacy of France's competitiveness, Ms. Bush considered, despite improvements measured by price and cost competitiveness. She would be interested in further comment by the staff or Mr. de Maulde on that question, especially in light of the recent realignment of EMS currencies. As for capital controls, she hoped that the authorities would move as promptly as possible to liberalize them.

Apart from rigidities in the form of price controls, capital controls, and credit controls, labor market rigidities seemed to be a key issue, Ms. Bush remarked. Some progress apparently had been made through the use of increased fixed-term labor contracts, early retirement, on-the-job training and apprenticeships, and more flexible shift work. Although the authorities had argued that approval for layoffs was generally granted without long delays, the existing practices were still an area of weakness. France followed an industrial policy for which her authorities had little enthusiasm, involving as it did extensive government involvement in industrial decision making. Moreover, subsidies and other government support continued to be given to some industries, such as steel, shipbuilding, and electronics, in part through the new Industrial Modernization Fund. She hoped that the French authorities would resist strongly the temptation to provide support that would end up creating sheltered and inefficient industries.

In conclusion, Ms. Bush observed, while the performance of the French economy had been in line with the gradualist aim espoused by the authorities, it was not clear that such an approach was consistent with a global outlook that called for dynamic and open economies in industrial countries in order to complement the efforts of indebted developing countries to achieve economic growth and adjustment. Therefore, while her authorities recognized the good adjustment progress made by the French authorities, they believed that further and continued progress--perhaps at a somewhat faster pace and particularly in many of the structural areas that she had mentioned--would be helpful in contributing to the adjustment efforts of debtor nations as well as to improving the prospects for the French economy.

Mr. Sengupta recalled that during the discussion of the 1984 Article IV consultation with France, the Executive Board had noted the need for continued progress in reducing the rate of inflation, strengthening profitability, and improving the external current account position. The Board had also recommended continued use of incomes policy, adequate constraint in financial policies, restraint of domestic credit associated with monetary targets, and a reduction of the budget deficit. France was one of the very few countries that had implemented practically all of the recommendations of the Executive Board, the most notable success of its broad set of policies having been the balance brought to the external accounts. The current account deficit, about F 80 billion in 1982, had been virtually eliminated in 1984; a modest surplus was expected in 1985. The authorities had also been successful in containing inflation, which had fallen from 14 percent in 1981 to 7 percent in 1984 and a projected 5 percent in 1985. That achievement was all the more noteworthy when viewed in the perspective of the ten years prior to 1983 when inflation in France had averaged about 11 percent annually.

Another important achievement was the remarkable improvement in business profitability in France, Mr. Sengupta added. Successful macroeconomic policies had been pursued, although the budget outcome and implementation of monetary policy had been less satisfactory than expected. Nevertheless, it was heartening to note from Mr. de Maulde's statement that the authorities were determined to pursue their major objectives with determination. He was convinced that France would undertake any additional measures for that purpose that were necessary.

The success of incomes policy in France was a major international policy development, Mr. Sengupta considered. By influencing the wage negotiation process, the French authorities had ensured that settlements were responsive to macroeconomic circumstances, and their continued success would not only have short-run benefits but also lead to structural improvements in the longer term.

The proposed budget deficit of 3 percent of GDP in 1985 was higher than the suggested target, Mr. Sengupta went on, but what had been achieved should not be underestimated. Substantial expenditure cuts had been put in place, but the deficit remained large because of tax relief amounting to F 2 billion. Low growth rates in recent years had imposed limitations on the authorities' capacity to prune expenditure further. On the other hand, continued large budget deficits would increase the debt servicing budget, thereby exacerbating the fiscal problem. Monetary policy had been restrained so far and had contributed little to inflation, even though the targets for end-1984 had been overshot. The current monetary policy indicated by Mr. de Maulde appeared satisfactory. The staff's note of caution with respect to interest rate policy was understandable; certainly, account should be taken of the impact on the debt servicing capacity of developing countries as well as on investment and expenditure in France. The recent introduction of new credit control mechanisms could lead to greater flexibility in trade policy.

The major structural changes under way in France, which had been underlined by Mr. de Maulde, should make it possible for France to match the average growth rate of OECD countries in the year or two ahead, Mr. Sengupta remarked. Incomes policy and the new industrial policy should make a substantial contribution to that achievement. The steps toward autonomy for public enterprises, modernization of the capital stock, and greater competitiveness in international markets, all went in the right direction and should help to improve the overall performance of the economy.

It was gratifying that the French authorities had not introduced any new protectionist measures since the 1984 Article IV consultation, Mr. Sengupta remarked. However, they should take positive steps to reduce protectionism as a whole within the framework of the EC, especially in relation to developing countries. By taking the initiative, France could lead other countries, and without necessarily initiating a new round of multilateral trade negotiations. However, as it was the EC itself that had laid an extensive protective net, the issue should be examined not in respect of individual countries that were members of the EC but on a multilateral basis so that the Executive Board could ensure effective surveillance of EC protectionist policies.

France had an excellent record on ODA, Mr. Sengupta stated. Indeed, its ODA to developing countries had risen from 0.48 percent of GNP in 1983 to 0.52 percent in 1984, and the authorities had made a commitment to increasing it to the UN target of 0.7 percent of GNP by 1988. Bilateral aid had been increased in 1984 by more than multilateral aid--21 percent compared with 6 percent--and as a result, the share of multilateral aid in French ODA had declined further from 26.8 percent in 1983 to 24.3 percent in 1984, or below the average for the Development Assistance Committee countries. Given France's well-known commitment to multilateral assistance, he wondered how that development had occurred.

Useful general lessons could be drawn from the French experience with adjustment in the past few years, Mr. Sengupta considered. First, gradualism did not necessarily have to be viewed as antithetical to adjustment. Second, the costs of adjustment to the nation and the people could be minimized by a judicious mix of policies shorn of the doctrinaire approached.

Finally, Mr. Sengupta said, it would have been useful if the staff report had included a short section on the multilateral significance and impact of the policies followed by France during the preceding year. Such an evaluation would have been particularly interesting in light of Mr. Polak's point that, within the context of the European economic system, France was not necessarily a country that should take an initiative in reflating the world economy. The analysis should cover in particular the impact of individual industrial countries' policies on the growth prospects for developing countries and not just on those for other industrial countries. He would like such an examination to be made of all industrial countries' policies in order to promote international cooperation, especially on issues of interest to developing countries.

Mr. de Groote remarked that if Mr. Sengupta's suggestion for such studies were accepted, the protectionist policies of the United States should not be excluded from consideration.

Mr. Romuâldez said that he agreed fully with the staff appraisal of developments in the French economy. The French authorities had indeed done what they had set out to do. They had moved forward in bringing the external current account into balance, albeit a precarious one since external debt service would continue to weigh heavily on the current account. While he endorsed the French authorities' plan to realize a current account surplus of about 0.2 percent of GDP in order to make it possible to reduce their gross external debt and consolidate the external monetary position, the illustrative debt projections made by the staff through 1995 could not be ignored. Should France's external current account not improve beyond equilibrium, the external medium-term and long-term debt would rise steadily in relation to GDP, and the debt service ratio would double from slightly over 5 percent in 1985 to about 10 percent by end-1995.

The rate of inflation had also slowed, and at a time of more positive economic growth, Mr. Romuâldez observed. However, the inflation differential with France's major trading partners remained significant. An incomes policy had been implemented with some success, contributing to the lowering of inflation and to a remarkable improvement in business profitability.

The remaining challenge for the authorities was fiscal restraint, Mr. Romuâldez said. While he recognized the decline of total expenditure growth--with a significant fall in operational expenditures--he regretted that, as in the previous year, the target for the budget deficit in 1984 had been exceeded. Such a slippage would succeed only, among other things, in absorbing an increasingly large share of domestic financial resources at the expense of the private sector, at the same time putting pressure on interest rates. Given the history of the past few years, the goal of reducing the budget deficit in 1985 to 3 percent of GDP might be optimistic. He also wondered how prudent it was to lower household taxes at a time when the heavy reliance on employers' payroll taxes to finance the social security system continued to weigh significantly on labor costs.

Monetary policy had not been particularly constraining, Mr. Romuâldez noted. If the monetary targets for 1985 were achieved, the necessary improvements in price performance and in the external accounts might not be realized. The rate of increase in the money supply in the first five months of 1985 had remained at an annual rate of 8 percent, well above the 4-6 percent target, but it was heartening that the authorities had announced some corrective measures as of the beginning of July, confirming their express determination to tighten policy. The recent move to a new form of credit control, replacing the system of direct ceilings on bank lending, went in the right direction, although the new system still rested essentially on a quantitative limitation on bank credit to individuals and to enterprises. He urged the authorities to exploit the potential of the new system and to move effectively and rapidly to make it more flexible.

As in many other countries of the European Communities, many sectors of the economy in France remained subject to subsidies and trade restrictions, Mr. Romuâldez noted. He did not overlook the fact that the authorities had not introduced significant new protectionist measures at the national level over the past year. Indeed, he appreciated Mr. de Maulde's reassurance that France had reaffirmed its intention to maintain a high degree of openness to the rest of the world.

In conclusion, Mr. Romuâldez recalled the suggestion of his chair, in discussing the case of Colombia, that a gradualist approach to adjustment might not be the wisest one. He agreed with the staff that gradualism required continued efforts toward establishing a basis for sustainable growth and, in the case of France, convergence with its main partners. The question was whether gradualism was practical in that context, and whether the cost might not be too high over the long run.

Mr. Qureshi said that he was in broad agreement with the staff appraisal on the general economic situation and related policy issues, and would concentrate on a few specific points. The staff had made the interesting statement in its appraisal that "the stance of monetary policy has accompanied the disinflationary process, without making in itself a major contribution to this end." In contrast, in other major industrial countries the burden of inflation control had been carried predominantly by a tight monetary policy, bringing to mind the well-known concept that inflation was everywhere a monetary phenomenon. Apparently, some tightening of the stance of monetary policy in France might be looked at as a concomitant of the decline in inflation rather than as a significant causative factor. A further elaboration of the staff statement would be useful in elucidating the staff's understanding of the relative roles of different factors in the appreciable reduction of inflation achieved so far in France.

Even if the decline in inflation could be attributed at first glance to some other policies such as incomes policy, to be successful those policies would need to be supported by adequately constraining financial policies, a point noted by the staff in its appraisal, although in a somewhat different context, Mr. Qureshi continued. Thus, monetary policy might still have constituted a significant supporting factor in facilitating the reduction of inflation. True, monetary policy could have been tighter, although for any given inflation target, the appropriate degree of monetary tightness might be less stringent when monetary policy was accompanied by other supportive policies than when it had to perform the job of controlling inflation almost singlehandedly. The general question that arose was whether, when inflation reflected both excess demand and wage-cost push, a combination of some kind of incomes policy, if practicable, and monetary restraint might not be a less costly approach than one relying exclusively or overwhelmingly on monetary restraint. However, he agreed with Mr. Clark that incomes policies, if they were to be used, should allow for adequate flexibility in the determination of wage differentials.

In discussing the case for further wage moderation, the staff had argued that a reduction in labor costs would contribute to raising employment by inducing more labor-intensive techniques of production, Mr. Qureshi noted. The effect of declining wage costs on employment resulting from changes in factor intensity was analytically separate from that resulting from an increase in profitability for a production method where no change in factor intensity was involved. While the profitability of a given technique of production would increase as a result of a reduction in wage costs, whether or not the change in the relative cost of labor would also produce a significant shift toward greater labor intensity would depend on other factors, such as the possibilities for factor substitution, given the nature of the production function. Thus, it had to be determined empirically whether a decline in relative labor costs would raise employment by significantly affecting factor proportions. In that context, the French authorities did not consider that employment would be very responsive to a reduction of real wages. In their view, the range of economically efficient techniques in industry was too limited to allow relative factor prices to exert a significant influence. They accepted that lower labor costs could support a more extensive development of labor-intensive activities in the services sector but noted that that sector--especially social services--was so extensive already in Europe as to limit the prospects for further expansion. To that he would add another reason, namely that the problems encountered by some labor-intensive industries in France--and in other industrial countries--were due not so much to movements in relative factor prices as to a general loss of comparative advantage to producers in developing countries.

It would be helpful if the staff could indicate how factor proportions had developed in the French industrial or manufacturing sector in the period during which the cost of labor was estimated to have risen relative to the cost of capital, Mr. Qureshi said. According to Appendix III of the report on recent economic developments, the ratio of the cost of labor to the cost of capital had risen significantly from 1965 to 1984. It would also be instructive to learn whether there had been any studies on the extent to which the observed behavior of industrial factor proportions could be related to the change in relative factor prices. Of course, other factors also influenced industrial factor proportions, including the degree of factor substitutability in a particular productive activity, factor bias in technological progress, and the structure of production as influenced by changes in the pattern of demand. The effect of such factors evidently had to be disentangled in order to arrive at an estimate of the responsiveness of factor proportions to changes in relative factor prices.

Finally, Mr. Qureshi said, it would have been useful if the staff report had included an estimate of the cyclical adjustment for changes in the fiscal position so as to give some idea of the position in respect of the structural fiscal deficit.

Mr. Archibong observed that the performance of the French economy in 1984 indicated that notable progress had been made toward establishing a basis for durable growth. Using a gradual approach, the authorities had grappled successfully with three major problems highlighted by Directors during the discussion in the Executive Board of the 1984 Article IV consultation with France: business profitability had been improved, inflationary pressures reduced, and the external deficit contained.

In a number of areas, however, progress had not been satisfactory, Mr. Archibong noted, citing the complex problems of low output growth, rising unemployment, unsustainable fiscal deficits, and persistent inflation differentials with other industrial countries. Real GDP growth of 1.3 percent in 1984, although better than the 0.7 percent recorded in 1983, had been modest both by historical standards and in comparison with the expansion of real output in some other major industrial countries. Weak domestic demand, and particularly restrained consumer expenditure--despite a sharp fall in the savings ratio--coupled with sluggish investment performance had dampened the growth of output, thereby aggravating the unemployment situation and further weakening the Government's financial position. Increased profitability had not been reflected in the level of investment; most of the increase in profits had been used to improve the financial position of enterprises, which remained weak. During 1984, inflation had fallen by about 3 percentage points to 6.7 percent, helped by wage and price controls, but had fallen short of the 5.5 percent target set by the authorities.

An important achievement of the incomes policy in force since 1983 had been the marked improvement in business profitability brought about by a strong recovery of productivity, a decline in labor costs, and some shift in the distribution of factor incomes, Mr. Archibong continued. Increases in labor unit costs had decelerated from 7.6 percent in 1983 to 2.4 percent in 1984, thereby contributing to a noteworthy reduction in production costs. That result, in conjunction with an effective depreciation of the franc, had improved business competitiveness and profit margins, the corporate mark-up rate having been raised to its highest level in the past decade. The depressed situation of domestic demand and the relative pickup in economic activity in France's trading partners meant that the expansion of output had been reflected in increased exports. Consequently, the current account had recorded only a small deficit, equivalent to 0.1 percent of GDP in 1984, compared with 0.9 percent in 1983. Notwithstanding those favorable developments, the failure of gross investment to benefit from the accumulation of business profits raised questions about the durability of the improvement in output and profitability and the ability of the business sector to respond efficiently to a future upturn in domestic demand as existing productive capacity approached its limits in the absence of an expansion of investment.

The acceleration in the rate of unemployment, which had jumped by 1 1/2 percentage points in 1984 to 10 percent, one of the highest figures in recent years, was of concern, Mr. Archibong stated. While the expansion of the labor force might have contributed to that outcome, the fall in employment by 1 percent in 1984 had no doubt aggravated the situation. The authorities were aware of the problem and were taking steps to stimulate employment, including the recently introduced youth employment program. He had also noted the assurance given by Mr. de Maulde that the authorities "are taking significant action on a number of fronts" to deal with the problem of structural rigidities.

The main 1984 fiscal objective of reducing the central government fiscal deficit to 3 percent of GDP had not been achieved, Mr. Archibong noted, and he joined others in urging the authorities to redouble their efforts to reduce the fiscal deficit. He shared the concern of the staff about the implications of the huge public sector and fiscal deficit on inflation, capital investment, and future growth, and endorsed its advice that vigorous action be taken on the expenditure side, including the elimination of subsidies and transfers. The authorities' efforts to ensure the profitable operation of public enterprises was an important step in the right direction.

The French authorities had been moving toward the deregulation of existing restrictions in different areas of the economy as the recovery proceeded, Mr. Archibong observed. The replacement of direct credit controls by a new credit system would allow market forces a larger role in the allocation of resources. The gradual decontrol of prices would help to achieve the same end.

The renewed commitment of the French authorities to the promotion of free trade and the fact that France had not introduced any new trade restrictions in 1984 were encouraging developments, Mr. Archibong noted. Nevertheless, he shared the staff's view that France could play an important role both internationally and within the European Community in promoting free trade and reducing protectionist barriers. His authorities fully supported the position of France on the proposed new round of multilateral trade negotiations. The French authorities had shown consistent support for the promotion of economic growth in developing countries, and had demonstrated in concrete ways the strong and abiding commitment of France to the well-being of the developing world. Despite the difficulties facing their economy, the French authorities had increased overseas development assistance to 0.5 percent of GDP. France was thus among the few large industrial countries that were actively seeking to reach the UN target of 0.7 percent of GDP by 1988.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/114 (7/26/85) and EBM/85/115 (7/29/85).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/158 and 84/159 are approved. (EBD/85/186, 7/22/85)

Adopted July 26, 1985

APPROVED: May 2, 1986

LEO VAN HOUTVEN
Secretary