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France: 2001 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with France, the following documents have been released and are included in this package:

- The staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 26, 2001,** with the officials of France on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement of **October 24, 2001** updating information on recent developments.
- A Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 26, 2001 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released:

- Report on Observance of Standards and Codes—Updates
- Selected Issues
- Assessment of the Compliance by France with the Basel Core Principles

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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FRANCE

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with France

Approved by Michael Deppler and Leslie Lipschitz

September 20, 2001

- The Article IV consultation discussions took place in Paris from June 26 to July 11, 2001. The team—Messrs. Leipold (Head), Everaert and Estevão, Mmes. Detragiache and Poirson (all EU1), and Mr. Cordella (RES)—met with Mr. Fabius, Minister of the Economy, Finance, and Industry, and his staff; Governor Trichet and officials of the Banque de France; Mr. Sapin, Minister of Public Administration; the economic advisor to the Prime Minister; officials of the Ministry of Labor and Solidarity, the national statistical institute, the Banking Commission, the securities supervisor, and the advisory board on pensions; as well as market participants, academics, and representatives of labor unions and employers. Mr. Milleron (Executive Director) or Mr. Bauche (Alternate Executive Director) attended the meetings.

- In concluding the last consultation, on October 27, 2000, the Executive Board commended the authorities for policies that had supported economic growth and a rapid fall in unemployment. To sustain these developments, they urged the authorities to press ahead with product and labor market reforms and to consolidate further the structural fiscal position. They encouraged the authorities to pursue declines in the overall tax burden, in tandem with effective expenditure restraint throughout the public sector.

- France is an Article VIII member, and apart from certain security restrictions (Appendix I), maintains an exchange system free of restrictions. Presidential and legislative elections are scheduled for May-June 2002.

- The assessment and projections in this report were finalized prior to the recent terrorist attacks. A supplement will be issued for the Executive Board discussion to update economic developments and provide information on the 2002 budget.

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France—Staff Report for the 2001 Article IV Consultation
Executive Summary

Background: The French economy enjoyed a vigorous upswing between 1997 and end-2000. By historical standards, and compared to other large euro area countries, per capita GDP and employment increased at very high rates. At the same time, unemployment declined sharply without sparking inflationary pressures. This economic record is attributable to a favorable external environment; supportive monetary conditions; protracted wage moderation; gradual labor market reforms; and sizable cuts in tax rates and social security contributions. Toward end-2000, the economy was initially shielded from the global decline in manufacturing and the effects of energy and food price hikes by fortuitously timed tax measures—but these could not prevent a marked deceleration in growth as from early 2001. Against the positive cyclical performance of the last four years, and despite progress in certain areas, key structural weaknesses persist (still high unemployment, low labor force participation, a large size of government, and scant progress in improving the structural fiscal balance). Structural reforms in key areas remain stalled.

Short-term policy issues: At the time of the discussions, economic prospects (though weakening and more uncertain) were seen to remain basically positive, with the key risk lying in a further deterioration of the external environment that could dampen job creation and restrain consumption. There was agreement that the slowdown did not warrant discretionary action: rather, staff noted, the medium-term orientation of policies should be safeguarded and strengthened. The authorities thus intended to proceed with the tax cuts announced in the 2001–03 tax reduction plan and the expenditure restraint envisaged in their Stability Program. Automatic stabilizers would be allowed to operate on the revenue side. They have maintained this view through some subsequent further weakening in the outlook. The authorities were less concerned than staff about short-term expenditure pressures and the possibility that the recent structural strength of revenues might have been overestimated.

Medium-term policy issues: While recognizing the importance of structural reforms to raise the productive potential of the French economy, the authorities—in maintaining that more progress had been made than was generally perceived (including in network services)—also emphasized gradualism and consensus-building. The authorities felt that the ground had now been prepared and noted that, without major elections during 2002–07, a window of opportunity would emerge to proceed in key areas. They reasserted their intention to achieve fiscal balance by 2004 and substantially lower the public debt-to-GDP ratio over the long-term. To reach these goals, they recognized the need to tackle civil service, health care, and pension reform and to strengthen the framework for fiscal policy and focus it more on binding medium-term expenditure norms. The new law on budget procedures would assist this process.

The authorities agreed that wage moderation had been key in promoting a job-rich recovery. Flexibility would be sought in the next phase of the workweek reduction (its application to small and medium-sized enterprises), and a shift to supply-side measures in the labor market—including through the introduction of an earned income tax credit—would be pursued further. The authorities felt that the banking sector would weather the slowdown well, though noting that operational costs remained unduly high. They strongly favored further financial sector consolidation and EU security market integration, and were in the process of streamlining securities supervision.

I. BACKGROUND

1. **The French economy performed comparatively well over the recent upswing that ended in late 2000** (Table 1 and Figure 1). Growth in GDP per capita and employment were remarkably high by recent historical standards and compared to other large euro area countries. A positive external environment, along with the depreciation of the euro, boosted export growth (Figures 2 and 3). At the same time, gradual labor market reform, continued wage moderation, and substantial cuts in social security contributions at the low end of the wage scale helped to ensure that inflationary pressures did not build up, even while the unemployment rate declined from a peak of 12¼ percent in 1997 to 8½ percent in mid-2001 (Figures 4 and 5). Reflecting the associated increase in confidence and disposable income, and the slower pace of fiscal consolidation, domestic demand was a more important source of growth for France than for other large EU countries during 1997-2000 (Figure 6).

2. **A number of adverse developments led to an abrupt slowdown in the first half of 2001**. The French economy initially showed relatively greater resilience to the adverse price shocks and the deterioration of the external environment that started in the second half of 2000. Contributing factors would appear to be a comparatively smaller terms-of-trade loss in 2000 (around 0.9 percent of GDP in France versus some 1.7 percent of GDP in both Germany and Italy), and domestic tax measures which turned out to be fortuitously well-timed in delaying and mitigating the impact of external shocks.[1] Nonetheless, GDP growth slowed sharply in the first half of 2001, as business investment growth, exports, and inventories all declined. By contrast, household consumption held up early in the year, but weakened subsequently, as consumer confidence—which had continued to rise through 2000—began to erode, especially as employment growth slowed and unemployment edged up (Figure 7). Export demand was sapped by sharp reductions in growth in Germany and the United States. Perhaps more importantly, the decline in global economic prospects undermined business confidence and cut investment plans. The business sector was further weakened by the reversal of fortunes in the IT and telecommunications sectors. Monetary conditions remained easy by historical standards, and the stance of fiscal policy (as judged by the change in the cyclically adjusted balance) was broadly neutral.

3. **Since the last consultation, initiatives to address structural weaknesses have focused mainly on lowering the tax burden and improving labor market performance,**

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[1] The reduction in the VAT rate in April 2000 and the introduction of variable energy taxation later in the year dampened the price shocks, and tax cuts boosted disposable income in late 2000. For a review of the divergences in economic performance between the three largest euro-area economies, see World Economic Outlook, October 2001, Box on *Relative Euro-Area Growth Performance: Why are Germany and Italy Lagging Behind France?*

though in the latter case with some mixed signals. Tax cuts are ongoing as part of the authorities' three-year plan to 2003, and unemployment contributions were reduced in the face of a widening surplus of the unemployment fund (managed by the social partners). In the labor market, following earlier emphasis on the demand side, the authorities have shifted increasing attention to address labor supply issues—most notably with the introduction, as from 2001, of an earned income tax credit (*prime pour l'emploi, PPE*), though it is initially quite small.[2] A "return-to-work" orientation also motivated the reform of the unemployment insurance regime, with the introduction of new programs aimed at enhancing active job search and strengthening the matching of beneficiaries with jobs—but at the same time the tapering of unemployment benefits was abolished and eligibility requirements were eased. Also, following widely publicized layoff plans, measures tightening dismissal rules are pending before Parliament.

4. **Despite the recent dynamic economic performance, several structural economic indicators remain unsatisfactory and fundamental reforms in key areas have stalled.** France trails the EU average in several respects. In particular: labor force participation is very low, especially among the young and elderly; the tax burden is one of the highest in the EU, even after the recent tax cuts (Figure 8); and the structural fiscal balance has not appreciably advanced toward the Stability and Growth Pact objective in recent years. In addition, work on civil service, health care, and pension reform has remained confined mainly to further study and consensus-building. In product markets, while competition is being promoted in some areas, there continues to be resistance in key network industries. On the latter, France's position is generally perceived to act as a brake on the liberalization timetable within the EU.

France. Selected Economic Indicators, 2000

	GDP per capita[1]	Employment rate	Unemployment rate[2]	Labor force participation 55-64	Structural balance/ GDP	Revenues/GDP
France	97.5	62.0	8.5	37.2	-1.1	51.9
Germany	100.0	68.9	7.9	44.7	-0.2	47.0
Euro area[3]	87.9	63.2	8.3	39.4	-0.5	46.1
European Union[3]	91.2	65.3	7.4	43.5	0.1	46.0

Source: OECD, Employment Outlook; IMF, World Economic Outlook; European Commission, Ameco, Eurostat.
[1] Germany=100.
[2] June 2001.
[3] Average excluding France.

[2] The *PPE* is a family-income tested earned income tax credit that will be phased in during a three-year period. It is available for employees earning up to twice the minimum wage.

II. Policy Discussions

5. Against this background, the discussions focused on two main issues: **(i) the policy response to the economic slowdown and (ii) the structural reform agenda to strengthen the resilience of the French economy and raise its productive potential.** On the former, staff and authorities—while recognizing the uncertainty of economic prospects—agreed that the nature of the slowdown did not warrant discretionary fiscal action and that the focus needed to be firmly on medium-term consolidation. Allowing full play of stabilizers on the revenue side and pursuing tax reductions as announced, while holding strictly to the targeted expenditure path, was jointly considered appropriate to support the economy. On the structural reform agenda—as has now been the case for some time—the authorities agreed with the staff on the direction of reform, but placed greater emphasis on the need for gradualism. Nonetheless, they felt that the ground had been sufficiently prepared in some important areas—e.g., civil service and pensions—as to allow early progress looking forward, and pointed in this respect to the window of opportunity provided by the absence of key electoral events during 2002–07.

A. Economic Outlook: Policy Response to the Slowdown

6. **Both official and staff projections envisioned a reversal of the slowdown, but recognized that the external climate harbored further downside risks.** At the time of the discussions, the authorities and the staff anticipated that GDP growth would slow to some 2¼ percent in 2001 and then rise to around potential (2½ percent) in 2002. These projections assumed no further deterioration in the external environment, with a relatively early turnaround in the US and German economies, and a global recovery setting in by end-2001. In the event, external conditions have worsened, and any recovery now seems likely to be delayed until 2002. Staff has accordingly lowered projected GDP growth to 2.0 percent in 2001 and 2.1 percent in 2002 (in both cases, 0.4 percentage points below latest Consensus Forecasts).[3] With the global recovery still remaining in the balance, and with the risks hovering on the downside, this outlook is subject to greater than usual uncertainty—further compounded by the recent terrorist attacks whose impact remains to be assessed.

7. **There was agreement that the recovery would hinge, in addition to an improved external climate, on the continuing strength of household consumption.** This strength would be underpinned by tax cuts now in the pipeline and the first installment of the new earned income tax credit, as well as the unwinding of the energy and food price shocks. More generally, the authorities expressed confidence in the resilience of the French economy, based *inter alia* on the view that it had become structurally sounder in recent years. The staff, while

[3] The annual averages mask significant changes in growth through the year (fourth-on-fourth quarter basis): after having declined from 3.1 percent in 2000 to 1.3 percent in 2001, growth is projected to rise to its potential rate (2.6 percent) in 2002.

providing some qualification (Box 1), agreed that there had been progress on the structural front, noting that the 1997-2000 expansion had been much more job-rich than the previous one, and that the reduction in the unemployment rate had not triggered inflationary pressures. A further positive factor was seen to reside in the relative absence of appreciable domestic disequilibria (e.g., in the form of weak household balance sheets or significant over-investment in certain sectors).

8. **Wage and price pressures were judged likely to remain well-behaved, provided second-round effects from the recent surge in headline inflation were contained.** With the fading of energy and food price shocks and the economic slowdown, headline inflation was expected to decline gradually during the second half of 2001, to less than 2 percent by early 2002, and to remain well below the euro-area average throughout this period. The authorities saw such moderation as essential to restoring consumer confidence and had taken action to spur competition in the energy retail and large distribution sectors to foster price cuts. They acknowledged staff concerns that the recent sizable increase in the minimum wage (largely driven by the indexation mechanism[4]) and the renegotiation of the first wave of 35-hour workweek contracts—which had explicitly included wage restraint in exchange for the reduction in working time—were likely to lead to slightly faster wage growth than in the recent past and could pose risks. On the other hand, slack in the economy had been increasing, a significant number of enterprises had yet to switch to the 35-hour workweek, and wage restraint in the public sector had continued (with the government imposing a moderate wage settlement by decree in the absence of a negotiated accord earlier this year).

9. **Monetary conditions from the perspective of the French economy were viewed as being supportive.** The authorities espoused the cautious stance of the European Central Bank (ECB) given its mandate for price stability and the paramount importance of preserving wage discipline in the wake of the surge in headline inflation. With France's output gap not appreciably different from that of the euro area, monetary conditions appropriate for the euro area were felt to be broadly suitable for France as well. Monetary conditions in France were judged to be supportive, or even somewhat on the easy side by the central bank, who pointed to the depreciation of the euro and the rapid pace of monetary and credit expansion. On the euro, the authorities reiterated their view that it remained significantly undervalued relative to long-term fundamentals and consequently had substantial potential for appreciation.

10. **In the face of cyclical weakening, the authorities agreed that adherence to announced expenditure and tax reduction paths, accompanied by the play of automatic stabilizers on the revenue side, would provide adequate support for the French economy**—a view they continue to hold also after the more recent downward revisions to the

[4] The basic minimum wage (*SMIC*) was increased by 4 percent on July 1, 2001, of which 3¾ percentage points were due to legal indexation provisions, and the remainder to governmental discretionary action.

Box 1. The Cyclical and the Structural of France's Recent Expansion

A supportive economic environment and structural changes underpinned the notable upswing of the French economy from 1997 to 2000. While not exceptional by French historical standards in terms of per capita GDP growth, the recent expansion featured an unprecedented rate of job creation. Indeed, compared to the upswing of the late 1980s (and adjusted for the difference in growth between the two episodes), it put to work about 230,000 more persons per year. It is also noteworthy that the associated sharp decline in unemployment did not trigger any inflationary pressures.

There is evidence of a structural improvement in the performance of the French economy, with however the reduction in hours worked detracting from the positive contribution of labor. Since 1997, active labor market policies and cuts in taxes and social security contributions ushered in further reorganization of labor market practices in the context of the reduction in the workweek. These reforms appear to have been effective in reducing the NAIRU and raising labor force participation, but the reduction in hours per worker has more than absorbed these factors (see table below). On the other hand, the increase in total factor productivity compared to the previous expansion is promising, though it will take a full business cycle to assess its durability with greater confidence.

Reflecting the wage moderation that started in the mid-1980s, labor has again been contributing to the growth of potential output over the past 15 years. Growth during the 1990s has been driven less by capital deepening. The underlying trade-off between wage inflation and unemployment appears to have shifted downward (see forthcoming background papers).

France: Contribution to Growth
(In percent)

	1980-85	1986-90	1991-96	1997-00
Actual growth of output	1.5	3.2	1.0	2.9
Contribution of:				
Capital (actual)	1.4	1.4	0.9	0.8
Labor-Cyclical (total hours)	-0.2	0.1	-0.3	0.3
Labor-Structural (total hours)	-0.6	0.5	0.2	0.2
NAIRU	-0.3	0.2	-0.1	0.2
Working age population	0.6	0.3	0.2	0.2
Participation rate	-0.4	0.0	0.1	0.2
Hours/worker	-0.6	0.0	0.0	-0.5
Total Factor Productivity	0.9	1.2	0.2	1.6

Source: Staff calculations.

economic outlook. They would accordingly proceed with the tax cuts announced in the 2001-2003 tax reduction plan to encourage job creation and sustain disposable income.[5] At the same time, they recognized the importance of adhering to the expenditure path envisaged in the most recent Stability Program (2002–2004). The resulting fiscal stance would be broadly neutral, but provide some stabilization as revenues would be allowed to fluctuate with the cycle. The staff, noting that little progress had been made on fiscal consolidation since the beginning of the upswing, concurred that discretionary fiscal expansion was inadvisable (even in the event that possible downside risks were to materialize) and placed the emphasis on the need to avoid expenditure slippages, with the health care sector again being the primary source of pressures.

11. **There was some discussion on the extent to which this fiscal strategy would provide output stabilization.** While the staff and authorities agreed that the deficit would widen compared to budgeted levels as a result of the economic slowdown, the timing and magnitude of such a widening was not easy to pin down. Assessing its impact on output was subject to an even larger margin of error, but an appreciable degree of stabilization could be expected.[6] In the staff's view, the actual general government deficit (excluding proceeds from the sale of UMTS licenses) would hover around 1½ percent of GDP in both 2001 and 2002, compared to a budgeted 1 percent of GDP in 2001 and a Stability Program target of 0.6 percent of GDP in 2002 (under considerably stronger growth assumptions—Table 2). The authorities were not in a position to provide updated budget estimates,[7] but thought that the 2001 deficit would be smaller than the staff projected, owing to higher-than-expected inflation, and lags in tax collection, which implied that the budgetary impact of the slowdown would not be fully felt until 2002.

12. **The authorities expressed some concern that a cyclical widening of actual budget deficits compared to the Stability Program targets could be perceived as a departure from the undertakings of the Stability and Growth Pact** (SGP), though pointing to the conclusions of the Göteborg European Council in mid-June as providing qualified support for the approach.[8] Agreeing with the importance of safeguarding the objectives of the SGP, the

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[5] For a description of the tax reduction plan, see the Staff Report for the 2000 Article IV consultation (*Staff Country Report No. 00/147*, Box 4).

[6] Staff analysis indicated that allowing revenues to fluctuate over the cycle had helped to dampen cyclical fluctuations in economic activity by about 30 percent during the 1990s (Appendix II).

[7] These will be available in late September in the context of the 2002 budget and will be discussed in a staff supplement.

[8] These stated that "automatic stabilizers should be allowed to work where possible"—with the latter qualifying clause being the subject of debate.

staff acknowledged the authorities' concern, but argued that, to the extent that the structural fiscal position would remain as envisaged in the Stability Program, the cyclical widening of the budget deficit would not be incompatible with achieving the SGP's medium-term fiscal objectives. Furthermore, a focus on achieving nominal targets at this juncture would be procyclical and aggravate the downturn. Nonetheless, staff emphasized that this approach to fiscal policy should be conducted symmetrically over the business cycle, i.e., automatic stabilizers should not be thwarted by discretionary tax cuts during the upswing. The latter proclivity had on occasion marked fiscal policy conduct in France, e.g., during the 1988–89 expansion and, more recently, in the first half of 2000.

13. **The authorities recognized that there were various sources of expenditure pressures, but felt that it would be possible to accommodate them within the announced expenditure framework, consistent with the Stability Program.** The staff was more skeptical, noting that health care spending was again running above budget and various initiatives with respect to the labor market and social assistance (e.g., the extension of the subsidized youth employment program (*emploi jeunes*), the introduction of new welfare benefits (such as the *allocation personnalisée d'autonomie* for the aged), and the changes in the unemployment insurance scheme) would place additional pressures on outlays, as would the reduction of the workweek in the public sector. With respect to the latter, there were strong pressures to ramp up hiring in the health care sector (with a recognized need for a substantial increase in hospital staffing) and, despite initial undertakings to the contrary, employment at the central government level (in education, the judiciary, and the police force) was also set to increase.

B. Medium-Term Fiscal Objectives and Framework

14. **The authorities reaffirmed their objective of achieving budget balance by 2004, consistent with the most recent Stability Program.** In conceding that only limited progress had been made in improving the structural fiscal position since 1997, the authorities noted that this reflected their deliberate strategy of using expenditure restraint primarily for tax cuts to stimulate economic growth and job creation. The ongoing tax cuts would allow them to meet their commitment to lower the tax-to-GDP ratio to its 1995 level (43.7 percent of GDP) in the near term—in itself an important structural reform. The staff encouraged the authorities to aim for an even lower tax burden, but not at the expense of moving decisively toward the objective of budget balance. In this context, it criticized the upward revisions of the targeted annual real rate of growth of expenditure from one Stability Program to the other. Apart from delaying consolidation, this response to expenditure pressures undermined the credibility of the fiscal policy framework. Moreover, the revised real spending growth target (an annual average of 1.5 percent in the 2002–2004 Program) was similar to the rate of spending growth during 1995-2000 and thus relatively unambitious.

15. **The authorities were reasonably confident that the Stability Program did not overestimate the structural element in the recent buoyancy of revenues.** Overall revenue elasticity with respect to GDP (on constant policies) had exceeded 2 during both 1999

and 2000, far higher than its long-term average of 0.9. Personal and corporate income tax receipts had been the main source of revenue buoyancy, each rising by ½ of one percentage point of GDP, despite tax rate cuts. The authorities felt that the increase in personal income tax revenue was largely structural, but noted that the acceleration of corporate income tax revenue could be particular to prolonged cyclical upswings, reflecting institutional features of the French tax system. They were confident that the revenue losses of the tax cuts embedded in the multi-year program had been estimated realistically.

16. **The discussions reviewed how best to buttress the framework for the medium-term conduct of fiscal policy.**[9] There was basic agreement on the appropriateness of multi-year expenditure norms as the framework's center-piece, as is the case in France's Stability Programs. Such norms, along with an explicit path for the tax-to-GDP ratio, were set with a view to achieving the SGP medium-term target (budget balance or small surplus) by, in France's case, 2004. Around this path, staff noted that revenues should be allowed to fluctuate with the cycle, providing automatic stabilization and avoiding a debate over the disposition of windfalls. It was furthermore important that the medium-term program be derived from realistic macroeconomic scenarios in terms of growth (neither too optimistic nor too cautious). In this regard, the central scenario of the most recent Stability Program had been based on annual real GDP growth of 3 percent. In the staff's view, on current policies, such a growth rate exceeds the potential growth rate by about ½ of one percentage point.

17. **The authorities felt that an explicit link to the need to reduce the debt-to-GDP ratio to provide for the fiscal impact of population aging would help illustrate the rationale of the medium-term balanced budget target to the public.** They noted that they had outlined this approach in the initial report to Parliament for the 2002 budget discussions (*Rapport pour le débat d'orientation budgétaire*). That report highlighted the importance to "prepare for the future" and linked a long-term target for the debt-to-GDP ratio to the need to deal with demographic pressures. To this end, it suggested a reduction of the debt ratio to its 1980 level of 20 percent of GDP by 2025—which, it was estimated, could be achieved by maintaining a balanced budget from 2004 onward.

18. **The authorities broadly concurred with other suggestions to raise the effectiveness of the multi-year expenditure norm.** The discussions covered the following staff proposals: first, the multi-year expenditure norm should be set on the level of expenditure rather than on its growth rate, to guard against base drift (as had happened in 1999) and facilitate monitoring of compliance. Second, a clear and transparent mechanism to correct deviations from the norms should be put in place, and mid-course target revisions

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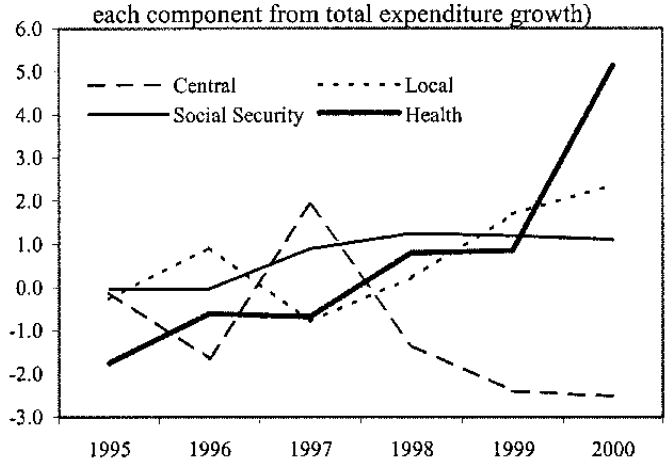
[9] For a comparative analysis of experience with fiscal management in the four largest euro-area economies and issues in the design of a rules-based fiscal policy, see "*Rules-Based Fiscal Policy and the Fiscal Framework in France, Germany, Italy, and Spain*" issued as a background paper. A draft of this paper was discussed in a seminar during the mission.

to the norms and underlying structural fiscal goals avoided. Third, these fiscal rules should be backed by a clear political commitment to ensure that the annual budgets are drafted in accordance with the multi-year expenditure norm. Finally, as is currently the case, the norms should encompass all levels of general government. Though the authorities concurred that, in keeping with the approach on the revenue side, there were valid economic arguments to exclude cyclically sensitive items from the expenditure norms, they noted that their weight in total spending was minor. The exclusion of particular categories of expenditure risked, in their view, undermining the approach's transparency and simplicity.

C. Curtailing and Controlling Public Expenditure

19. **To reconcile the objectives of fiscal consolidation and tax reduction, staff emphasized that it would be essential to take a more fundamental and comprehensive approach to expenditure restraint, requiring thorough reforms in key spending areas.** So far, the onus of curbing spending growth has fallen mostly on the central government rather than been shared with social security or local authorities. Expenditures on health care have been growing at a particularly strong pace.

France: Public Expenditure by Sector
(Cumulative percentage deviation of growth in each component from total expenditure growth)



Source: Authorities and staff calculations.

20. **At the central government level, the authorities saw the new law on budget procedures as key to improved and more selective expenditure control, while a new system of personnel management was being introduced in the civil service.** The authorities hailed the adoption of the new law on budgetary procedures as a milestone that would switch the mode of operation of spending agencies from means-based to results-oriented (Box 2). While the law would not take full effect until 2006, its gradual phase-in would begin to affect spending agencies earlier. Experiments in the same spirit under performance contracts (*contrats d'objectifs et de moyens*) had already yielded positive results and would be continued. Furthermore, with half of civil servants active in 2000 expected to retire by 2012, staff noted that—against a background of slowing labor supply due to demographics—any attempt to keep the number of civil servants constant would squeeze the private sector by in effect absorbing half of available labor supply in many of the requisite skill categories. To meet these challenges, the authorities expected to have a forward-looking personnel management system (*gestion prévisionelle*) in place in early 2002 as a first step toward rationalizing the civil service.

Box 2. New Law on Budgetary Procedures

Budgetary procedures, established in 1959 and little changed since, will undergo a radical overhaul, following the approval in June of a new organic law (*loi organique relative aux lois de finance*) regulating the budget process. The new law has a double purpose: to improve the quality of public expenditure by emphasizing results and efficiency, and to increase transparency and Parliament's role in fiscal management. Given the scope of the changes, implementation will be gradual, and the 2006 budget will be the first entirely implemented according to the new rules.

Increasing flexibility, accountability, and performance control:

- Budgeting will no longer take place by expenditure category but by objective. For this purpose, the current fragmentation of the budget will be eliminated by reducing the number of budget chapters from 848 to 100-150 and converting them into programs. Within each program, there will be complete fungibility of funds across different spending categories except for personnel expenditures. For the latter, fungibility will be asymmetric: allocations for personnel will be available for other purposes but not vice versa.

- As a counterpart to this increased freedom of action, there will be greater accountability and stricter control on results. Thus, the budget process will resemble a performance contract for the achievement of specific objectives between the administration and Parliament. In an annex to the budget law proposal, each ministry will present an action plan specifying general objectives, performance indicators, and specific targets to be achieved, as well as the associated financing needs.

Improving transparency and enhancing the role of Parliament:

- The administration will report to Parliament on the achievement of the targets in the context of the review budget (*loi de règlement*) in May of the following year. This performance assessment will provide the basis for the preliminary discussion of the next budget.

- The budget law will provide a detailed account and demand Parliamentary authorization for off-budget operations, such as government guarantees and expenditures resulting from co-financing operations.

- More information will be presented to Parliament, including accounts on an unchanged-policy basis and on an accrual basis, and details on financing of the budget and asset transactions.

- The preliminary Parliamentary discussion of the budget held in May, a practice introduced in 1996, will be made mandatory by the new law. The background document to this discussion will also cover the general strategy adopted in the Stability Program. The government can ask for the latter to be the object of a specific debate.

21. **With respect to two major areas of medium-term expenditure pressures—health care and pensions—initiatives over the past year have focused mainly on building consensus for reform.** An advisory board on pensions (*Conseil d'orientation de retraites, COR*) was established in July 2000, and had elaborated alternative pension cost scenarios that had clearly highlighted the importance of policy reforms to lower structural unemployment and raise participation and productivity—key parameters for the evolution of the pension burden. The work of the *COR* was seen to have helped build awareness through its involvement of the social partners and, in particular, to have usefully pointed out the interaction of the pension problem with labor market performance through its impact on participation rates of older workers. The authorities also noted the introduction of individual savings plans[10] and the creation of a pension reserve fund[11] as useful steps taken over the last year. This being said, they did not disagree that the problem had by now been amply analyzed, and that the time for action should not be delayed much further, given especially the relatively early onslaught of demographic pressures in France, with the effects of population aging beginning to be felt as early as 2005. On health care, there was recognition that spending would continue to outpace average public expenditure, but the level of spending was not thought to be excessive by international comparison, taking into account the quality of services provided. The authorities noted that discussions with health care providers on spending control mechanisms were ongoing, and a cost-saving prescription plan (*plan médicaments*) was being introduced.

D. Labor Market Performance

22. **By historical standards, labor market performance in France was distinctly positive during 1997–2000, with the business cycle, structural policies, and reductions in labor costs all playing a role.** Although progress has been most prominent in services, it was broad-based, with all sectors (except energy) expanding employment, and the secular decline in the share of low-skilled labor coming to a halt (Table 3). In terms of hours worked, performance has been less impressive owing to increased part-time work and the reduction of the effective workweek (Figure 9).[12] While buoyant output growth has been an important factor, the employment-content of growth during this past upswing has been larger than

[10] Such savings plans would benefit from tax advantages, and individually accumulated balances would be portable and could be withdrawn in cash after ten years of contributions.

[11] The *Fonds de Réserve pour les Retraites*, planned to reach FF 1 trillion by 2020 and to be funded from the bulk of the proceeds of the sale of UMTS licenses, earmarked taxes, and the social security surplus.

[12] Given the structural changes in the labor market, statistics are difficult to interpret. For example, part of the observed reduction in the effective duration of the workweek simply reflects reclassification of breaks formerly counted as working time.

usual. The authorities saw in this fact a vindication of their strategy to reinvigorate hiring by the private sector via labor market reforms, cuts in social security contributions and taxes, and the 35-hour workweek initiative. In this context they regretted the loss of momentum in reversing hysteresis effects that would be likely to result from the current deceleration of growth. The authorities conceded that public and publicly supported employment had accounted for nearly one-quarter of the total increase in employment since 1997, but noted that its role had become less important in recent years.

23. **Staff saw the substantial reduction in labor costs stemming from wage moderation, observed since the second half of the 1980s, as being key to raising the job content of the recent recovery.** Staff analysis of the four major euro-area countries, presented during the consultation, confirmed this observation.[13] Clearly, the reduction in the non-wage components of labor costs, notably employer social security contributions, had also played a role, particularly in halting the decline in low-skill employment, but only more recently. Even after accounting for downward wage pressures from unemployment, underlying wage moderation still remained a significant explanatory factor. Such wage moderation is consistent with a reduction of the "insider" power of unions or a shift in the preferences of workers internalizing the social costs of high unemployment. This finding appears to be relatively robust in the case of France.[14] The staff's multi-country analysis furthermore found that active labor market policies and deregulation of the labor market had also contributed to boosting the employment intensity of growth, though on a modest scale.

24. **The authorities recognized that flexibility would be key in the next stage of the 35-hour workweek initiative—its extension in 2002 to small and medium-sized enterprises** (SMEs). They felt that the experience so far had been positive, both in terms of job creation and social welfare, and pointed to surveys indicating that social partners were satisfied with the shorter standard workweek. Other observers, from employers to academics, thought that the initiative had indeed been effective initially, as benefits could be reaped from the accompanying reorganization of labor, but that it was becoming less so now that the reduced workweek had come to be seen as an acquired right and a legal obligation. Recognizing the challenge for SMEs in adopting the 35-hour workweek, especially against the background of a cyclical slowdown, the authorities noted that they would take a flexible and gradualist approach, applying discretion as needed to deal with specific issues, as had

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[13] For a detailed discussion and a multi-country perspective for the four largest continental European economies see the forthcoming background paper, "*Job-rich growth in Europe.*"

[14] In France, real hourly wages adjusted for productivity have been persistently lower than the levels implied by the unemployment rates, even after controlling for several labor force composition effects. For supporting analysis, see forthcoming background paper.

been the case in the hotel and restaurant sector.[15] In this context, the issue of lifting overtime limits—long pressed by staff—was under governmental discussion, and a readiness to make changes in this area has since been announced, though the details remain to be defined. Finally, staff expressed concerns about the sharp increase in labor costs that could be associated with the alignment of multiple *SMICs* and income guarantees which was planned to take place by 2005. The authorities responded that a working group was to put forward proposals by June 2002; they were hopeful a reasonable solution could be found.[16]

25. **To promote the return from inactivity to work and raise participation, the authorities have increasingly shifted their focus to supply-side measures—without however embarking on a comprehensive tax-benefit reform.** Following a number of measures taken in recent years to reduce high net marginal tax rates and encourage employment, the introduction of an earned income tax credit (*PPE*) this year was jointly seen as a decisive further step in this direction. Staff noted, however, that the credit is relatively small and will leave still high marginal tax rates upon return to work.[17] The authorities took note of the suggestion to increase the size of the *PPE* in exchange for the phasing out of some benefit programs, which staff encouraged as part of a more comprehensive tax-benefit reform. In its view, a greater focus on benefits remained needed, since—given the narrow base of the income tax in France—high marginal rates at the low end resulted essentially from the withdrawal of benefits.

26. **In the unemployment regime, the authorities and social partners were reasonably confident that the new programs to move the unemployed back into work (*PARE* and *PAP*), based on closer guidance of job-seekers, would be effective.** In this respect, they pointed to the success of a similar program that targeted specific groups of

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[15] In this sector, an agreement is being considered to phase in the 35-hour workweek over a longer period, up to 2006, depending on the type of enterprise. It should be noted that the legal normal workweek in this sector is high compared to the rest of the economy (43 hours).

[16] Multiple *SMICs* and income guarantees arise from differences in timing of the reduction in the workweek. At the time a sector or a firm adopts the 35-hour workweek, the hourly *SMIC* is complemented by a monthly guarantee to maintain the worker's monthly income. However, monthly guarantees are subsequently adjusted by a different, lower index than the *SMIC*. Simulations indicate that aligning all *SMIC*s and income guarantees to the highest one prevailing in 2005 could boost labor costs at the level of the *SMIC* by more than 15 percent, if there are no further discretionary increases in the *SMIC* in the intervening period.

[17] It is estimated that, with full effect, a family with two children and a single-income earner at the level of the *SMIC* would still face a marginal tax rate of about 84 percent, whereas a similar family with two persons earning a *SMIC* would face a rate of 47 percent.

unemployed.[18] The staff supported the new approach's emphasis on active job search and the aimed-for improvement in job-matching, but expressed two main concerns—partly shared by a number of interlocutors. First, the abolition of the tapering off of unemployment benefits, and the potential practical difficulties, under the new procedures, of enforcing the conditionality of benefits to active job search, risked blunting financial incentives to seek work. Second, and in turn, this risked adding to budgetary costs, along with the significantly higher burden placed on the employment agency (*ANPE*), which had already necessitated increased hiring. While supporting the authorities' efforts to promote continuing education and tightening of early retirement provisions, the staff observed that it would take broader pension reform to make substantial inroads on reducing premature departure from the labor force, a particularly pronounced phenomenon in France.

27. **The authorities were not concerned about possible adverse effects of the tightening of dismissal rules embedded in the proposed labor-relation law** (*loi de modernisation sociale*). They emphasized that the law's more substantive changes involved better protection of workers from workplace harassment and job-related health care problems. They felt that the possibility of using a mediator in large-scale dismissals to be introduced by the law would be beneficial. Social partners viewed the proposals on dismissals as entailing little fundamental change, since they would apply mainly to large-scale collective firings, situations in which unions already had strong bargaining power. The staff argued that the proposed law was likely to lengthen procedures and introduce additional uncertainty, with the risk of adverse consequences for labor market dynamics.

E. Financial Sector

28. **The authorities viewed the financial sector as sound and capable of weathering the current economic slowdown.** In 2000, earnings and profitability of the banking sector continued to rise; average return on equity was 10.2 percent, up from 9.1 percent in 1999. Competition at the retail level kept interest margins very low, but fee income was strong, and loan quality improved further despite strong lending growth. Provisioning costs were stable, as the decline in nonperforming loans was offset by an increase in the allocation of general provisions during the upswing, in a move to a "dynamic provisioning" approach by some banks (Table 4). Nonetheless, operational costs were recognized to remain high and inflexible. Looking ahead, it was expected that the economic slowdown would lower bank profitability through a reduction in income from equity banking, asset management, and brokerage activities. Specific exposures did not raise problems for the time being: exposure

[18] Compared to a reference group, the exit probability for beneficiaries of these programs rose on average by 5 percentage points, and by up to 8.8 percentage points for unemployed aged 25-39 and benefiting from minimum income support. In contrast, the program had no noticeable impact for long-term unemployed younger than 25 (DARES, *Premières Informations et Premières Synthèses*, May 2001, N. 18.1).

to the United States had increased steadily since end-1999 but, at the same time, emerging market exposure had declined significantly and was well distributed. Though the share of bank lending to the technology and telecommunication sectors had risen sharply, it remained modest (in the range of 2½ to 3½ percent of total assets for the largest banks). Lending to the real estate sector appeared to be sound and continued to be closely monitored.

29. **The financial system continues to undergo further changes, driven by international integration and domestic consolidation of the banking system.** In this context, the authorities defended the proposed creation of a large publicly controlled bank (*Alliance*), through the merger of the state-owned *Caisse de Dépots et Consignations* and the mutual *Caisses d'Epargne*, as a means to foster the competitiveness of French banks. In response to staff concerns that the new entity could benefit from certain regulatory advantages, the authorities stressed the strict legal separation that would exist between *CDC*'s private activities (through its investment banking arm, *CDC-Ixis*) and the remaining public activities of *CDC* proper. Staff nonetheless noted the continued existence of certain exclusive rights, most notably *CDC-Caisses d'Epargnes*' unique role in the collection and distribution of major savings instruments, such as the *Livret A*. While taking note of the mission's suggestions to fully liberalize the retail side of the market by removing the widespread system of administered interest rates and the requirement to provide checks free of charge, the authorities had no concrete plans in prospect in these areas. At the European level, the authorities stressed their interest in promoting the integration of EU financial services (expressed *inter alia* through the establishment of Euronext) and their support for the Lamfalussy Report and the Financial Services Action Plan. In this respect, they viewed the rejection of the EU takeover directive by the European Parliament as a major setback.

30. **The structure of financial supervision is being updated to deal better with an increasingly integrated financial sector** (Box 3). A proposal to consolidate the three securities market authorities and enhance cooperation between the banking and insurance supervisors will be implemented shortly. Staff noted that the reform appeared to follow the "twin peaks" model (one agency for the market and one for market participants), but stopped short of its full application in that the banking and insurance bodies would not be merged. The authorities felt that, given the widely different skills and practices involved in supervising banking, insurance, and securities, the approach of close cooperation between separate supervisory bodies was superior to their unification, combining the advantages of specialization and coordination. Details of the arrangements—including the fact that several common members would sit on both the banking and insurance supervisory bodies—provided reassurance that the need for appropriate coordination could be addressed. In another area, the law governing mutual insurance firms not subject to the insurance code (*mutuelles de 1945*) had been updated to comply with European insurance regulations. With the prospective adoption of corresponding regulations, these firms will have to comply to the same solvency rules as provided in the insurance code, though they will remain subject to a

separate supervisory authority.[19] The Fund mission assessing compliance of supervision with the Basel Core Principles found that France was in compliance with most of the Principles, and that the overall quality of supervision was high.[20]

Box 3. Reform of Financial Supervision

The proposed law to reform financial supervision aims at modernizing, simplifying and rationalizing the French supervisory and regulatory system and adapting it to new developments in financial markets. The reform is based on the following three elements:

- A merger of the three financial markets supervisory authorities, the *Commission des Operations de Bourse*, the *Conseil des Marchés Financiers* and the *Conseil de Discipline de la Gestion Financière*, into a single *Autorité des Marchés Financiers (AMF).* This unification is intended to allow the supervisory authority to adapt better to the integration of euro area capital markets and to improve the effectiveness of oversight by merging the staff allocated to market surveillance, control of financial market participants, and internal control. In addition, the procedures for insider trading will be clarified by consolidating the three disciplinary regimes into one. As a consequence, insider trading will be considered in penal courts, whereas the *AMF* will have administrative powers over the dissemination of false information and price manipulation.

- An increase in cooperation between the banking supervisor (*Commission Bancaire*) and the insurance supervisor (*Commission de Contrôle des Assurances*) by: (i) creating an entity to coordinate the communication and consultation with market participants and consumers (*Conseil National des Assurances, du Crédit et de Titre*); (ii) unifying procedures for the elaboration of banking and insurance laws; and, (iii) increasing coordination across sectors, by ensuring that five people sit in both the banking and insurance supervisory authorities.

- An increase in the powers of control and prevention of the insurance supervisor, by allowing the issuance of recommendations to insurance firms before the solvency thresholds have been breached, and harmonizing its powers with the banking supervisor.

[19] The ROSC on Financial Transparency (SM/00/236) recommended subjecting these mutual insurance firms to the insurance code and insurance supervisor so as to improve transparency.

[20] For the assessment of compliance with the Basel Core Principles, an MAE mission headed by Mr. Ize took place from November 6 to 14, 2000, and follow-up discussions with the French authorities were held at headquarters on July 3, 2001.

F. Other Matters

31. **The authorities were making every effort to ensure a smooth changeover to the euro and anticipated no significant macroeconomic effects in the near term.** They had stepped up the campaign to prepare the public for the changeover, but nonetheless noted a slow speed of adoption of the euro by the consumer (where this was already possible—e.g., check writing), and by small enterprises (e.g., switching over registers and accounting systems). On the other hand, the financial sector and large enterprises appeared to be well-prepared. The authorities also underscored the unprecedented logistical and security issues of the changeover, but felt preparations were well in hand. Given competitive pressures, they did not expect any impact on the price level, and intended to use available legal provisions to combat abuse as needed. Other than on timing, effects on consumption were equally unlikely, but there could be a minor effect on investment during the second half of 2001 to adjust software and vending machines.

32. **On product markets, the authorities were broadly satisfied with the pace of reform, arguing that it was further advanced than generally perceived.** In countering these perceptions, advanced also by staff, the authorities noted that, in network industries, telecommunications were nearly fully liberalized, while for electricity 30 percent of the market was exposed to competition.[21] In both sectors, prices had dropped significantly over the past two years. In the electricity sector, the establishment of regulated third-party access, an independent regulator and operator of transmission, and the prospective auctioning of part of generating capacity would reinforce transparency and the liberalization of the sector. The authorities recognized that delays were being incurred in the legal liberalization of the gas market, but stated that about 20 percent of it was subject to competition through the transitory third party access regime that had been put in place. Finally, the authorities noted that new public procurement legislation had simplified procedures, increased transparency, and leveled the playing field, especially for SMEs, and that competition was being fostered in the large distribution sector and the retail of gasoline products.

33. **Nonetheless, staff noted, the perceptions of France as a relative laggard in this area, particularly with respect to key network industries (other than telecommunications), were not without foundation.** At EU level, France consistently took a position against the setting of firm deadlines for the opening up of the energy sector; its transposition of EU directives in a number of areas was often minimalist and/or delayed; and it was among the three member states that were the most behind in the targeted implementation of internal

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[21] As of end April 2001, 9 percent of the eligible clients of the state-owned utility (EDF) had switched to other suppliers.

market measures.[22] With respect to the prospects for the privatization of network industries, the authorities noted continuing progress with divestiture, but observed that the public remained unconvinced of the merits of further privatization of electricity, gas, mail, and railways. The dominant sentiment remained that provision of essential services through public companies was necessary to ensure equitable, reliable, and nation-wide access.

34. On **trade policy,** the authorities stated their support for the continuing liberalization of trade in a multilateral context (WTO) and were keen to extend this process to long-term investments and product market competition. They emphasized that improved market access should be integrated in strategies for development and poverty reduction and, in this respect, called for increased coordination among the WTO, the Fund, and the World Bank. In 2000, France spent 0.32 percent of GNP on **overseas development assistance** (ODA), somewhat less than in 1999, mainly owing to the exclusion of French Polynesia and New Caledonia from the list of ODA-eligible countries. Despite this decline, France remains the top contributor among the G-7 countries on this criterion.

35. The OECD Working Group on the implementation of the **anti-bribery convention** viewed the law adopted by France—effective September 29, 2000—as generally conforming to the requirements of the convention. France's efforts to combat **money laundering** are recognized as exemplary, going beyond the forty recommendations of the FATF in many areas.[23] **Economic statistics** and data provision to the Fund are of high quality and adequate for surveillance (Appendix III), although improvements in the transparency and timeliness of general government data would be desirable.

III. Staff Appraisal

36. **France has enjoyed a vigorous upswing between 1997 and end-2000, helped by a favorable economic environment and several years of wage moderation and gradual reforms that have improved labor market performance.** As a result, the pace of job creation has been unprecedented and broad-based. At the same time, taxes have been reduced, while the fiscal deficit has narrowed. No doubt, the economy is now structurally sounder. Part of the positive outcomes are however also cyclical in nature, and several structural indicators remain comparatively weak. Labor force participation is low, unemployment is still high, the tax burden remains heavy, and the structural fiscal balance has not improved appreciably in recent years. At the same time, structural reforms in a number of key areas have stalled.

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[22] According to the EU Commission's *Second Annual Review of the Internal Market* (April 2001), "The transposition deficits of Greece, France and Portugal are still more than three times as great as those of the best performers."

[23] For details, see FATF Annual Report (at http://www.oecd.org/fatf/Members_en.htm).

37. **Since the end of last year, adverse developments have dented economic growth, but the anticipated slowdown is not such as to warrant short-term activism.** In this vein, calls to address the cyclical downswing by raising public spending, boosting wages, or tightening labor market regulations are misplaced. Rather, the medium-term orientation of fiscal and structural policies should be further strengthened, and the policy focus placed resolutely on the long-term requirement of raising the economy's growth potential, especially by expanding labor supply. Formidable challenges remain if France's employment rate is to be raised toward the Lisbon EU Council target of 70 percent.

38. **In the near term, fiscal policy should contribute to addressing cyclical risks by allowing automatic stabilizers unfettered play on the revenue side, while firmly observing planned expenditure restraint.** The associated cyclical widening of the deficit should not be a cause for concern, provided there is no worsening of the underlying fiscal position compared to medium-term plans. This outcome will not however be ensured without both action and vigilance in the coming period. First, overruns on health care spending—once again in evidence—will need to be addressed. Second, expenditure pressure from the workweek reduction in the public sector and from social and labor market initiatives will need to be contained or offset by savings elsewhere. And, third, the structural strength of revenues—especially of corporate income taxes—will need to be kept under close review.

39. **To deal with demographic pressures and allow a further reduction in France's high tax burden, rapid progress toward structural fiscal balance, paving the way for a sustained long-term decline in the debt-to-GDP ratio, is paramount.** With a structural fiscal position that is essentially unchanged since the start of EMU, France has been in the rearguard in terms of underlying deficit reduction. Against this, demographic pressures are due to emerge comparatively soon. Achieving broad structural balance by 2004 as implied by the latest Stability Program is an appropriate medium-term target and, in updating the Program, should not be moved further into the future. Tax reduction should be pursued to strengthen the supply side of the economy, but must not be allowed to outpace expenditure control.

40. **In each of the remaining major areas where reform is needed—civil service, pensions, health care—the time has come to shift from study to policy action.** The newly adopted law on budget procedures and the wave of retirements of civil servants provide an opportunity to rationalize the public service. Pension reform should move decisively from the drawing board to the implementation stage, in tandem with broader benefits reform. Pension reform should aim to eliminate remaining disincentives to participation in the labor force, remove differences between public and private sectors, reduce intergenerational inequities, and allow the individual an actuarially fair choice between work and retirement. Health care will remain a source of budgetary pressures requiring reforms to promote effective cost control, but also accommodation by increased savings elsewhere.

41. **Strengthening the medium-term fiscal framework by centering it squarely on a binding multi-year expenditure norm can provide an effective instrument to implement**

fiscal consolidation. The current approach—based on a medium-term target of budget balance in line with SGP commitments and an explicit path for tax reduction, from which consistent multi-year expenditure norms are derived—provides an appropriate framework for medium-term consolidation. It could however usefully be strengthened, in particular by establishing a more explicit political commitment to adhere to the multi-year norms in the preparation of the annual budgets, instituting clear and transparent mechanisms to correct deviations from the norms, and firmly avoiding mid-course revisions to the underlying structural fiscal goals. To be effective, the expenditure norms should preferably be expressed in terms of levels and should continue to encompass all government spending, and in particular social security. Their implementation will thus require a clarification of the respective roles and commitments of the central government, local authorities, and social security funds in contributing to expenditure restraint. In the year-to-year implementation of the framework, revenues should be allowed to fluctuate with the cycle, providing automatic stabilization, in both upswings and downswings.

42. **In the labor market, despite significant strides in promoting employment, structural unemployment needs to be lowered further and labor market participation increased.** Prolonged wage moderation has been key to raising the job-content of the recent upswing. A series of specific policy measures has also been successful in raising the demand for labor, though at a considerable fiscal cost. New initiatives are needed to make work more rewarding and alleviate inactivity traps. The adoption of the earned income tax credit is a welcome step in this direction. Consideration should be given to raising the tax credit and improving its targeting in exchange for phasing out some existing benefits. In the unemployment insurance system, the renewed emphasis on helping the unemployed to return to work is well-placed. However, it will be important to ensure that the new programs are effective at an acceptable fiscal cost. In light of the elimination of a financial incentive to seek work (the tapering of unemployment benefits), maintaining effective conditionality of benefits will be crucial. Should the new approach fail to deliver the intended results, the tapering should be reinstated and measures taken to safeguard the financial health of the unemployment insurance system. Finally, the proposed tightening of dismissal rules represents an ill-advised change in the direction of recent reforms.

43. **The workweek reduction initiative is entering a new phase that will require adroit handling.** The 35-hour workweek initiative has facilitated more flexible work organization and wage restraint, and been accompanied by cuts in social security contributions. Riding on the coat-tails of the cyclical upswing, these factors have helped put more people into jobs. The deliberate policy of trading off productivity gains for increased leisure thus appears to have worked, though at the expense of constraining individual choice on work effort, especially for high-skilled labor, which remains scarce. For small and medium-sized enterprises these constraints are likely to be more binding. More flexibility should be granted, in particular by lifting overtime restrictions, allowing a longer phasing-in period, and granting more autonomy to social partners to define the new organization of the workweek. The political commitment to align multiple minimum wages and income guarantees should be implemented in a manner that does not erode the gains of years of wage

moderation that have contributed to the recent rise in employment, especially of lower-skilled workers.

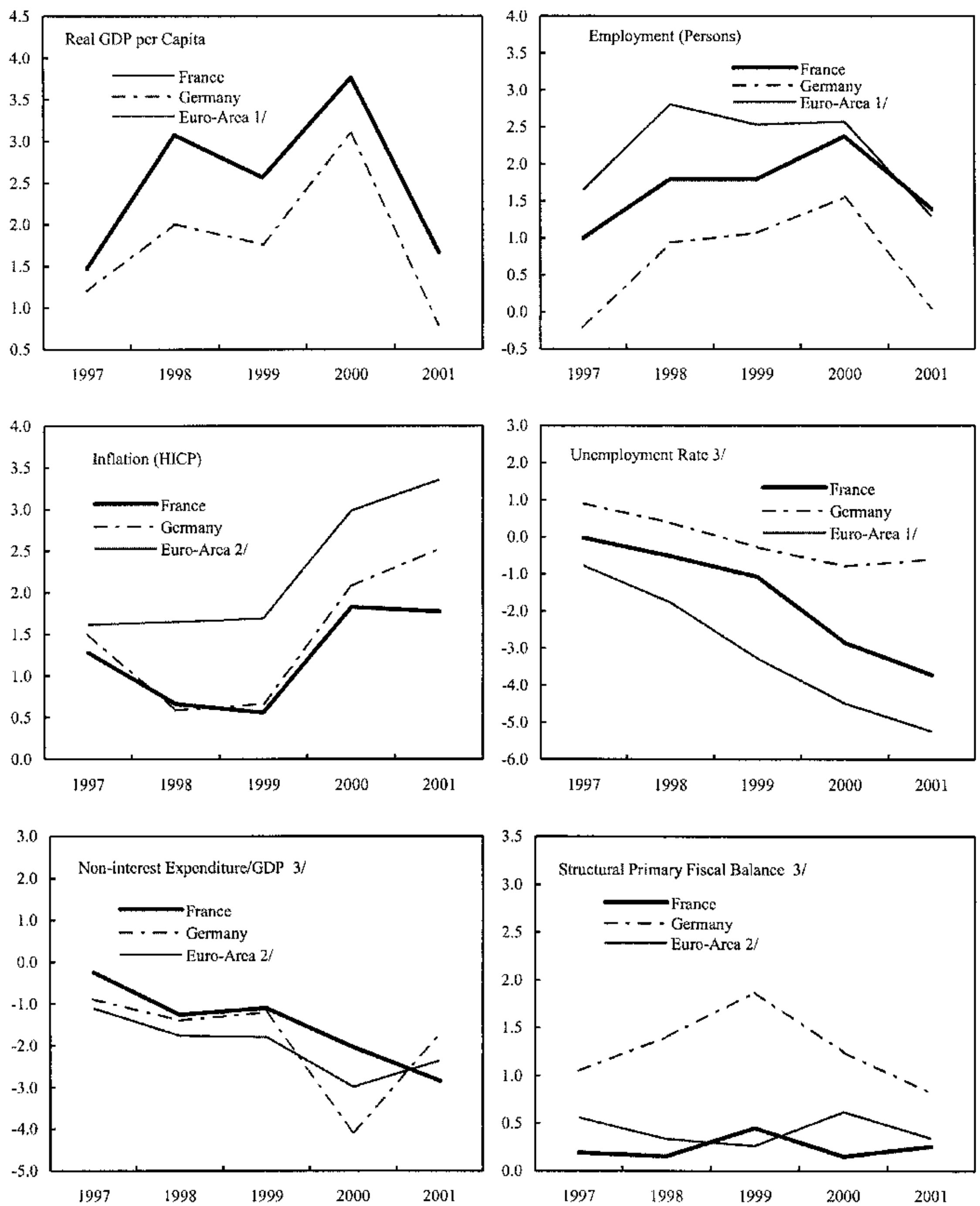
44. **More decisive action will be needed on product market liberalization to strengthen the supply-side potential of the economy.** The authorities view negative perceptions of France's record on product market liberalization as largely unfounded; to dispel them convincingly France should assume a leadership role in promoting an acceleration of product market reform in the EU, beginning at home. Despite recent progress in some areas, further efforts remain needed to enhance competition and open up access. The experience in the telecommunications sector stands to demonstrate the benefits of this approach. Liberalization should be stepped up by extending this success to other sectors—notably the energy industry—and embracing more fully privatization as a valid strategy.

45. **The financial sector performed well in 2000, but further structural strengthening is desirable to deal with increasing international integration and competition.** Efforts by supervisory authorities and the banking community to lower operational costs and remove rigidities in the cost structure of banks should be pursued. The ongoing process of financial consolidation should be seized as an opportunity for the public sector eventually to withdraw from the banking system and promote a fully level playing field. In the same vein, vestiges of public interference at the retail level—such as administered interest rates and the requirement to provide checks free of charge, with the associated practice of not remunerating sight deposits—should be removed. The proposed changes to the structure of financial supervision rightly emphasize mechanisms and procedures designed to ensure enhanced cooperation between banking and insurance supervisory authorities, whose workings will need to be carefully monitored as experience matures.

46. The authorities are encouraged to raise spending on **ODA** to the UN target of 0.7 percent of GNP.

47. It is proposed that the **next Article IV consultation** take place on the standard 12-month cycle.

Figure 1. France: Comparative Cyclical Performance
(Percent Change)

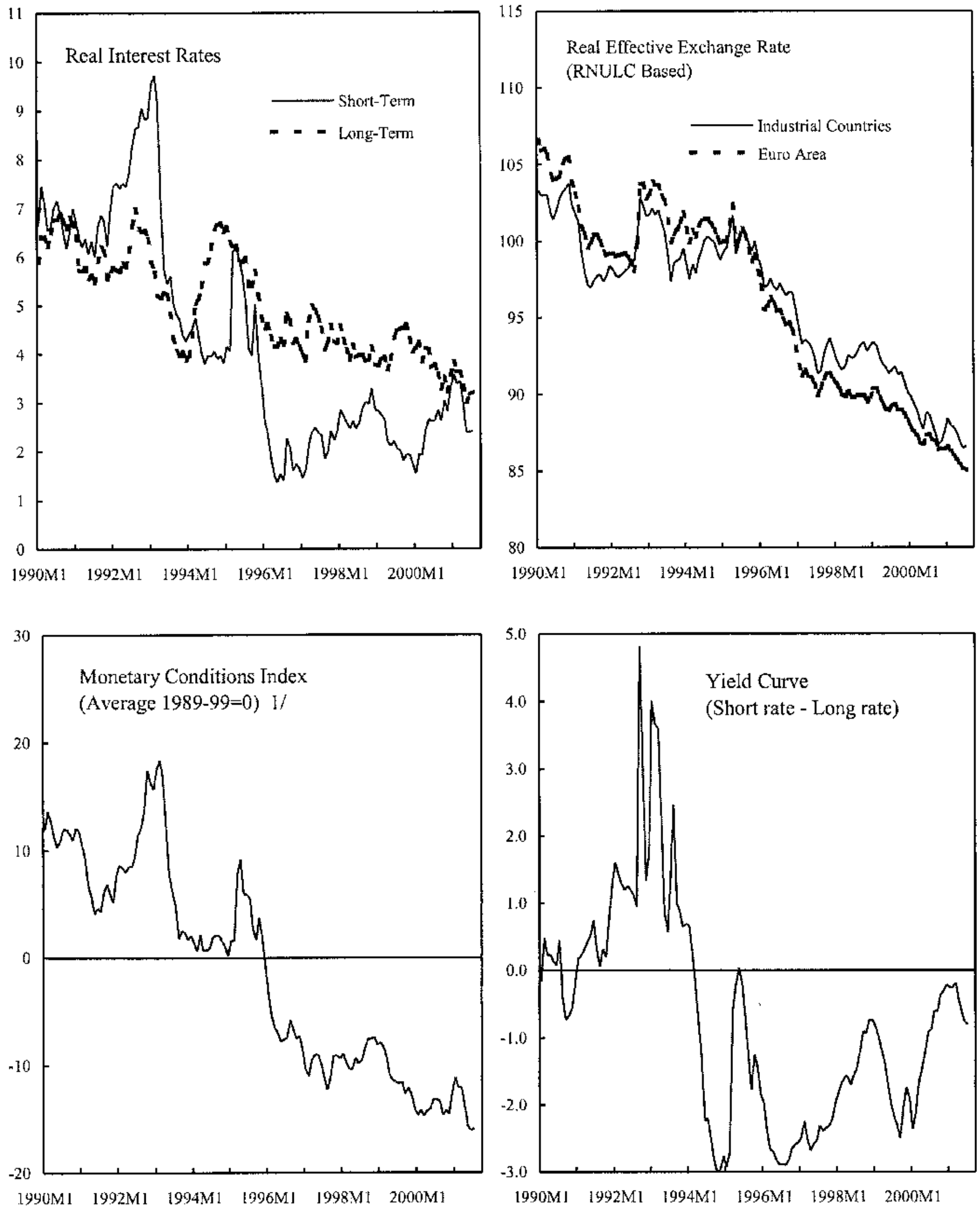


Sources: IMF, WEO; and OECD, Economic Outlook Database.
1/ Excluding France and Germany, weighted average.
2/ Excluding France and Germany, unweighted average.
3/ Cumulative change in percentage points.

Figure 2. France: External Indicators

Sources: INSEE, Quarterly National Accounts; WEFA; and IMF, WEO.

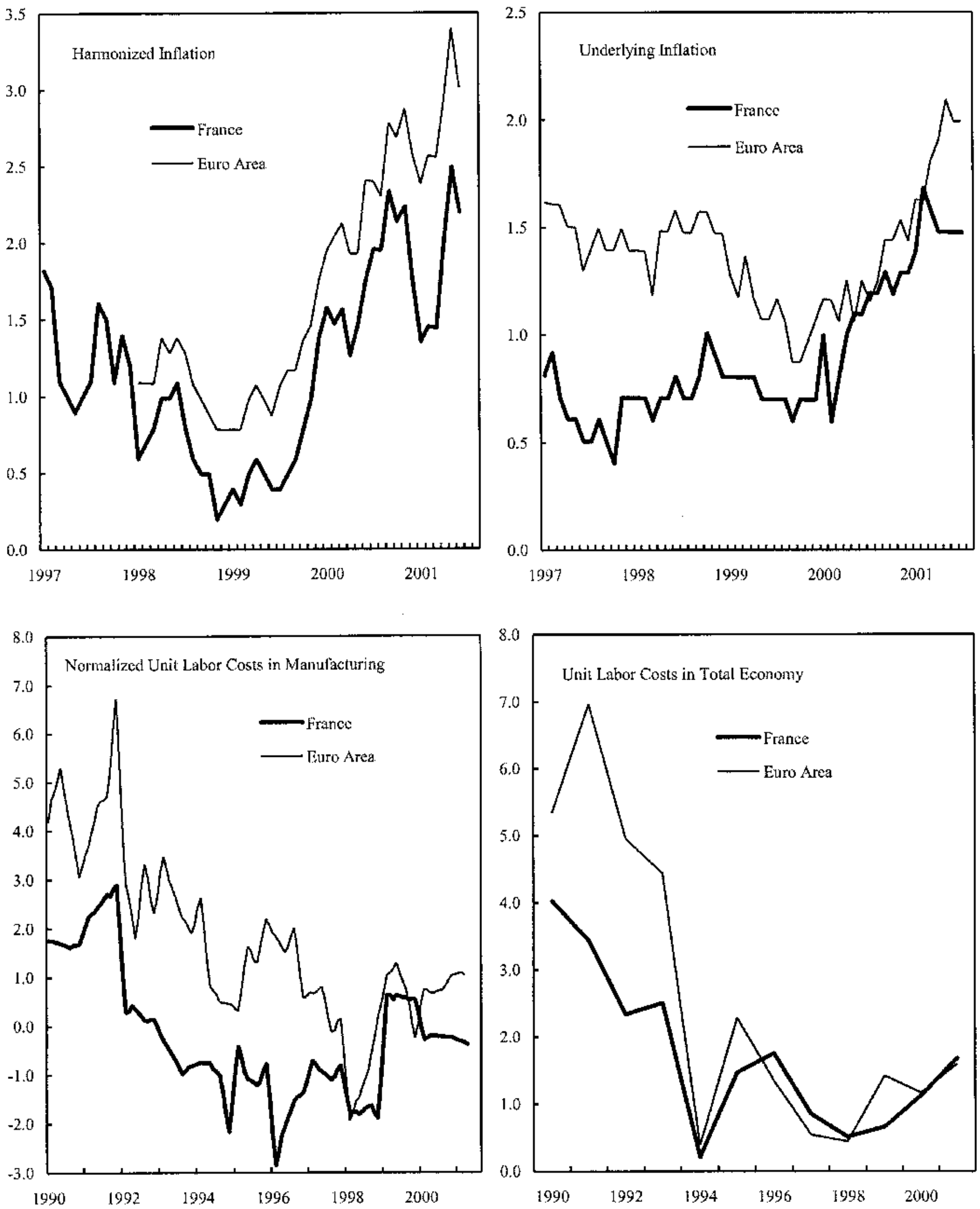
Figure 3. France: Monetary Conditions



Source: IMF, IFS.

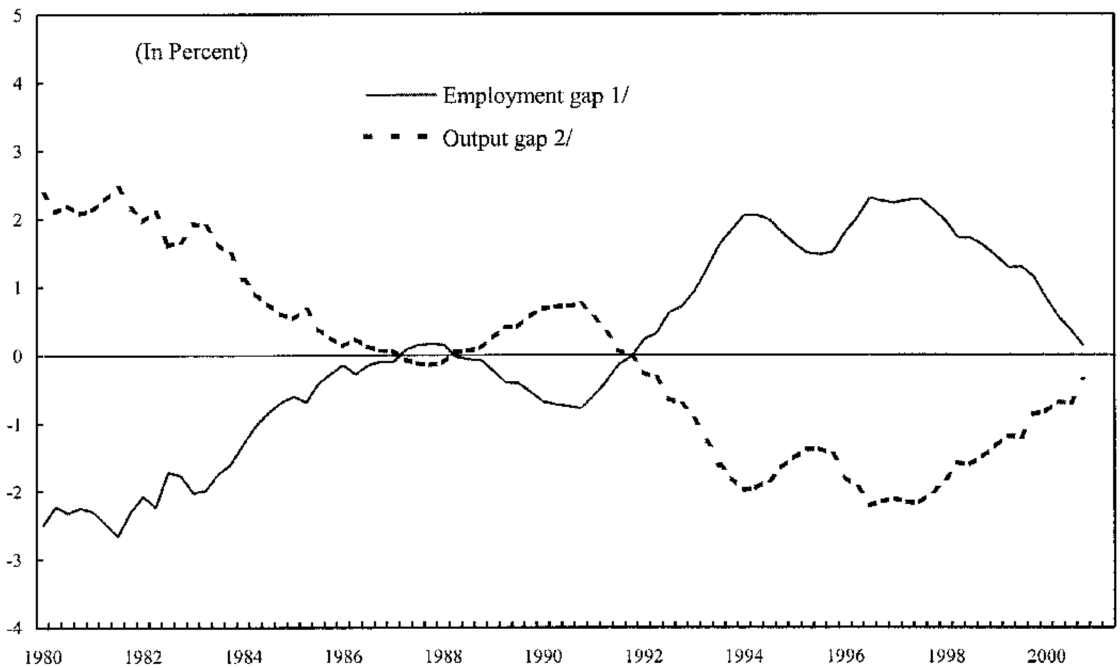
1/ The monetary conditions index is a weighted average of the real effective exchange rate and the short-term real interest rate, with weights, 1 and 2.5, respectively. A higher index implies tighter conditions.

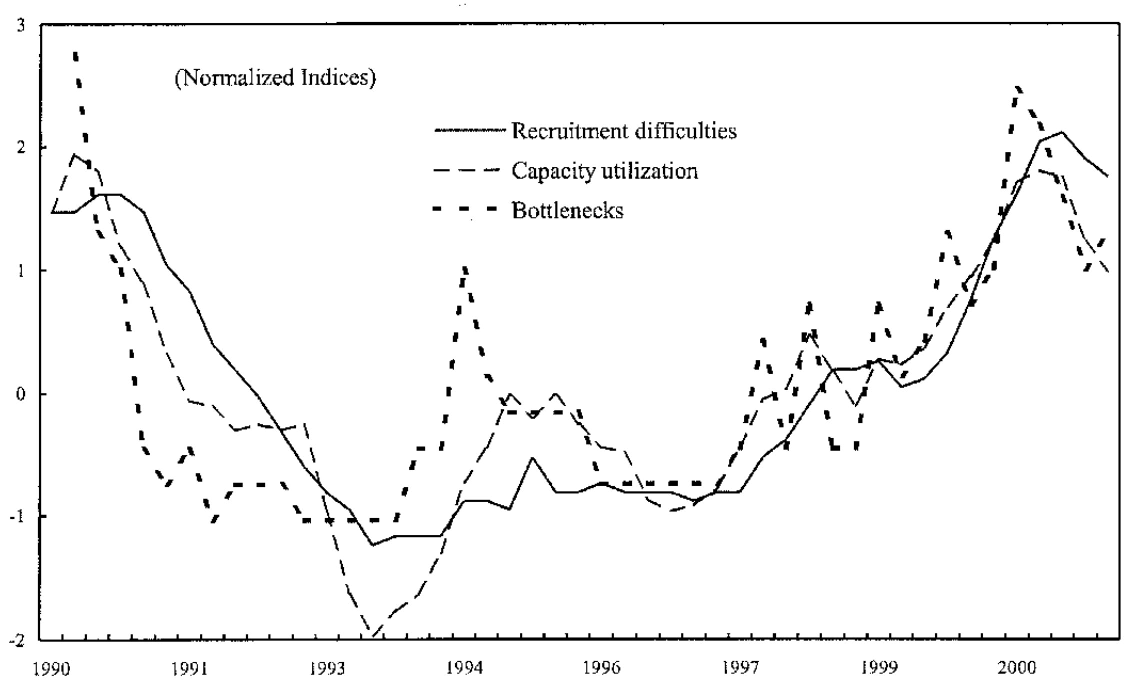
Figure 4. France: Inflation and Unit Labor Costs
(Annual Growth Rates)



Sources: Eurostat; INSEE; and IMF, IFS.

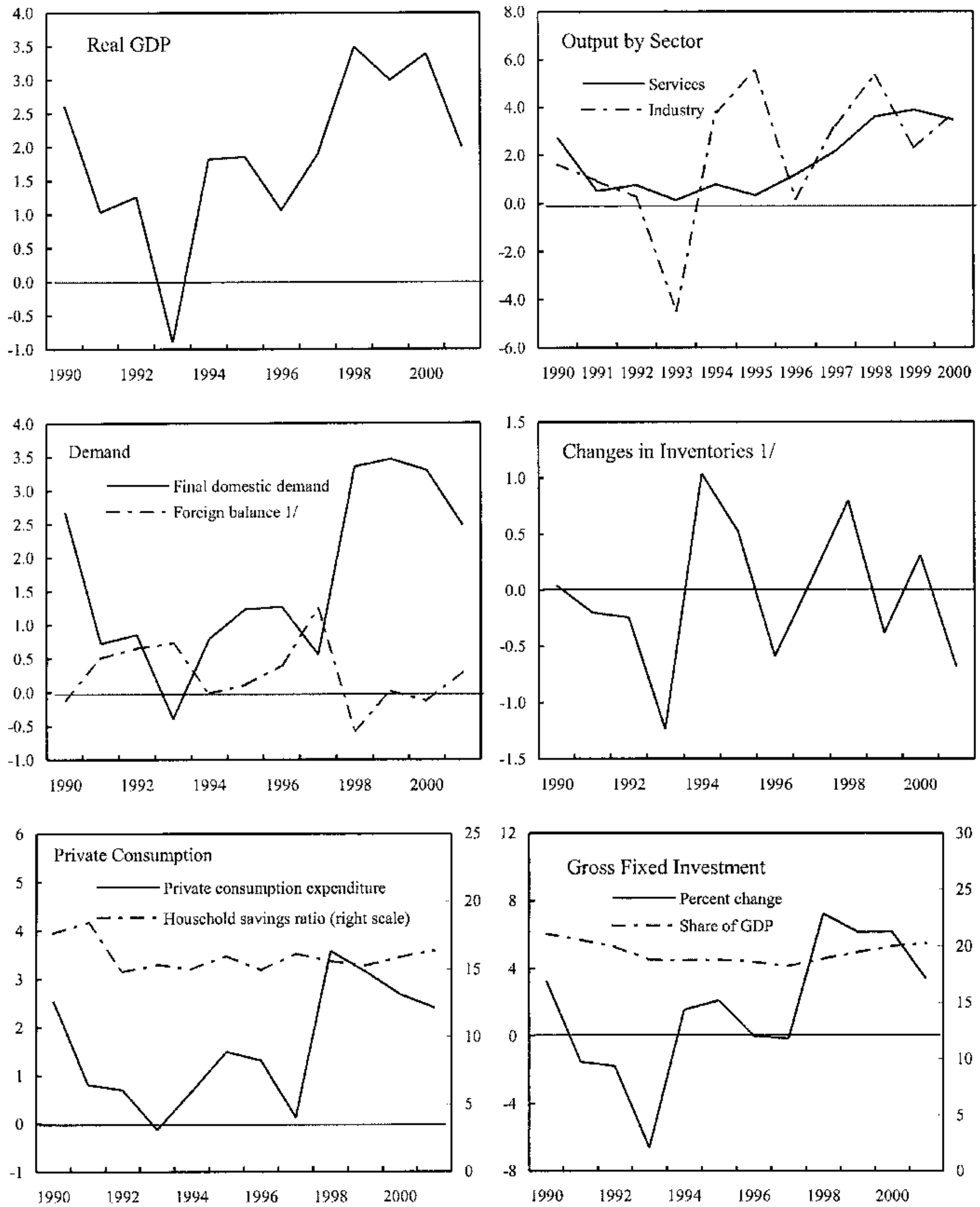
Figure 5. France: Measures of Slack





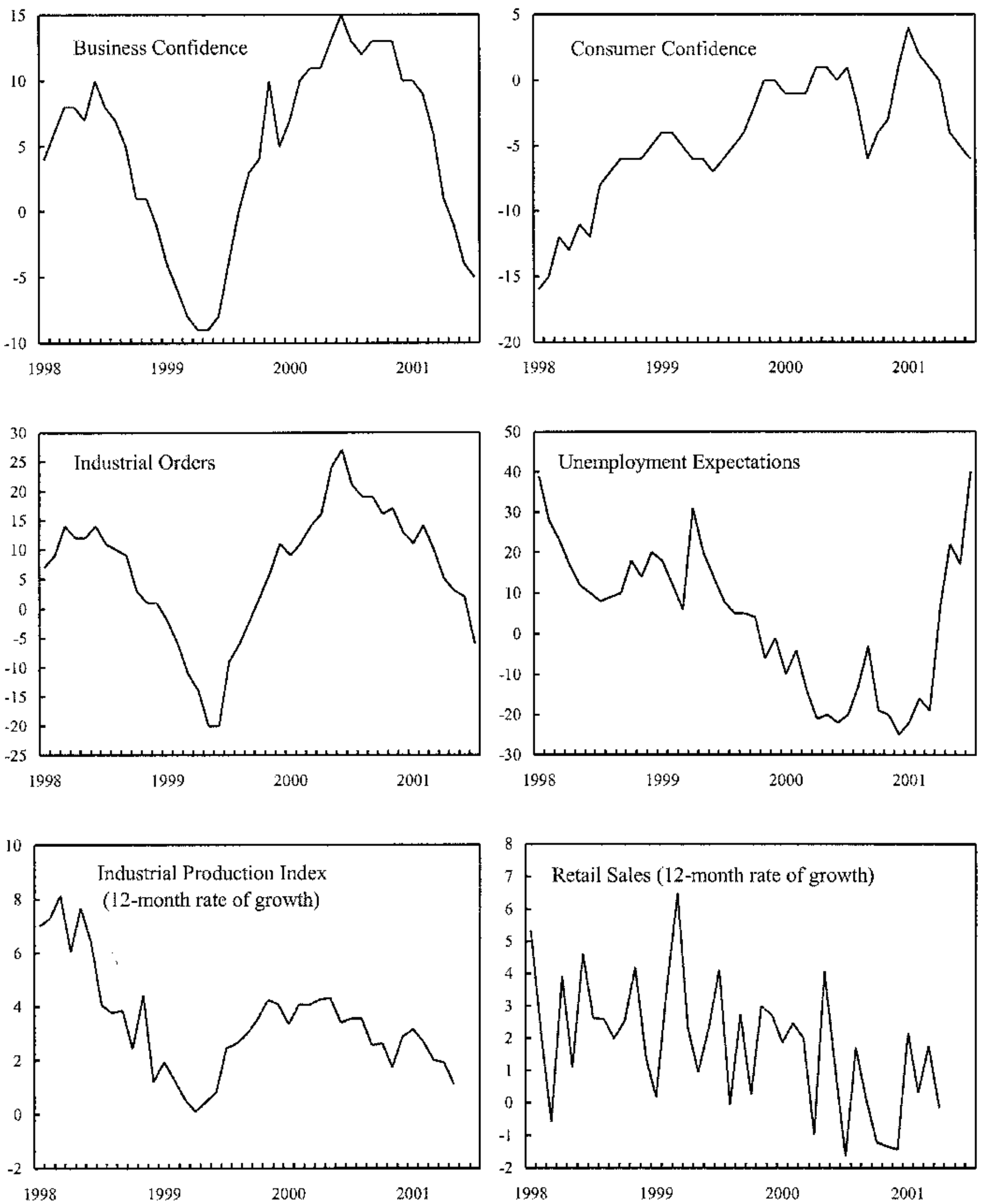
Sources: WEFA; INSEE; and staff calculations.
1/ Defined as the unemployment rate minus the NAIRU.
2/ Defined as output in percent of potential output.

Figure 6. France: Economic Developments
(Percent change)



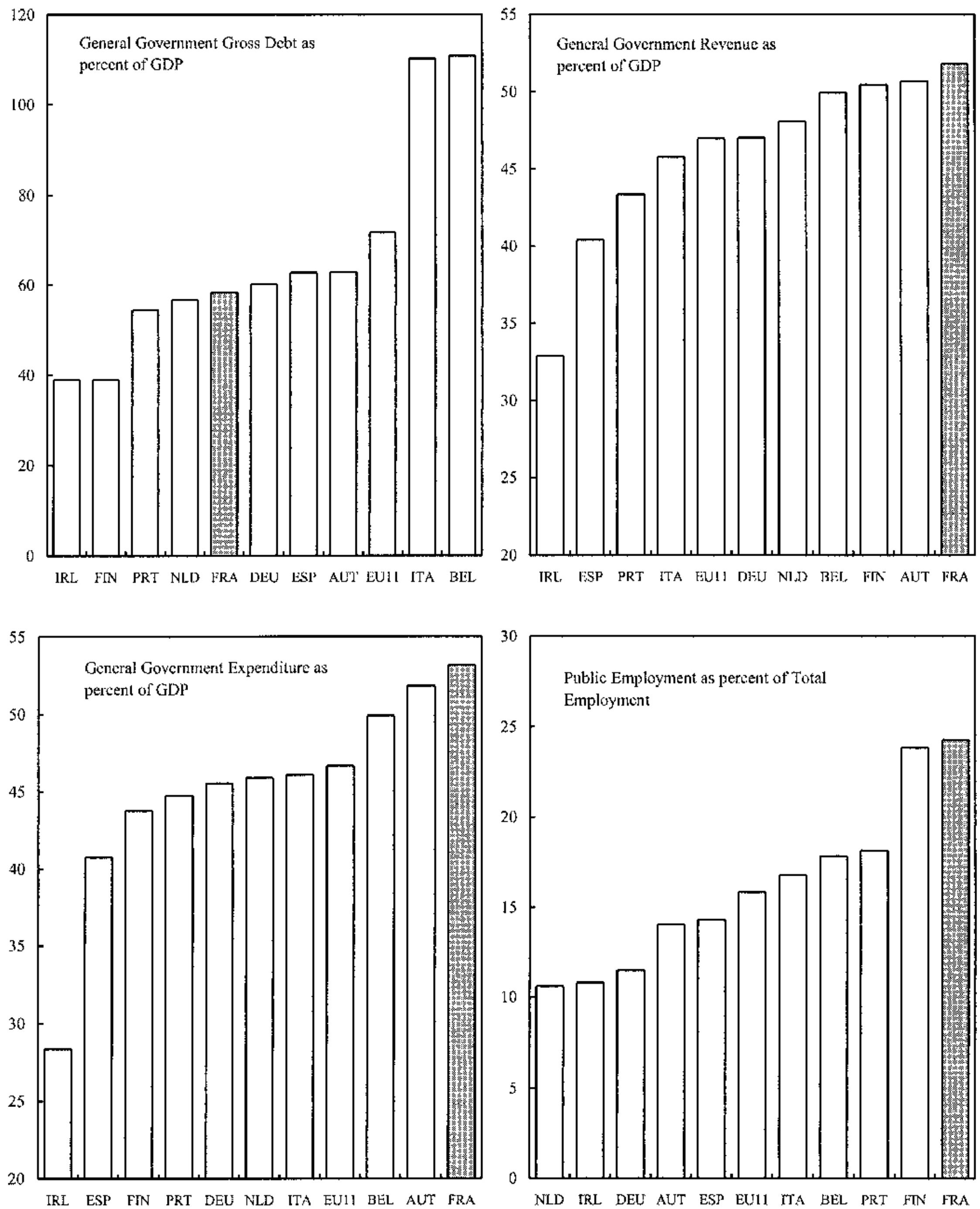
Sources: INSEE, Quarterly National Accounts; WEFA; and IMF, WEO.
1/ Contribution to growth of GDP.

Figure 7. France: High Frequency Indicators
(Dispersion Index)



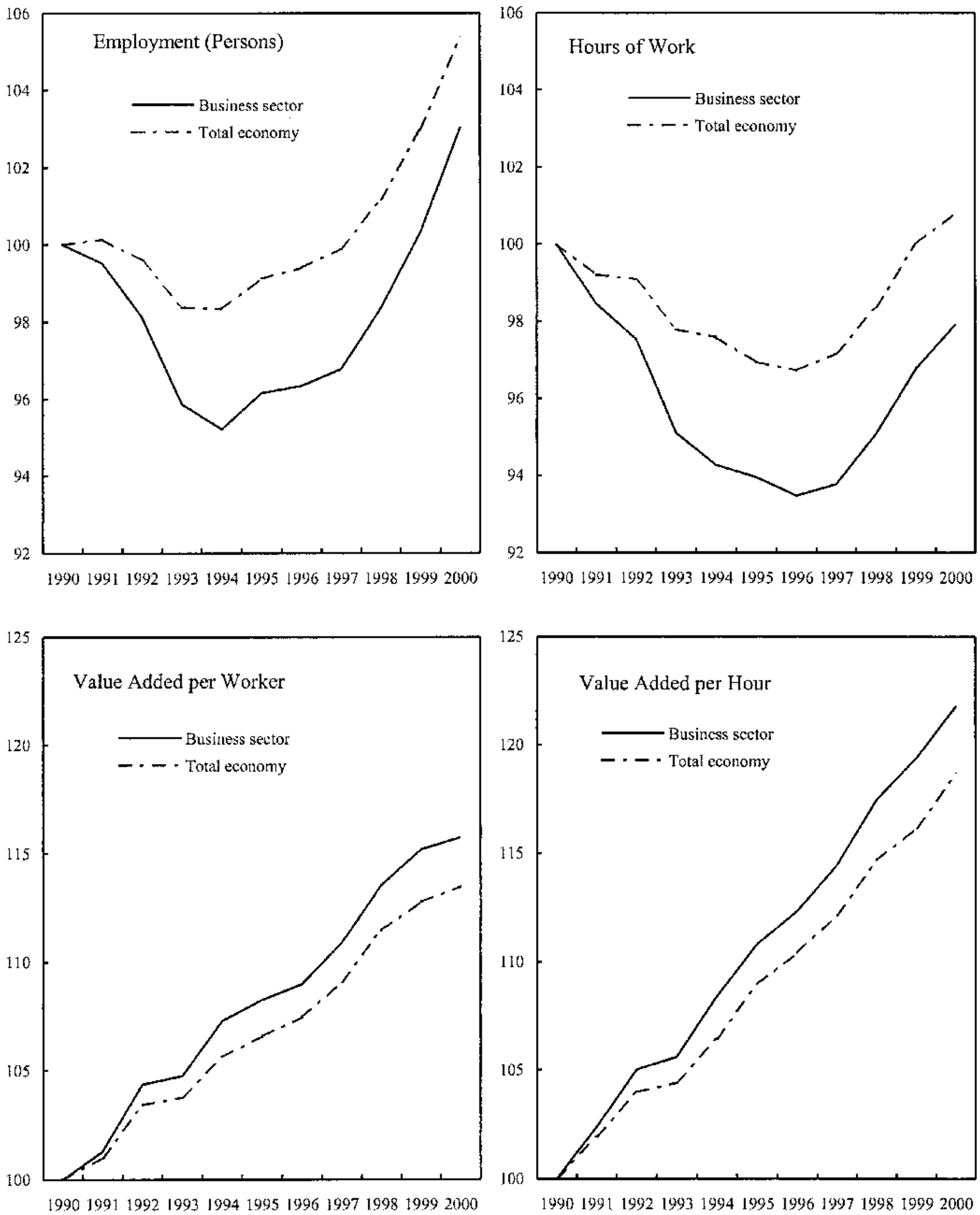
Source: WEFA Database.

Figure 8. France: Burden of Government in the Euro Area, 2000



Sources: OECD, Analyical Database; and IMF, WEO.

Figure 9. France: Employment and Productivity
(1990=100)



Source: INSEE, Annual National Accounts; and staff calculations.

Table 1. France: Main Economic Indicators
(Annual percentage change, unless otherwise indicated)

	1997	1998	1999	2000	2001 Proj.	2002 Proj
Demand and supply in constant prices 1/						
Gross domestic product	1.9	3.5	3.0	3.4	2.0	2.1
Private consumption	0.1	3.6	3.2	2.7	2.4	1.9
Public consumption	2.1	-0.1	2.0	2.3	1.9	2.4
Gross fixed investment	-0.1	7.2	6.2	6.2	3.4	1.8
Business investment	1.0	10.1	6.2	7.4	4.9	2.3
Residential investment	0.9	3.9	7.6	4.6	0.0	0.3
Public investment	-5.5	1.9	3.6	4.2	2.9	2.1
Stockbuilding 2/	0.1	0.8	-0.4	0.3	-0.7	0.1
Total domestic demand	0.7	4.2	3.0	3.6	1.8	2.1
Foreign balance 2/	1.2	-0.6	0.0	-0.1	0.3	0.1
Exports of goods and NFS	12.1	8.2	3.9	13.4	2.7	2.7
Imports of goods and NFS	7.2	11.9	4.2	15.2	1.8	2.6
Prices						
GDP deflator	1.2	0.9	0.3	0.8	1.5	1.4
Consumer prices (average) 3/	1.3	0.7	0.6	1.8	1.8	1.1
Consumer prices (end of period) 4/	1.2	0.3	1.4	1.7	2.0	...
Employment and wages						
Employment	0.5	1.4	1.4	2.4	1.6	0.4
Unemployment 5/	12.3	11.8	11.2	9.5	8.7	8.5
Productivity 6/	1.3	2.1	1.6	1.0	0.4	1.7
Unit labor costs (whole economy)	1.2	-0.2	1.8	0.3	2.1	1.2
Output in manufacturing	5.8	5.3	2.6	4.7	1.7	1.8
Hourly labor compensation in manufacturing	1.7	2.6	5.0	3.4	2.8	3.2
Unit labor costs in manufacturing	-3.7	-2.8	2.1	-1.9	1.3	1.4
Personal sector						
Real disposable income 7/	1.5	2.9	2.7	3.4	3.0	1.9
Savings ratio 8/	16.2	15.6	15.3	15.9	16.4	16.4
Output gap 9/	-3.2	-1.8	-1.2	-0.3	-0.8	-1.2
Rate of growth of potential output	1.7	2.1	2.4	2.4	2.5	2.5
Balance of payments						
Trade balance (billions of francs)	164.3	146.7	123.7	20.4	78.2	92.6
(in percent of GDP)	2.0	1.7	1.4	0.2	0.8	0.9
Current account (billions of francs)	230.1	221.7	228.5	168.7	235.1	255.3
(in percent of GDP)	2.8	2.6	2.6	1.8	2.5	2.6
Terms of trade	0.5	1.4	-0.3	-3.2	...	...
Nominal effective exchange rate 10/	96.7	97.2	95.8	92.7	92.4	...
Real effective exchange rate 10/	92.9	92.5	91.7	88.2	86.6	...
Public sector accounts 11/						
Revenue	51.9	51.3	52.2	51.4	51.0	50.5
Expenditure	55.0	53.9	53.8	52.8	52.4	52.1
General Government balance	-3.0	-2.6	-1.6	-1.4	-1.4	-1.6
Structural balance	-1.5	-1.5	-0.9	-1.1	-1.0	-1.0
Primary balance	0.7	1.0	1.7	1.9	1.8	1.6
Gross debt	59.3	59.5	58.5	57.5	57.8	57.8

Sources: Bank of France; data provided by the authorities; and Fund staff estimates.
1/ Data from the INSEE quarterly national accounts system.
2/ Change as percentage of previous year's GDP.
3/ Harmonized CPI.
4/ For 2001, year on year in August.
5/ In percent of labor force; harmonized index.
6/ GDP over total employment.
7/ Personal disposable income deflated by the implicit deflator for private consumption.
8/ In percent of household disposable income.
9/ In percent of potential GDP.
10/ Index; Base 1995=100. For 2001, data as of July.
11/ In percent of GDP; Data for 2001 excludes the proceeds from the sale of UMTS licenses, which amounts to about 0.5 percent of GDP.

Table 2. France: Fiscal Scenarios[1]

	1997	1998	1999	2000	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
A. Authorities [2]								
Expenditure	55.0	53.9	53.7	52.8	52.2	51.4	50.7	49.8
Revenue	51.9	51.2	52.1	51.4	51.2	50.8	50.3	50.1
Tax revenue	44.9	44.8	45.6	45.2	45.1	44.8	44.0	43.8
Balance	-3.0	-2.7	-1.6	-1.4	-1.0	-0.6	-0.4	0.2
Interest payments	3.7	3.6	3.3	3.3	3.2	3.2	3.1	3.0
Primary balance	0.7	0.9	1.7	1.9	2.2	2.6	2.7	3.2
Gross debt	59.3	59.5	58.5	57.6	57.0	55.4	54.7	53.0
Memorandum items								
Real rate of growth of GDP	1.9	3.4	2.9	3.1	2.9	3.0	3.0	3.0
Real rate of growth of potential GDP	1.7	2.1	2.4	2.4	2.7	2.8	2.9	3.0
Real rate of growth of expenditures	0.8	1.5	2.5	1.0	1.8	1.6	1.5	1.3
B. Staff Projection								
Expenditure	55.0	53.9	53.7	52.8	52.5	52.2	51.4	50.6
Revenue	51.9	51.2	52.1	51.4	51.1	50.5	50.1	50.0
Tax revenue	44.9	44.8	45.6	45.2	44.8	44.4	43.9	43.7
Balance	-3.0	-2.7	-1.6	-1.4	-1.4	-1.6	-1.3	-0.6
Interest payments	3.7	3.6	3.3	3.3	3.2	3.2	3.1	3.0
Primary balance	0.7	0.9	1.7	1.9	1.8	1.6	1.8	2.4
Structural balance	-1.5	-1.5	-0.9	-1.1	-1.0	-1.0	-0.8	-0.1
Primary structural balance	2.2	2.1	2.4	2.2	2.2	2.2	2.3	2.9
Gross debt	59.3	59.5	58.5	57.6	57.8	57.8	58.2	57.3
Memorandum items								
Real rate of growth of GDP	1.9	3.4	2.9	3.1	2.0	2.1	2.8	2.9
Real rate of growth of potential GDP	1.7	2.1	2.4	2.4	2.5	2.5	2.6	2.6
Real rate of growth of expenditures	0.8	1.5	2.5	1.0	1.8	1.6	1.5	1.3
Output gap	-3.2	-1.8	-1.2	-0.3	-0.8	-1.2	-1.0	-0.7

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

[1] In 1997, the France Telecom transfer is not included in the calculation of the structural balance. In 2001, receipts from UMTS licenses, amounting to 0.5 percent of GDP, have been excluded from the calculation of both the overall and structural balances. The rate of growth of expenditures is deflated using the authorities'deflator.

[2] This scenario uses the projection for 2001 and 2002 included in the Perspectives Economiques 2001-02 and the Stability Program 2002-04 thereafter. Consistently with the methodology used by the French ministry of finance, all variables are defined as a proportion to GDP as defined by the **annual** national accounts system. Consequently, some of the figures shown here may differ from table 1, which is based on the **quarterly** national accounts system.

Table 3. France: Employment 1997–2001

	Rates of Growth (End-of-period percent changes)						Levels at the End of the Period (In thousands)					Increase
	1997	1998	1999	2000	2001[1] June	2000/1996[2]	1997	1998	1999	2000	2001 June	2000-1996
Nonfarm business (dependent empl.)	1.5	2.1	2.8	3.6	3.0	2.5	13,549	13,832	14,222	14,731	14,909	1,385
Industry	-0.6	0.1	0.4	2.4	2.1	0.6	5,188	5,196	5,217	5,344	5,385	127
Food and Bev.	1.3	0.3	0.7	-0.3	---	0.5	534	536	540	538	---	11
Energy	-2.5	-4.3	0.8	0.1	---	-1.5	247	236	238	238	---	-15
Construction	-1.0	0.7	3.0	5.2	4.7	1.9	1,118	1,126	1,159	1,220	1,243	91
Manufacturing	-0.5	0.3	-0.5	2.1	1.8	0.3	3,290	3,298	3,280	3,348	3,365	40
Service producing of which:	2.9	3.3	4.3	4.2	3.5	3.7	8,361	8,636	9,005	9,387	9,523	1,258
Trade	1.1	2.1	2.5	3.7	---	2.3	2,549	2,604	2,667	2,765	---	244
Transports	1.3	3.5	4.0	4.2	---	3.2	932	964	1,003	1,045	---	125
Services	5.2	4.8	6.1	5.1	---	5.3	3,915	4,102	4,354	4,574	---	853
Finance	-0.2	-0.5	0.6	1.8	---	0.3	659	655	658	670	---	12
Other	0.2	1.7	3.9	3.0	---	2.2	306	311	324	333	---	27
Nonbusiness[3]	0.7	2.2	2.0	1.4	---	1.6	6,192	6,326	6,454	6,544	---	395
Total[4]	1.0	1.8	2.3	2.5	---	1.9	22,505	22,917	23,436	24,023	---	1,727
Annual change							223	411	520	587		

Source: Data provided by the authorities.
[1] Rate of growth with respect to June 30, 2000.
[2] Rate of growth at an annual rate.
[3] Includes publicly assisted employment.
[4] Includes employment in agriculture and self-employed.

Table 4. France: Vulnerability Indicators
(In percent of GDP)

	1997	1998	1999	2000	2001 Latest estimate	Date
External Indicators						
Exports (annual percentage change, in U.S. dollars)	0.4	5.8	-1.4	-1.4	...	
Imports (annual percentage change, in U.S. dollars)	-3.2	7.0	0.2	3.0	...	
Terms of trade (annual percentage change)	0.5	1.4	-0.3	-3.2	...	
Current account balance	2.8	2.6	2.6	1.8	...	
Capital and financial account balance	0.2	0.2	0.2	0.2	...	
Of which : Inward portfolio investment (debt securities etc.)	2.5	4.6	9.0	9.8	...	
Inward foreign direct investment	1.6	2.3	3.6	3.2	...	
Other investment liabilities (net)	3.5	0.5	5.8	4.0	...	
Official Reserves (in billions of U.S. dollars, end-of-period)	55.9	74.2	68.0	63.7	62.3	May
Exchange rate against U.S. dollar (period average)	5.837	5.900	6.149	7.100	7.200	August
Euros per U.S. dollar (period average)			0.939	1.085	1.098	August
Market Indicators						
Financial Markets						
Public sector debt (Maastricht definition)	59.3	59.5	58.5	57.6	57.0	Estimate for 2001
3-month T-bill yield	3.4	2.9	3.1	4.8	4.2	August
3-month T-bill yield (real)	2.2	2.3	2.5	3.0	2.5	August
Spread of 3-month T-bill with the U.S. (percentage points, end-of-period)	-1.9	-1.5	-2.2	-0.5	0.8	August
10-year government bond	5.3	3.9	5.5	5.0	4.9	August
Spread of 10-year bond with the U.S. (percentage points, end-of-period)	-0.4	-0.7	-0.9	-1.4	0.0	August
Yield curve (10 year - 3 month)	1.9	1.0	2.4	0.2	0.7	August
Corporate bond yield (AAA)	...	...	5.9	5.6	5.6	August
Corporate bond yield (BBB1)	...	...	6.8	6.6	6.6	August
Stock market index (end-of-period)	2998.9	3942.6	5958.3	5926.4	4962.6	August
annual percentage change	29.5	31.5	51.1	-0.5	-24.9	August
Real estate prices (index, 1997=100)	100.0	102.3	108.1	118.6	121.4	March
Credit markets (end-of-period growth rates)						
Credit to the private sector	3.1	4.8	9.9	12.0	12.5	May
Bank credit to households	4.8	4.1	7.8	6.8	5.2	May
Mortgages	2.9	3.7	8.2	7.1	6.7	May
Bank credit to nonfinancial enterprises	2.0	3.8	6.4	12.0	9.7	May
Sectoral risk indicators						
Household sector						
Household savings ratio	16.1	15.6	15.4	15.9	...	
Household financial savings ratio	7.7	6.9	6.6	6.6	...	
Real estate household solvency ratio (index, 1992=100) 1/	145.5	153.8	162.6	153.3	...	
Corporate sector						
Profitability of business sector	39.9	40.7	40.0	39.8	...	
Investment ratio	16.1	16.7	17.2	17.8	...	
Savings ratio	16.9	18.1	16.9	15.9	...	
Self-financing ratio	97.4	100.5	91.4	82.5	...	
Financial sector						
Share of mortgage credit in bank credit to the private sector	25.6	26.1	26.8	26.1	25.8	May
Share of non-performing loans in total loans	6.8	6.3	5.7	5.0	...	
Ratio of provisions to gross operating income	41.6	26.6	13.4	12.4	...	

Sources: Banque de France; IMF, International Financial Statistics; Bloomberg; FNAIM; Commission Bancaire.

1/ This index combines the effect of real disposable income, repayment conditions for loans, real estate prices, and public incentives for the purchase of houses.

FRANCE: FUND RELATIONS

As of July 31, 2001

I. **Membership Status**: Joined December 27, 1945; Article VIII.

II. **General Resources Account**:	SDR Million	Percent of Quota
Quota	10,738.50	100.0
Fund holdings of currency	7,338.61	68.3
Reserve position in Fund	3,399.89	31.7

III. **SDR Department**	SDR Million	Percent of Allocation
Net cumulative allocation	1,079.87	100.0
Holdings	354.10	32.8
Designation plan	0.00	

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs): None

VII. **Implementation of HIPC Initiative**: Not applicable

VIII. **Safeguards Assessments:** Not applicable

IX. **Exchange Rate Arrangements**:

- Since January 1, 1999 France participates in Stage III of the European Economic and Monetary Union (EMU).

- France continues to apply exchange restrictions vis-à-vis Iraq, the Federal Republic of Yugoslavia (Serbia and Montenegro) and the Socialist People's Libyan Arab Jamahiriya. These restrictions have been notified to the Fund under Decision No. 144-(52/51), as follows: in respect of Iraq, see EBD/90/234 (8/8/90) and EBD/93/92, Supplement 1 (1/6/94); and in respect of the Federal Republic of Yugoslavia (Serbia and Montenegro) and the Socialist People's Libyan Arab Jamahiriya, see EBD/93/92 (12/27/93) and Supplement 1 (1/6/94).

X. Article IV Consultation:

The last article IV consultation was concluded at EBM/00/105 (10/27/00). France is on the standard 12-month consultation cycle.

XI. FSAP Participation and ROSC:

	Date Issued	Document No.
Transparency in Monetary and Financial Policies	10/17/00	SM/00/236
Fiscal Transparency Module	10/18/00	SM/00/238

AUTOMATIC FISCAL STABILIZERS[24]

The government budget balance as a share of GDP tends to fluctuate over the business cycle. With changes in tax revenues reflecting changes in aggregate income and some expenditure items (such as unemployment benefits) moving in opposite direction than the cycle, in general the budget balance is positively correlated with economic activity. The magnitude of the resulting demand impulse depends on the cyclical sensitivity of the budget—which in turn is a function of the type of shock driving the cycle—and its ultimate impact on output is further determined by the size of the fiscal multiplier.

A study by the OECD suggests that automatic fiscal stabilizers have dampened cyclical fluctuations in economic activity by about a fifth in France, somewhat less than the average of OECD countries (a quarter).[25] The methodology of the study consists of simulating the INTERLINK model, with tax and expenditure flows set at their structural levels, while monetary policy is assumed to respond to the cycle according to a Taylor rule. This approach requires an estimation of the cyclical component of the budget for which widely different methods exist, each with specific strengths and weaknesses. The OECD estimates that a 1 percent change in GDP would have led to a change in the budget deficit of 0.45 percentage points of GDP in 1999 in France. This estimate is near the average of the OECD countries included in the sample, but somewhat below the EU average. A recent staff study by the European Commission finds a lower response—about 0.4 percentage point—though its size depends on the type of shock.[26]

Using a different method, the staff finds that automatic fiscal stabilizers reduce the cyclical variation of output by about 30 to 40 percent, depending on the estimate of potential output used, with almost all the action stemming from the revenue side. The staff's methodology is simple and circumvents the econometric issues involved in simulating a counterfactual with a large structural econometric model. Employing ARIMA models, the staff separates permanent and transitory components of relevant macroeconomic variables (the main demand components of the national accounts) and fiscal aggregates (total expenditure and eight components of revenues). The transitory components of fiscal aggregates can be econometrically related to the transitory components of output, and the residual of this regression is added to the permanent component of fiscal aggregates to define the structural level of these variables. It turns out that government expenditure (as measured

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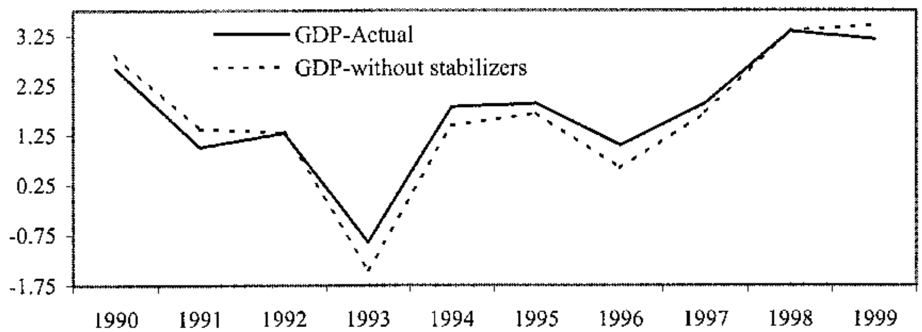
[24] The analysis presented in this Appendix draws on Gabriel Di Bella (2001) "Automatic Fiscal Stabilization in France", IMF Working Paper Series, Forthcoming.

[25] Paul van den Noord (2000), "The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond", OECD, Economics Department Working Papers No. 230.

[26] European Commission (2001), "European Economy-Public Finances in EMU–2001".

in the national accounts) is not significantly affected by output fluctuations. The structural fiscal variables permit the derivation of household disposable income, net earnings of entrepreneurs, private consumption, investment, and GDP stripped of the effect of the operation of automatic fiscal stabilizers. The resulting GDP series is more volatile than the actual series:

France: Impact of Automatic Stabilizers on Real GDP growth
(percent)



Source: IMF, WEO; and staff calculations

The magnitude of automatic fiscal stabilization can be gauged from the ratio of the root mean square of the output gap without stabilizers and the one with:

France: Effect of Automatic Fiscal Stabilizers
Ratio of root mean square of output gap
without and with stabilizers

	1980–89	1990–99	1980–99
ARIMA Potential Output Estimate	1.50	1.42	1.46
Multivariate Potential Output Estimate[1]	1.37	1.29	1.33

Source: Staff estimates.
[1]Series consistent with measures of slack used in the staff report (Figure 5). For methodology see France: Selected Issues for the 2000 Article IV Consultation, October 13, 2000. Since the multivariate estimate is smoother than the ARIMA estimate, the resulting stabilizer effect is smaller.

There was a slight decline of the dampening effect of automatic fiscal stabilizers between the 1980s and the 1990s, though it is not clear whether this decline is statistically significant. Explanatory factors could be a structural lowering of the output elasticity of the tax systems, for which there is, however, little evidence in France. Alternatively, fiscal multipliers could have declined, perhaps as a result of increased openness of the French economy.

FRANCE: STATISTICAL INFORMATION

France's economic database is comprehensive and of high quality. The authorities regularly publish a full range of economic and financial data and calendar dates of main statistical releases are also provided. The transmission of data in electronic form from INSEE and the profusion of data from various institutions (Banque de France, INSEE, Ministry of Finance, Ministry of Labor and Solidarity) have helped to build an infrastructure in which all data can be easily accessed through the Economic Data Sharing system. As a subscriber to the Special Data Dissemination Standard (SDDS), France posts its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB) on the Internet.

Since the beginning of 1999, France's monetary and banking statistics methodology has changed to reflect the standards of the European Monetary Union. Statistics for *International Financial Statistics* on banking institutions and monetary aggregates are prepared on a monthly basis and are timely.

France adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. Although data for GDP and its components are available since 1978, data for the household, corporate, and public administration accounts are only available since 1992. France produces annual national accounts aggregates based on two methodologically different systems of accounting: the quarterly and the annual accounts. Both systems provide valid information although estimates from the two accounts differ slightly.

Recent data issues include the need to provide monthly or quarterly developments not only in the finances of the central government, but also in the social security and local governments. These data should be presented in a comprehensive fashion and under national accounts accounting standards, to facilitate surveillance of the general government accounts.

France: Core Statistical Indicators
as of Mid-September 2001

	Exchange Rates	Int'l Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP/GNP	External Debt/Debt Service
Date of Latest Observation	Sep 14	July 01	Sep 14	Sep 14	July 01	Sep 14	Aug 01	July 01	May 01	July 01	2000 Q2	July 01
Date Received	Sep 14	Sep 7	Sep 19	Sep 19	Sep 7	Sep 14	Sep 12	Sep 19	Aug 7	Sept 6	Sep 11	Sep 7
Frequency of Data	Daily	Monthly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Monthly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update	Reuters	Banque de France	Banque de France	Banque de France	Banque de France	Reuters	INSEE	Reuters/ INSEE	Banque de France	MoF	INSEE	Banque de France
Mode of Reporting	Electronic	Electronic/Fax	Electronic/ Fax	Electronic/ Fax	Electronic/ Paper	Electronic	Electronic/ Fax	Electronic/ Fax	Electronic	Electronic	Electronic	Electronic/ Paper
Confidentiality	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published
Frequency of Publication	Daily	Monthly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

1/ Includes all gross international reserves of the state; reserves at the Banque de France are reported weekly, and within a week.

INTERNATIONAL MONETARY FUND

FRANCE

Staff Report for the 2001 Article IV Consultation
Supplementary Information

Prepared by the European I Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Deppler

October 24, 2001

1. This supplement provides information on economic developments and policies that has become available since the preparation of the staff report for the 2001 Article IV consultation with France (SM/01/287). It reviews the economic outlook in light of newly released data on economic activity and the September terrorist attacks, and reports on the 2002 budget proposal. The new information does not alter the thrust of the staff appraisal. The expected 2001 outturn and draft 2002 budget indicate higher-than-anticipated expenditure pressures, mainly stemming from social security and local authorities, with fiscal policy otherwise broadly in line with the authorities' intentions reported in the staff report. With the increase in expenditure, the fiscal stance is now estimated to be marginally expansionary in 2002. Consequently, achieving structural fiscal balance by 2004 as envisaged in the latest Stability Program will require greater expenditure restraint in 2003 and 2004. The French authorities have notified their intention to publish the staff's assessment of France's compliance with the Basel core principles for effective banking supervision (SM/01/320).[1]

2. **Information that became available since issuance of the staff report—mostly relating to the pre-September 11 situation—points to stronger-than-expected consumption in the third quarter, but also to a slightly worse near-term economic outlook.** Consumer and business confidence indicators have continued their steep decline, though consumption of manufactured products was up strongly in the third quarter (4 percent over the same quarter of 2000, with continued modest growth even in September), driven in

[1] Factual updates of the Reports on Observation of Standards and Codes on Fiscal Transparency and on Monetary and Financial Transparency have been circulated to the Executive Board (SM/01/316).

part by significant wage and employment growth during the first half of 2001 (Figure 1). Industrial production increased by 0.5 percent in July-August (1.7 percent on a 12-month basis). Business prospects are dim, though, with falling capacity utilization rates and expectations of decreasing foreign sales, which had worsened more than expected even prior to the September 11 events. Consequently, investment plans are being scaled back further. Employment creation has slowed to a trickle and the number of unemployed has started rising; the rate of unemployment (Eurostat basis) has nonetheless remained stable from May through August (at 8½ percent).[2] Lower energy prices have been the key force behind the decline in inflation. In September, year-on-year inflation (HICP) was 1.6 percent, down from a peak of 2.5 percent in May 2001.

3. **Against this background, and reflecting the heightened uncertainty in the aftermath of the September 11 events, the staff now projects the start of the recovery to be delayed to the second quarter of 2002, despite the monetary easing and lower energy prices**. The staff's projection for average growth in 2001 (2.0 percent) is unchanged from the staff report, with a stronger-than-anticipated third quarter (notably due to consumption) offsetting the projected weakness of the final quarter of the year. The carryover effects from the latter, however, are set to reduce average annual growth appreciably in 2002. The evolution of growth in the course of 2002 is subject to a wide margin of uncertainty, affecting also main partner countries. On the currently common assumption of a relatively short-lived fallout from the September 11 events, the initially weaker international trade environment and precautionary increase in household savings (compared to the staff report) would be reversed in the second half of 2002. With fiscal and monetary policies supportive of growth in France and elsewhere, a positive terms of trade effect, and receding uncertainty, the economy is projected to revert to slightly higher-than-potential rates of growth during the second half of 2002. On this basis, average growth for 2002 would be around ½ percentage points below the staff report's projection (2.1 percent).[3] This projection is subject to risks, especially regarding the magnitude of the impact of the September events and the timing of the recovery, with a possibility of greater underlying global weakness. The authorities, pointing to the strength of consumer demand and the stimulus provided by the payment of the earned income tax credit in September, are more optimistic on the outlook. They recognize, though, that their pre-September 11 projection for growth of 2.5 percent in 2002 is now ambitious. With lower energy prices and increased economic slack, the staff projects inflation

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[2] On the ILO definition, it rose by 0.3 percentage points in the same period, to 9.0 percent.

[3] Staff projections are ongoing in the context of the current interim WEO round. The October Consensus forecast (1.8 percent in 2002) is slightly higher—though it was revised down by a similar magnitude to that of the staff following the attacks.

to fall appreciably in 2002; for their part, the authorities anticipate it to remain at around 1.6 percent, the current 12-month rate.[4]

4. **The 2002 draft budget reflects the authorities' intentions to allow full play of automatic fiscal stabilizers; in addition, the general government numbers build in the projected higher expenditure outturn from 2001 and accommodate some increase in expenditure growth.** The draft 2002 budget, prepared before the September 11 events and based on growth of 2.5 percent in 2002, envisages a general government deficit of 1.4 percent of GDP, in line with the authorities' expected outcome for 2001 and on a par with performance in 2000 (Table 1). On the revenue side, the impact of the tax cuts already decided under the multi-year program is mitigated by a projected increase in non-tax revenues, in part due to higher dividends from state participations. On the expenditure side, while central government expenditure is to be kept within the announced norm, health care and local authorities' spending are contributing to an acceleration of general government expenditure growth to a rate in excess of the Stability Program's norm (to 2.2 percent in real terms, versus an initial target of 1.6 percent—see tabulation below). However, half of the increase in the growth of real expenditure (0.3 percentage points) results from a bringing forward (from 2003 to 2002) of the switch in accounting for contributions to the EU budget from revenue transfers (a negative revenue item) to increased expenditure.

France: General Government Real Expenditure Growth

	2000	2001	2002	2003	2004
2002 Budget	1.0	1.7	2.2	...	...
Stability Programs	1.0	1.8	1.6	1.5	1.3

Source: Authorities

5. **In presenting the budget on October 16** (but formally outside its provisions), **the government also announced a package of measures designed to counter the economic slowdown.** These include an earlier payment (in January 2002, rather than in the fall) of an increased earned income tax credit (the *PPE* described in the staff report), an acceleration of VAT refunds to businesses, a temporary increase in depreciation allowances (for investments completed or at least initiated through March 31, 2002), and various forms of assistance to small and medium-sized enterprises and sectors particularly affected by the fall-out from the

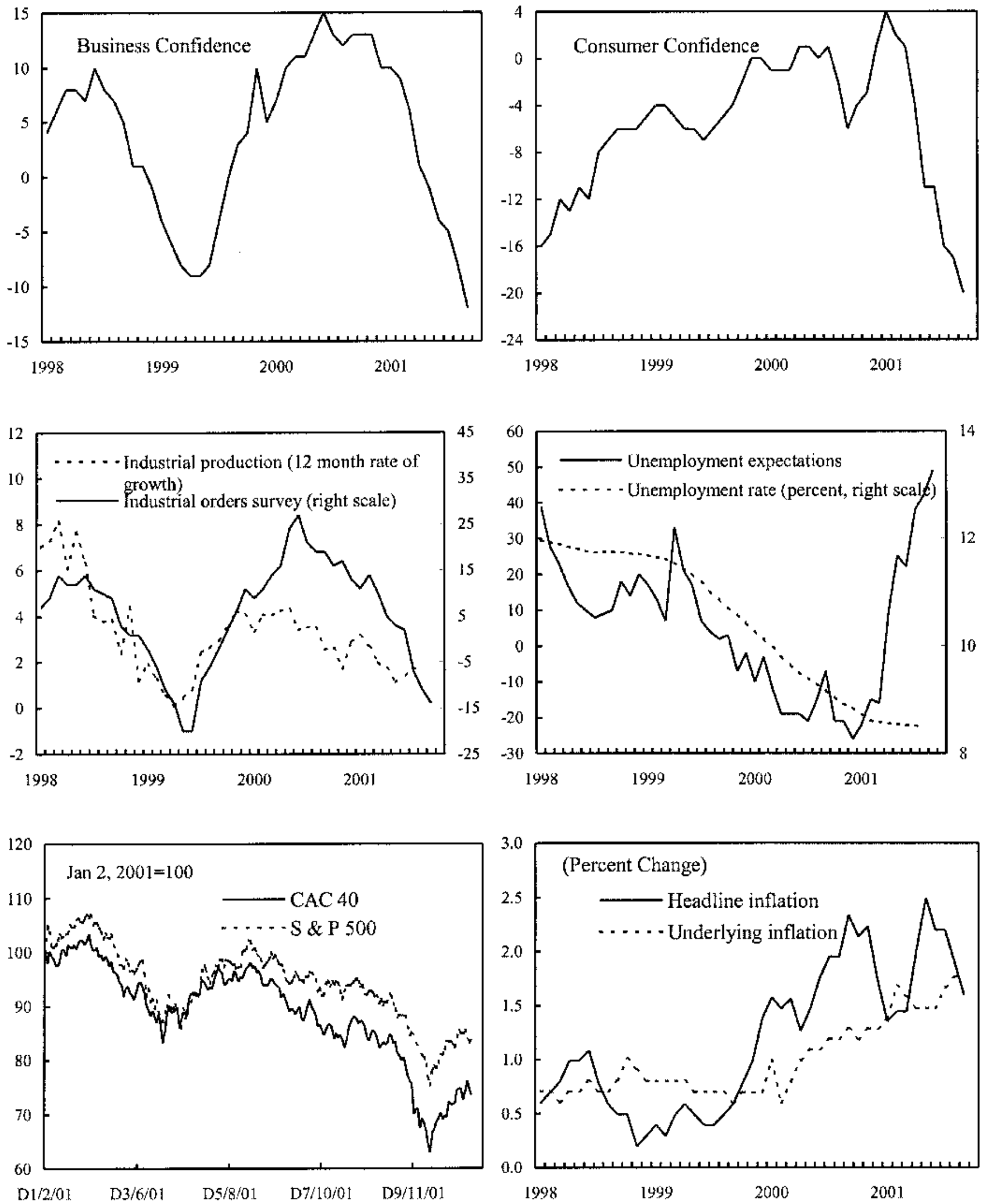
[4] Oil prices are assumed to fall to $21 a barrel on average in 2002 in the staff's projection, whereas the authorities assume constant oil prices at $23 a barrel from September 2001 onward.

September 11 events. In both the authorities' and the staff's estimation, these measures, if adopted, would not have significant cash implications for the budget.

6. **In the staff's calculations, the budget deficit for 2002 will be significantly higher than projected by the authorities, mainly reflecting lower growth.** Although, as noted, the extent and duration of economic weakness is subject to a substantial margin of uncertainty, on its current assessment, the staff projects that the general government deficit would be 1.5 percent of GDP in 2001 (compared to 1.4 percent in the staff report) and in the order of 2 percent of GDP in 2002. With higher expenditure reflected in the draft 2002 budget, the underlying structural deficit is slightly larger than projected in the staff report. The increase in expenditure will require a sharper-than-planned deceleration of real expenditure growth, to an average of about 1 percent per year in 2003 and 2004, in order to meet the three-year cumulative growth norm (of 4.5 percent) set in the 2002–04 Stability Program, and to an even lower rate to achieve the medium-term target of structural balance by 2004.[5] In updating the Stability Program later this year, the authorities should set targets that are consistent with this medium-term objective. Finally, these developments underscore the need to better internalize the Stability Program objectives in the elaboration of annual budgets and to strengthen control over expenditure, most particularly with respect to social security.

[5] Under the staff's inflation projection, which is considerably lower than that of the authorities, real expenditure growth in 2002 would be appreciably higher, thus necessitating an even sharper deceleration in 2003 and 2004 to achieve the medium-term targets.

Figure 1. France: High Frequency Indicators
(Dispersion Index)



Source: IMF, IFS; and WEFA Database.

Table 1. France: General Government Accounts[1]

(In percent of GDP[2])

	1997	1998	1999	2000	2001 Est.	2002 Budget
Expenditure	55.0	53.9	53.5	52.8	52.5	52.3
Revenue[3]	51.9	51.2	51.9	51.4	51.1	50.9
Tax revenue	44.9	44.8	45.6	45.2	44.9	44.5
Balance[3]	-3.0	-2.7	-1.6	-1.4	-1.4	-1.4
Interest payments	3.7	3.6	3.3	3.3	3.2	3.1
Primary balance	0.7	0.9	1.7	1.9	1.8	1.8
Gross debt	59.3	59.5	58.5	57.3	57.1	56.3
Memorandum items						
Real rate of growth of GDP[2]	1.9	3.4	2.9	3.1	2.3	2.5
Real rate of growth of expenditures[4]	1.2	1.6	2.1	1.0	1.7	2.2

Sources: Data provided by the authorities.

[1]Information based on the draft 2002 Budget (*Projet de loi de finance 2002*).

[2]Based on Annual National Accounts.

[3]Excluding proceeds from UMTS licenses.

[4]Nominal expenditure deflated by consumer price index minus tobacco.

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with France

On October 26, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with France.[1]

Background

The French economy enjoyed a vigorous upswing between 1997 and end-2000. By historical standards, and compared to other major euro area countries, per capita GDP and employment increased at high rates. At the same time, unemployment declined substantially, to 8½ percent in mid-2001 from 12¼ percent in mid-1997, without sparking inflationary pressures. This economic record is the result of a favorable external environment; supportive monetary conditions; gradual labor market reforms; protracted wage moderation; and substantial cuts in tax rates and social security contributions.

A number of adverse developments led to an abrupt slowdown of economic growth in the first half of 2001. Initially, the French economy showed more resilience than elsewhere because of a comparatively smaller terms-of-trade loss in 2000 and domestic tax measures that mitigated the impact of external shocks. However, the weakening of international business prospects induced a sharp downward revision of investment plans for 2001, dampening industrial production growth, and adversely affecting employment prospects and consumer confidence. Consumer and business confidence was further shaken by the September 11 terrorist attacks, leading to a likely further slowdown in growth through end-2001. However, supportive monetary and fiscal policies, a positive terms of trade effect, and receding uncertainty could underpin a pickup by the middle of 2002, barring further global weakness. On this basis, the staff expects average GDP growth to be 2 percent in 2001 but to slow appreciably in 2002.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 26, 2001 Executive Board discussion based on the staff report.

According to the draft 2002 budget, the government intends to implement its medium-term tax reduction plan as envisaged, while allowing expenditure growth to exceed slightly earlier plans. Automatic stabilizers will be permitted to operate fully on the revenue side, implying that nominal deficit reduction will be on hold given the appreciably weaker growth outlook. Thus the 2002 draft budget—which is still based on 2.5 percent growth for 2002—anticipates a deficit of 1.4 percent of GDP, broadly unchanged from 2001 and on par with performance in 2000. In the staff's view the budget implies a marginally expansionary fiscal stance in 2002. On the basis of the staff's weaker outlook, the budget deficit would be significantly larger. From a structural perspective, the adoption of the new law on budgetary procedures, and the prospective implementation of a forward-looking personnel management system as a first step toward rationalizing the civil service, are noteworthy.

On other structural issues, the most important recent initiatives have been in the labor market with the introduction of an earned income tax credit and a new program to return the unemployed to work, though the latter also involved eliminating the tapering of unemployment benefits, and dismissal rules are set to be tightened somewhat. However, structural reforms in some other key areas (notably pensions and the health sector) have remained on hold. In the financial sector, the supervision of securities markets is set to be streamlined, and Fund staff found that banking supervision was in compliance with most of the Basel Core Principles for effective banking supervision and that the overall quality of supervision was high.

Executive Board Assessment

Executive Directors commended the authorities on their skillful economic management, which has supported robust economic growth with low inflation and declining unemployment in recent years. Directors welcomed, in particular, the role played by the steady implementation of structural reforms in contributing to the unprecedented job-richness of growth. Directors observed, however, that the economy is now also experiencing the impact of the global slowdown, recently exacerbated by the September terrorist attacks. In the circumstances, the timing and speed of a recovery are necessarily uncertain. Nevertheless, Directors agreed that the growth prospects for the French economy remain good, reflecting economic reforms that have improved economic resilience and efficiency. Directors stressed that, going forward, policies should continue to be firmly geared toward raising the growth potential of the economy by meeting the serious challenges remaining for lifting labor force participation, lowering structural unemployment, and further reducing the tax burden in a context of medium-term fiscal consolidation.

Directors broadly supported the authorities' policy response to the economic slowdown. In particular, they agreed that the automatic fiscal stabilizers should be allowed to play fully on the revenue side, and that the associated cyclical widening of the budget deficit should not be a cause for concern. They also supported the ongoing tax cuts as part of a medium-term tax reduction program, and a number of Directors saw merit in the recent measures proposed to counter the economic slowdown and provide temporary support to those sectors of the economy most affected by the fallout from the September 11th events.

Directors agreed that monetary conditions from the perspective of the French economy have been supportive, noting that further action by the ECB on monetary policy will be determined by euro area considerations.

Assessing the underlying fiscal position of France, Directors observed that only limited progress has been made with structural fiscal consolidation in recent years. They noted that expenditure pressures, especially in social security, have been difficult to contain and have translated into an upward revision of expenditure growth during 2001 and 2002. Pointing to the impending onset of demographic pressures, Directors welcomed the authorities' commitment to stay the course of fiscal consolidation. They stressed the importance of bringing the general government accounts to structural balance by 2004 as implied by the latest Stability Program, a target that, in updating the program later this year, should not be moved further into the future. They noted, however, that achieving this objective will require a significant deceleration of real expenditure growth during 2003 and 2004.

Directors considered that achievement of the authorities' medium-term fiscal objectives will also require that they enact timely reforms in key areas necessary to achieve lasting expenditure control and restraint—the civil service, the health care system, and pensions. They welcomed the new law on budgetary procedures which will improve public expenditure performance, and, together with a drive to put in place a forward-looking personnel management system, should encourage reform and rationalization of the civil service. Directors welcomed the efforts to build a broad-based consensus in favor of pension reform, and urged the authorities to move toward the implementation of a well-designed pension reform which, in tandem with benefits reform, should help raise labor force participation and promote a fair choice between work and retirement. Directors also encouraged the authorities to pursue reforms aimed at better containing the costs of health care.

Directors saw scope for strengthening the current framework for multi-year expenditure control embedded in France's Stability Programs. They considered that such a strengthening could be obtained from backing the expenditure norm by a more explicit political commitment, instituting in the annual budget process a clear and transparent mechanism to correct deviations from multi-year norms, and avoiding upward revisions of the norms between Stability Programs. Some Directors suggested that it would also be helpful to set the expenditure norm in terms of the level of expenditure, and to clarify the respective roles of the central government, the social security administration, and local authorities in contributing to overall expenditure restraint.

Directors highlighted the success of ongoing labor market reforms in raising the demand for labor, and expected that the recent supply-side measures, including the institution of an earned income tax credit, will help to reduce inactivity traps. They also welcomed the newly expanded emphasis on helping the unemployed return to work and encouraged further supply-side oriented reforms, while ensuring that their fiscal costs remain modest. A number of Directors cautioned that recent proposals to tighten dismissal rules could discourage hiring by enterprises, and that the effects of the abolition of the tapering of unemployment benefits will need close monitoring. Noting that the wage moderation, together with labor market reform, has been one of the key factors underlying the job-rich nature of France's growth record during the second half of the 1990s, Directors underscored the need to preserve these gains in the years ahead. In this context, they welcomed the intention to relax overtime limits as small and medium-sized enterprises switch to the reduced work week next year. It would also be important to avoid a sharp increase in labor costs as a result of the prospective alignment of minimum wages and income guarantees.

Directors underscored that, despite recent progress in product market liberalization, the supply-role potential of the economy would benefit from more decisive action in this area. Many Directors encouraged the authorities to commit to specific timetables for opening up the energy and transportation sectors.

Directors commended the authorities on the high quality of banking supervision. They looked forward to the completion of reforms aimed at consolidating securities supervision and ensuring sufficient cooperation between the various supervisory institutions. Several Directors saw merit in phasing out administrative intervention in the operation of financial sector activity at the retail level, particularly as regards the continued existence of administered interest rates. Some Directors suggested that the ongoing process of consolidation in the domestic banking sector should be seized as an opportunity for the public sector to withdraw from banking. Directors welcomed France's strong efforts to combat money laundering.

Directors welcomed the generally high quality, comprehensiveness, timeliness of French economic statistics.

Directors commended the authorities for their continued support for trade liberalization in a multilateral context, and their emphasis on improved market access for developing countries' exports. A few Directors urged the authorities to encourage further reform of the agricultural sector in the context of the EU. While welcoming France's relatively high contribution to development assistance, Directors encouraged the authorities to raise the level of development assistance to the U.N. target of 0.7 percent of GNP.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

France: Selected Economic Indicators

	1997	1998	1999	2000	2001[1]
Real economy (change in percent)					
Real GDP	1.9	3.5	3.0	3.4	2.0
Domestic demand	0.7	4.2	3.0	3.6	1.7
CPI (year average)	1.3	0.7	0.6	1.8	1.8
Unemployment rate (in percent)	12.3	11.8	11.2	9.5	8.7
Gross national saving (percent of GDP)	20.7	21.7	21.9	22.4	22.0
Gross capital formation (percent of GDP)	17.9	18.4	19.0	19.6	19.8
Public finance ((percent of GDP)					
Central government balance	-3.6	-3.7	-3.0	-2.4	-2.5
General government balance	-3.0	-2.6	-1.6	-1.4	-1.5
Public debt	59.3	59.5	58.5	57.2	57.9
Money and interest rates					
M3 (end of year, percent change)[2]	2.0	2.7	6.9	4.9	9.1
Money market rate (in percent)[3]	3.3	3.4	3.0	4.4	4.5
Government bond yield (in percent)[4]	5.6	4.7	4.7	5.5	5.3
Balance of payments (in percent of GDP)					
Trade balance (percent of GDP)	2.0	1.7	1.4	0.2	0.3
Current account (percent of GDP)	2.8	2.6	2.6	1.8	1.9
Official reserves (US$ billion)[5]	30.9	44.3	39.7	37.0	36.7
Exchange rates					
Exchange rate regime		Member of euro area			
Nominal effective exchange rate (1995=100)[6]	96.7	97.2	95.8	92.7	92.4
Real effective exchange rate (1995=100)[6 7]	92.9	92.5	91.7	88.2	86.6

Sources:

[1]IMF Staff projections, unless otherwise noted.

[2]Data for France until 1998 and for the euro area from 1999 onwards. 2001 figure refers to the 12-month percent change as of June.

[3]2001 figure refers to July.

[4]Average yield to maturity on public sector bonds with original maturities of more than five years. 2001 figure refers to July.

[5]Excluding gold, end-of-the period; from 1999, eurosystem definition. 2001 figure refers to June.

[6]While the franc to euro rate was irrevocably fixed on January 1, 1999, the external exchange rate of the euro is market determined. The franc will remain in circulation until end-2001, when euro banknotes and coins will be issued. 2001 figure refers to July.

[7]Based on relative normalized unit labor costs in manufacturing.