

France: 2000 Article IV Consultation—Staff Report; Supplement to the Staff Report; and Public Information Notice Following Board Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with France, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions with officials in France on economic developments and policies that ended on **July 10, 2000. The staff report was completed on September 22, 2000, based on information available at that time.** 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 supplement to the staff report prepared by IMF staff reflecting new information and/or developments and policies since the consultation discussions that may affect the staff appraisal or the outlook.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the October 27, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

A Selected Issues report prepared by IMF staff as background to the Article IV staff report has been released separately.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (<http://www.imf.org>)—as part of a pilot project.

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FRANCE

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation with France

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I. INTRODUCTION AND OVERVIEW

1. The **2000 Article IV discussions** were held in Paris during June 28 to July 10. The mission¹ met with Mr. Fabius, Minister of the Economy, Finance, and Industry, and his staff; Governor Trichet and officials of the Banque de France; the economic advisor to the Prime Minister; officials of the Ministry of Labor and Solidarity, the national statistical institute, and the Banking Commission; 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. The authorities have expressed their intention to publish this staff report; they also for the first time released the mission's concluding statement. Municipal elections are scheduled for early 2001, and national parliamentary and presidential elections for 2002. France is an Article VIII member and, apart from the security restrictions described in Appendix II, maintains an exchange system free of restrictions.

2. **France has conducted self-evaluations of its observance of the Fund's Codes of Good Practices**, including with respect to the transparency of financial policies and fiscal transparency; for each of these, the staff prepared ROSC modules which will be circulated to the Board.² France has also conducted self-evaluations of its observance of the Basel Core Principles, and the Fund's Special Data Dissemination Standards. Reports on these and other financial standards (particularly IOSCO standards for securities markets and IAIS insurance standards) will be completed by the staff in the course of the 2001 Article IV cycle.

3. In concluding the **last consultation**, on October 22, 1999, the Executive Board commended the authorities for policies that had sustained growth and employment creation without igniting inflation. Many Directors noted that the favorable near-term outlook provided an opportunity for a faster pace of fiscal consolidation to position the public finances on a sustainable path, while seeking deeper expenditure-financed reductions in the tax burden over the medium term. Directors also called for an invigoration of the structural reform effort, notably with respect to tax, pension, labor, and product market reforms.

4. **Economic developments since the last consultation have been clearly positive** (Table 1 and Figure 1). The economy is now in the midst of its third consecutive year of strong output growth with low inflation (see Box 1 for details). A distinctive feature of this upswing has been the pace of job creation and the marked fall in unemployment. While this performance has clearly benefited from supportive monetary conditions and a favorable external environment, it is also the result of policies and reforms that have been in place for some time and that are now bearing fruit in a propitious macroeconomic setting. In particular, the robust employment response owes much to substantial cuts in social security taxes at the

¹ The staff team comprised Messrs. Leipold (Head), Ford, Ubide-Querol, Levy, Estevão (all EU1), and Ms. Mahfouz (FAD); Ms. De Leva (EU1) was the administrative assistant.

² For the assessment of the financial policy component of the Code of Good Practices on Transparency in Monetary and Financial Policies, an MAE mission (Head: Ms. Dziobek) overlapped with the Article IV visit.

low end of the wage scale that have improved the employability of the low skilled,³ and to the liberalization of labor contracting arrangements that have allowed expanded use of part-time, temporary, and fixed-term employment to meet high demand (Table 2). Reflecting in part the confidence engendered by the performance of the labor market, domestic demand has been a more prominent source of growth in France than in Germany. Despite some indications that the economy might weaken (including flat industrial production and weaker consumption than expected in the second quarter), and an intensification of the downward risks stemming from oil price developments, the staff's projection and the consensus forecasts expect output growth to be sustained through next year.

Box 1. A Continued and Job-Rich Cyclical Upswing

Output has grown strongly, sustaining the cyclical expansion which began in 1997, as the economy proved more resilient than its main euro partners to last year's emerging market turmoil. Real GDP rose by close to 3 percent in 1999 (Table 1, Figure 1) and—though slowing somewhat from earlier expectations—growth remained strong in the first half of 2000. Private consumption and investment have been sustained by supportive monetary conditions (Figure 2) and buoyant household and business confidence.

On the external side, in the decade leading up to the introduction of the single currency, France had improved its competitiveness with regard to the euro area, and entered EMU with a **competitive edge that has been largely maintained** thanks to moderate growth in unit labor costs. Furthermore, the depreciation of the euro since its introduction has improved competitiveness strongly against the rest of the world. Despite the upswing, the current account surplus has thus hovered around 2½-2¾ percent of GDP since 1997.

A particularly encouraging (and unusual) feature of the current cyclical expansion has been the rapid pace of job creation. Employment has risen by a total of about one million since mid-1997 and by a record 450,000 jobs in 1999 alone. As a result, the unemployment rate has declined from a peak of 12½ percent in 1997 to 9¾ percent in mid-2000, and appears set to fall further. New jobs were overwhelmingly concentrated in the services sector, with temporary employment and fixed-term contracts playing a prominent role (Table 2).

Inflation has remained subdued in the face of diminishing margins of slack. Capacity utilization rates, bottlenecks, and recruitment difficulties have all risen markedly in recent years (Figure 3), although remaining below the levels of the previous cyclical peak. Wage settlements have nevertheless been moderate, in part due to trade union restraint as a counterpart to the reduction of working time (the 35-hour work-week initiative). Headline inflation has risen due to higher oil prices, but is one of the lowest in the euro area, and core inflation has remained below 1 percent (Figure 4); there is also no evidence of an acceleration of non-traded goods prices.

5. **Policies have been broadly supportive of growth.** The interest rate increases by the European Central Bank have been countered by the depreciation of the euro, leaving monetary conditions only marginally tighter than a year ago (Figure 2). On the fiscal policy front, the general government deficit narrowed to 1.8 percent of GDP in 1999, almost a full percentage point below the 1998 outcome. This reflected an unexpected surge in tax

³ These cuts have been reflected in a halt to a 15-year decline in the share of the unskilled in total employment.

revenues, which boosted the tax-to-GDP ratio to a record 45.7 percent (Table 3), more than offsetting a sizable slippage from the newly-introduced expenditure norms (a real growth of 2½ percent versus a norm of 1 percent), due largely to overruns in health care and local authority spending.⁴ The nature of the underlying developments complicates the calculation of the fiscal impulse: the revenue overperformance was not associated with higher output growth than expected and, on the basis of the standard approach, it improved the structural balance by about ½ a percentage point of GDP. However, the revenue surge (due mainly to corporate taxes and a shift in the base for income taxes) may well prove to reflect cyclical or other transitory factors. Nonetheless, in early 2000, the strength of the tax intake generated political pressures for new tax cuts or additional expenditures. A supplementary budget allocated the then-estimated revenue overperformance for 2000 (about ½ percent of GDP, due both to base effects and an upward revision in growth) mostly to tax reductions (with a cut in VAT being the largest of these) and the remainder to expenditure increases (essentially health and education outlays).⁵ Despite the subsequent decision to allocate any additional revenue overperformance in the current year to deficit reduction, the fiscal stance is set to be mildly stimulative in 2000.

6. **On the structural front, the record since the last consultation registers both advances and setbacks: an important focus continued to be on employment-support measures, the implementation of the reduced work-week, and the preparation of a multi-year tax reduction package; some initiatives in other areas were foiled by social opposition.** A number of measures in 1999 carried forward the long-standing focus on cutting indirect labor costs to boost labor demand, particularly at the low end of the wage scale. In this vein, the 1999 budget extended the tapered rebate on employers' social security contributions from 1.3 to 1.8 times the minimum wage (SMIC) for firms implementing the 35-hour work-week, and also reformed the local business tax (*taxe professionnelle*) by phasing out the wage bill from the tax base. For their part, the bulk of the tax measures undertaken in 2000, including notably the reduction in the VAT rate, did not address labor market or other supply side impediments directly.⁶ The latter considerations however featured explicitly in the tax reduction package for 2001–03, announced in late August. In other key areas, despite some steps forward, potentially far-reaching proposals (such as lengthening the pension contribution period for civil servants and reform of the complex tax administration structure) were put on hold in the face of opposition from affected groups. In product markets, there was further liberalization of key network sectors (i.e., telecom-

⁴ As a result, the ratio of expenditure to GDP—the highest in the euro area—remained largely unchanged from the previous year, instead of falling by nearly ½ a percentage point of GDP as budgeted.

⁵ In contrast, the ECOFIN Council, in reviewing France's Stability Program in March 2000, had advised using the opportunity provided by any "wider budgetary room for maneuver" to reduce the deficit more quickly.

⁶ Exceptions in this respect were the exemption of the residence tax (*taxe d'habitation*) for low-income families, and announced changes to housing subsidies (*aides au logement*), both designed to reduce unemployment traps.

munications, electricity, and gas), though with continued delay relative to European Community directives.

II. POLICY DISCUSSIONS: PROMOTING CONTINUED GROWTH

A. Overview

7. **In view of the favorable short-term outlook for output, employment, and inflation, the discussions focused on the policies needed to sustain a continued robust expansion in the years ahead.** To some extent, this choice was motivated by the experience of several European countries of the past three decades, during which expansions have been cut short by capacity constraints and rising inflationary pressures, and downturns have been characterized by rising structural unemployment and sharply deteriorating fiscal positions—as experienced in France in the early 1990s. There was broad agreement that output and labor market gaps might close by end-2001, leaving further room for strong growth and declining unemployment in the short term, but raising the longer-term sustainability of the upswing as a major policy concern. Lying behind many of the exchanges was the “new economy”—the extent to which its effects were already raising potential growth, and the policies needed to exploit new technologies in the years ahead.

8. **There was wide recognition in official circles of the key challenges facing the French economy and the corresponding policy requirements, but—as noted in last year’s staff report—policymaking remains circumscribed by the perception that successful reform must be gradual.** This perception is reflected in the pace and scope of fiscal and structural reforms, which remain modest when set against the opportunity provided by the strong economic expansion. While this gradual approach has eased the introduction of reforms over time, the risk is that momentum will flag in the absence of explicit political support and in the context of an intensive electoral calendar, and therefore reforms may fall short of what would be needed to ensure a long-lasting, resilient recovery.

B. The Economic Outlook

9. **The authorities and staff shared a positive assessment of the short-term outlook.** The staff WEO projections are for real GDP growth of 3½ percent in both 2000 and 2001, based on strong consumer and business confidence, and the ongoing competitiveness effects of the depreciation of the euro.⁷ Underlying inflation is projected to remain low. Although official projections had not been updated since the spring, the authorities broadly agreed with the staff assessment, but cautioned that 2001 might prove somewhat weaker due to some slowdown in investment growth (especially residential investment, whose pattern may be affected by the timing of certain tax breaks). The two main downside risks were that

⁷ The August Consensus Economic Forecast is 3.7 percent for 2000 and 3.3 percent for 2001. Neither the WEO projection nor the Consensus Forecast incorporate the second quarter national accounts, released in early September. A supplement will be issued to the Executive Board discussing the most recent data and the 2001 budget, which was published as this report was being readied for distribution.

continuing high oil prices would reduce disposable income and demand; and the consequences for export markets, along with the possibility of financial turmoil, should there be a hard landing of the U.S. economy. Although France is not especially exposed in either area, the materialization of these risks would tend to cut growth in the euro area as a whole.

10. **In both the staff and the authorities' assessment, monetary conditions remained supportive**, even after the interest rate increase by the European Central Bank in June; the latest (August) increase does not materially change this assessment. This stance was jointly viewed as broadly appropriate from the perspective of the French economy, given a cyclical position that is not appreciably different from that of the euro area as a whole. Nevertheless, the Banque de France expressed concern that inflationary pressures were beginning to build, pointing to high capacity utilization rates and growing reports of hiring difficulties. In this light, it viewed benignly the interest rate increases priced into the yield curve for the remainder of the year. As to the contractionary impact of higher real short-term interest rates on the French economy, the authorities did not believe there were significant differences in the transmission of monetary policy between France and other main euro economies (notably Germany). Banque de France estimates suggest a relatively limited effect, with a 100 basis point increase reducing GDP growth by a cumulative $\frac{1}{4}$ of a percentage point over a two-year horizon. Although other estimates (including by staff, based on the Oxford Economic Forecasting model) would suggest a higher impact, there are grounds to believe in a relatively low response in view of the still limited recourse to consumer credit in France, the prevalence of fixed-rate mortgages, and banks' sluggishness in passing on changes in market rates (due, in part, to the continued importance of administered deposit rates and the prohibition of remunerated sight deposits).

11. **Regarding the euro, the authorities viewed it as significantly undervalued relative to long-term fundamentals and as thus having substantial potential for appreciation.** They attributed euro weakness mainly to the relative cyclical position of the United States and the euro area, and expressed guarded confidence that a realignment of these positions would help to strengthen the currency. More generally, they also saw a need to enhance policy coordination within the newly-named Euro Group (including with respect to structural policies) and placed this high on the EU agenda as they assumed the Council Presidency for the second semester of 2000. As to the possible impact on economic growth of a significant rise of the value of the euro, the authorities estimated that the depreciation of France's effective exchange rate since early 1999 had contributed a cumulative 0.8 percentage points to GDP growth over two years; a reversal of this depreciation was thought likely to have a symmetrical and broadly commensurate contractionary effect.

12. **A key risk beyond next year is that capacity constraints would brake growth and lead to inflationary pressures.** There was agreement that past policy reforms, and the restructuring generated by the single market and EMU, were likely to have enhanced the economy's supply response and attenuated the factors that had undermined previous recoveries fairly early in the upswing. Estimates of the natural rate of unemployment had generally been revised downward, and several interlocutors felt that the NAIRU might prove

lower still.⁸ Nevertheless, in pointing to the uncertainty surrounding the extent and import of these changes, the staff pressed for policies that would sustain the expansion and ensure its resilience by avoiding steps that would exacerbate demand pressures while strengthening the supply side through tax, expenditure, and structural reforms.

13. **Staff noted that the expected tightening of the labor market was likely to be aggravated by the policy of reducing working time (Box 2).** Two factors will tend to curtail labor supply. First, at the beginning of 2002, small firms (fewer than 20 employees) will become subject to the 35-hour law. Second, for larger firms, the limit on annual overtime will become increasingly stringent, as the basis for calculating overtime (currently 37 hours) is reduced to 35 hours. By reducing labor supply, the application of the 35-hour law will tend to exacerbate already intensifying labor market tensions just as economic slack is estimated to be largely absorbed. Moreover, this will occur as the initial wave of wage-moderating contracts signed at the outset of the 35-hour initiative are to be renegotiated. Other features of the 35-hour law will also tend to put upward pressure on wages: directly, monthly wage incomes are to be preserved, even though hours worked are to decline, raising hourly wages; indirectly, the SMIC is in part indexed to hourly wages, and so will rise mechanically.

14. **The authorities pointed to mitigating factors, but the staff felt that there was a strong case for maximum flexibility in the application of the 35-hour law.** The authorities pointed to the flexibility allowed to firms in implementing 35-hour agreements, due notably to annualization (computing the 35-hour week on average over the year) and the possibility of temporarily exceeding the overtime limit during the year. The 35-hour week policy had also opened up the dialogue between the social partners, which was expected to yield productivity gains in the form of more flexible working arrangements. Finally, reductions in social charges would compensate for the direct and indirect labor cost increases. At the same time, they recognized that small firms would find it more difficult, relative to large firms, to take advantage of more flexible work arrangements. More generally, for both large and small firms, there was still considerable uncertainty about the size of the productivity increases that might result from the 35-hour week. The staff argued that, mitigating factors notwithstanding, the risks called for relaxing the restriction on overtime hours, in order to allow flexibility in labor supply, and for foregoing discretionary increases in the SMIC.

15. **There was general agreement that the new economy has not been, and in the near term probably would not be, a major factor in easing supply constraints.** The sharp acceleration of labor productivity that has characterized recent U.S. experience has not occurred in France (Box 3).⁹ This may reflect the fact that, by U.S. standards, investment rates in high-tech equipment have been low and the diffusion of new technologies is still

⁸ See the Selected Issues paper, which estimates jointly potential output and the NAIRU, attempting to control for supply-side effects. The key result is that the NAIRU has been declining since the mid-1990s and could reach 9 percent by end-2000, raising potential output growth to about 2½ percent.

⁹ The Selected Issues paper examines new economy developments and prospects in France, in parallel to a similar paper covering Germany.

Box 2. The Implementation of the 35-Hour Work-Week

By June 2000, 33,600 agreements reducing the statutory working hours for 3.6 million employees had been signed. The bulk of these agreements were signed before 2000, under the so-called Robien and first Aubry laws, which provided financial incentives for firms that chose to “increase or preserve” jobs in exchange for reducing working hours. The second Aubry law changed the financial incentives, removed the requirement that jobs be increased or preserved (though it required that talks be held on this issue), and made the reduction of working hours mandatory for firms with more than 20 employees by 2000 and for firms with less than 20 employees by January 2002. Independent of an agreement, any firm that reports to have switched to the 35-hour week will now automatically receive an incentive aimed at partly offsetting the increase in unit labor costs due to the reduction in statutory working hours. These incentives—which can be cumulated with those accruing from agreements signed under the old laws—follow a sliding schedule, starting at F 21,000 a year for full-time minimum wage (SMIC) jobs and declining to F 4,000 a year for full-time jobs paying 1.8 SMICs or more.

Firms are using several methods to reduce statutory working hours. The annualization of working hours (that is, the 35 hours a week can be computed as an average over a year), the exclusion of more holidays from working days, and a clearer distinction between hours worked and hours spent at the workplace have contributed to limiting the reduction in actual hours worked. For example, some large firms have been able to reduce the work week by almost two hours by excluding pauses from the calculation; savings also arise from the fact that 8-hour shifts sum to less than 35 hours in a week with a holiday. In principle, judicious use of these features and of overtime could allow a firm to switch to the 35-hour week without marked changes in traditional working schedules. However, doing so can be cumbersome: overtime costs more than normal hours, and its regular use reduces the ability of the firm to respond to surges in demand. As a result, half of the firms have increased the number of days or half days of rest, and some have shortened the work day.

The counting of overtime will become increasingly stringent in 2001–2002. The basic overtime quota for full-time jobs remains at 130 hours per employee per year (where it has been for several years), but the basis for its calculations has changed. For firms with more than 20 employees, the basis will be the hours worked over and above a 37-hour week in 2000, a 36-hour week in 2001, and a 35-hour week in 2002. The same tapering will apply to firms with fewer than 20 employees from 2002 to 2004. Sectoral agreements can allow for the quota of hours worked over and above the weekly basis to be exceeded temporarily, but the annual ceiling on total hours of work—corresponding to the annualization of the 35-hour week plus 130 hours (typically, 1,600 hours plus 130 hours of overtime)—will continue to be enforced by requiring firms to give compensatory leave to bring total annual hours back to the limit.

Official statistics indicate a substantial decline in average hours of work (-1.6 percent) in the first quarter of 2000. The number of firms reporting to have switched to the new regime in the first quarter of 2000 exceeded the number of agreements recorded and government projections by a large margin. Indeed, the reported average hours of full-time jobs dropped by more in this quarter than in the whole of 1999. Given the buoyancy of the economy, hourly productivity growth, measured by these data, doubled vis-à-vis the second half of 1999 (and tripled vis-à-vis 1999 as a whole). These results may, however, be somewhat overstated. According to the annual household survey, average hours worked in the whole economy dropped by 1.3 percent from March 1999 to March 2000, while statistics based on firms’ data indicated a decline in excess of 2.5 percent. Given the uncertainty surrounding the data, it is still too early to know whether the productivity gain of 3 percent (for a reduction in working hours of 10 percent), implicit in most agreements, is effectively occurring.

limited (in France, along with much of continental Europe). There are also two country-specific factors that might be affecting the observed impact of the new economy. First, the high-tech production sector is relatively small in France, but this is the sector responsible for a large part of the productivity gains in the United States. Second, the current expansion phase of the cycle has been job rich. While this development is clearly desirable, as it signifies that more workers (many of them low-skilled) are being brought into the labor force, it temporarily depresses labor productivity growth.

C. Fiscal Policy and the 2001-2003 Stability Program

16. **The authorities' fiscal strategy is, in broad terms, to reduce the tax burden while moving gradually toward budget balance by constraining real expenditure growth within pre-announced norms.** Specifically, the government has committed, in the 2001-03 Stability Program, to reducing the tax ratio by some 2 percentage points of GDP (which would still leave the ratio of government revenue to GDP at one of the highest levels in the euro area) and to narrow the general government deficit by about 1 percentage point to 0.3 percent of GDP, by 2003. To achieve these objectives, the Stability Program sets a norm for general government real spending growth of 1.3 percent a year on average over the period.¹⁰

17. **The staff argued that somewhat more should be done on deficit reduction in the next two years, with fiscal policy geared to taking advantage of the upswing and moving more rapidly to a position of structural balance.** Despite appreciable reductions in actual deficits over the past three years, there has been little progress in structural terms. As a result, France is set to have among the highest structural deficits in the euro area in 2000. Considering both domestic and euro-area policy needs, the staff thought it desirable to aim for a general government deficit of under 1 percent of GDP in 2001 and to achieve balance in 2002; this would imply structural balance in 2002 or certainly by 2003—shortly before the initial effects of population aging are expected to be felt in 2005. In contrast, under the current Stability Program, the structural deficit would still amount to $\frac{3}{4}$ of a percent of GDP in 2003, by which time two-thirds of euro area countries are projected to be in structural balance or surplus.¹¹ Together with the planned reduction in the tax burden, the staff's slightly more ambitious deficit path would require that real expenditure growth be held to about 1 percent in each of the next two years (versus 1.3 percent envisaged in the Stability Program).

¹⁰ The fiscal data in this report, as in the 2001 preliminary budget documents, do not include the receipts from the sale of four UMTS licenses scheduled for 2001. The government has opted, in line with the opinion of the relevant regulatory authority, for a combined "beauty contest" and entry fee system. This is expected to yield F 130 billion, or about 1.3 percent of GDP, which is equivalent to some € 340 per inhabitant (compared with receipts of € 615 and € 630 per inhabitant in Germany and the United Kingdom, respectively).

¹¹ Table 4 compares the adjustment path envisaged in the Stability Program with that suggested by the staff.

Box 3. The New Economy and France

The term “new economy” has been used to describe the combination of high output growth and low inflation in the U.S. economy in the 1990s due to the widespread use of new information technologies. Recent studies have confirmed this phenomenon. Notably, Oliner and Sichel conclude that about ¾ of the acceleration in labor productivity in the second half of the 1990s is due to either the increased use of high-tech equipment (mainly computers and semiconductors), or the production of such goods.^{1/} This said, it is hard to distinguish the relative contribution of cyclical factors and the new economy to the recent high productivity growth.

In Europe, by contrast, labor productivity growth declined in the past decade. Schreyer shows that investment in several European countries has been well below that in the United States, and that (except in the United Kingdom) high-tech investment accounted for a smaller share of overall investment (at least until 1996, when his analysis ends, and even in the United States aggregate productivity effects were detected only in the mid-1990s).^{2/} Nevertheless, preliminary data from the French statistical institute (INSEE) imply that the contribution of the accumulation of computers and software to labor productivity growth increased since 1996, although it remained at only 0.14 of a percentage point—less than a one-fifth of estimates for the U.S. economy. This estimate would probably double if the analysis took account of use of communications equipment (on which data are unavailable for France). Thus, the accumulation of high-tech equipment and software, though relatively small, has contributed positively to productivity growth in France in the last few years.

In the United States, sharp increases in total factor productivity growth among computer and chip makers were an important factor behind increased aggregate labor productivity growth. However, hardware production is relatively small in France and the impact of this sector on aggregate productivity figures is thus bound to be limited. Indeed, preliminary calculations suggest that total factor productivity growth in France in the 1990s was lower than in the 1980s, although the last three years have shown significant improvements. These calculations show that the decline in labor productivity growth in France since 1996 can be explained by a sharp slowing in capital deepening outside high-tech equipment and software.

In summary, and taking into consideration anecdotal evidence on the diffusion of the Internet and of other new technologies in OECD countries, the “new economy” is at a relatively early stage in France. However, should France follow the U.S. pattern, appreciable increases in productivity would be expected to flow from further accumulation of high-tech capital and from wider adoption of new information technologies.

Labor Productivity in the Nonfarm Business Sector

(Average annual log difference within the period shown multiplied by 100)

	1974-90	1991-99	1991-95	1996-99
France	3.19	1.50	1.62	1.34
Contrib. Kcs/H ^{3/}	0.10	0.09	0.04	0.14
United States	1.43	2.06	1.61	2.67
Contrib. Kcs/H ^{3/}	0.34	0.62	0.45	0.85

Source: 1) France: INSEE and DARES. First period average refers to 1979-90; 2) US: Oliner and Sichel (2000).

1/ Oliner, Stephen and Daniel Sichel. “The Resurgence of Growth in the Late 1990s: Is Information Technology the Story?” *Journal of Economic Perspectives*, forthcoming 2000.

2/ Schreyer, Paul. “The Contribution of Information and Communication Technology to Output Growth: A Study of the G7 Countries.” STI Working Paper # 2000/2, OECD, 2000.

3/ Contribution of increasing capital deepening of computers and software (in percentage points).

18. **The authorities viewed the implied additional expenditure restraint as unrealistically tight. In this light, more rapid deficit reduction would mean sacrificing cuts in the tax burden (as measured by the tax-to-GDP ratio).** The authorities were unwilling to contemplate such a course of action, and emphasized that tax reductions were an important structural reform per se, and central to longer-run improvements in labor market performance. At the same time, they thought that higher growth could entail overperformance with respect to the Stability Program's deficit targets, and that budget balance might be achieved by 2003.

19. **There was agreement on the benefits of further strengthening the medium-term orientation of fiscal policy.** In this spirit, the authorities concurred that the legitimate desire to reduce the tax burden over time should not lead to an excessive focus on year-to-year movements in the tax-GDP ratio, which are affected by cyclical or other transitory factors. The staff noted the adverse consequences of such a focus in the debate surrounding the disposition of the tax windfall in the 2000 supplementary budget. On that occasion, tax cuts in response to strong revenue growth had generated a fiscal stimulus in the midst of already robust aggregate demand growth. The staff also raised the more general risk that tax-rate cuts in a cyclical upswing could result in an unintended and undesirable deterioration of the underlying fiscal position. Indeed, during the previous business cycle expansion, the structural deficit deteriorated by over a percentage point of GDP in 1988 and 1989, while real GDP grew by 4½ percent a year, and deteriorated by another percentage point during the subsequent slowdown in 1990–92. This episode illustrates how tax cuts based on temporary revenue surges due to a cyclical upswing can pave the way for a substantial deterioration in the underlying fiscal position. Staff noted that it would thus be helpful to have clear principles governing the disposition of windfalls, generally devoting them to deficit reduction and thereby ensuring the operation of the automatic stabilizers.

D. Medium-Term Public Expenditure Control

20. **The expenditure norms constitute the appropriate foundation of the Stability Program, but issues of practical implementation have arisen.** Staff strongly welcomed the multi-year expenditure framework of the Stability Program—the evident prerequisite for sustainable reductions in both the deficit and the tax burden. It expressed concern, however, about the practical implementation of the framework to date, with potentially adverse effects on the norms' medium-term credibility. First, there was a worrisome slippage from the norms in 1999, with real expenditure rising by 2½ percent (versus a norm of 1 percent). Second, the subsequent Stability Program allowed this base shift to become permanent by building the expenditure overrun into the medium-term path, rather than correcting it (Figure 5). Third, that Program also raised slightly the real expenditure growth norms.¹²

¹² Allowing for changes due to the shift to the SEC95 national accounts, the 2001–03 Stability Program increased real expenditure growth, cumulated over the three years of the program, by about ½ of a percentage point.

21. **Staff saw a need for a clearer, more transparent presentation of targets and outcomes at the level of both the general government and its sub-sectors, and for a greater continuity from one stability program to the next.** The authorities had recently announced steps which, the staff agreed, should help to increase budgetary transparency. As set out in the relevant staff ROSC, France has achieved a high overall level of fiscal transparency and is in broad compliance with the Fund's *Code of Good Practices on Fiscal Transparency—Declaration on Principles*. Areas for possible further improvement concern the reporting on quasi-fiscal activities and on activities that occur outside the appropriations process, and a more detailed presentation of expenditure plans combined with a process of reconciling previous plans and current budget proposals.

22. **Looking forward, achieving the expenditure control needed to deliver substantial tax reductions will require reforms in key spending areas, with health care in particular being a recurrent source of spending pressures.**¹³ The authorities contrasted the success in observing the expenditure norms at central government level and the intrinsic difficulties in controlling outlays by the health care system, which enjoys considerable autonomy. Indeed, it was noted that the scope for corrective action in this sector had been limited by constitutional objections to the application of sanctions and other control measures. The slight increase in the expenditure norms in this area in the latest Stability Program was seen as a realistic recognition of such difficulties. Nevertheless, despite some recent progress with intra-year adjustments in doctors' fees, data for the first half of 2000 suggest an appreciable overrun also vis-à-vis the new norms.

23. **The large state-run pension system remained a source of concern, particularly as the effects of population aging will begin to be felt as early as 2005.** Although the need for further pension reform had been well established by the 1999 *Charpin Report* (analyzed in Appendix II of the 1999 Staff Report), and was widely recognized during the discussions, substantive action remained to be taken. The authorities pointed to the broad reform guidelines set out by the Prime Minister in March 2000, including boosting the assets of the pension reserve fund (*Fonds de réserve pour les retraites*),¹⁴ the establishment of a monitoring body on pensions (*Conseil d'Orientation des Retraites*), and, for civil servants, the extension to 40 years (the same as in the private sector) of the minimum contribution period needed to receive a full pension. The mission welcomed these proposals (though the

¹³ The health care system is extensively analyzed in the most recent *OECD Economic Survey of France*. The study finds that the French health system delivers good-quality medical care, offering wide freedom of choice and equity of access. But it is costly—absorbing close to 10 percent of GDP, one of the highest ratios in the OECD—inter alia due to heavy consumption and prescription of drugs (encouraged by the generosity of refunds) and high spending on ambulatory care.

¹⁴ The fund is to receive surpluses from the pension program, which (along with the return on assets) are officially projected to accumulate to F 1 trillion by 2020. The authorities explained that this would be identical to reducing the government's debt position (F 1 trillion is about one-fifth of 1999 gross debt). In addition, the bulk of the proceeds from the sale of UMTS licenses is to be allocated to the pension reserve fund.

last has not been implemented), but argued that they fell well short of what would be required. While not disagreeing that comprehensive reform remained a necessity, the authorities responded that the new *Conseil* and the reserve fund should both help to ensure that the pension issue remained a priority. Regarding the latter, the staff cautioned against the risk that the relatively small reserve fund would instead be perceived as a substitute for needed reform.

24. **A promising related development was the proposed creation of new wage-based saving plans (*Plan partenarial d'épargne salariale volontaire*),** to be discussed in Parliament in the fall. These instruments, to be negotiated between firms and unions, would allow employees and firms to pay into a fund over a minimum of 10 years, after which the employee could exit by either redeeming the capital or drawing an income. The instruments would be portable between jobs and enjoy tax benefits. The staff found them a promising step as a complement to the public pension system; the authorities stressed that they were not conceived primarily in this light, but would enlarge the menu of tax-favored long-term savings instruments available to workers and could promote saving for many uses, including retirement if the saver wished.

25. **In the longer term, with public sector employment accounting for some 20-25 percent of total employment, human resource management was recognized to be key to expenditure control.** In terms of employment, government revenue, and expenditure, the French government is as large as any in the euro area, an indication of the need, and the scope, for action (Figure 6). An oft-cited promising avenue in this regard is provided by the large number of retirements projected over the coming decade, which will create scope for a policy of attrition and related budgetary savings.¹⁵ A reduction of the public service workforce was, in the staff's view, a necessary corollary of population aging, which is set to shrink the labor force and narrow the tax base. There was agreement that attrition could not be done blindly, and would need to be based on strategic choices on public employment policy. Work was underway, including within a newly-created monitoring unit (*Observatoire de l'emploi public*), and by means of benchmarking studies comparing operating costs between France and other countries.¹⁶ The authorities also pointed to pilot experiments with "management contracts" in parts of the administration as a means of establishing firm multi-

¹⁵ The *Rapport Cieutat* projected that 45 percent of the civilian employees of the central government (about 810,000 individuals) would retire by 2012.

¹⁶ One such study, the 1999 *Rapport Lépine* on tax administration, estimated the cost of tax collection at about 1½ percent of the tax yield, or about three times the cost in the U.S. and Sweden, and 50 percent more than in the United Kingdom. Though such comparisons are subject to several reservations, the scope for improvement is widely recognized. After the failure of a reform attempt aimed at merging tax collection and assessment earlier in the year, the authorities' efforts had focused on alleviating the administrative burden on taxpayers by moving toward a "one-stop" approach.

year expenditure ceilings and enhancing efficiency, through a combination of block grants and performance goals.¹⁷

E. The Tax-Benefit System: Strengthening Incentives to Employment

26. **At the time of the mission, the authorities were elaborating the tax reduction package announced in late August** (see Box 4 for details). Following the progress made over the past several years in promoting labor demand by reducing social security charges, both the staff and the authorities stressed the need to improve incentives to work and invest. The proposed cuts to income tax rates, which built on those in the 2000 supplementary budget, are therefore welcome. However, they are focused on the low end, and may have only limited impact on work incentives because households with incomes below twice the SMIC are subject to little if any income tax (typically none if they have more than one child); indeed, only about one half of households pay income tax. In this respect, the reductions in the CSG (*contribution sociale généralisée*), a broad-based tax on all incomes, at the low end may prove to be the more important reform. At the high end of the income scale, more relevant for mobile labor, the top marginal income tax rate is also to be reduced, by 1½ percentage points by 2003; after adjustment for a basic income deduction (the *abattement fiscal*), this will leave the top marginal rate broadly in line with the rate in Germany after its recent reform.¹⁸ On the investment side, it was recognized that recent corporate income tax reforms in Germany would put pressure on other EU countries, including France, to lower rates. The August package will lower the standard corporate tax rate to 33.3 percent, whereas the German reform will reduce the rate to 25 percent.¹⁹ Finally, the package (and some other decisions) also provided tax relief in response to oil price increases.

27. **Staff pointed to the need to reform benefits as well as taxes, as these interact to make work unrewarding.** Indeed, given the narrow base of the income tax, high marginal rates at the low end result essentially from the withdrawal of benefits. France has several basic income support schemes, covering some 6 million people. These are widely recognized

¹⁷ These contracts have points in common with the more extensive agreements used in the United Kingdom to establish ministries' performance goals and expenditure ceilings.

¹⁸ Income taxes at the high end and the wealth tax were felt to be driving qualified people out of the country, but the August package made no changes to the latter.

¹⁹ However, it is difficult to compare raw tax rates. For example, in Germany, the local trading tax and the solidarity surcharge bring the total tax rate on corporate income to 38 percent. In France, local business taxes (*taxe professionnelle*), which vary by locality, are also levied on corporations. Germany is also abolishing its "imputation" system, which avoids taxation of profits at both the corporate and household levels, while allowing half of dividends to escape personal income taxation. France has retained its imputation system (*avoir fiscal*).

Box 4. The 2001-03 Tax Reduction Plan^{1/}

The government announced on August 31, 2000 a 3-year tax reduction plan for the period 2001-2003, amounting to a total of about F 120 billion (1.2 percent of GDP). Together with earlier measures in the 2000 budget and supplementary budget, the total cuts over 2000-2003 amount to some F 200 billion (about 2.1 percent of GDP, compared with the German tax package of 2001-2005 plus relief offered in 1999 of about 2.2 percent of GDP). This package aims at realizing the government's commitment to reduce the tax burden by about 2 percentage points of GDP by 2003. In announcing the package, the authorities described tax reductions as a key structural reform to ensure sustainable inflation-free growth and highlighted the goal of strengthening incentives to work. The main measures of the package are as follows:

Personal income tax rates are to be reduced at all income levels, following reductions of the two lowest tax rates in the 2000 supplementary budget. The lowest marginal rate (already reduced by 1 percentage point in 2000, to 9.5 percent) will be reduced by a further 2½ percentage points, to 7 percent, by 2003. The highest marginal rate will be cut by 1½ percentage points, from 54 percent to 52.5 percent, by 2003. The budgetary cost of these measures is about F 45 billion.

In order to further increase in-work take-home pay for low-income workers already exempt from the income tax, and thus contribute to reducing unemployment traps, a **graduated rebate on the CSG** (a flat-rate levy on all incomes, earmarked for social security), as well as on the CRDS (a similar levy for the reimbursement of social security debt) will be introduced for wages up to 1.3 SMIC (affecting 7 million individuals). Workers paid at the minimum wage will thus benefit from an increase in their net wage of about 10 percent in 2003. This measure will reduce tax revenues by about F 25 billion.

The 1995 surcharge on the **corporate income tax** is to be eliminated over three years, lowering the normal statutory rate from 36.7 percent to 33.3 percent in 2003. In addition, the statutory rate is reduced in stages to 15 percent on the first F 250,000 of profits for small and medium-sized enterprises. These measures will be partly financed by changes in the rules for the taxation of dividends between subsidiaries, depreciation allowances, and imputation, leaving the overall cumulative cost at about F 20 billion.

Finally, excise taxes on domestic fuel oil will be reduced to lessen the impact of increases in crude oil prices on households' income. In addition, excises on gasoline will be adjusted to offset increases in VAT due to changes in oil prices. In the same vein, the annual tax (*vignette automobile*) on private cars is to be eliminated.

^{1/} The selected issues paper covers tax policy issues in France. A parallel paper for the German consultation analyzes tax reform in Germany.

to act in ways that lead to higher net marginal rates of tax and discourage employment.²⁰ The authorities noted various alleviating measures that had been taken (including temporary and partial in-work payment of certain benefits, the exemption of the *taxe d'habitation* for low-income families, and announced changes to housing subsidies). They were also examining the feasibility of addressing work disincentives through an earned income tax credit, along the lines of similar programs that have existed for some time in the United States and the United Kingdom, and that is scheduled to be introduced in the Netherlands next year. It was recognized, however, that a measure with some impact would likely be costly, and such a program was not included in the package announced at end-August.

28. **The discussions on the benefits system focused in particular on the workings of the main basic income support scheme, the *revenu minimum d'insertion* (RMI).** The stated aim of the scheme is to return individuals with no other sources of income to the labor force, but its record on this score has been distinctly disappointing: indeed, the number of RMI recipients rose even as the upswing was well under way (by over 7 percent in 1998-99). One source of weakness was that the original administrative requirements, including a formal commitment to seek work or training, had remained largely unenforced, with benefits being indefinitely renewed. But, above all, the effective replacement rate of the RMI, particularly when combined with other benefits (such as the single-parent allowance), remains very high (in some cases exceeding 100 percent; see Box 5). The authorities were of the view that the RMI had provided an important backstop for some who had little chance of getting a job, and were accordingly not actively considering changes to its workings.

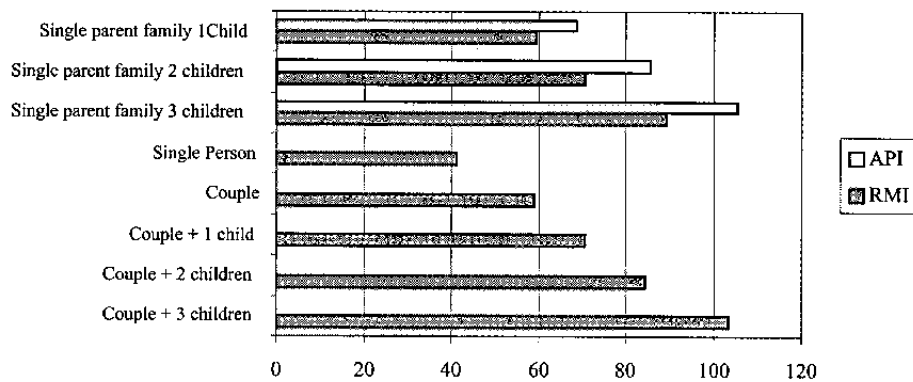
29. **In another key benefits area—the unemployment regime—the social partners have proposed substantial changes, designed *inter alia* to enhance job search and strengthen sanctions for refusing to accept work.** In June, the employers' associations and two of the five union groups agreed on reforms, the key innovation being to require beneficiaries to enter into a formal commitment to seek work or training, with benefits being terminated if a beneficiary repeatedly refused suitable employment. The staff strongly supported the "return-to-work" orientation of the agreement, while noting the importance of ensuring that the institutional support for matching beneficiaries with jobs be up to the task (questioning the capacity of the public employment agency, ANPE, in this role), and the potential practical difficulties of enforcing the conditionality of benefits. There were,

²⁰ A number of recent studies have provided empirical evidence in this regard. Laroque and Salanié (*Une décomposition du non-emploi en France*, Documents de travail, INSEE, 2000) determine that 57 percent of non-employment results from tax-benefit disincentives to work (with such "voluntary unemployment" explaining two-thirds of non-employment among married women). The same authors (*Prélèvement et transferts sociaux: une analyse descriptive des incitations financières au travail*, Économie et Statistique, 1999) document in detail the disincentive effects of the interplay of tax and transfer payments in assuming a job at SMIC pay. Bourguignon and Bureau (*L'architecture des prélèvements en France*, 1999) also show that marginal rates are very high at the lower end of the income distribution. In a similar vein, Afssa and Guillemot (INSEE Première No. 632, 1999) report that one-third of former RMI recipients who have returned to work consider that their financial situation has not improved.

Box 5. Poverty and Unemployment Traps in France

There has been growing recognition in France of the extent to which the replacement rate of some benefits for the unemployed and the loss of these benefits upon starting work adversely affect the functioning of labor markets. Despite some reductions in the last two years, the replacement rates of the RMI (*revenu minimum d'insertion*) and of the API (the allowance for lone parents with children aged three or less) vis-à-vis the minimum wage can exceed 100 percent. This ratio can be even higher when benefits and waivers that are computed differently for the unemployed are factored in.

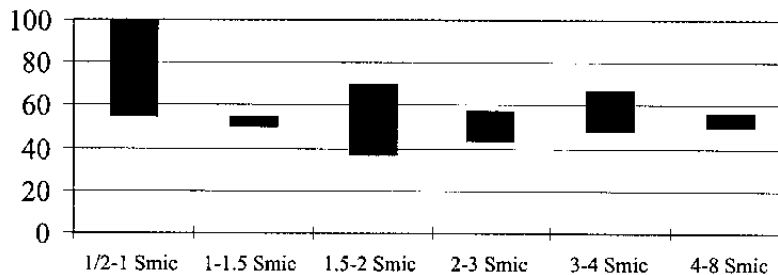
Replacement Rates of the RMI and API vis-à-vis the Net SMIC (%), 2000



Source: French Authorities

The marginal rate on wage income can exceed 100 percent for the lowest incomes, because of the withdrawal of benefits and exemptions entailed upon entering work. The tradeoff is most discouraging for people offered a part-time job. In this case, the marginal tax rate is typically 80 percent. When the loss of allowances is factored in, a part-time job paying the SMIC results in net pecuniary gains of less than US\$150 a month for about half of potential job-takers, including those not receiving the RMI.

Marginal Tax by Wage (%), 2000



Sources: Staff calculations, based on Laroque and Salanié (1999), Bourguignon and Bureau (1999-*L'architecture des prélèvements en France*); the boxes represent the marginal tax for the workers from the first to the third quartiles of the population in a given income bracket, and reflect the variety of marginal rates corresponding to the large diversity of benefits for which low-income households are eligible.

however, serious drawbacks to the proposal. As viewed by the staff, the substantial increase in the generosity of the system (easier eligibility requirements and the elimination of the tapering of benefits) would tend to blunt incentives to seek work. The authorities also had reservations about a potential “two-track” system, whereby unemployment insurance beneficiaries might receive a preferential treatment in their job search vis-à-vis other unemployed. Both the staff and the authorities were concerned about the fiscal implications of the substantial cut in contributions (mainly on the employers’ side) contained in the proposal. In July, citing some of the reasons above, the government declined to implement the regulations necessary for the reform to go ahead, and the final outcome remains uncertain.

30. **Subsidized employment programs have played an important role in recent job creation (one-fifth of the new jobs created since 1997), but staff questioned the continued role of such schemes in a cyclical upswing.** Apart from their budgetary cost, in the context of strong employment growth these programs risked competing with the private sector for labor and, although the unemployment rate was still high, it seemed likely that labor markets were robust enough to withstand a scaling back of such programs. The authorities, in contrast, felt that the programs provided an alternative to straight income support for many who otherwise had little prospect of employment. In particular, they felt that the job scheme for youth (*Nouveaux Services-Emplois Jeunes*) had proved highly successful, reducing youth unemployment appreciably and thereby boosting consumer confidence.²¹ A growing share of participants had moved into regular employment, even before their contracts had expired. The authorities noted that in many cases current employers would like to retain the jobs beyond the life of the program, but it was unclear how many would prove viable without subsidies. The mission argued that continuing subsidization ran counter to the idea of the program as a temporary boost in a recessionary situation, and incorporating the jobs into the public sector would conflict with the need to reduce the size of government.

F. Other Issues

31. **On product markets, the discussions focused on the opening of network sectors (telecommunications, gas, and electricity) to competition.** France has been relatively tardy in implementing EU directives in this area, in part because the strong ethic of public service has limited popular support for privatization and deregulation of these key sectors. For electricity, partial deregulation was legislated only in February 2000, and the state-owned utility (EDF) still enjoys a virtual monopoly, prompting EU legal proceedings. The transposition of the gas directive into law was also late relative to the August 2000 EU deadline, and mail and rail services are heavily sheltered. The authorities pointed out that steady progress was nonetheless being made (e.g., some provisions of the gas directive have been implemented and competition is clearly on the rise) and felt that political support for further reform was strengthening. In part, support for deregulation was beginning to come

²¹ This program has provided 200,000 subsidized job contracts lasting up to five years, in the public sector (mainly at the local level), as well as in quasi-public and charitable associations; the last contracts are to be offered in 2002.

from the regulated industries themselves, since in exchange for a monopoly position they had been barred from branching out into other activities.

32. **The position of the financial sector improved substantially in 1999, reflecting essentially the upswing in economic activity in France and an improving global financial situation.** Domestically, robust economic growth was reflected in large increases in fee income that offset the still slim interest rate margins. However, there was recognition that the recovery had not been used to strengthen appreciably the underlying position of the system. Already high operational costs had increased further due to investments in information technology (some of it perhaps linked to Y2K and the introduction of the euro) and to continued high personnel costs. Provisioning had declined markedly, in line with improved loan quality associated with the cyclical upswing (Table 5). In this regard, the supervisory authority noted that they had called for a system of pre-provisioning to enable banks better to cope with a crisis. Supervisors were also monitoring the growing banking commitments in highly cyclical sectors, especially commercial real estate. At the same time, the French banking system (in common with those elsewhere) is undergoing deep structural change following the advent of EMU and the rapid pace of globalization and technological change.²² Though the mission voiced concern that the importance in France of cooperative and saving banks might prove a disadvantage, the authorities argued to the contrary that these institutions had proved very active and dynamic. The mission also encouraged further deregulation of retail banking, including with respect to deposits with administered interest rates and the prohibition of interest on sight deposits.

33. **Regarding financial supervision, the authorities were of the view that current decentralized arrangements, buttressed by close cooperation, were adequate.** On the issue of supervision of conglomerates, they noted that many countries had opted for specialist supervisors rather than a unified one, reflecting a judgment that the potential gains of unified supervision—the ability to supervise an entire conglomerate and to assess effectively similar instruments sold in different lines of businesses—could equally be reaped through lead supervisor arrangements, memoranda of understanding, and other means of supervisory coordination. For supervision across the euro area, the authorities were of the view that the current decentralized approach maximized the benefits of country-specific expertise, and that current efforts were appropriately directed toward enhancing coordination among regulators and harmonizing legislation. In the latter respect, they attached particular importance to the work of the Committee of Wise Men on EU Securities Regulation, and—more generally—to imparting new impetus to the integration of EU securities and financial markets. The Fund mission assessing the financial policy component of the Code of Good Practices on Monetary and Financial Policy Transparency²³ reported that France observed all relevant standards.

²² This and other issues pertaining to the euro-area banking sector are analyzed in detail in “Euro-Area Banking at a Crossroads,” a background paper for the Article IV consultation on euro-area policies. A draft of this paper was presented and discussed in a seminar with the French authorities in the course of the consultation (in parallel with seminars at the ECB, in Germany, and in Spain).

²³ See the separate ROSC. The monetary policy component was not done as France is a member of EMU.

The mission suggested that more clarity in the responsibilities concerning the supervision of the mutual insurance firms would improve the transparency of the supervisory framework.

34. On trade policy, the authorities supported continuing liberalization, stressing the need to bring developing countries into the process. They supported another global trade round, and favored increased transparency of the WTO. They noted a shift in emphasis from border issues to such matters as the environment, product market competition, and labor standards, and saw a need for strengthened coordination between the WTO, the Fund, and the World Bank. Legislation implementing the OECD Convention on Combating Bribery was passed earlier this year. In 1999, France devoted 0.4 percent of GNP to overseas development assistance, substantially higher than the average for industrial countries, although below the United Nations target of 0.7 percent. Economic statistics for France are, from the point of view of surveillance, comprehensive and produced on a timely basis (see Appendix I).

III. STAFF APPRAISAL

35. **France's recent economic performance has been distinctly positive, supported by policy reforms over a number of years and a favorable monetary and external environment.** Output growth has been well above potential for three years running, while inflation has remained low and stable. A most welcome feature of this upswing has been the marked employment gains and, consequently, substantial declines in unemployment. While supportive monetary conditions and a favorable external environment have clearly underpinned the recovery, the groundwork for this strong performance was prepared by policies put in place over a number of years. Notably, gradual liberalization of labor market institutions and a multi-year program of cuts in social security contributions at the low end laid the foundation for the strong employment growth in the current upswing.

36. **While aggregate demand is not expected to falter significantly in the next year, supply-side constraints may begin to choke off growth thereafter.** Although inflationary pressures are not yet evident, signs of bottlenecks are beginning to emerge in certain sectors and occupations, and industrial capacity utilization has risen above historically average rates. As demand continues to grow briskly, and as labor supply is restrained by the expanding application of the 35-hour work-week, these tensions can be expected to intensify. There is the associated risk that tax cuts based on buoyant—but ultimately transitory—growth in tax revenues, if unaccompanied by durable expenditure reduction, may have to be reversed, in a repetition of the experience of a decade ago.

37. **The fiscal deficit has narrowed significantly in recent years, and further progress would ensure the health of the public finances before the pressures of population aging begin to rise.** Fiscal requirements should be seen not only in domestic terms, but also from the perspective of the euro area where, despite considerable progress on the actual deficit, France is now in the rearguard in terms of structural deficit reduction. To guard against unintended fiscal slippages in a climate of strong growth and, therefore, buoyant revenues, clear principles are needed to govern the disposition of revenue windfalls—devoting them to deficit reduction would help to ensure the operation of the automatic stabilizers. More fundamentally, efforts should be made to achieve budget balance in 2002, which would ensure structural balance by 2002 or certainly by 2003. This would

leave the public finances in a stronger position to deal with the rise in pension expenditures which is to set in as early as 2005.

38. Improving long-term economic performance depends crucially on significant reductions in France's high tax burden, and the tax reduction package for 2001-2003 is a significant step in this regard. France has the highest revenue (tax plus non-tax revenues) burden in the euro area, and in recent years it has tended to drift up. As stressed by the authorities in presenting the 2001-03 tax reduction package, raising economic performance on a durable basis will hinge in large part on successfully easing this burden. The multi-year orientation of the package is welcome, and should help to shape expectations and provide greater certainty about the future tax regime. It should also serve to avoid an excessive focus on year-to-year movements in the tax-GDP ratio, which can be hostage to transitory or cyclical factors. The package falls short, however, of being a comprehensive tax reform, and the tax regime remains overly complex, characterized by myriad exemptions and deductions.

39. The longer-term reduction in the tax burden should be firmly focused on strengthening incentives to work. A number of steps, including the plan to reduce the CSG at the low end, have moved significantly in this direction. But ensuring that work pays and alleviating employment traps at the low end remains a key policy challenge. Further efforts should deal with several areas: as a matter of first priority, benefit programs should be reformed; an earned income tax credit would help to reconcile sharper work incentives with concerns regarding income distribution; and a bolder approach to reductions in marginal income tax rates at the higher end of the schedule would provide greater incentives for entrepreneurship. More generally, it is important that tax cuts be designed to maximize the supply side impact, with the reduction in the standard VAT rate and measures alleviating the impact of rising oil prices on households' incomes running counter to this requirement.

40. Tax cuts cannot be allowed to outrun expenditure control: the use of multi-year real expenditure norms is helpful, but their implementation needs to be strengthened. The failure to correct the expenditure slippage observed in 1999, and the upward revisions in growth norms between stability programs, risk undermining the credibility of a multi-year approach. Clarifying the relationship between norms and outcomes, and ensuring continuity from one stability program to the next, would be beneficial. The authorities' intention to further enhance fiscal transparency—where France already meets the Fund's *Code of Good Practices on Fiscal Transparency—Declaration on Principles*—is welcome.

41. Effective expenditure control over the medium term will depend on reforms of the civil service and of the major transfer programs, notably pensions. The wave of retirements over the coming decade or so provides a unique opportunity to reduce the size of the large public sector, but also to restructure and improve its effectiveness. In other areas, the health-care system will continue to be a chronic source of spending pressure, which will be aggravated by population aging. And the pension system remains a weak spot, despite past reforms and an improvement in public understanding of the issue. The Prime Minister's proposals earlier this year—particularly the extension of the contribution period for civil servants—are welcome as a first step, but much more fundamental reforms should be undertaken at the earliest opportunity. These are likely to have to include a combination of measures to ensure the viability of the system, including raising the age at which pensions

can be drawn (or extending the contribution period) and developing a complementary private-sector pension pillar.

42. **There remains a need to improve the effectiveness of programs to move people from inactivity into market employment.** The basic income support scheme (the RMI) has had only limited success in this regard, and should be reoriented toward its original goal of temporary support. Implementation of the proposals by the social partners to create incentives for unemployment insurance beneficiaries to accept work or training would be welcome. On the other hand, increasing the generosity of unemployment insurance—for example by, as proposed, eliminating the taper on benefits—would blunt work incentives and should be avoided. The time has also come to reconsider the extent of subsidized employment programs, including the *emplois jeunes*. Such programs have played a role in providing on-the-job training and support, particularly when employment growth was sluggish, but could be scaled back in the current buoyant job market.

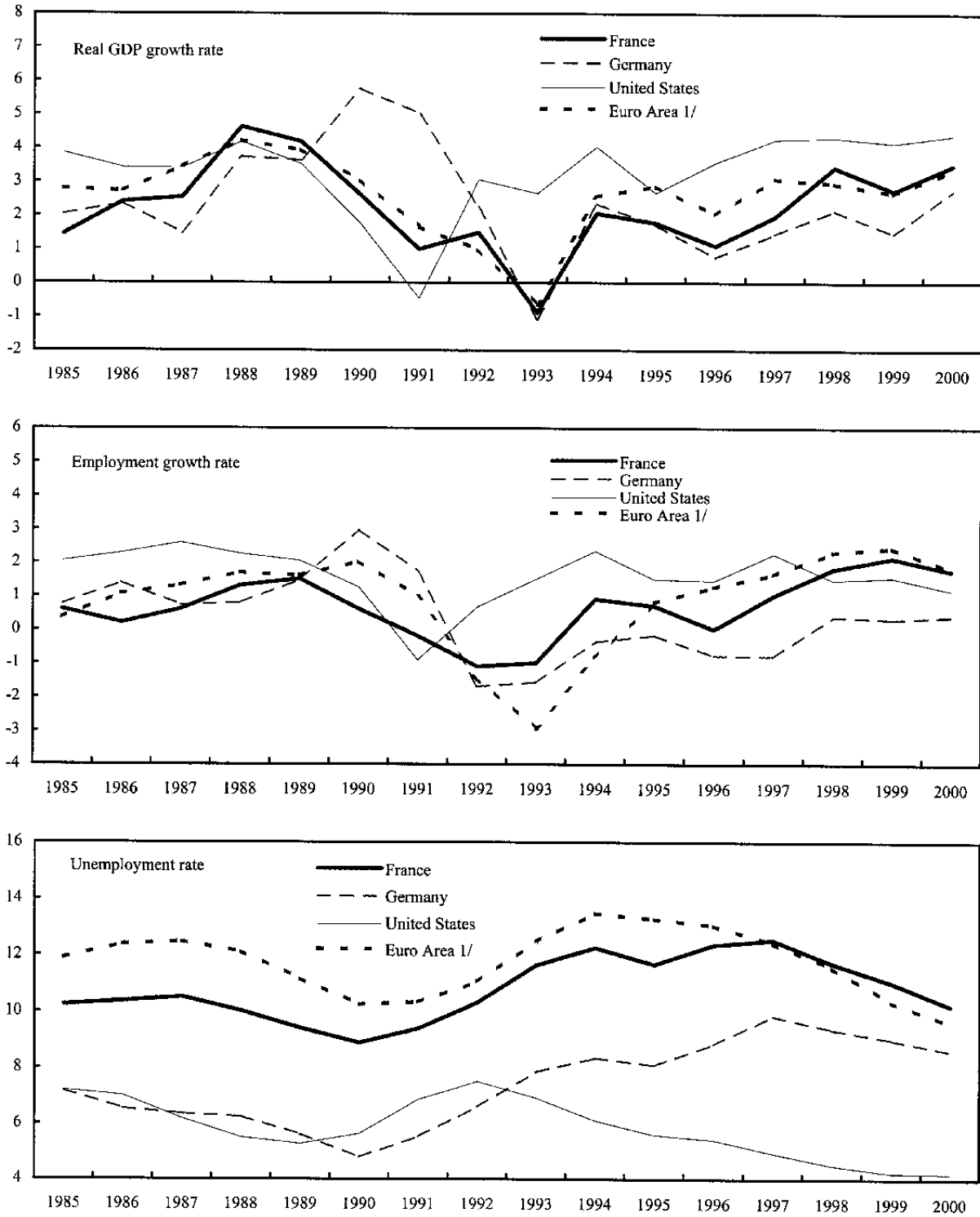
43. **The 35-hour work-week initiative has proceeded relatively smoothly to date, promoting a broader dialogue on work practices, but flexibility should be the hallmark of its implementation.** The 35-hour law was conceived and launched at a time when absorbing excess labor was the principal policy concern. In currently tightening labor markets, the risks have shifted from insufficient employment to shortages and bottlenecks. In this light, the case for relaxing restrictions on allowable annual overtime hours has become compelling. Early consideration should also be given to providing extra flexibility to smaller firms, who have much less scope to rearrange work practices to accommodate the shorter work-week. And, in order to avoid aggravating the mechanical effect of the implementation of the 35-hour week, the decision to forego a discretionary increase in the minimum wage in the most recent adjustment was judicious and should be extended into the future.

44. **In product markets, there has been notable progress in privatization, but less in opening up key network sectors.** Yet, in areas where there has been privatization and liberalization, notably telecommunications, the advantages have been immediate and substantial. If France is to fully reap the benefits of rapidly advancing technologies, greater progress will have to be made in increasing the dynamism of product markets through deregulation and further measures to promote entrepreneurial activity.

45. **The financial sector rebounded sharply in 1999, largely reflecting cyclical factors.** The increase in profitability and decline in bad loans bode well for the ability of financial institutions to underwrite economic growth and to absorb the costs of the restructuring that is flowing from the single market (including EMU) and technological change. However, to the extent that the recent improvement has been closely tied to the cyclical upswing, steps to reduce costs and continued supervisory vigilance with regard to provisioning and credit developments will be required to ensure that the sector will be in a position to weather a downturn. Structurally, it would be helpful to liberalize the retail side of the market, where some aspects—notably the large system of administered interest rates and the prohibition of interest on sight deposits—appear out of date. Because of the increasing integration of the banking sector in the euro area, consideration should be given, in the longer term, to ensuring the adequacy of euro-area wide supervision of systemically important institutions.

46. It is recommended that the next Article IV consultation take place on the twelve-month cycle.

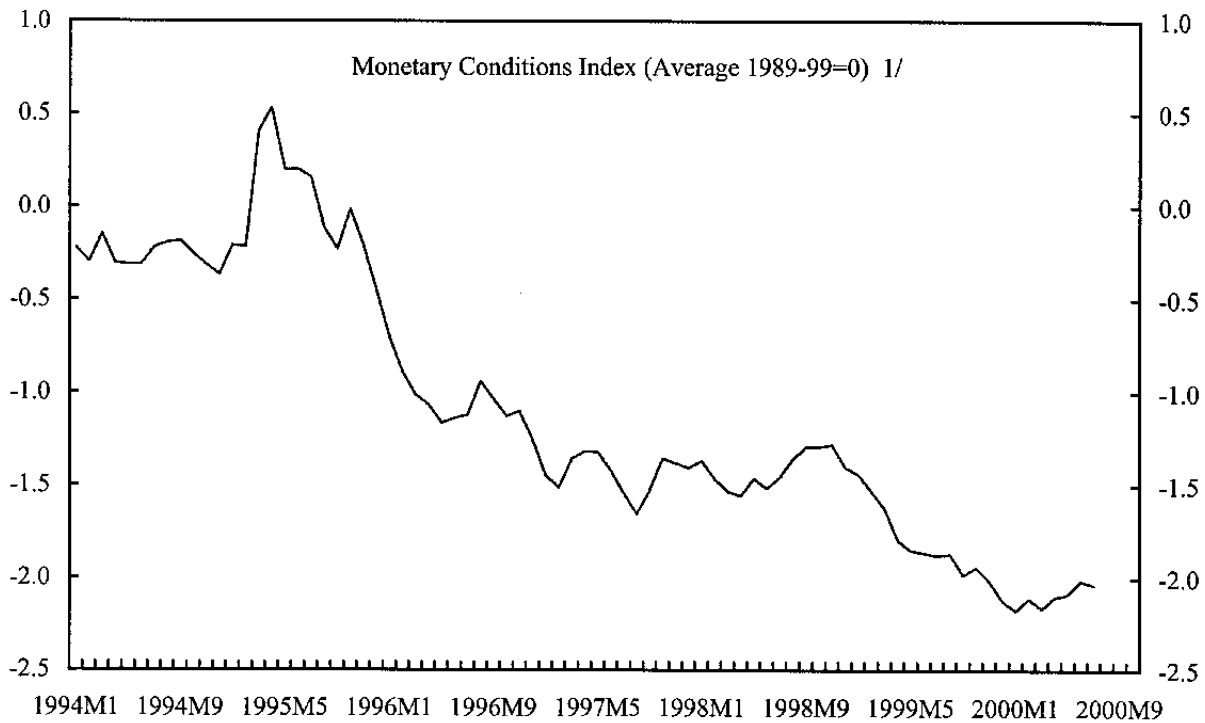
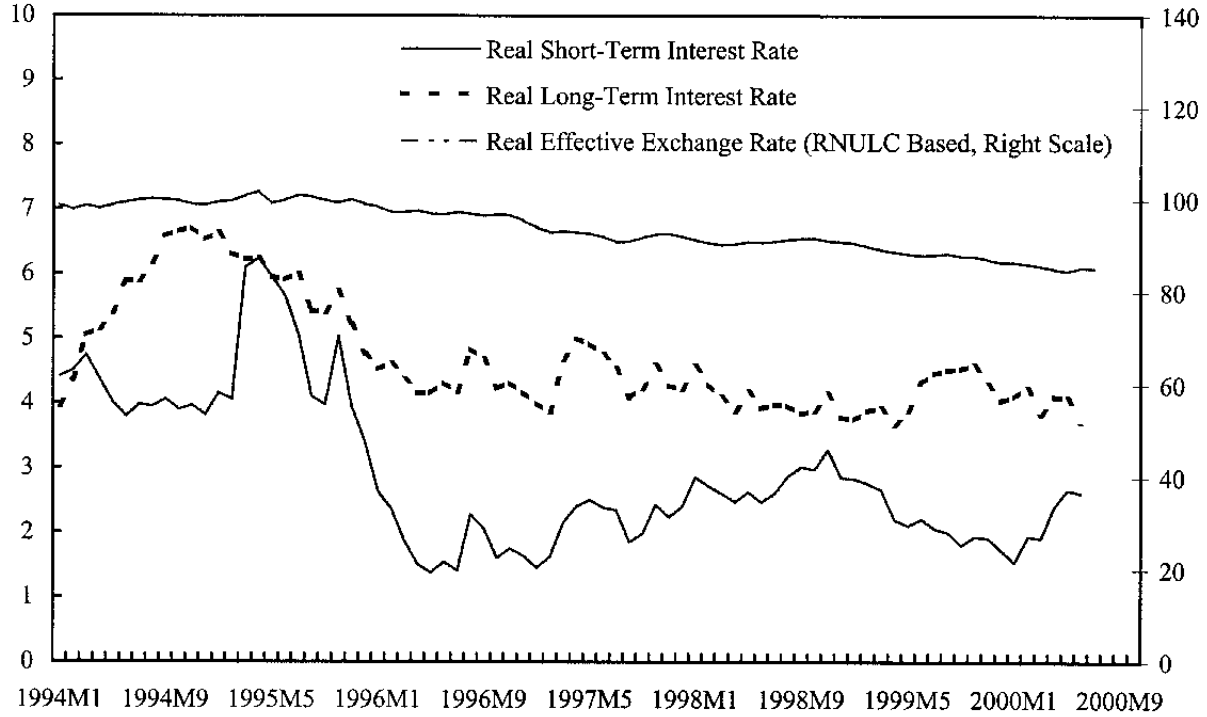
Figure 1. France: Output and Labor Market Developments



Source: IMF, WEO.

1/ Euro area countries excluding France and Germany.

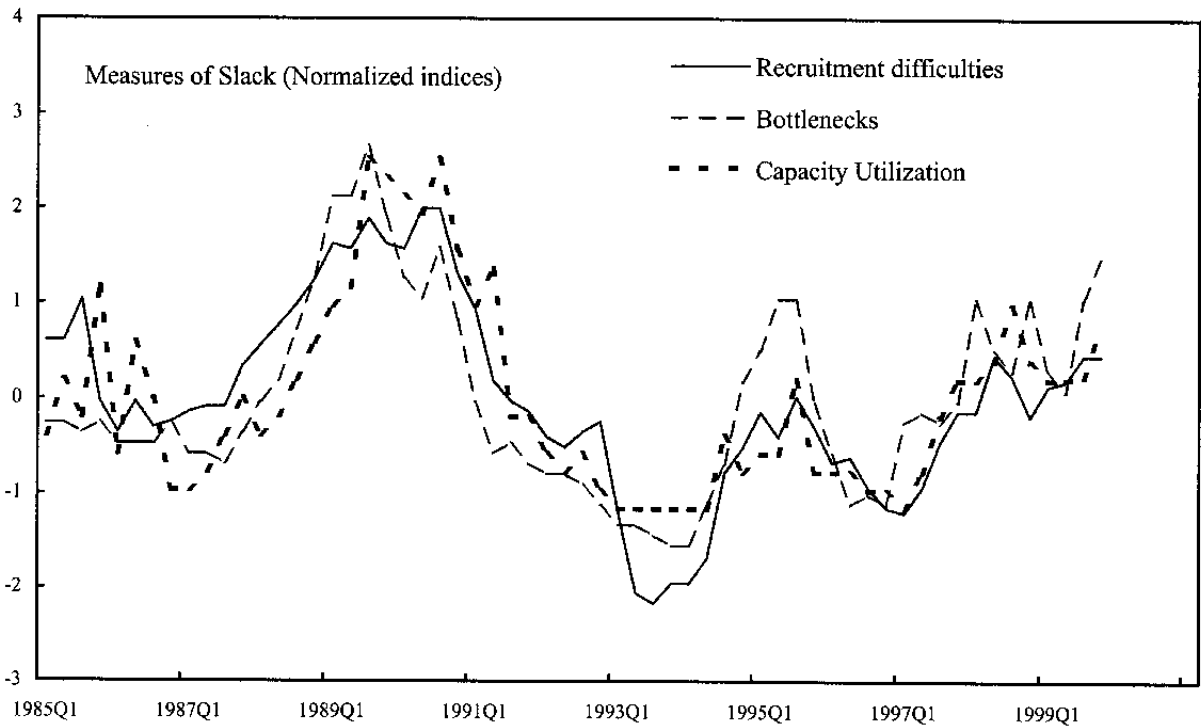
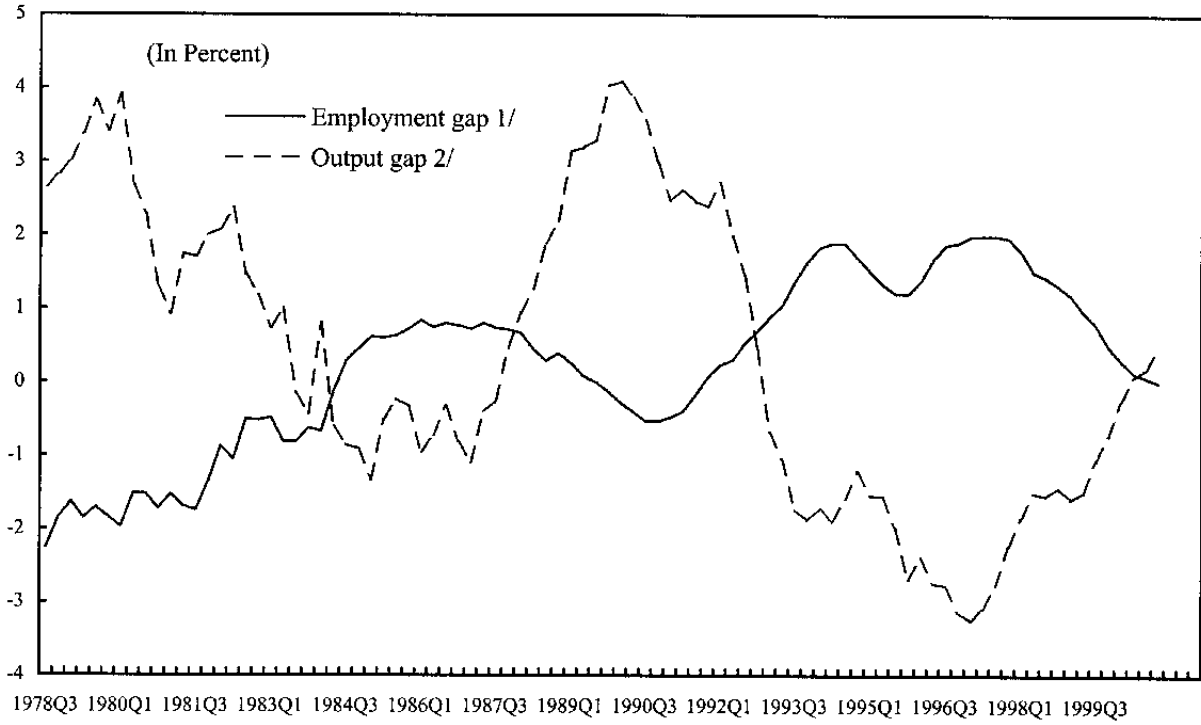
Figure 2. France: Monetary Conditions



Source: 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.

Figure 3. France: Measures of Slack

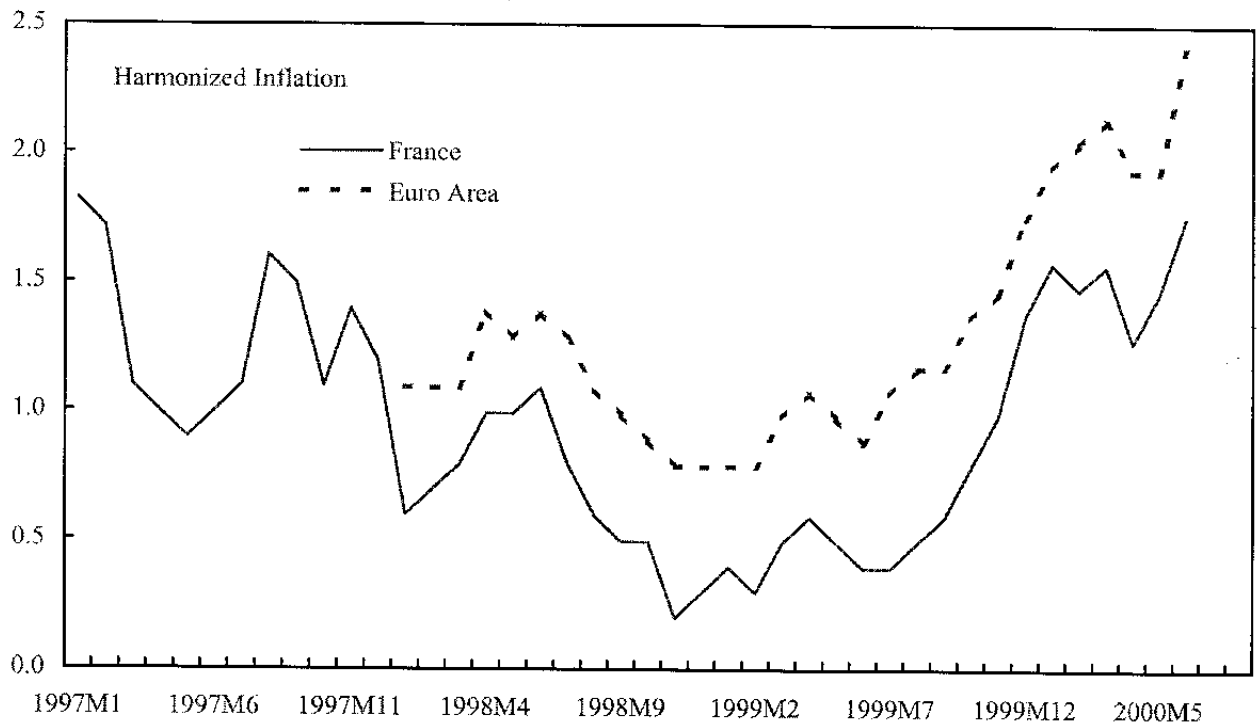
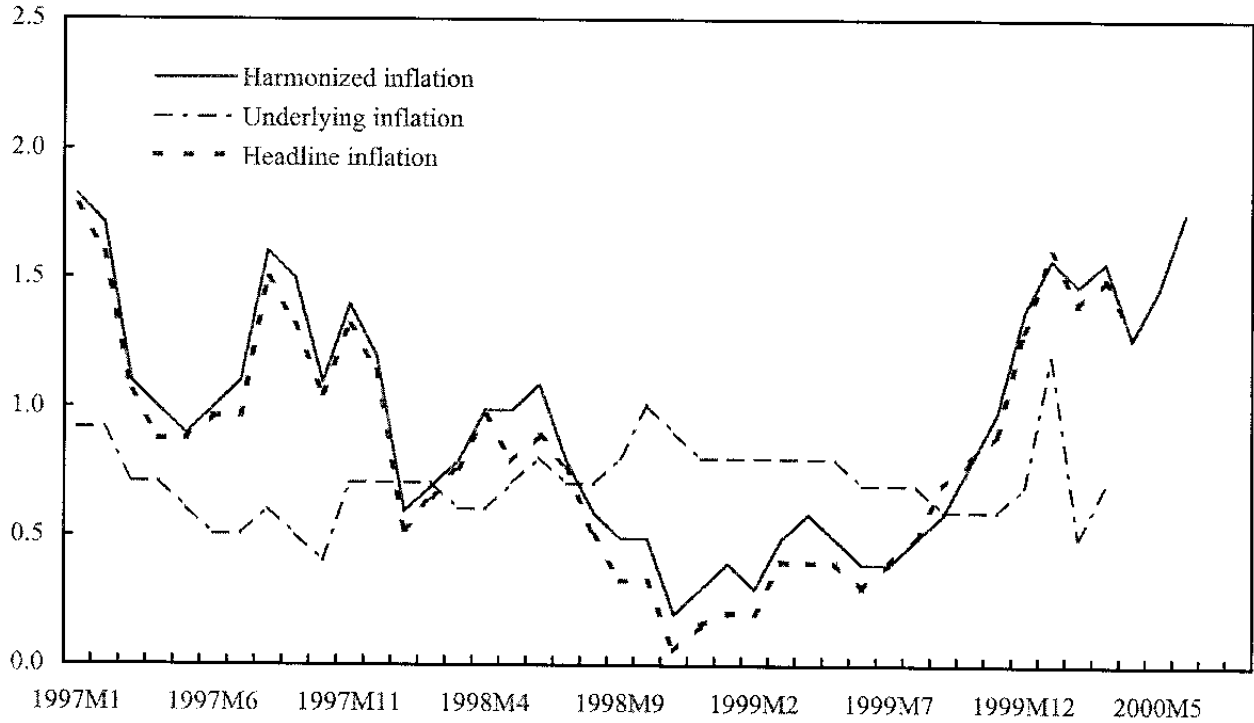


Source: INSEE and staff calculations.

1/ Defined as the unemployment rate minus the NAIRU.

2/ Defined as output in percent of potential output.

Figure 4. France: Evolution of Prices
(Twelve month rate of growth, in percent)



Sources: Eurostat, INSEE, and IMF, IFS.

**Figure 5. France: Expenditure Paths
(In Percent of GDP)**

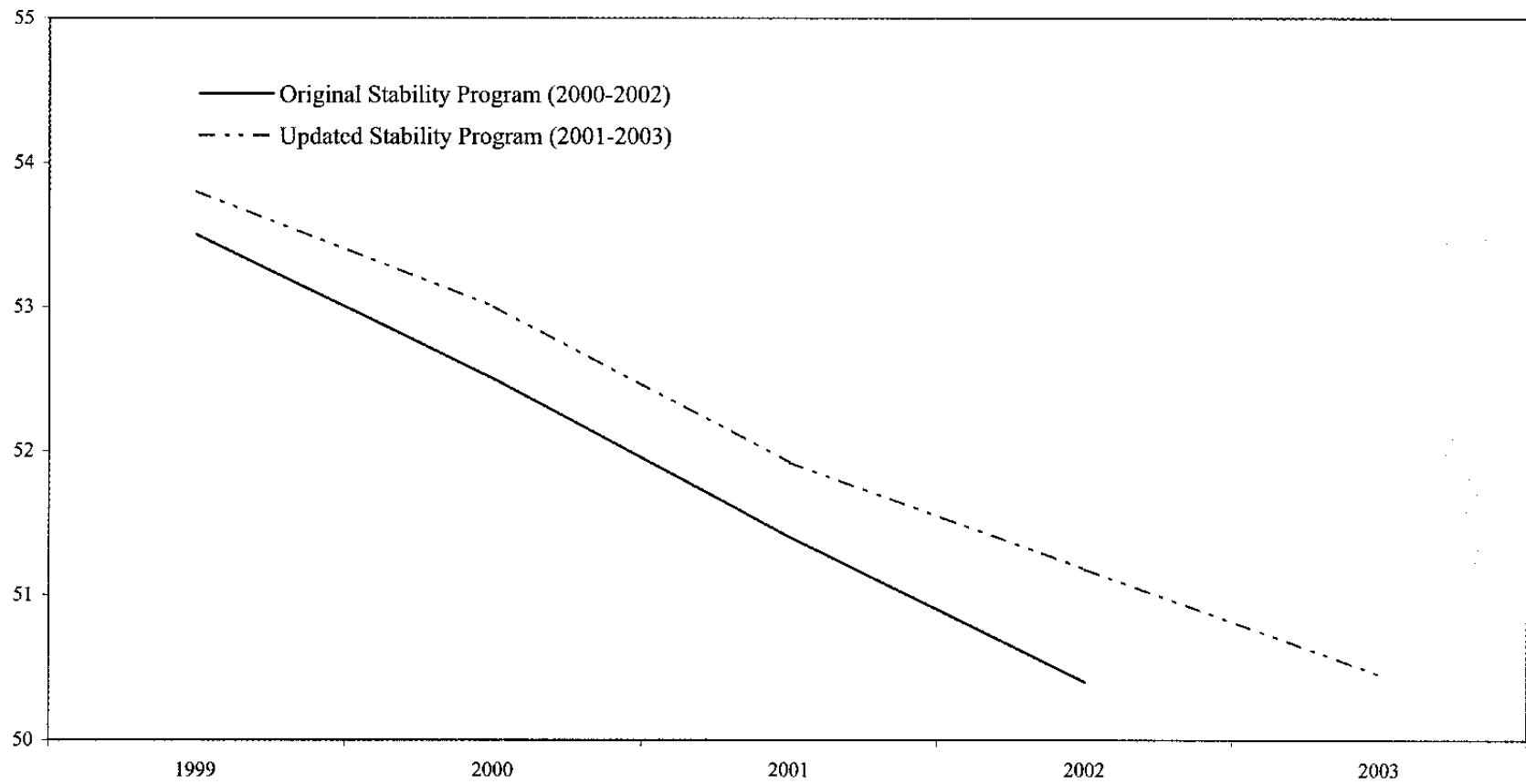
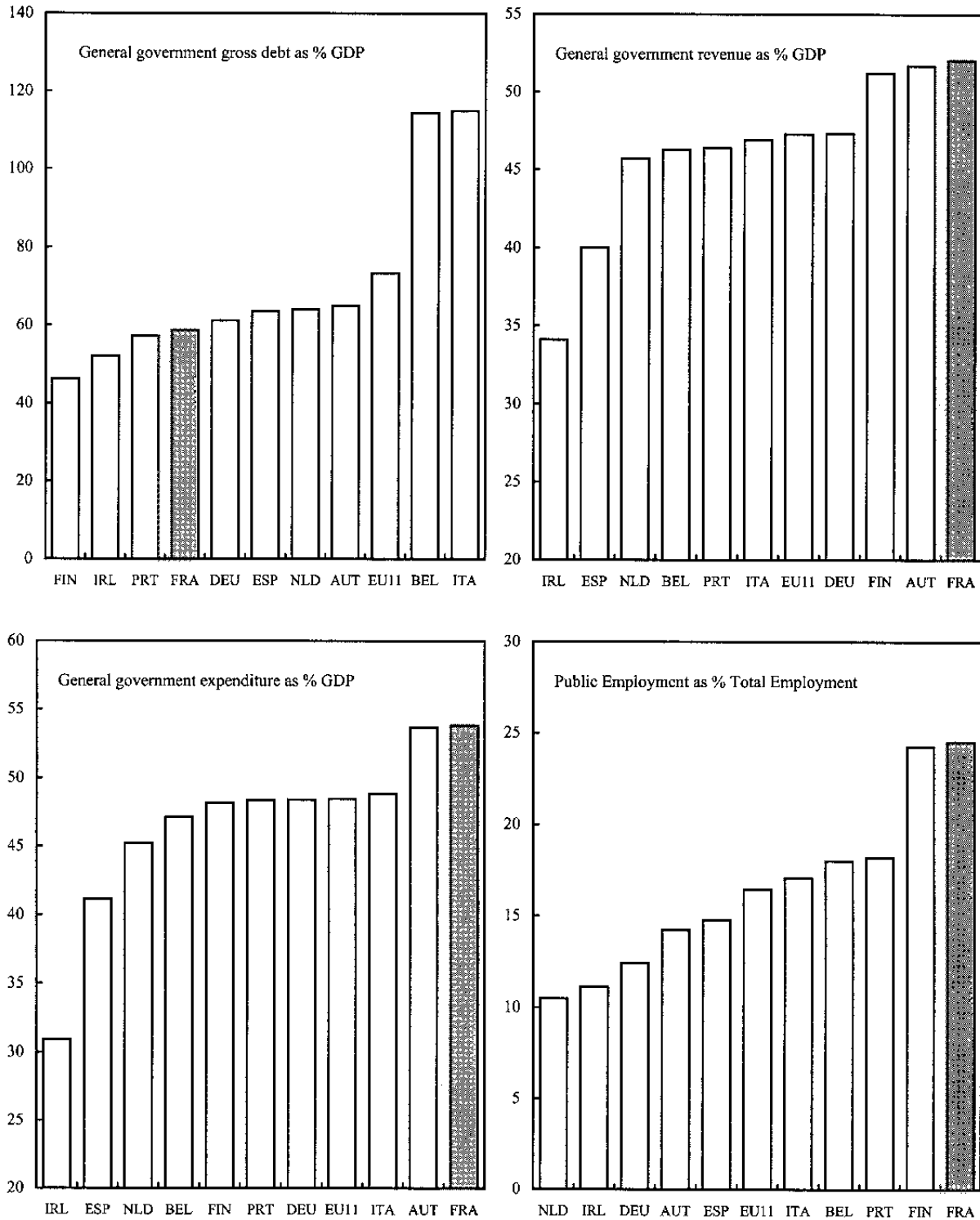


Figure 6. France: The Burden of Government in the Euro Area, 1999



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

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

	1997	1998	1999	2000	2001
Demand and supply in constant prices					
Gross domestic product	2.0	3.2	2.9	3.5	3.5
Private consumption	0.2	3.4	2.3	3.1	3.1
Public consumption	1.7	0.7	2.5	1.2	1.2
Gross fixed investment	0.5	6.1	7.3	6.6	6.7
Business investment	2.1	7.9	8.2	7.4	7.7
Residential investment	0.6	4.1	8.2	6.9	6.5
Public investment	-4.9	2.3	2.2	3.0	2.8
Stockbuilding 1/	0.2	0.5	-0.4	0.3	0.0
Total domestic demand	0.8	3.8	2.9	3.6	3.4
Foreign balance 1/	1.2	-0.5	0.1	0.0	0.2
Exports of goods and NFS	10.7	8.8	3.8	8.6	7.0
Imports of goods and NFS	6.2	12.1	3.7	9.6	6.8
Prices and credit					
GDP deflator	1.4	0.9	0.3	0.6	0.8
Consumer prices (average) 2/	1.3	0.7	0.6	1.5	1.1
Consumer prices (end of period) 3/	1.2	0.3	1.4	2.0	...
Credit to the private sector 4/	3.1	4.4	9.4	4.1	...
Bank credit to households 4/	4.8	3.7	8.3	8.6	...
Mortgages 4/	2.9	3.4	8.5	9.3	...
Bank credit to nonfinancial enterprises 4/	2.0	3.5	6.7	8.4	...
Employment and wages					
Employment	1.0	1.8	1.8	2.6	1.9
Unemployment 5/	12.5	11.7	11.3	9.8	8.8
Productivity 6/	1.0	1.4	1.1	0.9	1.6
Unit labor costs (whole economy)	0.6	0.5	0.8	1.3	0.4
Output in manufacturing	4.7	4.2	4.2	5.1	5.0
Average hourly earnings in manufacturing	3.2	2.6	2.6	3.2	2.3
Unit labor costs in manufacturing	-3.0	-1.3	-0.7	-0.3	-1.0
Personal sector					
Real disposable income 7/	1.6	2.5	2.8	3.0	3.2
Savings ratio 8/	15.4	14.6	15.0	15.0	15.1
Output gap 9/	-3.2	-2.1	-1.6	-0.6	0.4
Rate of growth of potential output	1.8	2.1	2.4	2.4	2.5
Balance of payments					
Trade balance (billions of francs)	164.3	158.3	127.2	125.4	192.9
(in percent of GDP)	2.0	1.8	1.4	1.4	2.0
Current account (billions of francs)	230.1	232.2	238.6	249.4	331.1
(in percent of GDP)	2.8	2.7	2.7	2.7	3.4
Terms of trade	0.7	1.4	-0.4
Nominal effective exchange rate 10/	96.7	97.2	95.8	93.1	...
Real effective exchange rate 10/	92.2	90.8	90.9	85.2	...
Public sector accounts 11/					
Revenue	51.9	51.3	52.1	51.4	50.8
Expenditure	55.0	54.0	53.9	52.6	51.8
General Government balance	-3.0	-2.7	-1.8	-1.2	-1.0
Central Government balance	-3.6	-3.0	-2.5	-2.3	-1.9
Social Security balance	-0.4	-0.1	0.2	0.3	0.5
Structural balance	-1.0	-1.2	-0.7	-0.8	-1.3
Primary balance	0.7	0.9	1.6	2.1	2.1
Gross debt	59.2	59.5	58.7	58.1	56.9

Sources: Bank of France; data provided by the authorities; and Fund staff estimates.

1/ Change as percentage of previous year's GDP.

2/ Harmonized CPI.

3/ For 2000, year on year in July.

4/ For 2000, year on year in June.

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 2000, data as of July.

11/ In percent of GDP. In 2001, the expected receipts from the sale of third generation mobile phone licenses, amounting to about 1.3 percent of GDP, have not been included.

Table 2. France: Sources of Employment Growth, 1997-2000
(Percent)

Share of jobs 1/	Self-employed	Non-farm business			Total	Public sector	Agriculture
		Manufacturing	Services	Other			
New jobs 2/	2.7	2.5	47.9	38.6	91.7	14.0	-5.7
All jobs (1997) 2/	7.9	14.7	17.3	27.7	67.6	28.0	4.3
	Subsidized	Nonsubsidized					
New jobs 3/	20.3	79.7					
All jobs (1997) 3/	9.5	90.5					
	Temporary work (<i>Interimaires</i>)	Fixed-term (<i>CDD</i>)	Apprenticeship	Other			
New jobs 4/	20.0	11.5	4.6	63.9			
All jobs (1997) 4/	1.5	3.8	1.0	93.7			
	Part-time	Full-time					
New jobs 4/	20.9	79.1					
All jobs (1997) 4/	16.6	83.4					

1/ If the share of new jobs exceeds the share of all jobs, the employment gains in that category were stronger than in the past. Figures in the table are staff calculations based on original source data from French authorities.

2/ INSEE - France, monthly statistics. Data refer to March of each year.

3/ Ministère de l'emploi et de la solidarité - France. Annual data: unlike the other rows, share of new jobs refer to the 1997-99 period. Subsidized jobs include all jobs receiving direct subsidies from the government. It excludes, however, jobs benefiting only from reductions in social security contributions.

4 / INSEE - France: Enquête d'emploi, an annual survey performed every March. In 1999, the survey was performed in January.

Table 3. France: Medium-Term Outlook for the Public Finances

	1997	1998	1999	2000	2000	2001	2001	2003	2003	Variation
			Outturn	Budget	Sup. Budget 1/	Prel. Budget 2/	Staff Projection 3/	SP2003	Staff Projection	1999-SP2003
(In percent of GDP)										
Expenditure	55.0	54.0	53.9	53.2	52.6	51.8	51.8	50.4	50.4	-3.5
Revenue	51.9	51.3	52.1	51.3	51.4	50.6	50.8	50.1	50.4	-2.1
Tax revenue	44.8	44.8	45.7	44.8	44.9	44.2	44.4	43.7	44.0	-1.9
Balance	-3.0	-2.7	-1.8	-1.8	-1.2	-1.2	-1.0	-0.3	0.0	-1.5
Central	-3.6	-3.0	-2.5	-2.4	-2.3	-2.1	-1.9	-1.5	-1.2	-1.0
Social security	-0.4	-0.1	0.2	0.3	0.3	0.5	0.5	1.0	1.0	-0.8
Interest payments	3.7	3.6	3.3	3.3	3.3	3.1	3.1	3.0	3.0	
Primary balance	0.7	0.9	1.6	1.5	2.1	1.9	2.1	2.7	3.0	-1.1
Structural balance	-1.0	-1.2	-0.7	-1.3	-0.8	-1.3	-1.3	-0.7	-0.7	-1.3
Gross debt	59.2	59.5	58.7	58.7	58.1	57.1	56.9	56.0	55.7	-2.7
Memorandum items										
Real rate of growth of GDP	2.0	3.4	2.9	2.8	3.5	3.0	3.5	3.0	3.0	
Real rate of growth of expenditures	0.6	1.3	2.5	0.6	0.4	1.3	1.3	1.3	1.3	
Output gap 4/	-3.2	-2.2	-1.6	-0.8	-0.6	0.2	0.4	0.7	1.1	

Source: Data provided by the authorities and staff calculations.

1/ Based on the 2000 supplementary budget and adjusted by the F 30 billion extra revenues announced in July 2000.

2/ Based on the lettres de cadrage (preliminary budget).

3/ The expected receipts from the sale of third generation mobile phone licenses, amounting to some 1.3 percent of GDP, have not been included.

4/ In percent of potential output.

Table 4. France: Deficit Reduction Scenarios

Authorities' Scenario 1/

	1999 2/	2000 3/	2001 4/	2002 5/	2003 5/	Change 1999-2003
Revenue	52.1	51.4	50.6	50.3	50.1	-2.0
Tax revenue	45.7	44.9	44.2	44.0	43.7	-2.0
Expenditure	53.9	52.6	51.8	51.0	50.4	-3.5
Balance	-1.8	-1.2	-1.2	-0.7	-0.3	-1.5
Structural balance	-0.7	-0.8	-1.3	-1.0	-0.7	0.0
GDP Growth	2.9	3.5	3.0	3.0	3.0	

Staff Adjustment Scenario 6/

	1999 2/	2000 3/	2001	2002	2003	Change 1999-2003
Revenue	52.1	51.4	50.6	50.3	50.1	-2.0
Tax revenue	45.7	44.9	44.2	44.0	43.7	-2.0
Expenditure	53.9	52.6	51.3	50.3	49.6	-4.3
Balance	-1.8	-1.2	-0.7	0.0	0.5	-2.3
Structural balance	-0.7	-0.8	-0.9	-0.3	0.0	-0.7
GDP Growth	2.9	3.5	3.5	3.0	3.0	

Sources: Data provided by the authorities, and staff calculations.

1/ In 2001-03, it assumes an average real rate of growth of expenditures of 1.3 percent per annum.

2/ Outturn.

3/ Supplementary budget, adjusted by the F 30 billion extra revenues announced in July 2000.

4/ Lettres de cadrage (preliminary budget). It does not include the expected receipts from the sale of third generation mobile phone licenses, amounting to about 1.3 percent of GDP.

5/ 2001-03 Stability Program.

6/ Assumes zero nominal deficit in 2002 and structural balance in 2003, an average real rate of growth of expenditures of 1 percent per annum in 2001-03, and follows the revenue path of the 2001-03 Stability Program. In 2001, the expected receipts from the sale of third generation mobile phone licenses, amounting to about 1.3 percent of GDP, have not been included.

Table 5. France: Vulnerability Indicators
(In percent of GDP)

	1995	1996	1997	1998	1999	2000	
						Latest Estimate	Date
External Indicators							
Exports (annual percentage change, in U.S. dollars)	18.4	0.7	0.0	6.0	-3.7	21.0	June
Imports (annual percentage change, in U.S. dollars)	18.7	0.1	-4.3	7.0	-3.7	19.1	June
Terms of trade (annual percentage change)	0.2	-0.6	0.7	1.4	-0.4		
Current account balance	0.7	1.3	2.8	2.7	2.7		
Capital and financial account balance	0.1	0.2	0.2	0.2	0.2		
<i>Of which:</i> Inward portfolio investment (debt securities etc.)	0.9	-0.5	3.2	5.2	8.8		
Inward foreign direct investment	1.7	1.5	1.6	2.1	2.7		
Other investment liabilities (net)	1.3	1.4	3.4	0.5	5.4		
Official Reserves (in billions of U.S. dollars, end-of-period)	58.5	57.2	55.9	74.2	68.0	66.6	July
Broad money to reserves ratio	18.1	18.2	16.1	12.5	14.1	15.0	May
Central bank foreign liabilities (in billions of U.S. dollars)	11.4	0.8	0.6	1.0	1.2	1.6	May
Foreign assets of the financial sector (in billions of U.S. dollars)	692.2	700.3	755.9	...	63.3	39.2	May
Foreign liabilities of the financial sector (in billions of U.S. dollars)	650.3	687.7	712.6	...	50.3	51.5	May
Total external debt	78.8	79.5	91.2	105.5	...		
<i>Of which:</i> General government debt	0.8	0.7	0.7	0.7	0.6		
External debt to exports ratio	16.8	17.3	20.5	23.3	...		
Exchange rate against U.S. dollar (period average)	5.0	5.1	5.8	5.9	6.2	7.1	August
Euros per U.S. dollar (period average)					0.9	0.9	August
Financial Markets Indicators							
Public sector debt (Maastricht definition)	54.6	57.1	59.0	59.3	58.6		
3-month T-bill yield	4.8	3.2	3.4	2.9	3.1	4.6	August
3-month T-bill yield (real)	3.0	1.1	2.2	2.3	2.5	2.9	August
Spread of 3-month T-bill with the U.S. (percentage points, end-of-period)	-0.3	-2.0	-1.9	-1.5	-2.2	-1.7	August
10-year government bond	6.6	5.7	5.3	3.9	5.5	5.5	August
Spread of 10-year bond with the U.S. (percentage points, end-of-period)	1.1	-0.7	-0.4	-0.7	-0.9	0.2	August
Corporate bond yield	6.0	6.8	6.3	5.5	7.6	7.5	August
Spread of 10-year government bond with the corporate bond	0.6	-1.1	-1.0	-1.6	-2.1	-2.2	August
Stock market index (end-of-period)	1872	2316	2999	3943	5958	6625	August
Financial Sector Risk Indicators							
Share of mortgage credit in private credit	25.2	25.4	25.6	26.1	26.9	26.6	May
Share of non-performing loans in total loans	8.1	7.8	6.8	6.3	5.6		
Net provisions as a percent of gross revenue	76.5	59.5	41.6	27.3	17.0		

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

France: Statistical Information

France's economic database is comprehensive and of generally high quality. The authorities regularly publish a full range of economic and financial data; 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) 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.

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 2000

	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 21	July 00	Sep 15	Sep 15	July 00	Sep 21	Aug 00	July 00	May 00	July 00	2000 Q2	July 00
Date Received	Sep 21	Sep 10	Sep 21	Sep 21	Sep 10	Sep 21	Sep 12	Sep 15	Aug 8	Sept 9	Sep 7	Sep 10
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.

France: Fund Relations

As of August 31, 2000

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	7,470.88	69.6
Reserve position in Fund	3,267.64	30.4
Operational budget transfers (net)	-75.00	

III. SDR Department	SDR Million	Percent of Allocation
Net cumulative allocation	1,079.87	100.0
Holdings	285.59	26.4
Designation plan	17.00	

IV. **Outstanding Purchases and Loans:** NoneV. **Financial Arrangements:** NoneVI. **Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs): NoneVII. **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).

VIII. **Article IV Consultation:**

The last article IV consultation was concluded at EBM/99/118 (10/22/99). France is on the standard 12-month consultation cycle.

INTERNATIONAL MONETARY FUND

FRANCE

**Staff Report for the 2000 Article IV Consultation
Supplementary Information**

Prepared by the European I Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Deppler and Leslie Lipschitz

October 25, 2000

1. This supplement provides information on developments since the preparation of the staff report for the 2000 Article IV consultation with France (SM/00/217). In particular, it revisits the short-term economic outlook in light of the increase in world oil prices and of newly released data on economic activity, and reports on the 2001 draft budget proposal; a revised Public Information Notice (PIN) is also attached. The new information does not alter the thrust of the staff's policy advice.

2. **Though monetary conditions remain supportive, recent economic data have been somewhat weaker than assumed in the projection in the staff report.** Despite official intervention to support the euro in late September and the 25 basis point increase in the ECB refinancing rate on October 5, monetary conditions have been broadly unchanged since earlier in the year. The staff retains the view that these conditions remain appropriately supportive of growth in France as in the euro area as a whole. National accounts data for the second quarter put quarterly real GDP growth at 0.7 percent, against a generally expected rate of about 1 percent. This outturn is primarily attributable to a deceleration in the growth of private consumption, particularly in the consumption of food items and energy products, the latter in response to rising oil prices. There is also the possibility, suggested by INSEE but difficult to confirm at this stage, that capacity constraints may be biting earlier than envisaged in the staff report. Industrial production growth slowed at mid-year, before rising again more recently, and business and consumer confidence have softened somewhat (Figure 1). The unemployment rate was 9.6 percent in August, little changed from a month earlier. Higher oil prices have raised headline consumer price inflation, which reached 2.3 percent in September; excluding energy, however, inflation has been broadly stable at about 1 percent, although it has inched up in recent months.

3. **In light of these developments, the staff has revised the growth projection for 2000 and 2001 from 3½ percent to 3¼ percent** (Table 1). Official and consensus growth forecasts are in a similar range. A factor that is likely to attenuate the domestic impact of

higher oil prices in France¹ is the extent of front-loading of the tax reduction: about two-thirds of the F 200 billion to be granted over 2000-2003, or 1.3 percent of GDP, is concentrated in 2000 and 2001. The oil price rise implies an upward revision of the forecast for consumer price inflation to 2 percent in 2000. Assuming oil prices average about \$32 a barrel in the fourth quarter of this year and then decline gradually—the same assumption made in the supplement to the euro area paper, and a 10 percent increase in prices relative to the projection in the staff report—inflation is projected at 1½ percent in 2001. This forecast hinges on continued wage moderation, which currently appears to be a tenable assumption: wage conflicts in the private sector remain rare and there is no evidence of a pickup in nominal wages. There are risks, however, as wage claims appear to be intensifying in the public sector (railways, electricity and gas, and the civil service).

4. **The 2000 general government deficit is now officially projected at 1.4 percent of GDP, with both expenditure and tax levels above those projected in the staff report.** The deficit outcome compares favorably with the initial budget target of 1.8 percent of GDP, which was predicated on appreciably lower growth. Following the April supplementary budget, and the government's commitment to devote all further revenue windfalls to deficit reduction, an even better outcome appeared feasible (underlying the deficit projection of 1.2 percent of GDP in the staff report). However, in the event, taxes on energy products were reduced and economic growth has slowed somewhat. In addition, there has been further slippage in health care spending (now projected to grow in real terms by 2.3 percent, compare to the target of 1.5 percent), an area that has in the past been a persistent source of overruns. Tax revenues are estimated to amount to 45.2 percent of GDP, a decline of 0.4 percentage points of GDP from the 1999 peak. This fall is less than projected at the time of the supplementary budget, when tax cuts of about 1 percent of GDP were expected to lead to a commensurate decline in the tax burden. All in all, the structural balance is projected to remain unchanged in 2000, at close to 1 percent of GDP.

5. **The draft 2001 budget targets a general government deficit of 1 percent of GDP, improving on the Stability Program target but estimated to entail a slight deterioration in structural terms (Table 2).**² The budget is based on a central GDP growth projection of 3.3 percent, the mid-point of an unusually wide 3.0-3.6 percent range which is reflective of current uncertainties. Tax revenues are set to decline by ½ of 1 percent of GDP, as envisaged in the multiyear tax-reduction package. Total general government expenditures are set to

¹ The increase in oil prices between the projection in the staff report and this revised projection has resulted in a transfer of about 0.1 percent of GDP from France to oil exporters.

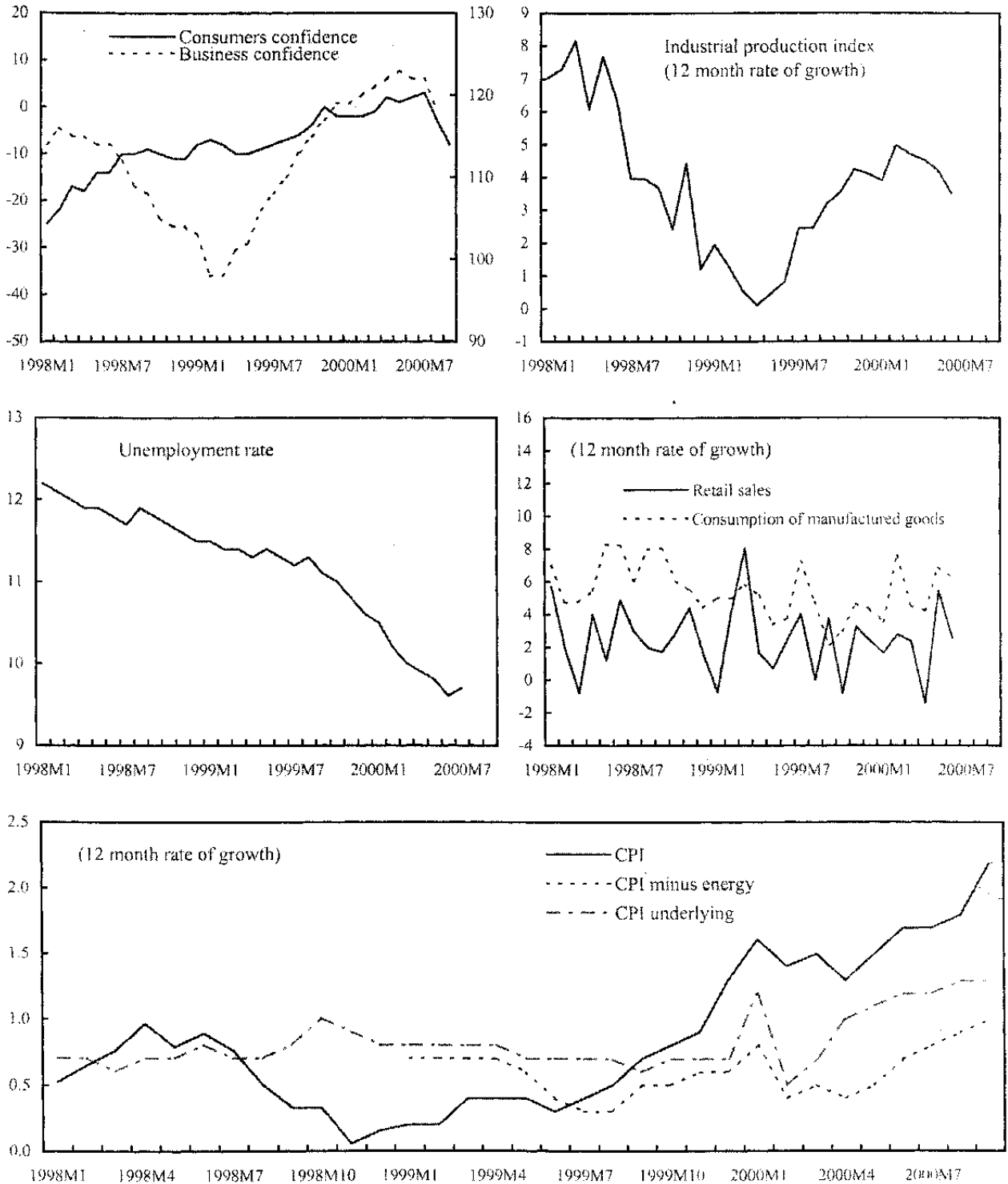
² The deficit target excludes Universal Mobile Telephone Systems (UMTS) license receipts, expected to amount on a cash basis to F 32.5 billion in 2001 (0.3 percent of GDP; on the Eurostat methodology, which attributes the entire stream of proceeds to the year of the sale, these receipts amount to 1.1 percent of GDP in 2001). Of the cash revenues, F 18.5 billion are to be allocated to the pension reserve fund, and the remainder directly to debt reduction.

increase in line with the Stability Program's norm (1.3 percent in real terms). Pensions are to be raised by more than inflation for the first time since the 1993 reform: the increase will match both the unexpected rise in 2000 inflation and projected 2001 inflation, with an additional amount for low pensions. The main risks on the expenditure side stem from the public sector wage bill and, again, health care spending. There are pressures both for civil service wage increases and for the absorption into the public sector of young workers currently employed under the *Emplois Jeunes* program. Also, 11,000 workers are to have their contract status upgraded to become civil servants. As to health care spending, the draft budget recognizes the control difficulties by allowing for a real increase of 2.3 percent, putting at risk the achievement of the Stability Program's target of a cumulative real increase of 4.5 percent in the three years to 2003. All in all, the deficit target for 2001 implies a deterioration in the structural balance of about $\frac{1}{4}$ of 1 percent of GDP.

6. In sum, since the issuance of the staff report:

- **The near-term macroeconomic outlook has softened somewhat, but growth is expected to remain above estimated potential and core inflation to remain contained—subject to continued wage moderation.** If wages begin to accelerate, however, stagflationary risks would be appreciably stronger. Indications that higher headline inflation, driven by oil prices, is intensifying wage demands in certain (essentially public) sectors, as well as the possible emergence of supply side bottlenecks, require policy attention. Government firmness in the face of public sector wage claims and flexibility in the implementation of the 35-hour work week will both be key to keeping the expansion on track.
- **The estimated fiscal outcome for 2000, and that budgeted for 2001, mark welcome improvements with respect to original targets, but structural deficit reduction remains elusive.** Indeed, the estimated structural deficit for 2001 (slightly over 1 percent of GDP) would be the largest since EMU participation in 1999, despite strong growth in the intervening period. Achieving the staff recommendation of fiscal balance in 2002 and structural balance in 2003 will therefore require an intensified effort, but remains within reach under the current growth scenario.

Figure 1. France: High Frequency Indicators



Source: INSEE.

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

	1997	1998	1999	2000 Proj.	2001 Proj.
Demand and supply in constant prices					
Gross domestic product	1.9	3.2	2.9	3.3	3.3
Private consumption	0.2	3.4	2.3	2.4	2.6
Public consumption	2.1	0.2	2.5	1.4	1.4
Gross fixed investment	0.5	6.1	7.2	6.6	6.6
Business investment	2.1	7.9	8.2	7.1	7.6
Residential investment	0.6	4.1	8.2	6.7	6.0
Public investment	-4.9	2.3	2.2	4.2	3.4
Stockbuilding 1/	0.1	0.7	-0.4	0.1	0.0
Total domestic demand	0.8	3.8	2.9	3.1	3.2
Foreign balance 1/	1.3	-0.6	0.1	0.3	0.2
Exports of goods and NFS	11.8	7.7	3.8	12.6	7.5
Imports of goods and NFS	6.9	11.4	3.8	12.8	7.4
Prices and credit					
GDP deflator	1.3	0.7	0.4	0.8	0.9
Consumer prices (average) 2/	1.3	0.7	0.6	1.9	1.6
Consumer prices (end of period) 3/	1.2	0.3	1.4	2.3	...
Credit to the private sector 4/	3.1	4.4	9.4	4.1	...
Bank credit to households 4/	4.8	3.7	3.3	3.7	...
Mortgages 4/	2.9	3.4	8.5	9.3	...
Bank credit to nonfinancial enterprises	2.0	3.5	6.7	10.1	...
Employment and wages					
Employment	1.0	1.8	2.1	2.3	1.9
Unemployment 5/	12.5	11.4	11.3	9.8	8.8
Productivity 6/	0.9	1.4	0.7	1.0	1.4
Unit labor costs (whole economy)	0.6	0.5	1.1	1.3	0.6
Output in manufacturing	4.7	4.2	4.2	4.9	4.8
Average hourly earnings in manufacturing	3.2	2.6	2.6	3.2	2.3
Unit labor costs in manufacturing	-3.0	-1.3	-0.3	-0.4	-0.8
Personal sector					
Real disposable income 7/	1.7	2.7	3.0	2.6	2.6
Savings ratio 8/	15.4	14.8	15.4	15.5	15.5
Output gap 9/	-3.2	-2.1	-1.6	-0.7	0.0
Rate of growth of potential output	1.7	2.1	2.4	2.4	2.5
Balance of payments					
Trade balance (billions of francs)	164.3	157.4	120.2	48.7	89.9
(in percent of GDP)	2.0	1.8	1.4	0.5	0.9
Current account (billions of francs)	230.1	231.3	225.9	212.6	270.5
(in percent of GDP)	2.8	2.7	2.6	2.3	2.8
Terms of trade	0.5	1.7	-0.7	-4.2	...
Nominal effective exchange rate 10/	96.7	97.2	95.8	93.1	...
Real effective exchange rate 10/	92.2	90.8	90.9	85.2	...
Public sector accounts 11/					
Revenue	51.9	51.3	52.1	51.6	51.1
Expenditure	55.0	54.0	53.9	53.0	52.2
General Government balance	-3.0	-2.7	-1.8	-1.4	-1.0
Central Government balance	-3.6	-3.0	-2.5	-2.3	-1.9
Social Security balance	-0.4	-0.1	0.2	0.4	0.5
Structural balance	-1.1	-1.3	-0.9	-0.9	-1.1
Primary balance	0.7	0.9	1.6	1.9	2.2
Gross debt	59.3	59.7	58.9	58.1	56.9

Sources: Bank of France; data provided by the authorities; and Fund staff estimates.

1/ Change as percentage of previous year's GDP.

2/ Harmonized CPI.

3/ For 2000, year on year in September.

4/ For 2000, year on year in June.

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 2000, data as of July.

11/ In percent of GDP.

Table 2. France: Medium-Term Outlook for the Public Finances

	1997	1998	1999 Outturn	2000 Projection 1/	2001 Budget 2/	2003 SP2003	2003 Staff Projection	Variation 1999-SP2003
(In percent of GDP)								
Expenditure	55.0	54.0	53.9	53.0	52.1	50.4	50.7	-3.5
Revenue	51.9	51.3	52.1	51.6	51.1	50.1	50.4	-2.0
Tax revenue	44.9	44.9	45.7	45.2	44.7	43.7	44.0	-2.0
Balance	-3.0	-2.7	-1.8	-1.4	-1.0	-0.3	-0.3	-1.5
State	-3.6	-3.0	-2.5	-2.3	-2.0	-1.5	-1.2	-1.0
Social security	-0.4	-0.1	0.2	0.4	0.5	1.0	1.0	-0.8
Interest payments	3.7	3.6	3.4	3.3	3.1	3.0	3.0	
Primary balance	0.7	0.9	1.6	1.9	2.1	2.7	2.7	-1.2
Structural balance	-1.1	-1.3	-0.9	-0.9	-1.1	-0.8	-0.8	-0.1
Gross debt	59.3	59.7	58.9	58.4	57.2	57.2	55.7	-1.7
(In percent)								
Memorandum items								
Real rate of growth of GDP	2.0	3.4	2.9	3.3	3.3	3.0	3.0	
Real rate of growth of expenditures	1.0	1.3	2.4	0.4	1.3	1.3	1.3	
Output gap 3/	-3.2	-2.1	-1.6	-0.7	0.1	0.8	0.8	

Source: Data provided by the authorities and staff calculations.

1/ Based on the projections in the 2001 budget.

2/ Receipts from the sale of third generation mobile phone licenses, amounting to about 1.1 percent of GDP, have not been included in the calculations.

3/ In percent of potential output.



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IMF Concludes Article IV Consultation with France

On October 27, 2000, the Executive Board concluded the Article IV consultation with France.¹

Background

Real GDP growth has been almost 3 percent on average since 1997, and the staff projects growth of 3¼ percent for 2000 and 2001. This momentum reflects the buoyancy of private consumption and investment, which have been sustained by supportive monetary conditions and high levels of household and business confidence. External demand has also contributed to the recent growth performance, owing to an improved external environment, the depreciation of the euro since its introduction, and competitive unit labor costs. In addition, several years of gradual but significant structural reform have improved labor market performance. However, growth was lower than expected in the second quarter of the year and more recently confidence indicators have declined somewhat, reflecting in part the rise in world oil prices.

A particularly positive feature of the current cyclical expansion has been the rapid pace of job creation. Employment has risen by a total of about one million since mid-1997 and by a record 450,000 jobs in 1999 alone. As a result, the unemployment rate declined from a peak of 12½ percent in 1997 to around 9½ percent in September 2000. New jobs were overwhelmingly concentrated in the services sector, with temporary employment and fixed-term contracts playing a prominent role. Even though an appreciable number of these jobs—one-fifth since 1997—were government subsidized, the employment performance also stems from the targeted reduction of social security contributions and labor market reforms carried out over a number of years.

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. In this PIN, the main features of the Board's discussion are described.

Cost and inflation pressures have been muted despite diminishing margins of slack: capacity utilization rates, bottlenecks, and recruitment difficulties have all risen appreciably, although they remain below the levels of the previous cyclical peak. Wage settlements have been moderate, in part due to restraint as a counterpart to the reduction of working time (the 35-hour work-week initiative) introduced at the beginning of 2000. Although core inflation has been broadly stable at about 1 percent, rising oil prices have increased headline inflation to 2.3 percent in September, which has in turn intensified calls for further wage increases, particularly in the public sector.

On the fiscal front, the deficit in 1999 was 1.8 percent of GDP, compared with the target of 2.2 percent of GDP. Most of the overperformance was due to higher-than-expected collection of corporate taxes. For 2000, the general government deficit is expected to be 1.4 percent of GDP, taking into account revenue windfalls announced at mid-year as well as tax reductions on energy products and renewed slippages on health care outlays. At the end of August, the government announced a package of tax reductions amounting to about 1¼ percent of GDP, to be implemented over the 2001-03 period. The most important from a macroeconomic and structural perspective are reductions in all income tax brackets, rebates at the low end for the *contribution sociale généralisée* (a tax on all incomes to finance social security), and reductions in the corporate income tax. The draft 2001 budget, presented at end-September, targets a deficit of 1 percent of GDP, a reduction in the tax-GDP ratio and, consistent with the current Stability Program, real expenditure growth of 1.3 percent.

Reports on the Observance of Standards and Codes (ROSC) have been concluded regarding the Code of Good Practices on Fiscal Transparency and the financial component of the Code of Good Practices on Transparency in Monetary and Financial Policies.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities on the recent performance of the economy, which has been characterized by a continuation of strong growth in output and employment amidst low and stable inflation. Directors welcomed in particular the vigorous employment performance and the related rapid fall in unemployment. While pointing to the downside risks for the short run represented by the rise in oil prices and some indications of a softening of demand, they generally shared the view that the upswing would continue into 2001. The resilience of the recovery in a possibly less favorable external environment would, Directors noted, depend importantly on continued wage moderation and on the implementation of measures to invigorate the supply side of the economy.

In this regard, Directors commended the authorities for policies that have enhanced the employment response of the economy—particularly by reducing labor costs for the low-skilled—and that have thus helped to underpin the recovery. To support lasting growth, attenuate the inflationary risks inherent in a sustained expansion, and prepare for the demographic pressures that will begin to be felt as early as 2005, Directors urged the authorities to press ahead with product and labor market reforms, and to further consolidate the fiscal position. A few Directors pointed to the importance of building social consensus for reform efforts to be successful, which could require a more gradual approach to the implementation of reforms and fiscal consolidation.

Directors noted the continued narrowing of the general government deficit in recent years, while calling for further progress to ensure the soundness of the public finances before the pressures of

population aging set in. In particular, pointing to the slow improvement in the cyclically-adjusted deficit despite strong growth in recent years, most Directors called for a stepped-up effort with respect to the deficit reduction path envisaged in the 2001–2003 Stability Program. They viewed the strengthening of the deficit target in the 2001 budget proposal as a step in this direction, and a number of Directors felt that—on present growth projections—achievement of budget balance by 2002 is both a feasible and a desirable objective.

Directors agreed that improving long-term economic performance will depend critically on significant reductions in the high tax burden. They accordingly welcomed the authorities' emphasis on this objective and the announcement of a multi-year tax reduction package for 2001-2003.

Welcoming the reduction in the overall tax burden, Directors emphasized the importance that tax cuts be designed to maximize their supply-side impact. They commended the fact that several recent and announced measures had been explicitly designed to strengthen incentives to work, and urged that this be a continued policy priority. Besides tax reduction, several Directors also pointed to the need for simplification and streamlining of an overly complex tax system.

At the same time—given the importance of continued deficit reduction—Directors stressed that tax cuts should not be allowed to outrun expenditure control. The long-term health of the public finances was seen to depend squarely on durable expenditure control. The use of multi-year real expenditure growth norms was thus viewed as useful, but it will be important—for the credibility and effectiveness of this approach—that implementation be strengthened, adherence improved, upward revisions to the norms avoided, and continuity between one stability program and the next ensured.

Directors underscored that effective expenditure control over the medium term will depend on reforms in health care, the civil service, and pensions. In particular, they noted that health care outlays continue to be a worrying source of budgetary overruns, and that such pressures will be aggravated by population aging. Regarding the civil service, Directors saw the wave of retirements over the coming decade as providing scope for selectively streamlining the public administration without undermining its high quality. They noted that the outlook for the pension system remains of concern. While some steps to reform the system have been taken or proposed, Directors stressed that more fundamental measures will be needed to ensure the viability of the system. These should include increases in the retirement age (or extensions in the contribution period) and the development of a complementary private sector pension pillar.

Directors noted the need to reform benefits as well as taxes, since the major disincentives to work at the low end of the income scale result primarily from the withdrawal of benefits, rather than from high income taxation. They recommended that basic income support schemes, such as the RMI, be reoriented toward providing temporary support while encouraging a return to work. In this regard, Directors strongly supported the "return-to-work" elements of the unemployment insurance reform proposed by the social partners, although they warned against those aspects of the proposal that risk instead blunting work incentives and increasing financing costs. Some Directors also considered that the extensive subsidized employment programs should be reconsidered in light of the buoyant job market.

Directors noted that the 35-hour work-week initiative has proceeded relatively smoothly to date, and welcomed the broader dialogue on work organization it has promoted. Given the tightening labor market, however, they urged that implementation be flexible. In particular, in order not to curtail labor supply further, many Directors saw a pressing case for relaxing restrictions on allowable annual overtime hours. Further, these Directors also argued that additional flexibility should be provided to smaller firms, which have much less scope to rearrange work practices to accommodate the shorter work week.

Directors welcomed the notable progress in privatization, but saw further scope in the opening up of key network sectors. Regarding the financial sector, they cautioned that its current strong position owes much to the cyclical recovery of the economy as a whole. Directors therefore stressed the importance of cost reduction by banks and continued vigilance by supervisors with regard to provisioning and credit developments, in order to ensure that the sector will be in a strong position to weather an eventual downturn. Several Directors also saw scope for a further liberalization of the financial system, with regard in particular to the continued presence of administered interest rates and the prohibition of interest on sight deposits.

Directors welcomed the work on France's observance of the Fund's Codes of Good Practices. They expressed satisfaction about the positive findings of the reports on compliance with the *Code of Good Practices on Fiscal Transparency—Declaration on Principles*, and on the financial policy component of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. Directors encouraged the authorities to give careful consideration to the reports' main recommendations.

Directors welcomed France's comparatively high level of development assistance. They also noted the generally high quality, comprehensiveness, and timeliness of its economic statistics.

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

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. As part of a pilot project, the staff report for the 2000 Article IV consultation with France is also available.

France: Selected Economic Indicators

	1996	1997	1998	1999	2000 1/
Real economy (change in percent)					
Real GDP	1.5	2.3	3.4	2.9	3.3
Domestic demand	0.9	0.8	3.8	2.9	3.1
CPI (year average)	2.1	1.3	0.7	0.6	1.9
Unemployment rate (in percent)	12.4	12.5	11.7	11.3	9.8
Gross national saving (percent of GDP)	18.7	19.7	19.9	21.5	22.1
Gross capital formation (percent of GDP)	17.4	17.1	17.2	18.8	19.0
Public finance (percent of GDP)					
Central government balance	-3.7	-3.6	-3.0	-2.5	-2.3
General government balance	-4.1	-3.0	-2.7	-1.8	-1.4
Public debt	57.1	59.3	59.7	58.9	58.1
Money and interest rates					
M3 (end of year, percent change) 2/	-3.5	1.6	4.3	7.3	4.6
Money market rate (in percent) 3/	3.8	3.3	3.4	2.9	4.3
Government bond yield (in percent) 3/	6.3	5.6	4.7	4.7	5.5
Balance of payments (in percent of GDP)					
Trade balance (percent of GDP)	1.0	2.0	1.8	1.4	0.5
Current account (percent of GDP)	1.3	2.8	2.7	2.7	2.3
Official reserves (US\$ billion) 4/	26.8	30.9	44.3	39.7	39.6
Exchange rates					
Exchange rate regime		Member of euro area 5/			
Nominal effective exchange rate (1995= 100) 6/	99.9	96.7	97.2	95.6	93.1
Real effective exchange rate (1995 = 100) 6/ 7/	96.6	92.3	90.8	90.9	85.2

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

1/ Staff projections, unless otherwise noted.

2/ June 2000.

3/ July 2000.

4/ Excluding gold, as of June 2000; from 1999, euros system definition.

5/ 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 2002, when euro banknotes and coins will be issued.

6/ July 2000.

7/ Based on relative normalized unit labor costs in manufacturing.