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France: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with France, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 30, 2003,** with the officials of France on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 12, 2003 .** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **October 3, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 8, 2003 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

FRANCE

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the 2003 Article IV Consultation with France

Approved by Michael Deppler and Leslie Lipschitz

September 12, 2003

The discussions took place in Paris during June 19–30, 2003. The team—Messrs. Leipold (Head), Everaert, Estevão, Nadal De Simone (EU1), Fonteyne (MFD), and Mottu (MED)—met with Mr. Mer, Minister of the Economy, Finance, and Industry, and Mr. Lambert, Minister of the Budget, and their staff; Governor Trichet and officials of the Banque de France; Mr. Poncelet, president of the Senate; Mr. Delevoye, Minister of Public Administration; economic advisors to the Prime Minister; the presidents of the finance commissions of the National Assembly and the Senate; officials of the Ministries of Health and Social Affairs, Labor, and Solidarity, the national statistics institute, the Banking Commission, the securities and insurance supervisors; as well as market participants, academics, and representatives of labor unions. Well attended seminars were held on drafts of the staff's Selected Issues Papers. Mr. Duquesne (Executive Director) or Mr. Boitreaud (Alternate Executive Director) attended the meetings.

France is an Article VIII member and, apart from certain security restrictions, maintains an exchange system free of restrictions (Appendix I).

France subscribes to the Fund's Special Data Dissemination Standard and comprehensive economic data are available on a timely basis (Appendix II).

Contents

Page

Executive Summary 3

I. Overview 4

II. Policy Discussions 4
- A. Economic Performance and Near-Term Outlook 5
- B. Fiscal Consolidation Strategy 11
- C. Labor and Product Markets 16
- D. Financial Sector 20
- E. Other Issues 21

III. Staff Appraisal 23

Figures
1. GDP and Demand Components 5
2. Household Savings and Unemployment Expectations 5
3. Household Consumption and Disposable Income 6
4. Investment, Enterprise Margins and Tobin's Q 6
5. Unemployment Rates Normalized by their Recent Trough 7
6. Sectoral Employment 7
7. Business Indicators 8
8. Consumer Indicators 8
9. Real Effective Exchange Rate 9
10. Inflation Components 9
11. Monetary Conditions 10
12. General Government Balance 11
13. General Government Debt 11
14. Public Health Care Spending 15

Tables
1. Main Economic Indicators 26
2. General Government Accounts 1995–2002 27
3. General Government Real Expenditure Growth 28
4. Vulnerability Indicators 1999–2003 29

Text Boxes
1. Fiscal Sustainability and Pension Reform 13
2. Tax Policy and Economic Efficiency 17
3. Do Active Labor Market Policies Increase Employment? 19
4. Administrative Intervention in Financial Markets 22

Appendices

I. Fund Relations 30

II. Statistical Information 32

Executive Summary

Prospects for a near-term recovery are tentative and dependent on global conditions while over the long term population aging will lower potential growth and challenge fiscal sustainability. Pension reform has made major inroads on the latter, but fiscal consolidation needs to resume, with sustained adjustment over the medium term based on credible expenditure restraint, while structural reforms are needed to increase growth potential, especially by raising labor utilization.

The French economy has been no exception to the prolonged global slowdown and economic recovery has remained elusive, though there are now tentative prospects of an uptick. With the impact of adverse shocks waning and external demand conditions, business indicators, and equity markets improving, a gradual recovery is expected, though there remain downside risks from the external environment and, domestically, from the unemployment outlook and corporate balance sheet adjustment. Staff projects GDP to grow by 2 percent in 2004, after 0.5 percent in 2003.

The authorities agreed that monetary policy and the full operation of automatic fiscal stabilizers should deal with cyclical requirements, while already envisaged modest tax cuts should proceed as planned, accompanied by strict expenditure control. The budget deficit is set to rise to 4 percent of GDP in 2003. Administrative interest rates have been lowered to enhance the effectiveness of monetary policy, but are not fully in line with market rates.

Attaining long-term fiscal sustainability will require that the recently enacted pension reform be accompanied by the achievement of a small structural surplus within about five years and structural reforms that deliver an appreciable increase in potential growth. Following the milestone pension reform, the authorities declared their intention to resume fiscal consolidation at a moderate pace of about ½ of one percentage point of GDP per year as from 2004. The staff recommends that this approach be pursued through expenditure reduction until a small structural surplus is reached (excluding the costs of aging). Health care and civil service reform and decentralization offer scope for expenditure reduction. The expenditure control framework needs to be strengthened and extended to cover social security. A reduction in the high tax burden would be helpful for growth, if accompanied by credible expenditure cuts, while the staff also advocates a revenue-neutral tax reform to remove distortions.

Labor and product market reforms are needed to deliver higher medium-term growth. With low employment rates providing scope to improve labor utilization rates, staff welcomes the shift in policies toward tempering the rise in labor costs and promoting private sector employment and recommends stepping up labor market reforms while being mindful of the budgetary cost. Product market functioning is being improved but network liberalization and divestiture should be pursued more resolutely. Financial markets are holding up well to the downturn while supervision and governance are being strengthened, but ***administrative interventions in financial markets should be phased out.*** Staff urges ***more ambitious agricultural and trade reforms while welcoming a high level of ODA.***

I. Overview

1. **The French economy has been no exception to the prolonged global slowdown and, despite tentative signs of a prospective upturn, the near and medium-term outlooks remain uncertain.** The economy's initial resilience to the downturn based on the strength of private consumption—supported by employment growth and fiscal easing—has been eroded as growth slowed progressively during 2002 and the economy flirted with recession through mid-2003. Investment underperformed and consumer confidence weakened when layoffs materialized and geopolitical uncertainties rose. With the latter uncertainties receding and the global outlook improving, an economic recovery is now expected in late 2003 but it is likely to be gradual and remains subject to downside risk. Over the medium term, population aging will reduce potential growth and associated expenditure increases will challenge fiscal sustainability. Low activity rates and an onerous tax and administrative burden remain fundamental structural weaknesses.

2. **On the policy front, the resumption of fiscal consolidation was put on hold in 2003 owing to the weak state of the economy, but key structural issues began to be addressed.** Expenditure slippages and the operation of automatic stabilizers have boosted the deficit to a level that has triggered a rise in the public debt-to-GDP ratio. On the other hand, the recent pension reform represents a milestone toward longer-term fiscal sustainability, and reform of the health care system—an important source of spending pressure—has been placed high on the agenda. In other structural areas, gradual progress is being made, in the labor market mostly by reversing some earlier detrimental measures, while divestiture and liberalization of network industries have advanced somewhat haltingly.

3. **Over the past several years, implementation of Fund recommendations has been lacking not so much in intention as in pace and timing owing to political economy considerations and a strong social preference for publicly-provided services.** The Fund has long stressed the need to strengthen public finances through pension, civil service, and health care reform, while reducing the heavy tax burden and raising low activity rates. Following considerable progress in the run-up to EMU, fiscal consolidation was reversed in 2000–03 owing to tax cuts—induced by a misjudgment on the strength of structural revenues during the cyclical upswing and electoral considerations—and, lately, to widespread expenditure overruns. Meanwhile, the advocated structural reforms remained largely on the drawing board, with the government favoring gradualism. More recently, however, the success of the pension reform, despite extensive social protest, is a decisive move in the opposite direction, buttressing the political will to reform but—the discussions suggested—not necessarily providing an impetus to accelerate its pace.

II. Policy Discussions

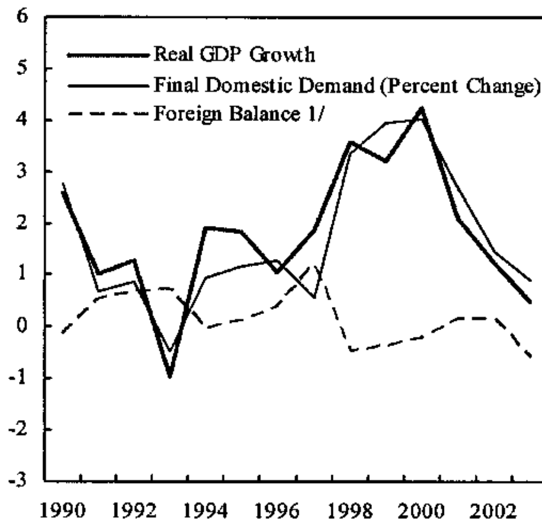
4. **The discussions focused on how to foster a durable economic recovery while tackling long-standing threats to fiscal sustainability.** To promote the recovery, the authorities favored a fiscal strategy consisting of tax cuts and a neutral underlying fiscal stance in 2003, shifting in 2004 to moderate underlying adjustment through expenditure

restraint. Meanwhile, they were embarking on long-term oriented reforms to deal with the consequences of population aging. The staff pressed the need to resume fiscal consolidation as a necessary complement to such reforms; tackle health expenditure overruns; lift administrative interventions in financial markets; and provide impetus to product market and trade reforms.

A. Economic Performance and Near-Term Outlook

5. **Economic recovery has remained elusive and the economy's initial resilience has recently given way to a brush with recession** (Figure 1 and Table 1). There was agreement that the downswing mostly reflected global developments, including the bursting of the equity bubble, that had led to a sharp decline in exports and a morose outlook for investment, reflecting also overinvestment by some large French firms during the boom. Consumer demand had held up well, bolstered by supportive policy conditions, including tax cuts and the operation of fiscal stabilizers, as well as initial labor hoarding by enterprises. However, with geopolitical uncertainties rising at the beginning of 2003 and pressures mounting on firms to reduce employment, household savings—already on a secular rise owing to demographics—had increased further (Figure 2). As in the past, household consumption has

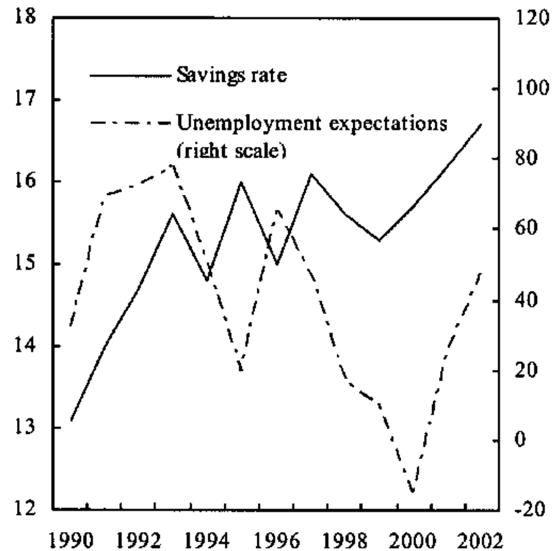
Figure 1. GDP and Demand Components



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

1/ Contribution to GDP growth.

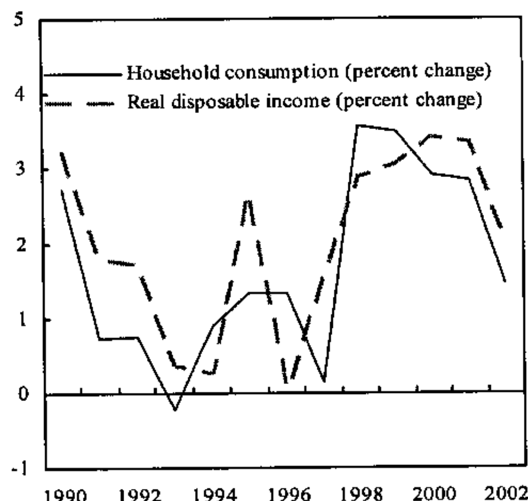
Figure 2. Household Savings and Unemployment Expectations



Source: INSEE.

continued to be well explained by developments in disposable income and the employment outlook (Figure 3), with only a marginal role for wealth effects, as equities represent only a small part of household financial wealth and mortgage refinancing to take advantage of higher house prices is limited.

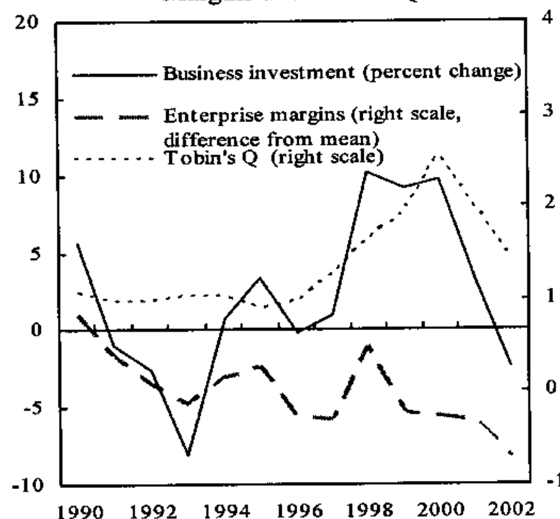
Figure 3. Household Consumption and Disposable Income



Source: INSEE, National Accounts.

6. **Fixed investment has been weaker than could be expected from the state of its traditional driving forces**. Indeed, the authorities noted, the decline in 2002—the first since 1996—was stronger than could be explained by changes in demand, profitability, and Tobin's Q (Figure 4). It is likely that the fall in equity valuations exerted an exceptional drag on investment and worsened financing conditions, as evidenced by the initial sharp rise in risk premia for borrowing by large enterprises. There was consensus that, with the exception of some large corporate groups that had participated in debt-financed acquisitions abroad in the late 1990s, corporate accounts had held up quite well to the slowdown both compared to the previous downturn and internationally. Companies not belonging to large groups had lower indebtedness than in the early 1990s, lower interest rates made for easier debt service and, unlike in previous downturns, there had thus far not been any marked increase in bankruptcies or nonperforming loans. Nevertheless, the situation of some troubled large companies had heightened—in the authorities' view excessively so—the focus on debt reduction and deleveraging, adversely affecting investment decisions of other companies through direct linkages and indirect confidence effects. This could explain why positive investment intentions had not translated into an equivalent rise in investment in early 2003. The information technology and communications cycle also contributed. The associated weakness in bank credit to enterprises was seen as mostly demand-driven.

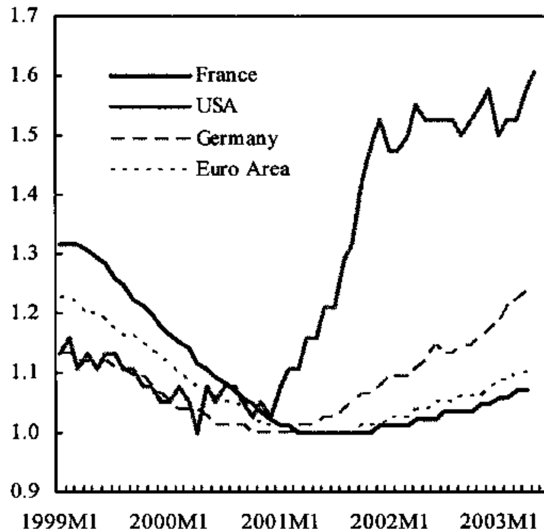
Figure 4. Investment, Enterprise Margins and Tobin's Q



Source: Data provided by the authorities.

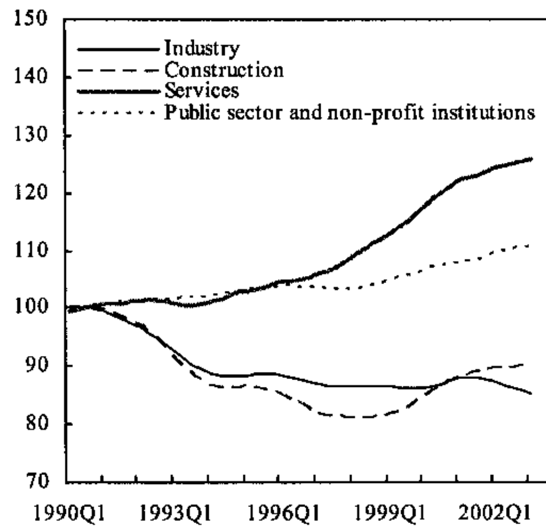
7. **Employment expanded for longer than expected and unemployment rose by less than in the previous comparable downturn and in some other major industrial countries** (Figure 5). The wage moderation of the 1990s has led to a higher labor content of each unit of output produced, a development that was accentuated by the ongoing structural shift in production from industry to services—with the latter typically exhibiting a lower capital-labor ratio (Figure 6). In these circumstances, output has to grow by less to keep unemployment from rising. Nonetheless, once output falls—as in the last quarter of 2002 and again more recently—employment losses would be larger, likely exacerbated by the currently higher share of temporary work. The step increase in the unemployment rate in late 2002 is consistent with this interpretation.

Figure 5. Unemployment Rates Normalized by Their Recent Trough



Source: Cronos Database.

Figure 6. Sectoral Employment (1990=100)

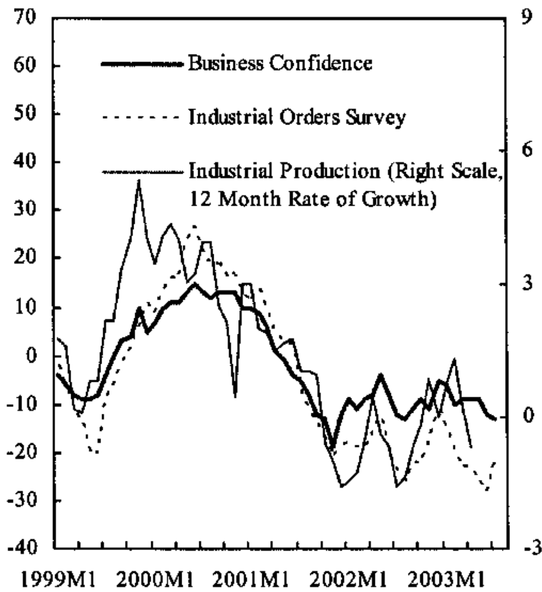


Source: INSEE, Quarterly National Accounts.

8. **At the time of the mission, the shared view was that a gradual recovery was likely to take hold in the second half of the year, though there was as yet little hard evidence of an upturn**. It was noted that the repeated failure of projected recoveries to materialize—while weakening the credibility of forecasts—should not swing the pendulum toward excess pessimism. The impact of adverse shocks was waning, policies had been generally supportive, and a large correction in the investment rate had taken place. With external demand improving, investment would be rekindled, supporting employment and, in turn, private consumption. On the other hand, following euro appreciation, the foreign

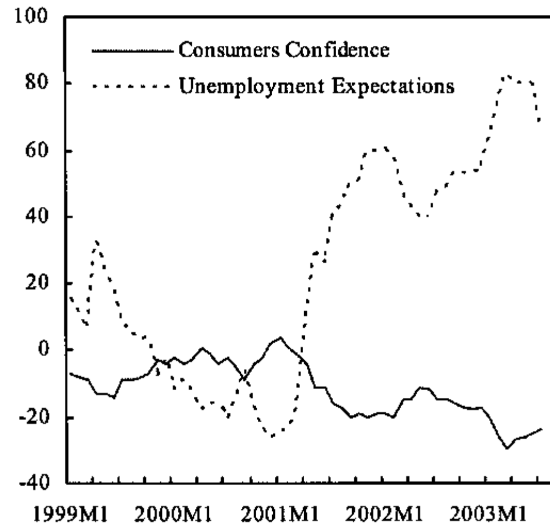
contribution would turn negative. There was, however, little actual sign of recovery as short-term indicators had failed to rebound following the end of the Iraqi war (Figures 7 and 8), and strikes against pension reform weighed on second quarter activity. While new official forecasts would not be released until the fall, the authorities accepted that GDP growth in 2003 could be in line with staff's projection of 0.8 percent at the time of the mission, but were somewhat more optimistic than the staff's projection of about 2 percent for 2004.

Figure 7. Business Indicators
(Dispersion Index)



Source: WEFA Database.

Figure 8. Consumer Indicators
(Dispersion Index)

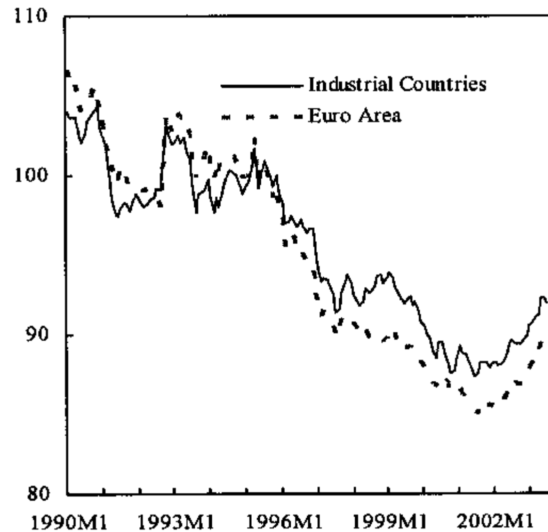


Source: WEFA Database.

9. **Developments since the mission point to weaker average growth for the year, but otherwise support the scenario of a gradual, mostly externally driven recovery, with downside risks.** Strikes and a mild spring led to a decline in activity and energy production in the second quarter, while the expected associated technical rebound in the third quarter is likely to be mitigated by a drought which is adversely impacting agriculture and by labor action affecting tourism. Consequently, staff now projects real GDP to grow by only 0.5 percent in 2003. On the other hand, the recovery in the U.S. and Asia, the improvement in equity markets, relatively strong household balance-sheets, and the stabilization of the euro are reassuring factors. The euro's appreciation was seen as a move toward equilibrium

(Figure 9), which had not compromised competitiveness unduly, though it would dampen tourism revenues somewhat and add to the risk of weaker-than-expected intra euro-area demand. The loss of competitiveness vis-à-vis Germany was seen to be in line with the relative performance of the two economies and would contribute to a decline in the foreign balance. In this context, the authorities expressed concern that further weakness in Germany could jeopardize the expected recovery. Domestically, the household savings rate could increase further if the employment outlook remained gloomy, or in reaction to pension reform that could be perceived as wealth-reducing by the current generation, while investment could remain weak if corporate balance sheet adjustment continued to be judged incomplete.

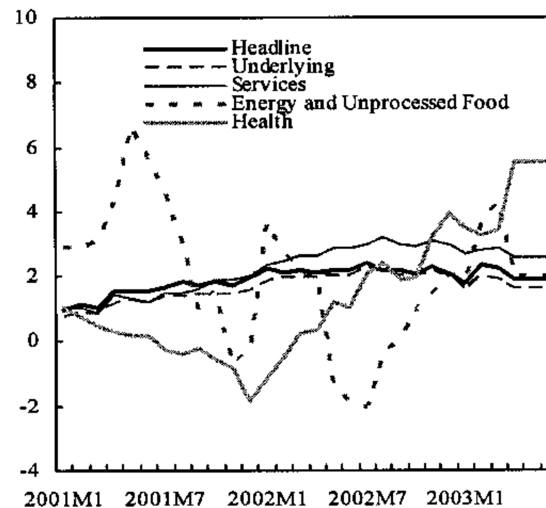
Figure 9. Real Effective Exchange Rate (RNULC Based)



Source: IMF, IFS.

10. **The persistent rise in core inflation ended in 2002 and the price outlook was judged to be benign**. Energy and food prices, along with increases in tobacco excises, had buffeted headline inflation, while underlying inflation had been boosted by increases in health care fees and other service prices (Figure 10). The latter stemmed partly from small service-sector enterprises passing on higher hourly labor costs as a result of the workweek reduction. However, with slack in the economy increasing, wage growth slowed down, contributing, together with euro appreciation, to a decline in underlying inflation. These factors are expected to continue to exert downward pressure on inflation, but the sizeable hike in the minimum wage (*SMIC*) in July 2003—the first of three annual installments in the process of aligning multiple minimum wages[1]—and possible further health care fee increases will have the opposite effect. All in all, the staff projects annual inflation to average

Figure 10. Inflation Components (Annual Growth Rates)



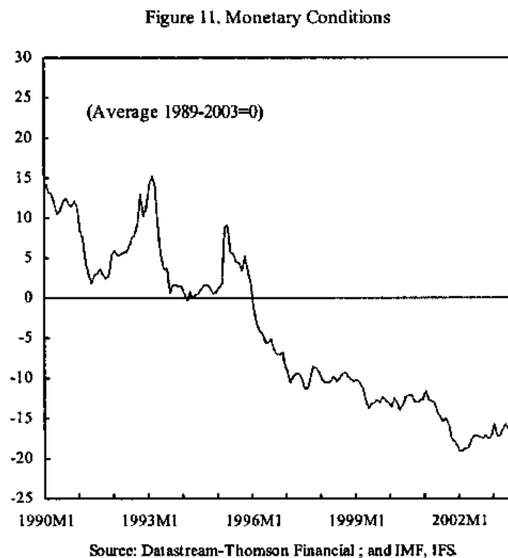
Source: Cronos Database.

[1] Multiple monthly minimum wages emerged from the phased adoption of the 35-hour workweek. The authorities elected to harmonize these minimum wages under the constraint of maintaining purchasing power for all workers. As a result, the average minimum wage will rise by 6.3 percent in real terms by mid-2005.

1.8 percent in 2003–04. There was agreement that there were no indications that deflation is a risk in France at this point.

11. **Against this background, monetary policy would need to take the lead role in supporting the recovery, in part by making it more effective through the removal of administrative controls.** With the appreciation of the euro and the ECB's interest rate cuts broadly offsetting each other, monetary conditions were seen to remain supportive (Figure 11). There was agreement that monetary policy remained the prime tool to address area-wide conditions. The authorities were sympathetic to the staff's euro-area advice favoring an accommodative bent for monetary policy. Staff noted, however, that various national controls (most particularly the prominent role of administered interest rates—unchanged since mid-2000) were acting to dampen the effects of ECB monetary easing in France. Staff pressed that, as a first step, administered interest rates be urgently brought down and kept in line with market rates and that other impediments to the efficient functioning of credit markets be removed (¶ 29). The authorities concurred on the first point and, effective August 1, lowered administered savings rates and announced a new formula for future adjustments.

Figure 11. Monetary Conditions



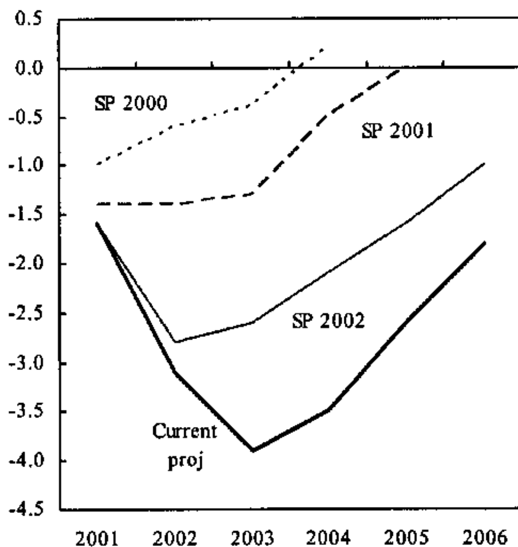
Source: Datastream-Thomson Financial; and IMF, IFS.

12. **The authorities were attentive to the possible adverse short-run effects of underlying fiscal adjustment on growth.** They accordingly intended to keep the fiscal stance broadly neutral in the near term and resume consolidation as the recovery got under way in 2004, while allowing automatic fiscal stabilizers to provide support. Already planned cuts in social security contributions (designed to offset some of the labor cost increase due to the *SMIC* realignment) would provide further stimulus. With long-term fiscal sustainability in question from population aging and doubts about expenditure control, the staff felt that an immediate resumption of fiscal consolidation could have positive short-run effects through its confidence-enhancing aspects. In particular, it would establish the credibility of recent tax cuts, thus inducing households to spend rather than save more of the associated increase in disposable income. The demand effects of fiscal consolidation would also depend on its composition. Staff welcomed the recent pension reform as an important step in strengthening the long-term fiscal outlook but noted that it would not in itself suffice to secure fiscal sustainability.

B. Fiscal Consolidation Strategy

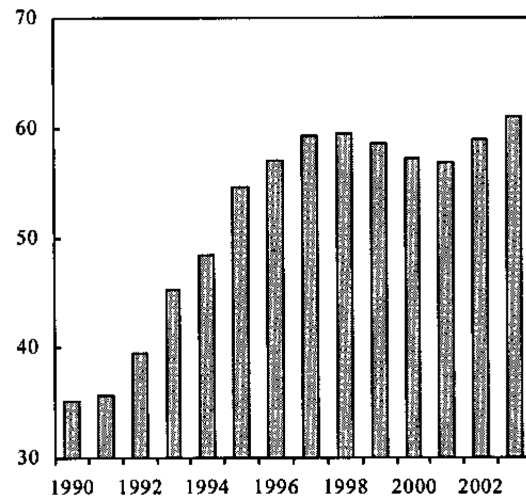
13. **Expenditure pressures, modest tax cuts, and cyclical weakness are set to push the deficit further above the SGP ceiling in 2003, well in excess of initial plans** (Table 2 and Figure 12).Owing to overruns on health care, increases in unemployment compensation, and the catch-up of previously underfunded spending programs, overall real expenditure rose by 3¼ percent in 2002, contributing to a doubling of the general government deficit (to 3.2 percent of GDP, excluding the proceeds from sales of UMTS licenses). In 2003, overruns in social security spending are continuing and revenue performance is expected to flag further in relation to GDP. To contain slippage, the authorities implemented some expenditure freezes that were intended to limit the deficit officially to 3.4 percent of GDP, but they recently announced that cyclical weakness would push the deficit to 4 percent of GDP and the public-debt-to-GDP ratio above 60 percent, in line with staff projections (Figure 13).

Figure 12. General Government Balance
(Percent of GDP)



Sources: Authorities and Fund staff estimates.

Figure 13. General Government Debt
(Percent of GDP)



Source: INSEE.

14. **The level of the underlying deficit and the extent of its deterioration were subject to debate, but there was full agreement that the pension reform represented a notable improvement in the long-term structural fiscal position.** The authorities felt that the staff underestimated potential output and growth somewhat, leading to an exaggeration of the structural deficit. They noted that specific features of the French tax system, in particular the absence of withholding for personal income taxes and lags in corporate taxation, induced an overestimation of the structural deterioration during downturns—while the opposite held during upswings. Also, as acknowledged by staff, pension reform had improved long-term fiscal sustainability considerably, but this was not reflected in current measures of the

structural deficit. Nonetheless, even though potential growth had risen in the second half of the 1990s to about 2¼ percent per year, owing to increases in employment rates and capital accumulation that more than compensated for a decline in total factor productivity growth (see Selected Issues Paper), there was agreement that the impending demographic shock would reduce potential growth appreciably.[2] While there was ample scope for policies to raise employment rates to offset some of this decline, it was also important to resume fiscal consolidation.

15. **The authorities felt that a moderate pace of consolidation, starting in 2004, would strike the right balance between the short-term concern of unduly weighing on the recovery and the long-run need of securing fiscal sustainability**. Although final plans were still being elaborated, the authorities stated that these would aim for an underlying adjustment in the order of ½ of one percentage point of GDP per year as from 2004, as per the Stability Program presented at end-2002. For 2004, central government spending would be kept constant in real terms (versus real growth of 0.3 percent in the Stability Program), and social spending growth would be curbed significantly from current rates, for which specific measures would be needed in the 2004 budget, especially for health care. There was agreement that already planned modest tax cuts should go forward but, in the absence of credible and tangible expenditure reduction measures, staff saw no room for additional tax relief. The authorities concurred that any such room was limited, although the political intent to grant some further tax relief has gained momentum. At the time of the mission, the authorities had not translated the implications of this approach into a nominal deficit target, while officially posting the intention of reducing the deficit to below the 3 percent SGP ceiling in 2004.[3] Staff saw this as a remote prospect, and projects a deficit of 3½ percent of GDP.

16. **Staff stressed the importance of ongoing and durable adjustment**. Indeed, while the current pension reform addresses a significant fraction of the adverse fiscal consequences of the demographic shock, further consolidation is equally necessary to secure fiscal sustainability (¶ 18 and Box 1). Achieving a small structural surplus within the next five years and maintaining it for a substantial period would be a prudent strategy to deal with the remaining cost of aging and the uncertainty surrounding long-term growth projections. This was all the more relevant as, in the context of the liberalization of the main network industries, the state could incur additional pension liabilities worth several percentage points of GDP. The authorities responded that they intended to pursue gradual fiscal consolidation beyond 2004 toward a medium-term objective of achieving structural balance. In

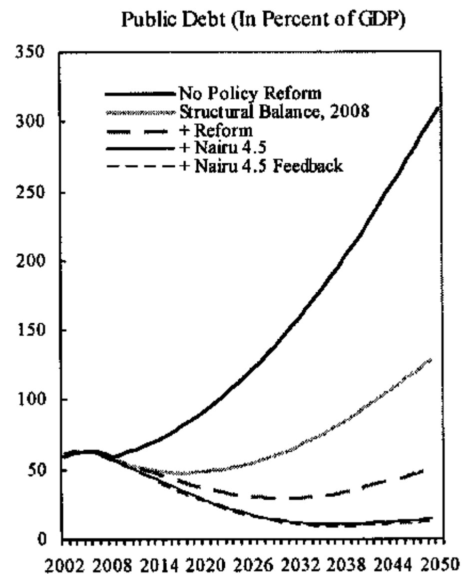
[2] The temporary reduction in potential growth in 2003 shown in Table 1 reflects the cumulative effect of the decline in the investment rate following the equity bubble.

[3] In its recommendation to France of June 2003, the Ecofin Council established a deadline of October 3, 2003 for France to take "appropriate measures… to put an end to the present excessive deficit situation as rapidly as possible and by 2004 at the latest." A supplement to the staff report will report on the 2004 draft budget.

Box 1. France: Fiscal Sustainability and Pension Reform

The current structural fiscal deficit and the prospective higher budgetary outlays stemming from population aging threaten fiscal sustainability. Prior to the recent pension reform and taking into account the recent ongoing increase in health care spending, budgetary outlays on pensions and health care due to aging were set to rise by about 6.2 percentage points of GDP between 2002 and 2040 (of which somewhat more than 4 percentage points due to pensions) and remain stable at this higher level thereafter. In the absence of any improvement in the underlying fiscal balance from its 2003 level, the general government public debt-to-GDP ratio was on an explosive trajectory, under any set of realistic macroeconomic assumptions (figure-No Policy Reform).[1]

The recently enacted pension reform, together with the achievement of a small structural surplus after 2008, and a reduction in the NAIRU to 4.5 by 2010 would address the fiscal shock of aging. Reaching structural balance by 2008, consistent with the SGP, and subsequently maintaining it except for the impact of the spending increases due to aging requires an adjustment of somewhat more than 2½ percentage points of GDP. This would still leave the debt-to-GDP ratio on an explosive trajectory (Structural Balance 2008). The recently enacted pension reform (without feedback effects and assuming a NAIRU of 7) dramatically improves debt dynamics, but is unable to stabilize it (+Reform). Thus it is crucial that labor market policies deliver a rapid decline in the NAIRU, allowing resources devoted to unemployment compensation to be reallocated to pension spending (+NAIRU4.5). Nonetheless, even when feedback effects on participation—projected to raise the activity rate of the cohort of 55-64 years by 7 percentage points by 2020—are taken into account (+NAIRU4.5 feedback) the debt-to-GDP ratio is not fully stabilized. To attain this objective, further changes to the pension or health care regime or a further structural adjustment (of ¼ of one percentage points of GDP in 2009) would be needed.



Key uncertainties involve the long-term GDP growth rate, the pace of fiscal consolidation and reduction of the NAIRU, and the possible realization of contingent liabilities from public enterprises. Lower long-term GDP growth by ½ of one percentage point would require an additional permanent structural adjustment of 1 percentage point of GDP from 2009 onward. Postponing fiscal consolidation or increasing the public debt-to-GDP ratio due to the realization of contingent liabilities would require more adjustment to cover the related additional interest expenditure. A 10-year delay in reducing the NAIRU to 4.5 would require additional fiscal adjustment of ¼ of one percentage point of GDP.

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[1]This scenario is based on: (1) the Summer 2003 WEO projections through 2008, followed by average annual GDP growth of 1.9 percent over 2009-2050; and (2) a gradual decline in the real interest rate from the current implicit rate of 3.8 percent to 3 percent.

recognizing the need for rules-based fiscal discipline in EMU, they felt that their intended approach was consistent with the move to greater emphasis on structural balances in the application of the SGP, and noted the importance of giving adequate weight to both the growth and stability aspects of the Pact.

17. **With the adjustment strategy crucially relying on keeping real spending growth below potential output growth, a robust expenditure control framework was recognized to be essential**. The authorities acknowledged that instruments employed to date to control spending—such as the multiyear norms set out in Stability Programs (Table 3) and the health care spending limit (*ONDAM)*—had been ineffective, primarily because of the absence of a mechanism to correct overruns and the lack of accountability, particularly for the *ONDAM*. In response, new initiatives had been undertaken, notably in-depth reviews of ministerial spending priorities and the ongoing application of the new law on budgetary procedures. They conceded that these initiatives were focused on the central government and that establishing expenditure control in other areas would be essential and would require agreement among social partners. Furthermore, the preparatory document for the 2004 budget contained a comprehensive review of possible medium-term fiscal rules, drawing also on other countries' experiences, e.g., Netherlands, Canada, and United Kingdom. They noted with interest staff suggestions to (a) set multi-year limits on the nominal or real *level* of expenditure; (b) base budgets on conservative economic projections (though they saw difficulties in the staff proposal of using growth projections somewhat below potential growth); and (c) establish clear rules devoting positive budget windfalls to debt reduction. The absence of such rules accounted for the lack of adjustment during the latest upswing, and staff advised strongly against the stated, procyclical intention of stepping up tax cuts in the event of higher-than-expected growth.

18. **The recently enacted pension reform will make a key contribution toward fiscal sustainability as it lowers the expected increase in budgetary outlays appreciably**. The reform is expected to remove two-fifths of the increase in pension costs of aging directly (generating savings of slightly less than 2 percentage points of GDP per year in steady state), mainly through the alignment of the contribution period for civil servants with that of the private sector and a further lengthening of the contribution period in line with life expectancy for all.[4] Another one-fifth of the cost increases is projected to be absorbed by a shift from unemployment to pension contributions as the unemployment rate is projected to fall to 4½ percent by 2010—a prospect which the authorities acknowledged to be uncertain and whose realization would require a strengthened focus of labor market policies on raising employment rates. In addition, since the choice between working and retiring was being made actuarially fairer, early retirement was no longer being encouraged, and the effective retirement age was likely to increase, although this effect would likely be small. Nonetheless, staff simulations suggested that these reforms—even if be accompanied by the achievement of structural balance by 2008—are unlikely to stabilize the debt-to-GDP ratio in the very

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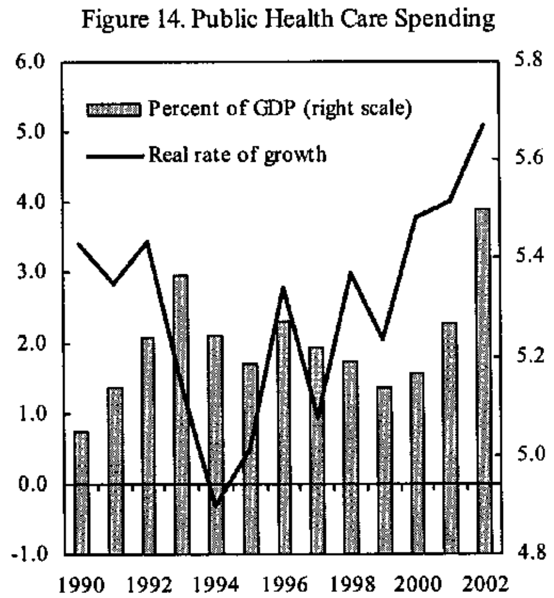
[4] Current provisions lengthen the contribution period for all workers to 41 years by 2012; further modifications will be decided in the context of five-yearly reviews.

long run, though such calculations are sensitive to small changes in underlying assumptions (Box 1).[5] Further changes to the parameters of the system would thus be necessary and the authorities underscored that the anticipated five-yearly reviews would serve to correct the pension regime as needed to secure its fiscal sustainability.

19. **The authorities acknowledged that containing health care spending growth would be a key challenge.** Sharply rising health expenditures were responsible for an appreciable part of budget overruns, despite measures to rein in overconsumption of drugs (Figure 14). With pension reform in full debate in mid-2003, the authorities had been loath to use the new tool of a corrective social security budget, also because it would likely have entailed recourse to the facile "solution" of an increase in the general social contribution (*CSG*). The authorities intended resisting such an increase, while working toward broader health care reform over the coming year. Staff supported these intentions but noted the need for early and continuous steps to curb spending growth (e.g., effective increases in co-payments, the establishment of a referral system, and a clamp-down on abuses of long-term sick leave), especially since population aging was already expected to add about 2 percentage points of GDP to health care outlays by 2040. The authorities agreed that the 2004 consolidation objective would require concrete savings measures already in this fall's social security budget, though specific proposals remained to be defined.

Figure 14. Public Health Care Spending



Source: INSEE.

20. **Civil service reform was also seen as key to medium-term fiscal consolidation and efficiency.** France's broad public sector employs nearly one-quarter of the labor force[6] and the wage bill of the general government amounted to 13.7 percent of GDP in 2002, well above the euro-area average. With a large fraction of civil servants scheduled to retire within the next decade, natural attrition is seen as an opportunity to achieve efficiency gains. Several ministries are adopting plans to only partially replace departing staff by making judicious use

[5] Potential debt sustainability problems are not well-captured by the standard template in cases—such as France—where such problems stem from slow-moving demographics (see "Sustainability Assessments—Review of Application and Methodological Refinements," SM/03/206, 6/11/03). Box 1 accordingly modifies the assessment to capture such effects.

[6] Compared to an EU-11 average of less than 16 percent.

of information technology, focusing on core tasks, and outsourcing non-essential services. Specific figures on the associated budgetary savings were not available, however, and retrenchment was likely to run into union opposition. Staff pressed for meaningful progress in this area, well beyond the modest steps initiated in 2003.

21. **The authorities viewed decentralization as crucial to increase government efficiency and generate additional savings**. They noted that decentralization would allow public services to be better tailored to local preferences, reduce the cost of their delivery, and increase their quality. In March 2003, a constitutional amendment defined the framework for devolution of responsibilities and resources to subnational governments, and specific further steps would be forthcoming (e.g., in education and transportation). To finance devolution, the proceeds of the excise tax on petroleum products (*TIPP*) would be shared with subnational governments, who would be allowed to set their own tax rate within a band of a few percentage points. The authorities acknowledged that providing the right incentives for efficiency gains and maintaining fiscal discipline would be a challenge. They did not share the staff's concern that the *TIPP* arrangement might not suffice to establish effective local fiscal autonomy as it would de facto permit only small variations in tax rates across regions.

22. **While it was agreed that a reduction in the tax burden—if earned through expenditure restraint—was essential and would benefit growth, staff saw merit in a revenue-neutral modification of the tax system in the interim to alleviate distortions.** A reduction in taxes that fall solely on labor financed by increased revenue from broader-based taxes such as the VAT and the general social contribution (*CSG*), and environmental taxes, would help reduce labor costs and strengthen work incentives (Box 2). Noting that reduced VAT rates are not a cost-effective way to achieve social objectives, as in absolute terms they benefit the wealthy more than the poor, the staff advised against intended steps in this area (e.g., for restaurant services) and recommended raising existing reduced rates toward the normal rate to improve the buoyancy and neutrality of the VAT. It also argued in favor of eliminating some unusual local taxes that were costly to collect and applying instead local surcharges to national taxes. The authorities felt that the net economic gains of such a strategy would be limited and that any such reforms would best take place in the context of a reduction in the tax burden. Still, they felt that there was scope to remove some anomalies and continue to reduce collection costs through administrative reform.

C. Labor and Product Markets

23. **With social objectives traditionally pervading labor market policies, incentives for labor market participation and job search had been distorted, but ongoing initiatives attempted to sustain the recent increase in employment rates.** Unemployment insurance, non-work related income support, high marginal tax rates, and the workweek reduction have depressed labor supply, while high minimum wages have lowered demand. In response, the unemployment regime had been modified in 2002 to promote active job search, supported by higher resources for the public employment agency. Although strengthened

Box 2. France: Tax Policy and Economic Efficiency[1]

France's tax system is characterized by high effective tax burdens, dominant social security contributions, a complex income tax system, atypical local taxes, and a high administrative burden. In 2001, tax revenues were the fifth highest in the OECD. Effective taxes on labor and corporate income are comparatively high. Social security contributions generate about half of revenues and income taxes are fairly progressive. Local authorities levy two antiquated taxes with low yields. Several administrations manage the tax system, burdening taxpayers and the budget.

Effective Tax Rates (2000)

	Labor	Capital	Consumption	Tax Wedge on Labor	Corporate Rate (1999)*
France	41.8	21.8	23.9	55.7	33.2
Euro Area	38.5	20.0	21.2	51.5	n.a.
EU	36.2	23.0	20.9	49.5	20.2
United States	23.9	22.9	9.1	30.8	n.a.

Sources: Martinez-Mongay, European Commission.
* Marginal.

High labor taxation and high marginal effective tax rates increase labor costs and create disincentives that may reduce output. Consequently, policies to reduce labor taxes and improve the neutrality of taxation, even without reducing the average tax burden, could yield growth dividends. The QUEST model of the EU, for example, shows that a shift of 1 percentage point of revenue from labor taxes to consumption taxes could increase the level of GDP by 0.4-0.7 percentage points after 10 years.

Thus a possible avenue for reform in France would consist of altering the overall tax structure to remove distortions. Specifically, this would entail reducing social security contributions while increasing revenues from broader-based taxes such as the VAT or the CSG. Other beneficial reforms would include: (i) selectively reducing taxation on low and high-income earners; (ii) improving VAT efficiency by increasing reduced rates; (iii) lowering corporate taxes; (iv) eliminating low yielding and costly taxes; and (v) increasing administrative efficiency. Against this background, the increase in the earned income tax credit, the phasing out of a surcharge on corporate income taxes, the removal of the payroll element from the local business tax base, and ongoing targeted reductions in social security contributions are likely to be beneficial. In contrast, possible additional across-the-board reductions in personal income taxes, and the proposed lowering of the VAT rate on restaurants, are unlikely to be helpful.

[1]See Selected Issues Paper for details.

controls had increased administrative removals from benefit rolls and raised the exit rate from the unemployment insurance system, in a weak economy these represented mainly exits from the labor force rather than new-found employment. The staff, while supporting the emphasis on job search, suggested that consideration also be given to reinstating the phasing-out of unemployment benefits and establishing experience-rating for employers.[7] While the former remained in the domain of the social partners and had been ruled out at this stage, the latter was considered with some interest, though the authorities noted significant employer resistance. With respect to income support programs, the authorities agreed that the basic income support scheme (the *revenu minimum d'insertion, RMI*) had largely failed in its stated aim of returning destitute individuals to the labor force, despite a reduction in replacement rates. They now aimed to promote the return to activity by supporting the demand side: employers who hire people that have been on protracted income support would receive the basic income support as a subsidy for a given period of time. Finally, high marginal tax rates were being reduced, including through the increase in the earned income tax credit (*PPE*) and, in order to promote participation of older workers, early retirement was being discouraged and a continuing education initiative was being developed.

24. **The staff observed that labor market policies implemented to offset other policy-induced increases in labor costs appeared effective in raising employment but were costly to the budget** (Box 3). For example, alleviating the impact of the *SMIC* realignment that resulted from the introduction of the 35-hour workweek is likely to absorb most of the available room for tax cuts for some years. The *PPE*—which the staff sees as a useful tool—avoids labor cost increases while redistributing income and enhancing work incentives, though not without budgetary implications. The various targeted cuts in social security contributions needed to price labor back into the market given the high minimum wage and income support also weigh on the public purse.

25. **In response, the authorities observed that the tenet of labor market policies had now decisively shifted toward tempering the rise in labor costs and promoting private sector employment.** To stem increases in labor costs without adverse budgetary consequences, workweek reduction requirements for smaller enterprises had been eased and some employment protection provisions introduced by the previous government suspended. In the past, policies had included substantial job creation in the public and non-profit sectors, but the phasing out of these schemes was now being accelerated. The uptake of the new youth employment program (*jeunes en entreprise*), in which young newcomers to the job market with little education get unlimited duration contracts in exchange for temporary cuts in employers' social security contributions, was stronger than expected. Though some additional resources had been devoted to rekindling non-private sector-oriented programs, the authorities stressed that this effort was limited in size and would not overturn the declining trend, which would be pursued.

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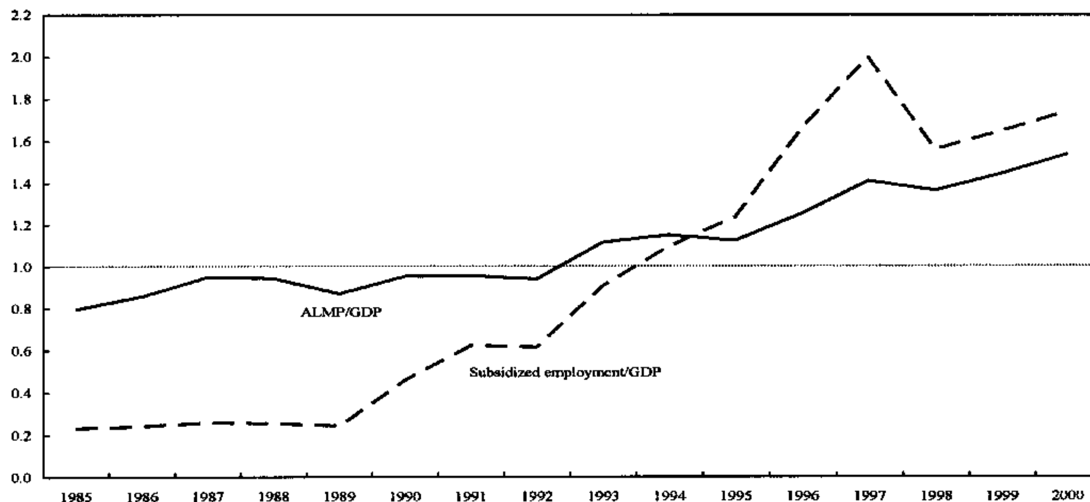
[7] In an experience-rated unemployment insurance system (such as that of the U.S.), firms that have higher recourse to the system pay higher contributions to cover the additional burden imposed thereon and to counterbalance the system's implicit layoff subsidy.

Box 3. France: Do Active Labor Market Policies Increase Employment?

Active labor market policies (ALMPs)—training, subsidies to job creation, public employment services and other expenditures to promote employment—affect employment in many ways. They may enhance vacancies/job matching, increase productivity, keep idled workers attached to the labor force and reduce labor costs. However, they may dampen productivity growth, create windfall benefits for non-target groups, and boost wage demands as they lower the opportunity cost of being unemployed. France spent more on ALMPs than virtually any other industrial country since the early 1990s and, in a relative sense, raised resources devoted to direct job subsidies dramatically, mainly in the form of reduced social security contributions (figure).

Using panel data techniques applied to a large sample of OECD countries during 1985-2000, the staff finds a strong and robust positive impact of spending on ALMPs (ALMP/GDP) on business employment rates in the 1990s but not in the 1980s (see Selected Issues Paper). Specifically, a one percentage point increase in ALMP/GDP would boost employment rates by about 1.9 percentage points. The wage moderation associated with ALMPs in the 1990s is a likely explanatory factor, while the absence of any effect in the 1980s is most likely due to the low spending on ALMPs. These results hold when controlling for other policy, institutional and economic variables. The overall positive effect in the 1990s masks the fact that direct subsidies to private sector jobs had a large positive effect on business employment rates while spending on training and public employment services were either ineffective or had negative effects. The increase in spending on ALMPs is estimated to have raised the net business employment rate in France by close to one percentage point between 1990 and 2000, though it should be noted that it remains 7 percentage points below the average of the other 14 countries in the sample (55 percent).

Ratio of expenditures on ALMP to GDP in France relative to other 14 industrial countries



Source: OECD and staff calculations.

These results should, however, not be interpreted as implying that ALMPs are an effective treatment for low employment rates in a general equilibrium sense. Increases in ALMP spending in some European countries could be seen as a response to counteract the deleterious effects of rigid labor market institutions or, in France, of high minimum wages. Thus, similar or even stronger employment effects could be attained by changing labor market institutions to improve work incentives and lower labor costs. Finally, while the fiscal costs of increased recourse to ALMPs would be mitigated by larger tax revenues and lower inactivity-related expenditures, it is by no means established that ALMPs pay for themselves.

26. **Product market functioning was being improved gradually through a variety of initiatives.** The regulatory and administrative burden was being eased in several areas and, following some recent high-profile cases, the need to modernize bankruptcy legislation has moved up on the agenda. Divestiture was being promoted (e.g., sale of Renault, plans for Air France) though its pace would depend on equity market developments, while obstacles to such progress in network industries (namely, unviable company pension regimes) were being addressed. A new agency had been set up to strengthen governance of state participations. The staff pressed for full divestiture of commercial involvement; conversely, episodes in the opposite direction (e.g., interventions in France Telecom and Alstom), as well as the use of divestiture proceeds to recapitalize other state-owned enterprises, needed to be strictly circumscribed.

D. Financial Sector

27. **Financial sector performance has been favorable compared to previous economic downturns and relative to a number of other countries.** As the financial health of the household and corporate sectors—with the exception of some large groups—generally remains good, nonperforming loans have not increased significantly, helping to maintain profitability and solvency in the banking sector (Table 4). The insurance sector has suffered from the decline in equity prices, although limited guaranteed returns in life insurance and conservative asset-liability management have mitigated the impact. Profitability has been negatively affected by higher reinsurance costs and low interest rates, but an ongoing repricing of premiums is improving results and reducing dependence on investment returns. There was agreement that, in a scenario of gradual economic recovery, the risks to the financial sector would remain manageable. Finally, although the merger of *Crédit Agricole* and *Crédit Lyonnais* has entailed a significant step-increase in concentration, available indicators suggest that banking market conditions remain highly competitive.

28. **In response to increased risks stemming from protracted economic weakness, financial sector supervision is being strengthened.** First, supervisory authorities have stepped up their vigilance: banking supervisors are closely monitoring the quality of loan portfolios and banks' risk management policies, while the insurance supervision agency has worked to improve provisioning requirements. Second, a new law on financial security, approved in August, simplifies the supervisory landscape and increases consumer protection. The law creates a Financial Markets Authority by merging three agencies previously responsible for securities market supervision and regulation. It establishes an autonomous insurance supervisor that integrates the agencies in charge of commercial and mutual insurers. Finally, the law specifies the responsibility for banking system competition policy, assigning it to the Ministry of Finance. The authorities have requested participation in the Financial Sector Assessment Program (FSAP) which is envisaged to take place in 2004.

29. **The need to reduce administrative intervention in the financial sector was broadly acknowledged.** Administrative controls on savings, deposit and payment instruments, and on lending rates, have become more distortive and burdensome as market

interest rates have fallen (Box 4). Staff maintained that the misalignment of interest rates was adversely affecting the profitability of the banking system and the transmission of monetary policy. It needed to be corrected, and a transparent and simple mechanism put in place to prevent future misalignments, as an interim step toward abolishing controls. The authorities concurred on the need for a realignment, reducing the rate on the benchmark savings account (*livret A*) from 3 percent to 2¼ percent, effective August 1, and setting a new adjustment formula.[8] However, the new rate is still appreciably above comparable rates in other euro area countries and will furthermore remain frozen until August 2004, when the new rate-setting system will enter into force. In advocating the lifting of all controls, the staff also noted that the provision of social housing finance—the main institutional purpose of the administered savings system—could be achieved more efficiently with other mechanisms (e.g., through the budget). In other areas, the legal requirement to provide checks free of charge had led to overuse of this cumbersome payment instrument, imposing a collective cost. Staff also saw merit in relaxing or abolishing the usury rate for lending to individuals and company overdrafts, thereby opening access to credit to a significant fraction of admittedly higher-risk economic agents. Having recently removed the usury rate for most business lending from the penal code, the authorities doubted the feasibility of further steps in this area. Finally, they noted with interest staff suggestions to review government-imposed fees that hindered mortgage refinancing.

E. Other Issues

30. **The framework for corporate governance, auditing, and accounting standards was being strengthened**. In these areas, France had initiated and actively supported domestic, European, and international initiatives. A supervisory body for auditors had been created, the independence of auditors reinforced, and transparency in the relations between enterprises and shareholders enhanced. Internationally, the authorities would like to see the EU adopt a stronger regulatory framework and favor greater harmonization of regulations.

31. France has a comprehensive anti-money laundering framework and continues to strengthen efforts to combat **money laundering and terrorist financing**, remaining proactively involved in these efforts at the European and international levels. The OECD has judged France's legal framework as conforming to the **anti-bribery convention's** requirements.

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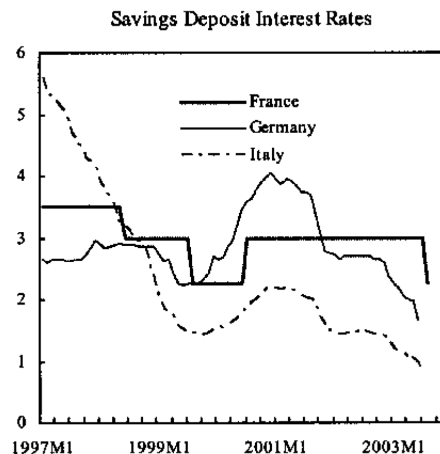
[8] The formula sets the remuneration equal to the average of inflation and short-term interest rates, plus 0.25 percentage points; adjustments will be six-monthly.

Box 4. France: Administrative Intervention in Financial Markets

Administrative interventions in the French financial system broadly cover three areas: administered savings, the "ni-ni" requirement, and the usury law. Administered savings comprise a range of bank savings products designed by the government and offering government-imposed interest rates and/or other conditions. A significant share of the deposits collected with these products is centralized in a government-controlled fund that is used in part to finance social housing projects. The "ni-ni" requirement prohibits the remuneration of demand deposits and requires banks to provide checking services free of charge to their clients. Finally, the usury law—despite its recent relaxation—still prohibits lending to individuals at rates above four-thirds of the average rate observed in a given loan category.

These interventions have a substantial impact on the functioning of the financial system and fail to achieve their policy objectives efficiently. Administered savings amount to half of France's resident bank deposits, and the "ni-ni" requirement affects a further 35 percent. One-fifth of bank deposits is centralized in a publicly managed fund, overuse of "free" checks is a costly phenomenon, and the usury law inhibits sub-prime lending. Administered interest rates that deviate from market rates introduce unnecessary volatility in banks' profitability (with a bias on the downside) and resources, and hamper the transmission of monetary policy. The centralization of deposits to finance social housing entails liquidity and interest rate risks that can only partially be addressed by investing most of the centralized funds in financial markets.



Source: IMF, IFS.

32. **The authorities expressed support for multilateral trade liberalization, with adequate safeguards, and considered the recent EU agreement on reform of the Common Agricultural Policy a breakthrough.** In response to staff questions, they argued that France's position on preferential trade arrangements for African countries was consistent with its support for overall liberalization, mainly because unconditional trade liberalization would worsen the terms of trade of a number of developing countries that lacked the means to compete. In this respect, they regretted that President Chirac's initiative for African agriculture had not received wider support. With respect to the CAP, the authorities agreed that France was a net beneficiary whose position would erode with EU enlargement. They stressed that the recent agreement on CAP reform improved the chances of progress at the Cancún meeting. Staff concurred, but, noting that many distortions remained, urged more ambitious steps and expressed the hope that these developments would lead to less use of agricultural subsidies and trade measures to achieve social and environmental objectives.

33. The authorities noted that the gradual increase in **official development assistance** (ODA) would continue, with the aim of reaching 0.5 percent of GNP in 2007 and the U.N. target of 0.7 percent of GNP in 2012. In 2002, ODA had amounted to 0.36 percent of GNP—the highest among G-7 countries—and was concentrated on the poorest countries in Africa.

III. Staff Appraisal

34. **Amidst weakening performance, the authorities have succeeded in appreciably strengthening the long-run fiscal outlook, but expenditure control remains elusive and further reforms are needed to secure sustained robust growth.** The recent pension reform has made major inroads in tackling long-run fiscal sustainability, but fiscal adjustment was further postponed in 2003. A welcome shift toward a resumption of fiscal consolidation has been announced and it will be critical to deliver on this front through durable expenditure restraint. Civil service and health care reforms provide substantive scope for the latter, but a strengthening of the expenditure control framework is needed to secure lasting success, while broad structural reforms are required to raise potential growth.

35. **There are tentative signs of a prospective economic recovery, but it is likely to be gradual and subject to downside risks.** With external demand recovering, policy conditions supportive, the impact of adverse shocks waning, and balance sheets of households, corporations, and financial institutions holding up relatively well, the stage appears set for a resumption of growth—a scenario that is now being validated by some improvement in forward-looking indicators. Nonetheless, growth is likely to remain below potential for some time, and several downside risks persist. Core inflation is projected to decline, without indications that deflation is currently a risk.

36. **Against this background, macroeconomic policies will need to continue to do their part to support the economy.** Monetary policy remains the primary tool to address euro-area wide developments, but administrative controls that dampen the effects of ECB monetary action in France and other interventions in credit markets should be lifted. The recent reduction in administered interest rates is welcome and should be pursued until rates

are fully in line with market rates. As to fiscal policy, the full play being given to automatic stabilizers together with the cuts in social security contributions related to the *SMIC* realignment should suffice. Non-cyclical expenditures should be held to budgeted amounts in 2003 and the planned, moderate fiscal consolidation for 2004 adhered to. Any further tax reductions should be backed by additional concrete expenditure reduction measures, and geared toward lowering high marginal rates on labor.

37. **With pension reform in hand, a major step has been taken toward fiscal sustainability but a resumption of fiscal consolidation is needed.** To achieve long-term sustainability, pension reforms will need to be complemented by further fiscal adjustment. The aim should be to improve the structural balance by about ½ of one percentage point of GDP per year until a small surplus is achieved to deal with any remaining costs of aging. Such an approach could well have positive confidence effects on economic performance in the near term, as it would establish the credibility of past and ongoing tax cuts, while the related strengthening of the public finances would buttress the common fiscal framework within EMU. Some rephasing of this pace of adjustment could be considered if credible, high quality expenditure measures were put in place that would yield the required cumulative fiscal adjustment over the next three years. Absent such a more forward-looking approach, however, consolidation should resume as from 2004 and proceed at a steady pace thereafter.

38. **The 2004 budget plans need to be backed by concrete measures to slow the growth in non-cyclical social security spending**. In 2004, the adjustment of the underlying deficit is set to be achieved by keeping central government spending constant in real terms and curbing health care expenditure growth. To deliver the latter, specific measures will need to be identified and implemented without delay.

39. **The credibility of the government's fiscal strategy hinges crucially on its ability to reduce the share of public spending in GDP**. New initiatives to control spending are highly welcome and should be supplemented by the adoption of multiyear expenditure norms expressed in terms of the level of non-cyclical spending in the context of budgets based on prudent growth assumptions (for example, somewhat less than potential). Importantly, this framework should clarify that windfalls from growth exceeding potential would be saved, reducing the public debt. Such an approach would limit contentious debates on growth projections, provide clarity on the level of resources available to spending agents, introduce a reference point to correct overruns, and secure consistency across successive budgets.

40. **Reforms of pensions, health care, and the civil service, and well-designed decentralization, provide scope for substantial spending restraint**. The recent pension reform is an important milestone in this respect but, as envisaged, the system's parameters will need to be reviewed periodically to secure long-run viability. In the health system, in the absence of a blueprint for successful reform, it will be necessary to take continuous steps to curb spending growth. Civil service reform offers ample potential to improve the efficiency of the public sector, and the reduction in public employment through attrition should be pursued vigorously. Decentralization should provide an opportunity to streamline and eliminate overlaps between the many levels of government and to tailor services better to

local preferences. Nonetheless, safeguards will need to be built in to maintain fiscal discipline.

41. **While ultimately France's tax burden should be lowered—once room has been created on the expenditure side—consideration should in the interim be given to a revenue-neutral reform of the tax system to remove distortions.** To reduce labor costs and strengthen work incentives, the tax structure could be rebalanced by decreasing social security contributions, high marginal income taxes, and corporate taxes, and raising revenue from broader-based taxes such as the VAT. Low yielding and costly-to-collect taxes could be abolished and the various collection administrations streamlined. New reduced VAT rates on specific products or services should not be introduced, while existing reduced VAT rates could usefully be raised to narrow the difference with the normal rate.

42. **Steps to enhance labor and product market efficiency need to continue.** In the labor market, attention should be paid to the cost effectiveness of policies: the easing of workweek reduction requirements for small enterprises and the suspension of some employment protection measures are welcome in this regard. Consideration should be given to restoring the phasing-out of unemployment benefits and introducing experience-rating for employers' unemployment contributions. Product market functioning stands to be improved by the initiatives to reduce the administrative and regulatory burden and the strengthening of governance of state participations. Nonetheless, network industry liberalization should be accelerated for the benefit of consumers, divestiture should be pursued resolutely, and the practice of using privatization proceeds to recapitalize other enterprises phased out.

43. **The functioning of credit markets should be improved and the ongoing strengthening of supervision and governance pursued.** Administered interest rates need to be reduced further to market levels without delay, and, more fundamentally, the system of administered savings would best be phased out. The mechanism to finance social housing should be made more efficient and transparent. The interdictions on remunerating sight deposits and charging for checks also need to be lifted. Supervisory authorities have rightly stepped up their vigilance, and the financial situation of some large corporate groups will continue to warrant attention. The new law on financial security will further strengthen and simplify supervision, and improve corporate governance and consumer protection. Given further consolidation in the banking sector, competitive conditions should be monitored closely.

44. The shift in France's position that contributed to the medium-term reform of the **Common Agricultural Policy** is welcome, though the authorities are encouraged to actively pursue the removal of agricultural subsidies and other barriers to trade, working toward a successful conclusion of ongoing **multilateral trade negotiations**. France's contribution to development through its relatively high level of **ODA** and its intention to reach the UN target by 2012 is commendable.

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

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

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Demand and supply in constant prices[1]										
Gross domestic product	3.2	4.2	2.1	1.2	0.5	2.0	2.7	2.6	2.5	2.5
Private consumption	3.5	2.9	2.8	1.5	1.2	1.8	2.6	2.4	2.3	2.3
Public consumption	1.5	3.0	2.9	4.1	1.6	1.6	2.0	2.2	2.2	2.2
Gross fixed investment	8.3	8.4	2.1	-1.4	-1.0	2.4	4.2	4.0	3.8	3.8
Business investment	9.1	9.7	3.1	-2.3	-2.0	3.2	6.0	5.6	5.3	5.3
Residential investment	7.2	3.4	0.8	0.8	1.0	1.1	1.2	1.2	1.2	1.2
Public investment	7.0	10.7	-0.2	-1.0	-0.1	1.1	1.3	1.3	1.2	1.2
Stockbuilding[2]	-0.2	0.5	-0.7	-0.4	0.2	0.0	-0.1	0.0	0.0	0.0
Total domestic demand	3.7	4.5	2.0	1.1	1.1	1.8	2.7	2.7	2.6	2.6
Foreign balance[2]	-0.4	-0.2	0.1	0.1	-0.6	0.1	0.1	-0.1	0.0	0.0
Exports of goods and NFS	4.2	13.4	1.8	1.3	-1.6	5.2	7.5	6.2	6.4	6.4
Imports of goods and NFS	6.2	15.3	1.4	0.8	0.4	5.0	7.6	6.7	6.7	6.8
Prices										
GDP deflator	0.4	0.7	1.7	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Consumer prices (average)[3]	0.6	1.8	1.8	1.9	1.9	1.7	1.6	1.6	1.6	1.6
Consumer prices (end of period)[4]	1.4	1.7	1.4	2.2	2.0	...	...	...	...	...
Employment and wages										
Employment	2.0	2.6	1.8	0.7	0.0	0.4	1.1	0.9	0.7	0.7
Unemployment[5]	10.7	9.3	8.5	8.8	9.5	9.7	9.2	8.9	8.3	7.5
Productivity[6]	1.2	1.6	0.3	0.6	0.5	1.5	1.7	1.7	1.8	1.8
Unit labor costs (whole economy)	1.2	0.8	2.8	2.3	2.1	1.5	1.6	1.5	1.3	1.3
Output in manufacturing	4.3	6.7	3.1	-0.1	0.3	4.0	4.5	4.0	4.0	4.0
Hourly labor compensation in manufacturing	1.1	4.7	2.5	3.2	2.6	3.7	4.0	4.0	4.0	4.0
Unit labor costs in manufacturing	-1.8	-2.8	0.3	0.7	0.6	-0.1	-0.1	0.0	0.0	0.0
Personal sector										
Real disposable income[7]	3.1	3.4	3.4	2.0	0.9	2.1	2.8	2.4	2.3	2.3
Savings ratio[8]	15.3	15.7	16.2	16.7	16.2	16.4	16.6	16.5	16.5	16.5
Output gap[9]	-1.0	0.7	0.4	-0.6	-2.1	-2.4	-1.9	-1.2	-0.6	0.0
Rate of growth of potential output	2.4	2.4	2.4	2.3	2.0	2.3	2.3	1.9	1.9	1.9
Balance of payments										
Trade balance (billions of euros)	16.5	-3.6	3.9	10.1	5.5	6.7	8.5	8.5	8.6	7.7
(in percent of GDP)	1.2	-0.3	0.3	0.7	0.4	0.4	0.5	0.5	0.5	0.4
Current account (billions of euros)	39.4	19.5	25.7	27.5	19.1	25.2	28.9	30.3	31.6	32.1
(in percent of GDP)	2.9	1.4	1.7	1.8	1.2	1.6	1.7	1.7	1.7	1.7
Terms of trade	0.1	-2.7	1.0	1.5	-0.1	0.4	0.4	0.3	0.2	0.1
Nominal effective exchange rate[10]	95.8	92.7	93.0	93.8	96.6	...	...	...	...	...
Real effective exchange rate[10]	92.3	89.0	88.2	89.0	91.4	...	...	...	...	...
Public sector accounts[11]										
Revenue	51.8	51.2	51.0	50.4	49.9	50.0	49.9	49.8	49.8	49.8
Expenditure	53.6	52.6	52.6	53.5	54.0	53.6	52.6	51.7	50.9	50.1
General Government balance	-1.8	-1.4	-1.6	-3.2	-4.0	-3.5	-2.7	-1.9	-1.0	-0.2
Structural balance	-1.1	-1.8	-1.8	-2.8	-2.7	-2.1	-1.5	-1.1	-0.6	-0.2
Primary balance	1.6	1.8	1.6	0.0	-0.9	-0.5	0.4	1.2	2.0	2.8
Gross debt	58.5	57.1	56.8	58.9	61.3	62.9	63.0	62.5	61.1	59.0

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

[1] Data from the INSEE quarterly national accounts system.

[2] Change as percentage of previous year's GDP.

[3] Harmonized CPI.

[4] For 2003, year on year in July.

[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 2003, data as of June.

[11] In percent of GDP; Data for 2001-02 excludes the proceeds from the sale of UMTS licenses, which amounts to about 0.1 percent of GDP.

Table 2. France: General Government Accounts, 1995–2002[1]

(In billions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002
General Government								
Revenue	587.4	623.1	649.7	668.4	701.9	728.0	753.3	766.9
Tax revenue	515.9	542.5	562.8	584.9	616.1	638.4	658.9	667.6
of which:								
VAT	85.7	92.4	96.3	99.2	102.6	104.5	106.2	108.0
Income tax	42.6	43.3	40.2	41.8	46.3	49.8	48.7	45.6
Corporate tax	19.2	21.8	26.3	28.7	34.4	37.7	44.3	39.5
TIPP	21.8	22.6	22.8	23.5	24.7	24.3	23.6	24.3
Non-tax revenue	71.4	80.6	86.9	83.5	85.8	89.6	94.4	99.3
Expenditures	652.4	672.5	687.7	703.2	725.8	748.0	775.8	814.4
of which:								
Salaries	161.9	168.5	172.7	178.9	185.6	191.7	199.2	...
Pensions	117.0	121.2	125.1	129.3	134.2	137.8	144.6	...
Health expenditure	62.6	65.5	66.3	69.2	70.5	76.7	81.2	...
Other social transfers	218.6	225.5	235.2	240.3	248.0	252.8	264.1	...
Balance	-65.1	-49.4	-38.0	-34.9	-23.9	-20.0	-23.8	-48.2
Primary balance	-20.7	-1.7	8.3	11.9	21.1	25.7	23.7	0.2
Structural balance	-45.1	-24.0	-13.0	-21.8	-15.6	-24.9	-26.1	-42.5
Central government balance	-48.8	-45.1	-44.7	-39.0	-35.3	-34.8	-34.4	-57.5
Social security balance	-8.0	-5.3	-5.4	-1.4	3.7	7.2	4.0	-4.4
Local government balance	-2.1	0.7	2.9	4.0	4.3	2.8	2.1	3.3
ODAC balance	-6.2	0.3	9.2	1.5	3.4	4.8	5.7	11.0
Gross debt	645.3	691.8	741.6	777.3	792.1	812.1	838.7	896.6
Interest payments	44.3	47.7	46.3	46.8	45.0	45.7	47.5	48.4
Memorandum items								
Nominal GDP[2]	1181.8	1212.2	1251.2	1305.9	1355.1	1420.1	1475.6	1520.8
Structural nominal GDP	1216.4	1253.7	1290.6	1329.3	1367.6	1411.3	1469.6	1531.3

Source: INSEE and IMF staff calculations.

[1]Excludes UMTS receipts.

[2]Annual national accounts; Maastricht definition.

Table 3. France: General Government Real Expenditure Growth
(Percent per year)

	2000	2001	2002	2003	2004	2005	2006	Cumulative difference Actual-SP
Actual/Staff Estimate 2003	1.4	2.0	3.2	1.5				
SP 1998	1.2	1.2	1.3					3.1
SP 1999		1.3	1.3	1.3				2.8
SP 2000			1.5	1.5	1.5			
SP 2001				1.3	1.3	1.3		
SP 2002					1.2	1.4	1.4	

Source: Authorities and Fund staff calculations.

Table 4. France: Vulnerability Indicators

(In percent of GDP)

	1999	2000	2001	2002	2003	
				Prel.	Latest estimate	Date
External Indicators						
Exports (annual percentage change, in U.S. dollars)	-1.4	-1.4	-1.5	5.5		
Imports (annual percentage change, in U.S. dollars)	0.2	3.0	-1.7	2.8		
Terms of trade (annual percentage change)	0.1	-2.7	1.0	1.5		
Current account balance	2.9	1.4	1.7	1.8		
Capital and financial account balance	-2.4	-2.2	-2.4	-3.4		
Of which: Inward portfolio investment (debt securities etc.)	8.1	10.2	7.7	4.2		
Inward foreign direct investment	3.2	3.3	4.0	3.5		
Other investment liabilities (net)	5.2	4.2	2.7	1.9		
Total reserves minus gold (in billions of U.S. dollars, end-of-period)	39.7	37.0	31.7	28.4	29.5	June
Euros per U.S. dollar (period average)	0.939	1.085	1.118	1.063	0.903	July
Market Indicators						
Financial Markets						
Public sector debt (Maastricht definition)	58.5	57.2	56.8	59.0		
3-month T-bill yield	3.0	4.9	3.3	2.9	2.2	June
3-month T-bill yield (real)	1.7	3.1	1.9	0.8	0.2	June
Spread of 3-month T-bill with the U.S. (percentage points, end-of-period)	-2.2	-0.9	1.6	1.7	1.2	June
5- to 8-year government bond	5.3	5.1	5.1	4.4	3.8	June
Spread of 10-year bond with the U.S. (percentage points, end-of-period)	-0.9	-0.1	0.0	0.4	0.4	June
Yield curve (10 year - 3 month)	2.3	0.3	1.7	1.5	1.6	June
Stock market index (end-of-period)	321.1	319.4	249.2	165.1	178.4	August
Real estate prices (index, 1997=100, period average)	113.2	124.6	132.6	144.8	158.0	June
Credit markets (end-of-period growth rates)						
Credit to the private sector	6.4	9.6	6.0	3.9	3.6	July
Bank credit to households	7.8	6.8	5.8	6.9	7.0	July
Mortgages	8.2	7.1	6.3	6.9	8.8	July
Bank credit to nonfinancial enterprises	6.4	11.9	3.6	3.1	0.0	July
Sectoral risk indicators						
Household sector						
Household savings ratio	15.3	15.7	16.2	16.7		
Household financial savings ratio	6.7	7.3	7.2	7.9		
Real estate household solvency ratio (index, 1992=100)[1]	162.6	153.7	150.4	152.7	146.5	June
Corporate sector						
Profitability of business sector	40.0	39.9	39.9	39.5		
Investment ratio	17.5	18.4	18.3	17.4		
Savings ratio	17.8	16.5	16.4	16.0		
Self-financing ratio	93.9	82.0	82.0	83.9		
Banking sector						
Share of mortgage credit in bank credit to the private sector	30.3	29.2	29.4	30.8	31.1	July
Share of non-performing loans in total loans	5.7	5.0	5.0	5.0		
Ratio of provisions to non-performing loans[2]	60.7	60.8	59.9	58.3		
Ratio of non-performing loans net of provisions to capital	14.1	12.8	12.5	12.6		
Liquid assets to total short-term liabilities	147.9	138.5	152.5	157.0		
Return on assets	0.6	0.7	0.7	0.6		
Return on equity	12.8	13.3	13.2	11.7		
Regulatory capital to risk-weighted assets	12.7	12.2	12.3	12.3		

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

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

[2]Refers to metropolitan France.

FRANCE: FUND RELATIONS

As of July 31, 2003

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	10,738.50	100.00
Fund holdings of currency	6,158.33	57.35
Reserve position in Fund	4,580.13	42.65

III. **SDR Department**

	SDR Million	Percent of Allocation
Net cumulative allocation	1,079.87	100.00
Holdings	485.88	44.99
Designation plan	0.00	

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

V. **Financial Arrangements**: None

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

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

VIII. **Safeguards Assessments:** Not applicable

IX. **Exchange Rate Arrangements**:

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

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

X. **Article IV Consultation**:

The last article IV consultation was concluded at EBM/02/110 (10/28/02). France is on the standard 12-month consultation cycle.

XI. **FSAP Participation and ROSC**:

	Date Issued	**Document No.**
Transparency in Monetary and Financial Policies	10/17/00	SM/00/236
Fiscal Transparency Module	10/18/00	SM/00/238
Fiscal Transparency, Transparency in Monetary and Financial Policies—Update	10/18/01	SM/01/316
Fiscal Transparency Module—Update	10/07/02	SM/02/312
Transparency in Monetary and Financial Policies—Update	10/07/02	SM/02/313

FRANCE: STATISTICAL INFORMATION

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

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

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

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

France: Core Statistical Indicators
As of September 10, 2003

	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 9	Jun 03	Sep 5	Sep 5	Jun 03	Sep 9	Jul 03	Jun 03	Jun 03	Jul 03	2003 Q1	Jun 03
Date Received	Sep 9	Jul 03	Sep 10	Sep 10	Jul 03	Sep 9	Aug 03	Aug 03	Aug 03	Sep 03	Aug 20	Jul 03
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/ Fax	Electronic	Electronic/ Fax	Electronic/ Fax	Electronic	Electronic	Electronic	Electronic/ Paper
Confidentiality	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published
Frequency of Publication	Daily	Monthly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

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

INTERNATIONAL MONETARY FUND

FRANCE

Staff Report for the 2003 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 3, 2003

1. **This supplement to the staff report for the 2003 Article IV consultation with France (SM/03/318, 9/15/03) provides an update on recent developments, in particular the authorities' 2004 budget proposal and medium-term fiscal plans.** Revisions to GDP reveal a weaker-than-previously estimated economic performance, leading the staff to lower 2003 annual growth slightly with a consequently larger general government deficit. The economic outlook remains one of an only tentative and gradual recovery. On the policy front, fiscal consolidation is planned to start in 2004 and continue at a steady pace through 2007. The EU institutions' reaction to the fiscal plans—which indicate that the deficit is not expected to edge below the 3 percent SGP ceiling until 2005—is still being formulated. Policy intentions are in line with the staff appraisal, whose thrust remains unchanged. There are questions, however, as to whether health spending can be controlled as envisaged. Along with only modest progress on civil service retrenchment, the additional income tax cuts contained in the 2004 draft budget risk running ahead of effective expenditure control.

2. **The authorities have lowered their growth projections appreciably, with the economic recovery expected to start only toward the end of 2003.** GDP growth is officially estimated to be ½ percent in 2003, somewhat higher than staff (now at a revised 0.3 percent), and 1.7 percent in 2004, in line with the September Consensus Forecast, but somewhat less than the staff projection of 2 percent (Table 1). The latter mainly reflects higher staff projections for growth in the US and EU. Both the authorities and staff nevertheless recognize the existence of significant downside risks. French data released following the staff report's issuance—though clearly affected by the summer heat-wave—also suggest caution: while business sentiment picked up slightly, consumer confidence remained at depressed levels, salaried employment continued to stagnate, and unemployment rose further. On inflation, the staff has marginally raised its CPI projection for 2003 and 2004 given a stronger effect of the drought on food prices and the rebound in oil prices.

3. **The 2004 budget envisages a reduction in the general government deficit to 3.6 percent of GDP, through expenditure restraint designed to accommodate both the**

government's key priorities and some further tax cuts. The authorities estimate the 2003 budget deficit at 4 percent of GDP, as spending overruns have continued, partly masked by an upward revision of revenues. The staff has a higher deficit estimate (4.2 percent of GDP) mainly owing to weaker nominal growth. At the central government level, the budget stabilizes expenditures in real terms while also assigning increased resources to governmental priority areas (notably security, justice, defense, education and research). The draft social security budget (to be officially presented in early October) is to include a number of measures designed to curb demand for health care (including reductions in the reimbursement of medicines, increases in patients' contributions to hospitalization charges, and a tightening of copayment exemptions), while also raising the tobacco tax, earmarked to the social security system. These measures are expected to reduce the social security deficit by slightly more than 0.1 percentage point of GDP. On the revenue side, apart from the previously decided measures (described in the staff report), the 2004 budget contains an additional 3 percent across-the-board cut in personal income taxes and an increase in the earned income tax credit (*PPE*).[1] The intended introduction of a reduced VAT rate on restaurant services remains pending, subject to agreement with EU partners. The budget also takes further steps toward greater transparency, by eliminating or integrating certain off-budget accounts and operations.

4. **The authorities view the 2004 budget as striking the right balance between the government's key priority of supporting the economic recovery and its commitment to fiscal sustainability**. The authorities note that, with overall real expenditure growth kept at 1.1 percent, the expenditure-to-GDP ratio is set to fall by some ½ of one percentage point. At the same time, they note, the budget is based on conservative growth assumptions and a prudent budgeting of tax revenues (with an underlying GDP elasticity of only 0.6). Consequently, the structural balance is estimated to improve by 0.7 percentage point of GDP. The authorities view the budget as placing public finances on a more transparent and sounder footing, and initiating measurable fiscal consolidation as from 2004.

5. **Over the medium term (2005-07), the authorities aim to improve the structural balance by about ½ of one percentage point of GDP per year, while further reducing the tax burden and raising public sector efficiency**. In the central scenario, annual average GDP growth is set at 2½ percent, while overall real expenditure growth is to be contained at 1 percent per annum. Social security expenditure is projected to grow at an annual real rate of 2¼ percent—a substantial reduction from recent experience—with the social security accounts targeted to be in balance by 2007 (from a projected deficit of 0.6 percent of GDP in 2003). This target is contingent on a comprehensive overhaul of the health care system, to be elaborated in the course of 2004. The authorities estimate these intentions to imply a total

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[1] Total income tax cuts in the 2002-04 period will thus amount to 10 percent of receipts, or 0.3 percentage point of GDP, with the marginal income tax rate declining to 48.09 percent in 2004 (from 52.75 percent in 2002). Only about half of French households are subject to income tax.

underlying adjustment of close to 2½ percentage points of GDP over the four years to 2007 (see text table), bringing the general government accounts to close to structural balance by the end of the period.

France: 2004 Budget and Medium-Term Fiscal Plans (baseline scenario)
(In percent of GDP)

	2002	2003	2004	2005	2006	2007
GDP growth in volume (in percent)	1.2	0.5	1.7	2.5	2.5	2.5
Tax revenues	43.9	43.8	43.6	...	...	...
Overall balance	-3.1	-4.0	-3.6	-2.9	-2.2	-1.5
Growth rate of real expenditure (in percent)	3.2	2.2	1.1	1.0	1.0	1.0
Structural balance	-2.9	-2.8	-2.1	-1.5	-1.0	-0.4

Source: *Projet de loi de finances 2004.*

6. **In the staff's assessment, the 2004 budget, while initiating the promised structural adjustment and containing a number of helpful features, remains wanting in a number of respects.** After several years of underlying deterioration, the planned resumption of fiscal consolidation is most welcome as are the prudent growth assumptions, the careful budgeting of tax revenues, the steps toward increased transparency, and the attention given to further structural reforms. The targeted adjustment however hinges crucially on effective expenditure control, and recent experience has been disheartening in this respect: despite technical measures, budgeted amounts were substantially exceeded in 2002 and appear at risk in 2003 even at the normally well-controlled central government level. In this respect, while marking an advance on previous trends, the planned recourse to attrition to reduce the size of the civil service in 2004 remains overly timid, with a net reduction of about 4,600 budget positions representing less than 10 percent of departures into retirement. While greater ambition on this front would not generate large short-term savings, it could make a key contribution to containing spending growth in the medium term. On the revenue side, the further across-the-board reduction in personal income tax rates is running ahead of measures that ensure durable expenditure restraint and not being geared toward the priority of lowering high marginal rates on labor.

7. **In social security, more far-reaching measures than those currently envisaged are likely to be required to contain real health spending growth** within the targeted 4 percent in 2004. Thus, the authorities are encouraged to strengthen savings measures upon the formal presentation of the social security budget in early October. While the planned work on broader health care reform in 2004 is welcome, staff remains of the view that—in the absence of a successful blueprint for such reform—continuous steps to curb spending growth will be required in the course of the year. In addition, a mid-year correction of the social security budget—eschewed in 2003—should be adopted in 2004 as needed.

8. **The authorities' plans for underlying fiscal adjustment during 2005–07 need to be backed up with concrete measures and stepped up as needed to secure long-term fiscal sustainability.** As noted in the staff report, the recent pension reform will make considerable inroads toward reaching fiscal sustainability provided it is accompanied by the

achievement of structural balance by 2008 and of a small structural surplus thereafter and a substantial reduction of the NAIRU. Even so, further changes in the pension or health care regime (or further structural adjustment) would be required to fully stabilize the debt-to-GDP ratio. Against this setting, identified savings measures to date do not provide assurance that the structural deficit will improve as envisaged in the authorities' medium-term plans. Furthermore, given the importance of expenditure control in achieving the fiscal objectives, staff would encourage further strengthening of the medium-term framework and fiscal rules. In this spirit, the new medium-term plan's explicit guideline to devote revenue windfalls from higher-than-projected growth to deficit reduction is welcome and will need to be closely observed as growth recovers.

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

	1999	2000	2001	2002	2003	2004	2005	2006	2007
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Demand and supply in constant prices[1]									
Gross domestic product	3.2	4.2	2.1	1.3	0.3	2.0	2.8	2.7	2.5
Private consumption	3.5	2.9	2.8	1.5	1.5	1.7	2.6	2.4	2.3
Public consumption	1.5	3.0	2.9	4.1	1.9	1.6	2.0	2.2	2.2
Gross fixed investment	8.3	8.4	2.1	-1.4	-0.8	2.5	4.2	4.0	3.8
Business investment	9.1	9.7	3.1	-2.3	-1.7	3.2	6.0	5.6	5.3
Residential investment	7.2	3.4	0.8	0.8	1.1	1.4	1.2	1.2	1.2
Public investment	7.0	10.7	-0.2	-1.0	0.2	1.6	1.3	1.3	1.2
Stockbuilding[2]	-0.2	0.5	-0.7	-0.3	0.0	0.1	0.0	0.0	0.0
Total domestic demand	3.7	4.5	2.0	1.1	1.1	2.0	2.8	2.7	2.6
Foreign balance[2]	-0.4	-0.2	0.1	0.2	-0.9	0.1	0.1	0.1	0.0
Exports of goods and NFS	4.2	13.4	1.8	1.3	-2.1	4.9	7.6	6.6	6.6
Imports of goods and NFS	6.2	15.3	1.4	0.8	0.9	4.9	7.7	6.7	6.8
Prices									
GDP deflator	0.4	0.7	1.7	1.9	1.6	1.6	1.6	1.6	1.6
Consumer prices (average)[3]	0.6	1.8	1.8	1.9	2.0	1.8	1.6	1.6	1.6
Consumer prices (end of period)[4]	1.4	1.7	1.4	2.2	2.0	...	...	...	...
Employment and wages									
Employment	2.0	2.6	1.8	0.6	0.1	0.5	1.0	0.9	0.7
Unemployment[5]	10.7	9.3	8.5	8.8	9.4	9.5	9.0	8.7	8.2
Productivity[6]	1.2	1.6	0.3	0.6	0.2	1.5	1.7	1.8	1.9
Unit labor costs (whole economy)	1.2	0.8	2.8	2.3	2.4	1.5	1.5	1.4	1.3
Output in manufacturing	4.3	6.7	3.1	-0.1	0.3	4.0	4.5	4.0	4.0
Hourly labor compensation in manufacturing	1.1	4.7	2.5	3.2	2.6	3.7	4.0	4.0	4.0
Unit labor costs in manufacturing	-1.8	-2.8	0.3	0.6	0.6	-0.1	-0.1	0.0	0.0
Personal sector									
Real disposable income[7]	3.1	3.4	3.4	2.0	0.8	2.0	2.8	2.4	2.2
Savings ratio[8]	15.3	15.7	16.2	16.7	16.0	16.1	16.2	16.2	16.2
Output gap[9]	-1.0	0.7	0.4	-0.6	-2.3	-2.5	-2.0	-1.2	-0.6
Rate of growth of potential output	2.4	2.4	2.4	2.3	2.0	2.3	2.3	1.9	1.9
Balance of payments									
Trade balance (billions of euros)	16.5	-3.6	3.9	10.1	2.7	2.9	4.3	5.8	6.0
(in percent of GDP)	1.2	-0.3	0.3	0.7	0.2	0.2	0.3	0.3	0.3
Current account (billions of euros)	39.4	19.5	25.7	27.5	14.3	18.6	21.6	24.8	26.2
(in percent of GDP)	2.9	1.4	1.7	1.8	0.9	1.2	1.3	1.4	1.4
Terms of trade	0.1	-2.7	1.0	1.5	0.0	0.4	0.4	0.3	0.2
Nominal effective exchange rate[10]	95.8	92.7	93.0	93.8	96.6	...	...	...	...
Real effective exchange rate[10]	92.3	89.0	88.2	89.0	91.4	...	...	...	...
Public sector accounts[11]									
Revenue	51.8	51.2	51.0	50.4	50.3	50.2	50.2	50.1	50.0
Expenditure	53.6	52.6	52.6	53.5	54.6	54.0	53.1	52.2	51.4
General Government balance	-1.8	-1.4	-1.6	-3.2	-4.2	-3.8	-2.9	-2.1	-1.3
Structural balance	-1.1	-1.8	-1.8	-2.9	-2.9	-2.3	-1.7	-1.3	-0.9
Primary balance	1.6	1.8	1.6	0.0	-1.0	-0.6	0.1	1.0	1.7
Gross debt	58.5	57.1	56.8	58.9	61.8	63.3	63.3	62.6	61.3

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

[1] Data from the INSEE quarterly national accounts system.

[2] Change as percentage of previous year's GDP.

[3] Harmonized CPI.

[4] For 2003, year on year in August.

[5] In percent of labor force; harmonized index.

[6] GDP over total employment.

[7] Personal disposable income deflated by the implicit deflator for private consumption.

[8] In percent of household disposable income.

[9] In percent of potential GDP.

[10] Index; Base 1995=100. For 2003, data as of June.

[11] In percent of GDP; Data for 2001-02 excludes the proceeds from the sale of UMTS licenses, which amounts to about 0.1 percent of GDP.

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700 19th Street, NW
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IMF Concludes 2003 Article IV Consultation with France

On October 8, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with France.[1]

Background

The French economy has been no exception to the prolonged global slowdown despite generally supportive policy conditions. The economy's initial resilience to the downturn based on the strength of private consumption has been eroded in the course of 2002. Investment plans were repeatedly postponed, in part because of a heightened focus on corporate deleveraging, while consumer confidence weakened when layoffs materialized and geopolitical uncertainties rose. Consequently, the economy flirted with recession from end-2002 through mid-2003. With the impact of adverse shocks waning and external demand conditions improving, the staff expects a gradual, if tentative economic recovery to materialize toward the end of the year. Thus, real GDP growth is projected to increase from about 0.3 percent in 2003 to 2 percent in 2004. Despite pressures from energy and drought-induced food price rises, a sizable hike in minimum wages, and possible further health care fee increases, the outlook for inflation remains benign, reflecting considerable slack in the economy and euro appreciation. Over the medium term, population aging will reduce potential growth and add several percentage points of GDP to budgetary outlays on pensions and health care. By international comparison, the tax and regulatory burdens remain high in France, while activity rates are low despite considerable increases since the mid-1990s.

[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 2003, the staff estimates the general government budget to widen to 4.2 percent of GDP from 3.2 percent of GDP in 2002, mostly due to the cyclical downswing. However, there are also appreciable spending overruns that are being masked by a better-than-expected revenue performance. The 2004 budget targets a reduction in the deficit to 3.6 percent of GDP (from an official estimate of 4 percent of GDP in 2003, and assuming GDP growth of 1.7 percent). It intends to keep central government spending constant in real terms, curb social spending growth, and implement further cuts in taxes and social security contributions. In the context of a broader reform of the State, public sector employment will decline as about 7 percent of retiring civil servants will not be replaced. The staff estimates that these plans imply a structural improvement of slightly more than half a percentage point of GDP. The 2004 budget also presents the authorities' plans for 2005–07 which include tax cuts and further consolidation to bring the fiscal accounts close to structural balance by 2007 based on a reduction in real spending growth to an annual average of 1 percent. This requires a sustained slowdown in the annual real growth of health care expenditure from more than 4 percent in recent years to 2.25 percent. The general government deficit would edge below 3 percent of GDP in 2005.

On structural issues, a key pension reform was adopted in mid-2003. The reform is expected to eliminate 40 percent of the projected increase in the pension costs of aging. Further fiscal consolidation and policies to lower structural unemployment are expected to absorb the remaining costs while five-yearly reviews of the pension system will allow for further modifications as needed to secure the sustainability of the system. Health care reform has been placed on the reform agenda for 2004. To strengthen labor market performance, subsidies will be provided to employers who hire people on protracted income support; the earned income tax credit (*PPE*) has been raised; further cuts in social security contributions are being implemented; 35-hour workweek requirements for small enterprises have been eased; and some employment protection provisions have been suspended. Divestiture by the state of remaining stakes in commercial enterprises is being pursued; obstacles to reform of network industries are being addressed; and a new agency was created to strengthen governance and transparency of state participations. The framework for corporate governance, auditing, and accounting standards is being strengthened.

Supervision in the financial sector is being intensified in response to increased risks stemming from protracted economic weakness. A new law on financial security simplified the supervisory landscape and increased consumer protection. After remaining unchanged for about a year and a half, administrative interest rates have been reduced in mid-2003, though they remain above market rates. A new adjustment mechanism that will become effective in mid-2004 has been introduced to prevent future misalignments.

Executive Board Assessment

Executive Directors welcomed the forward-looking policies recently being pursued by the French authorities, and, in particular, commended their adoption of the milestone pension reform, which will appreciably strengthen France's long-run fiscal outlook and make a key contribution toward addressing the major challenges for future GDP growth and fiscal sustainability arising from the impending demographic shock. Going forward, Directors urged the authorities to press ahead with their plans for steady structural adjustment announced in the context of the 2004 budget, and for the elaboration of a comprehensive health care reform. They also underscored that important synergies can arise from simultaneously pursuing fiscal consolidation and raising potential output based on further labor and product market reforms.

Directors observed that the prolonged global slowdown has not spared the French economy. However, with the impact of adverse shocks waning and external demand conditions improving, a gradual recovery is expected to take hold toward end-2003. Directors nevertheless pointed to continued corporate balance sheet adjustments and a still weak employment outlook domestically, as well as a possible faltering of the recovery externally, as possible sources of downside risk to the recovery. Owing to the considerable slack in the economy, France's inflation outlook remains benign.

Against this background, Directors agreed that macroeconomic policies will need to continue to do their part to support the economy. Monetary policy remains the primary tool to support euro-area wide conditions in a context of overall benign inflation. Most Directors welcomed the recent reduction in administered interest rates, which, by improving the monetary transmission, will enhance the effects of ECB monetary easing in France. They encouraged the authorities to bring rates fully in line with market rates and to further phase out administrative controls on savings and deposit instruments.

Directors recognized the difficult trade-offs between short-and long-term objectives confronting France's fiscal policy in the current conjuncture, which have been exacerbated by the absence of consolidation during the boom years. Directors welcomed the authorities' decision to base the 2004 budget on conservative growth assumptions. Most Directors endorsed the cumulative fiscal consolidation envisaged for 2004–07, which aims at improving the structural balance by about 0.5 percentage point of GDP per year with full play being given to the automatic stabilizers around this path. Some Directors urged the authorities to aim for more ambitious adjustment in 2004, which, they felt, would further underpin the credibility of the fiscal framework of the euro area while at the same time strengthening confidence in the authorities' fiscal strategy. Some Directors also suggested that, by pursuing fiscal consolidation beyond the current horizon until a small budget surplus is achieved, France would be in a stronger position to deal with the costs of population aging and achieve fiscal sustainability.

Directors emphasized that the authorities' fiscal consolidation strategy will now need to be backed up by concrete measures, and, in this connection, highlighted several issues that will warrant close attention in the period ahead. As envisaged by the authorities, the pension system parameters will need to be periodically reviewed and corrected given the uncertainties surrounding long-term projections, especially those related to the reduction in structural unemployment. A number of Directors noted that until a comprehensive health care reform takes hold, it will be necessary to take continuous specific steps to curb spending growth. Many Directors urged the authorities to pursue more ambitious civil service reform aimed at improving efficiency in the public sector and reducing public employment through attrition more vigorously. To ensure the full benefits of ongoing decentralization efforts, Directors pointed to the need for safeguards that will help maintain fiscal discipline. Many Directors also underscored the importance of greater expenditure restraint to create room for reducing France's high tax burden. In the interim, they considered that a rebalancing of the tax structure—by reducing taxes to lower labor costs while increasing reliance on broad-based taxes—could already begin to make significant inroads in removing distortions and improving incentives to work.

Directors underscored that the credibility of the authorities' fiscal strategy will hinge crucially on the ability to control spending. They noted the disappointing track record of the past few years which had seen significant spending overruns in health care and, more recently, also at the

normally well-controlled central government level. Directors accordingly welcomed the new initiatives being taken by the authorities to enforce spending limits, and urged them to complement these initiatives with the adoption of multiyear expenditure norms to be expressed in terms of the level of non-cyclical spending. They welcomed the principles, announced in the 2004 budget, whereby any additional revenues from better-than-expected growth will be used to reduce the deficit and any new tax cuts will be financed by cuts in spending, and they encouraged the authorities to incorporate these principles in their medium-term framework.

Directors underscored the need for continued labor and product market reforms to raise France's medium-term growth and reduce structural unemployment. They commended the authorities for the favorable labor market performance achieved over the past several years, including during the downturn, while calling for further steps to improve labor market flexibility and contain increases in labor costs. Recent measures such as the easing of the workweek reduction requirements for small enterprises, the suspension of some employment protection measures, and the increase in the earned income tax credit were welcome, but Directors saw scope for further sharpening incentives to return to work and improving—through streamlining—the cost effectiveness of the multitude of active labor market policies. Directors supported the authorities' efforts to reduce the administrative and regulatory burden and strengthen the governance of state participation, but a number of Directors saw scope for more rapid progress in subjecting network industries to competition. They also welcomed the renewed drive for divestiture, with some Directors encouraging a more rapid phasing out of the State's involvement in enterprises pursuing commercial activities.

Directors noted that France's financial sector has weathered the protracted economic slowdown well and encouraged the supervisory authorities to remain vigilant, in particular with respect to the financial situation of some large corporate groups. They supported the changes in the supervisory framework contained in the new law on financial security and ongoing initiatives to strengthen corporate governance and accounting rules. They commended the authorities' decision to participate in the Financial Sector Assessment Program as well as France's leadership role in the fight against money laundering and the financing of terrorism.

Directors were encouraged by the authorities' support for the reform of the Common Agricultural Policy and for multilateral trade liberalization. In the context of the reformulation of EU agricultural trade policy, and given the importance of resuscitating the Doha round, many Directors looked forward to the leadership of France in working to reduce agricultural subsidies and remove other barriers to trade. Directors commended France's contribution to development assistance, and looked forward to further increases in official development assistance toward the target of 0.7 percent of GNP.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with France is also available.

France: Selected Economic Indicators

	1999	2000	2001	2002	2003[1]
Real economy (change in percent)					
Real GDP	3.2	4.2	2.1	1.3	0.3
Domestic demand	3.7	4.5	2.0	1.1	1.1
CPI (year average)	0.6	1.8	1.8	1.9	2.0
Unemployment rate (in percent)	10.7	9.3	8.5	8.8	9.4
Gross national savings (percent of GDP)	22.5	22.4	22.2	21.1	19.6
Gross capital formation (percent of GDP)	19.6	21.1	20.4	19.3	18.7
Public finance (percent of GDP)[2]					
Central government balance	-2.6	-2.5	-2.3	-3.8	-3.9
General government balance	-1.8	-1.4	-1.6	-3.2	-4.2
General government debt	58.5	57.1	56.8	58.9	61.8
Money and interest rates					
M3 (end of year, percent change)[3]	5.2	4.3	10.8	6.6	...
Money market rate (in percent)[4]	3.0	4.4	4.3	3.3	2.1
Government bond yield (in percent)[5]	4.7	5.5	5.0	4.9	4.2
Balance of payments (percent of GDP)					
Trade balance	1.2	-0.3	0.3	0.7	0.2
Current account	2.9	1.4	1.7	1.8	0.9
Official reserves (US$ billion)[6]	39.7	37.0	31.7	28.4	28.7
Fund position (as of August 31, 2002)					
Holdings of currency (percent of quota)					57.4
Holdings of SDRs (percent of allocation)					46.2
Quota (SDRs million)					10,738.5
Exchange rates					
Exchange rates regime			Participant in EMU		
Euro per U.S. dollar (September 30, 2003)					1.16
Nominal effective exchange rate (1995=100)[7]	95.8	92.7	93.0	93.8	97.7
Real effective exchange rate (1995=100)[7, 8]	92.3	89.0	88.2	89.0	92.3

Sources: Data provided by the authorities and IMF staff estimates.

[1]Staff projections.

[2]Data for 2001-02 excludes the proceeds from the sale of UMTS licenses, which amounts to about 0.1 percent of GDP.

[3]Data for France until 1998 and for the euro area from 1999 onwards. The figure for 2002 refers to the 12-month percent change as of July.

[4]Data refer to money market call rates up to 1998, and to the interbank rate from 1999 onwards. For 2003, data are as of August.

[5]Average yield to maturity on public sector bonds with original maturities of more than five years. The figure for 2003 refers to August.

[6]Excluding gold, end-of-period; from 1999, eurosystem definition. The figure for 2003 refers to July.

[7]The figure for 2003 refers to June.

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