

**France: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for France**

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 2007 Article IV consultation with France, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 19, 2007, 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 January 25, 2008. 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 February 12, 2008 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 15, 2008 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for France.

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

Selected Issues Paper

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FRANCE

**Staff Report for the 2007 Article IV Consultation**

Prepared by Staff Representatives for the 2007 Consultation with France

Approved by Michael Deppler and G. Russell Kincaid

January 25, 2008

**Executive Summary**

**France's near-term economic outlook is moderately positive, but clouded by risks from the global environment.** While direct linkages between the ongoing financial turbulence and France's domestic real economy have so far been limited, staff analysis indicates that France's economy is highly sensitive to global common shocks. In 2008, spillovers arising from higher oil prices, the financial turbulence, and the rise in the euro are set to more than offset a tax cut stimulus. Staff forecasts GDP growth of 1.6 percent in 2008, with a recovery in 2009. Core inflation remains low, but has edged up. With weaker growth and some likely slippages, the fiscal deficit is forecast to widen temporarily to 2.7 percent of GDP in 2008.

**The authorities' reform stance provides an historic opportunity to place France onto a sustained growth path.** Other countries' experience and staff simulations suggest that a "critical mass" of structural reforms is the most apt to exploit synergies, generate faster and larger payoffs, and attenuate opposition. Experience also indicates that the payoffs are largest where current market distortions are the greatest. In France's case, labor market rigidities and pervasive constraints on competition in services markets are appropriately at the center of the reform agenda. Staff and the authorities differed however on the importance assigned to raising "purchasing power" and on the related demand-side orientation of some of the government's measures.

**With a pause in fiscal adjustment in 2008, France remains distant from its medium-term objective of budget balance.** The 2008 budget entails no underlying adjustment—due to tax cuts—and fiscal balance has been deferred to 2012. The authorities see the cuts as fulfilling campaign pledges and paving the way for the broader reform effort. Staff view the postponement of the medium-term objective as eroding credibility and is critical of some of the measures (notably the tax exemption of overtime, a second-best response to the original distortion of the mandatory workweek reduction). Going forward, it advocated the return to an ambitious fiscal adjustment path. The authorities are conducting potentially far-reaching, and welcome, tax and spending reviews.

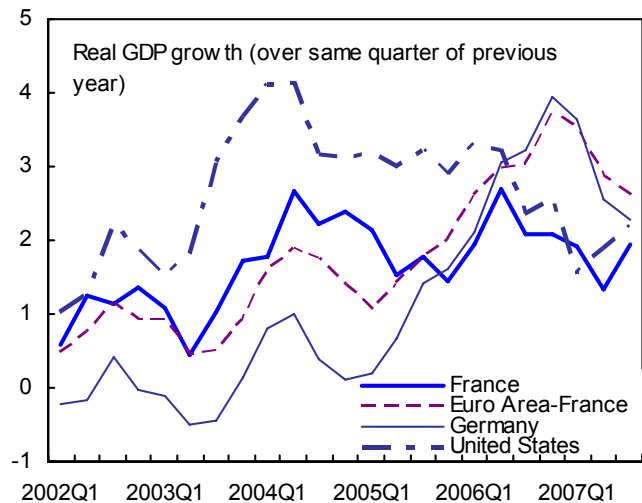
**The financial system has weathered the market turmoil comparatively well, and repercussions on the real economy have so far been limited.** Bank losses to date imply manageable effects, and lending standards have been tightened only marginally. Well capitalized banks, limited exposure to the U.S. subprime market, and a comprehensive supervisory framework have contributed to this relative resilience, but global market conditions have yet to return to normal and there are risks of a deeper fallout. The authorities have launched a "Paris-Place Financière" initiative, providing an opportunity to modernize France's financial system and boost its contribution to growth, purging the remnants of a heavily regulated and administered past. The authorities are also supportive of ongoing efforts to strengthen the EU's cross-border crisis management framework.

Executive Summary .....	1
I. Background.....	3
II. Outlook.....	5
III. Policy Discussions .....	7
A. France’s External Sector Weakness.....	7
B. The Reform Agenda .....	8
Freeing the labor market .....	10
Goods and services markets—raising competition and consumer welfare .....	11
C. Achieving Fiscal Sustainability.....	13
The fiscal position and objectives.....	13
Fiscal reform .....	16
D. Combining Financial Sector Stability and Efficiency .....	17
IV. Staff Appraisal .....	20
Figures	
1. Economic Developments .....	23
2. External Sector Developments.....	24
3. Labor Market Indicators .....	25
4. Monetary Conditions .....	26
5. Financial Market Developments.....	27
6. Competitiveness and External Performance .....	28
7. France vs. Germany: Out of Synch? .....	29
8. Combining Fiscal Consolidation and Structural Reform—Canada.....	30
Tables	
1. Main Economic Indicators, 2003-12 .....	31
2. Balance of Payments.....	32
3. High Frequency Indicators.....	33
4. Vulnerability Indicators, 2001-07.....	34
5. General Government Accounts, 2000-07 .....	35
6. The Core Set of Financial Soundness Indicators, 2000-06.....	36
7. Encouraged Financial Soundness Indicators, 2000-06.....	37
8. Financial System Structure, 2000-06.....	38
Text Boxes	
1. <i>Pouvoir d’Achat</i> : Perception and Reality .....	9
2. Key Product and Services Market Reforms.....	12
3. Canada’s Experience: Combining Fiscal Consolidation and Structural Reform.....	15
4. Tax Reform in France: Challenges and Options.....	18
Appendices	
I. Fund Relations .....	39
II. Statistical Issues.....	45

## I. BACKGROUND

1. **While reforms have advanced in recent years, France’s economic performance has remained comparatively weak.** In its conclusions of the Article IV consultation last year, the Executive Board observed that France “has changed more than is commonly perceived,” but that “much remains to be done.” This continues to be the case. Reform progress has been gradual and piecemeal, growth has stalled below other major industrial economies, unemployment—though falling—has remained high, and export growth has been weak. A growing consensus has emerged that a more aggressive reform strategy is required to move the country onto a higher growth path—a consensus reflected in President Sarkozy’s explicitly reformist platform.

2. **GDP growth has been modest due to supply-side weakness.** GDP has risen by less than the euro area average for nine consecutive quarters (2005Q3-2007Q3), with France not participating in the revival of European growth since 2004, prompting political emphasis on a “growth deficit.” For 2007, growth is expected to be 1.9 percent, down from 2.0 percent in 2006 (Figure 1 and Table 1). Growth has been sustained by domestic demand, with the external sector persistently negative. The main contribution to growth has come from private consumption, reflecting steady increases in real disposable income. With domestic demand growth outstripping supply, imports have surged, with a net external drag on growth of some ½ percent of GDP per annum over the past five years.

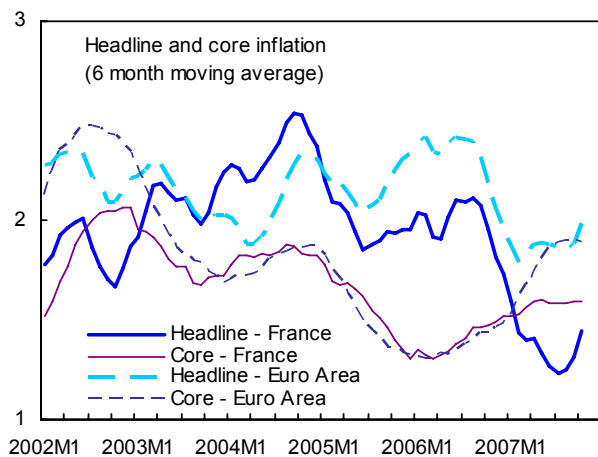
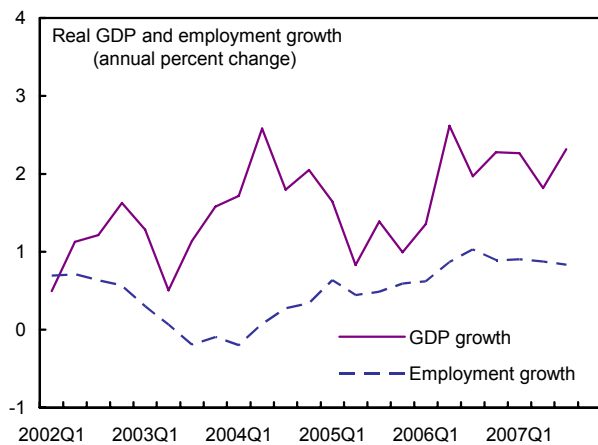
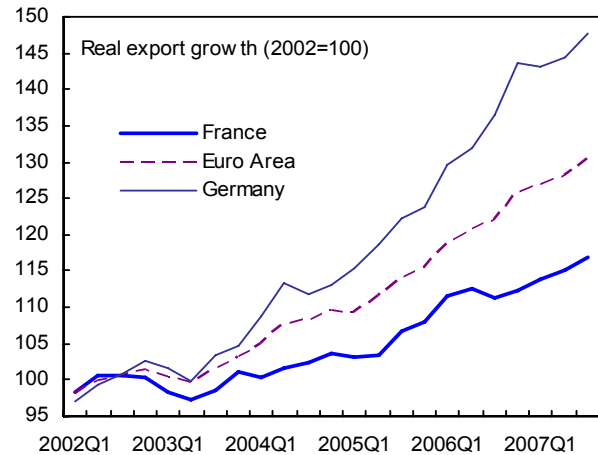


3. **Export growth has slowed in recent years, heightening concerns about competitiveness.** Real export growth has lagged behind the euro area average since 2003, generating a drop in market shares for French exports, both worldwide and within the EU and the euro area (Figure 2). With strong import growth, France’s current account balance has deteriorated from a surplus of 1.4 percent of GDP in 2002 to a projected deficit of 2.0 percent of GDP in 2007 (Table 2); current account and trade balances with the euro area

have also deteriorated.<sup>1</sup> The ratio of exports to GDP has risen by 2 percentage points versus a surge in import penetration of 5.1 percentage points of GDP.

4. **While unemployment has declined, labor market performance remains weak** (Figure 3). The (EU harmonized) unemployment rate has fallen 1 point over the past year (to 7.9 percent), mirroring the decline in the euro area (to 7.2 percent). However, unemployment remains stubbornly above the EU average and is particularly acute among younger workers (near 20 percent). At the same time, the employment rate is among the lowest in Europe. While employment creation has improved since 2004, it remains under 1 percent per year. Growth of the minimum wage (SMIC) has sharply outstripped general wages (and productivity), pricing many low-end workers out of the market.

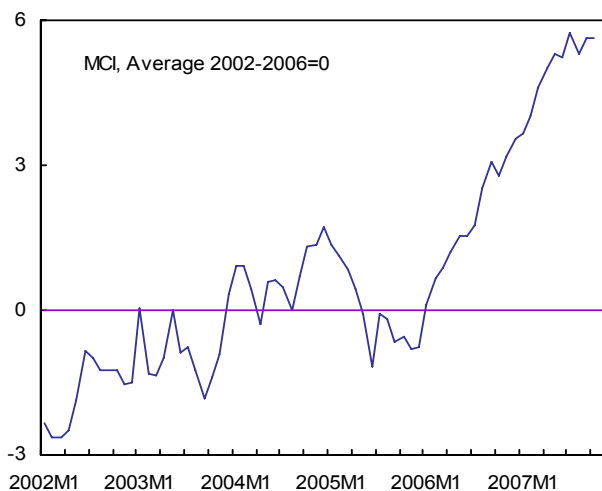
5. **Inflation was muted through the summer, but has since spiked.** Core inflation has edged up since early 2006, but remains at 1.7 percent, below the euro area average. Headline inflation fell sharply in 2006 and early 2007 to a 1.2 percent annual rate in August. Since then, however, the sharp increase in food and energy prices pushed headline inflation to 2.8 percent in December. Notable in the good performance of French inflation through the summer has been the role played by measures to liberalize product markets. The authorities estimate that laws easing restrictions on large stores and retail sales margins helped lower inflation by ½ percentage point since mid-2004, with most of this



<sup>1</sup> Balance of payments data should be interpreted with caution, given the size of the “errors and omissions” item.

effect since 2006. Unit labor costs have been climbing, as productivity gains have lagged wage inflation. French labor costs rose 3.2 percent in the year to Q3 2007 (versus 2.5 percent for the euro area).

6. **Monetary conditions have tightened since 2006.** The monetary conditions index (MCI) has moved sharply upward since early 2006, reflecting ECB tightening and, more recently, euro appreciation. Moreover, risk premia on lending have increased due to the fallout from the financial turbulence (Figure 4). While long-term interest rates have risen moderately, short-term rates have spiked in recent months. In contrast, the fiscal stance has eased.



## II. OUTLOOK

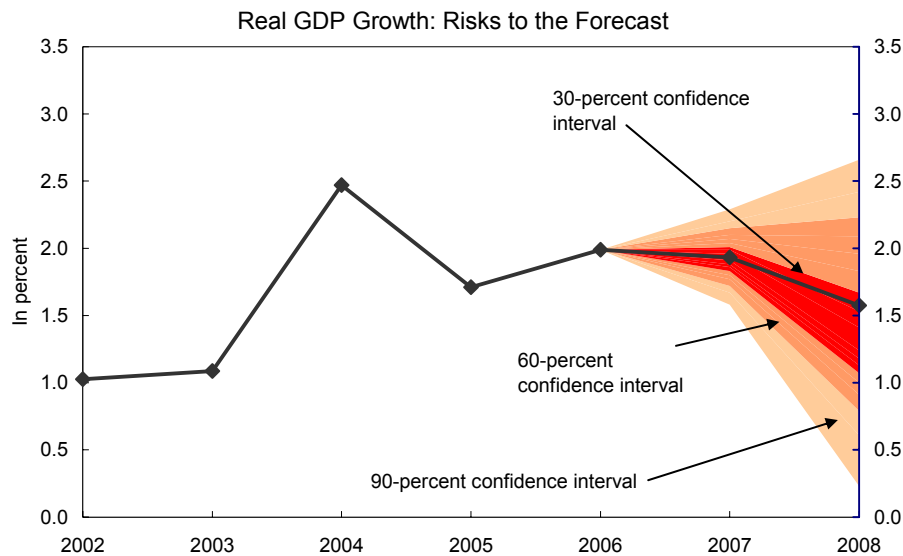
7. **Financial turbulence has had little impact on the domestic economy to date, with limited effects on French banks, but global spillovers stand to dampen growth.** Banks' performance has continued to be solid, and exposure to the U.S. subprime market appears limited. Credit default swap spreads have risen, but somewhat less than for some other major European banks (Figure 5), and no bank has yet experienced the type of difficulties seen elsewhere. French banks are generally well-capitalized and there is no domestic subprime market as such. While real estate prices have risen markedly and may be somewhat overvalued, French households are much less indebted than their U.K. or U.S. counterparts, and the share of variable rate mortgages is low. This low leverage of French households may soften the impact of any weakening of the real estate market. Nevertheless, the turmoil is expected to dampen growth in 2008 via effects on partner country demand as well as generally tighter credit conditions. Lending standards have been tightened by French banks, but less so than elsewhere in the euro zone.<sup>2</sup> Tighter conditions in 2006-07 may also trim growth in 2008-09, given the lags in monetary transmission.

8. **For 2008, staff forecasts growth of 1.6 percent, weaker than anticipated earlier and below official projections.**<sup>3</sup> The spike in oil prices, the rise in the euro, and weakening economic prospects in partner countries will be a drag on growth, offsetting the stimulus

<sup>2</sup> Lending survey data through October indicate that only 10 percent of French banks reported tightening conditions, versus 30 percent for the euro area as a whole.

<sup>3</sup> The December consensus forecast growth for 2008 is 1.8 percent. Staff forecasts might be reviewed further in the course of the current WEO process, and would be reflected as needed in a Supplement.

from the 2007-08 tax cuts.<sup>4</sup> Domestic demand will continue to sustain output, with the external sector contributing negatively. Downside risks predominate, notably concerning the depth and persistence of the financial market turmoil and its effects on other advanced economies. On the upside, rapid reform progress could help sustain confidence and growth. The authorities maintain the budget forecast of growth of 2-2½ percent for 2008. Core inflation is expected to remain around 1½-1¾ percent, but headline inflation may rise due to pressure on food and energy prices.



The chart includes the following risks to the baseline projections of growth (1.9 percent in 2007 and 1.6 percent in 2008):

- persistent tightening of financing conditions;
- 10 percent euro appreciation;
- 1 percent drop in foreign demand;
- boost in domestic confidence reflecting steady progress in reform agenda;
- a US recession and a disorderly unwinding of global imbalances.

They are weighted by the staff's subjective probability assessment of their occurrence.

**9. The staff baseline for medium-term trend growth is just under 2.2 percent annually—close to the authorities' 2.1 percent.** Growth is forecast to remain somewhat below potential in 2009 due to the aftereffects of slower global growth and tighter monetary conditions. Thereafter, staff projects growth to accelerate, with scope for an increase in potential output growth through structural reform. Staff projects 1 percent total factor productivity growth annually in the medium term. Relatively high fertility, strong immigration, and lower mortality should attenuate the effects of aging of the labor force. Staff estimate that the incentive effects of reduced taxation on overtime and other measures of the 2007-08 fiscal package might marginally boost growth, but more far-reaching,

<sup>4</sup> Staff analysis indicates that France's economy is highly sensitive to global common shocks (especially demand shocks, which seem to originate from the U.S.) and reacts more through changes in employment and productivity than through wage and price flexibility, buttressing the case for structural reforms (Alain Kabundi and Francisco Nadal De Simone, "France in the Global Economy," *IMF Working Paper 07/129*).



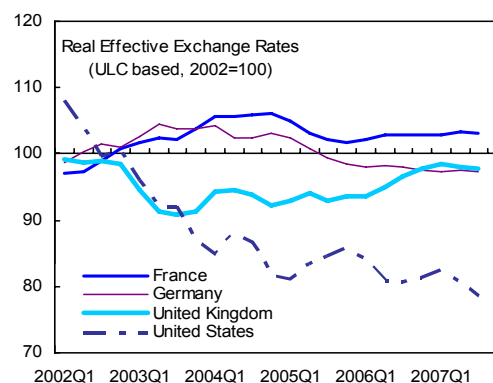
simultaneous reforms could boost long-run GDP by much more—up to 10 percentage points over 10 years.<sup>5</sup>

### III. POLICY DISCUSSIONS

10. **The government’s policy agenda is centered on implementing comprehensive structural reforms to generate higher growth, raising employment and purchasing power.** Labor market reform is central to the government’s program, as is captured in the slogan “work more to earn more.” Key initiatives are also underway in product and services markets, as well as broad tax and expenditure reviews. Policy discussions centered on these initiatives, with staff stressing the need for ambitious efforts and a focus on the country’s supply deficiencies. The supply-side focus was prompted by some early (mainly demand-oriented) measures and the emphasis on increasing households’ purchasing power, where there is sharp political pressure for action. Fiscal policy was also central to the discussions, with differences of view over the perceived trade-off between fiscal adjustment and structural reforms, and the related “adjustment pause” in 2008, but full agreement on the importance of rethinking the state’s role in the economy in order to secure expenditure-based consolidation in the medium term.

#### A. France’s External Sector Weakness

11. **Competitiveness—as measured by the real effective exchange rate—has deteriorated, but the appreciation fails to fully explain France’s poor export performance.** France’s real effective exchange rate has risen by 4½ to 12 percent since 2002, depending on the deflator used—due to euro appreciation and to higher French labor cost growth (Figure 6, panel 1). Within the euro area, competitiveness deteriorated against Germany, but improved against other countries; on balance, it strengthened modestly. Wages have increased faster in France, only partially compensated by higher productivity growth (Figure 6, panel 5). According to CGER-based estimates, France’s competitiveness gap remains modest—in a range of 1 to 9 percent (Figure 6, panel 6).



12. **Broader structural factors underlie faltering export performance.** A strengthening euro is no doubt increasingly challenging exporters, but staff viewed structural factors, including high wage increases, supply constraints, and insufficient flexibility in

<sup>5</sup> Luc Everaert and Werner Schule, “Structural Reforms in the Euro Area: Economic Impact and Role of Synchronization Across Markets and Countries,” *IMF Working Paper 06/137*.

responding to changing global demand as more important constraints on export performance. The authorities acknowledged the structural rigidities, but also saw a widening cost gap chiefly with Germany as a key factor in weakening French export performance within the EU.<sup>6</sup> France’s sector specialization is also unfavorable—with export weakness concentrated in automobiles and small firms.<sup>7</sup> Consequently, strengthening the export capacity of SMEs and increasing investment in R&D were seen as major levers to further export performance in the medium run. While few workers in the export sector are at the minimum wage (SMIC), strong SMIC increases have contributed to wage pressure elsewhere, and have helped boost imports.

## **B. The Reform Agenda**

13. **The move to a more forceful reform stance raises several political economy considerations.** The authorities have opted to pursue simultaneous reforms across a wide range of areas, breaking with the incrementalist approach of the past. Staff supported this strategy, noting that important synergies exist in contemporaneous action. Properly calibrated, simultaneous reforms—addressing rents in several areas—could help attenuate the political opposition of special interests.<sup>8</sup> A “critical mass” of reforms would also generate faster and larger payoffs in terms of growth, employment, productivity, and lower prices for consumers, thereby garnering consensus. However, staff and the authorities had different views about the interaction between fiscal adjustment and structural reforms. The authorities felt it important to fulfill campaign pledges and provide early tangible benefits to pave the way for reforms whose results take more time. It was in this light that they justified the government’s early tax reduction measures. These measures also addressed a key concern of the electorate—the perception of stagnant or declining real incomes (*pouvoir d’achat*). While acknowledging the political potency of these arguments, staff’s reading of the data suggests that French incomes have actually risen more than in other euro area countries (Box 1). Staff noted that the emphasis on purchasing power risked obfuscating the true nature of France’s growth difficulties—the weakness of its supply potential—while raising expectations that could not be met. More generally, staff viewed fiscal adjustment and structural reforms as complementary and thus considered the decision to pause fiscal consolidation in 2008 ill-advised.

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<sup>6</sup> It has been apparent for some time that the German and French economies have been out of synch on several dimensions (Figure 7).

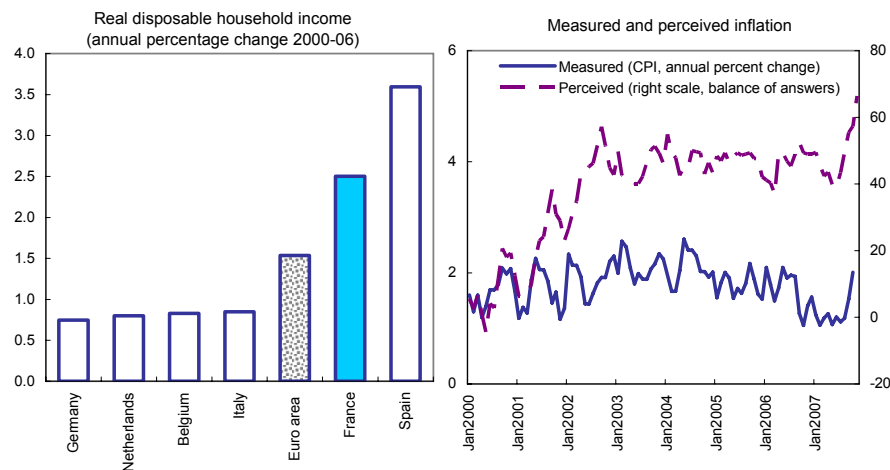
<sup>7</sup> See the background study on non-price competitiveness from a regional perspective, forthcoming.

<sup>8</sup> The authorities did not see much scope for pursuing proposals (cf. in particular Jacques Delpla and Charles Wyplosz, *La Fin des Privilèges: Payer pour Reformier*, 2006) to “compensate” stakeholders for the loss of rents created by long-standing public policy.

### Box 1: *Pouvoir d'Achat*: Perception and Reality

In recent opinion polls, French consumers rank eroding purchasing power (*pouvoir d'achat*) as their greatest economic concern, above unemployment. Yet data show that over the past seven years, real disposable household income has increased in France faster (18 percent) than in the euro area (11 percent), and significantly faster than in most neighboring countries (panel 1). There is thus a wide disparity between a public perception and the national accounts data.<sup>1</sup> Reasons for this disparity may include:

- **Income per head** has increased less than the aggregate due to population growth (0.6 percent).
- While real wages per hour have risen, real wage incomes have stagnated since the 1980s largely due to a **decline in paid hours worked**.
- **Perceived inflation** has been persistently higher than measured inflation since early 2001 (panel 2). Highly visible price increases (e.g for food) may have had a disproportionate impact on perceptions.
- Strong **increases in rents**, which are weighted less in the consumer price index (6.1 percent) than in the national accounts (18.6 percent weight in private consumption, including imputed rents by owners).
- A **rising share of non-discretionary spending**, such as for housing, financial services, and insurance. Down payments on housing loans, for example, are savings in the national accounts, but many private households regard them as reducing their purchasing power.
- An **unequal distribution of income**, leaving certain households financially pressed. Income distribution data (available only through 2004) indicate that real incomes for the lowest and highest deciles of the population rose between 2002-04, but most other deciles were stagnant or declining, resulting in a middle class “squeeze.” As noted in the October 2007 WEO, however, “among the largest advanced economies, inequality appears to have declined only in France.”



Sources: European Commission, Ameco, and EC consumer survey.

<sup>1</sup> J. Accardo and others (2007), *La mesure du pouvoir d'achat et sa perception par les ménages*, in *L'économie française*, 2007. The statistical agency (INSEE) has been charged with elaborating new purchasing power data, and Nobel laureates Stiglitz and Sten have been asked to consider including “quality of life” factors in measuring growth.

## Freeing the labor market

14. **There was agreement that labor market rigidities are probably the single most significant barrier to higher economic growth and employment.** France’s already low labor input declined further in recent years, reflecting both high unemployment and lower working hours among the employed. Main shortcomings in the labor market, as identified by the authorities and the OECD (Figure 3), are: (i) burdensome legal restrictions on hiring, firing, working hours, and functional mobility under permanent contracts, generating inefficiencies and a severe “insider-outsider” divide; (ii) pervasive judicial involvement in labor relations; (iii) inefficiencies and lack of coordination among public job placement and unemployment compensation agencies; (iv) a high minimum wage; and (v) one of the highest tax wedges on employment in the OECD. These distortions in turn weigh heavily on the public purse, as tax breaks attempt to compensate for the rigidity of labor market institutions.

15. **The social partners have concluded a 4-month long negotiation on the reform of labor contracts.** Changes in the labor framework include an increase in the trial period, a new labor contract that will allow project-linked employment and new incentives to end permanent contracts through amicable separation. Dismissed workers will carry with them rights to complementary health insurance, training and unemployment benefits that reflect the contributions they made while employed. While this agreement should allow increased use of temporary contracts and facilitate separations on permanent contracts, it falls short of a comprehensive reform. Staff noted that studies suggest that reforms making the labor market more flexible at the margin are ineffectual, tending to artificially increase the turnover rate and only modestly affecting job creation, while having potentially harmful effects on welfare.<sup>9</sup>

16. **The government is undertaking other initiatives to mitigate labor market distortions.** The most important among these are a review of the mechanism for setting the SMIC, the merger of the unemployment and job placement agencies, and steps to impart greater flexibility to the 35-hour workweek arrangement. There was agreement that the secular rise of the SMIC has priced young and unskilled workers out of jobs and compressed wages at the bottom end, demotivating effort. To begin correcting these distortions, the government omitted the habitual discretionary increase of the SMIC in 2007 (the so-called *coup de pouce*), limiting the adjustment to that determined by the indexation formula (a combination of inflation and the increase in the average base salary). While staff saw drawbacks in the formula, it is unlikely to change. The authorities are leaning rather toward a

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<sup>9</sup> See Pierre Cahuc and Stéphane Carcillo, “The Shortcomings of a Partial Release of Employment Protection Laws: The Case of the 2005 French Reform,” *IMF Working Paper 06/301*. The scope for reform may also be affected by the fact that France is among eight OECD signatories of the ILO Termination of Employment Convention No. 158. In November 2007, an employment contract introduced in 2005, aimed at facilitating hiring and dismissals in small enterprises (the *Contrat Nouvelles Embauches*—CNE), was found by the ILO as not in observance of the Convention.

U.K.-style “low pay commission” to provide technical input and de-politicize decisions. The merger of the job placement and unemployment agencies aims to promote a “return-to-work” orientation via a closer, one-stop guidance of job-seekers.

17. **The authorities have attempted to make the 35-hour workweek less binding, without formally reversing what is viewed as a social *acquis*.**<sup>10</sup> The main measure to date is the elimination of taxes and social charges on overtime work. While uncertain, estimates suggest that the measure would create relatively few new jobs, at a budget cost of about 0.3 percent of GDP. The authorities highlighted the signaling value of the measure in extolling work effort, providing greater flexibility, and reducing marginal wage costs, while not completely discounting staff criticisms of its shortcomings (windfall effects, operational complexity to avoid probable fraud, and further recourse to the budget to alleviate a distortion). More recently, the president has announced other possibilities to ease the workweek limit, including through majority agreements in individual companies in exchange for wage increases. These steps have met with a mixed reception, given their administrative complexity, especially for smaller firms.

#### **Goods and services markets—raising competition and consumer welfare**

18. **Staff and the authorities agreed that further goods and services market reforms could significantly boost potential output, competitiveness, and consumer welfare.** This emphasis is supported by studies showing that the benefits would be sizeable.<sup>11</sup> The authorities have assigned priority to early reforms in the retail distribution sector, while undertaking preparatory work for the implementation of the EU Services Directive. A careful review of all existing regulations is underway to ascertain their compatibility with the Directive’s provisions. There was agreement that action need not await the Directive’s drawn-out timetable, and could proceed in several areas—notably as regards regulations in retail distribution, hotels, and restaurants, and tightly controlled activities and professions (Box 2).

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<sup>10</sup> Staff work raises questions about the extent to which workers approve of the mandatory reduction in working hours, which is estimated to have constrained the choice of a significant number of individuals. See Marcello Estevão and Filipa Sá, “Are the French Happy with the 35-Hour Workweek?” *IMF Working Paper 06/251*.

<sup>11</sup> Romain Bouis, “*Évaluation de l’impact macroéconomique de réformes sectorielles à l’aide d’un modèle à deux secteurs*,” September 2007, finds an increase in GDP growth of 1.2 percentage points and of 250,000 jobs resulting from structural reforms in financial markets, the distribution sector, and hotels and restaurants (representing about 15 percent of GDP). These results are comparable to those in Everaert and Schule (2006).

## Box 2. Key Product and Services Market Reforms

Several reform areas appear particularly promising in their ability to improve economic efficiency, yielding lower consumer prices and greater productivity:

- **Supplier-retailer relations.** Heavy-handed regulations originally designed to protect against predatory pricing (codified in the *loi Galland*) have in practice strengthened the market power of large existing firms, resulting in higher consumer prices. Previous steps to contain prices on national branded products and the 2005/06 reform of the *loi Galland* yielded positive results. More recently, the government introduced legislation to free wholesale margins, passing savings fully on to consumers.
- **Retail space and openings.** Legal entry barriers<sup>1</sup> have reduced new establishment of large retail shops, hotels, and restaurants by almost 60 percent and limited the share of “maxi-discounters” to 13 percent in France, compared to 30 percent in Germany. These barriers strengthen the bargaining position of large retailers against suppliers and protect incumbents from competition. The authorities also intend to ease regulations on retail opening hours and on sales periods.
- **Regulated activities and professions.** Pervasive entry barriers include training requirements (certified accountants, notaries, lawyers, architects), licenses (taxi drivers), and restrictions on establishment (medical profession, pharmacies). Partly a result of self-regulation, entry barriers limit the supply of services, providing rents. Accordingly, there is significant scope for reforms, as recognized by earlier reports (e.g. Camdessus,<sup>2</sup> and Cahuc and Kramarz<sup>3</sup>). The latter includes a list of 75 regulated activities (*métiers*) and 28 regulated liberal professions.

<sup>1</sup> The *Lois Royer* (1973) and *Raffarin* (1996) protect small retailers by subjecting the establishment of “*grandes surfaces*” (above 300 m<sup>2</sup>)—including hotels—to special approval.

<sup>2</sup> *Le sursaut—Vers une nouvelle croissance pour la France*, 2004.

<sup>3</sup> Cahuc, P. and F. Kramarz, *De la précarité à la mobilité: Vers une sécurité sociale professionnelle*, 2004.

19. **Moving competition policy to center stage would, in staff’s view, be aided by a unified, independent, and reinforced competition authority.** In line with both the OECD and the Attali Commission,<sup>12</sup> staff advocated a change in France’s institutional framework for competition policy, modifying its dualistic setup (split between the *Conseil de la Concurrence* and a Directorate at the Ministry of Economy and Finance), including removing responsibility for merger control from the ministry—an arrangement at odds with international best practice. The authorities concurred that there was scope for greater advocacy vis-à-vis the public of the virtues of competition, but expressed doubts that the French institutional arrangement has compromised policy effectiveness. They pointed to the favorable ratings France has received in comparisons of national competition authorities, and questioned whether a unified authority was a genuinely superior arrangement.

<sup>12</sup> The Commission has been charged with recommending measures to boost France’s growth.

### C. Achieving Fiscal Sustainability

#### The fiscal position and objectives

20. **After several years of fiscal adjustment, progress stalled in 2007.** Between 2003 and 2006, the structural deficit fell by over 1½ percentage points of GDP, bringing the overall deficit to 2½ percent of GDP in 2006. However, higher revenues contributed most to the adjustment, with the share of general government outlays to GDP remaining broadly unchanged. Strong growth of social security and local government spending largely offset tight control of central government expenditures. This trend continued into 2007 due to slippages in health and pension-related spending. As a result, the general government deficit is estimated to have remained broadly unchanged in 2007 (at 2.4 percent of GDP), implying an underlying adjustment of only ¼ percentage point of GDP—half the SGP-recommended pace for countries and still distant from their medium-term objectives.

21. **Despite continued spending restraint, the 2008 fiscal plans entail no underlying adjustment due to the costs of tax-reducing measures.** On the positive side, real general government spending growth is limited to 1.4 percent, which would produce a 0.6 percentage point decline in the expenditure-to-GDP ratio (to a still high 52.6 percent of GDP). The budget also incorporates an unprecedented reduction in public employment (by 23,000); improves the coverage of the central government expenditure norm; limits the growth of transfers to local authorities; increases precautionary reserves; and contains further steps to enhance the co-responsibility of health care users and discourage early retirement. However, this expenditure restraint is largely undone by the cost of the tax package (½ percent of GDP). In addition to the tax exemption for overtime hours, the package includes tax credits for mortgage interest—viewed critically by staff due to its demand-side orientation with likely little impact on home ownership or economic growth (as demonstrated by international experience).<sup>13</sup> Indeed, France had removed this deduction in the mid-1990s. More positively, the 2008 budget includes a reformed research tax credit. The authorities project a general government deficit of 2.3 percent of GDP (based on GDP growth of 2¼ percent), resulting in an essentially unchanged structural balance and a marginal reduction in the public debt ratio (to 64 percent of GDP).

22. **The 2008 budget appears subject to risks of slippage.** The budget's macroeconomic and revenue assumptions are optimistic, social security overruns remain a major risk (notably in health care), and expected efficiency gains in central government outlays could prove elusive. As a result, staff expects a structural balance deterioration of ¼ percent of GDP and the overall deficit to reach 2.7 percent of GDP, close to the Maastricht

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<sup>13</sup> Edward Glaeser and Jesse Shapiro (“The Benefits of the Home Mortgage Interest Deduction,” *NBER Working Paper* No. 9284, October 2002) find the mortgage interest deduction to be “a particularly poor instrument for encouraging homeownership.”

limit (Text Table)—perilously so were downside risks to growth to materialize.<sup>14</sup> The authorities thought staff overstated the risks, and viewed the possibility of approaching the Maastricht limit as remote.

Text Table 1. General Government Accounts 2006-12  
(In percent of GDP; unless otherwise indicated)

	2006	Staff Projection					
		2007	2008	2009	2010	2011	2012
<b>Staff projection (baseline)</b>							
Tax revenue	44.2	44.0	43.7	43.5	43.4	43.4	43.4
Real spending growth (in percent) 1/	2.1	2.0	1.6	1.6	1.6	1.6	1.6
Overall balance 2/	-2.5	-2.4	-2.7	-2.6	-2.3	-1.9	-1.4
Structural balance 2/ 3/	-1.9	-1.6	-1.7	-1.6	-1.5	-1.4	-1.2
Structural change (in percent)	0.8	0.3	-0.1	0.1	0.1	0.2	0.2
Gross debt 2/	64.2	64.1	64.6	64.8	64.4	63.6	62.5
Real GDP growth assumption	2.0	1.9	1.6	2.2	2.5	2.5	2.5
<b>Authorities' budget plan</b>							
Tax revenue	44.2	44.0	43.7	43.5	43.4	43.4	43.4
Real spending growth (in percent) 1/	2.1	2.0	1.4	1.1	1.1	1.1	1.1
Overall balance 2/	-2.5	-2.4	-2.3	-1.7	-1.2	-0.6	0.0
Structural balance 2/ 3/	-2.5	-2.2	-2.1	-1.6	-1.1	-0.6	0.0
Structural change (in percent)	0.8	0.3	0.1	0.5	0.5	0.6	0.6
Gross debt 2/	64.2	64.2	64.0	63.2	61.9	60.2	57.9
Real GDP growth assumption	2.0	2.3	2.3	2.5	2.5	2.5	2.5
<b>Memorandum items (percent change):</b>							
Difference in structural adjustment							
Authorities' objective - staff's baseline	0.0	0.0	0.2	0.4	0.4	0.4	0.4
Due to: Higher expenditure growth	0.0	0.0	0.2	0.3	0.3	0.3	0.3
Lower non-tax revenue	0.0	0.0	0.0	0.1	0.1	0.1	0.1

Sources: INSEE; IMF staff calculations; and 2008 Budget proposal.

1/ Real growth (in percent) adjusted using CPI excluding tobacco prices.

2/ Maastricht definition.

3/ Excludes pension transfers and other one-off measures; assumes a tax revenue-to-GDP elasticity close to unity.

23. **Views differed on the 2008 fiscal adjustment pause.** The authorities considered the 2008 budget to contain positive pro-growth measures and other effects underestimated by staff, particularly in terms of generating goodwill for future, fundamental reforms. Staff, for its part, viewed fiscal consolidation and structural reforms as complementary and pressed that fiscal consolidation be restored as a national priority, as enshrined in last year's budget documents and in the Pébureau Report on public debt. Experience in other industrial

<sup>14</sup> Each 0.2 percentage point in lower growth increases the deficit by roughly 0.1 percent of GDP. Thus, if growth fell to 1 percent in 2008 (a 20 percent probability by staff's estimate), the deficit could breach the Maastricht limit absent corrective action.



economies (such as Canada—see Box 3—and others<sup>15</sup>) has shown that contemporaneous fiscal consolidation and structural reforms can generate virtuous cycles of improved competitiveness, higher growth, and healthier public finances. Maintaining a steady pace of fiscal adjustment would promote credibility, eroded by the continuous postponement of the

### **Box 3. Canada's Experience: Combining Fiscal Consolidation and Structural Reform**

**Facing debilitating economic conditions, Canada launched path-breaking fiscal and structural reforms in the mid-1990s.** During the 1980s and early 1990s, Canadians saw a marked deceleration in the growth of living standards combined with a chronic deterioration of public finances. Slowing productivity and employment growth led to sub-par economic performance while lax public spending contributed to further policy dislocation and spiraling debt dynamics (Figure 8). In 1994, the government set out a bold economic reform to strengthen Canada's macroeconomic performance by cutting government deficits, rebalancing the policy mix (with lesser reliance on monetary tightening), and establishing conditions to heighten competition and boost job creation.

**A key priority was to eliminate the federal government deficit** of over 5 percentage points of GDP based on the following initiatives:

- *A retooling of the budget process* to incorporate a transparent budget forecasting framework, including a contingency reserve for debt reduction.
- *An expenditure review of all federal ministries* to refocus the role of the government and stress the cost effectiveness and efficiency of public services. A similar approach is guiding France's recently launched review of public policy.
- *An ambitious state reform* including notably a 20 percent cut in the federal civil service; a reduced presence of the government in the economy through selective privatization, and contracting out; and broad deregulation.

**Steps to raise economic flexibility and competitiveness complemented the fiscal reforms.** Key initiatives included reform of employment insurance and social assistance, pension reform, reduction of internal and external trade barriers, deregulation of major network industries, and cutback of administrative burdens.

**The fiscal turnaround after 1994 was remarkable.** The federal government outperformed its fiscal targets every single year thereafter and achieved fiscal surplus in 1998, a year earlier than planned. Expenditure cuts allowed federal spending to fall from near 17 percent of GDP in 1994 to about 12 percent in 1998. With the improvement of the fiscal situation, the government enacted one of the largest tax cuts in Canadian history in 2000.

**The improved macroeconomic framework based on sound fiscal, monetary, and structural policies created the conditions for sustained economic growth.** Between 1997 and 2006, Canada enjoyed the highest job creation and output growth among G7 countries.

<sup>15</sup> Sweden's experience in combining fiscal consolidation and structural reform is illustrated in S. Thakur, M. Keen, B. Horvath, and V. Cerra, *Sweden's Welfare State*, International Monetary Fund, 2003. See also A. Annett, "Lessons from Successful Labor Market Reformers in Europe," *IMF Policy Discussion Paper* 07/01, which shows that four top EU reformers improved fiscal balances (while cutting labor taxation) during episodes of labor market reform. Germany provides a more recent example.

medium-term objective (Text Figure). Staff noted that an adjustment of  $\frac{3}{4}$  percentage point of GDP per year in 2009-10 would bring the fiscal accounts close to balance by 2010.

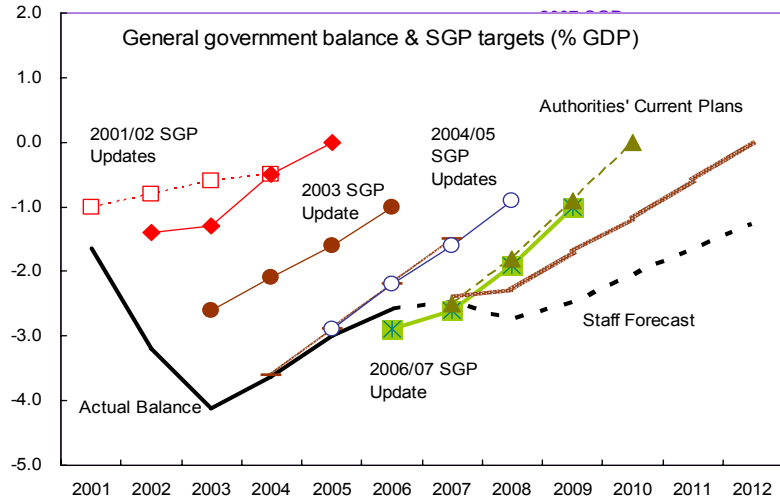
**24. The authorities now aim for fiscal balance by 2012, a date they view as more realistic.** They

consider balance by 2010—as

set out in the end-2006 Stability Program—possible only with appreciably higher growth (~3 percent). They viewed insistence on the same target date for all euro area countries as a conceptually flawed “one-size-fits-all” approach likely to fail in several euro area countries. Such an outcome was seen as more harmful to SGP credibility than France’s approach of a realistic 2012 target based on comprehensive tax and expenditure reviews (see below). Staff responded that the 2010 date *per se* was not the key issue; rather it was the failure to maintain a consistent adjustment pace and the repeated rescheduling of adjustment commitments that undermined credibility and increased the costs of adjustment (due to higher debt stocks and increased demographic pressure). Staff noted that any successful adjustment would require returning to a path of steady consolidation, achieved in the short-run by stricter spending targets; general pension reform in 2008, building on the reform of the special regimes underway; further healthcare reforms to expand co-payments and reduce underlying spending pressures; and strengthened commitments to restrain local government spending.

### Fiscal reform

**25. The government has launched a comprehensive review of public policy to secure better public services and lasting expenditure efficiency and reduction.** Building on substantial efforts in recent years to improve fiscal governance and control expenditures (notably via the Organic Budget Law, LOLF), this broader review (RGPP) aims to go beyond marginal improvements in cost and efficiency to achieve a more fundamental improvement in public services and reduce spending as a share of GDP. A review of the extensive role of the state in the economy is key, refocusing on core missions and rationalizing the overlapping functions of multiple levels of local government. The planned merger of the tax and public accounting directorates (DGI and DGCP), modernizing tax administration structure, is a positive example of this rationalization. Finally, the review will serve to place public spending in a strategic framework, with a move to multiyear budgeting for the period 2009-11. Recently, the authorities unveiled the interim findings of the



comprehensive audits underway, including some 100 streamlining measures. Staff strongly supported the exercise, noting the positive fruits that effective implementation yielded elsewhere (such as Australia, Canada, and Sweden), while cautioning against expectations of early results.

26. **The government has also initiated a general review of the tax system.** The review (RGPO) will allow the authorities to reevaluate the type of tax system needed to address the challenges of the globalized economy of the twenty-first century. The review's objectives of greater stability, a supportive framework for business and investment, and greater use of environmental taxes should guide reform toward a more efficient system. Staff noted that the reform should give prominence to simplification and greater neutrality, producing a system with fewer distortions (deductions, exemptions, and tax credits, see Box 4). A key element should be a sharp reduction in tax expenditures, and the enshrining of the principle that all such tax decisions be taken only in the context of the budget (*Loi des Finances*). Until then, staff advocated a freeze on further tax expenditures, which are often taken off-budget cycle in response to sectoral pressures—a proposal viewed with favor by the budget authorities. The authorities, while noting the staff's proposals, saw a tension in the call for stepped-up fiscal adjustment and its concomitant support for tax reform which, they noted, is seldom revenue-neutral.

#### **D. Combining Financial Sector Stability and Efficiency**

27. **French banks remain sound and well-capitalized, though the recent financial turmoil has weighed on profitability and highlighted the importance of maintaining a strong capital base.** Consolidated net income and return on equity of the eight main banking groups rose sharply and the ratio of nonperforming loans continued to decline in 2006 (Tables 6-7). This solid performance continued in the first half of 2007 which, combined with strong capitalization, provided a cushion to absorb the impact of the crisis without jeopardizing solvency. However, growth came mostly from corporate and investment banking, asset management, and foreign markets, with expansion in domestic retail banking weaker. This slowdown in domestic retail earnings and increasing reliance on non-intermediation activities have increased banks' balance-sheet vulnerability to heightened risk aversion and global liquidity retrenchment. Recent actions by some banks to consolidate off-balance sheet exposures, albeit generally not large, may also drive down banks' earnings, as may rising risk in corporate credit.<sup>16</sup> In addition, the cooling-off in real estate prices, tightened mortgage lending, and expected sluggish demand raise the risk of a future downturn in the mortgage market.

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<sup>16</sup> An analysis of the impact of the turbulence on the French corporate sector is presented in the selected issues paper "Financing and Risks of French Firms."

#### Box 4. Tax Reform in France: Challenges and Options

**The increased complexity of the French tax system has been an unfortunate by-product of a piecemeal approach to tax reform.** In recent years, the government has undertaken several initiatives to reduce the tax burden on labor while seeking to accommodate global competitive pressures to lower capital taxation. Some of these, such as the earned income tax credit (PPE), simplification of the personal income tax, or the reform of the *taxe professionnelle* have brought noticeable improvements to the system. Nonetheless, measures have also been introduced to compensate for other policy distortions, notably in the labor market, degrading the overall coherence of the tax system by creating new distortions and loopholes. The August 2007 tax package is another example of such a piecemeal approach.

**Against this background, the announced general review of the tax system is timely.** The strategic assessment of the tax system should aim for greater stability, a supportive framework for business and investment, and greater use of environmental taxes. It is the first tax assessment exercise of this scope in France, and provides an opportunity to strategically revamp the system to increase tax efficiency and competitiveness. Fundamental reforms elsewhere in the EU, notably to corporate and capital income taxation, pose challenges for France by offering an attractive regime while safeguarding revenue. Staff sees several areas for reform of the main taxes:

- The statutory rate of the **corporate income tax** will soon be the highest in Europe. A lower rate with a broader base could make the system simpler and fairer, deterring the shifting of profits and investment to lower-taxed countries.
- There is scope for further simplification and base-broadening of the **personal income tax**; transition issues in moving to mandatory withholding are surmountable.
- The intended restructuring and streamlining of France's **income support system** (*minima sociaux*) and work-pay initiatives (*PPE*) could help eliminate the distortions produced by the complexities of the tax-benefit system.
- The **VAT** in France is increasingly out-of-step with international best practices. A move to unify VAT rates and broaden coverage could raise as much revenue with a headline rate significantly below the current 19.6 percent, reducing incentives to informality and allowing distributional objectives to be pursued by better-targeted instruments.
- The **"tax shield"** (*bouclier fiscal*) complicates tax administration and represents a second-best solution to limiting the distortions caused by a high tax rate and an overly complex system. Reform should reduce rates, including through the phasing-out of the wealth tax.

The emphasis being placed on **environmental issues** in reviewing the tax system is welcome.

28. **The exposure of the French financial sector to ongoing financial turbulence appears manageable, despite some challenges.**<sup>17</sup> Direct exposure to subprime through retail banking in the U.S. is negligible. French banks appear to be in a position to provide liquidity and regulatory capital to their off-balance sheet vehicles if needed. The outstanding amount of asset-backed commercial paper (ABCP) is low (about 3 percent of the U.S. level).

<sup>17</sup> In Q3 2007, BNP Paribas reported losses from the subprime and structured credit of €230 million, Société Générale €328 million, Natixis €407 million, and Crédit Agricole Group €546 million. These banks all reported overall profits for the quarter, however.

French banks run several conduits and one structured investment vehicle (SIV), but exposure to mortgage-backed securities represents only 0.3 percent of total assets, and potential subprime exposure via conduits accounts for less than 2 percent of assets. No banks have taken their conduits onto their balance sheet yet, but Société Générale announced a US\$4.3 billion bail-out of its sole SIV, with an impact of about 5 b.p. on its tier-one capital ratio. French banks' exposure to Leveraged Buy-Out (LBO) risk also appears manageable.<sup>18</sup> According to the authorities, French banks' participation in recent ECB's liquidity operations was disproportionately low compared to their share of euro area assets and liabilities.

29. **Some French mutual funds, including notably so-called “dynamic” money market funds, experienced temporary difficulties at the start of the global turbulence.** These funds, run by large financial institutions, suffered due to exposure to U.S. subprime mortgages, leading in a few cases to a temporary trading suspension. While the timing of this action—at the height of market jitters—was sensitive (given the potential for confusion between operations on the bank's own account and those in funds managed by the bank), the decision is seen to have protected investors' interest and safeguarded equality among investors. The authorities have nonetheless initiated a review of financial product advertising and of the marketing practices of these funds, whose nomenclature could be read as suggesting liquid money market investments.

30. **On financial stability issues, the authorities are contributing to initiatives to improve financial supervision and favor greater EU cooperation and regulatory harmonization.** Domestically, the authorities see the relative resilience of the French financial system as clear validation of their supervisory model, with the proximity provided by separate banking supervision (and coverage of *all* credit-granting institutions, the absence of which they view as a determinant of the subprime crisis) ensuring timely information. Internationally, they see the turbulence as demonstrating the need for coordinated initiatives, set out inter alia in the Brown-Merkel-Sarkozy declaration of October 2007. At the European level, the authorities strongly support strengthening the financial stability framework, favor including an EU dimension in the statutory mandates of national regulators, and aim to press the Lamfalussy process forward ahead of France's EU Presidency in the second half of 2008.

31. **The authorities agreed that the financial sector's contribution to growth could be enhanced, and viewed the “Paris-Place Financière” initiative as contributing to this end.** The initiative aims to promote Paris as an international financial center, and envisages steps to attract long-term capital, modernize the legal framework, and improve the tax and regulatory environment. The authorities have also taken advantage of the implementation of MiFID to implement “better regulation” principles. Finally, a commission headed by

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<sup>18</sup> Senior LBO tranches predominate (85 percent), with a small share of junior tranches (less than 6 percent) on banks' balance sheets. While there are signs of increasing leverage and longer time to syndicate, the pipeline is estimated to be less than €10 billion and banks are decreasing origination volume.

Michel Camdessus has recommended ending the monopoly of distribution for certain administered savings instruments (notably the *Livret A*), and the affected Banque Postale has been granted the possibility of offering consumer credit—steps toward gradually phasing out administered loan and savings schemes and reducing the state’s role in the financial sector, as long advocated by the Fund.

#### IV. STAFF APPRAISAL

32. **The government’s reformist intentions provide an historic opportunity to place France onto a sustained higher growth path with greater opportunities for all.** An unwavering drive for reforms, entailing a true rupture from the past and complemented by a stronger fiscal adjustment than currently planned, would create a virtuous cycle of higher growth, healthier public finances, and lower unemployment. Aiming for a “critical mass” of simultaneous reforms across different areas exploits the synergies of contemporaneous action and—by addressing rents across several markets—more fairly distributes costs and benefits. Fund staff simulations show that such a strategy would yield appreciably larger and faster growth dividends than a gradual and piecemeal approach. However, to the extent that choices must be made, efforts are best concentrated where current market distortions are the greatest—in the labor market and constraints on competition in services markets—as is indeed being planned.

33. **Economic policy should address the root cause of France’s faltering growth performance: the weakness of its supply potential.** While there is a widespread public perception that a lack of purchasing power is constraining growth, the sources of France’s growth difficulties lie not in deficient consumer demand, but in rigidities that impede supply and impair export performance. The government rightly aims to address these rigidities, but its emphasis on raising purchasing power—while understandable in political economy terms—blurs the problem and raises unrealistic expectations. An unambiguous focus on the country’s supply deficiencies would impart an overarching internal coherence to the government’s economic strategy.

34. **Weak external sector performance adds urgency to the case for structural reforms.** While France’s measurable competitiveness gap is modest, its disappointing export performance is testimony of deep-seated rigidities. Broad reforms addressing these rigidities, along with fiscal adjustment, are key to raising future growth and export performance.

35. **With one of the lowest labor inputs in the OECD, France indisputably needs to “work more” if it is to “earn more.”** The government’s emphasis on work effort is most apposite given the country’s low labor force participation, employment rates, and hours worked. Three areas should receive priority attention. First, the various measures to ease the 35-hour workweek restrictions, including the tax exemption for overtime, do not address the original distortion of the statutory reduction in working time, and as such are complex, second-best responses. It is emblematic of the pernicious nexus between rigid labor market

institutions and the budget that—having spent considerable sums to implement the 35-hour workweek—additional public money is now being diverted to circumvent it. Second, the secular rise of the minimum wage needs to be halted. The decision to forego a discretionary adjustment in 2007 is thus welcome, and should be maintained going forward. A “low pay commission” of independent experts to advise on the yearly setting of the SMIC and raise awareness of the impact of a high minimum wage on unemployment and public finances could be helpful. Third, the present, highly limiting juridical framework for labor relations merits comprehensive reform. While the outcome of the recent negotiation on labor contracts is a welcome step towards reducing severe labor market rigidities, since social partners have taken the current limiting framework as given, the agreement may only marginally ease labor market constraints. A superior option would be to ease the restrictiveness of permanent contracts more generally.

36. **Further goods and services market reforms could significantly boost potential output and consumer welfare.** Placing competition policy at center stage would be aided by replacing the current dual responsibilities for competition policy with a single, reinforced, and independent competition authority, as recommended by the OECD and the Attali Commission. This authority could also be vested with a mandate to be a public advocate for competition. For the benefit of consumers, current reforms of retail distribution should lead to a complete removal of the prohibition of below-cost pricing, allowing full contractual freedom between suppliers and retailers. More generally, the liberalizing opportunity offered by the EU Services Directive should be fully seized.

37. **While the 2008 budget contains several commendable initiatives, it implies an inopportune pause in fiscal adjustment, stemming from the tax-cutting provisions.** The 2008 budget incorporates several positive features to contain spending, including an unprecedented reduction in public employment. But the resulting expenditure restraint is offset by the tax cuts, which focus largely on demand-side stimuli rather than on increasing productivity and flexibility on the supply side.

38. **Fiscal policy should be vigilant to the risk of slippage in the fiscal deficit in 2008 and aim for a return to an ambitious fiscal adjustment path going forward.** Risks in 2008 stem primarily from the prospect of lower-than-budgeted growth and from continued spending pressures, most notably in social security. In addition, if growth were to turn down, the deficit could move perilously toward its Maastricht limit, and early corrective action should be taken. From 2009, a structural adjustment path of  $\frac{3}{4}$  percentage points of GDP per year, around which the stabilizers could be allowed to play, would bring the fiscal accounts close-to-balance by 2010, contributing to the credibility of the medium-term objective.

39. **The ongoing expenditure and tax policy reviews are most welcome.** International experience shows that these exercises stand to yield appreciable results, providing lasting improvements in the fiscal position and in the efficiency of public services. Expectations of early results should however be tempered. In 2009-10, fiscal consolidation should be based

on tight spending plans and the recognition that the present state of public finances allows no scope for further tax reductions or for continued recourse to tax expenditures to address distortions or sectoral requests.

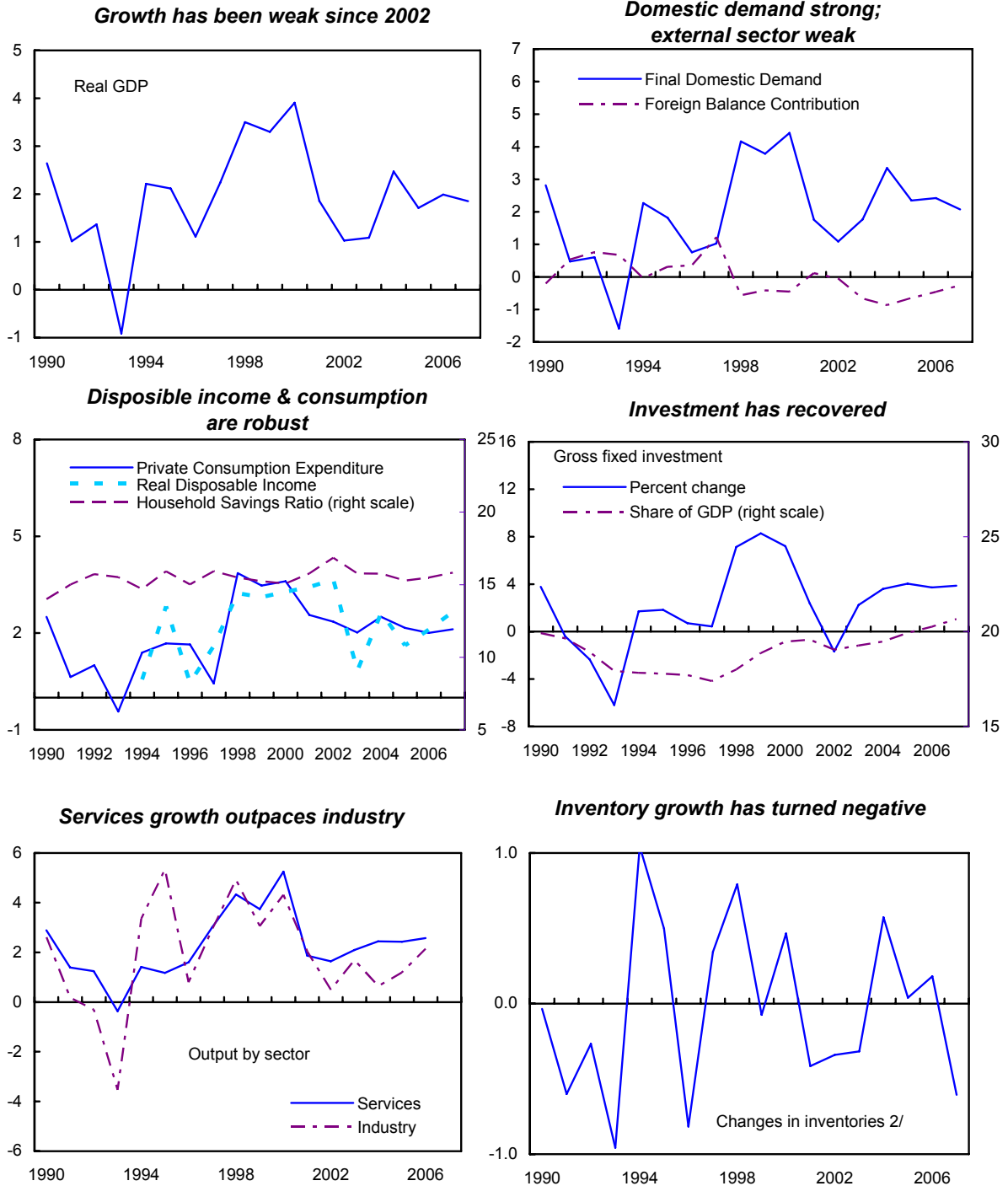
40. **The French financial system has weathered the recent financial market turbulence comparatively well so far, but risks remain.** The system's strong capitalization, its modest exposure to the U.S. subprime mortgage market, and a supervisory system that covers all credit-granting institutions have all contributed to this relative resilience. Still, the current environment continues to pose challenges, as market conditions have yet to return to normal, which could further increase banks' financing costs, reduce their profitability, and induce credit tightening. Continued vigilance will thus be paramount. The authorities' readiness to include a European dimension in the statutes of national regulators and the impulse they intend to give to the Lamfalussy process are welcome.

41. **The contribution that a modernized financial sector can make as a driver of economic growth deserves greater prominence.** In this regard, the "Paris-Place Financière" initiative provides an opportunity to modernize France's financial markets. France's financial system, while a leader in some sectors, continues to carry the legacy of a heavily regulated and administered past. To improve the efficiency of the banking sector, administered schemes should be phased out and the state's role in the financial sector reduced. Ending the monopoly on the distribution of *Livret A* provides opportunities in this direction; in particular, with the Banque Postale being given the possibility to become a full-fledged bank and in due course privatized.

42. It is proposed that France remain on the standard 12-month consultation cycle.

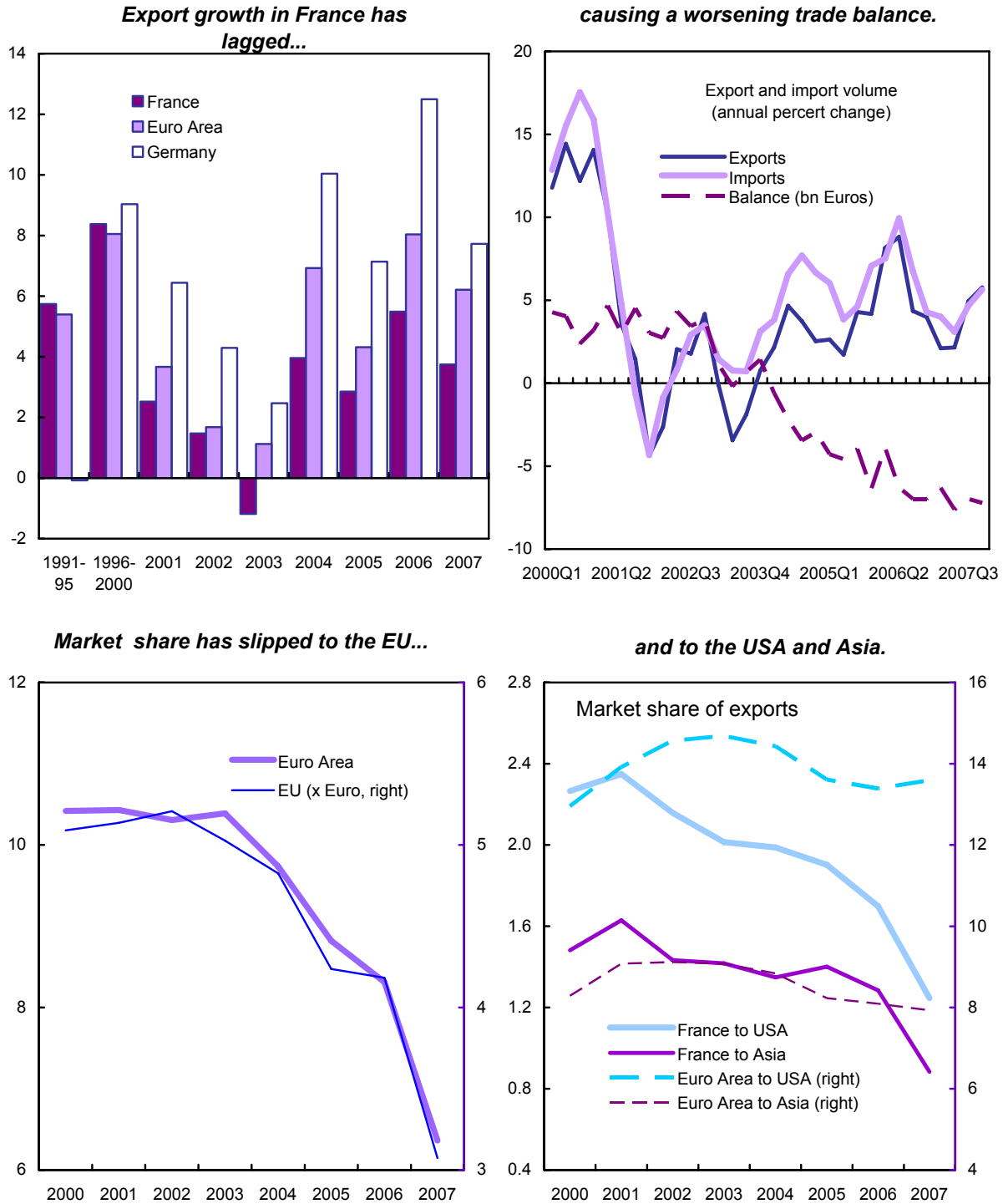


Figure 1. France: Economic Developments 1/  
(Percent change)



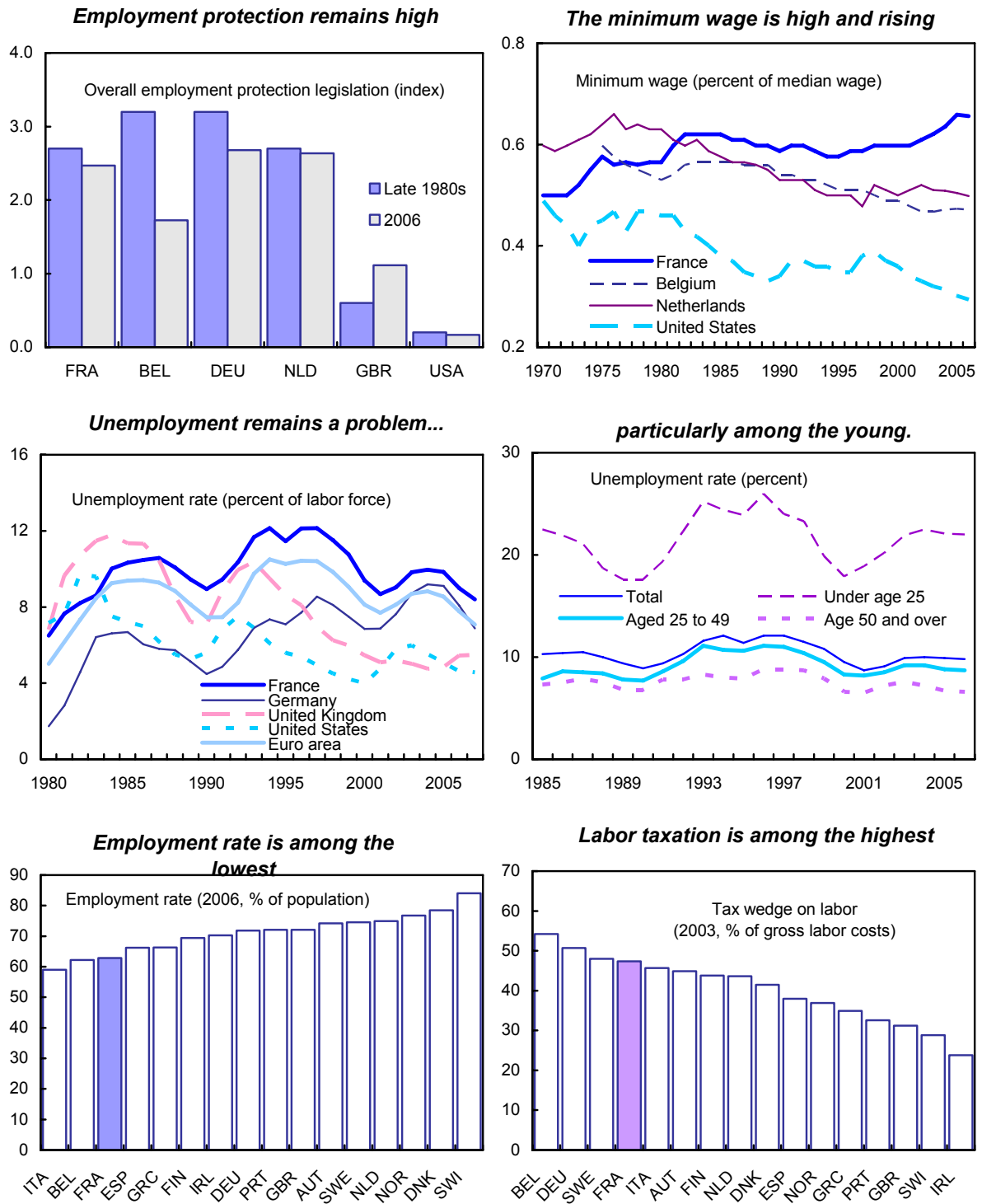
Sources: Global Insight/DataInsight and IMF, WEO.  
1/ 2007 data are estimates.  
2/ Contribution to growth of GDP.

Figure 2. France: External Sector Developments



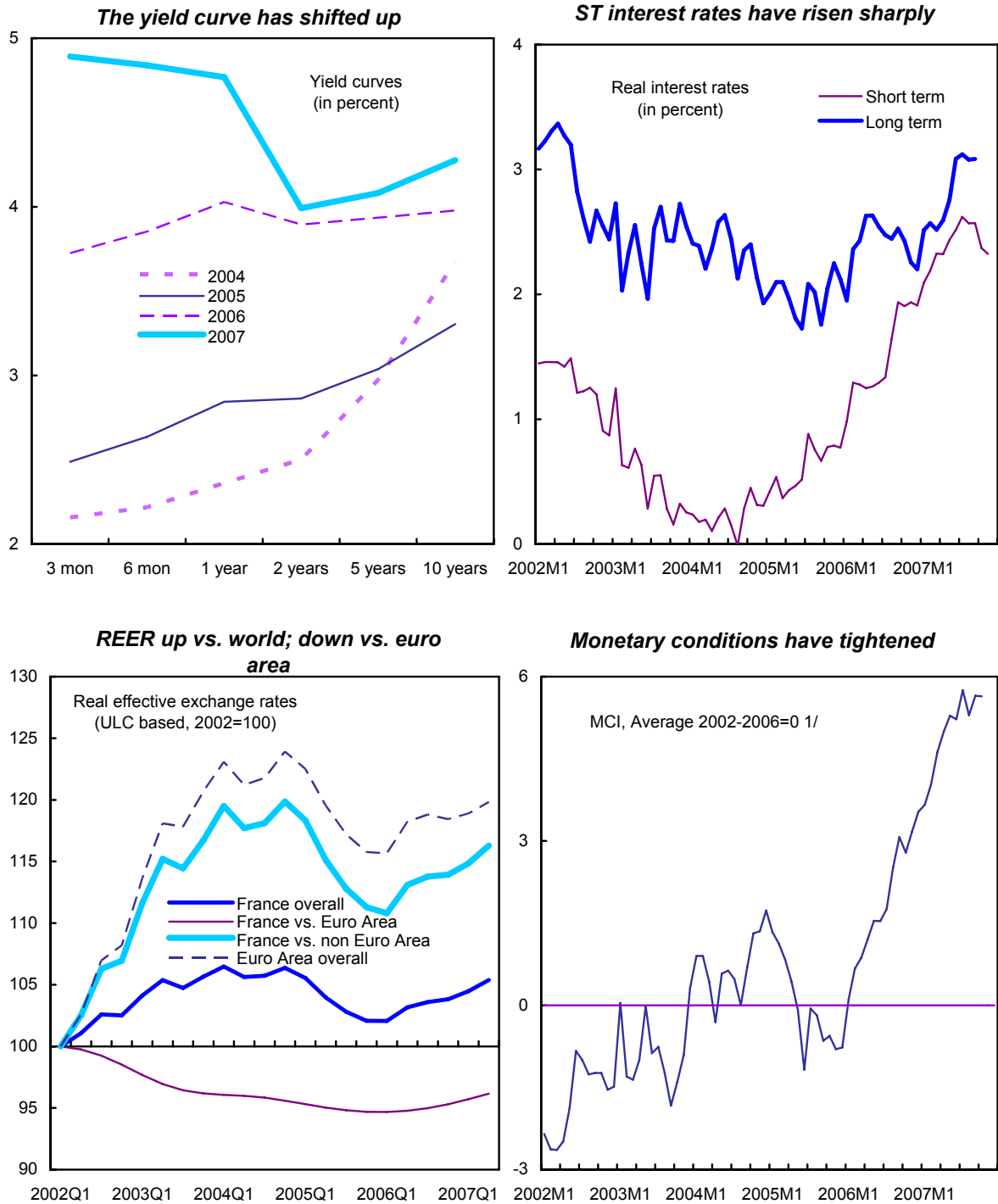
Sources: IMF; DOT and WEO.

Figure 3. France: Labor Market Indicators



Sources: OECD; Datastream; and IMF staff calculations.

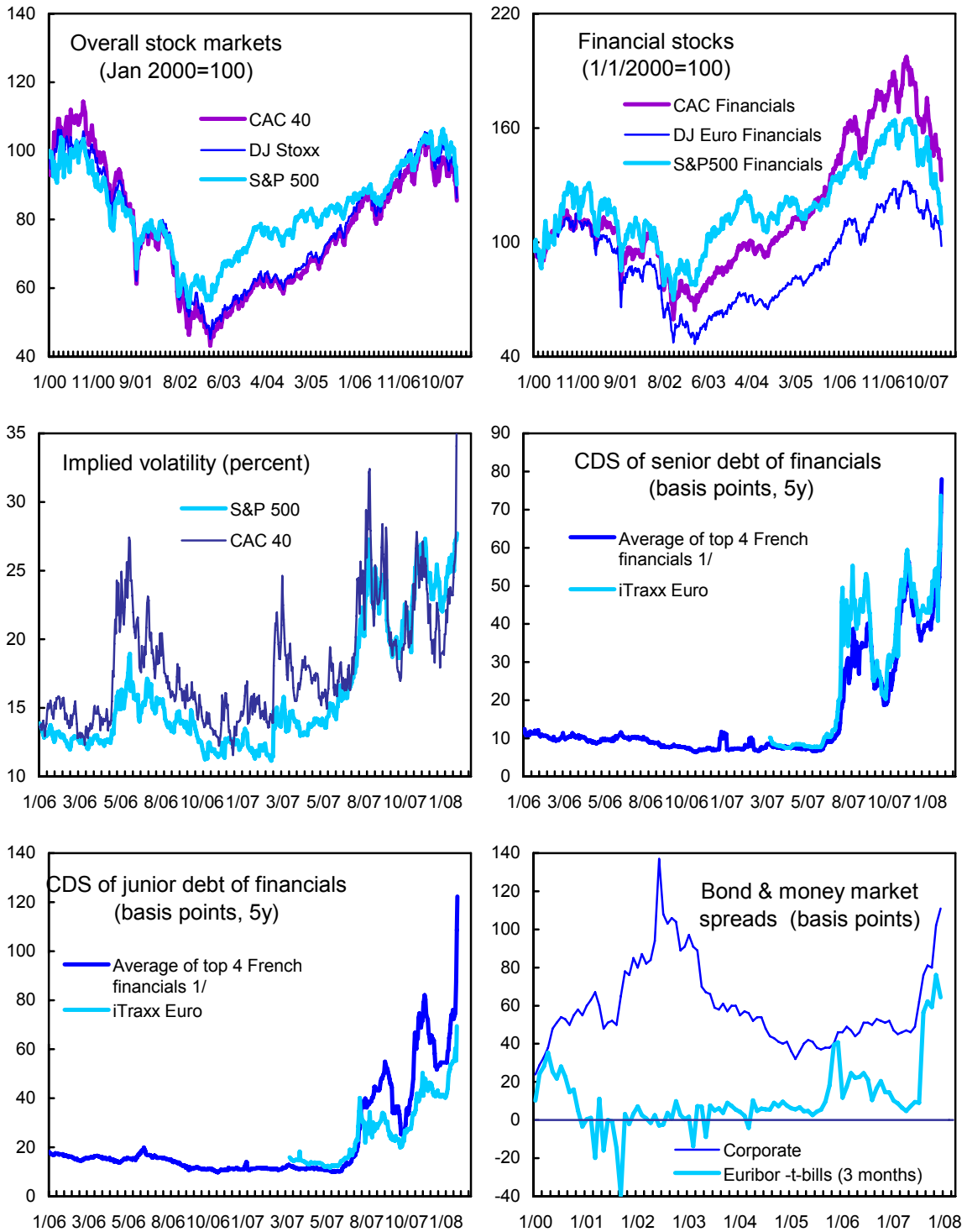
Figure 4. France: Monetary Conditions



Sources: Datastream/Thomson Financial; European Commission; and IMF, IFS and WEO.

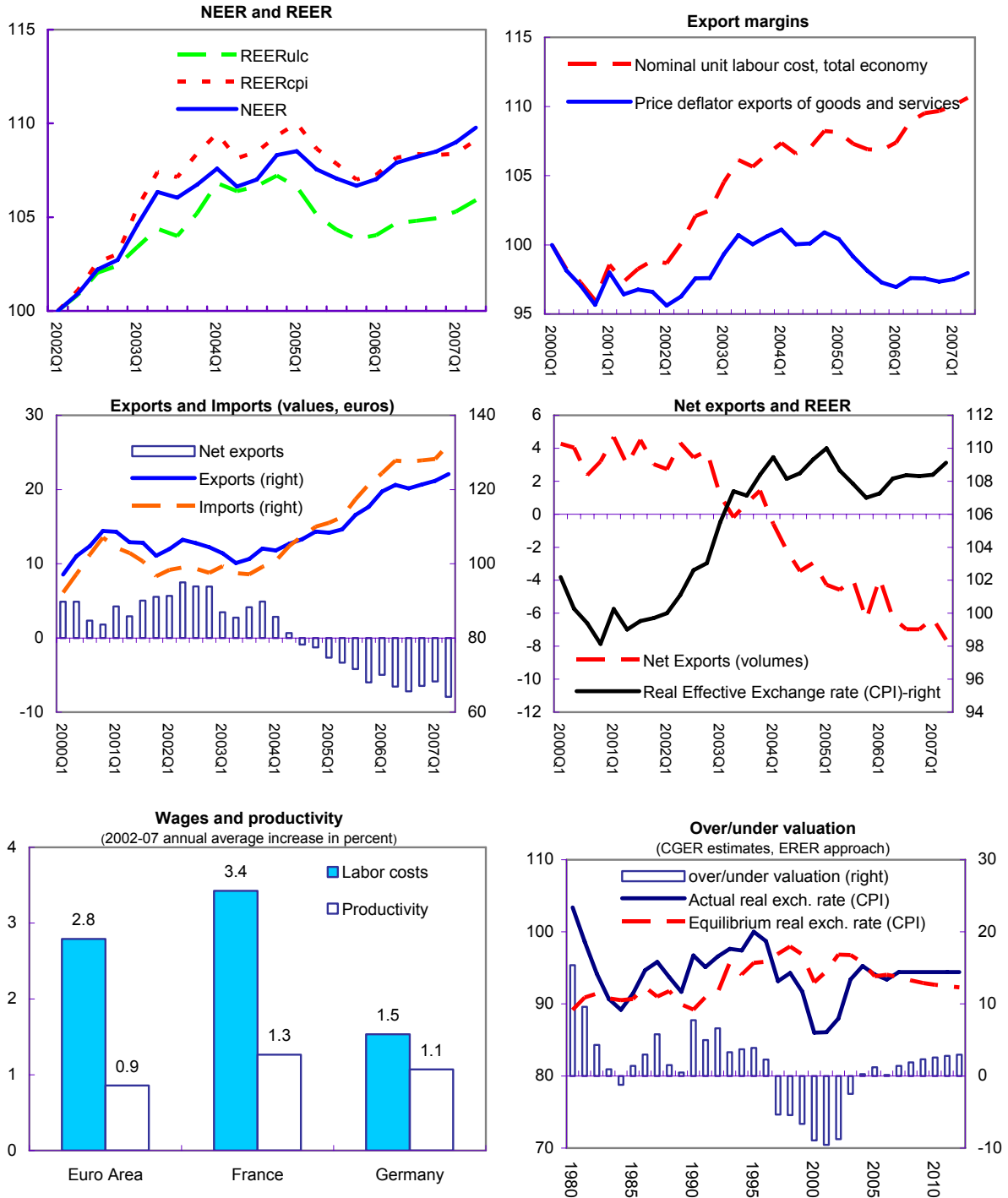
1/ The monetary conditions index is a weighted average of the real effective exchange rate and the short-term real interest rate, with weights, 1 and 2.5, respectively. A higher index implies tighter conditions (using underlying CPI).

Figure 5. France: Financial Market Developments



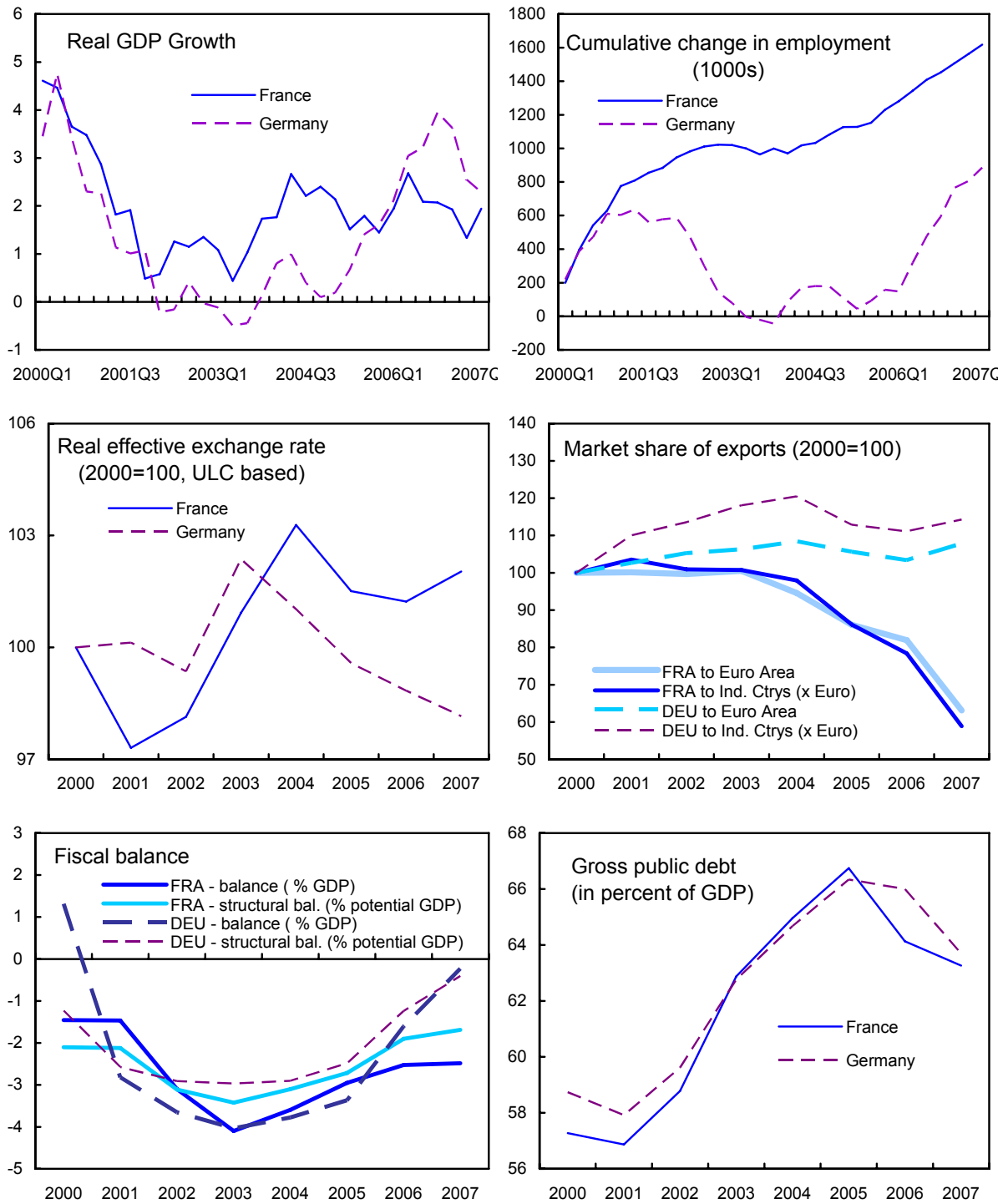
Source: Thomson Financial/Datastream.  
 1/ AXA, BNP Paribas, Credit Agricole, and Societe Generale.

Figure 6. France: Competitiveness and External Performance



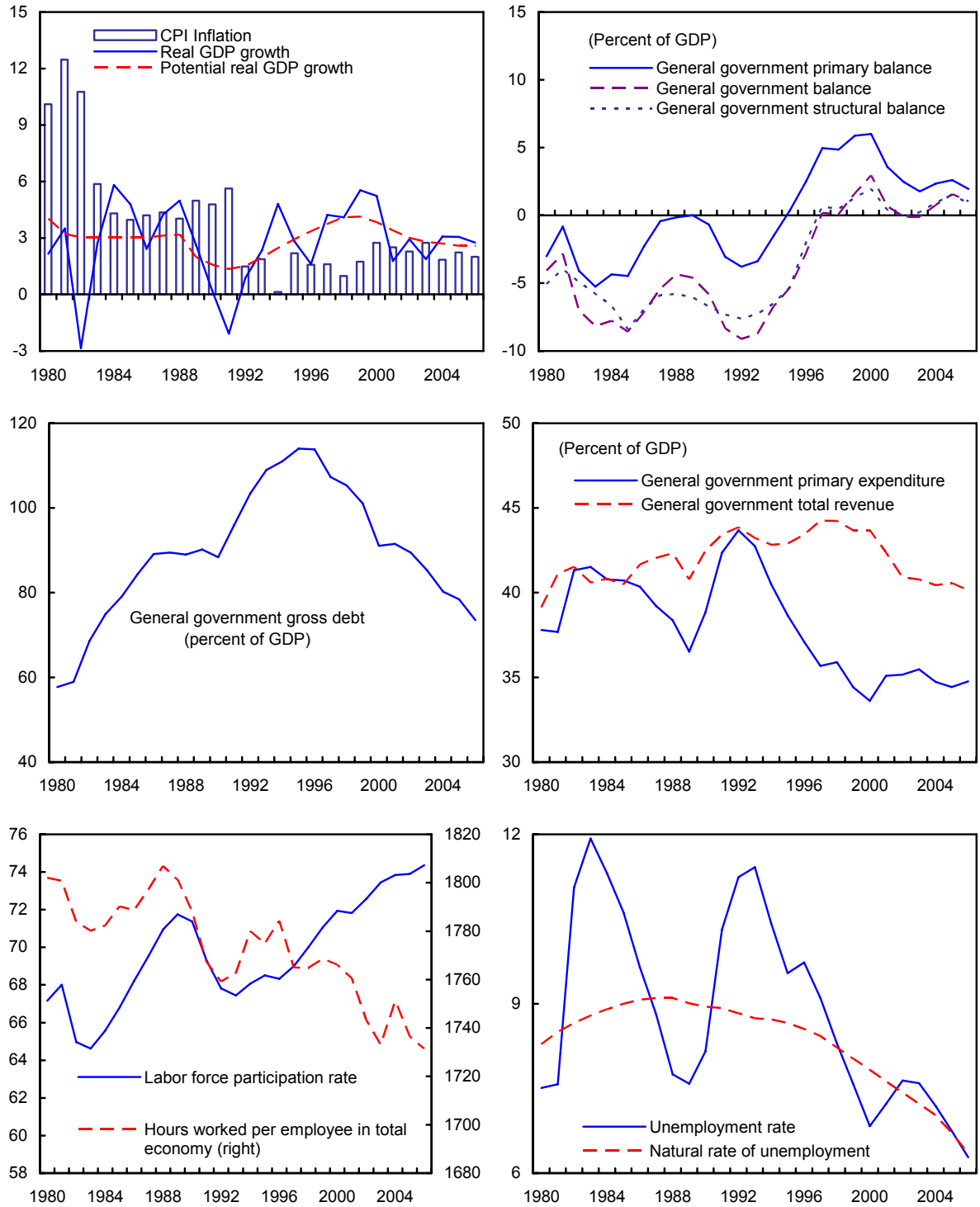
Sources: INSEE; IMF, IFS; Eurostat; and Haver.

Figure 7. France vs. Germany: Out of Synchrony ?



Source: IMF, WEO, DOT, and IFS; and OECD; Economic Indicators.

Figure 8. Combining Fiscal Consolidation and Structural Reform - Canada



Sources: OECD, Economic Outlook; and IMF, WEO.



Table 1. France: Main Economic Indicators, 2003-12

(Annual percentage change; unless otherwise indicated)

	2003	2004	2005	2006	Est. 2007	Projection				
						2008	2009	2010	2011	2012
Demand and supply in constant prices 1/										
Gross domestic product	1.1	2.5	1.7	2.0	1.9	1.6	2.2	2.5	2.5	2.5
Private consumption	2.0	2.5	2.2	2.0	2.1	1.9	2.3	2.5	2.4	2.3
Public consumption	2.0	2.3	0.9	1.4	1.6	1.6	1.7	2.0	2.1	2.1
Gross fixed investment	2.2	3.6	4.0	3.7	3.9	2.7	3.7	3.9	3.7	3.8
Business investment	1.3	4.2	2.1	4.2	5.0	3.3	5.0	5.2	4.7	4.8
Residential investment	2.1	3.2	6.1	4.4	1.5	2.3	1.7	1.6	1.5	1.5
Public investment	5.9	2.3	7.1	1.2	4.2	1.2	1.9	2.7	3.1	3.2
Stockbuilding 2/	-0.3	0.6	0.0	0.2	-0.1	0.0	0.0	0.0	0.0	0.0
Total domestic demand	1.7	3.2	2.3	2.4	1.6	2.1	2.4	2.7	2.6	2.6
Foreign balance 2/	-0.6	-0.7	-0.6	-0.4	-0.2	-0.6	0.0	0.0	0.0	0.0
Exports of goods and NFS	-1.2	4.0	2.8	5.5	3.4	3.5	5.3	6.7	6.7	6.5
Imports of goods and NFS	1.1	7.1	5.0	6.8	4.3	4.9	5.9	6.7	6.5	6.4
Prices										
GDP deflator	1.9	1.4	1.8	2.5	2.1	1.9	1.8	1.7	1.7	1.7
Consumer prices (average) 3/	2.2	2.3	1.9	1.9	1.6	2.3	1.8	1.7	1.7	1.7
Consumer prices (end of period) 4/	2.4	2.3	1.8	1.7	2.8	...	...	...	...	...
Employment and wages										
Employment	0.1	0.1	0.5	0.8	1.1	0.5	0.3	0.3	0.3	0.3
Unemployment 5/	9.5	9.6	9.7	9.5	8.7	8.2	7.9	7.7	7.4	7.1
Productivity 6/	1.0	2.4	1.3	1.2	0.9	1.1	1.8	2.3	2.2	2.2
Unit labor costs (whole economy)	1.8	1.0	1.7	1.8	2.6	2.4	1.7	1.2	1.3	1.3
Output in manufacturing	1.0	0.4	1.4	2.0	2.5	2.5	2.5	2.5	2.5	2.5
Hourly labor compensation in manufacturing	2.5	4.2	1.8	3.4	3.2	3.0	2.5	2.5	2.5	2.5
Unit labor costs in manufacturing	-1.8	0.7	-2.5	-0.9	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Personal sector										
Real disposable income 7/	0.8	2.6	1.6	2.1	2.7	1.8	2.1	2.2	2.3	2.3
Savings ratio 8/	15.8	15.8	15.3	15.5	15.9	15.8	15.7	15.4	15.4	15.4
Output gap 9/										
Rate of growth of potential output	-0.9	-0.5	-0.8	-0.9	-1.1	-1.6	-1.6	-1.3	-0.8	-0.4
Balance of payments										
Trade balance (in billions of euros)	2.9	-3.8	-23.0	-30.0	-38.7	-58.0	-61.1	-63.6	-65.8	-68.9
(in percent of GDP)	0.2	-0.2	-1.3	-1.7	-2.1	-3.0	-3.0	-3.0	-3.0	-3.0
Current account (in billions of euros)	13.0	8.5	-15.7	-22.5	-36.6	-58.6	-61.7	-63.7	-65.3	-67.7
(in percent of GDP)	0.8	0.5	-0.9	-1.3	-2.0	-3.0	-3.1	-3.0	-3.0	-3.0
Terms of trade	-0.5	-0.5	-1.8	-0.3	0.0	-1.9	0.5	0.3	0.3	0.2
Nominal effective exchange rate 10/	106.1	107.6	107.7	108.1	110.0	...	...	...	...	...
Real effective exchange rate 10/	100.9	103.3	101.5	101.2	102.1	...	...	...	...	...
Public sector accounts 11/										
Revenue	49.2	49.6	50.7	50.8	50.7	50.3	50.1	50.0	50.0	50.0
Expenditure	53.3	53.2	53.7	53.4	53.1	53.1	52.7	52.3	51.8	51.4
General government balance 12/	-4.1	-3.6	-2.9	-2.5	-2.4	-2.7	-2.6	-2.3	-1.9	-1.4
Central Government balance 12/	-3.9	-3.2	-3.0	-2.6	-2.1	-2.3	-2.1	-1.8	-1.4	-1.0
Social Security balance 12/	-0.6	-0.9	-0.2	-0.3	-0.4	-0.3	-0.5	-0.5	-0.5	-0.4
Structural balance 12/ 13/	-3.4	-3.1	-2.7	-1.9	-1.6	-1.7	-1.6	-1.5	-1.4	-1.2
Primary balance	-1.3	-0.9	-0.3	0.0	0.2	-0.1	0.0	0.3	0.7	1.1
Gross debt 12/	62.9	64.9	66.7	64.2	64.1	64.6	64.8	64.4	63.6	62.5

Sources: *Banque de France*; data provided by the authorities; and IMF 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 2007, year-on-year October.

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 2000=100; for 2007, average to October.

11/ In percent of GDP.

12/ Maastricht definition.

13/ Data for 2005 and 2006 exclude the EDF and La Poste pension fund transfers, respectively (0.5 percent and 0.1 percent of GDP).

Table 2. Balance of Payments  
(Percent of GDP)

	2002	2003	2004	2005	2006	Est. 2007 1/
Balance on current account	1.4	0.8	0.5	-0.9	-1.3	-2.0
Balance on goods and services	1.7	1.1	0.5	-0.7	-1.2	-1.6
Balance of trade (f.o.b., c.i.f.)	0.3	0.1	-0.3	-1.3	-1.5	-1.6
<i>Of which to:</i>						
Euro area	-0.3	-0.3	-0.4	-1.0	-0.9	...
Extra euro area	0.6	0.3	0.1	-0.4	-0.7	...
Exports of goods and services	26.9	25.5	25.9	26.2	26.7	28.9
Exports of goods	21.0	20.1	20.4	20.6	21.5	23.3
Exports of services	5.9	5.5	5.5	5.6	5.3	5.5
Imports of goods and services	-25.2	-24.5	-25.4	-26.9	-27.9	-30.5
Imports of goods (f.o.b.)	-20.5	-19.9	-20.7	-21.9	-23.1	-25.4
Imports of services	-4.7	-4.6	-4.8	-5.0	-4.8	-5.1
Income, net	0.6	0.8	1.1	1.1	1.2	0.6
Current transfers, net	-1.0	-1.1	-1.1	-1.3	-1.2	-1.0
Balance on capital account	0.0	-0.5	0.1	0.0	0.0	0.0
Balance on financial account	-1.5	1.0	-0.8	-0.9	3.4	2.0
Direct investment, net	-0.1	-0.6	-1.2	-1.9	-1.5	-1.3
Portfolio investment, net	-0.7	0.4	-3.2	-0.8	-3.3	-1.9
Other investment, net	-0.9	1.4	3.8	1.3	8.7	5.1
Reserve assets	0.3	-0.1	-0.2	0.4	-0.5	0.0
Errors and omissions, net	0.1	-1.3	0.2	1.8	-2.1	0.0

Sources: IMF, WEO; and the authorities.

1/ Staff estimates.

Table 3. High Frequency Financial Indicators

	Change since:					
	Jan 22, 2008	Jan 2, 2008	Oct 1, 2007	Jul 2, 2007	Apr 2, 2007	Jan 2, 2007
Financial institution equity prices 1/						
BNP Paribas	66.7	-9.3	-14.5	-23.7	-14.5	-21.3
Credit Agricole	19.7	-13.8	-28.3	-33.9	-32.7	-38.8
Societe Generale	82.5	-15.6	-30.8	-39.6	-35.7	-37.2
Credit default swap spreads 2/						
BNP Paribas	57.0	32.0	32.5	48.3	51.0	51.0
Credit Agricole	80.4	39.4	55.9	71.5	72.9	74.4
Societe Generale	77.0	47.0	52.8	67.6	70.2	70.7
Stock indices						
CAC 40	4843	-12.8	-16.1	-19.7	-14.2	-13.8
Euro stoxx 50	3754	-13.5	-14.9	-16.0	-10.4	-10.2
Interbank interest rates 3/						
Overnight	3.99	0.21	0.13	-0.08	0.16	0.39
3-month	4.33	-0.34	-0.46	0.15	0.40	0.61
Government interest rates 3/						
3 month	4.04	0.00	0.03	-0.13	0.07	0.36
10 year	4.08	-0.20	-0.33	-0.48	-0.04	0.13
Money market risk spread 4/	29.00	-33.50	-49.10	28.40	33.30	24.50

1/ In Euro's.

2/ Basis points, 5 years.

3/ Percent; and change in percentage points.

4/ Basis points; 3 month interbank rate minus 3 month Treasury Bill.

Table 4. France: Vulnerability Indicators, 2001-07

(In percent of GDP; unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	Estimate 2007	Date
<b>External indicators</b>								
Exports (annual percentage change, in U.S. dollars)	-0.4	2.5	19.7	18.4	7.2	10.7	13.5	Q3
Imports (annual percentage change, in U.S. dollars)	-1.4	4.1	21.6	19.6	11.8	11.6	15.9	Q3
Terms of trade (annual percentage change)	0.5	2.6	-0.5	-0.5	-1.8	-0.3	-0.9	Q3
Current account balance	1.9	1.4	0.8	0.5	-0.9	-1.3	...	...
Capital and financial account balance	1.6	1.3	0.1	-0.1	-0.9	-0.8	...	...
<i>Of which</i>								
Inward portfolio investment (debt securities, etc.)	0.0	0.0	11.1	8.0	10.6	10.2	...	...
Inward foreign direct investment	0.0	0.0	2.4	1.5	3.0	2.9	...	...
Other investment liabilities (net)	0.0	0.0	1.4	3.8	1.2	1.2	...	...
Total reserves minus gold								
(In billions of U.S. dollars, end-of-period)	31.7	28.4	30.2	35.3	27.8	42.7	51.8	october
Euros per U.S. dollar (period average)	1.118	1.063	0.886	0.805	0.804	0.797	0.703	october
<b>Market indicators</b>								
<b>Financial markets</b>								
Public sector debt (Maastricht definition)	56.9	58.8	62.9	64.9	66.7	64.2	65.3	Q3
3-month T-bill yield (percentage points, end-of-period)	3.3	2.9	2.1	2.2	2.5	4.2	4.7	october
3-month T-bill yield in real terms (percentage points, end-of-period)	1.9	0.8	-0.2	-0.2	0.7	2.5	2.6	october
U.S. 3-month T-bill	1.7	1.2	0.9	2.2	3.9	4.8	4.0	october
Spread with the U.S. T-bill (percentage points, end-of-period)	1.6	1.7	1.2	0.0	-1.4	-0.6	0.7	october
5- to 8-year government bond (percentage points, end-of-period)	5.1	4.4	4.4	3.7	3.4	4.7	4.7	july
10-year government bond (United States)	5.1	4.0	4.3	4.2	4.5	5.0	4.5	october
Spread with U.S. bond (percentage points, end-of-period)	0.0	0.4	0.1	-0.5	-1.0	-0.3	0.1	october
Yield curve (10 year - 3 month, percentage points, end-of-period)	1.7	1.5	2.2	1.5	1.0	0.5	0.0	october
Stock market index (period average)	268.0	202.6	166.5	196.9	228.0	0.0	305.4	november
Real estate prices (index, 2000=100, period average)	106.1	118.7	135.7	156.7	172.8	190.6	188.1	2006:Q2
<b>Credit markets (end-of-period 12-month growth rates)</b>								
Credit to the private sector	6.1	4.0	5.2	8.3	8.9	8.9	11.5	May
Bank credit to households	6.1	7.1	7.8	9.6	11.7	11.7	11.9	May
Housing loans	6.3	8.0	9.9	13.6	15.0	15.0	15.1	May
Bank credit to nonfinancial enterprises	3.3	2.8	-1.1	6.0	7.2	7.2	10.7	May
<b>Sectoral risk indicators</b>								
<b>Household sector</b>								
Household savings ratio	15.8	16.9	15.8	15.8	15.3	15.5	...	...
Household financial savings ratio	6.9	8.0	6.6	6.2	5.5	5.4	...	...
Real estate household solvency ratio (index, 2000=100) 1/	99.1	101.9	97.9	89.4	91.0	91.0	...	...
<b>Corporate sector</b>								
Profitability of business sector (financial margin)	38.5	37.8	37.9	37.6	37.1	37.6	...	...
Investment ratio	18.3	17.3	17.0	17.3	17.6	18.1	...	...
Savings ratio	16.6	15.2	15.9	14.7	13.6	11.7	...	...
Self-financing ratio	83.7	81.1	87.4	79.1	72.0	60.1	...	...
<b>Banking sector</b>								
Share of housing loans in bank credit to the private sector	29.4	31.0	32.8	34.7	36.6	36.6	36.3	May
Share of nonperforming loans in total loans	5.0	5.0	4.8	4.2	3.5	3.0	...	...
Ratio of nonperforming loans net of provisions to capital	12.6	12.6	11.6	9.8	8.6	7.2	...	...
Liquid assets to total short-term liabilities	152.5	157.0	153.7	155.1	148.1	148.1	...	...
Return on assets 2/	0.5	0.5	0.4	0.5	0.6	0.7	...	...
Return on equity 2/	9.6	9.1	8.5	10.6	11.8	15.6	...	...
Regulatory capital to risk-weighted assets	12.1	11.5	11.9	11.5	11.3	10.9	...	...

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

1/ This index combines the effect of real disposable income, repayment conditions for loans, real estate prices, and interest subsidies.

2/ All credit institutions aggregated data on a parent-company basis.

Table 5. France: General Government Accounts, 2000-07 1/  
(In percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	Est. 2007
General government								
Revenue	50.2	50.0	49.5	49.2	49.6	50.7	50.8	50.7
Tax revenue	44.1	43.8	43.1	42.8	43.1	43.8	44.2	44.0
<i>Of which</i>								
VAT	7.4	7.2	7.1	7.0	7.2	7.4	7.3	...
Income tax	3.5	3.3	3.0	3.0	2.8	2.9	2.9	...
Corporate tax	2.7	3.0	2.6	2.4	2.5	2.4	2.7	...
TIPP	1.7	1.6	1.6	1.5	1.5	1.4	1.4	...
Nontax revenue	6.0	6.2	6.4	6.3	6.5	6.9	6.6	6.7
Expenditures	51.6	51.6	52.6	53.3	53.2	53.7	53.4	53.1
<i>Of which</i>								
Salaries	13.3	13.3	13.5	13.5	13.3	13.3	13.1	...
Pensions	12.2	12.3	12.4	12.5	12.6	12.8	13.0	...
Health expenditure	6.4	6.6	6.8	7.0	7.1	7.1	7.1	...
Other social transfers	5.6	5.4	5.7	5.8	5.8	5.8	5.4	...
Balance 2/	-1.5	-1.6	-3.2	-4.1	-3.6	-2.9	-2.5	-2.4
Primary balance	1.4	1.4	-0.2	-1.3	-0.9	-0.3	0.0	0.2
Structural balance 3/	-2.2	-2.1	-3.1	-3.4	-3.1	-2.7	-1.9	-1.6
Central government balance 2/	-2.5	-2.5	-3.7	-3.9	-3.2	-3.0	-2.6	-2.1
Social security balance 2/	0.5	0.4	-0.2	-0.6	-0.9	-0.2	-0.3	-0.4
Local government balance 2	0.2	0.1	0.1	0.0	-0.1	-0.2	-0.3	-0.2
Other central government agencies balance 2/	0.3	0.3	0.6	0.3	0.6	0.4	0.6	0.2
Gross debt 2/	57.3	56.9	58.8	62.9	64.9	66.7	64.2	64.1
Interest payments	2.9	3.1	3.0	2.8	2.8	2.7	2.6	2.6

Sources: INSEE; and IMF staff calculations.

1/ Data for 2001-02 exclude the proceeds from the sale of UMTS licenses, which amount to about 0.1 percent of GDP.  
Annual national accounts.

2/ Maastricht definition.

3/ Data for 2005 exclude the EDF pension fund transfer (0.5 percent of GDP).

Table 6. France: The Core Set of Financial Soundness Indicators, 2000-06

Indicator	2000	2001	2002	2003	2004	2005	2006
Deposit-taking institutions 1/							
Regulatory capital to risk-weighted assets	11.9	12.1	11.5	11.9	11.5	11.3	10.9
Regulatory Tier I capital to risk-weighted assets	9.9	10.5	9.2	9.0	8.8	8.2	8.2
Nonperforming loans net of provisions to capital	12.8	12.6	12.6	11.6	9.8	8.6	7.2
Nonperforming loans to total gross loans	5.0	5.0	5.0	4.8	4.2	3.5	3.0
Sectoral distribution of loans to total loans, <i>of which</i>							
Deposit-takers	31.6	33.6	33.6	34.2	34.0	30.1	30.6
Nonfinancial corporation	20.8	19.5	19.8	18.9	18.7	18.8	18.6
Households (including individual firms)	22.9	21.7	22.6	24.5	24.9	26.5	26.6
Nonresidents (including financial sectors)	5.0	4.9	4.4	4.3	4.2	4.7	4.9
ROA (aggregated data on a parent-company basis) 2/	0.5	0.5	0.5	0.44	0.5	0.6	0.7
ROA (main groups on a consolidated basis) 3/	0.60	0.45	0.43	0.39	0.53	0.49	0.55
ROE (aggregated data on a parent-company basis) 2/	9.7	9.6	9.1	8.50	10.6	11.8	15.6
ROE (main groups on a consolidated basis) 3/	15.3	10.8	9.6	10.0	12.7	13.5	14.5
Interest margin to gross income	33.3	32.5	37.5	35.5	33.2	32.4	28.2
Noninterest expenses to gross income	67.7	66.9	65.5	64.4	63.9	64.3	62.4
Liquid assets to total assets	19.5	20.4	20.7	21.6	21.3	20.5	18.1
Liquid assets to short-term liabilities	138.5	152.5	157.0	153.7	155.1	150.1	146.3
Net open position in foreign exchange to capital							
Net open positions in FX (in millions of euros) 4/	6,715	6,738	3,134	4,772	6,669	5275	4,313
Net open positions in equities to Tier I capital	3.9	2.9	4.9	3.5	4.8	n.a.	n.a.

Sources: *Banque de France*, *Commission Bancaire*, BIS, and ECB.

1/ These may be grouped in different peer groups based on control, business lines, or group structure.

2/ All credit institutions' aggregated data on a parent-company basis.

3/ Consolidated data for the seven main banking groups (2005, IFRS).

4/ Impact of the creation of the euro has to be taken into account.

Table 7. France: Encouraged Financial Soundness Indicators, 2000-06

(In percent, unless otherwise indicated)

Indicator	2000	2001	2002	2003	2004	2005	2006
Corporate sector							
Return on equity	10.1	10.7	11.1	9.4	9.3	8.9	8.9
Interest paid to financial firms 1/	33.3	37.3	34.6	31.5	28.9	28.8	n.a.
Number of enterprise bankruptcies (thousands)	43.6	42.8	44.7	47.0	48.0	48.9	n.a.
Number of enterprise creations (thousands)	272.9	271.4	269.6	292.8	320.5	317.9	n.a.
Deposit-taking institutions							
Capital (net worth) to assets	4.9	4.9	5.2	5.4	5.1	4.4	4.5
International consolidated claims of French banks, <i>of which</i> (BIS data, as percent of total international claims)							
Advanced countries	80.4	81.0	83.7	85.0	84.0	83.4	84.9
Developing Europe	1.7	2.4	2.0	2.7	2.5	2.9	3.3
Latin America and Caribbean	2.7	2.5	1.8	1.4	1.0	1.1	0.9
Africa and Middle East	3.8	3.8	3.6	3.3	3.1	3.1	2.6
Asia and Pacific Area	3.9	3.2	2.8	2.7	2.6	2.6	2.5
Offshore Financial Centers	7.0	6.6	5.6	4.5	6.5	6.6	5.6
Gross asset position in financial derivatives to capital	202	244	379	307	373	544	319
Gross liability position in financial derivatives to capital	169	217	344	283	359	485	269
Large exposures to capital	n.a.	n.a.	5.2	0.9	4.6	3.6	1.4
Trading income to total income	8.0	6.2	2.4	16.8	20.0	23.9	26.0
Personnel expenses to noninterest expenses	55.9	55.0	55.2	56.0	56.5	58.3	54.7
Customer deposits to total (noninterbank) loans	77.3	81.6	81.5	82.8	80.6	83.5	80.5
FX loans to total loans 2/	15.1	15.3	12.6	11.2	10.8	12.0	11.4
FX liabilities to total liabilities	17.3	18.4	15.1	14.2	15.1	17.8	18.6
Market liquidity							
Average daily turnover ratio in the securities market	15.0	17.0	20.0	18.0	18.0	10.5	7.0
Other financial corporations							
Assets to total financial system assets	36.2	35.8	35.2	36.6	38.0	37.6	38.1
Assets to GDP	152.3	149.8	142.3	151.3	168.7	188.5	207.1
Households							
Household debt to GDP	34.9	35.4	36.4	37.8	40.0	43.0	45.9
Household debt service and principal payments to income	n.a.	n.a.	n.a.	10.1	11.2	10.1	12.2
Real estate markets							
Real estate prices	8.8	7.9	8.3	11.7	15.3	10.3	n.a.
Residential real estate loans to total loans	30.8	31.5	32.8	35.2	37.1	39.3	n.a.
Commercial real estate loans to total loans							

Sources: *Banque de France*; *Commission Bancaire*; BIS; and ECB.

1/ In percent of financial firms' gross operating surplus.

2/ Data cover interbank and customer lending to residents and nonresidents on a metropolitan basis.

Table 8. France: Financial System Structure, 2000-06

(End of year)

	2000	2001	2002	2003	2004	2005	2006
<b>Number</b>							
<b>Banks</b>							
Commercial banks	362	357	345	333	326	316	313
Private	354	352	341	329	323	312	309
Domestic	140	144	142	138	139	131	131
Foreign	214	208	199	191	184	181	178
State-owned 1/	8	5	4	4	3	4	4
Credit unions and mutuals	154	148	136	129	127	125	121
<b>Other credit institutions</b>							
Finance companies	557	524	494	464	427	411	388
Of which: mortgage institutions	3	4	4	4	4	4	4
Specialized financial institutions	19	17	16	15	11	8	7
Municipal credit institutions	22	21	21	21	21	21	20
Securities firms	146	144	136	131	124	119	116
<b>Insurance companies</b>							
Life and retirement	127	126	126	125	119	119	115
Nonlife	304	304	295	286	274	267	263
Reinsurance	33	36	35	33	30	29	29
<b>Concentration</b>							
Commercial banks 2/	11	10	11	10	10	10	9
Securities companies 2/	3	3	3	4	3	2	2
<b>Assets</b>							
	(In billions of euros)						
<b>Banks</b>							
Commercial banks	2,145.0	2,402.8	2,359.7	2,440.4	2,861.7	3,719.4	4,283.9
Private	2,123.0	2,323.9	2,277.7	2,365.3	2,850.4	3,599.6	4,159.3
Domestic	1,681.5	1,884.6	1,865.7	1,982.5	2,428.5	3,005.0	3,558.9
Foreign	441.5	439.3	412.0	382.8	421.9	594.6	600.4
State-owned 1/	22.0	78.8	82.1	75.1	11.3	119.7	124.6
Credit unions and mutuals	847.7	857.4	880.8	934.7	1,053.5	1,127.6	1,259.0
<b>Other credit institutions</b>							
Finance companies	411.2	473.9	507.9	536.2	432.7	405.3	476.7
Of which: mortgage institutions	50.9	62.3	75.9	91.9	107.2	125.7	148.6
Specialized financial institutions	46.4	46.8	42.9	46.9	40.4	21.2	19.6
Municipal credit institutions	1.8	1.9	1.9	1.9	1.9	1.7	1.3
Securities firms	44.1	51.9	64.9	218.7	215.3	270.8	353.6
<b>Insurance companies (assets)</b>							
Life and retirement	749.7	798.3	832.4	907.3	985.2	1103.4	1232.1
Nonlife	130.4	139.3	143.1	152.2	159.8	170.5	179.6
Reinsurance	27.9	33.1	31.4	31.3	22.2	31.4	42.2
<b>Deposits</b>							
<b>Banks</b>							
Private commercial	435.8	515.9	516.1	526.8	573.9	677.1	758.1
State-owned	2.7	5.6	3.6	7.9	0.2	92.4	92.0
Foreign-owned subsidiaries	44.2	50.8	52.7	47.7	45.2	56.6	58.9
Branches of foreign banks	16.3	17.1	19.4	20.9	19.7	26.1	24.8

Source: *Banque de France*; and Ministry of Finance.

1/ Including development banks. Nonbank development finance corporations are included separately under "Other credit institutions."

2/ Number of institutions with 75 percent of total assets.



**APPENDIX I. FRANCE: FUND RELATIONS**

(As of December 31, 2007)

**Mission:** Paris, November 8–19, 2007. The concluding statement of the mission is available at <http://www.imf.org/external/np/ms/2007/111907.htm>.

**Staff team:** Messrs. Leipold (Head), Franks, Schule, Nadal De Simone, Luzio, Ms. Xiao (all EUR), and Mr. Keen (FAD).

**Country interlocutors:** The minister of the economy, finance, and industry; the minister of the budget and the reform of the state; the governor of the central bank; the director general of the treasury; the directors of the budget, taxation, health, social affairs, and labor and their staffs; the economic advisor in the cabinet of the prime minister; the *rapporteur* of the finance commission of the National Assembly; INSEE; the Commission Bancaire; the Financial Market Authorities; the Council for Economic Analysis; representatives of labor unions, employer organizations, academia, and the financial sector. Mr. Fayolle (Executive Director) or Mr. Claveranne (Alternate Executive Director) attended the meetings.

**Fund relations:** The previous Article IV Consultation took place on November 1, 2006. The associated Executive Board's assessment is available at <http://www.imf.org/external/np/sec/pn/2006/pn06127.htm> and the staff report at <http://www.imf.org/external/pubs/ft/scr/2006/cr06389.pdf>. France accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange system free of restrictions.

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

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

II. <b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
Quota	10,738.50	100.00
Fund holdings of currency	10,025.19	93.36
Reserve position in Fund	713.39	6.64
III. <b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent of Allocation</b>
Net cumulative allocation	1,079.87	100.00
Holdings	629.62	58.31
IV. <b>Outstanding Purchases and Loans:</b> None		

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	<u>Forthcoming</u>				
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Principal					
Charges/interest	<u>15.86</u>	<u>15.80</u>	<u>15.81</u>	<u>15.81</u>	<u>15.82</u>
<b>Total</b>	15.86	15.80	15.81	15.81	15.82

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

VIII. **Safeguards Assessments:** Not applicable

IX. **Exchange Rate Arrangements:**

- France's currency is the euro, which floats freely and independently against other currencies.
- In accordance with EU regulations and the relevant UN Security Council resolutions, certain restrictions are maintained on the making of payments and transfers for current international transactions with respect to the former government of Iraq, the former government of Liberia, Myanmar, certain individuals associated with the previous government of the former Republic of Yugoslavia, and Zimbabwe. Financing of, and financial assistance related to, military activities in the Democratic Republic of the Congo (from October 1, 2003), Somalia (effective January 27, 2003), and Sudan (from January 26, 2004) are prohibited. Restrictions also apply on transfers with respect to the Taliban and individuals and organizations associated with terrorism. The restriction with respect to the Socialist People's Libyan Arab Jamahiriya has been notified to the Fund under Decision No. 144-(52/51).
- Measures have been taken to freeze accounts of listed persons and entities linked to terrorists pursuant to the relevant EU regulations and UN Security Council resolutions.

X. **Article IV Consultation:**

The last Article IV consultation was concluded on October 25, 2006. France is on the standard 12-month consultation cycle.

XI. **FSAP Participation and ROSC:**

*France—Report on the Observance of Standards and Codes (ROSC): Module I—Fiscal Transparency* October 17, 2000

*Fiscal Transparency—Update* IMF Country Report  
No. 01/196, 11/05/01

*Fiscal Transparency—Update* IMF Country Report  
No. 04/345, 11/03/04

**Summary:** The report found that France has achieved a high level of fiscal transparency and has introduced a number of improvements in coverage and presentation of fiscal information. Notable areas of progress include the development in the final accounts publication to include more complete information on government assets and liabilities as well as disclosure of contingent liabilities. Accounting standards have been changed to reflect accruals principles in a number of areas, and these standards are clearly explained. The staff suggested that further steps could be taken to identify and report quasi-fiscal activities in the budget presentation, provide a more consolidated picture of fiscal activity outside the appropriation process, and improve the reconciliation of stated policies with outcomes at the general government level.

These issues have been addressed in the *Loi organique aux lois de finance* (LOLF), which has become fully effective on January 1, 2006. In addition to the annual appropriations, the government has to commit to a multi-annual framework, details of which are provided in the economic, social, and financial report attached to the Budget Act. The budget is organized along missions and provides details on the level of appropriations for each mission and performance indicators by which the expected results of the mission will be assessed ex post. The State Audit Office has been given the new assignment of certifying the public accounts, and implementation of accruals-basis accounting has been confirmed. Parliamentary oversight powers have been strengthened.

*France—Report on the Observance of Standards and Codes (ROSC): Module II—Transparency in Monetary and Financial Policies* October 2000, corrected:  
2/15/01

*Transparency in Monetary and Financial Policies—Update* IMF Country Report  
No. 01/197, 11/05/01

*Transparency in Monetary and Financial Policies—Update* IMF Country Report  
No. 02/248, 11/13/02

**Summary:** The 2000 ROSC noticed that transparency of financial policies is accorded a high priority by all financial agencies assessed, and they are in observance of the good practices of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. The major agencies disclose their objectives, their legal and institutional frameworks, and have open processes of policymaking and regulation. The principles of transparency are observed by dissemination of relevant information to the public and in the agencies' arrangements for internal conduct, integrity, and accountability. However, the staff noted that the framework for supervision and regulation applicable to mutual insurance firms is not as well defined and suggested to improve its transparency. The transparency of monetary policy was not assessed by the Fund team as the *Banque de France* is a member of the European System of Central Banks and no longer conducts independent monetary policy.

Subsequently, the framework for supervision and regulation applicable to a specific group of mutual insurance firms was modified in a number of steps. In August 2003, legislation created a single supervisory body, the *Commission de Contrôle des Assurances, Mutuelles et Institutions de Prévoyance* (CCAMIP) by merging the regular insurance supervisor (CCA) and mutualities' supervisor (CCMIP). Coordination with the banking sector supervisors was strengthened and the powers of the supervisory authorities extended.

***France—Report on the Observance of Standards and Codes (ROSC): Data Module*** IMF Country Report No. 03/339, 10/29/03

***Data Module—Update*** IMF Country Report No. 04/345, 11/03/04

***Data Module—Update*** IMF Country Report No. 05/398, 11/07/05

**Summary:** The report found that France is in observance of the Fund's Special Data Dissemination Standard (SDDS). In particular, the mandate of INSEE and the *Banque de France* for the production of the six macroeconomic datasets is clearly defined, with the reporting burden and the confidentiality provisions given special consideration notably through the CNIS. Professionalism is central to the statistical operations of the two institutions, internationally and/or European accepted methodologies are generally followed, the degree of accuracy and reliability of the six datasets is remarkable, statistics are relevant and provided on a timely basis, and they are accessible to the public.

The report made a number of suggestions for further improvements: the responsibility of INSEE as the producer of government finance statistics should be clarified; data sharing between the *Banque de France* and the rest of the French statistical system improved; classification and valuation methods in balance-of-payments statistics reviewed; consistency between the current account of the balance of payments and the goods and services account

in the national accounts improved; the timing of revisions in the quarterly and annual national accounts aligned; and identification of data production units of INSEE facilitated.

France continues to implement several of the 2003 ROSC Data Module recommendations, including by promoting a broader understanding of statistical data revisions, making greater use of firm-level data to improve the measurement of changes in stocks, and intensifying work on portfolio investment income with the objective of starting to record those transactions on an accrual basis.

<i>France—Financial System Stability Assessment (FSSA)</i>	IMF Country Report No. 04/344, 11/03/04
<i>FSAP Assessment and Reports on ROSCs</i>	IMF Country Report No. 04/345, 11/03/04
<i>FSAP Assessment</i>	IMF Country Report No. 05/185, 06/08/05
<i>Publication of FSAP—Detailed Assessment of Observance of Standards and Codes</i>	IMF Country Report No. 05/186, 06/08/05

**Summary:** The report concluded that France’s financial sector is strong and well supervised. No weaknesses that could cause systemic risks were identified. The strength of the system is supported by the financial soundness indicators and the strong conformity to the supervisory and regulatory standards approved by the Basel Committee, IAIS, IOSCO, FATF, and CPSS.

The degree of observance of the transparency code is high in all relevant areas. The French banking sector has been modernized and restructured over the past two decades and is well capitalized. Systemic vulnerabilities in the important insurance sector are well contained. Securities markets are large and sophisticated.

Notwithstanding the strengths of the French financial sector, a number of issues emerged from the FSAP, including (i) concentration in banking may have reached a point where further consolidation could intensify concerns over the scope for collusion and long-term stability where many banks could be considered “too big to fail;” (ii) banks’ large and growing portfolios of fixed-rate residential housing loans could represent a longer-term risk in the event of large increases in funding costs and/or a significant fall in real estate prices; (iii) some administered savings schemes and other policy measures give rise to costs and impede financial market innovation. These schemes are not well targeted to achieve intended social goals and are not well aligned with current priorities, such as strengthening the pension system; (iv) the banking system’s rapid accumulation of capital strengthens banks’ resilience. This accumulation is harder to control for mutual banks, given their legal restrictions on remuneration of their members. And, for all banks, it could encourage

expansion through expensive takeovers and risky new ventures; (v) the supervisory system of the financial sector is composed of specialized segments. Coordination mechanisms need to be further adapted. Additional steps should be considered in the future as cross-sectoral financial groups become more prevalent; (vi) the consolidation of the French stock and futures markets with others in Europe has increased the importance of effective cooperation across national jurisdictions. Moreover, the authorities face the challenge of adjusting to and effectively implementing the significant regulatory overhaul that took place in late 2003; and (vii) the infrastructure for the clearing and settlement of payments and securities is generally sound and modern. However, there is some room for improvement in the clearing and settlement of retail payments and securities, where the multilateral netting systems lack fully adequate safeguards to ensure timely settlement in case of default.

## APPENDIX II. FRANCE: STATISTICAL ISSUES

The economic database is comprehensive and of high quality, and data provision to the Fund is adequate for surveillance. The authorities regularly publish a full range of economic and financial data, and calendar dates of main statistical releases are also provided. France subscribes to the Fund's Special Data Dissemination Standard. The transmission of data in electronic form from INSEE (*Institut national de la statistique et des études économiques*) 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. A data ROSC mission conducted an assessment of the statistical system in March 2003, and the report was published in October 2003. A factual update to the main report was published in November 2004.

France's monetary and banking statistics methodology conforms with the European Central Bank framework, which provides comparable details as the Standardized Report Forms developed by STA. Statistics for *International Financial Statistics* on banking institutions and monetary aggregates are prepared on a monthly basis and are timely. Monetary data are also disseminated in the quarterly *IFS Supplement* on monetary and financial statistics.

France follows the European System of Integrated Economic Accounts 1995 (ESA95). Data for GDP and its expenditure components are available from 1978 onwards. Both annual and quarterly accounts provide reliable information, although estimates from the two accounts differ slightly before the quarterly accounts are revised to be aligned to the annual ones. In 2005, national accounts estimates were rebased to 2000 prices.

Government finance statistics have been strengthened recently. Both central and general government data are presented in a more comprehensive fashion than previously and the data for 2006 and 2007 also reflect the various impacts of recent budgetary reform. Although the source data is collected by the Ministry of Economy and Finance, INSEE is principally responsible for the compilation and dissemination of fiscal data in a framework that is consistent with ESA95. INSEE's website has recently been enhanced; in particular, it includes expenditure tables and government revenues by subsector (central government, miscellaneous central government agencies, local governments, and social security administration).

Balance-of-payments statistics should be interpreted with caution, given large errors and omissions. Greater coherence between the external current account and the rest of the world account in the national accounts is needed. In this regard, work with promising early results has been undertaken on the transportation account.

**APPENDIX II. FRANCE: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE**  
(As of December 28, 2007)

	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting	Frequency of Publication	Memo Items:	
						Data Quality—Methodological Soundness <sup>6</sup>	Data Quality—Accuracy and Reliability <sup>7</sup>
Exchange Rates	11/07	12/06/07	Monthly	Monthly	Monthly		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	10/07	11/30/07	Monthly	Monthly	Monthly		
Reserve/Base Money	06/06	08/06	Weekly	Weekly	Weekly	O, O, LO, LO	O, O, O, O, O
Broad Money	11/07	12/07	Monthly	Monthly	Monthly		
Central Bank Balance Sheet	10/07	11/28/07	Monthly	Monthly	Monthly		
Consolidated Balance Sheet of the Banking System	10/07	11/28/07	Monthly	Monthly	Monthly		
Interest Rates <sup>2</sup>	10/07	12/17/07	Monthly	Monthly	Monthly		
Consumer Price Index	11/07	12/18/07	Monthly	Monthly	Monthly	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> —General Government <sup>4</sup>	Q2:2007	10/07	Quarterly	Quarterly	Quarterly	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> —Central Government <sup>5</sup>	07/05	09/06	Monthly	Monthly	Monthly		
Stock of Central Government Debt	07/06	09/06	Monthly	Monthly	Monthly		
Stock of Central Government-Guaranteed Debt	Q1:2006	08/06	Quarterly	Quarterly	Quarterly		
External Current Account Balance	Q2:2007	11/07	Quarterly	Quarterly	Quarterly	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Q3:2007	12/07	Quarterly	Quarterly	Quarterly		
GDP/GNP	Q3:2007	12/07	Quarterly	Quarterly	Quarterly	O, O, O, O	O, LO, O, O, O
Gross External Debt	12/31/05	06/06	Monthly	Monthly	Monthly		

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup>This information is provided on a budget-accounting basis (not on a national accounts basis).

<sup>6</sup>Reflects the assessment provided in the data ROSC or the Substantive Update (published in October 2003, and based on the findings of the mission that took place in March 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

<sup>7</sup>Same as footnote 6, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.



INTERNATIONAL MONETARY FUND

FRANCE

**Staff Report for the 2007 Article IV Consultation  
Supplementary Information**

Prepared by the European Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Depler and Matthew Fisher

February 12, 2008

This supplement to the staff report for the 2007 Article IV consultation with France provides an update on staff's revised economic outlook, recent developments in financial markets, and structural reform proposals. The information does not alter the thrust of the staff appraisal.

**Summary**

*Growth is forecast to dip in 2008 to 1.5 percent, slightly lower than anticipated in the staff report due to a further weakening of the global environment, as set out in the recent interim WEO. Headline inflation has continued to rise, given higher oil and food prices, but core inflation remains below 2 percent. While the banking system so far appears to be only moderately affected by the ongoing financial turmoil, the full extent of necessary write-downs is still unknown, and a massive fraud case at Société Générale is troubling. The Commission for the Liberalization of Growth in France (Attali Commission) has presented its report and the government has undertaken to implement most of its (over 300) specific recommendations, though protests by taxi drivers seem to have led it to distance itself from the report's proposals in this area.*

**Output and inflation**

1. **Staff projects a deceleration of GDP growth to 1½ percent in 2008** (Table 1). The revision is driven by slower growth in the U.S. and Europe and the effects of higher inflation on consumer spending. It is consistent with the mark-down of ½ percentage point in euro area growth in the interim WEO published on January 29, which reflects broadly evenhanded reductions across main euro area countries. While lending flows to the private sector have continued to be strong, the global financial market turmoil has led to appreciably tighter bank lending standards for firms. Recent developments have also weighed on consumer confidence, which dropped in January to its lowest level in 12 years. The tax cuts approved

in July 2007 and in the 2008 budget (½ percent of GDP) became fully effective in January and stand to mitigate somewhat the negative external effects on demand. With a fiscal deficit projected by staff to widen to 2.8 percent of GDP (versus 2.7 percent of GDP in the staff report) in 2008—near the Maastricht limit—and a relatively high debt/GDP ratio, there is no room for additional discretionary fiscal stimulus. In this respect, on February 12, 2008 the ECOFIN Council invited France to “strengthen the pace of budgetary consolidation and debt reduction.” The risks to the staff’s forecast are broadly balanced, with downside risks related to the international environment and, on the upside, a possibly stronger rebound in the aeronautics and automobile industries. A relatively strong showing of industrial production in December 2007 may provide some ground for the latter.

### **Financial sector**

2. **On January 24, Société Générale (SG) communicated that a massive rogue dealing fraud has cost the bank €4.9 billion.** SG reported the fraud in addition to €2.1 billion in U.S. residential mortgage and monoline related write-downs; the latter were revised to €2.6 billion on February 11. SG has launched a rights issue to raise €5.5 billion in fresh capital in the market. In a report, issued on February 4, the authorities concluded that the fraud was an isolated event, but pointed to failures in the bank’s internal controls of derivatives trading, with questions already raised last year by the derivatives exchange, Eurex. The report finds that the subsequent unwinding of the trader’s position conformed to market practice, but was carried out under difficult market conditions. Minister Lagarde has asked for clarification of the communication requirements between regulatory agencies and the government in crisis management. Various other enquiries into the episode are underway. Separately, the authorities have indicated their aversion to possible hostile takeover bids of SG.

3. **Notwithstanding the SG episode, the French banking system appears to be only moderately affected by the ongoing financial turbulence.** So far, most of the large French banks have disclosed manageable exposure to the U.S. subprime market. Two of the large banks have revealed preliminary results for the entire year: BNP has reported an increase over last year’s net income, and—excluding the fraud-related write-downs—SG has reported stable results, despite losses related to the turbulence. However, banks’ exposure and risk may increase in case of a worsening situation of monoline bond insurers<sup>1</sup> and a persistence of the turmoil.

4. **The government has asked financial institutions and regulators to join in efforts at both the national and international level to strengthen internal control of market operations.** The government has asked firms and regulators to work together on improved

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<sup>1</sup> BNP and SG are among the eight banks that have joined to aid Ambac Financial Group, a large bond insurer hit by the global turmoil.

internal control systems and better regulation of operational risk management, to reduce vulnerabilities in the French banking system. It noted that banks' management should be fully involved in risk control and fraud identification, and that supervisors may need to raise monetary sanctions against violations of regulations. France has called for setting homogeneous international standards on the management and transparency of operational and reputational risk, within the framework of Basel II.

5. **Credit standards have tightened appreciably in corporate lending, but not in household lending.** The *Banque de France*'s most recent lending survey reported a sharp tightening of banks' credit standards to firms in the fourth quarter and expectations of a further tightening in 2008. French firms have relatively strong balance sheet positions and are less reliant on bank lending than in some other euro area countries; nonetheless, tightening credit conditions, especially if confirmed going forward, would compound downside risks to growth.<sup>2</sup> In contrast to firms, lending standards to households have remained little changed. This difference suggests that, beyond the impact of the turmoil on bank leverage, the worsening economic outlook may have played a major role in the credit tightening.

### Structural issues

6. **President Sarkozy has undertaken to implement most of the Attali Commission's proposals to generate growth in France.** In mid-January, the Commission presented 316 specific measures (*décisions*) covering education, future technologies, competitiveness of SMEs, labor markets, rents and privileges, taxation, and public spending. The objectives are to raise potential growth by 1 percentage point, reduce unemployment to 5 percent, cut poverty, and improve living conditions in problem neighborhoods by 2012. Prime Minister Fillon announced the presentation of a draft law on the "modernization of the economy" in spring 2008, which would also include proposals on the deregulation of retail trade, strengthened competition policies, and measures in support of SMEs. He also initiated consultations with social partners and economic agents to formulate reform plans in a number of other areas, including the regulated professions. Protests by taxi drivers seem, for their part, to have induced the government to distance itself from the specifics of the Attali report's recommendations. Other report proposals are to be covered by existing processes, such as the general expenditure review (RGPP) and negotiations on pension reform due later this year. Ahead of these talks, the government has announced a multi-year increase in the minimum pension (*minimum vieillesse*), with a first installment already in 2008.

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<sup>2</sup> See Selected Issues II, Financing and Risks of French Firms ([www.imf.org](http://www.imf.org)). The tightening of lending standards for credit to firms, which was more moderate in France until October 2007 (¶7 of the staff report), is now in line with the euro area average.

## Staff assessment

7. **The events at Société Générale are troubling, and revealing of serious shortcomings in internal controls, but not such as to affect the overall stability of the French financial system.** If Société Générale successfully concludes its announced recapitalization of €5.5 billion or is merged with a stronger partner, there are unlikely to be systemic repercussions. Contestability, including by potentially interested foreign parties, should however be fully assured. Efforts to enhance operational risk management to avert similar frauds in the future are welcome, with effective enforcement of existing regulations being the priority, and incentives to undue risk-taking in proprietary trading re-examined; regulatory changes might also be needed, and weighed against their cost implications.

8. **Many measures proposed in the Attali report could help lift growth and raise consumer welfare.** The removal of barriers to doing business in the retail sector, including hotels and restaurants, and the strengthening of competition policies would raise supply, improve the efficiency of markets, and lower consumer prices—and are specifically endorsed in the staff report (¶36 and others). Their inclusion in a broader liberalizing draft law in the spring is welcome. With respect to other reforms, it will be important that consultations with social partners and professionals do not result in undue delays or weak agreements, maximizing long-term benefits to consumers. Given the state of public finances, it will be important to offset the budgetary costs of some of the proposals by a redeployment of resources.

Table 1. France: Main Economic Indicators, 2004-13

(Annual percentage change; unless otherwise indicated)

	2004	2005	2006	Projection						
				2007	2008	2009	2010	2011	2012	2013
Demand and supply in constant prices 1/										
Gross domestic product	2.5	1.7	2.0	1.9	1.5	1.9	2.6	2.6	2.5	2.5
Private consumption	2.5	2.2	2.0	2.1	1.8	1.9	2.6	2.5	2.4	2.4
Public consumption	2.3	0.9	1.4	1.6	1.6	1.7	1.8	1.8	1.8	1.8
Gross fixed investment	3.6	4.0	3.7	3.9	2.6	3.7	4.0	3.8	3.9	3.9
Business investment	4.2	2.1	4.2	5.0	3.2	5.0	5.2	4.8	4.8	4.8
Residential investment	3.2	6.1	4.4	1.5	2.1	1.7	1.7	1.8	1.8	1.8
Public investment	2.3	7.1	1.2	4.2	1.1	1.9	2.9	3.3	3.2	3.2
Stockbuilding 2/	0.6	0.0	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 2/	-0.7	-0.6	-0.4	-0.2	-0.6	0.0	0.0	0.0	0.0	0.0
Exports of goods and NFS	4.0	2.8	5.5	3.4	3.3	5.3	6.9	6.8	6.5	6.3
Imports of goods and NFS	7.1	5.0	6.8	4.3	4.8	5.9	6.7	6.4	6.3	6.3
Prices										
GDP deflator	1.4	1.8	2.5	2.1	1.9	1.8	1.7	1.7	1.7	1.7
Consumer prices (average) 3/	2.3	1.9	1.9	1.6	2.3	1.8	1.7	1.7	1.7	1.7
Consumer prices (end of period)	2.3	1.8	1.7	2.8	...	...	...	...	...	...
Employment and wages										
Employment	0.1	0.5	0.8	1.1	0.5	0.3	0.3	0.3	0.3	0.1
Unemployment 4/	9.6	9.7	9.5	8.7	8.2	7.9	7.7	7.4	7.1	7.0
Productivity 5/	2.4	1.3	1.2	0.9	0.9	1.6	2.4	2.3	2.2	2.4
Unit labor costs (whole economy)	1.0	1.7	1.8	2.6	2.5	1.9	1.1	1.2	1.4	1.3
Output in manufacturing	0.4	1.4	2.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Hourly labor compensation in manufacturing	4.2	1.8	3.4	3.2	3.0	2.5	2.5	2.5	2.5	2.5
Unit labor costs in manufacturing	0.7	-2.5	-0.9	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Personal sector										
Real disposable income 6/	2.6	1.6	2.1	2.7	1.8	2.1	2.2	2.4	2.4	2.4
Savings ratio 7/	15.8	15.3	15.5	15.9	15.9	16.1	15.8	15.7	15.6	15.6
Output gap 8/										
Output gap 8/	-0.5	-0.8	-0.9	-1.1	-1.8	-2.0	-1.5	-0.9	-0.5	0.0
Rate of growth of potential output	2.1	2.1	2.1	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Balance of payments										
Trade balance (in billions of euros)	-3.8	-23.0	-30.0	-38.1	-58.2	-61.1	-62.2	-63.0	-65.5	-69.3
(in percent of GDP)	-0.2	-1.3	-1.7	-2.0	-3.0	-3.0	-3.0	-2.9	-2.9	-2.9
Current account (in billions of euros)	8.5	-15.7	-22.5	-24.4	-58.8	-61.7	-62.1	-61.9	-63.6	-67.1
(in percent of GDP)	0.5	-0.9	-1.3	-1.3	-3.0	-3.1	-3.0	-2.8	-2.8	-2.8
Terms of trade	-0.5	-1.8	-0.3	0.0	-1.9	0.5	0.3	0.3	0.2	0.0
Nominal effective exchange rate	107.6	107.7	108.1	110.3	...	...	...	...	...	...
Real effective exchange rate	103.2	101.4	101.1	102.3	...	...	...	...	...	...
Public sector accounts 9/										
Revenue	49.6	50.7	50.8	50.7	50.3	50.1	50.0	50.0	50.0	50.0
Expenditure	53.2	53.7	53.4	53.1	53.1	52.9	52.4	51.9	51.4	51.0
General government balance 10/	-3.6	-2.9	-2.5	-2.4	-2.8	-2.8	-2.4	-2.0	-1.5	-1.1
Central Government balance 10/	-3.2	-3.0	-2.6	-2.1	-2.3	-2.2	-1.8	-1.4	-1.0	-0.6
Social Security balance 10/	-0.9	-0.2	-0.3	-0.4	-0.4	-0.6	-0.6	-0.5	-0.4	-0.3
Structural balance 11/	-3.1	-2.7	-1.9	-1.6	-1.7	-1.7	-1.5	-1.4	-1.2	-1.0
Primary balance	-0.9	-0.3	0.0	0.2	-0.2	-0.2	0.2	0.6	1.1	1.5
Gross debt 10/	64.9	66.7	64.2	64.1	64.7	65.2	64.9	64.1	63.0	61.5

Sources: *Banque de France*; data provided by the authorities; and IMF staff estimates.

1/ Data from the INSEE quarterly national accounts system.

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

3/ Harmonized CPI.

4/ In percent of labor force; harmonized index.

5/ GDP over total employment.

6/ Personal disposable income deflated by the implicit deflator for private consumption.

7/ In percent of household disposable income.

8/ In percent of potential GDP.

9/ In percent of GDP.

10/ Maastricht definition.

11/ Data for 2005 and 2006 exclude the EDF and La Poste pension fund transfers, respectively (0.5 percent and 0.1 percent of GDP).



INTERNATIONAL MONETARY FUND

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International Monetary Fund  
700 19<sup>th</sup> Street, NW  
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## **IMF Executive Board Concludes 2007 Article IV Consultation with France**

On February 15, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with France.<sup>1</sup>

### **Background**

Economic growth in France has averaged 2 percent since 2003, lagging both the revival of European growth and past growth performance at the same stage of the economic cycle. While domestic demand has remained robust, net exports have been a significant drag on growth, detracting close to ½ percentage point of GDP per year on average. In 2007, growth was 1.9 percent, down from 2.0 percent in 2006. Domestic demand has remained the driver of growth. As a result of the deceleration in real export growth and the continuation of dynamic import growth, France's current account has deteriorated steadily: from a surplus of 1.4 percent of GDP in 2002 to an estimated deficit of 1.3 percent in 2007.

Inflationary pressures are mounting, but headline inflation remains one of the lowest in the euro area. After ebbing down to 1.2 percent in mid-2007, headline inflation has rebounded to 2.8 percent in December 2007 with the surge in food and energy prices. Unit labor costs have risen, as productivity gains have lagged wage inflation. Monetary conditions have tightened noticeably since 2006, reflecting ECB rate increases and, more recently, euro appreciation and the increase in risk premia due to the fallout from the financial turbulence.

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<sup>1</sup> 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.

Financial turbulence has had a limited impact on the domestic economy to date, and performance of the banking sector remains solid. French banks' exposure to the U.S. subprime market appears fairly limited and credit default swap spreads have risen less than for some other major European banks. Nonetheless, financial institutions remain vulnerable, particularly with regard to off-balance sheet exposures. In addition, profitability may be further impacted by rising risk in corporate credit, the cooling-off in real estate prices, and generally tighter credit conditions. Recent events at Société Générale have revealed shortcomings in internal control, which the authorities intend to address.

For 2008, GDP growth is projected to reach 1.5 percent, substantially weaker than anticipated earlier. The spike in oil prices, the rise in the euro and weakening economic prospects in partner countries will be a drag on growth. The risks to the staff's forecast are broadly balanced, with downside risks related to the international environment and, on the upside, a possibly stronger rebound in the aeronautics and automobile industries.

The authorities are pursuing an ambitious structural reform program across a wide range of areas. At the center of the program is the need to increase flexibility in labor markets. To date, the government has introduced a number of measures to make the 35-hour workweek restriction less binding. In addition, social partners have reached agreement on key labor market reforms, upon which the government intends to act. Other labor market initiatives include a review of the mechanism for setting the minimum wage (SMIC) and the merger of the unemployment and job placement agencies. The government is also pursuing goods and services market reforms, which could boost potential output and consumer welfare. Among the key priorities, early action is expected in reforming the retail distribution sector.

The 2008 budget represents a pause in fiscal consolidation. The budget maintains spending restraint (including an unprecedented reduction in public employment), but it is offset by the cost of the August 2007 tax package, leaving little deficit improvement. Over the medium term, the government aims for an annual structural adjustment of ½ percentage point of GDP consistent with the objective of reaching fiscal balance by 2012 under its central scenario.

The government has launched a comprehensive general review of public policy. The review aims to achieve a fundamental and lasting improvement in public services while reducing public spending on a sustainable basis. Analogously, a general review of the tax system has also begun. It would be the basis for reform toward a more efficient tax system based on greater stability, a supportive framework for business and investment, and greater use of environmental taxes.

### **Executive Board Assessment**

Directors commended the authorities for their intention to accelerate the economic reform process and to push for simultaneous reforms across different areas. Directors noted that this strategy increases the prospects for an appreciable acceleration in economic growth by exploiting the complementarities of reforms. They welcomed the authorities' focus on reforming areas where market distortions are currently greatest—notably labor and services markets.

Such an approach would address the sources of France's growth difficulties which, Directors noted, lie not in deficient consumer demand, but in rigidities that impede supply and impair export performance. Directors stressed that eliminating these rigidities would raise productivity and stimulate growth, and over time yield a greater contribution to improving the purchasing power of French households than short-term measures to boost disposable income.

Directors noted that near-term growth prospects for France have weakened with the onset of the global financial turmoil and the slowdown in advanced economies, with a recovery expected in 2009-10. Growth in recent years has been sustained by domestic demand, with the external sector contributing negatively. Export growth has lagged, producing a widening current account deficit. Directors noted that competitiveness, as reflected in the real effective exchange rate, shows some deterioration. However, the deterioration is modest—suggesting that the exchange rate is not the principal constraint on exports, and underscoring the need to address inefficiencies in factor and product markets to boost performance.

Directors saw labor market reforms as central to a strategy of raising growth, reducing unemployment, and improving the purchasing power of French households. They noted that the government has already taken steps to alleviate the country's highly restrictive labor regulations, including by relaxing the 35-hour workweek requirements and fostering an agreement between employers and trade unions to rationalize labor contracts and improve employment flexibility. Directors also welcomed steps to rationalize public employment services. They highlighted the need for further reforms, including steps to reduce wage compression by limiting future discretionary adjustments in the minimum wage, further relaxing the 35-hour workweek, and making more fundamental improvements in the flexibility of permanent employment contracts. In this context, a number of Directors noted the fiscal costs implied in trying to alleviate labor market rigidities via the budget, and favored an approach that addressed the core problems directly.

Directors viewed goods and services market reforms as having the potential to significantly boost output and consumer welfare. They welcomed steps to liberalize retail distribution, which should lead to a positive effect on inflation, and the planned move to a unified competition authority. More generally, the liberalizing opportunity offered by the EU Services Directive should be fully seized. Directors looked forward to the draft law expected in the Spring taking up the recommendations of the Attali Commission.

Directors noted that, while the 2008 budget contains several commendable initiatives to contain spending, including an unprecedented reduction in public employment, it entails a pause in fiscal adjustment due to tax cuts. While recognizing the challenges to policy making in the present conjuncture, most Directors stressed that fiscal consolidation should proceed in tandem with structural reforms. They accordingly encouraged the authorities to be vigilant to the risk of slippage in the fiscal deficit target in 2008. With lower growth forecast in 2008, the deficit risked moving toward its Maastricht limit, leaving in these Directors' view no room for additional discretionary fiscal stimulus. Several other Directors, however, felt that it was appropriate for fiscal policy to play an active countercyclical role in the face of the weakening global economic environment and other downside risks to the French economy. More generally, Directors urged



the authorities from 2009 to return to an ambitious adjustment path for the fiscal deficit, strengthening the credibility of their medium-term objective of budget balance.

Directors strongly welcomed the government's ongoing expenditure and tax policy reviews. They observed that international experience shows that these exercises can provide significant lasting improvements in the fiscal position and in the efficiency of public services. They noted, however, that these improvements take time to materialize, so fiscal consolidation in 2009-10 should be based on tight spending plans.

Directors noted that the French financial system appears to have been only moderately affected by the recent financial market turbulence. The system is well-capitalized, exposure to the U.S. subprime market is limited, and off-balance sheet exposure appears to be moderate. But market conditions have yet to return to normal and risks remain. Directors thus encouraged the authorities to remain vigilant to the possibility of further spillovers from other countries and from other market segments. The recent trading fraud at Société Générale, while it appears to be an isolated event, points to the need to continue to reinforce risk management controls in banks. Directors welcomed the authorities' prompt investigation of the affair and their commitment to take the necessary steps to ensure that similar problems do not recur. Directors recommended that the authorities move forward with the modernization of France's financial market, moving away from its administered past, as advised also by the recent Camdessus report on regulated savings. A more efficient financial sector could make a significant contribution to boosting economic growth. The impulse that the authorities intend to give to the Lamfalussy process is also welcome.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2007 Article IV Consultation with France is also available.

**France: Selected Economic Indicators**  
(Annual percentage change; unless otherwise indicated)

	2003	2004	2005	2006	2007 1/
<b>Real economy</b> (change in percent)					
Real GDP	1.1	2.5	1.7	2.0	1.9
CPI (year average)	2.2	2.3	1.9	1.9	1.5
Unemployment rate (in percent)	9.5	9.6	9.7	9.5	8.7
Gross national savings (percent of GDP)	19.7	19.7	19.1	19.8	19.9
Gross domestic investment (percent of GDP)	18.8	19.3	19.8	20.5	20.8
<b>Public finance</b> (percent of GDP)					
Central government balance	-3.9	-3.2	-3.0	-2.6	-2.0
General government balance	-4.1	-3.6	-2.9	-2.5	-2.4
General government gross debt	62.9	64.9	66.7	64.2	64.0
<b>Money and interest rates</b>					
Money market rate (in percent)	2.3	2.1	2.2	3.1	4.2
Government bond yield (in percent)	4.2	4.2	3.5	3.9	4.3
<b>Balance of payments</b> (percent of GDP)					
Trade balance	0.2	-0.4	-1.5	-1.4	-2.0
Current account	0.8	0.1	-1.1	-1.2	-1.3
Official reserves (US\$ billion) 2/	30.2	35.3	27.8	42.7	51.8
<b>Fund position</b> (as of December 31, 2007)					
Holdings of currency (percent of quota)					93.4
Holdings of SDRs (percent of allocation)					58.3
Quota (SDRs million)					10,738.5
<b>Exchange rates</b>					
Exchange rate regime					Participant in EMU
Euro per U.S. dollar (February 14, 2008)					1.46
Nominal effective rate (2000=100)	106.1	107.6	107.7	108.1	110.3
Real effective exchange rate (2000=100) 3/	100.9	103.3	101.5	101.2	102.3

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

1/ First results.

2/ Excluding gold, end-of-period; eurosystem definition.

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

**Statement by Ambroise Fayolle, Executive Director for France**  
**February 15, 2008**

We wish to thank staff for a quality report that provides an in-depth analysis of the strengths of the French economy—and the challenges it faces—at a pivotal time in its history. We are also grateful for the *Selected Issues*, which we found most interesting. The discussions with the team were warmly appreciated by the French authorities, in addition to providing useful input for their own assessments. As the authorities themselves explained during the mission, they are hopeful that the IMF can more widely disseminate cross-country analyses and experiences. The French authorities set great store by the surveillance exercise, as evidenced by their decisions to implement two of the resulting recommendations: the ending of the monopoly over the distribution of the *livret A* accounts and the establishment of a unified regulatory authority in charge of competition issues.

**Structural reforms**

**“France is on the move,” IMF staff asserted in the Concluding Statement for the 2007 Article IV Consultation.** The government’s strategy is to free productive capacities. To achieve this goal, the government has embarked upon a **reform process** distinguished by one clear objective and three characteristic features: its scope, its method, and its speed of implementation.

- **Objective:** raise France’s potential growth by 1 percent over time.
- **Scope:** achieve a “critical mass” of reforms so as to maximize synergies. France is implementing a comprehensive structural reform strategy aimed at raising productivity, increasing the employability of individual workers, and enhancing the attractiveness of France’s economy.
- **Method:** move quickly while allowing adequate time for collective bargaining, consensus and avoiding deadlocks.
- **Implementation:** once decisions have been reached, the authorities will press ahead quickly with the structural reforms. A sizable number of reforms have already been carried out, as staff has pointed out. I would like to touch upon some of these reforms.

**Improve labor market mobilization**

The reform of overtime rules, adopted last August, is producing a supply-side effect. A mere 3 months after its adoption, by November 2007, 50 percent of firms with more than 10 employees had reported already using the new system. In addition, special pension plans have been reformed, with particular reference to contribution periods and indexation rules, which have been aligned with the rules governing reformed pension plans. In 2008, the full set of financing parameters of pensions will be examined with a view to reducing medium- and long-term financing requirements. The merger of UNEDIC and ANPE, a reform that has been on the table for over twenty years, will foster a more effective matching of supply and

demand, while improving labor market flexibility. And as Fund staff have pointed out, the decision to forego any hike in the SMIC (minimum wage) in July 2007 will make it easier for employers to hire unskilled workers. Furthermore, the agreement reached between 8 out of 9 employers' and workers' unions on January 11, 2008 will increase the flexibility of the labor market and improve the employment rate. This agreement relaxes the requirements for terminating employer-employee relationships in exchange for the introduction of an occupational and social safety net for workers in addition to the preservation of their acquired rights. Negotiations have begun in other areas, in which the employers' and workers' unions are expected to reach agreement by March 31, 2008. I am referring in particular to the strengthening of vocational training and negotiations with respect to working hours.

**Increase competition in the market for goods and services.** The law adopted last December, rightly described as “particularly promising” by staff (Box 2), frees wholesale margins and passes savings on to customers. According to forecasts, this key measure should decrease the CPI by 1½ to 2 points. Other reforms have already been decided upon, with implementation beginning in early 2008: the liberalization of ports and rail freight, and the over-the-counter sale of pharmaceutical products. Finally, a draft law is expected in the Spring to take up the recommendations of the Attali commission.

**Strengthen R&D.** The London protocol has been ratified. This will allow French firms to reduce patent costs while at the same time increasing the international comprehensibility of patents. The research tax credit (implemented on January 1, 2008) modifies the eligible tax base with the aim of encouraging long-term innovation efforts. It is one of the most attractive settings in Europe. The GDP increment associated with the latter reform will be in the range of 0.3 and 0.5 point of GDP after 10 years. Furthermore, the universities were reformed in August 2007.

**France is drawing inspiration from successful foreign experiences.** When discussing foreign experiences, it is vital to take full account of those factors—monetary conditions in particular—that are key to the successful implementation of the accompanying reforms. The annex and the box on the Canadian experience could be amended in that regard.

**Last but not least, reflecting France's commitment to the surveillance exercise, the authorities recently adopted two decisions long recommended by the IMF.** First, last December, the Prime Minister announced the ending of the monopoly on the distribution of *livret A* accounts, which should take effect by January 1, 2009 at the latest, as called for by the Fund (paragraph 41). Moreover, on January 23, 2008 the President of the Republic announced his support for the Attali Commission's proposal to establish a unified competition authority, in accordance with IMF recommendations (paragraph 19).

### **Economic environment**

**The short-term outlook is reasonably good.** Naturally, France is not immune from the slowdown in the global economy. Consequently, the government has indicated that for 2008,

France's growth forecast will be around 2 percent. The most recent INSEE economic outlook survey, published in mid-December 2007, projected a growth carry-over of 1.7 percent by mid-2008, i.e., well above Fund staff's estimates.

**The French economy performed well in 2007.** In particular, job creation has been robust: more than 230,000 new jobs appeared in the business sector during the first three quarters of 2007, in contrast to 190,000 for all of 2006. The unemployment rate at the end of the third quarter was 8.3 percent (down from 9.8 percent at end 2005). Furthermore, short-term economic indicators are on track. The business climate in the manufacturing sector has thus remained buoyant throughout 2007 in France. This is attributable in particular to the recovery of the automobile industry and the ongoing dynamic performance of the aviation sector.

**These welcome developments are expected to continue in 2008 and to support France's industrial production and exports.** In spite of the increase in inflation through end-2007, household consumption is expected to remain strong in early 2008, benefiting from the steady improvement in the labor market in 2007 and measures adopted last summer. Furthermore, despite tighter interest rates, consumer credit remained dynamic at end-2007. The relatively low level of household indebtedness (68 percent of gross disposable income), mainly at fixed rates, and a real estate market unhampered by risks identified in other countries, are two other positive factors going forward.

**With respect to the impact of the financial crisis on French firms, as analyzed in the *Selected Issues*, we share the view that French firms continue to perform favorably.** However, we wish to point out that in view of the selection bias in the study, its conclusions are relevant to the sole listed companies.

**France's economy is more resilient to a global slowdown than other comparable economies, given the manner in which its growth is structured, contrary to the claims made by staff, particularly in the *Selected Issues*.** Although the analytical method proposed by staff is appealing, it will require further verifications and additional econometric support if it is to be truly convincing, particularly with regard to the suggested policy recommendations.

### **Economic policy**

**The authorities have indicated their intention to pursue their fiscal consolidation effort through 2010, cyclical conditions permitting.** The timetable and arrangements for this adjustment are consistent with the government's economic strategy, which is designed to achieve sustainable improvements in government finance, focusing on two key areas.

**First, the implementation of structural reforms is designed to boost potential growth.** Available research (IMF studies in particular) shows that current and proposed reforms will raise potential growth by 1 percent over time.

**Second, the government is embarked upon an unprecedented drive to control public expenditure.** Specifically, the framework for expenditure control (stabilization in volume terms) has been broadened, particularly to include withholdings from revenue (in favor of regional governments and the European Union). In light of those expenditures for which increases are automatic (pensions, debt outlays), compliance with the expenditure framework will necessitate volume reductions in other government expenditures. The decision not to replace one out of every two civil servants will represent a key component of this effort, as adopted in the 2008 budget law (except for national education, where the ratio will be one out of three). Lastly, the government has made a commitment to parliament to identify a tax expenditure supervision tool, as a complement to the expenditure framework. The 2008 budget will be rigorously implemented.

**The objectives of public expenditure control are credible.** First, the broad review of public policy (RGPP) is under way. As a result of this review, staff reductions should be accompanied by organizational changes and streamlining. This exercise is being led at the very highest levels of government and the main decisions will be taken in the Spring. Then, in 2009, a three-year government budget will be adopted to supplement the RGPP, in order to align the timetable of the reforms with the budget process. This multi-year approach will make it possible to strengthen the beneficial reforms introduced by the budget framework law (LOLF).

**We are in broad agreement with the main message in the *Selected Issues* regarding the French tax system. However, the claim that the fundamental changes of the kind seen elsewhere have yet to appear in France is unduly harsh.** Staff's message (i.e., the need for a comprehensive approach) is consistent with the wide-ranging review of the tax and social contribution system (RGPO) currently being pursued by the authorities. However, the reforms that are already in place should not be overlooked. For example, the maximum marginal rate of the income tax in France is now one of the most competitive. Moreover, France is at the forefront of efforts to achieve tax neutrality—for example, through the phase-out of double taxation on equity securities for businesses. Finally, although the nominal rate of corporate income tax remains high, France has lately been focusing its corporate income tax reduction efforts on the reform of the *taxe professionnelle*, as acknowledged in Box 4.

### **Financial system**

**Like staff, we believe that France's financial markets have weathered the recent financial turbulence well.** The impact of the crisis in France has affected different banking groups in different ways, depending on their operational structure; yet, as IMF staff make clear, the impact was softened by the solid performance in the first half of 2007 and strong diversification of services and products, as well as the limited direct and indirect exposure of major French banks to the subprime market. In particular, the overall solvency of the French banking system remains satisfactory. With regard to the difficulties encountered by mutual funds (paragraph 29), the staff report should specify that the amounts associated with funds

that have undergone closure or temporary trading suspension account for less than 0.5 percent of total assets under management.

**The existing supervision model, which is relatively straightforward, has proven its worth in the face of recent financial upheavals.** In fact, in managing this crisis, close cooperation between supervisory authorities and central banks has proven to be instrumental in enhancing the effectiveness and credibility of government policy. France's supervision mechanism allows the supervisory authority to give the Bank of France prompt notification of factors influencing bank behavior, which is essential in times of crisis. Furthermore, market information, data on payment systems, as well as the statistics gathered by Bank of France staff enable policymakers to make a more informed assessment of the dynamics of the crisis. All in all, the close links between the two institutions allow for a better understanding of the financial system's vulnerability to credit and liquidity risks, and this partnership enhances their capacity to assess the situation properly. This is particularly important for understanding indirect risk—for example, risks associated with contagion effects.

**One of the largest French banks, Société générale, has been the victim of a huge fraud.** I would like to make four comments. First, depositors and savers were protected; there was no panic. Second, the bank's capital will be restored to levels higher than those preceding the fraud, thereby ensuring its financial soundness. Third, the stability and integrity of financial markets have been preserved. Last but not least, there has been no recourse to government money. The Minister of Economy has already submitted a report to the Prime Minister. In particular, the authorities are seeking to strengthen internal controls of financial institutions, to toughen regulations governing internal oversight of operational risk, to focus more intently on the detection of internal fraud as a key component of internal supervision, and to ensure the wholehearted involvement of senior and middle management of banks in risk control.

**Even before the financial crisis, the French authorities were committed to improving the competitiveness of Paris as an international financial center,** as Fund staff make clear (cf. paragraph 31). They have pursued vigorous and coordinated action with professionals in order to bolster France as a firmly established, strong and well-structured financial center.