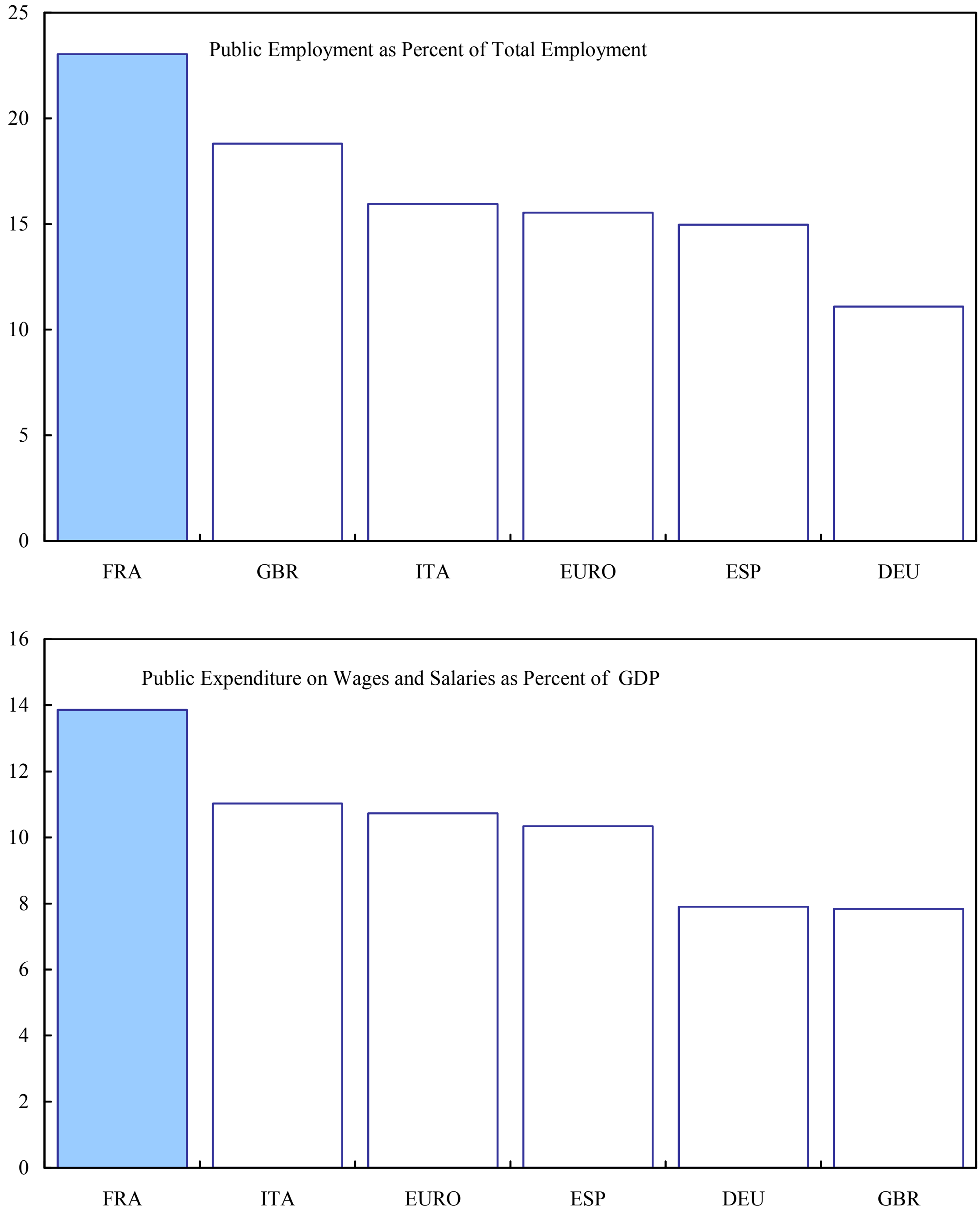
Figure 1. France: Public Employment Indicators
(In percent)



Source: OECD, Analytical Database.

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700 19th Street, NW
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IMF Concludes 2004 Article IV Consultation with France

On October 20, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with France.[1]

Background

The French economy has produced a strong upturn, especially in comparison with other large euro-area countries. Initiated by a rebound in exports, domestic demand has become the driver of growth, thanks to supportive policies and a favorable starting position. Savings rates were unusually high, balance sheet problems in the corporate sector were confined to a small number of large firms, the financial sector was profitable, and the housing market was robust. The strength of private consumption reflects both fundamental and exceptional factors: implementation of key social security reforms diminished uncertainty, prospects for growth and inflation improved, and incomes of the cash constrained were supported. Fiscal measures were implemented to help sustain the momentum in household spending. Fixed investment had been weaker than usual during the downturn, with replacement investment being postponed, but after a period of deleveraging and widening profit margins, business investment rebounded. Residential construction strengthened, reflecting several years of rising house prices. However, with higher oil prices and some softening of the external environment, the staff expects real GDP growth to slow from 2.5 percent in 2004 to 2.2 percent in 2005, while official forecasts foresee continuing growth at 2.5 percent. Headline inflation, which reached

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

2.2 percent in September, is seen to remain persistent, slowly moderating in the course of 2005. It will continue to reflect special factors—base effects from the tobacco tax increase, changes in regulated prices, oil price volatility, and the price cut agreed by large distributors. Long-term growth is being fettered by adverse demographics and structural weaknesses, a high tax and regulatory burden and, despite its increase in the 1990s, a low degree of labor utilization.

The 2005 draft budget targets a reduction in the general government deficit to 2.9 percent of GDP continuing the decline from 3.6 percent of GDP in 2004 and a peak of 4.1 percent of GDP in 2003. Following a structural improvement of about 0.5 percentage point of GDP in 2004, achieved through expenditure restraint at the central government level, the staff estimates the structural balance to improve by 0.2 percentage point of GDP in 2005 (excluding the transfer of the electricity utility's pension fund, equivalent to 0.4 percentage point of GDP). Central government expenditure is set to remain constant in real terms, but spending growth in other areas is relatively high. The net tax burden rises marginally because the increase in contributions related to the health care reform is not fully offset by a variety of smaller tax cuts in other areas. The size of the civil service is set to decline, as about 12 percent of retiring civil servants will not be replaced. For 2006–08, the authorities plan a steady reduction in the structural deficit by one-half of a percentage point per year on average, to reach a level of just below 1 percent of GDP by the end of the period. The health care reform is assumed to achieve a durable deceleration of annual nominal spending growth to 3.6 percent during 2006–08, and the volume of overall spending is targeted to increase by 1.2 percent per year on average.

On structural issues, a health care reform has established the key instruments to gain control over the system's budget, with adjustable parameters to influence its revenues as well as the behavior of patients, providers, and insurance agencies. Ongoing civil service reform and decentralization are providing the opportunity to realize efficiency gains and tailor public services better to local needs. In product markets, the statutes of the public electricity and gas companies have been changed, opening the door for private investment; the authorities intend to accelerate divestiture from commercial activities as market conditions permit; and steps are being taken to accelerate the transposition of EU internal market and competition directives. In labor markets, cuts in social security contributions are set to continue to mitigate the impact of rising minimum wages stemming from the implementation of the 35-hour workweek; social partners have been allowed to negotiate derogations from the workweek regulations, including at the enterprise level; and the earned income tax credit has been raised. Other possible changes to labor market institutions—notably as regards employment protection—have for now been left to negotiations among the social partners. A "social cohesion" program has been adopted to bring people back to the labor market, relying on fiscal incentives and closer administrative follow-up of unemployed and benefit recipients, as well as public sector employment schemes.

The Financial System Stability Assessment conducted by IMF staff this year found no immediate systemic financial sector risk and confirmed the high quality of oversight and prudential supervision of the financial sector. It recommended a further strengthening of supervision through enhanced coordination and vigilance on banks' risk exposure.

Executive Board Assessment

Executive Directors congratulated the French authorities for their skillful pursuit of reform policies, which have fostered confidence and supported an early and robust economic recovery. They welcomed the resumption of structural fiscal adjustment in 2004. Pension and health care reforms have improved the long-term fiscal outlook against the background of the impending demographic shock, while ongoing reforms in product markets are likely to boost growth. Directors urged the authorities to build on the strong performance by strengthening structural reforms and stepping up fiscal consolidation to secure higher long-term growth and fiscal sustainability. A key challenge will be to improve labor market institutions to raise labor utilization, while reducing the reliance of employment policies on budgetary resources.

Directors observed that the recent economic recovery has been driven by domestic demand. Downside risks exist on the external front. Although the pace of growth is likely to slow in 2005, mainly as a result of higher oil prices, France’s economic outlook remains comparatively favorable. With monetary conditions likely to remain quite accommodative from France’s perspective, stronger fiscal consolidation is unlikely to threaten the recovery.

In this setting, Directors urged the authorities to proceed decisively with fiscal adjustment. They saw a need to strengthen adjustment in 2005 compared to current budget plans, given France’s weak underlying budgetary position and rising public debt. They noted that recourse to a pension fund transfer from the electricity utility would be a one-off measure, and not a durable fiscal adjustment. Directors considered that the alternative of genuine structural adjustment through reinforced expenditure restraint is feasible, inter alia through advancing and strengthening health care reform measures and reducing the large size of public employment by making more decisive use of the opportunity provided by the ongoing wave of retirements.

Directors considered that the intended cumulative fiscal consolidation by 2008 is broadly appropriate. It should be complemented by the early implementation of comprehensive growth-enhancing reforms to secure long-run fiscal sustainability. In the absence of concrete measures in this direction, Directors felt that credibility would require stronger up-front and sustained adjustment until a small underlying surplus is achieved.

Directors stressed that early fiscal adjustment and growth-enhancing structural reforms will be essential to create room for a much-needed reduction in France’s high tax burden. In the meantime, consideration should be given to changes in the tax structure to yield efficiency gains and remove distortions, especially those on capital and labor. Some Directors questioned the increased recourse to tax exemptions, with doubtful economic benefits, in the 2005 draft budget.

To ensure successful consolidation, Directors encouraged the authorities to continue strengthening France’s fiscal framework. They welcomed the ongoing implementation of the output-oriented budget law and the efforts to address an ingrained spending culture at the central government level. They recommended the extension of this approach to social security and local authorities, where spending control has proven more difficult. Directors saw merit in setting multi-year limits on the level of general government spending. A few considered that establishing an independent agency to conduct forward-looking budget assessments would be useful. Directors stressed that preserving cyclical revenue windfalls will be crucial for fiscal consolidation and considered that the envisaged rule governing the ex ante allocation of such windfalls should allow for full play of automatic stabilizers to avoid structural slippages.

Directors emphasized the need for further efforts to reorient labor market policies, in order to move away from the current heavy reliance on budgetary measures. These measures had been instituted to mitigate the adverse consequences on labor costs and employment of high and rising minimum wages, the mandatory 35-hour workweek, and high marginal tax and benefit replacement rates. Directors stressed the need for comprehensive reforms of employment protection and benefits to sharpen incentives to work. They viewed the ongoing initiatives to tighten job-search requirements and reduce the duration of unemployment benefits as steps in the right direction. They called for further efforts to refocus entitlement systems toward moving people into market jobs. Other steps in this direction could include reducing the role of the judiciary in layoffs, ensuring greater flexibility in workweek regulations, and slowing the real increases in minimum wages and benefits, which have had the effect of excluding a large number of potential workers from activity. A number of Directors questioned the role assigned to public sector jobs in the new “social cohesion” program, while a few Directors felt that the program could help reconnect people with the labor force and reduce structural unemployment. Directors suggested that the cost effectiveness of this program be monitored closely. Directors welcomed the report of the Camdessus Commission, which makes far-reaching recommendations to enhance France’s growth potential and reduce unemployment.

In product markets, Directors welcomed ongoing efforts to lighten the regulatory burden, simplify administrative procedures, and promote divestiture of commercial activities. They valued the change in the statutes of the electricity and gas utilities, which has introduced the possibility of private capital participation. Directors looked forward to the pending reform of corporate bankruptcy legislation. Directors believed that the attractiveness of France for investors is best defended by reforms in the goods and labor markets and steps to strengthen competition, rather than by an emphasis on “national champions.”

Directors noted that the French financial sector has increased its resilience with the economic upturn. They welcomed the findings of the Financial Sector Stability Assessment, which has confirmed the high quality of oversight and prudential supervision. They recommended continued vigilance with respect to banks’ potentially risky expansions, intensified cooperation among supervisory agencies, improved price transparency in financial services, and enhanced competition in the financial sector. Directors also encouraged the authorities to phase out remaining administrative interventions in the financial system, so as to improve resource allocation and monetary transmission. Directors welcomed France’s leadership role and ongoing efforts to apply international standards against money laundering and the financing of terrorism and looked forward to the implementation of further reforms to strengthen this framework.

Directors commended France’s contribution to official development assistance and looked forward to a further increase toward the U.N. target level. They encouraged France to promote efforts to bring the Doha round to a successful conclusion, in particular by supporting comprehensive liberalization of agricultural markets. Several Directors felt that moving forward the national implementation of the June 2003 reform of the Common Agricultural Policy would be helpful in this respect.

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