November 2005
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France: 2005 Article IV Consultation—Staff Report, Staff Supplement, and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with France, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 11, 2005, with the officials of France on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 21, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a supplement to the staff report of October 27, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 2, 2005 discussion of the staff report that concluded the Article IV consultation.

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

Report on the Observance of Standards and Codes—Data Module—Update
Selected Issues Paper

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

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

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FRANCE

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with France

Approved by Michael Deppler and Michael Hadjimichael

September 21, 2005

Mission: Paris, June 30–July 11, 2005

Staff team: Messrs. Moghadam (Head), Everaert, Nadal De Simone, and Schule, and Mmes. Allard and Zhou (all EUR).

Country representatives: Mr. Breton, Minister of Economy and Finance, and his staff; Governor Noyer and officials of the *Banque de France*; Mr. Larcher, Deputy Minister of Labor Relations and his staff; economic advisors to the president and the prime minister; the president of the finance commission of the senate; officials of the National Statistics Institute, the Banking Commission, securities supervisors, and the national health insurance agency; market participants, academics, and representatives of the employers' federation and labor unions. Mr. Duquesne (Executive Director) or Mr. Cuny (Alternate Executive Director) attended the meetings.

Political situation: Following the rejection of the EU constitution in the May 29, 2005 referendum, the centre-right government was reshuffled and a new prime minister appointed. General and presidential elections are due in the second quarter of 2007.

Fund relations: France is an Article VIII member and, apart from certain security restrictions, maintains an exchange system free of restrictions (Appendix I). It participated in a Financial System Stability Assessment and the Fiscal Transparency and Data Modules of the Reports on the Observance of Standards and Codes. An update to the Data Module will be issued with this report.

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

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EXECUTIVE SUMMARY

In response to public discontent about the inability of policies to reduce unemployment, the authorities have given priority to job creation. While the new labor market initiatives will facilitate hiring in the near term, important additional reforms are necessary to deliver appreciably higher employment growth. Nonetheless, the signal to rely less on budgetary resources to solve labor market problems is helpful, though more decisive and persistent fiscal adjustment is needed to reduce the high structural budget deficit. With the present outlook of below-potential near-term growth, it will be difficult to reduce the deficit to less than 3 percent of GDP. The authorities' gradual consensus-building approach to structural reform has paid off, but benefits of coordination between labor and product market reforms, within both France and the euro area, should be taken advantage of. The financial system appears resilient, and the supervisory authorities are vigilant about banks' heightened exposure to the housing sector.

Weakness in the second quarter of 2005 surprised, as hitherto robust domestic demand faltered, but a moderately-paced recovery is expected. The staff sees GDP growth rising from 1.5 percent in 2005 to about 1.8 percent in 2006. With economic policies emphasizing job creation and investment, domestic demand should regain poise. Export growth may remain sluggish though, underscoring the need to preserve competitiveness through structural reforms, especially given important downside risks from oil prices and trade partner weakness.

Following good progress in 2004, fiscal consolidation stalled in 2005, but it should be resumed in 2006. Health care reform is helping, but the pace of other social security and local spending needs to be curtailed. The staff recommends a structural adjustment for 2006 of ½ of one percentage point of GDP, while the authorities' plans remain to be clarified. Achieving a nominal deficit of less than 3 percent of GDP will remain beyond reach, unless growth surprises on the upside. Over the medium term, through further fiscal adjustment and growth-enhancing reforms, a small structural surplus should be achieved in preparation for the rise in the fiscal costs of aging. The authorities viewed their fiscal framework sufficiently robust to deliver consolidation and saw no need for an independent fiscal council.

While structural reforms are proceeding, faster and broader progress is needed to deal decisively with the challenges posed by aging and changes in the global economy. Pension and health care reforms have made inroads toward fiscal sustainability. The new labor contract represents an innovation, but to achieve appreciable results, it will need to be supported by a fundamental revamp of labor market institutions and entitlements. Although intent on making progress, the authorities noted that they would tread carefully to nurture confidence and reform momentum. Administrative deregulation is proceeding, and it was agreed that further product and services market deregulation, also in the EU context, would facilitate labor market reform and enhance its benefits.

The ***financial system*** was found to be resilient, with supervisory authorities vigilant about banks' risk exposure, especially to the housing market. Phasing out of administered savings and mortgage loan schemes was deemed necessary, though no specific plans were set. The staff urged France to promote a successful conclusion of the ***Doha round*** and welcomed the relatively high level of ***official development assistance***.

I. Introduction

1. **Achieving fiscal sustainability, full employment, and higher trend-growth remain the key challenges facing the French economy.** Economic policies to meet these challenges have followed the direction of Fund advice, but the pace of implementation and scope of reform, particularly in the labor market, have been insufficient to achieve decisive results (Box 1). Nonetheless, pension and health care reforms have made inroads toward fiscal sustainability, and the recent adoption of a new labor contract signals a novel direction in reform. Reflecting the authorities' preference for a gradual approach to preserve social cohesion, the new initiative is too limited to significantly boost long-term employment growth, though it is likely to have positive short-run effects in lowering unemployment. Moreover, its implementation at a time of slowing growth and public discontent with policies, which culminated in the rejection of the EU constitution treaty, signals the authorities' intent to proceed with needed structural reforms.

Box 1. France: Past Fund Policy Recommendations and Implementation

Successive governments have concurred broadly with the direction of the Fund's economic policy advice but have underscored the importance of social cohesion, expressed in generous welfare arrangements and a narrow income distribution. The dialogue with staff on these issues has been traditionally open and frank.

Fiscal policy: Budgetary execution in 2004 concurred fully with the staff recommendation to use growth-induced revenue windfalls for fiscal adjustment. However, the Fund's long-standing advice to consolidate at an annual pace of 0.5 percent of GDP until structural balance or surplus is achieved was not followed during 2000–04 on average. The pension reform has appreciably diminished the projected cost of aging, and health care reform is making inroads, but civil service reform is yet to start in earnest. The authorities do not see room for sizable expenditure cuts that would permit a much-needed early reduction in the tax burden.

Labor and product markets: In line with Fund advice, additional flexibility was introduced in labor markets, especially in the context of the reduction of the workweek to 35 hours. The new employment contract *(contrat nouvelle embauche, CNE)* represents a first step to reforming labor market institutions, but entitlements (other than pensions) remain to be tackled. In product markets, divestiture has been accelerated and deregulation is ongoing, albeit at a slower pace than advised by the Fund, and liberalization of trade in services needs new impetus.

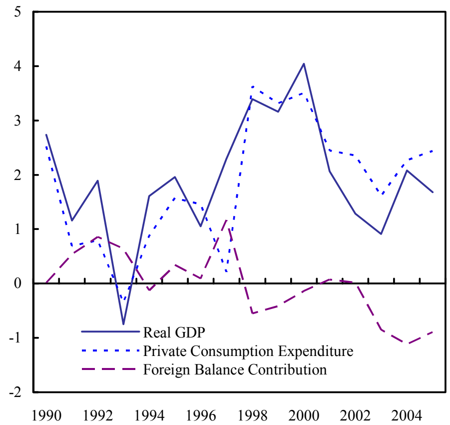
Financial sector: In line with Fund advice, the financial sector has been subject to strong supervision. The authorities have been reluctant to phase out widespread administrative interventions in financial markets, but some saving schemes have become more market-oriented.

Trade policy: The Fund has called on France to help advance trade liberalization, partly through an early implementation of Common Agricultural Policy (CAP) reform, now planned for 2007.

II. BACKGROUND

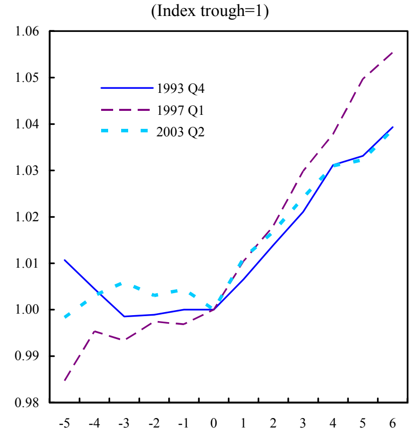
2. **Following a strong year, the economic recovery stalled in early 2005.** In 2004, growth was faster and more consumption-driven than in other large euro-area countries, though the recovery remained weaker than in the previous cycle (Figures 1 and 2 and Table 1). Private consumption benefited from a rebound in employment growth (in hours), increases in the minimum wage, and some fiscal measures, though the overall fiscal stance was contractionary (Figure 3). A key difference with other euro area countries lay in the willingness of the French consumer to dip into savings, reflecting more dynamic demographics, rising financial wealth, and a confidence-preserving execution of pension and health care reforms. A sound financial sector permitted a rapid expansion of mortgage credit in support of residential construction. Direct effects on consumption were limited though, as refinancing is costly and home equity lending nonexistent (Table 2).[1] Household indebtedness, while rising, remains comparatively low (at about 60 percent of GDP). Against this background, the fall in household consumption in the second quarter of 2005 surprised. It is most likely related to stagnating employment and the turmoil surrounding the rejection of the EU constitution treaty.

Figure 1. GDP and Demand Components
(Percent change)



Source: French authorities.

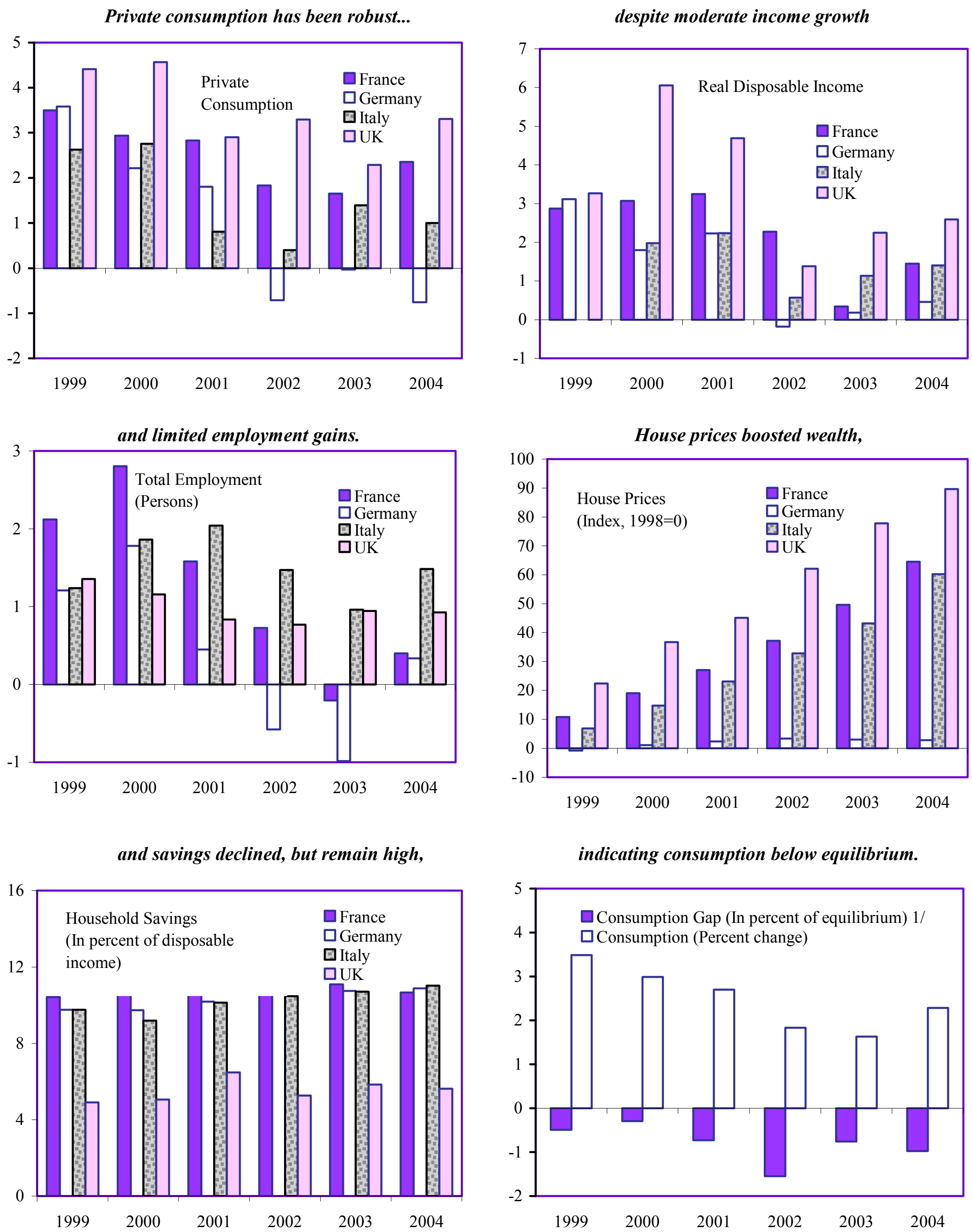
Figure 2. GDP Across Cycles
(Index trough=1)



Source: IMF staff calculations.

[1] The authorities and staff find no econometric evidence of a direct impact of house prices on consumption.

Figure 3. France: Consumption Determinants
(Percent change)



Sources: OECD Economic Outlook; AMECO; Cronos database; national authorities; and IMF staff estimates.

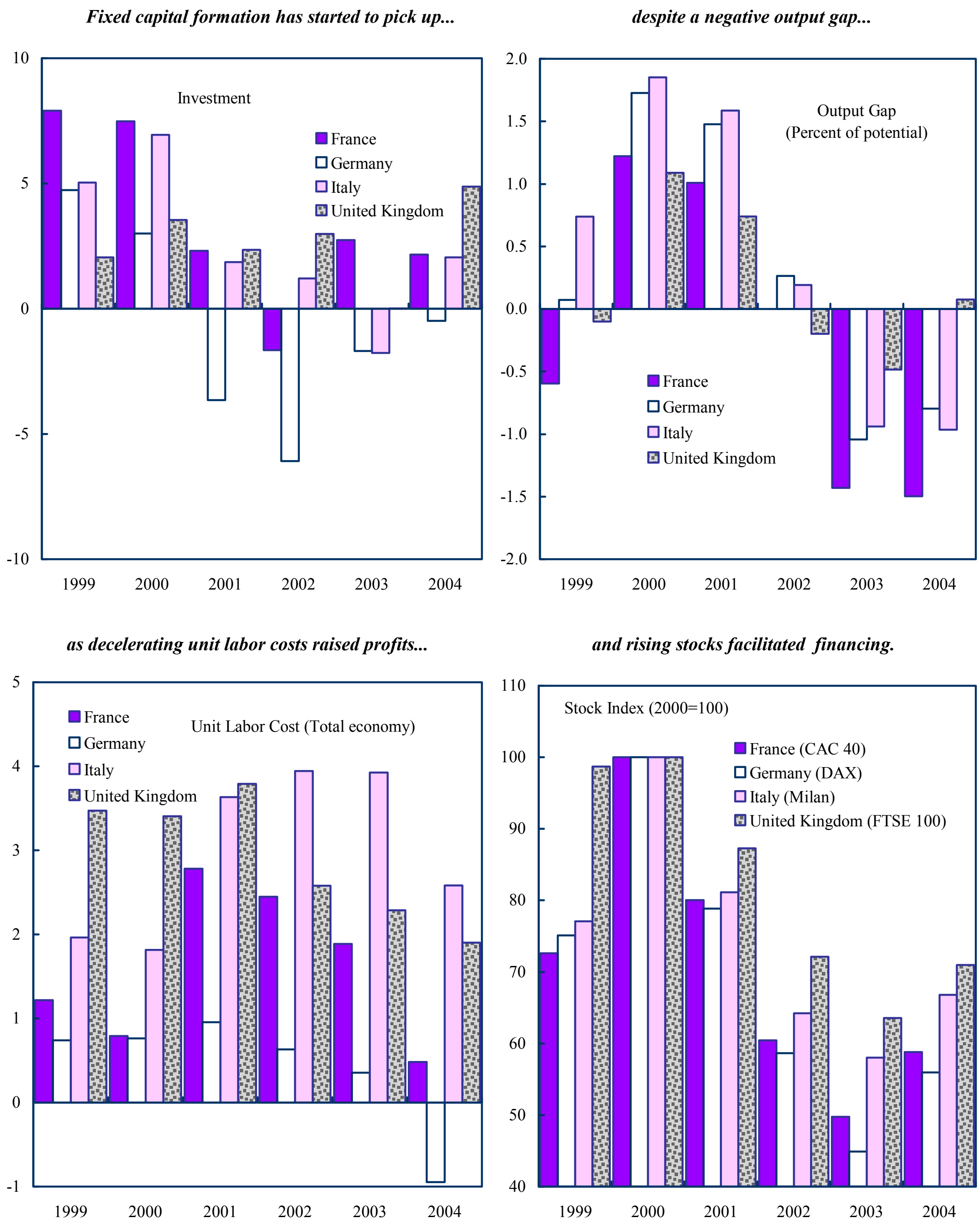
1/ The consumption gap measures the difference between actual consumption and its estimated long-run equilibrium. A negative gap implies that consumption will be higher in the near term.

3. **Fixed capital formation revived during the upturn but stumbled in the second quarter of 2005.** Strong productivity growth, low interest rates, and subdued wage pressures strengthened enterprise margins and increased internally-generated funds. Fixed investment moved up in line with its usual determinants, as elsewhere in the EU (Figure 4), while the suspension of the *taxe professionnelle* (an implicitly high marginal tax rate on the profits of capital-intensive industries) on new investment seems to have contributed only marginally. Stocks have been behaving somewhat erratically, in part owing to the weight of developments in specific industries (e.g., aeronautics) but also because of measurement issues. Their contribution to growth should therefore best be read in conjunction with that of the external sector.

4. **In contrast with previous cycles and some other euro area countries, the external sector exerted a drag on growth, raising questions about competitiveness.** Cyclical differences in private domestic demand between France and its key trading partners (Germany and Italy) explain most of the sudden evaporation of the trade surplus, while fiscal stimulus in 2002–03 and exchange rate appreciation also played a role (Box 2). Reflecting these developments, the current account turned into deficit in 2004 for the first time in more than a decade. Competitiveness does not seem to be an issue at this stage as its recent deterioration is partly cyclical and has so far only slightly dented the trend improvement that took place between the late 1980s and 2000. Still, part of the weakness in trade appears structural and part is unexplained.

5. **The recovery created fewer jobs than usual, and unemployment continued to rise until recently as enterprises favored increasing hours worked per employee** (Figure 5). To some extent, this mirrors the resilience of employment during the downswing, reflecting past trend-wage moderation and uncertainty about the strength of the outlook, factors affecting other countries similarly. However, firms have been reluctant to hire as minimum wage increases continue to outstrip the growth of low-skilled workers' productivity, while proposals to raise the flexibility of hiring and firing took time to materialize. In addition, the reversal of some of the workweek restrictions, while beneficial in the long run, favors increasing hours over adding workers in the short run. Unemployment appears to have crested in May 2005 at slightly more than 10 percent of the labor force, one of the highest levels in the EU but well below historical peaks. Its increase affected disproportionally the young and the low-skilled. It is too early to draw firm conclusions from the moderate fall in the unemployment rate in June–July 2005, as salaried employment stagnated in the second quarter.

Figure 4. France: Determinants of Investment
(Percent change)



Sources: Datastream; OECD; and IMF, WEO.

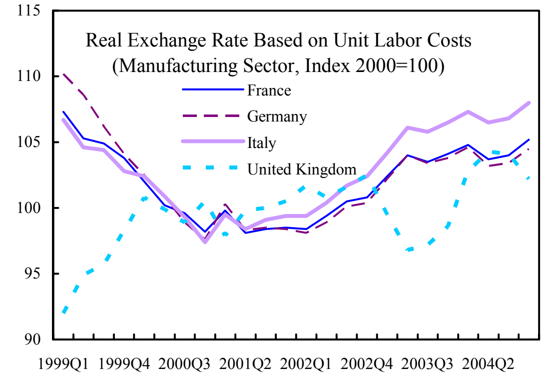
Box 2. France: External Competitiveness

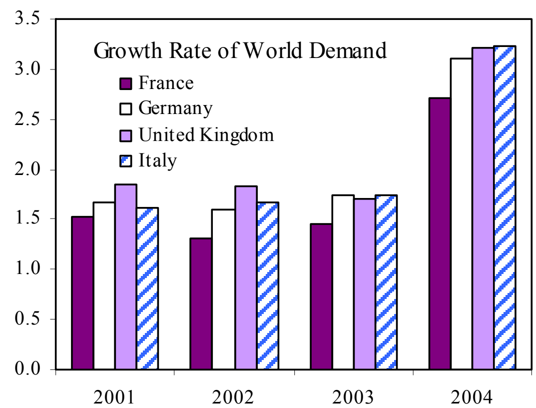
After a decade of significant surpluses, France's trade balance moved into deficit in 2004 as net trade contributed negatively to growth for the third year in a row. Conversely, Germany, for example, posted a record export performance. While much of this divergence can be attributed to differences in domestic and foreign demand, the recent real appreciation of the exchange rate has adversely affected French exports.

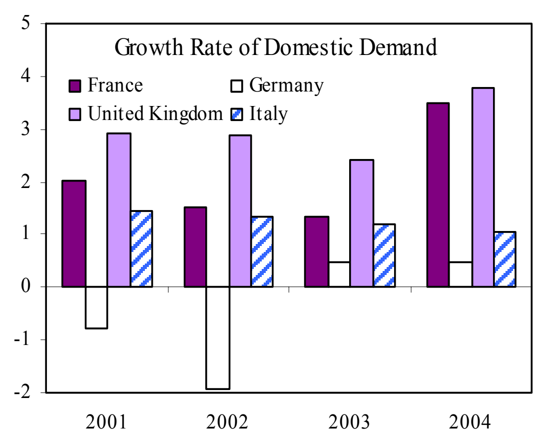
- **The evolution of the euro has contributed to an appreciation of the real effective exchange rate, but not more than elsewhere.** Developments have been in line with those in Germany and less worrisome than for Italy.

- **Weaker export performance is linked to lower foreign demand and geographical orientation.** Since 2001, France has faced consistently lower foreign demand than its large euro area neighbors and the United Kingdom. Furthermore, its elasticity of exports to foreign demand, while near unity, is much smaller than Germany's, partly reflecting Germany's relative specialization in capital goods, which are more cyclical. The geographical orientation of French exports is also structurally less geared toward fast-growing areas, with a share of exports to the United States and Asia (excluding Japan) of 11.6 percent in 2004, compared to 13.7 percent in Italy, 15.9 percent in Germany, and 22.4 percent in the United Kingdom.

- **Strong domestic demand in France in 2004 led to buoyant imports.** Since 2001, France has had the most dynamic domestic demand among the three main euro area countries, exceeding that of Germany by 2½ percent per year on average over 2001–04.



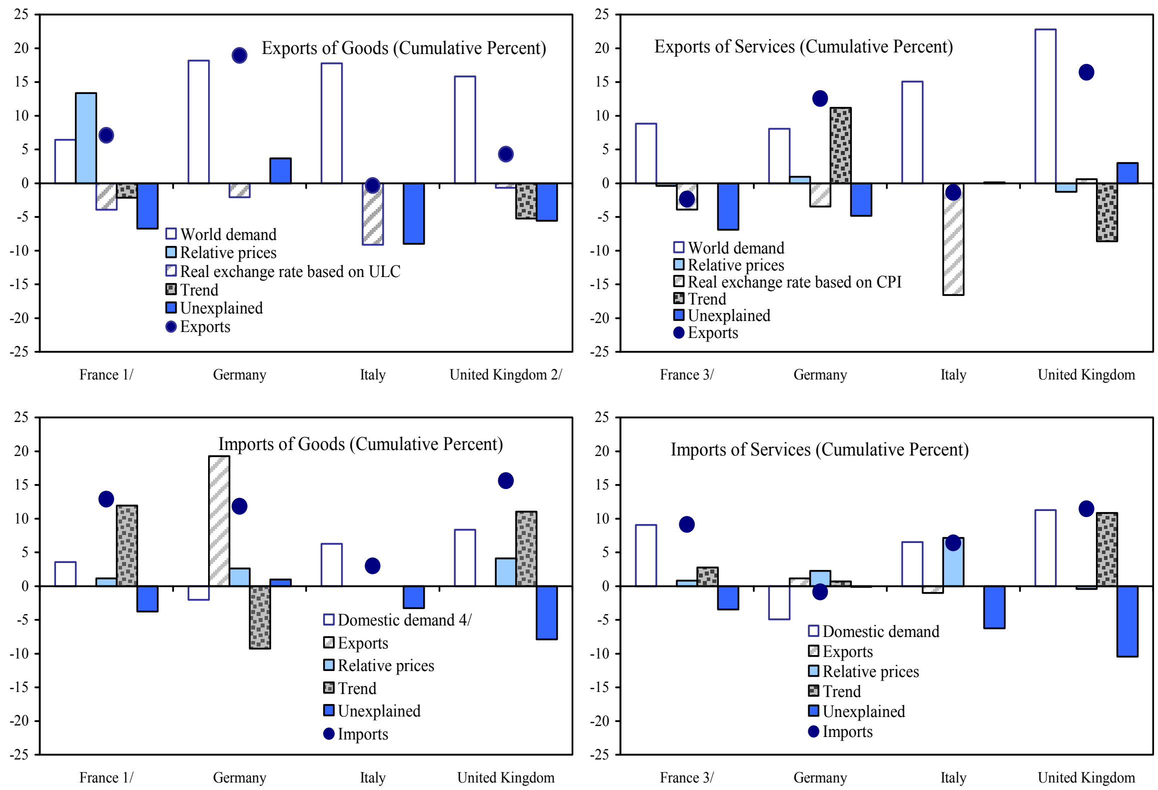




Box 2. France: External Competitiveness (Concluded)

Econometric analysis for four European countries points to a significant impact of the euro's appreciation on exports, and to a lesser extent on imports.[1] During 2001–04, real exchange rate appreciation in France is estimated to have reduced export growth on a cumulative basis by about 4 percentage points. This is more than in Germany, but less than in Italy, where the cumulative impact reaches 9 and 16 percentage points, for goods and services exports, respectively. At the same time, in France, a reduction in export margins mitigated the loss of market share. On the import side, the econometric analysis confirms the dominant role of domestic demand on import growth in France and in the United Kingdom; the importance of exports in explaining German imports; and a small boosting effect from the currency appreciation in all three euro area countries.

Econometric analysis allows to compute by how much, over 2001–04, the growth of their determinants contributed to the growth of ...



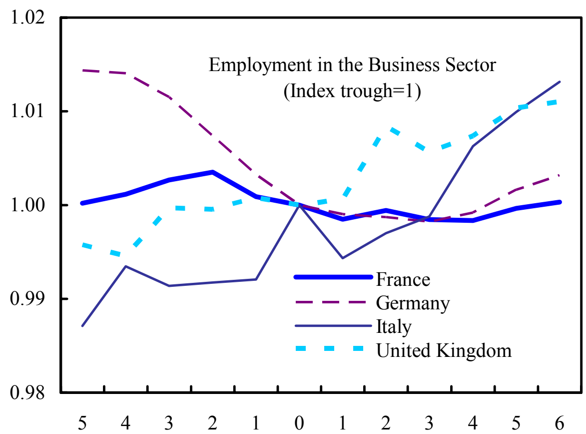
1/ Manufactured goods for France.
2/ Goods excluding oil for the United Kingdom.
3/ Nonmanufactured goods and services, and excluding oil for imports, for France.
4/ Including utilization rate.

The methodology used in this study does not fully explain recent export developments. For France, substantial residual weakness in exports (about 6¾ percentage points over 2001–04) remains unexplained, but it is too early to interpret this as a structural loss in competitiveness. Italy suffers from an even larger negative residual while Germany seems to be enjoying some unexplained gains, at least for goods. The United Kingdom appears to have shifted its export specialization from goods toward services.

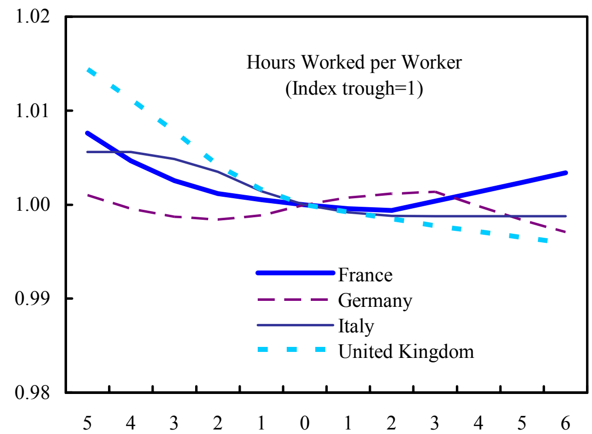
[1] See Selected Issues paper: "Explaining Differences in External Sector Performance Among Large Euro Area Countries."

Figure 5. France: Employment and Wages in Selected Countries

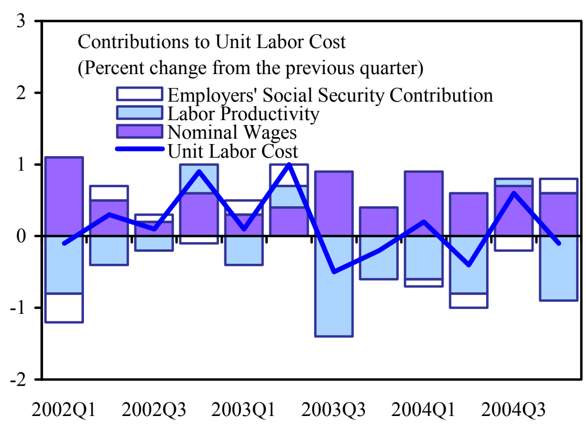
Employment has hardly responded to growth,



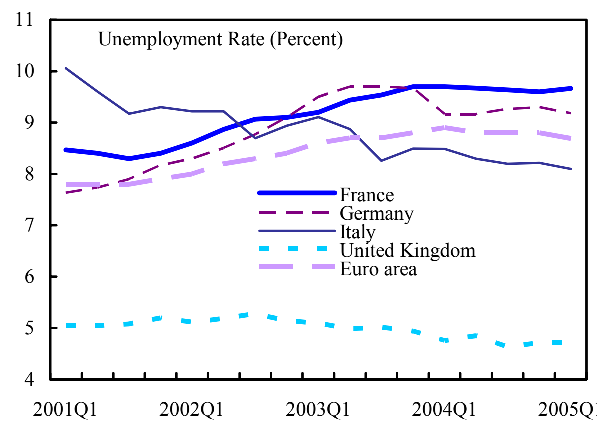
as firms seem to favor increasing hours over workers.



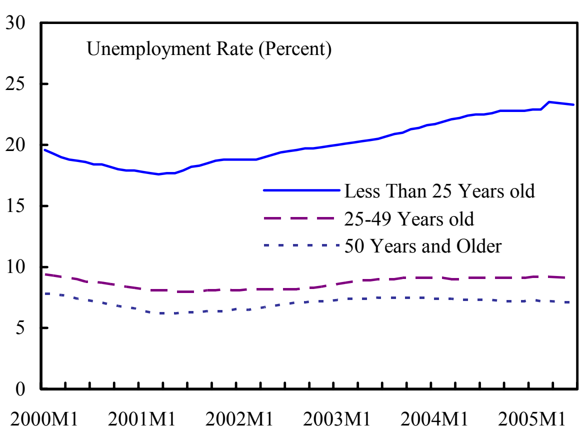
Productivity and tax cuts helped contain costs,



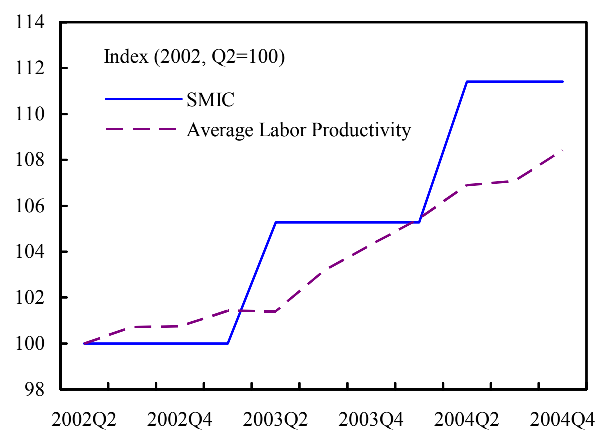
but unemployment has risen,



affecting young adults disproportionally,



while mimimum wages are outpacing productivity.



Sources: OECD; INSEE; WEO; and IMF staff estimates.

6. **Slack in the labor market has not resulted in declining inflation, due to mostly temporary factors.** Core and headline inflation have exceeded the euro area average since 2003, owing to increases in indirect taxation and administered prices, including health care (Figure 6).[2] Energy prices played a key role in pushing up headline inflation but did not trigger second-round effects. Rents edged up, as they are legally tied to the construction price index, in turn pulled by a strong housing market. Services provided by unskilled labor imparted some, albeit marginal cost-push pressures, reflecting higher labor costs in the context of the workweek reduction. Overall unit labor costs appear well behaved, in part because of exceptionally strong productivity gains, which may, however, be hard to sustain (Figure 7).

7. **Policy conditions have been supportive.** In 2004, against a background of buoyant domestic demand, they tightened as the euro appreciated (Figure 8) and the structural fiscal balance improved considerably (by about 0.8 percentage point of GDP). With growth weakening, but still projected to exceed the euro area average in 2005, and the euro having lost some strength, monetary conditions have remained supportive from the perspective of the French economy. In addition, a key administered interest rate declined by 25 basis points on August 1, 2005, in accordance with its automatic adjustment formula.[3] Initial fiscal plans for 2005 were for a modest consolidation (0.2 percentage point of GDP), with the automatic stabilizers being allowed to operate fully on the revenue side.

8. **Potential growth has been subject to opposing forces, which on balance constitute a drag.** The secular decline in labor utilization, mainly due to a fall in hours worked per person, seems to have ended. Capital utilization has risen, reflecting the lower relative price of capital and more shift work. Still, these phenomena have been accompanied by an unexplained trend decline in total factor productivity growth. While aging will reduce the labor force, recently-observed higher-than-expected fertility and lower mortality indicate that the impact on potential growth may be less than anticipated. Consequently, without reforms, annual potential growth is projected to decline moderately from 2.1 percent at present to 1.9 percent in the medium term and 1.8 percent by 2040.

III. Policy Discussions

9. **Discussions focused on the outlook and the pace of fiscal consolidation and of structural reform in the context of the authorities' priority to tackle unemployment.** The authorities saw the lack of confidence expressed in the rejection of the EU constitution treaty as stemming from fears of unemployment and the failure of past reforms to provide job security in an era of global change. Hence, they focused on promoting job creation in the

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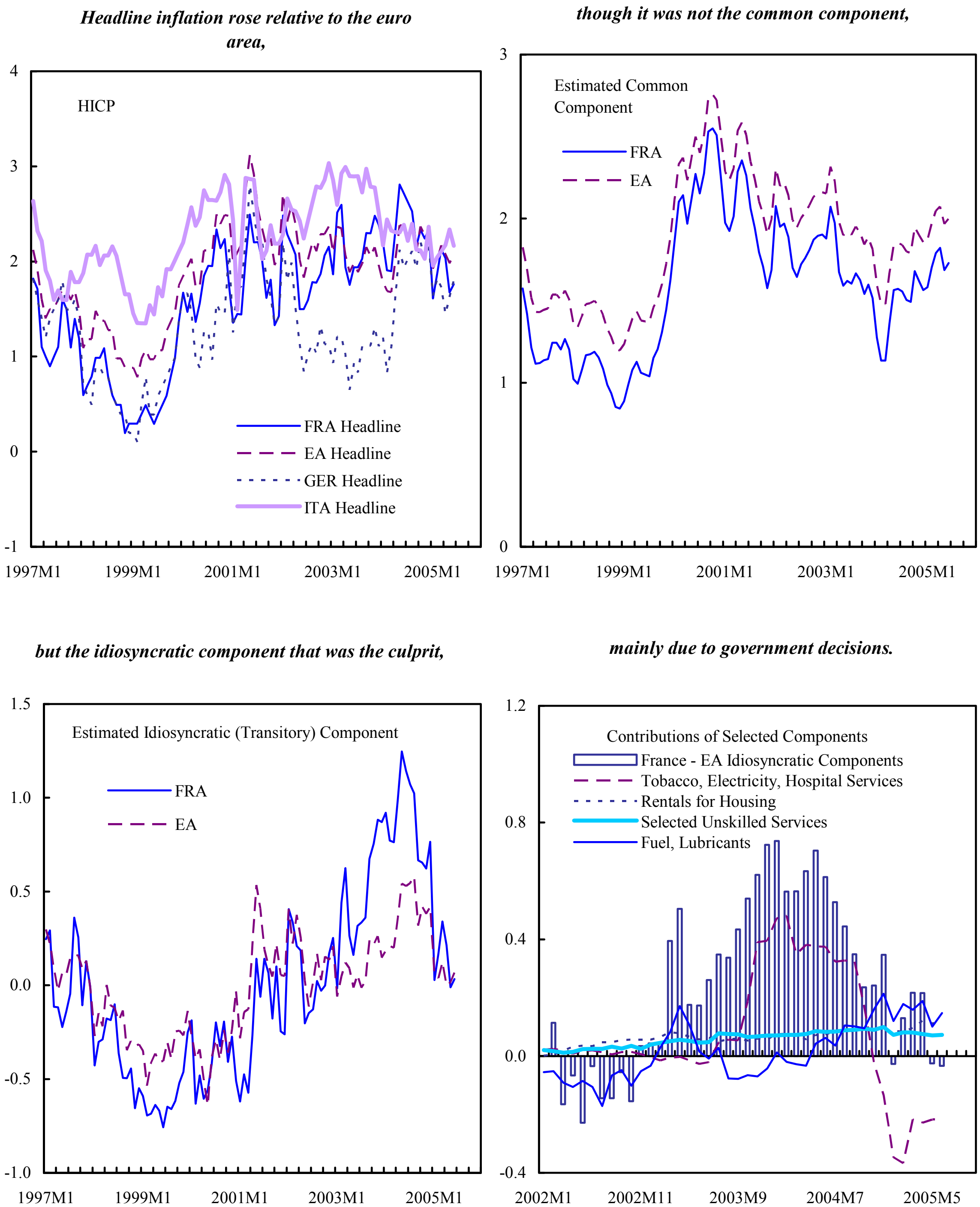
[2] See Selected Issues paper "Recent French Inflation Behavior: Is it any Different from the Euro Area?"

[3] Administered interest rates, covering half of the bank deposits, still lag prevailing market rates as they are adjusted at six-month intervals. Moreover, with inflation as a floor, their downward adjustment is limited.

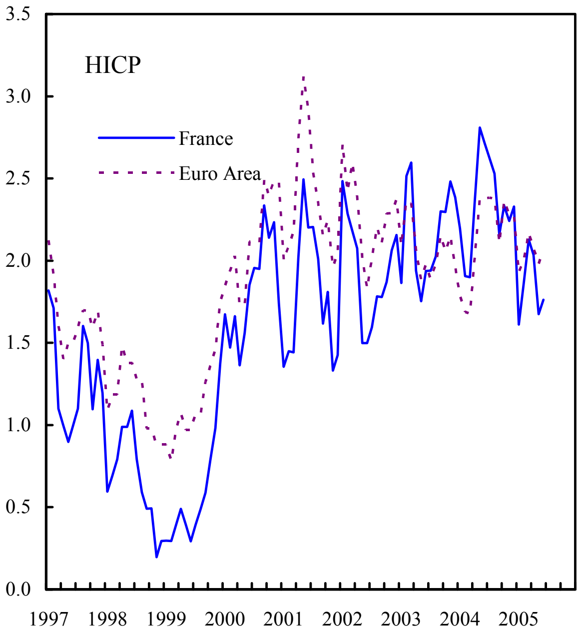
Figure 6. France: Inflation Analysis
(Percent change over same period of previous year)



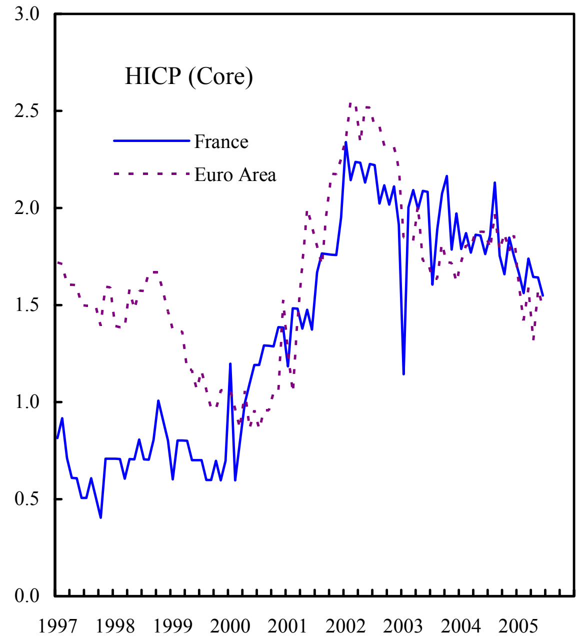
Sources: Cronos database; and IMF staff calculations.

Figure 7. France: Inflation and Unit Labor Costs
(Annual growth rates)

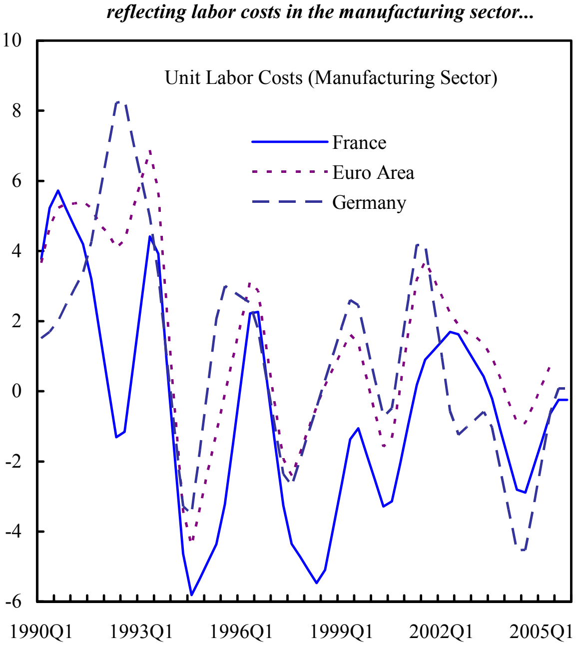
Headline inflation is stable,



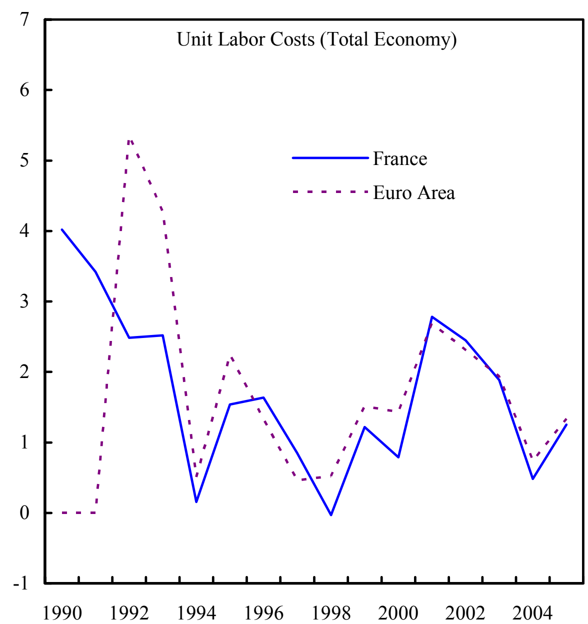
while underlying pressures are easing,



reflecting labor costs in the manufacturing sector...

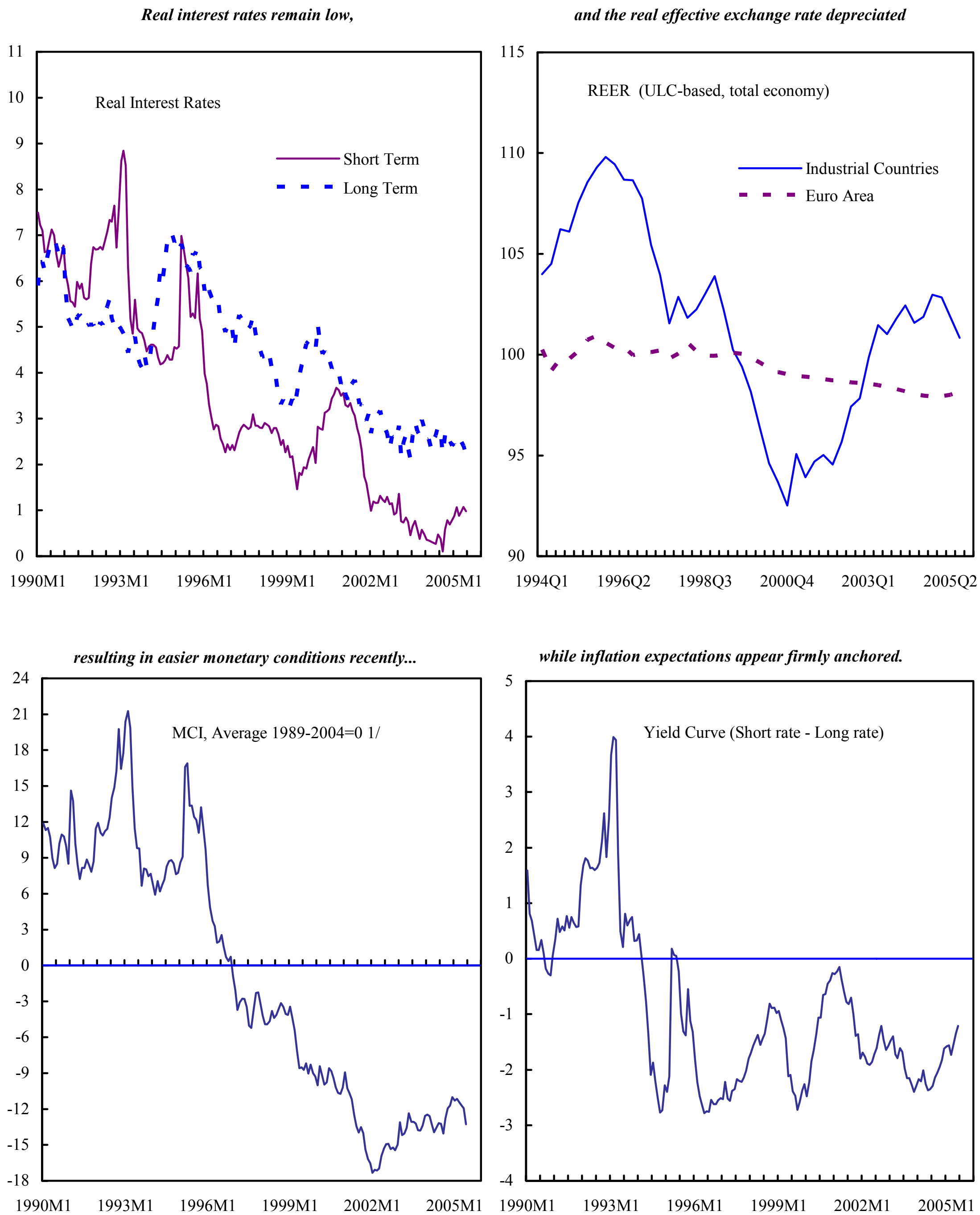


and in the total economy.



Sources: Eurostat; INSEE; OECD, Analytical Database; and IMF, IFS.

Figure 8. France: Monetary Conditions
(Using underlying CPI)



Sources: Datastream-Thomson Financial; Cronos database; and IMF, IFS.

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

runup to the 2007 elections. They agreed with the staff's call for broader reform efforts, lest results remain limited or temporary, but underscored that they would tread carefully to nurture confidence and reform momentum and thus proceed at a slower pace than advocated by the staff. Similarly, the authorities emphasized that their approach to fiscal consolidation would be measured as growth remained fragile. With high deficits and rising public debt, the staff saw a need for somewhat stronger and more sustained fiscal adjustment.

A. Near-Term Economic Outlook

10. **At the time of the mission, it was agreed that the near-term outlook held promise, though data released subsequently point to a weaker second quarter than expected.** Industrial output was rising in May, and forward-looking indicators were pointing to a mild expansion, but first estimates showed GDP growth in the second quarter slowing unexpectedly to 0.1 percent, quarter-on-quarter. Consequently, the staff lowered its growth outlook by ¼ of one percentage point in both 2005 and 2006, to 1.5 percent and 2 percent, respectively, reflecting less robust domestic demand. This projection, which implied quarterly growth rising to somewhat less than potential, seemed plausible as consumer and business confidence appeared to be recovering (Figure 9). For households, the July increase in the *SMIC*,[4] the acceleration of assisted employment programs, and the continuing rise in wealth should allow private consumption to regain composure. For businesses, the signal of continuing structural reform should support investment, a point underscored by the authorities, though the July decline in industrial production does not bode well.

11. **Subsequently, downside risks from oil prices materialized, prompting the staff to reduce growth projections further, especially in 2006.** Oil price assumptions were revised considerably, in particular for 2006.[5] Adverse effects are marginal in 2005, leaving average GDP growth at 1.5 percent, but are projected to constrain growth to 1.8 percent in 2006. These estimates take into account indirect effects from lower growth abroad (including the recent reduction in the U.S. growth outlook) and characteristics of the domestic pass-through of oil prices, including the dampening effect from the specific nature of part of oil taxation.[6]

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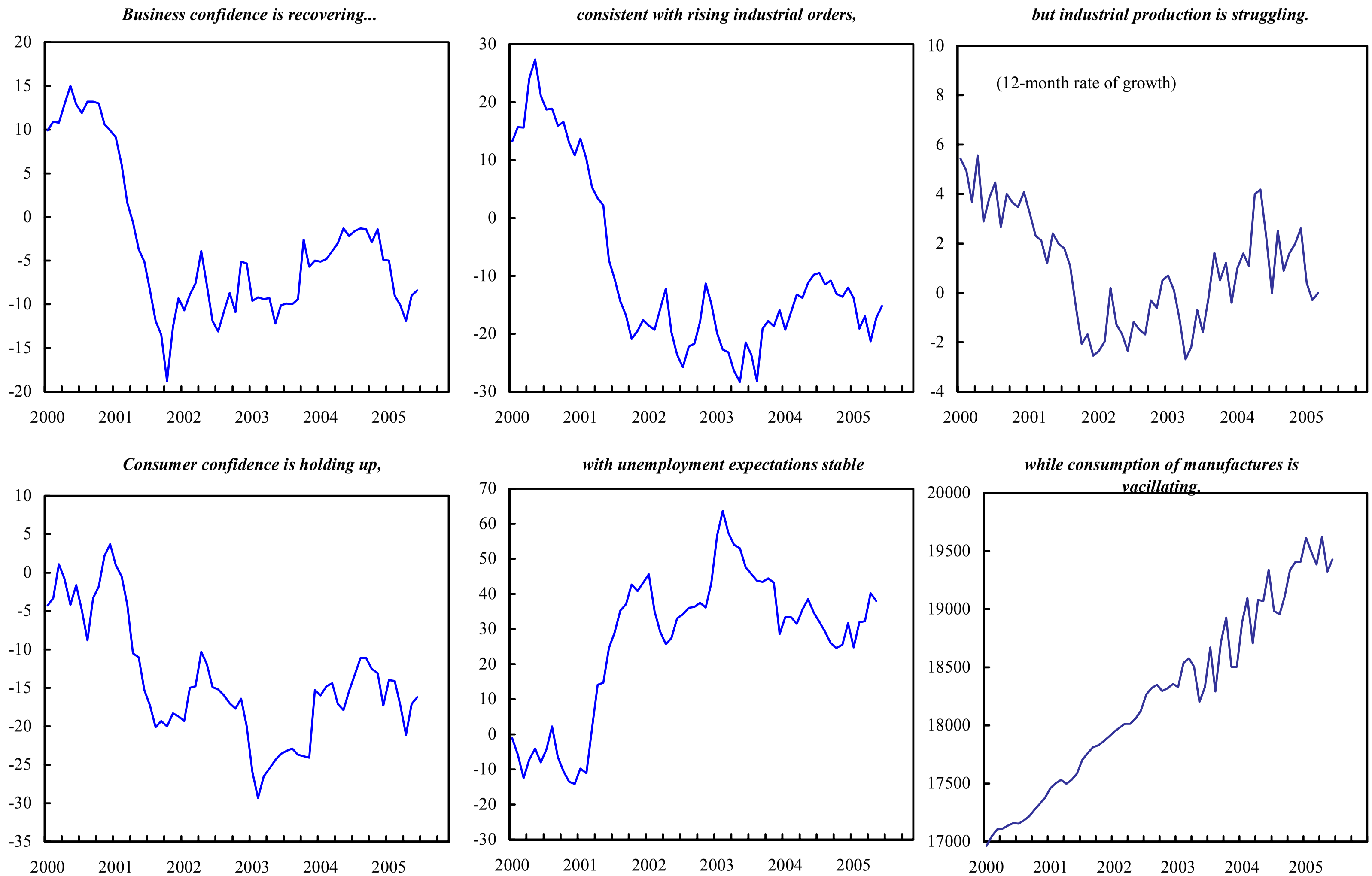
[4] The *SMIC* increased by 3.7 percent in real terms on July 1, 2005. This was the final installment needed to align the hourly minimum wage with multiple minimum monthly income guarantees. The latter arose from the staggered adoption of the 35-hour workweek as monthly income was preserved when the workweek was reduced, thus raising the hourly minimum wage for those who adopted a reduced workweek. Henceforth, there will be only one minimum wage, indexed to a weighted average of inflation and the average wage, possibly topped up by a discretionary amount (*coup de pouce*).

[5] They are now $54.23/bbl and $61.75/bbl in 2005 and 2006, respectively, compared to an actual price of $50.78/bbl in the second quarter of 2005, representing an increase by 7 percent in 2005 and 16.5 percent in 2006.

[6] The staff's estimated output elasticity of oil prices is such that a 20 percent permanent increase in prices reduces GDP growth in the current year by 0.1 percentage point and in the following year by 0.2 percentage point.

Figure 9. France: High Frequency Indicators
(Dispersion index)



Source: WEFA Database.

12. **In the staff's view, risks around this lowered baseline are broadly balanced.** Aside from oil prices, there are other external sources of downside risk. The projection relies on a declining negative contribution of the external sector as demand from trading partners strengthens. Though this assumption remains to be verified, recent data from Germany and Italy are encouraging. The authorities felt that the weakness in export performance reflected mainly the different cyclical positions of demand between France and its key trading partners, as well as some structural factors such as the regional pattern of trade and product specialization and that France's competitiveness position remained sound. However, while the stabilization of the euro at a less appreciated level would help, there was some concern that not all of the weakness in exports could be explained. Hence, the authorities agreed that continuing with structural reforms was also needed to preserve competitiveness going forward in the face of sharply heightening global competition. They shared staff concerns that a disorderly unwinding of global imbalances with euro appreciation would slow growth directly and indirectly, through declines in profits and wealth as France has a net dollar asset position. The financial sector was not a risk as it seemed fully hedged against exchange risks.

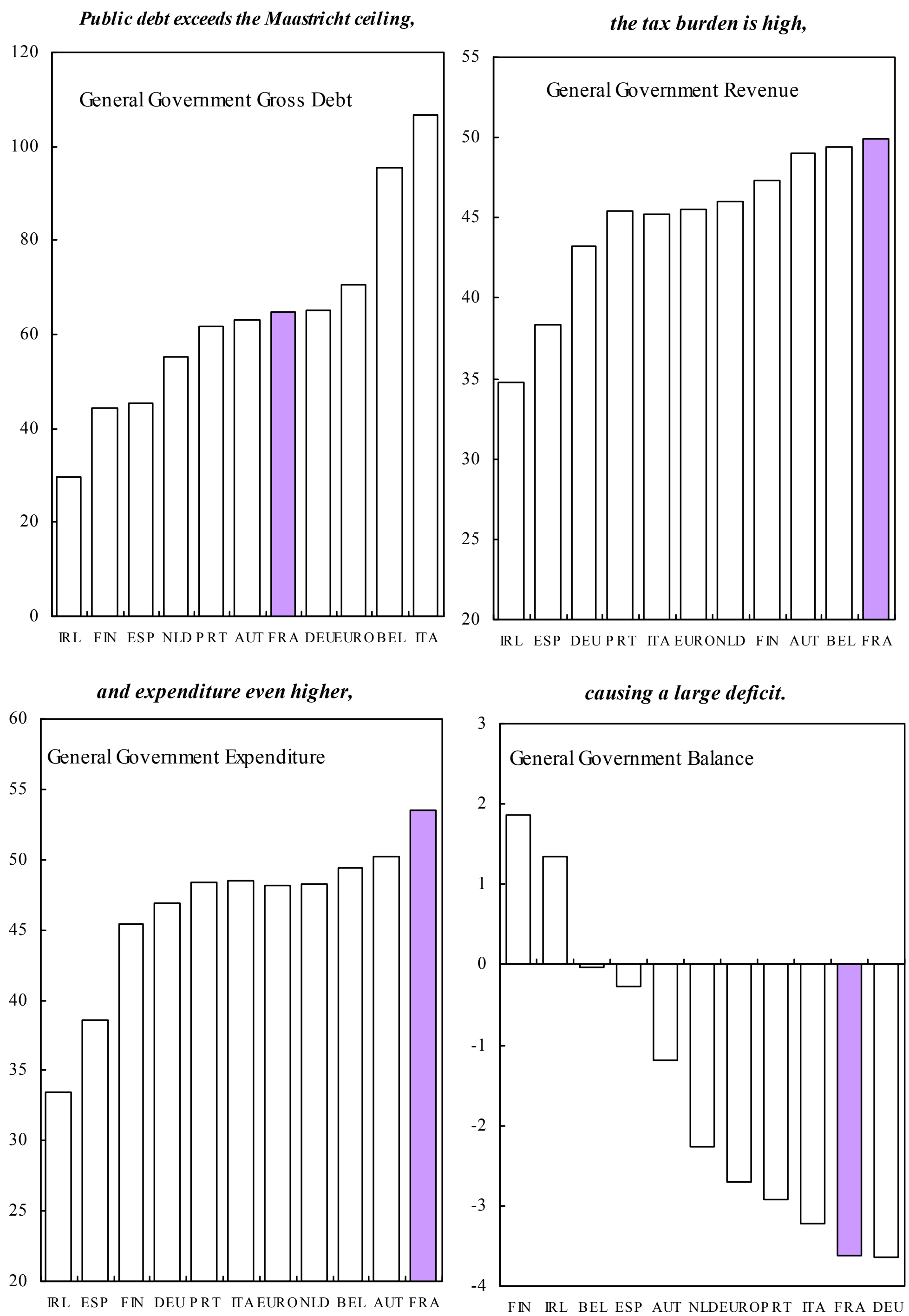
13. **Domestically, risks appeared limited and mostly related to private consumption.** The authorities did not see house prices as a major concern as their wealth effects were small. Recent price increases had been driven by fundamentals rather than by speculative activity, and household indebtedness, while rising, was low by international standards. A decline in house price growth would mainly dampen residential construction activity, which is prudently projected to slow down in the baseline. In addition, with household savings still high (and rising again in the second quarter), private consumption could surprise on the upside, especially if—the authorities emphasized—efforts to boost job creation paid off rapidly.

14. **Headline inflation is expected to average about 2 percent in the 12 months ahead, though core inflation will be considerably lower.** For inflation, further oil price increases and health care reforms constitute upward risks, while the reform of regulations governing distribution margins could increase competition and lower consumer prices appreciably below baseline. The authorities and staff agreed that it would be important to avoid second-round effects from energy and regulated price hikes.

B. Fiscal Consolidation Strategy

15. **Fiscal consolidation progressed significantly in 2004, but the general government deficit remained high, and public debt is rising.** The execution of the 2004 budget was exemplary. By projecting growth realistically, keeping central government spending constant in real terms, and—in a break with past inclinations to spend revenue windfalls—allocating all higher-than-expected revenues to deficit reduction, considerable adjustment was achieved (Table 3). Nonetheless, the deficit, at 3.6 percent of GDP, remained high, and the debt-to-GDP ratio reached a historic peak (Figure 10). The staff estimates the structural balance to have been in a deficit of about 2.6 percent of GDP in 2004.

Figure 10. France: Burden of Government in Selected Euro Area Countries, 2004



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

16. **Fiscal consolidation faltered in 2005, mainly because objectives were unambitious.** Once exceptional one-off operations are excluded,[7] there is no structural adjustment, as modest initial plans (0.2 of one percentage point of GDP) are being scuppered by a lower-than-projected GDP deflator, which, given the nominal spending approved in the budget, contributed to raising expenditure to almost 55 percent of GDP (Text Table 1). In terms of execution, expenditure appears to be broadly on track, especially because health care reform is keeping spending in line with the targeted deceleration, for the first time in several years. The authorities felt uncertain about whether they could still achieve an actual deficit below 3 percent of GDP in 2005, as they did not plan to offset revenue shortfalls due to weaker-than-expected growth. To limit deficit overruns, the authorities had frozen some spending at the central government level, while social partners had renounced the conventional indexation of unemployment benefits. However, the staff projects the actual deficit to reach about 3.5 percent of GDP in 2005. To stem the increase in debt, the authorities were accelerating divestiture, which was expected to yield about 1.5 percentage points of GDP in 2005.

Text Table 1. France: General Government, Current Policies

(In percent of GDP)

				Staff Projection					
	2002	2003	2004	2005 1/	2006	2007	2008	2009	2010
Expenditures	52.8	53.7	53.5	54.9	54.7	54.0	53.3	52.6	52.0
Real growth rate	3.8	2.2	1.6	3.6	1.4	1.3	1.1	1.1	1.1
Revenue	49.6	49.5	49.8	51.4	50.8	50.8	50.8	50.8	50.8
Tax revenue	43.1	43.1	43.4	44.2	44.1	44.1	44.1	44.1	44.1
Balance	-3.2	-4.2	-3.6	-3.5	-3.9	-3.2	-2.5	-1.8	-1.2
State	-3.8	-3.9	-3.2	-3.1	-2.8	-2.2	-1.7	-1.2	-0.8
Social Security	-0.2	-0.6	-1.0	-0.6	-0.6	-0.3	-0.1	0.1	0.3
Primary balance	-0.1	-1.2	-0.6	-0.5	-0.9	-0.1	0.6	1.3	1.9
Structural balance	-3.1	-3.4	-2.6	-2.6	-2.4	-2.2	-1.9	-1.6	-1.2
Gross debt	58.2	62.8	64.7	66.3	68.1	68.1	67.9	67.1	65.7
Memorandum items:									
Staff recommendations (Reform and adjustment)									
Balance	-3.2	-4.2	-3.6	-3.5	-3.6	-2.7	-1.9	-1.1	-0.4
Primary balance	-0.1	-1.2	-0.6	-0.5	-0.3	0.6	1.4	2.0	2.5
Structural balance	-3.1	-3.5	-2.7	-2.6	-2.2	-1.7	-1.3	-0.9	-0.4

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

1/ Preliminary data due to revisions of the national accounts up to 2004.

17. **At the time of the mission, the authorities were aiming for a deficit of less than 3 percent of GDP in 2006.** The authorities agreed that this target would be difficult to achieve—especially if growth disappointed, which seems to be the case—because an

[7] In the process of preparing the electricity utility for public listing, the state took over its pension fund assets and liabilities, boosting revenue by ½ of one percentage point of GDP.

exceptional revenue item (the assets of the electricity utility's pension fund) of almost ½ of one percentage point of GDP had to be replaced with durable spending restraint. Central government spending would be kept constant in real terms for the fourth year running—yielding underlying adjustment of ¼ of one percentage point of GDP—and promised income tax cuts would be postponed. It was agreed that continued success of the health care reform and measures to eliminate the deficit of the unemployment insurance system would be imperative. Over the medium term, these reforms would reduce the deficit by ¾ of one percentage point of GDP. While the details of the 2006 budget are not yet available—but will be discussed in a supplement to this report—the authorities wanted to avoid entering the 2007 elections with a deficit in excess of 3 percent of GDP.

18. **The authorities intended to proceed with fiscal adjustment, though specifics remained to be elaborated.** They observed that the 2003 pension reform had considerably cut contingent liabilities, reducing the estimated budgetary cost of aging by almost two fifths, and that the structural deficit was well below 3 percent of GDP (Text Table 2). They agreed

Text Table 2. France: Deficit, Debt, and Cost of Aging

(In percent of GDP)

	Structural Balance	Debt Stock	Rise in Pension Spending
	2004		2000-50 1/
France	-2.6	64.7	3.7
Germany	-3.2	64.5	5.0
Italy 2/	-2.9	106.6	0.3 2/
Spain	0.6	45.3	1.7

Sources: WEO, IMF; and EPC, EU.

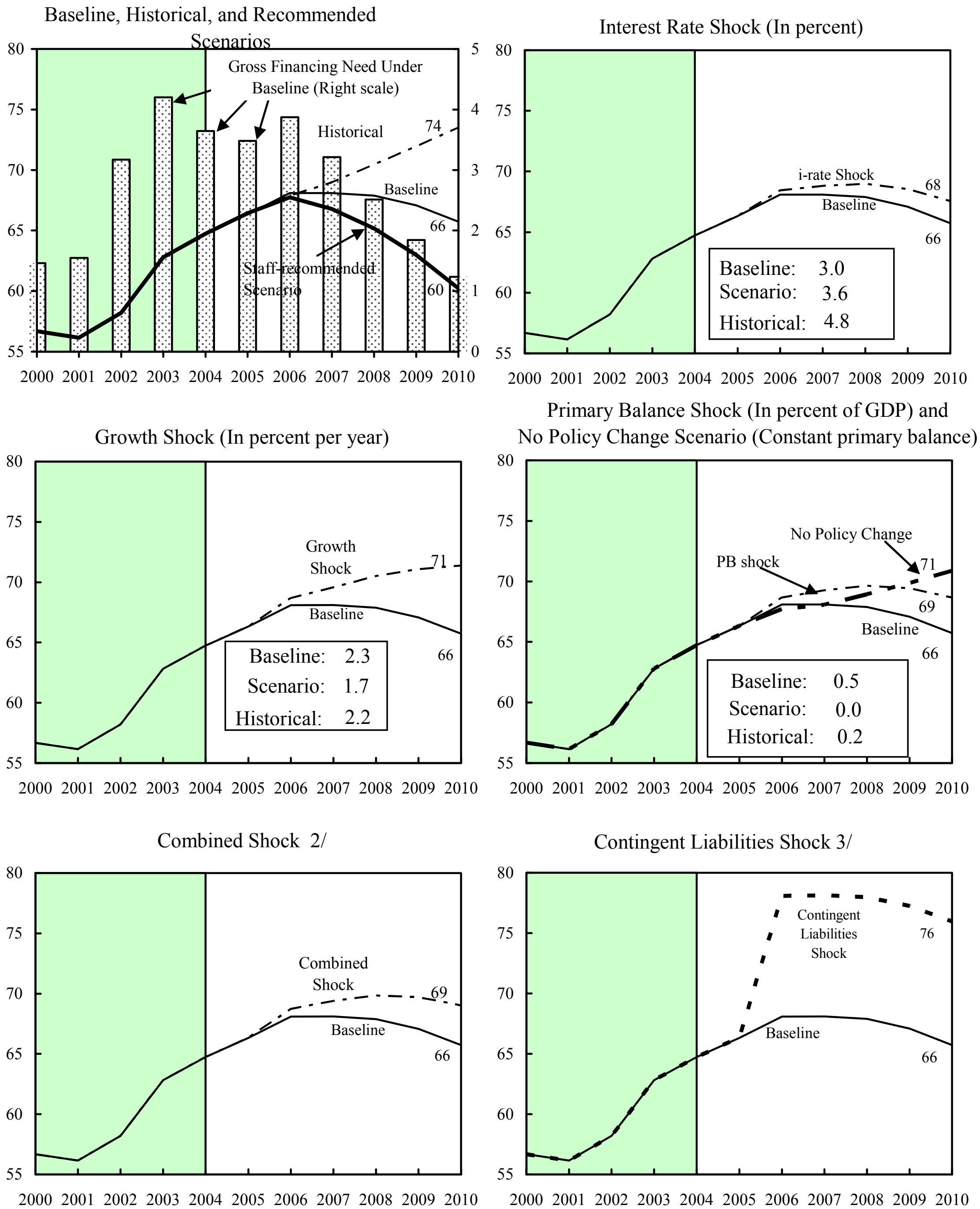
1/ EPC calculations (see http://europa.eu.int/comm/economy_finance/epc/epc_sustainability_age

2/ For Italy, the aging cost increase peaks at 2.1 percent of GDP before 2050.

that, without adjustment, the public debt ratio was vulnerable to significant increases, as brought out by the standard debt sustainability analysis (Table 4 and Figure 11), while in the long run, the remaining costs of aging still threatened fiscal sustainability (Figure 12, current policies[8]). They affirmed their preference to achieve most of the needed fiscal consolidation through growth-enhancing reforms, some of which would simultaneously reduce budgetary

[8] The current policy scenario reflects fiscal policies as described in Text Table 1 through 2010 and assumes that structural reforms implemented to date are sufficient to reduce the NAIRU to 7 percent. Beyond 2010, potential growth declines due to demographics, while the cost of aging rises to the level noted in Text Table 2.

Figure 11. France: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)

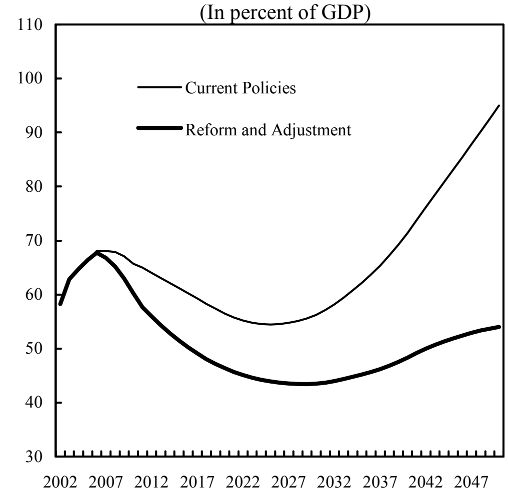


Sources: IMF, country desk data; and IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ Ten percent of GDP shock to contingent liabilities occur in 2006.

outlays (e.g., the increased flexibility of the new labor contract, if it led to higher employment, would reduce transfer spending). The staff supported this approach, pointing out that even with reforms in line with a (delayed) Lisbon agenda, annual fiscal adjustment by nearly 0.5 percentage point of GDP would be needed over the next five years to secure fiscal sustainability (Figure 12, reform and adjustment[9]). This implies about 1 percentage point of GDP more adjustment than envisaged under current policies, which could for example be achieved by replacing only one out of two retiring civil servants during 2006–10.[10] The staff underscored that it would be crucial to no longer rely on budgetary means to promote employment and product market reforms, e.g., divestiture. Otherwise, upfront adjustment would need to be larger. Moreover, efforts at expenditure restraint would need to be broadened beyond the central government.

Figure 12. Public Debt Scenarios
(In percent of GDP)



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

19. **The staff urged the authorities to proceed with durable expenditure reforms.** It was agreed that health care reform had been effective so far, but that the reform would not contribute to overall consolidation as the pace of health spending was unlikely to fall below that of potential GDP. While recognizing that an across-the-board approach to nonreplacement of retiring civil servants was undesirable, the staff called for more efforts to utilize the ongoing wave of retirements to help with medium-term consolidation, but political will appeared to be lacking. The staff emphasized the need to take advantage of synergies between structural reforms and fiscal adjustment and curb local spending to safeguard the credibility of the decentralization process. To improve labor market performance, for example, it would be important to curtail out-of-work benefits and phase out special retirement regimes. In this context, the staff welcomed the authorities' recognition that the avenue of relying on budgetary resources to solve labor market problems had been exhausted, though implementation of past initiatives (such as the social cohesion plan) continued to weigh on the budget.

[9] The reform and adjustment scenario assumes, in addition to the current policies scenario assumptions, the implementation of product and labor market reforms, which raise steady state GDP by about 10 percentage points (consistent with the GEM simulations of Box 4).

[10] Of about 170,000 civil servants retiring during 2004–06, only 16,800 are not being replaced.

20. **Awareness is building of the need to overhaul the tax system, and some important tax distortions are being addressed.** The distortions involved in the *taxe professionnelle* (a tax that falls mainly on capital) are being mitigated by capping the tax as a percentage of value added at the level of the enterprise while broadening its base. The authorities agreed that ultimately this tax (which had been suspended for new investments) should be eliminated, but its large yield prevented them from doing so immediately. More generally, the authorities recognized the need to phase out tax exemptions and tax credits (except for the earned income tax credit) and broaden tax bases. They agreed with the staff that a simplification of the taxation of savings products and a shift in focus of tax incentives to the promotion of retirement savings would benefit the budget and the economy's efficiency.

21. **The authorities noted that their fiscal framework was being strengthened and saw no need for an independent fiscal council.** For the central government, a new organic budget law, in effect with the 2006 budget, had increased the oversight role of parliament, heightened the accountability of spending agents, and enhanced the assessment role of the *Cour des Comptes* (the independent audit office). A similar organic budget law is set to be adopted for social security, while for health care spending, a watchdog is in place with the formal powers to ask parliament to adopt corrective measures. The unemployment insurance system is run by social partners and designed to be in balance in the medium term. The authorities argued that under the (modified) SGP, the independent assessment of the EU was a strong safeguard. The staff responded that more national ownership of budgetary analysis through independent forward-looking assessments by a domestic institution could provide added momentum for fiscal adjustment, in line with the approach followed for pension reform. In addition, it could assist in making local authorities and the various watchdogs internalize the overall consolidation requirement.

C. Structural Reforms

Reform Strategy and Impact

22. **Mindful of the need to preserve social cohesion, the authorities pointed to the success of their gradual approach to structural reforms.** They argued that without building sufficient public awareness of the need and benefits of reform, reforms had often faltered due to public hostility, expressed in strikes or electoral defeats of reform-minded governments. In contrast, when reforms had been well prepared, through well-publicized studies, debate within committees involving all stakeholders, and consensus-building, resistance had been overcome (Box 3). The most striking success had been the 2003 pension reform, while the recent health care reform had followed a similar mold. Consequently, the authorities decided to adopt the same approach for labor market reform through the recently established Advisory Council for Employment. To begin this process for product market issues, they were emphasizing the need to focus on consumer welfare and had initiated studies on the switching costs for consumers in utilities, financial services, and telecommunications.

Box 3. France: Studies, Committees, and Consensus:
France's Approach to Structural Reforms

Since the end of the 1990s, **the French authorities have developed an approach to reform that emphasizes consensus-reaching, based on technical studies and committees**, before any legislative action is taken. This method has been utilized in areas where strong public resistance had previously prevented the authorities from changing the status quo, such as pensions (2003) and health care (2004), and is ongoing in the area of labor policies.

Preliminary studies were conducted by academics, and committees were created at the beginning of the reform process. Each time these committees bring together all involved actors—members of parliament, social partners, experts, and representatives of the state. Following initial diagnosis by established academics in their fields, these bodies are mandated to reach consensus on a technical assessment of current situations and problems, and make recommendations for policy reform.

Based on extensive consultation and cross-disciplinary expertise, these forums have proved valuable in reaching consensus. They laid the foundations for the actual negotiations between social partners and the government that took place later. Wide-spread dissemination of the academic reports and the councils' work has also been key in generating a somewhat less politicized debate and public support for the reforms:

- An initial report (*Rapport Charpin*, in 1999) followed by one from the Pension Advisory Council, established in 2000, spelled out a detailed financial assessment of the **public pension funds** that made the need for reform obvious to all its members. Based on these works, consultations were held over 2002–03 and led to a major reform of the pension system in August 2003.

- The first report of the High Council for the Future of Health Care Insurance, created in 2003, illustrated how unsustainable current **health care spending** had become. It served as background analysis for the negotiations held in the first half of 2004, leading to the passage of a comprehensive set of measures in August 2004.

- Well-publicized studies commissioned by the government from Blanchard and Tirole in 2003 put forward new ideas to reshape the employment protection system. An **Advisory Council for Employment** is scheduled to be set up in September 2005 to help reach consensus on these or other reform proposals to improve the functioning of the labor market.

23. **The staff acknowledged that this consensus-building approach had delivered results, while pointing to the benefits of a well-focused and coordinated package of product and labor market reforms.** Staff simulations with the Fund's new Global Economic Model (GEM) suggest that structural reform in France alone could raise French GDP in the long run by more than 10 percentage points (Box 4). Simultaneous

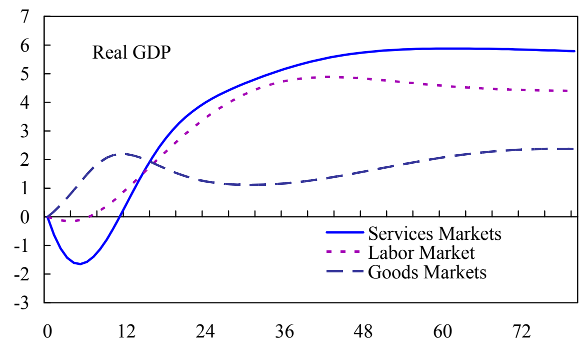
Box 4. France: Macroeconomic Impact of Raising Product and Labor Market Competition

Increasing competition in French product and labor markets has potentially very large macro-economic payoffs. The Fund's GEM was used to measure the impact of raising competition in France to the average level in Denmark, Sweden, and the United Kingdom—the group of countries in the EU with the most competitive markets (see Selected Issues Paper, "Estimating the Macroeconomic Effects of Higher Competition in Product and Labor Markets" for details). In the GEM, markups are summary measures of competition, reflecting the impact on wages and prices of barriers to market entry, such as regulations, state involvement in markets, and legal protection of incumbents. The experiment involved a reduction in French markups to the level of the above-mentioned group of countries.

Stand-alone reforms in France across all markets raise real GDP by more than 10 percent in the long run. The contribution of higher competition in services is the largest (5.8 percent), followed by labor markets (3.7 percent) and goods markets (1.2 percent). The differences across markets are mainly due to the size of the decline in markups. As a result of the EU's internal market, the distance between France and the group of best-performing countries is smallest in goods markets. Where progress in deregulation has been slower—services and labor markets—markups in France are much higher than in the comparator group.

Labor market reforms are effective in creating jobs, even if implemented in isolation. However, for the full benefits to workers to accrue, it is better to combine them with measures opening goods and services markets to greater competition. Otherwise, lower labor costs are not completely passed on to consumer prices, and real wages remain permanently below baseline (Figure 1).

Figure 1: Stand-Alone Reform in France
(Deviation from baseline in percent)



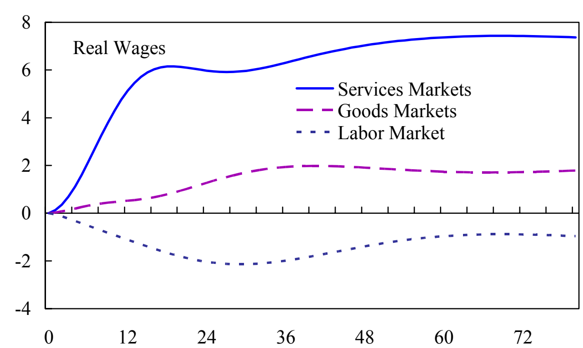


Table: Stand-Alone Reform in France

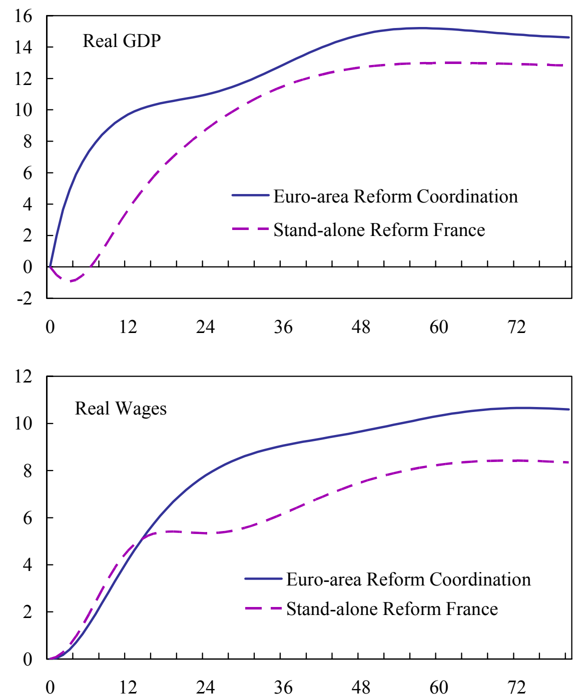
(Deviations from baseline in percent)

	Real GDP	Consumption	Hours Worked
Labor market	3.7	3.6	4.7
Services	5.8	3.8	5.0
Goods	1.2	0.8	1.5
All Markets	10.7	8.1	11.3

Box 4. France: Macroeconomic Impact of Raising Product and Labor Market Competition (Concluded)

Coordination of structural reforms within the euro area has important advantages for France. In the long run, real GDP in France increases by an additional 3 percentage points, due to spillovers from higher output in the other euro area member states. In addition, French consumers profit from lower import prices. In the short run, euro area-wide inflationary pressures are significantly reduced, which could allow monetary policy accommodation by the ECB. Production capacities increase with the entry of new firms and higher labor supply; however, due to nominal and real rigidities, demand is slow to adjust, resulting in a negative output gap. If as a result prices decline, monetary authorities would react to allow area-wide interest rates to decline temporarily, which brings forward investment and consumption responses (Figure 2).

Figure 2: Stand-Alone versus Coordinated Reform
(Deviation from baseline in percent)

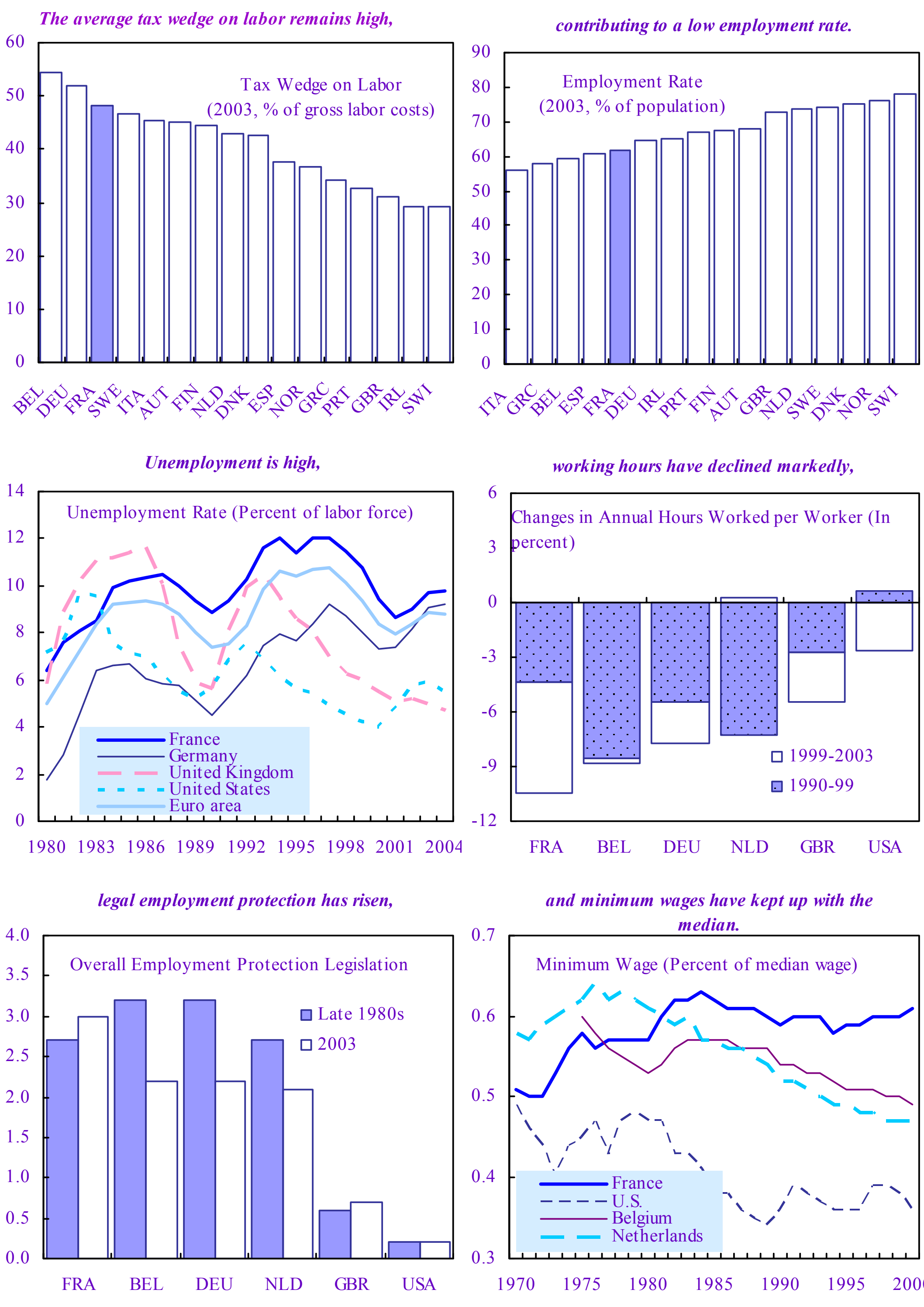


implementation of product market deregulation and labor market reforms has significant benefits, particularly in terms of political economy. Product market reforms would allow consumers to benefit from lower prices and higher purchasing power, thus easing the transition cost of labor market reforms which would necessarily involve a period of wage moderation as increased labor supply is put to work. Similarly, reform within the entire euro area would allow larger cumulative effects due to spillovers, while coordination of its timing could permit an easing of monetary policy which would virtually eliminate transition costs. The authorities agreed with the thrust of this analysis, while noting that coordination might be hard to achieve politically.

Labor Markets

24. **Despite improvements in labor market functioning during the 1990s, overall utilization of labor potential remains among the lowest of OECD countries.** Legal employment protection is strong, the labor tax wedge is high, and wage flexibility is limited for the low-paid (Figure 13). The staff noted that existing rigidities, while temporarily shielding those with permanent jobs, reduce the capacity of the economy to adapt to changes in technology and preferences. Consequently, structural unemployment is high, labor force participation of the young is low, older workers exit early from the labor market, and annual

Figure 13. France: Labor Market Performance and Institutions in Selected Countries



Sources: OECD; and IMF staff calculations.

hours worked per worker are comparatively low. The staff observed that policies dealing with these challenges had thus far focused on fiscally expensive active labor market programs, leaving institutional obstacles to labor market flexibility untackled.

25. **Against this background, the authorities saw their new plan to promote job creation as a breakthrough because it directly addressed some key labor market rigidities** (Box 5). The plan builds on existing reforms, such as the easing of the 35-hour workweek restrictions, the social cohesion plan to bring long-term unemployed back to the labor market, the promotion of personal services, and the adoption of an enabling framework for life-long learning. The proposed new labor contract with a term of up to two years (*CNE*) is an innovation as it has no firing restrictions and does not rely on budgetary support to facilitate job creation. It had been focused on small enterprises because of their large number and dynamism and their difficulties to benefit from measures facilitating the workweek reduction. The authorities estimated that this initiative and its associated administrative and fiscal simplifications could reduce the unemployment rate by 0.1 to 0.5 percentage point.

26. **There was agreement that additional, supporting reforms would be essential to boost job creation meaningfully in the long term.** The authorities did not dispute the staff's concern that the new labor contract might not have significant long-term effects, but underscored that it should be seen as opening the door to more reforms. In essence, the *CNE* increases the flexibility of fixed-term contracts without addressing the rigidities involved in open-ended contracts. As shown theoretically and by experience elsewhere, such partial reform may lead to more job turnover and less investment in human capital, ultimately raising rather than lowering unemployment. As suggested in studies initiated by the authorities (e.g., Kramarz-Cahuc), it would therefore be necessary to integrate all existing labor contracts into a single one, with internalization of the social costs of layoffs and as little legal uncertainty as possible.

27. **The staff welcomed the authorities' determination to strengthen employment services and job search incentives and called for a modification of the minimum wage adjustment mechanism.** The staff urged the adoption of complementary measures such as the capping and phasing of unemployment benefits and the introduction of sanctions for noncompliance with job search requirements, which were partially enacted shortly after the mission. The staff further argued that future increases in the minimum wage should be limited to changes in underlying consumer price inflation to increase the employability of low-skilled workers and wage dispersion at the low end of the pay scale. The staff saw a need for decreases in benefits in some cases to make the return to work pay and for the removal of incentives inducing premature exit from the workforce. In this context, the staff welcomed the intended elimination of the dismissal tax on older workers (*contribution Delalande*). The authorities responded that the forthcoming renegotiation of the convention governing the insurance system (*UNEDIC*) would provide an opportunity to consider the staff's proposals, but that it was primarily up to social partners to implement changes in this area.

Box 5. France: Are New Labor Market Initiatives a Breakthrough?[1]

1. **In mid-2005, the government adopted an emergency plan for employment (*le plan d'urgence pour l'emploi*) and set the reduction of unemployment as the top economic policy priority.** Specifically, the plan includes: (i) introducing a new employment contract (*CNE*) for small enterprises with up to 20 employees, with no hiring and firing restrictions during the first two years; (ii) simplifying administrative procedures and extending certain tax exemptions to more enterprises by raising the eligibility threshold from 10 to 20 employees; (iii) providing an income tax credit to promote youth employment in specific sectors and more support to facilitate job search; and (iv) fiscal incentives and administrative deregulation to improve employment in the personal service sector.

2. **Past policy actions to tackle unemployment focused on active labor market programs, while leaving labor market institutions largely unchanged.** Remedial actions relied on employment subsidies, earned income tax credits, and cuts in social security contributions—all at considerable cost to the budget. Attempts were made to reduce unemployment also through work redistribution effort such as the reduction in the work week. The results have been modest, as the French unemployment rate remains higher than the euro area average.

3. **The new plan, while still relying partly on budget resources, takes an important step toward reforming labor market institutions, but whether it will deliver the desired result is uncertain.** While it will facilitate hiring, the *CNE* represents only a partial reform of the employment protection legislation (EPL). It introduces the needed flexibility for only up to two years and is limited to small enterprises. Academic studies find this type of partial reform an ineffective way to reduce unemployment, with negative implications for workers' welfare and productivity, the main effect being a high turnover in fixed-duration workers with insufficient investment in human capital, leading in turn to higher, not lower, unemployment.[2] Experiences from other countries, including Germany, Spain, and Sweden support this finding. For instance, after a partial reform of employment protection legislation (EPL) in the late 1980s, the Spanish unemployment rate initially fell, but began to rise rapidly in the early 1990s. Unemployment began to fall significantly only after the Spanish government reformed the EPL for permanent contracts in the mid-1990s.

4. **The effectiveness of the new labor contract in promoting job creation and reducing the unemployment rate will depend crucially on broadening its application and adopting supporting reforms.** Simulations of a search-matching model, with hiring and firing restrictions calibrated to the French labor market, suggest that a reform, which effectively merges existing contracts into a single one by eliminating firing restrictions and legal uncertainty (e.g., as in the proposal by Kramarz and Cahuc), would lower the structural unemployment rate by 2 percentage points. This effect could be even larger (about 3 percentage points) when firing costs are completely eliminated. The magnitude of these estimates should be interpreted with caution, however, as high and binding minimum wages prevent the internalization of high hiring costs, while inefficient employment services slow down the match of vacancies and unemployed workers. In this regard, further reforms in these areas are needed to yield results of this magnitude.

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[1] Based on the Selected Issues paper "Employment Protection and Unemployment in France."

[2] Blanchard, O., and A. Landier, "The Perverse Effects of Partial Labor Market Reform: Fixed Duration Contracts in France," NBER Working Paper No. 8219, 2001.

Product Markets

28. **Privatization is being accelerated, while other important product market reforms are set to continue.** The authorities observed that the gas utility shares had been

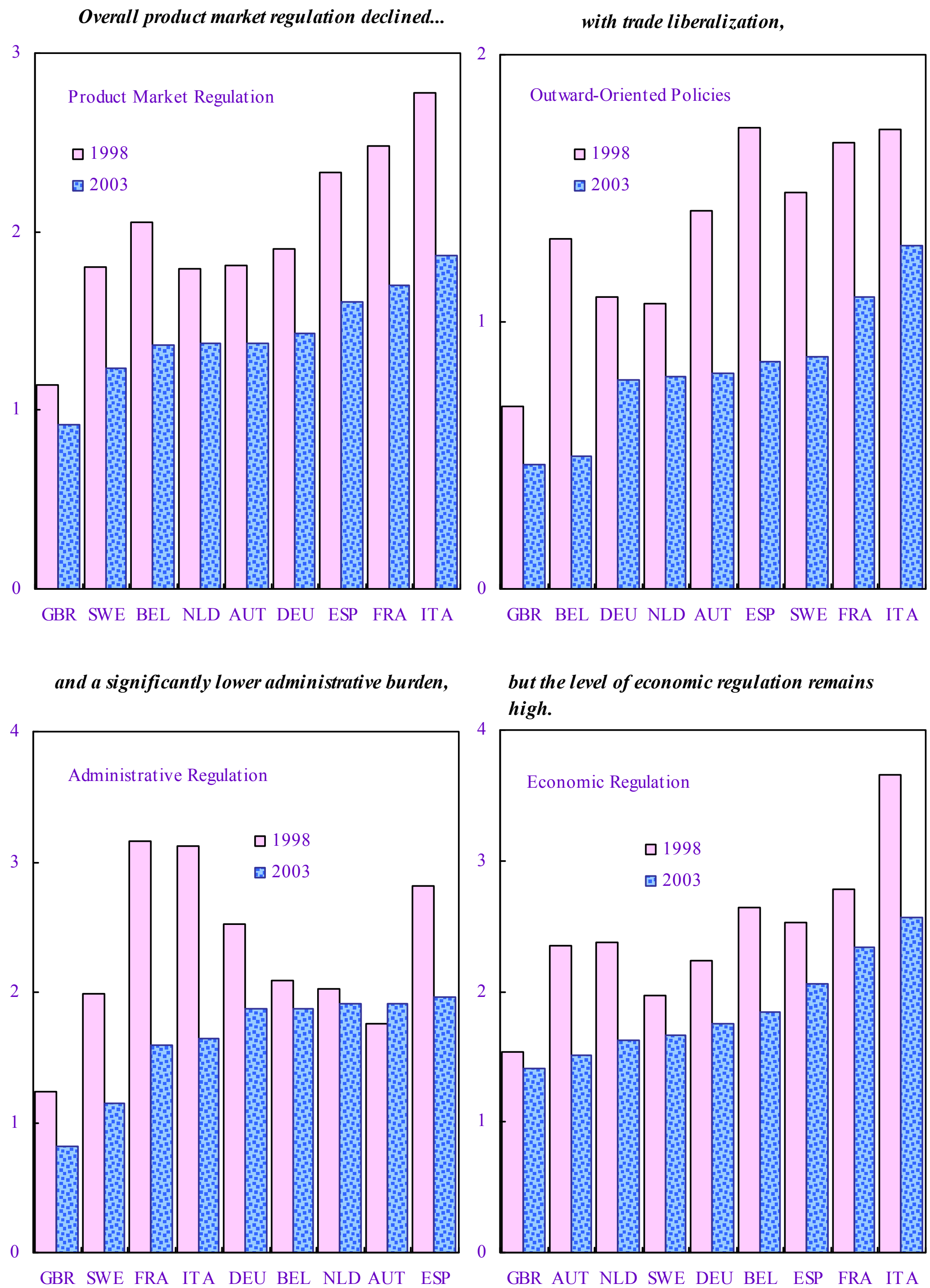
successfully floated on the stock market, soon to be followed by the electricity utility and further divestiture of highways. Legislation restricting large retailers' ability to lower distribution margins imposed by suppliers (*loi Galland*) is set to be modified, which is expected to lead to a significant reduction in consumer prices. The authorities agreed that while good progress had been made in reducing administrative regulation, more deregulation was needed, particularly in the service sector (Figure 14). In this context, they favored services sector liberalization in the EU, though they saw difficulties in accepting the "origin" principle of the Bolkenstein directive as it would erode France's social model.

D. Financial Sector

29. **Following up on last year's FSAP, the authorities noted that they were raising the efficiency of the financial sector but were not prepared to swiftly phase out remaining administrative interventions.** A bankruptcy law has been enacted, which enables Chapter 11 type procedures and improves creditors rights; the prohibition to remunerate sight deposits has been lifted, which prompted one bank to introduce such remuneration; and administered interest rates are operated mostly by automatic formulas. The planned creation of the postal bank—by separating mail activities—is expected to establish a level-playing field with private institutions. It would increase competition, in particular for mortgage loans, though since this is not a profitable business for banks (¶31), it is unlikely to affect other banks' profitability. In addition, mortgage markets are set to be reformed with the introduction of home equity loans and the reduction of legal and regulatory transaction costs. The latter will increase mortgage market activity, though only progressively, as changes will became effective only in the course of 2006, and households remain reluctant to engage in mortgages. While agreeing with last year's FSAP's observation that publicly-administered savings schemes had lost their relevance and hampered monetary transmission somewhat, the authorities felt that they could not easily unwind them because they enjoyed continued public support.

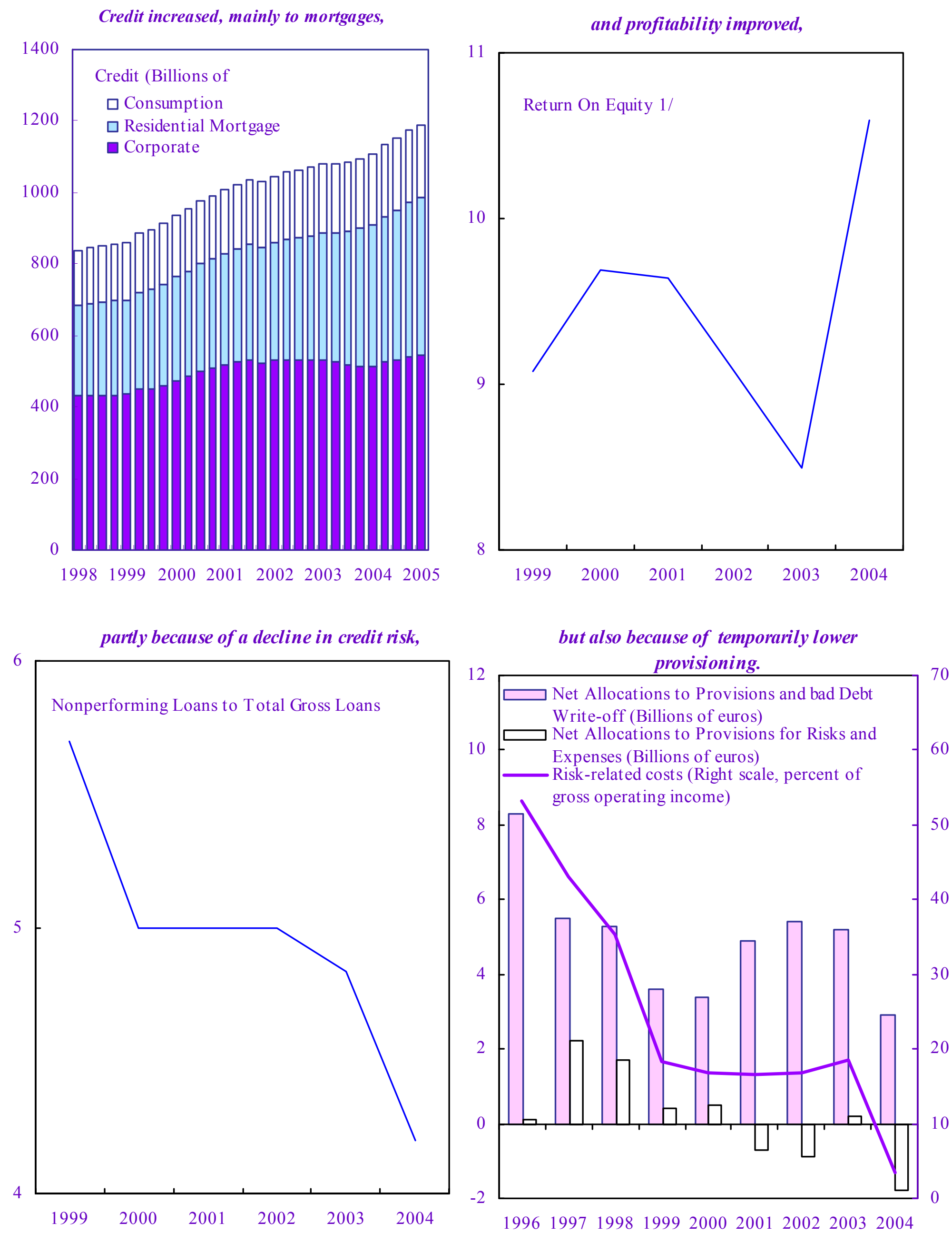
30. **The financial sector performed well over the past year, though part of the increase in profitability stemmed from a transitory reduction in provisioning as risk declined** (Figure 15 and Tables 5–7). Underpinning these good results, the authorities listed excellent performances in retail banking, a drop in nonperforming loans, which allowed lower provisioning, and successful diversification. They noted that owing to good preparation, financial institutions and markets had adapted well to new accounting standards, though they and sector representatives underscored that the full extent of the changes would only be visible in a couple of years. While the supervisory body considered that recent losses in derivatives incurred by some institutions did not raise systemic concerns, it urged all banks, including mutual groups, to continue to upgrade their internal control system. With respect to financial markets, the authorities were vigilant about hedge funds operating from less regulated jurisdictions because of their attendant lack of transparency, and about the difficulty of monitoring of risk, which has moved out of the financial sector but may retain significant macroeconomic consequences through their impact on household savings and wealth.

Figure 14. France: Product Market Reform Indicators
(Ordinal index)



Source: OECD.

Figure 15. France: Financial Sector Indicators



Sources: Haver Analytics; Thompson Financial; and Yahoo.com

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

31. **In the context of a buoyant housing market, banks' exposure to mortgage risk would need to be closely watched.** The authorities did not see evidence of a real estate bubble as prices were still not at their previous peak in real terms, and household affordability ratios remained reasonable. If very recent decelerating trends were to persist, they thought that price increases might settle down to a moderate pace. In addition, mortgage loans had so far been banks' least risky activity. However, with the very rapid pace of mortgage loans over the last few years, the authorities' focus was on financial institutions' balance sheets, which now included a large amount of new long-term assets with low profitability. Indeed, mortgage interest rates are very low, as mortgages are used as loss leaders to attract customers. A sharp increase in such rates would reduce financial sector activity, but more importantly, would negatively impact households as a larger proportion of mortgages is now at variable rates. However, the impact would be limited as the bulk of mortgages is at fixed rates or subject to interest rate caps, and supervisory authorities considered that banks still had sufficient buffers against this risk.

E. Other Issues

32. The authorities expressed their commitment to securing a successful completion of the **Doha round** of multilateral trade talks, though they noted that progress had been slow. They supported EU initiatives with respect to **textile imports** from China, as they were in line with quota agreements previously made. The adjustment of the French economy to the removal of textile quotas was on track, with employment in the sector having declined by more than half over the past 10–15 years. The authorities observed that the **CAP reforms** agreed in 2003 as part of the mid-term review would be implemented in 2007 as envisaged. Acceleration of its implementation, as recommended by the staff, would be tantamount to reneging on agreements made with farmers. The authorities were determined to further increase **ODA** from 0.41 percent of GNI in 2003, the highest among G-7 countries, to the U.N. target of 0.7 percent of GNI in 2012. They expressed concern about the lack of funding for developing aid, which was hampering progress toward achieving the millennium goals.

IV. Staff Appraisal

33. **While reforms and new labor market initiatives are fostering job creation, faster and broader structural reform and fiscal adjustment are needed to overcome the headwinds facing the recovery and deal with the consequences of aging.** Though pension and health care reforms of the past two years have substantially improved the prospects for fiscal sustainability, the structural deficit remains high, and public debt has reached historic peaks. Recent policy initiatives have added a new direction to labor market reforms, much needed to reduce high unemployment, and ongoing product, services, and financial market deregulation should foster support for reform. Nonetheless, it will be essential to build further reform momentum, above all in the labor market. Otherwise, benefits in terms of growth and job creation are likely to remain too limited to help achieve fiscal sustainability.

34. **Economic growth is expected to pick up, though at a below-potential pace and subject to important risks.** Growth is projected to edge up from 1.5 percent in 2005 to

about 1.8 percent in 2006. With the clarification of the direction of economic policies, domestic demand should recover after a poor second quarter of 2005. However, compounding downside risk from oil prices and trade partner weakness, export growth is likely to remain sluggish, underscoring the importance of further structural reforms to preserve competitiveness. With growth of output and domestic demand still ahead of the rest of the euro area, monetary conditions are likely to remain quite accommodative. In these circumstances, the necessary structural fiscal adjustment in 2006 would only slightly detract from growth.

35. **Fiscal consolidation needs to resume in 2006 and should be sustained at a steady pace.** Growth-enhancing reforms should play a key role in this respect, but further fiscal adjustment is equally necessary and should aim to achieve structural balance by 2010, before rising costs of aging set in. Execution of the 2004 budget was exemplary. Sizable planned consolidation was achieved by allocating all higher-than-expected revenues to deficit reduction in 2004 and keeping central government spending constant in real terms. However, consolidation stalled in 2005 primarily because initial plans lacked ambition. For 2006, key elements are in place to secure some adjustment, but further measures are required to ensure that the structural deficit falls by ½ of one percentage point of GDP. On the staff's current growth projections, bringing the deficit to less than 3 percent of GDP in 2006, as the authorities seek, will require more adjustment.

36. **Fiscal consolidation should be underpinned by durable expenditure restraint.** Use of budgetary resources to help solve structural problems should be terminated, as it prevents the budget from reaping the benefits of reforms. Instead, synergies between structural reform and fiscal adjustment should be fully exploited. The forthcoming renegotiation of the unemployment convention should be used as an opportunity to eliminate the deficit of the unemployment insurance system. While short-term benefits of civil service reform are limited, more efforts should be made to utilize the ongoing sizable wave of retirements to help with medium-term consolidation.

37. **An overhaul of the tax system could significantly improve economic efficiency but should be revenue-neutral unless accompanied by additional spending restraint.** At present, there is no further budgetary room for targeted reductions in social security contributions. The *taxe professionnelle* should ideally be eliminated in the context of a broader reform together with the establishment of alternative sources of revenue for local authorities. Marginal tax rates should be reduced, by making use of the available room from base-broadening.

38. **The framework for fiscal governance should be further strengthened.** While institutional changes for the central government and social security, in particular health care, should keep spending on track, there is merit in mandating a domestic institution with independent forward-looking budget assessments. This would provide momentum for fiscal adjustment and increase buy-in from all sectors of the general government, including local authorities.

39. **The authorities' gradual consensus-building approach to reform has proven successful, but the benefits of a coordinated package of labor and product market reforms should be taken advantage of.** When reforms had been well prepared, such as in the case of pensions and health care, they had been well accepted by the public. As current labor market reforms are likely to involve transition costs, it will be helpful to enact accompanying product market reforms to boost consumer welfare. In addition, in the context of monetary union, coordination of the timing of reform within the euro area could allow monetary policy easing to mitigate these transition costs.

40. **To lower unemployment permanently, the recent innovative labor market initiative needs to be accompanied by supporting reforms.** The new labor contract for small enterprises will facilitate job creation. Reducing unemployment in the long run will, however, require the integration of all labor contracts into a single one and the elimination of legal uncertainty. The ongoing strengthening of employment services will need to be effective and complemented by capping and phasing of unemployment benefits and strict enforcement of benefit duration limits and sanctions for noncompliance with job search requirements. Future minimum wage increases should be restricted to underlying consumer price inflation to price low-skilled workers back into the labor market.

41. **Ongoing and planned reforms in product markets should be accelerated.** The impending deregulation of retail distribution margins and the public flotation of the gas and electricity utilities are helpful. Important strides are being made in reducing the administrative burden on businesses, and similar determined efforts in economic deregulation would be welcome. Opening up the services markets to orderly competition, both domestically and within the EU context, is likely to generate appreciable efficiency gains.

42. **The financial system has been performing well, while reforms to improve its efficiency should be complemented by the phasing out of remaining administered savings and loan schemes.** The supervisory authorities are appropriately focused on the financial sector's provisioning behavior, the adoption of new accounting standards, and the rising exposure to residential real estate. The end to the prohibition to remunerate sight deposits and the planned creation of the postal bank will promote competition. Long-standing administered savings schemes should be eliminated, given that their objectives are no longer relevant. As planned, mortgage markets should be further developed by reducing transaction costs and facilitating home equity withdrawal.

43. In the **trade area**, France should promote a successful completion of the Doha round and support comprehensive liberalization of agricultural markets, in particular of market access. In this context, rapid progress with the implementation of the **CAP reform** would be helpful. It should avoid recourse to protectionist measures. France's contribution to development through its relatively high and steadily increasing level of **ODA** is commendable, as is its intention to reach the UN target by 2012.

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

Table 1. France: Main Economic Indicators, 2001-10

(Annual percentage change; unless otherwise indicated)

	2001	2002	2003	Proj. 2004	2005	2006	2007	2008	2009	2010
Demand and supply in constant prices 1/										
Gross domestic product	2.1	1.3	0.9	2.0	1.5	1.8	2.6	2.4	2.3	2.3
Private consumption	2.4	2.4	1.6	2.3	1.9	2.1	2.6	2.4	2.3	2.3
Public consumption	1.9	2.9	2.1	2.7	1.5	2.1	2.1	2.1	2.1	2.1
Gross fixed investment	2.3	-1.7	2.7	2.1	2.9	2.7	2.7	2.7	2.7	2.7
Business investment	3.4	-3.0	0.8	1.4	3.0	3.4	3.6	3.6	3.6	3.6
Residential investment	1.4	1.3	3.8	3.2	2.9	1.9	1.2	1.1	1.1	1.1
Public investment	-0.3	-1.0	8.5	3.0	2.4	1.8	1.6	1.6	1.6	1.6
Stockbuilding 2/	-0.3	-0.4	-0.2	0.8	0.4	-0.2	0.0	0.0	0.0	0.0
Total domestic demand	2.0	1.3	1.8	3.2	2.4	2.0	2.5	2.4	2.3	2.3
Foreign balance 2/	0.1	0.0	-0.9	-1.1	-0.9	-0.2	0.0	0.0	-0.1	-0.1
Exports of goods and NFS	2.6	1.5	-1.7	2.0	2.1	6.2	7.9	6.8	6.6	6.3
Imports of goods and NFS	2.5	1.5	1.3	6.1	5.2	6.6	7.2	6.5	6.5	6.4
Prices										
GDP deflator	1.8	2.2	1.4	1.6	1.3	1.7	1.8	1.7	1.7	1.7
Consumer prices (average) 3/	1.8	1.9	2.2	2.3	1.9	1.8	1.8	1.7	1.7	1.7
Consumer prices (end of period) 4/	1.4	2.2	2.4	2.3	1.8	...	...	...	...	...
Employment and wages										
Employment	1.7	0.7	-0.1	-0.1	0.3	0.5	0.9	0.7	0.5	0.4
Unemployment 5/	8.4	8.9	9.5	9.7	9.8	9.6	8.9	8.2	7.6	7.0
Productivity 6/	0.3	0.6	1.0	2.1	1.2	1.2	1.7	1.7	1.8	1.8
Unit labor costs (whole economy)	2.4	2.8	1.5	0.8	1.8	2.1	1.9	1.9	1.6	1.6
Output in manufacturing	2.1	-0.4	-1.4	0.7	3.0	4.5	5.0	4.0	3.0	2.0
Hourly labor compensation in manufacturing	1.2	4.1	4.1	3.4	3.2	3.9	4.5	3.0	2.7	2.0
Unit labor costs in manufacturing	0.2	0.3	4.0	-0.4	0.6	-0.6	-0.5	-1.0	-0.3	0.0
Personal sector										
Real disposable income 7/	3.3	3.6	0.6	1.6	1.8	2.0	2.6	2.5	2.3	2.2
Savings ratio 8/	15.8	16.9	16.0	15.4	15.7	15.8	15.8	15.9	15.9	15.9
Output gap 9/	1.0	0.0	-1.5	-1.4	-2.0	-2.1	-1.4	-0.9	-0.4	0.0
Rate of growth of potential output	2.4	2.3	2.0	2.1	2.1	1.9	1.9	1.9	1.9	1.9
Balance of payments										
Trade balance (in billions of euros)	3.9	8.0	2.9	-6.3	-27.2	-31.4	-29.6	-28.8	-29.4	-30.7
(in percent of GDP)	0.3	0.5	0.2	-0.4	-1.6	-1.8	-1.6	-1.5	-1.5	-1.5
Current account (in billions of euros)	24.0	15.4	7.0	-6.8	-21.8	-25.6	-21.1	-18.7	-17.9	-17.7
(in percent of GDP)	1.6	1.0	0.4	-0.4	-1.3	-1.5	-1.2	-1.0	-0.9	-0.9
Terms of trade	0.6	2.6	0.4	0.8	-1.8	-0.2	0.3	0.3	0.2	0.2
Nominal effective exchange rate 10/	100.4	101.7	106.1	107.6	...	...	...	...	...	...
Real effective exchange rate 10/	97.6	98.7	102.6	103.9	...	...	...	...	...	...
Public sector accounts 11/										
Revenue	50.1	49.6	49.5	49.8	51.4	50.8	50.8	50.8	50.8	50.8
Expenditure	51.7	52.8	53.7	53.5	54.9	54.7	54.0	53.3	52.6	52.0
General government balance	-1.6	-3.2	-4.2	-3.6	-3.5	-3.9	-3.2	-2.5	-1.8	-1.2
Central Government balance	-2.4	-3.8	-3.9	-3.2	-3.1	-2.8	-2.2	-1.7	-1.2	-0.8
Social Security balance	0.4	-0.2	-0.6	-1.0	-0.6	-0.6	-0.3	-0.1	0.1	0.3
Structural balance	-2.1	-3.1	-3.4	-2.6	-2.6	-2.4	-2.2	-1.9	-1.6	-1.2
Primary balance	1.5	-0.1	-1.2	-0.6	-0.5	-0.9	-0.1	0.6	1.3	1.9
Gross debt	56.2	58.2	62.8	64.7	66.3	68.1	68.1	67.9	67.1	65.7

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 2005, year-on-year July.
5/ In percent of labor force; harmonized index.
6/ GDP over total employment.
7/ Personal disposable income deflated by the implicit deflator for private consumption.
8/ In percent of household disposable income.
9/ In percent of potential GDP.
10/ Index; Base 2000=100.
11/ In percent of GDP; data for 2001-02 exclude the proceeds from the sale of UMTS licenses, which amount to about 0.1 percent of GDP; data for 2005 exclude the *EDF* pension fund transfer (0.4 percent of GDP).

Table 2. France: Vulnerability Indicators, 2000-05

(In percent of GDP; unless otherwise indicated)

	2000	2001	2002	2003	Prel. 2004	Estimate 2005	Date 2005
External Indicators							
Exports (annual percentage change, in U.S. dollars)	-0.9	-0.4	2.5	19.7	16.5	…	…
Imports (annual percentage change, in U.S. dollars)	4.7	-1.3	4.2	21.7	19.7	…	…
Terms of trade (annual percentage change)	-3.8	0.6	2.6	0.4	0.8	…	…
Current account balance	1.4	1.6	1.0	0.4	-0.4	…	…
Capital and financial account balance	1.3	1.6	1.3	0.1	0.2	…	…
Of which							
Inward portfolio investment (debt securities, etc.)	10.0	8.0	5.3	11.1	5.8	…	…
Inward foreign direct investment	3.2	3.8	3.4	2.4	1.2	…	…
Other investment liabilities (net)	4.4	2.9	1.9	1.4	3.9	…	…
Total reserves minus gold							
(in billions of U.S. dollars, end-of-period)	37.0	31.7	28.4	30.2	35.3	30.9	July
Euros per U.S. dollar (period average)	1.085	1.118	1.063	0.886	0.805	0.831	July
Market Indicators							
Financial Markets							
Public sector debt (Maastricht definition)	56.7	56.2	58.2	62.8	64.7	…	…
3-month T-bill yield	4.9	3.3	2.9	2.2	2.2	2.1	June
3-month T-bill yield (real)	3.1	1.9	0.8	-0.2	-0.2	0.3	June
Spread of 3-month T-bill with the United States							
(percentage points, end-of-period)	-0.9	1.6	1.7	1.3	0.0	-0.6	June
5- to 8-year government bond	5.1	5.1	4.4	4.4	3.7	3.3	June
10-year government bond (United States)	5.2	5.1	4.0	4.3	4.2	4.0	June
Spread of 10-year bond with the United States							
(percentage points, end-of-period)	-0.1	0.0	0.4	0.1	-0.5	-0.7	June
Yield curve (10 year - 3 month)	0.3	1.7	1.5	2.2	1.5	1.2	June
Stock market index (period average)	100.0	80.9	63.3	52.9	63.3	76.1	July
Real estate prices (index, 2000=100, period average)	100.0	106.1	118.7	135.7	156.7	178.4	June
Credit markets (end-of-period 12-month growth rates)							
Credit to the private sector	9.6	6.1	4.0	5.3	8.3	8.4	June
Bank credit to households	6.9	6.1	7.1	7.8	9.6	9.9	June
Mortgages	7.1	6.3	8.0	9.9	13.6	33.8	June
Bank credit to nonfinancial enterprises	10.7	3.3	2.8	-1.1	6.0	5.7	June
Sectoral risk indicators							
Household sector							
Household savings ratio	15.1	15.8	16.9	16.0	15.4	...	...
Household financial savings ratio	7.2	7.4	8.5	6.9	6.0	...	...
Real estate household solvency ratio (index, 2000=100) 1/	100.0	99.1	101.9	97.9	89.4	91.7	June
Corporate sector							
Profitability of business sector	38.1	38.5	37.8	37.8	38.0	...	...
Investment ratio	18.3	18.3	17.3	16.9	17.1	...	...
Savings ratio	16.5	16.5	15.1	16.1	15.5	...	...
Self-financing ratio	80.4	80.6	78.2	86.6	82.2	...	...
Banking sector							
Share of mortgage credit in bank credit to the private sector	29.4	29.4	31.0	32.8	34.7	35.2	June
Share of nonperforming loans in total loans	5.0	5.0	5.0	4.8	4.2	…	…
Ratio of nonperforming loans net of provisions to capital	12.8	12.6	12.6	11.6	9.8	…	…
Liquid assets to total short-term liabilities	138.5	152.5	157.0	153.6	155.2	…	…
Return on assets 2/	0.5	0.5	0.5	0.4	0.5	…	…
Return on equity 2/	9.7	9.6	9.1	8.5	10.6	…	…
Regulatory capital to risk-weighted assets	11.9	12.1	11.5	11.9	11.5	…	…

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 insitutions aggregated data on a parent-company basis.

Table 3. France: General Government Accounts, 1997-2004 1/

(In percent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004
General government								
Revenue	51.2	50.5	51.0	50.3	50.1	49.6	49.5	49.8
Tax revenue	44.4	44.2	45.1	44.3	44.0	43.1	43.1	43.4
Of which								
VAT	7.7	7.6	7.6	7.4	7.2	7.1	7.0	7.2
Income tax	3.2	3.2	3.4	3.5	3.3	3.0	3.0	2.8
Corporate tax	2.1	2.2	2.5	2.7	3.0	2.6	2.4	2.5
TIPP	1.8	1.8	1.8	1.7	1.6	1.6	1.5	1.5
Nontax revenue	6.9	6.3	5.9	6.0	6.1	6.4	6.4	6.4
Expenditures	54.2	53.1	53.5	51.7	51.7	52.8	53.7	53.5
Of which								
Salaries	13.8	13.7	13.7	13.5	13.5	13.7	13.9	...
Pensions	10.0	9.9	9.9	9.7	9.8	9.7	9.9	...
Health expenditure	7.3	7.2	7.2	7.3	7.4	7.7	8.0	...
Other social transfers	6.8	6.6	6.4	6.2	6.0	6.4	6.5	...
Balance	-3.0	-2.6	-2.5	-1.5	-1.6	-3.2	-4.2	-3.6
Primary balance	0.7	0.9	0.8	1.7	1.5	-0.1	-1.2	-0.6
Structural balance	-1.1	-1.8	-2.2	-2.1	-2.1	-3.1	-3.5	-2.7
Central government balance	-3.5	-2.9	-2.6	-2.4	-2.4	-3.8	-3.9	-3.2
Social security balance	-0.4	-0.1	0.3	0.5	0.4	-0.2	-0.6	-1.0
Local government balance	0.2	0.3	0.3	0.2	0.1	0.2	0.0	-0.1
ODAC balance	0.7	0.1	0.2	0.3	0.4	0.6	0.3	0.6
Gross debt	58.5	58.7	58.3	56.7	56.2	58.2	62.8	64.7
Interest payments	3.7	3.5	3.3	3.2	3.2	3.1	3.0	3.0
Memorandum items:								
Nominal GDP 2/	1,268.5	1,324.6	1,366.5	1,441.4	1,497.2	1,548.6	1,585.2	1,648.4
Structural nominal GDP	1,307.6	1,345.7	1,373.8	1,424.9	1,483.0	1,550.3	1,603.8	1,669.4

Sources: INSEE; and IMF staff calculations.

1/ Excludes UMTS receipts.
2/ Annual national accounts; Maastricht definition.

Table 4. France: Public Sector Debt Sustainability Framework, 2000-10

(In percent of GDP; unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing primary balance 8/**
1 **Baseline: Public sector debt 1/**	56.7	56.2	58.2	62.8	64.7	**66.3**	**68.1**	**68.1**	**67.9**	**67.1**	**65.7**	**0.5**
2 Change in public sector debt	-1.6	-0.5	2.1	4.6	1.9	1.6	1.8	0.0	-0.2	-0.8	-1.4	
3 Identified debt-creating flows (4+7)	-1.6	-0.6	1.2	2.9	1.4	1.7	1.6	0.4	-0.2	-0.8	-1.4	
4 Primary deficit	-1.7	-1.7	0.0	1.2	0.6	0.5	0.9	0.1	-0.6	-1.3	-1.9	
5 Revenue and grants	50.3	50.1	49.6	49.5	49.8	51.4	50.8	50.8	50.8	50.8	50.8	
6 Primary (noninterest) expenditure	48.6	48.4	49.6	50.7	50.5	51.9	51.7	50.9	50.2	49.5	48.9	
7 Automatic debt dynamics 2/	0.1	1.1	1.2	1.6	0.8	1.2	0.7	0.3	0.4	0.4	0.5	
8 Contribution from interest rate/growth differential 3/	0.1	1.1	1.2	1.6	0.8	1.2	0.7	0.3	0.4	0.4	0.5	
9 *Of which:* contribution from real interest rate	2.3	2.2	1.9	2.2	2.0	2.1	1.9	1.9	1.9	1.9	2.0	
10 *Of which:* contribution from real GDP growth	-2.2	-1.1	-0.7	-0.5	-1.2	-0.9	-1.1	-1.7	-1.6	-1.5	-1.5	
11 Residual, including asset changes (2-3) 4/	0.1	0.1	0.8	1.7	0.5	-0.1	0.1	-0.4	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	112.8	112.1	117.4	126.9	129.9	129.0	134.0	134.1	133.6	132.1	129.4	
Gross financing need 5/	1.5	1.5	3.2	4.2	3.6	3.5	3.9	3.2	2.5	1.8	1.2	
In billions of U.S. dollars	19.5	20.8	46.4	75.3	74.7	75.4	85.5	74.2	60.5	46.3	32.3	
Scenario with key variables at their historical averages 6/						**66.3**	**67.9**	**69.0**	**70.4**	**72.0**	**73.5**	**1.8**
Scenario with no policy change (constant primary balance) in 2005-10						**66.3**	**67.7**	**68.1**	**68.9**	**69.9**	**70.9**	**0.5**
Key macroeconomic and fiscal assumptions underlying baseline												
Real GDP growth (in percent)	4.1	2.1	1.3	0.9	2.0	1.5	1.8	2.6	2.4	2.3	2.3	
Average nominal interest rate on public debt (in percent) 7/	5.7	5.8	5.7	5.2	5.0	4.8	4.7	4.8	4.7	4.8	4.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.2	4.1	3.5	3.8	3.3	3.4	3.0	3.0	3.0	3.0	3.1	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-11.2	-0.6	14.1	20.7	9.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	1.5	1.8	2.2	1.4	1.6	1.3	1.7	1.8	1.7	1.7	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.5	1.8	3.7	3.2	1.8	4.3	1.3	1.1	1.0	0.9	1.0	
Primary deficit	-1.7	-1.7	0.0	1.2	0.6	0.5	0.9	0.1	-0.6	-1.3	-1.9	

1/ Indicates coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ For projections, this line includes exchange rate changes.

5/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 5. France: The Core Set of Financial Soundness Indicators, 1999-2004

(In percent; unless otherwise indicated)

Indicator	1999	2000	2001	2002	2003	2004
Deposit-taking institutions 1/						
Regulatory capital to risk-weighted assets	12.7	11.9	12.1	11.5	11.9	11.5
Regulatory Tier I capital to risk-weighted assets	10.0	9.9	10.5	9.2	9.0	8.8
Nonperforming loans net of provisions to capital	14.1	12.8	12.6	12.6	11.6	9.8
Nonperforming loans to total gross loans	5.7	5.0	5.0	5.0	4.8	4.2
Sectoral distribution of loans to total loans, *of which:*						
Deposit takers	32.3	31.2	33.3	33.3	33.8	33.6
Nonfinancial corporation	19.6	21.0	19.7	19.9	19.1	18.9
Households (including individual firms)	22.9	23.1	21.9	22.8	24.6	25.1
Nonresidents (including financial sectors)	19.0	18.5	19.6	18.3	16.5	16.3
ROA (aggregated data on a parent-company basis) 2/	0.4	0.5	0.5	0.5	0.44	0.5
ROA (main groups on a consolidated basis) 3/	0.5	0.60	0.45	0.43	0.39	0.53
ROE (aggregated data on a parent-company basis) 2/	9.1	9.7	9.6	9.1	8.50	10.6
ROE (main groups on a consolidated basis) 3/	11.8	15.3	10.8	9.6	10.0	12.7
Interest margin to gross income	77.0	70.2	64.4	65.4	60.8	58.4
Noninterest expenses to gross income	67.6	67.7	66.9	65.5	64.4	63.9
Liquid assets to total assets	19.6	19.5	20.4	20.7	21.6	21.3
Liquid assets to short-term liabilities	147.9	138.5	152.5	157.0	153.6	155.2
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
Net open positions in equities to Tier I capital	...	3.9	2.9	4.9	3.5	4.8

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 (2004).
4/ Impact of creation of euro has to be taken into account.

Table 6. France: Additional Encouraged Financial Soundness Indicators, 1999-2004

Indicator	1999	2000	2001	2002	2003	2004
	(In percent; unless otherwise indicated)					
Corporate sector						
Return on equity						
ROE (aggregated data on a parent-company basis) 1/	9.1	9.7	9.6	9.1	8.50	10.6
ROE (main groups on a consolidated basis) 2/	11.8	15.3	10.8	9.6	10.0	12.7
Interest paid to financial institutions over operating income	23.0	29.4	34.2	30.7	28.3	27.3
Number of nonfinancial companies filing bankruptcy	40,825	37,105	35,776	36,966	41,630	40,981
Deposit-taking institutions						
Capital (net worth) to assets	n.a.	4.9	4.9	5.2	5.4	5.1
International consolidated claims of French banks, *of which:*						
(BIS data, as percent of total international claims)						
Advanced countries	77.0	79.0	81.0	84.0	85.0	84.0
Developing Europe	2.0	2.0	2.0	2.0	2.7	2.5
Latin America and Caribbean	4.0	3.0	3.0	2.0	1.4	1.0
Africa and Middle East	4.0	4.0	4.0	4.0	3.3	3.1
Asia and Pacific Area	5.0	4.0	3.0	3.0	2.7	2.6
Offshore Financial Centers	8.0	8.0	7.0	5.0	4.5	6.5
Gross asset position in financial derivatives to capital	260.2	201.6	244.5	378.9	306.8	372.5
Gross liability position in financial derivatives to capital	220.9	169.2	216.6	343.5	282.7	358.5
Large exposures to capital	n.a.	n.a.	n.a.	133.0	130.6	140.7
Personnel expenses to noninterest expenses	59.3	58.9	57.9	58.2	59.2	59.7
Customer deposits to total (noninterbank) loans	83.0	77.3	81.6	81.5	82.8	80.6
FX loans to total loans 3/	14.9	15.1	15.3	12.6	11.2	10.8
FX liabilities to total liabilities	15.7	17.3	18.4	15.1	14.2	15.1
Market liquidity						
Average daily turnover of government's securities over average outstanding negotiable debt	0.21	0.15	0.17	0.20	0.18	0.18
Other financial corporations						
Assets to total financial system assets	34.5	36.7	36.3	35.6	37.2	36.9
Assets to GDP	144.5	154.2	151.6	144.1	156.1	164.6
Households						
Household debt to GDP	34.8	34.9	35.4	36.5	38.1	39.9
Interest charges over gross disposable income	2.0	2.2	2.6	2.2	1.9	1.8
Real estate markets						
Real estate prices (annual growth rate)	7.1	8.8	7.9	8.3	11.7	15.3
Residential real estate loans to total loans	31.2	30.8	31.5	32.8	35.2	37.1

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

1/ All credit institutions aggregated data on a parent-company basis.
2/ Consolidated data for the seven main banking groups.
3/ Data cover interbank and customer lending to residents and nonresidents on a metropolitan basis.

Table 7. Financial System Structure, 1999-2004

	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04
	(In number of institutions)					
Number						
Banks						
Commercial banks	365	362	357	345	333	325
Private	359	354	352	341	329	323
Domestic	159	140	144	142	138	140
Foreign	200	214	208	199	191	183
State-owned 1/	6	8	5	4	4	2
Credit unions and mutuals	156	154	148	136	129	127
Other credit institutions						
Finance companies	603	557	524	494	464	425
Of which: mortgage institutions	3	3	4	4	4	4
Specialized financial institutions	22	19	17	16	15	11
Municipal credit institutions	22	22	21	21	21	21
Securities firms	141	146	144	136	131	123
Insurance companies	459	464	466	456	444	412
Life and retirement	126	127	126	126	125	119
Nonlife	300	304	304	295	286	262
Reinsurance	33	33	36	35	33	31
Concentration						
Commercial banks 2/	11	11	10	11	10	10
Securities companies 2/	3	3	3	3	4	2
Assets	(In billions of euros)					
Banks						
Commercial banks	2,061.6	2,145.0	2,402.8	2,359.7	2,440.4	2,855.0
Private	2,052.3	2,123.0	2,323.9	2,277.7	2,365.3	2,853.9
Domestic	1,813.7	1,681.5	1,884.6	1,865.7	1,982.5	2,431.8
Foreign	238.5	441.5	439.3	412.0	382.8	422.0
State-owned 1/	9.3	22.0	78.8	82.1	75.1	11.3
Credit unions and mutuals	806.7	847.7	857.4	880.8	934.7	1,047.5
Other credit institutions						
Finance companies	381.1	411.2	473.9	507.9	536.2	430.6
Of which: mortgage institutions	39.3	50.9	62.3	75.9	91.9	107.2
Specialized financial institutions	141.8	46.4	46.8	42.9	46.9	40.3
Municipal credit institutions	2.0	1.8	1.9	1.9	1.9	1.9
Securities firms	11.3	44.1	51.9	64.9	218.7	173.6
Insurance companies (net asset value) 3/						
Life and retirement	622.2	691.5	738.5	769.2	820.3	n.a.
Nonlife	90.6	92.3	96.0	98.6	107.6	n.a.
Reinsurance	16.4	19.1	20.4	19.7	21.3	n.a.
Deposits						
Banks						
Private commercial	415.2	435.8	515.9	516.1	526.8	572.2
State-owned	2.3	2.7	5.6	3.6	7.9	0.02
Foreign-owned subsidiaries	23.4	44.2	50.8	52.7	47.7	45.2
Branches of foreign banks	13.9	16.3	17.1	19.4	20.9	19.7

Sources: *Banque de France*; and ministry of finance.

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

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

3/ Data for 2004 not available yet.

FRANCE: FUND RELATIONS

As of July 31, 2005

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

II. **General Resources Account:**

	SDR Million	Percent of Quota
Quota	10,738.50	100.00
Fund holdings of currency	7,846.30	73.06
Reserve position in Fund	2,892.52	26.94

III. **SDR Department**

	SDR Million	Percent of Allocation
Net cumulative allocation	1,079.87	100.00
Holdings	589.99	54.64

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

V. **Latest Financial Arrangements:** None

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/interest	6.39	12.96	12.96	13.00	12.96
Total	6.39	12.96	12.96	13.00	12.96

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

VIII. **Safeguards Assessments:** Not applicable

IX. **Exchange Rate Arrangements:**

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

- 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 at October 20, 2004). France is on the standard 12-month consultation cycle.

XI. **FSAP Participation and ROSC:**

	Date Issued	**Country Report No.**
Transparency in Monetary and Financial Policies	10/17/00	n/a
Fiscal Transparency Module	10/17/00	n/a
Fiscal Transparency, Transparency in Monetary and Financial Policies—Update	11/05/01	01/197
Fiscal Transparency Module—Update	11/13/02	02/248
Transparency in Monetary and Financial Policies—Update	11/13/02	02/248
Data Module	10/29/03	03/339
Fiscal Transparency and Date Modules—Update	11/03/04	04/345
Publication of FSAP—Detailed Assessment of Observance of Standards and Codes	06/08/05	05/186

France: Statistical Issues

France's economic database is comprehensive and of high quality. The authorities regularly publish a full range of economic and financial data, and calendar dates of main statistical releases are also provided. The transmission of data in electronic form from INSEE (*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. As a subscriber to the Special Data Dissemination Standard (SDDS), France posts its metadata on the Fund's Dissemination Standards Bulletin Board (DSBB) on the Internet. 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.

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

France adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. 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 data were rebased to 2000 prices. While current and constant 2000 prices are available, institutional sector data are only available from 1993 onwards and employment data from 1990 onwards. INSEE will publish in the near future the complete set of national accounts with base 2000, and starting in 1978.

Data issues include the need to provide monthly or quarterly developments not only for the finances of the central government, but also for social security and local governments. These data should be presented in a comprehensive fashion and on a national accounts basis to facilitate monitoring of public finances. The national accounts website has recently been enhanced: it includes expenditure tables and government revenues by subsector (central government, miscellaneous central government agencies, local governments, and social security administration).

With regard to balance-of-payments statistics, the data ROSC mission recommended initiating efforts to achieve greater coherence between the external current account and the rest of the world account in national accounts. Work with promising early results has been undertaken on the transportation account.

France: Table of Common Indicators Required for Surveillance

(as of September 5, 2005)

	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting	Frequency of Publication	Memo Items:	
						Data Quality – Methodological Soundness[6]	Data Quality – Accuracy and Reliability[7]
Exchange Rates	07/05	08/01/05	Monthly	Monthly	Monthly		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	07/05	08/30/05	Monthly	Monthly	Monthly		
Reserve/Base Money	05/13/05	05/31/05	Weekly	Weekly	Weekly	O, O, LO, LO	O, O, O, O, O
Broad Money	04/05	05/05	Monthly	Monthly	Monthly		
Central Bank Balance Sheet	07/05	08/26/05	Monthly	Monthly	Monthly		
Consolidated Balance Sheet of the Banking System	07/05	08/26/05	Monthly	Monthly	Monthly		
Interest Rates[2]	07/05	08/24/05	Monthly	Monthly	Monthly		
Consumer Price Index	06/05	08/05	Monthly	Monthly	Monthly	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	04/05	Annual	Annual	Annual	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government[5]	2004	05/05/05	Monthly	Monthly	Monthly		
Stock of Central Government Debt	04/05	05/05	Monthly	Monthly	Monthly		
Stock of Central Government-Guaranteed Debt	2004	02/20/05	Annual	Annual	Annual		
External Current Account Balance	Q1 2005	08/05	Quarterly	Quarterly	Quarterly	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2005	08/05	Quarterly	Quarterly	Quarterly		
GDP/GNP	Q4 2004	04/05	Quarterly	Quarterly	Quarterly	O, O, O, O	O, LO, O, O, O
Gross External Debt	04/05	05/05	Monthly	Monthly	Monthly		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] This information is provided on a budget-accounting basis (not on a national accounts basis).
[6] 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).
[7] 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 2005 Article IV Consultation
Supplementary Information

Prepared by the European Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Deppler and Matthew Fisher

October 27, 2005

This supplement to the staff report for the 2005 Article IV Consultation with France provides an update on recent developments, in particular the authorities' 2006 budget proposal and their medium-term fiscal plans presented with the budget. The new information does not alter the thrust of the staff appraisal except for the staff's assessment of the structural fiscal adjustment in 2005. Instead of noting an unchanged underlying position as in the staff report, the staff now welcomes the fact that fiscal consolidation continued in 2005 (¶2).

Summary

Recent short-term economic indicators are consistent with the mild recovery projected by the staff for the second half of 2005, but oil prices remain a risk and have pushed up headline inflation. Additional measures have brought the 2005 deficit target of 3 percent of GDP within reach. As a result, instead of an unchanged structural deficit expected on the basis of information available for the staff report, underlying adjustment this year is now estimated to be 0.4 percentage point of GDP. For 2006, the authorities count on growth of 2¼ percent together with constant spending at the central government level and higher social security contribution to reduce the deficit to 2.9 percent of GDP. Mainly owing to lower growth, the staff projects the deficit to increase to 3.3 percent of GDP. While this estimate of the deficit is much less than anticipated in the staff report, the corresponding structural adjustment is similar (0.3 versus 0.2 percentage point of GDP, respectively) and continues to fall short of staff recommendations.

Enterprises have begun to hire under the new labor contract (Contrat Nouvelles Embauches, CNE), but it is too early to assess its impact on employment. To help raise the employment rate of older workers, social partner representatives have agreed on a new fixed-duration contract for such workers, subject to labor union and parliamentary approval. With respect to international trade, the authorities are seeking to limit concessions proposed by the EU on agricultural tariffs and subsidies.

Output and inflation

1. **The authorities project growth to rise from 1½–2 percent in 2005 to 2-2½ percent in 2006, largely due to increasing exports.** The staff has maintained its projections of the staff report at 1.5 percent and 1.8 percent for 2005 and 2006, respectively. These projections are the same as the October Consensus forecast and, for 2005, of France's national statistics institute (*INSEE*) (Table 1).[1] Recent data releases are consistent with a modest recovery. Consumers have become slightly more confident, increasing spending on manufactured goods, but stocks remain high. Industrial production appears to be recovering, while services to enterprises show continued growth. Employment has been edging up, which together with stricter enforcement of job search requirements allowed the unemployment rate to fall to just below 10 percent of the labor force. Oil prices boosted headline inflation to 2.4 percent in September. As a result, the staff has increased its projection of average consumer price inflation somewhat in both 2005 and 2006, while lowering the GDP deflator in 2006 in line with the authorities' projection—reflecting a squeeze on profit margins.

2005 Budget

2. **The 2005 budget deficit target of 3 percent of GDP is within reach and achieving it would represent structural adjustment of 0.4 percentage point of GDP.** The latter is more than was expected in the staff report as revenues have been stronger in relation to income, and credits equivalent to ¼ of one percentage point of GDP have been cancelled. In addition, health care spending growth is being sharply reduced compared to 2004. Income support to mitigate the impact of high oil prices appears well targeted to alleviate social hardship and will have only limited consequences on the 2005 budget and marginal implications for economic efficiency. Fiscal incentives favoring energy conservation and investment in refining have been strengthened.

2006 Budget

3. **The draft 2006 budget aims to reduce the deficit marginally to 2.9 percent of GDP, which requires underlying adjustment of 0.5 percentage point of GDP to compensate for the decline in one-off revenues.** In addition to relying on growth of 2¼ percent, this is to be accomplished as follows (Text Table 1):

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[1] *INSEE* projects only two quarters ahead and thus has no forecast for 2006.

Text Table 1. France: Impact of New Measures on 2006 Deficit

(In percent of GDP)

	2005	2006: Impact of no Policy Change and Previously Enacted Measures	2006: Impact of new Measures
Revenue	50.8		
Tax revenue	43.9		
Central government		-0.2 1/	0.0
Social security			0.1
Dynamism of tax base		0.2 2/	
Nontax revenue	6.9	-0.5	0.2 4/
Expenditures	53.9	0.1 3/	-0.1 5/
Total impact		-0.6	0.4
Balance	**-3.1**	-3.7	**-3.3**

Sources: *Projet de loi de finances* 2006; and IMF staff calculations.

1/ This includes exemption of *taxe professionnelle* for new investments, a decrease in the corporate income tax rate, housing subsidies, and deductions on the inheritance tax.

2/ This is due to the wage bill—the tax base for social security contributions—increasing at a more dynamic rate than nominal GDP, and some other dynamic tax bases.

3/ This assumes spending at various levels of government continues to increase at the same rate as in 2005.

4/ Essentially exceptional dividends from state-owned enterprises.

5/ New measures on medicines and medical visits are expected to bring health care spending growth from 3¾ percent in 2005 to 2½ percent in 2006.

- On the **expenditure** side, general government spending is set to grow by not more than 1.6 percent in real terms. Central government spending will remain constant in volume for the fourth year in a row, though this is facilitated by moving some spending to the revenue side as negative items. The number of civil servants will decline by 9,700 (5,300 in terms of full-time equivalents).[2] With additional reform measures agreed in 2004 that have yet to come into effect, nominal health care spending growth is targeted to decline from 3¾ percent in 2005 to 2½ percent in 2006.[3]

- **Revenues from taxes and social security contributions** will remain stable at about 44 percent of GDP. To promote employment, the earned income tax credit (*prime*

[2] There are about 2.5 million civil servants.

[3] Reimbursements of medical consultations that avoid the use of a doctor-gatekeeper (*médecin de référence*), will be limited, and coverage of copayments by supplementary individual health insurances will also be limited.

pour l'emploi) is being raised, and temporary incentives for job-taking by welfare recipients and long-term unemployed are being introduced. The exemption of new investment from the *taxe professionnelle* has been made permanent for the first two years and the amount of the tax capped at 3.5 percent of value added. On the other hand, contributions are being raised to reduce the deficit of the social security system. All revenue windfalls, except those related to higher oil prices, are intended to go to deficit reduction. A national committee has been set up to assess and propose an allocation for any revenue windfalls due to higher oil prices.

- A **tax reform** is being implemented, which will have no effect on the 2006 cash budget but will lower revenues in 2007 by about 0.3 percentage point of GDP. It improves efficiency and transparency by reducing the number of income brackets and simplifying the tax rate structure. Statutory marginal tax rates are being lowered, but marginal effective tax rates change little, as rate reductions are largely being paid for by eliminating a 20 percent across-the-board tax exemption.

- **Nontax revenues** are maintained at above trend levels in 2006 through dividend payments by state-owned energy utilities, *Banque de France*, and a savings bank (*Caisse des dépôts*), and a transfer of pension fund assets of the post office against equivalent future liabilities.

Medium-term fiscal outlook

4. **Over the medium term (2007–09), the authorities intend to pursue expenditure restraint to achieve underlying adjustment, while reducing the tax burden slightly.** In the authorities' low-case medium-term scenario, growth is set to continue at 2¼ percent per year, while real general government spending growth would fall from 1.2 percent in 2007 to 0.6 percent by 2009 (Text Table 2). This will require a decline in real central government spending by 1 percentage point per year during 2007–09 and a durable reduction in nominal health care spending growth to 2.4 percent per year. This scenario would result in a structural adjustment of 1.1 percentage points of GDP over three years. In the staff's view, taking only explicit measures into account, real general government spending would continue to increase at about 1.4 percent per year. Consequently, the staff projects only a marginal improvement in the structural balance by 2009. The authorities also present a high-case medium-term scenario with higher annual economic growth of 3 percent due to structural reforms and additional spending restraint, mainly at the local level, yielding a further decline in real general government expenditure growth to 0.3 percent. As a result, structural adjustment would reach 2.1 percentage points of GDP over three years.

Text Table 2. France: 2006 Budget and Medium-Term Fiscal Plans

(In percent of GDP)

	2004	2005	2006	2007	2008	2009
Budget 2006 1/						
Overall balance	-3.6	-3.0	-2.9	-2.7	-2.1	-1.4
Tax revenue	43.4	43.9	44.0	43.7	43.5	43.4
Expenditures	53.5	53.8	53.6	53.1	52.3	51.5
Growth rate of real expenditure (in percent)	1.6	1.8	1.6	1.2	0.8	0.6
Real GDP growth (in percent)	2.1	1.8	2.3	2.3	2.3	2.3
GDP inflation (in percent)	1.6	1.3	1.4	1.5	1.5	1.5
CPI (in percent)	1.9	1.8	1.8	1.5	1.5	1.5
Staff projections (current policies)						
Overall balance	-3.6	-3.1	-3.3	-3.3	-2.8	-2.4
Tax revenue	43.4	43.9	44.0	43.7	43.7	43.7
Expenditures	53.5	53.9	53.9	53.4	52.9	52.5
Growth rate of real expenditure (in percent) 2/	1.6	1.5	1.4	1.4	1.4	1.4
Real GDP growth (in percent)	2.1	1.5	1.8	2.5	2.4	2.3
GDP inflation (in percent)	1.6	1.3	1.4	1.6	1.7	1.7
CPI (in percent)	1.9	2.1	1.9	1.7	1.7	1.7
Structural balance 3/	-2.6	-2.2	-2.0	-2.3	-2.2	-2.1
Structural improvement						
Authorities' estimate/plans (excl. EDF *soulte*)	...	0.4	0.5	0.1	0.4	0.6
Difference in expenditure growth rate	...	0.0	0.0	-0.2	-0.4	-0.5
Nominal potential growth difference	...	-0.1	-0.2	0.0	0.0	0.0
Lower nontax revenue 4/	...	0.0	-0.1	-0.2	0.0	0.0
Staff estimate/projections	...	0.4	0.3	-0.4	0.1	0.1

Sources: *Projet de loi de finances* 2006; and IMF staff calculations.

1/ The medium-term plans correspond to the "lower scenario" in the authorities' draft budget.

2/ Differs from the authorities in 2005 and 2006 because of differences in projected inflation.

3/ Excluding the *EDF* pension transfer in 2005.

4/ The authorities count on an increase in nontax revenue over 2007-09, which the staff does not incorporate.

Conclusion

5. **The execution of the 2005 budget is likely to deliver more fiscal adjustment than anticipated, and fiscal discipline is set to continue, but the 2006 draft budget falls short of staff recommendations.** Better revenue performance and additional fiscal measures have brought the 2005 budget deficit target of 3 percent of GDP within reach. For 2006, maintaining central government expenditure constant in volume terms is welcome while ongoing health care reforms will also contribute to spending control. Nonetheless, achieving the modest reduction in the deficit in 2006 relies on higher-than-consensus growth projections, increases in social security contributions, and further nontax revenue measures. Underlying fiscal adjustment, in particular excluding one-offs, is well below ½ of one percentage point of GDP and less than in 2005. The proposed tax reform increases efficiency, though its attendant revenue loss, which will affect the 2007 budget, runs ahead of the identification of specific expenditure cuts. The policy response to high oil prices is

welcome, but most of the income support measures will need to be subject to a sunset clause to prevent permanent price distortions.

6. **For the medium term, additional structural reforms and a considerable reduction in spending as a share of GDP in line with the authorities' high-case scenario are needed to deal with the consequences of aging.** On current policies, the staff projects the structural balance to remain in a deficit of about 2 percent of GDP over the medium term. Implementation of the authorities' low-case scenario would still leave the budget in a structural deficit, providing insufficient consolidation to address the costs of aging. Reducing real central government spending and sharply curbing local spending growth as in the authorities' high-case scenario would eliminate the structural deficit over the medium term, an appropriate response to the challenge of aging. Given the magnitude of the required adjustment, it will be important to identify early on durable expenditure measures to underpin the credibility of this scenario. Among these, greater advantage will need to be taken of the wave of civil servant retirements to realize the desired efficiency gains.[4]

[4] Current plans foresee a reduction in the number of civil servants equivalent to 15 percent of retirements.

Table 1. France: Main Economic Indicators, 2001-10

(Annual percentage change; unless otherwise indicated)

					Proj.					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Demand and supply in constant prices 1/										
Gross domestic product	2.1	1.3	0.9	2.1	1.5	1.8	2.5	2.4	2.3	2.3
Private consumption	2.4	2.4	1.6	2.3	1.9	2.1	2.5	2.4	2.3	2.3
Public consumption	1.9	2.9	2.1	2.7	1.5	2.1	2.1	2.1	2.1	2.1
Gross fixed investment	2.3	-1.7	2.7	2.1	3.0	2.8	2.7	2.7	2.7	2.7
Business investment	3.4	-3.0	0.8	1.4	3.2	3.4	3.6	3.6	3.6	3.6
Residential investment	1.4	1.3	3.8	3.2	3.2	1.9	1.2	1.1	1.1	1.1
Public investment	-0.3	-1.0	8.6	3.0	2.3	1.7	1.6	1.6	1.6	1.6
Stockbuilding 2/	-0.3	-0.4	-0.2	0.8	0.4	-0.2	0.0	0.0	0.0	0.0
Total domestic demand	2.0	1.3	1.8	3.2	2.4	2.0	2.4	2.4	2.3	2.3
Foreign balance 2/	0.1	0.0	-0.9	-1.1	-0.9	-0.2	0.0	0.0	-0.1	-0.1
Exports of goods and NFS	2.6	1.5	-1.7	2.1	2.1	6.2	7.6	6.8	6.6	6.3
Imports of goods and NFS	2.5	1.5	1.3	6.1	5.0	6.5	7.2	6.5	6.5	6.4
Prices										
GDP deflator	1.8	2.2	1.4	1.6	1.3	1.4	1.6	1.7	1.7	1.7
Consumer prices (average) 3/	1.8	1.9	2.2	2.3	2.1	1.9	1.7	1.7	1.7	1.7
Consumer prices (end of period) 4/	1.4	2.2	2.4	2.3	2.4	...	...	...	...	...
Employment and wages										
Employment	1.7	0.7	-0.1	0.0	0.1	0.4	0.9	0.7	0.5	0.5
Unemployment 5/	8.4	8.9	9.5	9.7	9.8	9.8	9.1	8.3	7.6	7.0
Productivity 6/	0.3	0.6	1.0	2.1	1.4	1.4	1.6	1.7	1.8	1.8
Unit labor costs (whole economy)	2.4	2.8	1.5	0.8	1.6	1.9	2.0	1.9	1.7	1.7
Output in manufacturing	2.1	-0.4	-1.4	0.7	3.0	4.5	5.0	4.0	3.0	2.0
Hourly labor compensation in manufacturing	1.2	4.1	4.1	3.5	3.2	3.9	4.5	3.0	2.7	2.0
Unit labor costs in manufacturing	0.2	0.3	4.0	-0.5	0.6	-0.6	-0.5	-1.0	-0.3	0.0
Personal sector										
Real disposable income 7/	3.3	3.6	0.6	1.6	1.5	1.7	2.7	2.5	2.3	2.2
Savings ratio 8/	15.8	16.9	16.0	15.4	15.2	15.0	15.2	15.3	15.4	15.4
Output gap 9/	1.0	0.0	-1.5	-1.4	-1.9	-2.0	-1.4	-0.8	-0.4	0.0
Rate of growth of potential output	2.4	2.3	2.0	2.1	2.1	1.9	1.9	1.9	1.9	1.9
Balance of payments										
Trade balance (in billions of euros)	3.9	8.0	2.9	-6.3	-26.2	-30.1	-29.1	-28.3	-28.8	-30.0
(in percent of GDP)	0.3	0.5	0.2	-0.4	-1.5	-1.7	-1.6	-1.5	-1.5	-1.5
Current account (in billions of euros)	24.0	15.4	7.0	-6.8	-20.8	-24.2	-20.6	-18.3	-17.4	-17.2
(in percent of GDP)	1.6	1.0	0.4	-0.4	-1.2	-1.4	-1.1	-1.0	-0.9	-0.8
Terms of trade	0.6	2.6	0.4	0.8	-1.8	-0.2	0.3	0.3	0.2	0.2
Nominal effective exchange rate 10/	100.4	101.7	106.1	107.6	108.0	...	...	...	...	...
Real effective exchange rate 10/	97.6	98.6	102.6	104.3	103.6	...	...	...	...	...
Public sector accounts 11/										
Revenue	50.1	49.6	49.5	49.8	50.8	50.6	50.1	50.1	50.1	50.1
Expenditure	51.7	52.8	53.7	53.5	53.9	53.9	53.4	52.9	52.5	52.1
General government balance	-1.6	-3.2	-4.2	-3.6	-3.1	-3.3	-3.3	-2.8	-2.4	-2.0
Central Government balance	-2.4	-3.8	-3.9	-3.2	-3.4	-3.0	-3.1	-2.9	-2.4	-2.0
Social Security balance	0.4	-0.2	-0.6	-1.0	-0.8	-0.5	-0.4	-0.3	-0.3	-0.1
Structural balance	-2.1	-3.1	-3.4	-2.6	-2.2	-2.0	-2.3	-2.2	-2.1	-2.0
Primary balance	1.5	-0.1	-1.2	-0.9	-0.2	-0.4	-0.4	0.1	0.6	1.0
Gross debt	56.2	58.2	62.8	64.7	66.1	66.9	67.3	67.3	66.9	66.3

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 2005, year-on-year September.
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 2005, data available up to August.
11/ In percent of GDP; data for 2001-02 exclude the proceeds from the sale of UMTS licenses, which amount to about 0.1 percent of GDP; data for 2005 exclude the *EDF* pension fund transfer (0.4 percent of GDP).

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IMF Executive Board Concludes 2005 Article IV Consultation with France

On November 2, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with France.[1]

Background

The cyclical recovery of the French economy was interrupted in the first half of 2005 as previously strong domestic demand faltered and the external sector continued to exert a drag on growth. In 2004, growth was faster and more consumption-driven than in other large euro area countries. Employment growth in hours, increases in minimum wages, and some fiscal measures supported private household incomes. Consumers also dipped into savings, reflecting relatively favorable demographics, rising financial wealth, and a confidence-preserving execution of pension and health reforms.

Against this background, the fall in private consumption in the second quarter of 2005 was unexpected, possibly related to stagnating unemployment, rising oil prices, and political turmoil surrounding the rejection of the EU constitution. Fixed investment and residential construction continued to expand. Net exports have been reducing annual growth by about 1 percentage point. Several factors play a role: the recent appreciation of the real exchange rate dampened exports, and partner demand has been cyclically weak. Conversely, domestic demand has been strong, boosting imports. However, as indicated by the staff's econometric work, these factors cannot fully explain the weak external performance.

While short-term indicators, e.g., consumer confidence, have improved somewhat, high oil prices dampen the outlook, prompting the staff to forecast growth rising from 1.5 percent in 2005 to 1.8 percent in 2006 as domestic demand and exports recover. The authorities foresee higher

[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.

growth in a range of 1.5 to 2 percent for 2005 followed by 2 to 2.5 percent in 2006. High oil prices have pushed headline inflation above 2 percent, but underlying inflation has remained stable at a lower level. The staff projects inflation to decline from an average of 2.1 percent in 2005 to 1.9 percent in 2006. Reflecting adverse demographics, potential output growth is projected to fall to 1.9 percent from 2006 onward.

The 2006 draft budget targets a reduction in the general government deficit to 2.9 percent of GDP from 3.0 percent of GDP in 2005 and 3.6 percent of GDP in 2004. Following a structural improvement of about 0.4 percentage point of GDP in 2005, the staff estimates the structural balance to improve by 0.3 percentage point of GDP in 2006. Structural adjustment is achieved through expenditure restraint at the central government level and in health care. The net tax burden remains roughly constant, because the increase in social security contributions, largely related to the health care reform, is offset by tax relief favoring investment and a variety of smaller tax cuts in other areas. For 2007–09, the authorities present a high- and a low-case scenario, with cumulative structural fiscal adjustment over three years of 2.1 percent of GDP and 1.1 percent of GDP, respectively, achieved through different paces of reduction in real general government spending growth. Taking into account known measures only, the staff sees no improvement in the structural deficit over this period.

On structural issues, a new labor contract without firing restrictions has been introduced for small firms, and social partners have agreed on a special fixed-term contract for workers aged 57 or older with the aim of raising their employment rate. The earned income tax credit (*PPE*) is being increased, relocation subsidies are being offered to those who accept work far from home, and fiscal incentives have increased for the return of the long-term unemployed to the labor market, and in support of employment in personal services. At the same time, public employment services and job search obligations have been strengthened. In product markets, divestiture from commercial activities has been accelerated. In the distribution sector, margin regulations have been relaxed.

Regarding the financial sector, a new bankruptcy law has been enacted, improving creditor rights; the prohibition to remunerate sight deposits has been lifted; a postal bank is being created by separating mail activities; and transaction costs in mortgage markets are set to be reduced. Bank profitability increased, and nonperforming loans declined. Supervisors urged banks to improve their internal control systems and closely watch exposure to mortgage risk, especially in light of possible increases in interest rates.

Executive Board Assessment

Directors commended the authorities for their continued progress on fiscal consolidation and pursuit of structural reform in an environment of weak economic growth and difficult political circumstances. They welcomed the larger than expected fiscal adjustment in 2005 and the new labor market initiatives, which they felt would foster job creation. Similarly, the ongoing product, services, and financial market reforms would underpin support for labor market reforms. To raise the growth potential further and achieve fiscal sustainability, Directors urged the authorities to sustain the recent pace of fiscal consolidation in 2006 and beyond and to build further structural reform momentum, especially by broadening recent labor market initiatives.

On the near-term economic outlook, Directors noted that growth is likely to pick up from its trough earlier in 2005, driven by an improvement in the external environment and a return of domestic demand to a normal pace following the clarification of the direction of economic policies in mid-year. However, compounding downside risk from oil prices and trade partner weakness, export growth could remain sluggish, underscoring the importance of structural reforms to contain labor costs and preserve competitiveness. In this context, it will be important to avoid second-round effects from high oil prices on wages. Directors saw the authorities' fiscal response to high oil prices as appropriately balancing the need to provide income support to selected groups with the need to preserve budget discipline and avoid significant price distortions.

Directors welcomed the continuing fiscal consolidation in 2005, whereby the objective of reducing the deficit to 3 percent of GDP was now within reach despite slow growth. For 2006, Directors urged the authorities to step up the pace of underlying adjustment and avoid recourse to one-off measures. They supported the intent to keep central government expenditure constant in real terms and sustain the decline in health spending growth. Directors noted, however, that achieving the targeted deficit of 2.9 percent of GDP in 2006 relied on an official growth projection on the high end of the current range of forecasts, increases in social security contributions, and nonrecurring nontax revenues. Consequently, Directors encouraged the authorities to consider additional measures to ensure that the underlying deficit falls by ½ of one percentage point of GDP in 2006.

To prepare decisively for the consequences of an aging population, Directors urged the authorities to be ambitious in reducing the share of public spending in GDP and in implementing growth-enhancing structural reforms. They urged the authorities to aim for structural budget balance before rising costs of aging set in at the end of the decade. As illustrated in the authorities' high case scenario, which would deliver this objective, this would require a reduction in central government spending in real terms and a sharp decline in local spending growth. Given the magnitude of this challenge, Directors urged the authorities to begin to implement durable expenditure measures early on.

Directors encouraged the authorities to focus fiscal consolidation squarely on expenditure restraint. With the tax burden already high, renewed increases in social security contributions to cover the deficits of the health care and unemployment systems would further discourage work effort. Instead, Directors saw scope for exploiting synergies between structural reforms and fiscal adjustment, especially in the area of labor market programs. Furthermore, while Directors acknowledged that short-term benefits of civil service reform are limited, they underscored that the ongoing wave of civil servant retirements provided an opportunity to reap efficiency gains that should be fully explored.

Directors supported the planned tax reforms as they would raise economic efficiency. They welcomed the permanent reform of the taxe professionnelle (a tax on enterprises), noting that in the long run, this tax should ideally be eliminated in the context of a broader reform establishing alternative revenue sources for local authorities. Directors supported the reduction in marginal income tax rates and the simplification of the rate structure, although they pointed out that the associated revenue loss should not derail the authorities' fiscal consolidation plans. In this context, Directors also underscored that use of budgetary resources to mitigate structural problems should be restrained and they saw, at present, no room for further targeted reductions in social security contributions to reduce labor costs.

To help achieve fiscal consolidation objectives, Directors saw merit in a further strengthening of the framework for fiscal governance. In this context, they welcomed the new objective-oriented budgeting framework for the central government, which came into effect with the 2006 budget, and the outreach approach to controlling health care spending. To help build momentum for fiscal adjustment and ensure buy-in from all levels of government, Directors welcomed the authorities' efforts to closely involve local governments in fiscal consolidation plans. In this context, further strengthening of domestic institutions to provide forward-looking budget assessments would be helpful.

Directors congratulated the authorities on their successful consensus-building approach to structural reform, encouraging them to take advantage of the benefits of a coordinated package of labor and product market reforms. A few Directors cautioned that this approach should not be allowed to lead to undue delays in implementing needed reforms. Directors observed that when reforms had been well prepared they had been well accepted by the public. They felt that, as current labor market reforms might involve some transitional costs and uncertainty, it would be useful to enact accompanying product market reforms to boost consumer welfare. Also, coordination of the timing of reforms within the euro area could allow monetary policy to respond, thus mitigating transition costs.

Directors strongly supported the recent labor market initiatives. They considered that the new labor contract for small enterprises would facilitate job creation and that the strengthening of employment services, job search compliance, and the earned income tax credit would help lower unemployment. They were also encouraged by social partners' agreeing to adopt a contract to promote employment of older workers. Directors urged the authorities to adopt more flexible labor contracts throughout the entire labor market to secure a durable and significant reduction of unemployment. In this context, Directors saw a need to restrict future minimum wage increases to underlying consumer price inflation so as to bring low-skilled workers back into employment.

In product markets, Directors welcomed the steps toward divestiture of network industries, the deregulation of retail margins, and the reduction in the administrative burden on enterprises, which would all enhance the growth potential of the economy. They encouraged the authorities to make similar determined efforts on economic deregulation and to open up further the services markets to competition, both domestically and within the EU context.

Directors observed that the financial system had been performing well and that supervisors had been appropriately focused on the sector's provisioning behavior, the adoption of new accounting standards, and the rising exposure to the residential housing market. Most Directors welcomed the impending establishment of the postal bank and the end to the prohibition to remunerate sight deposits, as it would promote competition. Most Directors encouraged the authorities to phase out remaining administrative interventions in the financial system to improve overall efficiency.

Directors urged France to show the flexibility necessary to contribute to a successful conclusion of the Doha round, which was at a critical stage. Particularly important will be achieving greater liberalization of the agricultural sector, which would benefit consumers as well as the international community.

Directors welcomed France's commendable contribution to development assistance and its intention to reach the U.N. target level.

France: Selected Economic Indicators

(Annual percentage change; unless otherwise indicated)

	2001	2002	2003	2004	2005 1/
Real economy (change in percent)					
Real GDP	2.1	1.3	0.9	2.1	1.5
Domestic demand	2.0	1.3	1.8	3.2	2.4
CPI (year average)	1.8	1.9	2.2	2.3	2.1
Unemployment rate (in percent)	8.4	8.9	9.5	9.7	9.8
Gross national savings (percent of GDP)	21.7	20.0	19.5	19.2	19.0
Gross domestic investment (percent of GDP)	20.1	19.0	19.1	19.6	20.2
Public finance (percent of GDP) 2/					
Central government balance	-2.4	-3.8	-3.9	-3.2	-3.4
General government balance	-1.6	-3.2	-4.2	-3.6	-3.1
General government gross debt	56.1	58.1	62.7	64.8	66.2
Money and interest rates					
Money market rate (in percent) 3/	4.3	3.3	2.3	2.1	2.1
Government bond yield (in percent) 4/	5.0	4.9	4.2	4.1	3.3
Balance of payments (percent of GDP)					
Trade balance	0.3	0.5	0.2	-0.4	-1.5
Current account	1.6	1.0	0.4	-0.4	-1.2
Official reserves (US$ billion) 5/	31.7	28.4	30.2	32.5	...
Fund position (as of August 31, 2005					
Holdings of currency (percent of quota)					73.9
Holdings of SDRs (percent of allocation)					55.8
Quota (SDRs million)					10,738.5
Exchange rates					
Exchange rate regime			Participant in EMU		
Euro per U.S. dollar (October 19, 2005)					1.20
Nominal effective rate (2000=100) 6/	100.4	101.7	106.2	107.6	107.5
Real effective exchange rate (2000=100) 6/ 7/	98.7	99.8	103.5	104.4	102.8

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

1/ Staff projections.

2/ Data for 2001–02 exclude the proceeds from the sale of UMTS licenses, which amount to about 0.1 percent of GDP.

3/ Data refer to the interbank rate (as from 1999 onwards). For 2005, data are as of October.

4/ Average yield to maturity on public sector bonds with original maturities of more than five years. The figure for 2005 refers to August.

5/ Excluding gold, end-of-period; from 1999, eurosystem definition. The figure for 2005 refers to August.

6/ The figure for 2005 refers to August.

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